PART B

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PART B

TREASURY AND CIVIL SERVICE COMMITTEE (TCSC) HEARING ON INTERNATIONAL MONETARY CONDITIONS AND EXCHANGE RATE POLICY, 31 JANUARY 1983

Begins: 26/1/83
Ends: 28/1/83 (CONTINUED)

DD: 25 Years
1/9/95

PART B

CONFIDENTIAL

FROM: DAVID PERETZ
26 January 1983

CHANCELLOR

cc Economic Secretary
Mr Burns
Mr Littler
Mr Middleton
Mr Carey
Mr Lavelle
Mr Kemp
Mr Odling-Smee
Mr Bottrill
Mr Burr
Mr Ridley

TCSC: 31 JANUARY

We are still working on both the briefing and opening statement for your appearance on Monday, but thought you would like an early opportunity to see how these are getting on; and to let us have any further comments you had. This minute also records (paragraph 4 below) the views Mr Limon, the Committee's Clerk, let me have this afternoon about the line he expects the questioning to take. Clearly we will have to take account of this in working further on the briefing.

2. I am attaching the following:-

(i) A first draft of an opening statement. This is mainly Mr Bottrill's work, and follows the broad outline suggested by Mr Lavelle, adjusted to take account of the points in paragraph 2 of Mr Kerr's minute of 25 January. The general idea is to assume in the opening statement that the Committee are sticking to the subject they are meant to be studying - international monetary arrangements, so there is not a great deal in it about domestic policy.

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(ii) Draft briefing, mainly the work of FEU, but also incorporating some EF1 material, on domestic policy points. This includes sections on the exchange rate and macroeconomic policy (with some extended possible speaking material, and covering interest rate policy also); "overshooting" and

questions about exchange rate over and under-valuation; intervention policy (including relative responsibilities of Treasury and Bank, and something on the December figures, and overseas experience); recent events in the market (including the now standard line on implications for inflation); exchange controls; EMS; competitiveness*; Dr Emminger; and a piece on Dr Bray's ideas about international policy optimisation*.

(iii) Draft briefing - the work of EF2 - on IMF and world economy matters (inter alia this includes a speaking note on the work of the Jurgensen group on intervention; a piece on IMF contact with the commercial banks*; and a passage on the sources of future growth).

(iv) Draft EF1 briefing on international banking matters.

(v) Copies of the notes prepared in Washington and New York of the Committee's principal discussions in the US.

(vi) The first draft of a speaking note on the current account position and prospect.

3. I am conscious that this leaves several points still to be covered, including some of the requests in Mr Kerr's minute of 25 January. In particular:-

(a) An up to date note on the international financial scene and problem countries is in preparation.

(b) We are combing through the report of the 19 January debate to see if there are any further exchange rate points not already covered.

(c) We are preparing a note on major currency swings in the last decade and their causes.

* To follow

(d) I will let you have separately copies of recent speeches by the Governor, Deputy Governor and Mr Cooke on international banking matters.

(e) I will also let you have copies of the written and oral evidence given by Treasury officials last summer; and the written and oral evidence given by Dr Emminger.

(f) I understand Mr Kerr's minute crossed with one from Mr Burr on what might be said about the current pay round (paragraph 3(e) of Mr Kerr's minute).

Below.

4. All this work was of course put in hand before the following guidance received this afternoon from Mr Limon, the Committee's Clerk, about how the Committee's advisers see the questioning going. I should preface this by saying that I warned Mr Limon that you had it in mind probably to make a short opening statement, and he will warn Mr Du Cann of this (his own advice was that this might be best kept shorter than 10 minutes if possible); that he expects Mr Du Cann to seek to rule out discussion of recent market events; and that on past form he would not expect more than half the following points to come up, and would expect an equal number of points not listed.

5. The idea is that the questioning would be divided into three sections as follows:

A. World Exchange Rate System

(a) Was the £ misaligned for the 2 years up to November 1982?

(b) If the Government had had an exchange rate target near the current rate over the period 1979-1982, is there any way it could have been met?

(c) Sir T Beckett still says we are 20 per cent less competitive than our rivals. Is this right? If so, does the exchange rate have to fall further, or are there other ways to close the gap? (Very much the same ground the Committee went over on your last TCSC appearance).

(d) The effect on the UK and world economy of oil price movements and uncertainties?

(e) The Committee claim to have noted disaffection among US academics with monetary targets, and growing interest in exchange rate management. Where do we stand?

(f) Would there be technical difficulties in making monetary targets conditional on exchange rate performance in a mechanical way?

(g) Did the Versailles monetary statement mean the 5 SDR currency countries are committed to keeping their currencies stable one against another? How does this affect UK policy?

(h) EMS membership.

B. International Debt Problems

The Committee have said they may produce a separate early report on this; and their advisers hope they will. A final decision will be taken after your appearance on Monday.

(a) Causes of current problems?

(b) Is a world wide stimulus to growth the only answer?

(c) Why did banks over-extend themselves?

(d) Can ldcs be expected to balance their books - or is extended access to official sources of finance the only answer?

(e) Where is the bulk of international lending to come from in future? Relative roles of banks, capital market, and official sources (IMF in particular)?

C. <u>International Policy Coordination and World Liquidity</u>

(a) Should their be more and deeper policy coordination between the major countries? Did a weakness in coordination contribute to the world recession? (You will have seen this point come up with the Deputy Governor).

(b) Forthcoming Interim Committee meeting. Our views on size of quota increase; should there be an increase in SDR allocations; should this be proportionate to the quota increase?

(c) Are there any circumstances in which the UK would agree to an exchange rate target/band in the context of an international agreement.?

6. This is the order of questioning the advisers are suggesting. But on Monday, with the Deputy Governor, the Committee decided to take B before A. At a quick glance many of the questions are already covered in one way or another in the present or planned briefing. But we will consider tomorrow what more is needed.

DCP

D L C PERETZ

Attachment (i) 26/1/83

DRAFT OPENING STATEMENT FOR THE CHANCELLOR TO THE TCSC

Mr Chairman, with your permission, I should like to make a few brief remarks about [the working of the international financial system in the light of] recent developments and in [the context of] the important negotiations on IMF matters in which we are currently engaged.

2. [I want in particular to address the case of] those who call for 'a new Bretton Woods'. I share the concern of those who are anxious about the volatility that we have seen in the world economy and in international financial markets in recent years. But it is important to consider the origins of these - in rapid inflation and disruptive oil price movements - before seeking solutions.

3. I do not believe that most of those who call for 'a new Bretton Woods' want to return to the old system of fixed exchange rates. This would be unworkable. Nor do they typically want a whole new set of institutions. The existing bodies - the IMF, the World Bank and the GATT - for the most part work well.

4. Perhaps the highest common factors among those who are concerned about the present working of the system are that they want to see evidence among the major countries of collective concern about the world economy. They want less volatility in financial markets and particularly exchange rates. And they want to see the international institutions adequately equipped to play an effective role.

5. If we can start from these common concerns and perceptions, then I believe that we can see a constructive way forward.

Reducing inflation

6. I said in Toronto that the world was passing through a difficult transitional phase as economies adjusted to lower inflation. Industrial countries have had to pursue firm monetary and fiscal policies both to tackle the entrenched inflation of the 1970s and to contain the effects of the 1979-80 rise in oil prices. The adjustment process, however, has been more prolonged than any expected with inevitable losses of output and jobs.

7. The international financial system has also been strained, reflecting the fact that although policies generally have moved in a welcome counter-inflationary direction, it has not always proved easy to structure them adequately. Monetary policy, particularly in the US, has at times carried too much of the burden without enough support from budgetary restraint. Individual countries' policies have not always taken enough account of effects elsewhere. As a result, interest rates have been high and volatile. Exchange rates have fluctuated widely and trade tensions have increased.

8. Recent events have shown again how great the forces acting on international financial markets can be. Since October, the Yen has risen 13 per cent and the Deutschemark 5 per cent against the dollar, reflecting to a large extent

uncertainty about the outlook for fiscal policy, interest rates and the current balance of payments of the US - the world's largest economy. I shall return to this briefly in a moment.

9. In developing countries, the strains of adjustment have involved tight financial constraints as a result of higher oil import costs in many cases, a slowdown in export receipts and a rise in debt service costs. Over-ambitious spending plans which relied upon inflated borrowing have been shown to be unsustainable.

10. The international banking system has also felt the strain as those who lent on over-sanguine prospectuses have had to re-assess prudently the viability of some of these loans.

Prospects of recovery

11. It is important, however, to remember the substantial progress that has been made. Inflation has fallen faster than many of us dared hope. Consumer prices in many countries have risen by less than 6 per cent in the past year - with the US, Japan, Germany and the UK at or below this. Interest rates, too, have declined steeply - in the United States they have almost halved from last summer's levels.

12. These should help to encourage a recovery in activity. Most forecasters now expect output in the major industrial countries to grow by 1-1½ per cent in 1983 with growth in Japan rather faster than this, the US /and UK7 close to the average, but little significant recovery in Continental Europe.

13. Among developing countries, a significant degree of adjustment is already taking place The overall current deficit of non-oil developing countries is estimated to have fallen from its 1981 peak of more than $/70_7 billion to around $/60_7 billion last year and a further reduction seems likely this year. Most major debtors are implementing firm adjustment programmes, often with IMF help. The recovery in industrial countries and the decline in world interest rates should help this process by improving developing countries' export prospects and cutting their debt service costs.

A strategy for the recovery

14. The problem for policy now is first to manage the recovery so that it is sustained without once more rekindling inflation and so jeopardising the stability of the international financial system. Second, it is to ensure that those countries with particularly severe debt problems are restored to economic health.

18. A particular responsibility rests with the United States, where the success in reducing inflation has been impressive but where the rising budget deficit - if unchecked - could risk a renewed surge in prices and interest rates as recovery gather pace. Mr Martin Feldstein, chairman of the Council of Economic Advisers, has said: 'I don't see how we can have a healthy economic recovery unless we have deficits coming down and coming down substantially'. (Wall Street Journal, 30 November 1982). I welcome the moves that President Reagan announced last week in his State of the Union Address to reduce the deficit, but the task is formidable and he will need the full co-operation of Congress if the deficit is to be put on a convincing declining path.

19. The third point of the strategy for recovery is the need for continued adjustment among major debtors, the size of whose problems has at times threatened to overwhelm the international financial and banking system. Here, the IMF has a crucial role and as chairman of the Interim Committee I intend to do my utmost to see that the Fund has the resources to play its role effectively.

20. We made a welcome start earlier this month when the Group of Ten industrial countries agreed to increase the General Arrangements to Borrow from SDR 6.4 billion to SDR 17 billion and in addition to make credits available to the Fund for lending to non-participants if major payments

15. This brings me back to the two themes that I mentioned earlier - the collective responsibility of the major countries for the stability of the world economy and the role of the international institutions in aiding adjustment. Perhaps I could pick out four elements of the strategy for recovery that seem to me particularly important.

16. First, major countries need to continue collectively to pursue prudent monetary and fiscal policies. This is the key to stability, as was acknowledged at last year's Versailles Summit when the major reserve countries undertook to pursue convergent policies to protect the internal and external values of their currencies. This, rather than artificial capital controls or massive intervention, is the way to reduce exchange rate volatility. Intervention has a role to play in steadying markets sometimes - but essentially I think Dr Emminger was right to refer to it as 'a very minor side issue', and to say that we should concentrate on promoting better underlying conditions. This is the way to make the multi-currency reserve system work.

17. Second, within the overall framework of prudent policies, countries need to ensure that the balance of their individual policies is right. In some countries where inflation has been brought down, where the budget deficit is under control and the external position strong, there may be scope to ensure that domestic activity fully sustains the recovery. In others continued firm policies may be needed.

imbalances threaten the stability of the international monetary system. Next month, we shall be seeking to put in place a further element in the package by agreeing to a substantial increase in Fund quotas at the Interim Committee meeting which I have asked to be brought forward from April.

21. Active adjustment policies supported by IMF finance should help substantially to restore confidence and encourage continued private banking flows which are essential to many developing countries.

22. My final point on the strategy for the recovery is the need to avoid protectionism. I do not believe that the way to solve payments problems and exchange rate fluctuations is through increased restrictions on trade which can only impoverish us all.

Conclusion

23. Mr Chairman, I am grateful to you for giving me the time to set out briefly how I see the major international issues that confront us. I think my main conclusion would be that we cannot look at the system in the abstract or seek remedies for real difficulties in artificial mechanisms. There is no substitute for collective agreement among countries on sound policies and their translation into individual practice. There is also no realistic alternative to building on the existing international institutions and ensuring they are effective. These things, we are committed to do.

Attachment (ii)

26/1/83

THE ROLE OF THE EXCHANGE RATE IN MACROECONOMIC POLICY

Extended Speaking Note

The Government's aim has always been to reduce inflation by monetary and fiscal means, and thereby create the conditions for sustainable growth. Monetary policy is directed at maintaining steady but not excessive downward pressure on inflation. It is operated flexibly. Thus the objectives for the monetary aggregates are expressed in the form of target ranges rather than point estimates. And a wide range of indicators is taken into account including not only the broad and narrow target aggregates set out in the last MTFS but also other indicators such as the exchange rate and real interest rates. There is no exchange rate target. But the level of the exchange rate is useful in assessing whether current policy is appropriate both because it is one indicator of existing monetary conditions and because it is part of the mechanism through which monetary conditions affect prices.

2. Both the level and the movement of the exchange rate can provide some indication of the tightness or otherwise of domestic monetary conditions. A falling exchange rate might be taken as a sign that domestic monetary conditions were unduly relaxed. On the other hand it could also reflect events in other countries or balance of payments developments of little direct consequence for UK monetary conditions. Thus although the exchange rate needs to be taken into account in assessing domestic monetary conditions, there can be no hard and fast rule by which exchange rate movements are linked to monetary and other policy decisions.

3. Conversely, the exchange rate provides one of the most important mechanisms through which changes in monetary policy are transmitted to prices. If there are rigidities in the domestic goods and labour markets then a change in monetary growth will tend to have its initial impact on the exchange rate (see brief on "overshooting" and "overvaluation"). A lower exchange rate means higher import costs for both industry and consumers. It is not easy, however, to determine the extent to which a fall in sterling will be reflected in a higher domestic price level. Much will depend on the circumstances surrounding the fall in the rate, eg on whether the Green £ adjusts, on whether the sterling/dollar

exchange rate falls in line with the effective rate, on the level of economic activity in the UK market and the degree of competitive pressure on importers to hold down prices etc.

Points to Make

Exchange Rate Targets or Monetary Targets? The Government's Choice

4. Experience both within the UK and elsewhere suggests that the control of inflation requires the control of some nominal magnitude. For a small open economy this could in principle be either the exchange rate or a domestic variable such as the money supply or nominal GDP. A completely fixed exchange rate would only be effective in controlling inflation to the extent that world inflation was also at a low level. A planned exchange rate appreciation could reduce inflation. But we have severe doubts as to the ability of any country to control its exchange rate effectively in a world of greatly increased capital mobility and closely integrated financial markets. There is the additional difficulty in the case of sterling that major changes in oil prices have different effects on the economy and hence the exchange rate than in other industrial countries. For these reasons, the Government has therefore placed more emphasis in the fight against inflation on the need for a gradual reduction in the rate of growth of the monetary aggregates, as set out in successive versions of the Medium Term Financial Strategy.

Why not Targets for both Exchange Rate and Money Supply?

5. Most policy instruments, such as interest rates, influence both simultaneously. Capital controls and intervention in the foreign exchange market are two methods sometimes suggested for enabling money supply and exchange rate targets to be pursued independently. But capital controls have in practice proved to have limited effectiveness in sophisticated financial markets; they also reduce the efficiency of financial markets and impose an administrative burden (see separate brief). Intervention, on the other hand, provides at most the prospect of a limited impact on the rate over the short run (see separate brief). Of course, on occasion separate monetary and exchange rate targets might be met, particularly if both were expressed as ranges. But when there is a conflict between them one or other must inevitably give way. This was most clearly evident in 1977, when the authorities sought to prevent a rise in sterling

owing to concern over the level of competitiveness. The balance of official financing increased by over £7 bn, adding substantially in the latter half of the year to the growth of £M3, which began to accelerate alarmingly.

Monetary Targets should be linked to the Exchange Rate - Conditionality

6. The exchange rate is certainly one factor that is taken into account in the setting of monetary policy. In this sense monetary policy - in common with that of a number of other countries - can be said to contain an element of conditionality. But a pre-announced commitment to allow monetary targets to change according to movements in the exchange rate - formal conditionality - is a different matter. The appropriate adjustment to the monetary targets must depend on the reasons for the exchange rate movement and on its effects. This cannot be predicted in advance.

A Crawling Peg for the (nominal) Exchange Rate?

7. This is subject to the same problems as any exchange rate target (see para 4 above); namely that with integrated financial markets and a high degree of capital mobility, it is difficult to control the exchange rate effectively.

Target for the Exchange Rate?

8. To attempt to hold the real exchange rate (and hence competitiveness) constant implies validating any surge in domestic inflationary pressures. It would remove an important aspect of discipline and could result in a vicious circle of high wage settlements followed by a fall in the nominal exchange rate, further inflation and even higher wage increases. It would seriously impair the ability of the Government to pursue an effective inflation policy.

Why not Interest Rate Targets instead of Monetary Targets?

9. The stance of monetary policy is encapsulated in targets for the monetary aggregates. One of the main instruments for achieving the target is the absolute level of nominal interest rates which can be influenced by the monetary authorities. Nominal interest rates provide an unsuitable target for anything more than the shortest time

period. When policy is directed towards reducing inflation, a nominal interest rate target may have the opposite effect from that intended. An unexpected rise in inflation will, for a given target, tend to reduce real interest rates and hence raise expenditure and place more upward pressure on inflation. While a real interest rate target would avoid this problem, it would be difficult to set it at the right level because of the problem of estimating inflation expectations correctly. The setting of interest rates may in addition be subject to political or institutional constraints which impart a 'bias to delay' in changing interest rates.

The Exchange Rate is (or was) too high owing to over-restrictive Monetary Policy

10. No. Part of the rise in the exchange rate in 1978-81 was attributable to oil-related factors. And some initial rise in the nominal exchange rate when disinflationary monetary policies are put in place is an important part of the process by which these policies influence inflation and the economy as a whole. As Dr Emminger explained in his evidence to the Committee, it would have been better if earnings and productivity had adjusted more quickly to the restrictive monetary policies so that the real exchange rate - although not necessarily the nominal rate - would have fallen earlier from its temporarily high level. But as they did not, the real exchange rate stayed high, as it had to if downward pressure on inflation was to be sustained. This can only be called an over-restrictive monetary policy if the objective is not to reduce inflation, or to reduce it less rapidly. (See also brief on "overshooting" and "overvaluation".)

'OVERSHOOTING" AND "OVERVALUATION"

Background: What are they?

The term "overshooting" is used by different people to mean different things. Often it seems to be used to describe any situation in which the exchange rate is higher than the speaker would like it to be. The usual sense in which it is used in technical discussions is to describe a situation in which the exchange rate has moved temporarily to above its long-term equilibrium level. Real overshooting, when the real exchange rate is higher than its long-term level, should be distinguished from nominal overshooting, when the nominal rate is above its long-term level.

2. Real overshooting tends to occur when monetary and fiscal policies are changed so as to bring about a sustained reduction in inflation. Financial markets adjust quickly to the change and cause the nominal exchange rate to rise, or to fall less than it otherwise would have done. If labour markets do not adjust as quickly, the real exchange rate also rises because earnings or productivity do not adjust quickly enough to offset the rise in the nominal exchange rate. This seems to have happened in both the US and the UK, although other factors have also contributed to exchange rate movements (eg North Sea oil in our own case). As a new lower level of inflation is achieved the real exchange rate, although not necessarily the nominal rate, can be expected to return to something near the level it would have been at, had inflation not been reduced.

3. Unlike overshooting, overvaluation does not have a technical meaning. It is used to indicate that the speaker thinks that the exchange rate should be lower than it is. Sometimes this view is based on a calculation of how much competitiveness has changed since a certain date (eg 1976), and sometimes on different short-term objectives from the Government's for inflation, output and the tightness of monetary conditions.

Speaking Note

4. The level of the exchange rate is not an explicit objective of Government policy, and so it is not possible to say whether it is or was too high or too low at any one time in relation to some desired

evel. Nevertheless, the broad movement of the real exchange rate over the last three or more years was entirely consistent with the strategy of reducing inflation. Monetary restraint raised the nominal exchange rate and, because domestic costs and prices did not adjust quickly, the real exchange rate rose too; in other words competitiveness worsened. The real exchange rate rose above, or "overshot", its long-term equilibrium level. But it was not "over-valued", in the sense of being inappropriately high. As Dr Emminger has said to the Committee, if earnings and productivity had adjusted more quickly, the real exchange rate would have fallen from its peak more rapidly, and perhaps not risen so far in the first place. But, given that this did not happen, the strong exchange rate played an important role in the disinflationary process, by reducing inflation and providing a stimulus for greater efficiency and productivity.

Points to Make

5. Should Government policy aim to eliminate real overshooting if possible?

Not necessarily. In a small open economy the exchange rate provides an important route by which monetary policy acts to reduce inflation. Real overshooting was an intrinsic part of the disinflationary process, although it would have been less if earnings or productivity had adjusted more quickly. Any successful attempt to reduce or eliminate overshooting, whether by lower interest rates, larger fiscal deficits or intervention, would have undermined the achievement of lower inflation.

6. How long might overshooting persist?

Adjustment lags in the domestic goods and labour markets may be such that real exchange rate overshooting can persist well into the medium term. In such situations governments have little choice other than to accept most of the overshooting which occurs. In practice, it is difficult to judge when the overshooting has come to an end, because there is no reason why the real exchange rate or competitiveness should return to any particular historical level. Indeed, North Sea oil has probably raised the long-term equilibrium level of the real rate somewhat.

. Can the period of real overshooting*be shortened?

Yes. As Dr Emminger explained to the Committee, faster deceleration of earnings and other domestic costs would bring the real exchange rate down to its long-term equilibrium level more rapidly. Changes in fiscal and monetary policy that are consistent with maintaining the disinflationary stance of policy cannot have much effect on the duration of overshooting.

8. Nominal exchange rate overshooting*

While disinflationary monetary and fiscal policies tend to cause the real exchange rate to overshoot, they do not necessarily cause the nominal rate to overshoot. The nominal rate may, of course, rise initially. But it may rise no higher than its long-term equilibrium, that is, it may not overshoot. This would be the case if all the fall in the real exchange rate from its maximum "overshoot" came about because of slower growth in UK than foreign costs rather than because of a fall in the nominal exchange rate. /To the extent that the nominal exchange rate overshoots and then falls back, the falling-back process may slow down the decline in inflation. The Government have said that they would prefer to see the recovery in competitiveness, that is the decline in the real exchange rate, come about as a result of slower growth in costs rather than a decline in the nominal exchange rate./

9. Recent fall in sterling a correction for previous overvaluation of the nominal exchange rate?

The recent fall reflects a number of factors, including the changing prospects for oil prices and for the major economies (Germany, Japan, US). These are real factors, and it is hardly surprising that the exchange rate responds. The Governemnt has always maintained that as its counter-inflation policies succeed and the recovery gets under way there will be an improvement in competitiveness. The best way for this to be achieved, however, is through slower growth of domestic wage costs rather than a fall in the nominal exchange rate.

*"Overshooting" in paragraphs 4-7 is used in the technical sense to mean that the exchange rate rose above its long-term equilibrium.

10. <u>The high level of sterling shows exchange markets to be unstable - therefore need for exchange controls, intervention</u>

No. The high real exchange rate concerns the failure of other markets to adjust (particularly domestic wages), rather than a failure within the exchange markets. Exchange controls, to the extent that they were effective, would direct attention away from the real problem. Intervention would tend to undermine monetary policy. There would be less incentive for other markets to undertake the necessary adjustment if there were no real overshooting, that is if the exchange rate mechanism were not allowed to work.

11. <u>The nominal exchange rate has to fall until competitiveness regains its 1975/76 level</u>

No. There is no historic year which provides the "correct" benchmark for competitiveness (ie the real exchange rate). Indeed, North Sea oil factors suggest that the real exchange rate can remain above historical levels; and other countries (eg Germany) have had a good performance when the real exchange rate was relatively high. If an improvement in competitiveness is to be achieved, it would anyway be much better if it resulted from lower domestic costs than from a lower nominal exchange rate.

INTERVENTION

(i) Role of Intervention - Experience both in the UK and in other countries strongly suggests that intervention has been most successful when related to very short-term objectives such as preserving orderly market conditions, smoothing erratic fluctuations etc. It has not been an effective instrument on its own for influencing the exchange rate over longer periods of time. The classic example here is the 1977 UK experience when the attempt to prevent the rate appreciating had to be abandoned because of the consequences for domestic monetary control. The main role of intervention is perhaps to give the authorities time in which to consider the causes of the current bout of pressure on the exchange rate and the appropriate policy response.

(ii) Limits to Intervention - There are limits to the scope for intervention in either direction. Prolonged support soon exhausts the reserves while borrowing capacity is not unlimited - international capital markets are now well acquainted with the concept of 'sovereign risk'. Neither can borrowing normally be arranged at very short notice. Similarly, sustained increases in the reserves soon create problems for monetary control.

(iii) Problems with an Active Intervention Policy - Exchange markets are subject to considerable random variation - they can jump in response to 'news', bandwagon effects etc. This makes it difficult for the authorities to distinguish

in advance between random fluctuations which could be smoothed by appropriate intervention, and more fundamental pressures on the rate.

