PART 4

SECRET

MT

Confidential Filing

The Exchange Rate

Exchange Control Policy

Inflow Controls

ECONOMIC POLICY

Part 1: May 79

Part 4: June 89

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~13-6-89~~							
~~19/7/89~~							
~~8/9/89~~.							
~~27.4.90~~							
~~28.8.90~~							
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8.5.92							
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PREM 19/3674

HMSO Dd8953031 6/88 C60 GP2265 CCN13412 (3932)

SECRET

FILE CLOSED

Future papers on exchange rates + ERM to go on EURO POL: EMS.

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

Prime Minister

Exchange Rate

The £ drifted lower in London closing at DM 2.8380. It drifted still lower in NY, at one time going below DM 2.83. Currently it is at DM 2.8325, virtually on the ERM limit. The Bank take the view that it is better to intervene in London in the morning so that it opens going upwards, rather than push rates up now and risk opening downwards. Some of the trouble is weakness of the dollar, but some stems from the grumblings of the Tory right who are openly advocating leaving the ERM.

The Chancellor will confer with officials in the morning and will no doubt raise this with you at 11.00am.

AT

8/1

PRIME MINISTER

FOREIGN EXCHANGE MARKETS

It has been a turbulent day. There are problems on three fronts:

i. The French, and a fortiori the Danes, are right at the bottom of their ERM limits. Exchange markets closed in Europe with both currencies under severe pressure.

ii. The US discount rate was cut by a full 1 per cent to 3.5 per cent in an unexpected move. As always, the subsequent fall in the dollar has rather dragged down sterling on the cross-rate against the Deutschmark - although we remain over Dm 2.85.

iii. Finally, there have been problems on UK money markets. The three month inter-bank rate is only just below 11 per cent - both one month and two month rates are above 11 per cent. While this superficially suggests upward pressure on banks' lending rates, the problem is not as severe as first appears. It is partly accounted for by banks' end positioning - closing accounts at the end of the year. Money management measures by the Bank have taken some of the heat out of the situation.

There is no action required. We are not intervening; the exchange markets' attention is devoted to the franc and the krone. The Bank are under instructions not to intervene unless sterling dips below Dm 2.85 . Both Bank and Treasury believe that, this close to Christmas, we should now be able to hold out without further action. (It remains a theoretical possibility that, even in the thin markets on Monday and Tuesday, we could come under pressure.)

But the longer term advantages of the Germans having moved so decisively, and the unexpected US move, are as follows:

- the next move in the UK domestic rates will now widely be seen as down not up; at some point this opens up the opportunity for the further reduction in interest rates, which we need on domestic grounds;

- it will not be long before the exchange markets assess the balance of risks on sterling as upside.

One final comment. The only 'wild card' is the possibility of a revaluation within the ERM. Tietmeyer has vaguely floated this possibility. No-one is quite sure why.

BHP

BARRY H POTTER
20 December 1991

c:economic\markets (eam)

fico

PRIME MINISTER

EXCHANGE MARKETS

Your manuscript note on last week's weekly report questioned whether the room against the effective exchange rate floor was only 2 pfennigs.

I have confirmed this with the Treasury. The effective limit of sterling within the ERM is shown in the second block in each MG evening report. Last Friday, the effective limit against the deutschmark was DM 2.888; the spot rate against the deutschmark was DM 2.9099 - thus a gap of 2 pfennigs.

The interesting question is whether this effective floor is a genuine constraint. Initially, Treasury seemed to be worried that we would hit this floor. Latterly, they have been much more relaxed.

> First, the high effective floor against the DM is of course a reflection of the peseta's strength. As the pound falls, in recent experience, so does the peseta. In other words, as sterling's spot rate falls, so does the effective floor rate, giving room to accommodate sterling comfortably within the ERM.
>
> Secondly, while the Bank initially flirted with the idea of direct intervention against the peseta to prevent the effective floor being a limit, the thinness of the market prevented this. So if we wished to cut interest rates further and sterling threatened to hit the effective limit, the Bank would rely on the ERM rules to intervene.

BHP.

BARRY H. POTTER

18 February 1991

C:\wpdocs\economic\exchange (pmm)

→ BP

PRIME MINISTER

Thank you. Good for them!

INTEREST RATES

You might like to see some reports which indicate that the Congdon/Walters group is not having things entirely its own way. I attach

- an extract from a paper written by Walter Eldis of NEDO pointing out that devaluation is far from a cure-all;

- the leader from the Independent. Having advocated membership of the ERM at least they are following through its consequences consistently;

- an extract from the Financial Times reporting sympathetic city views;

- an article by Roger Bootle in the Guardian. He agrees with the Congdon Group that a large cut in interest rates is justified but did not sign the letter as he believes it essential to stay in the ERM. He squares the circle by arguing that a two per cent cut, by removing uncertainty, improving the investment prospects for the economy, and by improving the Government's chances of re-election, would be consistent with the current exchange rate.

AT

ANDREW TURNBULL

14 February 1991

c:\pps\interest (kk)

Walter Eltis NEDO

inflation.

Not borne out by his article in the Guardian.

[Bootle and] Martin suggest hopefully but counterfactually that a downward realignment of sterling within the ERM would permit lower United Kingdom nominal interest rates. In the past devaluations have always led to an acceleration of inflation, and econometric studies suggest that the lag between devaluations and their subsequent transmission into equally higher prices has become a mere three years. The international evidence suggests that it is real and not nominal interest rates which converge because, with free international capital movements, funds will be invested in the countries which offer the highest prospective real interest rates, and this must produce the convergence shown in Figure 5. That means that a willingness to continually devalue sterling which must raise inflation, will at the same time produce among its inevitable effects a higher level of nominal interest rates in London.

If the pound is devalued within the ERM once, there will be expectations that faced with similar difficulties in the future it will devalued again - and again and again. The Governor of the Bank of England and Sir Brian Corby, the President of the Confederation of British Industry, have both remarked that if there is a downward realignment of sterling there will be a consequent loss of confidence in the maintenance of its future value within the ERM framework, which will cause interest rates to go up and not down. The view that if you put up inflation you raise the rate of interest within a few weeks, and certainly within three or four months, is basic and elementary economic theory and Figure 6 which sets out the development of nominal interest rates underlines its relevance.

That emphasises the importance of bringing United Kingdom inflation down. The high nominal interest rates it produces involve large risks for companies because interest payments form a considerable fraction of cash flows in inflationary periods. The proportion of interest payments to United Kingdom company profits has risen from 25 to 50 per cent over the last 5 years and this has been mainly due to the rise in nominal interest rates which has accompanied the increase in inflation. As the ratio of interest payments to company cash flows rises, the risks of insolvency

THE INDEPENDENT

40 CITY ROAD, LONDON EC1Y 2DB (telephone 071-253-1222; general fax 071-956-1435)

The monetarists turn wet

THE timing of yesterday's half-point cut in interest rates was political, coming as it did a few hours before the Chancellor, Norman Lamont, rose to address the House of Commons. But the test of the reduction is economic. Providing the foreign exchange markets accept the move, so that sterling retains its value within the exchange rate mechanism, the exercise will have been a success. Since yesterday's cut in the base rate to some extent reflected what had already happened to money market rates, the chances of that outcome occurring are good.

Where does this leave the devaluationists? They are of two kinds. Some have clung to the old illusion that the British economy can be made competitive by devaluation. Ignoring the fact that two remarkably successful countries, Japan and Germany, have prospered while their currencies rose in value, the devaluationists imagine an easier way can be found for British firms. If we devalue our currency, they ask, can we not undercut our competitors? It would be nice to think this were possible, but experience shows it is not. Well-run businesses, supplying products people want to buy, tend to succeed. Badly-run businesses cannot be transformed into well-run ones simply by a temporary easing in the terms of trade. Indeed, when devaluation leads managers to relax their search for improved productivity and quality, it actually diminishes firms' chances of survival.

But allied to the old-style devaluationists is an altogether stranger contingent, six of whom, including Tim Congdon and Sir Alan Walters, published a letter in *The Times* yesterday. These are the disappointed monetarists. They look back to the heroic period of the early Eighties, when the British Government reduced inflation by bringing the money supply under control, turning a deaf ear to industry's cries of pain. The disappointed monetarists want us to leave the ERM, or at least devalue within it, and repeat the remedy that worked 10 years ago.

In purely economic terms, they can mount a strong case. What they completely fail to understand is the politics of defeating inflation. The success of the early Eighties did not last: our politicians again contrived an inflationary pre-election boom. The disappointed monetarists blame the then Chancellor, Nigel Lawson, for this error, but even if the explanation were correct (and it implies an uncharacteristic degree of feebleness in the then Prime Minister, the monetarists' heroine Margaret Thatcher), it would still show up the limitations of monetarism. Many more of our politicians resemble Mr Lawson, prepared to take chances with inflation in order to win elections, than resemble the supposedly incorruptible Mrs Thatcher. Any counter-inflation policy that relies overwhelmingly on the self-discipline of British politicians will fail.

It follows that the disappointed monetarists are foolish to urge the Government to abandon the one external discipline on British counter-inflation policy, the ERM. The latter system is far from perfect. It will cause seemingly avoidable pain, just as monetarism did. But having gone into the ERM, we would be incredibly feeble — perhaps the *mot juste* is wet — to leave again after a few months. If we were to abandon the discipline of the ERM, who could believe we would accept the discipline of monetary targets?

The Independent
Thursday 14th February 1991

Financial Times
Thursday 14th
February 1991

Pragmatists gain on monetarists in close struggle

THE PRAGMATISTS took on the monetarists in the City yesterday – and at the close of play had edged ahead.

However, the battle is far from over and neither side is predicting who will emerge victorious.

The pragmatists are the economists arguing that the government's "softly softly" approach to cutting interest rates – as demonstrated by yesterday's ½-percentage-point reduction – is the right way both to ease constraints on lending and to reassure financial markets about future monetary policy.

In the opposing camp are the six economists, all identified with hard-line monetarist views, who signed a letter in The Times yesterday calling for deep and immediate cuts in interest rates to avert an economic collapse.

The arch-monetarists criticised yesterday's rate cut as ineffectual. They believe interest rates of about 12 per cent are required.

Their letter to The Times said Britain should "ideally" withdraw from the European exchange rate mechanism (ERM) to provide room for a large-scale easing in monetary policy.

Failing that, Britain should attempt to devalue sterling within the mechanism to make interest rate cuts possible without causing the pound to plunge to its ERM floor, they said in their letter.

The pragmatists appeared yesterday to have had the best of the arguments. Sterling closed in London at DM 2.90, slightly up on Tuesday night, illustrating that the pound's position in the ERM had not been fundamentally damaged.

Both sides agree that further reductions in interest rates will be required during the next few months. Whether or not the ERM discipline will hinder that remains to be seen.

Mr John Shepperd, an economist at Warburg Securities, an investment house, is among the pragmatists. He said that the rate cut had been "extremely sensible".

Scope remained within the ERM for a further cut of ½ percentage point by the time of the Budget on March 19, he added.

Mr Gavyn Davies, chief UK economist at Goldman Sachs, the US investment bank, said that in the long run Britain's ERM entry last October would aid the economy.

Mr Giles Keating, a leading monetarist economist and director of economics research at the London office of Crédit Suisse First Boston, a Swiss owned investment group, said the call in the letter to The Times for a devaluation of the pound was "iniquitous, stupid and counterproductive".

