PO CH/GH/0168
PART. A.

PO CH/GH/0168
PART. A

STERLING ASPECTS
OF EXCHANGE
RATES.

1981

DD's 25yrs NA 3/3
24/4/97

8.7.81

THIS FOLDER HAS BEEN
REGISTERED ON THE
REGISTRY SYSTEM

Exchange rate box.

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1. SIR K COUZENS

2. CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Mr Burns
Sir K Couzens
Mr Ryrie
Mr Middleton
Mr Lavelle
Mr Monck
Mrs Lomax
Mr Peretz
Mr Riley
Mr Spencer
Mr Ridley

THE OVERVALUED POUND

1. You asked for comments on the article by David King of OECD in the December issue of the Banker. He argues forcefully that the strength of the pound threatens the survival of UK industry and proposes exchange market intervention as the solution. Neither analysis nor prescription is especially new, but the questions raised are of such importance that we must expect discussion along these lines to continue and to engage public interest increasingly during the coming year.

Analysis

2. The appreciation of the exchange rate is attributable in part to relatively high interest rates in the UK and in part to oil production and prices. That much is common ground, although the relative importance of the two factors is in dispute: David King suggests only 10 per cent as the long-term effect of oil on the exchange rate, we would suggest more. There may well remain some appreciation which is not adequately explained by either of these factors. It could be that to some extent the pound is high simply because speculators have come to expect it to be high (or have come to expect the obvious alternatives like the dollar and the mark to be relatively weak).

3. David King is very confident that sooner or later the pound will fall. By 1985 he expects a depreciation of 30-50 per cent. We would be much less confident, perhaps because we have seen so many forecasts

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of depreciation - our own and others - proved wrong in the last few years. The latest print-out I have seen shows a depreciation by the mid-eighties of only about 10-15 per cent. This may be partly because we see domestic financial conditions as quite tight, even in the later years of the MTFS.

4. There may be some tendency to exaggerate the extent of damage which this loss of competitiveness will cause to UK industry, but we accept that the prospect for manufacturing industry in particular over the next few years is very bleak. There may be some relief from lower wage settlements, but (as King says) this can only offer us the hope of regaining competitiveness slowly over a period of many years. If we are to regain competitiveness anything like as swiftly as we have lost it, it can only be by means of a fall in the exchange rate.

Prescription

5. The article assumes that it would be advantageous to secure a very substantial fall in the exchange rate, if it were possible. "Overvaluation" of 35 per cent is mentioned, although the basis for that estimate is not made clear. But a fall of 35 per cent in the exchange rate during 1981 would probably add more than 10 per cent to prices over the next two years, maintaining an inflation rate of, say, 15 per cent a year up to the end of 1982. A more modest depreciation, say 15 per cent, might still be enough to hold the rate of inflation at around 12 or 13 per cent over the next two years. To the extent that the reduction in the scale of wage settlements was delayed as a consequence, the improvement in competitiveness would be eroded.

6. It is not easy to judge the relative priority of competitiveness and inflation, but the article is surely misleading in treating depreciation as an unambiguous gain. If sterling were to fall sharply this year, whether by accident or design, we would have to consider whether other steps, indirect tax cuts for example, were needed to blunt the immediate implications for the price level. If one accepts the thesis of the article, however, that depreciation sooner or later is inevitable, then the question is rather whether one would prefer to see the consequential rise in prices sooner rather than later.

7. On the assumption that depreciation is desirable, the article asserts that it is also achievable. The first step is to declare an intention to maintain the exchange rate close to the level indicated by the relative growth of the money supply at home and abroad. Tacitly, it is also proposed that we make an initial move on the exchange rate back to equilibrium from its present substantial over-valuation. This is a great deal more difficult than the article suggests. We do not know what the appropriate equilibrium level would be, and if we made a guess we have no reason to believe that the market would readily accept it. It is not enough to say, as King does, that in the long run everyone agrees that exchange rates tend to move in line with relative monetary growth. (In fact, even that proposition is debatable.) There is also the problem of picking the right starting level for the exchange rate, granted that the existing level is in some sense too high.

8. For these reasons, we have argued strongly against anything that amounted to a commitment to an exchange rate target. Experience both in the UK and elsewhere suggests that governments, despite the deployment of vast financial resources, usually fail in their attempts to control exchange rates. This, on its own, would not rule out some foreign exchange intervention if it were desirable on other grounds, but it suggests that one should steer clear of a commitment to a particular rate. Whether it is in fact possible to intervene substantially without declaring a target rate, is itself problematic.

