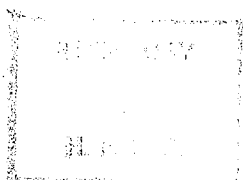




Note of a Meeting held in the Chancellor of the Exchequer's
Room, HM Treasury at 11.15 a.m. on Wednesday 26th May, 1976

Present: Chancellor of the Exchequer
Rt. Hon. H. Lever
Financial Secretary to the Treasury
Sir Derek Mitchell
Lord Kaldor
Mr. M.P. Posner
Mr. R. Barratt
Mr. J.G. Littler
Mrs. Hedley-Miller
Mr. F. Cassell
Mr. W. Ulrich
Mr. D. Walker



Pressure on Sterling

The meeting discussed Mr. Walker's paper of 20th May on "Pressure on Sterling in March and April" and the Bank's note of 17th May on "Sources of Exchange Market Pressure". It was recognised, as Mr. Walker had pointed out, that most of the figures in the papers showed the amounts flowing through various channels but did not show the sources of the pressure. The Chancellor said that the source of pressure was a live issue with the TUC. So far neither he nor the Governor had been able to convince the TUC that the main cause of the pressure was not speculation in the City but the view of foreigners about sterling.

2. In discussion it was pointed out that some of the pressure did come from within the UK. Much of this was perfectly legitimate and reflected a wish to avoid an exchange risk. For example, importers of goods or tour operators might reasonably want forward cover for liabilities denominated in foreign currencies. Equally banks which provided this cover reacted by acquiring spot currency to match their forward liabilities. In addition there was some fiddling, for example, by travellers who did not surrender foreign currency, but fraud of this sort was most unlikely to be of any macro-economic significance.



3. The Chancellor said he would like to have further information on the sources of pressure. He also asked the Treasury, in consultation with the Bank, to produce speaking notes which he and other Ministers could use in answering questions about this; they should include examples of "legitimate" selling of sterling.

Tightening exchange controls

4. Mr. Walker said the Treasury was pursuing with the Bank the two ways of tightening exchange controls mentioned in paragraphs 6 and 10 of his paper. The first was a reduction in the levels of spot currency which banks were allowed to hold against forward currency liabilities. In the recent period of pressure the aggregate sum held had reached \$515 million. This was less than the total limit (\$675 million), but some banks would have gone to their individual limits. The present limits were small in relation to the total value of transactions. Moreover if reducing the limit prevented people from selling sterling forward, they might sell spot instead and so add to the pressure on spot sterling. The second possibility was to reduce or abolish the traditional facility for banks to lend sterling overseas. This appeared to be a relic of the sterling area. A report on both possibilities would reach the Chancellor soon.

5. Sir Derek Mitchell said that tightening exchange control could damage confidence. Mr. Lever said that the amounts now at stake were small compared with 1968 and he was chary of adopting a candle-ends approach in this field.

Interest rates

6. The Chancellor said he had found it difficult to judge the size of the increase in interest rate that had been required on the two recent occasions and the effect on the £ that the increases had had.



7. Sir Derek Mitchell said that on the last occasion the Treasury had been united in thinking that some response to the rise in America was needed and in recommending a rise of $\frac{1}{2}\%$ in MLR was enough. They disagreed with the Bank view that the rise should be bigger. On both occasions they felt the increase had been too large and that the same effect on foreign exchange markets could have been achieved with smaller increases. Mr. Lever agreed that 1% had been too much. The Chancellor said that on the last occasion he had supported the Bank in going for 1%, in the light of some criticism that the previous increase of $\frac{1}{2}\%$ in MLR had not been enough.

8. Mr. Lever said that in his view those concerned with interest rate policy should not rely too much on the level of the crude "uncovered margin" for inter-bank rates shown in the evening market report. This would not necessarily be a good prediction of the movement of funds. The sterling market offered a wide range of possibilities. For example, at one time War Loan had shown a yield of 14%. It had been possible for an operator to hold War Loan for a relatively short period and benefit from an effective uncovered differential of 9% of which, say, 5% would be enough to cover the exchange risk.

9. Sir Derek Mitchell said there might be advantage if the Chancellor discussed interest rates with a wider group from the Bank, since the Bank was not necessarily monolithic in its views.

Funding Sterling Balances

10. The Chancellor said he would like to see the paper he had asked for on funding sterling balances in time to take decisions in the week beginning 14th June. At the same time it would be convenient to consider Mr. Lever's proposal (in his minute of 24 May) that the UK should borrow "at least \$3 billion" from the USA and Germany to enable the UK to support sterling at its present value.



Mr. Lever's minute of 21st May and Mr. Walker's comments of 25th May

11. (a) Mr. Lever suggested reviving the idea that the U.K. should offer a bond denominated in SDRs or foreign currency. Mr. Walker said a lot of work had been done on this in the autumn of 1975. The Chancellor and the Governor had decided then that it was not a good time to launch a pilot scheme. Mr. Lever said he thought the right time to offer such a bond, at least in terms of the likely cost, was soon after the value of sterling had fallen. He suggested that officials should consider the idea thoroughly again, together with other possibilities including guarantees (though not on the old basis which involved paying the interest rate prevailing for sterling assets although the assets were effectively denominated in dollars).

