

PRIME MINISTER

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MARKETS

It has been an active day in the markets today with strong upward pressure on sterling, as shown in the attached Market Report. In New York the pound was continuing to trade above \$1.89 and DM3.18 this evening.

You will see that intervention has been very heavy. The Treasury have kept me in touch with developments. At one stage there was a plan to undertake a further heavy bout of co-ordinated intervention during the afternoon, if the Bank (whose idea it was) were confident this would have the effect of driving the rate down. I cautioned against. In the event, this operation did not proceed.

The reasons for sterling's strength seem to have been:

- (i) reactions to yesterday's Bank of England Quarterly Bulletin - extract attached - in which the Bank made clear they would prefer to see interest rates higher and the exchange rate lower. The market has taken this as a clear indication that interest rates will not be reduced, and indeed could be raised, which has made operators more bullish about sterling;
- (ii) the never-ending story of your alleged disagreements with the Chancellor continues, with emphasis being placed on your alleged antipathy towards intervention;
- (iii) the continuing perceived politico-economic strength of the UK plc.

The Chancellor is having a major meeting with Bank and Treasury officials on Monday morning to consider next steps. He may then want to have an urgent word with you.

SECRET

If the upward pressure continues, we face the familiar three options:

- (i) do nothing and let the exchange rate find its own level;
- (ii) take another half point off interest rates;
- (iii) engage in further tactical intervention if market circumstances are thought favourable.

I understand that the Chancellor is resolutely opposed to letting the exchange rate go significantly higher. He may be becoming a prisoner of his own words in recent weeks about a higher exchange rate being unsustainable.

He is therefore likely to see the choice resting between more intervention and a half point off interest rates. I think it is an open question which of these he will opt for.

My view - and that of Brian Griffiths - is that it would not be right to make a further cut in interest rates. The whole "feel" at the moment is that the monetary position is too loose - the MO figures are high, credit is still growing fast and so on. Another half point off would trigger another cut in mortgage rates, so further boosting both the housing market and personal consumption.

So the question then becomes whether conditions are appropriate for further intervention. The arguments against intervention are well rehearsed. And the thing we must avoid above all is getting trapped in a position where we are seen to be defending figures of \$1.90 and DM3.20 - which the markets probably see as their next "target". If I could borrow your phrase, it is no good trying to buck a strong market trend. So the only circumstances in which substantial intervention might be appropriate is if the markets became uncertain and there is a reasonable expectation that a heavy burst of intervention might actually take the

SECRET

SECRET

rate down.

This has to be a matter of tactical judgment at the time. As of now I think it unlikely that intervention will do the trick. But I don't think we should immediately rule out the possibility of, say, a concerted \$500 million operation early next week if the market conditions are favourable. The ~~political~~ ^{potential} inflationary consequences of this - and indeed of several such operations - would in my view be much less serious than a further interest rate cut.

*I agree.
I can + 2 operations
not stop
the mix.*

You may want to reflect on the options over the weekend. Depending on the conclusions he reaches on Monday morning, the Chancellor may want to have an early word with you. This should not pose too much of a problem in diary terms.

PRCG.

PAUL GRAY

13 May 1988

PMMAYS

SECRET

The appreciation of sterling since the beginning of the year, both against the deutschemark and in effective terms, represents a tightening of monetary conditions, which has been in part offset by lower interest rates. A net tightening was a necessary response to concerns about potential inflationary pressure, associated in part with the continuing buoyancy of domestic demand and growth of liquidity. It should exert a cumulatively pervasive restraining influence on wage settlements and profit margins, as well as on many import prices. Experience shows that a firm exchange rate can provide an effective counter-inflationary discipline in an open trading economy like the United Kingdom, which remains more susceptible to inflationary tendencies than many others despite the progress made in reducing rigidities in labour and goods markets in recent years. Nevertheless, the combination of a stronger currency and lower interest rates does not represent an ideal response to current concerns and a different balance would be desirable if it could be achieved. Moreover, exchange rate stability remains desirable in its own right, with benefit to industry, and will continue to be sought so far as is possible without jeopardising the counter-inflationary thrust of policy.