(v) Does UK engage in Sterilised* Intervention - Yes. As a matter of course exchange market intervention in the UK can be regarded as automatically sterilised with regard to the monetary base. The EEA's transactions in the spot market are normally undertaken two days ahead of settlement. The effect of official intervention on bankers' balances and hence the monetary base can ∴ be considered to be exactly offset by the Bank's operations in the money markets.

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* Intervention is said to be sterilised if the effect of the change in the reserves on the monetary base is offset by a corresponding change in the monetary authorities' domestic assets. If, on the other hand, the change in the reserves is allowed to increase the monetary base, intervention is said to be unsterilised. Consider for example a purchase of dollars by the EEA from UK residents. This will increase bankers' balances at the Bank of England and hence the monetary base. But it could be offset (or "sterilised") if, at the same time, the Bank sold more Treasury Bills to UK banks, reducing bankers' balances by the same amount.

(vi) Does this mean that Monetary and Exchange Rate Targets can be considered independently? - No. In the absence of a fixed multiplier between changes in the monetary base and changes in the wider monetary aggregates we have no reason to believe that the wider aggregates will remain unaffected by sterilised intervention. Monetary base in the UK is not an aggregate which the authorities seek to control, it is largely demand-determined. The fact that official intervention in the UK is normally sterilised with respect to the monetary base has little relevance for the wider aspects of monetary policy.

(vii) Then why not Sterilise with respect to a Monetary Aggregate that is the subject of Targets? We do not consider it to be generally possible for the authorities to pursue independent objectives for both the wider monetary aggregates and the exchange rate. Consider the 1977 experience for example. To have attempted to sterilise the wider monetary aggregates would have required raising domestic interest rates - exactly the opposite direction to that indicated by exchange rate objectives, since it would have encouraged even greater capital inflows.

(viii) Who decides on when and how much to intervene? Overall policy is set by the Government, [and all decisions are discussed between the Treasury and the Bank of England. Immediate reactions to market events have to be left to the discretion of the Bank of England operators, who are close to the market. The EEA is a Treasury account managed by the Bank of England.]

(ix) How much Intervention has there been?

Much less under this Government than under previous governments in the UK; and much less than in many other countries, especially those that are committed to an exchange rate target (eg France).

26/1/83

THE EXCHANGE RATE AND INTEREST RATES IN RECENT WEEKS

Facts

Since the end of October sterling has fallen [12%] in effective terms [8%] against the dollar, [13%] against the deutschemark, [22%] against the yen. Further comparisons (going back to 1976) are attached.

Key Points to Make

(i) Reasons for movement - fall in sterling partly arises from general realignment of currencies, with long expected rise in the deutschemark and yen (reflecting underlying strength of German and Japanese economies and their improving trade balance) and in recent days resurgence of the dollar (reflecting expectations of higher US interest rates); partly from weakness and uncertainty about world oil prices (lower price helps other countries and their currencies; has relatively small impact on UK). Irresponsible Opposition policy statements have not helped, as market begins to take some insurance against the (however remote) possibility of an Opposition election victory.

(ii) Fall does not reflect change of policy - monetary policy remains as it was, namely to maintain steady but not excessive downward pressure on inflation. The exchange rate is, of course, one ofthe indicators of monetary conditions that is taken into account in assessing the overall stance of policy. The Government's financial and monetary determination is showing excellent results:

- Government spending and borrowing are under control and on target;
- the Government deficit, as a percentage of GDP, is one of the smallest in the industrial countries;
- we continue to run a substantial current account surplus, larger in 1982 than the £3½ bn forecast only last November;
- inflation is falling, and fell faster over the last year than in any other major country;
- monetary growth is within the targets, and the signs are it will stay there.

the fall in the exchange rate does not signal the need for a major shift in policy.

(iii) Why did Interest Rates rise and why did you let them? - market pressures took interest rates higher and base rates followed. To have resisted that move could have been interpreted as a weakening of the Governemnt's resolve.

(iv) What if Exchange Rate falls further - will you take action to stop Interest Rates rising? - Underlying monetary and economic conditions are sound, and in consequence there is no reason now for a further rise in interest rates. [However, any attempt to resist strong upward pressure from the market would have to be assessed in terms of its impact on expectations.]

(v) (Defensive) Impact of fall in Exchange Rate on Inflation - will no doubt be some modest impact on inflation of recent fall. But probably less or slower to come through than many commentators suggest. Reasons why major upturn in inflation not in prospect:

(a) importers into UK have had healthy profit margins and may be reluctant to raise prices in today's market conditions;

(b) food prices reflect the Green £ (fixed separately);

(c) commodity prices, including oil prices (one of reasons for exchange rate fall), are weak;

(d) continued monetary restraint offsets any tendency for impact on inflation to be more than temporary.

(vi) (Defensive) Exchange Rate fall shows need for target for Exchange Rate - No. The important thing is that overall financial policies are appropriate, and seen to be appropriate. The exchange rate is taken into account in assessing financial conditions, but it is not, and should not be, the only factor. Anyway, it would be very difficult to stick to any exchange rate target. A major international currency like sterling

cannot be immune from strong market pressures. Capital controls, intervention and joining the EMS do not provide the means of hitting an exchange rate target. Capital controls can be circumvented; intervention can rarely sustain an exchange rate significantly different from the market rate, at least without forcing a change in monetary policy; and membership of the EMS exchange rate mechanism is not a policy - merely a commitment to take policy action to try to defend a particular rate. (See separate briefs on each of these.)

(vii) Recent heavy Intervention indicates a shift in Exchange Rate Policy? - it continues to be the case that there is no exchange rate target; intervention is undertaken only to maintain orderly market conditions and smooth undue fluctuations in the rate.

(viii) Why was Reserve loss so high in December?-Market conditions were particularly unsettled last December - with sharp movements between other major currencies - the dollar, the yen and the deutschemark, and with the sterling market unsettled by the uncertain prospects for oil. In those circumstances it was hardly surprising that the Bank had to intervene on a slightly larger scale than usual in order to ensure sensible two-way trading and to preserve orderly market conditions. But the fall in the rate during December itself provides clear evidence against the notion of any 'target' level for the exchange rate.

(ix) Market Intervention in December? - It is not the practice to comment on the Bank's intervention tactics so no figure can be given. The published figure for the underlying change in the reserve is not necessarily a reliable guide to market intervention: it reflects other transactions as well.

(x) Who decides on the amount of Intervention? - (see separate brief on Intervention)

ackground Facts

	Q4 1976	May 1979	Q1 1981	End October 1982	January 25 1983
Effective Exchange Rate	78.1	86.3	101.4	92.5	81.7
£/$	1.651	2.058	2.309	1.677	1.537
£/DM	3.977	3.926	4.814	4.291	3.725
Competitiveness* (RULC)	84.7	108.0 (Q2 fig)	155.0	135.5**	120.0**
Reserves($b)ø	4.1	21.5	28.2	18.5	17.0 x
Official external debt ($b)	19.4	21.9	17.2	12.6	12.1 x

* rise in index - fall in competitiveness

ø at end of period

** estimates, based on the assumption that UK unit labour costs rose at the average rate in other countries from 1982 Q2

x end-December figures

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EXCHANGE CONTROLS

Factual

Exchange controls restricted transactions between residents and non-residents. They were introduced at the beginning of the Second World War to make gold and foreign currency available for the war effort. They were retained in the post war years when there was a need to defend a fixed exchange rate despite recurring current account deficits. The growth in trade flows and capital markets made exchange controls ineffective and the easing of the balance of payments constraint as North Sea oil was developed made them irrelevant. They were abolished in October 1979.

Points to make: Positive

(i) Exchange controls have little effect in the face of strong market movements, as in 1967 and 1976, for example. They did not control leads and lags on payments for imports and exports (one month's movement in payments on goods alone now totals around £10bn). And exchange controls did not prevent non-residents from switching funds between sterling and other currencies.

(ii) With modern communications and increased interdependence between countries no exchange control regime acceptable in a democracy can prevent movement out of an internationally traded currency like sterling.

(iii) The only defence against speculative flows is to maintain confidence by pursuing the right monetary and fiscal policies.

(iv) Exchange controls reduce the efficiency of financial markets.

(v) They impose an administrative burden on both public and private sectors.

Defensive

(vi) Abolition has led to huge outflows. The net capital outflows in recent years simply reflect - as a matter of arithmetic - the large current account surplus. Just as a country in deficit has to borrow abroad, a country in surplus improves its international balance sheet. Our balance between overseas assets and liabilities is in a better state than it has been for years - and this will provide a useful source of net revenue from overseas for the future.

(vii) Capital outflows mean lower investment at home. Abolition of exchange control has had no direct effect on net capital flow. But it may have meant larger UK investment abroad matched by higher investment in the UK - or a lower level of withdrawal of funds - by overseas investors. Much of our investment abroad increases our access to overseas markets and exports, encouraging increased investment at home also.

(viii) Economy vulnerable because short term inflows offsetting long term outflows. There was nothing in the exchange controls operated by the previous Government to stop such inflows.

(ix) Why retain the Exchange Control Act 1947 on the statute book. We are required by the European Communities Council Directive of 21 March 1972 to be able to act, where necessary, on capital flows without further enabling measures.

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EMS EXCHANGE RATE MECHANISM

Background

1. The UK is a founder member of the EMS and participates in negotiations on its modification and in realignment conferences, although the pound does not participate in the exchange rate mechanism.

2. The fundamental difficulty with participation is that the adherence to an exchange rate target might conflict with achieving domestic monetary aims. Some of the smaller countries whose financial systems are inevitably interlinked with those of a larger country (usually Germany) do not, anyway, have much scope for pursuing an independent monetary policy. A fixed exchange rate with the larger country provides the appropriate financial discipline in their case.

3. After enjoying a relatively tranquil two years since its inception in 1979, the EMS has in the last 18 months encountered more difficult conditions with major realignments taking place in October 1981 and February and June 1982. In September and October the market regarded the French franc and Danish krona as being liable to devluation against the relatively strong deutschemark and guilder. More recently the French and Belgian francs have also been under pressure, while the guilder and Danish krona have been the strongest currencies in the system.

4. Between June and October the pound enjoyed a period of relative stability against the deutschemark with the rate mostly in the range DM 4.26-4.30. However, from mid-November it weakened sharply, reaching a low of DM 3.676 on 11 January.

Points to Make

5. UK Membership would increase exchange rate stability?
There is no reason to suppose that the simple act of joining the EMS exchange rate mechanism would necessarily have an impact at all on exchange rate stability. This has not been the experience of the current participants. Lasting stability requires a return to low and convergent inflation rates throughout the community.

5. <u>Reasons for not joining</u>

Successive governments have decided not to join the exchange rate mechanism, because sterling's exposure as an international traded currency and its status as a petro-currency both make it vulnerable to large speculative flows between sterling and other EMS currencies. Recent events have demonstrated that sterling can still be affected sharply, and in a different way from other European currencies, by shifting expectations about oil prices.

DR EMMINGER

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The Opposition have made a great deal of the following quotation from a paper submitted by Dr Emminger to the TCSC in the course of their IMA enquiry. It features, for example, in Mr Shore's 23 November "Programme for Recovery".

> "At its peak in February 1981, the "real" sterling exchange rate was not only about 50% above its depreciated value of 1976, but about 30% higher than in 1972. This is by far the most excessive overvaluation which any major currency has experienced in recent monetary history. It dwarfs the "real" upvaluation of the D-Mark between 1972 and its peak at the beginning of 1980, which was slightly above 10%. The large real appreciation of sterling from 1979 to 1981 was probably the most important single element in that period's British economic policy, as concerns its effects both on domestic inflation as well as on British trade, production and employment".

Points to make

2. There are two points to make about this statement.

(i) The Opposition have taken it out of context. In the paper Dr Emminger was using sterling's experience as just one, albeit the sharpest, of many huge swings between major currencies in the 1970's and 1980's. He was making the point that we live in a world where such swings happen - and indeed that there is not much that can be done about them.

(ii) Dr Emminger expanded on his views in a subsequent oral hearing by the TCSC on 25 October 1982 (now published). He said:-

(a) The effect on British production and investment was serious not so much because of the appreciation itself but the inflexible reaction to it, particularly "as concerns wage developments".

(b) He did not think very much could have been done about the appreciation, which in any case

(c) probably in part reflected previous undervaluation of the £.

(d) Large countries with open economies and free capital movements, like the UK and Germany, cannot adopt a fixed or target rate in relation to the dollar.

Background: verbatim extracts from oral evidence

(i) "What I meant is whether a larger country, with an open economy and free capital movements, like the UK or West Germany, could adopt a fixed or target rate in relation to the dollar. It could not. We have seen that a fixed rate vis a vis the dollar is an invitation for big speculative flows whenever a lack of confidence in the dollar or in the other currency arises. Why? Because there are hugh amounts of volatile dollar funds in the world.... so we have to live with a floating dollar. What we should aim at, is to get better underlying conditions for the floating system eg to have better convergence of economic, in particular, monetary policies between the Americans and Europeans and the Japanese ...."

(ii) [In reply to a question from Mr English who quoted the last sentence of the passage at the beginning of this brief, and then asked Dr Emminger whether he meant that manufacturing industry and exports were sacrificed to keep the inflation rate down.] "Perhaps I should not have made that remark .... I do not subscribe to the word "sacrifice" .... because the real effect of that appreciation very much

depended on the British economy .... was rather inflexible as concerns wage developments, which, of course, meant there was quite some effect on employment and production .... Secondly also I do not think that very much could be done against that and, furthermore, this record appreciation consists of two elements, not only that the pound went up but also that before it was probably undervalued ...."

AMJ

Attachment (iii)

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WORLD ECONOMIC PROSPECTS

Points to note

i. World activity has yet to pick up. Depressed activity is part of cost of eliminating rapid inflation. But inflation has come down faster than expected - from 12 per cent in 1980 to 6 per cent (latest annual figure) for the major countries.

ii. Latest OECD/IMF forecasts have been revised down but still expect modest recovery throughout 1983 with US growing at or below 2 per cent. Japan's growth of 3½ per cent is based largely on domestic demand. Output in Europe remains broadly flat with no strong recovery.

iii. Elusive recovery demands a careful analysis of economic developments and the impact of policies but essential to maintain firm medium term economic policies and to resist calls for excessive reflation.

iv. Monetary policy should take account of a wide range of factors when assessing targets. But as economy recovers monetary growth should not allow any renewed upsurge in inflation.

v. On fiscal policy, recession inevitably pushes up cyclical component but firm action is necessary to reduce structural deficit and put budget deficits on a convincing declining medium term path. All countries have responsibility here but especially the US.

vi. Despite modest recovery the US budget deficit, which may exceed $200 bn this year, is unlikely to fall markedly without additional fiscal retrenchment given the desire to reduce taxes and maintain prospective spending plans for defence and social programmes.

vii. Agree with view of Institute of International Economics (Williamson) that policy co-ordination is necessary to ensure stability and recovery. As world trade prospects are poor low inflation countries with sound (internal and) external positions should explore short term flexibility, to encourage domestic recovery, but essential to maintain counter-inflationary thrust of medium term policies. Such policies should ensure convergence to durable non-inflationary growth.

viii. Dollar's fall and yen appreciation since November has recently reversed somewhat. Gradual realignment needed so as not to destabilise financial markets. Prospective current account imbalences, growing US deficit and Japanese surplus, may usher in further exchange rate volatility. Important major countries take account of the international repercussions of their policies.

ix. International financial system calmer now but remains delicate and requires adherence to firm policies by major SDR countries. Developing countries are adjusting, eg programmes adopted by Mexico, Brazil and Argentina while IMF expects NODCs current account deficit to fall to $70bn in 1983 against $90bn in 1982 and around $100bn in 1981. Adjustment must continue together with the provision of adequate finance by IMF and other lenders. Lower interest rates should ease debtors difficulties.

Background

1. Real GNP growth in the industrial countries is estimated to have fallen slightly in 1982. The protracted nature of the recession reflects poor real income growth, higher savings ratios, sluggish investment and continued stock adjustment to depressed levels of activity. The industrial world has also been affected in the past year by reduced demand from developing countries who have faced increasingly tight financial constraints.

2. The latest IMF and OECD forecasts see output picking up during this year and growing by 1-2 per cent. The US, Germany and Canada all experienced a sharp fall in output last year while Japan achieved reasonable growth and output in Europe as a whole stagnated. Growth prospects for 1983 have been revised down with the US growing by perhaps 1½-2 per cent, Japan by 3½ per cent but little revival in Europe. World trade fell last year for the first time since 1975. Both IMF and the OECD predict a mild recovery in world trade this year.

3. Early but tentative signs of the recovery in prospect are slowly beginning to appear now that inflation and interest rates have come down. Higher consumers' expenditure, positive stockbuilding and construction investment are the likely sources of growth this year. In the US housing starts, usually a good forward indicator, and retail sales picked up at the end of last year, and the leading indicators have continued rising. The fall in business confidence in Europe may have bottomed out as expected production levels increased while in Germany orders improved in the last two months of 1982.

4. Unemployment has continued to rise throughout the industrial world except Japan but may begin to level out this year. The major economies now face an unemployment rate of around 9 per cent by end-1983, with no early prospects of any reduction.

5. Inflation has come down much faster than expected as wage costs have moderated and import prices have remained weak. Consumer price inflation for the major countries has been halved, falling from 12 per cent on average in 1980 to 6 per cent for the 12 months to November 1982. A wide range however still exists with inflation in Italy at 16½ per cent compared to the 9-10 per cent in Canada and France, with the UK at 5½ per cent, Germany and the US at 4½ per cent and Japan with 2½ per cent.

6. The fall in inflation together with weak private credit demand has allowed some reduction in interest rates. From their earlier peak of 15-16 per cent 3-month money market rates in the US have fallen to around 8 per cent now. Elsewhere interest rates have also fallen but to a lesser extent. In Italy nominal rates remain near 20 per cent, against 12½ per cent in France, 6½ per cent in Japan and 5½ per cent in Germany. Real interest rates have eased but remain high compared to past experience.

7. The narrowing of the interest rate differential in favour of the US and large prospective US current deficits contributed to the depreciation of the dollar's effective rate from November to mid-January. This fall was matched by a stronger yen (up 18 per cent against the dollar)and DM. Since then the dollar has partly recovered - as expectations of lower US interest rates faded - and some of the earlier appreciation of the yen and the DM, in particular, have been reversed.

8. After moving towards rough current balance in 1981 forecasts show a growing aggregate deficit for the major countries dominated by the prospective US deficit. The US deficit is expected to be around $30 billion for this year. In contrast, despite a minor deficit last November, the Japanese current account surplus is forecast to grow steadily and reach over $11 billion for 1983 while Germany is expected to have a small current account surplus.

9. Current accounts of NODCs are expected to fall again this year to $70 bn (equivalent to 14 per cent of total exports) compared to $90 bn in 1982 (20 per cent) and around $100 bn in 1981 (22 per cent). This represents considerable adjustment given their adverse terms of

trade and depressed export markets. Financial constraints have been much tighter than expected. According to IMF estimates net bank lending to NODCs fell from $53½ bn in 1981 to only $25 bn in 1982, a fall of some $30 bn, and this year it could be lower. Most major debtors, Brazil, Argentina, Mexico are adopting adjustment programmes. The possibilities for major international defaults have receded but adjustment must continue together with adequate finance from the IMF and other financial institutions.

Policies

10. The task for policy is to ensure that a durable recovery is established without rekindling inflation. This implies probably some short-term flexibility in the operation of policies, particularly by those countries which though low inflation have achieved some room for maneouvre, but also a commitment to prudent medium-term strategy, particularly for those countries where structural budget problems could undermine the recovery. Important that policies of major countries are co-ordinated and seek to converge towards sustainable non-inflationary growth. Williamson's call for policy co-ordination is welcome but a general widespread relaxation of policy would inevitably mean higher inflation and thereby prejudice the recovery.

11. The appropriate stance of monetary policy is proving difficult to assess, particularly in the US at a time of institutional change and changing liquidity demands. The Federal Reserve Board has suspended its M1 target and adopted a more flexible approach but some have argued its stance is now too lax. M2 growth in the last four months of 1982 was broadly in line with revised higher targets of 9½ per cent. The Fed is considering returning to the original targets for this year though no final decision has been announced.

12. Monetary growth in Germany for 1982 remained within the 4-7 per cent target and this target is to be continued this year. In France monetary growth after being well above the 12½-13½ per cent target early last year has decelerated recently and the out-turn for 1982 may have been close to target. For this year France has adopted a tighter single figure target of 10 per cent. Canada has recently abandoned monetary targets but aims to keep its exchange rate closely in line with the US dollar.

13. The reduction of budget deficits has been hampered by the recession. The industrial economies' deficits have risen from 2 per cent of GDP in 1979 to 4 per cent last year and may remain at that level during 1983. Only Japan and the UK have reduced their deficits although Germany has managed to offset much of the effects of recession by tight discretionary policies. The Japanese announced a Yen 2 trillion reflationary package in October, but the budget for fiscal 1983 (starting in April) still projects a reduction in the central government deficit compared to the likely fiscal 1982 out-turn. Expansionary policies in France and particularly the US have contributed along the depressed activity to the overall increase in fiscal deficits.

14. Since 1979 the US Federal deficit as a proportion of GNP has increased from ½ per cent to 4 per cent. Much of this increase is due to the effects of the recession. However even with some recovery existing policy is unlikely to reduce the deficit which could exceed $200 bn this fiscal year (FY83). The basic dilemma facing the US Administration remains the same one of reconciling rising expenditure on defence and social programmes with the desire to cut taxes.

15. President Reagan's State of the Union speech, delivered on 26 January, proposed major steps to reduce the budget deficit. They included a freeze on federal expenditure, a structural reform of the social security system (following the report of the Greenspan Commission which proposed savings of $169 bn over the next seven years), cuts of $45 bn in the growth of defence expenditure and tax increases contingent on progress in reducing the deficit. The US Administration has put the fiscal deficit at over $200 bn this fiscal year. For FY84 the freeze would reduce the likely deficit from $230 bn to $188 bn but the plans would still leave the deficit higher than expected in the longer term. The final 10 per cent tax cut in July this year is still to be implemented. The precise details of this package and its feasibility can be assessed when the budget forecast is published at the end of January but it provides encouraging signs of the Administration's desire to tackle budget problems.

CONDITIONALITY - FUND'S ROLE IN ADJUSTMENT

Points

1. Fact that deficit caused by external factors beyond a country's control does not remove need for appropriate policy changes. Deficits cannot be allowed to grow unsustainably. Therefore need in the current circumstances for strong adjustment measures to achieve viable balance of payments.

2. Fund conditionality has been applied fairly rigorously in last two years but we judge that present degree of conditionality is about right. Fund does show sensitivity to specific national social and political priorities so as not to discourage early resort to the Fund.

3. Donor governments and banks, as well as the Fund, must recognize their mutual responsibilities in meeting ldc external financing needs. Fund lending is not intended to displace commercial bank loans but to be a catalyst for their continuation.

4. At Versailles we acknowledged special responsibility of major countries to take account of international consequences of their national policies. Fund surveillance under Article IV procedures have also been evolving in this direction. We believe these principles of surveillance are broadly right but its implementation might be made more effective eg by locating more clearly where burden of adjustment should be.

Background

5. The Fund's conditionality guidelines were reviewed in 1979 to pay the regard to the domestic social and political objectives of members. However, following pressure from major countries (including the UK) the Fund staff tightened conditionality during 1981-82 e.g. by more frequent use of prior actions (ie exchange rate changes) as preconditions and mid term reviews. Developing countries, in contrast, argue that the present degree of conditionality is too harsh particularly in the failure automatically to modify programmes in the case of adverse developments beyond a member's control. We have argued that appropriate conditionality is necessary to promote effective adjustment and to ensure that use of Fund resources is only temporary.

6. Following the 50% quota increase in 1980 and the enlarged access finance of SDR 9.3 bn, Fund lending rose to record levels in 1981 of net commitments of SDR 12.1 bn. The Fund was both supporting considerable adjustment efforts by non-oil developing countries and was doing so in a way which efficiently recycled substantial resources from the structurally surplus countries to deficit countries. But many countries (especially in Latin America and in East Europe) were still putting off necessary adjustment, and continuing to borrow heavily from the Euromarkets to finance growth. So too were many of the non gulf oil exporters whose ambitious development plans were expected to be financed from growing oil revenues. It is these two groups that are now coming to the Fund. Their quotas and debts are large and the support they need from the Fund is substantial, often over an extended period.

7. There are currently 25 SBAs in place for a total of SDR 6.9 bn; of these 4 are inoperative. There are 7 EFFs for a total of SDR 17.8 bn; all are operative (see Annex).

LK

ANNEX

USE OF FUND RESOURCES

	1981	SDR bn 1982
Net commitments (ie SBA/EFF)	12.1	2.4*
CFF, First Credit Tranche, Buffer stock purchases	1.5	3.0Ø

* Gross commitments were SDR 6.5 bn of which: Mexico 3.4 bn.
Ø includes SDR 0.5 bn for Brazil.

1982 as a whole saw a marked slowdown in the rate of commitment lending compared to 1981. However, following the approach by Mexico to the Fund in the autumn, it became clear that the rate of lending would speed up again although the bulk of lending will fall in 1983.

