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Prime Minister

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INTEREST RATES

There is, in fact, a division of opinion amongst Treasury officials. Peter Middleton favours reducing dealing rates; Sir D Wess & Sir K Couzens do not. MCS 21/5

1. At the monthly meeting yesterday between Treasury and Bank officials, which I also attended, the Treasury argued that there was a good case for a further gradual reduction of interest rates. The Bank were reluctant to recognise that the case was at all convincing. The Bank cited the Falklands uncertainties and difficulties with the Common Market as the main reasons for keeping interest rates where they were. But there was general agreement that:
 - (a) the monetary aggregates were currently well below their target growth and that they had under-shot the forecast for many months;
 - (b) that with nominal interest rates constant and the rate of expected inflation falling rapidly, real interest rates were rising;
 - (c) real output was fairly sluggish, although there were gratifying increases in house building; and
 - (d) the exchange rate had remained remarkably high, in spite of all the political uncertainties.
2. The general conclusion, which the Bank did not entirely subscribe to, is that our monetary policy has been tightening over the past month or two and should be slightly relaxed in order to get it back on course. This suggests that the Bank should take the opportunity after this week to reduce dealing rates and give the banks an incentive to adjust base rates.
3. I strongly recommend this course of action. I believe that we would have reduced interest rates again a month ago had it not been for the Falklands crisis. In retrospect the delay was probably something of a mistake, easy enough to see after the event. Because of the very sound monetary and fiscal position, the markets would, I believe, now take this adjustment of interest rates as quite normal and consistent with our general economic policy.

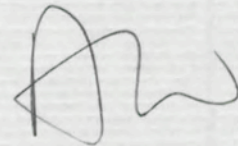
/3. I expect

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3. I expect you will shortly be receiving a recommendation from the Chancellor and the Governor. I am not clear at this stage whether the Governor's counsel of "caution" will prevail over the Treasury officials' recommendations. The Governor and the Bank generally are clearly anxious to establish that we are in fact operating an exchange rate regime. (At present sterling at 90 lies in what is said to be the unofficial band of 88-92.) I doubt if the Governor will be explicit about these motives, however.
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19 May 1982

ALAN WALTERS

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