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PRIME MINISTER

INTEREST RATES

The Treasury and Bank have provisionally agreed to go ahead with a half per cent reduction of base rates on Monday. The Chancellor and the Governor will meet at 1100 on Monday to consider the state of the markets. If they decide then to go ahead the signal will be given at 1200.

I know that you and the Chancellor are firmly in favour of a reduction now, but at the risk of being over cautious may I set out the arguments for waiting?

First though the arguments in favour. The cut in American rates gives cover for us to reduce our rates. The economy clearly is in a very sluggish patch and the recovery may come later than the Chancellor thinks (though there is little doubt that one is on its way at some stage late this year or in the first half of next). A reduction in interest rates now would take time to feed through into increased activity and it is important that the benefits should be coming through in the potentially important period politically of next spring and autumn. It is also the case that after each sharp increase in interest rates the reductions which follow seem always to leave us with a level which is a little higher than before. Moreover, if there is another increase in interest rates to come at some stage, better to start from a lower level because the increase needed to stabilise the exchange rate and restore confidence is likely to be no greater almost whatever the level we start from.

Against this, the Germans are unlikely to follow the Americans and the Japanese may well not. In that case we shall be joining only the Americans and the French. There is a risk that a cut now, which is not being signalled by the markets, will be seen as a "political" reduction. This could revive the fears which have surfaced from time to time over the past year that the Government is in a mood to take risks in order to help its electoral prospects.

Then there is the public expenditure Cabinet on Thursday to get through. If that goes well, we face the local authority finance announcements on 22 July. The markets have not yet properly woken up to the public expenditure problem, but those announcements could give them a pretty good idea. It also seems very likely that the local authority employers will be putting to the teachers preliminary figures for a pay offer on 22 or 23 July. Those numbers themselves are certain to be high and could reinforce worries both about public expenditure and about the prospects for the coming pay round. On the worst case, other public sector trades union leaders could begin to make aggressive statements on behalf of their own members when they know the starting point for the teachers' talks. The Government could also appear under pressure if the discussions on South African sanctions are going badly.

These are gloomy thoughts and they put almost the worst complexion on the events of the next two weeks. But they lead me to feel that it would be better to wait until those two weeks are past before looking for a further reduction in interest rates. If John Wybrew is right, higher oil prices may then help us. The Chancellor would no doubt say that Monday could be the last opportunity before the autumn. There are arguments both ways. I would still suggest that on balance it is not worth taking a risk at this stage in July. Better to have something in hand with the markets still believing that the next move is more likely to be down than up.

Yes Would you like to be consulted again before the final decision is taken? Or do you want to leave it to the Chancellor and the Governor?

I think we should look at this morning's market very carefully - what worried me was the effect of an article on the front of the Sunday Times business news yesterday. Irresponsible - but it may have some effect.

DN

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EL3BHM