

S E C R E T

PWP

From : D L C Peretz
Date : 29 October 1987

MR H P EVANS

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr C W Kelly
Mr Matthews
Mr Hudson

WORLD ECONOMY : NEXT STEPS : LETTER TO BAKER

I have one or two thoughts on the last few paragraphs of your draft, and attach a possible redraft.

DLP

D L C PERETZ

DRAFT PASSAGE

When we met in Washington last month, I argued for a further period of stability in the dollar. However, the sharp fall in equity prices in recent weeks is relevant to this judgement, also. Worries about a possible recession in the US, or at least a period of slow growth, having intensified. At the same time, worries about US inflation must be less. Against this background a lower dollar must carry less risk for inflation; and at the same time, with domestic demand less buoyant in the US next year, it might have a larger impact on the trade balance than we thought likely a month or so ago.

These arguments, and the intense pressures now being felt in the markets, suggest that it may be right to consider a further small step down in the dollar. That is not to argue for any substantial fall : as usual many of the numbers being tossed about are much too large. But the economic analysis suggests that it might be right to consider a modest dollar realignment as part of an overall package.

The other important elements of a package are clearly :-

- a) agreement between the US Administration and Congress on a new budget. To impress the

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markets I believe there will have to be cuts in the deficit of more than the \$23 billion provided in Gramm Rudman II, and also some element of increased taxes. Anything less is likely to be judged by the markets as too little and too late.

- b) lower interest rates in Japan and Germany. I have already reduced interest rates in the UK, but would be prepared to consider a further cut, particularly if the Germans and Japanese were prepared to move also.

Once such a package were announced, we would of course need to be prepared to intervene in the exchange markets, and set interest rates, as necessary to maintain currency stability at the new levels.

When we spoke on the telephone, we agreed it would be a great mistake to rush into a meeting of Ministers, until we have established a clear understanding and an agreement that would act to reassure and not alarm markets. Let us try to work towards such an agreement as quickly as we can. I am keeping in close touch with my European colleagues, so as to keep up the pressure on Germany. If time allows, the next step could be a meeting of our Deputies, to prepare the ground for an agreement, against the background of an analysis of recent stock market movements of the kind suggested by [M. Balladur].