

The Exchange Rate.
 Exchange Control Policy.
 Inflow Controls.

PART 1

ECONOMIC POLICY

MAY 1979

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
16.49		20.5.80					
27.5.79		28.5.80					
30.5.79		2.6.80					
1.6.79		2.7.80					
6.6.79		18.9.80					
7.6.79		6.10.80					
10.7.79		27.10.80					
13.7.79		26.11.80					
14.7.79		12.1.81					
10.8.79		11.3.81					
17.9.79							
24.9.79							
27.9.79							

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● PART 1 ends:-

HMT to MCS 23.10.81

PART 2 begins:-

Kerr to MCS 6.4.82

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

House of Commons Hansard
Exchange Controls

23/10/79
Columns 202-214

House of Commons Hansard
Civil Service Manpower

16/05/80
Columns 672-674

Signed Q Wayland Date 29 March 2011

PREM Records Team



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Parliament Street London SW1P 3AG

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M Scholar Esq
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LONDON
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Carroll
CF - please put
with Man Walters'

MTC in Exchange

Contre
indemnit

Mus 23/10

23 October 1981

Dear Michael

You asked about exchange controls. I attach a copy of the recent article in the Treasury Economic Progress Report; and a couple of pages of our standard background briefing on the subject. I have sidelined the relevant passages.

Yours ever
David

D L C PERETZ

Economic Progress Report



Published by the Treasury

No. 138 October 1981

Ending exchange controls

When the last United Kingdom exchange controls were removed two years ago in October, 1979, a period of 40 years of UK exchange controls came to an end. This article looks at some of the consequences of this step, in the light of two years' experience without controls.

Legal framework

Exchange control was introduced in the UK at the outbreak of the Second World War to ensure that gold and foreign currency were made available for the war effort. The legal basis of the war-time control was the Defence (Finance) Regulations 1939. In October 1947 these temporary regulations were superseded by the Exchange Control Act. The Exchange Control Act 1947 set up a barrier between residents of the United Kingdom and people resident outside the Sterling Area (known in the Act as 'the scheduled territories'). As the scheduled territories contracted, the number of countries affected by UK exchange controls increased. In 1979 the scheduled territories consisted of the United Kingdom, the Channel Islands, the Isle of Man, the Republic of Ireland and Gibraltar.

There are now no UK exchange controls in operation. However, the European Communities Council directive of 21 March 1972 requires member states to be able to act on capital flows without further enabling measures, in order to prevent serious disturbances in the money markets. The powers in the Exchange Control Act 1947 therefore remain on the statute book, and were amended in the 1981 Finance Act to make them more symmetrical between inflows and outflows.

Controls before 1979

As a general rule, UK exchange controls applied only to resident outflows (outflows of money paid by people resident here). The main effect on non-residents was to limit the extent to which they could borrow domestic sterling.

Exchange control rules on direct investment (for instance, to finance purchase of factories and equipment abroad) were not designed to prevent or restrict genuine

profitable outward direct investment projects, but were concerned primarily with the method of financing. Permission was usually given where the investment was financed with borrowed foreign currency; but it was also possible to finance overseas investment in other ways, including using official exchange (to a limited extent, where early benefits were envisaged), unremitted profits, or foreign currency purchased in the investment currency market. Abolishing exchange controls has removed the requirement to arrange foreign currency finance. Inward investment was generally welcomed as long as it was financed in foreign currency or from non-resident sources.

Investment currency

Overseas portfolio investment (in stocks and shares, for instance) had to be financed either with foreign currency bought in the investment currency market, or by borrowing foreign currency against collateral equivalent to not less than 115 per cent of each outstanding loan, in the form of the securities purchased, together with any unutilised funds, 'premium-worthy' securities and 'investment currency'.

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Editorial enquiries

Communications about the contents of *Economic Progress Report* should be addressed to the Editor, Information Division, HM Treasury, Parliament Street, London SW1P 3AG.

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Investment currency consisted of the proceeds of sales by UK residents of overseas investments. Because there was a restricted supply of this foreign currency it usually traded at a premium over the official exchange rate. This investment currency premium was also known as the dollar premium.

Between 1965 and 1978 UK residents selling premium-worthy foreign investments had to surrender 25 per cent of the proceeds at the official exchange rate. These rules generally reduced the profitability of investment in overseas portfolios. A further administrative obstacle was that foreign currency securities owned by a UK resident had to be deposited with an 'authorised depository', (such as a bank, solicitor or stockbroker) in order to stop the export of assets abroad in lieu of payment, which would not have been permitted, and to ensure that sales of foreign currency securities were monitored, to prevent them being illegally acquired and sold on the investment currency market.

Foreign bank accounts

Exchange controls made it illegal for UK residents to hold foreign currency without permission, whether in notes or in bank deposits. Residents were not allowed to maintain foreign currency bank accounts without permission and, if they bought foreign currency to travel abroad, they were required to sell currency not used for that purpose to an authorised dealer. Permission was normally granted for foreign currency deposits held as working balances. Emigrants were only allowed to take a limited amount of money with them (before June 1979 the allowances were £80,000 if emigrating within the EEC and otherwise £40,000). Any remaining sterling assets could be taken abroad after four years. Residents wishing to buy property abroad had to obtain permission, and, before June 1979 were required to buy investment currency to make the purchase.

A variety of other rules controlled residents with debts due from non-residents; controlled advanced payments for imports; restricted cash gifts to non-residents; restricted the holding of gold and the export of sterling bank notes; and controlled the positions which banks could take in the foreign currency markets. UK residents are now free of all these controls and may switch in and out of foreign currency as they wish (though, for prudential reasons, banks are still subject to supervisory control by the Bank of England). They may hold foreign currency deposits and notes and invest money abroad without any UK official formalities.

Administrative savings

Exchange controls entailed a formidable amount of work, particularly for banks and other financial institutions, but also for companies and private individuals. The effort and resources required to complete this work can now be used more productively. In the public sector about 750 jobs at the Bank of England have been saved. A further 25 jobs have been saved at the Treasury, and the work of Customs and Excise has been simplified. Eight staff at the Bank of England continue to administer the after-effects of exchange controls but no staff are now employed full-time on this work at the Treasury.

Loss of information

Exchange control statistics provided a useful source of information about overseas transactions but, partly because of the need to cover credits as well as debits, other sources of information were developed. By 1979 only four important balance-of-payments figures were dependent on exchange control sources:

- Outward portfolio investment; banks and brokers have been asked to provide information about transactions in foreign securities, and information about other financial institutions is available from existing statistical returns.
- Borrowing and deposits abroad (by the private sector other than banks); this information is now derived from banking statistics of countries in the Bank for International Settlements reporting area.

- Private transfer debits, such as payments to dependants abroad, migrants' funds, legacies, cash gifts; various sources including the Family Expenditure Survey provide useful information.
- Miscellaneous service debits, a collection of items including commissions on exports, agency promotion costs and consultancy fees; information about these items is collected from various sources including the Department of Trade's overseas transactions inquiry.

Effects on capital flows

The removal of exchange controls provided UK residents with an opportunity to increase the proportion of net foreign currency assets in their total portfolios. As they do so, there will be both temporary and continuing effects on the flow of new investment abroad.

The *temporary* effect reflects a once-for-all increase in the stock of overseas assets, as residents make up for low levels of overseas investment in the past ('the catching up' — or 'stock shift' effect).

The *continuing* effect, which is likely to be much smaller, arises as a higher proportion of new savings is invested abroad (the 'flow' effect).

Catching up will not necessarily take the form of a direct switch between existing domestic assets and overseas assets. Many institutions may prefer to build up their holdings of overseas assets by investing a larger proportion of their new savings abroad for a period, rather than by selling off domestic assets. The share of new savings invested overseas may then be allowed to fall back, when catching up is complete. Either way, however, the early impact of abolishing controls on capital flows is unlikely to be a good guide to the flows of overseas investment that will continue in the longer term.

Financial considerations

The amount of overseas assets that people resident here want to hold is likely to be influenced by a wide range of considerations, and it can be expected to vary considerably over time. The most important are likely to be financial — the size of total investible resources (wealth); relative rates of return on foreign currency as compared with sterling assets (in sterling terms); and the riskiness of different sorts of assets. Many capital flows reflect purchases and sales of overseas financial assets (portfolio investment).

The impact on capital flows of any investment in overseas assets ('real', such as plant and machinery, as well as 'portfolio') depends on how it is financed. If a UK firm builds a factory abroad, and raises the necessary finance entirely by means of a foreign currency loan, there will be no net effect on the capital account of the balance of payments. Decisions about whether to borrow sterling or currency will be influenced by general financial considerations — expected returns (the level of foreign relative to sterling interest rates, allowing for expected movements in exchange rates), and risk (including exposure to currency fluctuations).

The scale of outflows following the abolition of controls will have reflected, in part, underlying financial conditions since then. The abolition of controls has probably had a more pronounced effect on capital flows so far this year, as foreign interest rates rose and the dollar strengthened, than it did in 1980, when UK interest rates were relatively high and sterling was in heavy demand.

The capital account

It is almost impossible to quantify the effects of abolition from the capital account statistics. We can only guess what would have happened if controls had been retained. Capital flows are notoriously difficult to forecast. The problem is particularly acute for 1980 when the demand for sterling was affected by a number of exceptional or new influences as well as by the ending of controls

Table 1

BALANCE-OF-PAYMENTS FLOWS 1976-1981

£ millions, not seasonally adjusted (— means balance-of-payments outflow)

	1976	1977	1978	1979		1980		1981
				1st half	2nd half	1st half	2nd half	1st half
I Capital flows directly affected by abolition of exchange controls								
(i) Overseas portfolio investment	90	12	-1073	-292	-617	-848	-2110	-2470
(ii) Direct investment abroad	-2145	-1885	-2740	-1503	-1285	-1797	-772	-1772
(iii) Banks' external lending in sterling	-348	58	-507	305	-107	-851	-1611	-1665
(iv) Bank's net foreign currency borrowing	-106	364	-433	1389	236	1089	935	-1371
of which, borrowing to finance overseas investment	165	550	835	495	-965	na	na	na
(v) Total (i) to (iv)	-2509	-1451	-4753	-101	-1773	-2407	-3558	-7278
II Other capital flows	-564	5663	493	1549	2502	2575	1916	2008
III Capital account	-3073	4212	-4260	1448	729	168	-1643	-5270
IV Balancing item	326	3190	2195	1105	-709	974	-1513	na
V Current account	-881	-41	939	-1111	248	-387	3593	na
VI Official financing transactions	3628	-7361	1126	-1442	-267	-755	-437	154
Memorandum item: Residents' foreign currency deposits with UK banks (— means increase)	-382	-775	-895	-530	-272	-795	-685	-1973

(na = not available)

— notably the UK's position as an oil producer at a time of sharply rising oil prices, the Government's commitment to a tight monetary policy, and the ending of other direct controls on banks' behaviour (the 'corset').

Interpretation is complicated by the fact that the exchange rate has been determined by market forces. Changes in the demand for sterling have therefore been reflected in changes in its price (the exchange rate) rather than in the official reserves. That means that the net position on capital account is not very informative. If the authorities are not intervening in the foreign exchange market, the capital account balance is simply a mirror image of the current balance. In the short run, current account transactions are very much less sensitive to the exchange rate than capital flows. If the official reserves are unchanged, a net deficit or surplus on current account must be financed by a matching surplus or deficit on capital account, with the exchange rate rising or falling until this result is achieved.

More detailed analysis of capital account transactions offers some clues. Table 1 identifies the most important capital flows previously affected by control. The large net outflows in most of these categories are in striking contrast with the net inflows on other capital account transactions, which are principally carried out by non-residents.

Foreign currency loan repayments

The Budget of June 1979 gave permission for the early repayment of foreign currency loans taken out to finance overseas investment under the old regime. During the second half of 1979 almost £1 billion was repaid to UK banks and another £0.25 billion to banks and others overseas, out of a total debt at the outset of several billions. These repayments were recorded as long as exchange control permission was required for cash payment. Since October 1979 there has been no direct information on these flows. However, it is known from other sources that some institutions, such as investment and unit trusts, continued to make repayments during 1980, though on a much reduced scale. Most of these currency loans will have been refinanced in sterling, probably by bank borrowing.

Overseas portfolio investment

The abolition of exchange controls also seems to have had a major impact upon overseas portfolio investment. The level of investment did not apparently increase by very much to start with, but reached very high levels during the second half of 1980 and the first half of 1981, running at the rate of over £4 billion a year. This could reflect statistical problems during the first half

of 1980. It is also possible that financial institutions felt the need to build up expertise in new areas before committing a larger share of their funds, and also that the high level of UK interest rates and the strength of sterling immediately following the abolition of controls made overseas assets relatively unattractive.

Financial companies

The effect on the pattern of financial companies' investments has been marked, as shown by table 2. Investment and unit trusts invested a large share of their portfolios abroad (25-30 per cent) even before the controls were relaxed, much of it financed by foreign currency borrowing. The figures for 1978 shown in the lower half of table 2 are fairly typical of the pre-1979 situation. After the ending of controls in the second half of 1979 the trusts ran down their currency borrowing by nearly £0.25 billion and increased their gross holding of overseas assets. During 1980 acquisitions of overseas securities continued at a higher level and there were some further repayments of currency loans. As a result, the share of overseas assets (net of currency borrowing) in the total investments of these institutions rose from 24 per cent to 31 per cent during 1980. This increase occurred despite the capital loss implied by the rise in the exchange rate and the loss of the investment currency premium.

Table 2

OVERSEAS ASSETS HELD BY FINANCIAL INSTITUTIONS

(i) Acquisitions of overseas assets by financial institutions (£ millions)			
	1978	1979	1980
Investment and unit trusts:			
gross investments	132	101	459
net of foreign currency borrowing and repayments	17	334	603
Pension funds	372	384	1.186
Insurance funds		221	689
(ii) Holdings of overseas assets at market values (£ billions, end of period market values, including the foreign currency premium)			
	1978	1979	1980
Investment and unit trusts:			
gross investments	2.8	2.5	3.8
net of foreign currency borrowing		2.2	3.6
Pension funds	1.5	1.9	
Insurance funds	1.3	3.7	

The figures for insurance companies and pension funds are small relative to the overall scale of their portfolios, but larger in absolute terms. Comprehensive information on foreign currency borrowing by these institutions is not available, although it is known that, before exchange controls were abolished, they tended to rely mainly upon purchases of investment currency to finance their overseas investment. Insurance companies (especially the life funds) have a smaller propensity to invest overseas than pension funds — reflecting the nature of their liabilities, which are largely fixed in nominal sterling terms — but both types of institution made large purchases of overseas securities during 1980. The share of overseas investments in the portfolios of both pension funds and insurance companies rose during 1980, though the figures for 1980 are still highly tentative.

The sterling value of institutional investments overseas during 1981 will have been increased by capital gains resulting from the fall in the sterling exchange rate, offsetting some of the exchange losses seen during 1979 and 1980. The share of overseas assets in institutional portfolios may, therefore, have increased considerably from the end-1980 levels.

Foreign currency deposits

Another consequence of abolishing exchange control has been the recent build-up of foreign currency deposits by private individuals and companies. Between the third quarter of 1979 and mid-1981 the private sector acquired £3.9 billion of currency deposits with UK banks, half of which were acquired during 1981. There has also been a smaller increase in holdings of currency deposits with overseas banks.

The timing of this build-up, like that of portfolio investment, is concentrated in the last quarter of 1980 and the first half of 1981. Again, this may be in part because relative interest rates and exchange rate expectations were unfavourable during the spring and summer of last year. Unlike overseas portfolio investments, foreign currency deposits are mainly held by industrial and commercial companies.

The build-up of foreign currency deposits was offset at first by higher foreign currency borrowing from UK banks. This was running at a particularly high level during the first half of 1980, perhaps encouraged by the ending of controls over repayments of foreign currency loans. Since mid-1980, however, the net effect of deposits and borrowing has been to switch residents other than banks heavily out of sterling.

UK residents' currency deposits (and advances) with UK banks do not affect the balance of payments directly, because overseas residents are not directly involved in these transactions. But usually the funds are then lent on to another customer — typically an overseas bank — so that the UK bank simply acts as an intermediary between UK residents and overseas residents. The transaction will then be reflected in a change in the banks' net external foreign currency position (which is a balance-of-payments item). Although UK private residents were switching out of sterling during 1980, this was offset by a bank switch in the opposite direction and the banks' net external position changed in a direction favourable to sterling.

External bank transactions in sterling

Sterling bank lending to overseas residents has also grown strongly since 1979. Well over two thirds of this lending has gone to banks operating overseas, either overseas offices of the reporting bank or unrelated overseas banks. This lending has been partly reciprocated in the form of deposits placed by these banks with UK banks (although this accounts for only about half of the total increase in overseas sterling deposits in the last two years). Ending exchange controls seems principally to have had the effect of developing the links between the UK inter-bank and the Euro-sterling markets. The gross figures, therefore, greatly overstate the net effect of this lending on the balance of payments.

Outward direct investment

There is no evidence of a change in the pattern of overseas direct investment. The implication is that exchange controls had very little effect on the level of direct investment itself, as indeed

had always been thought probable. But the liberalisation of the rules regarding the financing of these investments has probably led to a net balance-of-payments outflow. As noted above, during the second half of 1979 about £0.75 billion of currency loans previously taken out to finance direct investment was repaid.

The Bulldog market

Non-residents are now beginning to raise sterling by issuing long-term bonds on the London market. The Bank of England organises queuing to ensure that the market is not flooded with issues. The market in these bonds is known as the Bulldog market and is comparable with the Yankee bond market in New York. Since July 1980 there have been eight Bulldog issues, totalling £405 million.

Other effects

Other effects of abolishing exchange controls are even less easy to quantify. Over the past two years the exchange rate has probably been somewhat lower than it would otherwise have been — though it is not possible to disentangle the separate contribution of ending controls from all the other influences on the rate over this period. The counterpart to the increase in residents' demand for overseas assets is a fall in their demand for a wide range of UK assets — including, probably, money. Relative interest rates, as well as, possibly, the general level of interest rates, may be somewhat different as a result, though again it is impossible to say by how much. In the future, a higher stock of overseas assets will yield income from abroad which may help to offset some of the effects of declining oil revenues on the UK's balance of payments and national income once oil production starts to decline. Most difficult of all to quantify, but no less important for that, a long-standing barrier to the efficient working of financial markets has been removed.

Treasury Working Papers

The series of Treasury Working Papers was launched in 1978 and forms part of a wider set of working papers produced by the Government Economic Service (GES). The more recent Treasury papers are as follows (the numbers in brackets denote the number in the GES series):

- No.9(22) *The Test Discount Rate and the Required Rate of Return on Investment* (Proceedings of a seminar held at the Civil Service College, Sunningdale, in June 1978).
- No.10(25) *The Treasury World Economic Prospects Model* by Stephen Davies.
- No.11(28) *Public Expenditure 1977-78: Outturn Compared with Plan* by Carolyn Jutsum and G Walker.
- No.12(29) *An Econometric Model of Manufacturing Investment in the UK* by Charles Bean.
- No.13(31) *Public Expenditure 1978-79: Outturn Compared with Plan* by Valerie Imber.
- No.14(33) *The Economic Effects of a Shorter Working Week* by Richard Allen.
- No.15(34) *Simulations on the Treasury Model* by Colin Mowl.
- No.16(40) *Public Expenditure 1979-80: Outturn Compared with Plan* by Valerie Imber.
- No.17(41) *Money and Prices: A Simulation Study using the Treasury Macroeconomic Model* by Peter Richardson.
- No.18(42) *The Role of Money in Determining Prices: A Reduced Form Approach* by Simon Wren-Lewis.

Copies of Treasury Working Papers are available subject to a handling charge of 50p per copy, and cheques, money and postal orders for this amount (made payable to HM Treasury) should be sent with the order to Committee Section, HM Treasury, Parliament Street, London SW1P 3AG.

their portfolios in London and in sterling securities: and are therefore comparable to UK portfolio investment overseas. And in part the inflows reflect London's role as an international financial entrepot, accepting deposits from surplus countries and on-lending to deficit countries. The more of this business that can be profitably done in London the better.

6. Overseas investment replaces domestic investment

The Wilson Committee concluded that it is the price of finance in relation to expected profitability which is the major constraint on real investment at present. Nothing^{that}/has happened since the report was published suggests that they were wrong. Trying to stop outflows in order to force money into unprofitable projects will not benefit anyone.

7. Why were new exchange control powers included in Finance Bill

The powers included in the Finance Bill will enable us to control inflows more simply and effectively if that is ever necessary.

8. In what circumstances might ~~new~~ exchange control powers be needed

Inflow Controls might be needed if, for example, there was sudden very strong pressure on the exchange rate, expected to be temporary, which was due to a major external crisis.

9. Why keep statutory powers to impose exchange controls

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; and for this purpose we need to have powers already on the Statute Book.

10. Are further changes in exchange control law planned

We have no immediate plans for more legislation on exchange control. The subject is a complicated one and before making further proposals we should want them carefully^{worked}/out within the limits of available staff.

11. Savings in exchange control administration

About 750 jobs at the Bank of England and about 25 jobs at the Treasury came to an end with an annual public expenditure saving of about £15 million; and the work of Customs and Excise was simplified. A considerable administrative burden on banks, companies and private individuals has been lifted. The effort and resources required to deal with exchange controls can now be used more productively.

12. How many people still work on Exchange Controls

8 staff at the Bank of England are concerned with residual work on exchange controls. After next month no staff will be employed full time on exchange control work in the Treasury.

~~Interest rates are covered in more detail in the News PG7.~~

SECRET

Mr Scholar ^{Even Pol}

18

Mr

PRIME MINISTER

EXCHANGE CONTROLS

There are many persistent rumours in the City that exchange controls are about to be reimposed. It is difficult to trace the reason or source of such rumours, but it seems likely that they are to some extent associated with the conjectures about the possibility of our joining the EMS.

I believe that these rumours have been very damaging in many ways. They have undoubtedly affected our funding programme. There are also persistent reports of large sums being sent overseas, in anticipation of some measures similar to those imposed in France. There are also latent and much less defined fears of the re-introduction of credit controls. I have, however, not been able to trace any of the effects of that particular rumour.

I think it is very important to scotch these rumours as soon as possible. There is a very considerable problem of credibility. Whatever may be said will be interpreted with large pinches of salt. One particular measure may be effective, that is if the Government announced that they were definitely going to repeal the Exchange Control Act of 1947. This Act provides the legislative basis for exchange control and, for various reasons, has not been repealed.

I think we have to have this under EEC rules.

22 October 1981

ALAN WALTERS

cc Mr. Alexander
Mr. Scholar
Mr. Hoskyns
Mr. Wolfson
Mr. Duguid
Mr. Vereker

SECRET

SUBJECT

cc Hasler

SECRET

17 ^{econ} ^{me} ^{vs}

Copy to
Domestic Monetary
Econ Policy R9



cc Mr. Walters

cc Euro Pol: EMS: June 79

10 DOWNING STREET

From the Private Secretary

14 September 1981

Handwritten initials

Dear Tim.

As you know, the Chancellor and the Governor called on the Prime Minister late this morning to discuss interest rates and the exchange rate. They were accompanied by Sir Kenneth Couzens.

The Chancellor said that towards the end of the previous week he had become increasingly concerned about the fall in the exchange rate. It had continued to fall this morning; and at noon the effective rate was 86.6, which was below its level at the time of the General Election, and the DM rate was just over 4.21. These rates compared with 98.6 and 4.66 respectively on Budget Day. He and the Governor now believed it would be appropriate to raise the undisclosed interest rate band - probably by 1½% - with a view to bringing about a 2% rise in base rates. This was partly with a view to arresting the fall in the exchange rate; but it was also justified to some extent by the domestic monetary situation. The latest money supply figures and their medium prospects, and in particular the strength of bank lending to the personal sector, were a cause for concern.

The Governor explained that sterling had been weakening for several months, but the fall against the DM had accelerated over the last few days. One reason for the decline was the widening of the interest rate differential between sterling and the dollar; another was the weakening of oil prices, which particularly favoured the DM. He supported the Chancellor's view that, on both exchange rate and domestic monetary grounds, a 2% rise in base rates was required.

The Prime Minister said that, if interest rates were to be raised at all, the increase should be sufficient to achieve a steadying of the exchange rate. She therefore agreed with the proposal that the undisclosed band should be raised so as to bring about an increase in base rates of 2%; anything less would be likely to be insufficient. The Prime Minister went on to say that recent developments on the exchange rate front raised the question once again of whether the UK should join the EMS. She hoped that the Chancellor would reconsider the options. The Chancellor said that he was already looking at this question, and he hoped to be in a position to advise the Prime Minister further before he went away later in the week.

Annexed

I am sending a copy of this letter to Tim Allen (Bank of England).

Handwritten initials and signature

John Kerr, Esq.,
H.M. Treasury

SECRET



Treasury Chambers, Parliament Street, SWIP 3AG
OI-233 3000

14 September 1981

T. Lankester, Esq.,
Private Secretary,
10, Downing Street

Dear Tim,

EXCHANGE RATE AND INTEREST RATES

As you know, the Chancellor discussed the exchange rate situation with the Governor this morning. Although the situation was put to the Prime Minister later this morning, and the decision has now been taken, you may like to know for the record a note of the arguments and their presentation.

The Governor said that the external arguments for raising interest rates were now very strong. The fall in the exchange rate had persisted over many months: in view of the inflationary impact it was now necessary to act. Intervention alone would not be enough. We now needed to do more on interest rates than had been agreed earlier in the summer, when the external situation had not seemed to call for a rise in bank base rates, and the prospect of lower American rates seemed both stronger and more likely to be sufficient. The rapid fall of sterling this morning added to the force of these arguments. The key figures are as follows and a fuller table is annexed.

	<u>Election</u> <u>day</u>	<u>Peak</u>	<u>Today</u>	<u>% change since</u>	
				<u>Election</u> <u>day</u>	<u>Peak</u>
Effective	86.7	105.6 (28 Jan '81)	86.6	-0.1	-18.0
£/\$	2.08	2.47 (24 Oct '80)	1.77	-14.6	-28.1
£/DM	4.0	5.07 (16 Feb '81)	4.21	+5.3	-17.0

Domestic monetary arguments pointed in the same direction, though here the situation was less clear-cut. The most threatening element was the rapid increase of bank lending particularly for housing. But it was also right to be cautious in view of the statistical fog generated by the Civil Service strike which would

/continue



continue to distort the CGBR and hence the £M3 figures for months ahead.

Treasury officials agreed with the Bank's analysis on both external and domestic fronts.

The Governor therefore proposed that the undisclosed band for very short term interest rates should be raised, from 11½-13½ per cent to 13-15 per cent. This rise of 1½ per cent was likely to lead to a rise of 2 per cent in bank base rates and a similar rise in mortgage rates, though the extent of these changes was uncertain.

The Chancellor agreed with the Governor's proposal, which he recognised was given with reluctance in view of the impact on the recovery of the economy and the obvious political difficulties. But as you know the threat to the Government's inflation strategy is in the Chancellor's view too great for inaction on interest rates to be a tolerable option in current circumstances.

Although there will be no announcement of the kind familiar when MLR was in use, it will of course be apparent that the rise in interest rates is being brought about by the authorities' action. The briefing which has been prepared will say that the action has been taken primarily in response to the external situation, but that in view of the rapid expansion of bank lending and of the obscurity surrounding the monetary figures as a result of the effects of the Civil Service strike which will continue for months ahead, a rise in interest rates will also be in line with the appropriately cautious conduct of domestic monetary policy.

I am sending a copy of this letter to Tim Allen at the Bank.

*Yours ever,
J.O. Kerr.*

J.O. KERR

Recent sterling exchange rates

(Percentage changes are calculated from Election Day)

<u>Date</u>	<u>US\$</u>	<u>Effective Exchange Rate</u>	<u>DM</u>
3. 5.79 (Election Day)	2.0759	86.7	4.0

15.11.79 (MLR increased to 17%)	2.1420 (+3.2%)	88.8 (+2.4%)	3.81 (-4.8%)
3. 7.80 (MLR to 16%)	2.3455 (+13.0%)	94.7 (+9.2%)	4.12 (+4.6%)
24.10.80 (\$/£ peak)	<u>2.4650</u> (+18.7%)	101.4 (+16.9%)	4.60 (+16.7%)
6.11.80 (1980 ERI peak)	2.4426 (+17.7%)	103.4 (+19.3%)	4.75 (+20.5%)
24.11.80 (MLR to 14%)	2.3485 (+13.1%)	98.9 (+14.1%)	4.50 (+13.9%)
28. 1.81 (Peak ERI)	2.4117 (+16.2%)	<u>105.6</u> (+21.8%)	5.01 (+25.3%)
16. 2.81 (£ peak against continentals)	2.2570 (+8.7%)	103.5 (+19.4%)	<u>5.07</u> (+28.5%)
5. 6.81 (£'s June trough)	1.9150 (- 7.8%)	93.8 (+ 8.2%)	4.64 (+ 16.0%)

14-9-81

% changes from
peak

13/9/81

SECRET

15-

- 1. MR RYRIE
- 2. CHANCELLOR

- cc Chief Secretary
- Financial Secretary
- Sir D Wass
- Sir K Couzens
- Sir A Rawlinson
- Mr Burns
- Mr Middleton
- Mr Hancock
- Mr Britton
- Mr H Evans
- Mr Lavelle
- Mr Bridgeman
- Mr Kemp
- Mr Peretz
- Mr Turnbull

~~cc. Euro PD: EMS: June 79~~

R

INTEREST RATES
 JOINT NOTE BY HF AND EF

There is now a strong case both on domestic monetary grounds and on exchange rate grounds for a rise in short term interest rates. The HF and EF sides of the Treasury are agreed on this and for logistic reasons we are letting you have this note in advance of Mr Ryrie's Monthly Monetary Meeting with the Bank early next week. We think you will need a meeting with the Governor which will only be possible in the first three days of next week. If there is no decision then, it may not be possible to get one before the end of the month. We cannot yet say how the Bank's thinking has moved since the August monetary meeting, but this note will give you more time to consider the issues. The key points are summarised below.

Domestic Monetary Policy

- 2. The key points are:-
 - a. the prospects for hitting the monetary target have looked bad since the weakening of the exchange rate and the last forecast in the summer;
 - b. despite the decisions in July and early August to allow upward movement in very short market rates, bank base rates have not changed and in the last month market rates have come down somewhat;

S E C R E T

- 2 -

- c. the August monthly meeting concluded that a strong case could be made in favour of a rise in interest rates but that the interest rate band should be centred on 12½% so that the launch of new monetary arrangements would not be associated with a rise in interest rates;
- d. the £M3 increase in banking August and the continued rapid expansion of bank lending were bad signs. We no longer claimed that the underlying growth rate was within the target range;
- e. we expect the rapid growth in bank lending particularly to persons, to continue. The Civil Service strike will add to the CGBR for banking September and October. The new 3 months forecast (see annexed table) shows high monthly increases in £M3 and rising cumulative figures for these months in both recorded and underlying terms. Banking November looks better but even after that we expect the cumulative underlying growth to be at an annual rate of 13%. The actual growth for February to November (not at an annual rate) would be about 9½%. That would mean that any further growth in underlying terms would take us over the top of the target range. The size of the effect of higher interest rates on monetary growth is uncertain. But on the basis of such figures in-action on interest rates would be incompatible with the Government's monetary policy in substance and this would become increasingly apparent to commentators and markets. It could not be explained either by reference to the exchange rate (see below) or by the movement of most other monetary aggregates;
- f. we are making no net debt sales at present. A rise in interest rates would help partly because it would signal

adherence to the monetary policy and partly because it would provide cover for raising the yield on conventional gilts.

The Exchange Rate

3. The key points are:-

- a. over much of the period since the budget the exchange rate has been falling; we have allowed the exchange rate rather than interest rates to take the pressure. The forecast at the time of the budget was for an effective rate remaining more or less steady throughout 1981 at around 100. At the end of May the effective rate stood at 99, the £/\$ rate at 2.08, and the £/DM rate at 4.82. Since then the rate has come down in a series of falls, first against the dollar and more recently against the continental currencies:

	<u>Jan 1980</u>	<u>10 Mar 1980</u>	<u>1 June</u>	<u>1 July</u>	<u>3 Aug</u>	<u>11 Sept</u>
		(Close)	(Close)	(Close)	(Close)	(Noon)
Effective	100.2	98.6	98.3	93.1	91.5	87.8
£/\$	2.38	2.21	2.06	1.90	1.81	1.79
£/DM	5.02	4.66	4.80	4.60	4.55	4.31

- b. the oil factor which earlier had insulated us against external pressure has clearly been moving against us, and the current account may have been in less gross surplus than earlier in the year;
- c. there has been an undertone of sentiment against sterling, with uncertainty about the direction of UK economic developments, and how to interpret those figures that have been available;
- d. at the same time, the interest rate differential between sterling and the dollar has widened from around 2-2½%

(three month rates) in the period immediately after the budget: it has been around 4½-5% in recent weeks. Others who have been vulnerable, like the French with their EMS commitments, have been unable to ignore this rising differential, and had to raise their interest rates some time ago;

- e. the rate is now below the level assumed for 9% inflation factor you have proposed for public expenditure in 1982/83. That was based on a forecast effective rate through next year of just under 90. Were the rate now to fall much further it must increase the difficulty of containing spending within the increase proposed;
- f. it would be unwise to expect that a modest rise in the unannounced interest rate band would have a marked effect on the exchange rate, or even prevent further falls, given the nature of the factors at work. But it might be expected to exercise a helpful influence in the short run, which could be more long lasting if it were taken as a sign of the Government's resolve.

Method of Raising Interest Rates

4. We envisage that an increase in rates would be achieved in the normal way - by reducing the scale of the Bank's money market intervention and raising the rate at which it operates (by at least 1%). It would nonetheless be clear that the authorities had decided to raise interest rates since this could not be represented as a move in line with market pressures. The rise in base rates, and perhaps also in long rates, might be higher than the rise in the Bank's intervention rate.

Other Factors

5. We shall be making a substantive recommendation on interest rates after discussion with the Bank early next week. In the meantime you will wish to consider the case for higher interest rates from the point of view of the Party Conference and of the public expenditure discussions on 20 October. Those who are critical of the present strategy may have their views about its costs strengthened by an interest rate move, but those who support the strategy will be heartened by clear action and to them the need for public expenditure cuts will be highlighted.

MM
N MONCK

11 September 1981

ANNEX

THE NEW THREE MONTHLY MONETARY FORECAST

Percent change in £M3 (banking months)

	Actual	Forecast		
	<u>August</u>	<u>Sept</u>	<u>Oct</u>	<u>Nov</u>
Monthly Increase				
Recorded	1.1	2.5	2.7	0.6
Underlying	1.5	2.3	1.7	0.8
Increase since February at annual rate				
Recorded	16.7	19.1	21.4	19.7
Underlying	9.3	12.1	13.4	13.0
Actual Increase since February (not at annual rate)				
Recorded	8.0	10.8	13.8	14.4
Underlying	4.5	7.0	8.8	9.6



Evan Pd

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

11 March 1981

I.K.C. Ellison, Esq.,
Private Secretary,
Department of Industry

Mc

Dear I.K.C.

BACKGROUND BRIEFING ON THE EXCHANGE RATE

The level of the exchange rate continues to be a matter for comment, and there may well be a number of references to this in the Budget debate.

.....
The Chancellor thought therefore that your Secretary of State and other colleagues might like to have the attached extended briefing note prepared in the Treasury. It includes sections on recent developments in the exchange rate and the factors underlying sterling's past rise, as well as a statement of Government policy towards the rate. It also deals briefly with difficulties associated with the most commonly proposed alternative policies; and the lessons of past experience.

I am sending copies to No.10, the Private Secretaries to Members of E Committee and Sir Robert Armstrong.

Yours sincerely

P.S. JENKINS
Private Secretary

BACKGROUND BRIEFING ON THE EXCHANGE RATE

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BACKGROUND BRIEFING ON THE EXCHANGE RATE

A. FACTUAL

(i) Recent developments

On 2nd March, sterling stood at \$2.18, DM 4.70 and 98.7 in effective terms. (The effective exchange rate measures the movement of sterling against a basket of other currencies, weighted by UK trade.) The rate reached a 7-year peak against the dollar (\$2.45) on 21 October 1980 and a 5-year peak against the Deutschmark (over DM 5.05) on 16 February 1981. However, since mid-February the exchange rate has fallen significantly, mainly against the dollar but also in effective terms.

2. Since the Government took office the effective exchange rate has risen by 14% and the rate against the dollar has risen by 5% (see Chart 1).

3. Over three quarters of sterling's rise against the dollar since the low point of 1975 occurred before the Government took office (33.5% under Labour, 40.3% over the whole period—see Chart 2).

(ii) History

4. Chart 2 shows the movement of the exchange rate between 1975 and 1980. The period can be split into four fairly distinct parts:

(a) February-October 1976: a period of crisis during which sterling fell from \$2.02 to \$1.56, despite very heavy intervention.

(b) November 1976-October 1977: confidence returned after agreement was reached with the IMF.

The rate continued to rise despite \$13 billion of intervention during 1977 and a fall of 9 percentage points in MLR. The Government abandoned the attempt to hold down the rate in October.

(c) November 1977-Spring 1978: the rate remained fairly steady. Monetary growth rose above target, as the effects of the earlier attempt to cut the rate worked their way through.

(d) Spring 1979 - and 1980: sterling came into renewed demand against a background of disturbance in the world oil market, a heightening of international tension and the determination of the new UK Government to fight inflation. Exchange controls were abolished in October 1979 but the capital outflows associated with this change will come through only over time.

B. FACTORS AFFECTING THE RATE

5. Various factors have contributed to sterling's strength in recent years; their weight no doubt varies from time to time.

(i) North Sea oil and oil prices

6. Part of the rise in the rate must clearly be attributed to the UK's possession of North Sea oil, while real oil prices have doubled, and against a background of uncertainty about future oil prices and supplies reflecting heightened international tension. Sterling rose as the market marked other currencies (eg the Deutschmark) down, assessing other economies to be more exposed to the effects of oil price rises than the UK.

(ii) Interest rates and monetary policy

7. The confidence of the market in the Government's determination to fight inflation compared,

must have been one factor underpinning the strength of the exchange rate. Indeed, the exchange rate represents one of the mechanisms through which a policy of curbing inflation through the control of money operates.

8. It is sometimes argued that interest rates have been set at higher levels than has been necessary to meet the Government's inflation objective and that this has raised the exchange rate unduly. However, recent experience has suggested that nominal interest rates have had an uncertain and at most not very large impact on the exchange rate (Chart 5). UK interest rates are now below those in the US, Germany and France.

(iii) Current account

9. The current account surplus has certainly been exerting a direct upward influence on the rate since the middle of 1980. Similarly, the weakness of the Deutschmark has reflected the large and persistent German deficit.

(iv) Portfolio shifts and other factors

10. Portfolio diversification out of the dollar since 1977 and more recently perhaps out of the Deutschemank seems to have been responsible for some of the capital inflows into sterling that were taking place up to mid-1980. The existence of a highly developed and accessible market in sterling financial assets has also made sterling a natural short-term home for a proportion of the increased OPEC surpluses since 1979.

11. Other factors have influenced the market's assessment of the prospects for other major currencies and so have affected the relative movement of sterling. The Deutschemank has fallen as the markets have become increasingly concerned about the exposure of the German economy to oil prices and its seemingly persistent large current deficit, as well as developments in neighbouring Poland. More recently, the Deutschemank has partly recovered in response to the German decision to allow interest rates to rise, while at the same time the dollar has been strong, reflecting the market's confidence in President Reagan.

(v) Future prospects

12. In addition to these factors underlying the strength of the exchange rate there are others which may affect the demand for sterling or to which the market is likely to pay attention in future:

- private sector capital outflows will probably continue to grow, facilitated by the abolition of exchange controls and encouraged by higher interest rates overseas.
- overseas borrowing in the sterling market could increase for similar reasons.
- developments in the oil market.
- the strength of the dollar may persist if President Reagan retains the confidence of the market.

- the Deutschemark could recover further if the German current account shows signs of recovery, and barring adverse political developments (eg in Poland).

But exchange rate predictions are notoriously unreliable, and it is impossible to predict the net effect of all these factors on the rate, or to know, for example, the extent to which some of them may already have been discounted.

C. THE EXCHANGE RATE, INFLATION AND THE ABILITY TO COMPETE

13. Many complaints are made about the loss of "competitiveness" associated with a high sterling exchange rate. Despite problems of measurement, it seems clear that those parts of British industry most exposed to international competition have suffered a sharp loss in price competitiveness since 1978. More than half of our loss on this measure over the last two years is due to the fact that we have allowed our labour costs to rise much faster than those abroad. But we have not experienced the depreciation of sterling which has followed previous periods of wage excess. The very rapid change has created difficulties for many firms; on the other hand result has been that industry has had the benefit of cheaper imported materials and components, and should benefit from reduced wage demands. The higher rate has reduced inflation and made consumers better off.

