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

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Pages 178-204

THE REAL EFFECTIVE DOLLAR EXCHANGE RATE

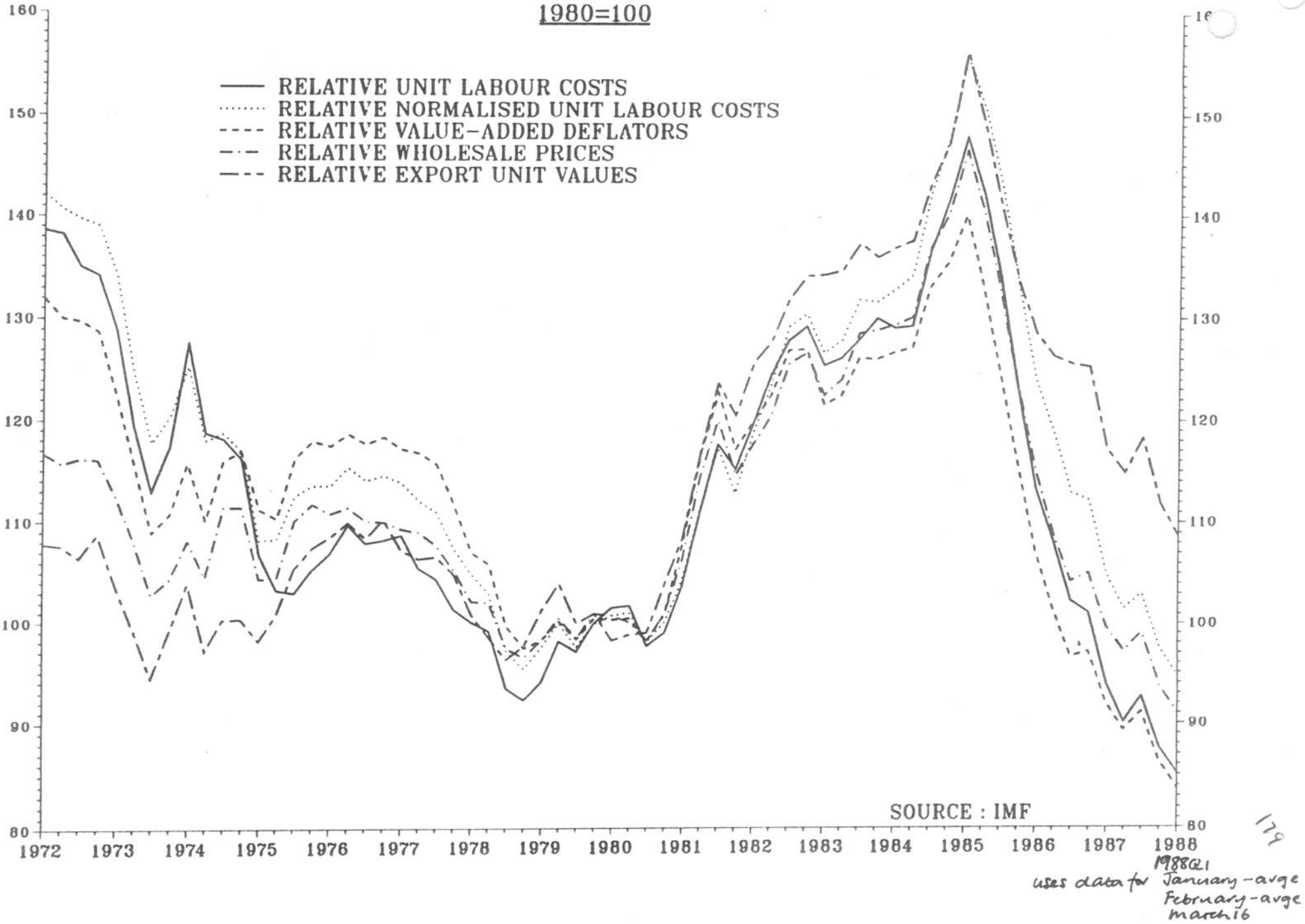
The attached chart shows the IMF's measures of cost and price competitiveness for the US manufacturing sector from 1972. The comparison is with sixteen industrialised OECD economies, with Japan, Canada, and the EC countries the most important competitors included. The IMF calculates five measures - all relate to manufactured goods. Values for 1987Q4 and 1988Q1 are estimates based on actual changes in nominal effective exchange rates.

2. With the exception of relative export unit values, all the competitiveness indices show a similar picture. Relative actual unit labour costs perhaps provide the best guide to the underlying competitiveness of the manufacturing sector and are currently lower than at any time in the period of 1972-87, including the previous low point of 1978. The fall in the index (improvement in competitiveness) since the 1985 peak has been more than 40 per cent.

3. The export price competitiveness measure (relative export unit values) has fallen less (by 30 per cent) since the 1985 peak, and remains close to the average for the period 1972-87. The smaller fall in this series suggests that US manufacturing exporters have been able to rebuild profit margins squeezed by the high nominal exchange rates of 1983-85, while exporters to the US have tried to keep down their prices in dollar terms (by cutting their domestic currency prices) in order to try to remain competitive in the US market. This may, though, be a transitional situation and if present levels of cost competitiveness are maintained, exporters may have to adjust their prices further.

4. From early 1985 to early 1988, all the indices show that the competitive position of US manufacturing has changed dramatically, from very weak to average or stronger than average. Various arguments have nevertheless been put forward suggesting that this will be insufficient to correct the US current account deficit and further depreciation will be necessary:

U.S REAL EXCHANGE RATES
1980=100



179

1988Q1 uses data for January-avge February-avge March16

THE SUSTAINABILITY OF THE DOLLAR

The question of sustainability is essentially whether the path of current account deficits to which the present level of the dollar gives rise are in some sense feasible. If it is infeasible, then the dollar must fall. There are two senses in which the level or path of the current account might be infeasible. Both are related to the ability to finance the deficits, but they differ in the time horizon over which financibility is considered.

