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MARKETS

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NOTE OF A MEETING HELD AT No.11 DOWNING STREET

AT 10.30 am ON TUESDAY 20 OCTOBER

Present:

Chancellor	Deputy Governor
Economic Secretary	Mr George
Sir P Middleton	Mr Loehnis
Sir T Burns	
Mr Cassell	
Mr Peretz	
Mr R I G Allen	
Mr Cropper	

MARKETS

The Deputy Governor reported that the equity market had fallen a further 240 points that morning. It had now fallen 22 per cent since the previous Thursday; Wall Street was off 26 per cent and Tokyo off 17 per cent. There were rumours that a number of US securities houses were in difficulties. In the London market, the Bank had been in touch with those banks which had securities subsidiaries: none of them seemed to be in particular difficulties at the moment, though some had lost substantial amounts. The Bank had also asked the Stock Exchange to talk to those market makers which were not owned by banks, but had not had any response yet.

2. In the exchange markets the dollar had fluctuated, falling on Monday morning but picking up that evening on the news of the Baker/Stoltenberg/Poehl agreement. It was now close to DM 1.80. Sterling had hit 3DM in Tokyo and the Bank had bought $236 million. Against the dollar, sterling had risen to nearly $1.69 as the dollar weakened, but had now fallen back to around $1.66.

3. The bond market in New York had strengthened on the expectation of an interest rate cut, and the gilt market in London had opened 2½ points up; but that had attracted some chunky selling, by insurance companies in particular, and it had fallen back.

4. The Chancellor thought that, for the UK, there were two difficult areas but also some relatively helpful effects. The markets we were most directly concerned with - the foreign exchange and gilt-edge markets - were not causing any problems. And we had wanted to cool things down a bit, which the fall in the Stock Market would certainly do. The two possible areas of weakness were

(i) if there were any UK houses in financial difficulty, though from what the Deputy Governor said this was not the case at present;

(ii) the BP offer; he had already made it clear that we had no intention of pulling the offer. The whole reason for having it underwritten was to guard against the risk that the price might fall.

5. The Deputy Governor noted that the Bank would be monitoring the exposure of underwriters and sub-underwriters; at present there did not seem to be any major problems. But he noted that if the fall went on for several more days, then the Bank might want to reconsider this view.

6. Mr George thought that the recent developments had some positive aspects. The realignment of the dollar against the deutschemark gave more room for sterling to rise in effective rate terms. And the fall in equity markets could be helpful to the gilt-edge markets, and hence to our funding programme, and should imply some tightening of policy. If the fall was short lived, the overall effects could be moderately helpful. But if - though this was unlikely - we did see large falls for several more days, the situation could get more problematic. There were risks that the US could be dragged into recession. And in the UK the company sector could be badly affected because of the impact on pension funds.

7. Sir T Burns also thought recent events could have quite a helpful effect on monetary conditions. They represented a considerable tightening of policy. But he would not want to underestimate the effects of domestic demand; the wealth effects could be quite substantial. The main policy problem might be that the pound could strengthen, especially if interest rates in the US fell. Up till now we had thought that dealing with upward pressure on the pound by cutting interest rates was out of the question. We might need to reconsider that, if not immediately.

8. Summing up, the Chancellor said it was agreed that there was no immediate action to be taken, but the position should be kept closely under review.

ACSA

A C S ALLAN

21 October 1987

Distribution:

Those present
PS/CST
Sir G Littler
Mrs Lomax
Mr C W Kelly
PS/Governor

NOTE OF A MEETING IN THE CHANCELLOR'S ROOM HM TREASURY AT 10.30AM ON FRIDAY 23 OCTOBER

Present		
	Chancellor	Deputy Governor
	Economic Secretary	Mr Loehnis
	Sir P Middleton	Mr Gulpin
	Sir T Burns	Mr Coleby
	Mr Cassell	
	Mrs Lomax	
	Mr Peretz	
	Mr Ilett	
	Mr Cropper	

MARKETS

After some discussion about the current market situation, the following points were agreed:

(i) The fall in the stock market had tightened monetary conditions, and a half per cent cut in interest rates was now appropriate. But it was important that this should be easily reversible if circumstances changed.

(ii) It would not be appropriate for the Bank to make any statement about standing ready to provide liquidity as necessary (on the lines of Mr Greenspan's remarks): the markets were already well aware of the position, and a statement might (falsely) cause alarm that the authorities knew that some firms were in difficulties.

(iii) There should be a temporary funding pause: the Bank should let yields rise further before they accepted bids for the remaining tranchettes; and should not bring forward any new issues for the time being. It did not make sense to stop long yields from falling, thus making it easier for investors to get out of equities into gilts. But the position should be kept under review.

(iv) There should not be any statement about a funding pause. The fact that the Bank did not bring forward any new issues would of itself be taken as a signal by the markets.

(v) The Deputy Governor would discuss with the Chairman of the Stock Exchange whether there was any case for the UK Stock Exchange to close early or open late for a temporary period. But there were no signs in London that the backlog of paper work was getting any worse.

2. Mr Loehnis reported on the discussions going on in Hong Kong about reopening the Stock Market.

ACSA

A C S ALLAN
30 October 1987

Distribution
Those present
PS/Chief Secretary
Sir G Littler o.r.
PS/Governor

New page 6 & pup

SECRET

NOTE OF A MEETING IN CHANCELLOR'S ROOM HM TREASURY

AT 11.45am ON WEDNESDAY, 2 DECEMBER

Present: Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr R I G Allen
Mr Cropper

Governor
Deputy Governor
Mr George
Mr Loehnis

MARKETS, AND G7

Markets

The Governor reported that the dollar was reasonably steady that morning, having recovered from its lows on Monday. This in part reflected the markets discounting a cut in the German discount rate on Thursday. Poehl had spoken to the Governor earlier that morning, and said that this cut could not be regarded as certain: some on the Bundesbank council felt it would be better on tactical grounds to hold up a cut until a G7 meeting; and others felt that the US would simply use the opportunity to cut their rates. The Governor had also spoken to the Larosiere, who had said that if the Germans did move ½ per cent, the French would move ¼ per cent.

2. Sterling was nudging firmly against 3DM: we had taken in $620 million in total the previous day, and $45 million in the Far East that morning. He thought that if the Germans did move, we would face even stronger upward pressure. In these circumstances he felt it would be appropriate for us to match the Germans and cut our rates by ½ per cent.

3. Sir P Middleton said he had discussed the general monetary situation with Treasury and Bank officials the previous day. There were some troublesome features about the present position:

(i) there had been a sizeable build-up of liquidity, and M0 was showing signs of moving above its target range;

(ii) although monetary conditions had tightened, the economy was still growing very strongly, and inflation and output were both higher than we had expected;

(iii) there were some dangers that the global inflation rate might rise.

But he felt that the only sensible course of action was to stick to our policy of holding the exchange rate against the Deutschemark. That seemed the most likely way of achieving our long-term goals, and we should not be driven off that in either direction. He agreed with the Governor that ½ per cent off interest rates was indicated. A concerted move on interest rates by the Europeans would be much better than heavy intervention.

4. Mr George said he remained concerned that we were taking risks with our counter-inflation strategy. The prospects for inflation had improved because of the rise in the effective exchange rate and the general weakening of commodity prices. But what concerned him most was the domestically generated inflationary pressures. He accepted that if we stuck with the Deutschemark we would eventually see rewards: but he was concerned about letting monetary conditions get so lax in the meantime. However, given our exchange rate policy, he accepted that a ½ per cent cut in interest rates was more desirable than heavy intervention.

5. Sir T Burns said he was less alarmed by the short-term risks. We had stuck to the Deutschemark at a time when the dollar was falling sharply, and that had produced a significant tightening of monetary conditions. He now expected the inflation rate to be

lower than forecast in the Autumn Statement. He thought the case for not letting sterling rise against the Deutschemark was overwhelming. The real policy problems would occur when pressure on the exchange rate turned.

