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PRIME MINISTER 13 June 1989

A CHAIN REACTION -
THE EXCHANGE RATE AND MONETARY POLICY

A. The 4 to 1 Rule

In discussions with the Treasury and Bank, I have become increasingly worried about the Pavlovian reaction of our monetary policy to exchange rate movements - or indeed the Authorities' anticipation of such movements and the reaction of the market. To illustrate, there was some considerable support for arguing that, if our £ERI fell to 88 (from the 92 of last Friday), we should increase interest rates by 1 per cent.

This is the sort of rule-of-thumb, which Charles Goodhart says in the June ECONOMIC JOURNAL emerged from the "Treasury Model", that explains the interest rate policy pursued in 1987 through to mid 1988. As the exchange rate rose 6 pfennigs (2 per cent), interest rates were reduced by 1/2 per cent. For present conditions we translate this: when the exchange rate falls 4 per cent, then interest rates are increased by 1 per cent. Nothing has changed except the direction.

B. Self-validation and chain reactions

It is claimed of course that there will be great discretion in interpreting exchange rate movements - discovering whether they are due to monetary policy or the many other events which have a considerable effect on rates. But the market believes, with Goodhart, that the Treasury is operating a rule. I suspect that the Chancellor's speech at Wednesday's debate was interpreted as confirming the rule. So the

ie the sentence we discussed at lunchtime.
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market reacts to such exchange rate movements and the rule becomes self-validating. There is no room for discretion.

Worst of all is the chain reaction which may set in. Suppose we have a string of bad poll results in 1990 or early 1991. The market will interpret this as increasing the probability of a Labour government and will start a capital flight, eroding exchange rates, increasing interest rates, eroding our poll support, and so on in a chain reaction.

C. Experience in 1983 and 1987

Fortunately in 1983 and 1987 there was no reputable (i e believable) poll that gave any significant chance to a Conservative loss. Nevertheless we had already taken some action to counter a potential capital flight - issuing more indexed linked gilts, and in 1983, a convertible. Fortunately the polls were so consistently good we did not need them. The boat was not rocked. Sterling was under no threat at all.

I do not think it would be wise to anticipate confidently a re-run of 1983 or 1987 in 1991 or 1992. We need to make sure that the markets know we are for ever off the 4 to 1 treadmill. Even those who believe in the primacy of the exchange rate in determing monetary policy must recognise that the 4 to 1 rule is not the way.

D. What can be done now?

The obvious "tough-it-out" policy of strictly fixing interest rates to conform to our monetary growth and ignoring completely the exchange-rate-poll reaction is economically right.*

But it is politically unrealistic - especially for sharp and sudden falls in the exchange rate, even though these falls are clearly due to changed electoral prospects.

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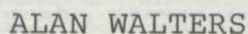
We do not need, however, to oppose and fight a <u>gradual drift</u> in the exchange rate. And this should be made perfectly clear to the markets. The "4 to 1 rule" should be abbrogated.

In fact we have already made a start in divorcing monetary policy from this rule. It has been relatively easy because of the decline of the Dmark against the dollar. <u>What we ought to avoid is being manouvered on to a new rule with respect to the effective rate.</u> One such translation of the old Treasury model rule would be that, for every depreciation of 4 points on the ERI, interest rates should increase by 1 per cent. (This is consistent with the Treasury view that, if the ERI fell from its present 92 to 88, interest rates should increase by 1 per cent.) Provided that we drift gradually to 88 - over a period of (say) more than three weeks - and provided that the markets are not inexorably pressing, we should <u>not</u> increase interest rates.

This gradualist policy is feasible both politically and economically, and would allow the adjustment of exchange rates to the underlying realities. It would also send a message to the market that we were not operating on any rule of a 4-to-1 kind. This would reduce, but not eliminate, the chain reaction effect.

* Today, the BIS have come to our assistance in condemning policies pursuing nominal exchange rate stability. It points out that such policies hinder adjustments for past inflation and for current account imbalances.



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