

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 23 MAY

You are having your regular weekly bilateral with the Chancellor tomorrow after Questions.

You will want to consider what, if anything, further to say to him following the weekend's events. You had a word with Andrew this morning, and I think you agreed it would be useful to press the Chancellor to share with you a paper analysing the reasons why no further progress has been made in reducing inflation since 1983 and for the recent acceleration in the rate. You might urge him to let you have this note in time for your next bilateral on Tuesday 6 June (a fortnight tomorrow). Andrew's note below (Flag A) comments on this, and attaches the recent Alan Budd article (Flag B). Your copy of the Tim Congdon booklet is at Flag C.

If the Chancellor shows resistance to this idea, you might like to remind him of his comment on the telephone on Saturday that he was always happy to discuss policy matters with you privately.

Although the Chancellor's office have not raised the point with me, you should also have in mind the possibility that he may mention Christopher Monckton's article in the Standard today, which Andrew showed you this morning.

The Chancellor's office have suggested two items for discussion. These are:

i. Markets

Today's evening report is enclosed (Flag D). You will see that there has been significant UK intervention; some of it on our own initiative, and some in concert with other central banks. But once again the Germans have stayed out.

The key issue for consideration is whether interest rate action later in the week would be appropriate if the Germans were themselves to make a move. There have been suggestions in the market today that an increase in Japanese interest rates was imminent; and on the basis of the Reuters' commentary market operators are said already to have discounted half per cent moves by both the Japanese and Germans. In the UK money markets, inter-bank rates have firmed somewhat today, suggesting the market now thinks a rise in UK interest rates is more likely.

The factors to consider in reaching a view are much the same as when you talked to the Chancellor last week. But one new development is the provisional April figures for UK retail sales which have come in today (Flag E) (to be published on Wednesday). These strongly confirm the view that consumer demand is slowing down. I imagine Alan Walters would say that this highlights the danger of a further interest rate increase restraining the economy too much. On the other hand, you will want to bear in mind the impact of any further exchange rate depreciation on import prices and in turn the RPI. The power workers pay settlement may also lead to a further ratchetting up in wage demands, which would be unhelpful both in itself and in terms of the possible market impact.

ii. Informal ECOFIN Council

You have already seen my note of yesterday reporting on the discussion of the Delors Committee (Flag F). On the other key items, I gather the outcome was:

- the withholding tax is virtually dead;
- member states agreed to consider Madame Scrivener's revised proposals. You may want to ask the Chancellor what his attitude to them is; is he (as I suspect) minded to regard them as offering the basis for a possible agreement?

Rec.
PAUL GRAY

22 May 1989