



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

8th August, 1979

PRIME MINISTER
You asked about the
scheduling of our debt
repayments - the record so
far this year is impressive,
as you will see.
MS

Dear Sir,

MS

EARLY REPAYMENT OF EXTERNAL DEBT
AND THE EXCHANGE RATE

In his letter to the Prime Minister of 16th July, Sir Arthur Knight, Chairman of Courtaulds Limited, suggested that early repayment of some of our official external debts would help to achieve a more competitive level for the sterling exchange rate. Tim Lankester asked for a note on this point for the Prime Minister's information. We understand that the Prime Minister is particularly interested in the argument that the present is a good time to pay off debts because sterling is strong.

It is certainly true that the country gains if we buy foreign exchange that we need while it is cheap. This applies to foreign exchange needed for any purpose, not just debt repayment. We have in fact been buying foreign exchange on a pretty substantial scale. Over the past two months, when the pound rose from \$2.07 to \$2.33, the Bank of England have acquired over \$2 billion in addition to what they need for Government expenditure overseas and other calls on the reserves apart from debt repayment. The primary objective of the intervention was not in fact to acquire reserves - we have ample for all immediately foreseeable purposes including the meeting of debt liabilities - but to moderate and smooth the upward movement of sterling. As a rule we do not favour heavy intervention, mainly because the acquisition of reserves tends to increase the money supply, except to the extent that the overseas purchasers of sterling put their funds in public sector debt or in non-resident bank accounts.

The addition to our reserves has however enabled us to repay ahead of time a large Electricity Council floating rate loan. This will bring total repayments in the course of 1979 up to more than \$5 billion. The total is made up as follows:

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	<u>\$ billion</u>
Debt scheduled for repayment in 1979	2.2
Repayments ahead of time arranged before 4th May	2.0
Repayments ahead of time envisaged since 4th May	0.9
TOTAL	<u>5.1</u>

Not all outstanding debt can be repaid ahead of time without penalty. Whether it is possible to do so depends on the nature of the particular contract. Owing to the substantial repayments undertaken since the beginning of 1978, the best opportunities will have been exploited as soon as the Electricity Council loan is repaid. It may therefore be necessary to hold foreign currency in the reserves until repayments can be made. From now on the scheduled repayments are heavy - they amount to another \$2 billion in 1980 and \$3 billion in 1981. And in 1981 it will become possible to repay ahead of time the massive \$2.5 billion loan raised by the last government from the syndicated bank market in late 1974 and early 1975.

The exchange rate for sterling is not affected by the act of repaying debt (as Sir Arthur Knight implies) but by the prior act of buying foreign exchange for sterling. The sums involved in official debt repayment are, generally speaking, too large to be raised from the foreign exchange market for delivery on the day of repayment without creating instability (which it is the purpose of the reserves to prevent). The foreign currency required is therefore bought over a period and held in the reserves until needed. When a debt is repaid, the foreign currency is transferred from the reserves to the lender. The transaction does not affect the exchange rate for sterling because no sterling is involved.

Conditions in the foreign exchange markets have changed since 16th July when Sir Arthur Knight wrote to the Prime Minister. The period of strong upward pressure on sterling seems, for the moment at least, to have come to a halt. Sterling in fact fell quite sharply on Tuesday, 31st July and, although there was a recovery during the rest of last week, further falls were experienced on Monday and Tuesday of this week. The Bank of England have accordingly ceased to buy dollars from the market and have given some moderate support to the pound - though the intervention has not

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been on the scale of the purchases of dollars when the pressure was upwards.

Yours etc,

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