6. Mr Cassell said that he too agreed that for tactical reasons we should cut interest rates by ½ per cent if the Germans did. Monetary and fiscal conditions had certainly tightened, though it did look as if the base from which that had occurred was rather looser than we had originally thought.

7. Summing up, the Chancellor said there was general agreement that we should cut interest rates if the Germans did. An additional point was that business confidence had been holding up very robustly following the stock market collapse, but nerves had set in over the last week as the dollar and the stock market had fallen further. He asked for views on whether we should move if the Germans did not move; and on whether we should resume funding more aggressively.

8. The Governor thought that if the Germans did not cut their interest rates, perhaps because they were holding back for a G7, we should probably not cut ours. Conditions in the equity market remained fragile, and he would be cautious about aggressive funding.

9. Mr George thought that if the Germans did not cut their interest rates that would send the dollar diving: in those circumstances we were unlikely to see the 3DM rate tested. But if we did find we were having to continue with massive intervention, he would prefer to see a cut in interest rates even if the Germans had not moved. Sir P Middleton agreed.

10. On funding, Mr George thought that even without the weakness in the equity market, we did not face a very robust gilt market.

Forcing prices down in order to stimulate sales was not likely to be productive. The only likely option was a convertible gilt. Sir P Middleton commented that an alternative would be not to bring National Savings rates down.

11. Summing up, the Chancellor said that it was agreed that if the Germans did not cut their interest rates, but waited for a G7, we should probably do the same unless strong upward pressure on sterling reappeared. The time did not seem propitious for aggressive funding, but he agreed with Sir P Middleton that it might be sensible not to reduce National Savings rates for the time being.

G7

12. The Chancellor said the main ingredients for a G7 meeting, other than on exchange rates, were now in place:

(i) the US budget package was likely to go through Congress; but even if it did not there was the Gramm Rudman fallback.

(ii) The Germans had announced their fiscal package; and would no doubt be prepared to say they stood ready to do more if necessary.

(iii) The Japanese economy was growing quite strongly, and the Japanese would be prepared to make suitable assurances.

(iv) The position on the monetary front, in Europe at least, was clear.

13. The major question was whether the US was prepared to commit themselves to action to stabilise the dollar. That was what the markets would be looking for. He had grave doubts about what the US would be prepared to do: even though Secretary Baker and President Reagan agreed with stability in principle, they did not seem willing to agree to use the necessary instruments. Baker was not ready to refer to stability "around current levels"; and the

Germans myopically thought this was helpful because it implied the dollar might go up.

14. Although Baker in private accepted that the US interest rates might have to go up, he was not prepared to say it publicly. Sentiment in the US was ridiculously concerned about the dangers of a recession, even though the US economy remained strong. In the Chancellor's view, it was not necessary (though it might be desirable) for the US to put its interest rates up straightaway. But what they needed to make quite clear was that they were committed to dollar stabilisation and if that required higher interest rates, they would do.

15. One other thing which would have a favourable effect on the market would be US foreign currency borrowing. But there were US political difficulties there too. Baker had, however, said that he would look at this again.

16. The Governor said that he thought the most damaging thing would be a "ceremonial" G7 meeting. He thought the chances of a meeting before Christmas producing anything convincing or concrete were slender, especially given the uncertainties over the US budget process. So he would prefer to wait and hold a meeting in January.

17. Sir P Middleton said that although a meeting was not likely to have a very satisfactory outcome, he thought that if Baker and others wanted one, we should not resist it though we should certainly not push for it. He doubted whether an unsuccessful meeting would make things worse than having no meeting. The mere fact that Ministers were co-operating would provide some help.

18. The Deputy Governor thought an unsuccessful meeting would have a rather more adverse effect. He thought there was something to be gained in waiting to see what the US budget negotiations produced. Sir G Littler agreed; he thought that meeting a week before

Congress settled the budget package would make Baker more reluctant to say anything about the exchange rate.

19. Mr George thought that US action on interest rates was the key. Without that, commitments to stability did not mean much, and it could be dangerous to have a meeting. It would be difficult for the US to talk about interest rates going up while the fiscal package was going through Congress, and so he saw advantages in waiting. He did not think foreign currency borrowing by the US was an adequate substitute, though it would be better than nothing. He doubted whether not having a meeting would do any great damage to the market. An alternative to a meeting would be some sort of statement saying that Governments had taken the necessary fiscal action, and these now needed time to work through.

20. Sir T Burns felt that without something worthwhile on the exchange rates, a meeting would not be worthwhile.

21. Mr Loehnis said the markets were not really expecting a G7 meeting. He felt that there were dangers over having no meeting at all: the fact that Ministers and Governors sat down together to discuss these issues would itself provide some reassurance; and, conversely, an inability of Ministers and Governors to agree to a meeting would be taken badly.

22. Summing up, the Chancellor said the general view was that if the US would not accept suitable action on exchange rate stability, then we should discourage a G7 meeting. But we should do this carefully: it would look bad if the UK were seen as obstructing international co-operation.

23. He was not convinced that waiting until January would help the position much. The central issue was still whether the US would commit themselves to stabilising the dollar, and this was unlikely to change between now and January. So if there was no December

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meeting, he felt we should not press for a meeting in January instead, but should look for each country to make a national statement, which would be released in a concerted way.

ACSA

A C S ALLAN

3 December 1987

Distribution

Those present
PS/EST

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Covering SECRET

Pup

FROM: A C S ALLAN

DATE: 7 December 1987

PS/ECONOMIC SECRETARY

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz
Mr R I G Allen
Mr Cropper
PS/Governor B/E

MINUTES OF MARKETS MEETINGS

I regret that, in the aftermath of the BP support operation, minutes of two Markets meetings (on 30 October and 4 November) were never circulated.

... 2. These are now attached, together with the minutes of the meeting last Friday.

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A C S ALLAN

SECRET

NOTE OF A MEETING IN NO.11 DOWNING STREET
AT 11.45AM ON FRIDAY, 4 DECEMBER

Present

Chancellor	Governor	)
Economic Secretary	Deputy Governor	)
Sir G Littler	Mr George	) B/E
Mr Peretz	Mr Loehnis	)
	Mr Gill	)

MARKETS

The Governor reported that the interest rate cut had not reduced the pressure on sterling, which remained hard up against 3DM. Intervention the previous day had totalled over $900 million, and there had been intervention in the Far East that morning of nearly $200 million. Things were rather quieter in London, but pressure could well return when the New York markets opened.

2. The Bank had explored as far as they could with the Bundesbank the scope for purchasing deutschemarks. The Bundesbank was very firmly opposed. They argued that to do so would cause strains within the EMS, and that it was counter to the EMS agreements. The prospects of securing agreement on the central bank network were closed. If we were going to do this it would be essential for the Chancellor to speak to Stoltenberg.

3. The Chancellor asked how our membership of the EMS fettered us. Sir G Littler explained that the agreement establishing the EMS, and the related central bank agreement, restricted members of the EMS to holding working balances in currencies of another country. Even though this had been modified recently, the new agreement simply said that large cross-holdings could be expected to emerge without a change in the underlying rules.

4. The Chancellor said he was not prepared to see the exchange rate go above 3DM: that would have a devastating effect on business confidence. There might come a time when a further ½ per cent off interest rates was needed, but it would be ridiculous to be rushed into that. We would have, therefore, to rely on a further intervention. The overwhelming bulk of our intervention recently had been in dollars and he did not wish that to continue. It was not our policy to build up too large a weight of dollars in our reserves; and, in his judgement, intervention in deutschemarks would have considerably more effect. He accepted that difficulties might be caused to the EMS if we intervened in deutschemarks alone; he therefore proposed that we should intervene in a basket of non-dollar currencies.

5. Mr George said that while he had great sympathy with what the Chancellor was proposing, it would be difficult if we were seen to switch suddenly from buying dollars to buying European currencies. That could have the appearance of an abrupt change, and would be taken as a marked loss of confidence in the dollar. There was also the technical problem that much of the pressure came in New York, where it was difficult to deal in many non-dollar currencies.