Current Fund Programmes

SBA

Barbados
Chile
Costa Rica
El Salvador
The Gambia
Guinea
Haiti
Honduras
Hungary
Liberia
Madagascar
Malawi
Mali
Morocco
Panama+
Romania
Senegal+
Somalia
S Africa
Sudan+
Thailand
Togo+
Turkey
Uganda
Yugoslavia

EFF

Dominica
India
Ivory Coast
Jamaica
Mexico
Pakistan
Peru

+ inoperative

QUOTAS AND GAB - INCREASING THE FUND'S RESOURCES

Points

1. The Fund's key role in adjustment means that it must have adequate resources. In Toronto I advocated an increase in quotas of at least 50%. Events since then have suggested a need to increase the quotas as quickly as possible. The UK has taken the lead in trying to accelerate the negotiation and ratification of the review. In view of the progress made in the Executive Board on increasing quotas and the priority attached to strengthening the Fund's resources, I have proposed bringing forward the date of the Interim Committee from April to 10-11 February.

2. There is widespread agreement that the quota increase should be substantial. Now that there is agreement on increasing the resources of GAB, my own view of an increase of about 50% in quotas would provide the Fund with adequate resources to help prospective borrowers. I would not expect the finally agreed quota increase to be too far from that figure.

3. On distribution, I attach great importance to a method that is uniform, fair and systematic and which allows quota shares to change in an orderly way over time to reflect more clearly member's positions in the world economy. These issues are under review and we hope to reach agreement in the Interim Committee. It is difficult to go in detail at this stage of the negotiations, particularly since important questions of national interest are at stake. However, if members display a willingness to compromise, I am hopeful that the outstanding problems can be resolved.

4. Ministers of the Group of Ten have agreed that the General Arrangements to Borrow should be increased from SDR 6.4 bn to SDR 17 bn. Moreover in future the GAB will be available not only to participants but to any member with a conditional programme at times when the Fund is faced with an inadequacy of resources associated with balance of payments problems of a size threatening the international monetary system.

5. The enlarged GAB represents the special contribution of the G10 to the solution of current difficult international financial problems. It is a useful step towards restoring confidence within the international financial community. It underlines the fact that our existing institutions are showing themselves capable of adapting and that the way forward is by building on this process of adaptation. There has been much talk of a new Bretton Woods but now is not the time to uproot the existing insitutions.

6. At present our contribution towards the GAB is denominated in sterling. The new GAB commitment will be denominated in SDRs. This will require legislation and accordingly I will be asking the House for authority to make some amendments to the 1979 International Monetary Fund Act.

Background

7. On size the Executive Board's report to the Interim Committee will indicate that almost all (ie all except the US) could support an increase in quotas to SDR 100 bn. Ldc directors have stated that SDR 100 bn must be a minimum. G10 directors support the range SDR 85 - 100 bn, with all except the US seeing a 50% in these as the practical minimum. The US have shown a marked reluctance to go over SDR 85 bn, usually citing Congressional difficulties. The US may simply be adopting a negotiating posture but agreement in the Interim Committee will presuppose a willingness for the US to go above SDR 90 bn.

8. On distribution, there is general agreement that the Australian method of distribution should be applied as the basis ie in order to reflect better the relative economic positions of member countries, the increase should be distributed in proportion to each member's share in the total of calculated quotas. There is equally general agreement that this purest method of distribution should be diluted by some degree of equiproportionally. The precise size of the equiproportional element is still to be decided that many directors

(ie 10-15) favour the range of 20-50%. The UK could accept any point in this range but the needs of the Japanese (who want the minimum equiproportional element) will have to be borne in mind.

9. Cost to UK. The various capital transaction involved in paying the increased subscription (whether in SDRs or sterling) do not score either as public expenditure or as increasing the borrowing requirement. The initial effect of paying in SDRs or having sterling used is to increase the reserves since our reserve position with the Fund rises. These transactions do, however, have small second round interest rate consequences which indirectly affect the borrowing requirement via debt interest.

10. The UK share in the GAB will be 10% of SDR 1.7 bn. If the UK accepted a GAB call, as with use of sterling, our reserve position with the Fund would rise (ie we would become larger creditors of the Fund). This would be treated as any other increase in reserves ie it would not affect the PSBR or public expenditure. However second round interest rate effects would mean a rise in debt interest payments and consequent possible rise in the PSBR. If, however, GAB commitments carried a market rate of interest, there would not be a PSBR effect.

Legislation

11. The 1979 IMF Act appears to be defective in making no provision for subscription payments other than in own currency: the relevant section refers to subscriptions being paid out of the NLF. In relation to the forthcoming quota increase we will want to take powers to make payments not only in sterling but in SDRs held by the Exchange Equalisation Account. This would seem to involve amendment of Section 1 of the Act followed by recapitulation of the powers to make future increases by statutory instrument.

12. Section 2 of the 1979 Act is widely drawn to permit loans "in accordance with the Fund's borrowing arrangements". However on present form it looks as if we shall need (as with quotas) to take provision for subscription in foreign currencies or SDRs as well as in own currency. In any event it is evident that new lending oblications will be denominated in SDR and this alone would require new primary powers.

13. In addition to the agreement on the GAB, G10 ministers agreed to continue discussions with the Saudis on what form of association with the GAB the Saudis were seeking. In particular they would discuss whether the Saudis were prepared to set up a credit arrangement with the Fund on comparable terms to the GAB participants. Discussions were held on 2 January in London with Habermeier, Diniand the Saudis.

14. The question of access is still being looked at. A decision will not be required at the Interim Committee but it is already beginning to look as if the outcome will be that no member loses access in cash terms. For ldcs this will be a decisive element in the Review. This should provide a satisfactory outcome for them since the ldc group as a whole will after the Review have a considerably higher share of quotas than their relative economic position in the world entitles them to.

SDR ALLOCATION (including method of payment)

Points to Make

1. Widespread agreement that the quota subscription should be in reserve assets (ie SDR or hard currencies).

2. Recognise that many countries are interested in further SDR allocations but this should be looked at in the context of IMF studies of the adequacy of global liquidity. We ourselves have an open mind on the merits of a further SDR allocation. We would welcome a review of the latest trends in world inflation and liquidity to see whether a new allocation would command support.

3. [If necessary] The risk of reigniting inflation is probably less than it was. The slowdown in bank recycling will need to be carefully monitored. But the primary need is for conditional rather than unconditional liquidity, and we should not be deflected from recognising this.

Background

4. Under the Articles, members are required to subscribe 25 per cent of a quota increase in SDRs; except that the Board of Governors may prescribe, by a 70 per cent majority, that the payment may be made, on the same basis for all members, in whole or in part in the currencies of other members specified, with their concurrence, by the Fund or in the member's own currency. Virtually all Executive Directors have agreed in principle that 25% of the increase in quotas should be paid in reserve assets.

5. However, many of those who in the last couple of years advocatedfurther SDR allocations (ie most of the membership except for the G5) have taken this opportunity to press for a further discussion on the merits of an SDR allocation. The agreement to subscribe either SDRs or hard currencies is therefore being given on two understandings. The first is that members in difficulties can promptly draw the reserve tranche thus created. The second is that the next Interim Committee will ask the Executive Board to review latest trends in world inflation and liquidity and report back to the Governors as a matter of urgency so that they could consider at the next Annual Meeting whether a new allocation of SDRs was called for at that time.

6. This seems a sensible compromise. It should avoid the Interim Committee being distracted from the prime concern of securing an appropriate increase in the Fund's resources.

7. It is not known whether the views towards an SDR allocation of the US (whose support is crucial for achieving the necessary 85 per cent majority) or of other G5 members have changed. If allocations are to be resumed, the likely starting date would be January 1984. We could expect arguments that the first allocation should roll up the allocations which might have been made in 1982 and 1983. If this is conceded the first allocation would be unlikely to be less than SDR 12 bn with further allocations of SDR 4 bn in later years, ie the same annual rate as in the period 1979-1981.

FUND LIQUIDITY

Points

1. Although the Fund has both unused ordinary resources and credit lines for the very immediate future, more will be needed in the period before the Eighth Quota Review is implemented (and the new GAB borrowing arrangements put in place).

2. The Fund should finalise arrangements soon for a third SAMA tranche of SDR 4 billion.

3. The Fund should continue to explore similar medium term borrowing from others who have not so far lent enlarged Access resources although we recognise that prospects here are not good. We would support market borrowing only if borrowing from official sources were inadequate.

Background

4. Since Toronto concern has grown about the Fund's immediately available resources before the Eighth Quota Review is put in place. The Fund currently has just over SDR 10.1 billion of uncommitted ordinary resources which should be just adequate for the next 18 months. However it has now only SDR 1.7 billion of uncommitted borrowed resources to finance Enlarged Access programmes. Brazil (SDR 2.8 billion) will more than absorb this. Without the third SAMA tranche a commitment gap of SDR 3.5 billion therefore, will emerge by April. For 1983-84 the staff's estimates of commitments of borrowed resources for members with quotas of less than SDR 800 million is SDR 3.4 billion (including, for example, Egypt, Pakistan, Zaire, Philippines, Portugal and Turkey). This would raise the commitment gap to SDR 7 billion. Some of these commitments may not materialise but a number of the OPEC high absorbers (Nigeria, Indonesia) are potential borrowers as well. Further commitments to members with quotas over SDR 800 million cannot be precluded.

5. This makes it particularly urgent to secure the third SAMA tranche of SDR 4 billion. (In 1981 the Saudis indicated their intention to consider a further commitment for the third year if their balance of payments and reserve position permitted). During his visit to Saudi Arabia with the Chancellor (7-9 January) the MD intended to discuss the third tranche with the Saudis. No definite conclusion was reached - the Saudis gave the impression that for them the main question was enhanced resources for the Fund (whether by the third tranche or parallel Saudi lending alongside the new GAB appeared a secondary question). Habermeier (Fund Treasurer) with Dini met the Saudis in London on 28 January to continue the contacts on GAB matters and will no doubt have sounded then out further on the third tranche. There seems a reasonably good chance of securing the third tranche in the coming months.

6. We have also been encouraging the Managing Director to approach other non-G10 potential leaders, such as Kuwait (SDR 2 billion) and the Emirates (SDR 1 billion) neither of which contributed under the Enlarged Access policy. The Kuwaitis have given a definite 'no' (their domestic financial system and stock market are in some disarray). The Fund are 'not optimistic' about the UAE either.

7. Therefore we cannot rule out a further approach to the G10 countries (i.e Germany, Japan and ourselves) for loans to tide the Fund over until the proposed new implementation date of mid-1984 for the Eighth Quota Review although the Fund may be reluctant to do this given the recent GAB decision. But we do not want to ease the pressure on the Saudis or other non-G10 lenders at this stage. Therefore the less said about this the better. We want to avoid giving the impression that the UK would agreed to lend more than the forecast SDR 150mn already committed.

8. Programmes breakdowns will reduce the need for borrowed funds. We may be able to wait and see which programmes fail and live with an uncovered commitments gap during late 83 - early 84 provided that the Fund is fully ready to go to the market of the GAB/quote increase in delayed. In the event that the Fund had inadequate resources

because of a shortfall from official sources, we would support direct market borrowing. If the Fund does go to the markets, it should do so from a position of strength well ahead of any immediate financing need.

9. The Fund may also explore the idea of selling sterling on an ad hoc basis in the operational budget. There has been a grater than expected use of ordinary resources in recent months and usable currencies have been substantially reduced (by SDR 1 billion) over the period.

GOLD

Points

1. Gold still has something of a role in the international monetary system as a store of value, even though it is no longer convertible at a fixed price. It still has a place in national reserves. However there is no official price for gold and currencies are not measured in terms of it.

2. It would not serve any useful purpose to fix the price of gold rather than let it find its own level now that it does not play any formal part in the international monetary system. In any case, in present circumstances there is no prospect that this could be achieved by co-ordinated official action.

Background

3. There are number of reasons why we would not want to remonetize gold:

(a) The supply of gold might not provide sufficient world liquidity to finance the growth of world trade. If there were not enough gold it would be necessary to raise its price, which is potentially just as inflationary as providing additional liquidity in any other way (eg SDR allocations).

(b) Gold ownership is concentrated in the hands of a few developed countries. Compared with our major partners (other than Japan) the UK has little of it (about 25% of our reserves).

(c) The lion's share of gold production is in South Africa (60 per cent) and the USSR (25 per cent).

(d) It would be very difficult to fix the price of gold.

4. There was some revival of interest in gold in the US in 1981 as a result of the US Gold Commission. In particular, supply side advocates (such as Laffer), fearing that high interest rates would frustrate the economic expansion promised as a result of tax cuts, argued that there could be no serious anti-inflation policy until gold convertibility was restored. However, the Commission (which included Sprinkel, Wallich and Reuss) was weighted against gold proponents and certainly orthodox fiscal conservatives are much more sceptical about gold than 'supply

siders'. The Commission's report could not conceal these deep divisions and the majority recommendations came down firmly against convertibility. The report in effect made any positive move on gold a non-starter.

JURGENSEN GROUP

SPEAKING NOTE

In my Fund speech, I said that I hoped study would not be an academic exercise or a means for each country to justify its present practice. The object should be a meeting of minds not a widening of differences.

This still seems to me right. As I understand it the Working Group are now reaching the stage of completing their report. This will be looking at the objectives of intervention, and how effective it has been - in effect a pooling of past experience. When this analysis is complete - and my impression is that a pretty thorough job will have been done - I think the next step will be for Deputies to see what they make of it. The issues would come to Ministers. But for the moment I cannot say more than that. No decision has been taken for example about publication.

BACKGROUND NOTE (CONFIDENTIAL)

The Group was established at the Versailles Summit. The Commission participate as well as the G-7 countries. It has had many meetings, and produced a mass of background material. By and large the conclusions seem likely to be in line with existing UK policy: it will not suggest that intervention by itself can stand in the way of major market trends; it will suggest useful modest "smoothing" role. G-7 Ministers will have to consider the Report before the Williamsburg Summit.

Attachment (iv)

26/1/83

INTERNATIONAL BANKING MATTERS

A. Nature of the "crisis"

(i) It is natural for the media to speak about a "crisis": it sells newspapers. [For different but perhaps equally understandable reasons no one expects officials, central bankers or Government Ministers to talk in similar terms.] Some of the problems are serious, and the activities of the international institutions, central banks and Governments over past months bear witness to that (and are in themselves also a source of comfort). But it is also important to see the problems in perspective.

(ii) Despite the headlines, there have been no defaults. And there are good reasons why both borrowers and lenders should continue to avoid that.

(iii) The increase in lending has been more modest than often thought. Between 1973 and 1982 the external debt of developing countries increased from around $100 billion to around $500 million. A large increase in nominal terms: but nothing like so dramatic once one has allowed for inflation and growth. The increase in relation to exports and trade over the decade was about 25 per cent. In fact the growth rate of lending in real terms seems to have been higher in the 1960's.

(iv) International lending has accounted for a growing proportion of banks' business. But in 1981 banks' international exposure accounted for around 17% of assets (average for banks from the major countries) - so the greater part of banking exposure remains domestic.

(v) Most lending is accounted for by a small number of countries. The top 10 developing country borrowers accounted for 60 per cent of the total in 1981. These are all countries with strengths in terms of natural resources or economic track record. [That is why they were able to borrow.] Although they may face temporary problems, these natural strengths must increase confidence that in the loans will prove good; and that additional bank lending undertaken following policy adjustments by the borrowers will help improve the the quality of existing loans.

(vi) Rescheduling and adjustment may be painful for borrowers and lenders alike. It is not a disaster.

(vii) In a broader sense the problems are all symptons of the transition to lower inflation in the world. The lower interest rates and more soundly based growth that lower / inflation will bring will help all countries solve their problems.

B. Supervision

Points to make

(i) Should be controls on banks' overseas lending/the euromarkets. It is wrong to suggest that / the euromarkets are not supervised from a prudential point of view; or not subject to any controls. They are. In the UK and all other major countries prudential supervision extends to banks' international operations as well as domestic operations. [Proposals for Government's or central banks to go further and decide how much banks should lend to individual countries, or direct the lending, are impractical and likely to be inefficient. Such decisions must be made in the market, and are for individual banks to make.]

(ii) International coordination of supervision is inadequate or has left lacunae (Ambrosiano). No system is perfect or can be foolproof to outright fraud. But it is important to recognise that a lot of work has gone on internationally since 1975 to seek to improve supervisory arrangements and cooperation between banking authorities in different countries. The Bank of England has played a leading role. They key committee is chaired by (and sometimes named after Mr Cooke [who the TCSC saw on 24 Jan.]

Background

(a) There have been many suggestions that the Euromarkets are unsupervised or uncontrolled. Often these arise from confusing monetary control arrangements - which do not in general apply to offshore markets, though their effect is transmitted via interest rates - with prudential supervision, which does.

There could be mention of Lord Lever's proposal for setting ceilings for bank lending to borrowing countries. This seems to take different forms on different occasions. Sometimes it sounds like a proposal for bureacratic control of all international lending; sometimes remarkably like the existing system of banking supervision.

(b) The Basle Concordat.

The Basle Committee of Banking Supervisors drew up in 1975 a set of guidelines - which has come to be known as the Concordat - on the responsibilities of different supervisory authorities for the ongoing supervision of banks where those banks operate in more than one national jurisdiction.

The principles underlying the supervision of the Euromarkets can be summarised as follows. The supervision of foreign banking establishments should be the joint responsibility of host and parent authorities and no foreign banking establishment should escape supervision. The supervision of branches' solvency falls primarily to the parent authorities, whilst liquidity of branches and subsidiaries is considered to fall primarily to the host authorities. Solvency of subsidiaries is in the first place for host authorities, but the principle of consolidation means a substantial role also for the parent authority.

The text of a statement issued by the Central Bank Governors in 1980 is appended. (Annex A)

C. Lender of last Resort

Points to make

(i) Arrangements do exist for preventing banking collapses (domestic or international) having serious domino effects.

(ii) Central bank Governors made this clear - as to international banking - in their 1974 statement.

(iii) But it would be wrong for any individual bank to think it would necessarily be rescued however imprudent it had been. Past rescues (eg the Franklin National Bank in the US) have not extended to helping bank managements, nor shareholders.

Background

The text of Governors' 1974 statement is appended. (Annex B)

D. Information about international indebtedness

Points to make

(i) There has been a greatly improved flow of information about international lending in recent years. This owes much to the efforts of the G10 central banks, with the Bank of England playing a leading role, working through the BIS. There is now a lot of information available. Although it is only published quarterly, about 3 months in arrears, it certainly should be enough to give banks adequate warning of countries getting into over extended positions: that does not happen overnight.

(ii) If the world's commercial banks decide to cooperate to pool further information through their new Institute of International Finance, that would of course be a welcome development.

Background

A decision to go ahead with the proposed Institute has been taken. But its precise role and functions remain unclear.

E. Bank provisions for bad debts

Points to make

(i) Obviously banks have to make the provisions they think proper against individual loans to problem countries, taking account also of the views of their supervisory authority (the Bank of England).

(ii) The circumstances may vary from loan to loan, depending on the details, existence of guarantees (eg from ECGD) etc.

(iii) It is not a matter of writing a loan off completely or not at all. And a loan can be written down one yar and up the next if circumstances change.

(iv) The position on the tax treatment of provisions was set out in a letter of 17 January from the Revenue to the British Bankers Association (which has now been published). [Copy attached at Annex C. It is believed banks are now generally content with the situation.]

F. Schemes to guarantee or refinance existing bank loans from official funds

Lord Lever's proposal for central banks to take over from commercial banks some of their existing loans to ldcs is one of a family of proposals floated recently.

Some time ago the IMF/IBRD Development Committee set up a Task Force to examine problems related to non-concessional flows to the less developed countries. The Task Force considered several ideas for new guarantee facilities, including a French proposal for a Multilateral Partial Guarantee Framework for extending partial guarantees to international banks on behalf of countries on the threshold of creditworthiness.

However, in their report to the Development Committee the Task Force decided not to recommend that these ideas be pursued, essentially because their consultations with commercial banks revealed that there was little prospect that a new mechanism of this sort would in fact generate additional lending. There may be some scope for multilateral institutions, such as the World Bank and the main Regional Development Banks, to make greater use of their existing powers to guarantee commercial loans in addition to lending in their own right but in the past there has been little demand for them to do so.

More recently a number of further schemes have been canvassed outside Government, including Lord Lever's proposals. For example, a Refunding Facility was suggested in a Financial Times leader on 13 September, which would issue long term bonds with an IMF guarantee, using these funds to purchase debts at a discount.

Line to take

One difficulty with some of this family of ideas is that they tend to cut across IMF conditionality. If conditionality is decreased there is a danger that guarantees will be called. More generally schemes of this sort seem liable to give the wrong signal about the respective roles of international institutions, banks and adjustment by developed countries. If a commercial fee were changed, as it should be, there would seem real questions to do with the extent to which the largest banks would be interested in some proposals in this field if (for example) they felt able to look after themselves in rescheduling operations.

The best way forward is first to tackle individual country problems on a case by case basis. Secondly insofar as the problem is a general one we need to make the existing institutions work better. This means in particular more resources for the IMF and closer liaison with the commercial banks in the establishment of programmes for problem countries. It may mean the Fund getting in earlier and leaving shorter gaps if a programme breaks down. This approach is not easy but it seems right in principle, and it avoids the hazards of attempts to establish major new bureaucracies in short order. The role the IMF has been taking recently in cooperating more closely with commercial banks over problem countries is on balance a helpful development.

CONFIDENTIAL until 27 November
then UNCLASSIFIED

26/1/83

Attachment (vi)

DRAFT

Statement on Current Account Surplus and Prospects

Members of the Committee will have noticed that the current account continues to perform very well. It now looks as if the surplus for 1982 will be over £4½ billion compared with the £3½ billion projected at the time of the Autumn Statement, and without the benefit in 1982 of the EC Rebate we had been expecting. Exports actually/ rose in 1982 despite a fall in world trade, helped it is true by rising oil prices. In December the monthly value of UK exports topped £5 billion for the first time. There is no sign yet of any massive surge in imports.

2. Obviously there are great uncertainties in this area. What will happen to world trade, what will happen to imports when current destocking comes to an end, what will be the effect of recent currency movements, and will the surplus on oil trade be maintained at the high levels we have seen recently? I would not want to pre-judge the Treasury forecast that will be published at the time of the Budget. But the prospects are somewhat better now than they were in November.

26/1/83

TCSC Supplementary Briefing ("points to make" and background format)

A. Domestic (mainly FEU)

(i) Exposition of Government policy in relation to exchange rate.
Ditto re interest rates. [illegible]

(ii) Case for exchange rate target in combination with monetary target.

(iii) Recent weeks: relationship of behaviour of authorities to (i). Why so much intervention in Dec? Who decided? When? Why? Why stopped

(iv) Overshooting.

(v) EMS membership. Any own extension of its value to others? Why not for us?

(vi) Role of intervention. Scale thereof? E.G. by France? Others? Outlets at previous times?

(vii) Exchange controls. How much of Jurgensen material to disclose

B. International (Mr Bottrill)

Our role + initiatives

(1) World economic prospects

(i) Case for action to assist recovery. What action?

(ii) US economy. How far to extent (+ how?) gap between US rhetoric + US action?

(2) International Coordination

(i) Target zones.

(ii) Versailles initiative.

(iii) Jurgensen Group.

(3) Role of IMF

(i) Quotas/GAB.

(ii) Conditionality.

(iii) Surveillance/exchange rate misalignments.

(iv) Relationship to Central Banks.

(4) Other

(i) SDR allocations.

(ii) Protectionism.

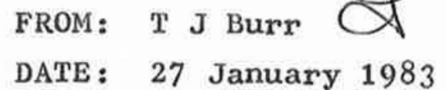
(iii) Gold.

C. <u>Banking</u> (Mr Peretz)

- Nature of "crisis"
- Supervision
- Lender of last resort
- Information
- Adequate provision
- LDC debt: restructuring ideas.

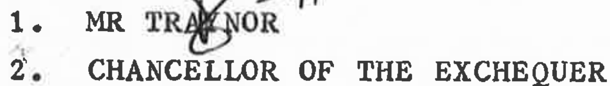
D. <u>Problem Countries</u> (AEF)

(Factual background.)



FROM: T J Burr

DATE: 27 January 1983



1. MR TRAYNOR
2. CHANCELLOR OF THE EXCHEQUER

cc: Economic Secretary
Minister of State (C)
Mr Burns
Mr Littler
Mr Le Cheminant
Mr Middleton
Mr Carey
Mr Kemp
Mr Lavelle
Mr Odling Smee
Mr Bottrill
Mr Ridley
Mr Peretz

TCSC: 31 JANUARY

Mr Kerr's minute of 25 January asked for a high profile note for verbatim use at the TCSC hearing on 31 January about pay settlements in the current round. In the light of my submission of 25 January, which crossed with Mr Kerr's minute, it was agreed that the note should concentrate less on what has been happening in the pay round than on what still needs to happen in terms of lower settlements.

2. I now attach a speaking note on these lines. You should also be aware that if the subject of pay is raised, the Committee may refer back to Mr Burns' evidence on 16 November when he said that the earnings assumption given to the Government Actuary (a 6½ per cent increase between the 1982 - 83 and 1983 - 84 financial years) would be:

> 'consistent with levels of pay settlement probably something like 5 or 5½ per cent'.

3. The Committee might suggest that the Government was therefore assuming from the outset that settlements would be in line with inflation and therefore higher than implied in the attached note. If so, you could say:

> "It is true that settlements around 5 per cent would be consistent with the assumption for the Government Actuary. But so would lower figures: for example 'drift' last year accounted for 2 per cent out of the total earnings growth.

