

PRIME MINISTER <sup>2</sup>

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INTERVENTION, STERILISATION AND FUNDING

At your recent meeting with the Chancellor, Peter Middleton and Terry Burns, there was some debate about whether the high level of intervention in 1987-88 had been genuinely sterilised and/or funded. In the light of that discussion, I asked Alan to prepare a note.

Alan's note is now attached. I think the key points are:

- he accepts that, in some sense at least, the intervention was automatically sterilised;
- but the real problem was that, in order to keep the exchange rate at DM3, interest rates had to be kept at too low a rate, and those lower interest rates generated the excessive monetary growth;
- on the funding side, it is right to stick to the policy of full funding and to avoid over-funding. This would not be a substitute for using the primary weapon of interest rates;
- he remains highly sceptical about the 'psychology' argument for intervention.

Plc.

PAUL GRAY

14 July 1989

Reaction very much  
not