The Chancellor agreed and said he would like to take a considered decision in mid-June about whether such a bond should be floated with the Saudis along with other possible alternatives to sterling paper.

- (b) Mr. Lever suggested we should seek means of paying much less for volatile foreign currency inflows into Government securities. The true cost of borrowing on these terms could be much larger than the nominal interest rate. Foreigners could buy long dated gilts at low prices after an increase in U.K. interest rates and then sell when the interest rate rose, taking the capital gain.



denominated in sterling and in currency. The Chancellor invited officials to prepare a note on this.

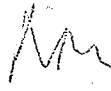
- (e) It was agreed that further discussions between Mr. Lever and officials should take place about points 4 and 5 in paragraph 7 of his note of 21st May.

Conclusion

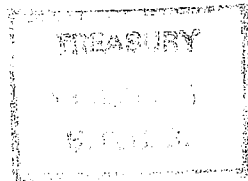
12. The Chancellor said he would like to hold a meeting on the central policy issues on the foreign exchange front in the week beginning 7th June. In particular, he would like to discuss the possibility of funding sterling balances, and Mr. Lever's proposal in his minute of 24th May for borrowing "at least \$3 billion" in advance of sterling, as well as other measure which would improve the stability of the pound. He would like to reach decisions in this area within the next three weeks and get endorsement, where appropriate, from EY.

Distribution:

Those present
 + Sir Douglas Wass
 Mr. Lord
 Sir Bryan Hopkin (o r)
 Mr. Jordan-Moss
 Mr. Bridgeman


 (N. MONCK)
2nd June, 1976

27/6
MR WALKER



Mrs Hedley-Miller
cc Mr Littler
Mr Cassell
Mr Bridgeman
Mr Middleton
Mr Edwards
Mr Norgrove

EXCHANGE RATES AND INTEREST RATES: IMF DISCUSSION PAPER

You and other recipients may be interested to see the attached IMF Staff paper on exchange rates and interest rates, which it is suggested might be discussed by the Executive Directors in an informal session or seminar. If you and others agree, I think it would be worth putting together our comments on the paper to send to UKTSD.

2. Briefly, the paper discusses the history of the "purchasing power parity"^{rates} theory of exchange/- ie that they adjust in line with inflation differentials; points to a number of periods when the theory appears not to have been valid; goes on to argue that in periods when the absolute level of inflation and of inflation differentials is high, the theory is more likely to be valid and proceeds to suggest that in order to prevent excessive movements in exchange rates caused by anticipation of future inflation interest rate differentials should be used as an inducement to persuade the international investor not to sell a depreciating currency. The table on page 5 of the paper then compares the "real" interest rate available to investors in a selection of industrialised countries and concludes that the countries with relatively higher prospective rates of inflation appear to have offered lower real interest rates. The conclusion drawn by the paper is that where countries are not in a position to intervene to defend an exchange rate against persistent capital outflows because of shortages of reserves "fund surveillance would have to be directed to a member's interest rate policy".

3. The paper, perhaps deliberately, seems to over-simplify the issues. It is not disputable that in a floating rate regime it is reasonable for the Fund to pay rather more attention to the external effects of interest rate policy. But the one-for-one relationship implied by the Staff's approach fairly obviously ignores a number of factors. Subject to your views and to those of

the other recipients of this minute, we might brief UKTSD to make the following points on the paper:-

- a. even in the medium-term there are factors other than inflation differentials which require exchange rate changes, eg structural changes in economies;
- b. in the shorter-term, this is even more true with confidence and political factors playing an important role;
- c. exchange rate competitiveness is extremely difficult to measure, the choice of base-date being particularly important. It would, therefore, be unwise to place too much reliance on any single indicator, eg whether exchange rates had moved in line with inflation differentials over a particular period;
- d. the conflict between domestic and external considerations in setting interest rate policy is probably more acute than implied on page 6 of the Staff paper. In theory, it should be the real rate of interest which is relevant to investment decisions. But there is an implicit assumption here that the economy in general and the corporate sector in particular adjusts without too much friction to changes in the rate of inflation. In practice, this assumption is not always fully borne out and other Government policies, for example price control, tend to interfere with the adjustment process. The conflict is also presumably sharpened when (as may be the case for the UK now) external expectations about future inflation may be too pessimistic.
- e. as implied by b. above, factors other than the real interest rate are also relevant to the decisions of external investors, eg the desire of the portfolio manager to maintain a balance between different currencies, the comparative advantage of some centres in handling financial investments.

In general, therefore, the conclusion to be drawn is that the analysis in the Staff paper should be used with some caution as a guide to the Fund's surveillance policy.

