SECRET

27. 7.79

MR.PAYTON

Copies to: Mr.Fforde
Mr.Dow
The Chief Cashier
Mr.Goodhart
Mr.Sangster

The Problem of the Exchange Rate
and Intervention Policy

You asked me earlier in the week if I could assemble some thoughts on this question. This I have done in the attached note which I dictated yesterday before knowing of the Governor's meeting. The note is therefore partly superseded, but I hope that it may still be thought worth circulating.

27th July 1979.

construed as an unfriendly act by the Americans. This last would be all the more the case when it is considered that they have made overtures to reactivate the Fed. swap arrangement with the UK. If the idea were therefore to be seriously considered at all, we should need to be on very sure ground in describing to our partners the damaging consequences of continuing heavy intervention without adequate US flanking measures.

For that reason, it is first necessary to examine to what extent our own domestic monetary objectives have been endangered or even thwarted this year as a result of our efforts to stem the apparently irresistible tide of funds flowing into the UK. The relevant facts are I think the following:-

(i) In the six banking months January to June inclusive the seasonally adjusted effect of external factors on sterling M3 was contractionary to the extent of £0.4 bn. The actual effect was also contractionary, at half that figure or £0.2 bn.

(ii) Nevertheless, during the same six banking months the change in reserves net of public sector official external borrowing was an increase of £1.7 bn. (over 3% of the money supply).

The Problem of the Exchange Rate and Intervention Policy

This note considers the question which was discussed at Books early this week, namely whether there could be any means of putting pressure on the United States to take action so that the dollar would stabilise of its own accord (with sterling preferably at a much lower level than at present) without massive interventions on both sides of the Atlantic. The suggestion was that we should try to persuade our European partners and the Japanese to cease entirely from dollar interventions and thus allow the dollar exchange rate to suffer such severe consequences that the US authorities would be driven to a fresh package which would carry the same conviction as the one of 1st November last year.

One must straight away say that this idea runs directly against the grain of everything that has happened since last November - and indeed somewhat earlier - and would therefore take a lot of selling to our European partners and would unquestionably be construed as an unfriendly act by the Americans. This last would be all the more the case when it is considered that they have made overtures to reactivate the Fed. swap arrangement with the UK. If the idea were therefore to be seriously considered at all, we should need to be on very sure ground in describing to our partners the damaging consequences of continuing heavy intervention without adequate US flanking measures.

For that reason, it is first necessary to examine to what extent our own domestic monetary objectives have been endangered or even thwarted this year as a result of our efforts to stem the apparently irresistible tide of funds flowing into the UK. The relevant facts are I think the following:-

(i) In the six banking months January to June inclusive the seasonally adjusted effect of external factors on sterling M3 was contractionary to the extent of £0.4 bn. The actual effect was also contractionary, at half that figure or £0.2 bn.

(ii) Nevertheless, during the same six banking months the change in reserves net of public sector official external borrowing was an increase of £1.7 bn. (over 3% of the money supply).

(iii) Looking at it from a different source (the figures we supply for EEC concertation purposes) in the six calendar months from January to June our exchange market interventions amounted to purchases of $3.7 bn. gross and, allowing for market swaps, of $2.7 bn. net - say £1¼ bn.

It will be seen that the figures in (ii) and (iii) above are of the same order of magnitude, in spite of some difference in definition and in time span. In a day-to-day way it is the figure in (iii) by which we can measure the inflows which the EUA is financing and which on the face of it should be swelling the growth in our monetary aggregates. Since, however, this has not happened in a direct statistical sense - see (i) above - the case against avoiding heavier interventions or indeed for stopping intervention altogether must rest on two other possible arguments, viz.

(a) The experience so far this year is misleading - it would be better to look at the end of 1977; and/or

(b) What counts is the indirect effects of the inflows, eg. reducing the amount of our gilt-edged sales to the UK non-bank private sector (by the amounts taken up by non-residents) and/or increasing the liquidity of the banking system beyond what it would otherwise have been so that the banks have been able to expand their lending much more than the corset/reserve asset ratio should a priori have permitted.