9. King argues that the authorities, having declared their target, should intervene as necessary to achieve it, financing their purchases of foreign currency assets by issuing sterling debt. This, he maintains, need not add to the money supply at all, and even if it does it will not be inflationary because it will be merely providing assets which the private sector wishes to hold. As a consequence, interest rates must be higher than they otherwise would have been - that is the expected fall in interest rates must be delayed. This will spread the restrictive effects of the counter-inflationary policy more evenly over the economy. In a rather obscure passage, he suggests that the resulting composition of saving and investment is in some sense "more consistent with policy". This may mean the same as saying that the impact of policy is more evenly spread. If so, it is probably

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a valid point, but one must remember that equality of sacrifice will not be universally popular. There would be a lot of disappointment now if interest rates did not fall in the course of this year, even if the exchange rate were lower.

10. The combination of intervention and higher interest rates might not in fact do very much to reduce the exchange rate. On balance, it would, we think, tend to move the rate in the "right" direction, but we have little idea how much intervention, and how much extra borrowing, would be necessary to have a significant impact on the rate. The numbers involved could be very large indeed - certainly if one was talking, as King seems to be, of a really sizeable depreciation as the aim.

11. It is really quite facile to conclude, as King does, that "sterling need not pass another week overvalued". The problems with the course of action he proposes are fomidable. So, however, are the problems we face over the next few years if the recent loss of competitiveness is not reversed.

AJCB

A J C BRITTON
8 January 1981

For Information:
Financial Secretary
Mr Terry Burns
Mr Ryrie
Mr Middleton
Mr Lavelle
Mr Monck
Mrs Lomax
Mr Peretz
Mr Riley
Mr Spencer
Mr Britton
Mr Ridley

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CHANCELLOR

Exchange rate box

THE OVERVALUED POUND

I agree with Mr Britton's note attached on the David King article in the December issue of the "Banker". Philosophy apart, what David King is saying is that we should intervene on a substantial scale to lower the exchange rate and offset the effect that might have on the money supply by selling more gilts. Both the Financial Secretary and Mr Britton have commented on the difficulties of achieving that and the likelihood that it would require higher interest rates, which would themselves offset the effect of the intervention on the rate.

2. During much of 1977 we were in fact trying to do very much what David King proposes: intervening on a large scale to hold down the rate and trying to step up gilt sales to control the money supply. In October 1977 the effort was given up in the interests of controlling the money supply, and the rate then rose only modestly. But on that occasion the intervention seemed to attract inflows, interest rates were forced down rather than up and for a time the sale of gilts was made easier by a combination of the expectation of falling interest rates and the increase in liquidity which the inflows represented or created. Interest rates were driven well below the levels appropriate to control of domestic credit and that was part of the reason for the final "uncapping".

3. This experience suggests that although trying to sell more gilts will always tend to put interest rates up compared with <u>not</u> trying to sell more gilts; the intervention itself and the policy of driving down the rate will also have an interest rate effect which

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may go in either direction and may swamp or accentuate the effect of the attempted extra gilt sales, at least for a time. If the market simply does not believe that the intervention will succeed in holding or pushing the rate down, the effect will be to attract inflows. People will rush to buy a currency which is being offered, as they think, on the cheap. The effect on interest rates may be on 1977 lines. On the other hand if the market decides that your intervention is going to succeed and that on reflexion your currency is indeed overvalued, you may precipitate a slide. That is more like what happened in the spring of 1976 when, although there was no intervention, the market got the idea that the authorities wanted the rate down. Then the effect will go the other way. One may precipitate a capital outflow, especially if one is holding a lot of volatile money of one kind or another. The result could be a lot of contraction, sharply rising interest rates, an acute problem of selling gilts and perhaps the intervention rapidly turning round into support for the rate, modest or otherwise. That was the story in 1976.

4. It is also true that traditionally countries like Germany and Switzerland, when they have made major efforts to hold down their exchange rate, have attempted to use interest rate policy in harness with intervention to achieve their purpose, just as Germany and others in Europe have used interest rates as well as intervention recently to hold their rates up. Perhaps the one sure conclusion is that if you are pursuing an exchange rate objective which carries you any distance from market rates you will probably be very lucky to end up with the interest rate you would like to have for domestic monetary purposes.

5. All of which leads me, like Mr Britton, to the view that Mr King's solution as rehearsed is a little simpliste.

KEC

K E COUZENS
9 January 1981

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Exchange rate box

Chancellor of the Exchequer

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Ryrie
Sir Kenneth Couzens

without attachment:

Mr Burns
Mr Britton
Mrs Lomax

NIEHANS

1. You and others might like to have a copy of the paper prepared by Jürg Niehans, a Swiss economist who was commissioned to do a study on sterling appreciation by the Centre for Policy Studies. The report is due to be published shortly by the Centre.

2. Dr Niehans was recommended for the study by Alan Walters. His views are very similar to those of Mr Walters. The report is a long one, so I also attach a short digest of key passages prepared by Mr Burns. He and I attended a seminar to discuss the study with Niehans who I have also seen on a number of earlier occasions.

3. The study is strong on views but not so strong on analysis and evidence. It also, not surprisingly for a piece of work done over a 5 week period by someone unfamiliar with our institutions, tends to treat the UK as though it was Switzerland. With one exception there is nothing very new in it. But it is a very good read for anyone with the time. Perhaps I could pick out a few points.

