

file DS3AJA
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SIR ALAN WALTERS

FUNDING POLICY/INFLATION

There has been a lot of speculation in the press over the last week or so about possible changes to the details of funding policy and management of the money market. This had its origin in comments from Tim Congdon and others, including the suggestion of a return to over-funding.

The Treasury went out of its way at the end of last week formally to deny the stories that a fundamental review of the conduct of policy was underway. But my understanding is that the Chancellor has asked for a number of the technical suggestions to be looked at. I think it would be helpful on your return if you could quickly take stock with Michael Scholar and others of what work is underway, and ensure that you are fully involved in it. You might want to consider letting the Prime Minister have a note, say, for next weekend's box.

There is also a separate Treasury exercise under way you should be aware of. About ten days ago, the Prime Minister told the Chancellor she thought it would be helpful to have a note analysing the reasons why we have made no further progress in reducing the rate of inflation since 1983 and for the recent acceleration in the rate. The Chancellor responded that he had already asked Terry Burns to do some work on this. I am told that Terry has now done a first draft, which focused almost exclusively on the experiment in shadowing the ERM. The Chancellor has discussed this with him and asked him to revise it, particularly by extending the analysis to cover the 1985-86 period as well. (You will be aware that Tim Congdon, amongst others, has argued that it is in that earlier period, not just in the 1987-88 ERM shadowing, that things started to

go wrong.) You may like to make contact with Terry to check progress on this exercise; I have told the Chancellor's office that it would be helpful to have this note available within the next week or so.

PAUL GRAY
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