

File- Monetary Policy Issues-Exchange Rate  
Intervention – Part D

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From : D L C Peretz  
Date : 9 March 1988

SIR T BURNS

cc Mr A Allan

PS/ESTP  
PS/Sir P Middleton  
Sir G Littler o/r  
Mr Scholar  
Mr R T G Allen  
Mr ~~Gl~~ice  
Miss O'Mara  
Ms Goodman

UNCAPPING IN 1977

As a matter of interest I have looked out the figures for what happened to exchange rates when sterling was "uncapped" on 31 October 1977. They are :-

London Closing Rates

	Friday 28 October	Monday 31 October	Friday 4 November	Friday 25 November
ERI (1971 = 100)	62.50	64.57 (3.3%)	63.35 (1.4%)	63.17 (1.1%)
\$/£	1.7772	1.8396 (3.5%)	1.8040 (1.5%)	1.8155 (2.2%)
DM/£	4.0200	4.1450 (3.1%)	4.0712 (1.3%)	4.0237 (0.1%)

% rise from 28th October in brackets

2. By comparison, movements in the £ so far this week have been :-

	Friday 4 March	Monday 7 March	Tuesday 8 March
ERI (1975 = 100)	74.8	76.2 (1.9%)	77.0 (2.9%)
\$/£	1.7715	1.8160 (2.5%)	1.8427 (4.0%)
DM/£	2.9986	3.0445 (1.5%)	3.0718 (2.4%)

% rise from 4 March in brackets

3. Circumstances are of course different, in many ways, (not least that in October 1977 interest rates were reduced by 1%, to 5%) - though the similarity of the \$/£ rates is uncanny!

19/10/88

*D L C*

D L C PERETZ

From : D L C Peretz  
Date : 9 March 1988

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MR A ALLAN

cc Sir P Middleton  
Sir T Burns  
Mr Scholar  
Miss O'Hara

MARKETS : INTERVENTION

I should record that, as you asked, I confirmed with Mr Foot in the Bank after yesterday afternoon's blip in sterling that the Bank's tactics in the foreign exchange market in the event of a further rise should remain as previously agreed - and as discussed between the Chancellor and Deputy Governor on the afternoon of 7 March.

2. I also confirmed that if, to meet the tactical objective, the Bank had to deal to some extent in dollars they should do so. We could consider whether or not to switch into other currencies later. The Bank will however tell us first if they see it becoming necessary to deal in this way in London. Their view at present is that so long as the amounts are relatively modest it is not technically difficult to switch any dollars bought into a mixture of French francs and ecu, and that there is some advantage vis-a-vis other central banks in doing this immediately, so that it can be reported as a single transaction. Switching out of dollars later on might be harder to explain to the Fed.

*DLCP*

D L C PERETZ

15/3 . 1988



FROM: A C S ALLAN  
DATE: 7 March 1988

## NOTE FOR THE RECORD

cc Sir P Middleton  
Sir T Burns  
Mr Scholar  
Mr Peretz

*of Miss D'Arcy*

## MARKETS

The Chancellor had a brief word on the phone with the Deputy Governor at about 3.00pm this afternoon. The Deputy Governor reported that demand from the US was strong. Intervention for the day now totalled some \$500 million, with the rate still bumping against DM3.05. He thought it would be wise to step aside for a while, wait for a pause and then try to pull the rate back. He also noted that the Bundesbank were unhappy about us buying deutschemarks when the DM/\$ rate was below 1.6875; we should need to deal in dollars and consider switching it into other currencies later.

2. The Chancellor agreed. In the event the demand eased and the rate remained below 3.05.

*ACSA*

A C S ALLAN

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FROM: H C GOODMAN  
DATE: 18 March 1988

MR GRICE

cc: Mr Peretz  
Miss O'Mara  
Mrs Ryding 10/4  
Mr Pike

PAY SETTLEMENTS AND EXCHANGE RATE CHANGES

We discussed this at the group meeting this morning and I suggested that the sectors with the highest level of pay rises might not necessarily be in those sectors exposed to exchange rate fluctuations.

