

# 14. Monetary Targets and Economic Policy

## Control of Monetary Aggregates

22/5/1980

FEU 2/35/01

24 MAY 1977

FINANCIAL SECRETARY

*Handwritten notes:*  
Pls. Thank Mr. Bonham.  
In re disk of his bank  
see graphs of ~~the~~ like  
over the past 3 yrs. (5)  
over the past 3 yrs. (1)  
(a) ~~main~~ Dec  
Dec, each

- cc Principal Private Secretary
- PS/Chief Secretary
- Sir D Wass
- Mr Burns
- Sir K Couzens
- Mr Ryrie
- Mr Barratt
- Mr Middleton
- Mr Bridgeman
- Mr Lavelle
- Mr Unwin
- Mrs Lomax
- Mr Peretz
- Mr Riley
- Mr Shields

MONETARY SITUATION

1. You asked to what extent the exchange rate is being strengthened by the high level of UK interest rates, in relation to US rates in particular. I attach charts showing movements in the sterling/dollar rate, the DM/sterling rate and the sterling effective rate, together with the corresponding uncovered differentials.
2. The recent history which is shown on the first of these charts consists of a movement of the <sup>eurodollar</sup>/differential against the UK and then back again between February and May of this year. The relationship between that movement and the fall and the recovery in the sterling/dollar exchange rate is quite impressive. Looking back over the last twelve months, the association is quite pronounced throughout.
3. It is worth recalling that an association of this kind has not always held, as is evident from the second chart. In 1977, for example, a very marked fall in UK rates relative to the US was accompanied by sustained upward pressure on sterling against the dollar (and once the "cap" was removed by significant appreciation). Then in the second quarter of 1978, sterling weakened against the dollar although the uncovered differential was moving in our favour.
4. To return to the present, the large swings in the sterling/dollar rate have made remarkably little difference to the effective rate. This may be explicable, at least in part, by the way that movements in eurodollar rates have been offset by "mirror image" movements in DM rates. One of the charts shows an attempt to construct an "effective rate" measure of interest rate differentials. This has some of the features of the eurodollar differential, but on a much reduced scale.


5. It is never easy to identify the arbitrage flows in balance of payments or monetary statistics. There is evidence of increases in overseas purchases of gilts and sterling deposits in the early months of this year. These are assets which we think of as having a rather high interest elasticity (given exchange rate expectations). The March figures also showed a substantial movement into sterling by one large OPEC holder. All this confirms the view that sterling interest rates have been attractive on average over the period, but it is not possible to match the capital movements month by month at all closely with interest rate changes here and in the US.

6. In referring to UK interest rates as "high", one must obviously remember our very high inflation rate. This is relevant to arbitrage flows to the extent that it is used as a guide to future movements in the exchange rate. Currently, it would seem that the market regards sterling as a relatively safe currency, at least for the period (up to three months or so) over which arbitrageurs have to take a view. In domestic terms, it is not at all clear that our rates are "high" in the sense of providing an effective deterrent to short-term borrowing.

7. The message of the charts, I think, is that interest rates may well be having an important influence on the exchange rate. The evidence is not really conclusive in that it refers mainly to movements in the eurodollar rate rather than movements in our interest rates relative to those of the rest of the world. It is also very clear that interest rates are not the only important influence on exchange rates - that is the reason for the oil price chart at the end\*.

8. Despite the message of the charts, I would not favour cutting our interest rates as a means of holding down the exchange rate. For that policy option, the relevant history to study may be 1977-78 rather than the last twelve months. Over the past twelve months our interest rates have been set in order to achieve monetary targets. In 1977 we were trying, unsuccessfully, to achieve targets for both the money supply and the exchange rate. The result was that interest rates did not fall enough to prevent the exchange rate rising, but far enough to produce an excess of DCE in the course of 1978.

\*Postscript: The strength of sterling in the last couple of days clearly owes a lot to oil price increases as well as the fall in eurodollar rates.

