FROM: P E MIDDLETON
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Chancellor of the Exchequer

cc Sir Douglas Wass
Mr Burns
Mr Littler
Mr Monck
Mr Lavelle
Mr Odling-Smee
Mr Turnbull
Mr Sedgwick
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Chief Secreta
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SHORT TERM INTEREST RATES

1. I promised to let you have a note on the way in which the authorities could resist a rise in interest rates. The attached note by HF3 has been prepared in consultation with the Bank.

2. At the risk of some slight repetition, perhaps I could go through the key points in summary form.

3. We cannot control markets. We can only influence them. We do this <u>by influencing their expectations</u>:

a. more fundamentally about the inflation prospect

b. more immediately, but closely related, about our tactics.

4. Expecations can be influenced in two ways:

a. by what we say about policy, and by what we are seen to do.

b. by spending money - markets are impressed by large sums of money.

<u>What We Say</u>

5. The policy line for some time has been that interest rates are influenced by the authorities to keep monetary conditions consistent with continued downward pressure on inflation. The exchange rate is seen as an important element in the assessment of monetary conditions. There are two ways of looking at its role:

a. as an <u>indicator</u> of tightness. We are never sure about our own assessments. A weak exchange rate may be telling us that conditions are slacker than we think - that we should be recouping some past monetary overshooting for example.

b. as a <u>contributor</u> to the tightness or otherwise of

monetary conditions - though the pressure it exerts on the company sector and on importers pricing.

6. This line or approach has led us to say that:

a. interest rates should not move automatically with either the monetary aggregates or the exchange rate

b. there comes a point when the exchange rate falls when we should wish to see interest rates raised - if other aspects of the monetary picture remain unchanged.

c. sufficient adjustment has taken place with the last rise in interest rates so that no furtherrise would be required if the exchange rate fell further.

7. If we stick to this line there is a problem about how we attempt to sell it. We can either:

a. try to persuade the markets that the exchange rate is firmly based - in this case there will be little tendency for the interest rates to rise.

or b. try to persuade them that we do not need to raise interest rates if the exchange rate falls either because:

i. as monetary conditions other than the exchange rate remain satisfactory, any fall in the exchange rate may be temporary; or

ii. there is no connection between the exchange rate and inflation so long as the monetary targets are kept to. Any acceleration in inflation will only be temporary.

8. Whether we succeed or not will depend on the circumstances. But clearly it is easier to achieve the desired result on interest rates if we can do (a). Three circumstances seem necessary to have a good chance of succeeding - on the assumption that the monetary position does not change:

i. the oil market needs to be moderately stable. Prices down a bit - $2-$3 - seem to be discounted. But more than that could cause renewed pressure on oil account. The OPEC meeting does not seem to have been very helpful in this respect.

ii. overseas interest rates need to be stable or in modest decline. Once again there are difficulties in interpreting US intentions.

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iii. we need to attack the idea that is prevalent in the market that sterling's natural value is 30% or so below the present rate on competitiveness grounds. Very little inroad has been made in this so far.

9. Course 7(b) is much more risky. It would require a lot of courage to maintain this if the exchange rate was falling rapidly. In its more extreme form (bii) it can look like a significant departure from the present policy stance. Markets know that exchange rates can both overshoot and stay overshot for a considerable time. Moreover the stance can easily be interpreted as determination to hold interest rates whatever the cost - the very opposite of a money supply policy with flexible interest rates.

Spending

10. Policy can be supported by spending money. It follows from para 7 that we can spend it in one of two ways:

a. in the foreign exchange market. This can work for a time. But continued heavy intervention is not a feasible policy. The fall in the reserves - which are finite - causes uncertainty, and intervention removes the risk of withdrawing sterling. Moreover it complicates the perception of monetary policy. All this is compounded if the natural result of this intervention to tighten domestic markets is relieved by further spending.

b. in the domestic markets. This can also have a temporary effect. But it can easily fuel a fall in the exchange rate if it is thought that it represents a complete reversal of policy - keeping interest rates down by increasing the supply of money. The resulting lower interest rates may induce residents to borrow to buy dollars. So though the money supply may be stable or even contract, the domestic generation of money rises rapidly - the reason the IMF set us DCE targets. It is rather like trying to convince the markets that raising public expenditure will increase the chances of being able to cut taxes.

11. Over anything other than short periods, spending money on a huge scale may not only fail, but be counter-productive. To

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succeed, spending has to be seen as justified by underlying conditions and the authorities' policy stance. Large scale spending tends to have the unfortunate effect of looking like an attempt to avoid necessary adjustments; it confirms the market in its original position.

12. It would be useful to have an early discussion on the basis of Mr Turnbull's note.

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