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CEP

PRIME MINISTER

11 October 1989

INTEREST RATES AND STERLING

1. OVERKILL

Interest rates at 15 per cent are likely to give us a sharp recession in 1990 perhaps running into 1991. I have argued that for domestic reasons interest rates circa 12 per cent (or even 13 per cent in extremis) were appropriate and would deliver an inflation rate below 5 per cent by mid-1991. With the very important provision that we allow the market to determine the exchange rate, that is to say no "targetting" and intervention, I am still of the opinion that 12 per cent was correct.

Received Treasury opinion is that the interest rate rise to 15 per cent was needed because the domestic economy indicators were not obviously contracting fast enough. The Bank demurred, saying that the economy was slowing but admitted that it was not certain. (One might ask, is one ever certain?!) But the Dm 3.0 level was widely seen as the target which would trigger interest rate rises. With some but not too much reluctance, the Bank acquiesced to the "defence of sterling" policy.

2. EXPECTATIONS RULE

What is driving us is not the domestic economy but the convictions of market operators that we have an exchange rate policy. They see it as a combination of holding at certain levels (often called psychological parities such as Dm 3.0) and, if the exchange rate does go through the barrier, allowing only a slow movement. That is to say, the authorities are expected to counter any potentially sharp fall with intervention and interest rates.

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● Sterling is a one way bet. It is expected to depreciate perhaps by some 10 per cent over the next year. If such an expectation is firmly held, the yield on sterling assets must offset this loss on the exchange rate. If the interest rate on one-year Dmark paper is 7 per cent, then the yield on sterling paper must be near 17 per cent.

Of course no movement of exchange rates is certain. But while the expected direction is down, the pressure on interest rates is always there. Under conditions of an expected fall, it is impossible to prevent a rise on the money markets. It was in this context that I believe you had no recourse but to acquiesce in the rise to 15 per cent last week.

The fault is in giving markets a one-way bet by pegging and then delaying or slowing the fall in the exchange rate to its new market value. Whether one believes that 12 to 13 per cent or 14 to 16 per cent is the right policy for domestic purposes is then irrelevant. You will automatically be driven to the high levels of interest rates. The Government can be accused of losing - indeed throwing away - control of monetary policy.

3. ADJUSTMENT OF EXCHANGE RATE AND THE PRICE LEVEL.

Weaning the market from these only-too-warranted expectations is a difficult task. But acquiescing will cost us dearly - as the 15 per cent illustrates.

The exchange rate will eventually go down. The longer we delay the fall, the longer will we have high interest rates. This fall will be a consequence of past monetary expansion. The fall will not cause inflation. Both inflation and the depreciation are consequences of excessive past monetary growth. We can only delay and distort both the consequential inflation and depreciation by price and exchange intervention (both forms of subsidy). But we cannot stop them.

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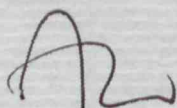
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You took a strong line in 1988 to stop the attempt to keep sterling rising above Dm 3.00. Now you need to take an even more difficult decision of allowing sterling to fall freely to its new market value. As I have urged to the Chancellor, a 17 per cent interest rate would soon generate a deep recession. I suspect also that it would be simply politically unacceptable. On the other hand, sterling at Dm 2.80 and at \$1.40 or so would be a basis which would generate a growth in exports and import substitutes in 1991. We would cease subsiding imports through an artificially maintained exchange rate.

4. A SUGGESTION

I suspect that the only way to make stick a policy consisting of monetary control and a free exchange rate is to announce it as a formal policy. It may be put forward as a medium term three year measure, rather like the old MTFs, because of the need to get our inflation rates and interest rates down to the OECD average. The Chancellor then could see it as an interim policy to get the inflation and exchange rate ready for a decision in 1992 or so on joining the ERM. It would get the Chancellor off the horns of his present dilemma.

Most important, the shadow of the Election in 1991 or 1992 will affect financial markets. If the present poll results do not turn sharply against Labour, portfolios will increasingly start to diversify out of the UK. This puts downward pressure on the exchange which, on past expectations, raises interest rates. This in turn will boost Labour's chances, so exacerbating capital flight ... and so on. This sorry process, loaded in favour of their financially irresponsible policy, must not be allowed to gather force and votes.



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