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Begins: 15/6/84
Ends : 4/7/84

Chancellor's (Lawson) Papers:

Treasury and Civil Service Committee Enquiry Into International Monetary Arrangements.

FROM: D R NORGROVE
DATE: 15 JUNE 1984

MR C W KELLY

cc Mr Peretz
Sir Peter Middleton
Sir Terence Burns
Mr Littler
Mr Unwin
Mr Lavelle or
Mr Lankester
Mr Sedgwick

TCSC: INTERNATIONAL MONETARY ARRANGEMENTS

We have now been sent the Chairman's draft report on International Monetary Arrangements, to "check the facts". We can interpret our remit fairly liberally.

2. The Committee are meeting to discuss the draft on Monday afternoon. I do not yet know the timetable to which we are being asked to work, but I think we should assume that we shall need to give our comments on Monday morning.

3. You have kindly agreed to co-ordinate them. Could comments therefore please be sent to you by 10.30 am on Monday, 18 June? You and I can then put them together to be telephoned to the Clerks.

4. At first sight this draft is in some areas quite a bit different from the draft published during the Election period last year.

D R Norgrove

D R NORGROVE

C
You might like to glance, at least at the conclusions (last page below), quickly over the weekend.
Not too bad at a quick read. Against EMS.
For more attention to mix of fiscal & monetary policy, & "taking account" of the
For more cooperation by US (see para 4.19).
Rather a lot of quibbling about "misalignment" (Williamson, I think): a point you could address in the MS (see para 4.4)
[But on balance quite useful, I thought.]
DRN

IMA 143

CHAIRMAN'S DRAFT REPORT

15/6/84.

INTERNATIONAL MONETARY ARRANGEMENTS

I. Introduction

1.1. This Report is the second instalment of our enquiry into International Monetary Arrangements, and deals with exchange rates, and arrangements for the international coordination of economic policy. It complements the Report on International Lending by Banks, published as the Fourth Report (Session 1982-83) at the end of March 1983.[1]

1.2. The dissolution of Parliament in May 1983 intervened before our predecessors could submit an agreed report to the House covering the second instalment of the enquiry into International Monetary Arrangements. They therefore decided, in view of the impending "Summit Meeting" in Williamsburg, to publish a short special report, to which was annexed a "Chairman's Draft" Report. No final decisions had been taken on any of the recommendations in the Draft Report. Since then the composition of our Committee has changed, and two economic Summits in Williamsburg and London have taken place. There have been various developments in the UK and the world economy. In view of this we have looked at International Monetary Arrangements afresh, but have taken fully into account the evidence previously received, most of which remains entirely relevant to the present situation. However, it should be borne in mind that only six of our eleven

1. HC(1982-83)21-I

Members participated in the taking of oral evidence in the last Parliament.

1.3. The procedure for taking evidence for this enquiry has already been explained in the Report on International Lending by Banks, where gratitude was expressed to the many persons and institutions who responded to the Committee's request for evidence. We again note our considerable debt to the specialist advisers. They were Professor Willem Buiter who was at the University of Bristol in the early stages of the enquiry, but who has subsequently moved to the London School of Economics, Professor Brian Tew of the Loughborough University of Technology and Professor John Williamson of the Institute for International Economics in Washington, United States of America. It should however be made clear that Professor Williamson was not available to assist the Committee in the present Session. We also record our appreciation for the work of the four academics who prepared special studies:-

- a survey article by Dr D.K.H. Begg, The Economics of Floating Exchange Rates;[2]

- a study by Dr L.A. Winters, the Consequences of Devaluing Sterling;[3]

- a study of Professor M.J. Artis and Dr E. Karakitsos, Intermediate Target Variables: Their Role in Policy Formation with Special Reference to the Money Supply and the Exchange Rate.[4]

2. Appendices, p.4.
3. Appendices, p.96.
4. Appendices, p.142.

All these people have gone to considerable lengths to help, and we are most indebted to them.

1.4. The structure of the present report is as follows:

The remainder of this Section outlines the context of the report. 5

Section II describes the operation of the floating exchange-rate regime that has operated for the past ten years.

Section III gives our assessment of the current position of the United Kingdom, including a review of the 10 Government's macroeconomic policy, with general reference to the overall international monetary environment, and with special reference to the authorities' attitude to the sterling exchange rate.

Section IV presents our conclusions. 15

1.5. The present Report may be regarded as a sequel to our predecessor's Report on Monetary Policy (Third Report of Session 1980-81, of 24 February 1981). In Chapter 7 of that Report they recognised that monetary policy had a major impact on the exchange rate, and that this was part of the 20 transmission mechanism from monetary growth to inflation. They raised the question as to whether intermediate targets ought to include not only £M3 (until then the only target publicly announced by Government) but also interest rates and

the exchange rate. They welcomed the prospective move away from £M3 as the sole monetary indicator which the Financial Secretary to the Treasury had recently adumbrated in a speech to the Zurich Society of Economics.[5] They also questioned the wisdom of having a inflexible target covering a period as long as four years.[6] They noted that Professor Artis had 'proposed that the announcement of exchange rate targets would be a useful step, either in place of monetary targets or as a factor which would condition the monetary targets'.[7] In the concluding chapter they said:

> "The practical way forward appears to be to take some account of both the money supply and the exchange rate as well as final objectives in setting the instruments of monetary policy."[8]

Finally, they saw the danger of a

> 'commitment to targets of whatever kind which force the Authorities to take actions which they themselves consider inappropriate in the light of what is happening to output, inflation, and the real economy'.[9]

Subsequently we have commented on these issues in our regular reports on the Autumn Statements and Budgets.[10] In the present Report we return to all these issues, considering them this time against the background of the international monetary arrangements with which they have perforce to mesh.

1.6. This Report naturally reflects the major developments in the world economy since our predecessors reported on Monetary Policy in February 1981 - the welcome reduction in inflation, and the unwelcome recession accompanied by a debt crisis. Those developments are related. In that Report our

5. HC(1980-81)163-I, para 9.46
6. Ibid, para 9.48
7. Ibid, para 9.41
8. Ibid, para 11.12
9. Ibid, para 9.42
10. For example HC(1983-84)170 and 341.

predecessors warned that inflation posed an intractable problem that would not subside painlessly in response to announcements about monetary policy, no matter how credible.[11] The severe recession that resulted from inter alia the determined use of monetary policy to bring inflation under control has confirmed their forebodings (see Table 1 and Figure 1).

1.7. The recession has been the deepest for a half century. It has raised unemployment in OECD to some 32 million and in Britain to over 3 million. This together with persistently misaligned exchange rates has provoked increasing resort to 'beggar-my-neighbour' remedies for unemployment, especially import restrictions. A recent estimate puts the proportion of world trade in manufactures subject to non-tariff barriers at

Table 1

Industrial Production

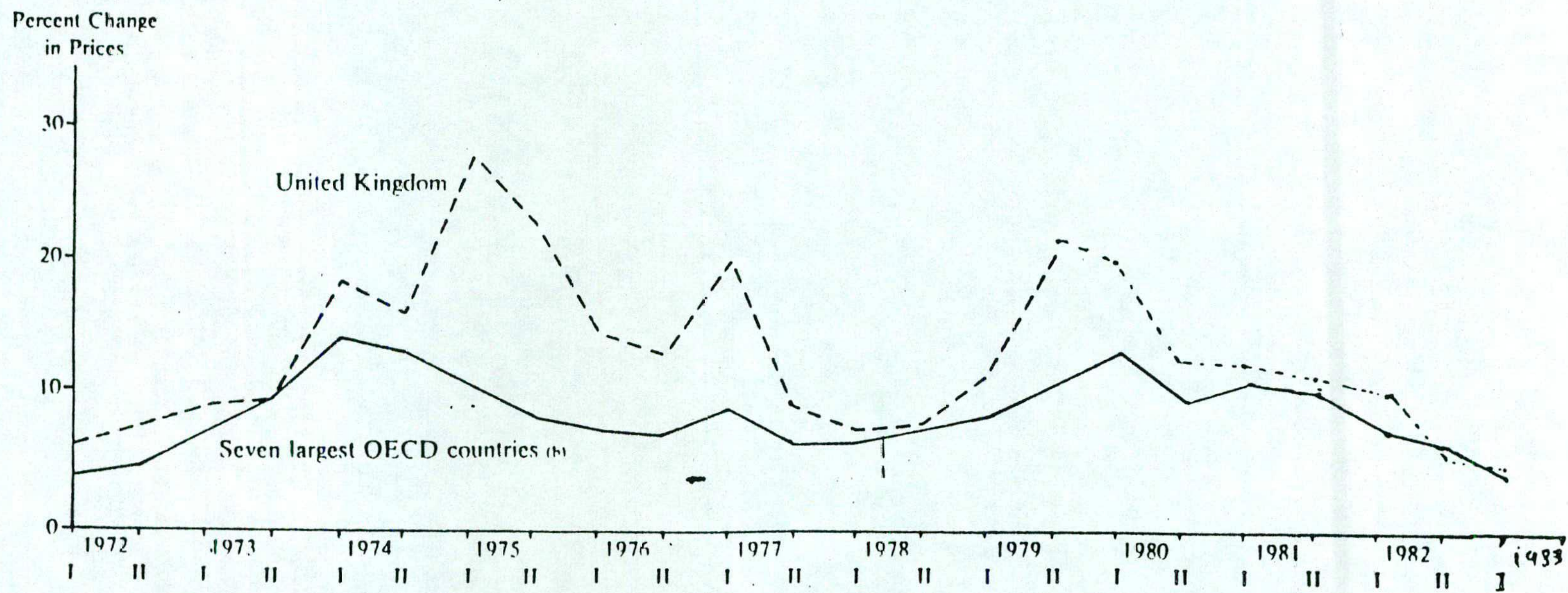
(Seasonally adjusted, 1980 = 100)

	United Kingdom		Industrial Countries
	Total	Manufacturing	
1978	103.1	109.6	96
1979	107.0	109.4	101
1980	100.0	100.0	100
1981	96.3	93.6	100
1982 i	97.0	94.3	98
ii	98.3	94.1	97
iii	98.6	93.5	96

11. Ibid, para 8.28

FIGURE 1

CONSUMER PRICE INFLATION IN UNITED KINGDOM AND SEVEN LARGEST OECD COUNTRIES (a)



(a) At six monthly intervals. Per cent change from previous record, annual rates, not seasonally adjusted.

(b) Including United Kingdom

Source: Data taken from OECD, *Economic Outlook*, December 1983

	iv	98.2	92.9	94
1983	i	99.5	94.4	96
	ii	99.5	94.1	98
	iii	101.5	96.0	100
	iv	102.9	97.1	

Sources:

United Kingdom: Economic Trends, Central Statistical Office, March 1983

Industrial Countries: International Financial Statistics.

24 per cent in 1980, as compared with 13 per cent in 1974, and all the indications are that this proportion has continued to rise since 1980.[12] There has been increasing anxiety about the drift toward protectionism over the past year: for example the latest IMF World Economic Outlook itemises nine significant measures or agreements relating to non-tariff barriers implemented through 1983.[13] The most recent explicit statement of this anxiety was included in the communique issued at the conclusion of the latest summit in London. In 1983 there were signs of recovery in the industrial countries from the depths of the depression. The recovery has been strongest in North America and Australia, where expansionary fiscal policies have been pursued, but much more fitful in Europe, where tougher fiscal policies are in fashion. The recovery of GDP in Britain is presently somewhat better than in the rest of the EEC, being sustained rather precariously by heavy borrowing by the personal sector and some relaxation of fiscal policy since 1982[14]; however unemployment in Britain is still considerably higher than in the rest of the EEC.

12. S A B Page: The Revival of Protectionism and its Consequences for Europe, Journal of Common Market Studies, September 1981.
13. IMF, World Economic Outlook, 1984, p.112, footnote 2.
14. For example HC(1983-84)341, paras 21-28 and Appendix 3; Centre for Europen Policy Studies, Europe: The Case for Sustainable Growth, Table H7; IMF, World Economic Outlook, 1984, Table 8.

