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1 February 1983

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
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cc The Deputy Governor.
Mr Loehnis
Mr George.
Mr Fforde
Mr Dow
Mr Coleby.
Mr Flemming
Mr Goodhart.
Mr G M Gill.

(My dear Geoffrey)

At our meeting with the Prime Minister just over a fortnight ago it was made clear that a primary objective of policy for the period ahead should be to avoid any further general increase in short-term interest rates, including particularly clearing bank base rates. This objective has subsequently been given prominence in statements made by both the Prime Minister and yourself.

Market conditions during the period since have been turbulent but not unmanageable. In the exchange market sterling has been adversely affected by further uncertainty surrounding the oil price following the breakdown of OPEC talks; and it has weakened against the dollar, as have currencies generally, as hopes of a further early decline in US interest rates, including a cut in the Federal Reserve's discount rate, have faded. Given these developments, sterling has held up reasonably well, with the ERI opening at 81.0 this morning, a little above the level it had reached before the rise in base rates on 11 January, and the £/$ rate at $1.52, a little above the low point reached a week ago. In the domestic markets there was considerable pressure in the immediate aftermath of the break-up of the OPEC meeting, but the combination of your statements and determined overprovision of cash to the money market helped to calm things down, and while the situation remains very fragile the 11% level of base rates is not as I write under immediate threat.

Looking ahead, it may be that the exchange rate and domestic interest rates will now consolidate at present levels. I am hopeful that the provisional money figures to be announced in a week's time will underline the firmness of the monetary stance; and there are few market doubts as to the resolution of your fiscal position, in marked contrast at present to the situation in the US.

But, despite the firmness of financial policy generally, and notwithstanding the depreciation (12%) that has already occurred, there is, as you know, still in my view a significant possibility that sterling could fall substantially further without finding a clearly sustainable level. Whatever we may think, there remains a widespread market perception that sterling is overvalued against currencies generally (with the CBI continuing to emphasise that industrial competitiveness remains 20% lower than in the mid-1970s); and this leaves the exchange rate vulnerable to shocks emanating from the US, from OPEC or from domestic political uncertainties.

If serious pressure on the exchange rate were to re-emerge, it could come upon us suddenly, giving little time to consider possible policy responses. I believe it would be useful therefore if, while there is a lull and while there is not any immediate policy decision to be taken, we could hold a small meeting to discuss this contingency. Given the domestic financial situation and the still fragile prospect of economic recovery, I would not wish to dispute that, in the first instance, if a further sterling slide were to develop, we should allow the exchange rate to take the strain and make all reasonable efforts to hold on to the present level of interest rates.

On the other hand, I am concerned that there could come a point beyond which further depreciation would seriously undermine the present basis of policy, because of its implications for future inflation, and so add to political uncertainties. It is not possible to foresee a precise point at which this situation would emerge: much depends upon the circumstances in which the fall in the exchange rate occurred. There would be particular danger, in our view, of a crisis atmosphere developing if the exchange rate were falling rapidly without any response from government.

The dilemma which we would face in this situation - as indeed we did face in November and again three weeks ago - is that official inaction, whether in the exchange or money markets, or, still more, the high profile action that might be taken in the attempt to hold market interest rates down, would carry the risk of intensifying the market pressures and so make matters worse.

As I have said above, I am not suggesting any alteration in the immediate stance of policy. But because of the speed with which circumstances can change, I am anxious that we should consider the possibility of this worst-case scenario and recognise the risks that it would carry.

For the immediate future, such considerations could have some bearing on the presentation of policy. In particular it is important, in our view, that policy should continue to recognise the relevance of the exchange rate and not come to be interpreted by the outside world as complete indifference towards it. In that context it would be unwise to encourage suggestions that positive policy action, including interest rate action, was totally excluded if that should become necessary to control a further plunge in the exchange rate.

(Yours ever)

(SGD) GORDON