c Alan Walters

Prime Minister

I called for this report so that you can keep in close touch - with a view to the timing of a further reduction in rates.

There looks to be room for a further fall. Would you like a discussion with Alan?

MCS 1/2

I think it is a little early for another fall in view of the money supply figures. MT.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

1 February 1982

Michael Scholar, Esq.,
No.10, Downing Street

Dear Michael,

INTEREST RATES

I wrote to you on 18 January about developments in the week beginning 11 January. Developments in the following week, described at the Prime Minister's meeting on 22 January, involved a reduction of ½ per cent in base rates and a fall of a full 1 per cent in the Treasury bill rate. This letter describes events last week, which was one of consolidation.

Monday 25 January saw a sharp rise in eurodollar rates - at one point they rose 1½ per cent to 16 per cent, inducing a fall in the pound of about 3 cents. This was mainly a reaction to the US money supply figures which rose again following the huge increase in the previous week. In the event, pressure was taken off the market by Mr. Volcker's announcement that the Fed would be treating the bulge in the money supply as an erratic factor and would not be raising its discount rate. This announcement coincided with the President's State of the Union message which indicated that the Administration was not prepared to raise taxes to reduce the deficit. Not surprisingly the markets were left in a state of some confusion - a confusion which still persists. The result in the money markets however was a falling euro-dollar rate which closed around 14½ per cent on Friday 29 January. The pound was strong at $1.88 and 91.6 effective.

Market rates rose a little early in the week but came back as US interest rates fell and the pound strengthened. Market shortages were fully relieved - at a cost of £1.5 billion for the week - and it proved possible to make some further progress in reducing dealing rates. Rates in bands 3 and 4 were brought down first to 13⅞ in line with bands 1 and 2; and on Friday the rate in Band 3 was shaved by a further 1/16. The Treasury bill tender rate was unchanged. The structure of money market rates, which consolidated at around 14½ per cent over the whole of the short term yield curve, was comfortably in line with the new level of base rates.

/On Monday

SECRET

On Monday 25 January, gilts were unsettled along with everything else but recovered during the course of the week. Gross sales during the week totalled around £125 million. Following the announcement of the third indexed issue, the price of the two existing issues fell. On Thursday it was announced that the Bank had only accepted bids of 90 or above, a yield of just over 3 per cent. At these prices some £230 million nominal was sold, the rest of the £750 million being taken into the Issue Department. The knowledge that the authorities were not prepared to allow the yield on IGs to be pushed up by successive issues was reassuring, and prices for both IGs and conventionals rose, helped also by an improved US bond market. On Friday, the Government Broker sold a further £56 million of the new IG at prices about ½-¾ up. Over the whole week, prices at the long end ended about 2-2½ points up on a week earlier, and the first two indexed issues recovered some of the lost ground to end 1-2½ points down on the week.

Latest news leaves the underlying position unclear. The US money supply figure announced over the weekend showed a small fall - much smaller than the market had anticipated. The 3 month eurodollar rose to around 12½ per cent. But sterling remained strong especially against the European currencies and the effective rate remains at around 91.8. The Bank was therefore able to allow its dealing rate in bands 2-4 to fall by another 1/16 to 13¾ per cent. The 3 month interbank rate stands at 14½ per cent.

We still have to proceed cautiously. The provisional money supply figures for banking January which will be published on 9 February are not very encouraging. The narrow aggregates grew sharply - M1 is estimated to have grown by 2¼ per cent bringing its growth since February to 10½ per cent. £M3 growth is put at 1½ per cent - rather better than we feared, but still on the high side. The tentative figure for PSL2 is around 1 per cent which would leave the increase over the past year at around 12 per cent.

A proposal to re-centre the undisclosed band on 14 per cent is now under consideration.

Yours ever,

John Kerr.

J.O. KERR