1.8. The beginnings of recovery in the industrial countries has so far done but little to improve the prices of non-oil primary commodities, which had been driven down to the lowest level in real terms in the postwar period[15] leading to a severe deterioration in the current balance of most non-oil developing countries.[16] Non-oil commodity prices recovered somewhat through 1983[17], but nevertheless remain at low levels in historical terms. Nor is there any solution in sight to the problems arising from the very high real interest rates on the vast overhang of floating-rate debt contracted by many of the middle-income countries, and by the reluctance since the second half of 1982 of commercial banks to continue lending to most of the heavily indebted countries. These problems were the subject of our predecessor's Report on International Lending by Banks (March 1983).[18] Here we simply repeat that one consequence of the adjustment programs adopted by the debtor countries has been to cut their demand for imports and hence make even more intractable the problem of world recession.[19]

1.9. Subsequent to the rise in oil prices at the end of 1973 the world economy was afflicted by 'stagflation' - a combination of stagnation in real output and inflation of prices. The inflation started in the late 1960s and early 1970s. Wages increased in excess of underlying productivity growth, and monetary policies were accommodating. Rising government spending preempted an increasing proportion of the available resources. The prices of many primary commodities were bid up in 1972-73 as a result of strong demand and in some cases a reduction of available supplies. The oil price

15. IMF, World Economic Outlook, 1984, p.176.
16. IMF estimates show a deterioration of the non-oil developing countries' combined current account deficit from US $12 billion in 1973 to around $100 billion in 1980 and 1981 and 1982. World Economic Outlook, 1984, Table 17.
17. IMF, World Economic Outlook, 1984, Table 4.2
18. HC(1981-82)21-I
19. Ibid, para 2.4

rise of late 1973 reinforced the inflation already in train and, by acting as an additional excise tax whose proceeds were not spent on goods (at least in the short run), had a contractionary effect on industrial output. That contractionary effect was in turn reinforced for a time by the anti-inflationary policies adopted by the major industrial countries, until the severity of the 1974-75 recession prompted a reversion to more stimulative policies. Liquidity again became cheap and abundant, and government expenditure was once more allowed to expand. A reasonable rate of growth was recovered in 1976-79, but inflation again started to accelerate even prior to the second oil price shock of 1979-80. This time the industrial countries were so alarmed by the pace of inflation as to commit themselves to non-accommodating policies involving both preannounced target rates of growth for the money supply and restrictive fiscal policies. For instance the head of the OECD Economic Prospects Division has estimated that in 1974 and 1975 the seven major OECD countries changed their fiscal policy stance towards expansion by an amount equivalent to 2 per cent of their combined GNP, but in the three years to 1982 the cumulative swing towards fiscal restriction in the same countries amounted to around 1½ per cent of their GNP.[20] The combination of the second oil price increase and the maintenance of restrictive monetary policies led to very high real interest rates. High oil prices, high interest rates and restrictive fiscal policies led to the deep and prolonged recession which began in 1980.

1.10. The state of international monetary arrangements since the early 1970s were at least a permissive factor in the

20. Llewellyn G E J: OECD Working Paper, "Resource Prices and Macro-Economic Policies: Lessons from Two Oil Price Shocks, April 1983; see also IMF, World Economic Outlook, 1984, Table 8.

unsatisfactory economic performance described above. Floating exchange rates became acutely misaligned for prolonged periods, thus exerting strong deflationary or inflationary effects on the countries involved. Of this there is little doubt: no individual or organisation who gave either written or oral evidence to us claimed that exchange rate misalignments have not occurred, while almost all except the Treasury and Bank of England were prepared to list identifiable cases of misalignment.[21] At the present time the most notorious misalignment is the over-valuation of the US dollar, which is widely attributed to an inappropriate mix of fiscal and monetary policy in the United States. A less expansionary fiscal policy, permitting a more relaxed monetary stance, would have moderated the capital inflow and hence the rise of the dollar in the foreign exchange market.

1.11. Subsequent to the collapse of Bretton Woods in the early seventies there has been little progress in international coordination of the methods or objectives of monetary and trade policy, despite the brave words of some of the communiques issued after the annual summits. Nor has there been any serious attempt to coordinate the use of policy instruments, such as taxation, government expenditure, or central bank transactions in the financial markets. The one possible exception is central bank transactions in the foreign exchange market. Such transactions did not come to an end with the collapse of Bretton Woods - indeed completely clean floating has been the exception rather than the rule, though there has been a great variety of practice as between one country and another and also between one time and another.

21. See responses to Question 1 of the Committee's questionnaire from Accepting Houses Committee, Artis, Bank of Japan, Bundesbank, Chrystal, Dornbusch, Emminger, Ford Foseco-Minsep, Labour Economic Policy Group, Padoa-Schioppa, Rybczynski, Thygesen, Unilever and van Ypersele.

However the only case of protracted international coordination of official intervention has been the EEC snake, from which the UK withdrew in June 1972, and from which both France and Italy temporarily defected in the 1970s, but which has held together (with the UK a non-member) since the setting up of the EMS in 1979. Outside the snake, coordination has been on US initiative, and has in consequence occurred only rarely, since most of the time the US has favoured clean floating. The exception was under the Carter administration, as from late 1977, when the US authorities cooperated with the Bundesbank, and to a lesser extent with the Swiss and Japanese central banks, to manage the dollar in the foreign exchange market. Under the succeeding Reagan administration the United States reverted to almost continous clean floating, though in August 1983 the US, Germany, Japan and Switzerland once again jointly intervened in the foreign exchange market, this time on a modest scale and apparently to little effect.

II. The Floating Rate Regime

2.1. The collapse of Bretton Woods meant that the currencies of the major industrial countries floated against the US dollar - the snake currencies in a joint float, the others (including sterling) in an individual float. However, the majority of developing countries have continued to peg, either on a major currency (mostly the US dollar) or on a basket of currencies (including the SDR).

2.2. To some authorities the change to floating was a leap in the dark. To others, however, especially those following the intellectual lead of Professor Friedman[22], but also many who did not, it was a release from a straightjacket; henceforth their instruments of policy could be directed exclusively towards the requirements of the internal economy. The problems of adhering to a fixed parity were dismissed as ones which the monetary authorities had created for themselves: henceforth exchange rates could, and should, be left to the market - a policy of so-called 'benign neglect'.

2.3. For those who viewed floating as a leap in the dark, the course of events immediately after March 1973 was reassuring. The banks maintained a market in spot currencies, with no spectacular increase in the margin between buying and selling rates, and the forward market functioned at any rate for the major currencies. International trade did not grind to a halt. International capital flows did not dry up. Clearly floating was viable.

22. HC(1979-80)720, page 61"Floating exchange rates are necessary in order for a monetary policy proper to be possible".

2.4. However, to those who had actively welcomed the advent of floating, the course of events did not come completely up to expectations. There were from the start large fluctuations in exchange rates, and it was rarely possible to see great logic in these movements in terms of offsetting inflation or interest differentials, or promoting needed balance of payments adjustment (the so-called 'fundamentals'). Views differed, however, as to whether this unexpectedly large exchange-rate variability could be explained by deficient functioning of the financial markets, or whether the blame was to be sought in the unpredictability and inconsistency of government policies. Professor Friedman had argued that under "free" or "clean" floating - ie without any official intervention - speculation[23] would be equilibrating, for otherwise the speculators would be bound to lose money. In fact intervention continued to occur on a massive scale, as the Bank for International Settlements noted:

> "The Group of Ten countries, including Switzerland, can be divided into two main categories so far as their intervention policies (in the foreign exchange markets) are concerned, according to whether they limited themselves to intervention designed merely to smooth out day-to-day market conditions or whether, in addition, they operated in the markets in a way that brought about substantial changes in their net official reserves, including official, or officially inspired, borrowing ... the United States belongs in the first of the categories mentioned above, as did Canada until ... November 1976 ..., while all the other Group of Ten countries, including Switzerland, belong to the second. Germany, however, may be said to have a foot in both camps, belonging with the United States so far as the Deutsche Mark/dollar rate is concerned but with its fellow participants so far as interventions within the framework of the European joint float are concerned.[24]

23. We use the terms "speculation" and "speculators" in their technical economic sense rather than perjoratively: an act of speculation involves choosing to hold an open position in foreign exchange when it would be possible to eliminate exchange risk. Thus many commercial companies, trading internationally, necessarily deal in currencies, often taking forward positions, in the ordinary course of their business.
24. BIS Annual Report, 1979, p.129

The question therefore remained open as to whether exchange-rate variability had to be explained by unstable government policies, including intervention, or by destabilising speculative behaviour. It was sometimes argued that, even if the latter were true, this was due to lack of past experience with floating rates, and that as such experience accumulated speculation would become better informed and serve to dampen swings in exchange rates.

2.5. One reason that intervention continued to be practised on a large scale was that the former reserve constraints were undermined. In the 1960s central banks could (and did) support a weak currency in the market, but the available finance was limited to their owned reserves plus borrowings from official sources, in practice from other central banks and the IMF. In the 1970s, however, and especially as from 1973, countries with weak currencies financed their intervention by sovereign borrowing from the private sector, predominantly from the big commercial banks. One of the first countries to exploit this source of funds on a large scale was the UK, which already in 1973 was encouraging local authorities and nationalised industries to do their borrowing in dollars, which were then sold for sterling to the Exchange Equalisation Account. There were of course limits to the process of financing instead of adjusting disequilibria, which were reached when the market lost confidence in a country's determination to avoid inflationary policies - as with Britain in 1976, when a country's creditworthiness was called into question, and as in many middle-income countries in 1982 and subsequently.

2.6. The choice between financing and adjusting disequilibria posed difficulties to countries with strong currencies as well as to those with weak ones. Apart from the 'low absorbing' oil exporters, where surpluses were earned by the public sector and could be invested abroad without any impact on the domestic economy, prolonged purchases of foreign exchange in the market made it more difficult to avoid an excessive growth in the money stock. Such a relaxation of monetary discipline was feared for its inflationary potential. In 1977, for example, when the pound rapidly strengthened in the market, the Bank of England capped the rise in sterling by purchases of dollars in the market - but only until October: as from October, as Bank officials explained in oral evidence, official intervention in the market was conducted with a much lighter touch.[25] But a policy of not capping the rate also had its dangers, which led some of the countries that had attached the greatest importance to combating inflation to intervene massively (as Germany and Switzerland did in late 1978),[26] even at the cost of excessive monetary growth, when the alternative was an appreciation that they deemed likely to undermine their competitiveness. Post 1977 this view was not given such high priority in Britain where competitiveness was not as central a preoccupation.

25. Q.206
26. Q.54, Q.820

Monetary policy and the exchange rate[27]

2.7. The actions by which a central bank seeks to influence the exchange rate include official transactions in the financial markets. These differ in detail from one country to another, but they virtually always amount in practice to the equivalent of official sales of foreign exchange and/or home-currency securities (to support the home currency's market value) or purchases of foreign exchange and/or home-currency securities (to depress the home currency's market value). Such official transactions are intended to influence the exchange rate mainly through capital inflows or outflows, whether on official account (when the central bank itself deals in the foreign exchange market) or on private sector account (through influencing the level of home-currency interest rates relative to foreign-currency interest rates).

2.8. Official purchases in any of the financial markets operate to depress interest rates, and official sales to raise them, but at the same time they have an important (but frequently unwanted) side effect on the domestic banking system. Official purchases, if from non-banks, are immediately reflected as an increase in the monetary liabilities of the banking system; moreover, whether the purchases are from banks or from non-banks they invariably serve to make the banking system more liquid and hence ready to supply credit on more favourable terms to would-be borrowers. Thus official purchases, whether of foreign exchange or of home-currency securities, necessarily imply a more reflationary stance in monetary policy, and conversely officials sales imply a more deflationary stance.

27. See Tew. B., The Implementation of British Monetary Policy, Appendix X (if published).

Sterilisation

2.9. When this "side effect" is unwanted, there is the possibility of insulating the banking system from the consequences of official transactions in foreign exchange by buying in one financial market and simultaneously selling in another; that is, the Bank of England might for instance try to support sterling with no contractionary side effect on the UK banking system by selling a million pounds' worth of dollars and simultaneously buying a million pounds' worth of sterling securities. But such a tactic of 'sterilisation', as it is called, is generally considered to be of only limited efficacy, since its effect on the exchange rate relies solely on the central bank's own transaction in the foreign exchange market, without inducing any supportive private sector transactions in the market (since sterilised intervention exerts no pressure on interest rates).