  
A J C BRITTON  
22 May 1980

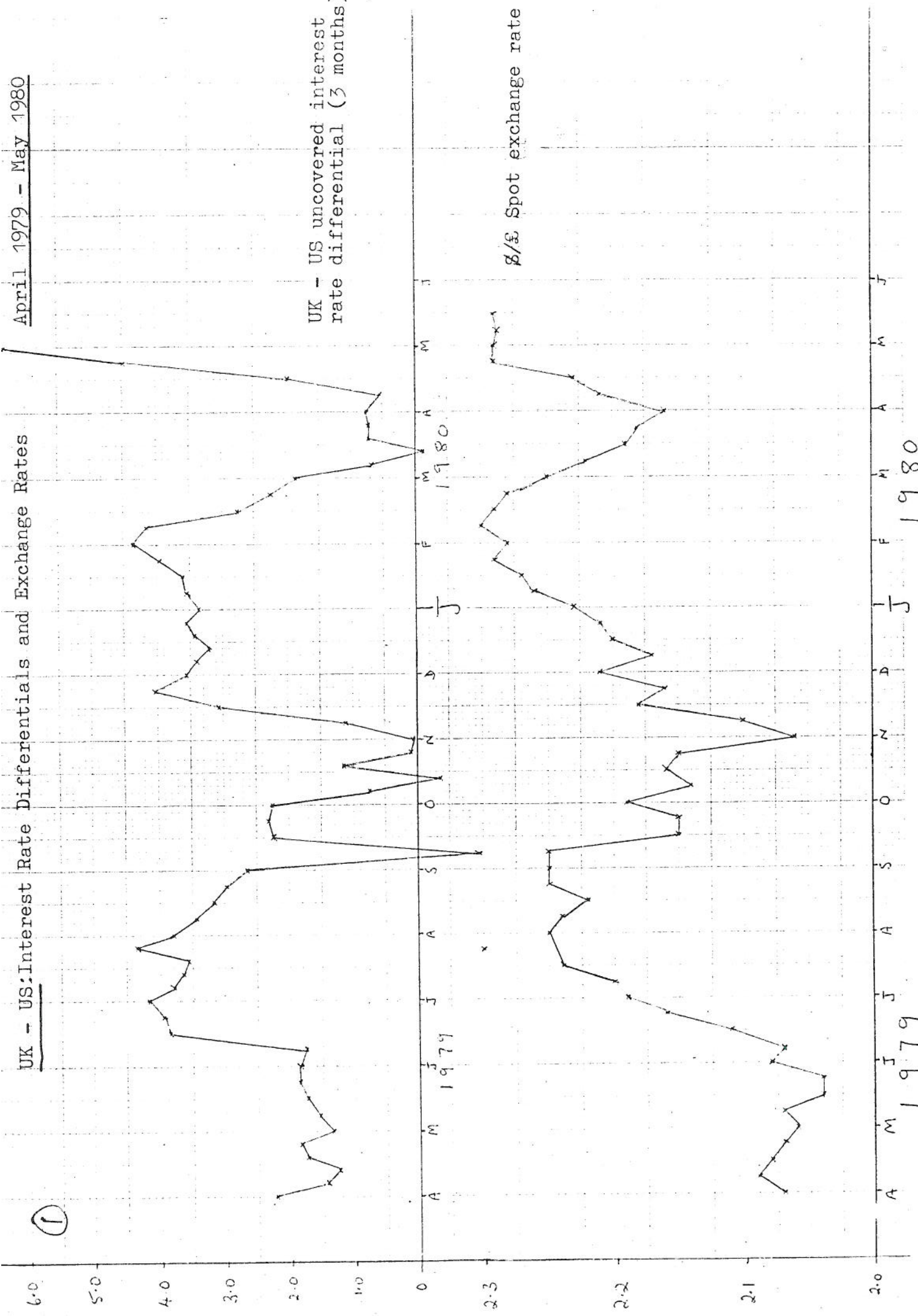
April 1979 - May 1980

UK - US: Interest Rate Differentials and Exchange Rates

①

UK - US uncovered interest rate differential (3 months)

