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PRIME MINISTER

INTEREST RATES

The Bank of England is busily unravelling many months of patient work of putting clarity into our economic policy.

We have laboured the point that we do not have an exchange rate target. And we do not have one for the following good reasons:

1. Only the market can fix a true rate for the pound.

2. No chosen rate can be defended in footloose and fast-moving international markets. Governments no longer have control of enough money, compared to other people, to manage the rate (this is good news in the broader scheme of things).

3. We have money targets. You cannot target money and the exchange rate at the same time and be sure of success. It is inevitable that you will choose a money target that will not work naturally with your exchange rate target, and you will not know which one is the important one to manage.

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The position is still the same as that 2½ weeks ago when the sterling problem first became apparent and we set out three options. You can cut public spending, you can do nothing, or you can raise interest rates.

At that juncture, it was rightly decided to do nothing. Unfortunately, the Bank then went off and did something. They made an absurd statement to markets to "reassure". **Nothing undermines a market more quickly than soothing words from rattled authorities.** And when the Bank said there was no **domestic** reason for raising interest rates, they naturally invited the response: "well, what about an external reason?"

That external reason soon became pressing, and so the Bank persuaded the Chancellor to allow them to increase interest rates modestly.

Now that interest rates have been raised in panic, a new dimension has been added to our troubles. There are enormous speculative money flows. Everyone now knows that sterling is a loser. There is plenty of knocking copy about - low interest rates compared to the US, industrial disruption, feeling the Government is losing its touch, etc. Speculators will go on selling with the Bank on the run. The final irony was the publication of the money supply figures. These were known roughly by the Bank at the time they made their statement. They demonstrated that there was a domestic reason for raising rates, and that the Bank had been lying.

Even Houdini would find it difficult to get out of this. Defending the pound with higher rates would take further rate increases. Not defending the pound would now look odd, given that the Bank has tried once, and is probably going to fail.

The best option now, therefore, unlike 2 weeks ago, is to cut public spending. The Government could respond to the heavy front-end loading of the Public Sector Borrowing Requirement, and to excess money growth, by reducing public spending. The option of benign neglect is still better than putting rates up, but it will leave open the criticism that the Government and the Bank are drifting, blowing hot one day and cold the next, and not quite sure how to behave.

The option of putting rates up is not working, is damaging to the rest of the strategy, and will be seen as a major defeat.

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