"Long-term" sustainability

2. A path for the current account will be ultimately unsustainable if it gives rise to overall levels of external debt which are too large to be financed. In the case of the US, such a position might arise either when US assets become so large a proportion of foreign portfolios that foreigners are unwilling to hold any more, at any reasonable interest differentials; or when US overseas debt becomes so large relative to US GNP that fears emerge amongst foreign lenders about the willingness of the US to service and ultimately to repay the debt. Increasingly, the US government loses control of its monetary policy, and the exchange rate and US interest rates become effectively determined by overseas creditors.

3. There is an important distinction to be made here between overseas borrowing by the private sector and by the government. (In 1987, just under 50 per cent of US net overseas liabilities was accounted for by the US government). To the extent that borrowing is undertaken willingly by the private sector in order to finance investment with a high rate of return, foreign investors have little to fear from an increase in debt. Furthermore, to the extent that the debt is spread through the economy amongst many individual debtors, the risk of widespread default is minimised. Overseas borrowing by the government, particularly in order to finance its own current expenditure, is in a different category from the lenders' point of view. On the one hand, the government is able at the end of the day to raise taxes to repay the debt. On the other hand, the US government is a large individual borrower and has the ability to reduce the burden of debt without defaulting on it through a deliberate

denominated in dollars, however, this latter measure has less relevance to the US. Looking to the future, most forecasts of the US current balance imply a continuing rise in the US debt/GNP ratio of over 2 percentage points per year into the medium-term (ignoring revaluation effects). However, the OECD projects only a further 8 percentage point deterioration in the ratio between 1987 and 1993, compared with a 12 point worsening from 1983 to 1987.

6. The above discussion raises the question of the maximum sustainable level of the US external debt/GNP ratio. It could be argued that foreign investors would be prepared to support a much higher ratio for the US than that for other debtors, because of the dominant position of the US (and the dollar) in the world economy, and because the US government would be perceived in the final analysis as having both the incentive and the necessary political will to take action to avoid an international debt crisis seen as caused by the US itself and involving the status of dollar assets.

7. On the other hand, most of the US assets held by foreigners are currently denominated in dollars i.e. the currency of the borrowing country, although there has been some shift towards real as against financial assets. The risk of loss arising from the possibility of default is relatively small. More important to overseas investors is the likelihood of dollar depreciation as the overhang of dollar liabilities rises, and this may be a deterrent to investment at an earlier stage in the build-up of debt than would be the case if borrowing is undertaken in other currencies. Secondly, the portfolio position of foreign investors may become a constraint. For example, the US current deficit in 1987 is estimated to have absorbed over 15 per cent of net saving in the rest of the OECD. Because of the scale of US borrowing, foreign investors may become saturated with claims on the US, and denominated in dollars, at a point <u>before</u> they become concerned about ability to repay or risk of default. Thirdly, large scale US borrowing would put the position of the dollar as principal reserve asset of the world financial system under question, and this might deter investors. For all of these reasons, there is likely to be a need for increased borrowing in foreign currencies by the US as the level of debt increases.

11. The conclusion to be drawn from the above discussion is that while there is no immediate need for precipitate action by the US to cut its current account deficit substantially, let alone eliminate it, on long-term financing grounds, the trade deficit will need to be reduced over a number of years to close to zero as net interest payments abroad rise. The time period over which this adjustment must take place depends on what is thought to be the ratio of US external debt to GNP which is sustainable in the sense of being acceptable to the US authorities and financible by foreign holders of US assets. That level is certainly much higher than the current level of up to 10 per cent. But on current forecasts of the US balance of payments and GNP growth with unchanged policies, the debt/GNP ratio is likely to rise by around 2-3 percentage points each year, and could reach a level which would be difficult to finance on a long-term basis before the turn of the century.

"Short-term" sustainability

12. In addition to the previous discussion of sustainability in relation to the stock of assets and liabilities, there is the question of whether the current account deficits forecast for the next two or three years can be financed at interest rates and exchange rates which are compatible with domestic US and rest of the world growth and inflation objectives. From a historical perspective, the move into balance of payments deficit which began in 1984 and is set to continue for some years yet, is a striking development. In the 20 years to 1983, the US current account was in broad balance. The key to the financing of the US deficits over the next few years, as over the past three or four, will lie with the Japanese, whose outflow of long-term capital accounted for 80-90 per cent of the US current account deficit in 1986 and 1987. (It is worth emphasising that a necessary condition for the continued financing of the US current deficit on a year-by-year basis without severe disruption to international financial and foreign exchange markets is that there should be a reasonable prospect of a long-term solution to the problem of the US deficits).

Japanese investors continued to invest massively in the US during 1986 and 1987 despite both an exchange rate for the dollar which was falling rapidly and widely expected (until the Louvre accord) to continue to fall and an interest differential which was not on average markedly higher than it is now. The much lower risk now of a substantial fall in the dollar should ensure that Japanese capital continues to flow to the US in substantial quantities;

v. but the reluctance of the US authorities to give a high priority to stabilising the dollar - preferring to give a higher weight to maintaining an easy monetary policy - puts financing by Japanese and other inflows at risk.

