CONFIDENTIAL

PM has seen
MAP 23/vii

Econ Pol: Dom Mon Policy

1. MR MIDDLETON
2. CHANCELLOR

cc Financial Secretary
Sir D Wass
Sir K Couzens
Mr Ryrie
Mr Burns
Mr Britton
Mr Lavelle
Mr H Davies
Mr Ridley
Mrs Gilmore

INTEREST RATES: NOTE FOR THE PRIME MINISTER

I attach a note which the Chancellor could leave with the Prime Minister, as he asked at his meeting this afternoon.

N MONCK
22 July 1981

Note for the record.

The Prime Minister discussed this v. briefly with the Chancellor on 22 July. They agreed on course (b) in para 3.

TL
30/7

MARKETS AND INTEREST RATES

The Markets since last Friday

The money market has been in a very uncertain state. Money market rates have been rising since last Friday. A table showing these changes is attached. Short term inter-bank rates rose sharply on Friday by about ½% following lower bids - which implied higher interest rates - at the Treasury Bill Tender. The tender was influenced by the doubling of the number of 3-month bills on offer to £200 million and the announcement that £800 million of bills maturing on 1 September would be issued at the end of this week. The market has also been influenced by events in the foreign exchange market and the very high federal funds rate in the United States.

2. Over this period the Bank has provided the market with very short term cash at interest rates at or just above 12%. But as the table shows, this has not prevented rates for 7-day money and longer maturities from continuing to rise, though it has held down the overnight inter-bank rate. The Bank's aim was to prevent money market rates from dislodging bank base rates and mortgage rates, particulary during Ministers' absence in Ottawa.

The Choice

3. The Chancellor has today discussed with the Governor the choice for the Bank's money market intervention tomorrow:

a. one possibility is to continue with the present holding tactics by supplying cash at below market rates. This could not be relied on for long to prevent bank base rates and eventually mortgages rates from moving up unless some event occurred either at home or overseas that altered the market's view. No event of this kind is on the horizon at present;

b. the alternative is for the Bank to bring the rate at which it supplies the market with cash more into line with other rates - at around 13%. This would be politically unwelcome, particularly before the Censure Debate next week. On the other hand for the Bank to continue its resistance to market pressures further would not be consistent with our earlier decision to nudge up interest rates primarily for exchange rate reasons or with the aims of our new monetary control arrangements which are designed to de-politicise interest rates. Moreover it would create clear opportunities for round-tripping which would be increasingly exploited. A rise in interest rates would also help to reduce the very rapid growth of bank lending to persons and to increase the chances of achieving our £M3 annual monetary target.

Presentation

4. In presenting option b. Ministers would distance themselves from what had been done. The line would be that the Bank had ceased to resist market pressures at the very short end; it had supplied cash at rates in line with those set by the market which had been reacting to the impact of sterling's depreciation on the inflationary prospect, as well as to very high American interest rates and the firm position taken on them by the American Government at Ottawa.

ANNEX

MONEY MARKET RATES, MARKET ASSISTANCE AND EXCHANGE RATE

Interbank rates at close on:	Overnight	7-day	1-month	3-month	12-months
Friday 17 July	11¾-12½	12⅞	13¾	14 3/16	14 7/16
Monday 20 July	12-12¾	12¾	14 1/16	14¼	14¼
Tuesday 21 July	12⅜	13	14¼	14½	14 7/16
Wednesday 22 July	12½	13 3/16	14 5/16	14½	14 7/16

Eligible bill rates at close on:	7 day	14 days	3 months
Friday 17 July	13¼-13	13½-13¼	13¾-13½
Monday 20 July	13-12¾	13¾-13	13 11/16 - 13 9/16
Tuesday 21 July	13½-13¼	13½-13¼	14 1/4 - 14
Wednesday 22 July (provisional)	13	-	14 1/4 - 14 1/8

Exchange Rate at close:	Friday 17/7	Monday 20/7	Tuesday 21/7	Wednesday 22/7
$ rate	1.8800	1.8710	1.8468	1.8565
Effective	92.43	92.33	91.68	91.72

Market assistance by the Bank	Friday 17/7	Monday 20/7	Tuesday 21/7
	The Bank bought £70 million of bills for resale on 24/7, providing cash at rates between 12-12½	The Bank bought £300 million of bills for resale part on Wednesday 22/7 and part on Friday 24/7 at rates between 12-12⅜.	The Bank bought £70 million of bills for resale on 22/7 between 12-12⅛.

Wednesday 22/7

The Bank bought £101 of bills for resale on Monday at rates between 12-12¼