

JAN 18 '91 04:29PM SENT BY PUTNAM, HAYES & BARTLETT DC

Mrs Margaret Thatcher,

Five Minutes
Alan Walker faxed this message to
Mr Thatcher via N.10. Interestingly
to know what he is thinking.
could be surprised on X. P.2

A note which might interest you!
Alan

January 15th 1991 Notes on Sterling

With interest rates at near 14 percent, sterling deposits, as compared with mark deposits at 9.4, are attractive - provided that there is a correspondingly small downside exchange risk. These notes assess that risk.

At present (Jan 15th) sterling is just below its central 2.95 Deutschemark value at 2.9366, after having been well below it at 2.86 or so, only four pfs above its ERM floor. Widely perceived as having a risk only on the downside, the recent appreciation against the mark is largely explained by political events in Lithuania and the USSR depressing the mark and promoting the dollar. Indeed sterling may well rise to a little over its 2.95 level. The underlying economic pressure on sterling is, however still there, while the adjustment for political events tends to be a once and for all movement. One must expect further pressure soon, and it is likely to subside well below its central value.

x | Will the government hold the 2.95 central value with its six percent limits? For a while I am sure they will. Politically it would be seen as a massive climb-down to ask for a realignment substantial enough to matter. But to hold this, it is unlikely that they will be able to make any much needed reductions in the 14 percent interest rates - especially if the Bundesbank nudges rates up to say 10 percent. It also seems likely that they will not have a very tight budget - that is to say large increases in taxes - in seven or eight weeks time - in order, they would believe, to give them room to reduce interest rates and yet keep the 2.95 value.

The most likely policy is for sterling to be devalued slightly under cover of adopting 2.25 percent limits (rather like Italy did - a move much admired by the ERM enthusiasts). It would be possible to get perhaps a 3 percent devaluation which, proponents will argue, should be enough to mollify the markets, at least in the short term. This may be the tactic for the budget in early March. Such is the pressure for cuts in the 14 percent interest rates that I suspect that the Chancellor would be tempted to bring rates down to 13 percent (even if Germany stays at 10 percent).

As a short term fix this might well succeed. But as the recession deepens, the unemployment soars at fast rates than we have seen in the post war years, and as the crescendo of complaints from industry rises, I believe that there will be overwhelming pressure for something like a 10 percent devaluation. I do not anticipate that this will be conceded until all the other avenues, such as coordinated intervention have been explored. The delay will do great damage to the economy, but the government has boxed itself in.

Finally there is the likelihood, much enhanced by this process of procrastination, that the electorate will turn to the Labour party. This will exacerbate any run on sterling, and so contribute to the pressures both on interest rates and the exchange rate. I would anticipate that this would occur somewhat later in the summer and fall of 1991. Then will sterling really fall.

A warning! Although at present this seems a plausible pattern of events, much could be upset primarily by unforeseen political circumstances. The only part of the story I am reasonably certain of is the next two months - up to the time of the budget. This should provide some reason to hold sterling deposits.

Alan Walker