Future Fund Policy on Exchange Rate Surveillance

4. You will see from the cover note to the Staff paper that the Fund will in due course be putting forward further papers on how it should proceed in exercising surveillance over exchange rate policies, given the new Article IV. Until we know what the Fund may have in mind, there is not much to be said on this topic. I will ask Mr Kent to see whether he can get any advance notice of the likely Staff proposals. It is, however, difficult to see that any dramatic change in the Fund's procedures is either necessary or desirable. Article IV does not represent a significant change in the working of exchange markets. While one can understand the Staff's feelings of frustration in this matter, the main procedure for surveillance of exchange rate policies should presumably continue to be periodic Article VIII/XIV and purchase consultations. Apart from this, there is the possibility, which we discussed to some extent in December, that the Fund might occasionally be present at Group of 5 and Group of 10 meetings, at least when these are held in the margin of Working Party 3 meetings. Apart from this, however, the Staff could and should be encouraged to do more research on the question of exchange rate movements on competitiveness. If they also wish to suggest a review of the existing guidelines for floating, in the light of the new Article IV, we would presumably not want to object, though it is not obvious that any significant changes are required.

5. Since dictating this note, I have seen a copy of Mr Littler's minute of 28 May to Mr Edwards on the general question of a more coherent collective approach to the subject of exchange rates and competitiveness. My preliminary reaction is not to alter what I have said above about the role of the IMF. I imagine we would want to pursue the question of a collective approach to the subject of exchange rates and competitiveness in the Group of 5 and Group of 10 in the first instance before involving the Fund.



G E FITCHEW

2 June 1976



Mr. McCallister

NOTE FOR THE RECORD

Dr. Witteveen telephoned the Chancellor at 5.15 p.m. on Thursday, 3rd June. He said he wanted to convey personally his concern about developments in the foreign exchange markets. He regretted the "unreasonable exaggeration" of the market and the risk that the fall in the value of the £ posed for the Chancellor's policy for reducing inflation. Dr. Witteveen regarded that policy as extremely valuable.

2. The Chancellor said that he naturally shared this concern. His aim was to hold the rate, or nudge it up a little, and he was considering Dr. Witteveen's suggestion to Mr. Rycroft on 7th June about the Fed Swap. He had, however, taken no decision about it yet.

3. Dr. Witteveen said it would also be important to reassure the market by some action on credit. Loans to business were now picking up rapidly as a result of the recovery of the economy. He favoured a move to a more restrictive monetary policy, e.g. on special deposits and also some reduction in the PSBR.

4. The Chancellor said he could not commit himself on this. It was not possible to cut this year's public expenditure programme but he thought he could guarantee that there would be no excess over the White Paper limits. He was having a blitz on local authorities' current expenditure and on certain central government departments. Next year's programme was now under consideration as part of the normal rolling 5 year review. He hoped to reduce the level of the programme and might announce it next month. The reduction would be below the White Paper level, but he stressed that no decisions had yet been taken and that nothing could be done overnight. It would be necessary to work through the programme and to reach agreement with his colleagues.



5. Dr. Witteveen acknowledged that the process was bound to take time but suggested that the Chancellor could indicate his intentions.

6. The Chancellor said he had said something on these lines on television the previous evening. He had said that he would take action if the recovery was so fast that he could not finance the public sector deficit without either raising interest rates excessively or printing money. It would not be possible to quantify any reduction for at least a month.

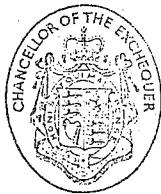
7. Dr. Witteveen said it would be helpful if the Chancellor could buttress any statement about public expenditure by taking substantial measures on special deposits.

8. The Chancellor said he had re-read Mr. Finch's closing statement. His impression was that, although the IMF was concerned about the resources aspect, ^{of the PSBR and public expenditure} the prime worry was about the monetary side. Dr. Witteveen agreed, referring again to the increased loans to the private sector. The Chancellor said he would consider action on special deposits but could not commit himself.

9. Dr. Witteveen said that in his view the ideal thing would be to announce expenditure cuts for the second half of the current year. The Chancellor said that this would be very difficult for a number of reasons, including the forthcoming TUC Special Congress. Dr. Witteveen replied that since the fall in the £ would mean a bigger cut in real wages, it would be in the unions' interest to take steps to stabilise the £. In any case it would be very helpful if the Chancellor could take a substantial measure in the monetary policy area and refer to his intention to cut public expenditure next year. The Chancellor could then negotiate with the IMF a back-up for the Fed Swap.

10. The Chancellor said that if a decision were taken to pursue the possibility of the Fed Swap, the UK would have to undertake to go to the IMF if it proved impossible to repay the swap facility.

S E C R E T



The undertaking would be contingent and might not need to be implemented if any sums spent on supporting the £ flowed back.

11. Dr. Witteveen did not comment on this but said he felt discussions between the UK and the IMF should start quite soon. He undertook that the IMF would do everything possible to help the Chancellor if he produced a suitable package. He felt that spending cuts should be made as early as possible. The Chancellor said he would reflect on what Dr. Witteveen had said. Mr. Ryrie had explained the difficulties of early action on public expenditure and he himself felt it would be a disaster to throw away the Government's understanding with the trade unions, which was the key to the progress made so far. Moreover, as he had pointed out, he had not consulted his colleagues about reducing public expenditure below White Paper levels.

12. In conclusion Dr. Witteveen wished the Chancellor success in carrying through the policies which had made such an excellent start.

WM

(N. MONCK)
3rd June 1976

Distribution:

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