I have checked out the figures and they are as follows. The CBI report for February shows settlements in manufacturing, averaging 5.5 per cent in 1987 Q4. As far as average earnings are concerned the twelve month increases to December 1987 are:

	<u>Actual</u>	<u>Underlying</u>
Whole Economy	8.6	8½
Manufacturing	8.4	8¼
Production	8.2	8¼
Services	9.1	8¾

Meanwhile the percentage change in the exchange rate between 20 February (the Paris Accord) and 14 March this year were:

Sterling / Index	11.7%
Sterling / Dollar	21%
Deutschemerk / Sterling	10.3%

*H C Goodman*  
H C GOODMAN

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FROM: HUW EVANS  
DATE: 18 MARCH 1988

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SIR TERENCE BURNS

cc

- Sir Peter Middleton
- Sir Geoffrey Littler
- Mr Lankester
- Mr Scholar
- Mr Odling-Smee
- Mr Peretz
- Mr Grice
- Mr Matthews
- Miss O'Mara
- Mr Dolphin
- Mr Hood
- Ms Symes
- Mr Edmonds

1. Mr Gordon  
2. Mrs Boyd

EXCHANGE RATE SYSTEMS

Last September in his speech to the Annual Meetings, the Chancellor outlined his approach to exchange rates. This minute and attachments written in IF2 set out:

- (i) the main points of that speech;
- (ii) a reminder of the different views on how exchange markets work;
- (iii) the costs of misalignments;
- (iv) the various notions of sustainability of the US current account deficit and the dollar;
- (v) reasons for making exchange rates the focal point of policy co-operation.

2. The last year has seen a strong revival of interest in both the international monetary system and greater stability of exchange rates. The work of the Committee of Twenty is being dusted off. The French, not surprisingly, are leading the pack. But continued US reluctance when setting monetary policy to give much weight to stabilising the dollar (particularly in advance of the Presidential election) and of course increased domestic sensitivities make this not the time for developing further in public ideas for a future exchange rate regime.

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The September Annual Meetings speech

3. Before outlining "a regime for the future" the Chancellor made a number of points about the nature of the world in which the major countries are attempting to manage exchange rates. Differences in the assumptions about the way the world works - in particular the way that foreign exchange markets operate - underlie the gap between supporters and opponents of more managed exchange rates. The principal points made by the Chancellor were:

(a) Floating exchange rates are subject to large medium term swings and misalignments.

(b) Exchange rate misalignments are costly.

(c) Circumstances are now more propitious for managed exchange rates than in the 1970s and early 1980s:

- inflation in the countries co-operating on exchange rate management is low and inflation differentials are small;

- these countries are similarly committed to using their macroeconomic policies to keep inflation down and they pursue market-orientated micro policies.

(d) The size of current account deficits and surpluses of the US, Japan and Germany (and other imbalances in the world economy) are compatible with more active management of exchange rates.

(e) Exchange rates should be the focal point of policy co-ordination. This view was stated explicitly in the January debate in the House on the Autumn Statement.

(f) Countries are prepared to give significant weight to exchange rates in the conduct of their monetary policy. The Chancellor drew this conclusion from the experience of Plaza and Louvre. Later experience, however, particularly since September, also suggests that countries will tend to take account of exchange rates only when it suits them.

(g) Governments are willing to use intervention, as well as monetary policies, to support an exchange rate agreement.

4. The Chancellor then went on to sketch a "regime for the future", covering central rates, fluctuation bands, flexibility, global indicators (on which some progress is being made: they are now in an extra table in the IMF's paper on indicators), discretion etc. This left open a number of questions, which we have not attempted to deal with here.

#### Exchange rate determinants

5. Annex A reminds us of the major differences in the theories of exchange rate determination, and uses the dollar in the period 1983-6 as an example.

#### Costs of misalignments

6. Annex B sets out the various costs of misalignments, drawing partly on Krugman's recent lectures.

#### Sustainability

7. We frequently hear the current account imbalances of the three largest economies being described as unsustainably large. What does this mean and how should we define an unsustainable situation? We have looked at a range of factors to see what insights they provide on this question:

(a) present and prospective current balances in relation to historical experience;

(b) reasons why structural shifts in national saving and investment balances could produce changes in 'equilibrium' current account positions;

(c) the consequences of imbalances for net external asset and liability positions and hence for the creditworthiness of the countries' concerned;



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(d) on the sustainability of current exchange rates, we have compared present real exchange rates with past experience.

8. Annex C gathers together a variety of projections of the US current account deficit: virtually all show a reduction over the next two years. This is followed by little change, or even some worsening, as the effects of dollar depreciation come to an end and US growth of domestic demand comes back to a rate close to that of its GNP. We have looked at assumptions about US saving and trade propensities more favourable to greater adjustment of the balance of payments. It is possible to get a US current account close to balance by the early 1990s, without a further depreciation of the dollar, but this requires a combination of relatively favourable factors. This is not inconceivable, but could involve a transitional period of weaker growth in the rest of the world.