The standardbearer in the monetarist camp is Professor Tim Congdon, economic adviser at Gerrard and National, a discount house.

Prof Congdon, one of the signatories of yesterday's letter, has criticised government policy for relaxing monetary targets and letting the economy overheat between 1986 and 1988.

He argues that inflationary forces unleashed by that "mini-boom" led to the period of high interest rates from late 1988 – a key factor in deepening today's recession.

The troubles were aggravated by the timing of ERM entry, which took place just as the German economy was starting to boom as a result of unification – requiring a period of high German interest rates which was bound to affect monetary policy in Britain via the ERM linkage.

Prof Congdon said yesterday that the change in interest rates was "a small step in the right direction, but I would like to see rates cut to 12 per cent immediately".

Sir Alan Walters, former personal economic adviser to Mrs Margaret Thatcher and another signatory, said the rate cut was "too little and far too late".

The involvement of Sir Alan in the latest public argument about the economy surprised some financial analysts.

Mr Paul Chertkow, chief currency analyst at Citibank in London, said the cut in rates was sensible and Sir Alan's signature on the letter did nothing to enhance the arguments of the other signatories.

"Sir Alan's the man who screwed things up", said Mr Chertkow. He argues that if Britain had joined the ERM in the mid 1980s, when Sir Alan was opposing such a move, the economy would be in better shape.

"Sir Alan's been a disaster in terms of policy and the markets should ignore him," he said.

Peter Marsh

Roger Bootle urges the Chancellor to be bold and lead the markets

A cut-rate cure for Britain

YESTERDAY six distinguished economists wrote a joint letter to the Times in which they warned of a deep recession, possibly even a thirties-style slump confronting Britain and blaming monetary mismanagement, specifically the failure to cut interest rates because of the ERM constraint. The implication was that to avoid the worst the Government must cut rates by a large amount immediately, then negotiate a realignment of sterling within the ERM, or withdraw from the system. I did not join them. Why not?

First let me make clear substantial areas of agreement. We are facing not simply an ordinary recession, but one perhaps as bad as 1979-81, or if things go badly wrong, something even worse. We are still at a comparatively early stage of the process. So far, although many consumers have suffered from high mortgage rates, these have been offset by others benefiting from higher income on savings. Overall, consumers' income has not been badly hit.

It is only now that we are beginning to see the hard-pressed corporate sector passing on some of its problems to the personal sector by slashing employment levels and cutting wage increases. As this happens, consumers' real income growth will be cut back. Meanwhile, the economic outlook is darkening so fast that consumers may decide to spend a smaller proportion of their incomes, thereby intensifying the squeeze on demand. All of this, of course, will worsen the position for companies, who will then have to begin another round of cutbacks, and so on and so forth until the process grinds to a halt.

It will not be easy to get out of this position. Whatever the Government does now will not stop a nasty recession this year. But there is still time to improve the position for next year. What the Government must do is to cut interest rates, cut them soon, and by a large amount.

There the agreement ends and disagreement begins. It has three elements. First, there is the question of sterling's membership of the ERM. Mistakes were made in joining the system. We joined at the wrong time, in the wrong way, for the wrong reasons, at the wrong level of interest rates and possibly (although this is far from incontrovertible) at the wrong exchange rate. But acknowledging this is not the same as an argument for withdrawing.

We did join the ERM, and coming out of it is not the same as never having joined. The Government's credibility would be seriously damaged, perhaps irreparably. Britain's relationships with her European partners would be fractured, and the pound would be far more vulnerable than if we had never joined in the first place. For the message would be: Britain has failed, again; the Government has shirked a difficult task; employers can now give way to excessive wage claims, confident that falling sterling would bail them out.

Secondly, the six signatories offer us instead of the ERM, "soundly based monetary targets". Properly interpreted, monetary aggregates do seem to be giving the right signals now, but surely no one who endured the farce of official obsession with Sterling M3 in 1979-81 could willingly subject Britain to another bout of steerage by monetary autopilot.

So what is the alternative? It is to cut rates boldly within the ERM and to hold to the present parity. Would it hold? Given that inflation is set to plunge over the next year to below 5 per cent and by the end of 1992 to 3 per cent, it ought to. There is scope for reducing the interest differential with Germany within the ERM, provided this is justified by the economic fundamentals and provided that the market believes this.

More importantly, there are reasons why sterling might even be stronger with lower interest rates. For the markets reason that the recession will be so serious that rates will be cut substantially this year. Given this assumption, the following holds: either rates will be cut with sterling within the current ERM levels or they will be cut with sterling outside the current ERM bands.

Now the longer the Chancellor refrains from cutting rates substantially with sterling within the current bands, the more the market begins to worry that he will, indeed can only, cut rates with sterling outside the current bands. That is to say that there will be a sterling devaluation or even a withdrawal from the ERM altogether. By comparison with maintaining the existing parity, 1 per cent on or off interest rates is neither here nor there. Credibility of the parity is all.

By not cutting rates now, the Chancellor is encouraging the view that sterling will, in due course, have to be devalued, or leave the ERM, thereby weakening it.

Moreover, the deeper the recession turns out to be, the greater are the chances of a Labour Government. If the market comes to believe that is the likely result, the odd 1 or 2 per cent on interest rates will be a minor consideration.

The upshot is that the Chancellor is weakening the pound by abstaining from substantial rate cuts. Yesterday's ½ per cent cut in rates, the timing of which was surely dictated by yesterday's debate in the Commons, made potentially more embarrassing by the Times letter, to some extent bore this out. After the cut, sterling rose. But the effect would probably have been greater if Mr Lamont had cut by more.

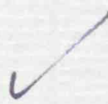
The way to settle sterling at this level or higher is to cut by 2 per cent in one go and to announce that for now that is it. For the danger in the current position is that the market will be worried about a continued dribbling out of small rate cuts which provide trading reasons for not holding sterling.

This Government has shown itself courageous on a number of occasions. Now it is time to be courageous in a different way. This is the time to lead markets not to follow them. If the following goes on much longer there could be disaster, not only for the Government, but also for the country.

Roger Bootle is chief UK economist of Midland Montagu

The Guardian
Thursday 14th February 1991

PRIME MINISTER



CONVERSATION WITH TERENCE BURNS

I telephoned Terry but did not get through until this morning, by which time the half per cent reduction in the interest rates had been decided. We discussed the letter in The Times from Congdon et al. Terry made the following points:

i) The group talk about adhering to "soundly based monetary targets". If one got down to specifics, one would find that there was little agreement within the group on what such targets should be. Congdon is a believer in broad aggregates; Minford, Pepper, Walters in narrow aggregates. Much of the difficulty of the 1980s was precisely because we could not decide the weight to attach to each.

ii) It is ironic that some members of the group, e.g. Alan Walters, who believe in free floating and are against fixed exchange rates, seem quite happy to nominate alternative rates at which the pound should be fixed. They also fail to distinguish between the rate against the European currencies and against the dollar. Few people deny that the pound is over valued against the latter but that is more a statement about the dollar than about the pound.

iii) Much of the debate is about priority being given to reducing inflation as opposed to sustaining output. One would normally have expected this group to have given greater weight to inflation.

iv) In his speech this afternoon the Chancellor pointed out that in the early eighties interest rates were brought down quite fast from 17 per cent to 12 per cent but this was not sustained and rates were pushed back up to 16 per cent. It is precisely this that the Treasury wish to avoid.

AT

ANDREW TURNBULL

13 February 1991 c\burns (kw)

Urgent need for interest-rate cut

From Professor Tim Congdon and others

Sir, We are deeply concerned about the state of the economy. The principles of good monetary policy imply that interest rates should have been cut significantly by now in response to the clear evidence of recession from monetary and indeed all other indicators.

Failure to cut them is increasing the risks of a depression which would get out of control and from which recovery would be long delayed. Many sectors are barely surviving and could be forced to close capacity on a massive scale; and the banking system is fragile, weakened by serious and repeated loan losses. It was just such monetary problems that triggered the Great Depression of the 1930s.

As interest rates fall there should also be a sharp depreciation in sterling which is seriously overvalued against the average of our world competitors, especially the North Americans. This would not be inflationary, any more than it was in 1981 after a period of tight money. Inflation is set to fall sharply in response to the monetary squeeze since 1988.

The exchange-rate mechanism obstructs this course. Ideally, we should leave it, in order to adhere to soundly-based monetary targets, the best long-term guarantee of a sound currency. Credibility would also be enhanced by such a sustainable monetary discipline, as compared with the present draconian policies that invite dangerous reversal.

Yet, even within the ERM, we and others in it have been pressed by the Bundesbank to realign, so that we should not be penalised by their domestic need for high interest rates. Even if others will not realign, it is still open to Britain to do so.

Such an outbreak of monetary common sense is desperately overdue. We urge the Prime Minister, the Chancellor and their colleagues in the Tory party to move rapidly before real disaster strikes our economy.

Yours faithfully,
TIM CONGDON,
BILL MARTIN,
PATRICK MINFORD,
GORDON PEPPER,
ALAN WALTERS,
PETER WARBURTON,
Liverpool Macroeconomic

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SUBJECT ec MASTER

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 February 1991

Dear John,

BILATERAL WITH THE CHANCELLOR

The Prime Minister held the regular weekly bilateral with the Chancellor today.

NO FURTHER COPIES SHOULD BE MADE of this letter, and it should be made available ONLY to other Ministers and officials with a STRICT NEED TO KNOW of its contents.

The Chancellor said he remained convinced that the present strategy on interest rates was correct. The Government would reduce interest rates by a half per cent once sterling showed greater strength within the ERM. But it was not right to act now, so quickly after the interest rate changes in Germany and the USA. There was a danger of being forced into retreat, if the Government acted prematurely. A cut in interest rates followed by an increase must be avoided: that would lead to immense pressure on the Government to quit the ERM.

A further discussion on tactics with Bank officials had taken place yesterday. Although there had been significant intervention last Friday, the UK had played only a minor role in the dollar support operation yesterday. Intervention to remove the so called peseta constraint on downward movement within the ERM bands would be difficult to achieve. The peseta/sterling market was very thin: rather than intervening in the market, it would be better to let sterling bump down against its effective exchange rate limit. Then the central banks would be forced to intervene under the ERM rules.

The possibility of a co-ordinated reduction in interest rates, alongside the French and the Italians, was being explored at official level. But the Germans were not keen on a revaluation, while the French and Italians positively wished to avoid a currency realignment. That did not necessarily mean however that support could be generated for a co-ordinated reduction in interest rates.

The Prime Minister said that, like the Chancellor, he was very anxious to achieve an early half per cent reduction in UK interest rates. He accepted the Bank's view that it should soon be possible, but would have to be delayed for a few days until sterling was seen to be stronger within Europe. It would be useful if action could be taken before the next inflation

figures were released on Friday 15 February. That would leave scope for another half point reduction in interest rates before the Budget.

It was not clear why sterling was relatively weak within the ERM - although the ERI itself was relatively strong. One factor was the recession and expectation of interest rate cuts. But was the 'Italian exit' also anticipated in the markets? What was the Treasury's strategy on moving to the lower bands?

The Chancellor said the primary aim was to get interest rates down further. It would be difficult to move to the narrower bands in the ERM soon, while the UK's inflation and interest rate differentials with most other ERM members were so high. Both had to be brought down considerably before the Government could sensibly shift to the narrower bands. Moreover, exchange markets remained unsettled because it was not quite clear whether German interest rates had yet peaked: it was even less certain that interest rates in the US had yet reached their low point.