6. The Chancellor said he was not proposing a switch to buying non-dollar currencies exclusively, though that would be appropriate in the short-term since we had already bought $1 billion over the last day or so. But he accepted that there was a case for buying some dollars noisily, when the New York markets opened.

7. He asked the Bank to do a significant burst in non-dollar currencies that afternoon - perhaps £100 million worth, with a further £100 million if necessary. The Governor could explain to Poehl why the Chancellor wished this done; Poehl should understand that it would not make sense for sterling to rise against the deutschemark. At least half of the intervention should be in deutschemarks, with the rest being spread among French francs, Guilders, Yen, Swiss francs and any other significant currencies.

8. This operation was certainly not designed to attract press attention, and a low profile was appropriate. But if pressed the line should be:

(i) to confirm that we had been intervening, as we had done on and off for some time, to maintain the stability of sterling against the deutschemark;

(ii) to say that for some time our policy has been to hold reserves in a variety of currencies, and not just dollars.

If the Germans were foolish enough to make their concerns public, then the line should be:

(iii) we had informed them in advance;

(iv) we had been careful to buy a mix of currencies so as not to cause ERM problems.

Postscript

9. The Governor subsequently rang the Chancellor to say that he had spoken to Poehl, who had reacted extremely negatively. He would stand full square on the various agreements, and maintain that what we proposed ran counter to agreed policy. After some discussion, the Chancellor confirmed to the Governor that the operation should go ahead that afternoon in all currencies except deutschemarks. He would raise the issue with Stoltenberg when he saw him on Monday and asked the Governor to pursue it with Poehl at Baslc.

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A C S ALLAN

7 December 1987

Distribution

Those present
Sir P Middleton
Sir T Burns
Mr Cassell
Mr R I G Allen
Mr Cropper

SECRET

NOTE OF A MEETING IN NO. 11 DOWNING STREET
AT 1PM ON WEDNESDAY 4 NOVEMBER

Present:

Chancellor	Governor
Sir P Middleton	Deputy Governor
Sir T Burns	Mr George
Sir G Littler	

MARKETS

The Governor noted that the equity market had fallen a further eighty points that morning, following a sizeable fall the day before. The London market was now some 30 per cent down on its mid-October level, compared with about 15 per cent in New York and Tokyo. The exchange rate remained firm. He thought that in these circumstances a further ½ per cent off interest rates now seemed justified.

2. Sir P Middleton said that he had been in favour of waiting, possibly until a G7 meeting, before contemplating a further cut in interest rates. But he thought the present fragile circumstances meant that the decision should be brought forward.

3. The Deputy Governor thought that it was very unlikely we could get through the following day without making a move on interest rates. It would be better to move pre-emptively now, rather than face another difficult opening tomorrow.

4. Mr George said that he fully accepted that we might need to make a move for short-term tactical reasons even if that meant cutting rates below what might be desirable in the longer term. He would have preferred to wait until we knew whether the Germans were moving their rates the following day, since if we could all move together that would have a very helpful market effect.

5. The Chancellor said that the balance of advantage seemed to be to move immediately. He agreed with Mr George that it would be preferable, other things being equal, to move with the Germans the following day. But we could not know whether the Germans would move; and if we did not move either today or the following day, that could have a very bad market effect. The Bank should therefore announce soon after 2 pm that they would lend at 9 per cent. He would speak to Stoltenberg and Baker as soon as possible to inform them of this decision.

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A C S ALLAN

Distribution

Those present
Mr Cassell
Mr Peretz
Mr R I G Allen
Mr C W Kelly
Mr Cropper

NOTE OF A MEETING IN THE CHANCELLOR'S ROOM TREASURY
AT 10.45AM ON FRIDAY 30 OCTOBER

Present: Chancellor
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr R I G Allen
Mr C W Kelly
Mr Cropper

Governor
Deputy Governor
Mr George

MARKETS

The Governor reported that the markets the previous day had been looking for a ½ per cent cut in interest rates. But rates were a little firmer that morning, at around 9¼ per cent. The equity markets were generally looking firmer. In the gilt market, the Bank had sold nothing since the end of the previous week. Intervention had been heavy, although the recent fall in the dollar had taken some of the pressure off. He thought that the combination of the interest rate fall the previous week, the absence of any funding and the heavy intervention meant that there was no case for cutting interest rates soon.

2. Sir P Middleton said that a balance needs to be struck between maintaining our strategy and dealing with the shock to the system. The important thing about the Stock Exchange fall was its speed, which had given a severe jolt to confidence. The exchange rate had risen, and there had been a tightening of monetary conditions. But some longer-term worries remained: intervention had added to liquidity; M0 was rising fast, and the annual growth of M3 was still rapid. But in the short-term we must not do anything to compound the shock of the stock market fall.

3. Mr George thought we did not at this stage know how large the long term effects of the shock would be. We started from a position where the risks were asymmetric and policy was arguably too lax. The first effect of the stock market fall was therefore to absorb the looseness. He thought the equity market was now quietening down and the amplitude of fluctuations, though still large, was getting smaller. We had done more so far than any other country, both in terms of interest rate cuts and, particularly, in terms of the massive intervention to hold down sterling. There was now the prospect of making substantial losses as the dollar fell. He was more convinced than ever that we should not continue to intervene heavily if the exchange rate remained firm, even if that meant abandoning the 3DM cap. He thought a resumption of funding was essential. If we did not, yields would run away downwards and the re-entry problem would be difficult. An announcement of tranchettes that afternoon would appear business as normal.

4. Sir T Burns said that his view was that, compared to the position a month ago, there had been a quite significant tightening of policy. The fall in the stock market plus the indirect - but significant - effects on confidence outweighed the effects of lower interest rates. The Treasury was in the process of revising down its forecast for both growth and inflation. He thought it was essential to hold on to the 3DM cap. If we let the DM rate go, industry would have to cope with both the loss of confidence arising from stock market fall and the uncertainties about the exchange rate. He thought that would be very unwelcome.

5. The Economic Secretary thought the effects of the financial crash were very serious. The outlook was not symmetrical even if markets recovered. He was in no hurry for funding to resume; the only problem was how we might explain a continued funding pause to the markets; he wondered to what extent some international agreement might be possible.

6. Summing up, the Chancellor said the general view was that we should resume funding, particularly since we would be publishing a large reserve increase the following week. He thought, however, that the Bank had understated the dramatic change in sentiment in the US. Even if market stabilized at their present level, the shock effect in the United States would be very substantial. He was determined to stick to the 3DM cap, though he did not welcome the large-scale intervention. We might want to go for a further ½ per cent cut in interest rates, but not immediately.

BP

7. Sir P Middleton reported on the developments since the previous night, covering the Takeover Panel and the SEC. He noted that the SEC would insist that the public offer in the US was pulled, so that any small shareholders who had applied got their money back. BP had in fact withdrawn it anyway since they were required to assist Goldman Sachs to get registration with the SEC. This was potentially a minor embarrassment vis a vis the UK offer, but not one of substance, since US small share holders could have revoked their applications anyway. The Deputy Governor reported that Wood-Gundy had a bank credit line in place.

8. The Chancellor noted that he had to speak in the House of Commons debate on Thursday. He would be grateful if before then the Treasury and Bank could see if there was anything separate that could be done for small investors. It looked legally very difficult, but the possibilities should be investigated.

