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PRIME MINISTER

THE MARKETS

I have now arranged for the Chancellor to come in at 1030 on Monday, and alerted his office that you want to talk about interest rates.

I enclose various bits of background material.

At Flag A is a note by Brian Griffiths, which effectively summarises the discussion at your meeting this afternoon with Alan Walters.

At Flag B is the Treasury's monthly monetary assessment which, in the most timely way, has just arrived this evening. You will I think find this a most interesting, if disturbing, read. The assessment is based on the position emerging from the Treasury's June forecast, which will not be formally sent to us until later next week. The summary on the first page brings out clearly that the economy is growing considerably faster than expected at Budget time, and that this extra pressure is now coming through in extra inflation as well as the external deficit. You will be particularly interested in the material on MO in paragraph 22 and table 25 near the back of the document. This clearly adds to the case for a significant interest rate move.

Next week is not a major week for new economic statistics but there is a clutch of material coming out on Monday:-

- the final May figure for retail sales - Flag C - showing a slightly stronger figure
- figures for credit business in May - Flag D - confirming that credit growth has if anything accelerated

- figures on housing<sup>e</sup> building in May - Flag E - showing the continuing pressures on the construction industry
- figures for the official reserves in June - I don't yet have the press release, but based on the evening report the overall figure will show <sup>little</sup> ~~real~~ net change.

Options for Interest Rates

You will I imagine want to press the Chancellor on the case for an early increase of more than 1/2 per cent. My impression is that he will resist that, but would accept 1/2 per cent on Monday.

Possible arguments for a bigger increase are:-

- the increase in German and other rates yesterday
- the very strong MO figures. Does the Chancellor still believe this an important indicator?
- the need to stimulate building societies to increase their rates, and so set in train the process of curbing personal consumption, rather than their continuing to wait until they see how many more 1/2 per cent increases will come (although there is clearly a short-term political argument against this.)

PRCC

Paul Gray

1 July 1988