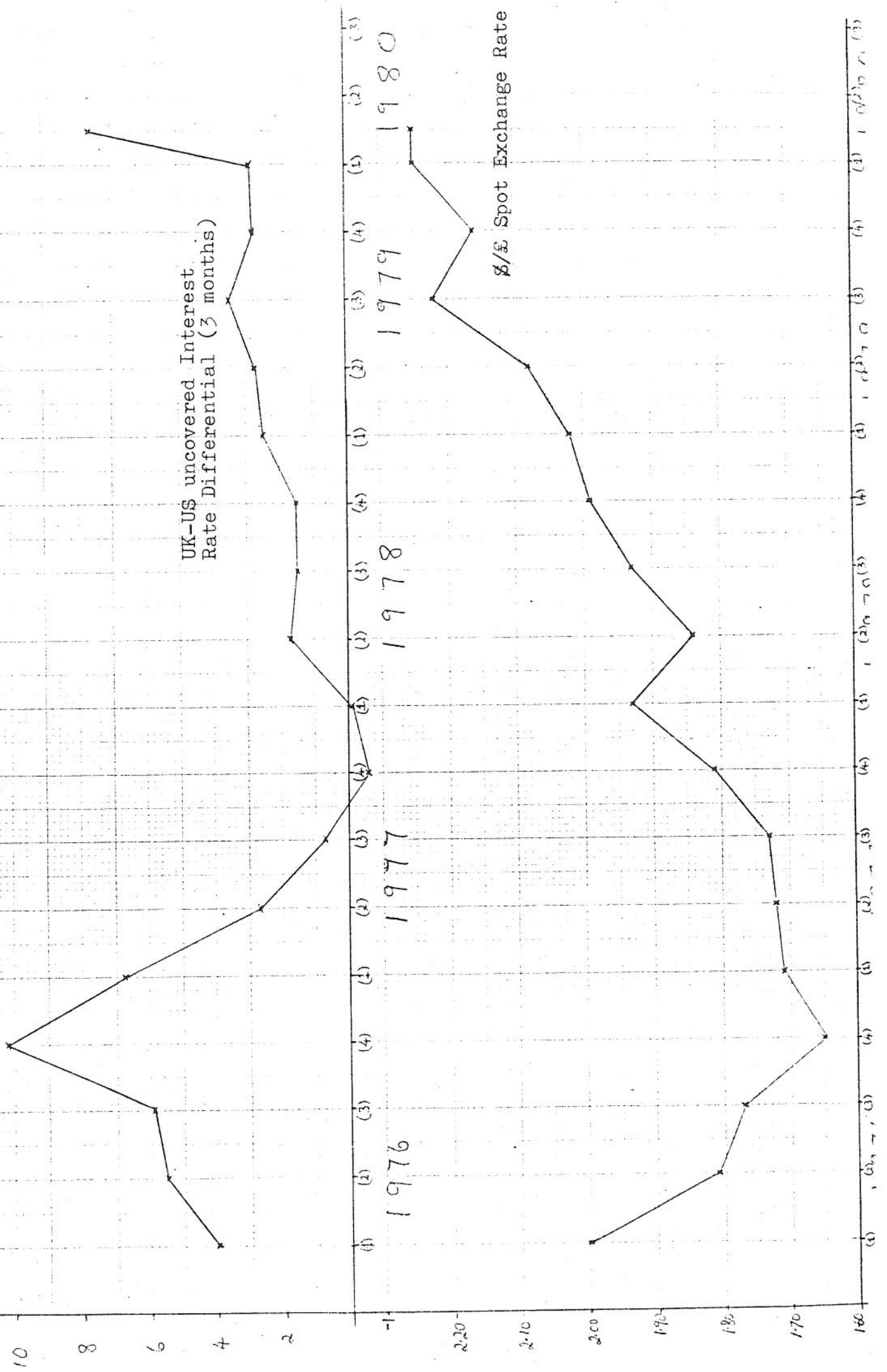
£/\$ Spot exchange rate



1976 Q1 - 1980 Q1

