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1-7-81

Copied to JSFF
to see CHS's comments

4FE440.07

Secret.

The Governor.

Thank you — extremely helpful.

Ch
8/7

Money & Exchanges
(I've no time to get this typed)

1. The £ has fallen to around $1.91 and the ERI to 93.2. There is worry that it will fall further and that there is nothing in place to help moderate or reverse such a fall.

2. As regards possible domestic policy action, it is clear that there are no fiscal measures to hand or called for — though signs/gossip of a weakening of fiscal resolve can make matters worse by further dispelling the 'Thatcher factor' in exchange markets. But a settlement of the C.S. dispute at 7½% ? might be better than allowing it to drag on with talk of it costing more in the end (via tax lost, airways losses etc) than 7½% w'd have cost at the beginning.

3. So attention focusses on short-term interest rates and/or exchange market intervention. As regards the former, there are forecasts & fears that the growth of £M3 may be excessive and require higher rates to hold it in check. But these are not fully considered/digested. Meanwhile the June figures (provisionals published next Tues) are apparently very good. So a hike in domestic rates would have to be presented as being almost exclusively 'for external reasons'. Politically disappointing and difficult.

4. If nonetheless HMG wants to move on rates, the great volatility of markets suggests need for a maximum flexibility in our responses to an evolving situation. Need come down quickly as well as up.

5. We can get rates up either by using the 'old' system (MLR) or the 'new' one (market forces plus open-market operations). If we go for MLR (? 14½), the move is clear-cut, and shows our hand for all to see. But:-

(i) It would maximise domestic discontent and maximise the clash with Tune money figures.

(ii) Its 'high profile' would render it vulnerable to market finger-pointing of the 'they haven't done enough and they will have to do more' variety. This risks great unpleasantness at the 'second round'.

(iii) It is less flexible downwards.

6. As regards the 'new' system: 3 month interbank is now about 12⅝% & hasn't responded to the fall in the £. 7 day rates are about 11¼. This pattern reflects the aftermath of the last exchange flurry together with persistent tendency to easy conditions o/a effects of the CS strike.

7. There is a surplus today (which has not fully appeared) and sizeable shortages tomorrow and Friday, and next week. We are now aiming to preserve the next 2 days' shortages as far as we can. If preserved these could be made effective and used to push up the very short rates via open-market tactics plus, if need be, penal lending. As and when this was seen, it is likely that 3 month rates would move up as well (more so if our motivation was also clear).

This would not seem so precise as MLR but the results would be obtained without the same degree of cards-upturned-on-table as an MLR shift.

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we might aim to 'nudge' rates up to 13% (7 days to 3 months) with perhaps the 3 month rates going above 13%. This might then be combined with heavier tactical intervention by EEA – which would also help to keep the money market short.

9. We would undertake this exercise and 'see what happens', with option to go further / stay put / retreat depending on what did happen. HMG would be seen to be going along with market forces – to some extent – with lower profile than with MLR and with cards less revealed. Also in line with HMG's declared intentions regarding new system. ? Less of a clash with June money figures

10. It c'd be unwise to press new system to deliver more, quickly, than the 1% + envisaged above. Could create too much anxiety / uncertainty, and expectations of a rise in rates to a degree that is not yet officially contemplated.

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