Finally, the Chancellor indicated that the Prime Minister's concern about sympathetic handling of Sir Kit McMahon's proposed retirement from the Midland Bank had been passed on to the Governor. The replacement was now likely to be Mr Pearse, the present Financial Director of Barclays. But the post represented a formidable challenge. Something little short of the reconstruction of the Midland Bank would be necessary.

Yours ever,

Barry

BARRY H POTTER

John Gieve Esq
HM Treasury

Flea 4(a-b) HK cc AT

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

4 September 1990

Dear John,

MEETING WITH THE CHANCELLOR AND TREASURY OFFICIALS

The Prime Minister discussed with the Chancellor today the prospects for the economy over the next few months; the scope and timing of any reductions in interest rates; and possible dates for the UK to join the exchange rate mechanism (ERM). The meeting was also attended by Sir Peter Middleton, Sir Terry Burns and Mr. Scholar (Treasury) and by Professor Griffiths (No. 10 Policy Unit).

I should be grateful if you could ensure that no copies of this letter are taken without your permission and that the letter is seen only by those with a strict need to know.

The Prime Minister has asked me to record the outcome of the discussion as follows.

It was agreed that the main policy priority must remain the defeat of inflation. At the same time, in its policy actions over the next few months, the Government must take into account the growing risks of a UK recession.

The Prime Minister agreed with the Chancellor's conclusion that, while it would soon be appropriate to cut UK interest rates, that point had not yet been reached. She also appreciated the risks which the Chancellor saw in any reduction in interest rates before the UK joined the ERM. There were therefore attractions in taking action on both interest rates and ERM entry at the same time.

A minimalist interpretation of the Madrid conditions would require the Government to be over the peak of inflation when the UK entered the ERM. That peak, in terms of published annual increases in the RPI figures, was expected towards the end of this year although the course of the figures from month to month was unclear.

EA

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SECRET ADSO

It was not possible to take a firm decision on the ERM entry date at this stage. But it would be right to join when inflation had peaked; and when an interest cut was justified by UK monetary indicators and by further evidence of slowdown in the real economy; and would be consistent with interest rate developments overseas.

It would now be necessary for the Treasury to consider practical dates for entry into the ERM up to the end of this year. The uncertainty and volatility caused by developments in the Gulf would also remain relevant to the timing of entry. But there might be circumstances in which it might be sensible to go ahead with entry, even if a further rise in oil prices generated by developments in the Gulf threatened a second short-term boost to inflation.

Yours ever,

Barry

(BARRY H. POTTER)

John Gieve, Esq.,
HM Treasury.

SECRET ASDO

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NOTE FOR THE RECORD

MEETING WITH THE CHANCELLOR AND TREASURY OFFICIALS

The Prime Minister discussed with the Chancellor today the prospect for the economy over the next few months; the scope and timing of any reductions in interest rates; and possible dates for the UK to join the exchange rate mechanism (ERM). The meeting was also attended by Sir Peter Middleton, Sir Terry Burns and Mr Scholar (Treasury) and by Professor Griffiths (No. 10 Policy Unit).

The Chancellor said that following his meeting with the Prime Minister last week, he had discussed the economic situation with both Treasury officials and with the Governor and Deputy Governor of the Bank of England. Most economic indicators now suggested a slowdown in the real economy after the unexpected resilience exhibited in the first half of the year. But it would be some time before inflation fell decisively. Both the recent oil price increases and the forthcoming wage round, threatened to keep inflation up at a higher level than had been expected in the summer.

Accordingly, while it would soon be appropriate to cut interest rates, that point had not yet been reached. An early cut would give the wrong signal to financial markets, and even more important to wage negotiators.

On the date for ERM entry, setting aside the uncertainty and instability caused by events in the Gulf, most of the conditions necessary had now been met. Inflation was still expected to turn down before the end of the year; the exchange rate was at an acceptable level; the monetary indicators were coming under firmer control, so that a cut in interest rates

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might soon be justified in any case. The UK should join the ERM as soon as possible, if it were not for the situation in the Gulf. If the Gulf confrontation was going to be long drawn out, there was no reason to delay entry. On the other hand, if the position deteriorated and war broke out, the impact on oil prices, the exchange rate etc would be unpredictable. But if the Government were to delay entry for too long the opportunity would be lost: and the £ value might drop substantially.

The Prime Minister said the fundamental reason for joining the ERM was to use the Deutschemark as a kind of gold standard. No other "spine" was available to the UK at present. The Government should join to inject the necessary spine and discipline into the anti-inflationary stance. But entry had to be at a reasonable exchange rate - not a level artificially buoyed up by high interest rates. The gap between developments in unit wage costs in the UK and those in principal competitors in the ERM was worrying. Entry now would also mean joining at a time of very high inflation, well above that of our competitors, and when the Government was clearly not yet on top of the inflation problem. The Madrid conditions required the UK to be getting inflation down. Entry now would look like reliance on the ERM and an inability to cope with our own inflation problem.

There was also some uncertainly about the deutschmark and how the German authorities would pay for the higher than expected costs of absorbing the East German economy. A rise in German interest rates might cause the £ to fall and require higher UK interest rates to keep within the bands. That would bring an increased risk of recession. A combination of 15 per cent interest rates; a central rate of 3 Dm; and high wage settlements when we joined the ERM would bring unacceptable risks of recession.

The following were the main points made in discussion.

(i) At a central rate of around 3 Dm = £1, the £ would be closer to its historic average level. It was wrong to think that depreciation of the exchange rate would improve competitiveness. It would only make the problem of accelerating wage settlements worse. To keep wage levels down, it was essential to keep a firm exchange rate in place.

(ii) The tradable sector might well strive hard to hold on to its existing market share. It could choose to absorb pressure through lower profit margins. A high rate against the $ would also lower import prices. Any easing of the squeeze on companies through action to lower the exchange rate, was bound to delay the date at which inflation was brought back under control.

(iii) Any reduction in interest rates, without an announcement that the UK was joining the ERM, would risk a sharp fall in the £. Although Phillips and Drew were expecting an entry into the ERM to be delayed until next year, most City authorities still expected entry in the autumn. It might therefore be sensible to consider a reduction in interest rates only at the same time as the UK joined the ERM.

(iv) The outlook on inflation had worsened in the short term because of the higher oil prices. The Treasury's best estimates were that the August figure might be between 10.2 and 10.4 per cent; the figure for September within the same bands; with the figure for October showing a reduction to somewhere between 9.8 and 10.0 per cent, and the November figure showing a further 1/2 per cent fall in the year-on-year rate. But all these figures were subject to a wide margin of error and the assumption of no further rise in oil prices. In order to meet the minimalist interpretation of the Madrid conditions, the possible

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entry date to ERM would have to be put back from October - it was now unlikely there would be any fall in the inflation rate between August and September.

(v) Entry to the ERM involved a shift in the focus of the anti-inflationary stance from monetary policy to the exchange rate. It might be difficult to sustain the anti-inflationary stance if the £ appreciated to the top of its bands so that an interest rate cut was demanded. There would have to be a willingness to revalue in those circumstances. And that might be difficult if it happened in the early months of joining the ERM.

(vi) On the other hand, there was no reason to expect any repeat of the bad experience from shadowing the Dm in 1987. This time the exchange rate stance would be overt and clear, and would represent a real and known challenge to wage negotiators. The Government must be ready to change the parity if it judged that was the best way to maintain the anti-inflationary stance. However, provided entry was on the wide 6 per cent margins, there was no reason on the basis of the last few weeks experience to expect that there would be any difficulty in keeping the £ within the bands.

(vii) It would be difficult to go on maintaining the credibility of the Government stance if throughout the early autumn expectations of entry into ERM were consistently thwarted. If entry were to be delayed, very careful consideration would need to be given to the presentation of the Government's anti-inflationary stance. Again, the course of events in the Gulf was a particularly difficult factor.

Summing up the discussion, the Prime Minister said the main priority must remain the defeat of inflation. However, the

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Government must avoid any policy action that could unduly raise the risks of recession. There must be concern about entering ERM with 15 per cent interest rates, with a rate of 3 Dm and with high wage settlements. However, she appreciated the risk which the Chancellor saw in a reduction in interest rates before the UK joined the ERM. There were attractions in taking action on both interest rates and ERM entry at the same time. It was also clear that a minimalist interpretation of the Madrid conditions would require the Government to be seen to be over the peak of the inflation rate. That was expected towards the end of this year. It was not possible to take a decision on ERM entry dates at this stage. It would then be necessary for the Treasury to consider practical possibilities up to the end of the year. Towards the end of the year the picture both in the Gulf and on German interest rate might be clearer.

BHP

(BARRY H. POTTER)
4 September 1990

REF JG/33
COPY 1 of 8

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

PRIME MINISTER

We are meeting tomorrow to take stock of the present monetary position and the implications both for interest rates and the timetable for ERM entry. Since we met last week, I have considered the position with the Governor and the Deputy Governor as well as Treasury officials. It may be helpful if I try to set the scene in this minute.

The present economic position

2. There are increasing signs that the measures we have taken to tighten economic policy are having their desired effect on the economy. Monetary conditions have improved with slower money growth and a higher exchange rate. Economic activity has slowed: retail and business demand are sluggish or falling and asset prices have peaked. But inflation and earnings are still high. And the trade deficit is still large and showing little signs of improvement.

3. A higher oil price complicates the picture. The price for Brent oil is presently $26-28. This will add to the deflationary impact on demand provided that there is no relaxation in monetary policy. But there will be higher prices in the short term. And the clear lesson of the 1970s is that the right way to deal with a jump in oil prices is a restrictive policy. We should not be seeking to accommodate this potentially inflationary shock by relaxing monetary policy; that would mean that the oil price would feed into the general price level.

4. Before the oil price rise, the June forecast pointed to GDP growth of around 1 per cent in both 1990 and 1991, with domestic demand rising about ½ per cent in each year. The RPI was expected to peak at 10.2 per cent in August and fall to an average 9.4 per cent in the fourth quarter of 1990 and 6.4 per cent in the fourth quarter of 1991.

5. It is early days to assess how higher oil prices and the course of events in the Gulf will affect this prospect. The RPI will clearly go over 10 per cent with the higher petrol price, but should fall after September. Underlying inflation will follow a similar path, with a shallow fall from then on till the effects of higher oil prices are overcome. The risk of one or two quarters of negative growth has increased correspondingly.

Interest rates

6. Against this background it is clearly time to consider when we should start to reduce interest rates. I am clear that we must proceed cautiously. We have invested heavily, both politically and economically, in the counter-inflation strategy. Getting inflation decisively down must be the priority. To achieve that we must keep and be seen to keep, money tight. That means keeping the price of money (and the return to savers who we still need to encourage) high.

7. Though capacity utilisation remains high, the risk of some recession next year certainly cannot be ruled out. That is the counterpart of three years of excessively high growth. But it is not the only risk: there is still a risk that we shall make very little impact on our inflation rate, which remains well above the average for our competitors. Moreover, the risks are asymmetric. The costs would be far greater if we relaxed policy too soon or by

too much; we should then be faced with the unwelcome prospect of raising interest rates again.

8. So I think we should rule out more than a very modest easing of interest rates over the next few months and set our faces against an immediate reduction. Three factors in particular are crucial.