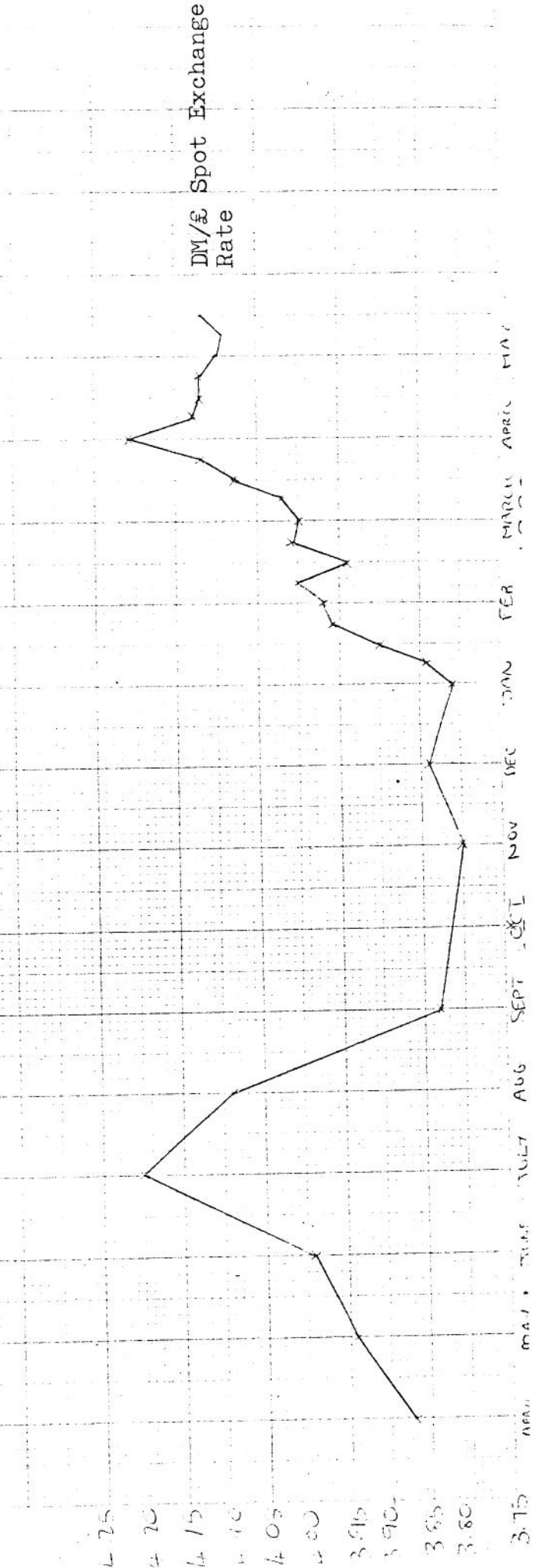
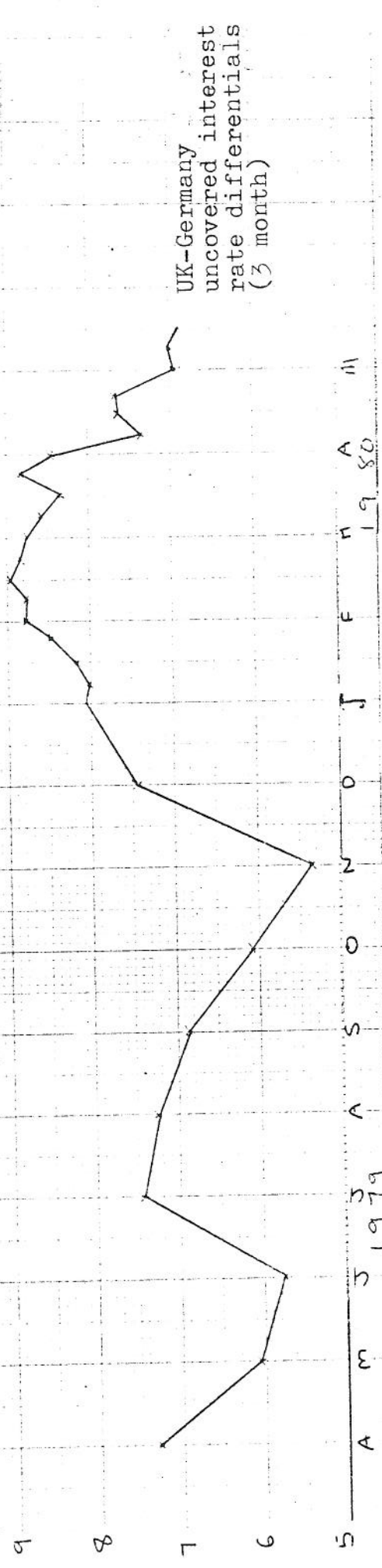
UK & USA Interest Rates and Exchange Rates

