

PRIME MINISTER

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BILATERAL WITH THE CHANCELLOR

The main item for discussion will be the markets.

The Chancellor's meeting this morning decided that there should be a further reduction of half a per cent in base rates on Wednesday next week. This reduction would be subject to what the balance of payments figures show (available on Tuesday night and published on Friday). The final figure to be published for the foreign exchange reserves would also be relevant.

You might also like to ask the Chancellor for his views on the prospects for the dollar. The weakness last night and today was caused by the strong US growth in the first quarter of this year (4.3 per cent at an annual rate) and fears of a revival of inflationary pressures. But there is an underlying weakness of sentiment which goes beyond this short term explanation. The Japanese Government's purchases of dollars by the billion are in one sense a result of expectations that the Japanese current account surplus will persist. But in another sense they show that private sector investors are increasingly unwilling to finance the US budget deficit. The Japanese Government is being forced to take on this task through the investment of its extra reserves in US Government paper.

The fundamental cause of the problems remains the US budget deficit. This must be reduced sooner or later, but the process of reducing it will not itself be painless: the result in the short term would probably be some slowing down in the US economy.

*DNS*

DAVID NORGROVE

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