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Prime Minister

Two notes on
interest
rates.

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

16 June 1982

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Michael Scholar Esq
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Dear Michael,

I wrote to you on 20 May, setting out recent developments in financial markets and the prospects for interest rates. The Prime Minister might again welcome a note setting out what has been achieved over the past month and what the prospects are.

A month ago we felt that there was scope for some reduction in interest rates, but that with a landing on the Falklands imminent, with the risks that entailed, no immediate move should be made. When the landing was successfully accomplished, it was agreed we should move the unpublished band down by 1 per cent to 12-14 per cent and should be prepared to move cautiously with the markets, acquiescing in a $\frac{1}{2}$ per cent fall in base rates in the first instance. This was done and base rates were reduced on 8 June. The Bank reduced its dealing rates by around $\frac{1}{2}$ per cent across the spectrum and its rate in band 1 is now $12\frac{5}{8}$ per cent. Market rates also fell by about $\frac{1}{2}$ per cent and three month interbank rate now stands at $12\frac{3}{4}$ -13 per cent.

Looking at the main monetary indicators we feel there is scope for a further reduction, of say $\frac{1}{2}$ per cent, over the next few weeks. Although the growth of £M3, fuelled by strong bank lending, may be growing near the top of the target range, M1 is still well below it. The effective exchange rate is firm. The performance on inflation remains good while activity, except perhaps in the housing market, remains weak.

Although the fundamentals point to a further easing of interest rates we still need to proceed carefully. The success in the Falklands appears to have been discounted in advance as there has, as yet, been no surge of optimism

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in the markets. If anything sentiment has worsened slightly, with US interest rates, which are now moving upwards, becoming the dominant concern. The three month eurodollar rate is now about 15½ per cent and the differential against UK rates has widened to 2½ per cent. Though the exchange rate remains firm in effective terms, the dollar rate has eased substantially. There is also concern about the continuing strength of bank lending. The gilts market too has cooled a bit though prices for the top stocks remain near market levels.

, The Chancellor feels that while it would be unwise to be seen to be pushing ahead of the market, the underlying position is such that we should be prepared to take advantage of any improvement in sentiment and to make a further reduction in short-term interest rates when the opportunity arises.

Yours sincerely,

Jim Rutter

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