

SECRET

Prime Minister

27

MR. SCHOLAR

MUS 7/12

*ms*

EXCHANGE RATE AND THE MARKETS

After the fall in the exchange rate and the rise in interest rates this morning, the market seems to have steadied and indeed come back a little bit. At 4.15pm the seven-day interest rates had fallen from 11% to 10 and three-quarters, but at the same time the three month rate had hardened slightly from 10 and three-eighths to 10½%. The yield curve has flattened out quite a bit.

The exchange rate has pulled back from 85.4 this morning to 85.7, with the dollar at about 1.629 and the Deutschemark at 3.93. This improvement was after the intervention of about £125m earlier in the morning. Eddie George suggests that it has "steadied at its own accord", although I suspect the money supply figures had a calming influence.

*\$125m*  
*ms*

Rumours abound. Some Swiss banks have been advising clients to diversify away from sterling because they believe there are signs of an easing of monetary and fiscal policy in Britain. They are concerned at reports of the Government encouraging spending, and the rumours of Ravenscraig, etc. And overall there is a belief that the Labour Party is at last becoming a credible Government. In short, they are all factors which we feared would affect sterling as we run up to the election.

*+ oil prices*

As you know, with present expectations in the market about our desire to maintain an exchange rate target, there is little we can do except apply cosmetics. The intervention of the orders we have been engaged in is very much superficial massaging. Unfortunately, it adds also to the convictions of the market that we are defending a limit of 85 or so. But I cannot see any other way of holding interest rates so that they are consistent with our basic monetary policy. We have to be careful that in buying sterling through the intervention mechanism we do not inadvertently produce an additional monetary squeeze. I have talked to the Bank about this and I shall watch this in the days ahead. (I was particularly concerned at the signs of a squeeze yesterday when we did about \$150m intervention.)

*AW*

7 December 1982

SECRET

ALAN WALTERS