

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 16 OCTOBER

You are seeing the Chancellor on Monday morning. This is primarily to discuss the position on the UK's paper on EMU. I suggest that you take that item first. Charles has put the papers separately in the box.

But there are also two other particular items the Chancellor wants to discuss, namely the markets and his Mansion House Speech.

MARKETS

The Chancellor will want to discuss how the markets are to be handled during your absence at CHOGM. I guess he will not wish to be particularly forthcoming and to leave himself substantial freedom of manoeuvre to respond as he sees fit. You will want to consider how far to seek to tie him down: as a minimum you may like to agree various guidelines.

Alan Walters returned yesterday to the United States for some two and a half weeks. But before he went he set down his thoughts in the note in Folder 1. Essentially Alan wants a public declaration that a formal policy of a free exchange rate will be adopted.

You will obviously want to consider Alan's arguments. I am bound to say I have various reservations:

- whatever view one takes about exchange rate management I find it hard to believe that interest rates at 12 per cent would have been sufficient to deal with the problem of domestic inflationary pressure. The underlying strength and enterprise in the economy is now so much greater than in the past, and as a result we do need historically high interest rates to contain

it. This is reinforced by the fact that we now have a totally liberated financial sector and lack of restrictions on credit availability.

- I do not think you can be indifferent to the future course of the exchange rate. Keeping the rate reasonably firm is certainly perceived by the markets as an important part of counter inflationary policy; and in reality a very weak exchange rate would put short-term upward pressure on the measured rate of inflation and hence once again on wage demands.

- Given all that has been said over the last year it is surely just not credible for the Chancellor suddenly to announce that we have a free exchange rate. I am clear he would not see this as getting him off the horns of his present dilemma; rather he would see himself as impaled on one of them.

All that said, I agree with Alan that there are major dangers of getting hooked - and being seen to be hooked - on trying to defend the exchange rate at particular levels. This could well serve to increase upward pressure on interest rates unnecessarily. It was therefore a very good thing that the exchange rate quickly fell through DM3 and we did not find ourselves in a corner in relation to that particular rate. So any policy of trying to manage the exchange rate has to be done very delicately and carefully.

On that basis the sort of approach you might want to put to the Chancellor would be:

- you are very worried about the prospect of any further interest rate increases, both in relation to the domestic economic need and the political consequences.

- we must therefore avoid getting trapped by being seen to defend particular levels of the exchange rate.

- if there is a very strong downward pressure on the exchange rate that may well have to be accepted, certainly in the range down to say DM2.80.
- nonetheless you accept the case for "smoothing" intervention, if it is felt this would do some good. In any event it should be kept relatively small in scale. You are open to proposals, if market circumstances seem appropriate, to an attempt to push up the exchange rate if it should fall in the meantime. But you would want to be specifically consulted about any such operations.

MANSION HOUSE SPEECH

The Chancellor will be looking over the weekend at the first draft provided by Treasury officials. But there is unlikely to be anything for you to see before your departure for CHOGM. You will want to press the Chancellor on Monday to say broadly how he plans to handle the key parts of the speech on monetary policy; and to insist that we should have a draft on Tuesday to face out to you (so that you can feed back any reactions in good time before the speech on Thursday).

OTHER ITEMS

I suspect all the above will take up the available time. But there are two other minor items, which were not reached at your last bilateral, to which you might want to refer if time permits. These are:

- the position on the balancing item; see papers in Folder 2.
- Ownership of pension fund assets; see papers in Folder 3.

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13.10.83