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PRIME MINISTER 2

INTEREST RATES

The Chancellor's ardour for an increase in base rates may be cooled by the fact that he would have to come back from his constituency to talk to you. But if he does, I guess he is likely to come to see you on Friday next week or Monday the following week. The first guess for the money numbers would not in the usual way be known until Tuesday 11 August (the day the July balance of payments figures are due to be published), but the Bank of England may have an indication a day or two before that.

If the figures are bad, particularly those for bank lending, the pressure for an increase in base rates is likely to be difficult to resist, and it would probably be wrong to do so. If they are bad enough the markets will anyway take interest rates up and the question will become one of market tactics - whether it is better for the Government to act in advance or not.

If the figures provide no clear signal for an increase, points you will wish to bear in mind include the following:

- the faster rate of growth in MO in the first half of the year was foreseen at the time of the Budget, and the latest monetary forecast shows a figure of 5.1 per cent in July, declining to 4.7 per cent in August and 4.8 per cent in September; the growth of MO in the second half of 1987 is however forecast to be higher than expected at the time of the Budget;

- the PSBR seems to be turning out much lower than expected at the time of the Budget, and the June forecast suggested an outturn for the year of around £1 billion as against nearly £4 billion at the time of the Budget, ie. the fiscal stance is tighter than expected;

- the growth of house prices seems to have slackened a little, down to an annual rate of 14.3 per cent in June compared to a peak of 15.2 per cent in March;

- the CBI survey showed an encouraging lack of concern about capacity constraints except perhaps in the area of skilled labour;

- it is not surprising that inflation is at present running rather high, given our present rate of growth of 4 per cent or more; that rate of growth is unlikely to be sustained and as it eases so too should concerns about inflationary pressures;

- the current account so far this year is still in surplus; we are a long way short of the £2½ billion forecast at the time of the Budget and the June forecast showed a deficit of only £½ billion for the whole year;

- total borrowing has fallen since 1979 from 13 per cent of GDP to 11 per cent and personal financial assets have grown faster than liabilities.

The Chancellor may emphasise the risks to the exchange rate. This goes with his wish to become a full member of the EMS. But there is no need to tie yourself to that particular hook: the exchange rate commitment is his, not yours. The most worrying combination would be a falling exchange rate with poor current account and money numbers.

DAVID NORGROVE

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SLHAME