14. The strong pound has also meant that the exports we have produced have earned much more for us. Figures so far available suggest that the value of our exports rose in 1980 at least as fast as our major competitors, with no decline in volume - although on the basis of past experience the recent loss of price competitiveness will have its greatest effect on the volume exports this year and next.

15. No country can maintain its industry's ability to compete by endless depreciations of its current. That is simply the way to accelerating inflation. The only sure way to maintain our ability to compete is to achieve the shift to much lower levels of wage inflation, improvements in productivity, better control of costs, and improved quality as Germany and Japan did continuously through the 1960's and 1970's despite currencies and declining "competitiveness".

D. POLICY

(i) The Government's policy

16. The exchange rate is determined primarily by market forces. The current level has not been sought as a matter of deliberate policy. There is no target rate for sterling. Whether the rate is rising or falling, intervention by the authorities is limited to "smoothing" to moderate excessive fluctuations and preserve orderly markets.

17. Experience in the UK and elsewhere has shown that to control the exchange rate, governments have to cease giving priority to reducing inflation. And even then they do not always succeed in controlling the rate. The last Government's experience in 1977 (see paragraph 4 (b) and (c) above) illustrates this.

18. Although the level of the rate is not a target of Government policy, it is one of the factors taken into account in assessing monetary tightness, and in framing fiscal policy.

(ii) Other proposals

(a) Talking the rate down

19. Experience of Government pronouncements in this and other countries intended to influence the rate contrary to the market has not been encouraging. If the attempt is made in the face of a clear market trend it has little or no chance of success; if done when the market is beginning to change its view it can cause over-reaction. If it is to have any chance of securing the right impact, it has to be backed by concrete policy measures.

(b) Intervention

20. In modern conditions, intervention beyond that for smoothing purposes has usually to be on a very large scale indeed if it is to affect the rate. Even then, the record of success is poor (eg the UK experience in 1977) except where intervention has been associated with other policy measures (including action on interest rates). Since the nature of intervention consists of selling sterling to make it cheaper it is likely to increase the money supply - unless offset, for example, by higher interest rates or reductions in public spending - with the risk of inflationary consequences.

(c) Relax monetary control/cut domestic interest rates

21. While relative interest rate movements do on occasion have some impact on exchange rates, past evidence does not suggest any firm or reliable relationship between changes in interest differentials and exchange rate movements (see Chart 3). Between May and December a change of 15 percentage points in the differential between US and UK interest rates seemed to have no impact on the exchange rate, though earlier in the year it looked as if there had been a relationship. Interest rate changes therefore offer no certain way of influencing the exchange rate, although they may have some effect in periods when other factors are not playing a dominant role.

(d) Measures to control capital inflows

22. The pace of capital inflows has greatly slackened in recent months and our interest rates have been overtaken by those of other major countries. This option has therefore even less relevance to present circumstances than it might have in other periods. Other countries (notably the Swiss and Germans) have found inflow controls to be effective only for short periods; they would be even harder to impose successfully on London's more sophisticated financial markets. They could actually prove counter-productive if the market took them as an indication that the Government believed the pound would remain strong.

(e) Tax measures

23. It has sometimes been suggested that a withholding tax could be imposed on the interest paid to non-residents. Such a tax could be readily avoided by non-residents directing their deposits into the Euro-sterling market; but in any case, many non-residents would be guaranteed exemption by the double taxation agreements currently in force between the UK and other countries.

(iii) EMS

24. The UK fully supports the EMS and welcomes the measure of stability it has brought to the exchange markets. We have shown our support by joining other member states in depositing 20 per cent of our gold and dollar reserves with the European Monetary Cooperation Fund and are participating fully in the discussions within the Community about ways in which the EMS might be developed further.
25. But we do not yet feel able to join the exchange rate mechanism. Britain is alone in the Community in being self-sufficient in oil, while other member states are substantial net importers. During the last two years this has meant that sterling has tended to move in the opposite direction from other EMS currencies at times of disturbance in the oil market and this could have destroyed the stability of the exchange rate mechanism, had the UK been a member. In addition, the obligation to control sterling's agreed margin of fluctuation against our partners' currencies could conflict with our domestic monetary policy because of the amount of intervention we might find ourselves obliged to undertake. It would be unrealistic to assume that we could realign our central rate whenever necessary. This would disrupt the system and might not always find favour with other members. Nevertheless, we fully intend to join the mechanism when conditions are right for the system and for ourselves.

CHART 2

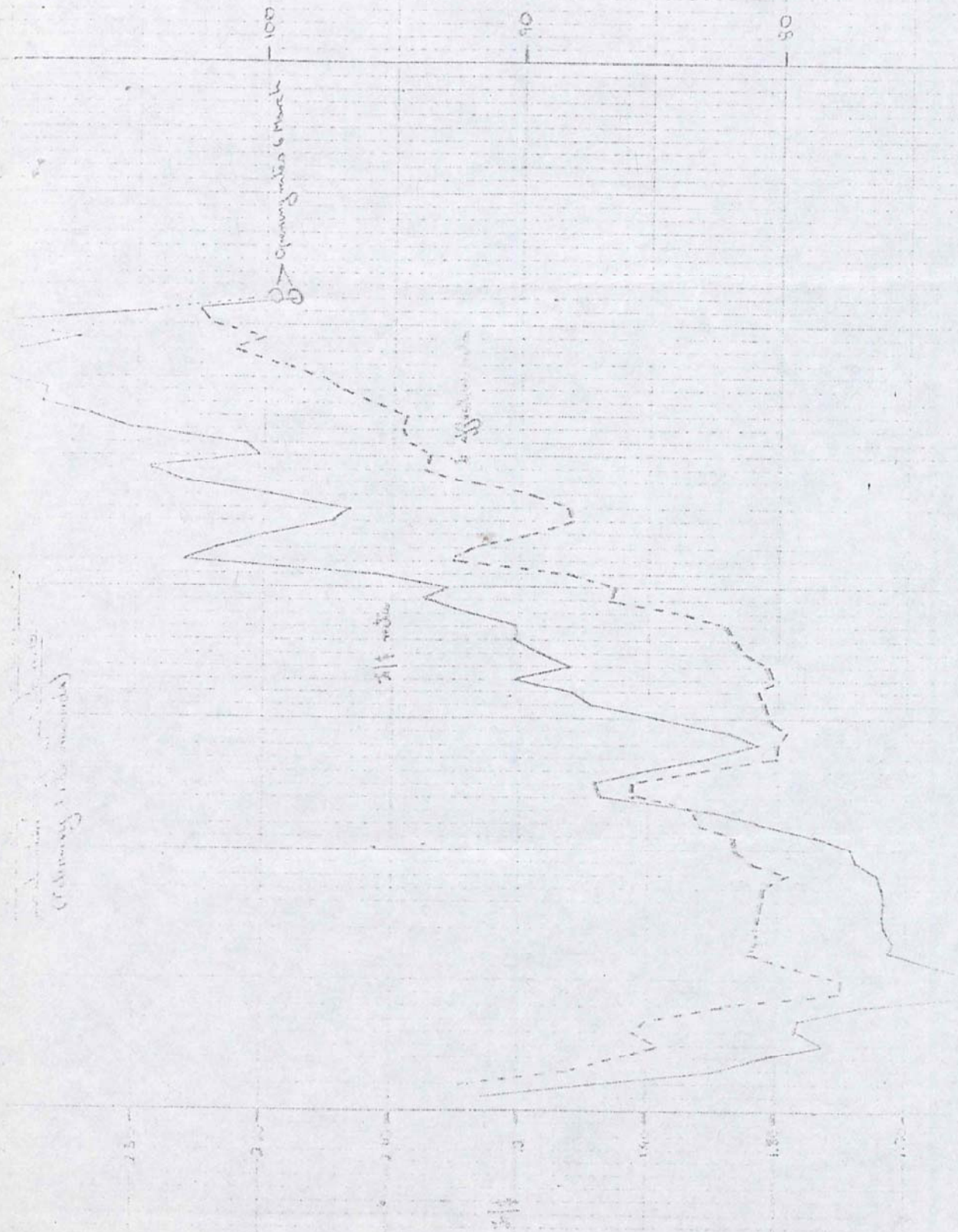


CHART 3:

245
240
235
230
225
220
215

Plot of $\log_{10} \frac{1}{\rho} \frac{d\rho}{dz}$ vs z (meters) for the CO_2 column (indicated by arrows)



Plot of $\log_{10} \frac{1}{\rho} \frac{d\rho}{dz}$ vs z (meters) for the CO_2 column (indicated by arrows)

ois



M. LANSKROTT - No. 10.

The Chancellor thought that

With the Compliments
of the

Chancellor of the Exchequer's
Private Secretary

the Prime Minister would be inter-
ested to see the attached note

Treasury Chambers,
Parliament Street,
S.W.1.

R. T. ...
18/2/81

For Information:

Chief Secretary
 Financial Secretary
 Sir Douglas Wass
 Sir Anthony Rawlinson
 Mr Terry Burns
 Mr Ryrie
 Mr Barratt
 Mr Hancock
 Mr Middleton
 Mr Lavelle
 Mr Unwin
 Mr Peretz
 Mr Britton
 Mr Hodges
 Mrs Lomax
 Mr Ridley
 Mr Norgrove

CHANCELLOR

MEASURES TO REDUCE THE EXCHANGE RATE

You asked us to look again at the possibility of introducing inflow controls or discouraging inflows by fiscal means; and Mr Wiggins' minute of 5 February to Mr Ryrie about Industrial Assistance and Public Expenditure Priorities also asked about the case for intervention in the foreign exchange markets as an alternative to the bids for extra public expenditure that are emerging in a number of areas as a consequence of a high exchange rate.

Exchange Rate Developments

2. A natural starting point is to look at recent movements in the exchange rate and the influences at work. On its new basis the effective rate had risen from an average of around 100 during the last quarter of 1980 to 105 by the end of January. By today (16 February) it has fallen back to 103 (79½ on the old index). There is some evidence that January is usually a month in which sterling is strong; and it was obviously buoyed up by the strong current account in that month, which produced a record surplus.
3. During this period the dollar has risen strongly and from a peak of \$2.43 on 6 January the sterling rate has fallen this morning to \$2.25 (-7½%). But the traditional "see-saw" has operated and we have risen against the EMS currencies; they have taken the brunt of the dollar revival. The DM has fallen against the £

from an average of 4.55 during the fourth quarter of 1980 to around 5.05 now - a 12% fall, over a period in which DM interest rates have risen in relation to sterling rates.

4. The major development of recent weeks has been the dollar surge and the weakness of the DM. It has had little or nothing to do with sterling or sterling interest rates. Exchange markets have been giving less weight than in the past to relative inflation performance and more weight to current account performance, possibly linking current account performance and trends with structural ability to cope with adjustment to high oil prices and uncertain supply. On this test Germany has so far come out badly relative to Japan as well as to the United States (or the UK). Exposure to events in Eastern Europe counts as a further structural factor against the DM in present circumstances. It is a major question for the international economy (and also for the European Community) whether in the second half of 1981/first half of 1982 the Germans can turn this round. Relative US and German interest rates may also have been a factor, and German complaints to the US may focus on this. But as usual the impact of interest rates seems very uncertain. Despite several billion dollars worth of intervention (about \$1 billion last week) by the Germans, Americans and French, the DM has fallen from an average of 1.91 in the fourth quarter of 1980 to 2.24 to the dollar now (- 17%).

5. The fall in sterling against the dollar costs us oil revenue, expressed in sterling, but helps important sections of UK industry (eg Rolls Royce, British Aerospace). However, many small UK exporters, as well as larger organisations such as BSC, are particularly sensitive to the £/DM rate. For the future, depending on how the German economy performs later in 1981, this fall could possibly reverse itself, in the same way as the similar fall in the Yen that took place in 1979 was reversed in 1980. And as we have said before, as UK interest rates come down this may stimulate capital outflows and overseas borrowing in the sterling market (both made possible by the ending of exchange

controls) to a point where they come to have a stronger impact on the sterling rate. A weaker oil market, if it persists, may also have an effect.

Intervention

6. There is nothing in this analysis which would lead me to see merit in or to recommend resort to intervention as an alternative to public expenditure. Although statistically it does not add to the PSBR, intervention has of course a similar impact on £M3 to an increase in public expenditure. The Government has to borrow sterling to acquire foreign currency assets for the reserves. But intervention is a form of expenditure where - because of the way the foreign exchange markets work - a very great deal indeed can be spent with little or no effect, particularly if it is not combined with changes in other policies including cuts in interest rates. As you have often reminded the House, in the course of 1977 the then Government "spent" over £7 billion trying to prevent the £ from rising and reduced MLR from 14% to 5%; and even then sterling had eventually to be uncapped. The abolition of exchange controls will have further weakened the effectiveness of intervention. Certainly any expenditure on intervention would have to be on a much greater scale than selective expenditure on industrial assistance if it were even to attempt to provide the same benefit for industry. Mr Burgner tells me that a 10% higher sterling/DM rate costs BSC £200m , though this allows nothing for offsets (lower pay reflecting a lower UK inflation rate, cheaper inputs, associated effects on their markets etc). As the Germans have recently demonstrated again, sums many times larger than this can be spent fighting the foreign exchange market through intervention without any perceptible effect.

Inflow Controls and Tax Disincentives to Inflows

7. The attached paper by Mr Norgrove reviews the case for controls on or fiscal disincentives to capital inflows. One can see the argument that if the Government feels obliged to take some action

on the exchange rate, inflow controls are less of a departure from policy on the money supply than intervention. However:-

- i. they could affect the meaning of the money supply figures (like other direct controls), and could have an adverse impact on the measured money supply, just at a moment when the Government would be trying to restore credibility to its monetary control;
- ii. at best, the effect on the exchange rate would be likely to be small;
- iii. but because the Government had acknowledged that policy steps ought to be taken to reduce the exchange rate, they could be pressed to take other steps moving in the direction of an exchange rate target if inflow controls were seen to achieve little.

8. Given the further difficulties, tax measures would seem unlikely to have any early impact either on the rate or on the revenue. Apart from the obstacles in double tax agreements and sovereign immunity, deduction of tax from non-resident bank deposits might direct these deposits into the Eurosterling market.

9. As the note shows, capital inflows into sterling have been running at a much lower level in recent months than earlier last year. There must now be a much stronger influence from the current account surplus. In these circumstances inflow controls or tax disincentives would on the face of it seem an even less appropriate response.

Conclusion

10. To my mind the arguments against resort to inflow controls are very strong: if anything they seem stronger now than when we last reviewed them. The Prime Minister in her speech in the House on

CONFIDENTIAL

5 February referred to capital controls and exchange controls as "Socialist Controls" that would imperil economic success. We do not of course need to take a final view either way now: the controls remain at 48 hours readiness. But any measures you are able to take to reduce interest rates or to help industry in the Budget would seem much more relevant.

KEC

K E COUZENS
16 February 1981

CONFIDENTIAL

MEASURES TO CONTROL OR DISCOURAGE CAPITAL INFLOWS

Inflow controls were last given extended consideration in the autumn, on the basis of two papers prepared by the Treasury and circulated in September and October. It was concluded that the Government should stick to the existing monetary strategy, but the Prime Minister asked for continuing thought to be given to the possibility of pushing the exchange rate down. Inflow controls were again considered in the run-up to the November statement. One factor which in practice ruled them out on that occasion was the decision to reduce MLR.

2. Since then we have continued to work up contingency arrangements. The present legal basis for introduction of controls has some weaknesses, which are to be tidied up in the Finance Bill. The contingency package includes the banning of the payment of interest on increases in non-resident sterling deposits; a prohibition on the acquisition by non-residents of gilts, Treasury Bills, local authority issues, sterling DCs and certain other securities; restrictions on sales of commercial bills; and the restriction of borrowing by residents of sterling from non-residents, and also of foreign currency from any source except for approved purposes. The package can be introduced at 48 hours notice, though longer notice would obviously be more efficient.

3. This note reviews the earlier assessment of effects of inflow controls and then discusses developments since November. It concludes with a discussion of tax options.

General

4. The main impact of controls would probably be their effect on confidence. The size and direction of this effect are hard to predict: much would depend on the circumstances in which controls were introduced. On the one hand the rate might fall if the market concluded that the Government were now less firmly committed to their monetary policy and were moving towards an exchange rate policy. On the other hand, the rate might rise if

the controls were seen as a sign of a Government belief that the pound would remain strong and especially if the action was taken as a signal that interest rates were likely to remain high. If strong enough, such expectations would make themselves felt on the rate regardless of the controls - for example through changes in leads and lags whose size could swamp the change in inflows. If inflow controls were unsuccessful in bringing down the rate the Government could come under increased pressure to take other measures, to intervene or to reduce interest rates.

5. Aside from the effects on confidence we would expect the impact of the measures on the exchange rate to be modest though there is considerable uncertainty in any estimate. In September on a generous estimate we believed that the effect might be to reduce the exchange rate by up to 2%. However with the reduction in capital inflows which has been a counterpart to the growth in the current account surplus (see below), the upper limit of a 2% fall might need to be lowered.

6. We would expect the package to lead to an increase in the recorded money supply, at least as measured by £M3. To the extent that controls are effective they will depress the return on some alternative assets which residents hold and encourage them to switch instead to bank deposits, thus increasing £M3. Particular examples are that residents would be given an incentive to switch eurosterling back into domestic deposits and to convert foreign currency deposits into sterling on a covered basis. The effect on £M3 could be quite substantial. The Government would be faced with the choice of whether to raise interest rates or try to reinterpret the monetary statistics, since the effect would be largely statistical: overall private sector liquidity would not have increased. Again, as with the corset, there would be further problems when the controls were removed.

7. It would be possible to argue that the effect on the money supply would be largely a statistical one as noted above: private sector liquidity in its broadest sense would not have changed. However it would not be at all easy to present an adjustment to the money supply targets on these grounds. In the aftermath of the corset, these additional complications might seriously undermine the Government's efforts to re-establish the credibility of its monetary policy.

Recent Developments

8. Recent developments have tended to reinforce the arguments against controls. In the early autumn sterling interest rates were substantially above the weighted average of rates in other OECD countries, by 3-5%. It might then have been possible to argue that inflow controls would provide a palliative until a fall in UK rates could occur*. From November onwards the sterling discount fell away and UK interest rates are now roughly equal to the weighted OECD average or even slightly below.

9. The disappearance of the interest differential and the growth of the current account surplus have been accompanied by a fall in capital inflows. The table below gives some relevant figures.

	<u>1980</u>			<u>1981</u>
	HI	III	IV	Jan
Overseas purchases of Government securities	+ 897	+ 454	- 189	+ 150 (provis- ional)
Non-resident sterling bank deposits	+1616	+ 806	+ 672	na
Total change in overseas sterling holdings	+2425	+ 992	+ 323	na

Columns do not add because of other changes in, for example, money market assets.

10. It is difficult to tell to what extent ex-ante non-resident inflows have been falling and to what extent the recorded fall is simply the ex-post result of a current account surplus and a strong rate. But it does suggest that the impact of inflow controls now could be even less than it would have been a few months ago. Moreover the gross flows may also be misleading as a guide to the forces acting on the exchange rate since some sterling inflows may have counterparts in sterling outflows, for example as a result of inter-bank trading between the domestic and Euro-sterling markets, which is very substantial, or from non-resident borrowing of sterling in order to buy gilts without exchange risk. Non-resident sterling deposits net of sterling lending overseas showed an outflow in November and December.

* Even at that stage the differential against the dollar had virtually disappeared.

Tax Options

11. The principal tax weapon would be to impose a withholding tax on interest paid to non-residents. It has the advantage that it could be presented in part as a way of raising extra revenue. Some of the main arguments on tax options were set out in Bank of England evidence to the Select Committee, though perhaps not quite in the way we would have expressed them.

12. Tax changes are inherently likely to be less effective than most other controls since they only provide a disincentive to inflows without prohibiting them. There are also substantial and probably unavoidable loopholes.

13. First, there are at present some 75 double taxation agreements in force between the UK and other countries. Some, including those with many of the major countries, do not permit the levy of a withholding tax and some limit the permissible level, but not uniformly. Many investors live in countries with which we have such agreements, or could route their investments through them. For the UK to abrogate these agreements unilaterally would at a minimum cause an international uproar. To renegotiate the agreements would take several years, and other countries would expect commensurate concessions (cf our troubles with the US agreement).

14. The second major objection is the existence of sovereign immunity from direct taxation. This covers the major Middle Eastern investors, among others. Sovereign immunity of this kind is based on an interpretation of our international obligations given by the Law Officers. UK practice on this is amongst the most generous, with that of the US. Of the major countries it seems that only Germany and Belgium do not permit sovereign immunity against direct taxation (though we are not totally clear about the position in Germany where the Government has recently agreed to immunity for EEA investments). The scope of British sovereign immunity is at present being reconsidered, but to abolish it for direct taxation would almost certainly require legislation. Abolition would probably cause difficulties with Middle Eastern investors. We believe that in the past the Germans have come under pressure from Kuwait to liberalise their policy. It would be difficult -

and we could expect major complaints, for example from the Saudis - for us now to tighten our practice: it is one thing never to have given immunity, another to take it away. We already discourage official investment in sterling through our official sterling balances policy, operated by the Bank.

15. The third major difficulty is that some non-residents might simply direct their deposits into the Euro-sterling market.

16. From 1917 to 1977 gilts were issued with interest payable gross to non-residents. Assurances were given by the previous Government that the tax status of these gilts would not be changed; to withdraw their gross status would lead to accusations of bad faith. Unless it were withdrawn this large amount of gilts payable gross to non-residents would remain accessible to them, whatever happened to double tax treaties.

17. We had earlier identified one very small change that could perhaps have some presentational impact. This would involve repealing the special corporation tax relief to UK companies for interest on foreign currency borrowing from abroad, which was introduced in 1969 specifically to attract inflows. We would however recommend against this. First, we have concluded that if this route were abolished there are others - one is known as the Swiss roundabout - which could be used to achieve the same effect. And second, we think it would also be difficult to present a change of this kind since it would appear to be damaging to British companies. So far from having presentational advantages, it could have the reverse effect.

Step towards an Exchange Rate Policy

18. The pressures on industry have increased and with them the pressures for a change in Government policies designed to bring about a depreciation of sterling. In the sense the presentational benefits of introducing measures to discourage inflows increased, but so too have the risks that one step towards an exchange rate policy (which we all expect to be rather ineffectual) will lead to another: thus reversing the Government's present policies. Other countries which have used inflow controls have not used them alone; they have used intervention, interest rate policy and domestic credit policy in harness with them (Switzerland, Germany).

Ann Amato



To note that the sterling effective index will shortly be re-based.

Treasury Chambers, Parliament Street, SW1P 3AG

T P Lankester Esq
10 Downing Street
LONDON
SW1

12 January 1981

*PL
12/1*

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Dear Tim,

STERLING EFFECTIVE EXCHANGE RATE INDEX

You might like to know in advance of some changes to this index to be announced in the next day or so. Copies of the proposed written answer and press notice are attached.

The sterling effective exchange rate index is calculated by the Bank of England several times each day, and is widely quoted in the press, as well as in our own internal daily foreign exchange market reports. It is calculated against a basket of currencies using weights estimated by the IMF. The present weights are based on trade flows in 1972.

The IMF have now revised their weights to take account of 1977 trade flows, and these have been published in the January edition of the Fund's "International Financial Statistics". Our index is therefore being revised to take account of these new weights. At the same time we are taking the opportunity to move the base of the index from 1971 Smithsonian parities to 1975 = 100. This will bring it into line both with IMF practice and with other UK economic indicators and competitiveness measures.

The result is that with sterling at its present level those who follow such things will from the beginning of February see effective rate figures in a range around 100 rather than 75-80.

I am sending copies also to the private secretaries to the Secretaries of State for Trade and Industry, Sir Robert Armstrong and the Governor.

*Yours ever,
Stephen*

S A J LOCKE

Draft PQ: To ask Mr Chancellor of the Exchequer what changes will be made to the sterling effective exchange rate index in view of the IMF's recent revision of its multilateral exchange rate model?

DRAFT REPLY

The Bank of England use weights derived from the IMF's multilateral exchange rate model (MERM) to calculate the official sterling effective exchange rate index. The IMF has recently revised the MERM and updated its weights to take account of 1977 rather than 1972 trade flows. Effective exchange rate indices using the new weights have been published by the IMF in the January 1981 edition of International Financial Statistics.

The Bank of England will use the new weights in calculating the official sterling effective index from 2 February. The index will also be rebased so that 1975 average exchange rates = 100 (instead of 18 December 1971 = 100), so bringing it into line with related UK economic series and the IMF series of effective exchange rates. The series of sterling effective exchange rates published in Table 50 of Economic Trends and Table 13.4 of Financial Statistics will be recalculated on the basis of the new weights from 1975.

In addition monthly averages of two new indices will in future be published in Financial Statistics. The first of these will show sterling's performance against the US dollar and the second against the ^{participating in the EMS exchange rate arrangements.} ~~the~~ ^{currencies/ Normalised MERM} weights will be used in the calculation of the latter.

Draft Press Notice

THE EFFECTIVE EXCHANGE RATE FOR STERLING

In a Parliamentary Written Answer today, the Financial Secretary to the Treasury made the following statement:

[Text of Written Answer]

NOTES TO EDITORS

The sterling effective exchange rate index was last revised in 1977 when weights calculated by the IMF and based on 1972 trade flows were introduced. The calculation of the index was described in an article published in the March 1977 edition of Economic Progress Report.

2. Following a revision of the weights calculated by the IMF, as published in the January issue of "International Financial Statistics", the following changes to the calculation of the sterling effective exchange rate index will be introduced from Monday 2 February 1981:

- (a) The currencies of Hong Kong, Taiwan and Yugoslavia will no longer be included in the calculation;
- (b) The weights will be revised to match those now published by the IMF and by reference to 1977 rather than 1972 trade flows;
- (c) The indices will be based on average daily London closing rates (1975 = 100) rather than on the middle rates reported to the IMF following the Smithsonian agreement.

3. For the United Kingdom the weighting changes include a fall in the weight of the US dollar from one third to one quarter and increases in the weights of the Irish punt (by three percentage points), the yen and the guilder (two points each) and the lira (one and a half points).

4. Quarterly average sterling effective exchange rates for the last four quarters calculated on both the old and the new basis are:

	Old basis	New basis
1980 Q1	72.2	93.0
Q2	73.4	94.5
Q3	75.4	96.7
Q4	77.3	99.9

On the basis of the proposed changes to the calculation of the index, the sterling effective exchange rate at the close of business on 9 January was ; calculated on the old basis it was



no reply received
Elon PD
P.

10 DOWNING STREET

Tiph

R.
M.

You asked whether we are
in reply to Lord Lever on the subject
of special Sterling Bonds.

Please see the last paragraph
of John Wiggins letter to you of
31 October 1980. He states that
one of the P.M. has seen the papers,
perhaps you and John could
have a word about a possible
reply.

Richard Bennett
26/11/80
Duty Clerk.

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cator wolfsan

10 DOWNING STREET

From the Private Secretary

25 November 1980

The Prime Minister has read your letter about the possibility of switching Bank customer transactions off market again, and she agrees that - for the time being at least - this option should not be pursued.

T. P. LANKESTER

A. J. Wiggins, Esq.,
H.M. Treasury.

CONFIDENTIAL

JS

Prime Minister 2

Sir Robert Armstrong
C. A. Herbertson



The Treasury are
not disposed to
supplying sterling
customers off-
market. Now

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

21st November 1980

but the upward
pressure on sterling

T. Lankester, Esq.,
No.10, Downing Street

has gone away,

Agreed

I suggest we
don't press them
further at this
stage.

Dear Tim,

CUSTOMER TRANSACTIONS

At her meeting with the Chancellor on 12 November, the Prime Minister asked us to consider switching Bank customer transactions off market again.

No one could say for sure what effect putting more transactions through the market in recent months has had on the exchange rate. They can have a noticeable effect on an individual day but over time there seems no reason why they should have more weight than any other flow of equal size.

On the other hand supplying sterling to customers off market has much the same money supply implications as other intervention: at various times in the past it has led to very substantial additions to the money supply. Changing the line would, in short, by no means be costless at a time when we may already be running some risks in this area. It would also arguably be inconsistent with our views about market determination of the rate: and not seem to fit too well with the policy of limiting sterling balances.

Having outlined some of the arguments as we see them, I should say that the Chancellor's preference is not to take a final view at this stage but to see first how the markets behave in the light of the various policy statements now in prospect for next week. If, for example, upward pressure were to develop we might wish to consider the position further. If I may, therefore, I will come back to you on this a little later on.

Perhaps, however, I could take the opportunity of this interim reply to comment on a related technical question you put to me in your letter of 6 November about the

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/consistency

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consistency of the Bank turning away customer transactions but being ready to provide assistance to the money markets.

The short answer here is that if the Bank supplies sterling to one of its overseas customers this very likely increases money supply: whereas the Bank's assistance to the banking system is intended to work to the opposite direction, to prevent an increase in the money supply.

It hasn't always had that effect!

It is true that a lot of the sterling supplied by the Bank to a customer ends up in the banking system, so increasing its holdings of reserve assets. But this is an indirect effect and the whole process carries a money supply cost. If the customer had instead had to go to the open market, some of the sterling would have been supplied by residents out of their bank accounts, so actually reducing the money supply.

The Bank's assistance to the money market, e.g. by a release of special deposits does not increase the money supply but acts to prevent an artificial short term increase in both the money supply and interest rates, arising from the way the reserve assets ratio works. It does so by lessening the need of banks to bid more aggressively for deposits and by reducing the danger of round tripping (because of a rise in market rates relative to banks' base rates). It is because the present Reserve Assets Ratio has these undesirable effects, while contributing nothing to monetary control, that the decision has been taken to abolish it.

Yours

John

A.J. WIGGINS

SECRET



10 DOWNING STREET

- 1) Mr. Ingham
 - 2) Mr. Vercher
 - 3) Return to Mr. R. C. T. L.
- 13/11 2

From the Private Secretary

14 13 November 1980

Original on: -
Exec Pol: Strategy: Pt 7

cc. J. H. H. H. H. H.

Dear Mr.

As you know, the Prime Minister held a meeting yesterday afternoon with the Chancellor and Sir Douglas Wass to discuss Sir Douglas' paper on policy options for taking the pressure off the corporate sector (your letter of 7 November refers). Sir Robert Armstrong was also present.

The Chancellor said that he had decided that the immediate aim must be to go for option II - i.e. an early, modest reduction in interest rates. He had in mind a reduction in MLR of 2 per cent. To enable this to take place, he would need to be able to demonstrate that the Government was not abandoning the monetary strategy; and he would therefore need to announce in his speech in the Debate on the Address a credible package of measures. His intention was to announce the following: a further extension of granny bonds and probably a restricted indexed gilt, the outcome of the current public expenditure review, the external financing limits for the nationalised industries in 1981/82, an increase in PRT to bring in about £1 billion in 1981/82, and the increase in employee national insurance contribution. He would also have to announce the roll forward of the monetary target and the Government's conclusions on the monetary base control Green Paper. All this would be against the background of the Industry Act forecast which would be published at the same time. Final decisions still had to be taken on most of these matters; but he hoped that - even though the conclusion on public expenditure was likely to be disappointing - the various measures taken together would produce a setting in which a 2 per cent MLR reduction would be defensible. Nonetheless, it had to be recognised that it would involve a considerable element of risk questions would be raised as to whether the Government was doing enough to get the fiscal balance right, and this might mean that the next budget would have to be even more restrictive; alternatively, it might conceivably be necessary to put MLR up again.

As regards the other options, the Chancellor said that he had concluded that option I - i.e. inflow controls - should not be adopted alongside a reduction in MLR. The two together would give the impression that the Government was moving to an exchange rate objective. But if it turned out towards the end of the month that an MLR reduction was not possible, it would probably be necessary to announce a package of inflow controls to show that the Government was "doing something", even though he did not think that they would have any significant effect. He had rejected the other options in

/Sir Douglas' paper

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Douglas' paper, Option V - i.e. a significant tax switch to the benefit of companies ... might be desirable in principle, but it was not possible in terms of cost. Nonetheless, it would be right to lean in the direction of making tax concessions for companies in the next budget.

In discussion the following points were made:-

- (i) The proposed 2 per cent reduction in MLR, though desirable on industrial grounds, could very well have a perverse effect on the exchange rate - since it might well result in heavy foreign inflows into gilts. On the other hand, it was argued that a fall in MLR was already being discounted, and that the exchange rate would be just as strong if there was no early reduction. The Prime Minister suggested that, if a 2% reduction were likely to have a perverse effect on the exchange rate, a 2½% reduction might be considered; against this, it was argued that such a figure would look like fine tuning, and would not be understood.
- (ii) The public expenditure figures for 1981/82 which the Chancellor would announce following the current review were likely to be £1b or more higher than the figures in the latest public expenditure White Paper; it was therefore crucial for the credibility of the strategy that the Chancellor should announce some of his intentions on tax for 1981/82 at the same time.
- (iii) The Prime Minister said she hoped that, even if option I were not adopted, the Treasury would consider switching Bank "customers'" transactions off market again.
- (iv) It had been suggested in some quarters that several £b of additional revenue could be raised from PRT rather than the £1b proposed by the Chancellor. But the marginal rate of tax on North Sea fields was already over 90%, and to take out more than an extra £1b could well put at risk the further development of the North Sea. As it was, the reaction of the oil companies was likely to be fairly hostile.
- (v) The Prime Minister said she found it difficult to understand the administrative arguments against a fairly radical extension of "Granny Bonds". She hoped that Treasury Ministers would look at the problem, if there was one, imaginatively.
- (vi) The Prime Minister said the most disappointing feature of the current PESC review was the deteriorating financial position of the nationalised industries. They had undermined the Government's whole public expenditure strategy. The Chancellor, who reported on a discussion he had had with Sir William Barlow, said that the

/ Government's

SECRET

Government's experience with the nationalised industries over the last 18 months reinforced the arguments for denationalisation and removing the nationalised industries' monopoly position wherever possible.

In conclusion, the Prime Minister said she was content for the Chancellor to proceed on the basis he had outlined.

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

her: ew.

Tin Lammor

A.J. Wiggins, Esq.,
HM Treasury.

SECRET

CONFIDENTIAL



10 DOWNING STREET

From the Private Secretary

6 November 1980

Re TMP
c Mr Wolfson
D Wright (Co)
(Missing for Exchange
Rate
file)

THE EXCHANGE RATE: LORD LEVER'S PROPOSAL

The Prime Minister has read the note on Lord Lever's proposal which you sent over under cover of your letter of 31 October.

The Prime Minister understands that the Treasury have issued instructions to the Bank to channel requests from their "customers" to purchase sterling through the market - with the purpose of reducing the money supply. This has clearly had some, though uncertain, effect in pushing up the exchange rate. On the other hand, she is well aware that the Bank have regularly been injecting liquidity into the banking system so as to reduce the pressure on the clearers' reserve assets, and that this has tended to inflate the money supply. She has accordingly asked whether the Bank have not been pursuing a contradictory policy; and in particular, whether it might not have been better to have handled "customers" requests for sterling off market. If this had happened, the exchange rate would be lower and presumably, the Bank's assistance to the clearers could have been less. In sum, we might have had a lower exchange rate for the same or similar money supply result.

You suggested when we spoke about this that there was a flaw in the argument: in particular, you argued that the Bank would have had to have provided the same amount of assistance to the clearers irrespective of more or less off-market handling of "customers'" requests in order to achieve the same interest rate result.

The Prime Minister has also pointed out that, although purchases of sterling by overseas holders have recently represented only a fairly small proportion of total inflows, the amount could still be large enough to have significantly affected the level of sterling: she has made the point that a relatively small shift in demand can have a big effect on price.

X I should be grateful for a further note on these points which I can show the Prime Minister; we can then consider how to respond to Lord Lever.

T. P. LANKESTER

A.J. Wiggins, Esq.,
H.M. Treasury.

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Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

31 October 1980

T. Lankester, Esq.,
Private Secretary,
10, Downing Street

John Wiggins

Dear Tim,

THE EXCHANGE RATE: LORD LEVER'S PROPOSAL ←

Lord Lever recently floated a proposal that a special sterling bond should be offered to suitable overseas authorities. We undertook to provide a critique of this proposal.

.....
I now attach such a note along with a copy of the short paper Lord Lever sent in to explain his idea. As you will see, we do not think it would solve any problems.

At the end of his note Lord Lever throws in the thought that debt repayment should be covered by market transactions rather than the reserves. However this would be no different in its monetary effects to intervention with any other motive. So this, too, does not seem really to advance matters.

When the Prime Minister has seen the papers, perhaps we could have a word about how best to transmit her conclusion to Lord Lever.

yours

John

A.J. WIGGINS

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THE EXCHANGE RATE: LORD LEVER'S PROPOSAL

Lord Lever's proposal is, in essence, that the Bank (or some specially created agency) should syphon off a proportion of inflows into sterling by offering a special sterling bond to overseas governments and other large investors, with the dollar purchase money added to the reserves. The idea is that this would neutralise the impact of the inflows both on the exchange rate, and on domestic monetary conditions.

The money supply and interest rates

2. There are a lot of snags to the Lever proposal. The first is that he overlooks the benefits to the money supply when overseas inflows go through the market.
3. If the exchange rate is floating, purchases of sterling by overseas residents must be matched by sales of sterling by residents. As a result the exchange rate rises. Some of the sterling will be supplied by banks as they switch into overseas currencies. But the scope for this is limited by prudential considerations. So most of the sterling will be supplied by non bank residents, mostly through a run down of their sterling bank deposits.
This will directly reduce £M3.
4. Such transactions have exerted a strong contractionary influence on the money supply recently. It is estimated that they have reduced it by £4 billion since the end of 1978. The rise in the exchange rate caused by the overseas inflows has also exerted a less direct downward influence on £M3 through its effect on prices and hence the demand for bank lending.
5. To avoid losing part of this benefit for the money supply we asked the Bank of England earlier this year to modify the policy under which, hitherto, they had handled off-market requests from their "customers" (other central banks) to purchase sterling, with the dollar proceeds being added to the reserves. They now try to channel these requests through the market where they can. The result has been a smaller increase in the reserves than there would otherwise have been, a higher exchange rate, and lower monetary growth.

6. A simpler alternative to the Lever proposal, but one which would have very much the same effect, would be a temporary suspension of this instruction to the Bank. This possibility was listed in the Treasury paper of 10 October on Inflow Controls and Other Options for Reducing the Exchange Rate. It was rejected because of its implications for the monetary strategy.

Other difficulties

7. There are other difficulties with the Lever proposal:-

(i) In practice the special bonds might well have to be limited to overseas official holders. Purchases of sterling by such holders have in recent months only represented a fairly small proportion (about 17%) of total overseas inflows into banks deposits and Government securities.

(ii) An approach of this kind, which would have to be public, would be inconsistent with our policy of seeking to limit official sterling balances.

(iii) There is no stick available to use to divert such flows into a new special bond which would have to be unmarketable. We would therefore have to offer a carrot in the form of particularly attractive terms in relation to those obtainable on sterling deposits and gilts: and to restore the flexibility the purchaser would want, we would have to offer special encashment arrangements. All this could be costly; and would risk attracting additional inflows.

(iv) The Government would be taking an exchange risk, holding dollars in the reserves to match a liability denominated in sterling. Depending on which way exchange rates moved subsequently, this too could turn out to be expensive.

8. Lord Lever draws a parallel with the recent private German placement of 2½ billion - 5 billion DM notes with SAMA, even though this borrowing has been carried out in very different circumstances from our own. The Germans need to attract inflows to finance a large current account deficit. They would presumably find any comparable action by us both tiresome and unintelligible.

Conclusion

9. Lord Lever's scheme would seem unlikely to have any significant effect on the exchange rate and would remove a contractionary influence on the money supply. Any such trade off could anyway be achieved more simply by handling all Central Bank requests for sterling off-market. The Lever scheme would also bid up and complicate the Government's funding programme. It would be inconsistent with the policy of limiting sterling balances and unwelcome internationally.

Exchange Operations

The price of sterling will go up or down according to the balance between its supply and demand in the market. The object of this proposal is to reduce the demand by meeting it at source thus avoiding monetary consequences of an equivalent direct intervention by the Bank of England. The demand on capital account is to a large extent by holders of other currencies who wish to convert into sterling fixed interest holdings as the preferred holding of their assets either for short or long periods.

An Agency should be created or an existing Department organised to supply that part of the demand which would be satisfied to have its sterling holdings in British Government guaranteed paper. The Agency would offer direct and outside the market sterling notes in exchange for major foreign currencies at the going rate of exchange at the time of the transaction. The way in which this would work in contrast with the present situation is best illustrated by a concrete example. Suppose the Saudi Government or Central Bank received at any given time \$500 million in payment for oil and wishes to place \$200 million of this in sterling perhaps with a view to converting this immediately or later into a sterling fixed interest investment, perhaps gilts. Suppose, too, (in order to place minimal strain on my arithmetic) that on the day in question sterling is trading at \$2 to the £. The Saudis would be offered by the Agency a Government guaranteed note of £100 million in exchange for \$200 million. This note could be of any date, short, medium or long and its terms would compete effectively with any alternative fixed interest British Government sterling security otherwise available to the Saudis. Indeed, they would avoid the commission, jobbers' profits and other expenses attached to buying and selling gilt-edged. The coupon would, of course, be payable tax free. The Agency would accept the obligation to redeem the notes on redemption date.

