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Prime Minister

I understood you were asking today about market reaction to the Budget and the prospects for the derestricted indexed gilt tender.

This note seems to me to complement Alan's (attached).

MCS 16/3

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

15 March 1982

Michael Scholar Esq.
10 Downing Street
LONDON
SW1

Dear Michael,

The markets have now had almost a week to digest the Budget; the Prime Minister might like to see a note on how we interpret their reactions.

The overall tone has been very positive. The exchange rate has remained firm, despite the occasional moment of uncertainty; sterling closed today at 90.3. This is encouraging, given the falling oil price, and the fact that interest rates here are appreciably lower than in the US. Eurodollar rates are about 1½ per cent above UK interbank rates. The money markets have confirmed their pre-Budget disposition to come down. The clearers delayed announcing a base rate reduction of ½ per cent until after the Bank had dealt at lower rates on Wednesday: this was a satisfactory outcome, confirming our cautious approach and helping to allay any suspicion of a lax policy stance. Since then rates have firmed slightly, but the new structure - base rates at 13 per cent, seven day interbank at around 14 per cent, and three month interbank at 13½ per cent - has been consolidated.

The half per cent base rate drop, plus the reduced competition from National Savings foreshadowed by the lower target announced in the Budget and the withdrawal of the 23rd issue certificate, caused the Building Societies to reduce their mortgage rate by 1½ per cent. This was the largest ever drop in the rate. It will have an immediate beneficial impact, and will also contribute to a good RPI performance over the next few months.

The new monetary control arrangements worked well over this period. We succeeded in steadying the market before the Budget, and afterwards it was able to think out its own reaction, which provided us with a secure foundation for a new pattern of dealing rates. The reduction in base rates reflected a combination of market approval of policy together with a light restraining hand from the authorities. This sort of posture seems appropriate at a time when we still have to deal with a

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difficult monetary situation, at least as far as the wider aggregates are concerned. The continued strong growth of bank lending means that our new target range will be vulnerable in the coming months. And there is, of course, always a risk on the exchange rate as we approach the end of the taxpaying season.

The capital markets have been firm. The two main changes announced in the Budget - the indexation of CGT and the derestriction of indexed gilts - were very well received. The former will certainly give encouragement to the equity market over time, though the effects seem likely to build up slowly. The latter had, as we expected, a more dramatic impact on prices in the short run. Both were well-kept secrets, not foreshadowed in any pre-Budget press speculation.

The market in conventional gilts opened very strongly after the Budget and has remained strong since. (Low coupon stocks, which could be expected to suffer most from the derestriction of the indexed stock, have been the exception.) We went ahead on Wednesday with the £500 million of tranchettes which we had in reserve. This steadied the market a little and demonstrated that we intended to pursue a mixed funding programme. The market in indexed stocks has been very strong, and there has been a considerable amount of trading. The principal feature has been sales by gross funds (pension funds) to net funds (insurance companies). The price has risen very sharply, by over 10 per cent in the case of all three stocks. The real yield has fallen from well over 3 per cent to around 2.35. This augurs well for Friday's auction of the new stock. We have seen no complaints yet about unjustified capital gains - presumably because the beneficiaries are pension funds, though the Economist referred unhelpfully to "Amersham-style" profits, and also picked up some of the external implications.

It is too early to judge the effects of derestriction with any confidence but on the evidence we have so far it seems that conventional long-dated stocks and indexed gilts can live side by side and that the prices of both can improve together in a market with good expectations about the future and, in the case of conventionals, expecting much less of this type. The modest change in interest rates after the Budget will help keep these expectations in place.

The equity market has taken a while to digest the news. It moved ahead quite strongly on Thursday but fell back slightly on Friday and today. It may be that derestriction has had a short-term depressive effect. Bank shares have moved down a little in response to the references to bank profits in the Speech. But the general tone remains quite bullish.

This all amounts to a most encouraging response. We have succeeded in moving interest rates down to a new level with no adverse effects elsewhere and leaving the market still optimistic about the next few months. The principal threat

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to this new equilibrium is, as before, renewed upward pressure on rates from the US. The prime rate drop which seemed to have started last Monday was stopped in its tracks. One of the five main banks to move down has gone back up to 16½ per cent, and this afternoon broker loan rates have started to rise again -often an indication that prime rates are on the way up. Sterling has shrugged off developments of this kind in recent weeks, but we cannot be certain that it will continue to do so.

Yours ever,

J O Kerr.

J.O. KERR
Principal Private Secretary