But the important point is not the assumptions used, but the need to get settlements as low as possible."

T J Burr

T J BURR

SPEAKING NOTE FOR TCSC ON 31 JANUARY

Pay in the current round

CBI figures have confirmed that the level of pay settlements is coming down in the present pay round. Their cumulative average for manufacturing settlements between August and the end of last year is around 6 per cent. The ratification of the 4.8 per cent National Engineering Agreement this month suggests that the current position might be somewhat lower than this.

2. But even so, we are talking about settlements no lower than the rate of inflation, which was 5.4 per cent in December. And of course other factors besides the annual pay settlement - known collectively as drift - contribute to the growth of earnings. So far from making sacrifices, many of those who have settled will be getting higher real earnings. And this at a time when industrial production is flat.

3. One is bound to wonder whether negotiators have yet adjusted to the lowest rate of inflation for 13 years. If settlements had declined since the summer by as much as prices, they would be averaging less than 4 per cent.

4. But the majority of settlements in this round have yet to come. They need to be kept as low as possible, and to be rigorously justified in terms of what can be afforded and the market situation.

Mr Kerr

MCMAHON [illegible]

week-end

TCSC: Background Reading

The Chancellor asked to see Dr Emminger's evidence. His three offerings are attached: formal written evidence; oral evidence; and a paper he gave the committee.

2. I also attach our own written + oral evidence, last summer.

David Peretz
27/1/83

MONDAY 25 OCTOBER 1982

Members present:

Mr Edward du Cann, in the Chair

Mr Anthony Beaumont-Dark
Dr Jeremy Bray
Mr John Browne
Mr Michael English
Mr Terence L Higgins
Mr Ralph Howell
Mr Michael Meacher
Mr Austin Mitchell
Mr Richard Shepherd

Examination of Witness

Dr Otmar Emminger, Former President of the Deutsche Bundesbank, called in and examined.

Chairman

814. Dr Emminger, we are most grateful to you for your kindness in coming to see us this afternoon. We have had very considerable help from the Bundesbank in the past, as you will know, when we were conducting our inquiry into the operation of the monetary policy, and I would like now, on behalf of the Committee, warmly to thank you for the paper you have sent to us.[1] It is an admirable document and enormously helpful to us. We are very grateful to you. The way in which we would like to conduct our affairs this afternoon, if we may, is this. I will call on a number of my colleagues to put questions to you and, as I remarked to you a moment or two ago privately, please feel free to volunteer any information you want at any time and we will see how we get on, but, as you know, Mr Padoa-Schioppa is here and we are hoping to talk to him some time after about a quarter past five. Is there anything you would particularly like to say to us before I call on my colleagues or shall I ask one of them to put questions to you rightaway?

(Dr Emminger) Mr Chairman, may I make a very brief introductory statement?

815. Please. How kind.

I make this in order to clarify my position of principle, so to speak, on the general subject of this Committee, which is international monetary arrangements. My first point is that I do not see any realistic chance in the foreseeable future of making substantive changes in the institutional arrangements of the system, so that we should concentrate on promoting better underlying conditions for this existing system. I may say, just as a footnote, I very much regretted that at the Versailles Summit Meeting so many able people wasted time and energy on a very minor side issue, namely, intervention in the dollar market, instead of concentrating on what was really the order of the day already in June this year, namely, a possible financial crisis and how to avert it. I have made it clear in my written statement that I considered this European request for joint action with the United States in dollar intervention as being entirely misplaced because in an organised way, as they had intended it to be, it is impossible anyway and nothing much will come out of it except a few historic documents. When I said we shall not be able to make any substantive changes in the institutional arrangements that means we will have to live with the present mixed system of, on the one side, free floating in relation to the dollar and to some other currencies and, on the other side, in a fixed but adjustable rate system on a regional basis, practically speaking the EMS system and with some other countries. As concerns the dollar, I want to repeat that we have very much to concentrate on improving the underlying economic conditions because here we have seen in the recent past that there have been widely divergent policies in Europe and in the United States, which has had very bad consequences for the world economy. As concerns the European Monetary System, I would repeat, perhaps in a very abbreviated form, what I have said already in my written statement, namely, that in my view the EMS has not yet stood the final test, which would be a convergence of economic and monetary policies towards

[1] See *Memoranda on International Monetary Arrangements*, HC (1981–82) 449, pp 18–26.

The cost of printing and publishing this Evidence is estimated by Her Majesty's Stationery Office at £3,168.

domestic stability, but the system is still better than a free-for-all chaos among countries which are so closely inter-connected in Europe and, therefore, the system should be given the benefit of a further testing period. I want to make a *second* point as concerns the effect of floating exchange rates. I think what is sometimes lacking is a clear distinction between the effect of erratic exchange rate movements, or what is sometimes called an exaggerated variability of exchange rates, on external trade and short-term payments transactions, what I would call the uncertainty or risk effect of these fluctuating exchange rates. A much more important side of it is, on the other hand, the effect of exaggerated shifts in the levels of exchange rates or, to be clearer, strong overvaluation or undervaluation of important currencies, and the effect of this on economic policy and in particular on monetary policy, as distinct from the mere uncertainty effect on external trade. Here is where I think our main problems lie. The *third* point I want to make very briefly is that we have had a particularly good example of the effects on economic and monetary policy in the present overvaluation of the dollar, which has mainly been brought about by a very unnatural combination of a weak American economy and very high rates of interest. This overvaluation, in my view, is likely to last as long as this unnatural combination persists. It is worth noting that under the floating rate system the dollar has been landed in a similarly overvalued position to that which it was in in the last few years of the fixed rate system under the Bretton Woods system. I still very clearly remember that at the beginning of the 1970s the Americans complained that because of this fixed rate system the dollar had become locked in in an overvalued position and they were glad to be free of that and were glad to be free of the position of the passive nth currency in the system. Now we have the floating rate system, which was supposed to liberate the Americans from this situation, and again they are in an overvalued position, although on a different basis, on a floating basis, but they are again also in the position of the passive nth currency and this they asked for voluntarily. This has had, as you know, enormous effects on European and Japanese monetary policies. I do not need to go into that. I want to conclude by saying that I have the feeling that although in the past the main sufferers from this very unnatural combination of recession and high interest rates were the outside world, now it seems that the overvalued dollar will become more and more of a burden on the United States themselves, while the outside world can possibly better live with that than we had thought. This shows also that the Americans are not so independent of these international monetary currency relationships as some time ago they were thought to be. Thank you.

816. Dr Emminger, that is a most interesting and significant statement. We shall want to ask Mr Padoa-Schioppa in a moment or two probably about EMS matters but I know that a number of my colleagues would like to follow up what you have said, and I wonder if I could ask you one question before I ask my colleagues to question you? You were saying you thought it very unlikely that changes in the institutional arrangements could be achieved. Is this because of the difficulty of getting agreement with the Americans?

When I say a change in the arrangements, I mean the institutional arrangements, a change in the EMS, a change in the rules, the fixed rules. Of course, there may be, and there probably will be, some agreement on, for instance, setting up a committee of surveillance, which is nothing particularly new and which is not an institutional arrangement as such. It is just to solve something which is already in the Articles of Agreement of the Fund.

Mr English

817. Mr Chairman, could I first fully support your remarks. I think we all appreciate Dr Emminger's presence here and also the help of his colleagues in the past. In the former Parliament we had some excellent advice from Germany on this subject of the European Monetary System and in this Parliament we have, of course, had evidence from Dr Dudler, which was not only excellent evidence in itself but also managed to be witty in good English. You have, I think, Dr Emminger, rightly caused us to think about some of our questions by implying that they were not as precise as they might have been. May I suggest to you that on page 18 your answer to our questions 18 and 19 was not quite precise itself. The answers there given could imply that they are answers to both questions. I do not really think you meant that.

On question 18 I had no comment.

818. I see now what is meant. So the answers are solely on question 19, is that it?

On question 19 I had a very brief answer, yes. That was about the allocation of special drawing rights.

819. I think it now makes sense. It was not clear.

It was not clear?

820. No, because it was not clear that you were not answering question 18. Mr Padoa-Schioppa has sometimes put questions together and answered them together and I was reading the two at the same time. What I think is another matter of much more interest, though, is that on page 11 in the second paragraph of your memorandum you say: "Monetarists are, therefore, always in favour of clean floating. For the same reason most monetarists in Germany are hostile to the EMS on principle. I would agree that one cannot have a money supply target together with an interest rate target. One can, however, have a monetary target together with an exchange rate objective, if the latter is not defined as a fixed target rate of exchange, but in the above-described sense as avoidance of extreme and damaging aberrations." I think most people in this country would loosely call themselves monetarists if they said you could not have a money supply target together with an exchange rate target. You are agreeing with them, though you are not agreeing with the extreme international monetarists, and I wonder if you would like to explain the subtle distinction, or what seems to some people to be the subtle distinction, between the points you are making?

It comes down to the question of what you understand by "monetarists" and by "monetary targeting". We in Germany have always applied this monetary targeting in what we call a pragmatic sense and not in such a dogmatic sense as has for some time been prevalent in the United States. But, as you know, recently they have deliberately come over to a more pragmatic view of these monetary targets and I had forecast that already, more than half a year ago, that they would have to come over to our more pragmatic view, otherwise they would just fail. This they have now done. This means we have never believed that one could be a slave of monetary targets over a short period, say three months or six months, or even one year, if other very important considerations come into conflict with that. So, we have played it in such a way, for instance, that (to give a concrete example) when the change in exchange rates seemed to damage our domestic economy or our stability and so on, then we looked more to the change in exchange rates than to the money supply. However, we always tried not to get too far away from our monetary target, and I always use, although perhaps it is not very fair, the Swiss example as being one which we would never follow, namely, that the Swiss, because they had an extreme upvaluation of the Swiss franc in 1978, simply suspended their monetary target and they created money more than three times their monetary target, with bad consequences afterwards. We also overstepped our monetary target in that period, but only from 8 per cent to 11 per cent, which was still tolerable, although—and now I come to the monetarists again—the dogmatic monetarists, of course, criticised us for that. Whenever we had to intervene in the European Monetary System, and there were several periods of that and we had sometimes to intervene by several billions of D-marks, they claimed that by intervention in favour of this fixed rate system we would undermine our monetary target policy. My point has always been that this, of course, may be true in the case of the dollar because in the case of the dollar the inflows and outflows of foreign exchange can be enormous—we have had such experiences and one of these experiences in March 1973 really led to the demise of the Bretton Woods system, to be quite frank. But in the case of the EMS up to now the inflows and outflows were usually of a magnitude which was manageable and did not disturb too much our monetary target. However, when the EMS was set up I was still in office and I made it a point that we, the Bundesbank—when I say "we" I still speak of the Bundesbank—would have the right in an extreme case to suspend the intervention if it would be so damaging that it would violate our priority goal of stabilising the money. This has been laid down and has been confirmed by the competent Minister. So I think the answer to your question simply is that in our more pragmatic system up to now we have been able to combine this partial fixed rate system and the concomitant intervention obligations with our monetary target. In case there is a too-sharp conflict, we would then decide to get out of this obligation, which, of course, would, in effect, mean that the Government would be under great pres-

sure to negotiate a change in exchange rates inside the system and to remove the cause of these flows of funds.

821. I remember well, Dr Emminger, that not only did you say that but you were also farsighted enough to make the assumption at the time of the creation of the EMS that it was just possible that the pound might go up whilst everybody else was thinking that it might go down in relation to the ECU?

Yes, I always thought it would, because I believe that when you have a continuous surplus on current account it is bound to have an influence on your exchange rate.

822. I have only two more points. One is on page 14, your second paragraph there.

Could you tell me which question it is because I do not have the manuscript, I have the printed version with me. Which question is it?

Mr English: It is page 14, the answer to question 13. Shall I read it out to you very quickly: "The exchange rate can be used to hold down domestic prices and wages if, for instance———"

Chairman

823. I think Dr Emminger has it. It is just that he has the printed version.

I have the printed version. Yes, I have it.

Mr English

824. It is the second paragraph. If I were being deliberately oversimple, are you really saying that if we pegged our currency to the dollar we could have brought inflation in this country down? You mentioned the point that Chile successfully, but brutally, did that in 1979. Are you really saying that if we had pegged our currency to the dollar we could have brought inflation down, whereas if we pegged our currency to the yen we could have increased our trade balance in manufactures? Is that really what you are saying?

The first part is certainly true, that if you peg your currency to an overvalued currency that has a stabilising effect on your domestic prices. For a short time the inflation rate in Chile was down to zero but a few weeks after I wrote that they had to relinquish the system because it was too brutal. In my opinion it was a brutal system and in the end far too brutal, so they had to relinquish it. But, of course, you can do it and there is no doubt that a number of countries have used the pegging of the exchange rate to a stable currency in order to have a stabilising effect on domestic prices, and it is quite clear that all countries which have an exchange rate policy (that is: practically all with the exception of the United States) also have to watch the effect on domestic prices. You said there was perhaps an option of having either the stabilising effect on domestic prices or to let exchange rate go down and have a better performance in exports. I said I am not sure about the second part of your statement because it would be true only if, in spite of letting your exchange rate go down, you would not yield to the inflationary pressures which would, of course, arise from that. So you would perhaps do it if you were a second Japan, for the Japanese have managed, in spite of the undervaluation of the yen, to keep their inflation rate to approximately 3 per cent, which is a miracle really. We would not have been able to do it because in our case, when the D-mark was strongly undervalued in 1981, this had an enormous effect on our domestic inflation rate. It went up to 6.7 per cent while all the domestic factors pointed towards a 4 per cent inflation rate, so something had to be done with the exchange rate and that meant that the Bundesbank had to persist in their rather restrictive monetary policy. So, the short answer to your second question is, you could have this impetus, this stimulus, to your exports, provided you can overcome the inflationary effect of this undervaluation on the domestic price and cost level.

825. But how would you and I do that when neither you nor I believe in institutional incomes policies?

It depends whether you call the Japanese system an institutional incomes policy or not. It is probably in between. Anyway they are very good. They managed, when they had very temporarily an increase in import prices of 50 or 60 per cent only for a few months, not to let that be reflected in their domestic prices.

826. I, too, would be fascinated to know how it was done. My last question relates to what, in my text, I have as page 5 of your annex. This is the "Exchange Rate Policy Reconsidered" paper[1] of 4th February, which is an annex we have here to your paper. In Section II, "Exceptionally large shifts in 'real' rates of exchange", you have what I have as page 5: "The fluctuations of

[1]Published by the Group of Thirty in a revised form as Occasional Paper 10, 1982.

the pound sterling and the yen . . ." Do you understand? It is the third paragraph.

Yes, I remember it.

827. You say: "The pound sterling rose against a group of important currencies on a trade-weighted basis between 1978 and the first quarter of 1981 by 25 per cent in nominal and by 37 per cent in real terms"—then you go on "and declined again . . . At its peak in February 1981, the 'real' sterling exchange rate was not only about 50 per cent above its depreciated value of 1976, but about 30 per cent higher than in 1972. This is by far the most excessive overvaluation which any major currency has experienced in recent monetary history. It dwarfs the 'real' upvaluation of the D-Mark between 1972 and its peak . . ." You say also: "The large real appreciation of sterling from 1979 to 1981 was probably the most important single element in that period's British economic policy, as concerns its effects both on domestic inflation as well as on British trade, production and unemployment." I think we are all bound to consider whether there is an implication behind your remarks. The implication clearly is that virtually British manufacturing industry and British exports were sacrificed to keep the inflation rate down. Is that what you meant?

Perhaps I should not have made that remark.

828. You did not make it in that way.

I do not subscribe to the word "sacrifice", that they were "sacrificed" to that, because the real effect of that appreciation very much depended on the reaction to it and at that time it seems that the reaction of the British economy—but again I do not want to intrude upon your policy problems—was rather inflexible as concerns wage developments, which, of course, meant there was quite some effect on employment and production. But it very much depends always on the more or less flexible reaction to this phenomenon. Secondly also I do not think that very much could be done against that and, furthermore, this record appreciation consists of two elements, not only that the pound went up but also that before it was probably undervalued and it came through an undervaluation. Perhaps you would be good enough to look at the table which I annexed to my statement for this Committee, Table 1, where you see the real exchange rates of some important currencies, and here you see that, as compared with 1972, the pound at first in its real rate went considerably down and it is mainly due to that that afterwards its upward movement was so exaggerated. That this created a problem for the British economy nobody could contest, but I do not want to intrude any further on your British province.

829. No, but I think we all agree with you that the overvaluation occurred since 1979?

Yes.

Dr Bray

830. Inviting you to intrude further into our domestic policy, and knowing that you did, of course, say this in Washington and, therefore, it was no kind of discourtesy in any way to Britain, you did say there was actually excessive overvaluation, meaning it did go too far. The effect was that the effective exchange rate rose to 103.9 and it has since then fallen to 92.8, which is only a 12 per cent decline in the effective exchange rate. Would you say that the pound is still excessively overvalued?

Now, of course, it is all a question of definition. First, I would have to define what is meant by "overvaluation" and "undervaluation". I did not go into all these niceties. I could not have gone into them. Secondly, I used the word "excessive" on purpose because there are situations where some overshooting, as it is usually called, or undershooting is inevitable. I mean where it is inevitable that the exchange rate does not conform to the purchasing power parity or inflation differences but where the currency depreciates or appreciates more than is justified by these inflation differences, that is usually called an overvaluation but as such an overvaluation may sometimes be necessary. I used the words "excessive overvaluation" to say this is something which goes beyond a reasonable overshooting or undershooting, meaning that this will lead to a misalignment of the currency.

Dr Bray: In defining misalignment in reply to the first question in your evidence you did say it is like the problem of recognising a pretty girl. It is difficult to define but you recognise her when you see her. If the male chauvinist piggery can be forgiven, it is not only that you recognise a pretty girl but you know what to do when you see one.

Mr English: Not everyone does.

Dr Bray

831. In those circumstances you seem to accept that there are divergencies in fiscal and monetary policy and different nations take a different view of what is a pretty girl. Would you agree?

Yes. There are many instances where you recognise her and do not do anything. This is often what nations are doing, too. They would recognise a clear misalignment and still cannot do anything or would not want to do anything.

832. But what then is the significance of the word "policy" when you say that nations cannot avoid having an exchange rate policy? What does "policy" mean?

I meant to say that in a most general way, that practically every country except perhaps the United States—I make that exception—has to have a view of its exchange rate, that is to say has to know whether its exchange rate is grossly overvalued or grossly undervalued, has destabilising effects on its domestic stability or very damaging effects on its external trade relations. You cannot avoid having a view. Why? Because exchange rate is such an important prize. The only country which can afford not to have such a view is the United States and here I mentioned in my introductory statement they will perhaps very soon recognise that they also have to have some view on the dollar exchange rate. That is the most general definition of having an exchange rate policy. The second more concrete definition would be that if you recognise that the exchange rate is misaligned in the sense that it leads to distortions and to damages, then you have to question or to ask whether one can do anything about it and that means whether one can do anything by monetary policy, by fiscal policy or by intervention. It is a misconception to believe that the exchange rate policy consists mainly or even only in intervention. I take again the example which we have before us: the overvaluation of the dollar. You cannot do anything about this overvaluation of the dollar because this is based on such a strong combination of underlying American developments. Only the Americans could do something about it, but very little by intervention. That has been the big mistake of the Versailles Summit, that one can do something about it by intervention. One can only do something about it by changing the underlying factors.

833. Taking that point, Dr Emminger, you say in reply to question 9 that the present independent management of sterling seems to be working well. Does that mean that on the whole the stability of the effective exchange rate at around the 90/92 level which following your earlier characterisation is excessively overvalued, is in fact being effectively maintained by the Government?

First, if you look again at table 1 which I annexed to my statement, you see that the real exchange rate of sterling is no longer so overvalued as it was at the peak—I mentioned it somewhere—at the beginning of 1981. The first quarter of 1981 was the peak and that is what you see from this table. Since then its overvaluation has been considerably reduced. Second, I think it is true also—I cannot claim very precise knowledge—that this average rate of exchange which you mentioned has been maintained without excessive need for intervention. It shows that it seems to correspond to the balance of payments, the trend development of the British balance of payments, and what it implies is that due to the fact that Britain has very useful oil properties of course you have a surplus in your current balance of payments and it means that you have to have an adjustment of your whole structure for this fact and this seems to have been going on.

834. So the lack of intervention suggests that the effective exchange rate does reflect what you describe as the underlying economic view, so in so far as the effective exchange rate is overvalued then it is the underlying economic conditions and the policy to secure those that are at fault?

Yes.

835. Moving on to the more general, you do talk in terms of the real exchange rate, and incidentally the real exchange rate has I think only fallen—I do not know exactly what definition you were working with—to about 8 per cent since its peak, so it still seems to be pretty high but this implies that there is, whatever the exchange rate policy may be, this best formula in terms of the real exchange rate rather than the nominal exchange rate. Is that your argument?

I think my answer is two-fold. First, if you want to look at the real effects of the exchange rate on your economy, on your competitiveness and so on, then you have to use of course the real rate of exchange. I used the one that was available to me in this table 1, namely the one based on the wholesale prices for manufactured products.

You could justly say, why do you not use unit labour costs, which is a better measurement for competitiveness. I usually take three measures and then I look at all three, just as I always look at least at two or three definitions of money supply with monetary targeting because one may be misleading. Now, the second part of my answer is whether you can use this real rate of exchange as a criterion for your day to day exchange rate policy and this you cannot do. There you have to cling to the nominal rate. That is quite clear because the real rate you get only a few months later although you can guess what it is. But you have to have some view on the nominal rate and for instance in Germany last year everybody thought that when the dollar went above 2.40 D-marks then it was highly overvalued; they did not ask the real rate. They just looked at the nominal rate because it was an easily understandable way of looking at it and nobody would have understood if there had been a public discussion of the real rate. So for day to day and practical purposes you have I think to stick to the nominal rate.

836. Although that nominal rate could be something that was defined to slide rather than to move in steps?

I have always been against setting any particular level for the nominal rate, except in a regional framework like the EMS.

837. But in so far as one is talking about a nominal rate one can talk about not just the level with the implication that it should move in steps. You could for example have built the EMS around sliding rates rather than fixed nominal rates.

Yes.

838. You then, having introduced the concept of the real exchange rate, treat that as a sort of first approximation which you then qualify in terms of the state of the current balance and the general background of fiscal and monetary policy. Is it a fair description of your attitude that you suggest that nations, with their differing objectives, their differing priorities, do in fact seek to manage those in a way which is most acceptable to them with some sort of eye as to what the exchange rate is?

Yes.

839. Well, then, is there not a second stage whereby one could introduce as a basis for international discussion, not asking for anything terribly formal, but suggesting that the variation of those exchange rates can then be used to in some sense optimise the sum of the separate national interests?

Except that this is extremely difficult and there is bound to arise conflicts of interest. I do not believe that you can really, say, conduct an international negotiation on an optimum international benefit of the exchange rate relationships; it is too difficult a problem in reality.

840. If each nation says, "We cannot control our exchange rate but we can do things for it, and other nations do, but if that is it then this is the fiscal and monetary policy we choose to pursue and this we think would be the result . . .", in that situation what is there to stop adding those results together for different nations? Where is the competitiveness in it?

What I mean is that it is unlikely that this would add up to a consistent pattern. Look at the present situation: if we say to the Americans, "Your domestic policy pattern is very disturbing to us and to a number of other countries", they might say: "Well, but it is the one which we need for domestic reasons", which is what they have always said.

841. The implication of the present American policy is that they prefer low inflation to high growth, now those are the conditions in which another nation would prefer high growth to low inflation and could do an effective trade with the Americans.

In what way?

842. In the work by the Japanese economist Aoki there is spelt out the conditions under which exchange rate unions benefit countries and they benefit countries if they have different priorities.

I do not quite see that this could be worked out in practice, frankly speaking. If I look at my experience with international discussions on these subjects they would never find a real basis for such a discussion.

843. Would it not greatly ease the course of international discussion if in fact within the EMS it could be accepted that the equilibrium situation must tolerate a higher inflation rate in France than Germany and if the EMS were adapted to accommodate this?

Again I do not understand the meaning that the EMS would tolerate or even require a higher inflation rate in France. Do I misunderstand you?

844. At present we are stuck with the situation where there is a revaluation every so many months and likely to be further ones?

Of course.

845. If in fact it had been built around a sliding parity system then a slower rate of reduction of inflation from France would have been accommodated without having constantly to introduce the uncertainties of revaluation?

You mean to say one could construct an EMS where some countries have a sliding parity———

Mr English: A crawling peg.

I think theoretically and mathematically you can but not in practice. But what you can do in practice is what has been done in the Italian case and I was a little instrumental in doing that because our people in Germany wanted to give way only up to 4 per cent on both sides and I said at the present time they are still in such unstable conditions that it is better to give them 6 per cent. This gives the Italians a rather wide possibility of adjusting their exchange rate flexibly without having to negotiate too often an ad hoc-parity change.

Dr Bray

846. For what it is worth Bank of England officials did tell us they could see no technical objections to sliding parities.

If the Italians and the French for eternity have a much higher inflation rate, instead of making a series of ad hoc exchange rate adjustments you could say, "Why do we not every quarter say there is such and such a change in the exchange rate which would replace the ad hoc negotiations." But it would have a very negative side because we have seen that the maintenance of the exchange rate in the EMS as some disciplinary effect, some psychological effect. Look at the big efforts which the Belgiums have made, look at the big efforts which the French are making in order to maintain their present parity. But if you would build into the system a permanent sliding scale exchange rate corresponding to a 10 or 12 per cent inflation rate for the French that would remove that disciplinary effect.

