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Prime Minister (2)

MLS 14/1

Treasury Chambers, Parliament Street, SW1P 3AG
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14 January 1983

D C R Heyhoe Esq
Private Secretary to
the Lord President
Privy Council Office
Whitehall
LONDON SW1

Dear David,

The Chancellor has suggested that Cabinet colleagues might like to see the attached note of points on exchange rate/interest rate issues of which public use could be made in forthcoming speeches, interviews etc. He has however asked that I should draw particular attention to the general guidance in the first paragraph of the note.

Copies of this letter and enclosure go to Michael Scholar at No 10, to the Private Secretaries of all members of Cabinet, and to Murdo Maclean at No 12.

Yours ever,

John Kerr.

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EXCHANGE RATE AND INTEREST RATES: GUIDANCE FOR PUBLIC PRESENTATION

General

The financial markets remain fragile - particularly the foreign exchanges - and very sensitive to anything we may be reported (or misrepresented) as saying. So the less said directly about exchange and interest rates the better. It will be best to concentrate on our strong underlying financial position, on the lines of (1) below. However, clearly direct questions will come up, and points (2)-(5) below suggest what line to take on some of these if pressed. A press release of the Chancellor's letter of January 13th to Jack Straw MP is attached as further background.

Points to make

(1) The fall in the exchange rate scarcely reflects any weakness of policy or in our financial position

Indeed the Government's financial and monetary determination is showing excellent results:

- Government spending and borrowing are under control and on target;
- the Government deficit, as a percentage of GDP, is one of the smallest in the industrial countries;
- we continue to run a substantial current account surplus, larger in 1982 than the £3½ billion forecast only last November;
- inflation is falling, and fell faster over the last year than in any other major country;
- monetary growth is within the targets, and the signs are it will stay there;
- official foreign currency borrowing is now only $12 billion against around $22 billion when we took office, the lowest level in real terms since the war.

(2) <u>A world currency like sterling is inevitably affected by outside influences</u>

- We are in a period of sharp readjustment between the world's major currencies, with the long expected recovery of the yen and deutschemark against the dollar;
- sterling affected in particular by the continued weakness and uncertainty about oil prices.

It is hardly surprising that irresponsible statements and policy proposals by the official Opposition should also have some effect on the market at a time when it is known there will be an election within 18 months (though much of the speculation about election dates is quite unrealistic, as Cecil Parkinson has made clear). In his "Programme for Recovery" published on 23 November Mr Shore said that "The most immediate task [for a Labour Government] would be to secure a substantial drop in the exchange rate".

(3) <u>The interest rate rise and the Government's monetary policy</u>

This is a complex area, and it will be best to return to the points in (1) where possible. Other points are:-

- Sound money remains at the heart of the Government's strategy to reduce inflation;
- to achieve that we have to maintain steady downward pressure on financial and monetary conditions;
- A sharply falling exchange rate can indicate loosening conditions, and adds to inflationary pressures;
- to maintain a consistent policy the Government was therefore right to accept recent market pressures for higher interest rates;
- In an unstable world environment periodic changes in exchange rates and interest rates are unavoidable;

- whatever the short run movements, the route to lower interest rates lies through success in the strategy to reduce inflation, through responsible Government finance and through wage moderation and increased productivity in industry.

(4) <u>The Government's attitude to the exchange rate</u>

The Government has no target for the exchange rate, and neither recent events nor past experience suggest that would be a viable policy in present conditions. That does not mean the Government is indifferent to the rate: it is important for the economy, for inflation and industry. It is also important to seek stability where feasible, and to seek to slow sharp movements and to prevent them becoming self-feeding. One of the ways in which the Government seeks to do that is through the Bank's intervention in the foreign exchange markets, though usually such action can have only a very limited impact.

(5) <u>Rise in interest rates - role of the markets and the authorities</u>

As is evident from the sequences of events, the initial impulse for higher interest rates came from pressures in the market. But it was neither feasible nor desirable for the Government to resist these developments.

<u>Background facts</u>

(a) <u>Exchange rate</u>

After fluctuating around an effective exchange rate of about 90 for most of 1982, the weighted exchange rate between sterling and other currencies began to fall in early November. Since then the decline has been around 11 per cent in the effective rate, 4-5 per cent against the dollar, 13 per cent or so against the Deutschemark and around 18 per cent against the yen.

(b) Interest rates

Base rates fell from 16 per cent in autumn 1981 to 9 per cent in early November 1982. They rose 1 per cent to 10 per cent on 26 November; and a further 1 per cent on 11 January to 11 per cent.

(c) Monetary aggregates

Since February, the start of the current target period, M1 and £M3 have grown by about 11 per cent and PSL2 by about 9 per cent. All three are within the target range of 8-12 per cent.

(d) Government borrowing

Government borrowing firmly under control. Outturn for 1982-82 likely to be well within forecast of £9 billion in autumn statement.