Prime Minister

If this analysis is correct it argues caution about becoming identified with a $ parity as high as £1 = $2.00 or $2.10.

MCS 7/12

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cc Mr. Hoskyns
Mr. Wolfson
Mr. Scholar
Mr. Duguid
Mr. Vereker

PRIME MINISTER

MONETARY POLICY AND THE EXCHANGE RATES

1. You have said on a number of occasions that you would like to see sterling at about two dollars to a pound. The main reason seems to be that a higher pound would mean cheaper imports and a slower rate of increase in the RPI.

2. This may, however, give rise to misleading signals about the effects of monetary policy. Our basic strategy has been to control the monetary aggregates and allow the exchange rate to be freely determined by the markets. In the long run the exchange rate will reflect the relative purchasing power parity of the pound as against the dollar. And this value to be determined in turn by the relative long term monetary policy (over a 3-5 year period) of the UK compared with that of the States. (For what its worth my guess is that the purchasing power parity of the pound compared with the dollar is round about $1.70 to $1.80.)

3. In the short run the exchange rate will reflect many other factors. The exchange rate is the price of one asset relative to another and, like any other asset price, will react to a whole spectrum of events and expectations, both political and economic. In the short run monetary policy is, however, usually the dominant influence. We could for example increase the dollar parity of sterling by pursuing a restrictive monetary policy - just as we did in 1979/80. There would then be a sharp but transitory increase in sterling which would take us well above the purchasing power parity. This would "help" with the RPI increase in that six month or so period. But you would pay for it later since inevitably sterling would come down again towards its purchasing power parity - which is what has happened since March 1981. Then the depreciation of sterling would be reflected "unhelpfully" in increasing the rate of growth of the RPI.

4. As far as the general thrust of inflation is concerned, it is best to ignore the oscillations in the RPI which are due to changes in sterling. One should concentrate only on domestic inflation. This is what we control directly and monotonically through the monetary

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aggregates. The effects brought about by the short term movements in exchange rates are misleading.

5. Trying to maintain a high dollar rate may be particularly damaging in the months ahead. It looks as though the restrictive monetary policy in the United States will really bite in the first half of next year. This may dramatically revise expectations in the United States and may indeed bring the inflation rate down to 5% or even below. This would normally be associated with a marked hardening of the dollar relative to sterling. Thus it may require a very drastic and very damaging monetary squeeze in order to keep sterling at a level above $2.

6. This argument applies mutatis mutandis to other currency parities. As far as our exports are concerned, the main currency that matters is the Deutschemark. As far as the Bundesbank is concerned, however, the Deutschemark dollar rate is the most important one for Germany. Sterling is a side-show. We cannot affect the DM/$ rate which determines relative export/import prices.

7. My main conclusion is that it is unwise to regard the value of sterling as an aid in the battle against inflation. It is best to concentrate where we can on monetary policy and leave sterling to find its own value. Occasionally, when the monetary aggregates are obscured, we can use short-run changes in the exchange rate as indicators of movements in M1. But they should be strictly used and carefully interpreted as indicators. In particular, entertaining idée fixe about the dollar value of sterling may be very damaging if, as seems likely, the Americans go into a sharp reduction of inflation during the first half of 1982.

AW

7 December 1981

ALAN WALTERS

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