

CC B/EP
11PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

Two subjects for discussion:

- the markets
- EC R & D.

The markets

Sterling continues in strong demand. The prospect of the Government's re-election is clearly a major factor. There is apparently also a widespread and firm belief in the City that sterling will go fully into the EMS after the election.

One response to the present strength of sterling could be a further reduction in interest rates. That would I believe be quite wrong. Events during an election campaign are unpredictable; you would very likely be asked your position on the EMS and make your continuing scepticism clear (which would send sterling down with the markets as they are at present); and there could well be pressure on sterling after an election as people take profits or exaggerated expectations are disappointed (if they are). All this points to great caution on interest rates.

Another response would be to stop intervention and let the exchange rate float freely. A respectable case can be made for this. Intervention distorts the monetary picture. And it can have perverse effects when a currency is rising as also when it is falling: in 1977 sterling weakened once the Government stopped its very heavy intervention to prevent the exchange rate rising. For the moment, however, our intervention is sustainable. And there would be risks in allowing the rate to rise strongly, if that is what happened: it would lead to protests from business and talk of damage to exports. Also, the higher the rate during an election campaign, the greater the potential fall after it.

My conclusion is that we should continue to intervene, heavily if necessary. A change in policy would only be necessary if the Bank of England were being swamped. If this occurs during an election campaign the response should be to cease intervention and allow the rate to float freely, rather than to reduce interest rates.

The other topic for discussion is European Community R & D. A note by Charles is elsewhere in your box.

DLW

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