16 A-B

file DCA ALK

Subject CC MASTER

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

24 June 1988

Dear Alex,

MARKET MANAGEMENT

The Prime Minister and the Chancellor this morning discussed market management issues against the background of the balance of payments current account figures to be published on Monday.

I should be grateful if you could ensure that this record of the discussion is seen only by named individuals on a strict need to know basis.

The Prime Minister said she was concerned at the picture shown by the balance of payments figures. She invited the Chancellor to give his assessment and say how he thought it was best to handle the markets once the figures were published.

The Chancellor said that he had indicated at Treasury Questions last week that the current account deficit for 1988 was likely to be higher than the forecast of £4 billion included in the FSBR. The May figures were a further indicator that the growth of the economy was moving ahead faster than had been expected. There were however crumbs of comfort to be drawn from the current account figures in that the fastest rate of growth within imports was for capital goods, reflecting the current strong performance of business investment. He felt it was uncertain how the markets would react to the current account figures, but unless the markets took extreme fright he would want to adopt a reasoned rather than a crisis response. He therefore would prefer not to take any immediate action further to raise interest rates. If there was immediate downward pressure on the exchange rate, he would propose to allow the rate to fall a little, but also to intervene on a sufficient scale to break the fall. Once the markets had settled, he would favour an initial further ½% interest rate increase.

The Prime Minister wondered whether such an approach would convince the markets that the authorities were taking the situation sufficiently seriously. In particular to raise interest rates only by ½% might lead the markets to the immediate conclusion that a further rise was essential. It might therefore be preferable to make a full 1% increase at the outset. She agreed that some intervention to break any fall in sterling would be appropriate, but this should not involve excessive amounts.

Responding, the Chancellor said he did not rule out making a full 1% increase if there was a markedly adverse market reaction to the current account figures. But, while this was a possibility, he did not think it was likely, and if circumstances allowed he would strongly prefer to continue to make interest rate adjustments in steps of ½%. He did however agree with the Prime Minister that it was appropriate to plan for a period of significant tightening of policy. He certainly thought it would be necessary to take interest rates up to 10%, and possibly higher.

In further discussion, the Prime Minister expressed concern that the United Kingdom could be moving into a sustained period of large current account deficit. Although the United States deficit now seemed to be falling substantially, the surpluses of Germany and Japan remained very high, and she feared the United Kingdom was poised to square the circle with an increased deficit. The Chancellor said that he was not unduly concerned by a temporary period of current account deficit following the large surpluses of recent years, and this could be viewed as a safety valve for the recent strong UK economic performance much preferable to the alternative of renewed upward pressure on inflation. He felt that the necessary process of adjusting the current account position would come about as the growth rate of the UK economy slowed down and growth rates in other economies possibly picked up. But the process was likely to be gradual and could not to completed quickly; a substantial deficit might persist for, say, two years. The Prime Minister said she would regard two years of substantial deficit as considerably too long, and she felt that the necessary policy adjustments should be made to complete the process more quickly.

There was also brief discussion of the implications for the 1988 public expenditure round. The Prime Minister and Chancellor agreed that the necessary overall tightening in policy must be reinforced by a tough public spending round. It was noted that they would be discussing the handling of public expenditure further next week.

(PAUL GRAY)

Alex Allan, Esq.,
HM Treasury.