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SECRET

THE GOVERNORS

GR 18/9

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THE EXCHANGE RATE AND THE DOMESTIC
MONETARY OUTLOOK

1. Last week we could get moderate encouragement from the domestic monetary prospect. The PSBR was seen to be falling and the pressure of private sector demand for bank loans to become not quite so heavy (especially if loans associated with the repayment of foreign currency debt were ignored). The burden on the gilt market was seen to be lower, and this was reflected in the modest amount of new stock issued 10 days ago. The growth of the money supply seemed to be falling back within the target range, though still benefitting from the cosmetics of the Bill leak.
2. However, this moderate encouragement was qualified by awareness of an increasingly disturbed industrial situation and the absence of signs that the going rate of pay settlement was soon going to fall below (say) 17%. But this was seen as more likely to bring about a more and more severe squeeze on company finance, particularly in manufacturing industry, than as likely to precipitate a steep fall in the exchange rate which, in the absence of countervailing measures, would act to relieve the pressure on the corporate sector.
3. The fall in the exchange rate and in gilt-edged since early last week, which in its early stages was largely attributed to domestic industrial developments, makes one re-think the above qualifications to our monetary optimism. Or at least to think further about the ways they may actually work.
4. Obviously enough, a combination of 17% pay settlements, industrial unrest, balance of payments deficit (or bare balance) on current account, and increasing freedom to move money out of the country, can produce a spontaneous downward trend in the rate of exchange. An upward trend in interest rates abroad, together with the speculative attractions of the low-inflation and industrially-strong currencies, makes us more vulnerable to such a trend.

5. A spontaneous fall in the exchange back to around the ERI of early June (68) or slightly lower, would not (has not) at first sight call seriously into question the domestic monetary prospect foreseen 10 days ago. It would indeed fit the arithmetic of the Budget-time forecasts against which the 7-11% target was decided. But it would also tend to fit the pessimistic forecasts of pay and prices and the forecast absence of a very severe squeeze on the corporate sector. The implications for interest rates would be none too clear; but the disappearance of the 'very high' pound and the (slight) worsening of inflationary expectations would probably tend to flatten the yield curve, with long rates rising and short rates remaining unchanged. This seems to be what has happened; and long rates have risen by up to $\frac{1}{2}\%$, to $12\frac{3}{4}\%$.

6. The situation may stabilise at around where we now are, and it may become possible to resume gilt sales at yields rather higher than previously. But equally there are features in the current set of circumstances which have distinctly 'dynamic' possibilities. The exchange rate could well undergo another spontaneous downward adjustment, in the absence of favourable developments that would bring back the 'petropound' attitude in markets; and another downward step could/would worsen price expectations and worsen the pay situation and so on. The money supply, or the 'rate of monetary expansion', would then accommodate itself to the inflationary dynamics unless countervailing action, in the form of yet higher interest rates, was taken (or happened).

7. We are not yet caught in this dynamic process. But the risk is, to me, clear and one against which HMG should be warned. Tiresomely it raises yet again not only the endless question of exchange market intervention but also the wisdom of further dismantling exchange control unless and until upward pressure on sterling has reasserted itself. It also forces one to contemplate the possibility of a higher rather than a lower MLR.

SF.

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