9. First, we need to be clearer how other countries are likely to adjust their policy stance in reaction to higher oil prices. We have just seen a rise in Japanese interest rates. If there is a general move to tighten policy I hope we could avoid doing the same because sterling is sustained by the expectation of continued high UK rates. But such action overseas, partly through its effect on exchange rates, would reduce the scope for easing we might otherwise have had.

10. Second, the monetary figures need to be moving decisively in the right direction and by the required amount. M0 in August (4.9 per cent) was just inside the target range. But we are likely to go outside it again in September. And the broader aggregates, though coming down, remain well into double figures - the 12 monthly rate for M4 in July was still over 16 per cent.

11. Third, there is a vital point of perception. We must not be seen to be more worried about recession than inflation at a time when policy has only just begun to show clear signs of working, when the money supply is just within an unambitious target range, when the rest of the world can remember our past mistakes in accommodating oil price increases and when we are on the threshold of a new round of wage bargaining.

12. We also need to consider how our approach to interest rates may interact with the timetable for ERM entry.

ERM entry

13. The major event since we considered the position before the holidays has been the Middle East crisis and the impact on oil prices. Uncertainty over how the position will resolve itself is undoubtedly a major new factor that we need to consider. But I suggest it would be helpful to consider the timetable and terms for our ERM entry in three stages. First, in practical terms what are the timetable possibilities? Second, how have recent developments affected the position, in particular regarding our earlier judgements about the range and rate of entry? And then third, how is all this affected by continuing uncertainty about the position in the Gulf?

(i) **Possible Dates**

14. Practical considerations do substantially limit the available timing options between now and the end of the year. A good many dates are ruled out by events like the September G7/IMF meetings, the Party Conferences, the Special European Council, Prorogation/ State Opening, the Autumn Statement, electricity privatisation, and the December European Council/IGCs.

15. If we were to join in good time before the IGC at the end of the year the two best dates from a practical viewpoint would be 14 September and 5 October. Following our last discussion with you, we have worked out detailed timetables for both dates.

16. So I suggest that we need to look tomorrow at the case for entry in mid-September/early October against the possibility, to put it no stronger, that the alternative might be waiting until the New Year.

(ii) **Recent Developments**

17. Earlier in the summer a major concern was that the then market exchange rate might be rather too low as an entry point. A related worry was that if entry was then followed by appreciation we might find ourselves under pressure to reduce interest rates which we judged inappropriate on domestic grounds.

18. Since then, sterling, though fluctuating, has appreciated. I regard that as a welcome development. If present conditions persist we could join at a rate either just above or just below 3DM. This seems about right for a central rate in the ERM. The Governor and the Deputy Governor would both strongly support joining at around this rate. It would reinforce counter-inflationary pressures in the short term. And I believe it would be sustainable. I know that some industrialists are saying that the rate is now too high. But I suspect that many of them are focusing on the rising dollar rate which appeared a few days ago to be approaching $2. But the dollar is not directly affected by ERM entry and is at present appreciating. It does not affect the case for concluding that something like the present DM rate is adequately, but not excessively, tight; it is broadly in line in real terms with the average for the 1980s as a whole, and is well below the rate in the early 1980s.

19. Moreover, if sterling retains its strength we shall no longer need to consider the possibility of joining on an asymmetric basis, with the central rate and margins set such that there was more room for sterling to rise than fall from current market levels.

20. In considering an appropriate central rate we also need to bear in mind developments within Germany. As was to be expected the path towards reunification is proving bumpy. The cost is likely to add to the pressure for higher German interest rates

which might come also from higher oil prices and inflation pressures in West Germany. But unification has not had any major exchange rate effect thus far and seems unlikely to lead to major disruptions in the currency markets.

21. I should emphasise that the present strength of sterling is based on three things. High interest rates, the expectation of joining the ERM and to a lesser extent the oil price. Of these, the expectation of our early entry into the ERM is very potent. Sterling fell sharply on Friday on rumours that we should not wish to join at a rate as high as 3DM. We shall remain vulnerable on this account until we join. And, of course, sterling will be especially vulnerable if it is thought that our prospective entry has been put off beyond the remainder of the year. If sterling fell we would require higher interest rates to sustain policy which is very unattractive; alternatively, we would have higher inflation next year.

22. If we did join soon at the sort of rate I have suggested we could still face upward pressure. Should that happen, we should be protected by wider margins, the case for which is strengthened by present uncertainties. A 6 per cent margin would cover the size of change we have seen over the past month.

23. Moreover, if sterling did rise towards its upper limit we should be in a position to consider a reduction in interest rates. This would be a much safer course than attempting to cut rates before entry, which in addition to the disadvantages I have already outlined, might be seen as a deliberate attempt to weaken sterling prior to entry. The Governor and the Deputy Governor see this as a serious risk.

24. A less helpful development relates to the short term inflation performance and prospects. The oil price effect we have already seen means that the summer RPI peak will be later than we

would have otherwise have hoped. That clearly has a bearing on one of the Madrid conditions. But higher oil prices will affect our European partners too and should not increase the differential.

25. In this context we need to consider whether to maintain the line that an improvement in inflation performance is required before we join the mechanism. There are of course strong arguments for holding to that approach. But there are also points the other way. Joining the mechanism would give a clear signal to private sector wage bargainers and, by supplementing a policy of tight money, help to bear down on underlying inflationary pressures. And once we are in the mechanism we will have much greater security that, as and when we judge it right on domestic grounds to reduce interest rates, those lower rates - and their impact on the headline RPI - will be acceptable to the markets.

26. A further consideration is how the timing of ERM entry relates to the wide debate on EMU. So far our hard ECU campaign has gone as well as we could reasonably have hoped. But it is still a major uphill task. And this week we will have to resist attempts to sweep our proposals aside at the 4 September Monetary Committee and 7-8 September informal ECOFIN Council. We will have to take stock of these discussions as we prepare for the run-up to the special European Council at the end of October and the December IGCs. But my present view is that we will have an even harder hand to play if we remain outside the ERM right through this period.

(iii) **Middle East Uncertainties**

27. In an ideal world we would certainly be looking for different circumstances in which to join the ERM than a position where major international hostilities could break out. Should the worst happen, it clearly could lead to turbulence in international

financial markets. There might for example be substantial movements in the dollar and other currencies still to come, though oil is not such a potent influence on sterling as it has been in the past..

28. Much depends on the nature of the conflict in the Gulf. If we face a long drawn out affair, the case for early entry is strong. We should be better placed to handle turbulence whilst maintaining a well judged domestic policy from within the ERM. And we should not risk disappointing market expectations about our entry. It is only if there is the prospect of immediate hostilities that we might wish to retain the added freedom of manoeuvre that we have outside the ERM - and even then we should need to be sure that this is not misunderstood as a desire to be free to relax the counter inflationary policy.

29. In short, in the absence of the Gulf conflict, I should be recommending entry at the earliest date. This view is shared by both Bank and Treasury officials. We might consider how the Gulf situation affects this when we meet tomorrow.

John M.

[J.M.]

3 September 1990

cc Bgtge

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SECRET AND PERSONAL

PRIME MINISTER 31 August 1990

ERM ENTRY AND INTEREST RATE POLICY

The Chancellor will almost certainly raise two major issues in his meeting next week - the timing of entry into the ERM and the possibility of easing the stance of interest rate policy.

The timing of entry to the ERM

We are at present enjoying the benefits of being in the ERM. Following Madrid and the unambiguous statements by yourself and the Chancellor, the market is convinced that we will definitely join the ERM. This certainly is one factor making for a strong pound. Another, which is easily forgotten, is the strength of the Government's commitment to reduce inflation evidenced most of all in 15% interest rates.

While we enjoy the benefits of being de facto in the ERM we are also free of the potential costs which its straitjacket might impose, namely:

- heavy intervention as the exchange rate approached the ceiling;

- higher interest rates as the exchange rate approached the floor;

- a revaluation or devaluation of the sterling fixed parity should that prove necessary.

The Treasury will almost certainly argue that now is the time to

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join. (They have since the Summer of 1985.) Their case will be that:

(a) It will be a useful feather in the Government's cap before the Party Conference.

(b) It is a necessary step before the IGC discussion begins.

(c) Most importantly, the flexibility from being outside could result in a devaluation of sterling and a boost to inflation.

Of these, by far the most important is the last: and on this point the assumptions made by the Treasury as to why the exchange rate might fall need to be examined.

I believe there are strong arguments against entry now.

If the market thought the Government was using the Gulf Crisis as an excuse for staying out, the effect on sterling could be severe. But if ever there was a time when any Government should retain maximum flexibility over the levers of economic policy - rather than tie its hands behind its back - it is when there might be a war. Markets understand this argument - which is why there has been no concerted pressure to join just now with the Gulf Crisis.

Prediction is always risky. But trying to predict the change in the price of oil over the coming weeks is particularly difficult. The worst possible thing to do would be to allow a substantial rise in the relative price of oil, producing a general appreciation of the exchange rate, and requiring in turn the need

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for heavy intervention in the foreign exchange market, which as we know all too well runs the risk of renewed inflation.

In addition the uncertainty created by the Gulf Crisis makes the choice of the appropriate exchange rate at which to join an extremely tricky if not impossible business. The current exchange rate is really very high given the current growth of wages. Locking ourselves in at this rate would almost certainly lead to deflation - which could be quite severe - in 1991.

In addition there are two other reasons for not joining in the immediate future:

(i) entry into the ERM would be more credible if inflation were seen to have peaked and better still was on a clear downward trend. This after all was one of the Madrid conditions. The Treasury have been telling us for some time that this inflation peak is just one or two months away. It would be better to have clear evidence;

(ii) immediate entry to the ERM will create strong pressure for reductions in interest rates. As the next section argues this would be premature.

Conclusion

We will join the ERM: we must get the timing right: we must minimise the risks associated with entry: the Gulf Crisis and the possibility of a war is not the time to fix sterling.

Interest Rate Policy

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Tied up with entry into the ERM is the future course of interest rate policy. Joining the ERM will certainly be viewed as an opportunity to cut interest rates.

Most of the new data being published on the economy points to an unambiguous slowdown in economic activity: sharp drop in retail sales; consumer confidence indicator very low; commercial vehicle regulations sharply down; construction sector very depressed: fall away in export orders. Most encouraging of all the monetary data is now behaving in the same way as the real economy: the growth of Mo is falling and it looks as if Mo could be in its target range very soon; also the growth of bank lending is slowing down.

So far little progress has been made on the inflation front and settlement and earnings growth continue to be high. But the continuation of the higher exchange rate and high interest rates is putting a considerable squeeze on the corporate sector and it is only a matter of time before companies reduce employment much more rapidly.

The current behaviour of the indicators plus the lobbying from the business sector raise the question of when the Government should start easing policy by reducing interest rates.

It is important that when interest rates are reduced, they remain at permanently lower levels. To bring rates down and then push them back up - say next year - would be politically disastrous.

On the present behaviour of the economy there can no longer be any doubt that the policy is working. But very little progress has been made on inflation and investment spending by companies looks to be very resilient. Relaxing policy at this stage would

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give quite the wrong signals to companies and the labour market. It is because of this that the market is not now pressing for interest rate cuts.

Conclusion

It is too soon to start reducing interest rates, even if we joined the ERM immediately. If we did reduce rates, the danger would be that wages would continue to grow at current levels, the growth of total spending be given a boost, and the Government could well be forced to raise interest rates to protect a weakened exchange rate.