ANNEX F

EXCHANGE RATE THE FOCAL POINT FOR POLICY CO-ORDINATION

Historical examples:

(i) Bretton Woods
(ii) EMS
(iii) Louvre Accord

2. In all these, policy co-ordination centred on exchange rates, with rules for exchange rate bands, a degree of agreement on who intervenes when, and a commitment to give weight to exchange rates in setting monetary policy.

3. Explicit co-ordination has always been needed to set up an exchange rate system; and then close co-ordination on intervention and monetary policy. There has been much less explicit co-ordination over fiscal policy which must be consistent with the needs of exchange rate and monetary policies. Hence policy co-ordination has often included references, and sometimes commitments, to fiscal policy.

4. Attempts to make fiscal policy deals the centrepiece of policy co-ordination have, however, been few and generally not successful. Bonn I (1978) produced a fiscal expansion in Germany and Japan which was ill-timed and inadvisable in the light of:

(i) the rate of expansion of the world economy, and of those two countries in particular, in 1978; and

(ii) the 1979 and subsequent rise in oil prices and in inflation.

5. Fiscal policy co-ordination has often carried the flavour of global demand management, without full recognition of the many difficulties. Moreover, the setting of fiscal policy in a medium term framework - e.g the MTFS - does not require fiscal policy co-ordination.

17
24/3 P56

From : D L C Peretz
Date : 24 March 1988

MR R I G ALLEN

cc PPS
Sir P Middleton
Miss O'Mara

THE MONEY PROGRAMME : LORD YOUNG

As I mentioned, the Money Programme are apparently running a feature on the exchange rate this weekend, and have been pressing Lord Young to appear. The DTI declined. They were then pressed for a statement from Lord Young that could be quoted. Again they declined. Finally they were asked for a statement they could use about the relationship between exchange rate movements and trade. On this DTI officials feel that Lord Young ought to be prepared to offer some kind of on the record statement.

2. They have sent me the attached text for clearance. As it stands there is not a great deal to object to, though I would want to suggest the change marked at x.

3. That does however leave the question of whether it is right for the only Government statement quoted on this programme to come from Lord Young, or whether we should try to balance it with something of our own. On that I suppose the natural course would be to point the Money Programme towards the Chancellor's various recent on the record comments, including that in the House of Commons on 10 March, and the section in the budget speech.

4. Given Lord Young's statement earlier in the week, it seems to me not unhelpful to have him saying something like this.

5. I am asked for clearance of the text by lunchtime today, but no doubt that deadline is to some degree flexible.

D L C PERETZ

£/DM EXCHANGE RATE AND TRADE

Germany is our second largest individual export market, following the United States. The EC, whose main currencies are tied to the DM already takes half our exports; and with the creation of the single market by 1992, it will increasingly be our most dynamic market. Our Community partners are our main competitors both in many third markets and in the UK. Competitiveness with our EC partners (and our other competitors) is therefore essential to the continued transformation of our economic and industrial prosperity that we have seen over the past seven years.

Competitiveness is not just a question of price. ~~In fact~~ Aspects such as quality, design, reliability and after-sales service are often more important. In a world of increasing volatility and competition from low-cost industrialising countries, sustained success will mean moving up-market to less price-sensitive products; competing on excellence.

But price remains important and broad stability of exchange rates removes one major element of uncertainty for business. ~~We have maintained broad stability against the DM [around a realistic rate] over the past year.~~ Stability does not mean no movement at all. But the That policy remains unchanged. Also unchanged is the Government's determination not to allow sterling to depreciate to accomodate excessive increases in domestic costs. Experience in the 1960s and 1970s has shown beyond question that competitiveness cannot be achieved by a policy of depreciation.

355/3.

FROM: A C S ALLAN
DATE: 24 March 1988

SIR T BURNS

cc Sir P Middleton
Sir G Littler
Mr Lankester
Mr Scholar
Mr Odling-Smee
Mr Peretz

D2

EXCHANGE RATE POLICY

... I attach the final version of the paper you prepared.

ACSA

A C S ALLAN

1. Mrs Goodman
2. Mr Rigby
Could you explain x to me done this morning 7/4

cc Miss O'Mara
Mr Grice

4/72.

EXCHANGE RATE POLICY

Monetary Policy and the Role of the Exchange Rate

1. The aim of monetary policy is to control inflation, which has been brought down from an average rate of 15 per cent in the 1970s to 3¼ per cent today.

2. Progress in recent years has been less rapid but it is clear that the trend has been downwards. Inflation over the past two years has been markedly below earlier years. And the forecast shows this improvement being held. Mortgage rate changes introduce additional fluctuations and the underlying trend is clearer if they are ignored.

Inflation

	RPI Total	RPI excluding mortgage payments
1982	8.6	8.5
1983	4.6	5.2
1984	5.0	4.4
1985	6.1	5.2
1986	3.4	3.6
1987	4.2	3.7

3. In comparing inflation in the UK and elsewhere it is important to note that:

- lower oil prices helped other countries much more than the UK as sterling fell during that adjustment period;

- the UK has experienced a number of years of sustained rapid growth. It is rare for inflation to fall in those circumstances; indeed it usually goes up.

4. The conduct of monetary policy has been difficult; partly because of changes to the financial system:

- broad money has been a particularly poor indicator throughout the 1980s. Chart 1 (page 3) shows the lack of correlation between £M3 and inflation. This seems to reflect

a number of factors. High real interest rates have added to the attractiveness of financial assets in general; increased competition in financial markets has led to rapid growth in private sector liquidity and borrowing; and the growing internationalisation of markets means that demand for broad money is intertwined with international capital flows and exchange rate expectations.

- narrow money (MO) has had a closer relationship with inflation (chart 2) and has a good record as an indicator of monetary conditions. But on its own it is not enough. It does not carry much market credibility; and it only gives a short lead, if at all, to inflationary trends.

