SECRET

Tile

cc A.W

SUBJECT.

10 DOWNING STREET

cc. Master set

From the Private Secretary

19 January 1982

Dear John,

The Prime Minister discussed this morning with the Chancellor and with the Governor of the Bank of England developments in the domestic money markets. Mr. Alan Walters, Sir K. Couzens, Mr. Burns and Mr. Middleton were also present.

The Prime Minister said that she had noted that there had been a reduction of 1/16th per cent in several of the Bank's dealing rates yesterday. She was encouraged by this, because she was concerned about the degree of inflexibility which seemed to have beset the authorities' operations in the market. She continued to be much worried about the effect on industry of our high domestic interest rates. She had been pressing since the middle of December for a move which would lead to a reduction of ½ per cent or so in bank base rates. Yet only minute moves had been made.

The Chancellor said that all were agreed on the desirability of a further ½ per cent reduction. The difficulty was in achieving a reduction without causing disturbance in the markets. The Governor said that the Bank's aim was to secure the desired ½ per cent as quickly and as safely as possible. But it was important not to bring about an excessive fall in the exchange rate. It also had to be borne in mind that the decision on the base rates was the banks', not the authorities'. He believed that the next few days should be propitious for engineering such a reduction provided that conditions did not change; but the Bank could not reduce their dealing rates while the exchange rate was falling. The Governor pointed out that, since his discussion with the Prime Minister at the end of the week before last, sterling had been weak, and it had only been on Friday of last week that we had seen a strengthening in the exchange markets. Notwithstanding the awkward US money supply figures at the beginning of this week, the better news on the UK industrial front had had beneficial effects in both the foreign exchange and the domestic money markets. This had enabled yesterday's moves to be made; given the favourable reception they had received, he hoped that some further such move would be made today. It had been possible to present these reductions as a sign of confidence. The Chancellor noted that with an underlying rate of inflation around 12 per cent or more, there was no prospect

/of

SECRET

of any substantial reduction in interest rates from their present levels; it was a question of a further reduction of no more than ½ per cent or so. Mr. Burns commented that the monetary aggregates did not suggest that there was scope for a marked loosening of monetary policy. The squeeze which Gordon Pepper's most recent bulletin made much of was exaggerated by the rise in inflation at the end of 1981 which followed the earlier exchange rate depreciation; it would not be right to adjust monetary policy to accommodate this temporary increase in inflation.

The Prime Minister said that it had sometimes appeared to her in recent weeks that our high exchange rate (when it was, say, above $1.90 with an effective rate above, say, 91) was maintained at this level purely by a high interest rate policy. She wanted the desired reduction in rates to take place this week, and she would then wish to consider whether conditions were suitable for a further reduction of the same order.

I am sending a copy fo this letter to Tim Allen in the Governor's Office.

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury.