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From the Private Secretary

16 October 1989

SUBJECT CC MASTER

FINANCIAL MARKETS

The Prime Minister and the Chancellor this morning discussed developments in the financial markets.

I should be grateful if you would ensure that this letter is seen only by those with a strict need to know.

The Chancellor said that the UK equity market had fallen by some 7 per cent at the opening this morning, but now seemed relatively calm. It was likely that dealers were awaiting developments on Wall Street when the American markets opened at 14.30. After a brief discussion it was agreed that it would be helpful for the Chancellor to issue a statement designed to calm the equity market; he would consider further whether this should issue at lunchtime or await the opening of the American markets.

Turning to the position on the foreign exchange markets the Chancellor said that sterling had this morning firmed against the dollar but had fallen substantially against the Dm. This was a cause for serious concern. Significant depreciation would undermine the Government's counter-inflation objective, particularly given the likelihood of the market overshooting. He therefore felt it was important to take action to resist depreciation.

The Prime Minister said that there was a strong case for a significant DM revaluation given the massive size of the trade imbalances; it now seemed the Germans were running a current account surplus of some £35 billion, while the United Kingdom was running a deficit of some £20 billion. As regards possible UK policy measures she felt very strongly that it would not be appropriate to consider a further interest rate increase. If there were strong downward market pressures on sterling then there was relatively little the authorities could or should do to counter this trend; and arguably the sooner the market adjusted to the new level the better. She accepted however that it could

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be appropriate to take action to break any fall; although intervention of some $400 million a day, as had occurred in the previous week, was too much, there might be a case for bouts of intervention of, say, $50 million.

The Chancellor said that, if other policy instruments were not to be used, this strengthened the case for considering entry into the exchange rate mechanism (ERM) of the EMS, initially on the basis of wider margins. The Prime Minister said there could be no question of joining the ERM at this stage; we should stick to the position established at Madrid. The priorities had to be getting down the UK inflation rate and ensuring that other European countries removed foreign exchange and other restrictions.

Discussion then turned to the Chancellor's forthcoming Mansion House speech on Thursday and the draft paper on EMU that he wished to submit in advance of the Eco-Fin Council. On the latter it was agreed that the Prime Minister would take a meeting with a small group of colleagues immediately after her return from CHOGM. The Chancellor said that, meantime, he proposed to "lift the veil" a little on his thinking on the development of EMU in the Mansion House speech. The Prime Minister agreed he should lift the veil a little but not to go into any details; as regards the ERM nothing should be said that went beyond the post-Madrid statement.

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