

RA

PRIME MINISTER

MARKETS

Today's evening report (attached) reveals intervention today totalling over \$600 million.

I reported to you at lunchtime that the Treasury had advised me of intervention of some \$140 million this morning. Apparently, faced with strong upward pressure on the rate - sterling was touching DM 3.19 - the Chancellor then authorised heavy intervention to knock the rate back down. So early this afternoon there was a concentrated burst of about \$400 million. There also seems to have been spasmodic intervention on a smaller scale at other times during the day.

I have some sympathy with the Chancellor's wish not to let the rate run away, by undertaking modest market operations of say \$100 million during periods of strong upward pressure. But there should be no question after Monday's meeting that the paramount need now is to tighten monetary conditions. Today's actions show the predicament faced if substantial weight continues also to be attached to exchange rate stability.

The reason for the market strength seems to be expectations that interest rates will go higher. We are in danger of getting the worst of all worlds if we then intervene strongly - and arguably ineffectively - to hold the exchange rate down but do not validate the expectations of higher interest rates.

I have explored the Chancellor's latest thinking on interest rates. Even if the foreign exchanges are quieter, he seems to be firmly opposed to doing anything tomorrow, on the grounds that this will mean two moves within the same week. I don't find that a persuasive reason. But on the other hand it probably doesn't much matter whether the next increase is at the end of this week or early next week.

I doubt if there is any point in your talking to the Chancellor about this tomorrow, but you might want me to pass a message saying you think today's intervention was excessive. You do have the chance for a private word with the Governor about market tactics after lunch at the Bank tomorrow - see the separate papers in the Bank lunch meeting folder.

As it has happened

I don't think we should

say anything at this time -

but we really do need to

have an interest rate increase

very early next week.

His reputation is at -

stake

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PLCG.

PAUL GRAY
21 July 1988

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