

PRIME MINISTER

RA

THE MARKETS AND INTEREST RATES

Sterling opened weaker this morning, mainly influenced by yesterday's set of economic statistics, although it has strengthened a little during the course of the day.

market
report
attached

I have discussed with the Treasury the Chancellor's latest thinking on interest rates. His views are:

- (i) It was not appropriate to have a half per cent increase today. It is too soon to assess the market trend and would have looked rather panicky.
- (ii) But if sterling remains weaker next week, he will want to make the further half per cent interest rate increase. In normal circumstances, this might best be done on either Monday or Tuesday. But he accepts that it would be unwelcome to make the change while you were both in Toronto. I made the point that you would not, for example, want your Press Conference on Tuesday diverted into discussion of the latest move by the United Kingdom authorities.
- (iii) So, unless there is any particular market weakness on Monday or Tuesday, the Chancellor will aim to leave the increase until later in the week - either Wednesday (by which time he will be back but you will still be away) or Thursday.
- (iv) The Chancellor's party will, however, be in touch with London first thing on Monday. If the Chancellor then reaches the view that action early in the week is appropriate, he will of course be able to discuss this with you in Toronto.

In reaching your view, you will want to consider the latest economic statistics. The figures published this week do, I think, clearly point to the need for some tightening of policy. Next week, ^{we} ~~you~~ will have on Monday the provisional

money supply figures for May (attached); these are not too bad, but again suggest that some tightening would be in order. Monday also sees publication of the latest CBI Monthly Trends Inquiry, but I have not yet seen that material. Other figures later in the week are of less significance, the most important being Tuesday's first quarter's GDP figures.

The next major figure to hit us will be the May Balance of Payments. That will be published on Monday 27 June. We will not know until well into next week the import side of the equation. The export figures have just arrived (also attached) and do not look too good, with a £0.3 million drop from April. So at this stage, it looks as though the current account figure will be far from healthy.

All in all, the conclusion I draw from this is that it would be right to take the opportunity to push interest rates up another half per cent. You will not welcome the impact this would have on mortgage rates. But two factors to bear in mind on that are:

- (i) Any rise will merely offset the reductions seen earlier this Spring.
- (ii) One of the most direct counter-inflation effects of rising interest rates is via the reduction in personal consumption as individuals' residual incomes are squeezed by the increase in mortgage repayments.

We shall have to consider whether it would be better to do also MT

PR CG. n' after us

Wade James

PAUL GRAY
17 June 1988