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PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 14 JUNE

I have discussed with the Chancellor's Office two main items for tomorrow's agenda:

- the position in the markets

- the Treasury paper on the causes of the present inflation.

Markets

We discussed aspects of this during the day. I enclose the following papers in divider 1.

Flag A - today's Market Report;

Flag B - a note from Alan Walters, commenting on the day's events;

Flag C - a further note from Alan Walters in which he sets out his worries about the over mechanistic link in Treasury thinking between the exchange rate and interest rates.

As I said this evening, I think today's operations have been moderately successful in arresting what was a potentially very difficult position. I am not sure what line the Chancellor will take tomorrow. But I think he shares your wish if possible to avoid a further interest rate increase, at any rate this week. You will want to talk over with him what our intervention policy should be; and in what conditions, if any, the interest rate option should be considered.

Causes of the present inflation

The papers in divider 2 are:

Flag D - the Treasury paper, which you saw last night;

Flag E - commentary by Alan Walters.

You had some discussion with Andrew earlier in the day about handling. We both see advantage in setting up a meeting to discuss all this with Alan Walters, Peter Middleton and Terry Burns present. You mentioned this evening the possibility of talking also to Alan Budd and Tim Congdon; but, given their private sector position, I do not think you could include them.

You will want to consider what to say to the Chancellor about such a meeting. If you suggest this handling to him, there is probably no need for you to have much discussion about the paper tomorrow. But points I think you should explore with him, either tomorrow or at the later meeting, include:

- the basis on which comparisons are being drawn with inflation in other countries. The RPI excluding mortgage interest is a very doubtful comparator; I suspect using the GDP deflator would paint a different picture;

- what significance, if any, to attach to broad money. Alan supports the Treasury in rejecting it as a cause of the present problems. I recognise his arguments, but am not sure broad money should be totally dismissed. It may be a poor short term guide; but over a period of years the build up of liquidity and access to credit implied by rapid growth of broad money must carry dangers in a period of high consumer confidence like last year. Surely it cannot be wholly disregarded;

- the links between the arguments about sterilised intervention (see Alan's note) and the balanced funding rule. Is it agreed that sterilised intervention does not add to monetary pressures?

- if so, is the main moral that what went really wrong in 1985-88 was incorrect decisions on interest rate policy because too much attention was given to the exchange rate

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rather than other monetary indicators? The Treasury concedes this to a point, but bizarrely does not even mention the final reductions in interest rates from 9 to 7½ per cent last spring. If during the whole of the last four years we had kept interest rates comfortably in double figures, might we not have had a position in which:

- the exchange rate would have stayed higher;

- growth would have been less, but very respectable, still with a significant fall in unemployment;

- inflation, however measured, was kept below 5 per cent;

- the balance of payments would have been stronger;

- we would have been facing now a position in which slow growth with low inflation could be sustained, without the need for the shock treatment we are now having to administer?

Paul.

PAUL GRAY

13 June 1989

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