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Prime Minister

Is this paper, in broad terms, acceptable to you? (It doesn't, of course, commit you to any particular decision in advance.)

Yes not

MCS 29/4

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Michael Scholar, Esq
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26 April 1983

Dear Michael,

STERLING AND THE ELECTION APPROACH

When the Chancellor minuted to the Prime Minister on 28 March about the weakness of sterling at that time, he mentioned that the Treasury were preparing a short paper on the possible risks to sterling in the run-up to an Election.

... I enclose the paper, which has been seen already by Alan Walters and by the Bank of England, who are content with it.

As is noted in its concluding paragraph, the paper is concerned primarily with downside risks. Pressures in the opposite direction cannot by any means be excluded, and the preference we might express between different options would not necessarily then be symmetrical.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

STERLING AND THE ELECTION APPROACH

This note discusses the "political" risks for sterling over the months between now and the election and the options available should downward pressure develop.

Possible Scale of Effect on Sterling

2. The potential for downward pressure on the exchange rate is very large. Non-residents hold around £25 billion in relatively liquid form; modest leads and lags in trade payments could give a further £10 - 15 billion of potential movement; and even these sums are small in comparison to what residents might seek to shift out of sterling. With a floating exchange rate no net flows would take place: each seller of sterling would have to find a buyer. The exchange rate itself would have to fall far enough to prevent outflows taking place or to attract offsetting inflows.

3. Any estimate of the potential effect on the rate can only be an informed guess, with wide margins of error. The most severe impact would arise if the market as a whole came to believe that a Labour Government would be elected with a clear majority and committed to the policies already published. In that event, a reasonable guess is that the exchange rate could fall by some 20 per cent or so below its current level, to an effective rate of around 60. Such a movement would be within the broad range of previous experience in the UK and elsewhere, and it matches the estimate of a 30 per cent devaluation, from an effective rate then around 90, when the Labour Party economic programme was publicised late last year.

4. It is possible that the market is already marginally discounting the "political" risks, reflecting the inevitable uncertainty in spite of a run of opinion polls broadly favourable to the present government. But there is the prospect of reaction at any time to a shift in the opinion polls, as well as increased discounting for uncertainty as the date of the election approaches, or is eventually announced.

Other Factors

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5. The exchange rate will not in coming months be immune from factors other than "political" risks. There may well be further developments in and reactions to oil prices; adjustments of other exchange rates with an impact on sterling; and domestic economic developments - among which it may be far from easy always to disentangle movements prompted only by the political factor.

Economic Effects

6. The economic effects of a pre-election fall in the rate would largely depend on how long it was expected to last. The impact of exchange rate changes on inflation, output and employment in any case take some time to come through, and in circumstances where a fall was seen as being likely to be temporary the effects might be even less in the short run. But a depressed rate persisting for, say, 6 months or more, even if then reversed after the election, would leave some legacy of impact on other economic and financial developments and indicators, although realised in the main after the event.

7. The same political factors which might exert downward pressure on the exchange rate would, however, also be likely to have a parallel impact on short-term interest rates. This would not simply be an effect transmitted from foreign exchange operations, but a direct impact of the revision by investors of expectations about future inflation, in the light of a possible Labour victory, and the higher interest rates which would be expected to result.

Policy Options

8. The range of policy options is the same as that available in the face of exchange rate pressure from more normal causes. But to the extent that pressure could be clearly related to the political factor, the choice could be different.

9. Exchange

9. Exchange Controls could not in practice be re-erected quickly enough, except in the crudest of forms likely to be disruptive to trade and normal commercial relations. Even then they would not prevent movements by non-residents or through leads and lags on trade payments. The experience in 1976 was that even long established exchange controls, with the machinery tried, tested and running, were of limited assistance in the face of strong pressure.

10. Joining the EMS exchange rate mechanism would not of itself help, and would carry a commitment to defend the rate that could easily prove impossible to achieve in the circumstances. To try to join at a time of sterling weakness would be unwise.

11. Fiscal conditions have now been set in the Budget. It would be neither appropriate nor practicable to adjust them to counter a temporary pressure on the exchange rate.

12. Intervention in the foreign exchange markets could not hold the rate for long in the face of the kind of pressure envisaged. It could indeed make matters worse, precipitating a rush to sell while the inevitably limited resources for official support were still available. Publication of the fact that there has been substantial intervention may provoke further pressure. Nevertheless, as during the Falklands crisis, some modest "smoothing" intervention could be helpful to steady market nerves from time to time. It would help avoid an impression of complete unconcern; and depending on the election outturn such intervention could prove profitable.

13. Interest rates are the remaining policy option. As already noted, they could well tend to rise in parallel with a falling exchange rate, directly prompted by the same political considerations. It would be difficult to resist such upward movement in interest rates, and conspicuous efforts to hold them down could even prove counter-productive. In considering action or inaction on interest rates, it would be particularly important to weigh

/factors other

factors other than political risk which might be exerting influence. However, where the political factor alone was concerned, there would seem to be very little to be said for deliberately raising interest rates in order to attempt to halt a fall in the exchange rate. In so far as there was a choice, it would seem best to take the strain on the exchange rate. In practice it is likely to be difficult to isolate the purely political factor, and higher interest rates to prevent a fall in the rate accelerating out of hand cannot ultimately be excluded. But the main criterion for interest rate movements should remain the domestic one of avoiding sharp changes, away from the desired path, in the rate of growth of the monetary aggregates.

Conclusion and Presentation

14. There is little that can sensibly and effectively be done to resist a determined decline in the exchange rate during a period of severe market nerves over the prospective election outturn. Where the political risk is clearly a dominant influence, the strain will have to be taken on the exchange rate, and the prospect of occasional sharp falls in the rate would have to be accepted if market sentiment goes through severe changes. Some parallel rise in interest rates would probably be unavoidable, and conspicuous efforts to prevent this could be damaging.

15. However, even if the policy in practice has to be to allow the exchange rate to fall under pressure, it would be unwise to display complete lack of concern or to exclude any particular course of action since that too could make matters worse. In public comment, Ministers could draw attention to:

- the soundness of the UK's underlying financial and economic position;

- the reason for the pressure: market concern about the policies of the Opposition;

/- the temporary

- the temporary nature of the fall (and of any associated rise in the domestic interest rates);

- the exposure of those now speculating against sterling to being caught after the election.

16. This paper has been concerned with downside risks. Strong expectations of a Government victory would present a number of policy options including allowing the rate to rise; allowing interest rates to fall; and intervening to replenish the reserves. The choice would depend on immediately preceding developments and other circumstances at the time.