9. Annex D looks at the various measures of US real exchange rates: on most measures of relative prices and costs, the US is already very competitive by the standards of the last decade and a half, though there are concerns that non-price factors (such as the level of technology) are less favourable.

10. Annex E looks at the main considerations relevant to the financing of US deficits. The conclusions are:

(i) In a world of mobile capital, different savings/investment propensities and different returns on capital, countries should not aim for balanced current account positions; indeed given the uncertainties over measurement and forecasting, this could be a very foolish medium-term objective (pace the current account as a performance indicator).

(ii) The ratio of US net external debt to its GNP, although growing rapidly, is still very low compared with countries like Canada and Sweden.

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(iii) A given level of debt will be more easily financed if:

(a) borrowing goes to finance additional profitable investment;

(b) the proportion of government debt is not too large;

(c) the US government gives a high weight to sound financial policies, especially the need for a stable dollar;

(d) the US government is prepared to issue liabilities in foreign currencies.

(iv) A sustainable position in the long run is possible with continuing current account deficits (as long as nominal GDP continues to grow). But as net interest payments abroad grow, the scope for a continuing deficit on trade declines, and ultimately - say within the next decade - the US trade deficit will need to decline to close to zero.

11. Conclusions on sustainability, looking at all this evidence, depend on the relative weight attached to the different pieces of evidence. It is tempting to conclude that, with US competitiveness now strong, with the US able to accumulate liabilities on a substantial scale, and with current account forecasts (especially over the medium term) notoriously uncertain, sustainability is a reasonable assumption. But the persistence of trade deficits in nearly all projections, the substantial improvements in performance that have to be made to most models in order to bring about a continued strong decline in the deficit, should make for caution. Perhaps most of all, the fact that currently US imports of goods are around 60 per cent higher than US exports is an indication of the size of the gap that sooner or later will have to be closed.

12. So we should continue to be cautious, arguing for a period of stability in the dollar and against the proposition that dollar depreciation alone will help, rather than asserting that the dollar is necessarily at or below a sustainable level in a longer term sense.

Exchange rates as the focal point of policy co-ordination

13. Annex F develops some of the arguments set out in the Chancellor's speech on January 14.

Next steps

14. You will want to consider how best to deploy the material in this minute and in the attachments (and the briefing note on the Balladur proposals) for the Chancellor in advance of the meeting on 23 March.

15. When we discussed this at your meeting on 3 March, we thought the Chancellor might want to cover, in his intervention at the Interim Committee, the following points in particular:

(i) The case for co-operation: partly to counter the impression that because we are against further development of the indicators at national level, we are hostile/lukewarm towards co-operation in general.

(ii) The case for making exchange rates, and not macro policies, the focal point for co-operation. This theme, which was in the January 14 speech in the Autumn Statement debate, could be restated for an international audience.

(iii) The costs of misalignments.

16. We have not tried to write speaking notes on all these subjects: we can develop them after the meeting with the Chancellor.

*H. P. Evans*  
H P EVANS

EXCHANGE RATE DETERMINANTS

Strong disagreements about the role of governments in exchange markets largely reflect different views about how these markets work. Among the first and most fundamental questions that we need to ask ourselves are what determines exchange rates and why have rates varied so much over the past decade and a half of floating?

2. We can see, with the benefit of hindsight, that circumstances in the 1950's and 1960's were unusually propitious for exchange rate stability. Inflation was low and taking one year with another the policies of the major countries (including especially the US) were directed at keeping it low, inflation differentials between countries were relatively small, financial markets were comparatively undeveloped and exchange controls impeded capital flows between countries. When generalised floating started in the 1970's, it was widely expected to facilitate necessary changes in rates (which the Bretton Woods' system of adjustable pegs was blamed for delaying unduly). It was also argued that rates would, assuming appropriate macro policies were pursued, remain relatively stable, since speculative capital flows would need to be stabilising, if they were to be profitable in the long-term.

3. In practice, not only has there been substantial day-to-day and week-to-week volatility of exchange rates, but also large medium-term swings in exchange rates - the latter being potentially much more serious, since it is difficult for exporters and importers to hedge against them.

