SUBJECT
CC MASTER

JA2ARW 7

file
Econ

# 10 DOWNING STREET

LONDON SW1A 2AA

*From the Principal Private Secretary*

6 August 1987

Dear Alex,

**INTEREST RATES**

The Prime Minister discussed with the Chancellor of the Exchequer this morning his proposal for a one per cent increase in interest rates.

The Chancellor of the Exchequer said that the market's reaction to the forthcoming trade figures would depend on its underlying tone. Information on the forthcoming money figures was based on a first guess and partial information, but it looked as if they would be a source of concern to the market. A particularly worrying feature was the indication of the underlying growth in MO, which was a good indicator of monetary conditions. Since he had last spoken to the Prime Minister there had been a slight deterioration in the tone of the markets, and sterling had drifted down despite some support. He remained of the view that it would be prudent to increase interest rates now. Monetary conditions were loose and we would regret it in the Autumn if there was not an increase now. Monetary policy was no longer bearing down on inflation. We could not afford to continue with a relaxed monetary stance or risk a gradually depreciating exchange rate. Without an increase in interest rates the chances of reducing inflation in the medium term would be reduced. He did not expect that one per cent increase in interest rates would reduce growth in any significant way. Of course inflation in the short term would be higher, for example, because the building societies would not proceed with the mortgage rate cuts envisaged for next month (which would add some 0.1 per cent to the RPI). But in the medium term an increase in rates now would reduce the level of inflation below what it would otherwise have been.

The Prime Minister said that she was most unconvinced about the need for any increase in interest rates. Sterling had maintained its position better than other currencies in the face of recent dollar strengthening. An increase in interest rates would be associated with tensions in the Gulf and could lead to damaging financial repercussions throughout world financial markets. A one per cent increase in rates would look as if the Chancellor was defending a particular exchange rate prior to entry into the EMS. She feared that it

would increase unemployment and inflation damaging those sections of society whom the Government wished to help most. It would make it harder for exports at the very time when the current account needed strengthening. Nor should it be overlooked that the total borrowing (public and private) was down, and that the fiscal stance was tighter than had been expected. She feared too that the increase in interest rates would come just at the wrong moment when the economy was beginning to slow down on its own accord.

After further discussion, the Prime Minister said that she would not wish to stand in the Chancellor of the Exchequer's way if he was intent upon the increase in interest rates. He should make himself responsible for the public presentation of the increase by giving many TV and radio interviews over the next few days. The arguments of Labour Party spokesmen like Mr. Gould and Mr. Hattersley, had to be countered right from the beginning.

Finally, the Prime Minister said that she would welcome a note on bankers' balances held at the Bank of England, indicating the factors which determined their level and the significance, if any, that they had for monetary policy. She also asked the Chancellor to consider whether it would be worthwhile to make arrangements so that the authorities had earlier information about the direction of bank lending.

Yours ever,

Nigel Wicks

(N. L. WICKS)

Alex Allan, Esq.,
HM Treasury.