

SECRET

Seen by the Prime Minister 3/10.

PRIME MINISTER

DWS

MARKETS

6/10.

Terry Burns and I spoke to Alan Walters this evening.

Alan's "firm view" is that monetary conditions are "not bad". He discounts the behaviour of £M3. He sees real interest rates as horrendously high. He thinks the exchange rate should move, and the quicker the better, because then it will get to the point where the only way it can go is up.

He agrees with Terry Burns that fiscal policy is too loose, and would look for a tight budget next year. He is not alarmed by the short run quicker increase in M0. When pressed on letting the exchange rate go, he argues that a slow movement is a gift for speculators. Indeed rather than intervening to buy sterling he would almost be prepared to intervene to sell sterling. He would be willing to see the pound fall as far as DM2.60 or \$1.20 (numbers picked off the cuff but designed to show that he would not mind a ^{sharp} short term movement). He argues that the exchange rate would rebound quickly.

He further fears that if interest rates were put up they would not come down at all quickly. But he sees a choice between allowing the exchange rate to fall with no increase in interest rates or putting up interest rates enough so that people would expect the next move to be down. In his mind there is no point in going for a 1% or 1½% increase to counter the pressure on sterling. But, as I say, his very strong preference would be to allow the exchange rate to fall. Any increase in interest rates should come later and would have to be justified by reference to the fundamental economic position and he does not think the need is there at present.

DWS

(DAVID NORGROVE)

3 October 1986

SECRET