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Re TMP

c Mr Wolfson
D Wright (CO)
(Missing from Exchange Rate file)

10 DOWNING STREET

From the Private Secretary

6 November 1980

THE EXCHANGE RATE: LORD LEVER'S PROPOSAL

The Prime Minister has read the note on Lord Lever's proposal which you sent over under cover of your letter of 31 October.

The Prime Minister understands that the Treasury have issued instructions to the Bank to channel requests from their "customers" to purchase sterling through the market - with the purpose of reducing the money supply. This has clearly had some, though uncertain, effect in pushing up the exchange rate. On the other hand, she is well aware that the Bank have regularly been injecting liquidity into the banking system so as to reduce the pressure on the clearers' reserve assets, and that this has tended to inflate the money supply. She has accordingly asked whether the Bank have not been pursuing a contradictory policy; and in particular, whether it might not have been better to have handled "customers" requests for sterling off market. If this had happened, the exchange rate would be lower and presumably, the Bank's assistance to the clearers could have been less. In sum, we might have had a lower exchange rate for the same or similar money supply result.

You suggested when we spoke about this that there was a flaw in the argument: in particular, you argued that the Bank would have had to have provided the same amount of assistance to the clearers irrespective of more or less off-market handling of "customers'" requests in order to achieve the same interest rate result.

The Prime Minister has also pointed out that, although purchases of sterling by overseas holders have recently represented only a fairly small proportion of total inflows, the amount could still be large enough to have significantly affected the level of sterling: she has made the point that a relatively small shift in demand <u>can</u> have a big effect on price.

I should be grateful for a further note on these points which I can show the Prime Minister; we can then consider how to respond to Lord Lever.

T. P. LANKESTER

A.J. Wiggins, Esq.,
H.M. Treasury.

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

31 October 1980

T. Lankester, Esq.,
Private Secretary,
10, Downing Street

c/c Mr Wolfson

Dear Tim,

THE EXCHANGE RATE: LORD LEVER'S PROPOSAL

Lord Lever recently floated a proposal that a special sterling bond should be offered to suitable overseas authorities. We undertook to provide a critique of this proposal.

I now attach such a note along with a copy of the short paper Lord Lever sent in to explain his idea. As you will see, we do not think it would solve any problems.

At the end of his note Lord Lever throws in the thought that debt repayment should be covered by market transactions rather than the reserves. However this would be no different in its monetary effects to intervention with any other motive. So this, too, does not seem really to advance matters.

When the Prime Minister has seen the papers, perhaps we could have a word about how best to transmit her conclusion to Lord Lever.

yours

John

A.J. WIGGINS

THE EXCHANGE RATE: LORD LEVER'S PROPOSAL

Lord Lever's proposal is, in essence, that the Bank (or some specially created agency) should syphon off a proportion of inflows into sterling by offering a special sterling bond to overseas governments and other large investors, with the dollar purchase money added to the reserves. The idea is that this would neutralise the impact of the inflows both on the exchange rate, and on domestic monetary conditions.

The money supply and interest rates

2. There are a lot of snags to the Lever proposal. The first is that he overlooks the benefits to the money supply when overseas inflows go through the market.

3. If the exchange rate is floating, purchases of sterling by overseas residents must be matched by sales of sterling by residents. As a result the exchange rate rises. Some of the sterling will be supplied by banks as they switch into overseas currencies. But the scope for this is limited by prudential considerations. So most of the sterling will be supplied by non bank residents, mostly through a run down of their sterling bank deposits. This will directly reduce £M3.

4. Such transactions have exerted a strong contractionary influence on the money supply recently. It is estimated that they have reduced it by £4 billion since the end of 1978. The rise in the exchange rate caused by the overseas inflows has also exerted a less direct downward influence on £M3 through its effect on prices and hence the demand for bank lending.

5. To avoid losing part of this benefit for the money supply we asked the Bank of England earlier this year to modify the policy under which, hitherto, they had handled off-market requests from their "customers" (other central banks) to purchase sterling, with the dollar proceeds being added to the reserves. They now try to channel these requests through the market where they can. The result has been a smaller increase in the reserves than there would otherwise have been, a higher exchange rate, and lower monetary growth.

6. A simpler alternative to the Lever proposal, but one which would have very much the same effect, would be a temporary suspension of this instruction to the Bank. This possibility was listed in the Treasury paper of 10 October on Inflow Controls and Other Options for Reducing the Exchange Rate. It was rejected because of its implications for the monetary strategy.

Other difficulties

7. There are other difficulties with the Lever proposal:-

(i) In practice the special bonds might well have to be limited to overseas official holders. Purchases of sterling by such holders have in recent months only represented a fairly small proportion (about 17%) of total overseas inflows into banks deposits and Government securities.

(ii) An approach of this kind, which would have to be public, would be inconsistent with our policy of seeking to limit official sterling balances.