Suppose, for example, the Saudis were minded to place the money in a 5 year gilt-edged bond. They would under the present procedure have to go into the market, buy the sterling, place it on deposit with their broker or with their bank who would in due course buy the gilt-edged. The buying of the sterling would add to the pressure on that day's market. It would

also add to bank deposits although this would be corrected when the gilts were bought. In the interval it would be a possible source of monetary pressure. As these transactions are going on frequently there is a pool of such funds always in the hands of bankers and brokers constantly replenished and depleted and this could be directly or indirectly a source of monetary pressure.

The sales of these notes would add to the reserves but without any of the monetary consequences of a market intervention. The Bank would take in the £ and would hold them in £ in securities of their choice as with other reserves.

Although the main thrust of the notes would be at major buyers such as OPEC Governments and Banks, one could make the proposal more wide in its impact by appropriate detailed action on the terms. These notes could in fact be made into the equivalent of major intervention in the market with equivalent effects to the Bank's sales of sterling without any of the monetary consequences. (More details on this if wanted.)

However, initially, I would suggest that there should be energetic direct negotiations with some of the known major buyers to anticipate their needs and to keep them from buying sterling in the market by the direct exchange of these notes for foreign currency. If these efforts were successful they would become known to the market which would appreciate that a source of demand was likely to be deflected from the market and this would be liable to create a slightly less optimistic view of sterling's parity prospects. Indeed, if this action was developed on a suitable scale, it would have the mechanical and psychological effects of a known willingness on the part of the Bank to sell sterling.

I have given the example of a 5 year bond but these notes could be made to accommodate short money as effectively. The foreign buyer of these notes would presumably wish to hold them until he moved out of sterling. The Bank could then offer his redemption direct into the foreign currency of his choice at the then going rates. Here, too, this would also eliminate any abrupt or untoward pressure on the market. This would deplete the reserves but again without any difficulty to the Bank because they would hold the matching foreign currency.

Early Repayment of Debt

I am not sure what arrangements are at present made when early repayment of debt is encouraged by nationalised industries and others. If the foreign currency required is bought with sterling direct from the Bank, this has no effect on holding the parity down except such psychological consequences as arise from the resulting depletion of the reserves. The Bank should not offer foreign currency in exchange for sterling for these premature repayments. The borrower seeking to repay should sell sterling on the exchange markets, thus tending to increase its supply and reduce the parity.

Mr Peretz

Econ Pol.

cc Sir Kenneth Couzens
Mr Barratt
Mr Lavelle
Mrs Lomax
Mr Mitchell
Mr Wolfson No 10

✓

Mr

EXCHANGE OPERATIONS

I attach a note on foreign exchange operations which Lord Lever has sent. He may yet wish to change or add to some of the points. But this is sufficient to confirm that we did not misunderstand his ideas and to enable you to complete your note for the Prime Minister.

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M*

P E MIDDLETON
27 October 1980

Enc

K.L.

Exchange Operations

The price of sterling will go up or down according to the balance between its supply and demand in the market. The object of this proposal is to reduce the demand by meeting it at source thus avoiding monetary consequences of an equivalent direct intervention by the Bank of England. The demand on capital account is to a large extent by holders of other currencies who wish to convert into sterling fixed interest holdings as the preferred holding of their assets either for short or long periods.

An Agency should be created or an existing Department organised to supply that part of the demand which would be satisfied to have its sterling holdings in British Government guaranteed paper. The Agency would offer direct and outside the market sterling notes in exchange for major foreign currencies at the going rate of exchange at the time of the transaction. The way in which this would work in contrast with the present situation is best illustrated by a concrete example. Suppose the Saudi Government or Central Bank received at any given time \$500 million in payment for oil and wishes to place \$200 million of this in sterling perhaps with a view to converting ^{this} ~~to sterling~~ ~~then~~ immediately into a sterling fixed interest investment, perhaps gilts. Suppose, too, (in order to place minimal strain on my arithmetic) that on the day in question sterling is trading at \$2 to the £. The Saudis would be offered by the Agency a Government guaranteed note of £100 million in exchange for \$200 million. This note could be of any date, short, medium or long and its

or later

1329/15

terms would compete effectively with any alternative fixed interest British Government sterling security otherwise available to the Saudis. Indeed, they would avoid the commission, jobbers' profits and other expenses attached to buying and selling gilt-edged. The coupon would, of course, be payable tax free. The Agency would accept the obligation to redeem the notes on redemption date, ~~by tendering~~.

Suppose, for example, the Saudis were minded to place the money in a 5 year gilt-edged bond. They would under the present procedure have to go into the market, buy the sterling, place it on deposit with their broker or with their bank who would in due course buy the gilt-edged. The buying of the sterling would add to the pressure on that day's market. It would also add to bank deposits although this would be corrected when the gilts were bought. In the interval it would be a possible source of monetary pressure. As these transactions are going on frequently there ^{is} ~~would be~~ ^{Such} a pool of funds always in the hands of bankers and brokers constantly replenished and depleted and this could ~~be~~ directly or indirectly a source of monetary pressure.

The sales of these notes would add to the reserves but without any of the monetary consequences of a market intervention. The Bank would take in the \$ and would ^{hold} them in \$ in securities of their choice as with other reserves.

Although the main thrust of the notes would be at major buyers such

as OPEC Governments and Banks, one could make the proposal more wide in its impact by appropriate detailed action on these terms. These notes could in fact be made into the equivalent of major intervention in the market with equivalent effects to the Bank's sales of sterling without any of the monetary consequences. *(More details on this if wanted)*

However, initially, I would suggest that there should be energetic direct negotiations with some of the known major buyers to anticipate their needs and to keep them from buying sterling in the market by the direct exchange of these notes for foreign currency. If these efforts were successful they would become known to the market which would appreciate that a source of demand was likely to be deflected from the market and this would be liable to create a slightly less optimistic view of sterling's parity prospects. Indeed, if this action was developed on a suitable scale, it would have the mechanical and psychological effects of a known willingness on the part of the Bank to sell sterling.

I have given the example of a 5 year bond but these notes could be made to accommodate short money as effectively. The foreign buyer of these notes would presumably wish to hold them until he moved out of sterling. The Bank could then offer his redemption direct into the foreign currency of his choice at the then going rates. Here, too, this would also eliminate any abrupt or untoward pressure on the market. This would deplete the reserves but again without any difficulty to the Bank because they would hold the matching foreign currency.

Early Repayment of Debt

I am not sure what arrangements are at present made when early repayment of debt is encouraged by nationalised industries and others. If the foreign currency required is bought with sterling direct from the Bank, this has no effect on holding the parity down except such psychological consequences as arise from the resulting depletion of the reserves. The Bank should not offer foreign currency in exchange for sterling for these premature repayments. The borrower seeking to repay should sell sterling on the exchange markets, thus tending to increase its supply and reduce the parity.

CONFIDENTIAL



Econ Pol.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

*Chancellor mentioned
his to my his
minij*

PRIME MINISTER

12

8/10

I realise that it is very tempting in current circumstances to predict good news on interest rates and the exchange rate. But any predictions by senior Ministers are taken by the markets as a guide to our policy intentions in the near future. This can have seriously disruptive effects on the financial markets. Much the best course is to say nothing about these things. But if colleagues feel that they must make statements could they please consult me first.

I am copying this to members of the Cabinet, the Minister of Transport and Sir Robert Armstrong.

G.H.

(G.H.)

7 October 1980

CONFIDENTIAL

TR (Mon) 87

Oct. 1980

CAW says to keep
this

INFLOW CONTROLS

INTRODUCTION

1 The relatively high level of nominal interest rates in the UK has, alongside many other factors tended to attract inflows of capital and thus to promote appreciation of sterling, which is now in effective exchange rate terms some 11.5% higher than at the beginning of this year. Suggestions have from time to time been made with a view to permitting interest rates payable to UK lenders to remain high while reducing the rates that can be obtained by non-residents on loans to borrowers in this country. A good deal of thought has been given to such schemes, but all of them run up against the substantial difficulty of erecting and maintaining any effective barrier between two categories of lenders in a capital market as sophisticated as that of the UK. Such difficulty is increased by the framework of double tax agreements between the UK and the majority of developed countries, and by sovereign immunity considerations in a number of other cases; this seriously limits the possibility of using fiscal devices as a means of stemming inflows. Although countries have resorted to such controls in the face of persistent and unwelcome inflows, their effect on the exchange rate seems likely to be small.

2 Referring to evidence to the Committee from several economists, and their writings elsewhere, the Assistant Clerk to the Committee has asked for the views of the Bank on the following specific proposals:

- (a) A real interest equalisation tax.
- (b) A dual exchange rate.
- (c) A tax on non-resident bank deposits and holdings of official debt.

This note examines each of these proposals in turn; Annexes A, B and C relate respectively to the former US interest equalisation tax,

the dual exchange system in Belgium and the experience of Switzerland and Germany with taxes on non-resident deposits.

A REAL INTEREST EQUALISATION TAX

3 Professor Dornbusch has advocated a real interest equalisation tax (RIET) on the ground that the high nominal interest rates associated with present domestic monetary policy in the UK offer excessive real returns to non-residents but small (or negative) real returns to residents. The proposed tax would, he suggests, facilitate the reconciliation of an exchange market intervention strategy designed to protect competitiveness with adequate control over money supply.

4 Despite the elegance of the proposition, there would be serious problems of implementation:

- (a) It is not clear how such a tax could be made to operate. Annex A describes the American experience with an (nominal) interest equalisation tax (IET) in the period 1963-70: but this experience is neither encouraging (in particular because it proved vulnerable to offshore avoidance and is credited with giving a substantial push to development of the Euro-dollar market) nor particularly relevant. The IET was designed and operated as a deterrent to outflows rather than inflows, being a tax paid by US residents on foreign bonds issued in the United States. The proposed RIET would, in contrast, be a tax on non-residents, who are effectively outside UK jurisdiction and would run into the problem that many of our double taxation agreements include provision that interest payments should be subject to a reduced (or zero) rate of deduction of tax; some other holders could claim sovereign immunity. Moreover, the terms of issue of many existing British government securities preclude the application of any such tax to them, and increased non-resident holdings of such securities would thus be a readily available route for circumventing discriminatory taxation of new issues.
- (b) Professor Dornbusch appears to envisage a tax imposed at a rate designed to equate ex post returns, so that the foreign purchaser of UK paper would not know the rate of tax at which he would be charged until after actual inflation and exchange rate movements during the period of his holding of the paper had been taken into account. This would preclude the collection of the tax as a lump sum on issue (as in the US IET) and would require either (or both of) some form of withholding tax with very frequent revisions of the tax rate or something more like a (variable) rate capital gains tax levied on non-resident disposals to residents (or redemptions). The administrative problems involved in assessing and collecting such a (variable) levy would be formidable.

- (c) Determination of the price index to be used for the measurement of real returns to non-residents would also be problematical. Unless a common measure were used that applied uniformly in respect of all non-resident holdings of the relevant sterling assets, the rate of tax would unavoidably vary with the residence of the holder, presenting obvious opportunities for avoidance or evasion through nominee holdings in third countries - especially if the tax were collected only on ultimate sale to a UK resident. While this means that a single common measure of inflation would be essential, this would in practice result in substantial variance in real rates of return to different non-resident investors, depending on their "home" currency and the inflation rate relevant to it. Thus, although some kind of tax on foreign holdings of UK securities would, if feasible, tend to reduce the exchange rate without resort either to direct controls or to intervention, it seems very doubtful whether anything approximating the ex post equalisation envisaged by Professor Dornbusch could be achieved.
- (d) It has been suggested that a RIET would be desirable in its own right, but Professor Dornbusch appears to have in mind that this be complemented by official intervention designed to maintain the exchange rate at a level consistent with constant competitiveness - possibly along the lines of a crawling peg. But controlled depreciation would be, to put it mildly, extremely difficult to achieve by means of intervention for a currency like sterling, which is internationally traded and held. Indeed our view is that it would be likely to prove impossible. This difficulty would not be materially mitigated even if some form of RIET were feasible.

A DUAL EXCHANGE SYSTEM

5 The essence of a dual exchange system is the distinction that is thereby maintained between current (or "commercial") and capital account transactions, with each of the two groups of transactions being settled in separate markets. Belgium has had a dual exchange rate system, initially designed to check undesired outflows, for about 25 years. Operation of the Belgian system depends on observation of elaborate regulations by the banks under the supervision of the Belgo-Luxembourg Exchange Institute (see Annex B). The two rates, for the "official" and for the "financial" franc, have deviated in both directions at different times; since 1971 the premium of the financial franc on the official franc has not exceeded 2% whilst the discount has rarely touched 5%. This is in spite of the fact that Belgium has been uninterruptedly committed to a fixed exchange rate system (in the EEC) for the official

market during this period and has had to intervene in the foreign exchange markets very heavily at times to maintain the declared official rate in circumstances in which confidence in the Belgian franc has at times been seriously shaken. This suggests that there may on occasion have been significant seepage between the two markets. This experience (and the not dissimilar experience of France, the Netherlands and Italy with such schemes over shorter periods) does not give any direct encouragement to hope that a similar dual exchange system in the UK could bring about a significant reduction in the "commercial" exchange rate relative to that determined by capital movements.

6 There would in any event be serious practical obstacles and other drawbacks in the way of adoption of such a scheme in the UK, and which would bulk very large in relation to the scale of relief that might be achieved through it. The position of sterling as a major currency asset and the variety of financial instruments and transactions in the UK is such that the problems to be overcome by any control scheme here would be much greater than those with which the Belgian control has to contend.

- (i) A comprehensive apparatus of exchange control would have to be resurrected, including the obligation to surrender foreign currency and to obtain payment for exports. In particular, all sterling payments to, from and between non-residents would have to be monitored to ensure that appropriate accounts were being used. Any significant divergence of rates would give stimulus to fraudulent transactions. Careful policing would be essential. If there were no significant divergence of rates, it would mean that the system was either ineffective or unnecessary.
- (ii) It would be impossible to determine, other than arbitrarily, whether existing non-resident holdings of sterling should be eligible for remittance through one market or the other; there would also be problems with the classification of resident holdings of foreign currency. Although the general principle would be that current transactions would have to pass through the official market, the classification of transactions would be extremely difficult at the margin - for example, the various forms of trade credit. Moreover, in circumstances in which the UK continued to run a current account surplus, it is not immediately apparent that pressure would be taken off the official rate by putting capital transactions through a separate market.
- (iii) Other problems would be that the division of non-resident sterling accounts and of resident foreign currency accounts into two supposedly watertight compartments would materially

increase costs of administration; and that the system would offer no more protection than any other against leading and lagging on current account (one day's leading and lagging in the same direction of UK visible trade alone would be equivalent to a flow of about £250 million).

A TAX ON NON-RESIDENT BANK DEPOSITS OR BAN ON INTEREST PAYMENTS

7 The feasibility of some form of ban on payments of interest to non-residents on bank deposits was demonstrated by the UK experience from August to December 1971 as well as that of Germany and Switzerland who have also used measures to reduce the rate of interest which non-residents could receive on their deposits (Annex C). Exchange controls rather than fiscal measures, have generally been used for these purposes: this is largely because of the problems which could arise from double taxation agreements and sovereign immunity if fiscal options were used. But, whatever the form of the approach which was adopted, the experiences mentioned above were precisely such as to cast doubt on the effectiveness of this sort of action. In the German and Swiss cases, there was truly massive intervention to defend fixed or declared exchange rates. Controls limited to a particular category of available assets could never be very effective in the presence of other interest earning assets in the target currency. Moreover, action taken to reduce the attraction of non-resident sterling deposits (which have no direct effect on the broader monetary aggregates) would tend to increase the relative attraction of sterling inflows to the non-bank private sector (where they would have greater domestic monetary effect).

8 More generally, the UK experience in 1971 showed that, although it is possible to prevent the direct earning of interest on certain kinds of additional sterling holdings, channels for avoiding this kind of control - particularly through inter-company transactions - can rapidly open up. Moreover, the limitations on transferability of pre-zero interest-bearing holdings quickly produced stresses which could only be relieved by progressively more elaborate rules.

Bank of England

October 1980

INTEREST EQUALISATION TAX

The interest equalisation tax (IET) was first introduced in 1963, subject to Congressional approval, and added an average of not less than 1% and not more than 1.5%* to the annual interest cost of foreign long-term financing through the USA - the actual rate charged varied according to the maturity of the security.

IET was effected by imposing a tax on the value of foreign debt obligations (normally measured by the amount paid), on their initial acquisition by a United States person, approximately equal to the amount which when discounted over the life of the bond would reduce the effective yield by around 1%. The tax was payable by the person acquiring the security.**

In broad terms the tax applied to bonds, with a remaining maturity of at least one year, issued by the Government (or any political sub-divisions) of any foreign state which was not considered to be a "less developed country" (designated by executive order) as well as to bonds, of a similar maturity, and shares issued by corporations (among other types of issuers) of any such foreign state. It also applied to bonds issued by any international organisation of which the United States was not a member. Bonds issued by the World Bank and the Inter-American Development Bank were exempt since the United States was a member of both organisations. In the case of countries whose securities would normally be caught by the tax, provision existed for specially exempting particular securities, or specified amounts thereof, where this was considered necessary in order to maintain international monetary stability. It was by virtue of this provision that most Canadian issues and certain Japanese issues, as well as certain other foreign securities, were exempt.

During the period (1963 to 1973) in which IET was in force US offerings (both public and private) by foreigners amounted to \$17.4 bn, an annual

* It was reduced to zero in January 1974.

** On stocks the tax amounted to a flat rate of 15% of the value of the securities acquired.

rate of \$1.6 bn, more than the annual rate of \$0.9 bn in the three years prior to the imposition of IET but considerably less than the annual rate of \$7.1 bn seen in the period (1974 to 1977) after its reduction to zero (see attached table).

The effect of the IET was, therefore, to reduce the issue of those foreign securities affected virtually to zero. The exemptions, ie mainly Canadian and ldc issues were made for political reasons. The effects were probably rather less than the table indicates as a proportion of foreign issues in New York, before and after IET, were no doubt acquired by non-residents. Moreover, the borrowers affected by IET turned not just, or probably even principally, to markets in other currencies but to the Euro-bond market. This market clearly received a sizeable stimulus from IET and attracted a large proportion of its investors from those who might otherwise have invested in the US bond market. Thus IET must have caused a decline in inflows as well as outflows. But it is difficult to isolate these effects as the IET was only part of a package, including the Voluntary Foreign Credit Restraint Program (restricting bank lending) and the Foreign Direct Investment Programme both of which also contributed to the growth of offshore US dollar markets.

The relevance of all US controls on capital outflows to consideration of the possibility of capital controls on inflows is clearly limited. This is particularly so in a comparison of the effects of IET and a tax (withholding?) on income received by non-residents on issues of securities by resident UK borrowers. The IET effectively deterred any foreign issues subject to the tax even though the effect on the after-IET yield was relatively small. A similar tax on inflows would probably need to be very much heavier to be effective, as securities affected would still be sold in the UK, tax or no tax, and would be unlikely, even if the after tax income were zero, to discourage inflows altogether.

BELGIUM: DUAL EXCHANGE MARKET

1 This system, which was established in the mid-1950s, lays down that certain transactions have to be settled in the official foreign exchange market, while others have to go through the so-called "financial" or free market. Broadly, current transactions relating to goods and services (except tourism) must go through the official market, with tourist payments and most capital transactions restricted to the free market. Interest, profits and dividends, and the liquidation proceeds of certain foreign inward investments may, however, be negotiated through either market. The authorities have always restricted their exchange rate intervention obligations - both under the former IMF par values system and under the present EMS mechanism - to rates in the official market. Spot and forward transactions are done in both markets.

2 Prior to 1971 the system was used to discourage capital outflows. By allowing foreign currency purchased by residents in the free market to be sold in the official market, the authorities effectively ensured that the rate for foreign currency in the free market could not - except, perhaps, very briefly - stand at a discount compared with the official rate. Depending on the size of the capital flows, the free market rate for the franc could only be at par with, or - more commonly, in fact - at a discount to the official rate.* In May 1971 the rules were changed to allow the system to act as a deterrent to inflows. In particular, although residents were still free to purchase currency on the financial market, they were no longer permitted to sell such currency in the official market. This change allowed the free market rate for foreign currency to fall to a discount against the official rate and, conversely, for the free market rate for the Belgian franc to go to a premium over the official rate and thereby become capable of discouraging inflows (but see below). Except for some minor adjustments in 1974, these arrangements are still in force.

*These arrangements are essentially similar to the former investment currency market in the United Kingdom, although the Belgian free market is also open to non-residents and embraces a wider range of transactions.

3 Following the May 1971 changes, the rate for the franc in the financial market moved immediately to a premium over the official rate, but this premium, which was maintained for lengthy periods during the following two years (a period of heavy inflows), did not appear to exceed 2% and generally remained below 1%. Since mid-1973, although a very small premium has emerged for very brief periods, the financial franc has generally been at a small discount (under 2% but occasionally reaching 5%). The financial franc rate has thus in practice reverted to its original function of providing a barrier against outflows rather than inflows.

4 The tendency for the financial and official rates to move very closely together may be explained by a number of factors:

- (a) An EEC Directive (of 11 May 1960) for the liberalisation of capital movements within the Community obliges member states to ensure that the exchange rates applied to capital transfers on "free" markets do "not show any appreciable and lasting differences from those ruling for payments relating to current transactions". Moreover, a large discount in the free market franc rate could well raise market expectations of a devaluation of the official rate, or imply a lack of resolve to maintain the central rate of the franc within the EMS. The authorities may also fear that a significant discount or premium would encourage leakages which would bring the whole system into disrepute. Although there is no evidence of any systematic policy of intervention in the free market, it is thought that the authorities have occasionally intervened to reduce the discount; but it is not known whether they intervened during 1971-73 to reduce the premium.
- (b) Since Belgian receipts of interest, profits and dividends may be sold in either market, recipients will sell these (more advantageously) in the official market at times of inflows, when the free market franc rate is at a premium (or vice versa, if there is a discount); such sales will tend to strengthen the official franc rate and to limit the divergence between the two rates. The authorities could also, of course, re-allocate transactions between the two markets to reduce the size of the divergence, but have not engaged in such fine-tuning.

- (c) During the 1971-73 period of heavy inflows, the authorities supplemented the dual exchange rate system with other emergency measures against inflows. These included the imposition of special deposits at the central bank against commercial banks' net external liabilities, a ban on interest payments on non-resident bank deposits, a reduction in domestic interest rates, and (for some two weeks only) a negative interest rate charge on non-resident accounts.
- (d) At times of speculative inflows the official rate has not been immune from pressure, but has tended to strengthen in line with the financial rate as a result of leading and lagging in current payments.

5 The Belgian authorities consider that the dual exchange market, which has generally been used to limit outflows rather than inflows, offers a maximum amount of freedom* to individuals to engage in capital transactions. And, under the present rules, speculative capital inflows have no impact on the official exchange rate, and do not therefore necessitate intervention by the central bank, with its effects on the liquidity of the Belgian banking system and, hence, on monetary policy. The system also has the administrative advantage that the central exchange control authority does not itself need to process individual applications for capital transactions (although some post hoc policing would seem to be necessary). However, while research work suggests that the system has been relatively effective in controlling outflows, it was clearly not, in itself, a sufficient barrier to inflows during 1971-73 (see above). Moreover, the effectiveness of the free market mechanism as a brake on capital flows may be reduced in practice by official reluctance - for reasons mentioned above - to allow a substantial premium or discount to emerge. The practical usefulness of the dual exchange rate system is also limited by the need to comply with IMF principles on multiple exchange rate practices, the essence of the Fund's policy being that any divergence in rates should only temporarily exceed 2% and should not confer any permanent advantage on the member country concerned. Similarly, it is clearly easier for Belgium than for

*Belgian residents are free to purchase unlimited amounts of foreign currency in the financial market, provided, of course, that the associated transactions qualify for this market.

other members of the EMS exchange rate mechanism to keep its currency within the bilateral margins and divergence threshold. Finally, the Belgian financial markets are narrow; and while the dual system may function reasonably well (and be effectively policed) in such a context, it is far from certain that it would work equally well in a larger, more sophisticated centre.

TAXES ON NON-RESIDENT DEPOSITS: SWITZERLAND AND GERMANY

1 During the past fifteen years both Switzerland and Germany have experienced periods of large capital inflows and have applied a wide range of tax measures in attempts to discourage foreign investment in bank deposits and other interest-bearing debt. At their most severe, these have included in Switzerland (but not Germany) a direct levy on foreign-owned funds held in bank accounts and, in Germany, the introduction of a withholding tax on non-residents' receipts of interest from German domestic bonds. In addition to taxes in the strict sense, both countries have used other measures which raised the cost to foreigners of holding financial assets denominated in Swiss francs or deutschemarks. Finally, both have also at various times supplemented tax measures and other financial disincentives with direct controls on inflows.

2 During 1972-73, and from 1974 until late last year, the Swiss authorities levied a commission (or negative interest) on the increase in foreign-owned Swiss franc deposits over a specified base date. The rate was altered on occasions but was at its highest - 10% a quarter - for nearly four years, from early 1975 till late 1979. Banks were obliged to debit their customers' accounts quarterly and to transfer the funds to the Swiss National Bank (where they were subsequently placed at the government's disposal). However, although non-resident Swiss franc deposits were virtually unchanged between end-1975 and end-1978, the negative interest rate, along with other measures (see below), did not succeed in preventing the exchange rate from appreciating during this period.

3 Withholding taxes on income paid to non-residents have been of little importance as a deterrent to inflows. However, in 1965 the German government did introduce such a tax on interest paid to non-resident holders of German fixed-interest securities (the "Kuponsteuer") with the specific intention of discouraging capital inflows. According to the Bundesbank, this tax - which is levied at 25% rate - drastically reduced foreign investment in German bonds during the late 1960s. However, after the transition to floating exchange rates, the tax lost most of its effectiveness, as

be difficult to administer. It is not considered to have been particularly successful.

6 For long periods during the 1970s both Germany and Switzerland prohibited banks from paying interest on non-resident accounts. Each country also at times used exchange control powers to prevent non-residents from purchasing domestic financial assets, in particular bonds and shares.

The present position in Germany is that residents are not allowed to sell to non-residents domestic money market paper or securities with a maturity of two years or less. As regards Switzerland, all financial assets may be acquired by non-residents. In addition, the Swiss authorities have for long periods stimulated capital exports by authorising foreign borrowing on the domestic capital market on condition that such funds were promptly converted into foreign currency.

7 Anecdotal evidence suggests that both the German and Swiss authorities were able to operate the various measures outlined above without excessive staff costs. In neither case, however, were the measures sufficient to prevent substantial appreciation of the exchange rate. This was partly because they could not prevent inflows through leading and lagging in current payments; partly because the closure of certain channels no doubt led to the creation of others, a task facilitated by the existence of the euro-Sw Fc and DM markets; partly because residents were free from control; but essentially because such measures do not necessarily affect market expectations. Indeed, inflow controls can be counter-productive if they are taken to indicate that no changes in domestic monetary or fiscal policy are being considered to restrain an appreciation in the exchange rate. So both countries have found their experience with inflow controls to be disappointing, and although they may have had presentational merits when introduced these were probably more than compensated for by the disrepute into which they ultimately fell before being abandoned.



Econ Pol. 2/2

cc Sir R Armstrong

10-DOWNING STREET

From the Private Secretary

6 October 1980

The Prime Minister was very grateful for your minute of 2 October on the exchange rate. She has asked if you would kindly send a copy to the Chancellor of the Exchequer.

TPC

Robin Ibbs, Esq.,
Central Policy Review Staff.

2 13

Mr Hoskyns
Mr Duguid.

SECRET

Prime Minister

Qa 05145

To: PRIME MINISTER

From: J R IBBS

Has this force to
1) Mr Chancellor
2) Terry Davis. not
Sterling Exchange Rate

A further plea
but we should
somehow get the
exchange rate down.
Gift for the 13 outside
meeting.

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

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

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

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

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

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

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

SECRET

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

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

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

SECRET

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

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

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

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

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

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

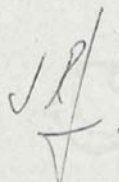
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(c) That it is desirable to find a way of doing this that does not undermine basic economic strategy. Possibilities such as inward controls, 'talking' or 'nudging' down need therefore to be looked at against the background that if one of them cannot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

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

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

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



2 October 1980

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10 DOWNING STREET

From the Private Secretary

18 September 1980

Dear John,

As you know, the Prime Minister held a meeting this morning to discuss the possibility of imposing inflow controls with a view to getting the exchange rate down. The following were present: the Chancellor of the Exchequer, the Financial Secretary, the Governor and the Deputy Governor of the Bank of England, Sir Ken Couzens, Terry Burns, Roger Lavelle, Robin Ibbs and Sir Robert Armstrong. They had before them the Chancellor's minute of 17 September and the note by officials which he had sent over with it.

The Chancellor said that, like the Prime Minister, he was concerned about the adverse effects on industry of the high exchange rate. There was therefore every reason to consider seriously the possible options for getting it down a little. But he had come to the conclusion, after a very careful review, that imposing inflow controls would not be an effective or appropriate response. On philosophical grounds he disliked the idea of mounting an elaborate set of controls; it would immediately give the impression that the Government had embarked upon an exchange rate policy, which would inevitably involve the subordination of its monetary strategy; it was by no means certain that the imposition of controls would have the desired effect - indeed, it could conceivably push the exchange rate up; and having created the apparatus of controls, the Government would be under continued pressure to maintain them. Because of North Sea oil the exchange rate was likely to be uncomfortably high from industry's point of view for a long time to come. Once controls had been introduced, therefore, there would be pressure from industry to continue with them. His own view was that the only secure way of getting the exchange rate down, while sticking to the monetary strategy, was to obtain a fall in interest rates. But this would only happen when the monetary aggregates were seen to be under control, and in particular the Public Sector Borrowing Requirement.

The Prime Minister said that, in contrast to the Treasury paper which suggested zero or negative interest rates on non-resident sterling deposits, she had envisaged merely a differential interest rate. If that approach were adopted, she wondered whether the panoply of controls outlined by the Treasury would be

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necessary. She still felt that the Swiss experience showed that action to restrain inflows could be effective. More generally she found it somewhat ironic that the monetary aggregates were running well above target and yet the exchange rate remained very strong. The failure to control the money supply rather undermined the Treasury's argument that intervention would put the monetary strategy at risk. Nonetheless she was not disposed to any further undermining of the strategy, and was therefore opposed to large scale intervention to get the rate down. If inflow controls would not work, she wanted to know what other measures would.

In discussion, it was argued that whether the authorities were to go for merely a differential interest rate or a zero interest rate on non-resident deposits, the same control instruments would be necessary. As for the Swiss experience, they had moved their exchange rate down mainly through intervention rather than through the effect of the controls which they had imposed. By intervening on the scale they did, they had quite explicitly decided to forget about their monetary targets. On the other hand, it was argued that the high interest rates in the UK compared with other countries did contribute to the high level of the exchange rate; and therefore the imposition of controls might be worth doing - even though the effect would probably be small. Although there were all kinds of difficulties inherent in introducing controls, any advantage to industry from a lower exchange rate should not be lost sight of.

There was then some discussion of the reasons for the high rate of monetary growth so far this year. The Prime Minister said that she was very disturbed by the large month-to-month fluctuations in the borrowing requirement and by the large size of the requirement during the first five months of the financial year, neither of which the Treasury seemed to have foreseen. The monthly fluctuations must make monetary management that much more difficult, and she was concerned that the borrowing requirement for the year might well turn out to be above the budget forecast - particularly given the expectation of a high figure in November.

In conclusion, the Prime Minister said that she was clear that the present exchange rate was too high and that a rate of between \$2.20 and \$2.30 would be desirable; anything below \$2.20 would jeopardise the fight against inflation. She would very much like to see a \$2.20 - \$2.30 rate achieved, though this should not be at the expense of the monetary strategy. She was still not entirely convinced that inflow controls and differential interest rates could not achieve this objective. She would like to consider this option again with the Chancellor and the Governor in early October, and any other ways which might be available of getting the rate down together with their advantages and disadvantages.

As for the money supply, she would be taking a meeting on monetary policy and controls on 13 October. She would like to have in time for that meeting some further analysis of the borrowing requirement. In particular, she would like to see the monthly profile of borrowing for 1980/81 as forecast at the time of the budget, an analysis of the reasons for any differences between the actual figures so far this year and the forecast,

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and the Treasury's latest forecast of the profile for the rest of the year and the Treasury's reasons for thinking this forecast will not be overrun. She would also like to have a note in advance of the meeting on the possibility of withdrawing the Government guarantee from certain borrowing by the nationalised industries and the local authorities with a view to excluding such borrowing from the PSBR: she had in mind in particular borrowing to finance profitable investment.

I am sending a copy of this letter to the Governor of the Bank of England and to Sir Robert Armstrong, and also to Robin Ibbs.

W. E.

The Labour.

A. J. Wiggins, Esq.,
H.M. Treasury.

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

INFLOW CONTROLS

....
At our meeting on 12 September I referred to the further review I had asked to be undertaken of the case for imposing inflow controls in present circumstances. I now attach a paper setting out the results of this additional analysis as background to our discussion tomorrow. I have had some discussion of it with the Governor of the Bank of England earlier this week.

2. The paper seeks primarily to assess such controls in their own right rather than consider them in a wider context. But I would like to add some more general comments.

3. I start with the Swiss experience, of which the paper gives an account. The central message which I learn from this is that whatever the priorities with which they may have begun, the Swiss became locked into an exchange rate policy: an extensive array of controls, accompanied by heavy intervention. In the end they decided to give the exchange rate priority, and abandon monetary control altogether. I do not think we want to follow them along that road.

4. This lead directly to my second point. We have been struggling since July with the problems caused by a set of controls of our own - the corset. The analogy may not be complete. But the general lesson seems to me quite striking. A control measure was adopted which led to distortions in the market. As so often with controls, the

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direction and extent of the distortions proved impossible to foresee. It was awkward to get rid of it and the problems of interpreting the underlying position are still very much with us.

5. We cannot be altogether certain whether the announcement of inflow controls would put the exchange rate down or up. If the market interpreted the announcement as meaning that the Government now had an exchange rate objective and that we could be expected to take other steps if necessary to enforce it, then the rate might well fall. But we would be regarded as having changed policy, as the Swiss did in 1978. If on the other hand we convinced the market that there was no change in underlying policy and that inflow controls were a temporary bridge to a period when interest rates would come down, then the market might conclude that the fall in interest rates was likely to be deferred for some while. That would tend to put the gilts market down and the exchange rate up.

6. I understand very well the concern which the CPRS expressed at our last meeting about the pressure on industry from the exchange rate. But I do not see inflow controls as offering a secure or an apt way forward. Some of the reasons are reflected in the paper. But in the last analysis - and this is my last point - this sort of device is not simply one that I find philosophically unattractive; it can offer no substitute for the far-reaching changes we need in the economy, notably in the balance between the public and private sector, and in the structure of UK industry (which will inevitably have to come to terms with a higher real exchange rate than in the past because of the fact of our North Sea oil). It is only, in my view, if we can get the public/private sector balance right that the other elements in the situation, including interest rates and the exchange rate, will fall into place.

17. I am

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7. I am sending a copy of this minute and its enclosure to the Governor of the Bank of England and also to Robin Ibbs.

R.I. Tolkin (Private Secretary)

on behalf of

(G.H.)

17 September 1980

CONFIDENTIAL

POSSIBLE MEASURES TO REDUCE CAPITAL INFLOWSNote by the Treasury

The Chancellor's minute of 29 February to the Prime Minister considered the case for imposing controls on capital inflows into sterling to offset upward pressure on sterling. The paper attached to that minute concluded that such measures could have a temporary effect and that they could be an appropriate response to short-term speculative inflows generated by events outside the UK - a collapse in confidence in the dollar for example. The Chancellor concluded that officials should press ahead with work on contingency plans for use in such circumstances.

2. This paper considers whether such measures might also have a role to play in the less extreme present circumstances to discourage short-term interest rate-induced flows into sterling. It describes what the Treasury and Bank see as the package of measures that would be required for the purpose; and assesses its likely effect on the exchange rate, on the money supply, and more generally.

The case for controls now

3. Seen in a longer term perspective the £ has been rising steadily if a little erratically ever since its 1976 low of \$1.56. This reflected, perhaps, initially a return to more normal levels after the 1976 low, and then in turn the market's anticipation of growing North Sea oil production, the increased value of that production following the Iranian crisis and subsequent oil price rises, the market's confidence in the present Government's monetary and economic policies and the attractiveness of high sterling interest rates with last October's abolition of exchange controls as an offsetting factor. Annex 1 shows the more recent trend in the effective rate. From a high of over 73 in July 1979 it fell to under 67 by the end of October - since when, with a slight dip when \$ interest rates peaked in March and April, it has risen fairly steadily to its current rate of around 76.

4. Of the factors contributing to sterling's more recent strength UK interest rates are expected to fall substantially in due course, so the interest rate differential in favour of sterling is expected to be a temporary phenomenon. (Annex 2 gives some indication of how the £/\$ rate has reflected changes in £/\$ interest rate differentials in recent months). A delayed build up of outflows following the ending of exchange controls and, perhaps, the prospects of a slightly steadier world oil market in the months ahead could also contribute to a reduction in the rate. Although a high exchange rate is one of the ways in which the effects of monetary policy are transmitted to lower inflation, there might be a case in these circumstances for a temporary shift in ^{the} balance of policy to give industry some relief from a temporary peak in the exchange rate. There is widespread sympathy for the problems being caused for industry by a high exchange rate. This would be ^{the} case for inflow controls. Their effects is expected to be temporary; but that is all that is required.

5. The Swiss and German experience is only partly relevant in this context; while they had some limited success with such measures for temporary periods during the 1970s, the circumstances in which they were introduced were different from those that face us now. Both countries were mainly concerned to avoid currency appreciations in the face of large speculative inflows attracted not so much by interest rate differentials as by the prospect of capital gains; and the controls were combined with very heavy intervention to seek to hold their rates down. Even so after a successive tightening of controls during 1972 and early 1973 the D-Mark was revalued and eventually forced to float against the dollar in March 1973. Perhaps significantly the Germans have made little use of inflow controls since 1973. In Switzerland the imposition of a wide range of inflow controls in 1978 probably had some effect in slowing the appreciation of the Swiss franc; but in the face of continued pressure in the summer of 1978 the Swiss authorities were forced to abandon their monetary target and replace it with an exchange rate target. In their recent evidence to the Treasury and Civil Service Committee the Swiss National Bank admitted this and said that:-

"This Swiss experience indicates that the exchange rate cannot be controlled without losing control over the appropriate monetary target."

Annex 3 describes the German and Swiss experience in a little more detail.

6. This experience does illustrate quite well some of the difficulties with such controls. Although they may be introduced in response to a situation thought to be temporary, it might turn out not to be so temporary after all. Even when interest rates do fall there is no guarantee that the exchange rate will too - there are plenty of other factors affecting the rate. In that case the Government would be faced with a choice between removing the controls even though the exchange rate continued to be high - with a probable outcry from industry - or embarking on a possibly prolonged process of patching the leaks in the controls as they occurred, facing increasing pressure to reinforce them with direct intervention. Put another way, to introduce such controls would no doubt be taken to imply that the Government had an exchange rate policy, if not any particular target; and that could be something of a slippery slope.

7. Nevertheless, it might be thought these were risks worth running if inflow controls offered a way of relieving the current pressure on industry without seriously detracting from wider economic policies. Despite London's more sophisticated financial markets, Swiss and German experience suggests that inflow controls could have some temporary effect on the exchange rate. In introducing a package in present circumstances the Government would presumably want to make it clear that interest rates would have to stay high for a while, and that what was being looked for was a temporary effect to soften the impact on the exchange rate until they could be reduced.

The Required Package of Measures

8. Annex 4 examines in some detail the measures we think required to have even the temporary effect on inflows looked for. Even then we cannot guarantee to have considered every significant potential loophole; but we are fairly sure that anything less than the following list would quickly be seen to be ineffective.