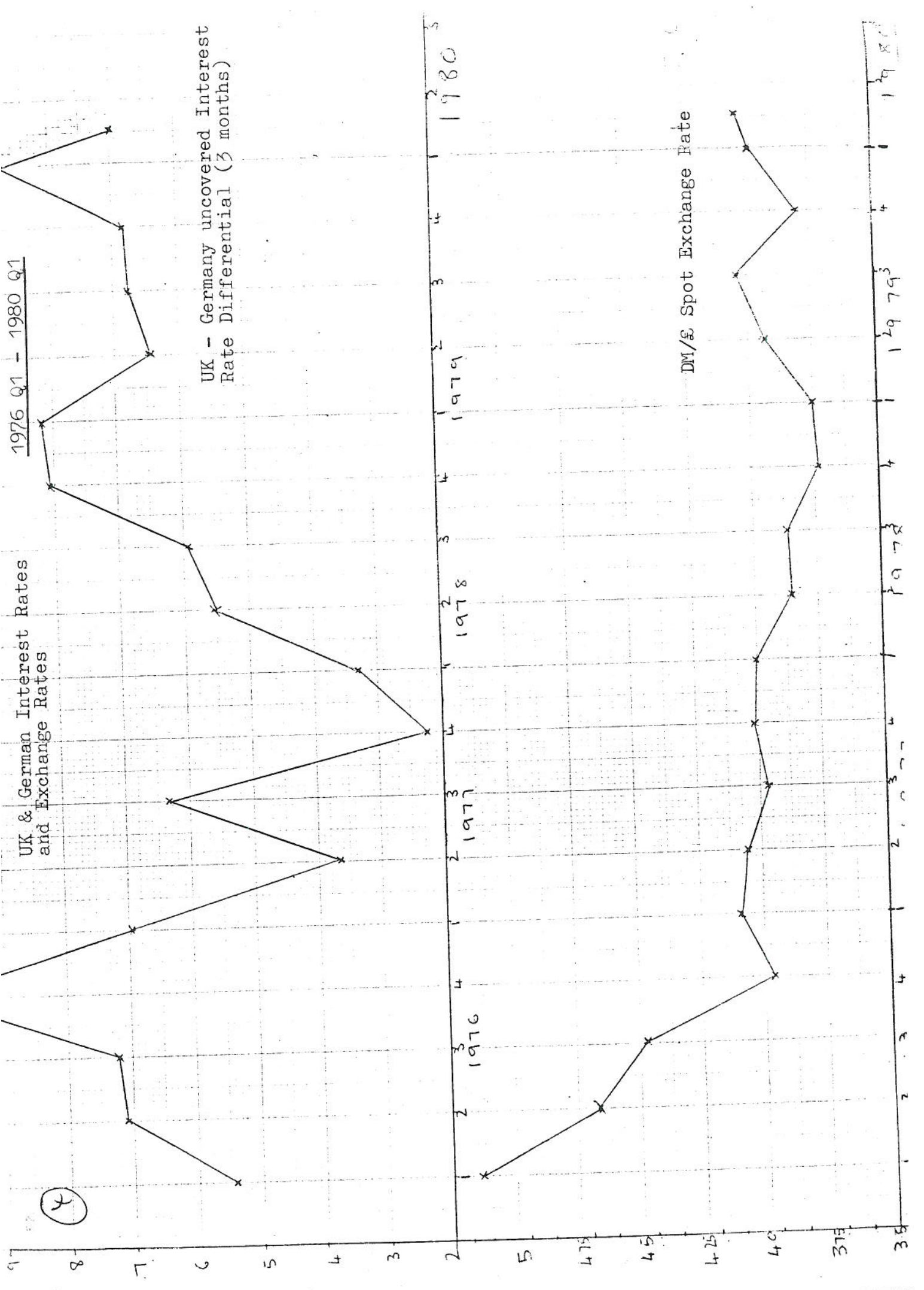
2



UK-Germany: Interest Rate Differentials and Exchange Rates

ER. (3)





(4)

