

cc of  
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PRIME MINISTER

## BILATERAL WITH THE CHANCELLOR

The main subject for discussion is the markets and interest rates.

The Chancellor does not intend to seek an increase in base rates this week. —

The Chancellor believes you are now giving too much weight to the PSBR and not enough to monetary conditions. He may argue that this year's PSBR with or without asset sales is lower than in any other year under this Government other than 1985-86, that the PSBR is running below the Budget profile, and that during the 1980s there has not been a very close correlation between interest rates and the PSBR. You could say in reply:

(a) you have never said the PSBR is the only thing that matters, and you have not completely ruled out an increase in interest rates if there is a trigger for it;

(b) but

(i) is the Chancellor now denying a connection between borrowing and interest rates (it is not good enough to say that the connexion is not obvious - of course it isn't; and it may well not be possible to prove it; but if there is no connexion between the PSBR, confidence, the exchange rate and interest rates, why did the Chancellor think it would help to say after the Autumn Statement that he would not be increasing the PSBR in next year's Budget?);

(ii) does he not accept that a lower PSBR (and no cut in income tax in the last Budget) would have meant lower consumer spending and less unease in the markets both for that reason and because people would have been more firmly convinced of the Government's commitment to prudence.

The essence of your argument is I think that the economy feels overheated, and just a little out of control. The PSBR needs to be set on the cautious side. Firm control of borrowing is not a panacea for all ills. But the United Kingdom is not, unlike the United States, able to take risks with fiscal prudence.

(The Treasury have looked at how interest rates have moved in relation to the Chancellor's interviews in November. They have increased since he said on 9 November that he would be prepared to raise interest rates to protect sterling and on 20 November that he did not want the pound to fall further. The move up of course also follows the Autumn Statement. The effect of the Chancellor's interviews has probably been to rule out a depreciation as a means for the markets to discount the effects of the Autumn Statement.)

You might mention your conversation with Sir Nicholas Goodison.

DW

DAVID NORGROVE  
15 December 1986



for back-up folder  
for Chancellor's bilateral

FROM: M G RICHARDSON  
DATE: 12 DECEMBER 1986

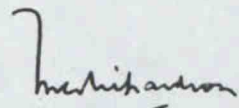
1. MR KELLY <sup>copy</sup>
2. MS RYDING

cc: PS/EST  
Sir P Middleton  
Sir T Burns  
Mr Cassell  
Mr Peretz

cc Mr D Noyce (No 10).

#### INTEREST RATES

As requested, I attach a chart showing the movements of sterling  
3 month interbank from 14 October.



M G RICHARDSON

# INTEREST RATES

