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SUBJECT

CC MASTER

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

10 December 1986

Dear Alex,

INTEREST RATES

The Prime Minister this evening held a meeting to discuss interest rates on the basis of the note attached to your letter to me of 9 December. Those present were the Chancellor of the Exchequer, the Governor of the Bank of England, Sir Peter Middleton, Sir Terence Burns, Mr. Eddie George and Professor Brian Griffiths.

The Chancellor said it was his considered view, shared by the Governor, that monetary conditions were now a little too lax. This view was widely shared in the financial markets. It would be appropriate to increase base rates by 1 per cent at a fairly early opportunity, though the timing need not be settled yet. It was a matter of great regret that an increase was now needed. But without it there could be a serious break of confidence. Whilst there could be no guarantee, it might well be possible to reduce interest rates again after the Budget.

The Prime Minister questioned the need for an increase in base rates. A surge in M0 (not seasonally adjusted) had taken place in the summer but it had declined thereafter until November's 1 per cent increase. The cause of the present problems had, with hindsight, clearly been a PSBR which had been set too high in the 1986 Budget. The result had been excessive consumer spending. The PSBR should be set at a very prudent level in the 1987 Budget, possibly as low as £5 billion, even if that meant leaving no room for tax cuts. To raise interest rates now would hit people with mortgages and increase inflation and public spending, and risked being seen as a way of making room for tax cuts in the Budget. It was in any case not clear that anything had changed since the decision to hold October's increase in interest rates to 1 per cent.

In discussion, it was argued that annual figures for M0 - seasonally adjusted - had been rising steadily for some months (though there would be a reduction, perhaps temporary, when the high figure for December 1985 dropped out). The growth in M0 was probably associated with the strength of consumer spending. Whilst an increase in interest rates would add now to inflation as measured by the RPI, that effect could well prove temporary, and the increase was needed in order to maintain the Government's firm counter-inflation policy. At the time the decision had been taken in October to increase interest rates by only 1 per cent it had seemed likely that a further increase would be needed at around the time of the Autumn Statement. Moreover, it had been agreed then that the need for a further increase would be reviewed after the first increase had taken effect. The Government in October had also not wished to confirm a view that interest rates always rose by 2 per cent when the exchange rate came under pressure.

The Prime Minister, concluding the discussion, said she recognised the reasons why an increase in interest rates was now proposed. It might among other things allow lost reserves to be recouped. However, the Chancellor and the Governor should keep in mind the effects on mortgage holders, the way in which people would perceive an increase in inflation, and the effects on public spending. The Prime Minister invited the Chancellor to consider whether it would be feasible to avoid an increase in interest rates in the run up to a very prudent Budget, which could if necessary be brought forward to the beginning of March. Interest rates should be increased if there was a clear trigger for an increase. But there was a need for very careful thought if none was apparent. The Chancellor should consider what such a trigger might be. The Prime Minister also asked the Treasury to prepare a note on the seasonal adjustment of M0.

I am copying this letter to John Footman (Bank of England)

Yours,

David.

(DAVID NORGROVE)

Alex Allan, Esq.,
HM Treasury.

MR NORGROVE

As requested:

		3 month interbank rate
Nov	3	11
	4	11 1/32
	5	11
	6	10 15/16
	7	11 1/16
	10	11 1/32
	11	11 1/16
	12	11 3/16
	13	11 1/4
	14	11 1/4
	17	11 7/32
	18	11 7/32
	19	11 1/4
	20	11 5/16
	21	11 11/32
	24	11 5/16
	25	11 5/16
	26	11 11/32
	27	11 3/8
	28	11 13/32
Dec	1	11 7/16
	2	11 13/32
	3	11 13/32
	4	11 7/16
	5	11 13/32
	8	11 7/16
	9	11 7/16
	10	11 7/16

9/11 Chancellor says he would raise interest rates if there were pressures on sterling. →

← Chancellor states to TCSC that he wants the exchange rate ~~no~~ lower.

Prime Minister 2

You may like to see. It bears out what you said.

DLW 10/12

Thank you. Has the Chancellor seen it? MT

Michael Richardson

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