2.10. It has come to be accepted[28] that sterilised intervention cannot have a strong and sustained influence on the exchange rate: such an influence requires that the central bank should be on balance a net buyer or seller in the financial markets, taken as a whole. It follows that monetary action designed to influence the exchange rate (except temporarily, and on a small scale) has an unavoidable side effect on the stance of monetary policy: supporting the exchange rate implies a more deflationary stance, depressing it implies a more reflationary stance. The more deflationary stance has the advantage of giving additional weight to the official support of the exchange rate (since a deflated economy buys less imports) but

28. Report of the Working Group on Exchange Market Intervention, January 1983.

may well be unwanted for its adverse effect on output and employment. Conversely a more reflationary stance helps to further depress the exchange rate, but it may well be unwanted for its adverse effect on the pace of inflation. Ministers and officials who opt for an active exchange rate policy therefore expose themselves to the possibility of having to face an awkward dilemma. However, as we shall argue below, at paragraph 4.11, this dilemma is far less acute if more attention were paid to getting the best mix of monetary and fiscal policy.

Exchange rate fluctuations and misalignment

2.11. In November 1983 the Deputy Governor of the Bank of England made a distinction,[29] which we think very important, between short-term fluctuations in the exchange rate and "major and lasting swings", which he discussed in terms of "undervalued" or "overvalued" exchange rates (or "misaligned" rates, as he also called them). The following is an extract from the address:-

> "In trying to assess the extent of costs of exchange rate instability, it is necessary to distinguish between short run instability, where changes in exchange rates are quickly reversed, and major and lasting swings. Short run instability may give rise to considerable inconvenience to traders and consumers; and it may, because of such obvious arbitrariness in what is for everyone such an important price, bring the system into a sort of disrepute. But it seems unlikely to impose important economic costs, if only because sophisticated and efficient financial markets appear largely to have provided an answer. Forward cover is available in most major currencies at maturities long enough to cover the production process of the great bulk of goods in international trade, and provides insurance against exchange risk at what seems to be a remarkably low cost.
>
> It seems likely, however, that major and more lasting exchange rate movements can impose real costs on national economies. Since wages, reflecting entrenched inflationary expectations, are slow to adjust, sustained movements in nominal exchange rates have generally been reflected in sustained changes in cost competitiveness. In modern conditions of high fixed capital costs and intense price competition, much of the strain is forced on to profit margins. There may follow scrappings of capital stock, lay-offs of labour and failures of firms that go further than required for fundamental adjustment but which, because of rigidities and imperfections, may not be reversed when conditions change.

29. Mr C W McMahon, Speech given at the International Herald Tribune's 9th Annual Conference on Tuesday, 15 November 1983.

On the other side of the coin, countries with undervalued exchange rates may undertake investment which later proves not to be viable at more normal levels of competitivenss; and may be subject to inflationary pressures while output is growing at a rapid rate.

Uncertainty of these kinds may thus be a potent factor in reducing investment world-wide, and in shortening investors' horizons. The result may be a failure of capital formation to respond to the usual extent to the current recovery in consumer demand in the world as a whole, even once unused capacity had been reduced to more normal levels.

Additional important costs may arise at a global level through the reaction of wages. In most industrial countries real wages probably tend to rise to take account of terms of trade gains, but are less ready to fall when the exchange rate depreciates. As a result, swings in exchange rates are likely to impart an inflationary bias to the world economy. Greater willingness on the part of wage bargainers to discount exchange rate effects, even when sustained, would do much to lessen costs of both kinds; but the relevant learning process does not yet appear to have gone very far.

There is finally perhaps the most harmful effect of all. This is the increased pressure for protection by producers in those countries whose exchange rates are currently overvalued in relation to some longer-run norm. This will normally not be fully offset by a greater liberalism in the undervalued country. More important, protectionist measures, once imposed, are hard to get rid of. Certainly they are not likely to be reversed as and when the relative exchange rate distortion is removed or reversed. And of course any such protective measures will themselves tend to perpetuate the overvaluation, by making the current account less weak than it would otherwise have been. Creeping and not always visible protectionism of this sort is, in my view, a serious threat at the present time.

Later in his address the Deputy Governor said that "there are occasions when it is clear that in some real economic sense

rates are over or under-valued even though it is usually hard to get agreement on the extent of the misalignment".

Misalignment

2.12. The distinction made by the Deputy Governor between short-term fluctuations in the exchange rate and "misalignments" has no operational significance for policy unless misalignments can be identified, not just ex post but in time for remedial action to be taken. We have therefore given close attention to views expressed on this matter, whether by academics or by practical bankers and officials. 10

2.13. We are greatly indebted to advice from Professor John Williamson, whose analysis is now available to the general public through his book, "The Exchange Rate System", published September 1983. In this, a misalignment is defined as a persistent departure of the exchange rate from its "fundamental equilibrium level", where the latter concept

> "... is intended to connote the obverse of "fundamental disequilibrium", the criterion for an exchange rate change under the Bretton Woods system. Although the term was never formally defined, the IMF's (1970) report on the exchange-rate system implied that fundamental disequilibrium was a situation in which a country could not expect to generate a current account balance to match its underlying capital flow over the cycle as a whole without, on the one hand, depressing its income below "internal balance" or imposing trade controls for payments purposes or, on the other hand, importing inflation. Conversely, therefore, the fundamental equilibrium exchange rate is that which is expected to generate a current account surplus or deficit equal to the underlying capital flow over the cycle given that the

country is pursuing "internal balance" as best it can and not restricting trade for balance of payments reasons.

2.14. Professor John Williamson then proceeds to a statistical estimation of the misalignments obtaining in the first quarter of 1983, deviations from 100 per cent in the table below representing his estimate of the undervaluation or overvaluation in relation to the effective exchange rate:

TABLE Estimates of misalignments, 1983 Q1

US dollar	118
Japanese yen	94
Deutschemark	96
French franc	97
Pound sterling	111
Other industrial country currencies	90[a]

a. Residual

2.15. Professor John Williamson warns us against attributing great accuracy to his calculations. He writes:

> "This is not to claim that those calculations are at all precise: on the contrary, the approach requires a belief that it is better to be roughly right than to be precise but irrelevant. The procedures employed are comfortably ad hoc. Numerous heroic assumptions are needed... It is quite easy to change the base periods and other necessary inputs in ways that can alter the results by 5 percent to 10 percent."

2.16. The attitude revealed in the evidence our predecessors received from bankers was more pragmatic. Dr Emminger submitted in his written evidence (answer to Question 1 of the questionnaire):-

> "In spite of the difficulty of defining precise criteria, it is not difficult to find examples where exchange rates were so much out of line that one can speak of a substantial misalignment. This is reminiscent of the story about the pretty girl: it is difficult to define her, but you recognise her immediately you meet her. One obvious example of a currency misalignment is the dollar/D-mark rate in 1981. Another one is the present undervaluation of the Japanese yen. The dollar/D-mark rate suffered from excessively large swings in 1980-81; at its high point in August 1981 (DM 2.57) it was nearly 50 per cent above its value at the end of 1979 (DM 1.73). The dollar was quite certainly overvalued in August 1981, and everybody (including central bank presidents) said so when the dollar was going above DM 2.40. It was astonishing that neither the market nor central banks were doing more to cash on this opportunity.

2.17. There was wide agreement among witnesses on the identification of numerous episodes of persistent and significant misalignments - undervaluation of the US dollar in 1978-79, and of the DM since 1980; and overvaluation of the US dollar since 1981, of the yen in 1974 and late 1978, and of the Swiss franc and DM in late 1978 and 1979.[30] The pound sterling was overvalued in 1980 and 1981. Although misalignments occurred under the Bretton Woods system as well, their frequency and magnitude have increased since 1973.[31]

2.18. These episodes can be traced to both economic and political factors. An important economic factor is the more rapid adjustment that takes place in asset markets, including

30. See responses to question 1 of the Committee's questionnaire from the Accepting Houses Association, Artis, Bank of Japan, Bundesbank, Chrystal, Dornbusch, Emminger, Ford, Foseco-Misep, Labour Economic Policy Group, Padoa-Schioppa, Rybczynski, Thygesen, Unilever and Van Ypersele.
31. Appendices, p.96. See also pp 19-26.

the foreign exchange market, compared to the slow rate of adjustment that characterises labour markets and most goods markets.[32] Exchange rates can and do get quite out of line with the levels warranted by equilibrium competitiveness. Even though these disequilibria tend to be eventually corrected, either by subsequent movement of the exchange rate or by induced movements in prices and costs or both, re-establishment of equilibrium is a lengthy business. The empirical evidence for the United Kingdom suggests that to the extent that adjustment is thrown on to domestic prices and costs, around half the adjustment is completed within a year, after which adjustment might continue several further years: even by then some competitve advantage might well remain.[33] Changes in competitiveness take some time to affect output and employment. Consensus estimates suggest that the full real effect is reached in the third and fourth year. This is because exports, and to a lesser extent imports, respond to changes in competitiveness with a fairly long lag. Thus misalignments can exert effects on the real economy long after they have been corrected.

The Real Cost of Exchange Rate Variations

2.19. In amplification of the points made by the Deputy Governor (see paragraph 2.11), exchange rate risks can be hedged, at modest cost for short-term cover, either in the forward market or by an appropriate combination of contracts in the spot exchange market, the domestic securities market and the foreign securities market. (Longer term cover, say five years or more, is more expensive, and may be more

32. HC(1982-83)385, Appendix A, Annex, para 11.
33. Appendices, p.96.

difficult or indeed impossible to arrange.) Dr Begg reported that there had been a significant increase in hedging activities since the switch to floating rates.[34] Appropriate choice of the currency in which international contracts are invoiced may also help firms to limit exchange risk. 5

2.20. While all the evidence received supported the view that misalignments were likely to produce harmful effects on trade and investment, and the allocation of resources at the international level, witnesses were nearly unanimous in claiming that short-term fluctuations had not been particularly harmful.[35] It has also been reported that a recent IMF study "has found no solid evidence that exchange rate volatility adversely affects the volume of world trade".[36] In contrast a study relating to West Germany and the United States undertaken by the Federal Reserve Bank of New York blamed volatile exchange rates for a significant reduction in trade flows between the two countries.[37] 10 15

2.21. While the weight of evidence does suggest that short-run fluctuations are not a major problem, we nevertheless believe that the there is justification for official intervention in the foreign exchange market of the kind currently practiced by the Bank of England to reduce short-term fluctuations. 20

34. Appendices, p.18.
35. For alternative views see HC(1981-82)449, p.28; HC(1981-82)21-III, p.139 and HC(1981-82)21-II, p.181.
36. Financial Times, 13 March 1984.
37. M.A. Ashton and R. Spence Hilton, Effects of Exchange Rate Uncertainty on German and US Trade, Federal Reserve Bank of New York Quarterly Review, Spring 1984, reported in Financial Times 4 June 1984.