UK and World Basket; Interest Rate Differentials and Exchange Rates

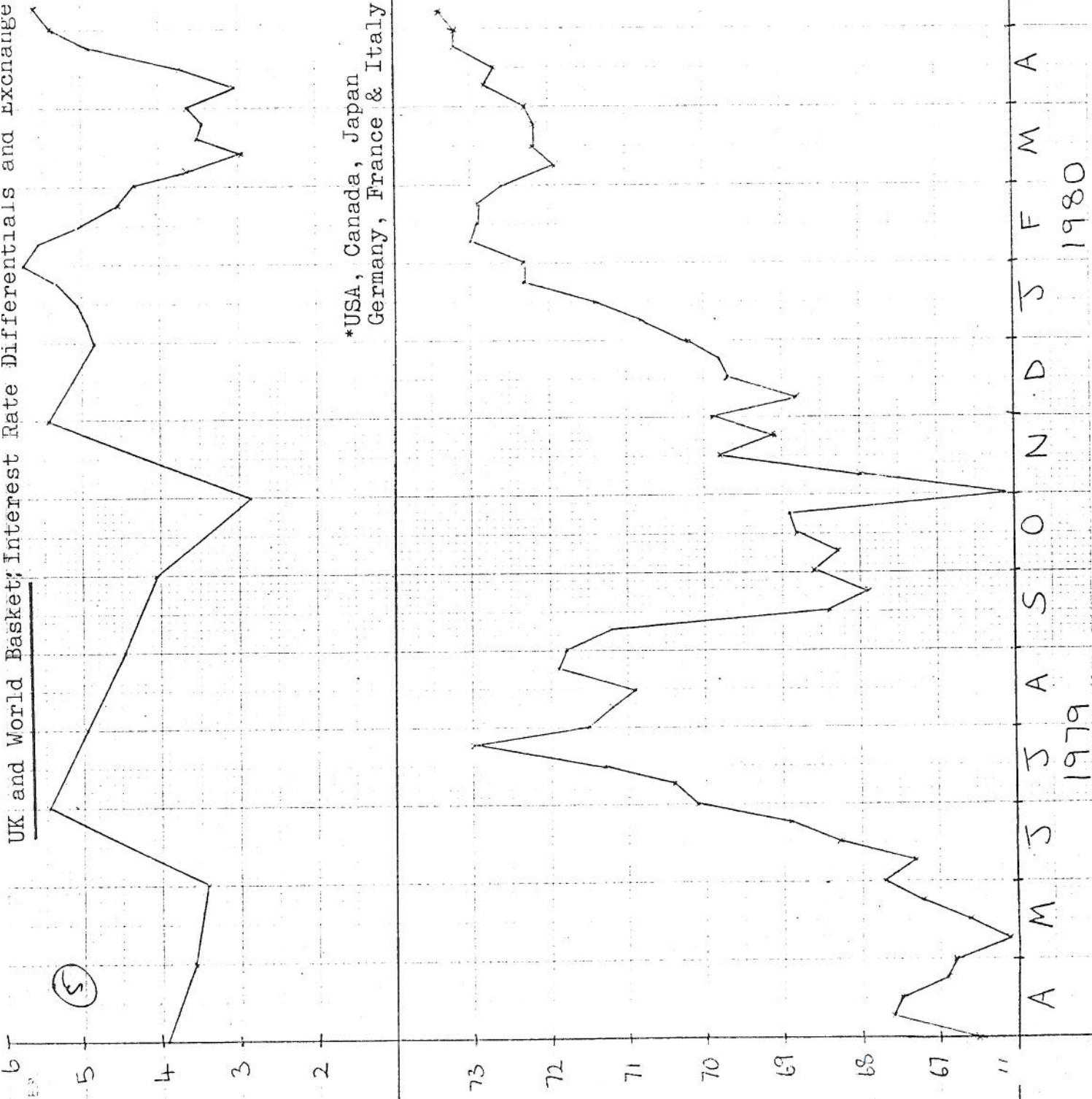
EP

(5)

UK weighted basket of world interest rates (3 months)

\*USA, Canada, Japan Germany, France & Italy

Sterling effective exchange rate index





1976 Q1 - 1980 Q1

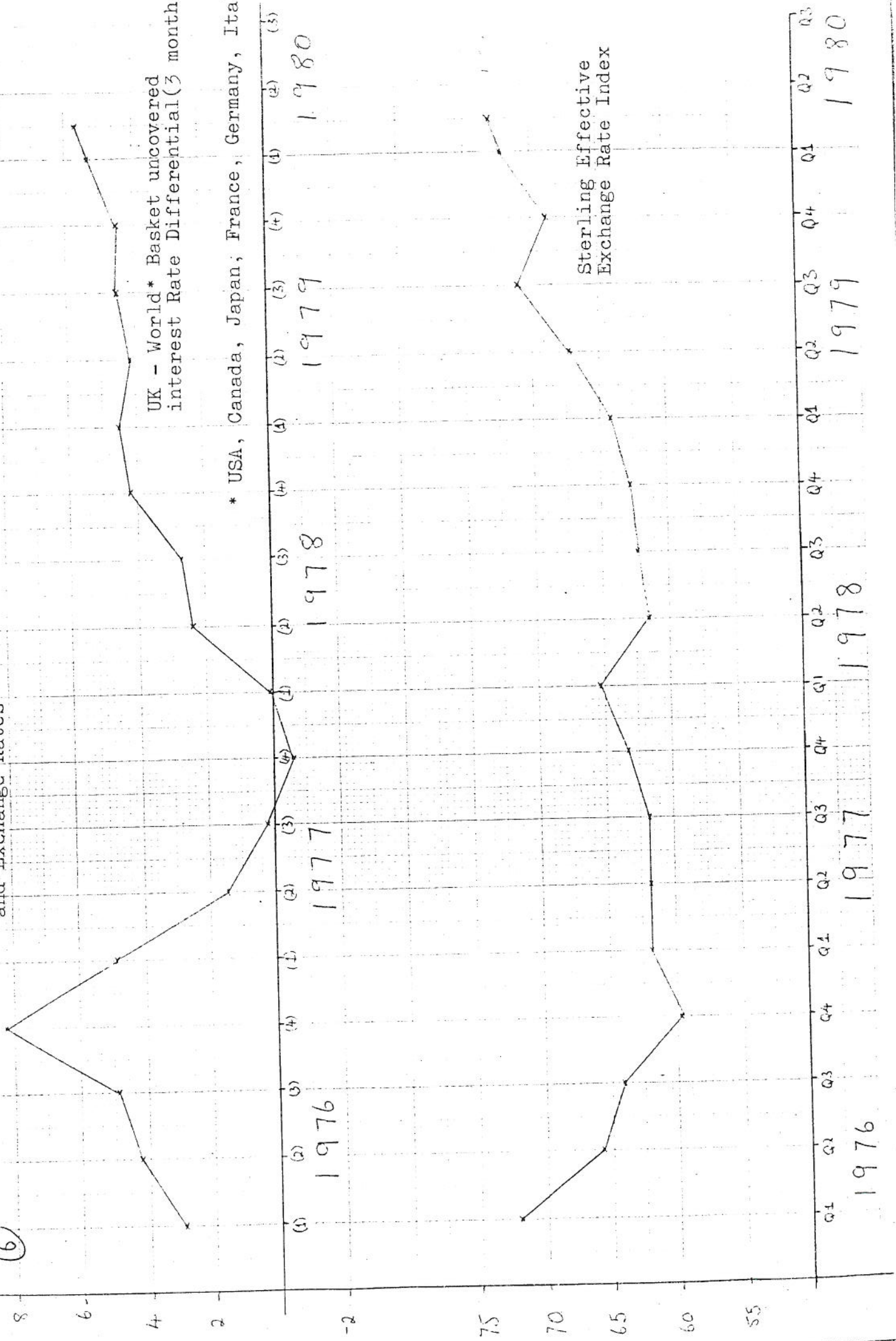
UK & World\* Interest Rates and Exchange Rates