It may be that in four, six or eight weeks, the situation will become much clearer, and rates can be cut. But we need a clearer picture before taking action.

At present such a course remains too risky.

Recommendation

(i) a final decision on ERM needs to wait till the uncertainty over the Gulf is reduced and inflation is cleary on a downward trend;

(ii) interest rates should not be cut now because of the confusing signals it would give.

The next few months are crucial in building a strong platform for reducing inflation and lowering interest rates throughout 1991. It would be tragic to buy short term political gain through lower interest rates which could prove counter-productive next year.

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SECRET AND PERSONAL

These crucial considerations take precedence over the argument that we must join before the IGCs.

Although the Treasury argues that entry is essential to give us credibility in the IGCs, it could equally be argued that holding our fire will give as greater leverage. Entry now will not make the slightest difference to the battle we shall have in resisting the Delors version of EMU; it will in fact make other Member States think they have us on the run.

Brian Griffiths

BRIAN GRIFFITHS

Prime Minister

(i) I agree there is little to be said for September entry into the ERM. The choice between Sept and Oct was always marginal; therefore why commit yourself when uncertainty in the Gulf is so great. But

(ii) I would not rule out October

(iii) I agree with Brian that if we do not enter ERM, interest rates should not be cut. A major inflationary impulse has entered the system. In 1974 we made it too easy to pass on the higher costs. We should continue the pressure now to prevent the same mistake being made.

AT
31/8

Prime Minister

The £ has fallen very sharply this morning. It is down by 4 pfennigs to 2.96 D.M. and by 2 cents to $1.89.

The reasons are:

i) an expectation that Germany will soon follow Japan & raise interest rates;

ii) a rumour that UK will cut interest rates soon;

iii) a fear that UK has decided not to join the ERM.

The Treasury have authorised modest intervention to smooth movements in the rate. They will issue a statement denying ii) & iii) if it becomes necessary.

BHP

31/8

Prime/Minister

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

YOU ARE SEEING CROWN PRINCE OF KUWAIT ON MONDAY

NOTE FOR THE RECORD

LUNCH WITH IAN HARWOOD - CHIEF ECONOMIST, S.G. WARBURG & CO.

The main points which emerged from my lunch with Ian Harwood were as follows.

(i) Although there was increasing evidence of a slow down in the UK economy, it was too soon to decide whether a cut in interest rates was justified. The picture was simply not yet clear enough.

(ii) The impact of any cut in interest rates on the exchange rate would also depend upon the course of interest rates abroad. This was particulary unpredictable given the Gulf situation. In time US interest rates would go down, although the Fed might resist any quick reduction given the impact of oil prices on the dollar. But German interest rates could well go up to help finance the borrowing necessary to transform the East German economy. Any rise in German interest rates might be delayed until after the December general election.

(iii) Whether or not the UK joined the ERM, international competitiveness pressures, combined with a slower growth in world trade, would restrain inflation in traded goods and services within the UK over the next year. The problems lay more in the local service sector: all developed economies were discovering that, without pressure to generate competition locally, price inflation in local services tended to reflect cost increases.

(iv) It was too early to assess the impact of the oil price increases on the world economy. But the general expectation was that oil prices might settle down somewhere within the $22-$25 range - <u>assuming</u> no damage

to the Saudi Arabian oilfields. But the tendency to play down the impact of the oil price increase should be resisted. Oil prices at the $22-$25 range clearly would not have the serious shock experienced in 1974-75 and again in 1979-80. But, the short golden era in the mid-1980s, when rapid growth had been accompanied by low inflation rates in the developed countries' economies could, with hindsight, be seen to have taken place against the background of falling real energy prices. Rising real energy prices would give a short term stimulus to inflation and hold back the growth in output.

BHP

BARRY H. POTTER

28 August 1990

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Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

27 April 1990

Barry Potter Esq
10 Downing Street
LONDON
SW1

Dear Barry

... I attach as requested a brief note on this week's foreign exchange movements. I hope this is helpful.

Yours
Kate

MISS K GASELTINE
Assistant Private Secretary

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FOREIGN EXCHANGE DEVELOPMENTS MONDAY 23 - FRIDAY 27 APRIL

EXCHANGE RATES (London close)

	£ ERI	$/£	DM/$	DM/£
23/4	87.4	1.6365	1.6972	2.7775
24/4	87.2	1.6347	1.6942	2.7695
25/4	86.9	1.6370	1.6830	2.7551
26/4	86.6	1.6348	1.6772	2.7419
27/4	86.7	1.6347	1.6792	2.7450

COMMENTARY

Sterling began week at ERI 87.3, $1.6370, DM 2.7723. It fell back during first half of week ahead of UK March trade figures. Worse than expected deficit caused sharp fall, despite absence of heavy selling, with public intervention helping to steady pound. Thursday opening saw sterling fall on large Middle East selling order, but then steadied assisted by covert intervention by Bank. Closed week quietly ERI 86.7, $ 1.6347, DM 2.7450.

chex.dc/jg/11 **SECRET AND PERSONAL**

Cf - pc.
Prio 26/9

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

21 September 1989

Paul Gray Esq
PS/Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul

MARKETS

The Chancellor has asked me to write to you to let you know the conclusions reached at a discussion he held this morning with the Governor, together with Treasury and Bank officials, to consider how best to handle the markets following publication of the August trade figures on 26 September.

... I am attaching a note by Treasury officials analysing the trade figures in greater detail.

The trade figures will, clearly, be a disappointment to the markets, which suspended judgement on the poor July figures and on the August money figures which were published this week. There must be a risk that we will face substantial downward pressure on sterling after the trade figures are published on Tuesday 26 September. The Chancellor believes nevertheless that it may be possible to contain that pressure by determined intervention, and he has authorised the Bank to act accordingly on the lines that were agreed on a contingency basis last month.

If, however, intervention proves insufficient to resist a significant fall in the exchange rate, the Chancellor believes that it will be necessary to raise interest rates, in order to support the exchange rate and maintain the credibility of the

SECRET AND PERSONAL

Government's anti-inflationary stance, at a time when MO growth remains stubbornly above the top of its target range. He hopes that this will not arise. I will in any case telephone you from Washington should events take an unpleasant turn.

Yours sincerely

J St. Gieve

JOHN GIEVE

The August Trade Figures

1. The August trade figures, to be published on Tuesday 26 September, will show a current account deficit of £2.0 billion which compares with last month's deficit of £2.2 billion. This will not be well received: the markets are predicting a deficit of around £1.7 billion, the monthly average for the year to date. It bring the total deficit for the year to date to £13.9 billion. It is clear therefore that the deficit for the year as a whole will be significantly above the Budget forecast of £14½ billion.

Table 1: Current Account

£ billion

		1988			1989				
	1988	Q2	Q3	Q4	Q1	Q2	June	July	August
Non-oil visibles	-23.6	-5.5	-6.4	-6.9	-6.2	-6.2	-2.1	-2.5	-2.4
Oil	2.8	1.0	0.6	0.4	0.2	0.3	0.2	0.1	0.1
Total visibles	-20.8	-4.5	-5.7	-6.5	-6.0	-5.8	-1.9	-2.5	-2.3
Invisibles	6.2	1.7	2.3	1.1	1.2	1.0	0.3*	0.3*	0.3*
Current balance	-14.6	-2.8	-3.4	-5.4	-4.8	-4.9	-1.6	-2.2	-2.0
Memo Items:									
Balancing Item	12.3	3.7	2.9	5.2	1.2	6.6	-	-	-
Non-oil deficit as per cent of GDP	5.1	4.8	5.4	5.7	5.0	4.9	4.8	5.9	5.5

* CSO projections

2. As far as we can ascertain there are no special factors that have distorted the August figure. The dock strike may have had some impact on the figures but the effects are unlikely to have been large.

3. The current account figures are only estimates and are frequently revised substantially. In the past the quarterly

invisibles surplus has tended to be revised upwards. The monthly invisibles figures are only projections as most of the data are only available quarterly or annually (and in some cases at even less frequent intervals). The balancing items - which represent an unknown combination of unidentified capital inflows and unrecorded net exports - have been particularly large in the last few years, and notably in the second quarter of this year. Any errors in the net export figures are likely to be mainly in the invisibles statistics. The visible data are thought to be relatively reliable.

Composition of the Deficit

4. Over the past six month the deficit in consumer goods appears to have deteriorated by slightly less than the deficit in other industrial groups (see table A1). Capital goods imports continue to grow very rapidly reflecting the high level of investment in the economy as a whole and capacity constraints in UK capital goods industries. There is a particular shortage of skilled labour in this sector. Capacity constraints have eased in other industries but remain at historically high levels (see chart 2). Around half of the deterioration in the visible deficit over the past year as a whole is due to increased deficits on fuel and cars, (see table A2). The oil balance has been badly affected by the various accidents in the North Sea and should improve as output comes back on stream. The rest of the deterioration in the deficit was spread fairly evenly across a number of industries.

5. Non-oil imports are now around a third higher than non-oil exports in value terms. Therefore with imports growing by 12 per cent in the latest 3 months compared to the same period a year ago, exports would have had to grow by 15½ per cent simply to prevent the deficit getting bigger. In fact export growth, at 14 per cent, is now in excess of import growth but the gap is clearly not yet sufficient to improve the deficit.

Assessment

6. Import growth should in due course decline in response to slower demand growth and as new capacity comes on line after the recent investment boom. But this process is taking longer than expected.