The Present Position

2.22.There is at present no international consensus as to whether intervention and interest rate policy should be used to reduce exchange rate fluctuations, especially among the governments of the countries whose currencies are in widespread international use - the US, Germany, UK, Japan, France, and Switzerland. At one extreme, the present administration in the United States practices 'benign neglect' involving 'free' or 'clean' floating, in which there is virtually no intervention and interest rates have usually been subservient to the overriding aim of guiding the money stock along a predetermined growth path. At the other extreme, the present government in France has intervened on a massive scale to hold the franc within the EMS. In Britain, the present government has practised light intervention aimed at smoothing out short-term fluctuations, but it has at least in principle accorded a higher priority to the achievement of money-stock targets than to the behaviour of the exchange rate and it claims that interest rate policy has been directed at the former. Other countries have adopted an intermediate course. In an attempt to breach international differences of view on the effectiveness of intervention, the Versailles summit commissioned a study of the subject (the Jurgensen Report) which was published in 1983.[39] Although the Working Group had agreed a Report that did not substantiate the US position on the ineffectiveness of intervention and the Ministerial statement accompanying the release affirmed agreement on the

39. Report of the Working Group on Exchange Market Intervention, January 1983.

need for greater exchange rate stability, US Treasury Secretary Donald Regan announced that there would be no change in US intervention policy, and indeed there has not been any fundamental change in US intervention policy, despite the intervention undertaken in August 1983 and on a smaller scale on several other occasions. 5

2.23. Despite the efforts of the monetary authorities in several countries to limit exchange-rate fluctuations, these have been very large since the advent of floating. Figure 2 shows the variability of monthly exchange rates of the other 10 seven principal currencies against the US dollar. Great variability is present also in rates recorded at shorter intervals (daily, say); in the rates against a trade-weighted average of other currencies (historical movements in these so-called "effective rates" are set out in Figures 3a and 3b); 15 and in rates corrected for changes in price levels at home and abroad (so-called 'real' rates or indices of competitivenss, see Figure 4). Effective rates naturally vary less than many bilateral rates, if only because averages are less volatile, but even on this basis movements have been large. The 20 Chancellor's predecessor said:

> "... the effective rate of sterling between November 1976 and January 1981, the peak, rose by 33.2 per cent, that is from November 1976, the bottom. The Deutsche Mark between the end of September 1975 and the end of 25 September 1979 rose by 37.3 per cent. The dollar, 1978 fourth quarter to November 1982 rose by 36.2 per cent and the yen, end of December 1975 to end of October 1978 rose by 61.3 per cent."[40]

In the longer run real rates normally tend to vary less than 30

40. Q.1329

nominal rates, since there is some tendency for nominal exchange rates to move to offset differential inflation. Nevertheless, the swings in real effective exchange rates have been enormous in recent years: the real effective exchange rates of the five principal currencies have shown the following maximum swings since 1976:[41]

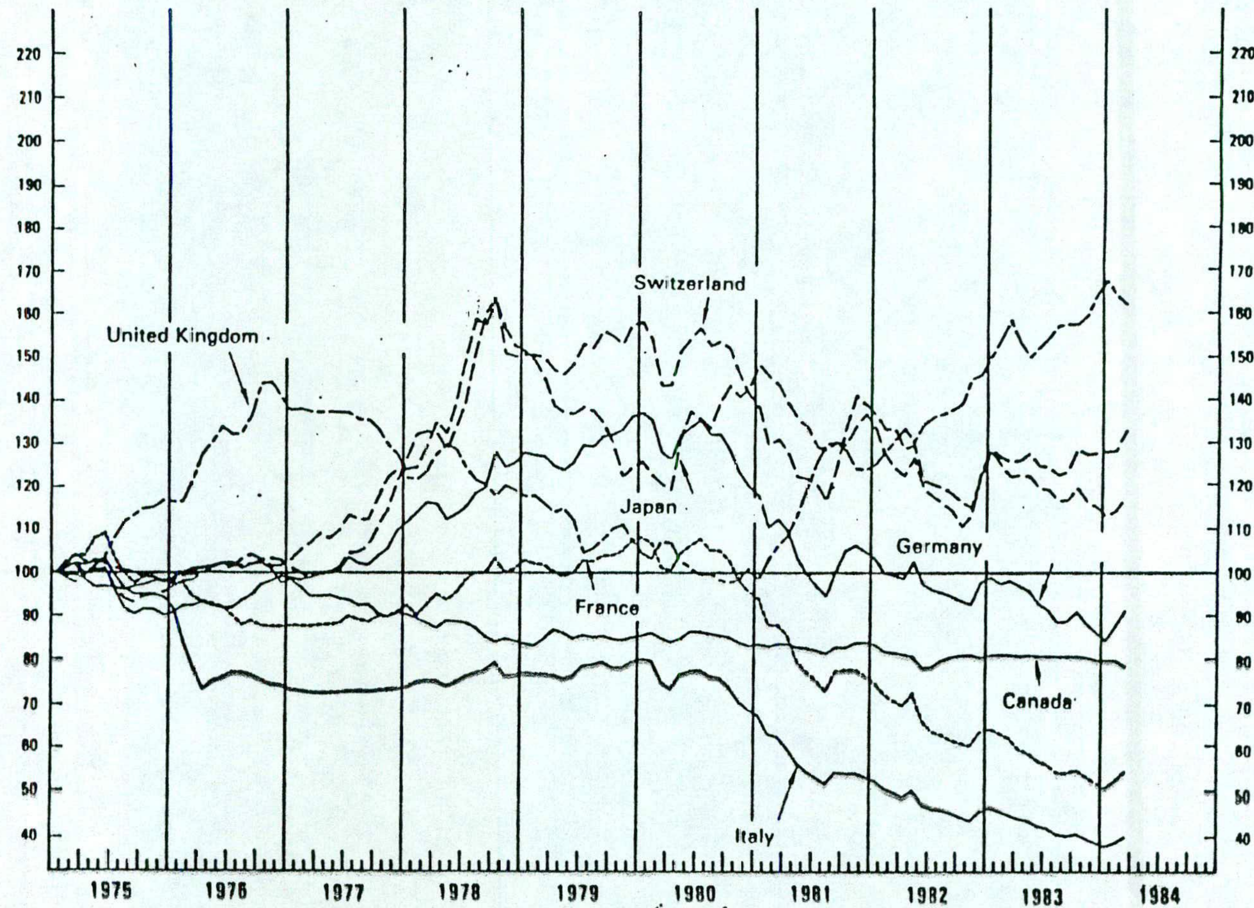
US dollar 32%
Deutschemark 11%
Pound sterling 72%
Japanese yen 51%
French franc 15%.

