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Prime Minister (2)

A situation report.

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Dear Michael,

The Chancellor thought the Prime Minister might like to have his up-to-date assessment of the position on the exchange rate and prospects for interest rates. This reflects a discussion with the Governor on 1 June and recent developments including provisional monetary figures for banking May.

The exchange rate has fallen back only a little from its peak on 31 May, when after a prolonged surge, the effective rate opened at 88.1 with the mark and dollar rates at DM 4.07 and $1.61. There was a sharp fall on 3 June followed by a further surge this morning, when the opening rates were 87.3, DM 4.05, $1.58. While lower than the average rates last November, these rates are high compared with recent months, particularly in relation to the mark. The monthly averages for March, the low point, were 79.1, DM 3.59, and $1.49. The exchange rate is only one factor in industrial performance but if it was thought likely to remain at current levels, or even to rise further, it would be bound to involve some risk to the resurgence of industrial confidence which was based, among other things, on better prospects for export orders. We understand, incidentally, that the CBI have it in mind to make - after the election - representations, reflecting grass roots reactions, about the high level of the exchange rate and interest rates.

The strength of the demand for sterling assets by residents who might formerly have preferred foreign currency assets is also an important factor to take into account in assessing how much monetary growth is appropriate. The provisional figures for monetary growth in banking May are an improvement on April so far as the broad aggregates are concerned, with increases of ¾ per cent in both £M3 and PSL2. However this still leaves growth at an annual rate, over the first three months of the current target period, of 15½ per cent for £M3 and over 18 per cent for PSL2, ie well above 11 percent, the top of the target range. As expected, M1 is also growing at a rate above the target range, and shows signs of accelerating. Gilt sales have

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been successfuly raised in order to offset high borrowing for funding. But even if this keeps the monthly growth of £M3 to the May level, the cumulative growth rate would remain above the target range for the next 2 or 3 months. The narrower "transaction aggregates", the wide monetary base, non-interest bearing M1, and £M2 are however all growing at rates within the target ranges. Although these do not have the status of targets, we take account of them. And the strength of sterling, together with the fact that real interest rates are relatively high, are evidence of some tightness in monetary conditions.

It is uncertain whether markets will react positively when the May provisional money figures are published tomorrow. But at present the pattern of short-term interest rates shows no evidence that the market is expecting a fall in interest rates. Indeed following the hardening of US rates last week in the wake of poor money figures and the feeling after Williamsburg that the US deficit problem was becoming intractable, the short-term yield curve is sloping slightly upwards. Friday's Treasury Bill tender produced a discount rate of 9.76, slightly higher than the previous week's. But this pattern could well change either after the announcement of the money figures or after the election result.

At his meeting with the Governor on 1 June the Chancellor analysed the monetary position, and explored the arguments for and against a cut in base rates. The primary argument in favour of such a cut was that it might serve to slow sterling's climb, which had been rapid throughout the preceding week. But the Chancellor's conclusion was that a cut before the money figures, and the election, would be unwise, since - in the absence of any market pressure for downward movement - the authorities would have to make a very public signal. This would be highly unusual late in an election campaign. The arguments for prudence were of course susbequently reinforced by sterling's decline on 1 and 2 June, which accelerated on 3 June.

Nevertheless, given sterling's renewed strength this morning, and the monetary picture overall (for he does not feel that the growth of broad money should be regarded as ruling out some downward movement in interest rates), the Chancellor believes that the case for a reduction of ½% in short-term interest rates should be re-examined immediately after 9 June. He intends, of course, to keep the Prime Minister fully informed.

Yours ever,

John Kerr.

J O KERR