5. Exchange rates have become a major complicating factor in the assessment of monetary conditions; they have shown substantial fluctuations - particularly the dollar. Very often the fluctuations are reversed; but not until they have moved a long way and had substantial direct and indirect effects.

6. Exchange rate changes have an important impact on monetary conditions:

- appreciation will tighten monetary conditions. There is a direct effect on import prices; and appreciation squeezes profits of UK manufacturers by constraining their ability to raise prices. Similarly depreciation will loosen monetary conditions;

- exchange rate changes can generate second round effects through their impact on inflationary expectations and wage negotiations.

7. In some respects a higher exchange rate can be seen as a substitute for higher interest rates. But there is an important difference. As compared with higher interest rates, tightening monetary policy through a higher exchange rate will produce a worse outcome for the balance of payments; it puts more pressure on exporters as well as those supplying goods at home who have to compete with cheaper imports; and less on the non-trading sector, particularly construction.

Chart 1

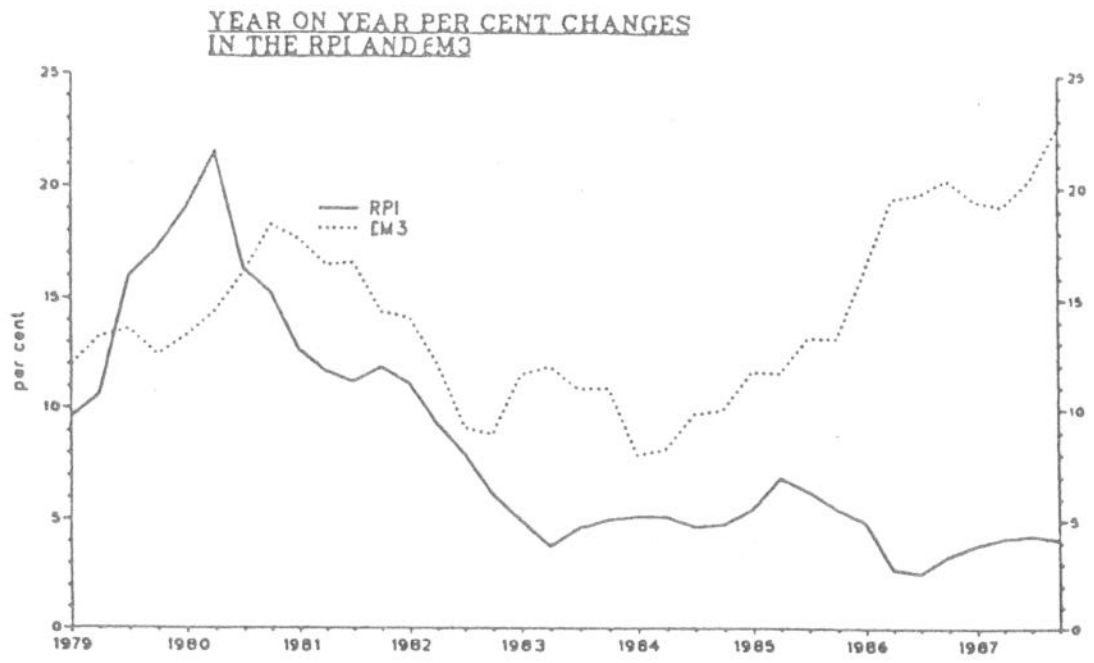
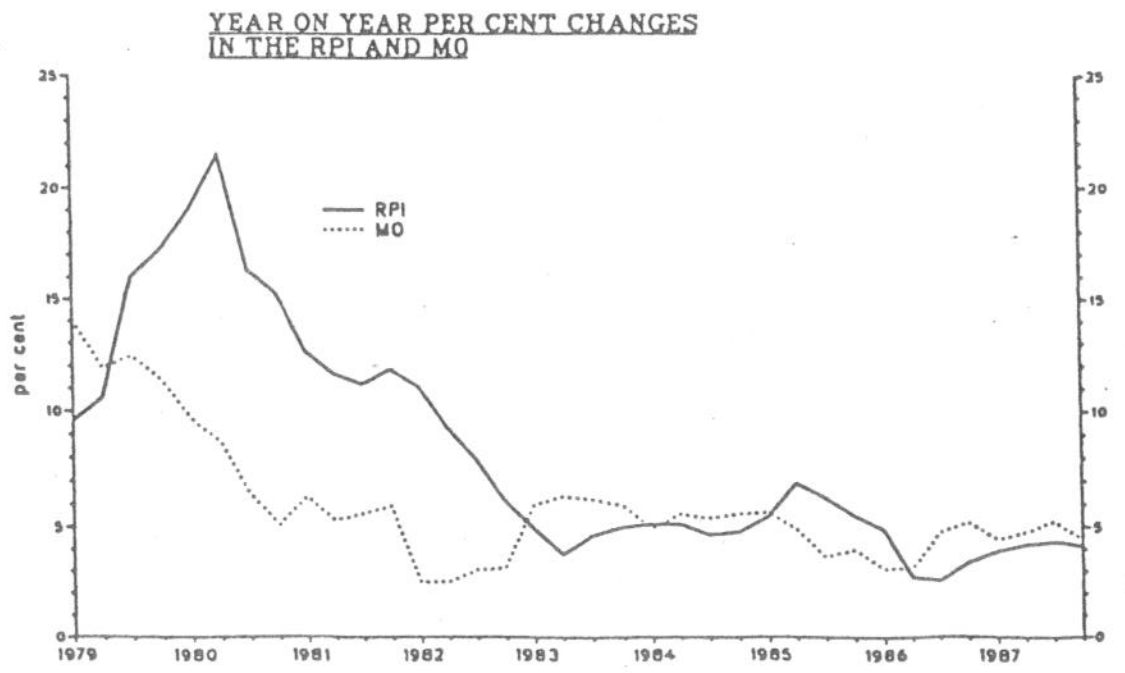


