Superceeded by new draft (? to C/E)
[initials] 31/1

await new draft

check against letter that we were to see if match up. [illegible] says send.

SECRET AND PERSONAL

25. 1.83

THE GOVERNOR

Copies to The Deputy Governor
Mr Loehnis
Mr Fforde
ONLY

I attach a redraft of the proposed letter to the Prime Minister which takes account particularly of comments received from JSFf.

25 January 1983.
Dictated but not seen by Mr George.

SECRET RE-DRAFT (24. 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 rose in response to the fall in the exchange rate even though financial policy is 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. On the conventional calculations, this 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. On this view the exchange rate was judged to be overvalued however sound the UK's financial policies and whatever was happening to interest rates abroad.

One can regard such views as exaggerated and judge that after the depreciation (12%) that has already 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 one of the worrying aspects of the recent fall was that even when the ERI fell towards 80 there was little sign of a strong spontaneous recovery. But it would in any event be dangerous, in the circumstances in which we find ourselves to rely upon so sanguine a view, and to ignore the possibility of a further substantial fall in the exchange rate. It is this possibility that lies at the heart of the difficulty for policy.

Turning to interest rates, we have to accept that if market opinion fears that there may be a large fall in the exchange rate which would not necessarily be quickly reversed, it will also fear that there may be a rise in domestic interest rates. This latter fear will then be reflected in a rise in interbank rates, which are essentially market-determined. There are several reasons for this, important among them being -

(i) Markets do not believe that the authorities in a major developed nation could in the end fail to respond, with an interest rate move, to developments which could risk turning into an exchange rate collapse.

(ii) A large and lasting fall in the exchange rate would arouse expectations of an acceleration of inflation, implying a rise in nominal interest rates if real interest rates were to be kept from falling away.

(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 included 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 interbank rates have been very sensitive to movements in the exchange rate.

The action that we have taken throughout, in response to these pressures, has been designed to reduce this sensitivity. We have regularly overprovided the money market with cash through our bill dealing operations, at unchanged interest rates, even though interbank rates rose substantially. In addition, during December, we undertook sizeable tactical exchange market intervention to protect the exchange rate, and thereby contain the pressure on interbank rates. One reason for doing this was the chance that the pressures on the exchange rate might prove reversible after technical year-end influences were out of the way.

But 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 by themselves bidding for interbank deposits. At times the level of interbank rates relative to base rates was such as to threaten opportunities for hard arbitrage (borrowing on overdraft and redepositing the funds at a profit in the interbank market) which would have both increased the commercial pressure on the clearing banks and artificially inflated the money supply. Against this background the rise in base rates became in the end unavoidable, 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 positive action on our part could have been interpreted as an attempt to defend a particular level of the exchange rate, or as a direct response to its weakening, so reinforcing the market's already pronounced sensitivity to movements in the exchange rate.

The dilemma that we faced was that our visible reluctance to see interest rates rise, and our 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. This in turn might have aggravated both the fall in the exchange rate and the associated upward pressure on interest rates. This did in fact happen quite visibly on 11 January, as was widely reported in the Press

the following day; and it may be that our chosen tactics had a more general effect of this sort over the whole period. In the end, both in November and again last week, we had to choose between accepting the 1% rise, and adjusting our own dealing rates accordingly, or else taking the considerable risk that by seeking to deny that rise we would aggravate market pressures to the point where an immediate larger, rise became unavoidable. On both occasions when base rates went up therefore we immediately consolidated the increase in our own dealing rates.

Consideration of the further steps that might have been taken to avoid, or further postpone, the rise in base rates only serves to point up the above dilemma.

We could simply have pumped more cash into the money market and made the overnight interbank rate softer than it was. Some of this effect might have spread to the 7-day rate. But this could have added to the selling of sterling in the exchange market by facilitating, and cheapening, the financing of such sales. More important, it could have an adverse 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 operate on the longer-dated interbank rates directly. For example, we might have announced that our bill dealing rates would be unchanged for some period ahead. But the effectiveness of this very unusual action on the interbank market would have depended on its impact on expectations, just as in the case of our existing tactics; 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 directly requested the clearing banks not to raise their base rates despite the commercial pressures on them to do so. But again such action would have been clearly visible, and in the circumstances at the relevant time would have risked adding

to the weakness in the exchange market and to speculation that interest rates would eventually have to go up, possibly more sharply. I recognise that the importance that should be given to these risks depends crucially upon judgments about the underlying position of sterling. If we were very confident that sterling would hit a floor and bounce back quickly, at a point close to its prevailing present level, then we could more readily take the risk, and show visible and determined resistance to a rise in interest rates. If, on the other hand, we had to admit to 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 stronger case for accepting the need for interest rates to rise, not with the aim of defending the exchange rate at around its prevailing level, but to the extent necessary to prevent a fall in the rate accelerating out of hand. This might 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.

We all of course hope that despite sterling's renewed weakness, associated with the turbulence surrounding the DM and the dollar and with the failure of the OPEC meeting over the weekend, these questions will not immediately present themselves in acute form. In the meantime we will do all that we can to ensure that base 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 come under heavy and sustained pressure; and that, in the face of such pressure, there would come a point at which 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.

Haven't we got it?

In the meantime there is little that we can do other than maintain the overall posture of policy and emphasise the increased need, in the new situation, to contain unit wage costs to minimise the inflationary consequences. In the presentation of policy it would be important - if a sufficiently persuasive case can be 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 continue to recognise the importance of the exchange rate and not come to be interpreted by the outside world as being indifferent towards it. In this context it would be unwise totally to exclude action, including higher interest rates however unpleasant that may be, if it should become necessary to control a further substantial break in the exchange rate.

Yours sincerely