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Dear Michael

MONETARY POLICY AND THE EXCHANGE RATE

The Chancellor has suggested that the Prime Minister might like to see the attached note which picks up some of the points they discussed on 9 December.

As you know the pound was weak again on Friday and there was a further rise in interest rates in the inter-bank market: the one month and three month rates were about $\frac{3}{8}$ per cent higher than yesterday's closing rates at about $15\frac{1}{2}$ per cent. The yield implied by the Treasury Bill Tender was about $\frac{3}{4}$ per cent higher than a week earlier. The rates at which bills were offered to the Bank also rose. In the circumstances the Bank raised its dealing rates for bills - the rates at which it assists the market - a little. But the move was smaller than that of the corresponding inter-bank rates and the dealing rate for "band 1" bills (2 weeks) remained unchanged at $14\frac{3}{8}$ per cent. The Bank was thus perceived to be leaning against the market-led movement towards higher interet rates, without - it is hoped - appearing to encourage any further fall in the exchange rate.

Yours ever

Peter

P.S. JENKINS

MONETARY POLICY AND THE EXCHANGE RATE

Introduction

The current basis of monetary policy is largely as presented in the MTFS and the Budget Speech and agreed at the Prime Minister's seminar in the Summer. £M3, for which the MTFS set out declining ranges for the following three years remains the main target variable. But in assessing monetary conditions and in setting interest rates other factors are taken into account. These include the growth of the other monetary aggregates, both narrow and wide; the exchange rate and its implications for inflation; and the growth of nominal GDP. The Government's aim is to maintain financial conditions such that they exert a "steady, though not excessive, downward pressure on monetary variables" in order to restrain inflation and create conditions for a recovery of output. This position has been reaffirmed on a number of occasions e.g. the announcement of the new monetary control arrangements, the Mansion House Speech and evidence to the TCSC.

Distortions to monetary aggregates

2. The conduct of monetary policy has been complicated by several problems. First, there have been distortions to the monetary aggregates. In 1980 these stemmed mainly from the unwinding of the corset. This year the figures have been distorted by the Civil Service strike. We have attempted to discern an "underlying" rate of monetary growth but this is subject to error at several points. We could be wrong in our estimate of the extent to which this feeds through into money. However, our best estimate is that by the end of banking November the strike was adding about 2-3 per cent to £M3 and perhaps half as much to PSL2. M1 might be relatively free from distortion.

3. In addition to this there have been structural changes in financial markets. The banks have entered the market for mortgage lending in a major way. The effect of this on the

monetary aggregates and the implications for inflation are difficult to interpret. If all we were witnessing was a change in the channel through which housing lending is made and bank lending was substituting for lending by building societies, the implications for inflation would probably be rather limited and there would simply be a downward shift in the velocity of circulation and PSL2 would be unchanged. Although £M3 would be inflated it would be appropriate to adjust the monetary targets. If, on the other hand, bank lending were additional to that by the building societies, we would expect, though possibly with a lag, that inflationary pressure would develop. When this phenomenon first appeared in mid-summer it looked as though much of the lending was additional, as building society lending continued at a high level. In recent months, however, building society lending has weakened substantially and much more of the bank lending appears to be in substitution. The growth in housing lending by banks may be just the most conspicuous example of a wider trend towards a larger role for banks in intermediating between savers and borrowers. But even allowing for these factors the growth of bank lending remains worrying.

4. The problems of interpreting movements in £M3 are not confined to the estimation of the size of statistical distortions of this kind. Although the relation of £M3 to inflation and the growth of nominal incomes appears reasonably stable in the medium term it is not close or predictable year by year. Economists are divided on the significance for future inflation of the rapid growth in £M3 over the past two years. Some continue to argue that £M3 is still the best guide to future price inflation. Others would attribute the rapid growth of the wider aggregates, here and in several other countries, to increased private sector savings, to a preference for liquidity in uncertain times and perhaps to a perverse effect of high interest rates.