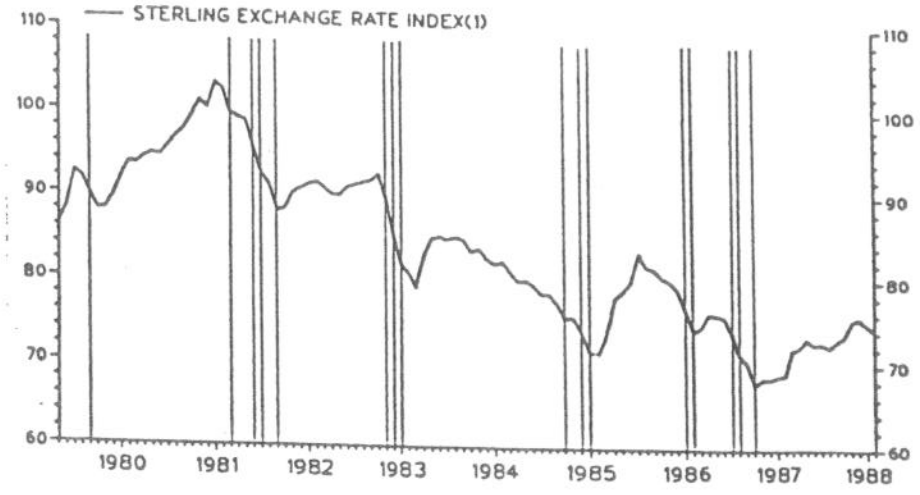
Chart 2

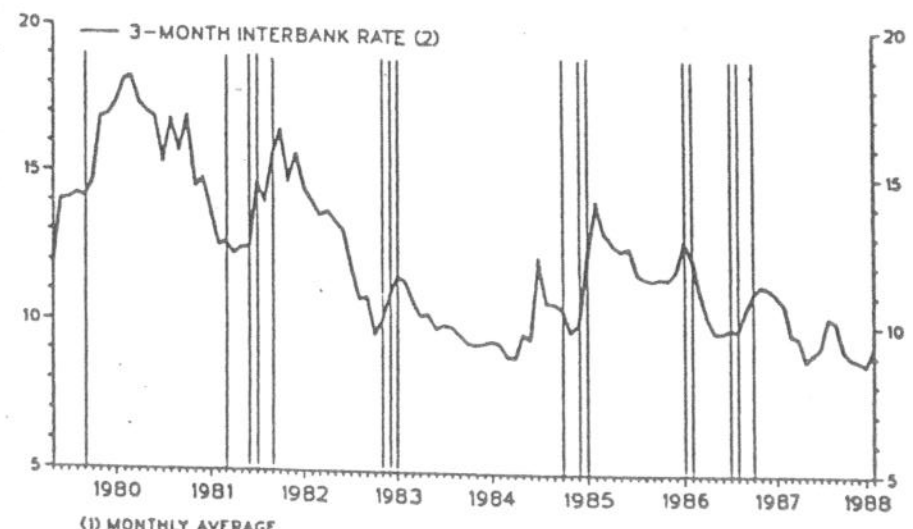


8. Because of the importance of exchange rate fluctuations for monetary conditions we have given a substantial weight to exchange rates in monetary policy decisions for many years. In successive editions of the MTFS the importance of exchange rate behaviour has been emphasised. And interest rate decisions have often been influenced by exchange rate changes. Chart 3 compares the monthly path for the sterling exchange rate index and the 3-month interbank rate since mid 1979. The vertical lines indicate the months in which the exchange rate depreciated by more than 2 per cent. It is evident that this almost always coincides with interest rate increases. The most noticeable episodes were the Autumn of 1981, the Winter of 1982-83, January 1985, and the Autumn of 1986. A similar pattern applies in reverse. The periods of sterling strength coincide with interest rate reductions.

Chart 3

THE EXCHANGE RATE AND 3-MONTH INTERBANK RATE





(1) MONTHLY AVERAGE
(2) END OF MONTH
(3) VERTICAL BARS INDICATE MONTHS IN WHICH THE EXCHANGE RATE DEPRECIATED BY MORE THAN 2 PERCENT

9. The approach to giving the exchange rate a substantial weight in monetary policy decisions is not new. During most of the past 100 years the UK has directed monetary policy towards exchange rate stability - most evidently in terms of the Gold Standard. Nor is the approach unique to the UK. And increasingly other major countries are once again giving exchange rates a major weight in the conduct of policy, generally for the same reasons: the difficulty of interpreting domestic monetary indicators at a time of structural change; and the important direct and indirect effect on inflation, activity and the balance of payments. The Swiss have been successful over long periods in keeping the Swiss franc steady against the Deutschemark. The Germans and Japanese have also had considerable success in managing movements in their currencies. And Hong Kong, one of the freest markets in the world, has successfully operated a fixed exchange rate against the dollar since 1983.

10. Since 1985 the finance ministers and central bankers of the major industrial countries have explicitly recognised the importance of appropriate exchange rates in contributing to better economic balance and restraining protectionist pressures. In the wake of the decline of the dollar following the October stock market crash some commentators suggested that the Louvre agreement was a mistake. But as Paul Volcker observed in a speech in Geneva in November:

> "The argument of some seems to be that the agreement sacrificed appropriate internal economic management to the requirements of a stable exchange rate. That seems to me a misreading of both the nature of the understanding and, more broadly, the need to accord the requirements of exchange rate stability more prominence in economic policy-making."

