ALH.ALV

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SUBJECT cc MASTER

10 DOWNING STREET

LONDON SW1A 2AA

28 July 1987

From the Private Secretary

Dear Alex,

INTEREST RATES

The Prime Minister this afternoon held a meeting to discuss interest rates. There were present the Chancellor of the Exchequer, the Governor of the Bank of England and Sir Peter Middleton.

The Chancellor recalled that in an earlier discussion he had said that if there were an opportunity to raise base rates by half a per cent, that would be desirable. The economy appeared now to have a lot of steam behind it, and credit was growing particularly fast. There were widespread concerns - though in some cases greatly exaggerated - that the economy was growing too fast for comfort, and the markets were edgy. The position would be eased if the Government gave a clear signal that it remained firm in its intention to keep financial conditions adequately tight. This would reduce the risk of difficulties in the autumn and possibly the need for an increase greater than half a per cent. It would be undesirable for the Government to be pushed by events.

The Prime Minister was not convinced that an increase in base rates was needed now. Total borrowing had fallen as a proportion of GDP since 1979 from 13 per cent to 11 per cent, so it was difficult to argue that there was excessive growth of credit. The disturbing scale of the settlement backlog at the Stock Exchange might also be a factor. The tone of the markets had improved today, and there was little evidence of edginess. Moreover, personal assets had increased by more than liabilities and of the deterioration in the current account in May, only a quarter was attributable to imports of consumer goods. It would in any case be wrong to take action on the basis of one month's figures. The June forecast had shown a substantially better prospect for the current account than the Budget forecast. An increase in base rates now would damage confidence and might well simply create a higher base for another increase in interest rates. Indeed the markets might well react badly to an increase, believing that the Government was aware of bad news not known to them.

In further discussion the Governor argued that the markets expected the next move in interest rates to be upwards, and the only question was one of timing. The yield curve now sloped upwards. The Chancellor agreed with the Prime Minister that many of the fears now being expressed were exaggerated. Nevertheless, his judgement was that conditions now warranted a small tightening. Figures for the past several months, including those for MO, supported this view. The confidence of the markets was of the first importance. Sir Peter Middleton noted that the growth of money GDP was uncomfortably high, and that there were at present poor prospects for a further reduction in the underlying rate of inflation.

Concluding the discussion, the Prime Minister said that the figures for monetary growth in July and the balance of payments in May had been known last week. An increase in base rates now would lead to accusations that the Government had simply delayed taking action until the Parliamentary recess. The June balance of payments figures would be known a few days before 11 August and there might also by then be indications of monetary growth in July. The need for an increase in base rates could be reconsidered if these figures suggested a case for action.

I am copying this letter to John Footman (Governor of the Bank of England's office).

Yours,

David.

DAVID NORGROVE

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H. M. Treasury