

CCB/SP

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After we must
just discuss
not

PRIME MINISTER

EXCHANGE RATE MANAGEMENT

You will want to see the attached two notes from Alan Walters, each covering similar issues.

The first note on intervention at Flag A sets out Alan's worries about intervention if there is downward pressure on sterling. He seeks your authority to discuss with the Treasury and Bank the imposition of explicit constraints on intervention activity.

The second at Flag B repeats the worry about intervention in relation to the policy being adopted by the Bundesbank. But Alan goes on also to argue that any external pressure to increase UK interest rates should be resisted.

I would offer two quick thoughts on this:

- in recent months you have adopted an asymmetric view on intervention. You have opposed intervention if the market has been pushing sterling up, but you have been content with modest intervention to prevent sterling going down. Alan favours symmetry, with no intervention in either direction. I continue to see a case for a degree of asymmetry, and would have worries about a completely "hands off" approach if there was downward pressure on the exchange rate.
- on interest rates, I do not dissent from the view shared by Alan and the Treasury that at present the stance of monetary policy in relation to the domestic inflation problem is right. But we need to keep that assessment continually under review and we certainly cannot rule out the possibility of the need for an interest rate increase; the separate note in the box on economic statistics next week points to a surprisingly large

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reduction in the latest unemployment figure, and - as we discussed when you saw Cecil Parkinson yesterday - further upward pressure on wage increases may also necessitate offsetting monetary action.

On handling, the issues raised in these two notes by Alan also inter-relate with his note on ERM that Charles has put separately in the box. Perhaps it would be sensible for you to talk through all these issues with Alan, before he discusses the intervention issue further with the Treasury and the Bank.

Content to proceed on that basis?

Paul.

(PAUL GRAY)

12 May 1989

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