

SUBJECT
(C master)

10 DOWNING STREET

LONDON SW1A 2AA

4 July 1988

From the Private Secretary

Dear Alex,

INTEREST RATES

The Prime Minister and the Chancellor discussed this morning the latest position in the markets.

The Prime Minister said she wished to see a further substantial tightening in monetary policy. She was concerned that markets and commentators felt that the Government was taking the present position of a large external deficit and higher inflationary pressures too lightly. The markets had now become accustomed to interest rate increases in steps of half a per cent, and she thought they would react to a further increase of this magnitude simply by anticipating that another would need quickly to follow. She had therefore concluded that it would be appropriate today to raise interest rates by a full one per cent.

The Chancellor said that he fully agreed with the need to tighten monetary conditions by further increasing interest rates. The principal mechanism by which this would affect the economy would be via increases in mortgage rates and the resultant effect on personal incomes and consumption. It was already clear that building societies would need to raise their rates by one per cent from 1 August, and if interest rates were raised by a further half per cent today that figure would become one and a half per cent. But the societies were unlikely to decide the precise changes in their interest rate structure until the third week in July; by which time the debate was likely to be between mortgage rate increases of one and a half per cent and two per cent. As to the immediate position, the Chancellor thought it was appropriate still to operate on the basis of half per cent interest rate adjustments; this was the best means of reducing exchange rate volatility. He also felt it was important to avoid any appearance of a crisis.

Following a brief discussion, it was noted that the Chancellor would arrange for the Bank of England to signal a half per cent interest rate increase at noon today.

Yours,
PaulPAUL GRAYAlex Allan, Esq.,
H. M. Treasury.



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MARKETS TODAY

Exchange Rate

	<u>Index</u>	<u>£</u>	<u>DM</u>
Friday close	75.0	1.7015	3.0984
Monday opening	74.7	1.6890	3.0802
9.00	74.8	1.6920	3.0842
10.00	74.8	1.6910	3.0835
10.20	74.7	1.6890	3.08

Equities

10.00	FTSE 100	<u>1851.9</u>
		-6.3