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PRIME MINISTER

THE INTERNATIONAL CURRENCY SITUATION

It may be useful as background to the weekly meetings which we are to have if I send you a short note about the international currency outlook and the implications which it might have for us.

2. The key issue is the position of the dollar, which is still overwhelmingly the main reserve currency. It is also the main currency of international trade, including the oil trade: and of international borrowing. In the early part of this year the dollar was firm. Countries which took large quantities of dollars into their reserves in 1977/78 were selling them again on a massive scale - the main countries sold over $16 billion in April and May alone. However, in the second half of June the dollar weakened and the seven important countries operating in the exchange markets bought $6 billion net. This month purchases of dollars have continued, though at a somewhat slower pace.

3. We cannot be sure how the dollar will perform during the second half of this year. The question is whether the factors making for a stronger dollar (like a decline in the US growth rate or evidence of determination to tackle oil imports) prove stronger or weaker than adverse factors (like US inflation,

doubts about the firmness of policy of the US Administration, the course of oil prices, delay in reducing the US current account deficit because of the high cost of oil imports; or a further narrowing of the important interest rate differential between the United States and Germany). There are signs that the Germans fear a further weakening of the dollar later in the year.

4. If the dollar does weaken, the question how far Germany will be ready to help, either through market intervention or interest rate policy, could be critical. The decision could well be a more difficult one for the Germans than it was in 1977 and 1978 when they took large quantities of dollars into their reserves. This time inflation is rising, not declining, in Germany. They will be reluctant for counter-inflationary reasons both to hold down the value of the mark and to risk inflating their money supply ("importing US inflation" as they would put it) either by large scale intervention or by lowering, or even holding down, their own interest rates. The line which the Bundesbank has been taking on all three points in the first half of this year in the interests of fighting inflation has been causing difficulty to Germany's partners in the EMS.

5. The international scene may not develop like this. For example, the risks to the dollar could be a good deal less if pressure on the oil price eased. But, if pressure on the dollar did continue, that could have implications for us. It might make it more likely that sterling would remain strong (which could lead to inflows which would tend to increase the money supply).

6. It would certainly affect the operation of the EMS and might well strengthen presures for realignment. It could in these circumstances have a bearing both on our own decision about entry to it and on the attitude of our European partners to early UK entry. It would probably tend to lead to a higher average international level of interest rates, and that could react on

the UK. It could encourage discussion of (partial) alternatives to the dollar as reserve and trading currency, and we would be involved in this. But there would also be important political implications from signs of US economic weakness, which I do not think we would welcome. We must hope that the course of the dollar will in fact be more favourable, but there is a strong link here to oil and all the matters we were discussing in Tokyo.

(G.H.)

11 July, 1979

11 JUL 1979