4. A wide variety of exchange rate models has been developed to try to explain the variability of floating rates. A key element of most of them is that the supply of and demand for domestic and overseas assets are the main determinants of exchange rates in the short-run. This accords with such observable facts as the huge size of asset stocks and the potential capital flows, compared with trade flows, that can be generated in the short-term by portfolio adjustments; the increased mobility of capital which improved communications and the relaxation of exchange controls have produced; and so on.

deficit? On average the US current account in the 1950's, 1960's and 1970's was close to a zero balance and the long-term equilibrium rate for the dollar in the 1980's might be expected to be broadly consistent with this. The growing current account deficit thus pointed (*ceteris paribus*) to an exchange rate below rather than substantially above this equilibrium rate.

9. These developments make it difficult to believe that the forward-looking expectations of financial market operators have consistently been based on a correct assessment of fundamentals. Nor do the views of academic economists, who argue that markets are efficient and their expectations rational, come out well from the more systematic and rigorous econometric tests to which they have also been subject and whose results, while not conclusive, offer little to support them.

10. In an effort to square the circle the possibility of rational speculative bubbles has been raised. On this view, while the bubble is expected to continue in the short-run, markets recognise that there is a chance that it will burst and the exchange rate fall back toward its equilibrium. They would need, however, over periods such as 1982-85 to have been compensated for this risk by a higher interest differential in favour of the dollar. Yet from 1983 onwards this differential fell, and the dollar continued to rise.

11. It is difficult not to draw the conclusion that the dollar, particularly in 1984-85, has been driven by market sentiment which is not based on considerations of fundamentals. Various explanations for this are possible. One important factor is that the time horizons of foreign exchange market traders are notoriously short and may ignore current account effects, which build up only with a lag - indeed, exchange rate appreciation may initially improve the current account (i.e. a J-curve effect).

COSTS OF EXCHANGE RATE MISALIGNMENT

Floating exchange rates have been subject to not only substantial day-to-day and week-to-week volatility, but also to large medium-term swings. The 1980's have seen an appreciation of some 40 per cent in the dollar's effective rate followed by a depreciation of similar dimensions. Some of the movements in bilateral exchange rates have been even greater.

2. Financial markets have evolved to help traders cope with the variability of exchange rates. For the main currencies, hedging against short-run volatility by using the forward exchange markets is relatively straightforward and inexpensive.

3. Coping with large medium-term swings is another matter. If exporters and importers know with certainty what their foreign currency receipts and expenditures will be over the next few years, they may be able to hedge (e.g. by making deposits or borrowings in foreign currency for the appropriate term). In practice the overwhelming majority of traders are not in this happy position. Investing in new plant and equipment or developing an export market are medium to long-term propositions involving considerable uncertainty about the actual scale of sales receipts or production outlays. This obviously makes it very difficult for a firm to protect itself against currency fluctuations.

4. Arguments that floating exchange rates are freely determined by market forces and must therefore be "optimal" miss the point. They are based on a static view of market efficiency, which ignores uncertainties and many other features of the real world. Far from improving the price mechanism floating which leads to large medium-term swings in exchange rates actually degrades it.

5. Adjustments which are inappropriate in the long-term are encouraged, with firms being forced to move out of markets where they have a genuine long-term comparative advantage. A persistent

10. Consumers may also suffer from exchange rate fluctuations as the implications for domestic prices prevent a steady expansion in living standards.

11. Perhaps most serious, if unchecked, are the protectionist pressures that emerge as industries become less competitive in the short run and uncertain about their long term future. Persistent misalignment threaten the open multilateral trading system.



MEDIUM-TERM PROJECTIONS OF THE US CURRENT ACCOUNT

In recent years the OECD and the IMF have produced many medium-term scenarios for the US current account, private forecasters have also extended their US forecasts into the medium-term and our own WEP forecasts continue to project current accounts over a four year horizon. This note sets out, in turn, the most recent medium-term forecasts/projections of the US current account from each of these sources:

- i. The WEP model - 1988 FSBR forecast.
- ii. The IMF - March 1988 WEO forecast and medium-term projections.
- iii. The OECD - February 1988 WP3 projections.
- iv. Private forecasters - Bryant and Holtham's analysis.
2. Direct comparisons between projections are difficult because they use different assumptions about domestic policies and exchange rates. But virtually all suggest that if no changes are made to "current policies" and if the real exchange rate of the dollar does not fall, the US current account deficit will decline only moderately over the next few years and by the early 1990s it will still be close to or over 2 per cent of GNP. This would mean that the US external debt:GNP ratio would still be rising.
3. There are various ways in which smaller US current account deficits might be brought about. The effects of a recovery in US saving (which might come about through a combination of increased household saving and a smaller Federal Budget deficit) and a better US trade performance are examined below. A combination of these events could come close to eliminating the US current account deficit by 1991 without further exchange rate adjustments. But there would still be substantial transitional costs for the rest of the world economy, as well as the US.