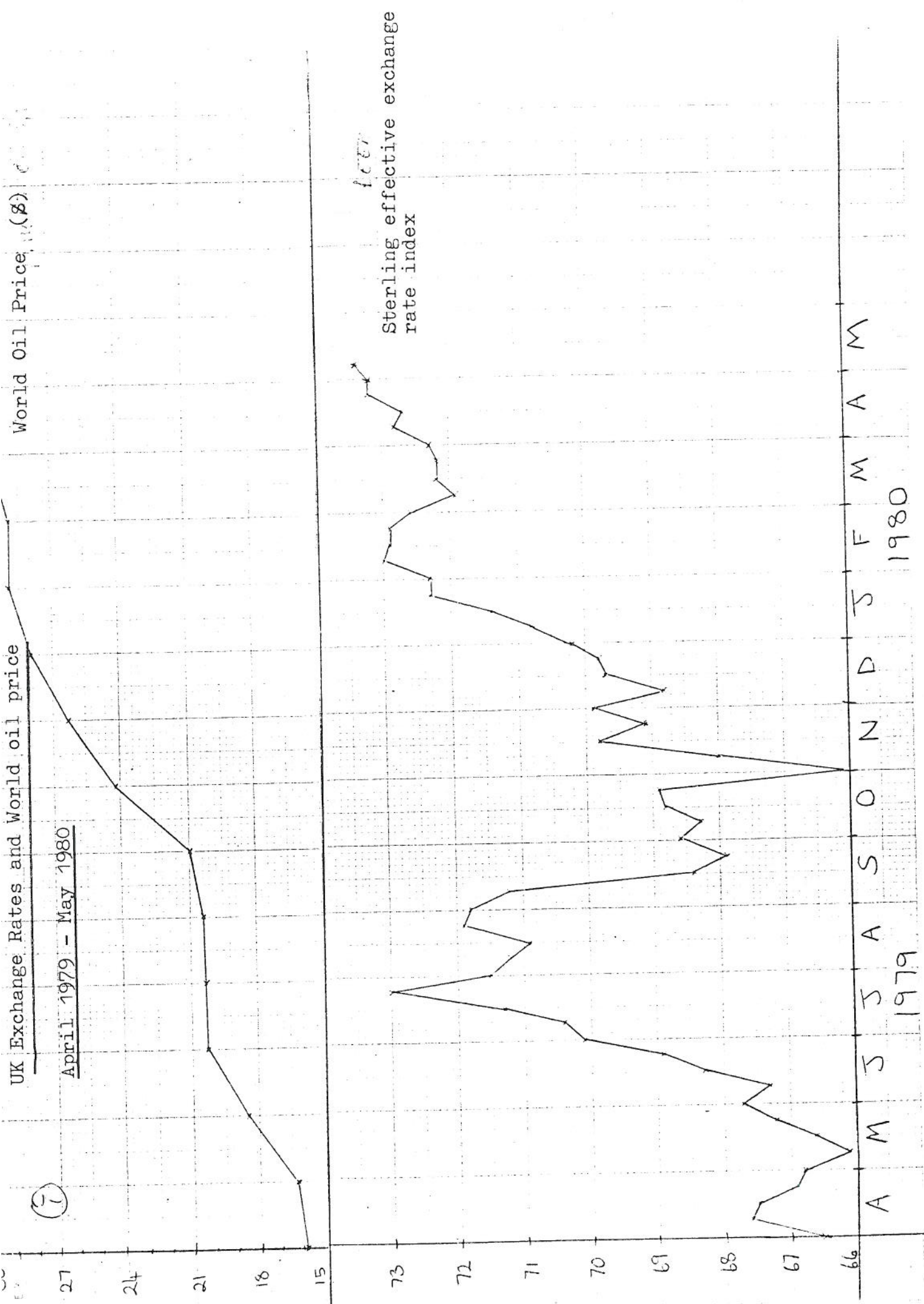
UK - World\* Basket uncovered interest Rate Differential (3 months)

\* USA, Canada, Japan, France, Germany, Italy

Sterling Effective Exchange Rate Index

⑥





1980

FEU 2/35/10

PS/FINANCIAL SECRETARY

- cc Principal Private Secretary
- PS/Chief Secretary
- Sir Douglas Wass
- Mr Burns
- Sir Kenneth Couzens
- Mr Ryrie
- Mr Barratt
- Mr Middleton
- Mr Bridgeman
- Mr Lavelle
- Mr Unwin
- Mrs Lomax
- Mr Peretz
- Mr Riley
- Mr Shields
- Mr Fisher
- Mr Denham

