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From the Private Secretary

28 January 1985

Dear Rachel.

INTEREST RATES AND THE EXCHANGE RATE

The Prime Minister held a meeting this morning to discuss developments in the financial markets. Present were the Chancellor of the Exchequer, Sir Peter Middleton, and the Deputy Governor of the Bank of England.

The Chancellor reported that sterling had opened lower in the morning at $1.1100, reflecting concerns about the OPEC meeting in Geneva. Later in the morning money market interest rates had risen sharply to just over 13 and on the back of this the exchange rate had risen to around $1.1140. He had discussed with the Bank what response the authorities should make. While they had originally concluded in favour of raising interest rates by 1 per cent in the course of the Bank's 12.15 dealing operations, a further rise during the course of the morning, reflecting reports of disarray at the OPEC meeting, had made it clear that 1 per cent would be insufficient. It was decided, therefore, to raise dealing rates by approximately 2 per cent. At the same time the clearing banks were raising their base rates to 14 per cent.

The Prime Minister said she agreed with this course but felt it was important to establish the way in which it would be presented. She accepted that the Government did not have a specific exchange rate target but nevertheless she felt that sterling at its current level was a serious cause of concern for the Government. Not only did it put at risk the Government's inflationary objectives but it did not reflect accurately the true state of the British economy. She accepted that there was little that could be done through use of foreign exchange reserves. It was necessary, therefore, to deploy higher interest rates. As had been the case last July, she believed higher interest rates need only be temporary. The Prime Minister was particularly concerned that expectations about sterling in foreign exchange markets all ran one way. She hoped something could be done to make speculation against sterling a more risky proposition.

The Chancellor agreed that the behaviour of the exchange rate was a major cause of concern and that the Government was right to respond by raising interest rates. He advised,

however, that it would be dangerous to present this action as being in response to the level of the exchange rate. This could also too easily leave the Government in the worst of all possible worlds, seeking to control the exchange rate and not having the instruments required to do it. The Government could be faced with the question of what to do if, even after the latest interest rate rise, sterling fell further. If the market perceived that the Government was not prepared to intervene and had gone as far as it could on interest rates, the problem of one-way expectations would reappear. It was essential, therefore, to relate the Government's action to the need to eliminate doubt about its commitment to sound financial conditions and a reduction in inflation.

It was argued that to raise interest rates in response to exchange rate movements could push the Government off its medium term strategy. Interest rates were now very high in real terms. While there was little threat of higher inflation, there was a danger that recovery could be damaged. It was important to look at the totality of financial pressure. Against this it was argued that the market was concerned about the perceived willingness of the Government to relax financial conditions, particularly as indicated by the PSBR, bank lending and broad money and that higher interest rates, at least for a time, were a proper response.

The Prime Minister said she had seen the note prepared by the Treasury on the possibilities for mounting a "bear squeeze" and had noted that this was difficult in the absence of exchange control. She asked whether there was any way of operating in the very short-term money markets which would not spill over into other parts of the yield curve. The Deputy Governor said action to raise very short money rates would affect all the participants in the money market and could not be confined to speculators. High interest rates could contribute little to discouraging speculation as, even at their present level, the cost of borrowing overnight was likely to be small relative to the possible gain on the exchange rate. The most effective course was significant intervention but this was difficult while the UK's foreign exchange reserves were low. The markets were aware of the resources available to the authorities and of the fact that the Government had not undertaken any borrowing to replenish them. One possibility in the short term was activation of the Fed swap though this would be a very major step. The Prime Minister agreed that this should not be pursued at present.

The discussion then turned to the EMS. The Prime Minister said she had asked Mr. Lubbers why the Netherlands as a major energy producer was not experiencing similar problems to the United Kingdom. Mr. Lubbers thought that the EMS gave some protection as no major change in the exchange rate was expected, other than in the context of a re-alignment. The Deputy Governor pointed out that, even when re-alignments took place, there was often no change in the market exchange rates; all that occurred was that parities changed so that a given market rate appeared at the top rather than the bottom of the band. This left little opportunity for speculators to make significant gains. The Chancellor pointed out that the

Netherlands sold its gas under long-term contracts and was therefore less vulnerable to short-term movements in oil prices.

The discussion then turned to the US dollar. It was argued that, following the G5 meeting, there had been a perceptible change in US attitudes, and expectations about the future course of the dollar were now more evenly balanced. Nevertheless, the Fed was inhibited from intervening too strongly as it was worried that this could trigger a major fall. It was difficult for any central bank to be seen as a seller of its own currency. Ironically, one of the side effects of the more stable dollar was that the recent fall in sterling was identified as a UK phenomenon.

Summing up the discussion, the Prime Minister asked the Chancellor of the Exchequer to draft the line to be taken on the rise in interest rates. This should stress that the Government's action was not in defence of a specific level of the exchange rate but in order to eliminate any doubt about its commitment to reducing inflation. The Government should stress that markets were over-emphasising the impact of changes in oil prices. The Chancellor should continue work on whether, in present circumstances, it was right for the UK to join the EMS. The Treasury and the Bank should look further at whether there was any way of reducing speculative activity against sterling and should seek to identify opportunities for such action.

I am copying this letter to the Private Secretaries to the Governor and Deputy Governor of the Bank of England.

Yours sincerely

Andrew

(ANDREW TURNBULL)