847. There is no question of building it in for them nor tolerating anything but zero but assuming a lower rate of inflation for the next two years.

For a very temporary period you may do that but then it is not much different from having an ad hoc adjustment every five or six months.

848. The generally worrying position is that we are going deeper and deeper into recession. Might it not just be conceivable that some different rules might be needed to pull the world out of recession?

I think the EMS is certainly not a very important factor in that. It is rather the relationship to the American economy and to the American dollar. It is my belief that this unnatural combination, as I call it in my introductory statement, of recession and high real rates of interest has spread the American recession over a large part of the world because it has pushed up the dollar rate, it has forced high interest rates, relatively high interest rates on other countries, it has depressed commodity prices. It has not had a deflationary but a disinflationary effect on some part of the world economy, to which it has not been easy to adjust, for instance as concerns the debt burden of highly-indebted countries. It is really my conviction you will not get out of this overall worldwide recession or stagnation except if, and when, the Americans get out of their present fix, namely their unnatural combination of recession and high interest rates. In spite of the very substantial decline in American interest rates, if you look at the real rates of interest, meaning inflation corrected rates of interest, and in particular if you look at long-term rates of interest, they are still exorbitantly high. Look at the mortgage rate, the mortgage rate in the United States is still nearly 15 per cent and the inflation rate is heading towards 5 per cent; this is an unheard of real rate. So they have made great progress in the short-term field but not yet enough progress in the long-term field and that is part of what is preventing them from having a recovery. Before the Americans have some recovery I do not think that the rest of the world will really be able to get out of this present stagnation.

849. What you say is very persuasive but you say there is a limit to the extent we can preach to America about what they should do and if we ourselves adopt policies which, if followed by the Americans, would move in the direction which you suggest would not be a good thing.

Sorry. I have not quite understood the meaning of that.

850. If we in Britain were to adopt policies of a kind which you suggest, moving in the direction you suggest, would that not help to encourage America to do so?

You mean that we in Europe—not only you but also we—would have to have an expansionary policy? Well, that would mean of course as long as the Americans are in their present situation our currencies would further depreciate. I would say maybe that is inevitable but it would lead me to another conclusion, namely that we could have more freedom from this fix in which the Americans are by having much more domestic stability ourselves. Then we would be more independent of the American situation. If we were down to 2 per cent inflation then we could afford expansion without too much fear from a higher dollar exchange rate. I would also explain that there has already been some change in that direction if I look at the German situation, and it is probably the same in Britain but I know it better in the German case. Last year the Central Bank in Germany had to look nearly exclusively to the exchange rate because that was the main influence on our domestic prices. When the dollar went up to 2.57 D-marks in August 1981 it had an enormous effect on domestic prices. Now the dollar is up nearly to the same high point. In spite of that our Central Bank is able to lower interest rates considerably and our long term interest rates have gone down more than the American long term interest rates. Why? Because now this overvaluation of the dollar does no longer have the same inflationary effect on our prices and this is due mainly to the fact that over the last year or year and a half commodity prices, in particular oil prices, in dollar terms have gone down so that, while last year the high dollar rate meant higher price inflation in Germany, this year the high dollar rate has had some effect but not a very substantial effect. Our import prices in D-mark terms have not substantially increased so we have become more independent. Secondly, we have in the meantime had more stability from the domestic side because we have had a reasonably moderate wage round in the beginning of the year and that has also increased the independence of our monetary policy from this American situation. What I want to say is: the better we are in our own domestic stability, as concerns costs and prices, the more independent we become from the dollar. So it is to some extent up to us to get more independent.

Mr Higgins

851. Dr Emminger, I was interested in the point you made in your opening remarks that in some respects the Americans seem to have found themselves now in much the same position as they were before the Smithsonian agreement. I think it is common ground between us that it is difficult for them to remedy the situation by way of intervention. My impression from what you said earlier is that it would however be possible to do so by altering the overall situation, for example with a major cut in American interest rates. Therefore I am not quite clear why you think the Americans are now in the same position as before since they could now, if they wished, unlock themselves from this position by adopting different domestic policies.

This is exactly the position. They are in the same position as concerns the overvaluation of the dollar. While in the previous fixed-rate system they believed they were locked in and could not move—although they could have moved if they had devalued the dollar but at that time they believed they could not devalue the dollar—so that is why the Secretary of the Treasury, Mr William Simon, said, "We were locked in" now, they could move well on interest rate policy. I am quite sure that the present loosening of their interest rate policy is not only prompted by their domestic situation but also prompted by some regard to the external situation because more and more the Americans are discovering that this longstanding overvaluation is very detrimental to their foreign trade. A few months ago the Federal Reserve Bank of New York made a research paper which showed that if they continued they could by the end of next year have a deterioration in their trade balance of up to 45 billion dollars as compared to 1980. I think it is exaggerating, but still, they are now recognising that this continuous overvaluation is very bad and they also recognise now that it is in their own hands to remedy it, so it is a big difference as compared with the former overvaluation in the fixed-rate system.

852. One of the main themes in your interesting paper is that it is not now possible for other countries to fix a rate or even a target range against the dollar. I was not quite clear, given what you said earlier about the effect of differential interest rates and capital flows and so on, why you believe that to be so.

One cannot fix a rate with the dollar?

853. Yes, if I understood your paper correctly. The argument is that it is not now possible for another country to fix a rate against the dollar, or indeed, a target range against the dollar. I was not clear why you thought that was so.

A smaller country can, of course, always peg its currency to the dollar at a fixed rate, or at a target rate, if it orients its whole domestic monetary (and other) policies to the exchange rate target, and if it undertook by itself to intervene with its dollar reserves in case of need. What I meant is whether a larger country, with an open economy and free capital movements, like the UK or West Germany, could adopt a fixed or target rate in relation to the dollar. It could not. We have seen that a fixed rate vis-à-vis the dollar is an invitation for big speculative flows whenever a lack of confidence in the dollar or in the other currency arises. Why? Because there are huge amounts of volatile dollar funds in the world. We had been exposed to these destabilising speculative flows in relation to the dollar area in the 60s and beginning 70s, which undermined our domestic monetary policy. We would never try it again. But fixing a dollar rate could not become a general arrangement also because the Americans would not accept a fixed dollar rate (and rightly so). So we have to live with a floating dollar. What we should aim at, is to get better underlying conditions for this floating system, eg have a better convergence of economic, in particular monetary, policies between the Americans, the Europeans and the Japanese, and also have less short-term volatility of interest rates in all important countries.

854. Are the reasons you have just mentioned the compelling reasons you feel why one has to have a floating rate against the dollar?

Yes.

855. That being so, despite constant protestations from Treasury officials and others that we do not have an exchange rate policy, there has been a change in attitude about a year ago because as the sterling rate began to fall freely against the dollar we found suddenly interest rates here were raised very rapidly. That being so, do you agree that it is possible for an individual country at any rate to maintain what it thinks is the right rate against the dollar providing it is prepared to use interest rates and so on in order to do so, and this is very important if one wants for example to prevent a fall in one's own exchange rate which would exacerbate inflation?

Yes, but take the Japanese yen as an example. Japan is a very powerful country but it is completely unable to manage its exchange rate in the desired direction. It is now a year since last September when the Governor of the Bank of Japan declared in all due form that he considers the yen to be undervalued vis-à-vis the dollar. In spite of this the yen rate has gone down and down and it is now even undervalued vis-à-vis the D-mark. Why? Because there are such strong forces working on this relationship between the yen and the dollar. Japan liberalised capital exports at the end of 1980, and this coincided with a widening of the interest rate differential between Japan and the United States to an exorbitant size. It was an unfortunate timing, and it resulted in a huge outflow of capital, so that for quite some time the deficit in Japan's long-term capital balance was more than twice as high as the surpluses on current account. It was such a flood, such an enormous flood that one could not do very much against it by intervention. The only thing which they could have done is to increase interest rates very much, which would have meant that they would have troubled their domestic economy and all the world would have cried in alarm because everybody wanted, of course, the Japanese at least to maintain some expansion of their economy but they themselves also wanted to do it. This was out. The other thing they could have done is to suspend the liberalisation of capital but when you have been proudly liberalising everything it is very difficult politically to say six months later: "We have made a mistake, we shall go back to some restrictions on capital exports." Now they are suffering from this mistake, which has resulted in a yen exchange rate which even by Japanese estimates is undervalued by 20 to 25 per cent.

Mr Higgins

856. Would you agree the United Kingdom has succeeded in doing it over the last couple of years?

I think the United Kingdom has succeeded much better.

Mr Mitchell

857. You say in the supplementary paper, "Exchange Rate Policy Reconsidered" that economic policies are becoming more exchange rate orientated. How far is

it true we are in the situation you describe of excessive overvaluation because we did not have an exchange rate policy in this country under either Labour or the early stages of the Conservative Government?

What I meant to say with this sentence was that because of the strong effect of the overvalued dollar on our domestic price situation in 1981, monetary policy both in West Germany and in the United Kingdom had to watch the dollar exchange rate in their interest-rate policy. When their exchange rate fell too much against the dollar, interest rates usually went up or were at least prevented from going down. Thus there was, at least in 1981, a greater exchange-rate orientation of monetary policy.

858. We either had an eye on the exchange rate or an eye on the situation in industry and it is a competitive situation; one of those eyes must have been blind.

Generally in such situations, in my experience, you look for a compromise, try to do it in such a way that neither of these interests is too much hurt. That is the usual thing.

859. If you are looking for a compromise why is the exchange rate excessively overvalued?

As far as the overvaluation of the dollar is caused by American policies, we can do nothing about it. My view is that this overvaluation is likely to be cured next year when the American economy is recovering and interest rates will go further down. I indicated in my paper I would foresee the overvaluation of the dollar followed by an undervaluation, again because these are the ways of over-correction.

860. I meant the excessive overvaluation of sterling.

Here again I do not want to intrude into your domestic policy because it is too difficult for me to see all the facets of your policy, frankly speaking.

861. But you could say that the Americans can take an independent passage because they are so big, it could also be said that in this country the excessive overvaluation is allowed to go on because the effects on industry were not realised?

This I do not know; no comment.

862. How far in that case is it true that the Japanese give the reason for the Japanese yen being undervalued, with the liberalisation of capital movements, that whatever the central bank wanted the government policy was that it should be undervalued because that was the way to keep the factories churning out, to keep employment at a high level and keep exports competitive?

To my knowledge that is not correct. I have many talks with high Japanese government officials and they were all, without exception, of the same opinion, namely that the yen was undervalued. When I was a little surprised about it they said, "You know, we are suffering very much from trade frictions with the United States and we would rather have a higher exchange rate and less trade friction and it would be much better for the rest of the world too." They meant it and it is definitely wrong to suppose that they deliberately wanted undervaluation for export reasons. Even if the yen rate was 20 per cent higher they might still have more or less the same export volume as they have now, but on a normal price and market basis, without so-called "voluntary" export restraints or dirigiste import restrictions by the United States and the EEC countries.

863. If we in this country wanted to get the exchange rate down for the purpose of industrial expansion, could we do it? How could we get it down?

Whether you should do it, I do not know, I must decline to give any advice on a situation which I do not fully understand but you ask me how it could be done. I think there is a very simple recipe for that: lower interest rates further, but this can only be done if there is not too great a risk involved of re-igniting inflation. The very simple way of getting your exchange rate down is having lower interest rates.

864. Are we in a situation now—and perhaps Sweden with its devaluation and France with its forced devaluation spring to mind—where you can only have expansion in one country in the present world climate by a devaluation to insulate you from the flood of imports which will be drawn in if you expand your economy?

There is one big difference between the Swedish example and your case. In Sweden they have a very big deficit on current account so they have at least a good pretext for devaluing; but it was also a competitive devaluation, clearly. In your case you do not have any big deficit on current account and so, of course, one could say if this was

done by a deliberate act, as in Sweden, without any domestic measures, just by an external devaluation, then it would look like a competitive devaluation to the rest of the world. It is however different if you get the depreciation or devaluation of the pound by domestic monetary policy measures. I think your original question, how can one do it, is certainly by lowering interest rates provided you can afford it without too much inflationary impact.

Mr Browne

865. I entirely agree with your statement about a balance between money supply targets and exchange rates, but is there not another factor: if you have an economy with a free banking system and uncontrolled creation of credit in the banking system and at the same time a lot of that credit is distressed borrowing in a recession; you have a recession, why create demand for credit? Is this not another factor you have to include in balancing money supply targets and exchange rates? Are money supply targets in a free banking system really under the control of the government? Secondly, when you talk about the American dollar and the effect of lowering interest rates on the value of the dollar, do you not feel we have reached the stage where there is another factor, a massive Euro-market investor desire to move, if they see interest yeilds drop, to move into long-term growth situations? If they see the United States economy going to be the first and also the strongest will there not be a demand for US dollars and demand to invest in the American economy and will this not have an effect on the dollar?

Your first question related to monetary targeting and what you call "the free banking system". This is, of course, not the subject of this exercise of your Committee but rather of a previous exercise. I do not want to get into that. Why? Because this is different in every country. We would say our banking system is not a free system in the sense that it is independent of the Central Bank, independent of the Central Bank's monetary policy, because in our system there is a very clear connection between money supply created by the Central Bank and the limits to which the banking system can expand credit. Now, your second question?

866. On the alternative from interest rates on long term growth.

You really question my remark that if and when the United States gets back on a recovery path then there will be also a turnround in the dollar. Now here at least past experience has shown that although not immediately but after some time business activity and relative growth rates are extremely important for the exchange rate, particularly for the dollar. If you go back into the history since the beginning of floating in 1973 you will always find a very big influence of relative growth rates on the dollar. There is a big impact on the current account. When you have a recovery in economic activity together with an overvalued currency, I would be prepared to bet that this would lead to a very big deficit on current account. But then it is a question of whether capital inflows into the United States due to special confidence factors or what-not will be higher than this deficit on current account. Here we have some past experience which has shown that these turnrounds, these shifts in current accounts, can be of enormous magnitude. In two years it could be 30 billion dollars or so, so it would really need an increase in capital inflows of a similar magnitude. This would really presuppose that American interest rates would remain relatively high and confidence in the American economy would increase even more than at present. It would take a very large increase in net capital inflows into the United States to compensate for the deterioration in the US current account which can be expected from a combination of American recovery plus overvalued dollar.

Chairman

867. Dr Emminger, I think it would be generally agreed that we have benefited twice: first, as we have said, from that admirable memorandum you so kindly sent us, and now secondly in the discussion which you have joined with us, from which we shall undoubtedly learn a considerable amount as we come to study the text of it. Thank you very much indeed for your kindness, for your courtesy and your helpfulness. We are greatly in your debt.

Thank you, Chairman, and thank you all for your attention.

PART OF ABOVE 27/1/83

Memorandum by Dr Otmar Emminger, former President of the Deutsche Bundesbank

RESPONSE TO THE COMMITTEE'S QUESTIONNAIRE

A. The Exchange Rate Mechanism

INTRODUCTORY REMARKS

There is a certain ambiguity about the meaning of "managing the exchange rate". Does it refer primarily to *intervention* in the foreign exchange markets? Or does it also include other policies (eg monetary, etc) which are apt to influence the exchange rate? Is the goal of exchange rate management supposed to be a specific exchange rate (incl. a specific target zone)? Or is it the management of a floating rate in the sense of (a) smoothing over erratic short-term movements, or (b) preventing excessive medium-term swings?

It may simplify things if I briefly summarise my own view on this matter.[1]

(a) Most countries cannot but have a conscious exchange rate policy, in the sense that *they cannot be indifferent to the level and the behaviour of their exchange rate*. The exchange rate is far too important a price—because of its effects on trade and the balance of payments, on domestic stability, on investment decisions, and not least on international trade and payments relations—to be treated with "benign neglect" or as a mere residual outcome of domestic policies here and abroad.

(b) Probably *only* one country, namely the United States, can afford to treat its exchange rate with "benign neglect". But even for the United States this neglect is not without some cost. Moreover, the American turnabout to non-intervention in the spring of 1981 does not necessarily mean that the US authorities don't have a view on the dollar rate. And they influence, of course, the dollar rate greatly—although not deliberately—by their domestic monetary and other policies.[2] But in market terms, the US dollar has reverted to the role of the passive n^{th} currency in the foreign exchange markets, a role which in the fixed rate system up to 1973 the Americans had been so eager to drop. In my view the rest of the world can live with this passive role of the Americans. *The European request for "joint action in the dollar market" is misplaced, except on an ad hoc basis in crisis conditions.* There are good reasons (which I have described in the attached Memorandum) why the United States is a special case with regard to foreign exchange intervention. The other countries should pursue their own exchange rate policy *vis-a-vis* the dollar, and not wait for the Americans to join in.

(c) It would be a misapprehension to confound exchange rate policy with intervention policy. Intervention has a role to play, both in the short run and in the medium run, and a more important role (according to my rather long experience) than dogmatic monetarists concede to it. But it is usually only a make-shift for smoothing over erratic short-term movements or for bridging the time until more fundamental factors can exert their influence. There are more important instruments of exchange rate policy, ranging from monetary measures to official borrowing abroad. Both in Britain and West Germany monetary policy in 1980–81 was largely oriented towards the exchange rate, because of its great short-run influence on domestic prices.

?

QUESTIONS RELATING TO THE EXCHANGE RATE MECHANISM

Q.1.

Monetary authorities have no way of knowing exactly what the "right" or "equilibrium" exchange rate is. But in most cases one can recognise when an exchange rate is *very much out of line* with fundamentals, is destabilising and distorting, and is likely to turn round again. Thus, one can only apply this negative test, not a positive one. There are several possible criteria: *inflation differences and concomitant changes in competitiveness* is one. But it is not always a good guide, especially in the short run. And which measure should

[1] Cf. also the attached Memorandum on "Exchange Rate Policy Reconsidered" which in a revised form will shortly be published as an "Occasional Paper" of the Group of Thirty. (Not printed herewith.)

[2] Over the last four or five months, in a rather absurd way a deterioration of the US budget outlook has often led to an improvement of the dollar exchange rate in the markets (because of its expected effect on US interest rates).

one employ: consumer prices, unit labour costs, GNP deflators? A common mistake is to start such inflation comparisons from an arbitrary period without examining whether the exchange rates were "in equilibrium" in the starting period. Most evaluations of the appropriateness of exchange rates in the EMS are made by simply comparing the different national rates since 1979 (or even: March 1979, the starting point of the EMS). This leaves out of account the likelihood that exchange rates in the EMS were somewhat out of line from the beginning. Another criterion for misalignment can be the *balance of payments on current account*. However, this is also not without problems. A change in the exchange rate usually takes time to be reflected in the trade and current account. Thus, the balance on current account is usually a lagging indicator and has, therefore, to be used with some caution. Moreover, structural changes in the capital balance have also to be taken into account.

In spite of the difficulty of defining precise criteria, it is not difficult to find examples where exchange rates were so much out of line that one can speak of a substantial misalignment. This is reminiscent of the story about the pretty girl: it is difficult to define her, but you recognise her immediately you meet her. One obvious example of a currency misalignment is the dollar/D-mark rate in 1981. Another one is the present undervaluation of the Japanese yen. The dollar/D-mark rate suffered from excessively large swings in 1980–81; at its high point in August 1981 (DM 2.57) it was nearly 50 per cent above its value at the end of 1979 (DM 1.73). The dollar was quite certainly overvalued in August 1981, and everybody (including central bank presidents) said so when the dollar was going above DM 2.40. It was astonishing that neither the market nor central banks were doing more to cash in on this opportunity.

The consequences of the roller-coaster movements and the overvaluation of the dollar in 1981 were the following: first, very disturbing uncertainties, with faulty signals given to trade and investment. Second, the overvalued dollar pushed domestic inflation rates in Germany (and other countries) far above the inflation rate expected on the basis of monetary and other data. Third, it undermined the competitiveness of the American economy and was partly responsible for an aggravation of trade frictions, especially with Japan, by distorting trade patterns. The present overvaluation of the dollar will probably be followed later on by a downward movement of the dollar, as soon as an American recovery makes the damaging effect of the overvalued dollar on the current account fully felt. Thus, one over-reaction is likely to breed another over-reaction in the reverse direction later on.

As concerns the *Japanese yen*, it became undervalued in 1979–80. The undervaluation was not fully offset by the subsequent recovery of the yen rate from the spring of 1980 to the beginning of 1981. Since then, the yen rate has again declined by 10 to 15 per cent, despite a substantial Japanese surplus on current account and despite the best performance of all industrial countries with regard to prices and unit labour costs. The main cause has been net capital exports which have exceeded the surplus on current account, and have been due to extremely high interest rate differentials in comparison with the United States and an untimely liberalisation of Japanese capital exports. The effect of the undervaluation of the yen has been a distorted trade pattern, aggravating the trade frictions with the US and the EEC. The premature liberalisation of capital exports has had to be paid for by increased protectionism and by artificial restraints on Japanese exports.

Q.2.

I think one has to distinguish between the short-run volatility of exchange rates, including erratic jumps from day to day or week to week, and larger swings lasting between four and 18 months, which significantly change the level of exchange rates and sometimes even lead from an overvalued to an undervalued position and vice versa. Finally, there are occasionally long drawn-out movements which may lead to long-term shifts in the relative levels of exchange rates. A good example is the appreciation of the D-mark over the period from 1971 to 1979 (with fluctuations in between) which led to a clear overvaluation in 1977–79; the subsequent downward movement of the D-mark has fully offset the previous overvaluation and led the D-mark, in real (inflation-corrected) terms, at the beginning of 1982 back to where it was in 1970–71. Correspondingly, the dollar regained, in real terms, in the two years from early 1980 to early 1982 more than it had lost in the preceding eight years, both bilaterally against the D-mark and also against a weighted average of a group of currencies (cf. Table 1).

As can be seen in Table 2, the *short-run volatility* of major exchange rates, after a decline in 1978–79, has increased again, mainly as a consequence of the very volatile American monetary policy since October 1979. Erratic jumps in exchange rates can certainly be burdensome for external trade. But they are no major problem for world trade and world payments, especially as exporters and importers can get forward cover through their banks over short periods. A study by the "Group of Thirty"[1] based on a detailed questionnaire to a number of internationally active banks and corporations brought rather surprising results: financial institutions, exporters and importers have learnt to cope with such short-term fluctuations. Most of them said that although floating rates introduced additional risks into international trade and investment, the costs involved were not material. None of the corporate treasurers questioned in the survey said that this had influenced the level of their company's international trade. I have, however, to make two reservations. First, only a limited sample of the largest multinational corporations were involved in this survey. Second, the survey was completed in October 1979, that is to say before the new period of turbulence in American interest rates and in major exchange rates. Erratic jumps can at least be mitigated and smoothed over by official intervention in the exchange market. The counter-argument that it is difficult to distinguish between short-term volatility and the beginning of a fundamental trend (which should not be opposed) does not carry too much weight. A central bank should ordinarily not try to hold a pre-determined fixed line and should always let part of the market pressure be reflected in the exchange rate. Thus, a fundamental change would not be impeded, but at most slowed down.

The real problem is medium-term volatility, which leads to *significant changes in the level of exchange rates* and may lead to over- and undervaluation. It is obvious that excessive medium- or longer-term swings can have disturbing effects

- — on the domestic inflation rates of countries with an undervalued currency (cf. the effect of the high dollar rate on European countries in 1981),
- — on the trade and current account of countries with over- or undervalued currencies, including negative effects on growth and employment (cf. the American experience where the change from an undervalued to an overvalued dollar in 1980–81 has had a remarkable impact on trade and growth),
- — on international trade by distorting trade patterns, fostering trade friction and protectionism (cf. the effects of the undervalued yen).

Forward markets cannot cope with the repercussions of such large medium-term swings. They could not, for example, prevent the impact of an overvalued dollar rate in the summer of 1981 on European import prices for dollar-denominated commodities ("equivalent to a third oil price explosion").

Q.3.

This question seems to imply that one could have a free choice between floating and fixed rates, based on an assessment of advantages and disadvantages. However, the transition to *floating against the dollar* in 1973 was no free choice but imposed on European countries by circumstances, and in particular by the enormous volume of volatile dollars in the world. Had it not happened in the spring of 1973, it would surely have come after the oil price explosion at the end of 1973, or—at the latest—at the time of the dollar weakness of 1977–78. Mr Witteveen, the then Managing Director of the IMF, said in a speech in January 1974: "In the present situation, a large measure of floating is unavoidable and indeed desirable."

This view had, however, nothing to do with the recycling of petrodollars. The exchange rate problem resulting from the oil price explosion was the enormous changes (and uncertainties) in the balances of payments, which would have made floating 'unavoidable' as a flexible adjustment measure, had it not already been introduced before. As concerns recycling, I would rather say that it was remarkable that international financial markets worked so well *in spite of* floating exchange rates.

I have to emphasise, however, that the unavoidability of floating refers only to the relation between European currencies and the US dollar (as well as the yen and a few

[1]Foreign Exchange Markets under Floating Rates, published by the Exchange Markets Study Group of the Group of Thirty, New York, 1980.

other currencies). The relations among European currencies can be governed by floating, a regional system of fixed parities, or anything in between. This requires a special analysis.

As a footnote I would remark that the reasons for free floating against the dollar are so compelling that they preclude even the fixing of a "target zone" for the dollar. This has been discussed at length in the past, and does not need detailed repetition here.

