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Prime Minister <sup>(2)</sup>

11 October 1982

ALAN WALTERS

PRIME MINISTER

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INTEREST RATES

You will have observed that, both at the end of last week and today, there has been great activity in both American and British markets. The fall in interest rates, and the increase in both equity and bond prices in America was, at least in part, due to the more relaxed stance of the Fed in reducing their interest rates. (The Federal discount rate was cut from 10% to 9.5% on Friday.)

Paul Volcker's announcement, after the market closed on Friday, was to the effect that M1 would be likely to be a somewhat misleading indicator during the months ahead. The Fed therefore is paying more regard to other monetary magnitudes which would have to be interpreted flexibly in the light of changes in banking regulations. It is uncannily like our announcements of March 1981 when we said we would pay attention to monetary indicators other than M3. But, like us, I am quite convinced that it does not presage a trend relaxation in monetary policy. I am convinced that there is no evidence to suggest that Volcker has changed course.

The fall in US interest rates, however, is not the only effect on London markets. Probably as important is the appreciation of sterling up to an effective rate of 92.8%. This has been brought about primarily by the depreciation of Scandinavian countries' currencies, the Finnish Markka, the Swedish Krona, etc. One would hope that the devaluation of such minor currencies would not affect our markets. And normally they would not. However, the City has been persuaded that we are on an exchange rate target. Thus when sterling appreciates above the 92 level, there is considerable expectation that we shall bring interest rates down to ensure that sterling falls once again below the level of 92. (I believe the view that we are on an exchange rate target has been propagated primarily by the Bank, but they deny it.)

However, as I suggested in my memo of 6 October, I do still think there is further room for reductions of interest rates. So it is wise to let the market carry us down another half or indeed as much as one percentage point. It is a pity, however, that it will

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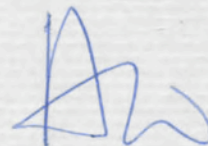
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reinforce the market's perception that we are on an exchange rate standard. But that cannot be helped. It is important to get interest rates down.

In my judgement, we should stop the process at 9% base rates. Much below that will threaten our monetary control and may give rise to too rapid an expansion in our monetary aggregates. Meanwhile over the next months we must expect fairly high month on month monetary growth rates. These, however, should be substantially absorbed as recovery gets under way, particularly in 1983. And they should be consistent with, still, a downward trend in inflation to 5% or less in 1983.

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