Argument (a) is obviously debatable; I am not properly qualified to judge argument (b) but its truth will certainly depend on a whole lot of complex relationships many of which must be hypothetical, eg. if there had not been a marked non-resident interest in our gilt-edged market would we have been more or less successful in selling gilts to UK non-banks?

What, however, the figures clearly demonstrate is that no direct blame can be laid at the door of intervention in the first half of this year for the fact that money supply has been rising too fast.

The next point to note is that our own intervention policy has been conducted in total isolation from the rest of the industrial countries, whereas the other European countries have found their dollar exchange rate influenced either indirectly by their membership of the EMS or directly because, in the case of Germany and Switzerland, of co-operative action with the United States. As the markets all know this, it is tempting to believe that our undoubtedly sizeable intervention effort has had less impact than it would have done if it had been seen or believed to be part of a more concerted approach. It is, of course, obvious that other well-known factors have played an important part and indeed have probably been the dominant cause for sterling's strength; North Sea oil and our high interest rates/ determination to stay within our monetary target range are the conventional culprits. But equally there are powerful factors on the other side and most people would judge that in the longer run these would have the greater weight (industrial performance, current account, and rate of inflation). If that judgment is right, it would be very dangerous to stop doing whatintervention we have been doing and simply allow the rate to roar ahead unchecked. (This is clearly an option to us with or without the participation of the Europeans; the difference between the two is a tacit recognition of the point made above that by behaving in isolation we are aggravating our own problems.) It seems to me that enough harm has already been done to the competitiveness of British industry by our present exchange rate without adding further to it in the hope that something will happen on the other side of the Atlantic to reverse the tide.

Of course, none of these opinions proves the contrary argument that since under our present policies the exchange rate has already reached levels which cannot long be sustained the time has come to alter course. Nevertheless, there must be a presumption that if we act decisively in the exchange markets with the active collaboration of the US authorities (and maybe, for that matter, the Europeans) we would have a very much better prospect of calling a halt to the present madness of the rate than by going on as we are. The gamble would have to be that the equivalent of three months' half-hearted and unadvertised resistance dispersed in a determined effort over a short period would produce the results required.

As I said at the beginning, we have had overtures from the Americans and indeed the Swiss to act in concert. This poses the question whether there are any monetary devices (other than the obvious manoeuvre of lowering MLR in the UK and getting the US to raise their rates) which could support or even partially replace intervention pure and simple. I offer for consideration two closely related ones:-

1. That the US authorities make a sterling issue in London on the same lines as they did in Germany and Switzerland at the end of last year. I would guess that the impact of such an issue would far outweigh its actual size - though this could be very large, certainly not less than £750 mn. If, say, £1 bn. could be placed (and for this purpose it might be necessary for the UK authorities to announce rightly or wrongly that they had made such good progress with the funding of the PSBR that they would be staying out of the market for a month or two), then it is not beyond the bounds of credibility that the proceeds need not all be spent in market intervention but could in part be sold by the Americans to us against dollars. The borrowing would then have not just a neutral effect on the UK money supply but a contractionary one.

2. That HMG do a sort of reverse operation - which would be a rather novel one - namely of issuing a sterling-denominated instrument which would, however, be subscribable only in dollars. If the residual exchange rules were observed, so that UK residents could not subscribe, the effect of the issue would be neutral on the UK money supply but would divert pressure off the exchange rate to the amount of the issue. If, on the other hand, the issue was open to UK residents then that would also mean some contractionary effect on the money supply as well as the exchange rate effect.

This note has ended with a U-turn from where it began. Unfortunately, just as I am quite convinced that it would be impossible to sell the notion of concerted inaction vis-a-vis the dollar by all the Europeans - which would really leave us in just as bad a case as if we alone abstained from dollar intervention - so the U-turn may be just as unsaleable to HMG which seems bent on ignoring the exchange rate, however high it may go.