

CONFIDENTIAL

15 March 1982

ALAN WALTERS

PRIME MINISTER

THE EXCHANGE RATE AND MONETARY POLICY

1. During the next few months we must be prepared for some quite sharp changes in exchange rates. It is important to keep our nerve during this period. We must not be misled by transitory depreciation of sterling, particularly against the dollar and the yen, and we must hold on to the successful monetary policy we have adopted over the last year, and particularly over the last six months.
2. The monetary aggregates, excepting the rogue behaviour of sterling M3 tell the story of a moderate squeeze:

	<u>March 1981 to February 1982</u>	<u>September 1981 to February 1982</u>
	<u>Annual rates of change seasonally adjusted</u>	
Wide monetary base	3.6	5.1
M1	8.7	6.3
Sterling M3	14.4	12.5
PSL2	12.1	9.5

3. Most of the effects on our exchange rate will be due to the substantial monetary squeeze, through high interest rates and low M1 growth, that is taking place in the United States. Just as our monetary squeeze induced an appreciation, albeit a transitory appreciation, of the currency, so the dollar is experiencing a temporary rise. The brunt of the dollar appreciation so far has been taken by European currencies, and in particular the Deutschemark and the yen. This is very likely to change over the next few months and we shall go down against the yen and Deutschemark.
4. All these considerations suggest that we ought to get used to the idea of a trade-weighted index touching 85, which, at the moment the Bank would regard as quite unthinkable! The Treasury also believe that the exchange rate will "change very little".
5. There is a danger that the Bank will persuade the Treasury to "defend sterling". But I believe this would be wrong. Provided we stick to

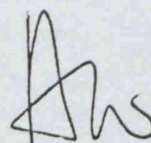
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on monetary policy this is

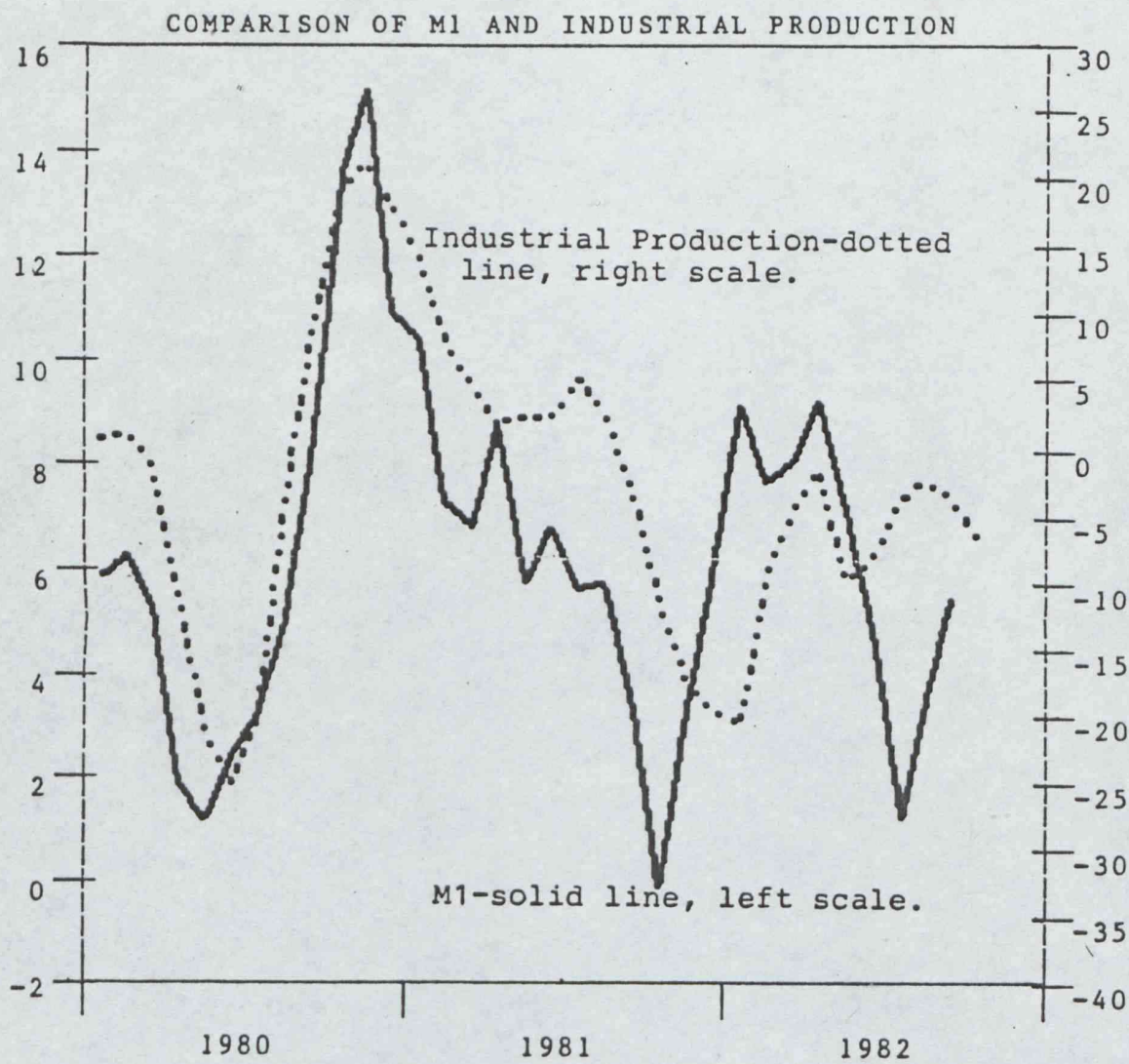
likely to be only transitory. We should not over-react by adopting a stringent monetary policy to meet what is simply a temporary phenomenon. Our monetary policy will ensure that eventually the Treasury view of "little change" is vindicated.

6. Such a transitory depreciation will have little or no effect in "importing inflation". It is very likely that dollar prices of commodities will crumble very rapidly - as they have done already in the case of oil. (Furthermore we should depreciate more against the Deutschmark and the yen than against the dollar.)
7. There is also the possibility, which at present I discount, that the United States will slip into a very deep slump. If the US monetary squeeze is carried on too long, and too stringently, this might happen. Then a very sharp depreciation of sterling against the dollar should not be interpreted as evidence of lax monetary policy in the UK. And we should certainly not change our monetary stance for this. It would be absurd to simply follow the mistake of the Americans.
8. The lynchpin of our policy is to maintain the consistent monetary squeeze as manifest in the monetary aggregates and real interest rates. The exchange rate may help in interpreting monetary strategy but it should be used only with subtlety and care. In particular we should not interpret sterling depreciation, due to an American or German monetary squeeze, as any grounds for changing our monetary policy. We should keep monetary policy steady for Britain.



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Latest date plotted: 31 October 1982.