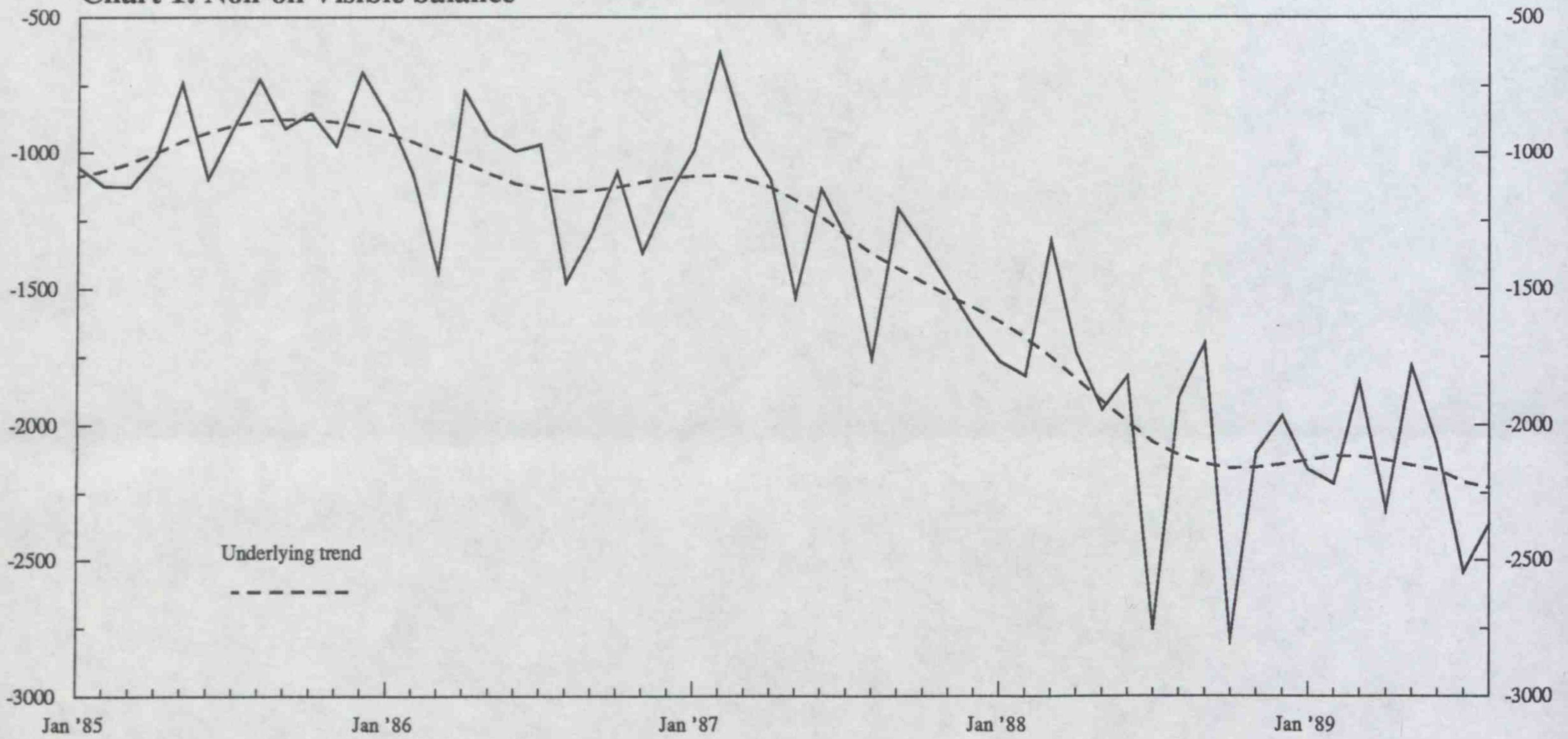


Chart 1: Non-oil Visible balance
-500
-1000
-1500
-2000
-2500
-3000
Underlying trend
Jan '85
Jan '86
Jan '87
Jan '88
Jan '89

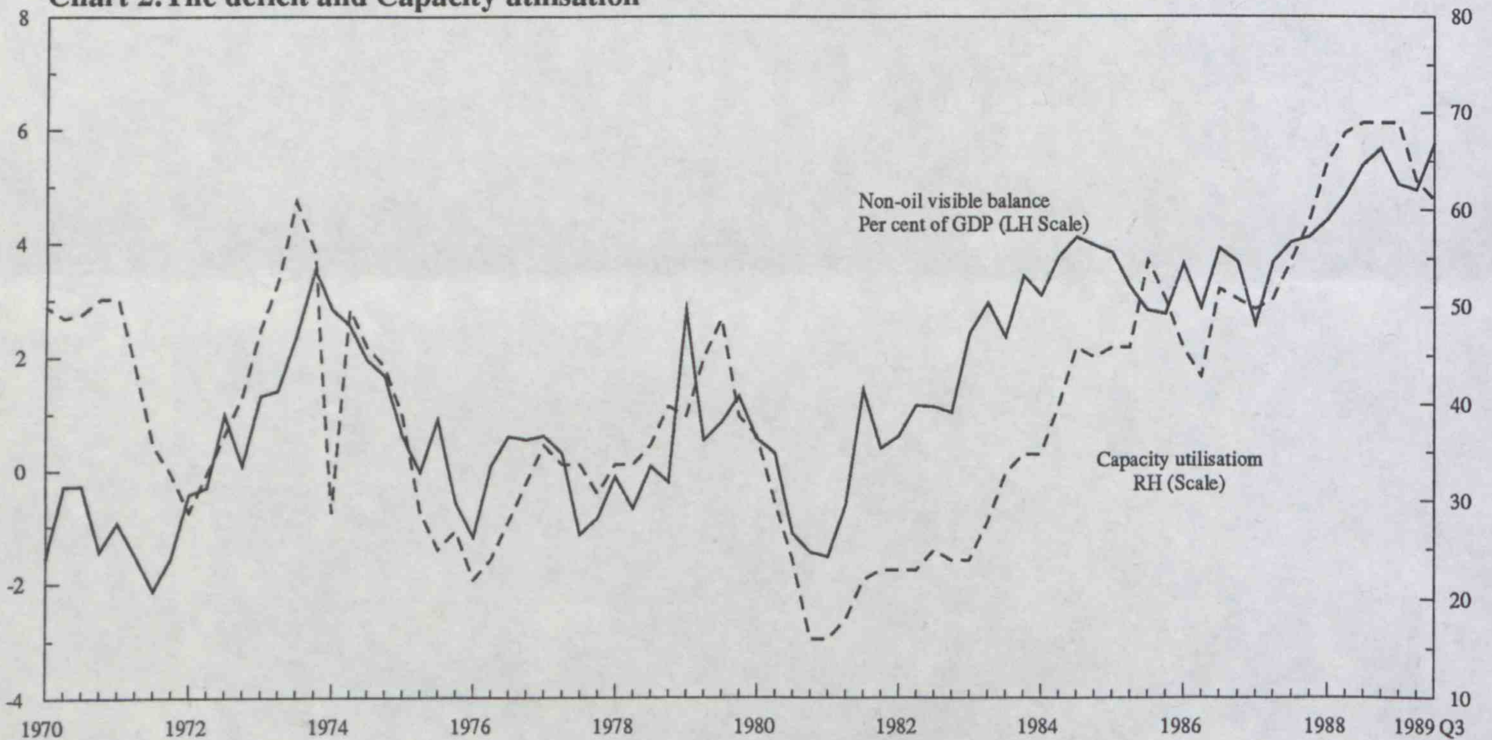


Chart 2:The deficit and Capacity utilisation
8
6
4
2
0
-2
-4
80
70
60
50
40
30
20
10
Non-oil visible balance
Per cent of GDP (LH Scale)
Capacity utilisatiom
RH (Scale)
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1989 Q3

Table A1: Trade performance by category of manufactured goods (OTS, excl erratics)

	Latest 12 months on previous 12 months			Change in trade balance between latest two 6 mth periods (£bn)
	Export growth (%)	Import growth (%)	Change in trade balance (£bn)	
Consumer goods	12½	19½	- 2.4	- 0.1
Capital goods	18½	18½	- 0.3	- 0.3
Intermediate and semi-manufactured goods	10	16	- 3.2	- 0.2

Table A2: Trade performance at industry level (OTS basis)

	Latest 12 months on previous 12 months			Change in trade balance between latest two 6 mnth periods (£bn)
	Export growth (%)	Import growth (%)	Change in trade balance (£bn)	
Fuels	-25½	5½	- 2.1	- 0.3
Road vehicles	15½	24	- 1.7	0
Electrical engineering	14½	17½	- 1.0	- 0.2
Clothing and footwear	- 2½	12½	- 0.5	- 0.2
Basic materials	12	12	- 0.5	0 (-)
Mechanical engineering	13½	18	- 0.3	0 (+)
Metals	21	24	- 0.3	- 0.1
Chemicals	9	13½	- 0.2	0 (+)
Scientific and photographic app.	8	15	- 0.2	- 0.1
Metal manufacture	11	16	- 0.2	0 (-)
Food, drink and tobacco	10½	5	- 0.1	0 (+)
Textiles	9	2	+ 0.1	0 (+)
Total	9	15	- 7.8	- 0.4

PRIME MINISTER

CF-PC
PRCG 11/9

FINANCIAL MARKETS

Following a rocky day or so earlier in the week, the Foreign Exchange markets have settled down in the second half of the week. I attach Thursday's evening report, showing that the sterling effective rate has steadied at just under 91. The Friday evening report is not yet available (we will send it in Saturday's box), but sterling has again been steady during the day.

Meantime, the UK Equity Market, which dropped quite sharply on Wednesday, has now had two days of renewed increase on Thursday and Friday.

PRCG.

P. GRAY
8 SEPTEMBER 1989

MRMAOJ

MG EVENING REPORT

FOREIGN EXCHANGE MARKETS

Thursday 7 September 1989

Previous close		Today opening 8.30am	Today close 4.00pm	%change $/currency since Plaza	since Paris	since 16 October 1987
90.9	£ERI	90.7	90.9	-12.9	6.2	-0.7
1.5502	$/£	1.5415	1.5447	13.0	1.1	-7.2
3.0666	DM/£	3.0640	3.0689	-21.4	9.9	2.4
1.4770	ECU/£	1.4758	1.4782			
72.3	$ERI	-	72.6	-26.5	0.0	4.3
1.9782	DM/$	1.9877	1.9867	-30.4	8.8	10.3
146.47	Yen/$	146.90	147.07	-38.9	-4.2	3.1
74.04	Yen/DM	73.90	74.03			

Sept $17.87 Oct $17.77 Nov $17.62 Spot Brent Sept $17.80 Oct $17.70 Nov $17.50

UK RESERVE TRANSACTIONS ($million)

(a)

	Today	This month so far	Total since 1 Apr 89
*	10	-30	-4895
	8	52	672
	18	22	-4223

* excluding -25$ agst DM

(a) Spot and forward transactions on a done date basis.

(b)

	Estimated end-month position *
Market intervention	-20
Off-market transactions	-143
TOTAL	-163
Net borrowing	-27
Valuation changes	0
TOTAL CHANGE IN RESERVES	-190

(b) Spot transactions only on a value date basis, as in published figures.

* On conventional assumption of no further market intervention.

OTHER COUNTRIES MARKET INTERVENTION ($million equivalent)

Belgium	-15$ agst DM	Germany	-50$	Italy	+75DM, -20$agst DM
Denmark	-10$ agst DM	Holland	-10$ agst DM	Japan	-200$
France	-20$ agst DM	Ireland	-	US	-50$ agst DM -50$ agst Yen

Nor -10$agstECU, -13$, Sp -15$agstY, Port -10$agstDM, +17$, Swed -10$agstDM, -10$agstY.
Swiss-30$, Austria-10$

MARKET COMMENT

Although weakening a little in New York, the dollar moved up this morning to just below DM1.99 in early trading after wire service report quoted Fed. official as saying that dollar's recent rise would not worsen trade deficit. Following Bundesbank mid-day announcement of no change in German interest rates, dollar rose to highs of DM1.9927 and Yen147.3 before easing on concerted intervention and profit taking.

Sterling has been side-lined for most of the day, trading steadily against the DM with some demand from Europe. After seeing a low of $1.5390 against strengthening dollar sterling regained lost ground as dollar slipped back after concerted intervention.

Rates at 5:37 pm. $1.5447 DM3.0716 DM/$1.9885 Yen/$147.09 Yen/DM73.97.

