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DISMANTLING EXCHANGE CONTROL

You asked me to consider the recommendation put forward by Sir Kenneth Couzens with his minute to you of 17 September which we are to discuss next Tuesday afternoon, 9 October. I have been into this matter with officials. An important implication for domestic monetary policy in 1979-80 has been identified which could affect the timing. Subject to what I say about that below, my conclusion remains that we should go ahead with the plan to remove virtually all remaining exchange controls in a single package on Tuesday 23 October.

Exchange control and exchange rate policy

2. From the point of view of exchange control policy, there is everything to be said for moving now to virtually complete abolition. No partial dismantling of controls over outward portfolio investment has been devised that makes any sense at all. And any intermediate

position between the abolition of control over outward portfolio investment and total abolition of controls would be riddled with leakages and liable sooner or later to bring the system to discredit.

3. The choice therefore, as I see it, lies between taking the radical step of total abolition as soon as possible and deferring it until later without any certainty that a better occasion will arise. We must recognise the risk that complete dismantling would add significantly to downward pressure on the exchange rate. If we could be sure that at some future point we would enter a period in which we could incur that risk with greater confidence than at present, that would be an argument for postponement on exchange rate grounds. But it is not realistic to think in these terms. There will always be reasons why sterling may fall.

4. No one can say for sure what the effects of abolition on the exchange rate will be. Perhaps the crucial question is this: if we do drop exchange controls in October and confidence seriously weakens in the winter, how far will the abolition of exchange controls add to pressure on the pound?. In my view, it is our determination to persist with our financial and monetary policies that is crucial to the underlying strength of sterling and not the presence of exchange control. There are so many means available within the present exchange control system of getting out of sterling - for example, leading and lagging by residents and the withdrawal of funds by non-residents - that I do not believe that the abolition of controls will make a fundamental difference to the exchange rate.

5. By contrast, a decision to abolish controls now would unquestionably assist one important Government policy: namely to cut the size of the public sector. To go ahead in October would permit a rapid rundown of staff at the Bank of England over this winter. To postpone the decision would delay the achievement of these staff savings.

Implications for domestic monetary policy

6. Paragraphs 15 to 18 of the paper on exchange control attached to Sir Kenneth Couzens' minute of 17 September describes the implications of exchange control relaxation for domestic monetary policy.

ie point is there made that, once the remaining exchange controls had gone, it would be easier for banks to avoid direct controls over the money supply (such as the present corset and various versions of the monetary base control system which officials are examining) by switching business to overseas banks.

7. This aspect has now been examined in detail. Mr Bridgeman's minute and paper dated 1st October dealt with the implications for monetary controls, while Mr Middleton's minute of the same date deals with the other implications for domestic monetary conditions. On the former the conclusion reached is that, without exchange controls, the use of direct monetary controls would be severely limited. To have one without the other would have the effect both of driving part of the British banking system offshore and of reducing, if not eliminating, the effectiveness of monetary controls. But retaining exchange control would not be an acceptable price to pay for the possible advantages (which are not undisputed) of adding direct controls to the more general monetary controls - namely fiscal policy and interest rate policy at both the short and long ends of the market. Officials have examined the possibility of keeping a few directly relevant exchange controls so as to preserve the option of retaining the corset or introducing the relevant form of monetary base control; but they have concluded that, once portfolio controls and the associated monitoring procedures had gone, it would not be possible to sustain an effective scaled-down control of this sort.

8. Neither I nor officials believe that this is a reasons for abandoning our plan to dismantle exchange control. But it is relevant to the timing of the final move. If we abolish controls in October there will be a strong case for allowing the corset to lapse in December. The ending of the corset could be followed by an addition to the sterling M3 statistic which might, depending on other developments, jeopardize the achievement of the target during the relevant 10 month period. Also the banks have been holding back on certain forms of marketing, such as the Lloyds home loan scheme, and

they would press ahead if the corset lapsed. It is possible that such developments, together with the possible effect as the exchange rate explined in Mr Middleton's note might require a further upward move in both long and short term interest rates to protect the target by further deterring bank lending and by securing most gilt sales in what may be uncertain conditions. This would strictly speaking reduce even further the already slim chance of interest rates falling sufficiently for building societies to stop the increase in their mortgage rate.

9. None of this is conclusive and it may well be that other developments will permit us to accept the consequences of the lapse of the corset (which, sooner or later, is inevitable anyway) at the end of the year. Much turns on the outlook for the PSBR over the months ahead and in particular the question of how soon we shall see the downturn in bank lending which we have been expecting for so long.

10. Further information on these points will be available for consideration at your meeting on Tuesday afternoon which is why it has been postponed to that time. My conclusion is that, if the outlook for the monetary aggregate is reasonably secure and the implications for interest rates acceptable, we should go ahead with the abolition of exchange control in October and the lapse of the corset in December. But, if the figures are likely to be disappointing to the market, there may be a case for postponing the abolition of exchange control, probably until the spring.

Other points

11. Three otherpoints are relevant to the decision on exchange control. The first concerns the European Monetary System. It would be difficult to join the EMS until controls had been fully dismantled and the foreign exchange market had absorbed the consequences of any stock-shift that might follow. This is an argument for abolishing controls at the earliest practicable moment - ie to bring forward the time at which the Government would at least have the option of joining the EMS at a realistic rate and without incurring the extra

risks due to the short-term effect of the abolition of controls on the exchange rate. The Prime Minister might think this a relevant factor in the context of the changes that we are seeking in the European Budget arrangements.

12. Second, it would be necessary to have special arrangments for continuing exchan ge controls against Rhodesia if the general controls are removed and sanctions cannot be lifted. Officials have preparations in hand for this. So long as these controls remain in place, we shall not be able to repeal the Exchange Control Act. But, in any case, I accept officials' advice that we should consider more carefully the case for retaining or replacing that legislation before we made any policy announcement about its future, and that for the time being at least the Act should remain on the statute book even if all the remaining controls were abandoned.

13. Third, the timing of the exchange control package needs to be related to that for the sale of BP shares because, if portfolio liberalisation came fairly soon after the sale and the BP share price fell, the Government would be seriously open to criticism (and might even be liable to be sued). In your absence, I have already drawn the Prime Minister's attention to this link. The best time for the BP sale seems likely to be about the end of October so the exchange control ammouncment should come about one week earlier - for that reason Tuesday 23 October has been identified for planning purposes. If 23 October is ruled out, we should have to postpone the package for at least 2 months after the BP sale: however, as explained in paragraph 10, postponement for monetary policy reasons probably means postponement until the spring.

Conclusion

14. Unless any new information available at your meeting on Tuesday shows that it would be too risky to allow the corset to lapse in December, I would recommend that you confirm the present plans for an announcement of the virtual abolition of exchange control on

23 October. The announcement could, of course, be aborted at any time between now and then if a new assessment of monetary conditions or devlopments in the foreign exchange market made that appropriate.

15. The next step after your meeting on Tuesday should, I suggest be a minute to the Prime Minister with copies to the other Ministers directly concerned, in which you will no doubt wish to rehearse the positive benefits of Exchange Control abolition, which I have deliberately omitted from this already over-long minute.

NL.

NIGEL LAWSON
4 October 1979