CONSERVATIVE RESEARCH DEPARTMENT

24 Old Queen Street, S.W.I.

MEMORANDUM

To Mrs. Thatcher

From Adam Ridley, Esq.,

15th March, 1976

The Sterling Crisis

Further discussions with Gordon Pepper and others have shed additional light on what has been happening in the last week or so. The initial pressure on sterling arose because last Thursday week happened, for no particular reason, to be a day on which the commercial requirements of holders of sterling for foreign currency was quite exceptionally large. This naturally led to acute pressure on the exchange rate. In the absence of serious pressure on this scale for some months the Market watches the pattern of events extremely closely to see whether the Bank of England is interested in intervening to support the exchange rate, or whether it is content to see it fall. On this occasion the Bank ostentatiously abstained from intervening although the decline in the parity was precipitate. Once that fact was clear it was immediately in the interests of other short-term dealers to sell more sterling in order to anticipate the further falls which seemed inevitable once the Bank's policy was clear. On top of that there was the matter of a partially correct rumour about the diversification of Nigeria on international reserves - correct in as much as a substantial branching into other currencies has indeed taken place, incorrect in as much as this process had nothing to do with last Thursday's events and has been taking place over many months.

The final factor was undoubtedly the excessively low interest rates which have come about as a result of the long sequence of small cuts in the Minimum Lending Rate in the recent past. These cuts combined with growing upward pressure on short term interest rates in America - a pressure which is likely to be sustained for the time being and increased by the second half of the year - meant that holders of short term sterling were likely to get restless in any case.

It now appears likely that interest rates will have to rise sharply before very long, perhaps by a full percentage point or even by two. If and when that happens the problems of selling gilt-edged securities may become more acute unless the increases are so large that there is at least the short term prospect of a revaluation to bring about falling interest rates and therefore rising gilts prices for a while.

It is clearly feared that the exchange rate is now likely to rise again. The Smithsonian depreciation of 33% or so should be more than enough in the very short run to compensate us for the recent excess over the rate of inflation over that in other countries. However, it is becoming increasingly apparent that the Government will allow the exchange rate to sink as far as they consider to be safe, in order to encourage exports, probably trying to ensure a rate of depreciation of about half a percent a month when measured over meaningful periods of

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time. While this may well help exporters who invoice for foreign currency terms and who are selling on short delivery dates, the continuing instability in the exchange rate and uncertainty about the Government's true intentions may well be increasing the problems faced by exporters of capital goods where long term debts are inevitable and the exchange risks can become very large indeed whatever the professions of the Government's Capital Cost Escalation scheme.

P.S. Gordon Pepper also mentioned that the work he has undertaken on the Government's forecast of debt interest confirms his feeling that the figures may well be on the generous side. He also mentioned that he may be offering ideas about a possible reconsideration in his current or forthcoming Monetary Bulletin.

c.c. Sir Geoffrey Howe,
John Nott, Esq.,
Chris Patten, Esq.,
George Cardona, Esq.,