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225.

Prime Minister  
To <sup>note</sup> passage on real  
interest rates.

AT  
17/10



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

17 October 1983

Andrew Turnbull Esq  
10 Downing Street

*Dear Andrew,*

Following the Prime Minister's meeting with the CBI last week, you asked us for some information about international comparisons of interest rates in UK, Germany and Japan.

I attach a note prepared here by officials, which compares short-term prime rates charged by commercial banks on corporate loans, together with money market rates and inflation.

I hope this serves your purpose.

*Yours,  
P.S. 1/6*

MISS J C SIMPSON  
Private Secretary

## INTERNATIONAL COMPARISONS OF INTEREST RATES

During a recent discussion with the Prime Minister, the CBI gave the impression that average interest rates for commercial borrowing in the UK were up to twice those in Germany and Japan.

2. The usual measure of corporate borrowing costs is the commercial bank's prime rate, which is the short-term interest rate charged to first-class borrowers. Prime rates are of course only a broad indication of the interest cost as the actual rates charged will depend on the lender's assessment of the borrower as regards risk, profitability, etc. Prime rates do not change as frequently as market rates. In Japan, for example, the administered interest rate structure has meant that the short-term prime rate, which is tied to the official discount rate, has not changed since the end of 1981. For both these reasons the comparison includes money market rates.

3. Nominal interest rates in the UK have been and are still higher than in Japan and Germany though the difference is more marked for short-term than for long-term rates. However, nominal rates say little about the real cost, that is after adjusting for inflation, to the borrowers. There are difficulties in deriving satisfactory estimates of real interest rates, particularly when making international comparisons.

4. Calculations of expected real interest rates, which are more relevant to a firm considering an investment, require an estimate of expected inflation or an inflation forecast. While short-term forecasts of inflation are readily available there are problems in obtaining a series on inflation expectations. Information from index-linked securities has been used to estimate the market's inflation expectations in the UK though there are no index-linked securities in either Germany or Japan.

5. The Bank of England produces a comparison of real short-term interest rates for the major countries (Table 2). These suggest that last year UK real rates were slightly higher though the difference has narrowed recently and UK rates are now not out of line with equivalent rates in Germany and Japan.

## RESTRICTED

All these estimates are pre-tax. Different tax treatment of interest payments would of course affect the actual cost to the borrower. Use of consumer prices provides only a rough guide as borrowers will typically face different prices. Nor of course do these estimates take account of the relative size of external debt compared to other sources of finance, equity and retained earnings.

Table 1

Short-term interest rates (per cent pa)<sup>(1)</sup>

	<u>Germany</u>		<u>Japan</u>		<u>UK</u>	
	<u>Prime</u>	<u>Interbank</u>	<u>Prime</u>	<u>Interbank</u>	<u>Prime</u>	<u>Interbank</u>
1982 (av.)	11.5	8.9	<u>6.0</u>	6.9	12.9	12.3
1983 Q1	8.9	5.7	6.0	6.6	11.8	11.1
Q2	8.0	5.4	6.0	6.4	11.0	10.2
July	8.0	5.6	6.0	6.5	10.5	9.9
Aug	8.0	5.7	6.0	6.6	10.5	9.9
Sept	8.3	5.9	6.0	6.7	10.5	9.7

Long-term interest rates (per cent pa)<sup>(2)</sup>

1982 (av.)	8.8	-	8.0	-	12.9
1983 Q1	7.4		7.6		11.4
Q2	8.0		7.5		10.5

Consumer price inflation (per cent pa)

1982 (av.)	5.3	2.7	8.6
1983 Q1	3.7	2.1	5.0
Q2	2.9	2.2	3.8
July	2.5	2.2	4.2
Aug	3.0	1.2	4.6
Sept	2.9	-	-

Notes

(1) For the UK prime rates are bank base rates plus 1 per cent. The Bank of England has provided nearest equivalent rates for Germany and Japan. The 'interbank' is a 3-month rate. UK banks cut base rates by  $\frac{1}{2}$  percentage point to 9 per cent with effect from Tuesday, 11 October.