He went on to say:

> ...the health and vitality of an open international trading order will be importantly dependent over time upon the willingness of governments of large trading countries to reach some realistic collective judgments about the broadly appropriate level of exchange rates. Those judgments will,

in turn, need to influence the design and implementation of domestic policies if they are to be meaningful and durable."

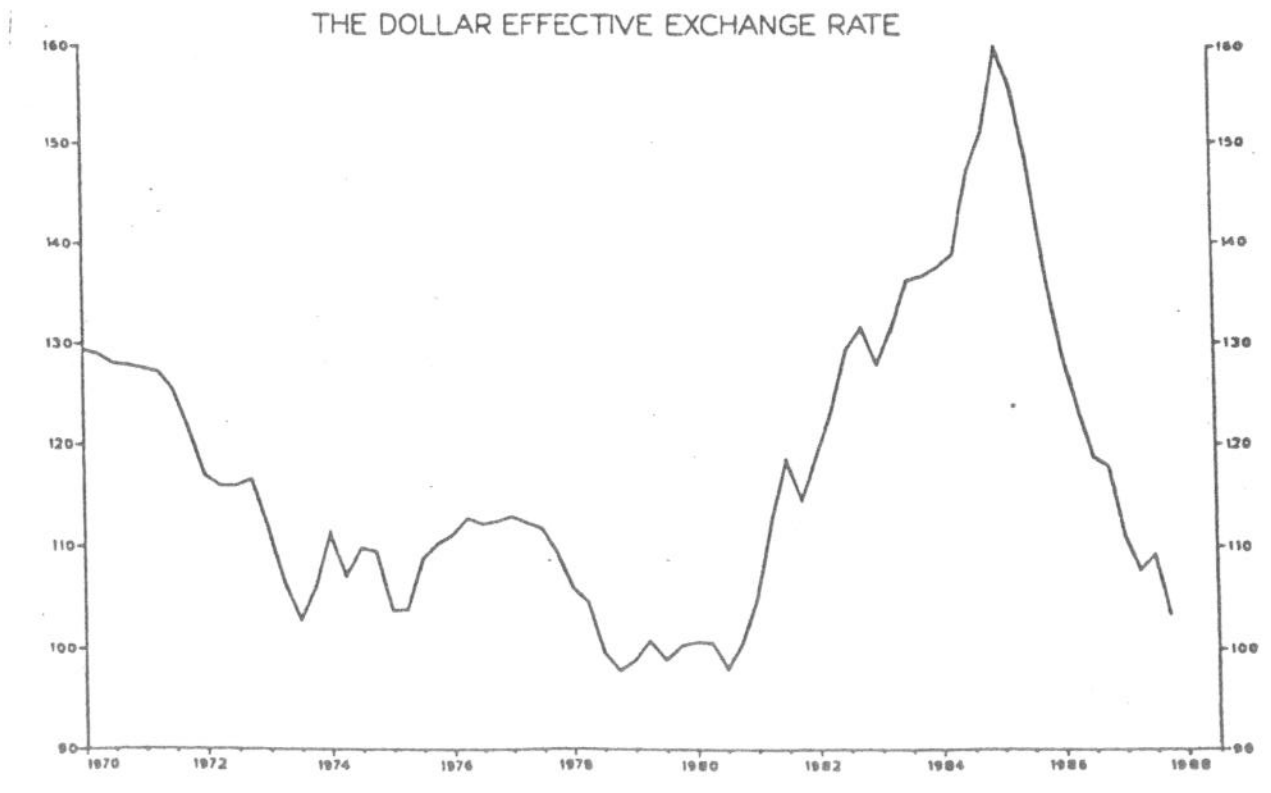
The Nature of the Foreign Exchange Market

11. In deciding the most effective way of taking the exchange rate into account it is necessary to consider the nature and characteristics of the foreign exchange market.

12. Gyrations of exchange rates are nothing new but they have been increased by the global 24-hour markets. Turnover has increased dramatically, but only a small part is related to commercial transactions.

13. In the long run the foreign exchange markets adapt to fundamentals but in the short run they generally do not. There are insufficient speculators who take a long view. Fluctuations away from levels consistent with fundamentals can take place for long periods; and they can be very large. Chart 4 shows movements of the dollar since the early 1970s. The rise and fall of the dollar since 1980 is inexplicable in terms of the underlying fundamentals of the US economy.

Chart 4



14. These fluctuations can be very damaging:

- scarce management time in business is taken up with currency fluctuations;

- swings of exchange rates dislocate businesses as profit rates and selling prices fluctuate;

- and because of the uncertainty companies take low risk decisions and are averse to investing where they fear they might find themselves uncompetitive later on.

15. Although Governments cannot control exchange rates precisely they can give a lead and keep exchange rates closer to fundamentals. They are not all powerful; but neither are they impotent.

16. Indeed, Governments can have a significant effect on exchange rate movements; something that is widely accepted in the markets. Their influence stems from the size and importance of Government; in particular they influence some of the most important factors determining exchange rates - the budget deficit and interest rates. Not surprisingly the markets give weight to what they interpret as the authorities' preferences in developing their own market strategy.

17. Market expectations are influenced by Government behaviour. And as a result they constantly try to find out the Government's policy towards the exchange rate. In these circumstances it is counter-productive to have a complete hands-off policy. It is all too easily interpreted by the markets as a positive desire by the authorities for the exchange rate either to fall (as in January 1985) or - when the pressure is upward - to go on rising. And if other countries are operating a hands-on policy the fluctuations of sterling will be even greater and even more costly as it attracts even larger amounts of speculative funds.

