JS.
cc HMT

10 DOWNING STREET

THE PRIME MINISTER

16 March 1981

Dear Emmanuel,

Thank you for your letter of 9 February, in which you described in stark terms the problems you and Maurice Hodgson face from the high value of sterling. I recall the letter you wrote to me on the same subject in April last year, and I saw Geoffrey Howe's reply.

I am very well aware of the pressures you and other companies are now enduring, and I have been impressed by the way that companies have fought to maintain their market share. Exporting is not easy at the best of times and it is particularly difficult now, at a time of world recession. I realise, too, that the most efficient firms had little scope for cost-cutting. Since you wrote, the sterling rate against both the dollar and other currencies has, of course, fallen appreciably; but I recognise that a good many companies are still finding it too high for comfort.

Against the short-term advantage that industry might derive from a lower exchange rate than we presently have, it would of course carry with it the dangers of higher inflation which could put at risk our economic recovery in the medium term. But whether or not a lower rate would be desirable, experience has shown that governments cannot manipulate the rate except possibly in the short run - and even then the costs can be very high. The fact is that the strength of sterling has to a

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very large extent been related to our possession of North Sea oil and confidence in our determination to defeat inflation. Our high interest rates may also have contributed, and I would dearly have liked to have seen interest rates falling earlier. But while we were borrowing so heavily - and that too I regret - an earlier and bigger fall in interest rates would have meant throwing away our whole strategy of beating inflation. That in turn might have pushed the exchange rate down; but it would have meant the complete reversal of everything we have been trying to do and it could all too easily have led to a major depreciation of the kind the country experienced in 1976.

You asked specifically about our plans for the Temporary Short Time Working Compensation Scheme. As you may know, expenditure on this scheme has increased very rapidly in the last few months and is likely to total more than £400 million this year. Despite the costs, we decided in November to continue the scheme for a further year until March 1982 and to increase the maximum period of support from six to nine months.

It is too early to say what effect an interest rate of 12% will have on the exchange rate, but at least our interest rate is coming down at a time when that of some of our competitors seems to be rising.

Yours ever

Sir Emmanuel Kaye, CBE.

Margaret