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Prime Minister (2)
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ALAN WALTERS

PRIME MINISTER

EXCHANGE RATES: THE APPROACH TO THE ELECTION

As we approach the election, we must expect that sterling will become volatile. The exchange rate is likely to slide quite dramatically if there are even small changes in the public opinion polls.

The underlying exchange rate will, of course, reflect our monetary policy relative to that of the rest of the world. But the day-by-day exchange rate will behave rather like the ordinary share of a company in a risky market. It will oscillate sharply to reflect the changing expectations of the market.

As I mentioned in my memorandum of 15 March 1982 (copy attached) I expected the effective exchange rate to decline to a low of around 85, mainly through the appreciation of the Deutschemark and Yen. We have got somewhere near that value in the last two weeks. But it may well be that we shall slip substantially below 85 if the Labour Party becomes more credible as an alternative government.

In the ^{iv}political area of exchange rates, the additional uncertainty, alarms and excursions will come with an approaching election. It would be very damaging if we tried to prevent such politically-induced depreciation either by intervention or by increasing interest rates. There is general agreement that intervention could not work; we simply haven't got the reserves to beat the market. This leaves us with the weapon of monetary policy and interest rates.

Increases in interest rates would have a speedy effect in reducing monetary growth and in damping down real activity and aborting any recovery. We have seen this on a number of occasions in the past three years. Furthermore the lag in their effect is now quite short, probably only about three months elapses before the contractionary effect is felt in output and activity (see graph of the United States M1 against industrial output, attached).

In order to stop or reverse a depreciating pound, quite large "crisis" increases in interest rates would be necessary - comparable to the 4% increase that was introduced in September and October of 1981.

/The consequences

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The consequences were then very painful. There was a sharp contraction in the rate of monetary expansion and in the rate of recovery.

Such a monetary squeeze, induced artificially by the imminence of an election, is very damaging, particularly to an economy that is in the process of emerging from a recession. We should avoid it like the plague. The best policy is to maintain the steady monetary conditions, to avoid the punitive increase in interest rates, and to let the exchange rate find its own level.

In political and electoral terms, it is much better to preserve the stability which has been the hallmark of this Government rather than engage in a pre-election squeeze in order to defend sterling. It would be at least plausible to blame the Opposition for the slide in sterling. But on the other hand, we could not convincingly blame Labour if we introduced a fierce financial contraction,

A fall in sterling is often said to induce inflationary expectations. I do not think that this would be the case. If we were returned in the election then sterling would get back to its long run value. The fall would have no effect on inflation. I suspect that the markets would appreciate that point. The correction would be swift and sustaining.

Our policy should be to maintain a low and stable monetary growth and a programme of declining deficits. This is the best contribution we can make to a stable, non-inflationary economy. If we attempt to eliminate the politically-induced and artificial swings of the exchange rate, we shall only destabilise the economy, induce a contraction and damage our electoral advantage.

If you agree with this policy, there is a good case for making sure all ministers and main spokesmen both understand it and agree. It would be damaging if ministers or spokesmen made remarks saying the exchange rate is too high or too low. They should follow the model of your answer in the House on Tuesday.

I would be happy to expand on these somewhat cryptic and sybilline statements.

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e.g. Mr
Parkinson
on Tuesday
"Sterling is
now
undervalued"