

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

There are two items for the agenda: the markets and public expenditure.

The Markets

At the time of dictating this (Tuesday afternoon) the equity markets were recovering strongly. But you will want to take stock of the position.

Provided the equity markets stabilise, the events of the last day or two may well prove salutary:

- bonds will have become relatively more attractive, not in terms of yield, but because of their more stable performance;
- some of the froth will have been blown off and perhaps some of the fears of overheating reduced;
- when the next upward pressure comes on sterling it may now be easier to reduce interest rates than it would otherwise have been;
- people in the City will have been reminded that equity markets can go down as well as up and there will be a healthy effect on salaries and bonuses.

The risk is the potential blow to the confidence of consumers and industry, particularly in the United States.

The events of the last few days have illustrated the fragility of the markets, and the fundamental problem remains the US budget deficit. Some people are likely to argue in the US that the possibility of a recession there makes it untimely to seek any further action on the budget deficit. But our own

experience shows that borrowing can be cut without jeopardising growth and indeed that reducing borrowing can promote growth. Forlorn hope though it may be, we really should continue to argue for a reduction in the budget deficit.

Charles will have reported to you the agreement reached between Baker, Stoltenberg and Poehl. Part of this agreement (not public) appears to have been a downward move in the agreed range for the Dollar against the DM. You might ask the Chancellor about this. You might also tackle him on how far he thinks it will be sustainable for central banks to take on the task of financing so much of the US current account and budget deficits as they have been this year. (The total has been put in the newspapers at over \$90 billion.)

#### Public Expenditure

All programmes except aid have now been settled. The details are set out in Annex C of the paper below.

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*pp* DAVID NORGROVE

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