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INTERVENTION AND RATES: 13 JUNE

We have spent about \$700m, most of it in the afternoon, in a "two-pronged" attack - with your support in the House as the other prong.

The effects of such a substantial intervention do not appear to be obvious in the market data. In fact the exchange rate firmed up as New York opened before the main intervention. And it did not appear to move as the purchases were recorded.

Similarly the interbank 7 day stayed at just below 14½ per cent.

I doubt if this intervention is any more than cosmetic. Eddie George thinks he needs some intervention to give signals to affect the psychology of the market and prevent it running away. But \$700m is high-priced psychology.

I still believe that our monetary squeeze is the right order of tightness to restore 4 per cent inflation by 1991. A gradual decline of the exchange rate of sterling is quite consistent with that programme (as we showed in the joint decline of sterling and inflation from 1981 to 1983).

but
unfortunately
the market
does not
always
decline
gradual
changes!

Recg.
The alternative of increasing interest rates is fraught with uncertainties and danger. First, one may have to choose between no increase and 16 per cent plus, since it is not at all clear that a 15 per cent rate would stem the outflow. A 15 per cent rate may be interpreted as a signal for an even higher rate. Secondly, a rate increase would undoubtedly risk a considerable recession in 1990 with the depths being reached at the end of that year. The timing could not be worse.

The pressure on exchange rates and so on the money market is virtually entirely generated by the markets' belief that we will not allow any depreciation (say below 90 or 3.07 Dmark) and that we will put up interest rates. It seems to me to be crucial to make it clear that we shall not dance to the tune dictated by the perceptions of participants in the exchange rate markets. It is not a question of fighting present inflation. That is taken care of by a suitably tight monetary policy. But it is a question of survival in the next election.

ALAN WALTERS