Michael Foot on duty

NAME: B.Nelson
TEL NO: 270-5558

SECRET

MONEY MARKETS — Thursday 7th September 1989

INTEREST RATES

	£ Interbank Today	£ Interbank Change	Eurodollar Today	Eurodollar Change
7 days	13 15/16	0	8 7/8	0
1 mth	14	0	8 15/16	0
3 mth	14 1/32	1/64	8 15/16	0
12 mth	13 3/4	0	8 7/8	0

BILLS

	Today	Change
3 Month Treasury Bills	13 9/16 - 13 7/16	0

BANK MONEY MARKET OPERATIONS

	Purchases £ m	Rates	Discount Rate on Eligible Bank Bills
Band 1 (0-14 days)	536	13 7/8	14-13 3/4
Band 2 (15-31 days)			13 27/32-25/32
Band 3 (32-63 days)			13 23/32-11/16
Band 4 (64-91 days)			13 9/16-7/16
TOTAL BILLS	536		
Repurchase			
Lending	25		
TOTAL OPERATIONS	561	against shortage £ 550 m	

US RATES

	3 month CDs		10 yr Tsy Bond		20 yr Tsy Bond	
Today/Change	8.80	0.00	8.17	-0.01	8.23	-0.02

STOCK MARKET

	FT Ind-Ord		FTSE		Gilt index	
Today/Change	1999.1	20.4	2415.9	25.1		0.00

HONG KONG	Previous	Today	Change
Hong Kong Dollar	7.8103	7.8095	0.0008
Hang Seng Index	2577.62	2583.16	5.54
3 month interbank rate	9 3/16	9 1/4	up 1/16

MARKET COMMENT

GILTS opened 1/16 better through the list and by mid-morning, was 1/8 better on modest bear closing. By early afternoon the tone had improved further following the Bundesbank decision and gains of 1/4 were seen in all sectors. Sellers of longer maturities were, however, reported at these best levels and by the close shorts were 3/16 better, mediums 1/8 and longs only 1/16.

INDEX-LINKED perked up a little, particularly medium maturities, and closed up 1/8.

EQUITIES opened firmly and progressed well for the rest of the day. Polly Peck has agreed to purchase Del Monte for £557mn, financed partly by a well-leaked rights issue for £283mn

NAME: James Welch
TEL NO: 270 4616

SECRET

GILT-EDGED MARKET Thursday 7th September 198

Transactions basis, cash values (£m); sales + purchases -

ISSUE DEPARTMENT: MARKET TRANSACTIONS

	Today	September
Gross sales shorts	25.8	165.6
Gross sales mediums	28.8	185.9
Gross sales longs and undated	44.8	193.6
Gross sales index-linked	21.9	52.5
Part paid calls		
Buying in non-next maturities shorts	-27.2	-199.4
Buying in non-next maturities mediums	-25.1	-253.9
Buying in non-next maturities longs	-50.8	-260.0
Buying in non-next maturities index-linked	-21.8	-81.9
CRND: Market transactions		-0.2
TOTAL 'GROSS' SALES	-3.6	-197.8
Buying in of next maturities		-6.5
Redemptions	-0.2	-0.7
TOTAL TRANSACTIONS WITH MARKET	-3.8	-205.0

Future calls

Sales required to meet * target of £ m

PRICES/YIELDS OF GILT-EDGED STOCKS

	Yesterday's close	Change from yesterday's close	
	Par yield (per cent)	Price (£/32)	Yield (%)
Shorts	10.689	6	-0.03
Mediums	10.147	5	-0.03
Longs	9.566	2	-0.01

REPRESENTATIVE STOCKS

	Price (£/32)			Yield (per cent)	
	Today		Change	Today	Change
8% Treasury 1992	92	24	7	11.30	-0.07
8 3/4 Treasury 1997 'C'	92	5	5	10.21	-0.03
11 3/4% Treasury 2003/07	113	31	2	9.84	0.01
3% Treasury 1992	84	28	2	9.33	-0.03
2 1/2% Index-Linked 2016	114		5	3.49	-0.01
2% Index-Linked 1994	104	14	2	3.05	-0.01

GILT FUTURES

		Open	Close	Volume
Long Contract	December	94.26	94.30	15366
Medium Contract	December			

NAME: James Welch
TEL NO: 270 4616

PRIME MINISTER 19 July 1989

C B I SURVEY

On Tuesday (11.30) 25 July, the CBI will release figures showing that the monetary squeeze is working. In manufacturing they will show:-

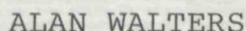
- the greatest decline in "optimism" since October 1982;
- investment intentions levelling off but not yet declining;
- orders down more than expected;
- continued modest growth expected, however;
- the expected reduction in stocks, over a 9-month period, turned out to be an increase;
- increased pressure on factory gate prices;
- increases in unit cost, especially labour costs?

With the exception of the cost pressure, this news is all consistent with the predicted effects of the monetary policy change in the second half of 1988.

On retail sales, all the preliminary indicators for July suggest that they have stopped growing and may even show a decline. Smaller increases in prices are expected as competition bites.

CBI have tried to translate these survey results into a future inflation figure and they have found them consistent with a 2.5 to 3.0 figure. I think we should treat this as their "guess" and put little or no credibility to it - yet.

Tomorrow (Thursday) the Chancellor and Terry Burns will get a CBI briefing before publication.



ALAN WALTERS

PRIME MINISTER 19 July 1989

PRCG 19/7

Good MT

MONETARY POLICY & EXCHANGE RATE TARGETING

The CPS held a conference on 18 July on "Monetarism Lost" a booklet by Tim Congden. Congden believes in targeting broad money and argued that since 1985 our policy has been inflationary. His argument was efficiently demolished, however, by Peter Lilley who showed that M_3 and particularly M_4 (= M_3 + building society deposits) were most misleading indicators, and that Mo was best. With the equivocal exception of Goodhardt, the other speakers (Lomax of Nat West, Budd of Barclays, Minford and Budgeon) all agreed with the Lilley critique and added substantially to the case for Mo.

The other remarkable feature was the general aversion, or at least scepticism, of targeting exchange rates. This is new. Both John Redwood and Patrick Minford remarked independently that they had detected this as a marked change from previous conferences.

Of course partly this may be due to the splendid outcome from Madrid, but we believe that there has been a noticeable change in the intellectual climate. Item: even Sam Brittan did not ride his careworn hobby horse - and he had ample temptation since Congden was also against joining the ERM.

AW

ALAN WALTERS

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PRIME MINISTER 13 June 1989

THE CAUSES OF THE PRESENT INFLATION

1. The Treasury point out that G6 is inflating but, as in the past, less than the UK. The reasons for G7 inflation listed by the Treasury include only the "usual suspects":

- monetary indicators awry because of deregulation;

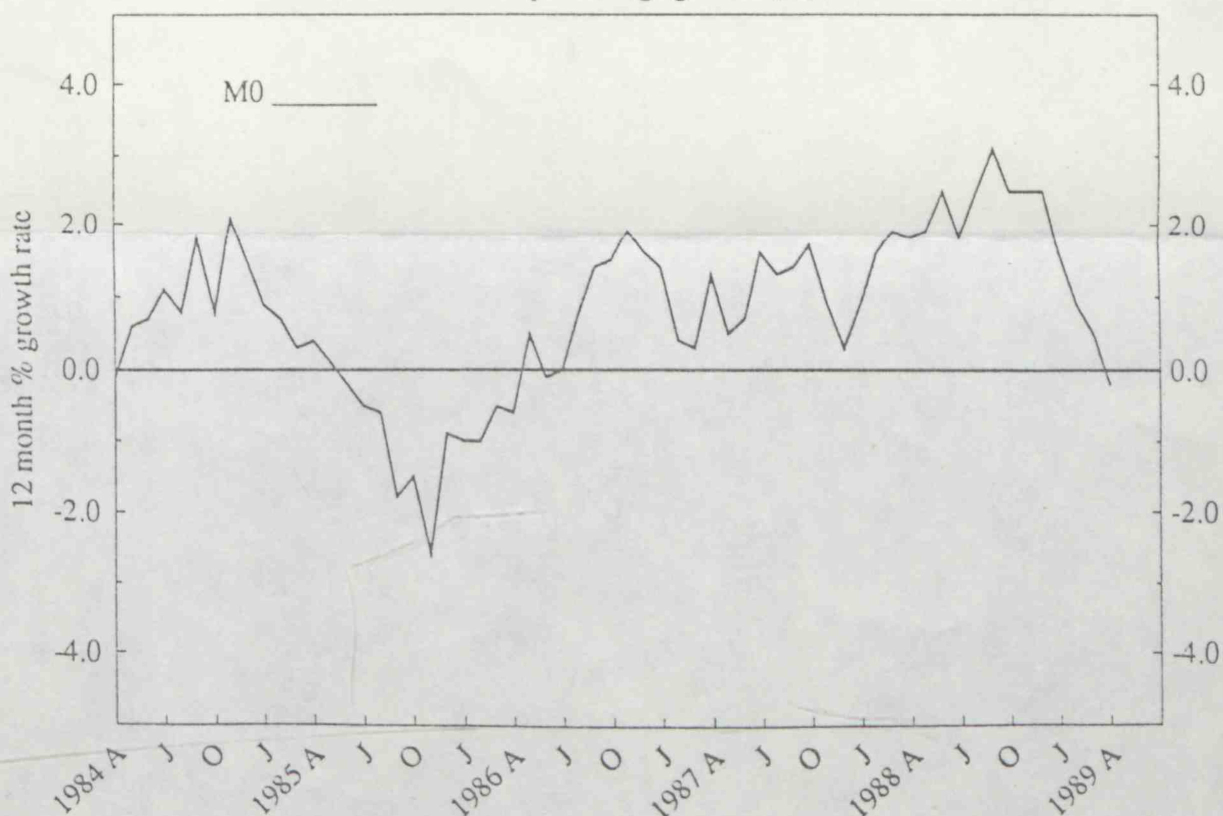
- oil prices - oddly enough because of the fall in 1986 rather than the rise!

- remaining over-liquid well after the October 1987 crash.

The Treasury do not point out that such G7 inflationary periods have always followed attempts by major countries to target nominal exchange rates (in 1972/3, 1978/9 and 1986/7).

2. These reasons for G6 inflation are applied a fortiori to the UK. The main cause in the UK is, rightly, reckoned to be monetary growth. It is admitted that policy in the last three years should have been tighter "but it is difficult even now to say how much".

3. Although agreeing that MO is the best indicator of monetary policy, the Treasury argues that it would not have given early enough warning of the demand pressures (paragraph 10). There is some truth in this. But I find it difficult to square with the following (Treasury) figure on real MO. This shows clearly the expansion in the rate of growth of real MO from mid 1986 onwards. [See Chart 4 attached]



4. The Treasury are however right to reject broad money (Congden) as a cause; it has cried wolf too often since 1980. Similarly the policy of not over-funding was not a contributor to inflation. I agree also with the main thrust of paragraph 13 that we cannot (and I believe should not) use monetary policy to attempt to eliminate the effects of shocks. Its job is to keep inflation low and stable.

5. On exchange rates, the Treasury seem to be confused. An axiom of policy is that our monetary policy, relative to those of our trading partners, is an important determinant of our market exchange rate. However, market exchange rates are also influenced, sometimes dramatically, by a myriad of other factors - political upheavals, foreign wars, disasters, oil, rumour and report. Clearly we should not adduce exchange rate declines due to troubles in China as evidence of monetary ease in the UK. In my view, we do not know how to sort out, even less measure, the effects of monetary policy from all the other influences on the market rate. So, for judging monetary conditions, the market exchange rate has been and is a treacherous yard-stick.

6. The market exchange rate is one of the vehicles (and a very important vehicle) through which monetary policy affects inflation. But it is only a vehicle and, contrary to the Treasury's paragraph 15, it has no separate effect on inflation. Of course one may fix an official exchange rate and vary interest rates or monetary growth in order to maintain the official rate. But still, it is monetary policy, duly subservient to the official exchange rate target, that determines inflation. Monetary policy is jigged to deliver a market rate equal to the official peg.