Instruments of Policy

18. Interest rates are the key instrument of monetary policy. They are also the Government's most important instrument for influencing the exchange rate. A higher interest rate will raise the return on holding sterling. It will therefore attract inflows, tending to raise the exchange rate, except when it reflects expectations of higher inflation.

19. If sterling is rising for speculative reasons, and an appreciation appears to be unjustified on fundamental grounds, it is possible to exercise some restraint through lower interest rates. The strengthening of the exchange rate will tend to tighten monetary conditions while the lower interest rate will mean easier monetary conditions. By adjusting interest rates in the face of fluctuations of sterling it is possible to reduce the volatility of exchange rates without monetary conditions becoming too loose or too tight.

20. If the authorities attempt to stabilise the exchange rate through changes to interest rates a conflict of interest can occur. It is possible that the maintenance of exchange rate stability will involve interest rate changes that tighten or loosen monetary policy more than is desirable. In particular for a country with an above average inflation rate it may be pressed to reduce interest rates too much. In practice this dilemma only occurs infrequently. For much of the time it is possible to combine exchange rate stability with suitable interest rates. If the pressure becomes too intense it becomes necessary to accept some change in the level of the exchange rate.

21. It is sometimes argued that economies generate a fixed amount of exchange rate-interest rate instability. If policy is directed towards limiting exchange rate volatility it is suggested that this will be replaced by increased interest rate volatility. But this ignores the impact of policy upon expectations. The reduction of exchange rate volatility may reduce the speculation

surrounding a currency and in time, as credibility is increased, lead to greater stability of interest rates. A comparison of experience between countries and over time lends no support to the hypothesis of a fixed amount of instability. Although the underlying reasons are complex, periods of exchange rate stability are usually associated with less rather than more interest rate volatility.

22. Intervention also has a role to play in helping the Government to counteract potentially damaging short-term movements in exchange rates. Although the total flows across the foreign exchanges are enormous in relation to the funds that Government can deploy to meet its objectives many of the private sector flows are offsetting transactions as market participants hedge positions. In net terms even quite modest sums deployed in intervention can have a useful effect. This is especially true if intervention is co-ordinated between countries. Much of its effect comes through the signals it gives the markets of the Government's wider policy intentions - since the market knows that fiscal and monetary policies can have a powerful effect on exchange rates.

23. Intervention is particularly useful in conditions of sudden surges of buying or selling because it is easily reversible. If offsetting action is limited to interest rates it could lead to unnecessarily large interest rate changes which are undesirable in themselves and in any event can look incompetent. Intervention can avoid some interest rate volatility. And it helps to demonstrate in a subtle way the Government's exchange rate preferences without explicit statements about ranges. It can give a signal without being pinned down to a particular range. And it is possible to vary tactics between currencies, and more or less obviously. Given the markets' interest in the Government's views this can lead to stabilising speculation.

24. The impact of intervention upon monetary conditions is often misunderstood. Obviously if, in the absence of intervention, the

exchange rate would have been higher or lower, there will be some effect on inflationary pressures. But there need be no monetary consequences. In the UK system the Bank of England immediately offsets any effect of the intervention upon the monetary base by its own market operations. And over time we have had a policy of offsetting any effect it might have upon liquidity by funding. Even over the past year when intervention has been very high we have succeeded in fully funding it. As a result there have not only been no monetary effects, but no liquidity effects either.

25. The profitability of intervention is a necessary consideration but this can only be evaluated when the intervention is unwound. Because the swings away from fundamentals can exist for some time there will be accrued losses at particular moments. But the large swings in exchange rates mean that opportunities do emerge for profitable intervention that would only become apparent after several years. It is important to accept that the aim is not to maximise profits from intervention - that would lead us to behave like other short-run speculators. Instead the aim is stabilising intervention that incidentally makes some profit.

26. When a currency is strong intervention serves as an insurance policy. It accumulates reserves that become available if pressures are reversed. If the currency appreciates over the longer term any exchange rate losses should be balanced against the success of the economy and the utility of the increased reserves; and if it is a temporary strength, the intervention will reduce fluctuations and make a profit.

27. There are limits to the effectiveness of intervention. This means that it should not become a way of life, and can only be a subsidiary instrument. But at times it can play an important part. It would be a mistake to have a policy of never using it, particularly when it is one of the few instruments available in a free market economy; but equally it must be used in a controlled way.

Experience over the past year

28. Although the exchange rate has played an important role in monetary policy decisions for many years it has had a greater weight over the past year. There have been a number of reasons:

- in the Autumn of 1986 sterling had been under considerable downward pressure. Interest rates were raised by 1 per cent to halt the slide. The Chancellor said that any further depreciation would be undesirable;

- in the Louvre agreement the major 6 industrialised countries agreed to co-operate to foster increased exchange rate stability whilst working to correct the fundamental reasons for the trade imbalances. In February the Chancellor said that he was more content for sterling to rise than to fall. This was expressed in terms of the DM rate as this is the single most important currency for UK manufacturing industry;

- in the run-up to the General Election in June there was a clear case for restraining the rise of sterling to avoid a speculative bubble emerging that could be very inconvenient for the conduct of policy during the election;

- and in the aftermath of the share price crash on October 19 there was a premium in maintaining as much stability as possible whilst confidence was restored.