4. Niehans' basic proposition that the exchange rate has overshot in both normal and real terms is one with which most people would agree. The causes of the overshoot are however hotly contested. Kay and Forsyth you will remember attribute a major role in this to North Sea oil. Niehans and Walters are right at the other end of the spectrum in assigning a very small weight indeed to the North Sea. They attribute the overshooting overwhelmingly to the tightness of domestic monetary policy.

5. The argument is one with which you will be familiar from the papers put into the Select Committee by some of their own advisers and outsiders such as Professor Dornbush. It suggests that the

exchange rate adjusts quickly to tighter monetary conditions. But prices and wages adjust only slowly. So interest rates have to remain high in the short term, and the exchange rate rises by more than is justified by the relative growth of the money supply in the UK and overseas.

6. You obviously cannot construct an argument based on £M3 growth because it is much too high. The argument is usually put in terms of expectations engendered by the medium term strategy or in terms of real interest rates. It has to be based on expectations in some form or other. The question is what determines the expectations.

7. Niehans (and Walters) have come up with a new angle in relating overshooting to the tightness of domestic policy as seen by observing movements in the monetary base.

This diagnosis affects the policy prescription to relax monetary policy:

a. to the extent necessary to rectify excessive past tightness; and if this does not succeed in bringing down the exchange rate

b. by specifically overriding the monetary target in favour of an exchange rate objective. Niehans picks a rate of $2.15 as the point at which the "Imperial Guard" is rolled out to expand the money supply temporarily until the exchange rate falls - by intervention and a progressive lowering of interest rates.

8. There are a number of difficulties with this:

a. the numbers for the monetary base cannot carry too great a burden of explanation. And they cannot have influenced expectations in a direct sense because practically no-one knows what they are. The base has been provided on demand under a system where discount window lending was available without penalty at a market rate. So the numbers cannot tell us too much about the banks' true demand for cash, or the tightness of policy.

b. Niehans uses some strange numbers - for good reasons, because we do not publish a series - for the base. He suggests that the base is about 10% below trend. Our figures suggest it is about half that.

c. The objective of monetary policy has of course been to reduce monetary growth in order to get inflation down. So there is no reason why we should expect monetary growth to be on the trend of the 70s. And there is some curious logic involved in suggesting that we should compensate for tightness in this sense.

Look at it this way. The monetary base school suggests keeping the growth of the wide base steady in order to bring long term stability to prices. It is not a fine tuning approach. A growth rate of 5-6% a year in M_0 is usually suggested as being consistent with the MTFS figures and also with a reasonable inflation objective for the time being. This is about the rate at which the base is currently growing. Most would want to get it down to 2% eventually. So it is very odd to recommend that the base should be allowed to expand back to 13-15% or perhaps a lot further if the exchange rate stays sticky, to counteract the effects of what is seen as excessive tightness over the past 3 years in order to get it back over perhaps a shorter period to where it is now.

d. There was considerable consternation at the seminar - particularly from Patrick Minford and Sam Brittan - that even if the argument for a temporary relaxation on the grounds of excessive tightness in the past was valid, it would be very difficult to present convincingly. People would assume that the domestic monetary policy was being relaxed permanently. Moreover, given the stickiness of the exchange rate, in relation to changes in interest rates and intervention - and indeed our past lack of success with exchange rate policy - they would probably be right. In this context, Niehans is however undoubtedly right in suggesting that intervention which does not affect the money supply is unlikely to have much effect on the exchange rate.

9. I must say that I think the issue is not all that complicated. If the exchange rate was not so high, no-one would be drudging the domestic monetary statistics looking for an aggregate that appeared to produce a degree of tightness which appeared to furnish a

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complete explanation for it. There would be satisfaction rather than consternation at having got the growth of the base to its present rate. If it is accepted - which it usually is - that there is no very clear explanation for the exchange rate in terms of conventional indicators, but that the high exchange rate does exert a strong downward influence in inflation, then so long as the exchange rate remains high there is a case for relaxing domestic monetary policy - something has done the job for you and you do not need to do it twice. But exchange rates go down as well as up and we are left with judging whether it is worth the risk of an adjustment to the monetary stance, taking account of what that implies for expedations, for what might be a temporary phenomenum but one which we cannot see the end of. That is exactly the issue which we have been discussing with you over the past few days. It is much the same issue that Harold Rose is raising when he says that the demand for money must have changed in the last year; the question is whether the change is permanent or temporary.

