

MR TURNBULL

SECRET

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EXCHANGE RATE POLICY AND FUNDING

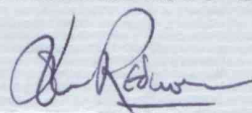
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Mr McMahon's statement on 15 November that direct intervention in foreign exchange markets was "a useful policy instrument" particularly when "national authorities are seen to act convincingly in concert" could be the beginnings of a dangerous shift of emphasis by the Bank. The Deputy Governor was on better ground when he stressed that fiscal and monetary policy had to be the prime means of responding to exchange rate pressure, and that all policies had to be in harmony for there to be success.

The Bank has also shown signs of wavering over funding policy at the last two funding meetings we have had. The Bank have been trying to move to a position where they sell more longs at lower prices than is necessary given current market circumstances.

We should resist these moves, and I am doing so at the funding meeting. The gilt-edged market in the last 2 months has been quite buoyant enough to make good sales of shorter-dated and medium-dated stocks, index-linked and convertible stocks not to need to alarm the market by returning to the long end to make funding possible. The disappointing money supply figures for banking October in part reflect a certain reticence to sell stock against a market background that would have accommodated more sales.

The Economic Secretary and the Treasury are steering a sensible course against the background of a restless Bank attempting to reverse some of the progress achieved in the last 2 years both in funding and in foreign exchange intervention. I do not think you should do anything at this stage other than note the drift in some of the Bank's statements. A satisfactory reception to the Public Expenditure Review, coupled with some more enthusiasm on the part of the Bank to take advantage of favourable market conditions under the stimulus of the Economic Secretary, should be enough to produce more satisfactory November and December figures. The only appropriate ways to tighten credit conditions at the moment are by holding a firm line on public spending and by continuing with the funding policy. Foreign exchange "stabilisation" is very rarely a good idea, and if the market got wind of a major change of policy, we could be involved in considerable expense in trying to hold any particular rate.



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