

SRWBOU

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 27 JULY

I have agreed two items for the agenda with the Chancellor's office.

(1) Foreign Currency Borrowing

The Chancellor's minute of 26 July attached seeks your agreement to repay early the \$2.5 billion Floating Rate Notes issued in 1985; and to refinance partly through an ECU bill programme and partly by running down the forward Reserves. You may be content to agree this on the basis of his minute. If not you can discuss it with him at the bilateral.

(2) Markets

There are two aspects here:

- (a) Action, if any this week; and
- (b) the arrangements during the summer particularly while you are on the Australia trip.

(a) This week

The last two days have been mercifully quiet (today's evening report enclosed).

As I mentioned yesterday, the Chancellor has agreed that any intervention should only be tactical and not designed to defend a particular rate. His office also agreed that you would be consulted before authorisation was given for intervention exceeding \$150 million in any one day. Fortunately that arrangement has not been tested so far this week.

My understanding is that the Chancellor continues to oppose any further interest rate increase while the pound remains at present levels. You will want to consider whether to press

him on this. If the exchange rate stays broadly where it now is following the trade figures you may not think it worth pressing him too hard. But you might want to suggest that, if the exchange rate shows any signs of falling, we should move quickly with another $\frac{1}{2}$ per cent increase.

(b) Arrangements for the summer

We shall have secure communications with you most of the time during the Australia trip. But these will be complicated by the time difference. We should be able to ensure that first thing each morning you get the key figures from the previous day's evening report. And if operational decisions are required early in the day here, we should be able to reach you in the late afternoon/evening your time. Communication difficulties will increase the further we get into the day here.

Against that background you might want to suggest the following guidelines to the Chancellor:

- he can take it that you would be most unlikely to object to any proposals to increase interest rates;
- but, however strong the exchange rate, you will take a lot of persuading that any interest rate reductions are appropriate;
- you are not opposed to all intervention. But you were concerned at the scale (\$600 million) authorised last Thursday, and think that "tactical" intervention ought to involve no more than \$150 million in a day. Without seeking to set this as a rigid limit, you hope he will operate within that sort of framework; if nonetheless the markets take the exchange rate up that should be allowed to happen. If he wanted to undertake substantially more intervention than that you would want to have the chance to comment.

PRCG.

(PAUL GRAY)

26 July 1988

SECRET