E. A. Clarke

pp P E MIDDLETON
16 February 1981

Encs

16|81

Exchange rate box

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1. SIR K COUZENS

2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Burns
Mr Ryrie
Mr Hancock
Mr Middleton
Mr Britton
Mr Kemp
Mr Lavelle
Mr Monck
Mrs Gilmore
~~Mrs~~ Lomax
Mr Riley
Mr Turnbull
Miss O'Mara
Mr Owen
Mr Ridley
Mr Cardona

Mr Anson - Washington

Mr Loehnis
Mr Sangster } - B/E
Mr Byatt

FALL IN STERLING: 1-8 JUNE

We thought Treasury Ministers might find it helpful to have a retrospective note about the sharp fall in sterling in early June; its causes and how it fitted with the pattern of developments of previous weeks; and how it was handled. There may be some lessons for the future; and the episode has served to reinforce some lessons of the past.

What happened

2. Over the period from early April to end-May the £ had fallen against the dollar by about 6% (from $2.20 to 2.07), risen against the DM (and other EMS currencies) by about 3%, with the effective rate remaining surprisingly steady at a little under 99.

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- On Monday 1 June for the first time the effective rate began to fall, ending the day at 98.25, with the dollar rate at $2.06, and the DM cross rate down from 4.82 to under 4.80.

- On Tuesday 2 June the dollar strengthened against all currencies, despite the publication of a substantial German current account surplus for April. Sterling closed at under $2.04.

- On Wednesday 3 June sterling came under strong selling pressure both from Europe and the US, and against European currencies as well as the dollar. Operators were said to be "testing $2.00", presumably to see if it was of psychological importance to the market, or, perhaps, a level at which the authorities would intervene - with the market mood sparked by the $4 a barrel cut in Mexican oil prices. Ministers agreed that the Bank should intervene on a more substantial scale (hopefully less than $80 million, certainly not in three figures) to try to steady the rate; that if it became clear more substantial amounts were needed they should desist; and that the operations should be handled so as to avoid giving any impression that we were trying to defend some particular rate (such as $2.00). In the event the Bank spent $59 million in London, using a wide variety of banks as agents - thus demonstrating in no uncertain manner their presence in the market. After the London close they spent a further $28 million in New York, but even so the rate fell below $2.00.

- On Thursday 4 June, the rate opened in London at $1.9740, with the DM cross rate down to 4.70 (from around 4.80 two days earlier). In the morning the Bank spent $39 million as sterling came under further selling pressure from speculative and commercial sources. At 1300 hours, at a meeting between the Prime Minister, Chancellor and Governor, an extended guideline for Bank intervention was settled. The Governor was authorised to continue smoothing action on the same general basis as had been agreed for 3 June, with an overall limit of $500 million for the rest of the week up to 11 June. Later in the day the dollar rose against all currencies as the Fed acted to tighten US domestic monetary conditions, and the DM fell on the "news" that the Bundesbank had decided against any further tightening of German credit policy. By late in the day (after the London close) the sterling dollar rate had fallen a further 3 cents, to $1.94; but the rate against the DM was little changed over the day at just under 4.69.

- On Friday 5 June the Bank sold $48 million a resumption of operations in the Far East; and a further $41 million when the rate weakened further in mid-afternoon in London. By London close the dollar rate was down to $1.9150, and the DM cross rate to under 4.64, with the news that BNOC had opened talks with North Sea producers to cut oil prices still undigested.

- On Monday 8 June the Bank started the week with substantial intervention ($115 million) in the Far East. Such operations two days running could not but be noticed (although the Bank's name was not passed openly) and this seemed to reassure operators because for the rest of the day, with the continental centres on holiday, the market was quiet. The dollar eased generally on publication of unexpectedly good money supply figures. By London close the rate against the dollar had recovered to $1.9410 and the DM cross rate to 4.67.

3. And that really marked the end of the episode. On 9 and 10 June the Bank intervened on occasion in a very small way (a total of $15 million over the two days); but by Thursday 11 June they were able to buy $8 million from the market. At close on 11 June the rate was $1.9502, and the DM cross rate 4.68. From the Prime Minister's meeting on 4 June up to close of business on 11 June

the Bank had spent a total of $211 million net out of the agreed "ration" of $500 million.

4. By Monday 15 June in New York sterling had risen against the dollar back above $2.00 (DM cross rate, 4.70), and was strong enough to take the news that BNOC had been obliged to agree North Sea price cuts of $4.25 per barrel with no more than a small reaction - opening in London on 16 June at $1.9980. The graph at Annex 1 shows these movements, and also how the effective rate moved over the period. At close on 16 June the dollar rate stood at $1.9970, the DM cross rate at 4.70, and the effective rate at 95.7. Today (26 June) all three rates have fallen back again, though they remain above the lows reached on 5 June (lunchtime rates on 26 June: $1.9413, DM 4.66, 94.4 effective).

<u>Why did it happen?</u>

5. Looked at over a longer period, the fall taken together with the subsequent recovery can be seen as a broad continuation of a fall (shared by all European currencies) against the dollar over a period starting towards the end of January, when sterling stood at over $2.40 (see Annex 2). With some fluctuations the dollar had risen to $2.20 to the £ in April and $2.10 in May. The principal reason for the dollar's growing strength must have been the continuing high level of US interest rates, against the background of some signs of downturn in the US economy and a US administration firmly committed to monetary restraint.

