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10 DOWNING STREET

From the Private Secretary

13 August, 1982

The Exchange Rate

The Prime Minister was grateful for the Chancellor of the Exchequer's minute of 10 August, which she has read without comment.

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Treasury Chambers, Parliament Street, SW1P 3AG

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Prime Minister

PRIME MINISTER

You may wish to see this
before your talks with Swiss
bankers. Otherwise we can
put back in the box on your
return.

THE EXCHANGE RATE

W. W. J.

I thought you might like to have a note that defines a little more what our attitude is to movements in the exchange rate, to accompany the note I let you have on 9 August on interest rates and funding policy. I know from our conversations that you sometimes become concerned about the low value of sterling/dollar exchange rate compared with eighteen months ago. We all tend to see special significance in the dollar rate. We both also sometimes wish for a lower rate against European currencies and the yen to help with competitiveness.

2. Of course we have no target for the sterling exchange rate, whether against the dollar or any other currency, or in effective terms. Nor do we have an exchange rate policy in the sense of seeking to move the rate one way or the other. I remain convinced that it would be greatly to our disadvantage were we to have a policy of either kind. Our policies must be directed to maintaining a firm domestic financial framework, and to managing those aspects of our affairs that are within our own control. We take account of the exchange rate as one indicator of domestic monetary conditions. But movements in the rate can also indicate changes in world circumstances outside our control: oil prices, political developments abroad, shifts in other countries' monetary and fiscal policies.

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3. There are certainly occasions when we have regard in this respect either to the level or rate of movements of sterling against particular currencies, such as the dollar or the deutschemark. Movements in the dollar rate can still have special importance for the financial and exchange markets, while parts of industry are particularly concerned with European rates for reasons of price competitiveness. But we believe that the best single indicator is the effective exchange rate index. This shows the average movement of sterling against other currencies and its implications for competitiveness and inflation; allowing for relative movements between currencies like the dollar and the deutschemark, which form part of the environment in which we have to live. Very often when these two reserve currencies move in relation to one another, sterling is in an intermediate position and our effective rate is not greatly affected.

4. Since the high point for sterling in January 1981 sterling exchange rates against the other main currencies have fallen as follows:-

	<u>January 1981</u>	<u>[5 August 1982]</u>	<u>% Change</u>
£/\$	2.40	[1.72]	-28%
£/DM	4.83	[4.26]	-12%
£/Yen	486	[445]	- 8%
Effective rate	103	[91]	-12%

This pattern of movements reflects many factors affecting different currencies. Changes in the oil price prospect have been a particular influence on sterling. But the largest single cause of relative currency movements over the period has without doubt been the course of US monetary and fiscal policy. We both know the limitations on what we can do about that.



5. While we could influence the overall level of sterling e.g. by interest rate action, I do not think we can much influence the pattern of rates against other individual currencies. That pattern is set by the rates between other countries' currencies, reflecting their own policies and circumstances. When we intervene in dollars that tends to affect the value of sterling against all currencies. It is not our experience (e.g. during the Falklands episode or earlier) that we can have differential effects against other currencies by intervention.

6. What I think this means is that we should not allow attention to focus too exclusively on the sterling-dollar rate - though we are bound to be nervous at times like the present. We should do more to ensure that people perceive the recent movements against the dollar as much more a consequence of dollar strength than sterling weakness. In practice, we have, in any case, practically no scope for taking action on the sterling-dollar rate as such. Much the better course is to focus attention on the effective rate, which is the best broad indicator of the level of sterling, of the effect of our exchange rate movements on inflation and of the position on price competitiveness.

7. We are not seeking a fall in the effective rate and certainly we should not give markets the impression that we want the rate down. That would expose us to a market view that we were less firm about the financial framework. It could run the risk of leading to an uncontrolled fall. But that does not mean we need worry unduly if the effective rate should move down moderately of its own accord, whether as a result of events overseas, or of any movements towards lower interest rates, provided we are fully satisfied that

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they are justified by domestic monetary conditions. We should continue to take account of the exchange rate as an indicator of monetary conditions but should be careful not to treat it as the sole or main indicator. It is one factor alongside other monetary information in deciding the speed at which we can move on interest rates (and indeed on fiscal policy).

(G.H.)

10 August 1982