Q.4.

I refer to my "introductory remarks" on page 18. Most countries (except perhaps the United States) cannot but have an exchange rate policy in a very general sense. The objectives usually are: to avoid, as best one can, destabilising influences from a misaligned exchange rate on domestic prices, trade and investment, international trade and payments relations (trade frictions, protectionism).

One should, probably, also try to avoid too much short-run instability. This should, in principle, be the task of the exchange markets and of stabilising foreign exchange speculation. However, as the markets often seem to work in a destabilising direction (bandwagon effects, oversensitiveness to psychological and political influences), central banks may often feel induced to "lend the market a helping hand".

Q.5.

For a country like West Germany, this question would be easy to answer. *In the EMS*, the target of exchange rate policy is the fixed, but adjustable parities with the partner currencies. Here, the question is when—and how—occasional parity adjustments should be made in order to avoid the emergence of unrealistic exchange rate relationships. *In relation to the dollar*, one cannot (and should not) aim at a specific target rate. This is simply out of reach. One should avoid exchange rate movements which are so far out of line that they are destabilising. "Out of line" can mean (among other things): so far away from purchasing power parity. But as I explained above, there cannot be, in relation to the dollar, a specific positive target, at best the avoidance of too large a divergence. The main instruments for achieving this goal would be a combination of monetary policy and, as the case may be, official intervention.

For the *pound sterling*, which is floating against all other currencies, one has probably always to have the relationships against both the dollar and the EMS currencies in mind. In normal times, the Bank of England's weighted average sterling value may be a sufficient indicator. It would, however, probably be asking too much to try to stabilise this average (in real terms), especially if this should require too large interventions. Here again, "avoidance of too large divergencies" would be the only practicable goal.

I could imagine also another approach, namely to try to hold the pound sterling de facto stable against the EMS currencies without any formal commitment, but not with a 2¼ per cent range on either side of the supposed parities, but with a wider range, say 4 per cent. This could provide a useful test of what the consequences of UK membership in the EMS would amount to. This also would leave it open to adjust the de facto level of the pound against the EMS currencies without any publicity.

Q.6.

No comment (here the "management" of the exchange rate seems to be tantamount to having a specific exchange rate *target*).

Q.7

is practically answered by the preceding paragraphs. To repeat: in relation to the dollar, no formal commitment is possible, whether to a fixed rate, or a target zone, or a crawling peg. In relation to European currencies, an adjustable target zone as in the EMS may be practicable. In the EMS, the intervention obligations are fixed by international agreement. However, in practice a large part of the intervention in the EMS is done by using dollars, and also by intervening in EMS currencies intra-marginally. If the UK adopted a voluntary target zone approach *vis-à-vis* the EMS currencies, all sorts of intervention may be possible.

Q.8.

Here again the first question would be: what is meant by "managing the exchange rate"? I refer to my introductory remarks.

If one wants to keep one's exchange rate stable (or within reasonable bounds) in relation to other currencies one has—*in theory*—to pursue similar domestic policies. In practice, things are more complicated. Look at the German experience of the last few years: the German inflation rate was consistently lower than the American one up to the end of 1981;[1] the German money supply M1 (so dear to the heart of the monetarists) was growing more slowly than in the United States, and yet the D-mark lost more value against the dollar in 1981 than was considered tolerable for German stabilisation policy. Why? Because the United States had to work its way down from an inflation rate of 13 per cent, more than double the German rate, and therefore had much higher interest rates. Other complications may enter the picture from the side of cyclical differences between countries.

In a general way, every monetarist economist would say: if you have a money supply target, you cannot at the same time have targets for interest rates and the exchange rate. They are merely the result of market forces and have to be accepted as such. Monetarists are, therefore, always in favour of clean floating. For the same reason, most monetarists in Germany are hostile to the EMS in principle. Now I would agree that one cannot have a money supply target together with an interest rate target. One can, however, have a monetary target together with an exchange rate objective, if the latter is not defined as a fixed target rate of exchange, but in the above-described sense as avoidance of extreme and damaging aberrations. Here again, the German experience is useful: in 1981 the German money supply was on target, and there was no difficulty in maintaining the regional fixed (and occasionally adjusted) EMS parities. The dollar rate, however, rose more than was tolerable; in order to keep it within an acceptable range one would have needed a more restrictive monetary policy, practically an undershooting of the money supply target. In this dilemma, one had to decide whether the destabilising effect of too high a dollar rate was more damaging than a temporary undershooting of the monetary target.

As concerns coordination among a group of countries, the EMS group is, of course, a prime example. Again and again, ministers (or prime ministers) of the member countries have passed resolutions about the need for better coordination of policies. The monetary and fiscal policies of member countries are constantly being examined by experts' committees; advice and suggestions are being given. The result? The inflation differentials between member countries have not been reduced since the inception of the EMS in March 1979. The French are going their own way in economic policies, more so than in 1979. This lack of coordination can be compensated by occasional parity adjustments. There have been six over the last three years (two of which were minor ones). There are people in responsible positions who have said that such recurrent parity adjustments will undermine the EMS, while others have maintained that these adjustments show that the EMS is functioning well. I will leave it for the moment at that. I have briefly set out the experience with economic policy coordination in the EMS, because it seems to me that it answers practically all of Question No 8.

Q.9.

First, I believe that the uncertainties connected with the sudden and complete lifting of the British exchange controls on capital outflows in 1979 are now coming to an end. The same is probably true of the special position of the pound sterling as a petro-currency. Thus, the stage may soon be set for an attempt at aligning the pound sterling to the EMS. However, there is no urgency about it, as the present independent management of sterling seems to be working well. An interim period of de facto membership (as outlined in my reply to question 5) may be useful.

Second, as concerns coordination of exchange rate policies among a larger group, including the US and Japan, the answer is twofold: as I have mentioned before, I do not see any arrangement containing fixed rates or a target zone to be practicable in the foreseeable future, quite apart from the fact that the present US administration would never accept such a commitment (in this case rightly). I could, however, imagine useful *ad hoc arrangements* in exceptional situations between three or four important countries, such as we had at the beginning of 1975 among the central banks of Switzerland, Germany and the US, or in the dollar crisis of October 1978 among four countries, or in April 1980 between the Bank of Japan and the West German and Swiss central banks. They would not lay down specific exchange rate targets, but a coordinated intervention behaviour in

[1]Since then, the American inflation rate in terms of consumer prices has been very similar to the German one; unit labour costs, however, are forecast to increase in Germany by 2½–3 per cent, in the US by 6–7 per cent in 1982.

order to overcome specific crisis situations; in some cases, eg October/November 1978, they also included specific measures of monetary policy.

Q.10.

The only modification which I would suggest is a widening of the exchange rate margins beyond the present ± 2¼ per cent. As the example of the Lira (± 6 per cent) shows, this is possible within the present EMS arrangement.

Q.11.

I would be very cautious in envisaging "a more structured" system at the present time, whatever that may mean. The only practical evolution I could foresee in the short run would be better *consultation* among the major countries on their general aims in the exchange rate field, on their tolerances as concerns maladjustments and aberrations of important currency rates, and on the instruments of policy (intervention, monetary policy, etc) they intend to use. But there are enough international bodies for such consultation available already—regular central bank meetings at Basle, Group of Five, Group of Ten, etc. So it is more a question of willingness to use the available international bodies more intensively.

Q.12.

Cf. answer to question 5.

Q.13.

I do not believe in an institutionalised incomes policy.

I do, however, believe that for economic policy as a whole, including exchange rate policy, it is important how wages respond to the prevailing situation, eg to unemployment, low profits, etc. Example: the recent moderate wage round in Germany (average increase 4 to 4½ per cent) has improved the international competitiveness of German industry even without a change in the exchange rate; thus German monetary policy, which is still to some extent exchange-rate-oriented, has got a larger leeway for domestic relaxation without having to fear a too negative impact on the exchange rate.

The exchange rate can be used to hold down domestic prices and wages if, for instance, it is pegged to a currency which is relatively stable in terms of purchasing power. In a world-wide inflationary situation, the currency has to be kept *overvalued* for some time in order to exercise a stabilising effect. This was done successfully (but also brutally) by Chile when in 1979, at a time when their inflation rate was above 30 per cent, they pegged their exchange rate to the dollar. The effect was to bring their inflation rate down even below the American inflation rate. A similar experiment in Argentina, of disciplining prices and wages by an overvalued exchange rate, foundered miserably, however, in 1980. In Germany the *involuntary* overvaluation of the D-mark in 1977–78 doubtless had a stabilising effect on prices and wages. Needless to say, overvaluation must be applied cautiously as a stabilising instrument, as it can also have negative side-effects.

Q.14.

The second question sounds rather queer to me, and this in two respects. What has an international exchange rate arrangement to do with handing over the exchange rate to "international brokers"? Even completely free floating does not mean handing the exchange rate over to "international brokers", but rather to international market forces. Any "arrangement"—whatever is meant by it—means that the government (or central bank) has some influence on the outcome. Why is this undemocratic? Was the Bretton Woods Agreement, with its fixed-rate arrangement, undemocratic? In West Germany it was approved by parliament.

Q.15.

I am not clear to what "negotiations on the exchange rate and the harmonisation of economic policies" among the three countries this refers.

Q.16.

I believe that over the last five years the exchange rate system has not worked very well, but not because it is deficient in itself, but mainly because the underlying economic conditions in important countries have had a damaging effect on the international monetary system. The most destabilising factor has been extremely high and very volatile interest

rates in the United States and their distorting effect on exchange rates. Here the whole world is paying a high price for the past neglect of inflation in the United States and for their undue reliance on monetary policy (bad policy mix). A disturbing factor for the international system has also been the long duration of economic stagnation and recession in the United States. Exchange rates have also been distorted by the untimely liberalisation of capital movements in Japan at a time of extreme interest rate differences.

The answer to these deficiencies is not a change in the international monetary system, but a change in defective national economic policies. I do not see the connection between all that and the presumed move towards freer trade or greater protectionism, except that the undervaluation of the yen and overvaluation of the dollar, resulting from the above deficiencies, have fostered protectionism. The answer again is: correct the underlying faults.

Finally, this has nothing to do with the allegedly unequal pressures on debtor and creditor countries. The trade frictions between Japan and the United States happen to be between two countries which both belong to the group of creditor countries: in 1981 Japan had a surplus on current account of $4.7 billion, and the United States one of $6.5 billion. Both are likely to have a (modest) current account surplus in 1982. The same is true of trade frictions between the two surplus countries Japan and Britain, which have also led to dirigiste and protectionist measures.

B. The Instruments of International Payment

Q.17.

Those countries which have diversified their reserves or intend to do so in future see obvious advantages for themselves which I need not enumerate. Question 17 probably refers to the advantages and disadvantages for the international monetary system as a whole. Here it seems evident that the destabilising effects have been preponderant. There is no doubt that, when Germany had a current account surplus in the years up to 1978, reserve diversification into the D-mark increased the upward pressure on the D-mark exchange rate and the downward pressure on the ailing dollar. When the roles were reversed in 1980–81, some reverse flows again were destabilising.

One can assume that some diversification of reserves has become an unavoidable process. Then the main questions are: how can the process be controlled so that there is not too large a concentration of money flows from one currency to another in a short space of time? How can the alternative reserve currency avoid too great destabilising pressures from the inflows and a dangerously large exposure to liquid foreign claims?

Fortunately, there are reasons to believe that the process has probably reached some natural limits. This seems to me likely for the D-mark, which accounts for 12 to 15 per cent of the total foreign exchange resources of the western world.[1] If there should be another movement of reserve diversification it is likely to hit more the Japanese yen which at the end of 1980 accounted for only 3 to 3.5 per cent of the total.

Q.18. (no comment).

Q.19.

(a) At some future time, yes, if and when the neccessary preconditions are there. Not at the present time.

(b) There are at present no other practical ways of increasing the SDRs in official reserves (at a later stage there may be more SDR-denominated market assets which might also be acquired by central banks; they would, however, not have the same conversion privileges as SDR claims held with the IMF).

Q.20.

I see some advantages over the long term, but no prospect of it at the present time.

Q.21.

Logically it could be reconciled. However, one can use SDRs as an intervention medium only if and when there is a genuine and large market in short-term SDR assets (eg SDR sight deposits with banks).

[1]The percentage depends in part on the way in which ECUs and the dollars deposited in the EMS Fund are counted.

Q.22.

First, I do not see any reason why central banks should (or legally can) eliminate gold from their balance sheets as long as it has any value at all and central banks can either sell it or use it as collateral for borrowing needed foreign exchange. Second, why bother about an impossible hypothetical situation?

Q.23.

Yes, the Eurocurrency markets can be a problem for the control of international liquidity. All ambitious and ingenious plans for controlling them directly have proved impracticable. The only practical method at present seems to be the one which the Basle central bank group has favoured since 1978, namely to ask for a consolidation of the balance sheets of bank subsidiaries working in the international markets with the mother banks, and applying capital ratio provisions etc to the whole consolidated group. This is essentially a measure of banking supervision which, however, could indirectly contribute to controlling the overall expansion of the market.

Q.24.

No. I do not believe that such overall control of international liquidity will be achieved in the foreseeable future.

C. Institutions

Q.25.

These institutions are all we have and are likely to get. Properly used, they should do a reasonably good although never fully adequate job.

Q.26.

I do not see a serious danger of debt default leading to an international financial crisis. However, with the fall-out from the cases of Poland and Argentina, and with a number of other reschedulings waiting in the wings, it cannot be entirely excluded.

Here I would have to refer you to two recent reports of the Group of Thirty (International Banking Study Group), one of which has recently been published,[1] while the other is to be published soon.[2]

29 *May* 1982

[1] How Bankers see the World Financial Market, Group of Thirty, New York, 1982.
[2] Risks in International Bank Lending, Report of the International Banking Study Group of the Group of Thirty, New York, 1982.

FROM: DAVID PERETZ
28 January 1983

CHANCELLOR

cc Economic Secretary
Mr Burns
Mr Littler
Mr Middleton
Mr Carey
Mr Lavelle
Mr Kemp
Mr Odling-Smee
Mr Bottrill
Mr M A Hall
Mr Sedgwick
Mr Burr
Mr Ridley

TCSC: 31ST JANUARY

I attach briefing material for Monday's appearance. There is an index immediately behind this minute

D L C PERETZ

THE EXCHANGE RATE AND INTEREST RATES IN RECENT WEEKS

28/1/83

Facts

Since the end of October sterling has fallen [12%] in effective terms [8%] against the dollar, [13%] against the deutschemark, [22%] against the yen. Further comparisons (going back to 1976) are attached.

Key Points to Make

(i) Reasons for movement - fall in sterling partly arises from general realignment of currencies, with long expected rise in the deutschemark and yen (reflecting underlying strength of German and Japanese economies and their improving trade balance) and in recent days resurgence of the dollar (reflecting expectations of higher US interest rates); partly from weakness and uncertainty about world oil prices (lower price helps other countries and their currencies; has relatively small impact on UK). Irresponsible Opposition policy statements have not helped, as market begins to take some insurance against the (however remote) possibility of an Opposition election victory.

(ii) Fall does not reflect change of policy - monetary policy remains as it was, namely to maintain steady but not excessive downward pressure on inflation. The exchange rate is, of course, one ofthe indicators of monetary conditions that is taken into account in assessing the overall stance of policy. The Government's financial and monetary determination is showing excellent results:

- Government spending and borrowing are under control and on target;
- the Government deficit, as a percentage of GDP, is one of the smallest in the industrial countries;
- we continue to run a substantial current account surplus, larger in 1982 than the £3½ bn forecast only last November;
- inflation is falling, and fell faster over the last year than in any other major country;
- monetary growth is within the targets, and the signs are it will stay there.

the fall in the exchange rate does not signal the need for a major shift in policy.

(iii) Why did Interest Rates rise and why did you let them? - market pressures took interest rates higher and base rates followed. [To have resisted that move could have been interpreted as a weakening of the Government's resolve.]

(iv) What if Exchange Rate falls further - will you take action to stop Interest Rates rising? - Underlying monetary and economic conditions are sound, and in consequence there is no reason now for a further rise in interest rates. [However, any attempt to resist strong upward pressure from the market would have to be assessed in terms of its impact on expectations.]

(v) (Defensive) Impact of fall in Exchange Rate on Inflation - will no doubt be some modest impact on inflation of recent fall. But probably less or slower to come through than many commentators suggest. Reasons why major upturn in inflation not in prospect:

(a) importers into UK have had healthy profit margins and may be reluctant to raise prices in today's market conditions;

(b) food prices reflect the Green £ (fixed separately);

(c) commodity prices, including oil prices (one of reasons for exchange rate fall), are weak;

(d) continued monetary restraint offsets any tendency for impact on inflation to be more than temporary.

(vi) (Defensive) Exchange Rate fall shows need for target for Exchange Rate - No. The important thing is that overall financial policies are appropriate, and seen to be appropriate. The exchange rate is taken into account in assessing financial conditions, but it is not, and should not be, the only factor. Anyway, it would be very difficult to stick to any exchange rate target. A major international currency like sterling

cannot be immune from strong market pressures. Capital controls, intervention and joining the EMS do not provide the means of hitting an exchange rate target. Capital controls can be circumvented; intervention can rarely sustain an exchange rate significantly different from the market rate, at least without forcing a change in monetary policy; and membership of the EMS exchange rate mechanism is not a policy - merely a commitment to take policy action to try to defend a particular rate. (See separate briefs on each of these.)

(vii) Recent heavy Intervention indicates a shift in Exchange Rate Policy? - it continues to be the case that there is no exchange rate target; intervention is undertaken only to maintain orderly market conditions and smooth undue fluctuations in the rate.

(viii) Why was Reserve loss so high in December?-Market conditions were particularly unsettled last December - with sharp movements between other major currencies - the dollar, the yen and the deutschemark, and with the sterling market unsettled by the uncertain prospects for oil. In those circumstances it was hardly surprising that the Bank had to intervene on a slightly larger scale than usual in order to ensure sensible two-way trading and to preserve orderly market conditions. But the fall in the rate during December itself provides clear evidence against the notion of any 'target' level for the exchange rate.

(ix) Market Intervention in December? - It is not the practice to comment on the Bank's intervention tactics so no figure can be given. The published figure for the underlying change in the reserve is not necessarily a reliable guide to market intervention: it reflects other transactions as well.

(x) Who decides on the amount of Intervention? - (see separate brief on Intervention)

Background Facts

	Q4 1976	May 1979	Q1 1981	End October 1982	January 25 1983
Effective Exchange Rate	78.1	86.3	101.4	92.5	81.7
£/$	1.651	2.058	2.309	1.677	1.537
£/DM	3.977	3.926	4.814	4.291	3.725
Competitiveness* (RULC)	84.7	108.0 (Q2 fig)	155.0	135.5**	120.0**
Reserves($b)ø	4.1	21.5	28.2	18.5	17.0x
Official external debt ($b)	19.4	21.9	17.2	12.6	12.1x

* rise in index - fall in competitiveness

ø at end of period

** estimates, based on the assumption that UK unit labour costs rose at the average rate in other countries from 1982 Q2

x end-December figures

28/1/83

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x end-December figures

28/1/83

Statement on Current Account Surplus and Prospects

Members of the Committee will have noticed that the current account continues to perform very well. It looks as if the surplus for 1982 will be over £4½ billion*. This compares with the £3½ billion projected at the time of the Autumn Statement, and has been achieved without the benefit in 1982 of the EC Rebate we had then been expecting. Non-oil exports held up in 1982 despite falling world trade. In December the monthly value of UK exports topped £5 billion for the first time. There is no sign yet of any massive surge in imports. [It is hard to see this - as some would have us believe - as the performance of a country with an overvalued currency.]

2. Obviously there are great uncertainties. What will happen to world trade, what will happen to imports when current destocking comes to an end, what will be the effect of recent currency movements, and will the surplus on oil trade be maintained at the high levels we have seen recently? I would not want to pre-judge the Treasury forecast that will be published at the time of the Budget. But the prospects would certainly seem better now than they were in November.

* Final figures for invisibles for the fourth quarter have not yet been published.

28/1/83

COMPETITIVENESS: MUST THE NOMINAL EXCHANGE RATE FALL UNTIL COMPETITIVENESS RETURNS TO THE LEVEL OF THE MID-1970's (EG THAT OF 1975)?

Points to make

Any target for the exchange rate - nominal or real - must involve willingness to make very sharp changes in fiscal and monetary policy in the event of pressure on the exchange rate. Such changes in policy would not necessarily help achieve our broader aims - the achievement of low inflation in order to create the conditions for sustainable growth.

2. There is inevitably little agreement on the part of those who would like targets for the nominal or real exchange rate about what the target level should be.

3. Efforts in the past to achieve an arbitrary level of cost-competitiveness by depreciation have always failed. For example 1967, 1972, 1976. On each occasion it has eventually resulted in faster growth of labour costs in the UK relative to elsewhere, and as a result a damaging upward movement in inflation and a loss of competitiveness.

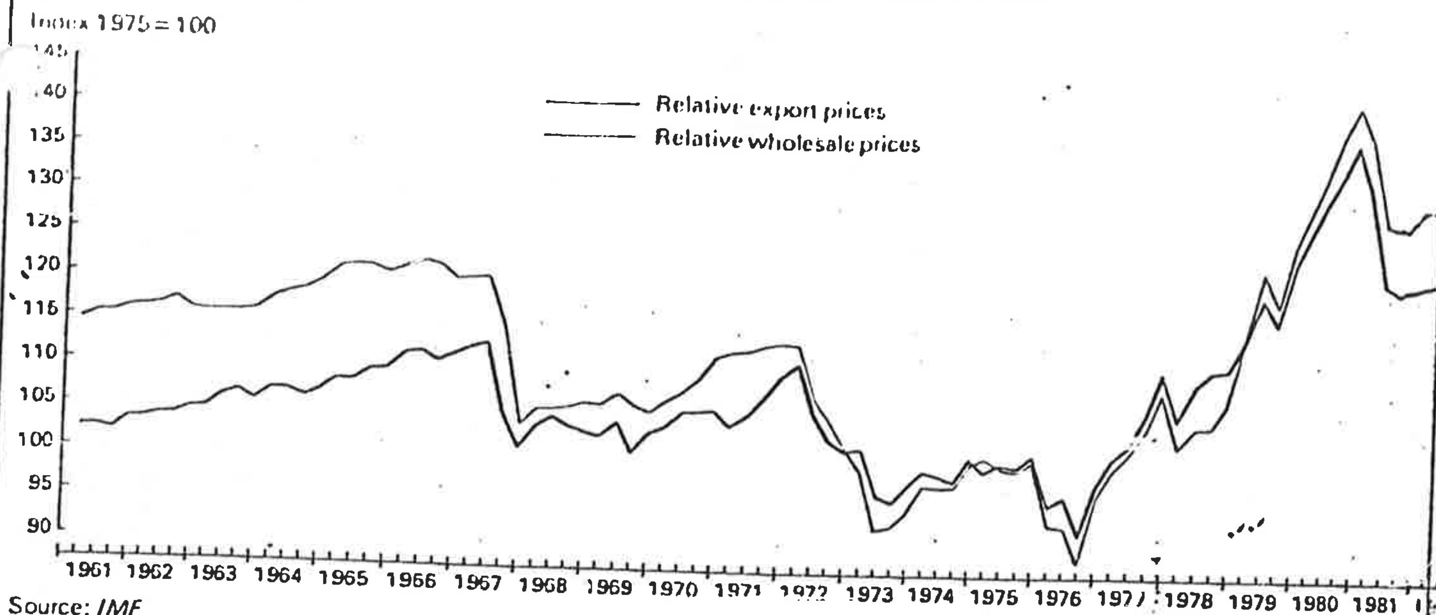
4. Lower pay settlements and higher productivity will improve competitiveness in a way that increases the profitability of industry. Such a gain in competitiveness will be sustainable. There is no painless way via currency depreciation to achieve a sustainable gain in competitiveness.

5. An improvement in cost-competitiveness during the 1970s brought about by depreciation did not stop our falling share in world export markets or rising import penetration of domestic markets.

6. There have been major structural changes in the UK economy since the mid-1970s; particularly the impact of North Sea oil production. This is likely to entail worse competitiveness (a higher real exchange rate) for some time than in the pre-North Sea period.

