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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 weakeness 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 marekts work - a very great deal indeed can be spent with little or no effect, particulary 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

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