6. As to the reasons for the particularly sharp fall by sterling in early June, the longer term performance of sterling against the DM (see Annex 3) is more revealing. At 4.65 - 4.70, the pound is still some 10% higher than it was last August, and over 20% above the rate at the beginning of 1980. Over the period from March sterling tended to drift up further against the DM. There seemed little to justify this. Oil market developments if anything pointed the other way. There had been overseas press stories - eg in Business Week - commenting on the UK's economic problems. The DM may have been

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held down for a time by heavy support given to the French Franc within the EMS arrangements particularly after the Presidential election result on 10 May; but by the end of May this pressure had eased. The market was ready to turn its attention elsewhere. In the circumstances it needed only a fairly small event - the Mexican oil price cut - to trigger a reassessment for sterling.

7. Once a fall was under way, the possible significance of a $2.00 rate may have been a complicating factor. And, as always, there was a danger of a fall becoming self-feeding. Suggestions began to appear on the tapes and in the overseas press about underlying economic and industrial difficulties. These became combined with comments that the falling rate itself would exacerbate inflationary pressures, worsen the current account and perhaps lead to capital outflows. All items of news tended to be looked at for their possible negative implications for sterling, whatever the logic. The negotiations over North Sea oil prices attracted some particular comment.

<u>Effect of intervention</u>

8. In these circumstances, the modest amount of intervention the Bank undertook almost cettainly had a braking effect, as intended. It is clear we could not have held any particular rate, such as $2.00, without much more substantial intervention. The rate itself had to be allowed to take most of the strain. It is of course possible that the market would have steadied itself with no help from the Bank. But this was not certain, particularlysince there may have been some in the market who thought the authorities wanted a lower rate, and would continue to intervene asymmetrically to that end. There was a risk of a self-feeding slide in confidence. We think it was well worth while undertaking a modest amount of intervention to help calm the market's nerves, and to remove any impression that the authorities would be content simply to stand aside should a continuing slide get under way.

Assessment and Lessons for the future

9. There are a number of reasons why we can perhaps feel reasonably happy about this episode.

- First, of course, the fact that on this occasion sterling recovered so promptly. This tends to suggest that the basic reason for the fall was as described in paragraph 6 above. The market overreacted a little at first, but soon recovered. The view held by some that the £ was likely to collapse at once at the first sign of any fall, has proved over-pessimistic.

- Secondly, others will have learnt how the Government will respond to this kind of pressure. We have always said that "whether the rate is rising or falling" the policy is to act to smooth undue fluctuations. People have now seen in practice the line we draw - neither standing idly by, nor intervening to try to achieve some particular rate. There is nothing magic, in particular, about $2.00.

- Thirdly, the demonstration that under the Government's policy the £ can fall as well as rise (while the fall in the effective rate has in practice been very limited) may have helped take some of the steam out of the campaign by the CBI and others for a lower exchange rate. The fall against the dollar seems to have brought home to many that a lower exchange rate brings higher imported costs as well as benefits for competitiveness. To have fallen more against the dollar than the DM is of course not ideal, but there is some hope that in future this situation will reverse itself to some degree if the DM recovers and dollar interest rates fall.

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- Fourthly, on the operations themselves, it was encouraging that we and the Bank were able to agree so promptly on the balance to be struck between standing out of the market altogether and excessive response the other way. We were as a result able to settle the pattern of intervention shortly after the fall began, recognising from the outset that intervention could only act as a brake, and that to prevent movement going further policy action (interest rates) would be required. Judged by results the tactics chosen were successful - the Bank needed to use less than half their agreed intervention "ration".

10. We would list the following lessons for the future:-

(i) This experience does nothing to change our view that the right way to tackle sharp changes in the rate is not large scale intervention, but modest intervention combined with a readiness to take policy measures if judged appropriate. (It is particularly important to avoid giving the market any impression that intervention is aimed at any particular rate). The rate can recover without large scale intervention; indeed it may do so more easily.

(ii) It was helpful that Ministers were able to take a calm line in public statements, and probably helpful too that the ground had been so well prepared. (As long ago as last year's Mansion House speech the Chancellor acknowledged the possibility that some fall in sterling could occur). In general though, the experience confirmed the importance of saying as little as possible in public during episodes of this kind.

(iii) On the operations themselves, it is clear that tactics in the market have to be left to the Bank. Neither the official Treasury nor Ministers can hope to backseat drive on an hour by hour basis round the clock.

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(iv) It is therefore of the greatest importance that the ground rules under which the Bank are to operate should continue to be agreed as clearly, unambiguously, and explictly as possible in advance. Things could, for example, have gone very wrong if matters had been ill defined and the Bank had wrongly derived the general impression that Ministers attached special importance to a $2.00 rate. Equally things could have gone wrong had the Bank been left with the impression that they were not to intervene at all, or (worse) to continue to do so asymmetrically to try to reduce the rate. Whatever the merits of these alternative courses, they would have been an incorrect interpretation of Ministers views.