29. The apparent importance of the 3DM rate grew out of these events. Once the markets had seen some resistance at 3DM they hesitated to push very hard. And the longer sterling remained within the 2.90-3.00DM range the more reluctant they were to push and we were to see it breached. There were clear gains to industry from stability; and benefits in the form of firmer expectations of the likely scale of exchange rate fluctuations.

30. The cumulative scale of the intervention was greater than would normally be desirable. But it has done no damage to monetary policy because it has been offset by funding. And it has helped to establish the Government's commitment to limiting the scale of fluctuations. So long as that commitment is continued and clearly understood, in future it should be possible to achieve a similar result with much less intervention.

31. It became clear on March 4 that the scale of exchange rate pressure was greater than could be coped with by intervention. And there was no scope for reducing interest rates as we had already concluded that, if anything, monetary conditions were on the easy side.

32. Since then the exchange rate has risen but because there have been tighter monetary conditions it has been possible to reduce interest rates by ½ per cent.

33. In reflecting on the events of the past year it is important to recognise that the present situation is very different from 1980-81 when sterling rose so sharply. There is no inconsistency between what was allowed to happen then and what we would prefer now. The circumstances then were very different: inflation was almost 20 per cent; North Sea oil was having a big impact; public expenditure and the budget deficit were not firmly under control; it was important to assert credibility for a non-accommodating policy stance; there was a need for a shock to expectations generally; and it was impossible to be sure for several months that broad money was giving the wrong signals.

34. It is also important to see the resistance to appreciation as an important component of avoiding excessive depreciation. We are all agreed that a firm anti-inflationary stance requires a commitment not to bail out excessive growth of labour costs by devaluation. If the impression is given that the exchange rate will go wherever it is pushed the market will also assume that a lower exchange rate will be accommodated if confidence is reversed. In these circumstances holding the exchange rate will

involve higher interest rates than would have been necessary if a presumption of stability has been created. On the other hand if it is clearly understood and accepted that cost rises will not be accommodated by allowing the rate to fall, then the same degree of downward pressure on inflation can be achieved with lower interest rates.

Options

35. The discussion in this paper suggests that:

- the Government must continue to give the exchange rate a substantial weight in the conduct of monetary policy;

- in the process it is desirable to have an explicit objective for greater exchange rate stability.

36. There are three main alternative approaches discussed in the remainder of this paper. In practice they lie on a continuum but separating them helps to focus the main points:

- taking the exchange rate "into account" in the conduct of monetary policy;

- an explicit statement about the desire for greater stability combined with a notional but unpublished range;

- full membership of EMS.

Taking the exchange rate "into account"

37. This was the presentation used for much of the 1980s. It means setting interest rates in a purely judgemental way in the light of the behaviour of a range of indicators, including the exchange rate.

38. **Advantages:**

- helps to balance monetary conditions so that neither excessive loosening nor tightening of conditions;

- avoids unnecessary oscillation of inflation rate;

- some effect in curbing excessive swings of sterling with benefit to industry;

- maximum tactical flexibility by avoiding any question of particular ranges;

- intervention can be limited to smoothing.

39. **Disadvantages:**

- gives little in the way of a steer to markets. Lose some of gains of stabilising speculation;

- can involve unnecessary degree of exchange rate volatility;

- markets will constantly press for a more explicit statement about exchange rate policy;

- requires considerable judgement in balancing factors;

- only a weak anchor against inflationary expectations, so likely to require higher interest rates.

Greater Stability

40. This is a more formalised approach. It would involve an explicit statement about the desire for stability. We would operate a notional, unpublished range. Interest rates would be adjusted to keep exchange rates within that range, supported by

some intervention. There would be changes to the range if market pressure were sustained so that interest rates were pushed too low, intervention was too great, or MO growth was too fast.

41. There are various degrees of formality, depending on: width of range; frequency of changing range; extent to which change range; amount of intervention before changing range.

42. **Advantages**:

- clear signals about exchange rate, especially important for business decisions and investment.

- mechanism for reducing exchange rate volatility;

- can be operated to maintain an appropriate degree of disinflationary pressure;

- uses all instruments available;

- range unpublished and therefore no bureaucratic operations involved in changing.

43. **Disadvantages**:

- less certainty for both business and for inflationary expectations than a published range although more than "taking into account";

- markets will test to find range;

- intervention will be necessary from time to time;

- no obvious way of distinguishing a change of range from a change of policy.

Membership of ERM

44. Advantages:

- makes commitment to exchange rate stability clear. Advantages for industry;

- if realignments are necessary, it is clear that overall policy remains the same;

- simple to explain policy to public and markets;

- useful anti-inflationary discipline;

- if maintenance of the parity is credible it will reduce scale of market pressure during periods of turbulence.

45. Disadvantages

- changes of ranges require discussion with other members of ERM;

- present ERM is dominated by Germany and Deutschemark;

- if the parity comes under question there could be greater pressure at times meaning larger interest changes and intervention;

- could sharpen conflict with other objectives of monetary policy.

Conclusion

46. In a complex world there is a great advantage in explaining and presenting policy in a clear way. A major objective of monetary policy is to give guidance both to the market and to the economy at large. This is why we publish the MTFS.

47. Once a policy has been formed it is essential to explain it and to act in a way that will bring it about. If a policy is made clear markets will support it by forming expectations in relation to Government statements and actions.

48. The original ambition of the MTFS was to conduct monetary policy in relation to monetary targets. For a variety of reasons that has not been possible - and the exchange rate has played an increasing role. There is a lot to be said for conducting policy towards the exchange rate in a way that can be understood. It does not need to be too precise. But if they understand it, see actions confirming it, and believe other policies are consistent with it, markets will respond in a constructive way rather than a destabilising way, and business confidence and hence enterprise will be enhanced.

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