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Prime Minister

3 March 1988

Intervention and the Markets

I believe the time is now right to uncap the DM/£ exchange rate.

The argument is as follows:

1. The scale of current intervention (£1bn in two days) shows that the authorities are under enormous pressure.

2. The current strength of sterling is a reflection of two factors: a government fiscal position which is enviable, and interest rate yields which are very high.

3. Nothing that is likely to happen between now and the Budget will ease these pressures. Indeed the Budget itself will only intensify them. Cumulatively therefore, the intervention could lead to large numbers.

4. The domestic perception is different from the external perception: domestic investors are worried about inflation - which is reflected in the upward slope of the yield curve. Foreign investors recognise inflation may rise, but not for some time; however as other currency relationships have stabilised, they wish to take capital gains in sterling.

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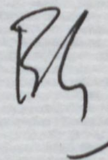
5. We already know, and it is certainly the view of the Bank, that monetary policy is if anything on the loose side. Continued intervention is emasculating monetary policy - and effectively telling business that we are protecting their comptitiveness. We are therefore creating an extremely unattractive climate for wage negotiations (earnings have increased by 8-8½% in the last three months).

6. The key question therefore is how long does intervention carry on if the markets continue to be under pressure?

As there are no factors in sight which look like changing the markets' current expectations - indeed quite the reverse - we should let the exchange rate rise and welcome its contribution to our anti-inflation policy.

If the exchange rate is allowed to rise now we will avoid the pressure for higher interest rates which will almost certainly follow the Budget.



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