SUBJECT
cc MASTER.

File

10 DOWNING STREET

LONDON SW1A 2AA

25 March 1988

From the Private Secretary

Dear Alex,

EXCHANGE RATE POLICY

The Prime Minister held a meeting his morning with the Chancellor and the Governor of the Bank of England to discuss exchange rate policy. The Deputy Governor, Sir Peter Middleton, Sir Terence Burns, Mr. Eddie George and Professor Brian Griffiths were also present.

The Chancellor introduced a paper on monetary policy and the role of the exchange rate. He said that there was clear agreement that the primary objective of monetary policy was to bring down the rate of inflation. But against the background of changing world conditions, particularly progressive deregulation of financial markets, it was necessary to adjust tactics in order to ensure that the continuing counter-inflation strategy remained effective. This evolution in recent years had involved taking greater account of the exchange rate; all the major industrialised countries had been moving in that direction. There were clear advantages of greater exchange rate stability once low inflation had been achieved; it imposed a discipline on and gave increased confidence for business planning, and increased international confidence in the British economy. Moreover when all the other major countries were pursuing a policy geared to greater exchange rate stability, if the UK did not behave in a similar way there were dangers of sterling becoming the focus for currency speculation and instability.

Continuing, the Chancellor said that on occasion there could be conflicts between the containment of inflation and the desirability of greater exchange rate stability. This was likely to arise infrequently, but when it did there was no doubt that control of inflation had to take precedence. The aim of intelligent management of the exchange rate was to create favourable expectations amongst market operators so that the markets worked with the authorities and not against them.

In discussion the following main points were made:

(i) It was important to ensure there was sufficient flexibility in the use of the three monetary policy instruments - the exchange rate, interest rates and

intervention. Ruling out all freedom of action for any one of these was likely to lead to excessive reliance upon the others.

(ii) In the six years 1981 to 1986 sterling had depreciated both against the deutschemark and in effective rate terms. In the circumstances of that period there had been good reasons for this. But this experience had given rise to an expectation by business that a steady depreciation of the exchange rate was the norm; this led to a serious risk of an inflationary bias in the economy. It was essential that industry understood that the authorities were not prepared to countenance a regular depreciation. In order to achieve credibility on this point the authorities should be seen to be taking action to limit appreciation of the exchange rate.

(iii) There had been periods, for example in 1981 and 1985, when the authorities had stood back from the markets and not pursued an active policy of exchange rate management. On these occasions excessive movements generated by the markets had led to difficulties, and in the end the authorities had needed to step in.

(iv) A major difficulty in pursuing greater exchange rate stability was the need to make judgements about the appropriate or credible levels of exchange rates. This was the more difficult given that substantial shifts were constantly taking place in the relative performance of different economies.

(v) The key requirements for controlling inflation were to pursue sound public finance, to provide incentives and to ensure that business responded to the disciplines of the market. Although greater exchange rate stability was desirable this had to come as a consequence of sound policies, and could not be elevated to the status of an objective in its own right.

(vi) Setting targets for the exchange rate involved gearing UK policies to those being pursued in the other major economies. This presented major risks.

(vii) If foreign exchange intervention was subsequently sterilised through funding policy this should prevent any inflationary consequences. On the other hand the very act of funding intervention could offset its initial impact on the level of the exchange rate.

(viii) The level of UK foreign exchange intervention in 1987 and during the two days prior to the lifting of the DM3 cap had been exceptionally high. It would not be appropriate in future to intervene on such a scale.

(ix) If as a result of the authorities' intervention tactics the market perceived that a precise limit or range was being set for the exchange rate this presented market operators with a one way option. The longer any limit was defended through intervention, the greater was likely to be the subsequent adjustment in the exchange rate.

(x) The Treasury paper had not included a conceivable fourth option of totally free floating. There was no support for such an approach. It was difficult to draw a precise dividing line between the first and second options in the paper, namely (i) taking the exchange rate "into account" and (ii) an explicit statement about the desire for greater stability. But there was a major step involved at some point in this continuum in moving from "taking account of" the exchange rate to "taking a firm view on the right rate".

(xi) It would not be appropriate for the UK to be seen to resile from participation in existing international agreements about seeking greater exchange rate stability.

Summing up the discussion the Prime Minister said it was agreed that the primary objective of monetary policy was the control of inflation. That depended on the adoption of sound underlying policies. Subject to that over-riding point, greater exchange rate stability could bring advantages to the economy. There was a role for foreign exchange intervention, but this should be restricted to a scale very much less than had been carried out over the last year, and the authorities should avoid becoming committed to precise levels for the exchange rate. Monetary policy should be operated so that flexibility was preserved for the possible use of each of the three available instruments, namely movements in interest rates, intervention and adjustment in the exchange rate. The appropriate policy mix had to be reviewed on a regular basis.

I am sending a copy of this letter to John Footman (Bank of England).

Yours,
Paul

(PAUL GRAY)

Alex Allan, Esq.,
HM Treasury.