9. First, further increases in non-resident sterling deposits with UK banks could be discouraged by banning interest on them. This is a version of the so called two tier interest rate system. Simply to ban increases in such deposits would cause great difficulties for trade and industry; and to ban interest on existing deposits would add little to the package's effectiveness - given the other loopholes that would also be disruptive and likely to tarnish the City's longer term reputation as a place to do international financial business. It seems unnecessary in the present context (as opposed to a major surge into sterling) to go so far as imposing a negative interest charge, as the Swiss have sometimes done. Banning interest on additional sterling deposits would provide windfall profits for the banks unless offset by calling on the banks for equivalent non-interest-bearing differential special deposits. There is no statutory power at present to require such special deposits, but the Bank of England expect that they could be negotiated under the 1972 Competition and Credit Control Agreement on the basis of nil interest (but probably not of negative interest). The imposition of differential deposit requirements under the existing agreement would present some difficulties. For example the normal timetable for calling deposits is not best suited to inflow controls, and, in present conditions of pressure on banks' reserve assets, deposit requirements could increase the extent of special assistance needed from the Bank of England.

10. Secondly, for this measure to have any effect, non-residents would need to be kept out of alternative sterling assets likely to attract them. Existing powers enable us to prohibit the acquisition

by non-residents of securities as defined in the exchange control legislation. In this context, we think they should be used to prevent purchases of,

- Treasury Bills
- Gilts
- Local Authority Securities
- Sterling Certificates of Deposit

A more permanent scheme or one directed against a speculative surge into sterling might involve extending the list to cover other fixed-interest securities, eg UK companies' sterling debentures, but this seems unnecessary, at least initially, for the present purpose.

11. Thirdly, we think it would also be essential to control acquisition of commercial bills and similar instruments which are not covered by the existing powers to control securities. Continued acquisition of these would be a very serious loophole, especially since non-residents have become used to holding commercial bills as a result of the effects of the "corset". The outstanding stock of commercial bills is £5.6 billion and, if non-residents were prevented from acquiring other interest-bearing sterling assets, they would soon start to bid bills away from the banks and the rest of the private sector; and, to the extent that this lowered the yields on commercial bills relative to other assets, companies might increase their issue of bills, there being no limit to the speed and extent to which new commercial bills can be created.

12. Existing powers to control payments could only serve the purpose by prohibiting (subject to appropriate exemptions) payment to a non-resident on maturing of a bill or on discounting it for him unless a reliable UK resident, eg a bank, could confirm that the underlying transaction was exempted. An offending resident could however still

be sued by the non-resident and have to make sterling payment into court. Also, such prohibitions might hamper the working of the bill market for trade financing. These serious practical difficulties would best be avoided except perhaps in extreme crisis. Thus, for any scheme of inflow controls to be credible or at all effective for more than a few days, it would be greatly preferable to control the issue, negotiation or transfer to non-residents of commercial bills. This would require new powers and mean being ready and able to legislate immediately to take them.

13. The fourth essential element would be ^{to} restrict the net dealing positions of UK banks so as to prevent any net exchange of foreign currency for sterling.

14. Fifthly, it would be necessary to ban all borrowing by UK residents of sterling from abroad and of foreign currency from any source except for approved purposes such as outward direct investment. Otherwise the effects of inflows would simply be felt through the on-lending to UK residents of non-resident deposits in the eurosterling market or by UK residents covering their foreign currency borrowing against sterling ⁱⁿ the forward markets.

15. The package outlined above would certainly not cover every avenue. It would not, for example, prevent residents switching their £6 billion of foreign currency deposits with UK banks into sterling. To the extent that the controls are effective all such transactions will become potentially profitable. Annex 4 sets out the various considerations at greater length. But we think this package would give the most reasonable balance between the maximum practicable control and measures which should influence the main flows without requiring complex administration and undue interference with normal business. Anything less would be quickly seen to be ineffective.

16. Such temporary measures would involve a small diversion of staff in the Bank of England and the appointment of recognised banks as "Exchange Control Agent Banks" and of them, licensed deposit-takers and stockbrokers as "Exchange Control Securities Agents". The control over securities and over foreign currency borrowing by residents would rely largely on signed declarations (under statutory penalty); and monitoring and enforcement could in practice be only minimal, although the controls would involve re-introducing some unpopular paperwork for the business community. Assuming that no significant evasion developed, the likely effectiveness of the package is discussed in paragraphs 18-20 below.

17. Most elements of the package would not conflict with our European Community obligations as to restrictions on capital movements. But controlling gilts would need a derogation from the Capital Movements Directives. Authorisation by the Commission could be sought and would probably be given under Article 108 of the EEC Treaty (balance of payments difficulties). But this could involve risks of forestalling. Unilateral action would have to be justified under Article 109 (sudden crisis in the balance of payments) or Article 73 (disturbances in the functioning of the capital market).

Impact on the Exchange Rate

18. This paper does not consider what might be considered by industry a desirable exchange rate, and it would presumably be no part of such a package to announce in advance what the Government expected its effect to be (though it might be hard in practice to avoid all implication of this - see below).

19. The main impact of the measures at least initially would be likely to be through their effect on sentiment; but the direction and size of this effect is hard to predict, and could depend on presentation and on the general state of the market at the time. The largest downwards pressure would come if the controls were seen as some kind of U-turn in policy-either a weakening of the Government's monetary resolve, or a retreat from the general policy of removing

administrative controls. So a sharp fall in the exchange rate is a possibility, but in circumstances unlikely to be considered helpful from other points of view. Perhaps more likely is a sharp rise at the time the controls were introduced - with the move being taken by the market as a symbol of sterling's strength, and further confirmation that high UK interest rates were likely to persist for some time. If strong enough such expectations would make themselves felt whatever controls were in force - for example through changes in leads and lags in normal commercial payments, where one day's shift could give an inflow of £½ billion. In that case there could be some pressure on the authorities to intervene in the foreign exchange market to try to hold the rate down in order to sustain the package's credibility - with obvious dangers both of setting up circular expectations about the authorities' tactics in the market (with speculators on a one way bet), and to monetary control.

20. Leaving confidence effects on one side, we would expect the impact of the measures on the exchange rate to be fairly modest. They would offset some of the impact on the rate of high sterling interest rates. But that effect itself is probably of limited size. There is no firm or lasting relationship between interest rates and the exchange rate. Much depends on the particular circumstances. But experience in recent months (see Annex 2) suggests that a change of 1% in the £/\$ interest rate differential would give about a 1% change in the exchange rate. The question thus becomes, how large a fall in UK interest rates would the measures simulate so far as the exchange rate is concerned. It seems implausible that they would have anything like as much effect as the order of fall in UK interest rates thought to be in prospect - say 5%. In practice the test - and the test of effectiveness of the measures - would be the size of interest rate differential they opened up between the (uncontrolled) eurosterling market and the (controlled) domestic sterling market. Our own experience with outflow controls and other countries' experience with inflow controls suggests that this package might open up a differential of up to 2%, perhaps rising to as much as 5% for very short periods. This estimate may if anything be on the high side, since with outflow controls the pressure came

from UK residents, whereas inflow controls would be seeking to fend off the whole of the rest of the world. The impact on sterling might thus on a generous estimate be as much as the impact of a 2% or so fall in UK interest rates. On this basis the measures could depress the exchange rate by up to 2% or 5 cents.

Effect on the Money Supply

21. We would expect the package to lead to an increase in the recorded money supply, at least as measured by £M3 , by an amount that is difficult to predict and which would be hard to measure. To the extent that the controls are effective they will depress the return on some alternative assets which UK residents hold and encourage them to switch instead to bank deposits, thus increasing £M3 . This could take many different forms and we doubt whether we have identified all the possibilities. But to give two examples, residents would be given an incentive to shift sterling deposits with banks outside the UK (eurosterling deposits) back to this country, and also to switch foreign currency deposits with UK banks into sterling deposits. (If non-residents were not prevented from buying commercial bills - see paragraph 11 above - then this too would increase the money supply, as residents sold bills to non-residents and instead held bank deposits).

22. It is difficult to give any precise magnitude for the increase in the money supply which might follow the imposition of inflow controls. But it could be substantial - perhaps up to several per cent. Residents' holding of eurosterling total some $\text{£}\frac{1}{2}$ billion. Residents' holdings of foreign currency are very much larger - around $\text{£}7\frac{1}{2}$ billion in all; even though much of this is working balances which would be slow to be switched into sterling, the mobility of these deposits can be gauged by the increase this year, which has amounted to around $\text{£}1\frac{1}{2}$ billion. (Residents' holdings of commercial bills outside the banking system amount to some $\text{£}1\frac{3}{4}$ billion.)

23. The Government would thus be faced with the question whether to increase interest rates to hold back the increase in the money supply (thus offsetting the effect of the controls on sterling) or to accommodate the increase by raising the monetary target. It would be possible to argue that ^{the} effect on the money supply would be largely a statistical one: private sector liquidity in its broadest sense would not have changed. And it would be unwound when inflow controls were lifted. But it would not be at all easy to present an adjustment to the monetary targets on these grounds. The distortions arising from the end of the corset would only just have worked through and further distortions and explanations might be badly received. We would never know exactly how much of any increase in the money supply was the result of the inflow controls and this would make the task all the harder. As with the corset, these problems would present themselves afresh when the controls were removed.

Summary

24. The case for inflow controls in present circumstances is that they might provide a means, consistent with the Government's wider monetary and economic strategy, of softening the acute pressure on parts of industry of a temporarily high pound. We have always seen such measures as only likely to have a temporary impact; but that could be what is required, with the differential between UK and overseas interest rates expected to narrow substantially in a matter of months. Swiss and German experience is only partly relevant, and suggests that such controls can become something of a slippery slope. But were there no other difficulties it might be argued that this was a risk worth taking.

25. A package of measures for introduction in present circumstances would have to comprise the following elements:-

- (i) A ban on interest on increases in non-resident sterling bank deposits.
- (ii) A ban on non-resident purchases of Treasury Bills, gilts, local authority securities, CDs and Commercial Bills (where legislation may be needed).
- (iii) Control of UK banks' currency positions.
- (iv) Control of residents' borrowing in foreign currencies and eurosterling.

26. The underlying effect of such measures might be a modest fall in sterling (perhaps up to 2% or 5 cents). This could be masked by much larger effects on sentiment, though the circumstances in which these led to a sharper fall in sterling - with the move interpreted as an about turn in Government policies - would hardly be welcome from other points of view. Alternatively, the confidence effects might well be perverse.

27. Other difficulties to be weighed in the balance are:-

(a) The likely reaction from those affected in industry and the financial markets to what would inevitably be a somewhat complex set of rules.

(b) The danger of getting trapped into heavy intervention in support of some perceived exchange rate objective.

(c) The adverse effects on measured money supply, particularly coming at a time when the statistics are already hard enough to interpret.

HM Treasury
17 September 1980

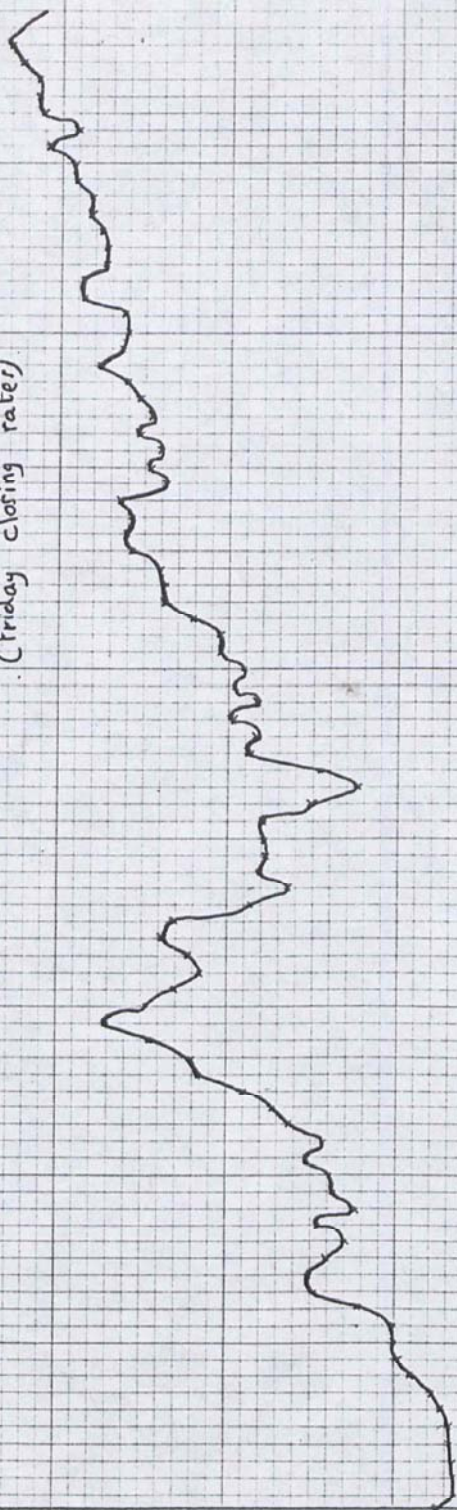
80

70

60

50

Sterling effective rate
(Friday closing rates)



J | F | M | A | M | J | J | A | S | O | N | D | J | F | M | A | M | J | J | A

1979

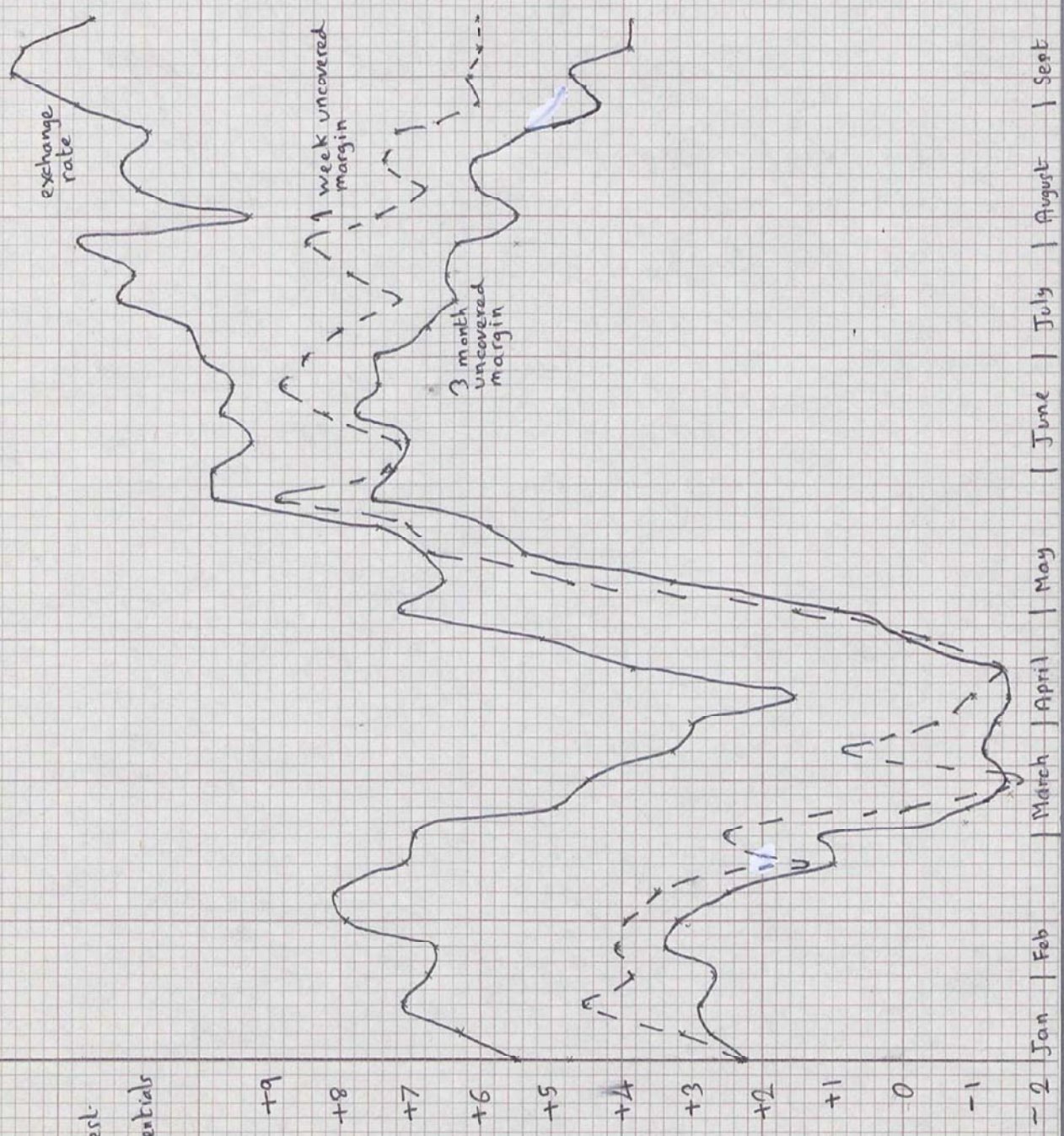
1980

2.45
2.40
2.35
2.30
2.25
2.20
2.15
2.10
2.05

exchange rate

\$/£ exchange rate

ANNEX 2



interest rate differentials

+9
+8
+7
+6
+5
+4
+3
+2
+1
0
-1
-2

M.P.

THE GERMAN AND SWISS EXPERIENCES WITH INFLOW CONTROLS:
1970-1980

I. GERMANY

The Germans started the 1970s with no inflow controls. Following the revaluation of the Deutschemark in September and October 1969 capital inflows had ceased, and the inflow controls imposed in 1968 and 1969 had been dismantled.

2. In 1970 capital inflows resumed, and the Germans had to intervene substantially to hold the new parity. In April 1970 supplementary (non-interest-bearing) reserve requirements were imposed on the growth of non-resident deposits and these requirements were gradually tightened during the year. These reserve requirements had the effect of reducing the interest rate which banks would pay on non-resident deposits. The requirements did not at first cover sales of commercial bills to non-residents; this led to avoidance of the controls and the Bundesbank had to step in to prevent this.

3. Inflows continued in 1971, and the Deutschemark was eventually floated from May until the Smithsonian realignment in December. In May the Germans imposed a ban on sales of money-market paper and in June the reserve requirements on non-resident deposits were tightened further.

4. These controls were effective in reducing short-term inflows into the banking system, but their impact was offset by a growth in inflows via other channels. These included in particular borrowing abroad by German companies and purchases of longer-term German securities by non-residents. In March 1972 the authorities imposed the "Bardepot", a system of cash deposits against companies' external borrowings. There was some exemption for normal credit periods on trade payments but otherwise almost all new borrowing was in principle covered. The deposit requirement was set initially at 40%, raised to 50% in July 1972 and to 100% in February 1973 (in effect a complete ban on borrowing abroad). In June 1972 the Germans banned non-resident purchases of bonds issued in Germany;

this was extended to shares in February 1973.

5. Inflows continued and in the words of the Bundesbank Annual Report for 1973 "waves of speculation speedily burst all the dams erected against external constraints". The dollar was devalued in February 1973, but upward pressure on the Deutschemark continued in spite of the tightening of inflow controls mentioned above. In March 1973 the Deutschemark and the other snake countries floated against the dollar (the "snake left the tunnel"). In June 1973 the sale of any domestic claims to non-residents was banned. Later that month the Deutschemark was revalued within the snake.

6. Finally, after the Deutschemark had appreciated by 55% against the dollar in two years and after intervention of around \$25 billion in four years, the upward pressure eased. The Deutschemark floated back down against the dollar, inflows were reversed and the capital controls gradually eased. Reserve requirements were reduced from January 1974 onwards; the Bardepot was relaxed in February 1974 and abandoned in September 1974; the bans on non-resident purchases of most German assets were lifted in February 1974. By September 1975 all controls had been lifted except for restrictions on purchases of bonds of less than two years maturity.

7. Since 1975 the Germans have relied very little on direct controls on inflows in spite of occasional sharp bouts of upward pressure on the Deutschemark. No changes were made until the end of 1977 when the differential reserve requirements on non-resident deposits were re-imposed and the ban on non-resident purchases of bonds was extended to those maturing within four years. None of the other controls of the early 1970s was re-imposed. The differential reserve requirements were dropped in June 1978 and have not been re-imposed since.

Assessment

8. The Germans' controls in the early 1970s may have had some impact on restraining inflows. But any such effect

appears to have been modest in relation to the pressure of funds flowing into Germany. The initial controls mainly had the effect of diverting flows to other channels, and the story of 1971 to 1973 is one of the authorities trying to dam these up as they developed. This necessitated an increasingly cumbersome set of controls, with companies' commercial operations being restricted considerably. It is perhaps significant that since 1973 the Germans have made very little use of inflow controls, besides a fairly short-lived reimposition of the most easily administered control.

II SWITZERLAND

9. The Swiss have until recently maintained an extensive array of controls against inflows including:

- (i) a negative interest rate of up to 10% per quarter on non-resident holdings of Swiss francs (the 10% rate applied from January 1975 to December 1979);
- (ii) restrictions on forward deals in Swiss francs;
- (iii) restrictions on banks' dealing positions in foreign currencies;
- (iv) at times, certain prohibitions on the acquisition of Swiss securities, including shares, by non-residents; there was a complete ban from February 1978 to January 1979;
- (v) restrictions on the import of bank notes;
- (vi) restrictions on company borrowing abroad.

10. Since the advent of generalised floating in early 1973 the Swiss franc has generally not been pegged to any other currency (it has never been in the snake). It was the object of almost continuous upward pressure for much of the 1970s, with the Swiss authorities varying between taking the pressure on the rate or on the reserves.

11. Perhaps the most interesting episode is that from February 1978, when the dollar began one of its bouts of weakness. There was strong upward pressure on the Swiss franc (which rose nearly 7% against the Deutschemark and 12% against the dollar during February). The authorities tightened up their inflow controls, banning sales of any securities to non-residents, tightening up the coverage of the negative interest rate, and re-imposing restrictions on the import of bank notes. These controls, coupled with substantial intervention, seem to have had some temporary effect but by May the Swiss franc was again rising against all other currencies, not just the dollar.

12. The Swiss franc continued to appreciate in the face of substantial intervention. The Swiss bought some \$2½ billion in the third quarter of 1978 alone but by late September the Swiss franc was over 60% higher against the dollar than it had been a year earlier, and 35% higher against the Deutschemark.

13. On 1 October 1978 the Swiss Government changed its policy. The authorities announced that they would intervene as much as necessary to keep the Swiss franc rate below 1.20 DM/SF. The monetary target for 1978 was abandoned and no monetary target was set in 1979. These measures were coupled with a slight relaxation of inflow controls, including allowing non-residents to re-invest the proceeds from sales of Swiss securities and allowing greater freedom for non-residents to subscribe to Swiss franc bond issues.

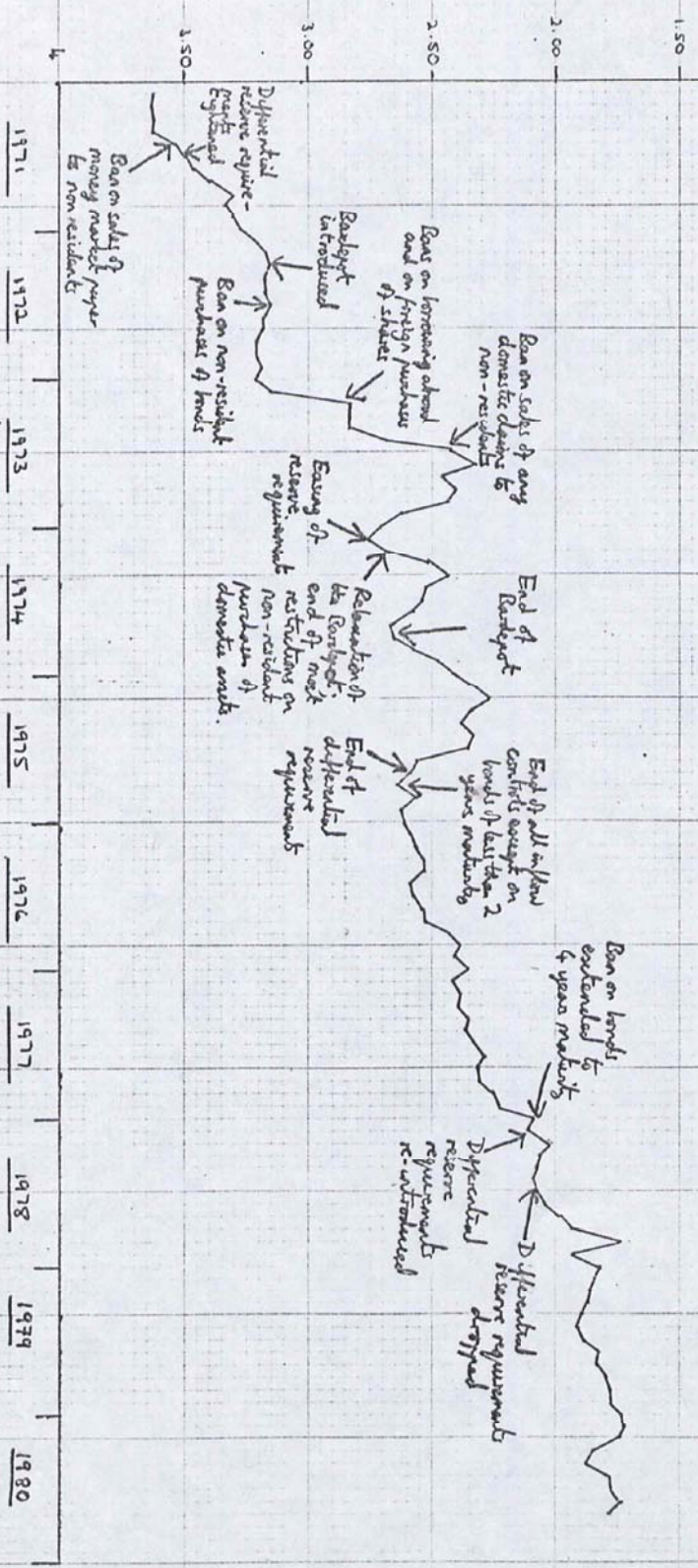
14. These measures were successful in holding down the Swiss franc. During 1979 there were in fact net capital outflows and the Swiss began to lift their restrictions on inflows. By the end of 1979 almost all the restrictions had been lifted - including the 10% negative interest rate. In February 1980 positive interest rates were allowed on non-resident deposits.

Assessment

15. As with the German controls, the Swiss inflow controls may have had some temporary restraining effect but were not sufficient to divert the upward pressure on the franc more than slightly. Eventually, the strength of the demand for Swiss francs prompted the Swiss to abandon their monetary targets and switch instead to an exchange rate target against the Deutschmark. The controls which were in force at the time were considerably more extensive than those in Germany.

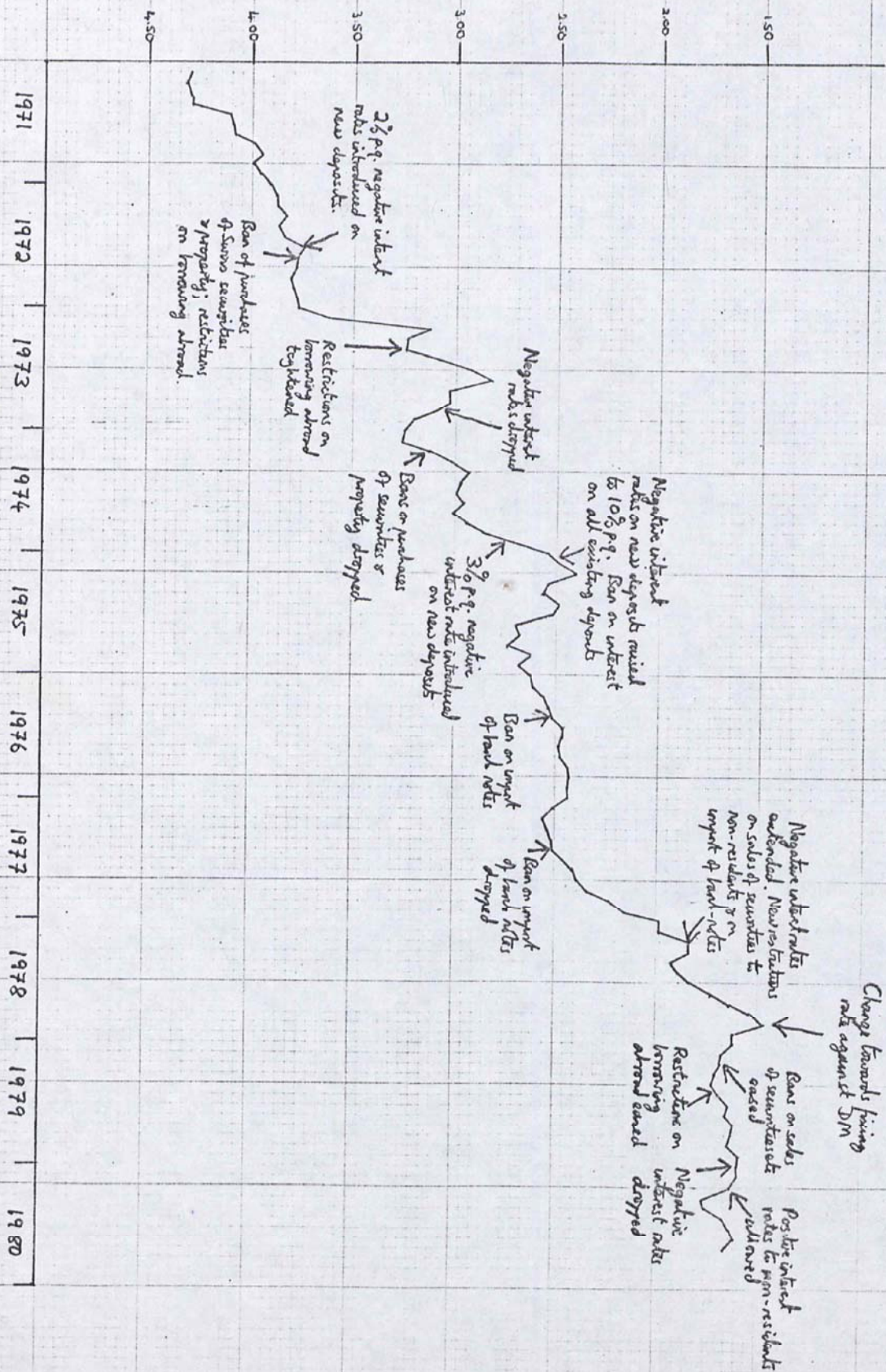
DEUTCHENMARK / DOLLAR EXCHANGE RATE, 1971 TO 1980

(END-MONTH; SOURCE: BANK OF ENGLAND QUARTERLY GULSTIM)



SWISS FRANC/DOLLAR EXCHANGE RATE: 1971-1980

(end-month; Source - Bank of England Quarterly Bulletin).



INFLOWS CONTROLS : BUILDING UP A PACKAGE

This annex discusses the elements which would need to be included in a package of inflow controls aimed at discouraging some interest-rate induced demand for sterling. The package would be intended to offset some of the effects on the exchange rate of a continued high level of UK interest rates relative to those overseas. It would not be expected to be in place for a long period and would ideally be kept fairly simple; it would not be aimed at controlling a massive speculative surge. The following paragraphs discuss in turn the various elements that could be included and identifies those that would be essential. It does not discuss the effectiveness of the package as a whole.

Non-resident sterling deposits

2. The first and most obvious candidate for control would be non-resident sterling deposits with banks in the UK. These have increased by around £2½ billion so far this year and now total over £10 billion. It would raise considerable difficulties for trade if we tried to ban increases in deposits (and it would run counter to some of our international obligations). A more promising approach is to ban interest payments on increases in non-resident deposits: this would seem the most appropriate action to take if we were trying to counter additional demand for sterling generated by a continued interest differential in favour of sterling.
3. With UK interest rates as high as they are, a ban on interest payments would represent a substantial disincentive to non-residents to hold sterling bank deposits in the UK. There does not seem to be much case for going further and imposing negative interest rates, especially since this would require new legislation. The Swiss have at times imposed negative interest rates, but that was against the background of very low domestic nominal interest rates.
4. It might be argued that we should go beyond a ban on interest payments on increases in non-resident deposits and impose a reduced rate of interest on existing deposits. To do this would

imply that we were doing more than aiming to reduce additional demand for sterling which might result from a continuation of a large interest differential in favour of sterling for longer than had been expected. It would imply we were actively seeking to reverse some of the demand for sterling which has already taken place. It would also cause considerable disruptions to the banks' business and to their customers', with possibly damaging long-term effects. We do not think this should be part of a package, certainly not initially.

5. Forbidding the banks to pay interest on additional sterling deposits would provide windfall profits for the banks on any increased deposits which did take place. This would be offset by requiring equivalent non-interest-bearing special deposits from the banks. These could be negotiated under the Competition & Credit Control arrangements.

Non-resident purchases of other sterling assets in the UK

6. Non-residents who were discouraged from acquiring additional sterling bank deposits in the UK would look to acquire alternative sterling assets. We have the powers to ban non-resident purchases of a variety of sterling assets and we think a package should include bans on purchases of

- Treasury bills
- Local Authority Securities
- Sterling Certificates of Deposits
- Gilts

7. There is a problem over banning non-resident purchases of commercial bills: this is discussed in the main paper. It would be essential that non-residents were prevented or discouraged from buying commercial bills; to omit this element from a package would be to leave a very serious loophole, especially now that many non-residents have become accustomed to holding commercial bills in preference to other money market instruments as a result of the effects of the corset. The outstanding stock of commercial bills is £5.6 billion and if non-residents were prevented from acquiring other interest-bearing sterling assets they would soon start to bid bills away from the banks and the

rest of the private sector; to the extent that this lowered the yields on commercial bills relative to other assets, companies might increase their issues of bills.

8. There are a number of other sterling assets which might be controlled. We could for example ban non-resident purchases of UK equities or of UK companies' sterling bonds and debentures. If we were planning a fairly permanent scheme, or one which was intended to counter a massive speculative surge into sterling, we would probably want to ban foreign purchases of fixed interest sterling securities at least. But we think these need not be an essential element in a more short-lived package of controls. A separate problem concerns unquoted securities and purchases of "shell" companies. It would in principle be quite easy for a non-resident to buy such a company and use it to acquire sterling assets on its behalf, remitting the interest in the form of dividends. Again, if the scheme were intended to be more than a temporary one we would need to cover this possibility, but we think that for the package considered here it would be better to do nothing initially, while watching developments closely.

Eurosterling

9. If we prevented non-residents from acquiring interest-bearing sterling assets in the UK, then an obvious alternative for them would be to see what rates banks in other countries would offer for sterling deposits. This in turn would depend on what use those banks could make of the funds.

10. If inflow controls were able to segment completely the Eurosterling market from the UK domestic market, then the banks could not pass the sterling on to the UK domestic market and would have to find a use for it outside the UK - for instance by finding a new non-resident to borrow the sterling. The interest rate on Eurosterling would be set by demand and supply in this segmented market. It would be somewhat lower than that in the domestic market, since non-residents are not restricted in borrowing domestic sterling: a new non-resident borrower would appear only at a rate lower than that at which he could previously have

borrowed domestic sterling. There would by assumption be no leakages back to the domestic market and these transactions would not effect the exchange rate - they would offset each other.

11. There are, however, a very large number of potential channels by which funds can leak back from the Eurosterling market to the domestic market, and thus undermine the impact of inflow controls. We need to dam up as many of them as we can, but there are inevitably some which we could not restrict. We could not segment the two markets completely.

12. The most obvious channel is UK residents' borrowing Eurosterling instead of domestic sterling. If interest rates on Eurosterling dipped significantly below those on domestic sterling then companies would have an incentive to borrow sterling from banks abroad rather than in the UK. With no inflow controls a non-resident would deposit sterling with a bank in London, which would on-lend it to a UK company. With controls on non-resident sterling deposits but no controls on residents' borrowing sterling from abroad, a non-resident would instead deposit sterling with a bank in France which would on-lend it to the UK company. The effects on the exchange rate and interest rates are the same in both cases. For any inflow control package we should thus need to ban residents' borrowing of sterling from outside the UK.

13. There are two related channels which we could do nothing to control. Since the abolition of exchange controls there has been a substantial increase in sterling lending to non-residents by banks in the UK. This has amounted to around £1½ billion so far this year. If Eurosterling interest rates showed a tendency to drop below domestic rates then new non-resident borrowers would borrow from banks outside the UK rather than from UK banks. The funds would be intermediated by a bank outside the UK rather than one in the UK. We could not prevent this.

14. The second channel is repatriation of UK residents' Eurosterling deposits. These have built up significantly since the ending of outward exchange controls. A part of this increase was the result of corset pressures and some of these deposits may now have been run-down (data on Eurosterling deposits is rather

slow to arrive). But we estimate that UK residents' Eurosterling deposits still total around £1½ billion. If Eurosterling rates dropped below UK rates most of these deposits would presumably be repatriated at once. The inflow controls would be having the effect of pushing non-resident deposits from UK banks to foreign banks while attracting an offsetting flow of resident deposits from foreign banks to UK ones. Again, we could not prevent this happening.

Forward rates and foreign currency borrowing and deposits

15. A similar, though slightly more complicated, problem arises from flows from the Euromarkets to the UK in the form of foreign currency transactions covered in the forward markets. There is very little difference between borrowing sterling from a bank in Paris, and borrowing dollars while at the same time buying dollars forward against sterling to cover the exchange risk. Interest arbitrage in the Euromarkets ensures that the interest rates on these two transactions are identical. (This is explained in more detail in the appendix). Thus it would not be enough simply to ban Eurosterling borrowing in an inflow control package: we should need also to prevent companies achieving the identical result by borrowing foreign currency and covering in the forward market.

16. A related problem arises from UK residents' existing foreign currency deposits, whether with UK banks or with banks abroad. Just as borrowing foreign currency and covering the exchange rate in the forward market would be cheaper than borrowing domestic sterling, so investing in foreign currency would yield a lower return than investing in domestic sterling and covering the exchange risk in the forward market. (This too is explained in the Appendix). There would be an incentive for UK residents to switch their existing foreign currency deposits into sterling, at the same time selling sterling forward.

17. Residents' foreign currency deposits have increased sharply since the abolition of exchange controls. Deposits with UK banks have grown by about £1½ billion, and now stand at over £6 billion. Residents' foreign currency deposits with banks overseas do not

appear to have increased very much (from the data we have available); this may simply reflect the greater convenience of holding deposits with UK banks. In total, foreign currency deposits with banks overseas amount to some £1 - 1½ billion. Much of the deposits, with both banks in the UK and banks overseas, represent working balances which might be fairly slow to respond to an inducement to switch into sterling. But the large increase in deposits since the ending of exchange controls gives some guide to the mobility of these funds.

18. This annex has so far discussed only the problems from residents' borrowing foreign currency covered, or switching foreign currency deposits into covered sterling deposits. These are essentially riskless arbitrage transactions which would act to channel non-resident demand for sterling back to the UK, affecting the spot rate rather than just the forward rate. There is also the possibility that residents would perform these transactions without forward cover. These would be speculative transactions by the residents themselves, acting because they thought the difference between UK and foreign interest rates was sufficiently wide for them to take on the risk that sterling might depreciate. They would directly affect the spot rate for sterling.

19. There are two approaches we could take to counter these problems; we should need to include both in any package that was intended to be other than fairly short-lasting. We could ban residents' borrowing in foreign currencies or we could ban residents' dealings in the forward exchange markets (in both cases with certain exceptions, discussed below). Both of these involve some restrictions on companies' commercial operations and both would produce additional administrative complications. But the controls would be very weak if we attempted neither.

20. Banning residents' dealings in the forward exchange markets would not stop companies borrowing abroad without forward cover, nor would it stop them converting foreign currency deposits into sterling. But it would force them to take an exchange risk on either transaction. We would be preventing any riskless arbitrage operations but not stopping residents using these channels to speculate in favour of sterling on their own account.

21. Such action would however create great administrative problems. We could not reasonably ban all forward foreign exchange transactions: we should have to allow some exemptions for deals connected with genuine trade transactions (buying foreign currency forward to pay for imports for example). This immediately raises a host of difficulties. We could not hope to monitor these transactions ourselves and we should have to rely on declarations from those operating in the forward markets and on some monitoring by the banks. There would also be great difficulties over defining in just what circumstances forward cover would be allowed: for imports of services?; for dividends or other contractual payments?; not for loans about to mature? - the list is almost endless. All in all we do not think it would be practicable to include controls on residents' forward deals in what was intended to be a simple and temporary scheme

22. Banning foreign currency borrowing by residents also presents difficulties. It would stop residents borrowing foreign currency instead of sterling, whether covered or uncovered; but it would not prevent residents switching existing foreign currency deposits back into sterling. It might give rise to some objections from companies, since we would be cutting off one source of finance at a time when they were under financial pressure. Again, we should have to give some exemptions: we should probably need to permit companies to borrow foreign currency to finance overseas direct investment for example. This would weaken the effect of the control but we think it would be unreasonable not to include such an exemption, at least initially. We would again have to rely on declarations from companies to enforce this, though this would be more manageable than for controls on forward deals since the number of transactions would be much smaller.

23. Our conclusion is that for the package discussed here we should include a ban on borrowing foreign currency, but not any control on forward transactions.

