



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

14 September 1981

T. Lankester, Esq.,  
Private Secretary,  
10, Downing Street

Dear Tim,

EXCHANGE RATE AND INTEREST RATES

As you know, the Chancellor discussed the exchange rate situation with the Governor this morning. Although the situation was put to the Prime Minister later this morning, and the decision has now been taken, you may like to know for the record a note of the arguments and their presentation.

The Governor said that the external arguments for raising interest rates were now very strong. The fall in the exchange rate had persisted over many months: in view of the inflationary impact it was now necessary to act. Intervention alone would not be enough. We now needed to do more on interest rates than had been agreed earlier in the summer, when the external situation had not seemed to call for a rise in bank base rates, and the prospect of lower American rates seemed both stronger and more likely to be sufficient. The rapid fall of sterling this morning added to the force of these arguments. The key figures are as follows and a fuller table is annexed.

	<u>Election</u> <u>day</u>	<u>Peak</u>	<u>Today</u>	<u>% change since</u>	
				<u>Election</u> <u>day</u>	<u>Peak</u>
Effective	86.7	105.6 (28 Jan '81)	86.6	-0.1	-18.0
£/\$	2.08	2.47 (24 Oct '80)	1.77	-14.6	-28.1
£/DM	4.0	5.07 (16 Feb '81)	4.21	+5.3	-17.0

Domestic monetary arguments pointed in the same direction, though here the situation was less clear-cut. The most threatening element was the rapid increase of bank lending particularly for housing. But it was also right to be cautious in view of the statistical fog generated by the Civil Service strike which would

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continue to distort the CGBR and hence the £M3 figures for months ahead.

Treasury officials agreed with the Bank's analysis on both external and domestic fronts.

The Governor therefore proposed that the undisclosed band for very short term interest rates should be raised, from 11½-13½ per cent to 13-15 per cent. This rise of 1½ per cent was likely to lead to a rise of 2 per cent in bank base rates and a similar rise in mortgage rates, though the extent of these changes was uncertain.

The Chancellor agreed with the Governor's proposal, which he recognised was given with reluctance in view of the impact on the recovery of the economy and the obvious political difficulties. But as you know the threat to the Government's inflation strategy is in the Chancellor's view too great for inaction on interest rates to be a tolerable option in current circumstances.

Although there will be no announcement of the kind familiar when MLR was in use, it will of course be apparent that the rise in interest rates is being brought about by the authorities' action. The briefing which has been prepared will say that the action has been taken primarily in response to the external situation, but that in view of the rapid expansion of bank lending and of the obscurity surrounding the monetary figures as a result of the effects of the Civil Service strike which will continue for months ahead, a rise in interest rates will also be in line with the appropriately cautious conduct of domestic monetary policy.

I am sending a copy of this letter to Tim Allen at the Bank.

*Yours ever,  
J.O. Kerr.*

J.O. KERR