41. Morgan Guaranty Index

FIGURE 2

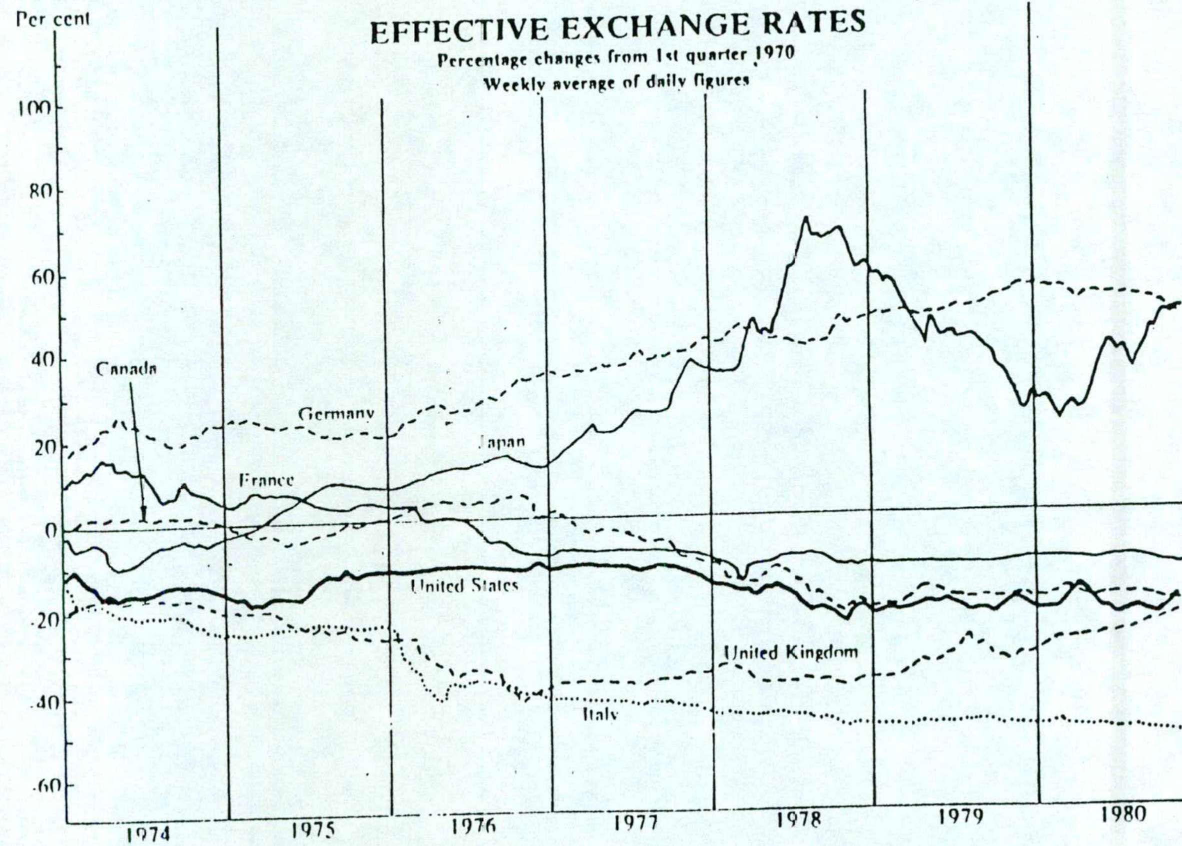
EXCHANGE RATES

U.S. dollars per national currency unit, January 1975 = 100



Source: OECD, Main Economic Indicators, May 1984

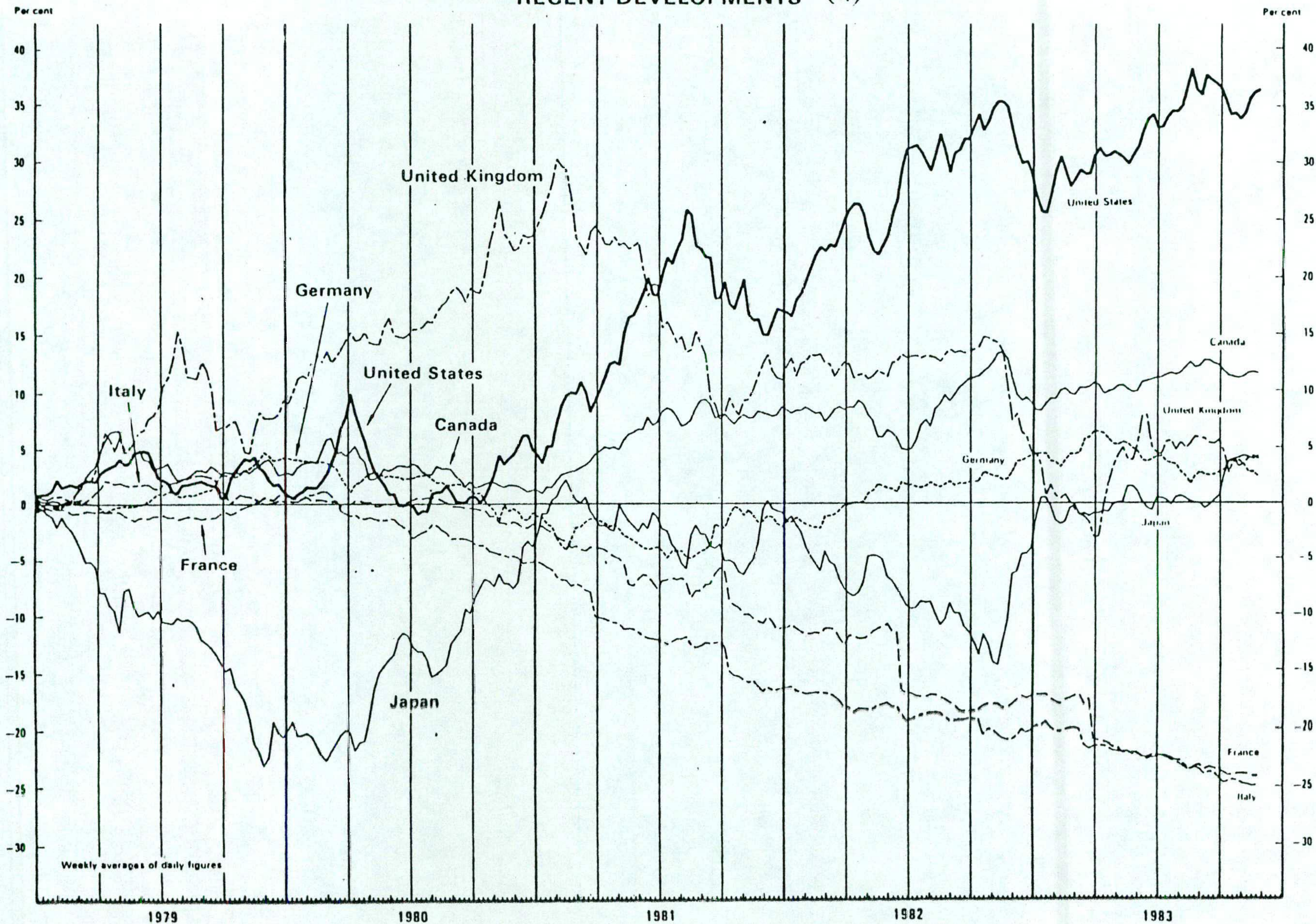
FIGURE 3a



Source: OECD, *Economic Outlook*, December 1980

FIGURE 3b

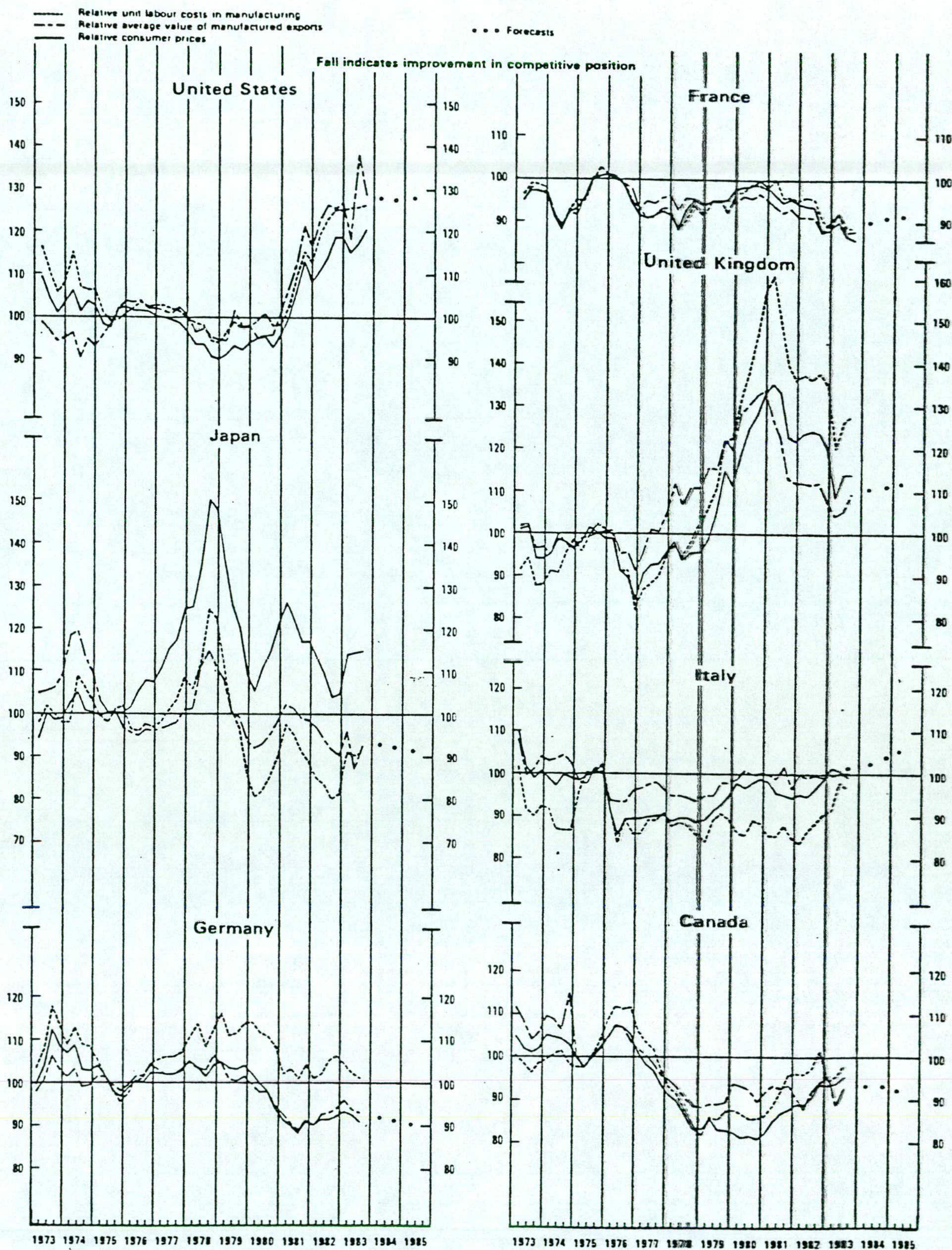
EFFECTIVE EXCHANGE RATES OF OECD CURRENCIES: RECENT DEVELOPMENTS (a)



(a) . Percentage variations from the last week of December 1978

Source: OECD, Economic Outlook, December 1983

FIGURE 4



Source: OECD, Economic Outlook, December 1983

III. The Position of the UK

3.1. The United Kingdom is still the most open of the five large non-communist economies. This makes us particularly vulnerable to variations in external demand, whether caused by fluctuations in the exchange rate or by the world business cycle. The importance of both factors is illustrated by recent experience. Before the appreciation of sterling and the world recession, in the first quarter of 1979, unemployment in the UK was around 6 per cent.[42] By the first quarter of 1983, it had risen to 13.6 per cent. Over the same period, unemployment in the 15 major OECD countries rose from 5.1 per cent to 8.9 per cent. Why should the rise in unemployment in Britain have been so much greater than in any other comparable economy? Dr Emminger, the former President of the Deutsche Bundesbank, referring to the level of the real effective exchange rate of sterling in 1980-81, stated:

> "This is by far the most excessive overvaluation which any major currency has experienced in recent monetary history ... The large real appreciation of sterling from 1979 to 1981 was probably the most important single element in that period's British economic policy, as concerns its effects both on domestic inflation as well as on British trade, production and unemployment."[43]

We agree that the overvaluation of sterling was an element in the rise in unemployment in Britain.

3.2. The present UK government has made the reduction of

42. OECD, Economic Outlook, Table R12, figures standardised for international comparability.

43. Emminger, O., Exchange Rate Policy Reconsidered. Dr Emminger supplied the Committee with a draft version of this paper which has subsequently been published as Group of Thirty, Occasional Paper No. 10, 1982

inflation the overriding objective of its economic policy. It sought to accomplish that objective primarily by limiting monetary growth to a pre-determined target path, and eschewed use of an incomes policy.[44].

3.3. From early 1979 to its peak in January 1981, the real effective exchange rate of sterling rose by some 45 per cent (on the Morgan Guaranty measure, and even more on some other measures). It is generally agreed that this appreciation was due to high interest rates and developments in the oil market, but there has been controversy about the relative importance of the various factors. There are, however, reasons for believing that the effect on the current account of the build-up in the output of oil from the North Sea did not play the major role:

(a) production increased rather steadily over the period 1975-82, whereas the appreciation was concentrated in 1979-80;

(b) the markets had good production forecasts and could therefore have discounted rising output before it occurred;

(c) the exchange rate has fallen back since early 1981 although oil output has continued to rise;

(d) the largest estimate of the direct impact of North Sea oil,[45] was that it would justify an appreciation of 15-20 per cent. This assumed a high oil price and

44. IMF, World Economic Outlook, 1984, Table 8
45. Forsyth P.J. and Kay J.A., The Economic Implications of North Sea Oil Revenues, Institute for Fiscal Studies, July 1980

low import and export price elasticities and made no allowance for the desirability of saving a large part of the extra income accruing from exploitation of this depletable resource. Under assumptions of higher trade elasticities an 8 per cent appreciation is implied,[46] But even that may be overstated if one takes the view that a large part of the increased income from oil should be saved in the form of a current account surplus, balanced by an equivalent amount of net overseas investment.

However the effect of an increase in the oil price on the balance of payments is not restricted to the current account. As Treasury and Bank of England officials noted in the course of our predecessor's enquiry into Monetary Policy,[47] an important effect of North Sea oil was in making sterling an increasingly attractive investment hedge as the price of oil rose. This greatly affected the capital account in 1979-80 by increasing the demand for sterling assets. Markets were equilibrated by the dramatic rise in the price of the pound sterling.

3.4. The Government appeared to welcome the initial appreciation of sterling as supportive of its aim of bringing inflation under control, while denying that the pursuit of monetary targets should or would be influenced by what happened to the exchange rate. Over time, however, its commitment to monetary targets seems to have weakened. The first sign of that revision of its position was the statement of the Financial Secretary to the Treasury which our

46. Buiter W.H. and Miller M., "THE THATCHER EXPERIEMENT: THE FIRST TWO YEARS", Brookings Papers, on Economic Activity, 2, 1981.
47. HC(1980-81)163-I, paras 7.29, 7.30 and 7.31

predecessor welcomed in our Report on Monetary Policy (see para 1.5 above). Since then monetary policy does at times appear to have been influenced by concern over the exchange rate. In early 1981, the vast overshooting of the monetary target was tolerated at least in part out of a concern to avoid exaggerating even further the sterling overvaluation which peaked at the time.

<u>Bank of England Transactions in Financial Markets</u>

3.5. The Bank of England acts in two ways to influence the exchange rate: by undertaking official transactions in the foreign exchange market ('intervention'), or by undertaking official transactions in the money market with the intention of influencing interest rates and hence the exchange rate.[48] Official transactions in the money market have since August 1981 been designed to keep very short-term interest rates within a predetermined but unpublished band, which is settled by the Bank and Treasury from day to day and may be changed at any time if circumstances so require. Such circumstances would include a deviation of the money stock from its targeted growth path. However, only occasionally have interest rates been raised with the proximate aim of supporting the sterling exchange rate; and at no time since 1977 have they been lowered with the proximate aim of capping the exchange rate because of the consequences for the money supply.

3.6. The rare occasions on which the Bank has in recent years engineered a rise in short rates specifically to support sterling undoubtedly include 16 September and 1 October 1981.

48. Tew. B., <u>The Implementation of British Monetary Policy,</u> Appendix X (if published).

Bank officials agreed with this: the Bank acknowledged that interest rates had been lifted in response to exchange-rate pressures over this period,[49] but stated that the interest rate rise had been engineered because of the pace of change, rather than the absolute level of the exchange rate.[50] Something similar appears to have happened on 26 November 1982 and 12 January 1983, but in these cases the initiative was taken by the Clearing Banks and the Bank of England followed. Much the same thing happened again on 9 May 1984, with the rise of ½ per cent (or in several cases .75 per cent) in banks' base rates. The Financial Times then commented as follows:-

> "The British authorities made it clear that they saw no domestic reason for Wednesday's rise of base lending rates to between 9 and 9.25 per cent, nor any immediate need for a further increase.
>
> The Bank of England reluctantly followed market rates up by raising the rates at which it supplied funds to the banking system by ½ a percentage point. If it had not done so, it was feared sterling might have been pushed into an unwelcome sharp slide."[51]

3.7. The Bank's transactions in the foreign exchange market are undertaken under a procedure quite different from its transactions in the money market. The Bank is emphatic that it does not have in mind any target exchange rate or band of any kind. For example the Deputy Governor said:

> "It is the case in practice that we intervene only against the movement and not in relation to a level."[52]

The Bank's decisions to intervene in the market are taken *ad hoc*, day by day. The Treasury is consulted depending on the scale of intervention envisaged. One of the Bank's Executive Directors involved stated:

49. Q.201, see also *Midland Bank Review*, Summer 1982, page 18
50. Q.202
51. Financial Times, 11 May 1984.
52. Q.1301, see also Bank Questionnaire answer 4, Q.148, Q. 198-204, Q.1306.

