

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

Subjects for discussion include the following:

The Markets

The Chancellor will have come straight from a meeting with the Bank and Treasury officials about the markets. Officials are very uneasy about the way the exchange rate is gradually drifting down. They fear a build up of inflationary pressures, and the risk that we might have to raise interest rates against a background of market turbulence. There is accordingly some feeling (including from Terry Burns) that we should raise interest rates by another 1 per cent now, even though inter-bank rates are still only a little over 11¹/₄ per cent. Weekly figures for M0 are showing disturbingly high growth, apparently.

The proposition that we now need a further increase in interest rates seems to me to be something to be treated with very great caution. Our interest rates are already exceedingly high and there is also the loss of credibility from having to increase rates again after all the protestations that 1 per cent should be enough. Tomorrow's meeting, if the Chancellor does want to seek an increase, should only be the first round of a discussion.

Related to this, the Chancellor may raise the way in which some commentators have sought to distinguish the line you have taken on interest rates and the exchange rate from the one he has taken. Following your interview with the Financial Times, it was suggested, as you know, that you are more reluctant to see interest rates rise than the Chancellor and less reluctant to see a fall in the exchange rate. Overcoming this will be a matter of what you both say in your next interviews.

Space

The Chancellor is concerned about propositions for greatly increased expenditure on space. These have not yet come to No.10, though Geoffrey Pattie has lobbied you privately from time to time in favour of HOTOL.

The question, as always with these grand projects, is whether they lead to greater commercial and other benefits than would have been the case if the money had been spent on directly commercial business by companies.

Cardiff and the Docklands

The Chancellor may raise with you the concern that we have rushed into the proposal for the eastern extension of the docklands light railway without properly considering the risks to the public sector. He would, as I have already mentioned to you, be concerned if the Cardiff scheme were to go ahead without proper consideration. Could you make it a condition that the scheme should go ahead only if there is no public money involved, as with the Channel Tunnel?

IMF Managing Director

The Chancellor may ask you to send a message to Signor Craxi.

Martin Sawyer

pp. DAVID NORGROVE
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