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AT

PRIME MINISTER

11 May 1989

THE Dmark, THE DOLLAR AND STERLING

It is becoming increasingly clear to the Bundesbank (and, I believe I suggested this to you some two months ago) that it (and, above all, Pohl) have greatly misjudged monetary policy. The monetary aggregates are all over the top, inflation is rising (the wholesale price index was over 6 per cent on a year-on-year basis), and there is very large exodus of capital. Per contra, Alan Greenspan has conducted a most responsible monetary policy and has laid the foundations for low and stable inflation for the next two years.

Currencies reflect these policies. The dollar soars, the Dmark sinks.

I conjecture that the Bundesbank will be driven eventually to tighten monetary policy through increases in interest rates. If the increases exceed 100 basis points, this will cause a decline in the Dmark exchange rate of sterling.

I am concerned about the reaction of the Treasury and Bank to these conditions. The immediate reaction is to use intervention to test sterling's decline against the Dmark. As you know, I think that running down our reserves by buying sterling on a market that is falling because of a fundamental change in monetary conditions in Germany is simply a recipe for losing money. If not sterilised, the intervention has the effect of a monetary squeeze. If sterilised, it is useless.

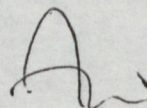
The next reaction is likely to be that we should put our interest rate up pari passu. This, like unsterilised intervention, will increase the severity of our present monetary restraints.

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This would be wrong. Last week the Treasury and Bank agreed that the present monetary squeeze was the right degree of severity for our domestic inflation problem. There is no reason why we should distort our policy and economy in response to the Bundesbank's past mistakes and their present attempts at redress. For example, if the Bundesbank increased rates by 150 to 200 basis points (not beyond the range of the feasible) and we followed with similar rises (to 15 per cent), I believe that such a policy would be very likely to induce a recession - perhaps a severe one - in 1990-1. (It would also create great dissension in the EMS; France in particular would hate to see a rise in interest rates.)

In short, we should stick to our present monetary stance. It is broadly right. And we should take any effects of a putative German squeeze on our exchange rate.



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