33

Prime Minister

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PRIME MINISTER

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We spoke last week about the reasons for the current weakness of sterling. This has seemed largely a matter of dollar strength, given the firm tone of US domestic interest rates, plus the uncertainties over the BNOC oil price, and what that could mean for the OPEC agreement. Negatively, operators have seen no reason to move into sterling.

2. It is difficult to attribute special weight to other factors. The trade figures last week seem to have had no impact either way. Reuters carried a report on Friday that the Darlington by-election result also had no visible effect, and that is the Bank's view too. But clearly the imminence of the by-election affected market sentiment over the past week or so and it is impossible to be certain what outcome had been assumed and discounted. Electoral factors continue to be mentioned fairly widely as one of the influences in the market, though not at present a dominant one, and it is possible that a different result could have had a greater effect. One or two commentators (last week's Economist, for example) have begun to argue that the time has come for speculators to start betting in favour of the pound. But I do not place much confidence in this, since there are still plenty of other voices arguing the opposite.

3. Geoffrey Littler has recently sent across to Alan Walters a paper which I had commissioned, discussing the risks for sterling in the period between now and the election, and the options available if pre-election nerves were to emerge as a major factor in the market. A meeting on this is planned with Alan and the Bank and I will let you have a note about it as soon as possible.

4. However, the broad conclusion which the paper reaches - that in so far as there is a choice the best approach would be to seek to allow the exchange rate itself to take most of the strain - is one I would endorse. This would also in my view probably be right in presentational terms.

5. Even this will continue to expose us to the risk (which has appeared more than once in the last couple of weeks) of the market taking interest rates up as the exchange rate falls. The more people begin to believe, as is now being said, that we are anxious above all to avoid a "pre-election" rise in interest rates, the greater the risk to the exchange rate.

6. This gives point to another message contained in the paper - that the longer we can last without election fears becoming a major feature in the market, the better. This is why it is obviously worth seeking to avoid - so far as anything is possible in this field - any statements or actions that are likely, as the experts put it, "to stir premature market excitement".

But that is not, of course, an argument for delaying an election. On the contrary, the position of the £ argues for an early election; just as it argues for discouraging speculation about that

(G.H.)

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