For Information:

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

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CHANCELLOR

THE OVERVALUED POUND

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

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

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

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

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

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

KEC

K E COUZENS
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