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PRIME MINISTER 8 December 1988

THE ECONOMY: CONFUSING SIGNALS

The effects of higher interest rates on the economy are not easy to assess. Consumer confidence (EC/Gallup survey) has fallen further and there is strong evidence of a slowdown in the housing market (despite large regional differences). On the other hand, the October retail sales figure was very strong (a rise of nearly 2%), producer confidence has held up, money GDP is expected to be a little above the 11% Treasury forecast in October (the upward revision is due to faster real growth) and money supply growth (MO) is still running at 7.6%.

Intervention Tactics in the Exchange Markets

Against this background, the government must not give confusing signals.

It is important that inflation is brought down to 3% or less by 1990 and that the real economy, having suffered some setback as inflation is reduced, is growing again in a healthy way before the next election. Far better to take the medicine now, than delay. However, this means high interest rates for some time. It also means a strong pound. Current intervention in small amounts is difficult to understand in this context. One also suspects it has little effect in keeping the pound down.

I am nervous that either the Chancellor or the Bank might suggest that a 'final' major assault on market expectations is needed if the exchange rate is to be prevented from rising further. I believe such a step should be resisted. It is a confusing signal to the market. It undermines directly the effect which higher interest rates have in reducing the demand for money because it provides extra cash to the market. Sterilisation then produces further adverse side effects - not least on the pound itself!!

Recommendation

Allow the pound to continue rising to say 3.35 DM or 82 effective rate before being worried about overkill.

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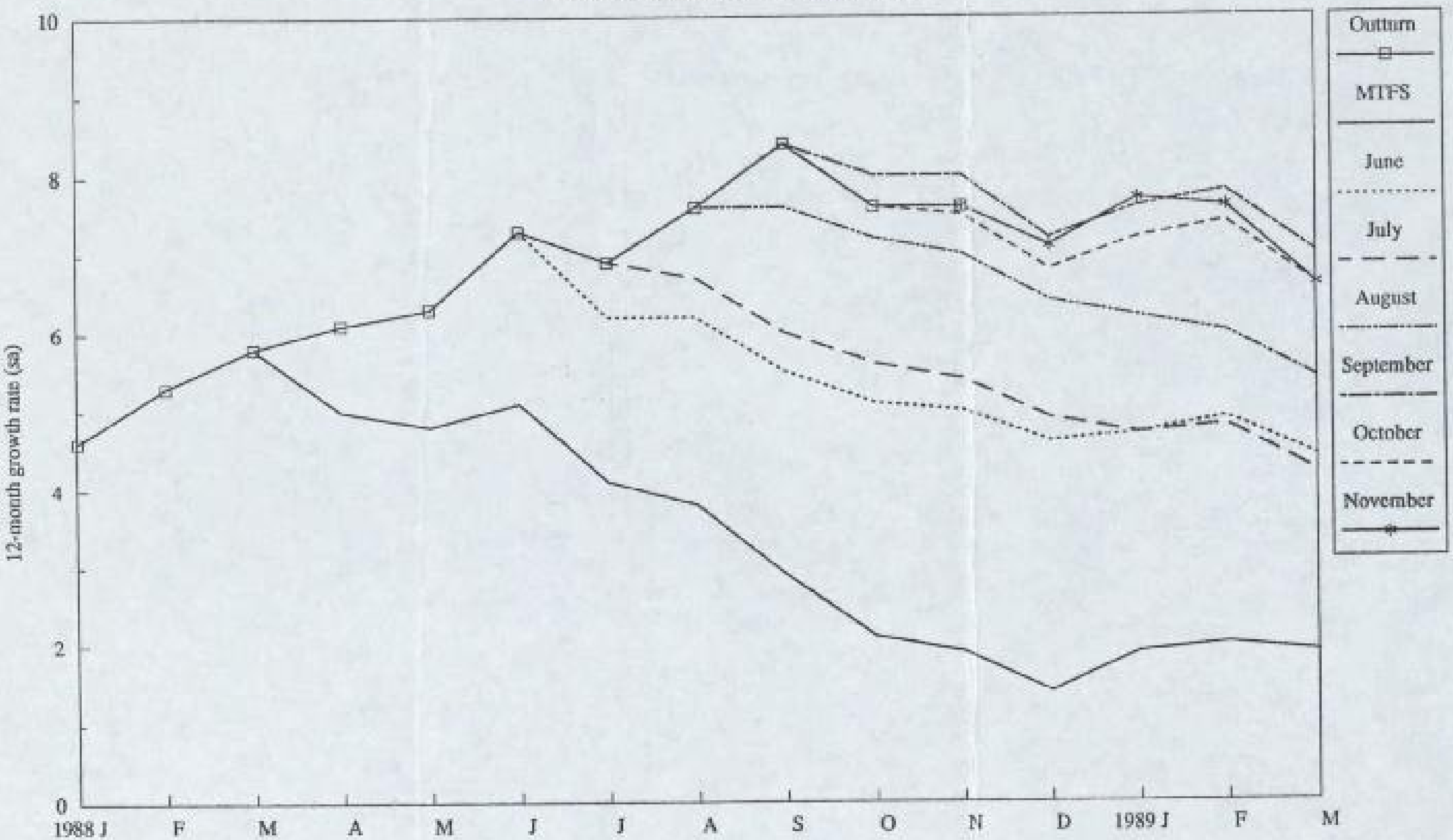
M0: FORECASTS v. OUTTURN

FORECASTS MTFS - NOVEMBER 1988



Forecasts as circulated in Monthly Assessment