(2) Long-term rates refer to the yields on long-term government bonds. For the UK it is the yield on 20-year government securities.

Table 2

Short-term real interest rates : *International comparison*

	<u>Germany</u>	<u>Japan</u>	<u>UK</u>
1982 (average)	4.6	4.5	5.2
1983 Q1	2.6	5.1	4.8
Q2	2.2	5.4	4.0
Q3	2.6	4.8	3.3

Source: Bank of England.

The real interest rate is defined as the nominal interest rate less an estimate of expected or actual inflation. The nominal interest rates used are monthly averages of interbank rates. The rate of inflation is the recorded change in consumer prices between six months past and six months ahead where available and a Bank forecast for recent periods for which data are not yet available.

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Short-term Real Interest Rates: International Comparisons

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From  
Sir Terence Beckett CBE  
Director-General

CF papers

CBI

②  
mb  
Prime Minister

The comparison on the rates at which companies borrow is not quite as adverse as Sir Terry Beckett implied, but is still significant. Economist table attached.

AT 10/10

7th October, 1983

Ref 10

Dear Prime Minister,

At the presentation Campbell Fraser and I made to you on pay on Wednesday, you asked for more information on interest rates in Germany and Japan, and how they compared with those in the U.K. for prime borrowers.

Both in Germany and Japan there is no easy rule, such as there is in the U.K., for working out interest rates for business borrowers. Rates are negotiated on an individual firm by firm basis and may even vary for one firm depending on why the loan is being requested.

The Economist publish a table showing interest rates for prime borrowers in individual countries. Their figures are based on reports from local bank offices (primarily those of Chase Manhattan). According to the most recent of these tables (published today) prime borrowers may expect to pay around 8% in Germany and 6% in Japan. These figures agree with those we were able to obtain by calling German and Japanese banks in London today.

With U.K. bank base rates now at 9% and prime borrowers likely to pay 1 to 2% above base, it can be seen that although equivalent German and Japanese rates are greater than half of those here, they are still significantly below rates in the U.K.

Thank you for your interest in the Pay Presentation. We believe it will prove useful.

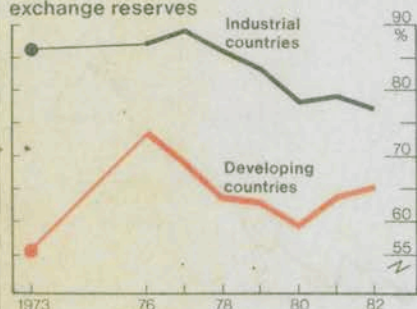
Yours sincerely,  
Terry Beckett

The Rt. Hon. Margaret Thatcher, MP,  
Prime Minister,  
10 Downing Street,  
London, S.W. 1.

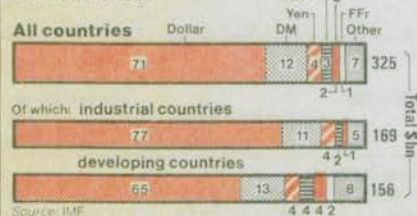
# ECONOMIC AND FINANCIAL INDICATORS 2

**FOCUS: FOREIGN RESERVES** The dollar is still the world's reserve currency. At the end of 1982, 71% of all countries' foreign-currency reserves were held in dollars, compared with 76% in 1973. The dollar's share shrank to 69% in 1980, largely because its exchange rate fell against currencies like the D-mark and the yen. Central banks want to hold reserves in a form that holds its value and can easily be used to finance trade. The dollar has scored on both counts while alternatives—principally the D-mark—have tended to resist a greater role as a reserve currency. Remember, though, that gold is still the most popular of all. In 1982 industrial countries held 60% of their foreign reserves in gold, only 30% in foreign currencies.