"[If intervention] is going to produce a figure which might require or might lead to, say, a ministerial question to the Treasury about what is going on - I would always hope to have avoided that by in fact having already cleared my lines with my opposite number in the Treasury. Indeed, there are occasions when of course the Governor gets involved and discusses matters with the Chancellor."[53]

"The essence of the thing is not to be too rigid. The markets move so rapidly. I think we have a very good rapport on this with the Treasury and I think they know that we are not going to do anything, or will try not to do anything, that causes them problems."[54]

A decision to intervene requires that somebody should be able to make a plausible argument for intervening. Besides intervention related to a rapid rise or fall in the exchange rate, intervention might result from special circumstances:

"... the peculiar circumstances of the Falklands crisis where ... there were quite considerable rapid movements which seemed to us to be understandable enough in the sense that nobody knew what was going to happen and the market subsequently recovered ... Then later on in the course of the hostilities in Argentina there were these hopes and fears which swung one way and another. There were, in fact, quite sharp reactions which were, I think, a typical example where it was hoped it would be useful to be in the market and smooth."[55]

In addition "bandwaggon" effects were mentioned:

"When the exchange rate moves for some reason people decide that it is going to go on moving and pile in and for a short time can make those expectations self-justifying, but it may well be the reason that the expectations can be carried away from fundamentals for a while is because the terms in which most of the relevant people are thinking are what other people are thinking rather than about the fundamentals."[56]

53. Q.229.
54. Q.230.
55. Q.199
56. Q.157

3.8. The Bank's witnesses were quite explicit that since the Bank adopted in October 1977 its present procedures for intervention in the foreign exchange market, its transactions in this market were never intended to do more than iron out short term fluctuations in the exchange rate. In practice the Bank has tended to buy the pound when it is cheap and sell it when it is dear; since the Bank adopted its present procedures its "smoothing operations have been substantially profitable". 57

3.9. Though only exceptionally has the Bank's setting of its monetary policy, in particular the setting of its band for money market rates, been directed proximately to influencing the exchange rate, nevertheless the behaviour of the rate, especially changes in it, as distinct from its absolute level, are considered to be of great importance for diagnostic purposes. The Deputy Governor said:

> "... we look at the movement from one date to another and if the situation is that the exchange rate is 12 per cent below what it was 12 months ago, that introduces the potential for some more inflation of prices, which would be very worrying and would have an effect which over time would introduce changes for the Government with regard to employment and the public sector deficit and all these kinds of variables. How they would all come out would depend on how we reacted and what our policies were, but it does change the framework in which we look at the domestic monetary policy. That is how we take it into account. We had a stable level before and now we have dropped right down again and because our exchange rate has changed it changes the environment in which we operate to produce the monetary target."58

In consequence, a different setting of monetary policy may be needed to achieve the monetary target.

57. Q.206
58. Q.1303

> "We will adjust what we do to achieve the money supply that we want in the light of the changes that come about in the exchange rate."[59]

In evidence given during the course of our enquiry into the 1984 Budget the Deputy Governor said:

> "if we judge that the exchange rate is abnormally high and therefore exerting by itself a deflationary downward pressure, we are prepared to tolerate monetary numbers going outside their target ranges"[60]

Conversely a gathering downward momentum in the exchange rate, associated with a deterioration in inflationary expectations, might signal a need for a tighter monetary stance, even though this was not indicated by the current behaviour of the money stock.[61]

3.10. Any such change in the setting of monetary policy will in turn feed back into the foreign exchange market: the Bank's witnesses were clear that they fully recognise such to be the case.

3.11. Treasury witnesses were as emphatic as those of the Bank in denying that the authorities have in recent years had in mind any target for the exchange rate. The last Chancellor said to our predecessors:

> "... throughout the policy has consisted of intervention in conditions of market turbulence of the sake of smoothing, but not intervention designed to hold any particular rate."[62]

More recent evidence which we ourselves have heard suggests that there has been no change in the official stance on this issue. In early 1984 Treasury officials said:

59. Q.1304
60. HC(1983-84)341, Q.53
61. HC(1983-84)341, Q.58.
62. Q.1325. See also Q.7-12.

> "There is a very small amount of intervention ... in order to maintain orderly market conditions, but there has been no sustained intervention in one direction ... the exchange rate we described has been the exchange rate which has been determined by the market."[63]

Also in the course of our 1984 Budget enquiry the Governor of the Bank of England stated:

> "The Bank will intervene in normal market operating solely in order to even out or to correct what it thinks to be an unsuitable or disorderly market situation but if the general trend of the market is moving in one direction or the other, it is not the policy of the Bank to seek to alter than trend."[64]

We have some difficulty in believing that the authorities in fact succeed in banishing from their minds all preconceptions of where they think the rate should be, and we note that in February 1981 the rate was allowed to fall abruptly from its peak effective level of 105.2 at end-January to 98.9 at end-February with no offsetting intervention. More important, we would question the wisdom of agnosticism as regards where the rate should be.

3.12. The recent behaviour of the Bank in early May 1984 is also somewhat puzzling. At a time when it was generally agreed that the monetary aggregates were not giving cause for concern, a downward movement in the exchange rate produced a rise in domestic interest rates and the Chancellor himself said "we cannot be totally immune to the upward pressures generated across the Atlantic".[65] It would seem that the

63. HC(1983-84)170, Q.91.
64. HC(1983-84)341, Q.42
65. Speech delivered at Scottish Conservative Party Conference, Perty, 9 May 1984.

market did not believe that the Government was wholly indifferent to the level of the exchange rate, and despite his evidence to us the Chancellor apparently was not prepared to decouple completely from US interest rates regardless of the exchange rate.

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IV. CONCLUSIONS

4.1 We recognise as the Bank of England clearly does (paras 3.9 and 3.10) a two way relationship between the exchange rate and the conduct of monetary and fiscal policy. Government may react to changes in the exchange rate (or decide not to do so). Conversely Government action may be taken to affect the exchange rate. It is helpful to distinguish the interaction of monetary policy and the exchange rate from the interaction of fiscal policy and the exchange rate before considering the important question of the "mix" of fiscal and monetary policy.

Monetary Policy

Bank and Treasury reactions to changes in the exchange rate

4.2 How do the Treasury and Bank of England react to events in the foreign exchange market? The Bank as well as the Treasury witnesses were emphatic that they have not in recent years had in mind any target or band for the exchange rate (above para. 3.11): however movements in the rate do affect their decisions about the implementation of monetary policy, in three specific contexts which were drawn to our attention by the Governor and Deputy Governor. These are:

(a) there may be a crisis of confidence which it may be difficult to contain without a rise in interest rates,[1] as was in the Bank's mind (among other things) when it raised money market interest rates on 16th September and 1st October 1981. This was of course the traditional reaction of the Bank to the crises of confidence under the gold standard and under the Bretton Woods regime. Whether it is always the appropriate reaction in a floating rate regime is open to question: the Deputy Governor did not quarrel with the

1. HC(1983-84)341, Q.51

proposition put to him that it is 'prudent to allow the exchange rate to act as the shock absorber rather than fiddling with your interest rates ... merely to counter a massive groundswell in the market'[1]. In our view a fall in the exchange rate due to a crisis of confidence may well justify sterilised intervention in the foreign exchange market, but would only in extreme cases justify a significant interest rate increase in circumstances when such a move 'stifles the recovery'[2].

(b) As the Deputy Governor said, a change in the exchange rate "changes the environment in which we operate"[3] and hence affects the steps the Bank needs to take to achieve the monetary target.

(c) again according to the Deputy Governor, a high exchange rate might, by itself exerting a deflationary pressure, justify allowing the money stock to exceed its target; conversely a gathering downward momentum in the exchange rate, associated with a deterioration in inflationary expectations, might signal a need for a tighter monetary stance, even though this was not indicated by the current behaviour of the money stock.[4]

The Treasury witnesses did not spell out the story in such detail although Sir Terence Burns assured the Committee that the present Chancellor 'is very happy to take the exchange rate into account in judging the overall state of monetary and fiscal conditions', though 'he is very unhappy with the idea of having a moving exchange rate target or a band of some kind'.[5]

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1. HC(1983-84)341, Q.56
2. HC(1983-84)341, Q.51.
3. Q.1303
4. HC(1983-84)341, Q.53
5. HC(1983-84)170, Q.90 .

4.3 We are wholly sympathetic to the pragmatic attitude of these official witnesses, which seems a long way away from a doctrinaire adherence to money-stock targeting. The present Governor's view is that the credibility of monetary policy should not depend on monetary targets always being hit: in his oral evidence to the Committee he agreed that "the public ought to be prepared to trust the politicians and Bank more and that, therefore, the slightly less rigid [targeting] structure is nonetheless accepted by the public and the market to a greater extent".[1] This is the view that we ourselves take.

4.4 Since we found ourselves so much in sympathy with the Bank's and Treasury's evidence to us on the relevance of the exchange rate to decision-making in the field of monetary policy, we have been puzzled at the unwillingness of either Bank or Treasury witnesses to accept the usefulness of the concept of 'misalignment' of exchange rates, as we are using the term (above, at 2.11 et seq.). At the most they conceded that the concept might be applicable to other currencies, but never to sterling: indeed the present Chancellor went as far as to describe the possibility of an overvalued pound as "something of a metaphysical question".[2] We readily admit that misalignment involves elements of judgment and is subject to error; nevertheless we have noted many cases where currencies were undoubtedly misaligned (above, at 2.17) and were widely recognised to be such at the time. One of these cases was the overvaluation of sterling in 1980, another the overvaluation of the US dollar at the present time (May 1984).

1. HC(1983-84)341, Q.15
2. HC(1983-84)170, Q.7.

Effects of Bank and Treasury actions on the exchange rate

4.5 The Bank and Treasury can affect the exchange rate in two main ways. Official transactions in the foreign exchange market, if sterilised (see above, para. 2.9), can contribute to ironing out short-term fluctuations, but not to correcting what we have called 'misalignments'. Since misalignments are in our view much more objectionable than short term fluctuations we do not attach a great deal of value to sterilised intervention, though we are in agreement with the Bank's present intervention procedures (paras. 3.7 and 3.8). More important, nonsterilised intervention in the foreign exchange market, and also official transactions in the money market and bond market (all of which show up as a change in the commercial banks' operational balances at the Bank of England) represent a much more powerful instrument of monetary policy, which enables the Bank to provoke a rise in the level of short money market rates (by reducing operational deposits) or a fall in the level (by increasing them). A change in short money market rates exerts a strong influence on external capital flows and hence on the exchange rate.

Fiscal Policy

Reaction of the changes in the exchange rate

4.6 The stance of fiscal policy cannot in practice be used for short-run management of the exchange rate, if only because of the infrequency with which it is adjusted. Fiscal policy is normally adjusted only once a year - in the context of the annual expenditure survey decisions and in the Budget. (Monetary policy, through interest rates and open market operations, is conducted as a daily basis and is the proper instrument to respond to unwanted exchange rate fluctuations in the short run.) [The Government can of course alter fiscal policy in reaction to a long term change in the exchange rate, but such reaction is evidently curtailed at present by the preoccupation with the need to reduce the PSBR as part of the MTFS. In any case fiscal policy action is likely to have only a relatively weak impact on the exchange rate (see para 4.10).]

Impact of fiscal action in the exchange rate

4.7 It is frequently assumed that an increased PSBR necessarily puts upward pressure on interest rates and hence on the exchange rate. However an increase in the PSBR is not in itself sufficient evidence of fiscal-policy-induced upward pressure on interest rates and the exchange rate. This depends on how the deficit has been brought about. An increase in the public sector deficit that merely represents the passive response of taxes and social security payments to a decline in economic activity originating in the private sector or abroad, may well be accompanied by declining interest rates and a falling exchange rate. However a discretionary fiscal stimulus (a cut in tax rates, an increase in the rate of social security benefits, an upward revision in the government's expenditure plans) is likely to raise interest rates.

4.8 It is important to consider whether a fiscal stimulus of this kind will be fully or partly "crowded out". By this we mean the effect of higher interest rates in discouraging domestic investment and attracting a capital inflow (the latter raising the exchange rate and hence reducing competitiveness).

4.9 However there is no empirical evidence which suggests 100% or full crowding out in the short and medium term. Fiscal policy thus maintains its potential demand-stabilizing role even under flexible exchange rates: over the time horizon relevant for stabilization policy, crowding out through interest rate increases and exchange rate appreciation is only partial.

