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PRIME MINISTER 25 July 1989

PROSPECTS FOR MONETARY CONDITIONS:
August - September

While it is true that monetary shocks usually occur in the summer months (you will recall no doubt the U S floating in 1971 and the Mexican default in 1982), I cannot forsee any "surprise" in store in August or September!

1. 14 per cent or more?

It is very unlikely that there will appear circumstances under which we should increase interest rates (to 16 per cent, say). All the evidence is consistent with a slowing down of the inflation rate and an increasing squeeze on profits and, eventually, wage costs. A rise to 16 per cent (real interest rates of 10 per cent) would be likely to bring on a serious recession. True, it would also bring down the underlying inflation rate more quickly. But the undoubted rise in mortgage interest rates would first increase the RPI and secondly involve political obliquy which would be difficult to survive.

There is a considerable body of opinion in the Treasury (Burns and Middleton) which is doubtful that enough has been done to ensure that inflation is unequivocally arrested and reversed. The Bank, on the other hand, do believe that higher interest rates would cause such deleterious effects on the real economy that any further disinflation would be bought at an unacceptable price. Nevertheless, if there is a sharp fall in the exchange rate from 92.5 down below 90, there will be Treasury if not Bank pressure to put interest rates up to 16 per cent. In my view this should be firmly resisted. Any surge in rates in the money markets, because of expectations of a rate rise, can be countered by leaving the market sitting on its excess cash (as we did a few weeks ago). We do not need to sell gilts and we need not sell bills, so the Bank can control the market rates. We should not be driven off our policy by the foreign exchange markets.

There are circumstances where an increase to 16 per cent may be justified - that is when M0 clearly jumps up to and stays above 8 per cent growth. But the possibility is so remote it can be ruled out.

2. **14 per cent or less?**

I cannot see a case now or how a case might plausibly develop for reducing interest rates. If, for example, the Fed gets worried about the imminence of a deep recession and cuts the Fed Funds rate from 9 per cent to less than 6 per cent, it would be tempting to follow with a 1 or 2 per cent cut in base rates to arrest the rise of sterling to "uncompetitive levels". Again, we should resist - unless the growth of M0 has actually become substantially negative.

In my view, however, Greenspan will never counternance such Fed incontinence, even under the most pressing political pressure. He wants to ease the tightness of monetary policy but only slightly. He still believes that there is a lot of inflationary pressure yet to be countered and eliminated.

3. **Another Black Monday?**

Again a crash, although conceivable, is the most remote of possibilities True stock markets have been creeping back towards their mid-1987 levels but they have not been driven there by a monetary expansion similar to those of 1985/7 (U S) and 1986/8 (U K). The continuing expansion in corporate profits is a more likely explanation of the modest rises in 1988/89. There is the expectation that the profit growth will shortly fade. So that may be accompanied by the modest fall in U S interest rates.

In short, this summer there is little or no chance of another stock market collapse and liquidity crisis comparable to that of October 1987.

4. **Sitting tight on 14 per cent?**

Yes: we should.

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