

For Information:

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SIR DOUGLAS WASS

THE EXCHANGE RATE

I attach two notes which may be relevant to your meeting tomorrow morning. One is about the nature of an exchange rate policy. The other summarises OF consideration of possible actions on the edge of present policy which might help to reduce the exchange rate. For the reasons given however we do not think much of them and, to the extent that they are new, we are not recommending them. I record them for completeness as options we have considered.

K E COUZENS  
 29 October 1980

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SECRET AND PERSONAL

1504/10

29/10/80

EXCHANGE RATE ACTION IN SUPPLEMENTATION OF AN  
INTEREST RATE REDUCTION

1. OF have considered whether, in a situation in which it was judged possible to reduce MLR by 2%, there are any steps which could be taken at the same time to secure some downward impact on the exchange rate:-

i. we would accompany the MLR cut with a single sharp burst of intervention to reduce the rate (say \$100 to \$200m.) This would be intended to prevent any perverse reaction from the MLR cut (inflows in anticipation of capital gains) and to signal to the market our wish that the interest rate reduction should produce a fall in the exchange rate. Thereafter the Bank could stay out of the market when the rate was falling: no smoothing on a fall. But there would be no continuing downward intervention on any scale after the initial burst. There would be a severe problem of explaining a limited intervention of this sort either at the time or soon afterwards if, as seems likely, it could not be done covertly. The formula would have to be on the lines that we were not embarking on an exchange rate policy and continued to give priority to control of the money supply, but attached importance to avoiding any perverse reaction from the MLR cut on the exchange rate. There would however be a real risk of a sharp fall in the rate (?like March 1976) if it were supposed that we had switched to an exchange rate policy.

- ii. we could suspend our policy of directing onto the market purchases of sterling by other central banks ("customer purchases");
- iii. we could take the opportunity of the fall in interest rates to draw the attention of some European etc sovereign borrowers to the possibility of borrowing sterling in the London market.

2. The first two of these ideas consist of taking extra risks with the money supply in an effort to reduce the rate, but without fundamental or permanent departure from present policy. There is however no guarantee that any of them would achieve anything worthwhile. The first might have some value as a gesture, but the risks are correspondingly higher: the possibility of misunderstanding in the markets; or of a market recovery once misunderstanding was removed which left the rate as high as ever; and the difficulty of explaining why a limited operation could be undertaken but not repeated. Half-hearted intervention could prove a waste of power and shot.

AN EXCHANGE RATE POLICY

1. An exchange rate policy designed to move the rate significantly away from the market rate will normally require both intervention and the use of interest rates. The two aims complement one another and can be used to some extent as alternatives. Countries which have an exchange rate policy (whether in the form of a target, or simply of a desire to lean strongly against the market) can be seen using both instruments. This applies to members of the EMS. It also applied to UK policy during much of 1977.
  
2. Whether an exchange rate policy can be described as a counter inflation policy (eg as an alternative counter inflation policy to a monetary target) depends on whether the general effect is to keep the exchange rate up. If the object is to get the rate down it must be an industrial competitiveness policy, not a counter inflation policy.
  
3. Large scale intervention in support of an exchange rate objective seems frequently to have been unsuccessful, especially with major currencies. The most striking example of success was the Swiss open-ended intervention of 1978, accompanied by temporary abandonment of any monetary target. The Belgians have from time to time beaten off bouts of pressure on their currency in the EMS, with the help of very high (real and nominal) interest rates.
  
4. If the UK switched to an exchange rate objective it would be desirable to consider whether this could be pursued at least inflationary cost by joining the EMS, once the rate showed signs of settling down under the new policy. Because the EMS involves an exchange rate target, it could land us with more intervention/ interest rate adjustment to achieve it than we might have to face in a less formalised situation, if we entered at the wrong rate or failed to change our rate to match changing circumstances.

But if the market accepted a rate we chose for entry to the EMS, either because they respected our determination or because they regarded it as realistic, we might get away with less intervention inside it than out. We would of course be under political pressure from the Commission to join.

5. What we would badly need in the EMS would be an understanding that we could readily move our rate in response to circumstances in the world affecting oil price or supply.

	1973	1974	1975	1976
	Actual	Value	Actual	Value
Oil	1,253	248.4	1,457	301.3
Coal	1,822	182.8	2,308	230.8
Other	227	22.7	289	28.9
U.K. Local Authority	380	38.0	472	47.2
Government	48	4.8	61	6.1
Other	1,225	122.5	1,373	137.3
Total	18,154	1,815.4	23,904	2,390.4
Total	11,278	1,127.8	14,700	1,470.0

... the year average level after 1975. The exception is 1977 when total foreign supply is 1.850 and value is 1.8 billion. But this is the only year in the period...