(v) The close reporting arrangements we have with the Bank are particularly necessary at times of pressure, when the regularity can be increased at will. We all need to know what is going on, with the opportunity to review the startegy in the light of developments should that become necessary.

(vi) Equally, during an episode like this the Bank need to be kept in touch very closely with other events that could have a bearing on the rate (eg the decision on North Sea prices).

(vii) Finally, we were lucky on this occasion in that the rate turned and it was not necessary for us to take a decision on interest rates. HF have since been considering with the Bank, how an interest rate decision might most helpfully be set up in these circumstances, and the ways in which it could be implemented.

11. For the period immediately ahead we have, of course, already confirmed with the Bank that the policy of some asymmetry in smoothing intervention that we had while sterling was rising last

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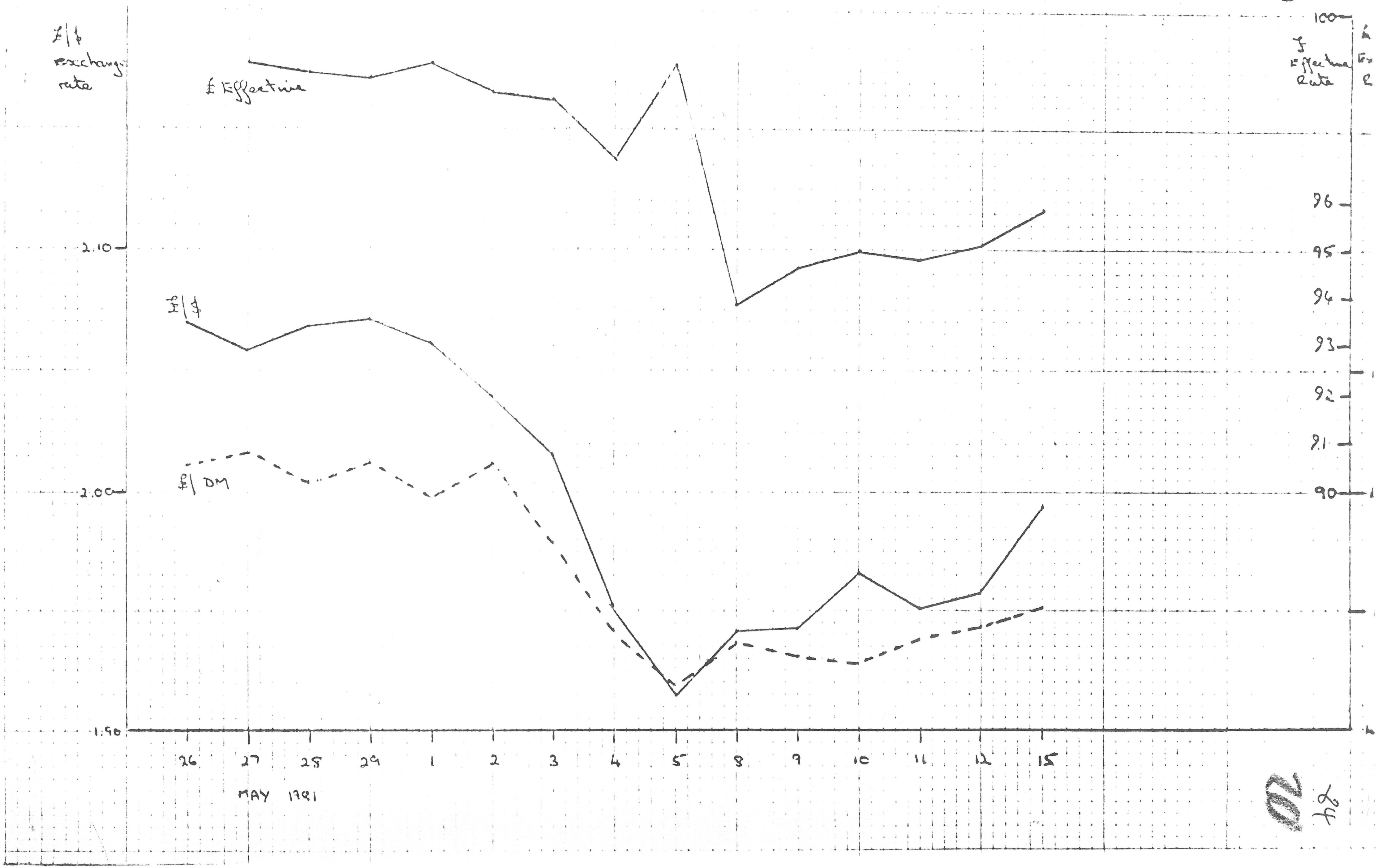
year no longer applies. We have also told them that should the rate come under sharp pressure again they should for the present regard the $289 million balance of the $500 million agreed for for week to 11 June as available for use on the same pattern as in the period 4-8 June; but that with the rate starting from a lower level the question of interest rate policy might well arise earlier than before.

