

NOTE FOR THE RECORDBASE RATES

The Chancellor today explained to the Prime Minister that there was a risk that base rates might need to rise tomorrow. The sterling three month interbank rate had risen to 12 per cent, a level at which a rise of a $\frac{1}{2}$ per cent in base rates would be justified. This increase had occurred gradually over the space of a day or a day and a half, and the money numbers published today had had little effect, even though monetary growth had been lower than of late. The exchange rate had not moved dramatically and indeed had been stable against the dollar, but it had a soft tone and had moved down to $77\frac{1}{2}$ on the effective rate. Expectations of lower oil prices had played some part in this, but there was rather generalised concern. (The Chancellor did not specify what this related to). Expectations of a fall in US interest rates had also been dissipated. As the exchange rate had softened, interest rates had risen in the expectation that this was what the authorities would want in order to reduce damage to the inflation prospects from a falling exchange rate.

The Chancellor said that if the authorities moved early tomorrow to validate the rise in market rates, this should have a salutary effect. But the need for a further increase could not be ruled out. Indeed, if market rates had risen further by the opening tomorrow, there might need to be an increase of more than a $\frac{1}{2}$ per cent, which could trigger an increase in the mortgage rate when the building societies met on Friday. The effect on the mortgage rate was, however, now hard to predict with the weakening of the cartel.

The Prime Minister was concerned that an increase in base rates now would come as a great shock. It would cause concern, among others, to the CBI, and the Prime Minister also mentioned the effect on farmers whose incomes had fallen substantially over the past year. Interest rates were already very high. The Prime Minister also argued that to increase

base rates after a rise in market rates which had lasted only a day or a day and a half would be seen as hasty.

In reply the Chancellor pointed to the difficulty of resisting the rise in market rates: this would be taken to show lack of resolve.

The Prime Minister concluded by saying that it would be necessary to wait to see where the markets opened tomorrow.

DRW

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