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A C S ALLAN

Distribution:

Those present

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NOTE OF A MEETING AT NO.11 DOWNING STREET AT 10.00AM ON MONDAY 14 DECEMBER AND CONTINUED IN THE CHANCELLOR'S ROOM, HM TREASURY AT 5.00PM THE SAME EVENING

Present: Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler

MARKETS

The Chancellor said he wanted to discuss the following issues:

a. Had we run out of road in our policy of intervening to prevent sterling going through 3DM? If not, how long could we keep going?

b. Could we give ourselves more room for manouvre by a sharp cut in interest rates, sufficient for the markets to believe that the next move would be upward (as Sir G Littler had suggested in his minute of 14 December).

c. If we concluded that neither continued heavy intervention nor a large cut in interest rates was practicable or desirable, and so decided to uncap, how large a cut in interest rates should accompany that? And should we go for a new, higher cap? Or should we simply switch to a more flexible policy of offsetting movements in the exchange rate and in interest rates? Or should we say we were taking temporary leave of absence from our existing cap?

d. In all these cases - but particularly for (c) - how should we present our policy?

2. Sir P Middleton said he was still uncertain whether we had got to the end of the road on intervention to hold 3DM; fixing the cross-rate against the deutschemark was a good counter-inflation policy if we could stick to it. If we found we could not sustain the level of intervention required, the alternatives were finely balanced. The arguments for cutting interest rates sharply were that our nominal interest rates still looked relatively high; Government accounts were in very good shape; the fall in the stock market should have a dampening effect on activity; and the emerging current account deficit made it inappropriate to let the exchange rate rise further. On the other hand, existing policy was beginning to lack credibility; the economy was undoubtedly very strong, and some additional discipline on companies might not be unhelpful; and there was increasing doubt whether the fall in the stock market would have much effect on activity. There were definitely some inflationary risks in accepting large reductions in interest rates. Even though it was tempting tactically, it was worrying strategically.

3. Uncapping was not, however, an alternative to cutting interest rates, in the sense that we could then keep interest rates unchanged. He did not believe that the situation was so lax that we wanted to see the kind of tightening that would be implied by a rise in the exchange rate with no cut in interest rates.

4. Sir G Littler said he had little to add to the points in his note. He thought we were suffering from an overhang of liquidity and he would like to get to a position were we could resume funding. But that would be difficult until the present conflicts on the exchange rate were resolved. He thought the best way to achieve that was to cut short-term interest rates sharply - and temporarily; he did not believe that would carry through to long rates.

5. Sir T Burns said he was reasonably well persuaded that sticking to 3DM would bring some downward pressure on inflation and hence on money GDP, consistent with the MTFS. He thought there was a reasonable chance of living with 3DM for quite a long time, at least so long as the better productivity performance in the UK

relative to Germany continued. Our traded goods sector was doing rather better than theirs, and in those circumstances we could accommodate a slightly faster inflation rate while maintaining overall competiveness. This was of course a steady-state analysis, and it was necessary to consider whether we were starting off with a gross undervaluation. But it was difficult to believe that this was so: against the dollar we were at 1979 levels, which implied a very tight position.

6. Paradoxically, the likelihood that we could substain a rate of 3DM for a considerable period itself posed real problems for us: in these circumstances, sterling looked like a good buy at current interest rates. We might therefore have to accept that if we pursued this policy we would have to have lower interest rates. The question was could we live with the consequences. If not - ie if lower interest rates would be damaging to other developments in the economy - then we would have to accept a higher exchange rate. This was a point Sir A Walters had made about fixed exchange rates some time ago: either the exchange rate was not credible, in which case it could not be held; or it was credible, in which case interest rate differentials would have to narrow very substantially. Sir A Walters' argument has been based on a situation where there were large inflation differentials between two countries, which was arguably not the case now so far as the traded goods sectors in the UK and Germany were concerned. But it nevertheless had some validity.

7. The Chancellor asked for views on how long we could hold 3DM by intervention alone. How dangerous was it to build up liquidity in this way? Increasing the reserves was no bad thing: as percentage of imports they were still lower than in most other European countries. The issue was whether the build-up in liquidity ran the risk of producing unacceptable inflationary pressures later on.

8. Sir T Burns said he was not greatly concerned about the extra liquidity generated by intervention. He thought the main effects of extra liquidity worked via the exchange rate and via construction and land prices. In the past, we had never seen large

liquidity effects without a fall in the exchange rate or a property boom. A weak exchange rate was certainly not the problem we now faced, though there were still some worries about the property market. The main danger in extra liquidity was that if there were price shocks, the economy could accommodate them very quickly; it made it harder to bottle up inflationary pressures.

9. He did not feel we could continue much longer with intervention at the sorts of levels we had seen recently, especially since we were causing a great deal of concern among our G7 partners. And if the Government had to intervene substantially in any market then that was prima facie evidence that we were introducing a distortion, as, for example, we had done with over-funding.

10. The Chancellor said the general view was that if pressure on the exchange rate did continue as strongly as it had recently, we could not hold 3DM by intervention alone. He asked for views on the alternatives of a sharp cut in interest rates or uncapping (perhaps coupled also with a cut in interest rates).

11. Sir P Middleton thought that both of the possible scenarios presented difficulties. Neither letting the exchange rate go up and then bringing it back down, nor reducing interest rates and then raising them again would be easy. The second was probably more in line with our recent policy, and would be easier to reverse. The crucial issue was whether if we stuck firmly to 3DM and that required interest rates 1-1½% lower, we would be taking a real risk with inflation. It was not clear that we would, though it would certainly imply a significant loosening of our policy stance.

12. Sir T Burns said that the latest GDP figures were likely to show money GDP growing at 10% a year and real growth at 5%, both rather stronger than in the Autumn Statement. This argued against any loosening of policy. He agreed with Sir P Middleton that if we held the exchange rate by cutting interest rates it would not necessarily have a very large effect on inflation. It would in the short-term lower recorded inflation, and that would itself have helpful effects on earnings. But it would certainly represent a

loosening of policy. On the rough rule of thumb we previously used for measuring whether interest rate and exchange rate changes offset each other, the increase in the exchange rate and the cut in interest ~~the exchange~~ rates we had seen since the summer more or less cancelled each other out. If we were to do a further $1\frac{1}{2}$% cut in interest rates that would begin to look rather too generous. He thought that, having had 9 months stability, it was not unreasonable to make a step change in the exchange rate, particularly in the direction of a tighter policy.

13. He therefore thought the best policy would be to cease intervening and then wait to see what happened to the exchange rate; if it started rising strongly we should cut interest rates by up to 1%, and then work to get back to 3DM and restablish ourselves there. If we did not get back all the way, and ended up with lower interest rates and a higher exchange rate, that would be acceptable; but the objective should be to get back to 3DM.

14. The Chancellor said it was clear we were faced with a most unpalatable choice. But if strong pressure on sterling continued we would be forced to choose one or the other. Reversability was an important criterion. It was undoubtedly true that a large cut in interest rates was in principle easier to reverse in terms of credibility and industrial confidence than an increase in the exchange rate. Sir G Littler's proposal was a clever one: it should have the desired market effect, without taking any substantial risks with inflation since it was intended to be temporary. The problem was that it might appear incompetent. Were we in the EMS, it might be possible to adopt a policy whereby we lowered and raised interest rates much more frequently in response to exchange rate pressures. But to do it in present circumstances might well risk looking a shambles. With the economy as strong as it was, it would look as if we were prepared to run risks with inflation.

15. There was also the question of what we would do if upward pressure persisted after a sharp cut in interest rates: if we uncapped then, it would represent a complete defeat. On the other hand, if the interest rate cut succeeded taking the pressure off

the exchange rate we would end up with a policy that was far too loose. Another important consideration was that it was critically important to get the tax package through this year; so we had to have an overall policy stance which enabled us to accommodate that. That meant not taking any risks.

16. He was forced into believing that it would better to uncap first. If nothing happened, then we could argue that we had maintained broad stability; if the rate did go up sharply, then we could make a matching cut in interest rates. This would not be a very comfortable position: we would have to be prepared to accept a period of current account deficit, of a size that was beginning to be significant. And it would no doubt be a severe blow to industrial confidence. But he felt this route would be preferable on balance to that of cutting interest rates sharply without uncapping.