Dollar assets as % of total foreign-exchange reserves



Foreign-exchange reserves by currency % shares, end-1982



## TRADE, EXCHANGE RATES AND RESERVES

Japan produced a current-account surplus of \$2.1 billion in August, bringing its 12-month total to \$15.5 billion. West Germany managed only \$4.7 billion over the same 12 months, still enough to push the D-mark's trade-weighted value to its highest point since July. Australia's current-account deficit—\$5.8 billion in the 12 months to August—was its smallest since 1980.

	Trade balance**		current-account balance	currency units per \$		3mth forward rate	Discount/premium %pa	Trade-weighted† exchange rate		currency units		foreign reserves††	
	latest month	latest 12 months		latest	year ago			latest	year ago	per £	per SDR	July	year ago
Australia	+0.01 (8)	- 0.3	- 5.8 (8)	1.10	1.06	1.11	Disc 3.16	82.3	84.7	1.64	1.17	6.3	4.1
Belgium	-0.14 (5)	- 3.5	- 2.5 (3)	53.5	49.5	53.5	Prem 0.11	90.7	93.4	78.9	56.6	5.5	3.7
Canada	+1.02 (7)	+14.0	+ 2.9 (6)	1.23	1.24	1.23	Prem 0.24	92.2	90.5	1.82	1.31	3.6	2.5
France	-0.05 (8)	-10.6	-10.6 (6)	8.01	7.20	8.10	Disc 4.78	67.4	72.5	11.8	8.47	20.4	15.4
W. Germany	+1.47 (8)	+19.0	+ 4.7 (8)	2.63	2.55	2.60	Prem 3.73	126.6	124.9	3.88	2.78	44.5	41.0
Holland	+0.47 (6)	+ 3.4	+ 3.6 (3)	2.94	2.79	2.92	Prem 3.37	116.5	117.1	4.34	3.11	10.7	8.3
Italy	+0.20 (5)	-10.3	- 3.3 (6)	1592	1434	1625	Disc 8.15	49.5	53.5	2348	1686	20.2	15.4
Japan	-3.13 (8)	+26.0	+15.5 (8)	234	273	232	Prem 2.90	153.0	126.1	345	248	25.4	25.6
Sweden	+0.24 (7)	- 0.2	- 3.2 (3)	7.83	6.29	7.88	Disc 5.66	67.1	80.9	11.5	8.27	3.6	3.2
Switzerland	-0.26 (7)	- 3.7	+ 3.5(12)	2.11	2.20	2.09	Prem 5.61	152.7	143.4	3.12	2.24	12.5	12.3
UK	-0.21 (8)	+ 0.5	+ 5.3 (8)	0.68	0.59	0.68	Prem 0.18	82.7	91.6	—	0.72	11.7	13.1
USA	-7.19 (8)	-57.5	-26.5 (6)	—	—	—	—	126.9	124.6	1.48	1.05	21.1	20.8

†Bank of England index 1975=100 ††excluding gold. \*\*Canada, Australia, Japan, France and UK imports fob, exports fob. All others cif fob.

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**WORLD BOURSES** Hongkong had a drubbing, falling to its lowest point since December, 1982, and 37.5% below its 1983 high. Wall Street drifted down on profit-taking, while London perked up after a fall in interest rates. France rose, hovering around the record high it achieved this week.

