

CCB/JP
11

PRIME MINISTER

MONETARY POLICY AND INTEREST RATES

The cynical way to see the present discussions is that the Chancellor wishes to increase interest rates now in order to smooth the way to a tax cutting Budget: squalls in the markets would strengthen the hands of those who argue for a lower PSBR. Treasury officials in their turn believe the Chancellor is likely to achieve a good part of what he wants in the Budget and therefore interest rates have to go up to keep the damage in bounds.

The more favourable interpretation is the one put by the Chancellor in his note.

My own view is that interest rates should rise but you should make it absolutely clear to the Chancellor that you will be looking for a 1987-88 PSBR below £7 billion in the Budget.

Tomorrow's meeting is not one for decisions. I suggest you use it to push the Chancellor to justify his recommendation and so far as possible to force out into the open the relevance of the Budget fiscal decisions.

Possible points to put to the Chancellor include the following:

i) the monthly rate of increase of MO not seasonally adjusted has been declining in recent months, and the seasonally adjusted figures show no very clear trend, though the figure for November shows a further jump;

(affected by British Gas?)
Probably not.

	Seasonally adjusted	Not Seasonally adjusted
	Monthly changes %	
May	+ 0.9	+ 1.1
June	+ 0.4	- 0.4
July	+ 0.1	+ 1.7
August	+ 1.0	+ 0.9
September	+ 0.6	- 0.6
October	0.0	- 0.5
November	+ 1.0	+ 1.0

ii) the rate of increase in house prices accelerated in the Spring, but has remained around the same average level (13%) since June/July;

iii) 3 month inter-bank rates have risen from 11% to nearer 11½%, but only since the Chancellor said so firmly to the Treasury Select Committee that he did not want sterling to fall any further;

iv) pay settlements are coming down a little;

v) the economy is growing fairly rapidly now, but it does not seem to be growing faster than envisaged in the Budget forecast, so why the sudden concern?

Against this, the Chancellor could point to the growth in credit, the strength of consumer spending and the general uneasiness about the Government's economic policies. He will argue that it will be better to raise interest rates now than to have an increase forced on the Government in January by pressure on the exchange rate.

DW

DAVID NORGROVE

9 December 1986

SECRET

BM2BAQ