17. Suming up, the Chancellor said that if we did have to move, we should uncap first, but be ready to cut interest rates very soon afterwards, and probably by 1%. We should if at all possible avoid doing this before the New Year; we had put a lot of capital into our present stance, and it would be uncomfortable to be pushed off it so quickly. He would hold a markets meeting with the Bank that Friday to take stock of developments (barring great pressures before then).

18. In further discussion, it would agreed that Sir G Littler would have to say to his colleagues at the Monetary Committee the following day that there was no change in our policy of purchasing deutsmarks and French francs. If he was pressed hard on purchasing Belgium francs, he could say he would report this back to the Chancellor who would no doubt consider it; but the Chancellor was not keen to re-approach the Prime Minister on this unless it was definitely necessary.

ACSA

A C S ALLAN

Distribution
Those present

psl/52A

SECRET

pwp

MINUTES OF A MEETING AT NO.11 DOWNING STREET
AT 3.00PM ON THURSDAY, 17 DECEMBER

Present

Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler

MARKETS

The Chancellor reported the main points from the telephone conversation he had just had with Stoltenberg (recorded separately). The problem would come if the Germans insisted that our agreement to the G7 intervention agreement required us not to buy deutschemarks.

2. Sir T Burns wondered whether we might agree to buy equal amounts of dollar and non-dollar currencies; we would present this as having no effect on the dollar/DM crossrate. This was a considerable change of stance, but represented progress on where we had been before we switched to buying deutschemarks.

3. The Chancellor wondered whether the G7 communique was really worth much: it offered nothing on US monetary policy and, without that, agreements on intervention meant little. In these circumstances, it seemed hardly worth conceding very much in order to get it issued. But on the other hand, it would look bad if the UK was seen as torpedoing international co-operation.

4. In discussion, various options for a softening of our intervention stance were put forward:

(i) we could do all intervention from now on equally in dollars and non-dollar currencies;

(ii) we could do our initial share of the $5 billion in dollars, and the remainder split equally;

(iii) we could do our share of the $5 billion in dollars, and thereafter purchase only non-dollar currencies.

5. The Chancellor said he would want to consider further what line he should take. One possibility was to say:

(i) we would accept an obligation to purchase our share of the $5 billion as part of any co-ordinated intervention;

(ii) for the time being we will cease to purchase deutschemarks; but if circumstances changed we might need to return to this;

(iii) if we did need to return to purchasing deutschemarks, he would be ready to consider buying equal amounts of dollars and non-dollar currencies.

6. He asked Sir G Littler to work up an expanded version of this line, for further consideration.

A C S ALLAN

17 December 1987

Distribution

Those present

FROM: A C S ALLAN
DATE: 18 December 1987

NOTE OF A MEETING HELD IN THE CHANCELLOR'S OFFICE
HM TREASURY
AT 11.45 AM ON FRIDAY 18 DECEMBER

Present	Chancellor	Governor
	Economic Secretary	Deputy Governor
	Sir P Middleton	Mr George
	Sir T Burns	Mr Loehnis
	Sir G Littler	
	Mr Peretz	
	Mr R I G Allen	
	Miss O'Mara	
	Mr Cropper	

MARKETS

Funding Rule

The Chancellor said that it had been agreed that no announcement should be made now of the plan to switch to an M4 funding rule; this should instead be done at the time of the Budget, certainly in the FSBR and possibly in the Budget Speech itself. He noted that the latest figures showed that over the year so far there had been an underfund of £½ bn on an M3 rule and and overfund of £½ bn on an M4 rule. He asked for views about whether this difference would persist to the end of the financial year.

2. Mr George said that there had been substantial net funding in November as the banks and overseas sector had sold gilts to the private sector. But since then we had done $5 bn of intervention. The latest arithmetic pointed to funding of £1½-1¾ bn a month for a full fund on an M3 basis; and £1¼-1½ bn a month on an M4 basis. Mr Peretz noted that the difference between the two was very uncertain, and depended on whether the building societies were buyers or sellers of gilts and on what happened to local authority deposits with building societies; but the best estimate was that the gap between the two would continue to be about £1 bn.

3. Sir P Middleton suggested that if we wanted to step up funding there was the opportunity to do more via National Savings, which need not be any more expensive than other forms of funding. Mr George said that with an upward sloping yield curve, and considerable uncertainty, funding via gilts was not easy. The Bank hoped for a successful auction in January, but selling through the secondary market continued to be difficult.

4. The Chancellor asked the Economic Secretary to review at his next funding meeting whether we should do more via National Savings: if we did aim to do that, he would prefer it to be achieved by stepping up advertising.

Markets

5. The Governor said that sterling was trading quietly and without pressure. Interest rates had risen slightly, and any expectation of another cut in rates had disappeared.

6. He thought this period of relative calm provided a welcome opportunity to review our general policy stance. There were two new features: the change in oil prices meant that we now had to consider the downside on the exchange rate; and we also needed to consider what intervention requirements might emerge in connection with the G7 statement.

7. Policy for the last few months had been dominated by the 3DM cap. The greater prominence given to the exchange rate had developed gradually since April; the cap had originally been seen as a temporary measure before the Election, but in the autumn it had become increasingly dominant. He saw two ways forward:

i. We could formalise our policy of pegging sterling to the deutschemark, recognising the implications not only of stopping the rate rising but also of stopping it falling. We had strained very hard to cap sterling rising at 3DM and we should correspondingly have a firm plan of action if sterling came under downward pressure.

ii. The alternative was to revert to a more pragmatic policy, where the effective exchange rate was one of the factors taken into account in forming judgments about monetary policy. This could imply uncapping if that proved necessary, but with any rise in the rate against the deutschemark being offset by a cut in interest rates.

8. Sir P Middleton said that he started from the proposition that we should stick to our existing policy for as long as we could. We had considerable capital invested in it, and it was a genuine long-term counter-inflation policy. Recent decisions on cutting interest rates had been taken with the explicit qualification that they were reversable: if there was downward pressure on sterling then interest rates would have to go back up.

9. Our main problems had come because we had found ourselves with very little room for manoeuvre. If upward pressure re-emerged, it might still be technically possible to keep below 3DM by cutting interest rates. But the problem was that the markets might feel we were taking risks with inflation. He did not see us being able to cope with more than fairly moderate upward pressure: we could not cut our interest rates all the way to German levels.

10. He therefore saw circumstances in which we would have to contemplate the second of the Governor's options, ie a simultaneous move on the exchange rate and interest rates - and accompanied by further intervention. This would provide a less clear line than our existing policy, but if there were extreme pressure we probably did need more room for manoeuvre.

11. The Deputy Governor said that we already faced domestic markets which were convinced that we might have gone too far in cutting interest rates. That was having a significant effect on our funding. Looking ahead, he thought that industry would find considerable difficulties with the present level of the

$/£ rate, for both invisible and visible trade. He certainly would not want to see sterling rising further against the dollar, though he recognised that might be unavoidable.

12. Sir T Burns said he was reasonably well persuaded that sticking to 3DM would bring downward pressure on inflation. He thought we had the opportunity of sticking with this deutschemark rate for quite some time. Even though our inflation was faster than that in Germany, our productivity growth was faster too, and unit costs were growing at much the same rate. But our success in making a stable rate against the deutschemark credible meant that we could not sustain interest rates at levels so much higher than the Germans.

13. He was concerned, however, that a substantial cut in interest rates would represent an unacceptable loosening of policy. On the normal rule-of-thumb, the changes in interest rates and in the effective exchange rate since October had broadly offset each other. He did not believe there was much further scope for cutting interest rates unless we were prepared to see some rise in the exchange rate. If we came under strong upward pressure he thought we would have to consider letting the exchange rate rise.

14. Mr George said he was concerned that the massive intervention we were undertaking to hold down the exchange rate might give an impetus to domestic cost pressures. We had not necessarily reached that position yet, but there were clear risks. In any fixed rate system there was scope for realigning. But he would prefer a switch back to a more pragmatic approach. When monetary policy was directed entirely towards the exchange rate, its effect was weakened: the exchange rate was an important transmission mechanism.