Fiscal/Monetary Policy Mix

4.10 It thus appears that fiscal policy as well as monetary policy has an effect both on the pressure of demand in the markets for goods and

services and also on the exchange rate. But it also appears, in the light of recent experience, that the relative magnitude of the two effects is not the same in the two cases: the impact of fiscal policy (even allowing for "crowding out") is predominantly on the pressure of demand, that of monetary policy predominantly on the exchange rate. Moreover the effect of the two policies is not symetrical: a tight monetary policy (one which mitigates the pressure of demand in the markets for goods and services) tends to <u>support</u> the exchange rate, a tight fiscal policy (in so far as it lowers yields on national debt instruments by reducing the issuance of new debt) tends to <u>depress</u> the exchange rate.

4.11 Because changes in monetary and fiscal policies have different effects, we believe it should be possible, by a suitable monetary/fiscal policy mix, to effect a reasonably satisfactory reconciliation between (on the one hand) the avoidance of a misaligned exchange rate and (on the other) the need to keep a stable internal economy. Hence we see an escape from the apparent dilemma to which we alluded at the end of paragraph 2.10 above.

4.12 Our view is that though minor cases of misaligment may be identifiable only in retrospect, serious cases, like those we mentioned in para. 2.17 can be diagnosed in time for useful corrective action to be taken; and that in such cases the stance of fiscal and/or monetary policy should be amended in a way appropriate to mitigate the misalignment. The precise action called for is a matter for judgment, in the light of the circumstances of the time, but we can make clear our views on the operational procedures required by taking as illustrations the dollar and sterling overvaluations mentioned in paragraph 2.17. In the case of the overvaluation of the dollar in 1984, we assume that in the US the recovery from the business depression is presently proceeding at a rate which it would be unwise to accelerate by government action: on that assumption the adjustment required is a change of <u>mix</u> of

fiscal and monetary policy. Fiscal policy should be tightened, by increasing tax rates and/or reducing government expenditure, while monetary policy should be relaxed by suitably stepping up Federal Reserve open market purchases. The overvaluation of sterling in 1980 was somewhat different, in that unemployment was already unacceptably high and still rising. So in this case the remedy for currency overvaluation needed to incorporate some measure of stimulus to the economy, in the form of a somewhat less restrictive fiscal policy, in addition to the stimulus afforded by the lowering of the exchange rate from its overvalued level. The easing down of the sterling exchange rate called for a lowering of short term interest rates by official transactions in the money market. This might have involved some increase in bank lending and bank deposits (and hence in the money stock) but in our view not on an unacceptably large scale, bearing in mind that with lower interest rates some firms might have borrowed less from banks, rather than more.

4.13 What gives us some confidence in our prescription for UK policy is that the remedial scenario just outlined was actually put into effect, though belatedly. First, short term interest rates were brought down from 16 3/4% in May 1980 to under 12% in February 1981, and though the fall was interrupted towards the end of the year (para. 4.2 above, at (a)), it then continued down to 10% in August 1982. Throughout this time £M3 was exceeding the upper limit of its original target range, but this deviation was tolerated by the authorities - and rightly so in our view. Second, the sterling effective exchange rate declined by about 10% from end-1980 to end-1981. Finally, in 1983 fiscal policy was eventually made less strict. So the actions which were needed to mitigate the overvaluation of the pound were eventually taken, but belatedly and half-heartedly.

Full Membership of the EMS

4.14 Since we favour an active exchange rate policy, in the sense that a country's authorities should take action to correct misalignments, we also come down strongly in favour of international policy coordination, to ensure that so far as possible countries agree on which (if any) of their currencies are overvalued and which undervalued, and then act together to correct the misalignments (instead of, as otherwise may happen, acting at cross purposes). We have considered the advantages and disadvantags of an international grouping dedicated to the cooperative management ofthe exchange rates of all the member countries. The Bretton Woods system provided such a grouping in the earlier postwar period, in which the UK participated. There is now no such arrangement at the world level: the only such arrangement in place is the European Monetary System (EMS). This provides that participants in effect agree a central rate for their currency in terms of the ECU; that they defend the resulting parities against every other member within a band of 2.25 per cent (6 per cent in case of the Italian lira); and that they adjust their central rates only by mutual agreement among all participants.

4.15 The considerations that seem to us to be relevant in considering the option of entry to the exchange-rate mechanism of the EMS are the following:

(a) For a country with an above average rate of inflation a formal linkage through to a more stable currency system is likely to lead to domestic inflation benefits, although at the same time unemployment problems may be exacerbated. In current circumstances, this argument provides no justification for joining, since as the Deputy Governor said:

> "... our own anti-inflation performance is going on rather well and better than a number of those in the EMS."[1]

1. Q.1026

(b) Because the EMS operates with constant nominal pegs misalignments can emerge from differential inflation in the EMS. The danger that such misalignments might perpetuated because of inadequate flexibility in central rates received much emphasis in Britain when formation of the EMS was under discussion in 1978. In fact EMS has permitted fairly frequent realignment (nine in just over five years). Dr Rieke described it thus:

> "These realignments were every time a cause for desperation but in the end ... they came off and the one thing you can say is that you did not get movements as much up and down; you got the adjustments more or less in one direction, namely in the direction dictated by the inflation differentials between the various participants."[1]

However, the recent realignments have been so large, involving parity changes of 8 per cent or even 9 per cent, as to force discontinuous changes in market rates. The speculative pressures, characteristic of the adjustable peg, have thus been returning.

(c) Full membership of the EMS would give the UK access to the very short-term financing facilities that members provide each other in order to support intervention. This would go some way towards meeting the greater difficulties of undertaking the more rigid commitments involved in EMS membership, but not very far.

(d) Changes in EMS central rates require collective agreement. Since exchange rates are inherently matters of mutual international concern, a requirement of collective agreement is not in itself unreasonable, but in the immediate future Britain would be wise to preserve somewhat more freedom of action. This is because the UK economy has sunk into a deeper depression than the EEC as a whole (above para 3.1); hence we need a bigger recovery than other industrial countries, which will be liable to stimulate our imports more than our exports. In these circumstances, what we must avoid at all costs is getting committed to an exchange rate which requires the UK authorities to abort our present fitful economic

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1. Q.1026

recovery, [as happened after 1925 following our return to the gold standard with an overvalued pound]. Admittedly the EMS is unlike the gold standard in that there is explicit provision for changing exchange rates by collective agreement, and our fellow members might be sympathetic to our case. But it is conceivable that they might not be, according to the evidence given by Mr John Forsyth to the House of Lords Committee,[1] and in practice some countries (eg Belgium) have found that their wishes have not always been conceded by fellow members.

(e) It is often argued that the petro-currency status of sterling is an obstacle to British participation in the EMS, since a rise in the oil price tends to strengthen sterling and to weaken the EMS currencies. For example, the former Chancellor said:

> "In our case I think ... the impact of petro-currency factors ... does make one still apprehensive about joining."[2]

In para 3.3 we argued that the main influence of the oil price on the strength of sterling stems from portfolio effects rather than the influence of increased oil earnings on the current account. Insofar as increased oil earnings are expected to be permanent, it is rational to allow balance of payments adjustment and to that end a real appreciation of sterling is called for. But it is not rational to spend more and save less, let alone to allow one's level of output to fall, just because investors want to hold a larger part of their wealth in the form of sterling. It follows that the appropriate response is to satisfy their increased demand to hold sterling by increasing the supply of sterling assets: in other words, to finance rather than to adjust. This is a response that might be encouraged by EMS membership; but, provided the matter is in future correctly understood, it could also be handled by unilateral management.

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1. 5th Report [1983-84]39, Evidence p.142.
2. Q.1339

(f) Unilateral management of sterling could be directed at stabilising the effective exchange rate, whereas full membership of the EMS would involve stabilising the rate in terms of the ECU. When there is a serious misalignment between the ECU and the dollar and/or yen, the sterling effective rate would become misaligned with a peg to the ECU. Sir Alec Cairncross said:

> "After all, the European Monetary System covers only a very small and very limited part of the total financial system of the world. The fact that the pound became linked with some European countries when the dollar and the yen and other currencies were right outside would still leave us open to considerable forms of instability."[1]

(g) The EMS with the full UK membership would be very different, in that it would have two major international currencies in it. As Dr Rieke said:

> "When two currencies like the deutschemark and the pound sterling, which are definitely international currencies, you might get problems."[2]

Our conclusion, and in this we disagree with the recent findings of the House of Lords Committee on European Communities,[3] is that though we cannot rule out eventual full participation in the EMS, the balance of advantage lies in remaining a non-member for the time being.

<u>International coordination of policies</u>

4.16 Our own view on how international coordination of policies could best be got under way, outside the mechanism of the EMS exchange rate mechanism, was so well covered by Mr. Paul Volcker, presently the Chairman of the US Federal Reserve Board, in an address way back in November 1975 [4], that we give the relevant passage in full:

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1. Q.799
2. Q.1023
3. 5th Report, Session 1983-84, 26 July 1983
4. Mr Volcker was then President of the Federal Reserve Bank of New York, whose Monthly Review, January 1976, published the text of Mr Volcker's address.

Floating rates are attractive precisely because they give us a beneficial new degree of freedom in reconciling our domestic policies with open international markets. But to act as though nations can have complete independence in national policy in an interdependent world would be to abuse the system. The result would be to diminish the chances for greater stability in exchange markets.

These are obvious points, and so are the difficulties in approaching better coordination of policies. All those old dilemmas and conflicts in domestic and external policy rear their heads. The United States and other nations will often find it difficult to give international considerations heavy weight. And because the exchange market is multi-sided, the difficulties are increased when several countries are involved.

Nevertheless, there is ground on which to build. The central problem primarily concerns a small number of major countries - if their currencies are reasonably stable , the rest can fall in place. Indeed, there is room in practice for a considerable variety of specific exchange rate practices; these can be managed without great difficulty so long as the exchange rate relationships between the United States, its European Common Market trading partners, and Japan provide a reasonably stable focus.

We have already gone a long way in developing informal consultative arrangements among these countries, and I hope an atmosphere of mutual trust and respect. Gradually, at least around the edges of economic policy, decisions can take into account the mutual desirability of relatively stable exchange markets. This seems to me possible for instance, in shaping the precise mix of fiscal and monetary policies and their timing. Eventually, a common view can emerge as to an acceptable broad range of exchange rates - possibly deliberately fuzzy around the edges - consistent with mutual balance-of-payment equilibrium and adjustment.

That view cannot be static and rigid if we are to retain the flexibility afforded by floating rates. Over time, it is the market that has to tell us what is realistic and what is not. But we also have seen the market move to extremes, and it is those extremes that could usefully be dampened.

4.17 The former Chancellor, (Sir Geoffrey Howe) held to a prescription along broadly similar lines:

"the notion that [the United States, Japan, France, Germany and the United Kingdom] have a special responsibility to the rest of the world is increasingly recognised, and it is also increasingly recognised that they must exercise that responsibility by seeking parallel or converged economic and financial policies

within their own boundaries, which will serve to maintain the values of their currencies, absolutely and in relation to each other ... I am sure this is the pratical way forward ... There is no substitute for collective agreement among countries on sound policies, and their translation into individual practice."[1]

"In some countries where inflation has been brought down, where the Budget deficit is under control and the external position is strong, there may be scope for a rise in domestic activity to sustain the recovery. In others continued firm policies may be needed rather longer."[2]

4.18 The only difference of substance between the above statements by Mr Volcker and Sir Geoffrey Howe is that the former implies that international coordination should appropriately focus on trying to achieve a common view as to an acceptable range of exchange rates, whereas Sir Geoffrey wants the focus to be on seeking sound economic and financial policies within the boundaries of the individual countries. While it would be unwise to lay down any hard and fast rule as to how statesmen should proceed in their discussions, Mr Volcker's proposal has the great advantage that focussing on exchange rates forces the representatives of different countries to face the fact that the national policies they adopt inevitably have an international impact. For example any policy change which shows up in a change in the £/DM rate clearly has a comparably serious impact on the British and German economies.

