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Memo to THE GOVERNOR ONLY

cc Mr Fforde only  
Mr Dow only  
Mr Blunden only  
Mr Loehnis only

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"POLICY AND THE EXCHANGE RATE"

Julie [Signature]

THE GOVERNOR ONLY

Copies to Mr Fforde o/r only  
Mr Dow only  
Mr Blunden only  
Mr Loehnis only

*On request one copy given to J&P.  
no copies with I & R.*

## POLICY AND THE EXCHANGE RATE

The level of the exchange rate is now clearly intolerable. There is no other country in the world who would permit - or has permitted - the rate of deterioration of competitiveness that we have suffered in the last year or so. If ICI makes a loss because of the exchange rate there will be many other companies in much worse case - many of them perhaps not yet fully aware of how badly off they are. The fall in the volume of exports in last month's trade figures may well prove to be the beginning of a very ominous movement that may already be too late to arrest in the short run, but which may gather pace if nothing is done and add greatly to a recession which already promises to be more serious than most forecasts have suggested.

There seems no ground for hope now that autonomous factors will bring about a fall in the rate. The rise in US interest rates has not shaken it. The weakness of the deutschemark looks likely to last for some time and the weight of OPEC funds remains very large.

One can have very little faith in inflow controls or a burst of intervention by themselves. They might shake the rate down because of the implication of changed policies but one could not count on any fall and there is quite a chance that effects could be perverse.

It seems to me that the only move which offers any hope of significantly reducing the exchange rate - and I would regard it as very important at least to get below \$2.30 - is a fall in interest rates. 2% would presumably be the minimum, 3% preferable; and even in these circumstances one cannot promise an exchange rate fall particularly if the interest rate reduction occurs in conjunction with a substantial fiscal tightening or - if it was delayed until after the November figures - on the back of a low money supply

figure. Ideally one ought to be prepared to back the fall in interest rate with some substantial intervention if it proved necessary.

There is now a widespread call for a reduction in interest rates and commentators who some months ago were monetary hard-liners are simply eliding the difficulty of compatibility with monetary control. The Economist leading article this week, for example, does not mention money supply from start to finish. The Times says effectively: "look at money supply and then reduce interest rates". We know, however, that the October figure provides no sort of justification in terms of money supply control as hitherto argued - at least in terms of the crude number. It may be that looking deeper into the external components will provide some sort of justification for interest rate easing but I would guess this is likely to be a bit specious. Perhaps, indeed, the high October figure is positively to be welcomed because it put the dilemma in a way that cannot be escaped.

An alternative way round the problem is to wait until mid-November and then if the public sector cuts are big enough, reduce interest rates as a complement to them. We have already argued, on several occasions, for something along these lines, but here too I have doubts. I am old fashioned enough to find it pretty nearly insane for the Government to be cutting back on social security payments and defence expenditure in the present and prospective economic climate. Public sector pay - though reductions here would also, of course, have effects on demand - seems to me another matter; but to renege on our NATO commitments and reduce defence work for the private sector in present circumstances seems to me misguided. Of course lower interest rates would produce some offsetting benefit to the private sector: but the more the fiscal stance is tightened, the less hope we have that the net effect of monetary policy will be to reduce the exchange rate. Looking further ahead and trying to take some account of political realities, it is very difficult to see how the Government is going to be able to meet its medium-term financial strategy commitments during the course of 1981 without the persistence of an intolerable level of interest rates and the exchange rate.

This poses a very acute dilemma for the Bank. One approach would be simply to sit tight, but refuse to countenance lower interest rates without a fiscal package; to hope that the exchange rate will somehow weaken; and to wait until by the spring the Government themselves will probably discover the incompatibility of their monetary targets and the needs of the real economy represented to them very strongly by much of the Cabinet. The drawbacks to this approach as I see it are first that much more damage may by then be inflicted on the economy, especially in the tradeable sector; and secondly that we are likely to come in for increasing criticism for not having met the targets or having only got near them at too high a cost.

This inclines me to the view that we should now recommend that the exchange rate be elevated to the primary aim of policy and that to this end interest rates be reduced by at least 2% together with a willingness to intervene if necessary. Such a move should be recommended and if adopted, promulgated explicitly on the basis that it might well mean considerably worse performance in relation to monetary targets at least in the short run. In other words, that the targets were for a while being suspended.

It will obviously be politically very difficult to make a recommendation of this kind. To do so would be likely to confirm the Prime Minister's suspicions that our heart has never been in her policies and to have the recommendation rejected out of hand. However, virtually the entire country outside a handful of Ministers and a few handfuls of commentators knows that the exchange rate is too high and wants interest rates down. Moreover, while any fall in the exchange rate must to some degree weaken the outlook for inflation and a spurt in the money supply may do likewise, one could argue that granted the climate in which this winter's wage bargains are in any case going to be conducted, these effects may not be too serious. Additionally there is a problem with getting too good a result on wages through deflation analogous to getting too good a result on wages through incomes policy: the bounce back later. It seems to me at least that the Government needs to be rescued from a short-term over-severity of policies because whatever they feel now about their determination, the more severely the economy is deflated now, the more likely it is that it will be over-stimulated before too long.