15. Even though the Chancellor had made it clear that he was committed to stopping sterling falling as well as rising, there had been other signals which had confused this. He thought it would be very helpful if we had an opportunity to demonstrate that we were just as resolute in resisting downward pressures.

16. Sir G Littler said he would very much like to stick to the present strategy. He thought it would have a damaging effect on business confidence if we let the rate rise above 3DM. But if we did come under very strong upward pressure, he agreed with Sir P Middleton that we might be pushed to a higher exchange rate and slightly lower interest rates.

17. Mr Loehnis said he favoured adopting a more flexible response if we did come under strong upward pressure again. The Chancellor had made clear in his Washington speech that there were times in any system of managed floating when currencies might need to be rebased.

18. The Economic Secretary said he thought it would be very difficult to present a decision to uncap. There had already been sentiments expressed that sticking to the deutschemark was too deflationary, and it would look very odd to let sterling rise against it. There seemed to be an asymmetry in interest rate effects at present: any increase in interest rates seemed to be ruled out because of the potential surge in inflows from overseas; but any cut in interest rates was unwelcome because of the domestic inflationary pressures.

19. The Chancellor said this had been a helpful discussion. He thought that existing policy had not been without its difficulties, but had been successful. He would wish to stick to it in present circumstances, though he had no wish to formalise it further.

20. He had made clear in several speeches that our policy was symmetrical, and we were not prepared to see sterling fall too low. There had not yet been any opportunity to demonstrate that by actions, since we had not come under any downward pressure. If that did occur, we should certainly be ready to intervene to support sterling, and to raise interest rates. It was not possible to give exact guidance on intervention tactics now: that would depend on the speed of the movement and the level of the exchange rate. But it was clear that we would be perfectly comfortable with a DM/£ rate at 2.90, and it was absurd to get boxed into too narrow a range.

21. If we did come under massive upward pressure again, he accepted that we might have to change our stance by allowing the exchange rate to rise and interest rates to fall. If we were forced down that route, he would hope that the upward movement in the exchange rate would be small; in those circumstances we could argue there had been no major change in policy: that was one of the benefits of not formalising our policy too rigidly.

G7 Communique

22. The Chancellor thought we could support the "agreement" on intervention which Stoltenberg had circulated. It was odd to have agreements on intervention with no real agreement on monetary policy, and with such vague guidelines. But nonetheless it did not seem worth objecting to. Our share of the concerted intervention would be very small, and we would have the choice of buying dollars either against sterling or against deutschemarks.

23. More difficult was what we would do independently for our own purposes: would others claim that buying deutschemarks ran counter to the Agreement? Our best line was to point out that we had done no intervention this week and were not contemplating doing any more. We could describe our purchases of deutschemarks as a temporary phase which might not recur. If it did recur, we could say we would be prepared to consider purchasing dollars in amounts equal to our non-dollar purchases. Others could not then accuse us of acting in a hostile way.

24. The Governor thought this was a very helpful approach.

pp A C S ALLAN

18 December

Distribution

Those present
PS/Chief Secretary
Mr Cassell - o/r

pmp

LAST MKTS MEETT-ING

NOTE OF A MEETING HELD IN THE CHANCELLOR'S OFFICE HM TREASURY

AT 2.45PM ON FRIDAY 15 JANUARY

Present	Chancellor	Governor
	Economic Secretary	Deputy Governor
	Sir P Middleton	Mr George
	Sir T Burns	Mr Loehnis
	Sir G Littler	
	Mr Scholar	
	Mr Peretz	
	Mr R I G Allen	
	Miss O'Mara	
	Mr Cropper	

MARKETS

Interest rates

The Governor summarised market reactions to the unexpectedly good US trade figures: sterling had fallen back against the stronger dollar from \$1.8150 earlier in the day to \$1.7625, gilts had recovered, and the FTSE was up 30 points at 2.00 o'clock. He saw a number of arguments in favour of raising interest rates while this opportunity was available. First, the growth of credit and domestic demand inclined him to think that some tightening was called for. Secondly, a differential of about ½% had developed between interbank and bill market rates and this gave scope for round tripping. Thirdly, it would be strategically useful to raise rates by ½% now if there was a good chance of avoiding a further rise shortly afterwards. However, there were two strong reasons against. A ½% rise was probably already discounted in the exchange markets, but if it were seen as an aperitif to a further ½% this could lead to renewed upward pressure on sterling; it would be important to be clear about the proposed response to this. Secondly, a rise in UK rates could lead to diplomatic problems with the rest of G7. On balance, the Governor was inclined to wait before acting, unless there were a clear willingness to see sterling go some way above 3DM before intervening.

2. Sir P Middleton said that he was keen on a ½% rise. He was not worried by the possibility that it might have to be reversed if sterling came under renewed upward pressure. He would be concerned if a ½% rise were seen as a prelude to further rises, and so led to a general loss of confidence; but he did not think that was very likely.

3. The Deputy Governor was also in favour of a ½% rise. On timing, he thought the move should be made within the next week - ideally on Monday morning, with PSBR and money figures following later in the week.

4. Sir T Burns agreed that a ½% rise would be desirable. But he was more concerned about the international aspects. If there were not sufficient daylight below 3DM when the move was made, the diplomatic problems of December could resurface. Sir G Littler said that he did not see this as an insuperable problem: however it would undoubtedly be prudent to notify the rest of G7 in advance with our own version of the reasons for the rise.

5. Mr George said that, so long as there were sufficient daylight below 3DM, he would be keen to make an early move. It was probably inevitable that the market would expect further interest rate increases to follow - but this could be resisted in a fairly high profile way.

6. The Economic Secretary agreed, but noted that to make a move before the PSBR and money figures were published could lead the markets to wonder what the Government knew.

7. The Chancellor said that he was keen to find the opportunity for a rise, especially one of ½% that would not be followed rapidly by a further half. But he felt that any move had to be in the context of the 3DM cap, not an alternative to it. The presentation would need careful handling. It would be important to make clear that - as he had said in the Autumn Statement Debate the day before - the interest rate cuts of the autumn had been warranted by the extreme fragility of the financial markets at that time. The markets had now settled down considerably.

8. It was agreed that the position would be reviewed on Monday morning. If the markets had settled at roughly the levels of Friday afternoon, then the Bank would announce at 12.00 that their dealing rates were being increased by ½%. In view of this possibility, the Bank should not proceed yet with the package of new gilts which the Economic Secretary had earlier approved.

MPW.

MOIRA WALLACE
20 January 1988

Circulation

Those present
PS/Chief Secretary

Pg

MINUTES OF A MEETING IN NO.11 DOWNING STREET
AT 3.30PM ON FRIDAY, 4 MARCH

Those present

Chancellor
Sir P Middleton
Sir T Burns

Deputy Governor - B/E
Mr George - B/E

MARKETS

The Deputy Governor reported that there was now strong pressure on sterling in London, rather than just in New York as previously. The Bank had bought $900 million, bringing the total to $2 billion over two days. The purchases had primarily been in deutschmarks, with part being swapped into French francs; the Bundesbank and Banque de France had not raised any objections. The US, however, had expressed some concern at our action in switching earlier dollar purchases into ecus.

2. The Deputy Governor noted that there were improved current account figures out the following Friday, and the Budget itself might lead to a further resurgence of pressure. Domestic investors showed some concern about the trade deficit, but overseas investors were focussing primarily on the very strong fiscal position, and would probably continue to be buyers of sterling. If we kept the 3DM cap, we should have to be prepared to intervene heavily. If we were ready to remove the cap, he would very much rather do it soon, rather than waiting and being clearly seen to be defeated by market pressure. He would prefer to make a move in London, where it could be controlled in a more orderly way, and so would recommend resisting further pressure that day and on Sunday night in Tokyo and then considering the position on Monday morning.