7. UK's balance of payments current account is in substantial surplus.

1



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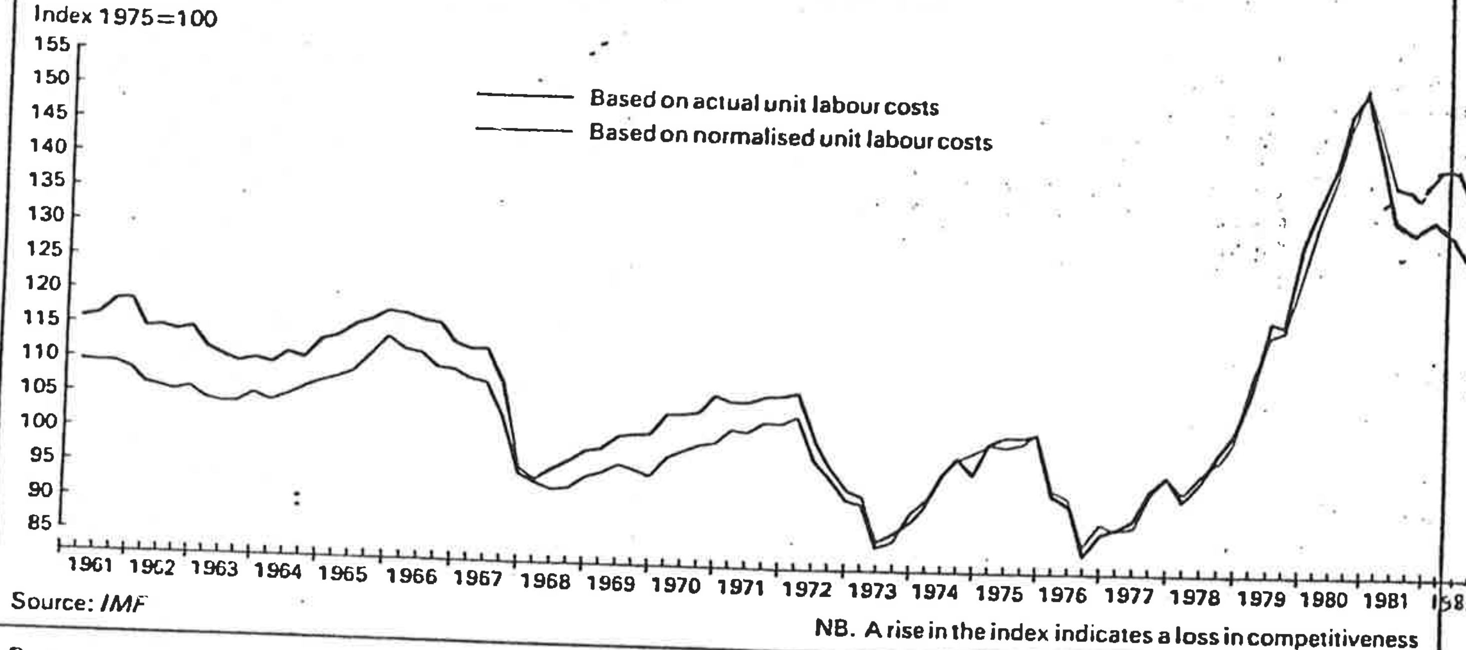

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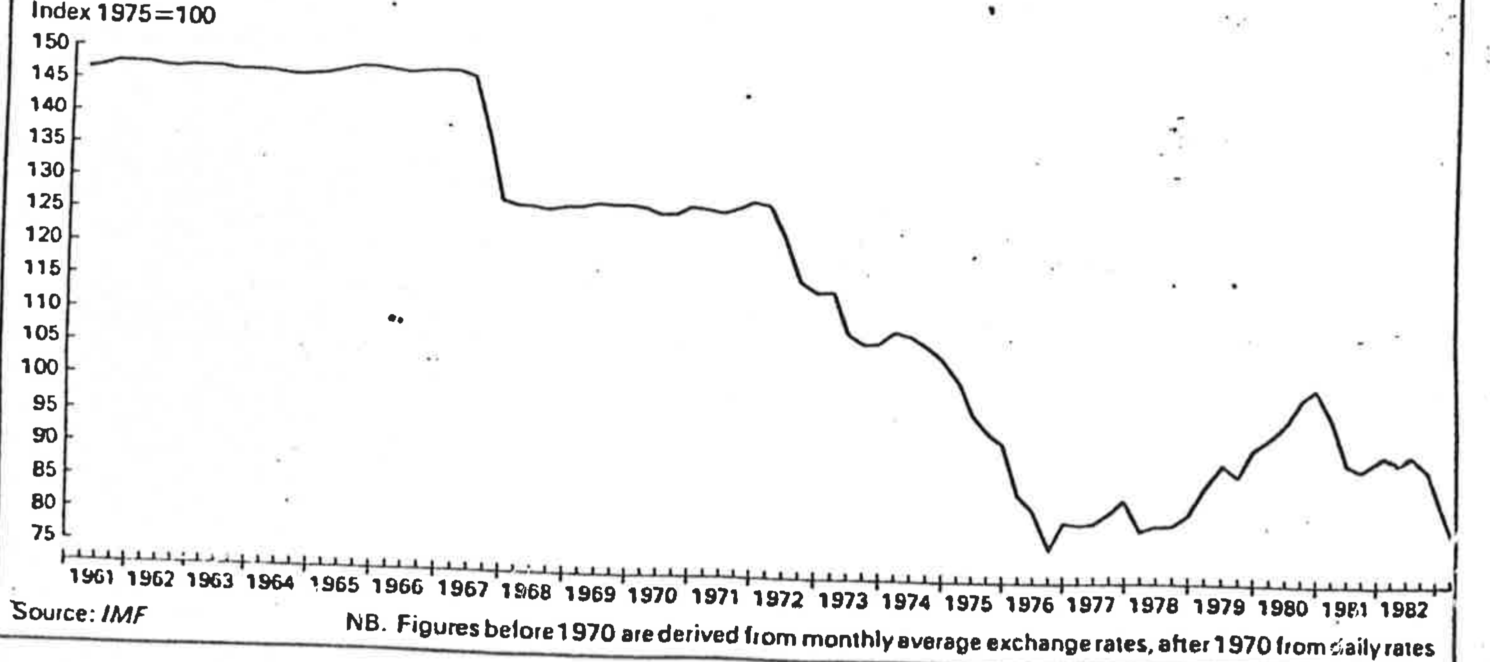

THE ROLE OF THE EXCHANGE RATE IN MACROECONOMIC POLICY

Extended Speaking Note

28/1/83

The Government's aim has always been to reduce inflation by monetary and fiscal means, and thereby create the conditions for sustainable growth. Monetary policy is directed at maintaining steady but not excessive downward pressure on inflation. It is operated flexibly. Thus the objectives for the monetary aggregates are expressed in the form of target ranges rather than point estimates. And a wide range of indicators is taken into account including not only the broad and narrow target aggregates set out in the last MTFS but also other indicators such as the exchange rate and real interest rates. There is no exchange rate target. But the level of the exchange rate is useful in assessing whether current policy is appropriate both because it is one indicator of existing monetary conditions and because it is part of the mechanism through which monetary conditions affect prices.

2. Both the level and the movement of the exchange rate can provide some indication of the tightness or otherwise of domestic monetary conditions. A falling exchange rate might be taken as a sign that domestic monetary conditions were unduly relaxed. On the other hand it could also reflect events in other countries or balance of payments developments of little direct consequence for UK monetary conditions. Thus although the exchange rate needs to be taken into account in assessing domestic monetary conditions, there can be no hard and fast rule by which exchange rate movements are linked to monetary and other policy decisions.

3. Conversely, the exchange rate provides one of the most important mechanisms through which changes in monetary policy are transmitted to prices. If there are rigidities in the domestic goods and labour markets then a change in monetary growth will tend to have its initial impact on the exchange rate (see brief on "overshooting" and "overvaluation"). A lower exchange rate means higher import costs for both industry and consumers. It is not easy, however, to determine the extent to which a fall in sterling will be reflected in a higher domestic price level. Much will depend on the circumstances surrounding the fall in the rate, eg on whether the Green £ adjusts, on whether the sterling/dollar

exchange rate falls in line with the effective rate, on the level of economic activity in the UK market and the degree of competitive pressure on importers to hold down prices etc.

Points to make

Exchange Rate Targets or Monetary Targets? The Government's Position

4. Experience both within the UK and elsewhere suggests that the control of inflation requires the control of some nominal magnitude. For a small open economy this could in principle be either the exchange rate or a domestic variable such as the money supply or nominal GDP. A completely fixed exchange rate would only be effective in controlling inflation to the extent that world inflation was also as a low and stable level. A planned exchange rate appreciation could reduce inflation. But we have severe doubts as to the ability of any country to control its exchange rate effectively in a world of greatly increased capital mobility and closely integrated financial markets. Attempts to fix the exchange rate in such an environment could involve very sharp and unpredictable changes in both fiscal and monetary policy. These would be disruptive and would not be a desirable way to achieve low inflation and sustainable growth.

Should the government have had an exchange rate target between 1979 and 1982, and if it had could it have been met?

5. Experience in recent years demonstrates the pressures - many coming from abroad and quite outside our control - to which exchange rates are subject. Any attempt to achieve a fixed or target exchange rate would have involved much laxer monetary conditions in the early years when domestic wage and price inflation was still higher. This would not have helped the UK economy to solve its long standing problems.

Why not targets for both exchange rate and money supply?

6. Most policy instruments, such as interest rates, influence both simultaneously. Capital controls and intervention in the foreign exchange market are two methods sometimes suggested for enabling money supply and exchange rate targets to be pursued independently. But capital controls have in practice proved to have limited effectiveness in sophisticated financial markets while intervention provided at most the prospect of a limited impact on the rate over the short run. Of course, on occasion separate monetary and exchange rate targets might be met, particularly if both were expressed as ranges. But when there is a clear conflict between them - as in 1977 - one or other must inevitably give way.

Would there be technical difficulties in making monetary targets conditional on exchange rate performance in a mechanical way?

7. The exchange rate is certainly a factor that should be taken into account in ~~the setting of~~ monetary policy. In this sense monetary policy - in common with that of a number of other countries - can be said to contain an element of conditionality. But a pre-announced commitment to allow monetary targets to change according to movements in the exchange rate - formal conditionality - is a different matter. Movements in the exchange rate will reflect other factors besides domestic monetary conditions, so there can be no simple mechanical link between the two.

A Crawling Peg for the (nominal) Exchange Rate?

8. This is subject to the same problems as any exchange rate target (see para 4 above); namely that with integrated financial markets and a high degree of capital mobility, it is difficult to control the exchange rate effectively.

Target for the Real Exchange Rate?

9. To attempt to hold the real exchange rate (and hence competitiveness) constant implies validating any surge in domestic inflationary pressures. It would remove an important aspect of discipline and could result in a vicious circle of high wage settlements followed by a fall in the nominal exchange rate, further inflation and even higher wage increases. It would seriously impair the ability of the Government to pursue an effective inflation policy.

Why not Interest Rate Targets instead of Monetary Targets?

10. Nominal interest rates provide an unsuitable target. When policy is directed towards reducing inflation, a nominal interest rate target may have the opposite effect from that intended. An unexpected rise in inflation will, for a given target, tend to reduce real interest rates and hence raise expenditure and place more upward pressure on inflation. While a real interest rate target would avoid this problem, it would be difficult to set it at the right level because of the problem of estimating inflation expectations correctly.

The Exchange Rate is (or was over the two years up to November 1982) misaligned

11. No. Part of the rise in the exchange rate in 1978-81 was attributable to oil-related factors. And some initial rise in the nominal exchange rate when disinflationary monetary policies are put in place is an important part of the process by which these policies influence inflation and the economy as a whole. As Dr Emminger explained in his evidence to the Committee, it would have been better if earnings and productivity had adjusted more quickly to the restrictive monetary policies so that the real exchange rate - although not necessarily the nominal rate - would have fallen earlier from its temporarily high level. But as they did not, the real exchange rate stayed high, as it had to if downward pressure on inflation was to be sustained. (See also briefs on "overshooting and "overvaluation" and competitiveness.)

28/1/83

"OVERSHOOTING" AND "OVERVALUATION"

Background: What are they?

The term "overshooting" is used by different people to mean different things. Often it seems to be used to describe any situation in which the exchange rate is higher than the speaker would like it to be. The usual sense in which it is used in technical discussions is to describe a situation in which the exchange rate has moved temporarily to above its long-term equilibrium level. Real overshooting, when the real exchange rate is higher than its long-term level, should be distinguished from nominal overshooting, when the nominal rate is above its long-term level.

2. Real overshooting tends to occur when monetary and fiscal policies are changed so as to bring about a sustained reduction in inflation. Financial markets adjust quickly to the change and cause the nominal exchange rate to rise, or to fall less than it otherwise would have done. If labour markets do not adjust as quickly, the real exchange rate also rises because earnings or productivity do not adjust quickly enough to offset the rise in the nominal exchange rate. This seems to have happened in both the US and the UK, although other factors have also contributed to exchange rate movements (eg North Sea oil in our own case). As a new lower level of inflation is achieved the real exchange rate, although not necessarily the nominal rate, can be expected to return to something near the level it would have been at, had inflation not been reduced.

3. Unlike overshooting, overvaluation does not have a technical meaning. It is used to indicate that the speaker thinks that the exchange rate should be lower than it is. Sometimes this view is based on a calculation of how much competitiveness has changed since a certain date (eg 1976), and sometimes on different short-term objectives from the Government's for inflation, output and the tightness of monetary conditions. That views on this should differ widely is hardly surprising, given the lack of any well-established criteria for deciding what an appropriate level for the rate should be.

Speaking Note

4. The level of the exchange rate is not an explicit objective of Government policy, and so it is not possible to say whether it is or was too high or too low at any one time in relation to some desired

level. Nevertheless, the broad movement of the real exchange rate over the last three or more years was entirely consistent with the strategy of reducing inflation. Monetary restraint raised the nominal exchange rate and, because domestic costs and prices did not adjust quickly, the real exchange rate rose too; in other words competitiveness worsened. The real exchange rate rose above, or "overshot", its long-term equilibrium level. But it was not "over-valued", in the sense of being inappropriately high. As Dr Emminger has said to the Committee, if earnings and productivity had adjusted more quickly, the real exchange rate would have fallen from its peak more rapidly, and perhaps not risen so far in the first place. But, given that this did not happen, the strong exchange rate played an important role in the disinflationary process, by reducing inflation and providing a stimulus for greater efficiency and productivity.

Points to Make

5. Should Government policy aim to eliminate real overshooting* if possible?

Not necessarily. In a small open economy the exchange rate provides an important route by which monetary policy acts to reduce inflation. Real overshooting was an intrinsic part of the disinflationary process, although it would have been less if earnings or productivity had adjusted more quickly. Any successful attempt to reduce or eliminate overshooting, whether by lower interest rates, larger fiscal deficits or intervention, would have undermined the achievement of lower inflation.

6. How long might overshooting* persist?

Adjustment lags in the domestic goods and labour markets may be such that real exchange rate overshooting can persist well into the medium term. In such situations governments have little choice other than to accept most of the overshooting which occurs. In practice, it is difficult to judge when the overshooting has come to an end, because there is no reason why the real exchange rate or competitiveness should return to any particular historical level. Indeed, North Sea oil has probably raised the long-term equilibrium level of the real rate somewhat.

* see next page

7. Can the period of real overshooting* be shortened?

Yes. As Dr Emminger explained to the Committee, faster deceleration of earnings and other domestic costs would bring the real exchange rate down to its long-term equilibrium level more rapidly. Changes in fiscal and monetary policy that are consistent with maintaining the disinflationary stance of policy cannot have much effect on the duration of overshooting.

8. Nominal exchange rate overshooting*

While disinflationary monetary and fiscal policies tend to cause the real exchange rate to overshoot, they do not necessarily cause the nominal rate to overshoot. The nominal rate may, of course, rise initially. But it may rise no higher than its long-term equilibrium, that is, it may not overshoot. This would be the case if all the fall in the real exchange rate from its maximum "overshoot" came about because of slower growth in UK than foreign costs rather than because of a fall in the nominal exchange rate.

9. Recent fall in sterling a correction for previous overvaluation of the nominal exchange rate?

The recent fall reflects a number of factors, including the changing prospects for oil prices and for the major economies (Germany, Japan, US). These are real factors, and it is hardly surprising that the exchange rate responds. The Governemnt has always maintained that as its counter-inflation policies succeed and the recovery gets under way there will be an improvement in competitiveness. The best way for this to be achieved, however, is through slower growth of domestic wage costs rather than a fall in the nominal exchange rate.

10. The high level of sterling shows exchange markets to be unstable therefore need for exchange controls, intervention

No. The high real exchange rate concerns the failure of other markets to adjust (particularly domestic wages), rather than a failure within the exchange markets. Exchange controls, to the extent that they were effective, would direct attention away from the real problem. Intervention would tend to undermine monetary policy. There would be less incentive for other markets to undertake the necessary adjustment if there were no real overshooting, that is if the exchange rate mechanism were not allowed to work.

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*"Overshooting" in paragraphs 5-8 is used in the technical sense to mean that the exchange rate rose above its long-term equilibrium.

DR EMMINGER

28/1/83

The Opposition have made a great deal of the following quotation from a paper submitted by Dr Emminger to the TCSC in the course of their IMA enquiry. It features, for example, in Mr Shore's 23 November "Programme for Recovery".

> "At its peak in February 1981, the "real" sterling exchange rate was not only about 50% above its depreciated value of 1976, but about 30% higher than in 1972. This is by far the most excessive overvaluation which any major currency has experienced in recent monetary history. It dwarfs the "real" upvaluation of the D-Mark between 1972 and its peak at the beginning of 1980, which was slightly above 10%. The large real appreciation of sterling from 1979 to 1981 was probably the most important single element in that period's British economic policy, as concerns its effects both on domestic inflation as well as on British trade, production and employment".

Points to make

2. There are two points to make about this statement.

(i) The Opposition have taken it out of context. In the paper Dr Emminger was using sterling's experience as just one, albeit the sharpest, of many huge swings between major currencies in the 1970's and 1980's. He was making the point that we live in a world where such swings happen - and indeed that there is not much that can be done about them.

(ii) Dr Emminger expanded on his views in a subsequent oral hearing by the TCSC on 25 October 1982 (now published). He said:-

(a) The effect on British production and investment was serious not so much because of the appreciation itself but the inflexible reaction to it, particularly "as concerns wage developments".

(b) He did not think very much could have been done about the appreciation, which in any case

(c) probably in part reflected previous undervaluation of the £.

(d) Large countries with open economies and free capital movements, like the UK and Germany, cannot adopt a fixed or target rate in relation to the dollar.

Background: verbatim extracts from oral evidence

(i) "What I meant is whether a larger country, with an open economy and free capital movements, like the UK or West Germany, could adopt a fixed or target rate in relation to the dollar. It could not. We have seen that a fixed rate vis a vis the dollar is an invitation for big speculative flows whenever a lack of confidence in the dollar or in the other currency arises. Why? Because there are hugh amounts of volatile dollar funds in the world.... so we have to live with a floating dollar. What we should aim at, is to get better underlying conditions for the floating system eg to have better convergence of economic, in particular, monetary policies between the Americans and Europeans and the Japanese ...."

(ii) /In reply to a question from Mr English who quoted the last sentence of the passage at the beginning of this brief, and then asked Dr Emminger whether he meant that manufacturing industry and exports were sacrificed to keep the inflation rate down./ "Perhaps I should not have made that remark .... I do not subscribe to the word "sacrifice" .... because the real effect of that appreciation very much

depended on the British economy .... was rather inflexible as concerns wage developments, which, of course, meant there was quite some effect on employment and production .... Secondly also I do not think that very much could be done against that and, furthermore, this record appreciation consists of two elements, not only that the pound went up but also that before it was probably undervalued ...."

EXCHANGE CONTROLS

28/1/83

Factual

Exchange controls restricted transactions between residents and non-residents. They were introduced at the beginning of the Second World War to make gold and foreign currency available for the war effort. They were retained in the post war years when thre was a need to defend a fixed exchange rate despite recurring current account deficits. The growth in trade flows and capital markets made exchange controls ineffective and the easing of the balance of payments constraint as North Sea oil was developed made them irrelevant. They were abolished in October 1979.

Points to make: Positive

(i) Exchange controls have little effect in the face of strong market movements as in 1967 and 1976, for example. They did not control leads and lags on payments for imports and exports (one month's movement in payments on goods alone now totals around £10bn). And exchange controls did not prevent non-residents from switching funds between sterling and other currencies.

(ii) There needed to be a correspond capital outflow to match the huge current account surpluses of recent years. Removing exchange controls on UK residents outflows will have helped this adjustment, reducing upward pressure on the exchange rate. At the same time any increase in UK interest rates due to the abolition of controls is likely to have been small [Because the free access of overseas investors to UK financial markets will have tended to keep UK interest rates in line with world rates, even when exchange controls on UK residents were in force] .

(iii) With modern communications and increased interdependence between countries no exchange control regime acceptable in a democracy can prevent movement out of an internationally traded currency like sterling.

(iv) The only defence against speculative flows is to maintain confidence by pursuing the right monetary and fiscal policies.

(v) Exchange controls reduce the efficiency of financial markets.

(vi) They impose an administrative burden on both public and private sectors.

Defensive

(vi) Abolition has led to huge outflows. The net capital outflows in recent years simply reflect - as a matter of arithmetic - the large current account surplus. Just as a country in deficit has to borrow abroad, a country in surplus improves its international balance sheet. Our balance between overseas assets and liabilities is in a better state than it has been for years - and this will provide a useful source of net revenue from overseas for the future.

(vii) Capital outflows mean lower investment at home. Abolition of exchange control has had no direct effect on net capital flow. But it may have meant larger UK investment abroad matched by higher investment in the UK - or a lower level of withdrawal of funds - by overseas investors. Much of our investment abroad increases our access to overseas markets and exports, encouraging increased investment at home also.

(viii) Economy vulnerable because short term inflows offsetting long term outflows. There was nothing in the exchange controls operated by the previous Government to stop such inflows.

(ix) Why retain the Exchange Control Act 1947 on the statute book. We are required by the European Communities Council Directive of 21 March 1972 to be able to act, where necessary, on capital flows without further enabling measures.

28/1/83

INTERVENTION

(i) Role of Intervention - Experience both in the UK and in other countries strongly suggests that intervention has been most successful when related to very short-term objectives such as preserving orderly market conditions, smoothing erratic fluctuations etc. It has not been an effective instrument on its own for influencing the exchange rate over longer periods of time. The classic example here is the 1977 UK experience when the attempt to prevent the rate appreciating had to be abandoned because of the consequences for domestic monetary control. The main role of intervention is perhaps to give the authorities time in which to consider the causes of the current bout of pressure on the exchange rate and the appropriate policy response.

(ii) Limits to Intervention - There are limits to the scope for intervention in either direction. Prolonged support soon exhausts the reserves while borrowing capacity is not unlimited - international capital markets are now well acquainted with the concept of 'sovereign risk'. Neither can borrowing normally be arranged at very short notice. Similarl sustained increases in the reserves soon create problems for monetary control.

(iii) Problems with an Active Intervention Policy - Exchange markets are subject to considerable random variation - they can jump in response to 'news', bandwagon effects etc. This makes it difficult for the authorities to distinguish

(ix) How much Intervention has there been?

Much less under this Government than under previous governmen[ts] in the UK; and much less than in many other countries, especially those that are committed to an exchange rate target (eg France).

JURGENSEN GROUP

SPEAKING NOTE

28/1/83

In my Fund speech, I said that I hoped study would not be an academic exercise or a means for each country to justify its present practice. The object should be a meeting of minds not a widening of differences.

This still seems to me right. As I understand it the Working Group are now reaching the stage of completing their report. This will be looking at the objectives of intervention, and how effective it has been - in effect a pooling of past experience. When this analysis is complete - and my impression is that a pretty thorough job will have been done - I think the next step will be for Deputies to see what they make of it. The issues would come to Ministers. But for the moment I cannot say more than that. No decision has been taken for example about publication.

BACKGROUND NOTE (CONFIDENTIAL)

The Group was established at the Versailles Summit. The Commission participate as well as the G-7 countries. It has had many meetings, and produced a mass of background material. By and large the conclusions seem likely to be in line with existing UK policy: it will not suggest that intervention by itself can stand in the way of major market trends; it will suggest useful modest "smoothing" role. G-7 Ministers will have to consider the Report before the Williamsburg Summit.

28/1/83

International exchange rate coordination (and Versailles initiative)

Points to make

1. There is understandable nostalgia for the Bretton Woods regime of fixed exchange rate. But we need to remember the conditions that led to the breakdown of that system, and which make its simple reimposition today so impracticable. High and varying rates of inflation in the major economies, in particular. The huge increase in internationally mobile funds. The after affects, that are still with us, of two major oil price rises in a decade.

2. We should all like to see a return to greater currency stability. That was agreed as a desirable objective at last year's Versailles summit [Copy of the "Monetary Undertakings" attached]. It was also agreed that such stability must rest on greater convergence of policies and economic circumstances. In particular convergence towards lower and more stable inflation. There is no short cut to currency stability. I was impressed by the views expressed to you by practical and experienced men - like Dr Emminger and Dr Reike of the Bundesbank - that achieving such stability as between the world's major currencies is not a simple matter, or something that can be done by the mere exercise of political will or by establishing exchange rate mechanisms or new bureaucracies.

3. The statement of international monetary undertakings agreed at Versailles recognised the responsibility to the rest of the world of the major countries to maintain "the internal and external values of our currencies." It also ruled out competitive devaluations. The soundness of the multi-currency reserve system imposes a special responsibility on countries like the UK, whose currency feature in the SDR, to maintain

the value of their currencies. [A thought I might leave with the spokesmen for the official Opposition]. ?

4. We have begun to make some progress on these matters, with the Managing Director of the IMF playing an important role. But I certainly would not want to pretend that I am content with this .. Simply talking is not enough. It is one of the matters I will want to pursue in my role as Chairman of the Interim Committee.

5. I would say, however, that I think it helpful that there is maybe an increasing recognition - perhaps even in the US - that it is right to take account of the performance of one's currency alongside monetary aggregates and other factors in assessing domestic monetary conditions and in interest rate policy. This will not fix exchange rates one against the other, but it will be a further factor tending to bring about convergence between the major economies, greater stability between their currencies, and a healthier development of the multi-currency reserve system.

Will this ever result in a system of exchange rate targets/zones that the UK would join?

