SECRET & PERSONAL 21.1.83

THE GOVERNOR

Copies to The Deputy Governor
Mr Loehnis
Mr Fforde
ONLY

I attach a first draft of a letter which you may wish to consider sending to the Prime Minister following your meeting with her on 13 January and in response to Scholar's minute of that meeting.

Given the presentation which has been adopted by the Prime Minister and particularly the Chancellor since your meeting, a letter on these general lines will no doubt be unwelcome. Nevertheless I believe that the approach they are adopting carries substantial risks which we need to point out on the record.

21 January 1983
Dictated but not seen by Mr George

SECRET DRAFT (21.1.83)

BANK OF ENGLAND
LONDON EC2R 8AH

Dear Prime Minister

INTEREST RATES

Reflecting on the recent discussion with yourself and the Chancellor, and on the events that preceded that discussion, I thought that you might find it helpful if I were to set down why interest rates should have risen in response to the fall in the exchange rate even though financial policy is fundamentally sound and even though interest rates abroad are tending to decline; and to examine some of the implications for policy.

A key element in the background to recent events has been an increasingly widespread market perception that sterling is heavily overvalued. As domestic expenditure, especially consumer spending, began to pick up through the summer, with little sign of a corresponding recovery in domestic output, market attention focussed increasingly on the competitive position of UK industry, which, on the conventional calculations, could be shown - before the exchange rate started to fall - to be as much as 30-35% less favourable than in the mid-1970s. Sterling was seen to be vulnerable to very large depreciation on this account. When sterling began to be affected too by concern about the oil price, by the backwash from the overdue adjustment between other major currencies, and by political uncertainties, there were many in the market who could see only a large downside risk: sterling could fall a very long way before it found a clearly sustainable level from which it might be expected to bounce back of its own accord. On this view the exchange rate is overvalued in an underlying sense however sound the UK's financial policies and whatever is happening to interest rates abroad: indeed the counter-inflationary stance of policy is seen of itself to have contributed to sterling's overvaluation.

One can of course take the more sanguine view that such fears were always exaggerated and that particularly now, after the large (12%) depreciation that has occurred, the exchange rate is broadly

appropriate to our competitive position so that any further fall in the exchange rate would be relatively small, and would be quickly reversed. That may indeed be the case, although it was one of the most worrying aspects of the recent fall that even as the ERI plunged towards 80 there was no sign whatsoever of spontaneous recovery. But it would be dangerous, in the circumstances in which we find ourselves, to rely upon that view, and to ignore the possibility that substantial downside risk to the exchange rate remains. It is this possibility that lies at the heart of the difficulty for policy.

Turning to the implications for interest rates, it has to be expected that market fears of the possibility of a large fall in the exchange rate which would not necessarily be reversed, at least for some considerable period, should give rise to fears of higher domestic interest rates and be reflected in a rise in interbank rates which are - certainly at all but the very short end - essentially market-determined. There are several reasons for this, important among them being -

(i) No government in any major country could ultimately fail to respond, with an interest rate move, to what could - on this perception - turn into virtual exchange rate collapse. Market interest rates would rise if there was even a remote possibility of this.

(ii) The acceleration in the RPI that would be seen to be implied by a large and lasting fall in the exchange rate would directly impact on interest rate expectations.

(iii) The effect in (ii) would be especially pronounced both because of the resolute counter-inflationary stance which has been consistently pursued by the present Government, and because the presentation of policy has explicitly recognised the exchange rate as a factor which the authorities take into account in assessing monetary conditions and determining the appropriateness of the level of short-term interest rates.

Certainly as a matter of fact this has been the effect: for most of the period since November short-term market interest rates have been tied directly to the movement in the exchange rate.

The action that we have taken in response to these pressures throughout the period has been designed to loosen those ties by making

it plain that we were reluctant to see interest rates rise. We regularly overprovided the money market with cash through our bill dealing operations, at unchanged interest rates, even though interbank rates rose substantially. (In addition, of course, during December we undertook sizeable tactical exchange market intervention to protect the exchange rate, and thereby the expectational pressure on interbank rates, from what might well have proved - though did not in the event prove - to be reversible pressures around the year end.)