3. Sir T Burns said he would ideally like to see the monetary stance slightly tighter, with the same exchange rate but higher interest rates. But that mix did not seem possible. Our hands were tied: we could not raise interest rates because we were tight up against the 3DM cap; but nor could we lower them without an undesirable easing of monetary conditions. He was pessimistic about our chances of holding 3DM, and thought the strong upward pressure could well continue. He thought it more sensible to move now, rather than just before or just after the Budget, when it would be more clearly a defeat and when it would be known that the references to exchange rate stability in the Budget documents would have been written before we uncapped. If we did move, it was important that we agreed in advance what the next point to defend would be, and that we acted before we got there, rather than letting the rate bang up against a new ceiling immediately.

4. The Chancellor asked how strong the demand for sterling was likely to be if the 3DM cap was lifted. Mr George noted that there were large positions in the option markets, and thought there would be a strong surge once sterling broke through 3DM. It would be difficult to see it faltering much below 3.10; the Bank would hope to intervene on the way up, taking their opportunities when the pace slackened. There might also be a case for a modest cut in interest rates if the rate did rise sharply.

5. There was some discussion about the conduct of policy after an uncapping. Mr George suggested that we might revert to the policy of offsetting upward movements in the exchange rate by graduated cuts in interest rates. The Chancellor was not attracted to this. He felt that we needed to get the exchange rate at a level where it did not fluctuate much, and where we had some scope for moving interest rates. Mr George was concerned that we should not get hooked on a new cap of, say, 3.10. The Chancellor thought that we could not just allow the exchange rate to rise unchecked: we must make it clear to the markets that we were not adopting a hands-off policy.

6. There was some discussion about whether it would be better to stop intervening immediately, and let the rate rise that evening. There were some attractions in allowing people time to reflect over the weekend whether it really was appropriate for sterling to rise, given the current account deficit. But the Bank were not able to exercise much control in New York or the Far East; the markets were thin, and there was a danger that with weekend press speculation on how high the pound might go, we could face a rate above 3.10 on Monday morning. On balance it was preferable to wait until Monday. It was agreed that the Bank should hold the rate over the weekend, providing that did not require intervention of more than $\$\frac{1}{2}$ billion.

7. In discussion of intervention tactics for Monday, it was agreed that the Bank should first test the pressure with modest intervention below 3DM, but should then let the rate rise. They would continue intervening at various points above 3DM, to see if they could encourage profit-taking. They would, if necessary, intervene substantially if the rate reached 3.08 - and would in any case keep the Chancellor in close touch with developments. If the rate did reach that level, a cut in interest rates would need to be considered.

8. The Chancellor noted that it was very important to maintain the line that policy was unchanged: we had never said that stability implied immobility.

ACSA

A C S ALLAN

8 March 1988

Distribution

Those present
PS/Economic Secretary
Mr Scholar

NOTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM AT THE TREASURY AT 10.00AM ON WEDNESDAY 16 MARCH

Present: Chancellor	Governor	)
Sir P Middleton	Deputy Governor	) Bank of
Sir T Burns	Mr George	) England
Sir G Littler		
Mr Scholar		
Mr Odling Smee		
Mr Peretz		
Mr R I G Allen		
Miss O'Mara		
Mr Cropper		

MARKETS

1. The Governor reported on market reactions to the Budget. The announcement of the Budget surplus had pushed the pound to 3.09DM, but it had settled down at about 3.08 overnight. During the morning it had again touched 3.09, but now stood at 3.08 5/8. Gilts had also risen on the announcement of a budget surplus, but had now fallen back. The three month interbank rate had risen by 1/8 per cent, as anticipation of an interest rate fall had dissipated. The Govenor did not think a move on interest rates would be appropriate until the general direction of the markets was clearer.

2. Mr George commented that trading had been quiet in New York. Early morning buying started by the KIO had initiated some professional activity, but so far there was no evidence of broadly-based commercial demand for sterling. The Deputy Governor noted that the US trade figures were due out at 1.30pm on Thursday, and might have an impact on sterling.

3. Sir P Middleton felt that if upward pressure re-emerged, there could be a strong case for an interest rate cut. But the rate was not yet quite at a level to justify that. It was important to demonstrate that we were not indifferent to the level of the exchange

rate. Sir T Burns agreed; with sterling at its present level against the Deutschemark the decision was very close. A ½ per cent cut would usefully resolve a number of uncertainties.

4. The Governor asked whether the Chancellor was prepared to authorise any intervention at sterling levels below that at which an interest rate cut would be appropriate. The Chancellor said that, while it had clearly been right to intervene in the immediate aftermath of the Budget announcements, to prevent a disorderly rise, in general the response to a strengthening ought to be on the interest rate front rather than by intervention.

5. The Chancellor asked Mr George how he thought the markets would view a ½ per cent cut. Mr George said it was possible that it might be viewed with some concern in the domestic markets, where some had seen an inflationary impetus in the Budget tax cuts. In this respect, it would be helpful if a move could be distanced from the Budget by a few days, with any pressure on the exchange rate held off by intervention in the meantime. In some circumstances there were no alternatives to intervention - eg in the Far East. He saw a case for intervening in amounts of up to $150 to test the strength of upward pressure: the buying immediately after the Budget Statement, for example, had not taken long to cool down.

6. Sir P Middleton said he was not keen on using intervention to resist upward pressure. It was important to demonstrate that the Government was willing to use all instruments, including interest rates. The Chancellor agreed.

7. The Governor mentioned another sensitivity, namely that of intervening in anything other than dollars. At Basle his opposite numbers had registered their opposition to intervention in ECUs.

8. Summing up, the Chancellor said that the time was not yet quite right for a ½ per cent cut, but there was a good chance that it would be appropriate later in the week, if the rate approached DM 3.10. But we should discourage any market perception that DM 3.10 was a new ceiling.

9. There remained the question of whether the Bank should intervene if there were an upward blip in New York or the Far East. Mr George said that he could see a case for limited intervention, to test the strength of upward pressure. Sir T Burns said that he thought it would be unwise to buy more than $100 million before going for an interest rate cut. The Chancellor agreed; the Bank could purchase up to $100 million to smooth fluctuations or test the strength of upward pressure. He would wish to be kept in close touch.

MPW.

MOIRA WALLACE

Circulation:

Those present
PS/CST
PS/EST

SECRET

DRAFT

MINUTE OF A MEETING HELD IN THE CHANCELLOR'S ROOM AT THE TREASURY AT 10.00AM ON WEDNESDAY 16 MARCH

Present: Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Odling Smee
Mr Peretz
RIG Mr Allen
Miss O'Mara
Mr Cropper

Governor
Deputy Governor
Mr George

~~Alex~~

Any suggestions?

M.

MARKETS

1. The Governor reported on market reactions to the Budget. The announcement of the Budget surplus had pushed the pound to 3.09DM, but it had settled down at about 3.08 overnight. During the morning it had again touched 3.09, but now stood at 3.08 5/8 ~~and~~ . Gilts had also risen on the announcement of a budget surplus, but had now fallen back~~ to more or less the level before the speech~~. The three month inter-bank ~~and~~ rates ~~in the bill market~~ had risen by 1/8 ~~of a point~~ per cent, as ~~the~~ anticipation of an interest rate fall had dissipated. ~~The position was therefore rather unclear, and~~ The Governor did not think ~~any~~ move on interest rates would be appropriate until the general direction of the markets was clearer.

2. Mr George commented that trading had been quiet in New York. ~~The~~ Early morning buying ~~had been~~ started by the KIO~~, which~~ had initiated ~~other~~ some professional activity,

But So far there was no evidence of broadly~~-~~based commercial demand for sterling.

3. Sir P Middleton felt that if upward pressure reemerged, there would be a strong case for an interest rate cut. But the ~~agreed that the exchange~~ rate was not yet quite at a level to justify that. ~~a move on interest rates, which would otherwise have been a useful way of demonstrating that the Government remained committed to resisting unreasonable upward pressure.~~ It was important to demonstrate that we were not indifferent to the level of the exchange rate.