Banks

24. These conclusions do not apply to banks, where the circumstances are rather different. We certainly would not seek

to control their gross foreign currency borrowing abroad - to do so would be to prevent them carrying out their eurocurrency business. Instead, we would impose a control over their open positions in sterling as against foreign currency: we would for instance stop any increase in foreign currency borrowing net of foreign currency lending. At the same time we would also seek to prevent banks' switching into sterling on a covered basis; this is a practicable (and a necessary) control to impose on the banks. We would ban any increase in forward foreign currency assets held against spot foreign currency liabilities; this is the exact reverse of the spot against forward control we used to maintain in the days of outward exchange controls.

Multinationals

25. The package outlined so far leaves a number of loopholes, particularly those through which multinationals could slip. There is however very little we could do about them without making the controls very much more extensive and very much more burdensome.

26. If a non-resident who wished to acquire additional sterling was a company with a branch or subsidiary in the UK, then it would be simple for it to channel the funds to this subsidiary rather than investing in its own name. We could prevent this transaction taking the form of a loan from the parent, but could not do much if it was disguised as new equity capital or if it took the form of leads and lags on inter-company payments. Similarly there would be an incentive for any UK company wishing to borrow sterling to do it in the Eurosterling market via an overseas parent or subsidiary. We could stop these funds being channelled to the UK company in the form of a loan, but again could not do anything if the channel was, for example, delayed payment of a dividend due to the overseas company. The very wide scope for leads and lags is a limitation on the effectiveness of any scheme of exchange controls.

The package

27. Our conclusion is thus that the essential elements in a package would be as follows :

- a ban on interest payments on additional non-resident sterling deposits with UK banks, coupled with appropriate
- a ban on non-resident purchases of Treasury bills, local authority securities, certificates of deposit and gilts; plus measures to prevent non-resident purchases of commercial bills;
- a ban on residents' borrowing of sterling from outside the UK or of foreign currency from any source, but with an exception for borrowing for direct investment overseas
- controls on banks' open positions in sterling against foreign currencies, and on their covered switching into sterling.

EUROSTERLING, FORWARD AND THE COVERED DIFFERENTIAL:
AN ILLUSTRATIVE EXAMPLE

Suppose we have the following pattern of interest rates and forward rates:

Sterling interest rate	15%
Dollar interest rate	10%
Forward discount on sterling against the dollar	2%

The uncovered differential is simply the difference between sterling and dollar interest rates, in this case +5%. The covered differential is the difference between sterling interest rates and dollar interest rates adjusted for forward cover. From the point of view of a borrower there is very little difference between borrowing sterling and borrowing dollars while at the same time covering his exchange risk by buying forward the dollars he will need to repay the loan. The same holds true in reverse for depositors. On the figures set out above, the cost of borrowing sterling is 15%, while the cost of borrowing dollars covered is 10% for the dollars plus 2% for the forward cover. The covered differential is thus +3%. It is clear that the figures above suggest the existence of some sort of capital controls: otherwise arbitrage pressures would tend to bring the covered differential closer to zero.

2. A Paris bank which is asked for a quote for a sterling deposit has to consider what it can do with the funds. We assume that it cannot lend them at the domestic rate because of capital controls. An alternative is for it to lend dollars and cover its exchange risk by buying sterling forward. This will earn it 10% + 2% equals 12%, so it will quote a Eurosterling deposit rate of 12% (ignoring margins).

3. Similarly a Paris bank which is asked for the cost of a sterling loan will consider how cheaply it can acquire the funds. The cheapest way - as set out in paragraph 1 above - is for it to borrow dollars and cover itself by selling sterling forward. This will cost it 12% and this will be the Eurosterling lending rate.

4. The Eurosterling rate is always set in this manner and it is fairly easy to see that the covered differential will represent the difference between domestic sterling and Eurosterling interest rates.

5. When, as in this example, there is a positive covered differential there is an incentive for anyone who can do so

- to borrow Eurosterling or, equivalently to borrow covered dollars, in preference to domestic sterling;
- to hold a domestic sterling deposit in preference to a Eurosterling deposit;
- to hold a domestic sterling deposit covered forward in preference to a dollar deposit.

If capital controls do not exist then these incentives will swiftly ensure that the covered differential does not stray far from zero. Capital controls prevent some or all of these transactions taking place and thus place a wedge between domestic sterling and Eurosterling interest rates.

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cc D/I

HLS



Econ Pol

Subject filed in

Econ Pol: May 79: Mgrwith
Walter Saloman.

10 DOWNING STREET

From the Private Secretary

2 July 1980

Dear Tom,

As you know, Mr. Walter Salomon called on the Prime Minister yesterday morning. The Chancellor and the Secretary of State for Industry were also present.

Mr. Salomon concentrated on two points. First, he argued that the Exchange Control Act 1947 should be altogether repealed, rather than amended. He suggested that, in the event that the Government might conceivably want to reintroduce exchange controls some time in the future, the 1946 Bank nationalisation act would provide adequate powers. The retention of the 1947 Act, even in modified form, was bad for confidence and would provide a Labour Government with too easy an opportunity to reintroduce exchange controls. Mr. Salomon asserted that neither Germany nor Luxembourg had specific exchange control powers; he did not see why we needed them.

Secondly, Mr. Salomon elaborated on his criticisms of the Banking Act 1979, which were set out in his April lecture to the Institute of Bankers. In particular, he criticised the sweeping powers of the Bank, which he implied they were not well qualified to make use of; the two-tier system of authorisation; and the personal questionnaire for directors and managers. In addition, he criticised the Bank's papers on foreign currency exposure and liquidity.

In reply, the Chancellor explained that exchange controls had been abolished, and that the exchange control department in the Bank had been disbanded and a large number of officials released for other work. Nonetheless, he had come to the conclusion after long and detailed consideration that a modified version of the 1947 Act was needed. He disagreed with Mr. Salomon about the powers under the 1946 Act: in theory, these gave the Government power of direction over the Bank, but not over the citizen.

The Chancellor also answered some of Mr. Salomon's criticisms of the Banking Act, but there was not time for him to rebut them in detail. The Prime Minister would accordingly be grateful if the Chancellor would now write to Mr. Salomon on his criticisms

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- 2 -

of the Banking Act, and if he would also set out his answers to Mr. Salomon's various criticisms of the Government's decision not to repeal the Exchange Control Act. Please could you send us a copy of the Chancellor's letter.

I am sending a copy of this letter to Catherine Bell (Department of Industry). I would be grateful if you would not show this letter to the Bank.

Wm *W*

Tim Laker.

John Wiggins, Esq.,
H.M. Treasury.

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Original - QR
CF to the PM



cc HMT

Econ Policy

vb

10 DOWNING STREET

THE PRIME MINISTER

2 June 1980

Dear Mr. Salomon

Thank you for your two letters of 28 April about the Exchange Control Act and the value of sterling.

With regard to the Exchange Control Act, the future of this legislation involves other factors besides the temporary need to retain powers while exchange controls had to continue (till 13 December last) in relation to Rhodesia. In particular, repealing the Act would not be compatible with our Treaty obligations in the European Community since the Council Directive 72/156 requires us to have available, without further enabling measures, certain instruments for the regulating of capital flows. The 1947 Act provides the only current legislative authority. While we do envisage ultimately seeking some changes in the law on exchange control, there is no prospect of finding time in the legislative programme for the early replacement or substantive amendment of the present Act. You may have seen that the Chancellor of the Exchequer recently made a statement in Parliament to this effect.

In your other letter you suggested that we should sell sterling to reduce the value of the pound, at the same time offsetting the domestic monetary impact by cancelling a corresponding amount of debt; I assume that you have in mind repayment of debt to overseas. (If we were to re-pay a corresponding amount of debt held in the UK, this would simply add to the money supply).

It is our policy to reduce substantially the burden of our foreign currency borrowing during the lifetime of this Parliament. But this policy does not offer a solution to the problem that I posed in the House. The monetary effect of intervention depends on

/its scale and

DMF

its scale and how it is financed. Any net inflow to the private sector would not be offset if we then used the additional reserves to repay overseas debt. Such repayments have no impact on domestic conditions at all; no private sector transactions are involved. Sooner or later, as I said, any attempt to hold down the exchange rate by intervention would jeopardise monetary control.

Even if we sought to offset the domestic monetary impact by, say, selling additional gilts there might well be little lasting impact on the exchange rate, although interest rates would need to be higher to achieve the necessary gilt sales. Mobility of international capital limits the extent to which intervention can effect the exchange rate, other than in the very short term. And if we succeeded in holding down the exchange rate, we would have to balance the advantage to exporters against the cost - some of which would be borne by exporters - of the higher level of domestic interest rates. We would also lose the beneficial effects of a higher exchange rate on inflation and monetary control.

signed

MT

W.H. Salomon, Esq.

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SECRET

Econ PA.

PRIME MINISTER

EXCHANGE RATE

The rate at 1420 was \$2.3560; effective rate 74.7. This is down a cent from last night. There has been no intervention to speak of by the Bank today. The dollar is generally stronger.

You will want to question the Chancellor about the prospects of getting interest rates down soon: the widening gap between sterling and Eurodollar rates is clearly a factor in the current strength of sterling. I am told that the May money supply figures are going to be bad because the Government borrowing requirement, for the first time since December, has been substantial and because lending to the private sector is still running at a substantial level. In these circumstances, an early reduction in MLR would be risky.

On the other hand, the combination of high interest rates and the high exchange rate is certainly causing industry great problems and there is a strong case on industrial grounds for providing some alleviation; but I suspect the Chancellor would argue that, if anything is to be done, it should be by way of fiscal relief (e.g. reduction in national insurance surcharge) rather than by trying to get interest rates or the exchange rate down ineffectively or prematurely.

R.

28 May 1980

SECRET

Econ RA



cc: PSChief Secretary
PS/Financial Secretary
Sir D Wass.
Sir K Couzens
Mr Barratt
Mr Lavelle
Mr P G Davies *vw Hedges*
Mr Sims
Mr D A Dawkins (B/E)

A. Kennard

PARLIAMENTARY CLERK

R.
20/5

RETENTION OF EXCHANGE CONTROL ACT 1947
PRIME MINISTER'S QUESTIONS ON TUESDAY 20 MAY

The following additional Q & A material may be helpful. It reflects consultation with the Chancellor and the Financial Secretary.

- Q.1 In what circumstances might the Government use the exchange control powers being retained?
- A.1 Hypothetical question. Impossible to foresee future circumstances.
- Q.2 Are the Government making any contingency plans to reimpose exchange controls?
- A.2 We have no intention of reintroducing controls, but work is proceeding on the legislative aspects in the light of EEC obligations.

JW

A.J. WIGGINS
20th May 1980



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

15th May 1980

gc Mr Lyham

MBM

T.P. Lankester, Esq.,
No.10, Downing Street

*12
14/5*

Dear Tim,

FUTURE OF THE EXCHANGE CONTROL ACT 1947

..... Following your letter of 21st March about the Chancellor's
..... minute of 19th March on this subject, it has now been
arranged for the statement annexed to that minute to be
given in the House by Written Answer tomorrow, Friday
16th May. It may of course attract some notice by the
media; and I enclose a copy of our Press briefing,
in Question and Answer form. For ease of reference, I
also attach a copy of the statement itself.

I am copying this letter, with enclosure, to the Private Secretaries of the other recipients of the Chancellor's minute of 19th March.

yours

John

A.J. WIGGINS

FUTURE OF THE EXCHANGE CONTROL ACT 1947

QUESTION AND ANSWER PRESS BRIEFING

Q.1. Why does this Government, dedicated to market forces, feel the need to retain statutory powers of control in this area?

A.1. We are required by the European Community Council Directive of 21 March 1972 to be able to act, where necessary, on capital flows without further enabling measures; and this in practice means having powers already on the Statute Book.

Q.2. What is the significance of making this announcement now?

A.2. Merely that it has become clear that, in the Chancellor's words, there is no time in the legislative programme for the early replacement or substantive amendment of the Act.

Q.3. What instruments does the 1972 Council Directive require to be available?

A.3(a) for effective regulation of international capital flows:-

(i) rules governing investment on the money market and payment of interest on deposits by non-residents;

(ii) regulation of loans and credits which are not related to commercial transactions or to provision of services and are granted by non-residents to residents;

(b) for the neutralisation of those effects produced by international capital flows on domestic liquidity which are considered undesirable:-

(i) regulation of the net external position of credit institutions;

(ii) fixing minimum reserve ratios, in particular for the holdings of non-residents.

Q.4. Are all our Community partners similarly equipped with statutory powers?

- A.4. Yes, as indeed are other industrial countries like the United States and Japan.
- Q.5. Is the statement to be seen as one move in a concerted international effort to moderate foreign exchange flows? Does it imply a UK move to join the EMS exchange rate system?
- A.5. No; it simply announces the outcome of reviewing our legislative position in the light of our Treaty obligations after exchange controls were abolished last year.
- Q.6. Does the statement reflect growing anxiety about the high exchange rate? Is it the start of a U-turn?
- A.6. No. There is no change of policy whatever implied as regards either the exchange rate or the control of either outflows or inflows.
- Q.7. Does the statement imply expectation of any imminent decline by another major currency?
- A.7. No.
- Q.8. If, as may be assumed, the present Exchange Control Act can be used in an emergency to control inflows, why is any substantive eventual amendment planned?
- A.8. Because the 1947 Act was designed for circumstances wholly different from those now prevailing or likely to prevail.
- Q.9. Can we be more specific on the nature and timing of the further legislation intended in this area?
- A.9. The detail of possible changes is still being worked out. The timing depends on what opportunities can be found in the Government's programme during the period ahead.
- Q.10. What is intended by "making the powers less draconian"?
- A.10. This relates mainly to the fact that the present Act gives the Treasury very great discretion, with little reference being needed to Parliament, whether or not to permit a very wide range of transactions.

For any control to be effective, however, the existing powers of enforcement need to be kept.

Q.11. How many staff will all this mean keeping on exchange control work?

A.11. About 2 people in the Treasury and a handful of experts remaining in the Bank of England, with recourse as necessary to the Government's legal services. There were about 20 in the Treasury and 750 in the Bank of England working on exchange control before its abolition.

Q.12. How have inflows and outflows affected monetary control in recent months?

A.12. The net impact is difficult to assess. Even though the exchange rate is mainly determined by market forces, there has been a net outflow from the non-bank private sector since last August, which will have tended to reduce sterling M3. (The outflow of funds in this period was associated with exchange control relaxations and the current account deficit. The counterpart inflow was directed mainly to public and banking sectors rather than bank deposits). But any net contractionary impact will have been offset to the extent that the outflow was financed by bank borrowing and reduced gilt purchases. In general terms a buoyant exchange rate helps to keep down inflationary pressure and reduce the demand for money, thus easing monetary control problems.

Q.13. What would be the monetary impact of inflow controls?

A.13. This is a hypothetical question. To the extent that they could be made effective, the main purpose of such controls would be to resist ^{severe} and probably short-term upward pressure on the exchange rate arising from events unconnected with UK domestic policies.

FUTURE OF THE EXCHANGE CONTROL ACT 1947
DRAFT PARLIAMENTARY WRITTEN ANSWER

Q. To ask the Chancellor of the Exchequer, if he has completed his review of the future of the Exchange Control Act 1947 and whether he will make a statement.

A. Yes. The House was told on 6 November last that, following my decision announced in October to abolish exchange controls, I would be reviewing the future of the Exchange Control Act 1947. I have now decided that, at least for the time being, the present Act should be retained.

I regard the 1947 Act as unsatisfactory in a number of ways, notably in the wide extent of its powers and in its bias, natural enough when it was introduced, towards the control of outflows. I see no prospect of time being made available in the legislative programme for the early replacement or substantive amendment of the Act; and simple repeal would not be compatible with our Treaty obligations.

I do however envisage that ultimately, and probably most conveniently in several stages, changes in the law will be sought with the objectives of making the powers available in this area less draconian and more symmetrical as between control of outflows and of inflows.

In the meantime, the Act needs to be kept in being because the United Kingdom Government is required under the European Community Council Directive 72/156 of 21 March 1972 to have available certain instruments for effective regulation of

/international

international capital flows and for neutralising those effects of such flows on domestic liquidity which are considered undesirable. The Directive also requires that these instruments may be able, where necessary, to be put into operation without further enabling measures. The Exchange Control Act 1947 is the only current legislative authority in the United Kingdom under which the Government could take such action.

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Original filed on:-

Iran Sit: Pt 6.

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NOTE FOR THE RECORD

The Chancellor called on the Prime Minister at 0900 hours this morning. The following points came up in discussion:

(i) Select Committee on the Treasury and Civil Service

The Chancellor said that the Committee were causing him considerable difficulty in their demands for information and the general tone of their approach to the Government's economic policies. Their first report was likely to be fairly critical, and this was bad for the Government's credibility. Unfortunately, the Chairman and some of his Tory colleagues were being almost as unhelpful as the Opposition members. He was trying to get the more sympathetic members of the Committee, such as Mr. Beaumont-Dark, to play a bigger role in the Committee's deliberations.

(ii) The Exchange Rate

The Prime Minister said that the high exchange rate was beginning to have a serious effect on manufacturing industry. She agreed with the Chancellor that there was no easy way of getting the exchange rate down, and in any case there would be disadvantages in terms of the RPI even if it were possible. Nonetheless, she hoped that the Chancellor was considering what might be done. The Chancellor said that the effect of the exchange rate was to move resources out of the manufacturing sector to consumers, and this was reflected in the recent big increase in real disposable income. But he did not think there was any mileage in trying to reduce the exchange rate: if anything was to be done for manufacturing, it would be better to look at fiscal reliefs. He had this whole question under review.

(iii) Interest Rates

The Chancellor said that the money supply figures for banking April now seemed likely to be worse than earlier expected: instead of a negative figure, sterling M3 was likely to show an increase of $\frac{1}{4}$ per cent. This in itself was not too bad, but it concealed a continued high level

/lending to

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- 2 -

lending to the private sector. Interest rates had fallen a little partly in sympathy with American interest rates, but it was too early to contemplate a reduction in MLR. The Bank would need to put out a new tap, probably this week, in order to maintain the funding programme.

(iv) Iran

The Chancellor referred to his minute of 28 April and said that he fully agreed with Mr. Nott that it would be very difficult to get legislation through Parliament if sanctions were to apply to existing contracts. The Prime Minister said she agreed. The Chancellor then turned to the question of Iranian assets, and reported that the Governor had recently met Mr. Nobari of the Iranian Central Bank - who had asked for an assurance that we had no intention of freezing. The Governor had given him this assurance, and in answer to further questioning, had made clear that he was not under any pressure from HMG to freeze the Iranian assets. He had explained to Mr. Nobari that the situation would have been different if the UN Resolution had included freezing of assets; but since it had not there was no question of HMG going down this route. Mr. Nobari had told the Governor that he had been given a similar assurance by the Germans and the Austrians. The Prime Minister said she was glad that Mr. Richardson had made our position clear.

T.

1 May 1980

cc: Mr. Michael Alexander

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Original filed
ham (sit) P46.

PRIME MINISTER

MEETING WITH THE CHANCELLOR ON THURSDAY 1 MAY

The Treasury tell me that the Chancellor wishes to discuss the attached minute which he has sent you on Iran.

This minute makes two points: first, sanctions should apply only to future contracts; and secondly, we should not move against Iranian assets in London.

I think it is already agreed amongst colleagues that we should not freeze Iranian assets. As for the question of sanctions, you have been inclined to agree with the Chancellor that existing contracts should not be affected. However, OD are due to have another discussion on this, and you will not want to pre-empt the outcome of that.

There is no other topic which the Chancellor has warned us he will raise. However, you might question him on the prospects for getting MLR down. The CBI have come out fairly strongly expressing disappointment that interest rates have not come down sooner.

UK interest rates have been falling. The inter-bank rate this evening was $17\frac{1}{8}$ per cent. But this is still above MLR, and until there is a little more evidence that bank lending to the private sector is moderating I think it would be unwise to move quite yet. The worst thing would be to reduce MLR and either for the markets to take no notice, or for us to be forced to increase it again. Nonetheless, caution can be taken too far; and you might tell the Chancellor that you hope he can get MLR down as soon as it looks safe to do so.

R.

30 April 1980

Original in G/R



Econ B cc *MIT*
DMR
DTT

10 DOWNING STREET

THE PRIME MINISTER

8 April 1980

Dear Brandon,

You wrote to me on 21 March about the sterling rate of exchange and its effect on industry. I am grateful for what you said about our economic policy.

I recognise that the recent high exchange rate has caused widespread concern, and has posed problems for exporters. But I cannot agree that these difficulties could be overcome by a policy of devaluing sterling. It is very doubtful whether, in a world of freely floating exchange rates, the Bank of England could engineer a major, but controlled, reduction in the exchange rate. Even if the Bank could do this, it would involve intervention in the foreign exchange markets on a scale which would jeopardise our monetary targets and hence the fight against inflation, which has to be our first priority. As the Chancellor said in his budget speech, it is an illusion to suppose that we have any real choice between defeating inflation and some other course.

It is true that a high exchange rate is an important channel through which a firm monetary policy is transmitted into a lower rate of inflation. But I must emphasise that there is no question of our keeping the exchange rate artificially high in order to combat inflation. Our policy is that the rate should be set by market forces. *That focus can never be resisted for long.*

We do, of course, attach the greatest importance to providing a favourable climate for manufacturing industry by removing unnecessary restrictions and increasing the rewards for extra effort. Last week the Chancellor announced a further

/series of measures

JS

series of measures designed to encourage economic change and improve incentives in the enterprise sector of the economy. But there are limits to what the Government can do. In the longer term, industry can only improve its competitiveness through higher productivity and through pay settlements which companies can afford. There is no easy other way.

*Y
Lousier*

Raymond

Sir Brandon Rhys Williams, Bt., M.P.

B/F 26-3-80
for Hansard
AS

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D/T
D/N
PGO

10 DOWNING STREET

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B OF E

From the Private Secretary

21 March 1980

Future of the Exchange Control Act 1947

The Prime Minister has read the Chancellor's minute of 19 March on the above subject, and subject to any points which Ministerial colleagues may have, she is content with the draft Written Answer enclosed with it.

I am sending copies of this letter to George Walden (Foreign and Commonwealth Office), Ian Ellison (Department of Industry), John Stevens (Office of the Chancellor of the Duchy of Lancaster), Stuart Hampson (Department of Trade), Bill Burroughs (Department of Energy), Richard Prescott (Paymaster General's Office), David Wright (Cabinet Office) and John Beverly (Bank of England).

J. P. LANKESTER

John Wiggins, Esq.,
HM Treasury.

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Prime Minister



Agree Chancellor's
proposed written
Answer - subject

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

to any points
from colleagues?

PRIME MINISTER

Yes

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20/3

FUTURE OF THE EXCHANGE CONTROL ACT 1947

As you know, since announcing the abolition of exchange controls on 23rd October last, we have given thought to the future of the Exchange Control Act 1947 and also to whether we should be considering the imposition of some kind of inflow controls.

2. On the latter question, sterling has indeed remained strong, although it has eased from its recent peak. While external factors have played a part, a major influence has been that of our monetary policy: a high exchange rate is an important linkage in the transmission of a tight monetary policy to lower inflation. Recent levels of sterling certainly create problems for British industry but, as we have been emphasising, those must be countered by a lower increase in domestic costs and not by any easing of the Government's counter-inflationary stance.

3. In any case, experience has shown that direct inflow controls tend to become ineffective against really strong pressures after quite a short period. Given that the level of sterling to some extent reflects anticipation of the medium-term lifting of the exchange rate which increased North Sea oil production and higher oil prices will bring, it would seem inappropriate to try to use short-term controls to deal with an essentially medium-term phenomenon. Also,

/of course,



of course, introducing inflow controls would conflict with much of the reasoning behind the decision to abolish outflow controls, notably our aims of letting the rate respond more freely to market forces, removing economic distortions and allowing administrative savings to be made in both public and private sectors.

*you have
already
agreed this
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4. We have concluded, therefore, that no action should be taken on inflow controls for the present. But it would not be prudent to ignore the possibility of needing to check really massive short-term speculative flows stimulated by events outside the UK, such as (less likely at present, I hope) a major collapse of confidence in the dollar. So my officials are working with the Bank of England on suitable contingency plans. This work relates closely to that on the future of the exchange control legislation, for the reasons below.

5. In the first place, it is at least doubtful whether existing powers would suffice to provide for controls which would be effective enough without impairing our monetary policy (we are awaiting advice from Treasury Counsel on this). Secondly, there remains in force a European Community Council Directive 72/156 of 21st March 1972 requiring member states to have available, without the need for further enabling measures, certain instruments for effective regulation of international capital flows. The Exchange Control Act 1947 is all we have for this purpose; and simply repealing it would conflict with our Treaty obligations.

6. At the same time, I regard the present Act as unsatisfactory for us to continue as it is for the longer term. I see no prospect, however, of there being time in the legislative programme for its early replacement by

/something more



something more suitable to our times - particularly less draconian and more symmetrical as between powers to control outflows and inflows. But officials are investigating what amendments might best be made to the 1947 Act in due course, perhaps by a gradual process in later Finance Bills with possibly an ultimate consolidation into a new Act - unless some unforeseen emergency were to force us to repair defects, particularly as regards inflows, by earlier legislation.

7. I announced to Parliament last November that I would be reviewing the future of the 1947 Act. I now intend, unless any colleagues directly concerned object, to report the outcome in a low key by a Written Answer, in due course, on the lines of the draft annexed.

8. I am sending copies of this minute to the Foreign Secretary, the Industry Secretary, the Chancellor of the Duchy, the Trade Secretary, the Energy Secretary, the Paymaster General, the Secretary of the Cabinet and the Governor of the Bank of England.

(G.H.)

19 March, 1980

FUTURE OF THE EXCHANGE CONTROL ACT 1947
DRAFT PARLIAMENTARY WRITTEN ANSWER

Q. To ask the Chancellor of the Exchequer, if he has completed his review of the future of the Exchange Control Act 1947 and whether he will make a statement.

A. Yes. The House was told on 6 November last that, following my decision announced in October to abolish exchange controls, I would be reviewing the future of the Exchange Control Act 1947. I have now decided that, at least for the time being, the present Act should be retained.

I regard the 1947 Act as unsatisfactory in a number of ways, notably in the wide extent of its powers and in its bias, natural enough when it was introduced, towards the control of outflows. I see no prospect of time being made available in the legislative programme for the early replacement or substantive amendment of the Act; and simple repeal would not be compatible with our Treaty obligations.

I do however envisage that ultimately, and probably most conveniently in several stages, changes in the law will be sought with the objectives of making the powers available in this area less draconian and more symmetrical as between control of outflows and of inflows.

In the meantime, the Act needs to be kept in being because the United Kingdom Government is required under the European Community Council Directive 72/156 of 21 March 1972 to have available certain instruments for effective regulation of

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10 DOWNING STREET

From the Private Secretary

4 March 1980

The Prime Minister was grateful for the Chancellor's minute of 29 February and for the paper which he enclosed with it about inflow controls.

She agrees with his conclusion that no action should be taken on inflow controls for the present, but that further contingency work should be undertaken. She also agrees with his proposal to send a minute to other Cabinet colleagues most directly concerned letting them know about this further work.

I am sending a copy of this letter to John Beverly (Bank of England).

I. P. LANKESTER

A. J. Wiggins, Esq.,
H. M. Treasury.

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Gr.



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

1
Prime Minister
This is a rather disappointing response.
But too many seem to have looked into this carefully.

PRIME MINISTER

ms.

Agree -

i) no action for the moment?

Yes

ii) future contingencies such as suggested in para 4 and at Page 4?

Yes

INFLOW CONTROLS

.....
You expressed concern about the upward pressure on sterling which the current level of interest rates appears to be causing, and asked whether we should not be considering the imposition of controls on inflows. This is something which we ourselves have been looking at recently. Since your enquiry the rate has eased somewhat and I have also answered a number of questions about it in the House. But you may be interested to read the attached note which sets out the issues in some detail.

TL 3/3

2. The first question to consider is the factors which might lead us to introduce inflow controls. It is helpful to start by distinguishing between different causes of high exchange rate. A major influence is that of our domestic monetary policy. A high exchange rate is an important linkage in the transmission of a tight monetary policy to lower inflation and it would not be sensible to frustrate this by the use of inflow controls. Another influence is North Sea oil; a likely consequence of oil production is an exchange rate that is higher than it otherwise would be. It would not be appropriate to try to offset this essentially medium term effect by the use of short-term inflow controls - the experience of other countries has demonstrated time and again that inflow controls cannot be effective for more than a short period.

/Inflow



Inflow controls seem most appropriate for use in countering short-term speculative inflows stimulated by events outside the UK - a collapse of confidence in the dollar for example.

3. The effects on monetary policy must also be taken into account. The most obvious inflows to control - increases in non-resident holdings of sterling assets - are those which do least damage to monetary control. There is a danger that if we controlled only these flows we should simply divert inflows to other, more damaging, channels. As a result any successful scheme of inflow controls would have to extend rather wider: this would inevitably conflict with our desire to remove administrative burdens from the private sector. And inflow controls would in any case run counter to our philosophy of letting market adjust freely.

4. Sterling has indeed been very strong recently, but it appears that this is largely the result of our firm monetary policies and of North Sea oil rather than of any external events. I have thus concluded that no action should be taken on inflow controls for the present. I do however feel that we should have suitable contingency plans and I have asked officials to press ahead with work on them. This is closely related to work on the future of the exchange control legislation, which is discussed briefly at the end of the note. If you agree with the approach I suggest on that subject, I propose to send a minute to those Cabinet colleagues most directly concerned in this area, letting them know what our plans are.

Flay A

5. I am sending a copy of this minute to the Governor of the Bank of England.

Andigun

for (G.H.)

29 February, 1980

Approved by the Chancellor and signed in his absence

INFLOW CONTROLS

The question of introducing inflow controls is one of several issues on exchange controls which Treasury and Bank officials have been examining recently. Since outward controls were abolished last October, consideration has been given by the Treasury and the Bank of England to the future of our exchange control legislation and the contingency plans which the Government should have in readiness to deal with inflows or outflows. The conclusion has been that no action should be taken at present but that officials should press ahead with work on the contingency planning and on preparing possible changes to the Exchange Control Act.

2. This note sets out the arguments about the circumstances in which we might wish to introduce inflow controls, and whether these circumstances exist now. It also describes the plans which the Treasury and Bank have in mind for future work on exchange controls.

Factors affecting a decision to introduce inflow controls(a) The exchange rate

3. The purpose of introducing exchange controls would be to resist severe upward pressure on the exchange rate. Another way of resisting this pressure, and one which has been tried on several occasions in the past, is for the authorities to intervene heavily in the exchange markets to hold the rate down. Intervention of this kind has an expansionary effect on the money supply and would not be consistent with the Government's monetary policies. Indeed even the fairly modest sales of sterling in January had an unwelcome effect on the money supply figures, a point which has ^{been} picked up in a rather exaggerated way by some outside commentators such as Greenwells. It is thus sometimes argued that inflow controls are an attractive alternative to intervention in the foreign exchange markets as a way of holding back upward pressure on sterling.

4. If the Government were thinking of introducing inflow controls it would be important to start by identifying what it was that was causing upward pressure on the exchange rate. The exchange rate is affected by a wide range of influences. The most important are the Government's monetary and fiscal policies. The level of the exchange rate is both a reflection of these policies and an important channel through which the effects of these policies are transmitted through to the economy. A firm monetary policy tends to produce a high exchange rate: this helps to reduce inflation both directly by reducing the cost of imports, including imports of industrial materials, and indirectly by increasing the pressure on both sides of industry to reduce costs including wage increases.

5. If the upward pressure on the exchange rate was the natural consequence of the Government's fiscal and monetary stance then there would not be any case for introducing inflow controls. To do so would be to weaken the effects of these policies in reducing inflation. This would be true whatever the particular channel through which the pressure was manifest. A firm monetary policy may require high interest rates and these may in turn attract non-resident deposits into sterling; in these circumstances the build-up in deposits is the natural consequence of the firm monetary policy rather than an unwanted side-effect of high interest rates.

6. There might, however, be other factors exerting severe upward pressure on sterling. There is great uncertainty at present among investors everywhere in the world about how best to protect the real value of their assets. The huge rise in the price of gold is an example of the forces which can be generated. It is possible that events quite unconnected with the UK could lead to massive demand for sterling. A collapse of confidence in the dollar - in which 80% of the world's foreign currency reserves are still held - disruption to Middle East oil supplies, general political tension, all these could lead to heavy switching into sterling.

7. It is in these sorts of circumstances that inflow controls might be appropriate. They could not be a long-term solution - the experience of other countries has indicated time and again that such controls lose all effectiveness after about six months - but they could help to divert the pressure while other solutions were found.

(b) Monetary control

8. If a scheme to control inflows were to be introduced the Government would have to take great care to ensure that it did not damage monetary control. In one sense any scheme which holds down the exchange rate is not helpful to monetary control; this is because a higher exchange rate reduces the price level and hence the demand for money. But perhaps of more significance is the implications for monetary control of inflow controls which affected only a limited range of transactions. The types of inflows which are the most obvious candidates for inflow controls (increases in non-resident holdings of sterling assets in the UK) are the ones which do least damage to monetary control. The danger would be that if these flows alone were controlled the Government might simply divert inflows to other, more damaging, channels. Non-residents might buy other types of sterling assets from the private sector thus increasing the money supply; or flows might be channelled through the Eurosterling market. To avoid this it would be necessary to extend the scope of the controls to cover a greater range of transactions.

(c) Other considerations

9. Another factor which has to be taken into account is that it was only very recently that the Government abolished exchange controls on outflows. To bring in inflow controls would conflict with a good deal of the reasoning behind that decision, notably the Government's aims of letting the rate respond more freely to market forces, removing the distortions which the controls imposed on the economy, and permitting important administrative savings to be made both in government and the private sector.

Imposing inflow controls would mean building up the Bank of England's Exchange Control Department again, though not to its former strength.

The position now

(a) The exchange rate

10. The exchange rate has been rising fairly steadily since the beginning of November, reaching £2.31 on 15 February with an effective rate of 73.3, the highest level for six months. But the rate has subsequently fallen back and is at present trading around £2.28 with an effective of about 72½. With the exchange rate floating freely it is likely that it will fluctuate fairly widely around its long-term trend. In the last week of July, for instance, the rate shot above £2.33 but then fell six cents on the final day of the month. It is therefore difficult to judge whether sterling has passed its current peak or whether upward pressure will resume.

11. The strength of sterling over the last year does to some extent reflect flows out of the dollar. International investors have been worried about the long-term prospects for the dollar and, more recently, about the troubles in Iran and Afghanistan. The prospect of continuing high inflation in the US, and the concern about the precedent set by the US freeze of Iranian assets have both increased the relative attractiveness of sterling.

12. But these external events have provided only a small part of the explanation of sterling's strength. More important, as mentioned above, has been the Government's firm monetary policy. The rise in the price of oil has also played an important part, and has generated considerable demand for sterling. This demand is of a different kind from short-term speculative demand based on political worries. It is to some extent an anticipation of the medium-term appreciation in the real exchange rate which increased North Sea oil production and increased oil prices will bring. It may be that the scale of the recent appreciation has been overdone, with overseas investors placing too much weight on oil and not enough on the structural problems elsewhere in the economy. But even so it does not seem appropriate to attempt to use short-term inflow controls to deal with what is essentially a medium-term phenomenon.

13. Whatever the reasons why sterling is so strong, its strength is having an important favourable influence on prices at a time when the Government's counter-inflation policy is at a crucial stage. The present level of sterling does indeed create problems for industry but, as Ministers have emphasised, those must be countered by a lower increase in domestic costs and not by any easing of the Government's counter-inflationary stance.

14. There does not, then, seem a case on exchange rate grounds for introducing inflow controls now. It is possible anyway that market forces will act to bring sterling back from its present

levels. Although many of the factors which have contributed to sterling's strength remain, there are some which point the other way: overseas interest rates are rising and narrowing the gap between those here and those abroad; and the world oil market is showing some signs of slackening. Overseas investors may in these circumstances pay greater attention to some of the underlying weaknesses in the UK economy.

(b) Monetary policy

15. Inflows are not likely to pose a major threat to domestic monetary policy in the near future, provided that the exchange rate is left to float freely. Until recently we have been experiencing very large outflows from the non-bank private sector offset by inflows with the banking and public sectors. This has tended to have a contractionary effect on £M3. But in the last two banking months the pattern has altered and external transactions have had a somewhat expansionary effect on £M3. This has been in part the result of some switching into sterling by the non-bank private sector, prompted by the liquidity pressures on companies, and in part the result of official sales of sterling. On the latter point, the Bank of England has been asked to bear very much in mind, especially at the present time, the priority the Government needs to give to control of the money supply. We have agreed that intervention in the exchange market should be very moderate.

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it has
gone too
high.
T.L.
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(c) Powers and Administration

16. In connection with the Chancellor's review of our existing exchange control powers, Treasury Counsel is being asked to advise on how far the present Exchange Control Act could be used to restrict inflows. It is already clear that for this purpose the Act is seriously defective in at least one respect. This point is explained in Annex A, which sets out the inflow restrictions imposed for a brief period in 1971. We could introduce a scheme for controlling inflows now, but it would not be a very satisfactory one.

Future work

17. Although there does not seem a good case for introducing inflow controls now, it is possible to foresee circumstances in which the Government might want to introduce them. Officials have accordingly been asked to investigate more fully how a scheme to control inflows could be organised. This will include a study of what the UK can learn from other countries' experience with inflow controls. One example is to consider whether the forms of direct controls which were employed in 1971 could usefully be supplemented by schemes for controlling company borrowing abroad which worked through requiring non-interest-bearing deposits against foreign credits. This was what the Germans did in 1973 (the "Bardepot") and a note giving some more detail of their experience ... with it is attached.

... 18. A note is also attached giving a summary of other countries' experience with inflow controls. Most of these controls have by now been lifted - the Swiss lifted their ban on interest payments on non-resident deposits only last week. In part this seems to reflect a recognition of the benefits to counter-inflation of a high exchange rate. ^{But} the lifting of these exchange controls also reflects doubts about their effectiveness.

These doubts arise in spite of the relative narrowness and lack of sophistication of the domestic capital markets of many of those countries and illustrates the problems which we might face in the UK with such controls.

19. Officials are also investigating what amendments might be made to the existing Exchange Control Act. As indicated above, it is defective in its powers to control inflows and that is something which needs to be remedied. It would ^{also} be worthwhile to consider amending the Act in order to provide for better Parliamentary control of the use of the powers it does contain. Some amendments along these lines might be included in the Finance Bill 1981: it would be impracticable to legislate in this year's

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Bill. Ultimately, it is envisaged that these amendments might be consolidated into a new Act, but that is not something which needs to be considered quickly.

20. For the longer-term Treasury Ministers/set some more work in hand as a follow-up to the abolition of exchange controls. For many years decisions in all sorts of areas have been influenced by a desire to strengthen the balance of payments and attract inflows. There are examples in the areas of taxation and export credit. That attitude is clearly inappropriate now and officials have been asked to reconsider these decisions and where appropriate to provide proposals for reversing any biases towards inflows which have been built up over the years.

OPTIONS FOR TEMPORARY INFLOW CONTROLS

1. The options considered in this Annex are first the standard exchange control measures which consist largely of prohibiting certain transactions and second those measures which involve compulsory deposits at the Bank of England when certain transactions are undertaken.

Standard exchange control measures

2. The scheme to control inflows which was introduced for a few months in 1971 was representative of the class of measures which work through prohibiting certain transactions (especially those taken at the initiative of non-residents). The measures taken were :

i. . a prohibition of payment of interest in respect of new and additional deposits by non-residents with UK banks. A similar prohibition applied to such deposits with other deposit-takers such as local authorities. (In both cases, a de minimis exemption of £20,000 for personal accounts of individuals applied).

ii. restrictions on the amount of foreign currency which UK banks themselves could switch into sterling for their own account;

iii. a ban on the sale to non-residents of :

- (a) British government securities, including Treasury Bills;
 - (b) Securities guaranteed by HMG, or issued by local authorities in the UK;
 - (c) Sterling Certificates of deposit;
- Conversion and re-investment were permitted.

(iv) a ban on the sale to non-residents of sterling acceptances, commercial bills and promissory notes denominated and payable in sterling.

These sorts of measures form the basis of the controls which some other countries have employed, details of which are set out on Annex C.

3. Our legal advice since 1971 is that the ban then imposed on sales of commercial bills to non-residents was ultra-vires the Exchange Control Act. Without this measure the effectiveness of the package would be much reduced and so new legislation to cover this gap would be needed if this type of scheme was contemplated again.

4. In addition it became clear during the operation of the controls in 1971 that simply to ban interest payments on additional non-resident deposits was inadequate. It did nothing to prevent banks taking deposits at their branches overseas and passing them on to the UK in non-interest bearing form. It would therefore be necessary if this kind of scheme was introduced in future to require banks to deposit interest free with the Bank of England amounts equal to any new sterling deposits from their offices abroad and perhaps more generally to impose special minimum reserve requirements on banks' sterling liabilities to non-residents. It is doubtful whether our existing powers are sufficient to enable us to require that, although it might be possible to enlist the voluntary co-operation of the banks.

