10 DOWNING STREET

THE PRIME MINISTER 2 June 1980

Dear Mr. Salomon.

Thank you for your two letters of 28 April about the Exchange Control Act and the value of sterling.

With regard to the Exchange Control Act, the future of this legislation involves other factors besides the temporary need to retain powers while exchange controls had to continue (till 13 December last) in relation to Rhodesia. In particular, repealing the Act would not be compatible with our Treaty obligations in the European Community since the Council Directive 72/156 requires us to have available, without further enabling measures, certain instruments for the regulating of capital flows. The 1947 Act provides the only current legislative authority. While we do envisage ultimately seeking some changes in the law on exchange control, there is no prospect of finding time in the legislative programme for the early replacement or substantive amendment of the present Act. You may have seen that the Chancellor of the Exchequer recently made a statement in Parliament to this effect.

In your other letter you suggested that we should sell sterling to reduce the value of the pound, at the same time offsetting the domestic monetary impact by cancelling a corresponding amount of debt; I assume that you have in mind repayment of debt to overseas. (If we were to re-pay a corresponding amount of debt held in the UK, this would simply add to the money supply).

It is our policy to reduce substantially the burden of our foreign currency borrowing during the lifetime of this Parliament. But this policy does not offer a solution to the problem that I posed in the House. The monetary effect of intervention depends on

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its scale and how it is financed. Any net inflow to the private sector would not be offset if we then used the additional reserves to repay overseas debt. Such repayments have no impact on domestic conditions at all; no private sector transactions are involved. Sooner or later, as I said, any attempt to hold down the exchange rate by intervention would jeopardise monetary control.

Even if we sought to offset the domestic monetary impact by, say, selling additional gilts there might well be little lasting impact on the exchange rate, although interest rates would need to be higher to achieve the necessary gilt sales. Mobility of international capital limits the extent to which intervention can effect the exchange rate, other than in the very short term. And if we succeeded in holding down the exchange rate, we would have to balance the advantage to exporters against the cost - some of which would be borne by exporters - of the higher level of domestic interest rates. We would also lose the beneficial effects of a higher exchange rate on inflation and monetary control.

Warm personal regards.

Yours sincerely

Margaret Thatcher

W.H. Salomon, Esq.