SUBJECT cc MASTER

SECRET AND PERSONAL

file LOSAKP

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

4 March 1988

MARKET MANAGEMENT

It may be helpful if I record the outcome of the two discussions the Prime Minister and the Chancellor had this afternoon.

When they met at 1400 the Prime Minister expressed her deep concern about the continuing heavy level of exchange market intervention, which had now totalled some $1.8 billion in the last 48 hours. She was concerned that this was adding to the inflationary pressures in the economy and she felt that the market perception that the authorities were seeking to hold the rate at DM3 was acting as a magnet and encouraging further pressure on it. In response, the Chancellor said that there would be no difficulty in sterilising the addition to liquidity through funding policy, and he was most reluctant to give up the benefits obtained from the recent period of exchange rate stability, particularly in the immediate run-up to the Budget. But he accepted that intervention at the rate of the last 48 hours could not be allowed to continue indefinitely.

At the end of this first meeting it was agreed that the Chancellor would consider the position further, in consultation with the Bank of England, and would report back to the Prime Minister later in the day on whether the DM3 "cap" should be removed and, if so, when.

When they met again at 1630 the Chancellor said that, in the light of developments over the last couple of days, it might no longer be possible to hold the exchange rate below DM3 until the Budget as he had originally hoped. After consulting the Bank of England he had concluded that further intervention should be undertaken today, if necessary, in the London and New York markets to hold the rate below DM3; it would be unwise for the "cap" to be seen to have been removed immediately before the weekend. However, if on Monday morning there was still strong demand for sterling he accepted that the rate should be allowed to go above DM3. The Prime Minister said she was content to proceed on this basis.

In further discussion, the Chancellor said he thought it essential to be prepared to undertake some further intervention to break the speed with which the exchange rate might rise. The Prime Minister expressed concern about this, and said her strong preference would be to allow time for the rate to find its own level without any intervention. Following further exchanges, it was agreed that some limited intervention (the Prime Minister mentioned a figure of up to $50 million) to smooth market movements should not be ruled out. But the position would need to be very closely monitored on Monday with regular contacts at least every half hour between this office and your office. Depending on developments, it might be necessary to arrange a further meeting to review the position at short notice.

PAUL GRAY

Alex Allan, Esq.,
H.M. Treasury.