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From: J. R. Ibbs

Prime Minister
I believe this letter from Robin Ibbs sets out the case for a lower exchange rate pretty convincingly. You might like to talk to the Chancellor - at your next meeting with him - about the ideas in the last para for getting it down.

Yes

Qa 05244

6 February 1981

Dear Chancellor,

The 1981 Budget

I have seen Sir Keith Joseph's letter to you of 30 January. Of the various matters he raises the one on which I wish to comment is the exchange rate, referred to in his paragraph 12.

As you know, my view is that the strength of sterling is the most serious problem with which British industry is grappling at present. The recession is affecting many countries and low demand is affecting much of UK industry. But the exchange rate is a major additional difficulty which falls on a number of sectors which are of immediate importance in terms of economic activity and employment, and which are of longer term importance if the economy is to be strong when there is less support from oil. Reduction in the exchange rate is therefore of structural importance and would provide financial relief where it is most needed. The relief could also be on a greater scale than I believe you are likely to be able to provide through fiscal adjustments. Anything which could be done to bring about a reduction in the rate would be as beneficial, if not more so, than any other relaxation being contemplated in the Budget.

The appreciation of sterling has been of such a magnitude and has happened over so short a period (as well as being largely unpredicted) that for many companies even the maximum

The Rt Hon Sir Geoffrey Howe QC MP
HM TREASURY
S W 1

cost reductions conceivably open to them would only partially counteract it. Many have been hanging on to their export markets in the hope that the exchange rate will ease but margins are now so low (and in many cases negative) this cannot continue indefinitely. Unless the rate falls, a range of important trading activities will have to be closed down entirely or at best continue in an impoverished way that results in further diminishing competitive strength through inadequate investment and R and D.

Sir Keith Joseph suggests a depreciation of between 5 and 10 per cent. I believe the latter figure is needed. I understand that the Treasury model indicates that depreciation of 5 per cent would bring a rise in the annual value of exports of around £2 bn. with a large part of this going into profit margins. A 10 per cent depreciation would give roughly twice this. Such changes would significantly ease financial burdens where they currently press most harshly.

Nor is the effect confined to exports. For products made and sold in this country which are subject to international price levels the reduction in the exchange rate would bring a corresponding financial benefit. This has been well illustrated by the recent figures we have seen on British Steel. The overall benefit of a 10 per cent fall might therefore amount to several £ billions.

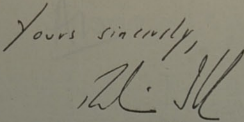
I appreciate that the loss of competitiveness has been in part the result of excess UK cost inflation and, moreover, that the appreciation of sterling has been a factor in bringing about the decline in the inflation rate. However, to put the suggested 5 to 10 per cent depreciation into perspective, a 5 per cent depreication would bring competitiveness back only to where it was in May 1980: a 10 per cent depreciation to the level at the beginning of 1980. Companies would still

need to make very challenging cost reductions through other means - their task would therefore have been made more feasible rather than easy. With a lower exchange rate higher import costs would have an adverse effect on the downward inflation path. But this is already well advanced compared to earlier expectations, and the penalty seems to be worth taking in relation to the great risk to important parts of the trading sector if nothing is done.

If these arguments are broadly acceptable the problem as always becomes one of finding a way to bring about the desired depreciation in a controlled manner. Reducing interest rates should help but I believe that a main task is to weaken the speculative factors which, because of so much talk of the effects of the petro-currency, have caused confidence to reach an exaggerated level. These factors would be weakened by declaring a particular exchange rate range as desirable within the broad framework of existing policies. Indeed, I understand that one specific proposal is that there might be a system of monetary targets which could be temporarily flexed to eliminate unacceptable exchange rate changes whilst still retaining confidence in the basic monetarist approach. In view of the immense importance of the problem and the need carefully to examine any potential solution, it seems to me that further exploration of this idea of 'conditional monetary targets' is worthwhile, perhaps in an interdepartmental discussion.

I am sending a copy of this letter to the Prime Minister, the Secretary of State for Industry, and to Sir Robert Armstrong.

Yours sincerely,



J R Ibbs

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