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From the Private Secretary

4 June, 1981.

The Chancellor and the Governor called on the Prime Minister at 1300 hours today to discuss the situation in the Foreign Exchange Market.

Having described developments in the market overnight and this morning, the Governor said that the Bank were intervening on a modest scale in order to provide some steadying, and so as not to give the impression that they were conniving in sterling's decline. Their intention was rather to demonstrate an attitude than to hold the rate at any particular level. Having taken in a certain amount of dollars when sterling was going up, the market might take it as a sign that they wanted the rate to go down if they were to spend nothing now. However, if the market was determined to pull the rate substantially further down, there was no way in which intervention would prevent this - unless it was on an absolutely massive scale. For the present, he proposed that the Bank should continue to show a modest presence in the market by spending not more than $100 m per day; and they would only spend up to this figure if they thought it would have a steadying influence. If, however, the rate were to fall to $1.90 or below, it would in his judgement be necessary to consider a change in policy. By this he meant a rise in interest rates. If it were decided to increase interest rates to support sterling, this might need to be accompanied briefly by a large scale intervention.

The Chancellor said that he essentially agreed with the Governor's position. But he was anxious that the Bank should not intervene on too large a scale. The figure of up to $100 m a day seemed on the high side. It was important that the Bank's intervention should not be interpreted as a decision to defend any particular rate.

Following a short discussion, the Prime Minister said that the Governor was authorised to continue with the present smoothing tactic. It should be left to him and his colleagues at the Bank to decide how this should be put into practice, as long as it was understood that they were not to be seen as

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defending any particular rate. Rather than their being set a maximum figure for each day, they should have authority to spend up to $500 m between now and next Thursday. If the downward pressure on sterling intensified, then the option of raising interest rates would have to be considered.

I am sending a copy of this letter to Tim Allen in the Governor's Office.

TPL

A.J. Wiggins, Esq.,
HM Treasury

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