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SUBJECT cc MASTER

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From the Private Secretary

29 September 1986

Dear Tony,

THE MARKETS

The Prime Minister this morning held a meeting to discuss the current pressures on sterling and interest rates. Present were Sir Peter Middleton (HM Treasury), Mr. Frank Cassell (HM Treasury), Mr. George Blunden (Deputy Governor of the Bank of England), and Mr. Eddie George (Bank of England).

The Prime Minister said that much of the present hysteria in the markets had been whipped up by the media. Talk of pressure on sterling tended to be self-fulfilling. The G5 meeting itself had contributed to the problem particularly because of the very public arguments between the Germans and Americans. The Prime Minister said she was also alarmed at the scale of intervention in the foreign exchange markets. Had the UK not recently borrowed $4 billion it seemed unlikely that intervention on this scale would have taken place. With oil prices still weak and with the more rapid growth of wages and even inflation in this country than in many of our competitors there was bound to be a depreciation and probably no point in trying to resist it by increasing interest rates, which were already very high. It would be better to take the pressure on the exchange rate than to raise interest rates, though it might be right to intervene to steady the movement.

As regards the shorter term market position, it was pointed out that a substantial part of the intervention undertaken during the past month (perhaps as much as three-quarters of it) had been undertaken off market. These were sales of foreign exchange which under normal circumstances would have been recouped in the market. This had not been possible against the background of weakness in sterling. The recent intervention had been necessary to avoid an immediate increase in interest rates, larger perhaps than might otherwise be necessary. Intervention now might buy time to allow the markets to calm down and to put the weekend meeting and the IMF annual meeting in perspective.

In further discussion it was noted that some depreciation had been inevitable. But, whilst the calculations were very uncertain, it did seem possible that the exchange rate was now lower than would have been justified simply by the fall in oil

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prices. The balance of payments figures for August had been extremely poor. There were now signs of looseness in the monetary statistics, not only sterling M3 but also in the behaviour of MO. It had been possible to look to the strength of the real exchange rate for reassurance but that was now no longer possible. The public expenditure position was a further cause for market concern, and the prospect of an election was also a background factor. It was hard to judge whether interest rates were high or low, but a huge demand for credit had continued month after month. This background suggested that market concerns were not entirely hypochondria. But these factors ought to be assessed calmly. An immediate increase in interest rates should be resisted.

It was agreed that the authorities should continue with tactical intervention today and that a further meeting should be held if necessary tomorrow. It was recognised that it would not be possible to hold the exchange rate against sale orders which might be as much as £500 million. Sir Peter Middleton would contact the party in Washington and generally consider the problem of news management.

The Prime Minister and the Chancellor then spoke by telephone, and agreed that the Chancellor would seek Poehl's agreement that the Bundesbank would intervene to support sterling.

The Chancellor later reported the results of a meeting with Stoltenberg and then with Stoltenberg and Poehl together. Stoltenberg had been sympathetic. However Poehl had said he could not offer the UK more favourable treatment than was available to ERM members. The Bundesbank was prepared to intervene in sterling but not to carry the exchange risk. The Bundesbank also held only dollars in its reserves.

The Prime Minister accordingly agreed that the Bank of England might negotiate a flexible swap arrangement with the Bundesbank. She stressed that the amount of any intervention undertaken by the use of the swap should be very small. Its value would lie in the signal it would give.

I am copying this letter to John Footman at the Bank of England.

Yrs,

David.

DAVID NORGROVE

Tony Kuczys, Esq.,
HM Treasury