5. When the controls were introduced in 1971, companies and other residents were already subject to a variety of continuing controls on their overseas transactions. In particular there were restrictions on companies borrowing abroad for domestic use in either sterling or in foreign currency. The normal rule was for such borrowing to be permitted only for a minimum period of five years; shorter term borrowing, a potentially important speculative channel for inflows, was for the most part not permitted. Controls of this kind would have to be re-introduced if the other controls on inflows were to be fully effective in future. Flows involving companies are a very important source

of speculative pressure, and although little can be done to control leads and lags on current payments, it is important to dam up as many other channels as is practicable. There is also a danger that controls which acted only on non-resident inflows to the banking and public sectors would have damaging monetary implications. Inflows would tend to be diverted to the non-bank private sector and add to £M3. A likely channel for this would be a growth in the Eurosterling market, with non-residents switching deposits there and companies looking to it for short-term borrowing.

6. Extending the scope of a scheme of inflow controls to take in company transactions would inevitably make the administration of it more complex. There would in particular be more need for discretionary action by the Bank of England, for instance to cope with requests for exemptions for genuine trade credits from a ban on borrowing abroad.

"Bardepot" or deposit schemes

7. An alternative to bans or restrictions on company borrowing from abroad would be to make borrowing abroad more expensive. This was the approach adopted by the Germans in 1972 when they imposed compulsory non-interest bearing deposits with the Bundesbank ("Bardepots") equal to up to 50% of any loans or credits from non-residents. It was a supplement to other controls which banned interest payments on non-resident accounts and the purchase by non-residents of certain German securities; and it complemented the compulsory non-interest bearing reserve requirements on banks' liabilities to non-residents. Details of the scheme are given in Annex B. New legislation might be required before a "Bardepot" scheme could be introduced in the UK - the opinion of Treasury Counsel is being sought.

8. The attraction of action of this sort is that it acts by imposing a financial disincentive to borrowing abroad and not by direct prohibition of certain actions. It would, it is true, have to form a part of a scheme would included direct prohibitions

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on other transactions, but these would primarily be prohibitions on the activities which non-residents could undertake.

9. The likely disadvantage is that it would require greater administrative effort and could not be introduced as quickly as a simple ban on borrowing abroad. Arrangements for paying and repaying deposits would have to be set up, and enforcement would be difficult. It would also tend to be effective only against interest-rate induced inflows and not against those induced by the prospect of a capital gain on exchange rate movements. As with a direct ban on borrowing overseas it could do little to control leads and lags.

ANNEX BThe German Bardepot Scheme

1. "Bardepot" means cash deposit. At the end of 1971, the German government secured an amendment to the Foreign Trade and Payments Law giving them powers to make regulations that German residents should have to maintain interest-free deposits in D-marks with the Bundesbank of up to 50% of any loans or credits taken from non-residents. The law exempted banks, as they were already subject to reserve requirements. Further exemptions were made by regulation. The requirement was actually imposed on 1 March 1972, with the deposit requirement set at 40%.

2. Introduction of the Bardepot has to be seen against the Germans' main economic policy objectives at that time and the measures already taken to meet them. The main objectives were to avoid a revaluation of the D-mark against the dollar (the rate was then fixed) and to curb monetary expansion. In the course of 1971, various measures (though no direct exchange control measures) had been taken, notably:

- (i) an increase in banks' reserve requirements;
- (ii) a staged cut in the discount-rate from 6% to 3%;
- (iii) a ban on the payment of interest on bank deposits by non-residents;
- (iv) a cut in the credit institutions' rediscount quotas.

3. The aim of the Bardepot was to extend the minimum reserve requirements already applicable to banks to non-banks and thus to fill a gap in the existing measures by making foreign borrowing more expensive for non-bank institutions. In 1971, this had been a significant channel for inflows. Foreign credits taken by German companies had increased from DM 20.1 billion in December 1970 to a peak of DM 35.5 billion in August 1971. Some large German companies had been in effect money-brokers between the Eurodollar and domestic markets by borrowing foreign currency abroad, converting it into D-marks and redepositing it with German banks. Monetary control was therefore being impaired by the availability of cheaper funds abroad.

4. The Bardepot was introduced along with an increase in the minimum reserve requirements on banks' liabilities to non-residents. (German legislation provides for a reserve ratio of up to 100% and permits different ratios to be imposed on resident and non-resident liabilities. In contrast

to the UK position, balances held at the Bundesbank earn no interest).

Exemptions

5. The main exemptions in the Bardepot scheme were:

- (a) "old" liabilities ie. those actually incurred before March 1, 1972 if contracted by 31 December 1971;*
- (b) trade credits;
- (c) debts arising from long-term investments abroad;
- (d) liabilities of upto a monthly average of DM 2 million per resident;

Changes to the Scheme

6. Mainly in response to evidence that it was still cheaper to borrow abroad despite the deposit requirement, the requirement was raised to 50% and the exemption ceiling was lowered to DM 500,000 with effect from 1 July, 1972. An attempt was also made to block one obvious means of evasion by introducing exchange controls to restrict the sale of D-mark securities to non-residents and by appealing to credit institutions not to breach the spirit of the Bardepot by selling D-mark paper to non-residents. At the same time, reserve requirements were increased eg. for additional non-resident sight deposits to 100%. The Capital Market Issues Committee decided not to permit foreign borrowers to make D-mark issues.

7. In the face of further speculative pressures, consideration was given to additional measures towards the end of 1972 and in early 1973. As a result, the Foreign Trade and Payments Law was amended to raise the maximum deposit requirement from 50% to 100%. However, it was not in practice increased above 50%. The exemption ceiling was lowered, for the second time, to DM 50,000.

8. A number of new measures were implemented in February 1973 involving further restrictions on inward investment, both portfolio (including equities) and direct, and borrowing abroad.

The restrictions on borrowing abroad appear to have superseded the Bardepot scheme, which may have been why the deposit requirement was never raised.

* The point of this was to catch anticipatory borrowing contracted and undertaken after the legal amendment became effective on 1 January and before the regulations were brought in on 1 March.

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9. Following the floating of the D-mark later in 1973, it was decided to relax a number of the inflow restrictions. The Bardepot was reduced to 20% in January 1974 and to zero in October 1974. Its legislative basis was not, however, removed.

Assessment

10. The view of the Bundesbank in its 1973 report was that:

".... experience has shown, however, that such measures [as the Bardepot] are fairly ineffective against purely speculative money movements and that they are ultimately of secondary importance under a system of floating exchange rates."

Moreover, reports from our Bonn embassy during this period suggest that the Bundesbank preferred direct exchange controls over inflows and resident borrowing from abroad as a means of dealing with the crisis and doubted whether the Bardepot could be of more than very limited help. They seem to have been especially worried by the opening up of new loopholes and by the limitations on its effectiveness arising from the exemption of trade credits.

11. However, an IMF staff report* provides a rather different perspective:

"The increase in the marginal reserve requirements on banks' liabilities to non-residents, the increase of the Bardepot to 50%, and the prohibition of net sales to non-residents of all fixed-interest securities led to dramatic declines during the second half of 1972 in inflows into non-resident accounts, residents' borrowings abroad, and sales of securities to non-residents. in judging the total effect of the measures, account has to be taken of any consequential changes in other capital movements, such as trade-financing or private direct investment. It is virtually impossible to make precise judgements concerning these - but in the short run it is highly probable there was a net overall restrictive effect."

The "impressive" evidence to which the Fund staff point for this conclusion is provided by a comparison of the German interbank loan rates and the equivalent covered euro-dollar rates. The divergence in favour of domestic rates increased substantially as the controls were tightened in 1972 and early 1973.

* SM/73/194 of 6 August 1973 by Finch, Lanyi, and Kidol

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12. Perhaps the conclusion to be drawn from the German experience is that along with other measures, a Bardepot may be of some help in deferring inflows induced by interest-rate differentials and in dealing with the adverse monetary consequences of inflows induced by currency speculation.

Administration

13. The Bundesbank was responsible for administering the scheme. It involved about ten full-time staff in its Frankfurt headquarters and an unknown number of staff in its 227 branches. It is not thought that any additional staff had to be recruited.

14. The scheme operated by requiring non-banks to notify the Bundesbank on a special form by the 20th day of the month following the taking of a loan or credit from a non-resident. The cash deposit had to be made in the month following notification. Policing was done by spot checks. Penalties for offences were up to DM 50,000.

15. There were a number of administrative problems, not least arising from the exemptions and questions of definition for that purpose. The scheme placed an additional administrative burden on companies as well, and many displayed their dislike of it by not complying with the requirement to send monthly returns.

INFLOW CONTROLS IN OTHER OECD COUNTRIESGeneral

It is difficult to know how effective the inflow controls described below have been. The evidence suggests that - particularly in the case of Switzerland and Germany - they have not been fully effective in preventing appreciation of the currency or adverse monetary consequences, given strong speculative pressure. The fact that the countries concerned tended to maintain them for some time suggests that they believed them to be at least partially effective (though they may have felt it important to be seen to be attempting to control the obvious channels of inflow). And of course it is not possible to say what would have happened in the absence of any inflow controls - they may have provided some "braking" effect on currency appreciation. However, it may be significant that most of these controls have now been lifted.

Germany

The German authorities have maintained various forms of inflow controls during recent years. Most of these have now been removed. They have included :-

- (i) discriminatory reserve requirements on banks' non-resident liabilities: these discriminatory requirements were suspended in May 1978;
- (ii) a cash deposit requirement of not more than 50% - the "Bardepot" - for all borrowing abroad by companies and for credit institutions not subject to reserve requirements. This was maintained between 1972 and 1974;
- (iii) restrictions on interest payments on non-resident accounts;
- (iv) prohibition of non-resident net purchases of certain German securities (including shares between 1972 and 1974).

Of these only (iv) is still in force - applied to non-resident purchases of money market paper and securities with under four years to maturity. It has recently been strengthened in one respect - sales to non-residents of promissory notes of less than five years maturity have been banned.

It is not clear how effective these controls have been. They proved ineffective against the massive inflow of speculative funds in early 1973, and generally have not stopped the DM appreciating or inflows having an expansionary impact on domestic monetary conditions. The German experience tends to suggest that such controls are at best of short-term value, since non-resident investors will sooner or later find alternative channels to evade them.

Switzerland

Until November 1979 when most controls were removed, the Swiss maintained an extensive array of temporary controls over inflows, comprising:-

- (i) a negative interest rate of up to 10% per quarter on non-resident holdings of Swiss francs;
- (ii) a ban on interest payments on foreign-owned Swiss francs;
- (iii) limits on forward sales of Swiss francs to non-residents;
- (iv) banks were required to cover their foreign currency liabilities by their foreign currency assets;
- (v) at times, certain prohibitions on acquisition of Swiss securities (including shares) by non-residents (complete ban from February 1978 to January 1979);
- (vi) restrictions on the import of foreign banknotes;
- (vii) authorisation was needed to raise funds abroad.

The imposition of a wide range of inflow controls in 1978 appears to have had only limited success in arresting a sharp appreciation of the Swiss franc, particularly in terms of the Deutschmark. This relative failure was followed by a further range of measures designed to increase the National Bank's ability to intervene on the exchange markets. This signalled a temporary subordination of monetary policy to defence of the exchange rate.

Controls on inflows, notably during 1971-72 and 1977-78, have included the following:-

- (i) restrictions on purchases of Japanese securities by non-residents (a ban for domestic yen-denominated bonds of up to five years maturity from March 1978 to January 1979);
- (ii) a reserve requirement of up to 100% on increments to non-resident yen accounts;
- (iii) controls over borrowing from non-residents.

The aim of these controls was to check upward pressure on the yen, and to prevent its use as a reserve currency. The second aim has met with some success. Controls were however less successful in checking appreciation of the yen, though they were possibly more effective in doing so than such controls in other industrialised countries. This may have been partly because of the closed nature of the Japanese system and institutional factors.

Netherlands

Measures to control inflows operated in the past (none are still in force) include:-

- (i) restricting banks' net foreign liabilities;
- (ii) establishing a closed / circuit (the "O-guilder circuit") for non-resident bond holdings, effectively preventing further foreign acquisitions. This was in operation from 1971 to 1974;
- (iii) prohibiting interest payments on certain non-resident accounts, and imposing negative interest charges on their growth; and imposing discriminatory reserve ratios on external deposits;
- (iv) setting up a separate free foreign exchange market for capital transactions.

Denmark

A ban on non-resident purchases of certain Danish Treasury bonds was imposed in February 1979 and is still in force.

Australia

Australia maintained certain restrictions on non-resident purchases of fixed-interest domestic securities between September 1972 and November 1974, and again between January 1977 and June 1978.

Austria

Austria maintained certain restrictions on non-resident purchases of domestic securities between November 1972 and January 1976.

Belgium

The authorities have, on occasions, maintained restrictions on the payment of interest on, and growth in, certain non-resident deposits. Their two-tier exchange market was originally intended to operate to counter inflows.

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→ Econ Pol (May 79)
'Exchange Rate'
d.f.f.

10 DOWNING STREET

From the Private Secretary

26 February 1980

Top copy filed on Germany (Pt 2)
'Chancellor Schmidt Visit
to the UK.'

Visit of Chancellor Schmidt: Economic Issues

I enclose a brief extract from the record of that part of the Prime Minister's talk with Chancellor Schmidt yesterday dealing with world affairs. You already have the record of their discussion of the Community budget.

I did not include in the main records any account of a brief discussion between the two Heads of Government about the performance of the British economy. The Prime Minister described the course of events since the final removal of exchange controls last autumn and the subsequent rise in the sterling exchange rate. Chancellor Schmidt expressed some scepticism both about the consequence of the rise in the value of sterling and about the possibility of controlling it. He said that the rise had been predictable and in the long run would do Britain no harm. The German Government had been told repeatedly by their own industrialists that an increase in the exchange rate would be disastrous. They had ignored the advice and had never regretted it. In any case it would be impossible for the British Government to resist the rise for long. We would have to accept the consequences of being oil rich. Devices such as negative interest rates might help for a short period but in the end the market would prove stronger. Chancellor Schmidt agreed however that it was important to hold the domestic money supply down. The German Government professed to control the country's monetary base although there was, perhaps, more pretence than reality in this policy. It was designed to keep the trade unions in line (Chancellor Schmidt noted ruefully that in Germany the Government had more difficulty in controlling the entrepreneurs than in controlling the trade unions).

The Prime Minister said that the rise in the exchange rate had a very damaging effect on British exports. Unlike German manufacturers, who sold on the basis of quality, design and delivery, the British manufacturers sold primarily on price. Chancellor Schmidt said that in the long run it was essential to make manufacturers sell on the basis of quality. Those who did not do so would go to the wall. The Prime Minister said that she agreed where private

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sector manufacturers were concerned. For her the difficulty lay with the large nationalised sector. Chancellor Schmidt admitted that this was indeed a "bad heritage".

Chancellor Schmidt then returned to the question of British membership of the EMS. You already have a record of this part of the discussion. Arising from that conversation, the Prime Minister has asked that a re-appraisal of our attitude towards the EMS should be put in hand in the light of developments since the autumn in the domestic and international economic scene. Such a re-appraisal might conveniently cover the question of participation within the narrow and wider bands, and policies short of outright acceptance or rejection of membership e.g. a declaration of intent coupled with an invitation to the other members to discuss the timing and conditions of British membership or a discussion of modifications to the existing scheme which would make it easier for us to participate

No doubt in preparing such a note you will consult the FCO, the Cabinet Office and the Bank. I think it would be helpful to the Prime Minister if your paper described the full spectrum of views on the question of full participation in the EMS.

I am sending copies of this letter to George Walden (Foreign and Commonwealth Office) and David Wright (Cabinet Office).

Yours sincerely

Nicholas Alexander

A.J. Wiggins, Esq.,
HM Treasury.

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Original on
Domestic Monetary
Policy: Part 3



Scan Bot

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

20th February, 1980

CF corr also
exchange rate on exch. rate
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Dear Tim,

We spoke last week about some questions in the monetary policy area. Mr. Peter Tapsell indicated he might raise at Question Time. Subsequently, Mr. Tapsell spoke to Sir Keith Joseph, who recorded some of his criticisms of Government policy. These were in the direction that we should not be seeking to avoid increases in interest rates occurring as a result of market forces, and that we should impose exchange controls on inflows as a way out of the dilemma that inflows are likely to result either in an appreciation of the exchange rate or in undesired increases in sterling M3. Mr. Tapsell further suggested that quantitative controls over bank lending would provide a means of reducing upward pressure on interest rates.

.....
Officials concerned here have been considering how Ministers might respond to criticisms on these lines. The attached note, which the Prime Minister may care to see, is the result. We suggest, however, that the arguments in paragraph 10 should be used with caution; although external flows have had relatively little impact in recent months on monetary growth, sterling could become the object of very sharp speculative pressure as a result of the petro-currency mentality in international markets, and we should not wish to rule out absolutely some use of inflow controls if the situation demanded it.

Yours

John

(A.J. WIGGINS)

T.P. Lankester, Esq.,
Private Secretary,
10, Downing Street

COMMENTS ON CRITICISMS OF GOVERNMENT POLICY FROM MR PETER TAPSELL
AS RECORDED BY SIR KEITH JOSEPH

1. "The logic of monetarism" requires that the Government has to be ready to move interest rates to whatever level may be necessary to achieve the monetary target, for a given fiscal stance.
2. This does not necessarily mean letting interest rates go up or down (say, under pressure from inflows as happened in 1977) with the market. Mr Tapsell's criticism would have had more force if the upward pressure on interest rates had been because the market thought that higher interest rates were necessary to achieve the target - but that was not the cause: it was rather technical factors related to the annual pattern of Government payments and receipts.
3. Given the reassessment of both the monetary target and the fiscal stance which is due in the Budget, within 6 weeks, it would seem wrong to act on one weapon alone - namely interest rates - in isolation, unless it was made essential to do so because of, say, a collapse in confidence in the markets which had to be corrected without delay - but that was not the situation. It would seem the more wrong to do so given that the way things have turned out in 1979/80 has meant that, if anything, the Government can be criticised for relying too much on interest rates and too little on fiscal policy.
4. It would be wrong to pre-judge what the Government has done on spending and taxing, until the Public Expenditure White Paper and the Budget.
5. Mr Tapsell criticises the Government for "window-dressing". But his remedy of directions to the banks in respect of bank lending would have only led to even more window-dressing, with liquidity and credit channelled into forms outside the control and outside the statistic.
6. The ending of exchange control has not significantly affected the problems of domestic monetary control - it is true that it may have made them ^{via some means} a bit harder, but the effect is marginal in relation to the general gains from greater freedom from control brought about by the ending of exchange controls, along with the other controls abolished by the Government.

7. The Governor has only asked the City not to use the freedom from exchange controls in one narrow respect, namely he has asked the banks based in London not to get round the SSD scheme/corset by putting business offshore.

8. Mr Tapsell's suggestion that the Government should relieve pressure on business by reducing the exchange rate seem inconsistent with his first complaint that the Government is not prepared to carry through the logic of monetarism. A tight domestic monetary policy inevitably means a high exchange rate. Indeed, the high exchange rate is one of the quickest ways in which the tight monetary policy feeds through into the price level, and so the rate of inflation.

9. The high exchange rate inevitably squeezes companies, but that is one of the purposes of a tight monetary policy - without such a squeeze on companies, and on activity, we will not get the lower rate of wage settlements. It is at least arguable that the high exchange rate has the least effect on those companies which are competitive on grounds other than price, and it is those companies which need to have the relative advantage in the interests of the long term growth of the economy.

10. Controls on inflows to lower the exchange rate would involve foregoing one of the benefits of the tight monetary policy. They would almost certainly lead to the creation of channels of evasion. There would be a grave risk that they would worsen the task of domestic monetary control by causing inflows to switch from forms which do not have much effect on the money supply - flows into Government debt and into non-resident bank deposits, which can be fairly readily controlled into forms which do affect the money supply - flows into the non-bank private sector, which cannot be so effectively controlled.

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BIF 29-2-80 ^{DSG}

Fue

18 February 1980

The Prime Minister is concerned about the upward pressure on sterling which the current level of interest rates appears to be causing, and has asked whether we should not be urgently considering the imposition of controls on inward flows, or the imposition of negative interest rates. She would be grateful if the Chancellor of the Exchequer would consider the possibilities, and report back to her as soon as possible.

I am sending a copy of this letter to John Beverly (Bank of England).

T. P. LANKESTER

John Wiggins, Esq.,
H.M. Treasury.

Tue

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9

PRIME MINISTER

Evening Market Report

Sterling/Dollar	opening :	2.3055
	closing :	<u>2.3133</u>
Sterling effective	opening :	73.07
	closing :	73.29

The bank took in \$23 million in the market. The effective index reached a new six month high.

In the guilts market the authorities bought £16 million. Guilts prices were a little lower.

I spoke to Gordon Pepper this evening. He is very worried about the continued upward pressure on Sterling, and thinks the Treasury should be seriously considering introducing exchange controls and/or negative interest rates on inward flows. We discussed this briefly today, but shall I ask the Treasury for a considered note?

R.

Yes please
no

14 February 1980

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10 DOWNING STREET

THE PRIME MINISTER

1 November, 1979.

Dear Lord Cromer,

Thank you so much for your letter of 25 October. It was good to have your encouraging comments on our decision to abolish Exchange Controls. As you say, Exchange Controls have, for too long, been an unjustifiable infringement of personal liberty and the economic case for their continuation had become increasingly irrelevant.

Yours sincerely,

(SGD) MT

The Rt. Hon. The Earl of Cromer,
K.G., G.C.M.G., M.B.E.

W



10 DOWNING STREET

THE PRIME MINISTER

30 October, 1979.

Dear Peter,

Since you asked me at Question Time on 25 October whether it is proposed to repeal the Exchange Control Act 1947, I have been in touch with the Chancellor of the Exchequer; and I am writing to let you know the present position.

As Geoffrey Howe explained in the House on 23 October, exchange control restrictions are still needed in relation to Rhodesia until sanctions can be lifted. The powers in the 1947 Act must be maintained for that purpose; and there are also some technical reasons, such as cross-references in certain Finance Acts, for keeping the statute in being till other provisions can be made. For the rest, the future of the 1947 Act is being reviewed and a decision about it will be taken in due course.

Yours ever,

(SGD) MT

Peter Tapsell, Esq., M.P.

Cabinet / Cabinet Committee Document

The following document, which was enclosed on this file, has been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB (CABINET OFFICE) CLASSES**.

Reference: CC (79) 18th Conclusions, Minute 9

Date: 25 October 1979

Signed *D. Wayland* Date 29 March 2011

PREM Records Team

Prime Minister 8


 ABJ
 Duty Clerk.
 24.10.

Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

24th October, 1979

Dear Tim,

EXCHANGE MARKET REACTION TO EXCHANGE CONTROL ABOLITION

The Prime Minister may like to have a brief account of the initial reaction of the exchange markets to yesterday's announcement of the abolition of exchange controls.

the Sterling had already fallen yesterday from \$2.15 at Monday's close to \$2.13 by the time of my statement in the House. This fall partly reflected the sharp rise in US interest rates on Monday. The dollar had a good day against all currencies. However there were also rumours in the market here that the Chancellor would be making a statement in the afternoon. Following the statement there was some fairly heavy selling of sterling but no panic. The Bank intervened to preserve orderly markets and to moderate the fall in the rate. By the close last night the rate was down to \$2.11½ and the Bank had spent \$300 million on the day, of which \$90 million had occurred before the announcement. The effective rate fell over the day from 68.9 to 67.9 (i.e. by 1½ per cent, compared with nearly 2 per cent fall on the dollar).

Overnight there was some selling of sterling in the Far East and the rate opened lower here at \$2.10¼. This morning it fell initially to \$2.09½ but has since recovered on two-way business and at close today was back to last night's London closing level of \$2.11½. Today the Bank have so far spent about \$50 million (net) and have operated both ways in the market. The effective rate at today's close was 67.7.

The market may remain nervous for a time but I think we can be satisfied at the way things have gone so far. The rate is lower, as was to be expected, but the Bank have

/been able

 T. Lankester, Esq.,
 Private Secretary,
 10, Downing Street

S E C R E T



been able to maintain orderly conditions in the markets without having to provide very heavy support.

I am sending copies of this letter to John Beverly and Martin Vile.

Y ev,

Ma

(M.A. HALL)
Private Secretary

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~~SECRET~~ *no longer ms*
Until 4 p.m. on 23rd October



7.
Exam Post.
PA

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

23rd October 1979

Dr Nick,

EXCHANGE CONTROLS : STATEMENT

..... I enclose the final version of the Chancellor's
statement for this afternoon.

..... I am copying this letter to the Private
Secretaries to the members of the Cabinet, and to
the Government Chief Whip (6 copies). A spare
copy is enclosed for your Press Office. Copies are
being sent separately to the Speaker and to the
Government Chief Whip in the Lords.

G. M.

MA

(M.A. HALL)

N. Sanders, Esq.,
No.10, Downing Street

S E C R E T

UNTIL 4 P.M. ON 23RD OCTOBER

STATEMENT ON REMOVAL OF EXCHANGE CONTROLS

With permission, Mr. Speaker, I wish to make a statement about exchange control.

In my Budget Statement on 12th June I announced our intention progressively to dismantle these controls. I made a number of relaxations at that time; and again on 18th July, when I informed the House of the first major move towards liberalising outward portfolio investment.

I have now decided to remove all the remaining exchange control restrictions from midnight tonight, apart from those still needed, I hope not for long, in relation to Rhodesia.

With that single exception, there will from tomorrow be full freedom to buy, retain and use foreign currency for travel, gifts and loans to non-residents, buying property overseas and investment in all foreign currency securities. Portfolio investment will be wholly freed; and the requirement to deposit foreign currency securities with an Authorised Depositary is abolished. Foreign currency accounts can be held here or abroad. Passport marking for travel funds can now be abolished. - The necessary Treasury Orders are being laid this afternoon.

The removal of controls will lead to public expenditure savings of about £14½ million a year, which represents the current cost of about 750 staff at present employed on exchange control work at the Bank of England and about 25 at the Treasury. I would like to thank all those who have had the task of administering the controls - not only in the Treasury,

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UNTIL 4 P.M. ON 23RD OCTOBER

the Bank of England and Customs and Excise, but also those in the private sector, whose co-operation has enabled the system to work.

Under arrangements announced in this House in 1971, exchange control has been used to prevent United Kingdom tax incentives supporting the leasing abroad of foreign equipment. I propose to introduce in the 1980 Finance Bill provisions, which will take effect from tomorrow, to continue to prevent this. Further details on this matter are available in the Vote Office.

From tomorrow, we shall be meeting in full our Community obligations on the freedom of capital movements.

Exchange controls have been with us in one form or another for just over forty years. They have now outlived their usefulness. The essential condition for maintaining confidence in our currency is a Government determined to maintain the right monetary and fiscal policies. This we shall do.

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10 DOWNING STREET

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Exchange Controls

From the Private Secretary

17 October 1979

Dear Tony,

The Prime Minister held a meeting at 0945 hours this morning to discuss the EMS and the Chancellor of the Exchequer's proposals for further dismantling exchange controls. The following were present: the Chancellor, the Foreign and Commonwealth Secretary, the Secretaries of State for Industry and Trade, the Governor of the Bank of England, Sir John Hunt and Sir Robert Armstrong. They had before them the paper on EMS circulated under cover of the Chancellor's minute of 24 September and the Chancellor's minute of 11 October on exchange control.

EMS

The Chancellor said that he was opposed to full membership of the EMS for the present. There was considerable uncertainty about the future path of the exchange rate, and this could make it difficult to reconcile strict adherence to monetary targets with the fixed rate obligations of EMS. One of the uncertainties on the exchange rate front related to his proposals for further dismantling exchange controls: if these were accepted, it would be necessary to wait several months at least before joining the EMS so as to allow time to see the consequences of future liberalisation for the exchange rate. He did not believe that a decision to join would make any significant difference to the UK's bargaining position in relation to the Community budget. On the other hand, it was a fact that the UK's continued exclusion from full EMS membership tended to isolate UK Ministers in their discussions in Europe; and he felt that full membership should remain an objective for the medium term. The Governor said that he supported the Chancellor's position, though he would like to feel that the UK was moving in the direction of full EMS membership.

The Secretary of State for Trade said that, while he acknowledged the political case in favour of joining, the economic arguments against early membership were strong. In any case, the dismantling of exchange controls must come first. The Secretary of State for Industry said that he too was opposed. The Foreign and Commonwealth Secretary pointed out that if the Government could be sure that sterling would be under pressure in a downward direction, there would be advantage in the UK joining. In that situation, there would be no conflict with the policy of holding the money supply, and the UK would benefit from the network of support under the EMS arrangements. However, he agreed that it would not be right to join for the time being.

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/ Summing up

Summing up

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Summing up this part of the discussion, the Prime Minister said that she agreed that the time was not yet ripe to join the exchange rate regime. She was particularly concerned about the potential conflict between the Government's monetary targets and the EMS intervention requirements. Adherence to the monetary targets was absolutely crucial if inflation was to be brought down, and the Government's monetary objectives must remain paramount. She herself was not optimistic that sufficient stability in the exchange rate would be achieved to make joining possible even over the next year. She did not intend to mention EMS in her Luxembourg lecture the following day, nor did she intend to offer any kind of commitment to the UK's joining EMS as a full member at the Dublin Council.

Exchange Controls

The Chancellor said that he had considered long and hard the final dismantling of controls, and had come to the conclusion that action next week would probably provide the last opportunity for some time. If the decision were postponed beyond next week, it would have to wait for at least two months until after the sale of the BP shares. By the New Year, it could well be more difficult, and it would probably be hard to present the abolition of controls at the time of the next Budget since the background to the Budget was likely to be difficult. He believed it was inherently right to dismantle the remaining controls. Failure to do so would be represented as a failure of confidence by the Government in its own policies; and there was a strong economic case for using part of the benefits of North Sea oil to purchase overseas assets which would yield foreign exchange earnings when North Sea oil began to run out. There were admittedly risks for the exchange rate and possibly for monetary policy; but on balance he was sure that it was right to go ahead.

The Secretary of State for Trade said that he strongly supported the Chancellor. In addition to the points which the Chancellor had made, he added that the Government were rightly trying to create a new climate of greater freedom, and it would be illogical to refrain from the final dismantling of exchange controls: to do so now could well unsettle the markets. A decision in favour would enable the Prime Minister to say something positive at the Dublin Council; it should also help the Government's position vis-a-vis the trade unions, by showing that the Government were determined that investors should be allowed to put their money where they can earn the best return. The Governor said that he, too, was strongly in favour of the Chancellor's proposals.

The Prime Minister said that, while she accepted the advantages of further dismantling of the controls (and, in particular, she favoured overseas investment in general), she was worried about the risks of moving at this time. The Chancellor's minute had suggested that the outlook for the money supply in the next few months was favourable; and that therefore the risk of an adverse impact on the money supply should be accepted. However, she understood that the October money supply figures were likely to be a good deal worse than the figures for September - and, moreover, worse than the Treasury had been forecasting.

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Commenting on this point, the Governor said that the latest estimates for the Central Government Borrowing Requirement suggested that the October figure was going to be perhaps £1 billion higher than had earlier been forecast; this was indeed likely to make for worse money supply figures for October. The reasons for the high Central Government Borrowing Requirement for October were not yet entirely clear but it appeared that delays in VAT payments were a substantial contributing factor, and also possibly repayment of debt by nationalised industries. Both of these factors were likely to be temporary. On the other hand, the September figures for lending to the private sector were well down on earlier months' figures, and there was still a reasonable prospect that - notwithstanding the high Central Government Borrowing Requirement - the money supply figures for October would be within the Government's target range. It was important not to concentrate simply on one month's figures: looked at on a three-monthly basis, M3 was moving in the right direction. Against this background, the Governor did not think it would be right to hold up the decision on exchange controls because of worries about the money supply.

Asked by the Prime Minister about the exchange rate risks, the Governor replied that these too were not sufficient to postpone a decision. The relaxation of controls in the summer had not resulted in a weakening of sterling. There was no indication that the institutions were likely to take precipitate action in moving funds out of sterling into currencies on which the controls still operated; for Wall Street in particular was not immediately attractive. Moreover, if there were to be a loss of confidence in sterling, this would result in movement into other currencies in any case: the Chancellor's proposals would not add very much overall to the scope for sterling outflows in the short term.

The Foreign and Commonwealth Secretary pointed out that exchange controls in relation to Rhodesia could not be lifted separately from sanctions generally. It would have been better from his point of view if the decision could have been held over until after a decision on sanctions had been taken in November; but in view of the difficulties which this would pose for the Chancellor, he would not press for any delay. There would remain a presentational problem which would have to be resolved.

Summing up, the Prime Minister said that - despite the risks involved - she agreed with the Chancellor's proposals.

As a postscript to the discussion on EMS, I should add that the Prime Minister has decided that she does not wish there to be a further discussion of this issue in OD Committee, and that the Chancellor's paper should not after all be circulated to OD.

I am sending copies of this letter to George Walden (FCO), Stuart Hampson (Department of Trade), Ian Ellison (Department of Industry), John Beverly (Bank of England) and Martin Vile (Cabinet Office). It goes without saying that the decisions recorded in this letter are highly sensitive, and therefore it should be circulated on a strictly "need to know" basis only.

Home cov.

Tim Lancaster

PRIME MINISTER

EMS : Reference in the Luxembourg Speech

You may wish to consider, briefly, with your colleagues tomorrow morning the question of whether or not to include a paragraph about EMS in your Luxembourg speech.

It is probably not worth saying anything if you agree with the line put forward by Treasury officials that we could go no farther now than the words to the effect that "we are reviewing the prospects for sterling in the light of the development of our new policies and of external factors"; and that we will take a decision about entry into the Exchange Rate Mechanism in the light of that review.

If, on the other hand, you felt able to say:-

- (a) that the EMS is an essential part of the Community's defences against monetary instability; and
- (b) that Britain's objective is to enter the Mechanism when the position of sterling has stabilised sufficiently (ie repeat the line you took in Rome),

The impact of your speech would undoubtedly be enhanced.

I attach a copy of a recent telegram from Sir O. Wright on the EMS question. It was in a batch of telegrams which I do not think you have seen. His argument, in brief, is that the EMS is a vital piece of Community machinery and that it is difficult to claim that we are full members of the Community so long as we stand aside from the Exchange Rate Mechanism.

Ant

16 October 1979

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FM BONN 091654Z OCT 79

TO PRIORITY FCO

TELEGRAM NUMBER 566 OF 8 OCTOBER

AND TO ROUTINE EEC POSTS

WASHINGTON UKDEL CECD

Prime Minister

It would, of course, guarantee ~~the~~ headlines for your Luxembourg speech if you feel able to go further on this subject: at the moment it says "our objective is to enter the mechanism when the position of sterling has stabilised sufficiently" in the form of words you used with Cossiga. More importantly, it would help on the Budget.

ANGLO-GERMAN CONSULTATIONS: EMS

1. THE GERMANS HAVE TOLD US THAT SCHMIDT WILL WISH TO DISCUSS EMS WITH THE PRIME MINISTER AND WE KNOW FROM MY TALK WITH HIM ON 19 SEPTEMBER THAT HE HAS STRONG VIEWS ABOUT IT. HMG HAVE SAID THAT THEY FOR THEIR PART WILL TAKE A DECISION ON WHETHER TO BECOME FULL MEMBERS THIS AUTUMN. A VIEW FROM BONN MAY THEREFORE BE HELPFULL AT THIS STAGE.

Print - 9/14

2. SCHMIDT HAS ALWAYS SEEN AND STILL SEES THE EMS PRIMARILY AS A POLITICAL ACT OF WILL, THOUGH ONE WITH BENEFICIAL ECONOMIC CONSEQUENCES. AND HE SEES IT AS A JOINT POLITICAL ACT WITH HIS FRIEND GISCARD: TO RELAUNCH A EUROPEAN COMMUNITY IN THE DOLDRUMS AND TO ESTABLISH A DISTINCT EUROPEAN IDENTITY IN THE FINANCIAL FIELD. THE CREATION OF AN AREA OF EXCHANGE RATE STABILITY IN EUROPE AND TAKING OUT A FORM OF INSURANCE AGAINST THE INCOMPETENCE OF THE CARTER ADMINISTRATION AND THE RESULTANT YO-YO EFFECT OF THE DOLLAR ARE USEFUL FINANCIAL BONUSES. HERE IN BONN, SCHMIDT PUT IT THROUGH AGAINST THE COMBINED SCEPTICISM OF THE MINISTRY OF FINANCE, THE BUNDESBANK AND MOST OF THE GERMAN FINANCIAL ESTABLISHMENT. IT IS NOT FOR ME TO ASSESS GISCARD'S MOTIVES: BUT ONE CLEAR RESULT HERE HAS BEEN TO REINFORCE THE PRIVILEGED NATURE OF THE FRANCO-GERMAN RELATIONSHIP. SCHMIDT AND GISCARD NOW SEEM TO ENJOY THE SORT OF POLITICAL AND PERSONAL RELATIONSHIP WHICH COMES AFTER PEOPLE HAVE BEEN THROUGH FIRE TOGETHER AND COME OUT STRENGTHENED ON THE OTHER SIDE. LAST WEEK'S FRANCO-GERMAN SUMMIT IN BONN (MY TELNO 555 OF 3 OCTOBER) CONFIRMS THIS VIEW.

3. SCHMIDT HAS, IN THE EVENT, BEEN PROVED ON THE WHOLE RIGHT AND HIS FINANCIAL ESTABLISHMENT ON THE WHOLE WRONG. THE SYSTEM WORKS AND HAS CLEARLY COME TO STAY. THE DOUBTS OF THE FINANCIAL ESTABLISHMENT HAVE BEEN STILLED EVEN IF THEY ARE NOT WHOLLY PUT TO REST. FOR PRACTICAL EXPERIENCE OF THE WAY THE SYSTEM WORKS OVER THE LAST SIX MONTHS HAS, ON THE WHOLE, BEEN SATISFACTORY. IT HAS NOT, OF COURSE, DONE AWAY WITH THE PROBLEM OF THE STRONG D-MARK AND WEAK DOLLAR, BUT, THEN, NOBODY EXPECTED THAT IT WOULD. BUT THE SYSTEM HAS SURVIVED CONSIDERABLE

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DOLLAR TURBULENCE FROM WITHOUT AND HAS DEMONSTRATED ITS CAPACITY TO MAKE THE NECESSARY INTERNAL ADJUSTMENTS. DESPITE MAJOR DIFFERENCES IN GROWTH RATES, INFLATION RATES AND BALANCE OF PAYMENTS OUT-TURNS, LIFE HAS BEEN EASIER BOTH FOR THOSE WITHIN THE SYSTEM AND FOR THOSE WITHOUT LIKE THE AUSTRIAN SCHILLING AND THE SWISS FRANC. NEITHER THE BELGIANS NOR THE DANES, THE WEAKEST PARTNERS OVER THE LAST SIX MONTHS, SEEM TO WANT OUT. MY VIEW IS THAT NOT ONLY SCHMIDT, BUT ANY FORESEEABLE ALTERNATIVE GOVERNMENT HERE, TOGETHER WITH THE GERMAN FINANCIAL ESTABLISHMENT NOW HAVE A VESTED INTEREST IN MAKING THIS QUOTE (NEXT TWO WORDS UNDERLINED) ACQUIS COMMUNAUTAIRE UNQUOTE WORK AND SURVIVE. IN OTHER WORDS, THE EMS IS DOING WHAT WAS EXPECTED OF IT - WITHOUT US. AS TO THE FUTURE, IS IS NOT CLEAR THAT THE EMS WILL LEAD AS QUICKLY AS PROCLAIMED TO AN EMF : BUT THAT IS FOR THE FUTURE AND WE SHOULD PRESUMABLY HAVE MORE INFLUENCE ON FUTURE DEVELOPMENTS FROM A POSITION FOUR-SQUARE WITHIN THE SYSTEM.

4. IT IS, I THINK, NO SECRET THAT THE REASON WHY BRITAIN DID NOT REPEAT NOT JOIN AT THE BEGINNING WAS ALSO PRIMARILY POLITICAL. THE FINANCIAL ARGUMENTS WERE ALWAYS, EVEN LAST WINTER EVENLY BALANCED. BUT THE THEN GOVERNMENT WITH THE WINTER OF DISCONTENT ON ITS HANDS AND AN ELECTION LOOMING, SIMPLY COULD NOT TAKE ON IN ADDITION THE TASK OF SELLING EMS TO ITS SUPPORTERS. WHEN THE POLITICAL DECISION NOT TO JOIN THE EXCHANGE RATE MECHANISM WAS TAKEN, THERE WERE NATURALLY PLENTY OF SOUND TECHNICAL ARGUMENTS TO BACK IT, JUST AS THERE WOULD HAVE BEEN PLENTY OF SOUND TECHNICAL ARGUMENTS TO BACK A DECISION TO JOIN HAD THAT BEEN THE DECISION. BUT THAT IS THE WAY OF POLITICAL DECISIONS WHEN THE TECHNICAL ARGUMENTS ARE EVENLY BALANCED. IT IS PERHAPS WORTH RECALLING THAT OUR MAIN FEAR AT THE TIME WAS THAT STERLING WOULD BE TOO WEAK TO STAY WITHIN THE SYSTEM WITHOUT INTERVENTION AND THAT WE MIGHT HAVE TO SQUANDER PRECIOUS RESERVES TO MAINTAIN THE RATE. THE FACT THAT PRECISELY THE OPPOSITE HAS HAPPENED PERHAPS DOES NO MORE THAN EMPHASISE THE DIFFICULTY OF DOUBLE-GUESSING THE MARKET.