MONETARY SITUATION

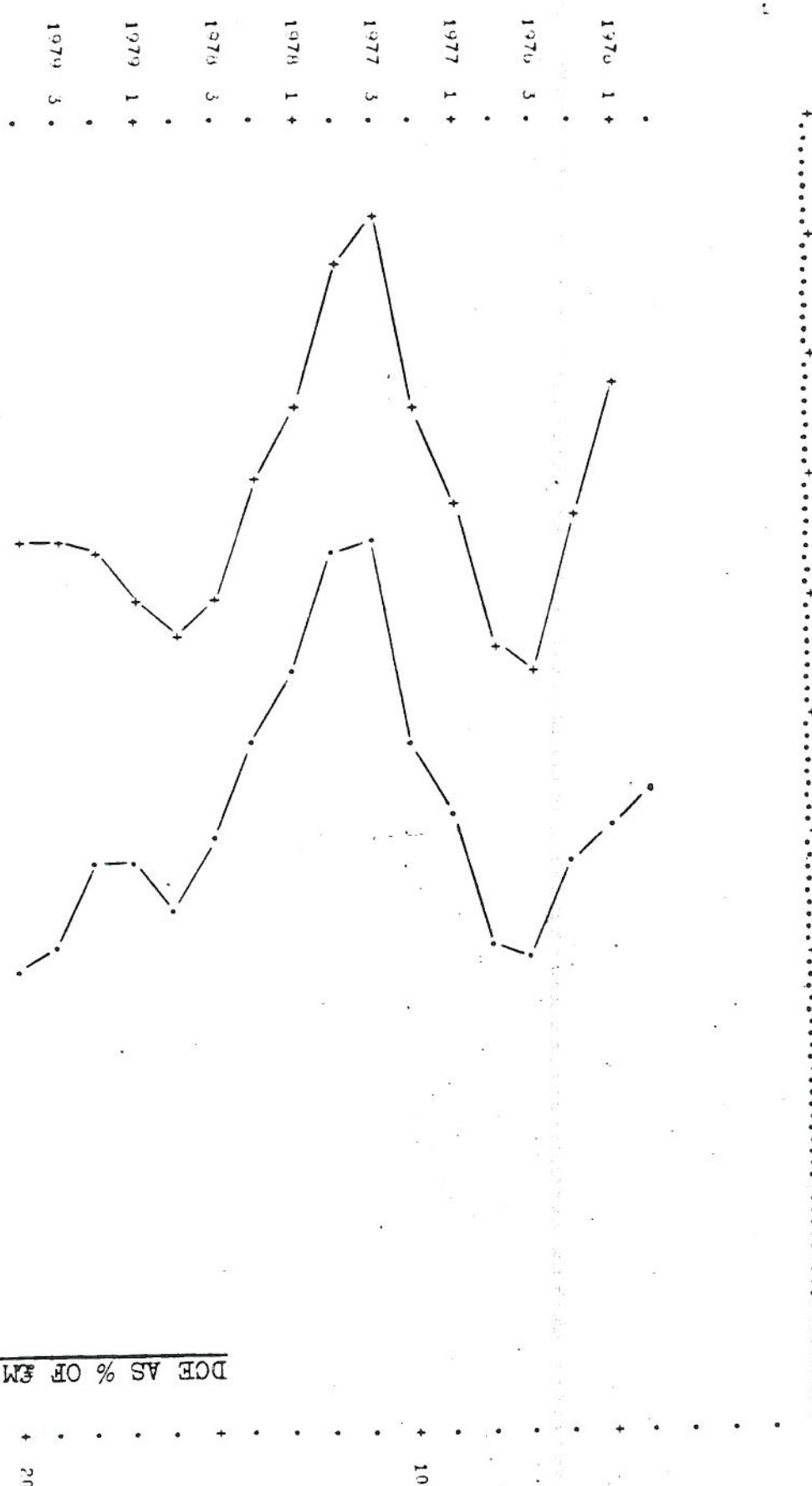
1. Thank you for your note of 28 May. I attach a graph showing DCE as a percentage of £M3 (nominal DCE) and the same series adjusted for the increase in the GDP deflator ("real DCE").
2. I also enclose (with top copy only - but available to others on request) a report prepared by Mr Denham in April of last year and recently unearthed for discussions within OF. It provides a useful description of the sequence of events in 1977 and 1978. As I said in my earlier note, I think it is an episode which could contain a warning against reducing interest rates as a means of holding down the exchange rate.

X/

*ASB*

A J C BRITTON  
6 June 1980

VARIABLE	MINIMUM	MEAN	MAXIMUM	INTERVAL
3 DCE	2.591	14.82	20.60	0.500
9 DCE*AI	-11.06	0.6103	7.811	0.500



DCE AS % OF £M3

"Real DCE"

DCE

20

10