DLCP

D L C PERETZ
26 June 1981

KEC
26/6/81

ANNEX 1



£/$ exchange rate
£ Effective
£/$
£/DM
2.10
2.00
1.90
£ Effective Rate
100
96
95
94
93
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91
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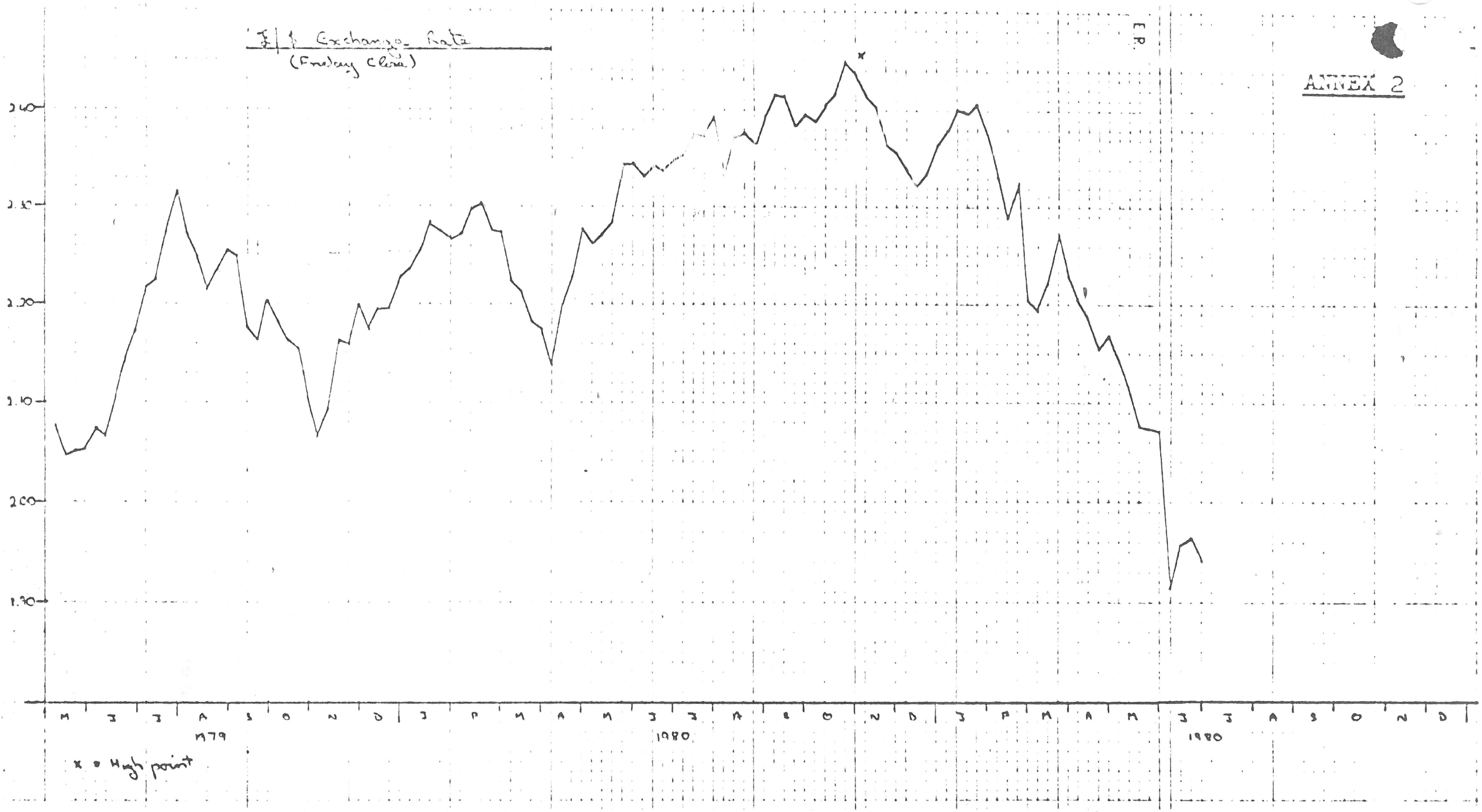
MAY 1981

ANNEX 2


£/$ Exchange Rate
(Friday Close)
2.40
2.30
2.20
2.10
2.00
1.90
M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
1979
1980
1980
x = High point

ANNEX 3


STERLING - DEUTSCHEMARK EXCHANGE RATE
(Friday Close)
5.25
5.00
4.75
4.50
4.25
4.00
3.75
M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D
1979
1980
1981
x = High point

92

-87

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CHANCELLOR

cc Financial Secretary
Sir D Wass
Mr Burns
Sir K Couzens
Mr Hancock Mr Middleton
Mr Britton
Mr Lavelle
Mr Peretz
Mr Riley
Mrs Rowlatt
Mr Spencer

1. Mrs Lomax

I can't remember whether I said so, to you, on the earlier draft: but I very much agree (as I'm sure you know) with paras 6-7.