7. The Treasury's arguments for holding sterling up were the same as when they rapidly changed to holding it down

(paragraphs 16-17)! It is of interest to note that the BIS report has warned that "focussing on nominal exchange rate stability when differentials in inflation and productivity growth persist at best [leads to] real exchange rate changes in the wrong direction, the erosion of competitiveness and ... the aggravation of external imbalances. At worst, it leads to an irresistible appreciation of the 'wrong' currencies with high interest rates and to even worse ... imbalances." Amen.

8. Paragraph 18 argues that, since intervention is, on any definition, sterilized, it has no effect on money supply or interest rates. If it is all sterilized contemporaneously, then it has no effect (except for a day or so at most) on exchange rates. But if the ineffectiveness of intervention to contain the rise in the Dmark in early 1988 lead the Treasury to reducing interest rates with consequent expansion of monetary growth, the end effect is much the same. In any case, it is difficult to see any, except the most fleeting and transitory, role for sterilized intervention.

9. The Treasury's basic excuse is that everyone was inflating, and that our errors were only a little, if anything, worse than the G6. This attitude does not learn from the fact that United States monetary policy since 1987 has avoided the errors we made and appears set to deliver a soft landing. As distinct from our policy, for example, the Fed reigned back very rapidly the liquidity to deal with October 1987. Nor has the Fed markedly relaxed its policy to keep the dollar down in recent months: domestic conditions have been paramount. Similarly, we can learn from the Bundesbank experience: they changed from a monetary base target to a wide money target (which they have since exceeded). Partly this was due to French pressure in the EMS and partly to other factors. But Germany now has what they regard as

a serious inflation problem - hence the decline of the Dmark. The variation of experience between the G7 is informative, but alas is ignored by the Treasury.

10. TREASURY CONCLUSIONS

The thrust of the conclusions (i e with all the excuses too loose a monetary policy) is correct. But the phrasing is on occasion incomplete and opaque. For example, they conclude that [21(g)] "excess depreciation ... remains an essential ingredient". But what defines excess: with respect to where the pound is at present?; purchasing power parity (however measured)?; the market rate?; "sustainable" current account deficits? and so on. It is meaningless. One man's excess is another's success.

11. MY CONCLUSION

Although many of the conclusions are sensible, the supporting argument is weak and resembles special pleading. It aims to show that, at the time, they did the right thing ... only with the benefit of hindsight, etc. This is not good enough. We must acknowledge and learn the lessons.

ALAN WALTERS

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C

PRIME MINISTER 13 June 1989

A CHAIN REACTION -
THE EXCHANGE RATE AND MONETARY POLICY

A. The 4 to 1 Rule

In discussions with the Treasury and Bank, I have become increasingly worried about the Pavlovian reaction of our monetary policy to exchange rate movements - or indeed the Authorities' anticipation of such movements and the reaction of the market. To illustrate, there was some considerable support for arguing that, if our £ERI fell to 88 (from the 92 of last Friday), we should increase interest rates by 1 per cent.

This is the sort of rule-of-thumb, which Charles Goodhart says in the June ECONOMIC JOURNAL emerged from the "Treasury Model", that explains the interest rate policy pursued in 1987 through to mid 1988. As the exchange rate rose 6 pfennigs (2 per cent), interest rates were reduced by 1/2 per cent. For present conditions we translate this: when the exchange rate falls 4 per cent, then interest rates are increased by 1 per cent. Nothing has changed except the direction.

B. Self-validation and chain reactions

It is claimed of course that there will be great discretion in interpreting exchange rate movements - discovering whether they are due to monetary policy or the many other events which have a considerable effect on rates. But the market believes, with Goodhart, that the Treasury is operating a rule. I suspect that the Chancellor's speech at Wednesday's debate was interpreted as confirming the rule. So the

ie the sentence we discussed at lunchtime. PRCG.

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market reacts to such exchange rate movements and the rule becomes self-validating. There is no room for discretion.

Worst of all is the chain reaction which may set in. Suppose we have a string of bad poll results in 1990 or early 1991. The market will interpret this as increasing the probability of a Labour government and will start a capital flight, eroding exchange rates, increasing interest rates, eroding our poll support, and so on in a chain reaction.

C. Experience in 1983 and 1987

Fortunately in 1983 and 1987 there was no reputable (i e believable) poll that gave any significant chance to a Conservative loss. Nevertheless we had already taken some action to counter a potential capital flight - issuing more indexed linked gilts, and in 1983, a convertible. Fortunately the polls were so consistently good we did not need them. The boat was not rocked. Sterling was under no threat at all.

I do not think it would be wise to anticipate confidently a re-run of 1983 or 1987 in 1991 or 1992. We need to make sure that the markets know we are for ever off the 4 to 1 treadmill. Even those who believe in the primacy of the exchange rate in determing monetary policy must recognise that the 4 to 1 rule is not the way.

D. What can be done now?

The obvious "tough-it-out" policy of strictly fixing interest rates to conform to our monetary growth and ignoring completely the exchange-rate-poll reaction is economically right.*

But it is politically unrealistic - especially for sharp and sudden falls in the exchange rate, even though these falls are clearly due to changed electoral prospects.

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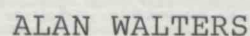
We do not need, however, to oppose and fight a gradual drift in the exchange rate. And this should be made perfectly clear to the markets. The "4 to 1 rule" should be abrogated.

In fact we have already made a start in divorcing monetary policy from this rule. It has been relatively easy because of the decline of the Dmark against the dollar. What we ought to avoid is being manouvered on to a new rule with respect to the effective rate. One such translation of the old Treasury model rule would be that, for every depreciation of 4 points on the ERI, interest rates should increase by 1 per cent. (This is consistent with the Treasury view that, if the ERI fell from its present 92 to 88, interest rates should increase by 1 per cent.) Provided that we drift gradually to 88 - over a period of (say) more than three weeks - and provided that the markets are not inexorably pressing, we should not increase interest rates.

This gradualist policy is feasible both politically and economically, and would allow the adjustment of exchange rates to the underlying realities. It would also send a message to the market that we were not operating on any rule of a 4-to-1 kind. This would reduce, but not eliminate, the chain reaction effect.

* Today, the BIS have come to our assistance in condemning policies pursuing nominal exchange rate stability. It points out that such policies hinder adjustments for past inflation and for current account imbalances.

ALAN WALTERS



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B

PRIME MINISTER 13 June 1989

INTERVENTION AND RATES: 13 JUNE

We have spent about $700m, most of it in the afternoon, in a "two-pronged" attack - with your support in the House as the other prong.

The effects of such a substantial intervention do not appear to be obvious in the market data. In fact the exchange rate firmed up as New York opened before the main intervention. And it did not appear to move as the purchases were recorded. Similarly the interbank 7 day stayed at just below 14½ per cent.

I doubt if this intervention is any more than cosmetic. Eddie George thinks he needs some intervention to give signals to affect the psychology of the market and prevent it running away. But $700m is high-priced psychology.

I still believe that our monetary squeeze is the right order of tightness to restore 4 per cent inflation by 1991. A gradual decline of the exchange rate of sterling is quite consistent with that programme (as we showed in the joint decline of sterling and inflation from 1981 to 1983).

but unfortunately the market does not always deliver gradual changes! PRCG.

The alternative of increasing interest rates is fraught with uncertainties and danger. First, one may have to choose between no increase and 16 per cent plus, since it is not at all clear that a 15 per cent rate would stem the outflow. A 15 per cent rate may be interpreted as a signal for an even higher rate. Secondly, a rate increase would undoubtedly risk a considerable recession in 1990 with the depths being reached at the end of that year. The timing could not be worse.

The pressure on exchange rates and so on the money market is virtually entirely generated by the markets' belief that we will not allow any depreciation (say below 90 or 3.07 Dmark) and that we will put up interest rates. It seems to me to be crucial to make it clear that we shall not dance to the tune dictated by the perceptions of participants in the exchange rate markets. It is not a question of fighting present inflation. That is taken care of by a suitably tight monetary policy. But it is a question of survival in the next election.

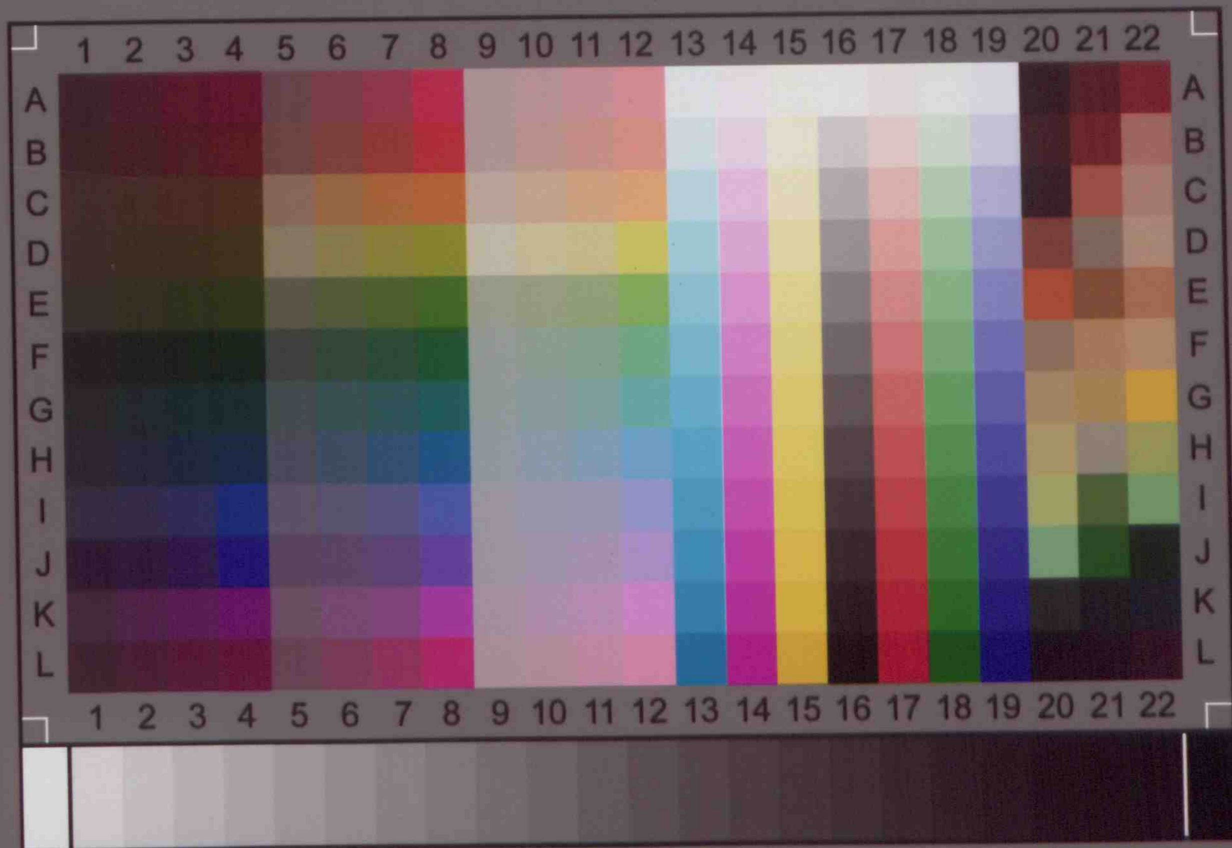
ALAN WALTERS

PART 3 ends:-

A. Walters to AT 18.5.89

PART 4 begins:-

A. Walters to PM 13.6.89



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