6. The US current account is expected to improve gradually over the next four years. In 1988 the lagged effects on trade volumes of past dollar depreciation are the main factor behind the improvement. In later years the assumed tightening of US policy slows domestic demand in the US relative to demand in the rest of the world and this leads to slower growth of US imports, while export volumes rise relatively rapidly.

The IMF Forecast

7. For the World Economic Outlook (WEO) the IMF construct a "reference" or "baseline" medium-term scenario in which they assume that external financing of the US current account deficit will be available at constant real exchange rates and unchanged nominal interest rates. They also assume that countries will stick to announced fiscal policy aims (though in the case of the US this is not interpreted as meaning that the Gramm-Rudman targets will be achieved) and that in all countries real GNP will grow in line with potential in the medium-term. No major changes in real commodity prices are expected.

8. Only limited results are quoted in the IMF's WEO documents. The projection for the US current account is shown in Table 2.

Table 2: IMF projection of US current account

	1986	1987	1988	1989	1992
Current balance (%GNP)	-3.3	-3.6	-2.9	-2.5	-2.1

Note assumes:

- i. constant real exchange rates,
- ii. no changes in announced fiscal policy intentions,
- iii. stable nominal interest rates.

9. The IMF expect rather greater adjustment of the US current account deficit in 1988 than does the WEP, but rather less adjustment thereafter because US policy is not assumed to change. Consequently, both forecasts expect the deficit to be slightly greater than 2 per cent of GNP in 1991/1992.

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Private Forecasts

12. Ralph Bryant has taken the US current account projections of five world economic models prepared for a January 1987 Brookings workshop and updated them for developments during 1987. The original projections and the update are based on the assumptions that US and foreign economies grow at similar rates and that real exchange rates are constant. The average of the updated results are shown in Table 4. (The projections of the individual models are shown in the attached chart).

Table 4: Private forecasts of US current account deficit

	1986	1987	1988	1989	1990	1991
Current balance (\$bn)	-145	-149	-125	-108	-113	-127
Current balance (%GNP)	-3.4	-3.3	-2.6	-2.2	-2.1	-2.3

Note assumes:

- i. constant real exchange rates,
- ii. US and foreign growth are equal,
- iii. figures as a percentage of GNP assume 6 per cent a year nominal GNP growth.

13. These averages mask a range of views. One of the models (the National Institute's GEM, which is based on our own WEP) forecasts a current account deficit close to zero by 1991, while another expects it to be over \$250 billion. However, the other three forecasts all put the deficit close to \$150 billion (2.7 per cent of GNP) in 1991.

Sensitivity analysis of projections

14. The projections cited above are inevitably subject to a substantial margin of error. The models may be an imperfect representation of how the world economy actually works and they may make incorrect assumptions about policies. We have therefore

different. Thus, the income elasticity in the US import equation (24) is the highest on the WEP model, while the markets elasticity in the US export equation (1) is the lowest. To stimulate the effects of more favourable trade elasticities both these elasticities have been changed to 1. The results of this exercise are shown in Table 6.

Table 6: US current account with higher US saving and more favourable trade elasticities

	1987	1988	1989	1990	1991
Current account (\$bn)	161	152	124	88	45
Current account (% GNP)	3.7	3.2	2.5	1.6	0.8

