

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

You have your regular bilateral with the Chancellor tomorrow at 6pm.

The Chancellor wishes to discuss recent developments in financial markets and the latest economic indicators. Attached, as background, is the Treasury's latest monthly monetary assessment (though some of the figures are now out of date).

Financial Markets

It might be useful to consider the financial markets under three headings - the exchange rate, equities and money markets.

On the exchange rate, sterling has weakened gently after the initial surge on entry into the ERM on 5 October. Elsewhere the dollar is weak; the DM and yen strong.

Sterling's relatively subdued performance in part reflects its tracking of the dollar; in part, it is the expectation of lower UK interest rates; and, more recently, it has been attributed to political uncertainty. Sterling is now the weakest currency within the ERM. But a fall in the Spanish peseta from the top of its band, has given us a little more room: sterling would not be down against its lower band until DM2.85.

The key policy question is clear: how far does sterling's weakness constrain the scope for further interest rate cuts which might (soon) be justified by domestic monetary conditions?

Equities have held up fairly well. Trading volumes remain subdued: financial institutions are maintaining high liquidity. Uncertainty about the Gulf is making the equities market nervous, not just in London but also Tokyo and Wall Street.

Finally on money markets, all the indicators on monetary growth are showing deceleration. The growth of M0 is well within target range. One result has been some market pressure for further cuts in UK interest rates - (resisted by the Bank through

Treasury bill operations).

Economic indicators

The main areas of interest are inflation and activity.

All recent inflation indicators are encouraging.

- (a) Output price rises appear to have peaked in the summer; the annual rate of increase is now gently decelerating.
- (b) Despite higher oil prices, the weakening of commodities prices means that, on a annual basis, input prices are falling.
- (c) The RPI figure on Friday should, at worst, show a constant annual rate of increase at 10.9 per cent; the November figure should show the first convincing reduction.

The worrying sign is that there remains no evidence of wage settlements moderating. Though the various settlements in the motor industry are atypical, they will nonetheless be a target for other powerful bargaining groups.

All indicators of activity show evidence of the slow-down. Most recently, the CBI survey and retail sales figures have indicated sharp decline. And the figures on manufacturing and production industries output released today showed a bigger fall than financial markets had expected.

Comment

The main worry is nicely encapsulated on the first page of the attached Treasury document:

".....how companies respond, as the squeeze tightens, will be the key to the economy's behaviour in coming months."

Crucial to the outcome is the large corporate sector deficit. It is at an unprecedentedly high level; and though the flow of

additional borrowing has significantly slowed in the last two quarters, the burden of financing the deficit is bearing hard on the company sector. A number of highly geared companies are now going to the wall.

The critical question is: how far will industry and commerce go on borrowing to finance this huge deficit; and how far will they cut activity in order to reduce the deficit instead?

- The more they adopt the latter course, the sharper the down-turn will be. There lies the danger of recession.
- Moreover the higher that interest rates remain, the less willing is the company sector likely to be to go on financing the deficits.

The right policy response would be a reduction in interest rates - as soon as justified by underlying domestic monetary conditions. But there are two problems.

- First, the Government's freedom of action is somewhat circumscribed by exchange rate considerations. Delaying reductions in interest rates adds to the burdens on industry - both the relatively high exchange rate and high interest rates themselves.
- Second, much of the decline projected next year in headline inflation is linked to a forecast fall in interest rates and hence mortgages. Without that, higher headline inflation will make it more difficult to keep down wage settlements.

Both factors would intensify industry's difficulties and the risk of deeper recession.

BHP

BARRY H. POTTER

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