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PRIME MINISTER

EXCHANGE RATES, INTEREST RATES, MONEY

The movements in exchange rates over the past two months have been very much in the right direction. The appreciation of the deutschmark and the yen, long expected, have at last occurred. This has occurred smoothly, with no violent oscillations or financial traumas. True we have spent about \$1 billion or so to smooth out the process, but we have not attempted to fight the basic market movement. The large depreciation against the DM and yen will greatly help industry, whereas the much smaller depreciation against the \$ will not much affect the price level.

There are some signs that our refusal to increase interest rates before Christmas, when we came under very considerable market pressure, has given the City a message that has been absorbed. The markets no longer believe that we shall automatically defend sterling by increasing interest rates. Changing market expectations in such short order is a remarkable achievement - but, of course, one cannot be certain that the new expectations will stick. We shall soon see.

Meanwhile it is likely that all our monetary aggregates will fall within the target ranges, (and the monetary base will be circa 4%). Thus our monetary policy is on course and there is at present no need for any substantial changes in interest rates.

Provided that we can continue to avoid the exchange rate exerting pressure on domestic money markets, we should be able to maintain these interest rates.

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AW

6 January 1983

ALAN WALTERS

SECRET