5. THE ESSENTIAL POINT HOWEVER, AS SEEN FROM BONN, IS THAT IN CONCEIVING AND BRINGING THE EMS TO FULL TERM, SCHMIDT HAS COMMITTED AN ACT OF POLITICAL WILL, HAS BEEN JOINED IN THAT ACT OF WILL BY GISCARD AND TOGETHER THEY HAVE BEEN JOINED BY THE SIX AND THE COMMISSION. WE ARE ON THE SIDELINES, AS EVENTS OF THREE WEEKENDS AGO, WHEN WE WERE NOT EVEN INVITED TO THE REALIGNMENT

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MEETING, DEMONSTRATED. IT IS CLEAR FROM WHAT HE TOLD ME AT DINNER
IN MY HOUSE ON 19 SEPTEMBER THAT SCHMIDT IS LOOKING FOR A SIMILAR
ACT OF POLITICAL FAITH AND WILL FROM THE PRIME MINISTER. IT IS
TRUE THAT GERMAN OFFICIALS AT ALL LEVELS DO NOT EXPECT US TO JOIN
AND WILL BE RELAXED IF WE DO NOT. THAT MESSAGE WE ARE GETTING
LOUD AND CLEAR. BUT IT IS NOT THE MESSAGE FROM SCHMIDT
HIMSELF. SCHMIDT WILL NO DOUBT BE TOO POLITE TO SPEAK IN THE SAME
TERMS TO THE PRIME MINISTER AS HE SPOKE TO ME: THE RELATIONSHIP
IS NOT YET OF LONG ENOUGH STANDING AND IN ANY CASE AMBASSADORS
EXIST (NEXT TWO WORDS UNDERLINED) INTER ALIA TO ACT AS SHOCK
ABSORBERS. BUT WHILE HE ACCEPTS THAT, WITH THE ADVENT OF A
CONSERVATIVE ADMINISTRATION TO POWER, MUCH HAS CHANGED FOR THE
BETTER IN ATTITUDES TO EUROPE HE IS NOW, TO PUT IT VULGARLY,
WAITING FOR US TO PUT OUR MONEY WHERE OUR MOUTH HAS BEEN SINCE
MAY. FOR ONCE AGAIN, THE EUROPEAN TRAIN HAS MOVED ON WITHOUT US,
AS IT DID AT THE FOUNDATION OF THE COMMUNITY. OR RATHER WITH US
CLINGING TO THE OUTSIDE OF THIS PARTICULAR CARRIAGE.

6. IN BRIEF, IT SEEMS FROM HERE AS IF A DECISION TO JOIN THE
FULL EMS SYSTEM IS A PREREQUISITE TO OUR COMING GOOD ON OUR
FREQUENTLY PROFESSED AND AS FREQUENTLY WELCOMED DESIRE TO PLAY
A FULL ROLE IN DETERMINING THE FUTURE OF EUROPE. WE CANNOT
DO SO FROM THE SIDELINES. IT IS CERTAINLY A PREREQUISITE TO
ESTABLISHING A STABLE EUROPE ON THE BASIS OF A BONN-PARIS-LONDON
TRIPOD INSTEAD OF, AS AT PRESENT, A BONN-PARIS AXIS. IT IS ALSO
CERTAINLY A PREREQUISITE FOR THE PRIME MINISTER'S ESTABLISHING
WITH SCHMIDT THE SORT OF RELATIONSHIP OF CONFIDENCE THAT HE HAS
WITH HIS FRIEND GISCARD. ALTHOUGH I COULD NOT CROSS MY HEART AND
SAY THAT A DECISION TO JOIN THE FULL EMS SYSTEM WOULD MAKE IT
EASIER TO GET WHAT WE WANT ON THE BUDGET OR THAT THERE IS ANY
SUCH CONJUNCTION ON SCHMIDT'S MIND, IT IS AT LEAST CLEAR THAT
IT WOULD TRANSFORM THE ATMOSPHERE.

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Prime Minister. 5 2

The Chancellor is hoping that there will be an opportunity to discuss this at Chequers on Sunday.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Abd

12x.

For discussion with the Chancellor and others on Wednesday morning.

PRIME MINISTER

EXCHANGE CONTROL

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We must now take a crucial decision on the future of the remainder of the exchange controls. As explained in the Financial Secretary's minute to you of 25th September, we must either announce any new package before the BP sale or postpone it for at least 2 months, ie. almost certainly beyond the end of the year. The effect of this is that we have probably to choose between an announcement this month when Parliament returns, and deferment of the next stage of our programme of dismantling these controls at least until the 1980 Budget. In this situation I have authorised preparations for an announcement of further exchange control relaxations on Tuesday, 23rd October. They can be countermanded at any time.

2. There is a clear case for completing the process of abolition in one step (leaving only controls affecting Rhodesia which must remain while sanctions last). The great bulk of the remaining controls relate to portfolio investment outside the EEC i.e. in practice mainly to investment in US securities. Direct investment is already wholly free and remaining restrictions on individuals are not of great economic significance.

3. Completing abolition would show our determination to implement the policies to which we are committed. It would sweep away another set of controls that has outlived its

/ usefulness.

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usefulness. It would enable individuals and firms to take investment decisions on commercial grounds and so further our aim of freeing the market economy to operate efficiently. It would reduce public expenditure by the cost of about 750 staff (mainly Bank of England staff) now borne on the Treasury's Vote. It would end a large burden in the private sector on banks, firms and individuals, and there would for example be no more marking of passports. It would fulfil our obligations on capital movements under the EEC Treaty and you could take credit for this at the Dublin Council. And it would please the Americans who do not like the present discrimination in favour of EEC securities that resulted from the relaxations we made in July.

4. We must first consider the implications for the exchange rate. These are exceedingly difficult to predict. Obviously the effect of abolishing exchange controls would be to ~~omit~~^{permit} outflows which, especially if they proved substantial, would cause the rate to be lower than otherwise. That is a necessary consequence of the achievement of our aim to abolish exchange control. The question thus is whether the present is a good time to accept the consequence or whether it would be better to wait. In my view, the present is as good a time as we are likely to get. First, though we must expect an adjustment of portfolio over a period, this is not a particularly attractive moment to buy U.S. securities. The outflow may, therefore, be gradual. Secondly, sterling has fallen back from the very high level it reached in the immediate aftermath of Iran and the oil developments in the summer. But, at its present level, it is not under pressure. The effect of last weekend's US package is an illustration of this point since, if the market had had serious doubts about the present rate for sterling, they would have shown

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themselves when the dollar revived. In fact, the effective rate and the cross-rates against the strong non-dollar currencies stood up well. Sterling seems to have come through this limited dollar rebound unscathed. Obviously this situation could change, but, provided we continue to show our determination to persist with our financial and monetary policies, I would not expect any downward pressure on sterling to get out of control. And the maintenance of the remainder of our exchange control regime will not be crucial since there are so many ways of getting out of sterling as things are at the moment.

5. A further point is that our reserves are very high - \$24 billion spot and forward. I would be opposed to sustained intervention to support an exchange rate that the market had come fundamentally to doubt. But in this case I could see a case for heavier intervention than we would normally think appropriate to finance any initial outflows following a relaxation of exchange control. We could explain that the effect of our intervention was to exchange public sector assets in the reserves for assets acquired by the private sector as a result of our change of policy; and I believe that this explanation would be accepted by the markets. If therefore, sterling showed signs of falling too far we could exercise the option to mitigate the fall by intervention.

6. The exchange control decision also has several implications for domestic monetary policy.

7. First, it would make it impossible for us to use effectively certain types of direct control over domestic banks - essentially because the alternative of "offshore" banking would become a readily available substitute. The only direct control we currently use is the "corset", and you will

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have seen the growing leakage into acceptances which bypass this control and are bringing it into disrepute already. The alternative direct controls which would be similarly ineffective in the absence of exchange control are some of the direct "penalty" versions of monetary base control. In their studies of this following your July seminar, however, the Bank of England and my officials have failed to identify any direct monetary base control which would be robust for any length of time even with full exchange controls. Our main monetary policy instruments: interest rates, PSBR management, management of gilt markets; would be unaffected by the removal of the remaining exchange controls.

8. There could be effects both ways on the £M3 figures, in the ensuing months. These will need to be explained but are likely to be well understood by the commentators as part of a switch in the stock of assets. If the outflow is modest, the effects will be small. And the outlook for the money supply in the next 3 months or so is much better than in the recent past. This is therefore a good time to accept the risk of some impact on the money supply figures arising from exchange control relaxation. This will also be a time when, in the light of the favourable M3 outturn, domestic pressures on interest rates should be a little less. That would help us to accommodate any slight upward pressure on interest rates arising from an outflow.

9. I conclude therefore that, unless there are new unfavourable developments before 23rd October, we should go ahead with the abolition of exchange controls on that date. Very careful consideration would need to be given to the presentation of this decision in relation to the whole of our

/ monetary policy,

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monetary policy, both on 23rd October when the exchange control package is announced and subsequently when we roll forward the target - probably after the announcement of the banking October money supply figures on 15th November. At that stage we would need to consider the future of the corset, due to end in December, and it may be better in the circumstances to let it lapse. It is already losing effectiveness anyway.

CONCLUSION

10. This subject has many ramifications. To keep this minute short I have concentrated on the main points. I hope that we may have an early opportunity to discuss the matter. In the light of the points I have made above, I hope you will agree that, unless there are any untoward developments in either the foreign exchange or the domestic monetary markets, we should go ahead as planned with the total abolition of exchange controls (except for those affecting Rhodesia) on 23rd October.

11. I am not sending copies of this minute to any of our colleagues at this stage. My officials have been in touch with officials of the Departments chiefly concerned and work is in hand, on a strictly contingency basis, for dealing with a number of consequences of abolition for other departments' policies.

(G.H)

11th October 1979

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FM WASHINGTON 072345Z OCT 79

TO IMMEDIATE FCO

TELEGRAM NO 3047 OF 7 OCTOBER

AND TO IMMEDIATE EEC POSTS UKDEL OECD OTTAWA TOKYO

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US MOVES TO SUPPORT DOLLAR AND TIGHTEN MONETARY CONTROL

1. THE FEDERAL RESERVE BOARD ANNOUNCED YESTERDAY A SIGNIFICANT PACKAGE OF MEASURES TO REASSERT CONTROL OVER MONEY AND CREDIT AND TO REASSURE THE FOREIGN EXCHANGE MARKETS.

2. THREE MEASURES HAVE BEEN ANNOUNCED.

(A) A ONE PERCENTAGE POINT INCREASE IN THE DISCOUNT RATE FROM 11 TO 12 PERCENT

(B) A CHANGE IN THE GENERAL STRATEGY OF MONEY MARKET OPERATIONS: INSTEAD OF USING THE FEDERAL FUNDS RATE AS THE PRIMARY TARGET IN ITS DAY TO DAY INTERVENTIONS, THE FED NOW PROPOSES TO CONCENTRATE MORE ON THE ACTUAL LEVEL OF BANK RESERVES

(C) THE IMPOSITION OF A NEW 8 PERCENT RESERVE REQUIREMENT ON INCREASES IN FUNDS FROM SOURCES NOT SUBJECT TO DIRECT FED CONTROL EG. EURODOLLAR BORROWINGS AND LARGE CERTIFICATES OF DEPOSIT MATURING IN LESS THAN A YEAR.

3. THESE MEASURES REPRESENT A CLEAR DEPARTURE FROM RECENT FED POLICY IN BOTH SUBSTANCE AND TIMING. THEY HAVE BEEN ANNOUNCED ON A SATURDAY AND ON A HOLIDAY WEEKEND (TOMORROW, MONDAY 8 OCTOBER IS COLUMBUS DAY). THEY FOLLOW ANOTHER WEEK OF CONTINUED DISTURBANCE IN THE FOREIGN EXCHANGE MARKETS WITH THE DOLLAR REMAINING VULNERABLE, PARTICULARLY AGAINST THE , AND OF LARGE FLUCTUATIONS IN THE PRICE OF GOLD. REPORTS OF PAUL VOLCKER'S RETURNING THREE DAYS AHEAD OF SCHEDULE FROM THE ANNUAL IMF/IBRD MEETING IN BELGRADE SERVED TO ENCOURAGE RUMOURS.

4. THE INCREASE IN THE DISCOUNT RATE IS THE SECOND IN LESS THAN A MONTH AND THE FOURTH SINCE JULY WHEN IT STOOD AT 9 1/2 PERCENT. A FULL PERCENTAGE POINT INCREASE WAS ALSO A MAIN FEATURE OF THE DOLLAR RESCUE PACKAGE OF 1ST NOVEMBER LAST YEAR WHICH MOBILISED ADDITIONAL RESOURCES FOR FOREIGN EXCHANGE INTERVENTION.

ON THIS OCCASION, HOWEVER, THE FED IS REACTING TO DOMESTIC CONCERNS AS WELL. THE GROWTH OF THE MONEY SUPPLY SINCE MID-JULY HAS BEEN ABOVE THE RATE IMPLIED BY THE TARGET FOR M1 AND FED CHAIRMAN PAUL VOLCKER IS REPORTED TO HAVE SAID YESTERDAY THAT TOTAL BANK LENDING QUOTE HAS BEEN EXCESSIVE UNQUOTE.

5. ON THE OTHER COMPONENTS OF THE PACKAGE, VOLCKER REPORTEDLY ACKNOWLEDGED THAT SWITCHING FROM THE FEDERAL FUNDS RATE TO BANK RESERVES AS THE FED'S TARGET COULD WELL RESULT IN LARGE DAILY VARIATIONS IN THE FEDERAL FUNDS RATE. THE IMPOSITION OF THE NEW 8 PERCENT RESERVE REQUIREMENT WILL AFFECT SOURCES OF FUNDS NOT COUNTED AS PART OF THE MONEY SUPPLY.

6. THE DECISION TO INCREASE THE DISCOUNT RATE WAS APPARENTLY A UNANIMOUS ONE BY THE FED BOARD. WHEN THE RATE WAS INCREASED FROM 10 1/2 TO 11 PERCENT TWO WEEKS AGO, THE BOARD OF GOVERNORS WAS SPLIT 4 TO 3. IN ADDITION, THE WHITE HOUSE HAS BEEN QUICK TO ENDORSE THE MEASURES. PRESS SECRETARY JODY POWELL IS QUOTED AS SAYING THE STEPS QUOTE WILL HELP REDUCE INFLATIONARY EXPECTATIONS, CONTRIBUTE TO A STRONGER U.S. DOLLAR ABROAD AND CURB UNHEALTHY SPECULATIONS IN COMMODITY MARKETS UNQUOTE.

7. FCO PLEASE ADVANCE TREASURY AND BANK OF ENGLAND.

HENDERSON

ADVANCED AS REQUESTED

FINANCIAL DISTN

NAD
FRD

Subject of Ewon B1
Exchange control
May 79

Meeting extract PM/Chancellor 4.10.79 at 9.00am

vii. The Chancellor said that he would be putting proposals to the Prime Minister shortly on a further exchange control package; he was also discussing within the Treasury the idea of medium term monetary targets, and would be reporting back to the Prime Minister on that too.

Subject file - Ewon B1
IMF consultation.

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OO FCO

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Hd WED.

OO BELGRADE (FOR DELEGATION TO IMF/IBRD)

Hd FRID

PP WASHINGTON

Hd En Sts D (2)

PP TOKYO

(Files)

PS

PP UKDEL OECD

IMMEDIATE

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PP UKREP BRUSSELS

PS/PUS

QPS 590A

ADVANCE COPY

M. Bullard

UNCLASSIFIED

Prime Minister

M. Ferguson

FM BONN 011635Z OCTOBER 79

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RC

TO IMMEDIATE FCO

TELEGRAM NO 546 OF 1 OCTOBER

No 10 DS.

INFO IMMEDIATE BELGRADE (FOR DELEGATION TO IMF/IBRD)

INFO PRIORITY WASHINGTON, TOKYO, UKDEL OECD AND UKREP BRUSSELS.

INFO SAVING OTHER EEC POSTS.

US/FRG FINANCIAL DISCUSSIONS, HAMBURG

1. THE FEDERAL CHANCELLOR, ACCOMPANIED BY THE FEDERAL FINANCE MINISTER AND THE PRESIDENT OF THE BUNDESBANK HELD TALKS IN HAMBURG ON 29 SEPTEMBER WITH THE US SECRETARY OF THE TREASURY AND THE CHAIRMAN OF THE FEDERAL RESERVE BOARD.

2. A JOINT STATEMENT ISSUED AFTER THE MEETING DESCRIBED THE DISCUSSIONS AS QUOTE VERY USEFUL UNQUOTE, CONTINUING AS FOLLOWS:-

1. WE AGREE THAT THE RECENT LARGE INCREASES IN WORLD OIL PRICES POSE A SERIOUS THREAT TO THE FABRIC OF THE WORLD ECONOMY BY FEEDING WORLD INFLATION AND REDUCING WORLD GROWTH. RESPONSIBLE OIL PRICING BY PRODUCERS IS ESSENTIAL TO WORLD ECONOMIC HEALTH.

THE FIGHT AGAINST INFLATION REMAINS THE FIRST PRIORITY. THE EARLIER WE WIN THAT FIGHT, THE EASIER IT WILL BE TO SOLVE OTHER PROBLEMS BESETTING OUR ECONOMIES.

WE AGREE ON THE NEED FOR A STRONG AND STABLE DOLLAR AND INTEND TO COOPERATE TOWARD THAT END.

2. SECRETARY MILLER AND CHAIRMAN VOLCKER STRESSED THAT THE U.S. WOULD CONTINUE TO PURSUE DISCIPLINED BUDGETARY AND MONETARY POLICIES. A SINGLE-DIGIT-INFLATION RATE AS WELL AS A CURRENT-ACCOUNT SURPLUS WILL BE REACHED IN COMING MONTHS. STRONG FISCAL RESTRAINT WILL BE CONTINUED AND MONEY SUPPLY GROWTH WILL BE TIGHTLY CONTROLLED.

3. MINISTER MATTHOEFER EMPHASIZED THE NEED TO REDUCE THE PUBLIC SECTOR DEFICIT IN GERMANY AS A MEANS OF CONTROLLING THE RATE OF PRICE INCREASES WHILE MAINTAINING ADEQUATE GROWTH. BY 1980, THE RATE OF PRICE INCREASES WILL BE LOWER THAN IT IS NOW. THE CURRENT ACCOUNT SURPLUS WILL BE ELIMINATED WHICH WILL ALLEVIATE SOME OF THE EXTERNAL CONSTRAINTS IMPOSED ON THE OIL-IMPORTING COUNTRIES OF THE WORLD AND THE NON-OIL-LDCS IN PARTICULAR. PRESIDENT EMMINGER STATED THAT MONEY SUPPLY TARGETS AND INTEREST RATE POLICIES WILL CONTINUE TO TAKE FULL ACCOUNT OF INTERNATIONAL AS WELL AS DOMESTIC REQUIREMENTS. THE FULFILLMENT OF THESE GOALS WILL BE FACILITATED BY EXCHANGE MARKET STABILITY, AN IMPORTANT OBJECTIVE OF BUNDESBANK POLICY.

4. BOTH SIDES REITERATED THEIR RESOLVE TO COMBAT UNWARRANTED AS WELL AS ERRATIC MOVEMENTS IN THE FOREIGN EXCHANGE MARKETS. THE NECESSARY INTERVENTIONS WILL BE CARRIED OUT PROMPTLY IN CLOSE COOPERATION BETWEEN THE AUTHORITIES CONCERNED. THE CORRESPONDING FUNDS ARE AVAILABLE TO THE INTERVENING AUTHORITIES. CHAIRMAN VOLCKER AND PRESIDENT EMMINGER REVIEWED INTERVENTION ARRANGEMENTS AND WILL TAKE ACTION TO ASSURE A COMMON AGREED APPROACH IN ALL RELEVANT MARKETS.

5. BOTH SIDES AGREED THAT THESE DEVELOPMENTS AND POLICIES SHOULD CONTRIBUTE TO EXCHANGE RATE STABILITY IN GENERAL AND TO A STRONG DOLLAR IN PARTICULAR, WHICH ARE IN THE INTERESTS OF BOTH COUNTRIES.

THE RECENT EMS-REALIGNMENT WAS REGARDED AS A VALUABLE CONTRIBUTION IN THE SAME DIRECTION.

6. BOTH SIDES AGREE THAT FOR THE LONGER TERM A STRONGER ROLE FOR THE SDR IS AN IMPORTANT OBJECTIVE IN THE EVOLUTION OF THE INTERNATIONAL MONETARY SYSTEM, AND THAT CONSIDERATION OF THE CREATION OF A QUOTE SUBSTITUTION ACCOUNT UNQUOTE IN THE IMF SHOULD BE PURSUED. WE AGREE FURTHERMORE THAT EFFORTS TO IMPROVE THE SURVEILLANCE OF THE EURO-MARKETS SHOULD BE PURSUED.

FCO PLEASE PASS ALL SAVING ADDRESSEES

WRIGHT

SECRET



*file in
cum bol 4*

10 DOWNING STREET

From the Private Secretary

27 September 1979

The Prime Minister was grateful for the Financial Secretary's minute of 25 September in which he sets out the timetable for a further exchange control package. As you no doubt know, the Prime Minister has told the Chancellor that she would be glad to discuss his proposals when he returns from the IMF/Bank meetings.

J. P. LANKESTER

Mrs. P. C. Diggle,
Office of the Financial Secretary,
H.M. Treasury.

TGR

SECRET

SECRET



PRIME MINISTER

TIMING OF EXCHANGE CONTROL PACKAGE AND BP SHARE SALE

You will be aware that there is a link between the timing of the sale of BP shares and the possible announcement of further steps in dismantling exchange controls.

The link arises because an exchange control relaxation on portfolio investment might have a marginally depressing effect on the shares of UK companies with high overseas earnings, like BP. If the relaxation were announced shortly after a Government sale of BP shares and the BP price fell, whether on account of the relaxation or for some quite different reason, there could well be complaints from aggrieved shareholders that the Government had deliberately held up the exchange control announcement so as not to affect the share price before the sale.

Such complaints might be expected to be taken to the Council of the Stock Exchange or to the Council for the Securities Industry or to an MP or to the Press. In the last resort legal action could not be ruled out. There could be a special problem with the US Securities and Exchange Commission even though the main sale will be confined to the London market.

This suggests that any announcement about exchange control relaxations should be made before the BP sale and our preliminary plans reflect this.

The Chancellor intends to consult you early next month about the possibility of a further exchange control package and its timing. We have not come to conclusions on the timing of the BP sale, but we think that it ought to take place as quickly as possible. The

cc The future of BIOC Energy, P&O. 2
3

Prime Minister

You told the Chancellor and the Governor that

you will discuss

A need not

them with them after their return from Belgrade.

TL
26/9

Chancellor will consult you later about the precise date, but it looks as if 30 October would be a convenient date, provided market conditions are right. There would be serious technical difficulties in postponing it for more than a week or so beyond that if the sale is to take place before December. This would suggest that, provided conditions generally are suitable for such a move, the ideal timing for the Exchange Control package would be more or less as soon as Parliament returns on 22 October.

if we
have
one.
N

We will keep you in close touch with developments on both these points, but I thought you might wish to be aware at this stage of the link between the two operations.

NIGEL LAWSON

25 September 1979

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Original on:
Econ Pt 1: Don Monetary
Pt 2.

Extract from PM/⁻²⁻Treasury Ministers + Governor Meeting
on 24.9.79
Exchange Controls

The Chancellor said that a decision would have to be taken within the next few weeks on the further dismantling of exchange controls. A firm decision one way or the other was needed partly in connection with the sale of BP shares. His own preliminary view was that the remaining controls should be dismantled.

The Prime Minister said that she would be glad to discuss this after the Chancellor returned from the IMF/Bank meetings: but her initial view was that there should be no further relaxation for the time being. She felt that it would be a mistake to relax the controls further until the Government's market philosophy was being seen to work. To move any further now could all too easily lead to a large outflow of funds.

I am sending a copy of this letter to John Beverly (Bank of England).

T. P. LANKESTER

M.A. Hall, Esq.,
HM Treasury.

CONFIDENTIAL

Evan Bling

PRIME MINISTER

STERLING

I thought you should be aware that there has been heavy selling of sterling this morning. Sterling closed on Friday night at \$2.18, with sterling effective at 69.3. At 1130 the sterling/dollar rate had fallen to 2.13, and the sterling effective rate was down to 67.6. The Bank have intervened heavily to moderate the fall - having spent \$280 million already this morning.

Worries about the industrial situation appear to be the cause of this. But in addition I suspect that the market is now realising that sterling - in terms of competitiveness and against a background of a big current account deficit - went a good deal too high earlier in the summer.

TL

Tried to say that the Chancellor and the
Government had decided not to take a
stand against a further drop if this
was to cost further significant amounts,
but that the Bank would try to moderate
any further fall (and even take the
opportunity of staging a reversal) if
this can be achieved without undue cost.
The PM fully concurred - and especially that we should not
intervene on a much larger scale. TL 17/9

17 September 1979

Gion
bl

10 August 1979

Early Repayment of External Debt and the
Exchange Rate

The Prime Minister has seen and noted your letter to me of 8 August. I am grateful to you for letting us have the information in it.

NJS

A.M.W. Battishill, Esq.,
H.M. Treasury.

RESTRICTED

VLB

FILE

Even PR

9 August 1979

The Prime Minister has seen and noted the paper on sterling and trade submitted by your Secretary of State under cover of his minute of 2 August.

M. A. PATTISON

T. G. Harris, Esq.,
Department of Trade.

RESTRICTED

GB



Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

8th August, 1979

PRIME MINISTER
You asked about the
scheduling of our debt
repayments - the record so
far this year is impressive,
as you will see.
MS

Dear Sir,

MS

EARLY REPAYMENT OF EXTERNAL DEBT
AND THE EXCHANGE RATE

In his letter to the Prime Minister of 16th July, Sir Arthur Knight, Chairman of Courtaulds Limited, suggested that early repayment of some of our official external debts would help to achieve a more competitive level for the sterling exchange rate. Tim Lankester asked for a note on this point for the Prime Minister's information. We understand that the Prime Minister is particularly interested in the argument that the present is a good time to pay off debts because sterling is strong.

It is certainly true that the country gains if we buy foreign exchange that we need while it is cheap. This applies to foreign exchange needed for any purpose, not just debt repayment. We have in fact been buying foreign exchange on a pretty substantial scale. Over the past two months, when the pound rose from \$2.07 to \$2.33, the Bank of England have acquired over \$2 billion in addition to what they need for Government expenditure overseas and other calls on the reserves apart from debt repayment. The primary objective of the intervention was not in fact to acquire reserves - we have ample for all immediately foreseeable purposes including the meeting of debt liabilities - but to moderate and smooth the upward movement of sterling. As a rule we do not favour heavy intervention, mainly because the acquisition of reserves tends to increase the money supply, except to the extent that the overseas purchasers of sterling put their funds in public sector debt or in non-resident bank accounts.

The addition to our reserves has however enabled us to repay ahead of time a large Electricity Council floating rate loan. This will bring total repayments in the course of 1979 up to more than \$5 billion. The total is made up as follows:

N. Sanders, Esq.,
10, Downing Street

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	<u>\$ billion</u>
Debt scheduled for repayment in 1979	2.2
Repayments ahead of time arranged before 4th May	2.0
Repayments ahead of time envisaged since 4th May	0.9
TOTAL	<u>5.1</u>

Not all outstanding debt can be repaid ahead of time without penalty. Whether it is possible to do so depends on the nature of the particular contract. Owing to the substantial repayments undertaken since the beginning of 1978, the best opportunities will have been exploited as soon as the Electricity Council loan is repaid. It may therefore be necessary to hold foreign currency in the reserves until repayments can be made. From now on the scheduled repayments are heavy - they amount to another \$2 billion in 1980 and \$3 billion in 1981. And in 1981 it will become possible to repay ahead of time the massive \$2.5 billion loan raised by the last government from the syndicated bank market in late 1974 and early 1975.

The exchange rate for sterling is not affected by the act of repaying debt (as Sir Arthur Knight implies) but by the prior act of buying foreign exchange for sterling. The sums involved in official debt repayment are, generally speaking, too large to be raised from the foreign exchange market for delivery on the day of repayment without creating instability (which it is the purpose of the reserves to prevent). The foreign currency required is therefore bought over a period and held in the reserves until needed. When a debt is repaid, the foreign currency is transferred from the reserves to the lender. The transaction does not affect the exchange rate for sterling because no sterling is involved.

Conditions in the foreign exchange markets have changed since 16th July when Sir Arthur Knight wrote to the Prime Minister. The period of strong upward pressure on sterling seems, for the moment at least, to have come to a halt. Sterling in fact fell quite sharply on Tuesday, 31st July and, although there was a recovery during the rest of last week, further falls were experienced on Monday and Tuesday of this week. The Bank of England have accordingly ceased to buy dollars from the market and have given some moderate support to the pound - though the intervention has not

/been on

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been on the scale of the purchases of dollars when the pressure was upwards.

Yours etc,

A. M. W. Battishill

(A.M.W. BATTISHILL)

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PRIME MINISTER

STERLING AND TRADE

No doubt the
Chancellor will
offer his views
as well

MS
[Handwritten signature]

Mr Nott's officials have considered
the impact of the unexpectedly
high $\%$. The conclusion is
essentially that:

- 1) We can do nothing about
it, but must simply await
events;
- 2) Even if we could influence
it, there are powerful
objections to each possible
approach. *MPD 3/11/11*

As you well know, the high sterling rate - much higher than anyone thought at all likely a few months ago - has been causing apprehension on account of our lack of industrial competitiveness at home and abroad.

2. About six weeks ago I asked my officials to undertake a quick study of the implications of our policies and of a continuing very high exchange rate for both our manufacturing and service industries, and consider what, if anything, we might do. I did not consider it sensible to burden colleagues with additional papers in the last few weeks of the Parliamentary sitting, but now that the pressure has eased a little I think it is worth circulating their note. I should add that it does not contain anything new, but it comes from a different stable to other economic papers emanating from the Treasury and hence it may be worth a brief study.

3. If the sterling rate stays up the current account will certainly turn out worse over the next year than we expected, both as regards visibles and invisibles. We are likely to come under increasing pressure to alter course in one way or another. But we cannot both follow our present strategies and try to manage the exchange rate. I see no scope, or justification, for departing from our general trade policies. As far as exchange controls are concerned, Geoffrey Howe is already looking towards a further move in the autumn.

4. Though the immediate outlook for our trade is very worrying, I see no alternative to sticking to our guns. Favourable movements in interest rates and better confidence in the dollar may in due course help. Otherwise we shall simply have to ride out the pressures, because of the overriding need to bring inflation down and improve our longer-term industrial performance.

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5. I am copying this to our colleagues on E Committee and to Sir John Hunt.

Talbot

J. N.
(approved by the Secretary
of State and signed in his
absence)

Department of Trade
2 August 1979

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STERLING AND TRADE

INTRODUCTION

This paper looks at the consequences of a high exchange rate and considers what, if anything, can or should be done as a result. Sterling is now a good deal stronger than anyone was prepared to forecast a few months ago. The high exchange rate may not last, but for as long as it does, although it will help to get inflation down, it brings the prospect of increasing losses in output and trade, at least until inflation does respond. Just how much the exchange rate has strengthened is shown in Chart 1.

ECONOMIC POLICY

2 The aim of the Government's economic policy is to increase the long-term rate of growth by containing inflation, restoring incentives, and getting a better balance between private and public sector activity. Control of inflation is to be implemented by means of tight fiscal and monetary policies - firm limits on the size of the Public Sector Borrowing Requirement (PSBR) and on the growth of the money supply. These exert their pressures on UK costs and prices in a number of (closely related) ways. First, a tight monetary and fiscal policy stance is likely to be reflected in a relatively high exchange rate. This will directly result in reduced prices of imported goods and services, which in turn should help to moderate wage claims. Secondly, because imports are cheaper, demand switches away from home produced import substitutes and/or profit margins on these goods and services come under pressure, and the same is true on the export side. The resultant deterioration in the prospects for



the traded goods and services sector, both in terms of output and profitability, is expected to stiffen employer resistance to pay claims, and once again to moderate wage demands. The effect should carry over to wages and prices in the remainder of the economy. Thirdly, tight monetary and fiscal policies will directly reduce demand at home, squeeze profits and threaten job prospects, and thus induce lower pay settlements.

3 It is clear that the exchange rate plays a central role in the process, though it remains true that there is much uncertainty about how quickly UK costs and prices will respond to tight monetary and fiscal policies, apart from the direct reduction in import prices.

CONSEQUENCES OF A HIGH RATE

4 While domestic wage and price adjustments to a high exchange rate are working through, the UK's lack of international price and cost competitiveness is bound to prejudice prospects for output and trade. As Chart 2 suggests, competitiveness had already worsened steadily during 1977 and 1978. So far this year Sterling has appreciated by some 12½ per cent and, measures of competitiveness apart, an increasing number of representations are bringing home just what this means for trade and for profits, both of which are important for future industrial prospects.

5 The forecast published with the Budget suggested the current account of the balance of payments would move towards balance over the next eighteen months or so as compared with a modest deficit in the first half of this year (thereafter some renewed deterioration was expected). The forecast also suggested a small



fall in GDP and in manufacturing output both in 1979 and in 1980.

6 It is now clear that the trade deficit in the first half of this year has been far from modest. Moreover, the oil price increase has been much bigger than was expected at the time of the Budget with adverse consequences for world activity and trade and therefore demand for UK exports. These factors on their own would be likely to produce a rather worse trade and current account performance this year and next than seemed likely a few months ago. Although the high exchange rate may very temporarily help on the trade balance, beyond the very short term it is likely to be an additional adverse influence on trade performance - holding back exports and encouraging imports - until consequent wage and price adjustments work through.

7 By way of illustration, the influence of a higher exchange rate path on trade and the current balance can perhaps be roughly estimated with the use of "ready reckoner" calculations based on the Treasury model. (A full simulation on the model would no doubt produce somewhat different numbers, but the general direction of the results seems reasonable enough.) For this purpose it has been assumed that, following average first and second quarter levels of 64 and 67 so far this year, the effective exchange rate averages 70 in the second half (the present level is nearly 74) and 68 in 1980. The results suggest an initial improvement in the current balance, worth perhaps £½ billion in the second half of 1979, due to trade prices adjusting to the higher exchange rate more rapidly than volumes (an inverted "J-curve" effect). Next year, however, the current account could be worse by an increment of £1 billion. As even without



the high exchange rate the trade outlook is worse than forecast at the time of the Budget (paragraph 6), this would appear to suggest a sizeable deficit on current account next year, with a big deficit on visible trade (despite North Sea oil), and an invisible balance moving into the red by the end of 1980. The higher exchange rate would also imply a sharper fall in GDP and in manufacturing output than thought earlier.

8 It is useful to consider in a little detail the effect of a high exchange rate path on individual manufacturing sectors and components of the invisible account. As regards manufacturing, the range of possible outcomes is very diverse, depending on such factors as the nature of each sector's products and markets, its use of imported materials, and the method of pricing its exports and imports. Firms in many sectors, especially those producing standardised products, may well prefer to lower the sterling price of their goods to continue to compete with imports at home, and maintain the volume of export sales. But their ability to do so may be limited by current low levels of profitability. The profitability of UK industry has been poor by historical standards for some years, and the consequences of further severe pressure on profits could well be a serious threat to the viability of some such price-taking companies. Relevant sectors include much of basic chemicals and iron and steel.

9 Other firms, for example, those producing specialised engineering products, may simply maintain sterling prices, relying on non-price factors to reduce the impact of appreciation. Nevertheless, in many cases there is certain to be a somewhat lower volume of sales when buyers respond to higher foreign currency prices abroad and more price competitive imports at home.



with early adverse consequences for employment and, in the longer term, for investment. In some instances, such as parts of pharmaceuticals and highly differentiated engineering products, firms may be price setters in international trade, with the result that unchanged sterling prices should have little effect on their chosen level of output.

10 In practice, the majority of firms will be obliged to make a commercial judgment between volume and profitability objectives. Sectors where there may be a combination of profit and volume response include textiles; industrial engines; pumps, valves and compressors; and office machinery. Throughout manufacturing there should be some offsetting gain from lower sterling import costs.

11 Industries dominated by multinational companies are in some ways a special case. Their response to sterling appreciation is likely to be re-sourcing of components and/or of finished goods in favour of plants located in other countries, assuming such plants have spare capacity. This will have an adverse effect on UK trade performance but the loss of market share by plants located in the UK may be more easily reversed when relative cost positions are reversed than in industries where markets are lost to rival foreign firms. Parts of the motor vehicle industry are an example (depending on capacity availability abroad), but similar considerations are thought to apply to mechanical handling, construction and earthmoving equipment.

12 As regards invisibles, a high exchange rate path will almost certainly result in an even more rapid worsening on transfers and on interest, profits and dividends than is already expected



because of EEC budget commitments and payments to foreign companies for their part in the exploitation of the North Sea. This is because credits can generally be expected to fall proportionately in sterling terms as the rate hardens, whereas at least some of our transfer debits, for example, are denominated in sterling.

13 Although experience is again diverse, the services account is somewhat different from manufacturing, because a greater proportion of services credit and debit payments are affected in the same direction by exchange rate changes. For example, the net balance on the substantial sea transport account, representing around a quarter of service credits and one-third of debits in 1978, may well be not much affected by a high rate, especially in the short run. The main effect will be that on profitability, and the crucial question is how reduced profitability will affect the willingness of UK companies to provide shipping services. The problem is likely to be much the same for many other services, though as in manufacturing there may be sectors - e.g. specialized solicitors' and financial services - for which the UK firms concerned in effect set the international price. An important exception to the above is travel; the general belief, reinforced by recent trends, is that tourism is quite sensitive to relative price changes, perhaps more so than much of manufacturing industry.

WHAT CAN (AND SHOULD) THE GOVERNMENT DO?

14 Exchange rate forecasting is an uncertain game, as experience, not least since last summer, has shown. There is no point in pretending that we know what is going to happen to the rate or that we can fully assess the factors explaining the present high



level. However, it is necessary to ask what, if anything, can and should be done to achieve some reduction in the exchange rate and/or to counter the consequences of the rate remaining high, particularly if it is at all likely that the rate may follow a path similar to that illustrated above. (It equally has to be admitted that we do not know the "right" lower rate which would avoid some of the possible longer term damage to certain industrial and commercial sectors.)

15 The most direct form of action on the exchange rate itself is clearly Bank of England intervention to hold the rate down. To be effective this might have to be on a large scale, and in consequence the attainment of the monetary target would be increasingly at risk. Much the same is true of a reduction in Minimum Lending Rate (MLR) to make London a less attractive place for internationally mobile funds. Early repayment of overseas debts is an option but, depending on how it is managed, could also cause some difficulty for domestic monetary policy. This leaves further relaxation of exchange controls as the clearest candidate for action on the exchange rate front. By inducing additional capital outflows this should reduce the exchange rate without any direct adverse consequences for monetary management. However, the immediate response of the exchange rate could be perverse, and the primary motive for relaxing control remains that of reducing distortion and hinderance in financial markets. For this reason (and because at least presentationally it would appear contradictory) the imposition of exchange controls on capital inflows, which the Swiss and German authorities have tried from time to time without much clear evidence of success, should be ruled out. A further independent reason for relaxing outward



exchange control is to facilitate the investment of some of the benefits from North Sea oil. .

16 In principle there is also scope for acting on the trade balance itself. Over the longer term, oil depletion policy is a relevant consideration. In addition, since trade performance depends on non-price as well as price and cost competitiveness, reflecting such factors as design, delivery and so on, Government action to improve industrial efficiency (e.g. labour retraining, greater encouragement to mobility, further shifts in the incidence of taxation) may also be of some long-term benefit in offsetting the adverse consequences of a high rate. But it is also possible that a high rate sustained over a number of years may begin to encourage industry to move to higher value-added, less price-sensitive output, strengthening our fundamental competitive position along the lines of Germany and Japan. However, an essential condition for such a "virtuous circle" path is that firms require profits to transform themselves and, as argued above, one effect of a high exchange rate path is precisely to compress the profitability of manufacturing and service industry.