4. The Governor asked whether the Chancellor was prepared to authorise any intervention at sterling levels below that ~~which would trigger~~ at which an interest rate cut would be appropriate. The Chancellor said that, while it had clearly been right to intervene in the immediate aftermath of the Budget announcements, to prevent a disorderly rise, in general the response to a strengthening ought to be on the interest rate front rather than by intervention. ~~He would be prepared to consider intervention after a ½ point cut, if the situation seemed unstable then.~~

5. Sir T Burns agreed; ~~that~~ with sterling at its present level against the Deutschemark the decision was very close. ~~But~~ A ½ ~~point~~ percent cut would usefully resolve a number of uncertainties.

6. The Deputy Governor noted that the US trade figures were due out at 1.30pm on Thursday, and might have ~~quite~~ could be expected to an impact on sterling.

7. The Chancellor asked Mr George how he thought the markets would view ~~a ½ point~~ a ½ per cent cut. Mr George said it was possible that it might ~~conceivably~~ be viewed with some concern in the domestic markets, where some had seen an inflationary impetus in the Budget tax cuts. In this respect, it would be helpful if ~~an interest rate cut~~ a move could be distanced from the Budget by a few days, with any pressure on the exchange rate ~~being~~ held off by intervention in the meantime. In some circumstances there were no alternatives to intervention - eg in the Far East. He saw a case for intervening in amounts of up to $150 to test the strength of upward pressure: for example, the buying immediately after the Budget Statement, had not taken long to cool down.

8. Sir P Middleton said he was not keen on using intervention to resist upward pressure. It was important to ~~re-establish~~ demonstrate that the Government was ~~free~~ willing to use all instruments, including interest rates. [~~Mr George agreed: he had in mind "invisible" intervention, to stabilise the position, rather than to demonstrate that the Government was taking action.~~]

?

~~9.~~ The Chancellor agreed. [~~with Sir P Middleton's view that the priority was to demonstrate a willingness to take action, via interest rates if necessary. To intervene could be unnecessarily provocative.~~]

?

10. The Governor ~~said that there was of course~~ mentioned another sensitivity, namely that of intervening in anything other than dollars. At Basle his opposite numbers had registered their opposition to intervention in ECUs.

11. Sir G Littler noted that the markets were assuming that 3.10DM was now the new ceiling at which the Government would act: this had disadvantages. Sir P Middleton said he hoped ~~the Government would be prepared to move on~~ an interest ~~rates~~ rate more could be made before ~~reaching~~ that point was reached. Sir T Burns agreed. The Chancellor saw no ~~need~~ reason to encourage the market perception that ~~this~~ 3.10 DM was the ceiling. He would favour doing a ½ ~~point~~ per cent before reaching 3.10. Alternatively, there were arguments for going a little over 3.10, and then cutting by a whole point, if necessary. If it was possible to move this week rather than next, there was more chance of this being seen as a Budget-related cut rather than as the implementation of a 3.10 ceiling.

12. Summing up, the Chancellor said that the time was not yet quite right for a ½ ~~point~~ ½ percent cut ~~was obviously not called for yet~~, but there was a good chance that it would be appropriate later in the week, ~~There wouldn't would not necessarily be a need for a formal meeting. The move would demonstrate that sterling was not a one-way bet, and allow time for consideration of the wider issues that had been raised.~~ if the rate approached DM3·10. But we should discourage any market perception that DM3·10 was a new ceiling.

13. There remained the question of whether the Bank should intervene if there were an upward blip in New York or the Far East. Mr George said that he could see a case for limited intervention, to test the strength of upward pressure. Sir T Burns said that he thought ~~scores of over a hundred~~ anything over $100m would ~~raise diplomatic problems and make it more difficult~~ to ~~get clearance for~~ agreement to a ½ point cut. The Chancellor ~~said~~ agreed; it would be unwise to buy more than $100 million before going for an interest rate cut.

~~he would be prepared to authorise intervention if consulted first, but in no circumstances must it go over double figures. In general, the clearest sign of the Government's intentions would be a move on interest rates.~~

the Bank could purchase up to $100m to smooth fluctuations or test the strength of upward pressure. He would wish to be kept in close touch.

MOIRA WALLACE

Circulation:

Those present ✓

PS/CST

PS/EST

MINUTES OF A MEETING AT 10.00AM IN THE CHANCELLOR'S ROOM, HM TREASURY ON FRIDAY 8 APRIL

Those present:

Chancellor	Governor - B/E
Sir T Burns	Mr George - B/E
Sir G Littler	Mr Loehnis - B/E
Mr Peretz	

MARKETS

The Governor reported on the markets. The pound had opened at 3.13¾DM, and then firmed to 3.14. The £ERI now stood at 78.4, and three month interbank rates were steady at $8^5/_8$. Since the No.10 meeting on 25 March the pound had been rising steadily, slowed only by small bouts of tactical intervention. The rate against the deutschmark was now 3 pfennigs (1 per cent) higher than at the time of the last interest rate cut, on 17 March. With meetings of OPEC and G7 coming up, and with US trade figures the following Thursday, it was obviously necessary to consider the scope for further intervention, or interest rate changes. The Governor said that he saw little prospect of bringing the pound significantly lower by intervention in amounts of $50 or $100 million - although heavy intervention around 3.15DM might be more effective. Clearly there was scope for a cut in interest rates as the exchange rate firmed, but the Governor saw a case for holding it in reserve for Washington.

2. Sir T Burns said that he thought the case was finely balanced on monetary policy grounds. At the last monthly monetary meeting, the consensus had been that at around 3.15DM an interest rate cut would be appropriate. On past form, the aftermath of the G7 meeting would serve to exaggerate whatever trend was already present in the market: in the present climate, that would mean a further strong upward push. So he felt there was something to be

said for an early ½ per cent cut to keep the markets guessing and to avoid an unhelpful weekend press. There was also one presentational advantage to an early move - if sterling was still around 3.15DM, the Chancellor would be very exposed in Washington, in dealing with the press etc. His position would be easier if a move had already been made.

3. Mr George said that he was reluctant to lower interest rates before it was absolutely necessary. He did not think it was necessarily true that the events of the following week would push the rate up. The impact of the US trade figures was uncertain. There was also a danger that the market would conclude that interest rates would be cut every time the exchange rate appreciated by 1 per cent. He favoured trying some heavier intervention, attempting to get some leverage at around 3.15DM. The Chancellor said that he would be reluctant to replace the "cap" of 3DM with a new one at 3.15DM.

4. Sir G Littler said he saw a strong case for moving now, deliberately and unexpectedly. A lot of foreign money was being drawn into sterling by UK interest rates, and the markets seemed to think that further cuts - or indeed intervention - had been ruled out.

5. Mr George expressed the concern that it could be difficult to reverse a cut until the rate fell below 3.10DM, without giving the impression that sterling was now pegged in a very narrow band. This would represent a considerable loosening of our stance. The Chancellor said that in those circumstances a one per cent rise in interest rates would probably be appropriate, thus maintaining tight monetary conditions.

6. Summing up, the Chancellor said that he thought the case was finely balanced, but was tipped by the likely turbulence of the market in the following week, when any feeling of disappointment post-G7 could cause resumed strong upward pressure on the pound.

It would be helpful for the authorities to be seen to be taking the lead. A half per cent cut now would have greater effect than a whole per cent in a turbulent G7 aftermath. He was concerned to ensure that the "spike" in the exchange rate was as small as possible. If the half point cut failed to achieve its objective, there was still the intervention card to play.

7. Mr George asked what scale of intervention the Chancellor would be prepared to consider during the Washington week: he would be inclined to think in terms of doing $500 million or so just beyond 3.15DM, to achieve maximum recoil. The Chancellor gave his agreement in principle.

MPW.

MOIRA WALLACE

12 April 1988

Distribution

Those present
PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Miss O'Mara
Deputy Governor - B/E