(iii) There is no stick available to use to divert such flows into a new special bond which would have to be unmarketable. We would therefore have to offer a carrot in the form of particularly attractive terms in relation to those obtainable on sterling deposits and gilts: and to restore the flexibility the purchaser would want, we would have to offer special encashment arrangements. All this could be costly; and would risk attracting additional inflows.

(iv) The Government would be taking an exchange risk, holding dollars in the reserves to match a liability denominated in sterling. Depending on which way exchange rates moved subsequently, this too could turn out to be expensive.

8. Lord Lever draws a parallel with the recent private German placement of 2½ billion - 5 billion DM notes with SAMA, even though this borrowing has been carried out in very different circumstances from our own. The Germans need to attract inflows to finance a large current account deficit. They would presumably find any comparable action by us both tiresome and unintelligible.

Conclusion

9. Lord Lever's scheme would seem unlikely to have any significant effect on the exchange rate and would remove a contractionary influence on the money supply. Any such trade off could anyway be achieved more simply by handling all Central Bank requests for sterling off-market. The Lever scheme would also bid up and complicate the Government's funding programme. It would be inconsistent with the policy of limiting sterling balances and unwelcome internationally.

/Paper provided by Lord Lever/

Exchange Operations

The price of sterling will go up or down according to the balance between its supply and demand in the market. The object of this proposal is to reduce the demand by meeting it at source thus avoiding monetary consequences of an equivalent direct intervention by the Bank of England. The demand on capital account is to a large extent by holders of other currencies who wish to convert into sterling fixed interest holdings as the preferred holding of their assets either for short or long periods.

An Agency should be created or an existing Department organised to supply that part of the demand which would be satisfied to have its sterling holdings in British Government guaranteed paper. The Agency would offer direct and outside the market sterling notes in exchange for major foreign currencies at the going rate of exchange at the time of the transaction. The way in which this would work in contrast with the present situation is best illustrated by a concrete example. Suppose the Saudi Government or Central Bank received at any given time $500 million in payment for oil and wishes to place $200 million of this in sterling perhaps with a view to converting this immediately or later into a sterling fixed interest investment, perhaps gilts. Suppose, too, (in order to place minimal strain on my arithmetic) that on the day in question sterling is trading at $2 to the £. The Saudis would be offered by the Agency a Government guaranteed note of £100 million in exchange for $200 million. This note could be of any date, short, medium or long and its terms would compete effectively with any alternative fixed interest British Government sterling security otherwise available to the Saudis. Indeed, they would avoid the commission, jobbers' profits and other expenses attached to buying and selling gilt-edged. The coupon would, of course, be payable tax free. The Agency would accept the obligation to redeem the notes on redemption date.

Suppose, for example, the Saudis were minded to place the money in a 5 year gilt-edged bond. They would under the present procedure have to go into the market, buy the sterling, place it on deposit with their broker or with their bank who would in due course buy the gilt-edged. The buying of the sterling would add to the pressure on that day's market. It would

also add to bank deposits although this would be corrected when the gilts were bought. In the interval it would be a possible source of monetary pressure. As these transactions are going on frequently there is a pool of such funds always in the hands of bankers and brokers constantly replenished and depleted and this could be directly or indirectly a source of monetary pressure.

The sales of these notes would add to the reserves but without any of the monetary consequences of a market intervention. The Bank would take in the $ and would hold them in $ in securities of their choice as with other reserves.

Although the main thrust of the notes would be at major buyers such as OPEC Governments and Banks, one could make the proposal more wide in its impact by appropriate detailed action on the terms. These notes could in fact be made into the equivalent of major intervention in the market with equivalent effects to the Bank's sales of sterling without any of the monetary consequences. (More details on this if wanted.)

However, initially, I would suggest that there should be energetic direct negotiations with some of the known major buyers to anticipate their needs and to keep them from buying sterling in the market by the direct exchange of these notes for foreign currency. If these efforts were successful they would become known to the market which would appreciate that a source of demand was likely to be deflected from the market and this would be liable to create a slightly less optimistic view of sterling's parity prospects. Indeed, if this action was developed on a suitable scale, it would have the mechanical and psychological effects of a known willingness on the part of the Bank to sell sterling.

I have given the example of a 5 year bond but these notes could be made to accommodate short money as effectively. The foreign buyer of these notes would presumably wish to hold them until he moved out of sterling. The Bank could then offer his redemption direct into the foreign currency of his choice at the then going rates. Here, too, this would also eliminate any abrupt or untoward pressure on the market. This would deplete the reserves but again without any difficulty to the Bank because they would hold the matching foreign currency.

<u>Early Repayment of Debt</u>

I am not sure what arrangements are at present made when early repayment of debt is encouraged by nationalised industries and others. If the foreign currency required is bought with sterling direct from the Bank, this has no effect on holding the parity down except such psychological consequences as arise from the resulting depletion of the reserves. The Bank should not offer foreign currency in exchange for sterling for these premature repayments. The borrower seeking to repay should sell sterling on the exchange markets, thus tending to increase its supply and reduce the parity.