

PRIME MINISTER

THE MARKETS: YOUR DISCUSSION WITH THE CHANCELLOR

I have now discovered from the Treasury what the Chancellor is likely to say to you this afternoon. I think it may cause you difficulties.

He will advocate a two part approach:

- (i) A half per cent reduction in interest rates at Noon tomorrow, Tuesday.
- (ii) Your use at Question Time in the afternoon of an agreed form of words. The Chancellor will bring a draft with him; but it sounds as if it will be along the lines of:
"Within the context of firm anti-inflationary policy, the Government does want to see some greater exchange rate stability."

This proposal emerged from a discussion with all the senior Treasury and Bank officials. Some people advocated a three part approach also including heavy intervention; but this was rejected as being too high risk and leaving nothing in the locker.

On the other hand an approach which just involved using an agreed form of words but with no actions to back it up was felt to be inadequate.

It was also agreed that domestic considerations did not point to the desirability of a interest rate cut. But it was felt to be defensible on the grounds that the exchange rate was DM 3.14 when interest rates were ~~last~~ reduced and the strengthening to over DM 3.18 has further tightened monetary conditions.

Comment

I remain uneasy about an interest rate cut. But equally, following all the weekend comment and the state of market expectations, I see no point in intervention at present. Although the market has not moved up very much this morning - currently DM 3.187 - the tide of sentiment is such that intervention would be ineffective.

So in terms of action it looks to be a choice between nothing or making an interest rate move.

As for words, you will clearly need to have some formulation for Questions tomorrow - it would be amazing if Kinnock did not return to the charge (John Smith put down a PNQ to the Chancellor today, but the Speaker rejected it). I gather the Bank see part of the difficulty at present as the fact that some market operators think you positively want to see the exchange rate move higher. So I think the wish for a fairly forthcoming statement tomorrow is coming from the Bank as well as from the Treasury.

But you will obviously want to consider very carefully what if anything you are willing to say about the desirability of greater exchange rate stability. There is always the risk that the more you say about the desirability of stability the more the market will think that it has a one way ^{option} bid in trying to push the rate up.

PRG.

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16 May 1988

KAYACP