These tactics did not prevent a rise in interbank rates whenever the exchange rate weakened particularly sharply - especially against the dollar. For prolonged periods, including most of December, the level of interbank rates relative to base rates was such that commercial borrowers switched their borrowing to overdrafts, and the clearing banks were obliged to finance such lending, at a loss, by themselves bidding for interbank deposits. /At times the level of interbank rates relative to base rates was such as to offer opportunities for hard arbitrage (borrowing on overdraft and redepositing the funds at a profit in the interbank market) which would not only have increased the commercial pressure on the clearing banks, but would also have artificially inflated the money supply./ In these circumstances a rise in base rates ultimately became unavoidable - certainly without much higher profile action on our part as discussed below - in November and again last week. On both occasions we conspicuously left it to the banks to make the move, deliberately refusing to give a lead ourselves. We did this because of the anxiety which others felt that more positive official interest rate action could have been seen as an attempt to defend a particular level of the exchange rate, or as a direct reflex response to the weakening of the exchange rate, so reinforcing the market's natural tendency to react in this way. Immediately after the event on both occasions we consolidated the rise in base rates in our own dealing rates in order to minimise the risk of an immediate further rise in interest rates generally.

The dilemma that we faced throughout this period was that our visible reluctance to see interest rates rise, and refusal to give a lead to the money markets, could have been interpreted as a willingness, or even a positive desire, to see the exchange rate fall. The risk was that this in turn might aggravate both the fall in the exchange rate and the associated upward pressure on interest rates. This undoubtedly occurred on 11 January as was widely reported in the Press the

following day reflecting market comment; a case can be made, but not of course proved, that our chosen tactics may have had a more general effect of this sort. In the end the situation which presented itself, both in November and again last week, came down to a choice between accepting the 1% rise which the markets were signalling at the time, or taking the risk that by visibly denying that rise we would aggravate market pressures to the point where an immediate greater rise in interest rates became unavoidable.

Consideration of what further steps might have been taken to avoid, or further postpone, the rise in interest rates only serves to point up this dilemma: essentially the problem is that, whereas no one wanted to see interest rates rise, more overt action to hold them down (in direct contradiction of one of the major declared aims of the present monetary arrangements which was to enhance the scope for market influence on interest rates) would have risked making matters worse because of its counter-productive effect on expectations.

Simply pumping more cash into the money market could have made the overnight interbank rate softer than it was, and some of this effect might have spread to the 7-day rate: but at the same time it could have added to the selling of sterling in the exchange market technically by facilitating, and cheapening, the financing of such sales: and it could have had a perverse effect on expectations in both the exchange and money markets thereby putting additional upwards pressure on the interbank rates for longer periods than 7-days.

Alternatively we might have tried to work on the longer-dated interbank rates directly, for example, by announcing that our bill dealing rates would be unchanged for some period ahead, ie, by reactivating MLR; but again whether this very high profile course would have been effective in bringing down longer interbank rates would have depended on its impact on expectations. We have often in the past been forced to move MLR; and had we tried this course and then failed, the very visible policy defeat would have been extremely damaging to policy as a whole.

Finally we might have leant on the clearing banks directly (who incidentally were fully aware of - and themselves shared - our wish to hold rates down if that was at all possible): but again such action would have been clearly visible, and in the circumstances at the relevant time might well have prompted increased speculation that interest rates would eventually have to go up, possibly more sharply.

The importance attached to these risks depends of course upon the assessment discussed earlier of the underlying position of sterling. If we were wholly confident that sterling would bounce back quickly, at a point not very far below its present level, then we could more readily take the risk that visible and determined resistance to a rise in interest rates would aggravate the exchange and money market weakness. If, on the other hand, there is considered to be a serious possibility that sterling could - despite the firmness of financial policy generally - fall very substantially further, and remain there for some time, there would be a greater policy disposition to accept the need for interest rates to rise, not with the aim of defending the exchange rate at any particular level, but to the extent necessary to prevent a fall in the rate accelerating out of hand. This would offer the best prospect of limiting the damage to domestic interest rates and keeping policy as a whole intact as far as was possible in those circumstances.

Happily, for the time being, these questions do not immediately present themselves in acute form: sterling is for the moment somewhat firmer despite the turbulence surrounding the DM and dollar, and the domestic markets too are settling down though still very nervous.

We all of course hope that this can continue and we will do all that we can to ensure that interest rates do not rise further. But you should be aware that there is still, in our view, a significant possibility that the exchange rate will again come under heavy and sustained pressure; and that, if such pressure did re-emerge, inaction on interest rates, or, still more, high profile action designed to hold market interest rates down, would carry a serious risk of making matters worse.

In the meantime there is little that we can do other than maintain the overall posture of policy and emphasise the need to contain unit costs. In the presentation of policy it would be important - if a sufficiently persuasive case can indeed by developed - to seek to dispel outside views that sterling is still significantly overvalued and that the UK's competitive position and projected current account weakness will require further large depreciation. It would also be important that policy should not come to be interpreted by the outside

world as indifference towards the exchange rate, or as totally excluding action, including higher interest rates however unpleasant that may be, if that should become necessary to control a further significant weakening of the exchange rate, should in fact occur.

Yours sincerely