6. One can certainly hope, as lower inflation and stability return, and as exchange rates become more stable that it might prove possible and helpful to provide cement for the system in the form of some new set of international exchange rate arrangements. The time for that, I would judge, isa good way offyet. When the day comes, certainly it would be right for sterling to participate along with the other currencies.

STATEMENT OF INTERNATIONAL MONETARY UNDERTAKINGS

1. We accept a joint responsibility to work for greater stability of the world monetary system. We recognize that this rests primarily on convergence of policies designed to achieve lower inflation, higher employment and renewed economic growth ; and thus to maintain the internal and external values of our currencies. We are determined to discharge this obligation in close collaboration with all interested countries and monetary institutions.

2. We attach major importance to the role of the IMF as a monetary authority and we will give it our full support in its efforts to foster stability.

3. We are ready to strengthen our cooperation with the IMF in its work of surveillance ; and to develop this on a multilateral basis taking into account particularly the currencies constituting the SDR.

4. We rule out the use of our exchange rates to gain unfair competitive advantages.

5. We are ready, if necessary, to use intervention in exchange markets to counter disorderly conditions, as provided for under Article IV of the IMF articles of agreement.

6. Those of us who are members of the EMS consider that these undertakings are complementary to the obligations of stability which they have already undertaken in that framework.

7. We are all convinced that greater monetary stability will assist freer flows of goods, services and capital. We are determined to see that greater monetary stability and freer flows of trade and capital reinforce one another in the interest of economic growth and employment.

28/1/83

COMPETITIVENESS

1. All measures of cost competitiveness risk misinterpretation by the wider public

Our present level of competitiveness is usually compared with the position prevailing in 1975, since that is the base on which the CSO currently construct their statistics. But the 1975 date has no special status. Movements in competitiveness can be measured just as satisfactorily from a base in 1979, 1981 or any other year. Indeed, the major structural changes which have taken place in the UK economy, such as the high impact of North Sea oil production on the current account of our balance of payments, make comparisons with 1975 inappropriate.

Similarly, while a cost-based measure which gives weight to both price and profitability factors is probably the most appropriate single indicator of competitiveness, other measures are also available, such as relative export prices or the trade weighted effective exchange rate. The table below illustrates what varied results can emerge if only four different indices and three different bases are used, with changes in competitiveness ranging from a 27 per cent deterioration to a 23 per cent improvement:

PERCENTAGE CHANGE IN COMPETITIVENESS ON VARIOUS MEASURES

	Relative actual unit labour costs	Relative normalised unit labour costs	Relative export prices	Effective exchange rate (trade weighted) +
1975-Jan 1983*	-19	-27	-7	-20
Q2 1979-Jan 1983*	-10	-14	+1	-6
Q1 1981-Jan 1983*	+23	+19	+21	-20

*Positive sign indicates improvement in competitiveness (ie a fall in the index)

+The trade weighted effective exchange rate used by the IMF to calculate competitiveness differs slightly from the usual index.

Each of these figures could legitimately be said to provide an indication of the UK's competitive performance; no one figure is the "correct" one. It may thus be unhelpful if a single figure, representing the movement of just one index from an arbitrary date, becomes lodged in the public mind as the definitive measure of UK competitiveness. Similarly, there is no reason to regard it as an objective of policy to return to a particular level of competitiveness which prevailed in the mid-1970s.

2. Improvements in competitiveness are not solely dependent on exchange rate movements

The key to improved competitiveness lies not in a further depreciation of sterling but in a lower level of pay settlements and still higher productivity. The exchange rate fell sharply in 1967, 1972 and 1975, yet on each occasion this was simply reflected in a faster growth of labour costs in the UK relative to other countries; we became less, rather than more, competitive, our share of world export markets fell and the import penetration of our domestic market rose. This point is still not widely appreciated and there are many who continue to believe that the solution to our poor performance lies in a further exchange rate fall. There is thus a risk that the more our loss of competitiveness is emphasised, the greater will be the pressure for a further depreciation, with, perhaps, the effects on the markets which we have experienced in recent weeks, while the important arguments in favour of improvements on the pay and productivity fronts will go largely unheard.

3. Relative prices, profitability and costs are not the only influences on competitiveness

If competitiveness were simply a reflection of movements in relative unit labour costs, there could be little explanation of the substantial surplus we are currently recording on our balance of payments current

account, nor of the fact that the UK share of world trade rose in volume terms last year. UK output has also been rising relative to output in the major industrial countries since mid-1981. These are all encouraging signs but we are not out of the wood yet and we need to improve our performance in such "non-price" areas as design, reliable delivery, marketing and after-sales service at the same time as we seek to cut costs.

[illegible]

28/1/83

Background

1. The UK is a founder member of the EMS and participates in negotiations on its modification and in realignment conferences, although the pound does not participate in the exchange rate mechanism.

2. The fundamental difficulty with participation is that the adherence to an exchange rate target might conflict with achieving domestic monetary aims. Some of the smaller countries whose financial systems are inevitably interlinked with those of a larger country (usually Germany) do not, anyway, have much scope for pursuing an independent monetary policy. A fixed exchange rate with the larger country provides the appropriate financial discipline in their case.

3. After enjoying a relatively tranquil two years since its inception in 1979, the EMS has in the last 18 months encountered more difficult conditions with major realignments taking place in October 1981 and February and June 1982. In September and October the market regarded the French franc and Danish krona as being liable to devluation against the relatively strong deutschemark and guilder. More recently the French and Belgian francs have also been under pressure, while the guilder and Danish krona have been the strongest currencies in the system.

4. Between June and October the pound enjoyed a period of relative stability against the deutschemark with the rate mostly in the range DM 4.26-4.30. However, from mid-November it weakened sharply, reaching a low of DM 3.676 on 11 January.

Points to Make

5. UK Membership would increase exchange rate stability?

There is no reason to suppose that the simple act of joining the EMS exchange rate mechanism would necessarily have an impact at all on exchange rate stability. This has not been the experience of the current participants. Lasting stability requires a return to low and convergent inflation rates throughout the community.

Reasons for not joining

Successive governments have decided not to join the exchange rate mechanism, because sterling's exposure as an international traded currency and its status as a petro-currency both make it vulnerable to large speculative flows between sterling and other EMS currencies. Recent events have demonstrated that sterling can still be affected sharply, and in a different way from other European currencies, by shifting expectations about oil prices.

28/1/83

EMS EXCHANGE RATE MECHANISM

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28/1/83

Major Currencies' Exchange Rate Fluctuations

Attached is a list of significant falls in exchange rates for major currencies since 1976, together with brief explanations of market conditions at the time. However, it must be emphasised that exchange rate changes reflect the outcome of many economic factors, and the causes perceived by market practitioners at the time may merely have been triggers for exchange rate adjustments necessary to correct more profound and longer-term imbalances. Economic researchers have had very little success indeed in explaining, after the event, for the major fluctuations that have occurred.

Major Currencies' Exchange Rate Fluctuations

For reference sterling's recent fall has been as follows:

	$/£ rate	effective rate
October 1982 average	1.6977	92.5
26.1.83	1.5470	81.2
Depreciation	-8.9%	-12.2%

YEN

1. Depreciation of November 1978

	Y/$ rate	Y effective rate
31.10.78	177.60	158.9
30.11.78	199.10	146.5
% change	-10.8%	-7.8%

The yen fell in largely reaction to policy measures designed to support the dollar: higher US interest rates and massive coordinated exchange market intervention. However, in part the fall also reflected an emerging deterioration in Japan's trade balance as exports performed weakly in response to rising domestic demand and the loss of competitiveness at such a high yen exchange rate.

2. Depreciation of March, April 1979

	$/Y rate	Y effective rate
28.2.79	202.35	142.6
30.4.79	219.77	130.6
% change	-7.9%	-8.4%

The yen's weakenss reflected a continued deterioration in Japan's current account accompanied by continued capital outflows. Japan's vulnerability to the tightening of international oil markets also contributed to the yen's fall.

Over the six-months of November 1978-April 1979 the yen fell by 19.2 % against the dollar, and by 17.8% in effective terms.

3. Depreciation of September-November 1979

	$/Y rate	Y effective rate
31.8.79	220.60	129.4
30.11.79	249.42	113.3
% change	-11.6%	-12.4%

The renewed fall in the yen followed the announcement of a current account deficit for July, further news of higher oil prices and supply difficulties and the deteriorating political situation in Iran.

4. Depreciation of January-July 1981

	Y/$ rate	Y effective rate
31.12.80	203.15	114.4
31.7.81	239.67	136.2
% change	-15.2%	-5.7%

The fall largely reflected the sharp appreciation of the US dollar in 1981; the fall in the effective rate was relatively modest. Relatively low Japanese interest rates were a significant factor in the fall against the dollar.

5. Depreciation of January-March 1982

	Y/$ rate	Y effective rate
31.12.81	219.55	144.9
31.3.82	247.62	133.7
% change	-11.3%	-7.7%

The yen's fall on this occasion resulted from large capital outflows reflecting the low level of Japanese interest rates, particular vis à vis the United States.

6. Depreciation of June-October 1982

	Y/$ rate	Y effective rate
31.5.82	243.00	135.1
31.10.82	277.01	125.2
% change	-12.3%	-7.3%

The yen's further fall reflected the continuation of the wide interest rate differential between the yen and the dollar. Political uncertainties following the resignation of the Japanese Prime Minister also contributed to the yen's weakness.

DEUTSCHEMARK

1. Depreciation of March 1980

	DM/$ rate	DM effective rate
29.2.80	1.7760	157.1
3.4.80	1.9627	150.0
% change	-9.5%	-4.5%

The deutschemark's fall was largely in reflection of the dollar's steep rise following the setting of a record high US discount rate in February and the announcement by President Carter of an economic package on 14 March.

2. Depreciation of October 1980-July 1981

	DM/$ rate	DM effective rate
30.9.80	1.8112	153.0
31.7.81	2.4652	116.2
% change	26.5%	-24.1%

This prolonged period of deutschemark weakness resulted from the weak German balance of payments (with current account deficits) and the adverse interest rate differential with the US.

3. Depreciation of December 1981-March 1982

	DM/$ rate	DM effective rate
30.11.81	2.2052	122.8
31. 3.82	2.4120	123.0
% change	-8.6%	+0.2%

The deutschemark's renewed fall largely reflected the dollar's strength at that time - in effective terms the deutschemark was little changed. In the US the growth of the money supply exerted an upward pressure on interest rates and hence the exchange rate.

4. Depreciation of June-mid-August 1982

	DM/$ rate	DM effective rate
31.5.82	2.3405	125.1
9.8.82	2.5216	124.3
% change	-7.2%	-0.6%

The continued strength of the dollar in reflection of high dollar interest rates brought about this further fall in the deutschemark.

FRENCH FRANC

1. Depreciation of March -July 1976

	Ff/$ rate	Ff effective rate
29.2.76	4.4867	108.9
31.7.76	4.9145	100.6
% change	-8.7%	-7.6%

The French franc began this period of weakenss inside the European "snake", but realignment pressures between the franc and the deutschemark became so intense that on 15 March 1976 the franc left the arrangement and floated. It subsequently fell further against the dollar owing to poor trade figures, pessimism over the outlook on inflation and, in July, fears that a drought would adversely effect the economy.

2. Depreciation of April-August 1981

	Ff/$ rate	Ff effective rate
31.3.81	4.9350	87.4
7.8.81	6.0775	80.6
% change	-18.8%	-7.8%

The franc was weak in April and May because of political uncertainty during the French Presidential election. Subsequently the overall strength of the dollar was reflected in a further weakening of the franc.

3. Depreciation of December 1981-March 1982

	Ff/$ rate	Ff effective rate
30.11.81	5.5675	81.5
31. 3.82	6.2515	79.0
% change	-10.9%	-3.1%

This period was one of considerable dollar strngth, and coincides with the third depreciation of the deutschemark which was noted above. However, the French franc fell a little further than the deutschemark (despite their being linked in the EMS) reflecting political uncertainties surrounding the local elections in March.

4. Depreciation of June-mid August 1982

	Ff/$ rate	Ff effective rate
31.5.82	6.1070	79.7
9.8.82	7.0140	73.5
% change	-12.9%	-7.8%

The French franc was devalued in the EMS by 5.75% on 13 June 1982. This reflected the concern felt in the markets about the prospects for inflation and balance of payments in Frence. In July and early August the strength of the dollar also contributed to the franc's fall.

US DOLLAR

1. Depreciation of June-October 1978

	$ effective rate
31.5.78	89.6
31.10.78	78.9
% change	-11.9%

The dollar fell largely due to market concerns about the adequancy of US monetary and counter-inflation policies. The fall was exacerbated by the publication of poor trade figures in July, and by the difficulties the Energy Bill encountered in Congress in October.

2. <u>Depreciation of April-June 1980</u>

	$ effective rate
31.3.80	90.8
30.6.80	83.5
% change	-8.0%

The dollar's fall reflected the easing of US interest rates from their early April peaks; signs that the US economy was entering a recession; and in April the unsuccessful attempt by the US Government to free the hostages in Iran.

3. <u>Depreciation of November 1982-January 1983</u>

	$ effective rate
15.11.82	126.1
10. 1.83	116.4
% change	-7.7%

Falling US interest rates together with a change in market sentiment in favour of the yen and deutschemark led to a sharp fall by the dollar. However, this has since been partly reversed as expectations have grown that dollar interest rates have reached their floor.

28/11/83

Effect of Oil Price Changes

Advice in light of changes made by G.M., PSM?

A. A lower oil price is on balance good for the UK. Large disruptive movements in any direction in no-one's interest: disrupt the world economy. If the price falls too low, future sharp rise may become inevitable. But a modest/gradual fall on balance good for the UK. Reduces inflation in the world, and raises growth, both of which are helpful to our industries - and offset relatively modest direct impact on the trade balance. Oil accounts for relatively small proportion of UK economy and overseas trade.

2. Improves output. Oil importing countries have better balance of payments, lower inflation, and can therefore go for faster growth. British exporters gain from higher world output and trade.

3. Reduces inflation. Direct benefit for inflation enhanced for countries that are oil importers, to the extent that their currencies rise; offset for us to the extent that sterling falls.

4. Impact on PSBR. Lower North Sea revenues would initially add to PSBR. But for this purpose the sterling price of North Sea oil counts, not the dollar price. Fall in £/$ rate since Autumn is enough to offset effect on revenues of significant fall in oil price.

5. Effect on Exchange Rate. Not surprising that changes in world price of oil affect currencies. Impact of a fall on UK modestly helpful (see above). Bigger benefits for other major currency countries (Germany and Japan in particular) that are large net importers of oil . So raises the value of their currencies against sterling. Part of the recent fall in sterling reflects expectations that oil price would fall, so if fall does occur it may already be discounted in exchange markets. No domestic reasons for sterling to fall: underlying UK monetary and financial conditions remain sound.

6. <u>Effect on UK current account</u> is not large, because net oil exports are only a relatively modest part of our overseas trade, any fall in £/$ exchange rate raises their sterling value. Current account would have been in very substantial surplus last year even had oil prices been 10 or 20 per cent lower. [Taking the <u>direct</u> impact only - and forgetting any effect on exchange rate the benefits to UK exports from better world growth - with a 10 per cent lower oil price the current account surplus last year would have been around £½ billion lower than the £4½ billion actually secured.]

7. <u>No reason to think a modest fall will necessarily worsen international banking problems</u>. Most developing countries benefit from lower oil price. Indeed, their problems were caused by the 1979/80 rise in oil prices. Brazil's problems, for example, would be eased by a fall in oil prices. Mexico's would be increased in the short run. All debtor countries, including Mexico, benefit to the extent that lower oil prices bring lower inflation, lower nominal interest rates and better growth in world trade. While those should be long term effects, possible of course that there will be adverse short term effects on confidence as oil producers' problems are increased.

$25 A BARREL TREASURY SIMULATION

/Reports in the 'Times' 21. 1. 83 of a Treasury model simulation of a $25 oil price simulation/

Current prospects for the future course of world oil prices are clouded by a great deal of uncertainty. Many people think that oil prices may fall but no-one knows by how much. In these circumstances it is appropriate for my officials to examine the consequences of a range of possible future reductions in the oil price. However, given present uncertainties no particular significance can be attached to any one possible outcome.

/If asked about North Sea oil prices - 'we will follow the market'/.

28/1/83

International debt problems: nature, causes and the way ahead

Is it a crisis?

[It is natural for the media to speak about a "crisis": it sells newspapers.] Some of the problems are serious, and the activities of the international institutions, central banks and Government over past months bear witness to that (and are in themselves also a source of comfort). But it is also important to see the problems in perspective.

2. Despite the headlines, there have been no defaults. And there are good reasons why both borrowers and lenders should continue to avoid that.

3. The increase in lending has been less exaggerated than often thought. External debt of developing countries has increased from under $150 billion in 1973 to around $600 million. A large increase in nominal terms: but nothing like so dramatic once one has allowed for inflation and growth. The increase in relation to exports and trade over the decade was about 25 per cent. In fact the growth rate of lending in real terms seems to have been higher in the 1960's.

4. International lending has accounted for a growing proportion of banks' business. But in 1981 banks' international exposure accounted for around 17% of assets (average for banks from the major countries) - so the greater part of banking exposure remains domestic.

5. Most lending is accounted for by a small number of countries. The top 10 developing country borrowers accounted for 60 per cent of the total in 1981. These are all countries with strengths in terms of natural resources or economic track record. [That is why they were able to borrow.] Although they may face temporary problems, these natural strengths must increase

confidence that in the loans will prove good; and that additional bank lending undertaken following policy adjustment by the borrowers will help improve the quality of existing loans.

Why did banks over-extend themselves?

6. This is a question more for the banks themselves [the TCSC are seeing the clearing banks again on 7th Feb). In some cases they probably underestimated the capacity for mis-management by the borrowers. [They may also not have expected such a firm response to inflation by the world's major economies.]

The way ahead

7. Rescheduling and adjustment may be painful for borrowers and lenders alike. It is not a disaster.

8. In a broad sense the problems are all symptoms of the transition to lower inflation in the world. The lower interest rates and more soundly based growth that lower inflation will bring will help all countries solve their problems. A return to inflationary growth might ease things for a whole ; but would store up even worse problems for the future.

Sources of future finance

9. Adjustment does not mean ldcs have to balance their books, in the sense of reaching current account balance. Developing countries will mainly be natural importers of capital, as overseas investors finance new capital projects.

U.S. [illegible] [illegible] [illegible]

10. Over the years it must be right for the bulk of this capital to come from the market - banks, direct investment, the bond market - rather than from official sources. The market will be more efficient and effective in channelling funds than any national or international bureaucracy.

Cf. SAUDIS

Supervision

Points to make

(i) Should be controls on banks' overseas lending/ the euromarkets? It is wrong to suggest that the euromarkets are not supervised from a prudential point of view; or not subject to any controls. They are. In the UK and all other major countries prudential supervision extends to banks' international operations as well as domestic operations. [Proposals for Government's or central banks to go further and decide how much banks should lend to individual countries, or direct the lending, are impractical and likely to be inefficient. Such decisions must be made in the market, and are for individual banks to make.]

BANKING SUPERVISION: DIVISION OF RESPONSIBILITIES BETWEEN THE TREASURY AND THE BANK

~~You asked for a couple of sentences for the Chancellor's Select Committee briefing. I suggest the following.~~

"The Treasury is responsible for the Banking Act 1979 and for general issues of policy relating to banking supervision, though of course the Treasury would take very close account of the Bank of England's advice on this subject. However, the statutory responsibility for supervising institutions in the UK under that Act rests upon the Bank of England subject to a right of appeal to the Chancellor against the Bank's refusal to recognise or license an applicant for authorisation. This means that the detailed operation of the Act is a matter for the Bank, not the Treasury.

(ii) International coordination of supervision is inadequate or has left lacunae (Ambrosiano). No system is perfect or can be foolproof to outright fraud. But it is important to recognise that a lot of work has gone on internationally since 1975 to seek to improve supervisory arrangements and cooperation between banking authorities in different countries. The Bank of England has played a leading role. They key committee is chaired by (and sometimes named after Mr Cooke [who the TCSC saw on 24 Jan.]

Background

(a) There have been many suggestions that the Euromarkets are unsupervised or uncontrolled. Often these arise from confusing monetary control arrangements - which do not in general apply to offshore markets, though their effect is transmitted via interest rates - with prudential supervision, which does.

There could be mention of Lord Lever's proposal for setting ceilings for bank lending to borrowing countries. This seems to take different forms on different occasions. Sometimes it sounds like a proposal for bureacratic control of all international lending; sometimes remarkably like the existing system of banking supervision.

(b) The Basle Concordat.

The Basle Committee of Banking Supervisors drew up in 1975 a set of guidelines - which has come to be known as the Concordat - on the responsibilities of different supervisory authorities for the ongoing supervision of banks where those banks operate in more than one national jurisdiction.

The principles underlying the supervision of the Euromarkets can be summarised as follows. The supervision of foreign banking establishments should be the joint responsibility of host and parent authorities and no foreign banking establishment should escape supervision. The supervision of branches' solvency falls primarily to the parent authorities, whilst liquidity of branches and subsidiaries is considered to fall primarily to the host authorities. Solvency of subsidiaries is in the first place for host authorities, but the principle of consolidation means a substantial role also for the parent authority.

The text of a statement issued by the Central Bank Governors in 1980 is appended. (Annex A)

Lender of last Resort

Points to make

(i) Arrangements do exist for preventing banking collapses (domestic or international) having serious domino effects.

(ii) Central bank Governors made this clear - as to international banking - in their 1974 statement.

(iii) But it would be wrong for any individual bank to think it would necessarily be rescued however imprudent it had been. Past rescues (eg the Franklin National Bank in the US) have not extended to helping bank managements, nor shareholders.

Background

The text of Governors' 1974 statement is appended. (Annex B)

28/1/83

Information about international indebtedness

Points to make

(i) There has been a greatly improved flow of information about international lending in recent years. This owes much to the efforts of the G10 central banks, with the Bank of England playing a leading role, working through the BIS. There is now a lot of information available. Although it is only published quarterly, about 3 months in arrears, it certainly should be enough to give banks adequate warning of countries getting into over extended position: that does not happen overnight.

(ii) If the world's commercial banks decide to cooperate to pool further information through their new Institute of International Finance, that would of course be a welcome development.

Defensive

(iii) Why did the banks not react earlier to the trends? Lamfalussy in his letter to the FT (copy attached) argues that the evidence of the rising proportion of the short term element in Mexico's debt was "crystal clear" well before the eruption of the crisis. In fact the trend was to a certain extent a reaction itself. Banks have traditionally taken the view that short-term lending, subject by definition to more frequent opportunities for review, is less risky than long-term loans. The banks were anyway faced with the problem of how they could have reacted much differently, without bringing about a crisis very similar to the one which we already have.

This does not meet Lamfalussy's "blunt" [illegible]

(iv) Why didn't the authorities make them do so? The role of the authorities is not to impose its own assessment of individual risk on the banks. First, there is no reason to believe that they are better able to make such judgements. Second, the purpose of supervision is to ensure that banks themselves have proper systems of risk analysis and that they spread the risk by diversification - not to prevent them taking risks.

Background

A decision to go ahead with the proposed Institute has been taken. But its precise role and functions remain unclear.

28/1/83

Financial Times
11.1.83

Early warning of Mexico's borrowing and short-term credits

From the Assistant General Manager, Bank for International Settlements

Sir, — In his comments (December 29) on our half-yearly international banking statistics your correspondent rightly notes that 60 per cent of Mexico's total net borrowing during the first half of 1982 took the form of short-term credits." He then goes on to say that "normally a bunching of short-term credits is a clear sign of incipient liquidity problems in a borrower country. Since the Mexican crisis the Bank for International Settlements has been criticised for the time taken to compile and publish its figures, which reduces their value as an early warning indicator."

The table shows the history of the Mexican debt figures and the time of their publication. You will see at once that by December 1980 anyone who cared to look at our figures could see that an increasing proportion of Mexico's external borrowing was beginning to take the form of short-term credits. This was confirmed in July 1981, and by January 1982 the trend had become crystal clear. It could then be seen that between end-1979 and mid-1981 Mexico's total gross banking debt had increased by $15.7bn. The short-term component of this total was $11.3bn, i.e. more than 70 per cent. To put it bluntly, actual or potential creditors did have early warnings on three occasions—December 1980, July 1981 and January 1982—well before the eruption of the Mexican crisis in July 1982.

A. Lamfalussy.
Bank for International Settlements,
CH-4002 Basle,
Switzerland.

The external banking debt of Mexico and the importance of the short-term component

	end-1978 $bn	mid-1979 $bn	end-1979 $bn	mid-1980 $bn	end-1980 $bn	mid-1981 $bn	end-1981 $bn	mid-1982 $bn
Gross banking debt	23.3	25.8	30.9	34.7	42.5	46.6	57.1	64.4
of which: debt maturing within one year	7.4	8.8	10.7	13.3	18.8	22.0	27.8	32.2
(expressed as % of total)	(31.6)	(34.1)	(34.5)	(38.4)	(44.3)	(47.1)	(48.7)	(50.00)
Month of publication	July 1979	Jan. 1980	July 1980	Dec. 1980	July 1981	Jan. 1982	July 1982	Dec. 1982

Note: Figures are taken from the BIS half-yearly publication on the maturity structure of the external assets of banks located in Group of Ten countries, Switzerland, Austria, Denmark and Ireland, and of certain of their foreign affiliates. Percentages have been computed from the original data and may, therefore, differ from those that can be derived directly from the rounded figures shown in the table.