PRIME MINISTER

me Lk 27 (a-d)

MEETING WITH CHANCELLOR AND TREASURY OFFICIALS: WEDNESDAY
5 JULY

As we discussed I have now fixed up a meeting with the Chancellor, Peter Middleton, Terry Burns and Brian Griffiths for next Wednesday afternoon. The Governor has not been invited. I have discussed further with Alan Walters the possibility of him coming back early from the United States to be present; unfortunately he has been unable to reschedule his commitments and sends his apologies.

There are a number of key issues you will want to cover in the discussion. But I think these fall under two broad headings:

- Where did we go wrong over the last 2-3 years on inflation?
- Where do we go from here on interest rate and exchange rate policy?

I have included various papers in the folder. You have already seen $\underline{\text{Flags A}} - \underline{\text{D}}$ which are mainly relevant to the first item. These are:

Flag A - The Treasury paper on the recent rise of inflation

Flag B - The Alan Budd article

Flag C - The Tim Congdon article

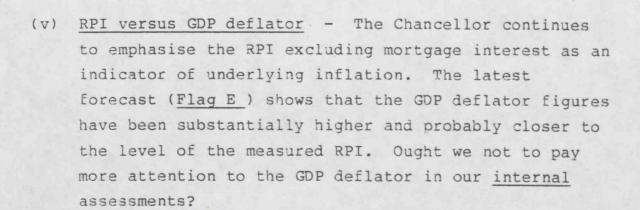
Flag D - The Stephen Hannah article on MO.

The main <u>new paper</u> in the folder, relevant for the discussion of where we go from here, is the <u>latest Treasury forecast</u>; this is at Flag E.

What went wrong?

- (i) <u>Broad money</u> was it really such a bad indicator?

 Notwithstanding the distortions can we really afford to ignore it if it constantly grows at around 20 per cent per annum? Should it really be dismissed to the extent the <u>Flag A</u> paper suggests, or is such an attitude just as much in error as Tim Congdon's belief that broad money is all important?
- (ii) Narrow money was it a good indicator? Was the problem that it gave good signals but we failed to act upon them? Or did it behave, as some have argued, only as a concurrent indicator, giving no advance warning of inflationary pressures? What importance should we attach to the Hannah P-star analysis?
- (iii) <u>Intervention</u> What was the impact of sterilised intervention? Did the process of sterilisation fully neutralise its adverse effect on the money supply variables and in turn inflation, while simultaneously rendering the impact on the exchange rate ineffective?
 - (iv) Loosening of monentary conditions When we say monetary conditions were too loose, what does this mean? Is this a comment on intervention policy? Or do we really mean that interest rates were too low? Is the main moral to be drawn from the 1985-88 experience that interest rates should have been kept substantially higher throughout so implying a higher exchange rate, restraining growth, keeping inflation lower and avoiding the present need for sharp corrective action?



(vi) The 4 for 1 rule - Was this a dangerous formula to adopt? It is argued with the exchange rate appreciating a "balancing" cut in the interest rates keeps monetary pressures overall unchanged. But for the personal sector may not the two things be reinforcing rather than neutralise each other - a cut in mortgage rates boosts the growth in real income from the appreciation of the exchange rate. The same is true when the exchange rate is falling - though when inflation is as high as it is maybe there should be a bias towards restrictiveness.

Looking ahead

You will want to have a careful look at the Treasury forecast (Flag E). Most of the key points are brought out in the Summary and Main Issue Section (Pages 1-9); but if you have time it will also be useful to skim through the other more detailed material. The main points that strike me are:

- As compared with the budget forecast, the economy is now expected to grow faster and inflation to come down more slowly (RPI still $6^3/4$ per cent at the end of this year and around 5 per cent still by 1991 (see page 51)).
- Even with the economy growing faster, the PSDR is projected to be smaller this year £12 billion rather than £14 billion. Tax revenues do now seem to be slowing down.

d.

The current account deficit for this year is now put at £16¹/4 billion, notwithstanding an assumed very strong export performance, and still forecast to be £13½ billion in 1990.

You may want to address the following issues in discussion:

- (vii) How confident are the Treasury about the forcast assessment? With the economy close to a turning point it is a particularly difficult point to reach a judgment.
- (viii) Is there a case on domestic counter inflation grounds for a further interest rate increase?
 - (ix) What forms of words will now be used about the ERM? You may want to emphasise that the Chancellor should stick closely to your Madrid approach, and avoid public statements that a decision will be taken sooner rather than later.
 - (x) What should intervention policy be? Are you content for heavy intervention in an attempt to prevent the exchange rate depreciating?
 - (xi) What should Ministers say about exchange rate depreciation? A balance needs to be struck between hawkish words which may subsequently have to be eaten, and giving sufficient reassurance of firmness to the markets.

PAUL GRAY

30 June 1989

KAYAXA