The Exchange Rate

5. The second problem is how the exchange rate should be taken into account. There is no target for the exchange rate. But its level and movement have implications for the rate of inflation and may in some circumstances help in the interpretation of domestic monetary conditions. Last year for example the rise in the exchange rate may have been partly the consequence of tight conditions in UK financial markets. Uncertainty about the movement and significance of £M3 is a further reason for the recent emphasis on the exchange rate as a factor in monetary policy decisions. Although it is sometimes important to look at particular exchange rates, e.g. against the dollar and the deutschemark, the best single indicator is the sterling effective exchange rate index - see Annex A.

Conflicting evidence

6. The third problem of monetary policy arises when there is conflicting evidence, particularly for the prospects for inflation. Sometimes the evidence points clearly in one direction as it did in September when the exchange rate was weak and £M3 and the other wider aggregates appeared to be accelerating. Since September the evidence has appeared to be much more in conflict as Mr Burns and Mr Middleton explained to the TCSC on Monday. As interest rates abroad fell, the exchange rate strengthened, the effective rate at one point reaching about 92. Having weakened in the last couple of days it now stands at about 90 compared with 87 in mid-September. Bank lending, meanwhile, has continued at a high level both to persons and to companies, though the housing market remains weak and consumer spending restrained. There have been differences in the growth of monetary aggregates with £M3 growing noticeably faster than either M1 or PSL2, though correction for the effects of the strike would tend to narrow the differences. The very slow growth of the wide monetary base (Mo) probably reflects trend changes in the use of notes and coin, its main component, rather than providing a reliable indicator of financial conditions in the economy.

Percentage change	Mo	M1	£M3	PSL2
Target period Feb-Nov Actual rate	1.1	7.4	13.1	10.3
Annual rate after adjustment for strike	1.5	10.0	14.5	12.2

Thus there are conflicting indications both between the exchange rate and the monetary aggregates on the one hand and within the monetary aggregates on the other, though the differences between the latter (Mo apart) are currently not as extreme as a year ago.

Are monetary conditions too tight?

7. The conduct of monetary policy is necessarily a judgemental process but a number of observers have argued that this judgement has not been exercised correctly. In particular, the Government is accused of following £M3 excessively and allowing monetary conditions to become too tight both now and during 1980. In the 1980/81 target period there was a substantial overshoot of £M3 (18 per cent compared with a target of 7-11 per cent). This overshoot was not only tolerated but while it was occurring interest rates were reduced because the other evidence, the exceptional strength of the exchange rate, the speed with which inflation was falling, the squeeze on the company sector, the slow growth of M1, all pointed to very tight monetary conditions. In addition much of the growth of £M3 was thought to represent the replenishment of financial assets which had been eroded by inflation in earlier years. Thus it is unfair to argue that the Government followed £M3 blindly though a case could be made that it reacted too slowly.

8. The current position shows some similarities and some differences. The growth of £M3 appears to be accelerating and by February 1982 £M3 may have grown by around 16 per cent compared with a target of 6-10 per cent. Perhaps 1 per cent could be accounted for by the effect of the strike, and a further

1½ per cent at most could be accounted for by bank lending for housing if all such lending were in substitution for building society lending. Thus even allowing for these factors, a significant overshoot is likely to remain. Though the exchange rate has fallen substantially from its peak, the real exchange rate still remains high relative to its historical position, and the competitiveness squeeze on companies exposed to international competition is strong, with cost competitiveness still over 20 per cent worse than in Spring 1979. Nevertheless, company liquidity and profitability have improved in recent months. Against this there has been a setback in the progress towards reducing inflation and the imbalance between the company and personal sectors which was thought to have contributed to the rapid growth of £M3 in 1980 is now being reduced.

9. The evidence from the other monetary aggregates is not clear cut; although the growth rate of M1 and PSL2 are less than that of £M3, they remain close to that of the rate of inflation, whereas in November last year, there was an enormous difference between the narrow and wide aggregates. (Over the previous year M1 had grown by 4 per cent and £M3 by 19 per cent.) Thus Mr. Pepper's charts give a less than complete picture of the diverse growth of the aggregates. He has highlighted an annual rate of growth of M1 in the three months to this October, which shows a fall of 4 per cent. In fact moving on one month to November takes this figure up to plus 8 per cent. His estimate of 5 per cent for the annual rate of growth of PSL2 in the second half of the target period looks a substantial underestimate.