17 There are, of course, several ways of intervening directly to affect flows of trade. Pressure for such intervention may well increase if firms find themselves in growing difficulties because of the high exchange rate. It goes without saying that all general measures to restrict imports run directly counter to the Government's Manifesto, as well as being inconsistent with its basic economic philosophy, as would be general subsidisation of exports. Apart from the well known objections to such courses of action based on our international commitments, and the

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probability of retaliation and emulation by others, if one of the main components of economic policy is to bring pressure to bear on firms to prevent high wage increases being granted, relaxation of such pressures by import control or export assistance is incompatible with the Government's macro-economic policy stance. In any case, measures to relieve the pressure from imports or to help exports may in part at least simply lead to a yet harder exchange rate and also introduce a major "re-entry problem".

CONCLUSIONS

18 A high exchange rate is an essential element in the Government's macro-economic policy; anything that is done to bring it down will weaken its macro-economic effect. However, the present level of the rate is inconsistent with our underlying industrial performance, and until domestic costs and prices react to the Government's economic policy, output and visible and invisible trade prospects alike are likely to be adversely affected. Moreover, there is some risk that long-term damage will be done to some sectors. Nevertheless, even if it were desirable, and further relaxation of exchange controls apart, little can be done to bring the rate down without prejudicing monetary control. As regards cushioning the adverse economic effects of the high rate, resort to trade policy measures is severely circumscribed and in any event inconsistent with the Government's general approach; and Government action in the industrial field is at best long-term in its effect. The hope must be that circumstances over the next few months will allow a reduction in UK interest rates and that economic policies in the rest of the developed world will restore confidence in other, flagging, currencies.

Chart 1

STERLING EFFECTIVE
EXCHANGE RATE

December 1937 = 100

Quarterly Averages.

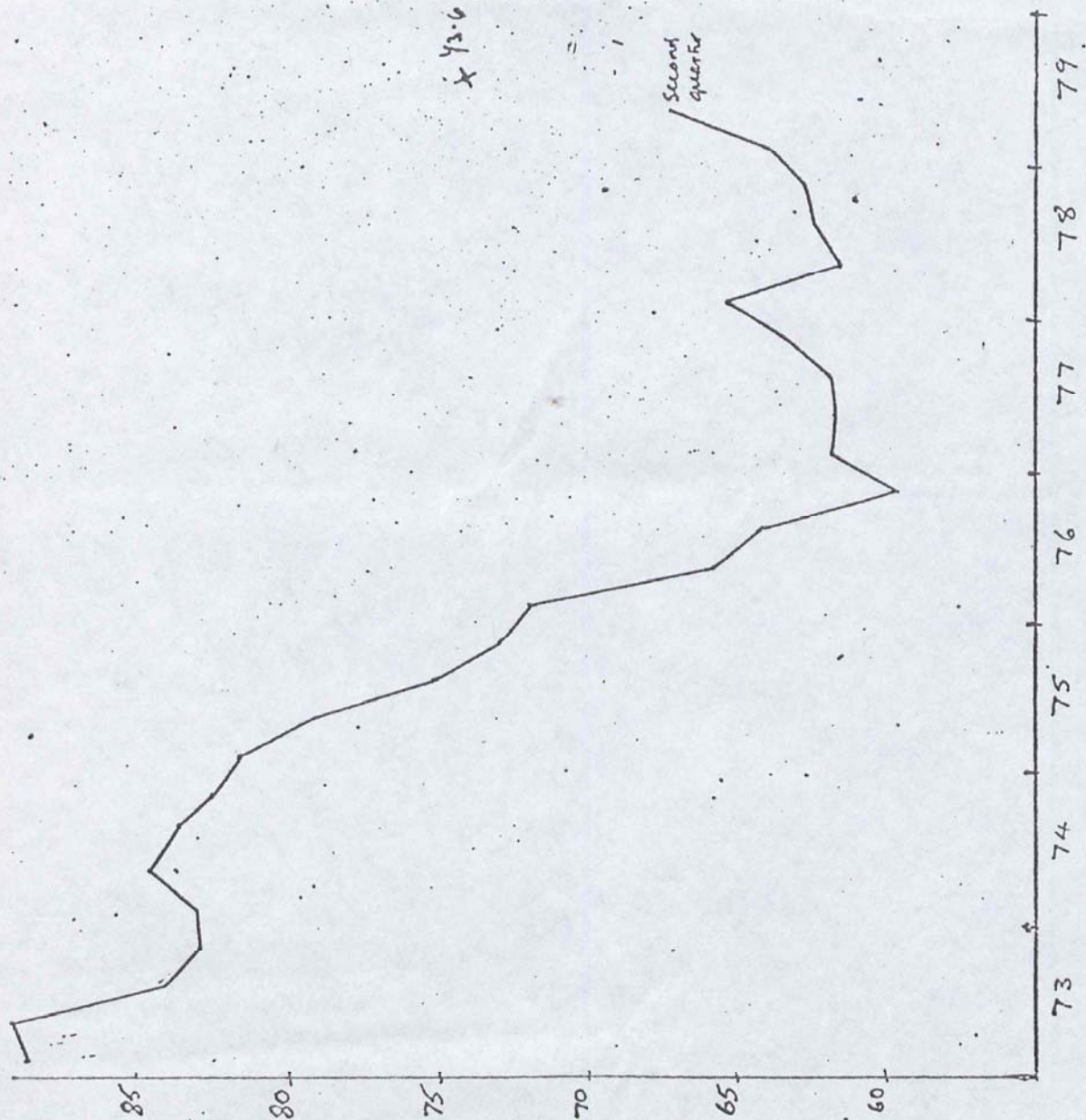
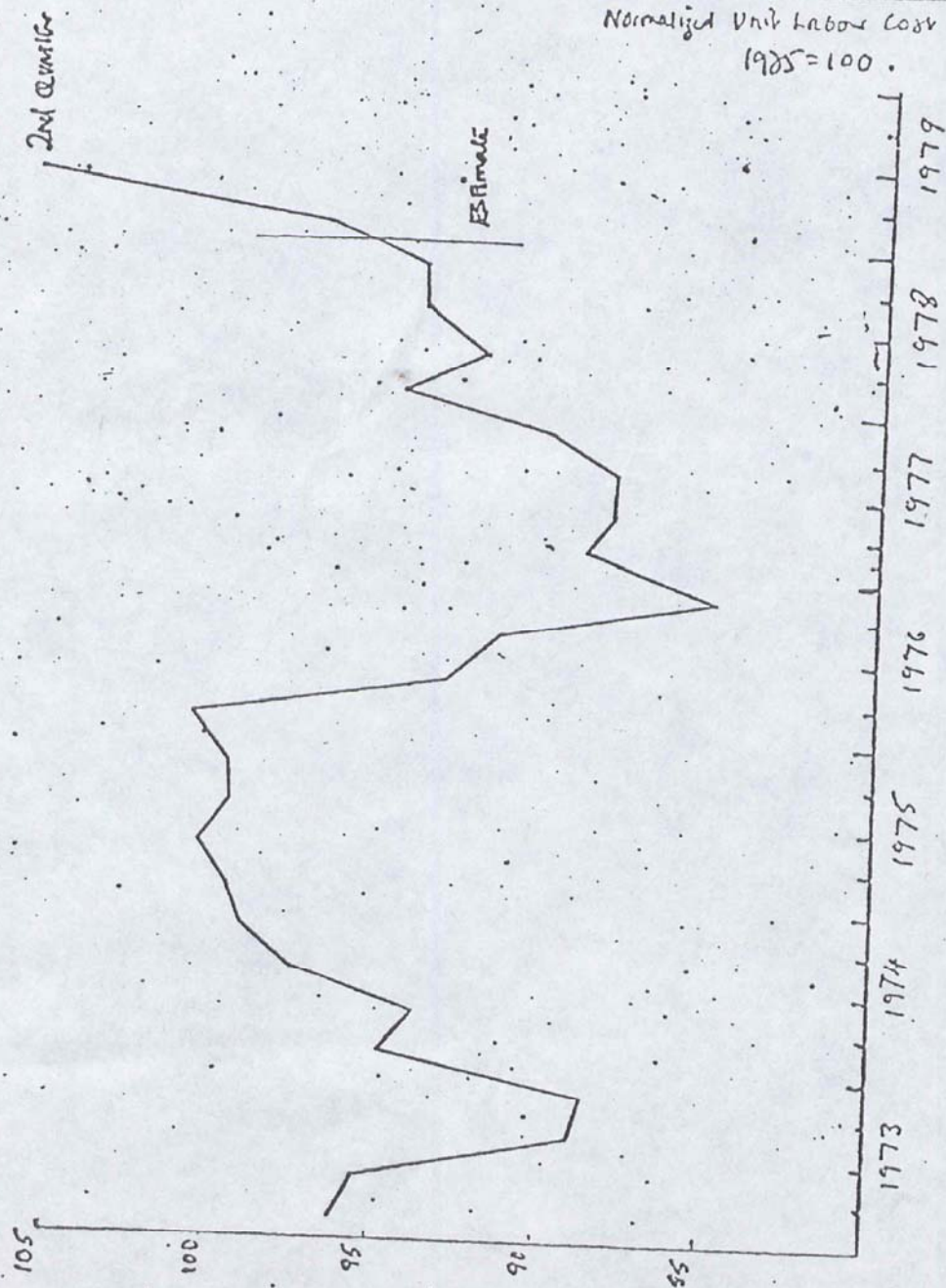


CHART 2

INTERNATIONAL COMPETITIVENESS
OF UK MANUFACTURING INDUSTRY

Normalized Unit Labor Cost Index
1975=100.



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Econ Pol



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

24 July, 1979

R
2413

A handwritten signature in dark ink, appearing to read 'John Nott'.

Thank you for your letter of 13th July about the relaxation of exchange controls.

As you recognise, the business involved in putting together a larger package would have delayed implementation of measures announced on 18th July. I have already set work in hand on preparing a third step in the dismantling of the controls which, if sterling remains strong, I would hope to take in the autumn; and this work will include studying further the question of extending sterling facilities for third-country trade to the banks, on which I have noted the views recently expressed to you by your British Overseas Trade Advisory Council.

As you say, this proposal raises rather fundamental questions about the role of sterling as an international currency. This is one of the points that my officials are now examining. I have asked them to keep the FCO and the Departments of Trade and Industry in touch with their work.

I am sending copies of this letter to the Prime Minister, the Foreign and Commonwealth Secretary, the Secretary of State for Industry, the Governor of the Bank of England and Sir John Hunt.

A handwritten signature in dark ink, appearing to read 'Geoffrey Howe'.

(GEOFFREY HOWE)

The Rt. Hon. John Nott, M.P.

CONFIDENTIAL

Econ PSI^{vb}

6/F 25.7.79

18 July 1979

Previous correspondence on:
Econ Pol, July 79, Sir Arthur Knight.

The Prime Minister has received the enclosed letter from Sir Arthur Knight about the exchange rate; she would be grateful if the Chancellor of the Exchequer would reply on her behalf.

I would be glad if you could let me have a note on Sir Arthur's suggestion that there should be an early repayment of external debt in order to bring the exchange rate down.

TPL

M.A. Hall, Esq.,
H.M. Treasury.

200



CONFIDENTIAL*From the Secretary of State*

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London, SW1

MBM
P 1317
13 July 1979

Dear Geoffrey.

I am very glad to see that the Prime Minister has endorsed the proposals set out in your minute of 9 July for an early next stage in the relaxation of exchange controls. I was particularly pleased to see the use of official exchange is now to be unlimited for both outward direct investment and for the purchase of all securities denominated in EEC countries.

I would myself have liked to have seen included in the package a complete relaxation of control over the use of sterling for the finance of third country trade. I realise this raises rather fundamental questions about the role of sterling as an international currency, but these questions will have to be tackled sooner or later if, controls are eventually to be abolished completely, as I believe and urge they should.

As you know, I fully support our present economic strategy which will generate very considerable pressures on employers, not least to settle pay at reasonable levels. A high exchange rate is an essential part of our present policy and in this sense the strength of sterling is of direct benefit in what we are trying to do. And yet industry is extremely worried by the levels to which sterling has been increasing, especially in the past few weeks. An increasing number of representations are making it clear the large amount of trade which we stand to lose,

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From the Secretary of State

well before the various gains through lower prices and costs work through. Hence my preference for what would be an even stronger package.

I am seized to write in particular having heard what members of my British Overseas Trade Advisory Council had to say on Thursday last. Of course I know how sentiment can swing and gloom reinforce itself at such a meeting, but the account of difficulties traders are now faced with was real enough and was supported by what struck me as a most sober assessment from the representative of the European Trade Committee of the British Overseas Trade Board, which deals with around half our manufactured export and import trade, and with our invisible trade as well. They took a clear view on the abolition of all restrictions on the use of sterling in third country trade.

In view of the fact that the discussion and preparation of a stronger package could well preclude an announcement next week, if not by the recess, I am perfectly content not to press for its extension now. However, I do urge that contingency work should be put in hand at the earliest opportunity for further possible relaxation in the autumn, assuming of course that sterling remains strong. I should like to press most strongly for this work to include whatever discussion is necessary of the various difficulties that stand in the way of a complete relaxation of the use of sterling in third country trade.

I am copying this to the Prime Minister, the Foreign Secretary, the Secretary of State for Industry, the Governor of the Bank of England and Sir John Hunt.

Yours ever
John

JOHN NOTT

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10 DOWNING STREET

From the Private Secretary

10 July 1979

EXCHANGE CONTROLS

This is to confirm that the Prime Minister is content with the Chancellor of the Exchequer's proposals for the further dismantling of exchange controls, as set out in his undated minute which we received yesterday.

I am sending copies of this letter to Paul Lever (FCO), Andrew Duguid (Department of Industry), Tom Harris (Department of Trade), John Beverly (Bank of England) and Martin Vile (Cabinet Office).

T. P. LANKESTER

M.A. Hall, Esq.,
HM Treasury.

Scan Paul

JS

*cc to
DI
DT
B. & E.
CO*

[Handwritten signature]

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Prime Minister 1



Agree the Chancellor's proposals for further relaxing exchange

Yes *ms*

Treasury Chambers, Parliament Street, SW1P 3AG controls?

01-233 3000

(He wants to discuss them with the Commission tomorrow, Tuesday)

PRIME MINISTER

EXCHANGE CONTROLS

TZ 9/7

I refer to my minute of 23rd May in which I described the proposals for exchange control relaxation that were subsequently announced in the Budget Speech.

2. The strength of sterling since the Budget partly reflects the effect on confidence of the Government's determination to squeeze inflation out of our economy by firm monetary discipline and strict control over public expenditure. It may also owe something to the high level of sterling interest rates, which are necessary to maintain monetary control. But it is mainly due to our favourable position as an oil producer at a time of rising oil prices. The effective rate for sterling today is over 70.5, an increase of some 4 per cent since the Budget. We spoke last night about the extent to which this is causing anxiety about the effect on competitiveness; the CBI will raise this matter when we see them later today.

3. At the time of the Budget I had planned to announce a second package of exchange control relaxations in October. As I mentioned last night, I still regard as valid the arguments (which I explained in my minute of 23rd May) for making relaxations one step at a time. But the recent strong upward pressure of demand for sterling does enable me to bring forward the October package. I therefore plan to make a new announcement on 19th July.

Flag A

/4. Exchange

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4. Exchange control notices are now being prepared to implement the following relaxations:-

(i) Unlimited official exchange for all securities denominated in EEC currencies.

(ii) Unlimited official exchange for investment in the bonds of international organisations of which the United Kingdom is a member, including those issued by Community institutions.

(iii) Permission to repay with official exchange all foreign currency borrowing taken out for portfolio investment one year or more before the date of the announcement.

(iv) Unlimited official exchange for outward direct investment.

5. Items (i)-(iii) constitute, in combination, a substantial first step in the relaxation of our controls over portfolio investment. It would not be possible in July to abolish controls on portfolio - a good deal more work will have to be done on the technical consequences of such a move before we are in a position to implement it. In any case, as I said earlier, I believe that the arguments for proceeding one step at a time remain valid.

6. The choice of securities denominated in EEC currencies as the first main block of securities which UK investors will be free to buy with official exchange will clearly please the Commission. The Americans on the other hand will be disappointed. Mr. Blumenthal expressed his satisfaction with the fact that my Budget package removed most of the elements in our controls which discriminated in favour of the Community. But I propose to write to him before the announcement and assure him that it is our intention to move steadily towards complete freedom for

/UK residents



UK residents to invest in securities denominated in any currency, including the dollar.

7. The international organisation bond proposal will also meet a point raised by the Commission - Mr. Ortoli hoped that I would be able to include such a relaxation for the bonds of Community institutions in the Budget package. The relaxation will also apply to the bonds issued by other international organisations including those that help the developing countries such as the World Bank. We shall therefore be able to take some credit for this change in discussions both at home and abroad about our relations with the developing countries; and this might have some modest value in counteracting the disappointment caused by cut-backs in our aid programme.

8. Many institutions do not like being obliged to borrow foreign currency to buy securities without paying the premium and will welcome the opportunity to repay with official exchange borrowing outstanding for a year or more. Taking this step now should also reduce the size of the outflow that will result from the abolition of the remaining controls over portfolio when we are able to do that.

9. The fourth constituent of the package is to give unlimited official exchange for outward direct investment - i.e. to increase the £5 million ration included in the Budget package to permission to use official exchange for direct investment at will. It might seem a bit soon to change policy within a few weeks of the Budget. But given the strength of sterling I do not think anyone will be very surprised and I will be able to explain that the continued strength of sterling permitted me to bring forward the time at which it was possible to complete the dismantling of controls over the financing of outward direct investment. The TUC reaction to the Budget package has been rather muted and this further step is unlikely to make much difference to their attitude. The CBI will obviously be very pleased.

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10. I know you agree that it is appropriate to accelerate our planned programme for the dismantling of exchange controls along these lines. Although the ^{rumour} ~~removal~~ of this relaxation is said to have had some downward effect on Friday, we cannot be sure that the announcement will reduce pressure on sterling in the short term. Indeed, it is still possible that the immediate effect could be to drive the rate up because this reaffirmation of the Government's intentions may make sterling seem an even more attractive currency to hold. But in the longer term we would expect the relaxations to result in capital outflows and to cause the exchange rate to be lower than would otherwise be the case. Perhaps even more important, dismantling these controls will improve the functioning of the markets and give investors greater freedom of choice. The combination of these new relaxations with those already announced in the Budget will constitute a very big step in the direction we all want to go.

11. I am sending copies of this minute to the Secretaries of State for Foreign and Commonwealth Affairs, Industry and Trade, to the Governor of the Bank of England and to Sir John Hunt.

G.H.

(G.H.)

July, 1979

CONFIDENTIAL

CONFIDENTIAL

FILE

M

5 July 1979

At the end of yesterday's meeting on building society mortgage rates, the Prime Minister asked the Chancellor about his plans for further relaxation of exchange control. The Chancellor said that he was hoping to release controls on portfolio investment in the EEC later this month, and to release portfolio investment elsewhere at some later date.

The Prime Minister took note.

T. P. LANKESTER

sd.

A. M. W. Battishill, Esq.,
H.M. Treasury.

CONFIDENTIAL



Treasury Chambers, Parliament Street, SW1P 3AG
 01-233 3000

7 June 1979

Dr King

M

St

EXCHANGE CONTROLS

Thank you for your letter of 1st June. It is helpful to have your views on portfolio relaxation and I shall of course take careful account of these in our further studies over the months ahead.

As regards your suggestion about raw material supplies, I have much sympathy with the industrial and strategic case you mention. In practice, however, I believe that the £5 million ration should go a long way to meet the needs of companies for both exploration and exploitation. But there are still uncertainties about our external position, and I should therefore prefer to see how things look after the Budget before deciding on any extension on the initial package of relaxations. Whether introducing a special raw materials scheme would then be a good move may, of course, depend on how soon we could envisage complete liberalisation for outward direct investment, in parallel perhaps with a first major relaxation on the portfolio front.

I am copying this letter to the Prime Minister, the Secretaries of State for Foreign and Commonwealth Affairs and for Trade, the Governor of the Bank of England and Sir John Hunt.

[Signature]
 (GEOFFREY HOWE)

The Rt. Hon. Sir Keith Joseph, Bt., MP.

CONFIDENTIAL

for BA MFO



FILE

CCHMT

10 DOWNING STREET

THE PRIME MINISTER

6 June 1979

I was grateful to you for sending your paper on exchange control of 4 May to Geoffrey Howe and me. We shall be taking your well-timed suggestions into account in judging how best to proceed with relaxing controls which are obviously now more restrictive than they need to be. I cannot of course anticipate what Geoffrey will decide to do; but I can say that, as you might expect, all the areas you mention are being thoroughly explored.

(MT)

Professor Douglas Hague, C.B.E.

CONFIDENTIAL

VLE



10 DOWNING STREET

PRIME MINISTER

You will remember that Douglas Hague sent you a note with his suggestions on how the Chancellor might relax exchange controls in the Budget. These suggestions were passed on to the Chancellor, and they have been taken into account by him. You may like to send Douglas Hague the attached letter.

5 June 1979

T.

SECRET



TOTAL COPIES 17

COPY No. 2

DEPARTMENT OF INDUSTRY

ASHDOWN HOUSE

123 VICTORIA STREET

LONDON SW1E 6RB

TELEPHONE DIRECT LINE 01-212 3301

SWITCHBOARD 01-212 7676

Secretary of State for Industry

The Rt Hon. Sir Geoffrey Howe MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1

1st June 1979

Jan Geoffrey

RTH 1/6

EXCHANGE CONTROLS

Thank you for sending me a copy of your minute to the Prime Minister about exchange controls.

While I can see the arguments for giving priority to the liberalisation of outward direct investment and for avoiding precipitate relaxation of controls on portfolio investment, I do hope that you will feel able to make substantial and early progress towards full dismantlement of exchange controls - perhaps in the autumn when it may be clear that further moves would not be disruptive.

You may find it helpful if I record my reasons for believing that full liberalisation of portfolio investment is no less important than the liberalisation of outward direct investment. My reasons are threefold. First, I believe that restrictions on portfolio investment overseas reduce the return on investment in the UK, since by restricting international capital movements we reduce the pressure on British management to increase profitability. Secondly, by limiting the opportunities for investment in overseas securities, especially by the pension funds, we distort the UK capital market and we also raise the prices of such assets as agricultural land (not to mention works of art!). To allow the institutions freedom to invest their funds where they judge they will secure the best return we should reduce some of those pressures. Thirdly, if we do not grasp the nettle now, when we should be thinking of spreading over a longer period the benefits of North Sea oil, we are unlikely to feel able to do so in a few years' time when these benefits seem about to decline.

I should like to suggest one extension of your detailed proposals which I hope you will have little difficulty in accepting. It is that there should be an immediate and complete relaxation in respect of outward direct investment in raw material supplies. In my view the industrial and strategic case for this is overwhelming.

I am sending copies of this letter to the Prime Minister, the Secretaries of State for Foreign and Commonwealth Affairs and Trade, the Governor of the Bank of England and Sir John Hunt.

Geoffrey Howe

Econ Pol



1. Mr Carrington ✓
2. Mr. [unclear] 12/5

CHANCELLOR OF THE EXCHEQUER

12
31/5

EXCHANGE CONTROLS

You sent Peter Carrington a copy of your minute of 23 May to the Prime Minister outlining a package of exchange control relaxations which you propose to announce in your forthcoming budget speech.

In his absence at a NATO meeting in The Hague, I am writing to say that I welcome your proposal to introduce some relaxations to our exchange control regime. I accept that the imminence of the budget makes it difficult to do more at this stage and I welcome your intention to keep the possibility of further relaxations under study. If we are to relax portfolio investment controls, as I think we should, I hope we shall do so sooner rather than later.

That said, I accept that the package is a valuable first step. If the proposed removal of controls generates an increase in the flow of direct investment overseas, including to the developing countries, this may to some extent offset cuts we are having to make in our official Aid Programme. It should also help to increase the diversity and security of our raw material supplies. Finally, it should help us counter the criticism which we have been under from both the Commission and the Americans over our current exchange control practices. I am glad that you will be giving the Commission advance notice of what you intend.

/I

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- 2 -

I am sending copies of this minute to the Prime Minister, the Secretaries of State for Industry and Trade, the Governor of the Bank of England and to Sir John Hunt.

I.H.G.

30 May 1979

I H G

CONFIDENTIAL



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

R4/6. 29th May, 1979

Dear Sir,

MR. DOUGLAS HAGUE

You wrote to Tony Battishill on 9th May, enclosing a note from Mr. Douglas Hague on the exchange controls. The Chancellor also received a copy direct from Mr. Hague. The Chancellor suggests that the Prime Minister may like to reply on the lines of the attached draft.

I am copying this letter to John Beverly.

Yours ever,

MA

(M. A. HALL.)

T. Lankester Esq.,

DRAFT REPLY FROM : PRIME MINISTER
TO : PROFESSOR DOUGLAS HAGUE
COPIES TO: CHANCELLOR OF THE EXCHEQUER
GOVERNOR OF THE BANK OF ENGLAND.

I was grateful to you for sending your paper on exchange control of 4th May to Geoffrey Howe and me. We shall be taking your well-timed suggestions into account in judging how best to proceed with relaxing controls which are obviously now more restrictive than they need to be. I cannot of course anticipate what ~~Sir~~ Geoffrey will decide to do; but I can say that, as you might expect, all the areas you mention are being thoroughly explored.

W. Hunkeler

Econ Pol.

CONFIDENTIAL

29 May 1979

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1

A quick note on your minute to the Prime Minister on exchange controls, of 23 May.

On page 2, you refer to "the introduction of a ration of official exchange of £5m per investment project per year".

It occurred to me that any self-respecting management would be able so to define and structure their operations, in "project" terms, as to yield as many £5m chunks as they wanted. But I am sure that someone at your end will have thought of that.

JOHN HOSKYN

CONFIDENTIAL



cc FCO
DI
DIT
Boj E
CO
JS

10 DOWNING STREET

From the Private Secretary

29 May 1979

EXCHANGE CONTROLS

The Prime Minister has considered the Chancellor's minute of 23 May on the above subject. She has also seen Mr. Nott's letter of 25 May, which broadly welcomes the Chancellor's proposals but argues that they should go rather wider.

The Prime Minister understands the reasoning behind Mr. Nott's suggestion that the exchange control relaxation should be more ambitious than the Chancellor proposes; but she considers that the precise degree of relaxation which can be immediately contemplated must be a matter for the judgement of the Chancellor and the Governor, and she therefore agrees that the Chancellor should proceed on the lines set out in his minute.

I am sending copies of this letter to Paul Lever (Foreign and Commonwealth Office), Andrew Duguid (Department of Industry), Tom Harris (Department of Trade), John Beverly (Bank of England), and Martin Vile (Cabinet Office).

T. P. LANKESTER

Martin Hall, Esq.,
HM Treasury.

of Mr Hoskyn

*GB
(HMT Spm)*

Mr Hasbany

CONFIDENTIAL

DEPARTMENT OF TRADE

1 VICTORIA STREET LONDON SW1H 0ET

Telephone 01-215 7877



From the Secretary of State

The Rt Hon Sir Geoffrey Howe MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
SW1

25 May 1979

Dear Chancellor of the Exchequer,

EXCHANGE CONTROLS

Thank you for copying to me your minute of 23 May to the Prime Minister.

As you know I share your view that the liberalisation of exchange controls would be helpful to British industry and exports. I believe also that a firm move to dismantle the constraint of these controls could be an important sign to the outside world of the Government's determination to tackle bottle-necks on the supply side of the economy.

In this respect I was assuming that you would remove all controls on overseas direct investment, since there can be little firm evidence that it would create substantial flows across the exchanges - and it would be seen as a symbolic gesture to markets indicating considerable self-confidence on the part of the in-coming Government. Announced with firm fiscal and monetary policies, embracing significant reductions in public spending, the two measures taken together, might well have the perverse effect of actually strengthening Sterling. The argument that our policies on exchange controls should be dictated by the impact of consequent moves in the exchange rate on exports is not one that I accept at this particular juncture, not least because it is so difficult to predict.



Your proposals therefore whilst welcome as far as they go may, I suggest, be regarded by markets as being unduly timid. For this reason they may not bring about the full political and economic benefits which might otherwise have been obtained. Undoubtedly they will meet criticism from the TUC which will be repeated each time that you take a further step. It is ironic that our outward capital flows should still be more tightly controlled than in almost any other major western industrial country, in spite of North Sea Oil. It is the excessive caution of successive governments in this area of policy that has brought about this situation - and I am disappointed that we cannot grasp this useful opportunity by taking a more courageous step.

The re-introduction of Sterling financing for third country trade is welcome. I accept that it would be unwise to abandon controls on portfolio investments at this stage but I fully support the limited steps that you are taking here at this time and I note your intention to study further relaxations in this field as circumstances permit.

I am copying this to the Prime Minister, the Secretaries of State for Foreign and Commonwealth Affairs and Industry, the Governor of the Bank of England and to Sir John Hunt.

Yours Sincerely,

T. Allan

JOHN NOTT
(approved by the Secretary of State
and signed in his absence)

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Prime Minister

1

cf Mr Wilson
see Mr Hoskyns



Are you content for
the Chancellor to
proceed as proposed?

Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

T
25/5

PRIME MINISTER

(Mr Mott - Flag B - broadly
supports these proposals, though he
would have liked to go further.
However, I think the Chancellor and the
Governor have to make the final judgment).

EXCHANGE CONTROLS

Flag A

One of our objectives is the liberalisation of our exchange control regime consistently with our EEC Treaty obligations. The present strength of sterling makes it appropriate to take a substantial first step in the Budget. I have therefore been considering with the Bank of England and Treasury officials, the form of an initial package of relaxations. I have taken account of the suggestions put to you recently by Douglas Hague.

It would not be sensible to attempt to dismantle our controls overnight. Our elaborate and restrictive regime has been in existence for 40 years. It is therefore very difficult to predict how all the companies and individuals would react to a massive liberalisation. The effects in the short run on the exchange rate could be destabilising. The world environment is particularly uncertain. One of the possibilities that we cannot exclude is a United States recession with a revival of the dollar that might cause a large outflow from sterling. The stability of sterling is important to our other policies. I conclude that we should proceed with exchange control relaxations one step at a time.

That being so, there are compelling arguments for starting with outward direct investment. I believe that, on balance, this will be helpful to British industry and exports. A big move to relax these controls can be made without jeopardising the

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remaining regime, and, in particular, the controls over outward portfolio investment where the risk of big and volatile capital flows is much greater. It is not possible to go the other way round and to make a large relaxation of controls on portfolio while attempting to retain controls on outward direct.

At present the rules are complex. Their overall effect is to require the bulk of outward direct investment to be financed either by foreign currency borrowing or by the reinvestment of overseas earnings. The most important relaxations I propose to make are

- (i) the introduction of a ration of official exchange of £5 million per investment project per year and
- (ii) the abolition of the rule which restricts the reinvestment of profits earned overseas by requiring the repatriation of at least two-thirds of net taxed earnings.

These would be accompanied by changes affecting repayment of foreign currency borrowing.

It is practicable to make significant changes also in the controls affecting individuals without undermining the portfolio controls. I therefore propose to make substantial relaxations in the rules concerning emigration allowances, holiday homes, cash gifts and payments to dependants and travel allowances. The reference to "holiday homes" involves some political risk, but it is an area of control which is particularly labour-intensive (and so expensive to operate) for a limited return. On the whole I think it would be



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easier to dispose of in the context of a large package of this kind than to deal with it separately later.

I should also like to take this opportunity to reverse in part the decision in 1976 to deny sterling finance for third country trade. This is an area in which experience has shown speculation can be severe if confidence in the existing rate for sterling is weakened. The imposition of the control in 1976 played an important part in restoring confidence in sterling. On the other hand it also placed our merchants at a competitive disadvantage and denied banks a useful source of earnings. The Bank of England on my instructions are now consulting the City interests concerned to see whether a scheme could be worked out that would enable both merchants and banks to benefit from a relaxation of the rules without excessive risk of volatile flows. I understand that there should be no difficulty on a scheme for the merchants, but that I may be obliged to consider that it would be imprudent to extend the concession to the banks. If so, I would propose to add a different concession to the package in lieu of the concession to the banks: namely the doubling of the present period of one month for which firms generally can retain foreign currency earnings before they are required to convert them into sterling.

Fuller details of the relaxations I have in mind are set out in the Annex to this minute. You will see that the list also includes two modest initial steps on portfolio investment and the abolition of the gold coins control introduced in 1975. Final decisions will need to wait until I have the Bank of England's further advice on third country trade and also until I am able to assess the probable effect of the Budget as a whole on the exchange rate. So long as our policies command the confidence of the financial markets (in particular, our determination to cut public expenditure and to control the PSBR and the



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monetary aggregates), it is unlikely that the relaxations listed in the Annex will cause a substantial outflow from sterling.

When announcing these relaxations I propose to say that I will be studying over the months ahead further proposals for a gradual relaxation of exchange control extending into the field of portfolio investment. I would explain that further relaxations would be announced when conditions were appropriate and that the speed of relaxation would be influenced by the effect of international events on sterling as well as by the speed with which we were able to solve our economic problems.

Officials have taken very informal soundings of Commission officials to find out how a package of the sort I envisage would be likely to be viewed by the Commission. This is important because our ability to keep the remaining exchange controls to which our EEC Treaty obligations apply depends on continued authorisation by the Commission. Also, in three minor respects, my proposals remove discrimination in favour of the Community. (At present the controls on outward direct investment, emigration allowances and cash gifts all have a more generous allowance for the Community than for the rest of the world. These discriminations add to the complexity of the exchange control regime and we are under strong pressure from the Americans to make our relaxations non-discriminatory.) The Commission would also prefer faster progress on portfolio; but Commission officials do not deny that there are important technical obstacles to be overcome before a controlled programme of relaxation for portfolio investment could be introduced.

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01-233 3000

I am advised that the Commission are likely to go along with my proposed package provided that they are seen to have been consulted. I therefore intend to invite Commission officials to London to discuss the details of the package with the Treasury and the Bank about a week before the Budget. I will speak to Mr. Ortoli on the telephone myself a day or two before the Budget; and we shall invite the Commission to issue a Press Notice on Budget day simultaneously with ours so as to make it quite clear that they were fully consulted.

I should be glad to know that you are content that I should proceed on the lines described above. Detailed work on the preparation of exchange control notices and other relevant documents is already in hand. To ensure no misunderstandings or confusion, the commercial banks and other exchange control agents should receive these notices by the morning after the announcement. To get them out on Budget Day, the texts need to be put in final form ready for printing no later than next Wednesday 30th May.

I am sending copies of this minute to the Secretaries of State for Foreign and Commonwealth Affairs, Industry and Trade, the Governor of the Bank of England and Sir John Hunt.

M.A.H.

(GEOFFREY HOWE)

(Approved by the Chancellor of the Exchequer and signed in his absence)

23rd May, 1979

PROPOSED EXCHANGE CONTROL RELAXATIONS

Outward direct investment

- (i) A ration of official exchange of up to £5 million per project per year for new outward direct investment.
- (ii) Abolition of the requirement that at least two-thirds of overseas earnings must be repatriated.
- (iii) Existing foreign currency borrowing to be repayable in five equal annual instalments - this replaces the "matching benefits" rule.
- (iv) New borrowing also to be repayable over five years (to the extent that repayment cannot be met from the ration).
- (v) Disinvestment proceeds to be allowed to be used to pay off unrelated borrowing.

Controls on individuals

- (i) Private property: replacement of the present requirement that investment currency must be used by a ration of official exchange of £100,000 per family per year. Further consideration to be given to whether this should be confined to one property per family.
- (ii) Emigration allowances: increase the initial allowance of official exchange per family unit to £200,000 worldwide. (At present it is £80,000 for the EEC and £40,000 elsewhere).
- (iii) Cash gifts and dependants allowances: combine these allowances and raise the annual limit per donor to £10,000. (At present, they are £1,500 - £3,000 in the EEC - for gifts, plus £2,000 for dependants.)

(iv) Travel allowances: allow banks to issue £1,000 per journey (instead of £500 now).

Third country trade

The re-introduction of sterling finance for third country trade.

✓ Decisions on whether it should be confined to UK merchants or extended to banks and on the precise nature of the scheme to be taken after consultations now proceeding.

Foreign currency retentions

If it is decided not to extend the third country trade concession to banks, permission for firms to retain for two months foreign currency sufficient to cover two months' needs (instead of one month in both cases now).

Outward portfolio investment

(i) Official exchange to be allowed to meet the interest on foreign currency borrowing taken to finance portfolio investment.

(ii) Abolition of the present rule that 115 per cent of the value of loans taken out of portfolio investment must be covered by foreign currency securities or investment currency.

Gold coins

Remove all restrictions on import of and dealing in gold coins.

CF
TO keep P 10/5



Economic Policy

10 DOWNING STREET

From the Private Secretary

9 May 1979

The Prime Minister has received the enclosed note from Mr. Douglas Hague on exchange controls. She would be grateful if the Chancellor would take Mr. Hague's suggestions into account in formulating his own proposals for the relaxation of exchange controls.

The Prime Minister is sure the Chancellor will wish to consult with the Governor on this subject, and I am therefore sending a copy of Mr. Hague's note to John Beverly (Governor's office).

L. P. LANKESTER

A.M.W. Battishill, Esq.,
HM Treasury.

llkm

9 May 1979

The Prime Minister has asked me to thank you very much for your note on exchange controls dated 4 May. She has asked the Chancellor of the Exchequer, in consultation with the Governor, to take into account your suggestions in formulating his own proposals in this area.

T.P. LANKESTER

Professor Douglas Hague



PRIME MINISTER

cc Mr. Ridley

This note from Douglas Hague argues for a big, and early, relaxation of exchange controls. I suggest that we ask the Chancellor to take this into account in preparing his Budget: I am sure he will be considering the possibilities for exchange control relaxation. And I could write on your behalf to Douglas Hague telling him this. Do you agree?

Yes. mtr

R.

8 May 1979

The Chancellor, I had a brief word about this yesterday but he must consult with the Governor first. mtr.

TO: The Prime Minister

FROM: Douglas Hague

c.c. Chancellor of the Exchequer,
Treasury Chambers,
Great George Street, S.W.1.

DATE: 4th May 1979.

EXCHANGE CONTROL

The strength of the pound presents both an opportunity and a challenge.

The opportunity is to give the market a greater influence on the capital account of the balance of payments. Individuals and businesses should be given a greater role relative to the Treasury and Bank of England in deciding how a current balance of payments surplus should be offset, on capital account.

The challenge is to find a way of preventing the exchange rate rising too far too quickly, because of the difficulties that a high rate would cause for non-oil exporting industries. Again, the market should play a greater role, and the monetary authorities a smaller one, in determining what happens. We should therefore begin to relax exchange control.

Exchange control affects three main types of transaction:

- a) finance of third-country trade in sterling;
- b) direct investment overseas by U.K. companies;
- c) portfolio and property investment through the dollar-premium pool.

A. Third-Country Finance

Until 1976, this was an important source of revenue for the U.K., with sterling used, for example, to finance exports of sugar from Cuba to Poland. Estimates of the amount of sterling involved range from £500m to more than £1b. Since a ban was put on the use of sterling to finance such trade, most of it has been financed in Euro-dollars. It will therefore be difficult to get back into the market, but many people in the City badly want to try. Because of this, the amount of sterling required to get back into the market would be less than £200m, but there would be a useful return on this once-for-all investment to the U.K. I recommend that we should permit third-country financing again.

B. Direct Investment

The outflow here would be larger - £300m^{per annum} or less. The Bank of England is apparently taking a generous view of applications for finance for direct investment overseas. I recommend that this part of the exchange control system should also be abolished.

If we do so, the trade unions will argue that investment which might have taken place in the U.K. is going abroad. The answer is that this is not an either/or question. If we allow more investment overseas and that lowers the exchange rate, we shall have more investment in export industries within the U.K. as well.

C. Investment through the dollar premium

Those I have spoken to in the City agree that this type of exchange control should also be abolished, when possible, however, they worry lest relaxation here should lead to so big a capital outflow that it has to be reimposed. Phillips and Drew estimate the total value of the portfolios of U.K. institutions (pension funds, insurance companies, investment trusts and unit trusts) at £100b, with about £8b per annum available for investment. If one adds what individuals might invest in securities and property, there is a large potential outflow.

I suggest a way of estimating the possible scale of outflow without taking an irreversible step. We could relax exchange control here, by arranging for the Bank of England to transfer foreign exchange into the premium-currency pool. One would want to give investors some indication of what was happening, perhaps by indicating the amount to be put into the pool in the next twelve months. The attraction of this idea is that one could quietly discover how much one had to put into the pool to reduce the dollar premium by a given amount. Indeed, in the end, one might be able to reduce the dollar premium to zero, and thus discover the cost of removing this type of control entirely.

I therefore suggest it as a way of moving towards the total abolition of exchange control without the risks involved in doing so completely and overtly. If the current account went into deficit, one could end, or even reverse, the procedure.

There is of course a good deal of economic theory and research lying behind this paper. I shall be delighted to go into more detail if asked.

J. C. H.