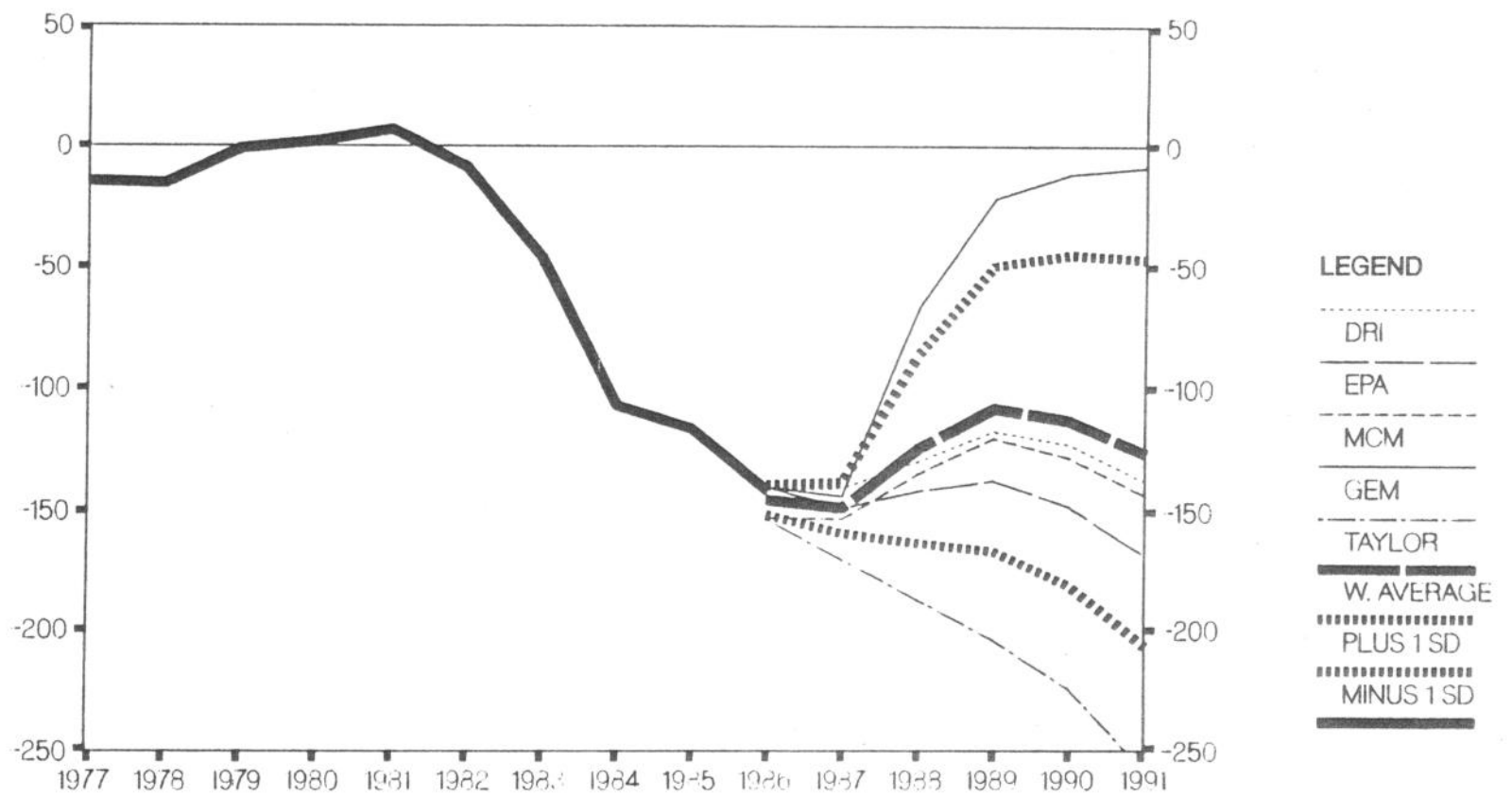
18. The main benefit to the US current account comes from lower imports (the present level of imports is higher than the level of exports and the adjustment to the import elasticity is larger). There will be significant offsets to the better US trade performance outside the US. This will mean a worse trade performance and lower growth in surplus countries such as Japan, Germany and the SE Asian NICs. But it will also mean a worse trade performance for many Latin American countries - e.g. Mexico, Brazil, Argentina - for which the United States is an important market for their exports.

19. The results of these two variants, as shown in Table 5 and 6, cannot be simply added together to give the effect on the US current account of higher US saving and more favourable trade elasticities. If the US import elasticity is much lower (1 instead of 24) then the benefits from higher US saving, which come through lower spending and thus fewer imports, will obviously also be lower. Nonetheless, a combination of higher saving and a better trade performance would be sufficient to come close to eliminating the US current account deficit by 1991.

20. The simulated changes in saving are regarded as plausible. Household saving in the US has fallen well below its historical average level and could recover again, and the US Federal budget deficit was cut by the equivalent of 2 per cent of GNP in 1987, so cuts of the magnitude assumed here are within the bounds of recent

# CURRENT ACCOUNT BALANCE History 1977-1986 and Conditional Projections for 1987-1991

Billions of Current U.S. Dollars



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