4.19 The machinery for policy coordination along the lines commended by Mr. Volcker and the former Chancellor is already well established, in the form of regular high level meetings of the Group of Five - US, UK, France, Germany and Japan. But though at these meetings there may be a useful pooling of information and exchange of views we see virtually no evidence that there is nowadays any coordination of policies, since as Bank officials noted 'the main player is not playing at the moment.[3]

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1. Q.1313
2. Q.1313
3. Q.223

4.20 [At this point it is possible that the Chairman will wish to submit one or two further paragraphs relating to the London summit and international coordination.]

Summary of Conclusions

4.21 Our main conclusions are:

(i) In considering changes in the exchange rate, a distinction has to be made between short-term fluctuations and what are usually called 'misalignments'. Both are harmful, but the former less so than the latter.

(ii) Short term fluctuations can be, and should be, mitigated by sterilised intervention in the foreign exchange market, as at present practised by the Bank of England.

(iii) Misalignments present a more intractable problem, inter alia because of the difficulty (emphasised to us by the Chancellor) of identifying them not merely ex post but in time to take corrective action. However, as the overwhelming majority of our witnesses agreed, cases of extreme misalignment can be identified in time.

(iv) Sterilised intervention is an inadequate policy instrument to combat misaligned exchange rates. However an expansionary monetary policy (in the sense of one where official transactions in all the financial markets taken together result in a net increase in banks' operational deposits at the central bank) will mitigate an overvaluation of the exchange rate; and the converse applies with a restrictive monetary policy.

(v) An expansionary monetary policy may result in an excessive pressure of demand in the markets for goods and services, and conversely with a restrictive monetary policy However, such a policy dilemma would become far less acute, if more attention were paid to getting the best <u>mix</u> of monetary and fiscal policy.

(vi) The timely identification of misalignments of exchange rates, and the adoption of appropriate remedial action, could be done much more successfully if there were more active international collaboration, especially between the major powers.

(vii) At present the only existing formal arrangement for such collaboration, in which Britain could immediately participate, is the EMS exchange rate mechanism. However for a variety of reasons it is undesirable to take this step, at any rate for the time being.

148/004

(PMP)

FROM: C W KELLY
DATE: 19 JUNE 1984

MR NORGROVE

cc Mr Peretz (personal)
Sir Peter Middleton
Sir Terence Burns
Mr Littler
Mr Littler
Mr Unwin
Mr Lavelle
Mr Lankester
Mr Sedgwick

TCSC: INTERNATIONAL MONETARY ARRANGEMENTS

We agreed yesterday that it was probably unnecessary to bother the Chancellor with this report until we have a copy of the version sent to the printers. But it might be helpful to record a few general comments. You have already passed our immediate points on to one of the committee's advisers.

2. The report is a revised version of the uncompleted Chairman's draft which caused such difficulty at the time of the election last year and which Mr du Cann publicly repudiated, principally because of its criticisms of Government policy. In the period since then the committee have taken no new evidence. But they have a substantially changed membership and a new chairman. They have also lost the services of the adviser primarily responsible for the original draft (Professor John Williamson).

3. The result is a much shorter, more friendly and in many ways more superficial report with virtually all its teeth drawn. If it survives in this form I suspect that it is the comparison with the original version which will attract attention rather than its present contents. It seems unlikely to cause us much difficulty.

4. Of the two most difficult parts of the previous version:

(i) The implication that Government policy was responsible for half the increase in unemployment; and

(ii) The extensive discussion of real exchange rate targets.

have both virtually disappeared. All that remains of (i) are some fairly muted references to the "mix" of policies. (ii) exists only in the form of a few sentences about the authorities needing to have some idea of the kind of exchange rate they would like to see.

5. There is still something of a hang-up about the extent to which it is possible to identify the degree of misalignment of exchange rates. The impression is given places that the Treasury is simply being obtuse on this issue. It is helpful, however, that the table giving Professor Williamson's estimates of misalignments is followed by a paragraph from him drawing attention to the extensive margins of error in a way which makes the whole exercise look pretty pointless.

6. There is also a general lack of appreciation in the report of the extent to which interest rates are affected by market influences rather than the Bank's dictat, and of the uncertainty and lack of symmetry through the spectrum of the Bank's influence. This may, however, be corrected in the next version.

7. Helpful points are:

(i) A conclusion that the balance of advantage lies in remaining a non-member of the EMS "for the time being".

(ii) A general endorsement of current intervention policy.

8. The Bank have also been sent a copy of the draft report, and have no difficulties with it.

C W KELLY

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PS/Chancellor
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Sir P. Middleton
Mr Bailey
Sir T. Burns
Mr Unwin
Mr Cassell
Mr Lavelle
Mr Monger
Mr Kelly
Mr. G. Smith

TREASURY AND CIVIL SERVICE COMMITTEE

PRESS NOTICE

International Monetary Arrangements

The Fifth Report from the Treasury and Civil Service Committee, entitled 'International Monetary Arrangements', will be published as HC(1983-84)502 on Thursday 5 July at 10.30 a.m. A press conference will be held at that time in Committee Room 15 of the House of Commons. Confidential Final Revise copies will be available in the usual way in the press gallery or from room 309, St Stephen's House, Victoria Embankment, SW1 from 2.30 p.m. on Wednesday 4 July.

The Report complements the previous Committee's Fourth Report of Session 1982-83 on International Lending by Banks (HC(1982-83)21-I) and is based on Evidence already published in HC(1981-82)449 and HC(1982-83)21-II, III and IV.

A Memorandum by Professor Brian Tew on the implementation of British Monetary Policy will be published together with the Report.

The poverty and unemployment traps

The Committee has published a Treasury Memorandum on the effects of increases in tax allowances and child benefit on the poverty and unemployment traps. The Memorandum, HC(1983-84)501, is available from HMSO.

2nd July 1984 S. Priestley

148/2

I think "misalignment" is a thoroughly misleading word. The point is not that exchange rates are "misaligned" – at least not usually unless the markets are distorted by x controls, etc – but that sometimes, policies (e.g. US) are.

FROM: C W KELLY
DATE: 3 JULY 1984

CHANCELLOR

c/A year's liberation has apparently removed most of the objectionable features of this report. This version is unlikely to prove controversial.

indeed, except for the point above, probably helpful.

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Littler
Mr Unwin
Mr Battishill
Mr Lankester
Mr Lavelle
Mr Sedgwick
Mr Culpin
Mrs Lomax
Mr Hannah
Mr Ridley

TCSC REVISED REPORT ON INTERNATIONAL MONETARY ARRANGEMENTS

The TCSC will publish a revised report on international monetary arrangements on Thursday, 5 July. Copies of the confidential final revise are not yet available. But I attach a copy of the conclusions. They are almost entirely harmless and in some respects (eg endorsement of the proposition that now is not the right time to join the ERM) even helpful.

2. This is an amended version of the report which was rushed out last year at the time of the election in the form of a "Chairman's draft" (mainly the work of Professor John Williamson) together with an alternative version by Dr Bray. It then caused considerable controversy because of the implied criticism of government policy and its effect on employment and its apparent sympathy for exchange rate targets. Mr Shore made considerable play with it in election press conferences and it had to be publicly repudiated by Mr du Cann.

3. At one stage it seemed possible that the Committee would leave matters there. They now have a substantially new membership

(only six of the previous eleven survived, not including Dr Bray) and a new Chairman. They have also lost the services as adviser of Professor Williamson. But they eventually decided to revise the report and re-issue it, without taking any further evidence.

4. The result is a shorter, considerably more friendly and in many ways more superficial report with virtually all its teeth drawn. It falls into four main sections:

(i) An introduction.

(ii) A general discussion of floating exchange rates and their effects. The report distinguishes carefully between short-run variability (which it does not believe to be a major problem, though it endorses "smoothing" intervention) and more persistent "misalignments" (on which it draws heavily on the work of Professor Williamson). On the recognition of the latter it quotes with approval Dr Emminger's suggestion that they are like a pretty girl - difficult to define but immediately recognisable.

He continued the analogy by saying that even when recognisable, that didn't necessarily mean there was anything you could do about it! [initials]

(iii) An assessment of the current position of the UK. This retains the suggestion that sterling was overvalued in 1980 and that this was an element in the rise in unemployment. Here and elsewhere there is an implied criticism of the Government for its lack of an objective for the level of the exchange rate and its unwillingness to moderate other policies in order to correct the perceived misalignments. But this is much more muted than in the previous version. As before, there is no recognition that some degree of exchange rate "misalignment" may form part of the inevitable adjustment costs in moving from a high to a low rate of inflation.

(iv) A section of conclusions leading up to the main points listed on the attachment. This includes a lengthy section on fiscal and monetary policy which

contains little of much substance. The main theme (which we would have little difficulty in accepting) is that one way to reduce the problem of misalignments is for the major economies (particularly the US) to pay greater attention to achieving an appropriate mix of fiscal and monetary policies. However, there is little elaboration of this point.

5. The new version omits all the analytical material from the previous version on exchange rate versus monetary targets and policy optimisation.

Line to take

6. It seems unlikely that the report will attract much attention, except in the extent to which it has been watered down since the previous draft. Its criticisms are relatively mild and parts of it are positively helpful. I suggest that the line to take in response to any enquiries should be that, while we do not accept it in every detail, we welcome the report as a much more realistic assessment than its predecessor which shows a better understanding of present government policy and which we will want to study in more detail.

CWK

C W KELLY

Summary of Conclusions

5/ 4.21 Our main conclusions are:

(i) In considering changes in the exchange rate, a distinction has to be made between short-term fluctuations and what are usually called 'misalignments'. Both are harmful, but the former less so than the latter.

(ii) Short term fluctuations can be, and should be, mitigated by sterilised intervention in the foreign exchange market, as at present practised by the Bank of England.

(iii) Misalignments present a more intractable problem, inter alia because of the difficulty (emphasised to us by the Chancellor) of identifying them not merely ex post but in time to take corrective action. However, as the overwhelming majority of our witnesses agreed, cases of serious misalignment can be identified in time.

(iv) Sterilised intervention is an inadequate policy instrument to combat misaligned exchange rates.

(x)e? (v) In cases of serious misalignment the stance of fiscal and monetary policy should be ~~raised~~ to correct, or at the very least, mitigate the misalignment. An expansionary monetary policy (in the sense of one where official transactions in all the financial markets taken together result in a net increase in banks' operational deposits at the central bank) will mitigate an overvaluation of the exchange rate; and the converse applies with a restrictive monetary policy.

(vi) An expansionary monetary policy may result in an excessive pressure of demand in the markets for goods and services, and conversely with a restrictive monetary policy However, such a policy dilemma would become far less acute, if more attention were paid to getting the best mix of monetary and fiscal policy.

(vii) The timely identification of misalignments of exchange rates, and the adoption of appropriate remedial action, could be done much more successfully if there were more active international collaboration, especially between the major powers.

(viii) At present the only existing formal arrangement for such collaboration, in which Britain could immediately participate, is the EMS exchange rate mechanism. However for a variety of reasons it is undesirable to take this step, at any rate for the time being.

6.9

(pw)

FROM: MISS J C SIMPSON

DATE: 4 July 1984

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Littler
Mr Unwin
Mr Battishill
Mr Lankester
Mr Lavelle
Mr Sedgwick
Mr Culpin
Mrs Lomax
Mr Hannah
Mr Ridley

MR KELLY

TCSC REVISED REPORT ON INTERNATIONAL MONETARY ARRANGEMENTS

The Chancellor has seen and was grateful for your minute of 3 July.

JS

MISS J C SIMPSON

FROM: H C GOODMAN
DATE: 4 JULY 1984

cc Mr Battishill
Mr Pratt

PS/CHANCELLOR
SIR PETER MIDDLETON
MR LAVELLE
MR KELLY

TCSC REPORT: INTERNATIONAL MONETARY ARRANGEMENTS

I attach (top copies only) confidential final revise versions of the fifth report from the TCSC on international monetary arrangements to be published tomorrow.

H C Goodman.
H C GOODMAN

C
You may like to glance at this.
The conclusions on intervention
and EMS on the whole are fairly useful –
and may provide some useable quotes
for the future.

[illegible]