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Prime Minister. 5 2

The Chancellor is hoping that there will be an opportunity to discuss this at Chequers on Sunday.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

12x.

For discussion with the Chancellor and others on Wednesday morning.

15/10

PRIME MINISTER

EXCHANGE CONTROL

We must now take a crucial decision on the future of the remainder of the exchange controls. As explained in the Financial Secretary's minute to you of 25th September, we must either announce any new package before the BP sale or postpone it for at least 2 months, ie. almost certainly beyond the end of the year. The effect of this is that we have probably to choose between an announcement this month when Parliament returns, and deferment of the next stage of our programme of dismantling these controls at least until the 1980 Budget. In this situation I have authorised preparations for an announcement of further exchange control relaxations on Tuesday, 23rd October. They can be countermanded at any time.

2. There is a clear case for completing the process of abolition in one step (leaving only controls affecting Rhodesia which must remain while sanctions last). The great bulk of the remaining controls relate to portfolio investment outside the EEC i.e. in practice mainly to investment in US securities. Direct investment is already wholly free and remaining restrictions on individuals are not of great economic significance.

3. Completing abolition would show our determination to implement the policies to which we are committed. It would sweep away another set of controls that has outlived its

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usefulness. It would enable individuals and firms to take investment decisions on commercial grounds and so further our aim of freeing the market economy to operate efficiently. It would reduce public expenditure by the cost of about 750 staff (mainly Bank of England staff) now borne on the Treasury's Vote. It would end a large burden in the private sector on banks, firms and individuals, and there would for example be no more marking of passports. It would fulfil our obligations on capital movements under the EEC Treaty and you could take credit for this at the Dublin Council. And it would please the Americans who do not like the present discrimination in favour of EEC securities that resulted from the relaxations we made in July.

4. We must first consider the implications for the exchange rate. These are exceedingly difficult to predict. Obviously the effect of abolishing exchange controls would be to ~~remit~~ permit outflows which, especially if they proved substantial, would cause the rate to be lower than otherwise. That is a necessary consequence of the achievement of our aim to abolish exchange control. The question thus is whether the present is a good time to accept the consequence or whether it would be better to wait. In my view, the present is as good a time as we are likely to get. First, though we must expect an adjustment of portfolio over a period, this is not a particularly attractive moment to buy U.S. securities. The outflow may, therefore, be gradual. Secondly, sterling has fallen back from the very high level it reached in the immediate aftermath of Iran and the oil developments in the summer. But, at its present level, it is not under pressure. The effect of last weekend's US package is an illustration of this point since, if the market had had serious doubts about the present rate for sterling, they would have shown

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themselves when the dollar revived. In fact, the effective rate and the cross-rates against the strong non-dollar currencies stood up well. Sterling seems to have come through this limited dollar rebound unscathed. Obviously this situation could change, but, provided we continue to show our determination to persist with our financial and monetary policies, I would not expect any downward pressure on sterling to get out of control. And the maintenance of the remainder of our exchange control regime will not be crucial since there are so many ways of getting out of sterling as things are at the moment.

5. A further point is that our reserves are very high - \$24 billion spot and forward. I would be opposed to sustained intervention to support an exchange rate that the market had come fundamentally to doubt. But in this case I could see a case for heavier intervention than we would normally think appropriate to finance any initial outflows following a relaxation of exchange control. We could explain that the effect of our intervention was to exchange public sector assets in the reserves for assets acquired by the private sector as a result of our change of policy; and I believe that this explanation would be accepted by the markets. If therefore, sterling showed signs of falling too far we could exercise the option to mitigate the fall by intervention.

6. The exchange control decision also has several implications for domestic monetary policy.

7. First, it would make it impossible for us to use effectively certain types of direct control over domestic banks - essentially because the alternative of "offshore" banking would become a readily available substitute. The only direct control we currently use is the "corset", and you will

/ have seen

have seen the growing leakage into acceptances which bypass this control and are bringing it into disrepute already. The alternative direct controls which would be similarly ineffective in the absence of exchange control are some of the direct "penalty" versions of monetary base control. In their studies of this following your July seminar, however, the Bank of England and my officials have failed to identify any direct monetary base control which would be robust for any length of time even with full exchange controls. Our main monetary policy instruments: interest rates, PSBR management, management of gilt markets; would be unaffected by the removal of the remaining exchange controls.

8. There could be effects both ways on the £M3 figures in the ensuing months. These will need to be explained but are likely to be well understood by the commentators as part of a switch in the stock of assets. If the outflow is modest, the effects will be small. And the outlook for the money supply in the next 3 months or so is much better than in the recent past. This is therefore a good time to accept the risk of some impact on the money supply figures arising from exchange control relaxation. This will also be a time when, in the light of the favourable M3 outturn, domestic pressures on interest rates should be a little less. That would help us to accommodate any slight upward pressure on interest rates arising from an outflow.

9. I conclude therefore that, unless there are new unfavourable developments before 23rd October, we should go ahead with the abolition of exchange controls on that date. Very careful consideration would need to be given to the presentation of this decision in relation to the whole of our

/ monetary policy,

monetary policy, both on 23rd October when the exchange control package is announced and subsequently when we roll forward the target - probably after the announcement of the banking October money supply figures on 15th November. At that stage we would need to consider the future of the corset, due to end in December, and it may be better in the circumstances to let it lapse. It is already losing effectiveness anyway.

CONCLUSION

10. This subject has many ramifications. To keep this minute short I have concentrated on the main points. I hope that we may have an early opportunity to discuss the matter. In the light of the points I have made above, I hope you will agree that, unless there are any untoward developments in either the foreign exchange or the domestic monetary markets, we should go ahead as planned with the total abolition of exchange controls (except for those affecting Rhodesia) on 23rd October.

11. I am not sending copies of this minute to any of our colleagues at this stage. My officials have been in touch with officials of the Departments chiefly concerned and work is in hand, on a strictly contingency basis, for dealing with a number of consequences of abolition for other departments' policies.

(G.H)

11th October 1979