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Unwelcome news

MLS 10/6

PRIME MINISTER

INTEREST RATES

The meeting with the Treasury and the Bank this morning agreed to allow the market to take dealing rates and so base rates down by one half a percentage point. We expect the best time to do this will be next Tuesday after this afternoon's announcement of a new short (1988) conventional stock.

There are no powerful arguments for this slight relaxation of interest rates. Monetary conditions are not obviously tight, and relative to sterling M3 and PSL2 they look, if anything, rather loose. Fortunately, however, the narrow aggregates NIB M1, the monetary base and M2, are all well contained. In addition the revision of expectations, now that you are elected, is such that real interest rates, already high, must have gone up a notch or two. The exchange rate reflects some of this monetary restraint and (particularly the deutschemark rate) is probably on the high side.

non-interest-bearing

One half a percent off base rates will help eliminate from the Building Societies' Agenda on 22 June some of the more dramatic interest rate changes which might otherwise have been suggested. But it is very unlikely that half a percent as such will prevent an eventual rise in mortgage rates. From January to May this year advances have been approximately twice as large as receipts. It would take a substantial increase in interest rates under present conditions, perhaps as much as 2%, to balance the demand and supply of Building Society credit. But the half a percent reduction in base rates will undoubtedly help reduce the magnitude of any such increase. And it is just conceivable that the Building Societies, if they believe that interests rates are likely to fall further, may not increase their mortgage rate at all. In present circumstances, however, this is unlikely, and I suspect that they will increase the mortgage rate by 1%.

Although this is politically a move of little merit, it is not possible to offset it without a damaging easing of monetary restraint; and such easing would have only a temporary effect - followed by perhaps an even larger rise in the rates.

AW

ALAN WALTERS
10 June 1983

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