For all these reasons the Bank might prove to be fundamentally in a rather strong position if it were to recommend perhaps rather gently, and even if we were initially rebuffed, a reduction in interest rates to reduce the exchange rate. There would certainly be risks. But I think there are heavy risks, both to the economy and to the Bank's long-term reputation in sticking with the view that the exchange rate can in no circumstances and even temporarily, be given a priority among our objectives.

7 I attach a rough draft of how the argument might be presented.

Cwm

27 October 1980

THE EXCHANGE RATE

The exchange rate is now almost universally regarded as too high - even by many people with a strong bias against trying to manage it. Of course a strong pound is an inevitable and acceptable part of the Government's strategy - a way in which monetary policy helps to bring down inflation, but even fully accepting this there are a number of senses in which the pound is too high.

(i) The real exchange rate has risen too fast: by 44% since the fourth quarter of 1977 and by 18% since the fourth quarter of 1979. No other country has permitted [check] or would permit such a rapid deterioration in its competitiveness without at least trying to prevent it. The most efficient firms cannot adjust to changes of that magnitude. It would take X years of zero wage increase here, assuming Y% annual wage increase in our competitors to recover to the level of competitiveness a year ago - assuming that such a splendid performance did not put the nominal exchange rate higher still.

(ii) The exchange rate is unpredictably high. It is [15%] higher than was assumed in the February forecast and has therefore made the monetary squeeze much tighter than was envisaged or intended.

(iii) It is inexplicably high: even with hindsight it is very difficult to explain the exchange rate in terms of money supply theory, interest rates, balance of payments developments, etc.

Because it cannot be explained one can have no confidence about its future movement - in particular no confidence that it will come down of its own accord. The rise in US interest rates has not shaken it, the deepening degree of relative depression here together with the effects of oil are likely to continue to be strengthening factors, as is the likely continued weakness of the deutschemark.

The possibility that the rate will continue indefinitely high is particularly damaging as it is likely to lead one firm after another to more or less irreversible decisions to withdraw from export markets. We could be in for a dramatic and very damaging fall in

the volume of our exports (which may have started last month) adding to the general forces of recession.

All these facts add up to a case for a lower exchange rate, if it could be achieved on practical grounds and they suggest that the present rate is not required in terms of the theoretical basis of present policy. Of course any fall in the exchange rate will mean that cost inflationary forces are stronger than they would be otherwise. But that argument would apply if the rate were already at \$3. Moreover, it looks arithmetically so difficult for the economy ever to adjust to the present exchange rate that one must conclude that at some point - perhaps still a long way off - it will fall somewhat with undesired inflationary effects.7

Our own experience and that of other countries and our analysis of various possible measures suggested lead us to the view that nothing short of a significant fall in interest rates, together, perhaps, with a willingness to intervene in quantity, is likely to have much permanent or significant effect on the exchange rate. (Nor, of course, can one be sure that any given fall in interest rates will do the trick.) It would be attractive to wait until the money supply is well enough within the targets to allow a fall in interest rates to occur as a natural consequence of monetary policy. The October figures suggest, however, that we may need to wait a long time for the justification to occur by itself.

Alternatively, if big enough cuts are made in the PSBR one might justify interest rate cuts even if the money supply was still running above target. But in these circumstances one would be much less sure that the exchange rate would actually fall. The fiscal tightening might offset the interest easing.7

We must probably face the fact that if we are to avoid present policies proving tighter and more damaging over a longer period to basic industry than was ever intended, we may have to give the exchange rate a temporary priority over the achievement of the monetary targets.

There would obviously be great difficulties in taking such a step, the risk of credibility would be serious. However, other



countries - especially Switzerland and Germany - have behaved similarly under less provocation from the exchange rate (though admittedly with lower inflation rates). Moreover, since £M3 has shown itself to be very interest insensitive over many months (much of the bank lending being involuntary) it is possible to argue that the deleterious effects of the monetary aggregates on low interest rates might be much less than one would fear.

As for credibility risks in the other direction, if the £M3 figures remain stubbornly high and the conclusion is drawn by the authorities month after month that their only line of action can be to keep interest rates where they are and/or to cut public sector demand at a time of deepening recession, a very wide section of the nation will find it difficult to understand or support the Government's line.

Advantage might even be taken of the present confused and overshot situation in relation to the monetary aggregates to suspend the targets say, until spring when the whole question of the mix of monetary fiscal and exchange rate policy could be reconsidered with the budget.

Cwm