10. There has been a striking disparity in the growth of the counterparts to £M3. The growth of bank lending to the private sector is substantially in excess of that of £M3. This reflects the fact that lending to the public sector is not growing. Over the target period the recorded PSBR is expected to be almost exactly matched by debt sales. This, taken in conjunction with a rising note issue, produces a cash drain from the banks which is being relieved by substantial money

market assistance. At present this is largely taking the form of purchases by the Bank of England of local authority and commercial bills. In the absence of this assistance there would be substantial upward pressure on short term interest rates as the banks bid for deposits in order to restore their liquidity. Thus the combination of selling debt to fund the PSBR and supplying money market assistance has the effect of reducing the growth of £M3, while holding short term interest rates down rather than up.

10. It is not the case that short term interest rates are being held up in order to ensure sales of conventional gilts and obviate the need for an unrestricted indexed gilt. The funding position is not, in fact, having a major influence on decisions on short term interest rates. The decision on whether to issue an unrestricted indexed gilt is under consideration, but it is a difficult one, with powerful arguments on both sides.

Conclusion

11. In the face of conflicting evidence the Government has proceeded cautiously, allowing interest rates to fall from their peak though not to the extent of reflecting fully the fall in interest rates abroad. However, in this year as well as last, the level of interest rates has been held substantially below that which would be required if monetary policy were being determined solely by reference to the £M3 target which is again likely to be overshot. Account is thus being taken of distortions to the data, structural changes and of the other indicators of financial conditions. Although the public presentation of the Government's financial policies is evolving, and less emphasis is being placed on £M3 as the central target, it has been possible to achieve this shift while still maintaining credibility in the Government's objective of maintaining a firm but not excessive anti-inflationary pressure on the economy.

ANNEX A

EXCHANGE RATE MOVEMENTS

Although it is sometimes important to look at particular exchange rates, e.g. against the dollar or deutschemark, the best single indicator is the sterling effective exchange rate index. This weights different currencies in a sophisticated way (devised by the IMF) in relation to their importance for UK trade. The dollar's weight in the index is 25 per cent, about twice the share of our exports going to or imports coming from the US, in part reflecting the importance of US competition in third country markets. It is sometimes said that the dollar rate is particularly important for UK inflation because of the number of basic commodities prices in $s. But this effect will be relatively short term and limited to existing contracts: beyond that commodity prices will tend to reflect supply and demand, and their dollar prices adjust to rises or falls in the dollar. Since the effective rate index gives the dollar a relatively heavy weight it probably already sufficiently allows for any extra importance of the dollar for inflation. Commentators, of course, still tend to concentrate on the £/$ rate - and that rate will be particularly important for some companies, as the £/DM rate will be for others - but for policy it contains no special magic.

The table below shows how the main sterling exchange rates have moved this year. Between the Budget and the end of August the £ fell by around 16 per cent against the dollar, and the effective index fell by 7 per cent - both falls largely reflecting the general strength of the dollar against all currencies. During September sterling was weak against all currencies with the effective rate falling a further 6 per cent, despite significant rises in UK interest rates in relation to those abroad. Thereafter sterling recovered generally with the effective rate rising again to its mid-August level before falling back again in the last couple of days. It is hard to be sure of the reasons for these movements, but changes in

overseas interest rates, prospects for the world oil market and other countries' current accounts, and confidence factors have all played a part, as well as changes in domestic economic conditions.

	May 1979	10 March	28 Aug	14 Sept	29 Sept	11 Dec
£/$	2.06	2.21	1.85	1.78	1.79	1.88
£/DM	3.93	4.66	4.53	4.24	4.15	4.25
Effective exchange rate index	86.3	98.6	91.3	87.0	87.0	89.8

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