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PRIME MINISTER

## POSITION IN THE MARKETS

As I mentioned on your return, today has been a rather rocky day in the markets. The market report attached summarises the position.

You will obviously want to take stock of the position when you see the Chancellor for your bilateral on Wednesday afternoon. That will be after the publication of the trade figures at 1130 on Wednesday morning, and it will be possible to assess then the immediate impact on the markets. As of now, however, the markets do not seem to be anticipating that the trade deficit will be quite as high as it is.

Meantime, I thought you would find it helpful to know how Eddie George views the position. I have, therefore, had a private conversation with him; you should not reveal your knowledge of Eddie's views to the Chancellor.

Eddie says that the markets are currently taking a more jaundiced view of the position of those countries with large external deficits protected by high interest rates. That covers Australians and Canadians as well as us. The change of sentiment is influenced by increasing interest rates elsewhere, for example, the Fed's increase in the discount rate of 7 per cent on Friday, and talk of a further German interest rate increase later this week.

In this mood of nervousness, the markets will be paying particular regard to Wednesday's trade figures.

You will see that total intervention today has been of the order of \$200 million. Eddie tells me this was carried out in three separate waves. He was slightly doubtful about the merits of this operation, fearing that it would have little effect. In the event, he thinks it has had some effect in holding the interest rate higher than it would otherwise have <sup>exchange</sup>

been.

Looking ahead, Eddie thinks there will be further nervousness when the trade figures come out, with the DM 3.15 level being tested. The pressure will be greater if it then seems likely that the Germans will be increasing their rates. Eddie himself hopes to get a clear indication from the Germans of their intentions on Wednesday; but we may not have any advance notice before they announce their decision on Thursday morning.

Subject to developments later in the week, Eddie does not think that we should be contemplating a further interest rate increase immediately after the trade figures announcement. He considers that, if there is downward pressure on the rate then, we should try a heavy bout of intervention - by which he means a figure of up to \$1 billion over a 1-2 day period. But if that does not work, he would then favour an interest rate increase.

#### Assessment

My own view is that, if downward pressure on the exchange rate continues, now is the time to contemplate heavy intervention. The Reserves are very high, and are there to be used in conditions like this. The monetary effect of running down the Reserves is helpful. And the last thing we want to see at the moment is a sliding exchange rate.

At the same time we should if possible try to avoid a further interest rate increase at this stage. The political and other difficulties of such a move in the run-up to the Budget speak for themselves, and on the underlying merits the balance of the present evidence is that 13 per cent interest rates probably are high enough to produce the desired slow-down in economic activity. A further increase could easily produce over-kill; particularly as, if the skids really get under the <sup>exchange</sup> interest rate, a 1 per cent interest rate increase may not be enough to calm the markets.

Obviously, we need to judge the position day by day.

If you agree with this analysis, you may want to take the opportunity on Wednesday of pressing the Chancellor to authorise substantial short-term intervention. If it works, all well and good, and if it doesn't, we have lost very little; the Reserves will still be far higher than they were in mid-1987.

PLCG.

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27 February, 1989.