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PRIME MINISTER

INTERVENTION

The Chancellor held a meeting this afternoon with the Bank about our intervention policy and interest rates, and I have had a brief report. The background is intervention in the last 24 hours of some $660 million, much of it in DM. The US deficit in August was only a little better than the record deficit in July, and $1 billion or so worse than market expectations.

Eddie George was apparently concerned about the continuing scale of the intervention and its effect on financial conditions. But, generally, there was not too much concern about funding policy: apparently the short-fall in funding against intervention is being offset by reductions in the forecast PSBR. (A surplus for this year is now forecast.) Most of those present felt that it would be wrong either to reduce interest rates or to allow sterling to rise against the DM. The Chancellor concluded that there should be no change of policy at least until after the Autumn Statement. We should continue to intervene. His Private Secretary told me he thought that the Chancellor would not want in fact to change policy even after the Autumn Statement.

I did not at this stage question whether continuing intervention and the present level of interest rates were the right combination. The problem seems to me to lie at least as much with the present objective of keeping the dollar stable against the DM. I put to the Chancellor's Private Secretary the parallel with the late 1960s, when European Central Banks and others shouldered the task of financing the US current deficit. Then the accepted wisdom (among non-Keynesians) was that the intervention needed to keep Bretton-Woods going was in effect allowing the US to export its inflation. I suggested that the pressure on sterling could well be eased if the dollar were now allowed to depreciate against the DM.

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The Private Secretary of course defended the policy loyally, arguing that the disruptive movements we have seen in exchange rates brought about by the markets could now be avoided by more substantial inter-Government agreements and intervention. But he told me, interestingly, that US Treasury officials had advised Baker at the time of the IMF meeting to look for some further depreciation of the dollar against the DM. There is apparently some belief at the top of our own Treasury that this may happen within a month or two.

All this is clearly something to be talked through with the Chancellor at an early opportunity on your return.

DAVID NORGROVE

14 October 1987