Stock price indices

	Oct 4	1983		% Change on				
		high	low	one week	one year	record high	31/12/82 in local currency	in \$ terms
London	708.2	740.4	598.4	+2.0	+22.8	-4.3	+18.7	+8.2
New York	1236.7	1260.8	1027.0	-0.9	+36.3	-1.9	+18.2	+18.2
Canada	2474.0	2598.2	1949.8	-4.1	+56.3	-4.8	+26.4	+26.3
Australia	697.4	736.7	487.8	-2.9	+40.5	-6.5	+43.6	+31.9
Japan	690.5	694.4	574.5	-0.3	+32.4	-0.6	+16.3	+16.8
Hongkong	690.1	1102.6	690.1	-13.8	-21.8	-61.9	-12.0	-32.7
Belgium	130.9	134.4	100.5	-1.5	+28.2	-8.0	+27.2	+11.7
France	139.5	139.7	96.1	+0.2	+41.8	-0.1	+39.2	+17.1
Germany	941.5	986.3	727.9	+0.1	+32.4	-8.8	+23.3	+11.7
Holland	116.5	116.5	83.5	nil	+69.6	-17.1	+39.0	+24.2
Italy	192.1	214.9	160.5	-1.6	+19.9	-34.2	+15.8	-0.4
Singapore	953.4	992.6	712.3	-2.9	+46.1	-3.9	+30.2	+28.3
South Africa	934.7	968.7	740.9	-2.2	+36.4	-3.5	+26.6	+21.7
Sweden	1433.7	1528.6	896.2	-4.1	+118.0	-6.2	+58.8	+48.3
Switzerland	335.1	347.0	294.4	nil	+29.3	-28.6	+16.2	+10.3

## MONEY AND INTEREST RATES

All Japanese interest rates eased, as did West German bond yields—a ready response to the strength of the two countries' currencies. British banks cut their base lending rates by half a point to 9%, helped by expectations that some British money supply figures for September will show a fall.

	Money supply		Interest rates % p.a. (Tuesday, except bonds which are previous Friday)							
	% rise on year ago		Money market	Commercial banks		Bond yields		Eurocurrency		
	Narrow (M1)	Broad†	Overnight	3 months	Prime lending	Deposits 3 months	Gov't long-term	Corporate	Deposits 3 months	Bonds
Australia	+ 7.0	+12.6 (8)	11.50	11.45	14.00	10.07	14.30	15.30	10.50	14.36
Belgium	+ 3.3	+ 5.1 (3)	8.40	9.25	12.50	9.00	11.43	11.34	10.25	13.04
Canada	+16.1	+ 0.5 (8)	9.50	9.25	11.00	9.30	11.80	12.14	9.63	12.28
France	+10.5	+10.3 (5)	12.63	12.63	12.25	12.03	13.39	14.36	14.50	11.12
W. Germany	+11.7	+ 6.8 (7)	5.55	6.20	8.00	5.64	8.38	8.35	5.81	8.16
Holland	+ 9.9	+10.0 (6)	5.88	6.38	8.00	6.38	8.63	8.78	6.06	11.53
Italy	+15.4	+15.0 (5)	17.63	17.69	18.75	11.50	17.64	17.32	17.75	12.87
Japan	+ 3.1	+ 7.1 (7)	6.75	5.38	6.00	3.75	7.57	7.68	6.69	6.91
Sweden	n.a.	+ 8.3 (6)	11.90	12.40	11.00	12.05	12.00	13.00	12.25	11.39
Switzerland	+ 6.8	+ 8.3 (6)	2.44	3.94	7.50	3.75	4.69	5.07	3.97	11.06
UK	+13.3	+11.0 (8)	8.44	9.44	10.00	9.31	10.85	11.89	9.44	12.24
USA	+12.7	+ 9.1 (8)	8.38	9.00	11.00	8.95	11.62	12.40	9.56	12.06

Other key rates in London 3 mth Treasury Bills 9.0%, 7-day Interbank 9.3%, clearing banks 7-day notice 5.5%. Eurodollar rates. (Libor): 3 mths 9.7%, 6 mths 9.9%.

† M2 except Australia, Canada, Switzerland, U.S.A., W. Germany, M3, Japan M2 + C.Ds, UK EM3. Definitions of interest rates quoted available on request. Sources: Chase Manhattan, Chase Econometrics, Banque de Commerce (Belgium), Nederlandse Credietbank, Credit Lyonnais, Svenska Handelsbanken, ANZ bank, Credit Suisse First Boston. These rates are indicative only and cannot be construed as offers by these banks.