2. Miss O'Mara

9/7

THE POUND IS STILL AFLOAT

You asked for comments on Christopher Johnson's latest piece in the Lloyd's Bank Economic Bulletin in which he describes his new exchange rate equation which, apparently, enabled him to predict the fall in the $/£ rate in the first five months of this year. Mr Johnson has kindly supplied us with a description of his equation and the underlying research. It is not an impressive piece of work, from either a theoretical or empirical standpoint. It offers very little insight into the past behaviour of the exchange rate and I cannot help feeling that there is a large element of luck in its relatively successful forecasting performance since last August. It is worth noting incidentally, that it did not predict the very sharp fall in the rate which has taken place since the end of May (it forecasts $2.08 and $2.05 for June and July respectively).

The Equation

2. The level of the $/£ rate is explained by the level of the covered interest rate differential between US and UK Treasury bills, by lagged rates of retail price inflation in the UK and the US, and by past levels of the exchange rate itself. The only other explanatory variable is a dummy representing the abolition of exchange controls in autumn 1979. There are no oil variables of any sort, and attempts to include them proved unsuccessful. A striking feature of

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the estimated equation is that the rate of inflation in the US is about four times as important as the UK inflation rate in explaining the $/£ rate. Mr Johnson argues that this disparity reflects the importance of North Sea oil. All the equation actually does, however, is describe the fact that the £/$ rate has changed in real terms. It does not explain why this has happened.

Comment

3. The apparently good tracking performance of the equation up to mid-1980 is deceptive. Estimated values of the exchange rate yielded by the equation are held close to actual outturns by the large weight assigned to past actual values of the rate itself. As a result the equation tends to pick up turning points in the rate only after they have happened. Again, this implies that the equation is simply describing what happened rather than identifying the main independent influences on the rate. The track record is therefore unlikely to be a good guide to the equation's ability to forecast.

4. The equation's value as a forecasting tool is also seriously limited by the use of the covered differential. Assumptions about future movements in this variable require forecasts of the cost of forward cover as well as relative interest rates. Changes in the covered differential are notoriously difficult to model, and Mr Johnson does not appear to have made the attempt. His published forecasts are based on judgemental guesses which do not appear to have been notably accurate.

5. The story underlying the forecast Mr Johnson made last August is not very compelling. For reasons he does not explain, he assumed that the covered differential in favour of sterling would rise in the latter part of 1980 to around 2, and then fall back to 0 and -1 by the Spring and early Summer of 1981. Since increases in the covered differential push up the $/£ rate, and 90% of the adjustment is complete within three months, this assumption alone would tend to produce the profile for the rate shown by his forecast. This element of

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the forecast is best regarded as a proxy for 'confidence' and while Mr Johnson may have made a reasonable guess at how this would develop there is no particular science involved. The other element in the forecast is the delayed - and differential - impact of changes in UK and US inflation rates some two or three years earlier. Recent changes in inflation have no bearing, since both inflation terms have a 'start delay' of eight quarters, and it is a further four quarters before even 90% of the adjustment to this information is complete.

Alternative models of the exchange rate

6. Detailed criticism of this particular equation aside, I am myself increasingly disenchanted with the general approach to exchange rate modelling which it embodies. It implies an exchange market which reacts only sluggishly to current developments - an assumption which is hard to reconcile with the short run volatility of exchange rates observed in practice. Models of the exchange rate which are forward rather than backward looking offer more insight into why the exchange rate is prone to sudden jumps. On this view, current levels of the rate incorporate all available information, and short run movements in the rate are dominated by unexpected developments. Applied to recent developments one might argue that the principal 'surprises' in recent months have centered on US monetary policy. What has prompted the dollar to rise against other major currencies has been the market's reassessment of the future prospects for US interest rates. I find this a more plausible explanation for the sharp fall in the £/$ rate than explanations which, like Mr Johnson's, rely on delayed reactions to old information about inflation, and guesses about movements in the covered differential which in practice are probably heavily dominated by changes in market sentiment.

7. Surprise models may be useful in understanding the past, but they have obvious limitations when it comes to forecasting. But experience of the last few years tends to support the view that attempts to predict the short run behaviour of the exchange

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rate are largely a waste of time. Forward rates have not been good ex post predictors of spot rates, but they may still represent the best guess about the future that can be made on the basis of existing information. It may be more rewarding to concentrate research on improving our understanding of the factors influencing long run trends in the real exchange rate - itself a difficult enough task, given North Sea oil and the uncertainties surrounding the world oil market.

RL

RACHEL LOMAX
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