PERSONAL AND CONFIDENTIAL

PRIME MINISTER

Interest Rate Policy: hysteria and fundamentals

Market sentiment in sterling is at present a mixture of hysteria and perceived adverse movement of fundamentals.

Questions over the fundamentals

1. Money Supply

Broad money is gowing rapidly reflecting the demand for credit. Most reccently narrow money has begun to grow faster as well. In August Mo grew by ½ per cent.

Changes in 12 months to

	Mo	£M3
June	3.1	18.3
July	3.0	19.3
August	4.1	18.5

2. Unit Labour Costs

Running at 7½% but the CBI report that pay settlements in manufacturing fell to an average of 5½% in the third quarter (lowest figure for three years). Our costs are substantially higher than all our major competitors.

The weaker sterling exchange rate has put companies in a very comfortable position - in which (on the basis of past evidence) they are just as likely to concede cost increases, as to expand in foreign markets.

3. Consumer spending

Up 3% in 1985; but Q2 1986 over Q2 1985 up by over 5%. Retail sales in August at record level. Real disposable income was 3½% higher Q1 1986 on Q1 1985. It is this which is driving the demand for Mo.

4. Balance of payments

Current account surplus of £3.6bn for 1985 hass been effeccitvely eroded in 1986. Devaluation will have a positive effect on the non-oil balance but will take time to come through.

5. Credit boom

Rise in equities and home prices substantial: partly fed by increased competition between banks and building societies. But existing interest rate levels are not restraining the demand for credit.

6. Political factors

Election within 18 months is a certainty: outcome less clear than 1983.

7. The dollar and the DM

The US economy is suffering a serious imbalance which requires a lower $. US will not lower interest rates for fear of higher inflation: Germany sees no reason to move: therefore continuedfall in $ accompanied by weakness of sterling

8. PSBR

The market suspects that the PSBR is overshooting its target by £1½ billion.

Conclusion

In the minds of market dealers all of this adds up to a consumer led-boom accompanied by the fear of an easing of monetary and fiscal policy in the run-up to an election. Nervousness over the fundamental behaviour of the economy is therefore producing volatile markets ready to move on the slightest rumours.

The deterioration in market sentiment is clearly evidenced by

(a) the rise in gilt yield over past six weeks;
(b) the devaluation of sterling over the summer
(c) the recent rise in money market rate in recent days

Policy Response

1. It is important to do everything possible to get the Germans to lower interest rates.

2. If this is very limited or does not take place the market itself will almost certainly force up interest rates.

3. The market does not yet know the state of the PES round. A rise in the planning total against this background would almost certainly mean a rise of at least 2 per cent in interest rates.

Recommendation

a. Continued intervention by the Bank in the market could well be giving conflicting signals as the market attempts to read the new "desired" level of the exchange rates. Permit the exchange rate to fall and keep intervention by the Bank to the very minimum.

b. The present slight deterioration in the fundamentals of the economy must be judged against the background of the unhelpful PES round. Ask the Chancellor to present his game plan on interest rates, taking this into account.

c. It ought to be possible to ride over this current bout of hysteria. But if the market insists on the interest rate increase because it is worried about the fundamentals of the economy rather than the G5 it would be better to lead rather than to follow. If the market forces rates to rise do not attempt to stop them. Far better to turn it to your advantage in the Party Conference as yet another example of your determination to fight inflation. This would have an important psychological effect on market sentiment which will be to your advantage in the difficult run-up to the election.

The worse thing to do would be to delay taking appropriate action in keeping to a sound monetary policy and letting people imagine that you were prepared to gamble on inflation. This would almost certainly prove counter-productive.

Brian Griffiths

Brian Griffiths

29 September 1986