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20 December 1982

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
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My dear Geoffrey

As you know, the monthly review of monetary conditions has now been completed.

The latest monetary figures give the impression of continuing rapid monetary growth in the three months to mid-November, but no further acceleration since the summer. This leaves the growth of both sterling M3 and M1 within, but close to the top of, the target range in the first nine months of the present target period. The short-term monetary forecast suggests that sterling M3 may now decelerate slightly, but that M1 will go above the top of the target range by the spring. The retail price figures continue to improve, but expectations about the future rate of inflation appear to have been adversely affected by the fall in sterling. Moreover, the fall in the exchange rate itself indicates some easing in monetary conditions. On the other hand, base rates have already risen to 10-10 1/4% in response to the fall in the exchange rate, and with interbank rates rather higher than that, real interest rates remain clearly positive. In the light of these considerations, we do not on balance see any clear need for a further rise in short-term interest rates, which would damage industrial confidence and could unhinge the recent cut in mortgage rates.

In current market conditions, however, we do not have a free hand. The immediate operational question is whether we can prevent interest rates from rising further. Having regard to rates in the money market, base rates are on a knife-edge. Interbank rates at up to three months are touching 11% and have been at or around this level for some time. These rates are not consistent with 10% base rates: very large amounts of borrowing have been switched from market-related rate sources to drawings on overdraft, and such switching has become still more attractive to borrowers in the last few days as the next date for charging interest on overdraft is not now until March*, and the clearing banks are having to finance drawings on overdrafts at a loss. Unless interbank rates soon ease, to below 10 1/2%, the clearing banks will not be able to avoid a further increase in their base rates.

These conditions in the money markets essentially reflect apprehension about the situation in the foreign exchange market. Despite the initially favourable reaction to the rise in base rates to 10-10 1/4%, and to the falls in continental interest rates and the US discount rate, the exchange rate has remained very fragile. Since the rise in base rates the ERI has fallen back to around 85, despite market intervention totalling over $3/4 billion as well as some $1/2 billion of purchases of sterling by the European Commission. We remain for the time being highly vulnerable to pressures emanating from the present OPEC meeting, the turbulence within the EMS, and factors (including end-year factors) affecting the dollar, and any significant further decline in the exchange rate for sterling will push base rates here over the edge.

In this situation our money market tactics have been quite clear. By consistently dealing down to the 10% rate of discount which has

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*Because interest on deposits taken in the interbank market is payable immediately on the maturity of the deposit (eg, after seven days or whatever) whereas interest charged on overdraft is receiveable only at the quarterly interest date (ie, now in March), the clearing banks make a loss on overdraft lending financed at short term in the interbank market even where the interbank deposit rate is as much as 1/4% or more below the rate charged on overdraft to blue-chip borrowers (ie, currently 11%).

been our lowest dealing rate since 26 November, and by endeavouring to over-do the amount of assistance at that rate, we have unambiguously signalled that we are looking to maintain the present rate structure. But while these tactics have succeeded so far in holding the position, they have made little impact on the upwards pressure on market interest rates which, as indicated above, reflects expectations about the exchange rate rather than technical money market influences. This being the case, and given the high priority attaching for the time being to preventing a rise in base rates, we have had to have recourse to the sizeable, tactical exchange market intervention mentioned above, as the only other means available to us for attempting to prevent the exchange rate falling further and thereby moderating the concerns in the money market.

We recognise, of course, the possibility that the pressure on sterling will intensify to an extent that such tactical exchange market intervention cannot sustain sterling at around present levels. Moreover we are quite clear that our present posture in the exchange and money markets may not necessarily be appropriate beyond the current tactical situation, which could last into the New Year. In particular, we would not want over a more prolonged period to seek to defend sterling at present levels in defiance of the market - whether through exchange intervention or interest rate policy. If, in the New Year, there are no signs of improvement in the present position we will need to review the whole stance of policy with you.

In the meantime, however, and subject to the pressure not becoming overwhelming, I propose that we should attempt to go on as we are, holding on to the present level of base rates and to that end seeking to prevent any significant decline in the exchange rate. It will not be possible for us to pursue simultaneously the tactical objectives just described and an objective for the level of the reserves, although we will of course attempt to keep the amount of exchange intervention to a minimum. In current market conditions, however, it may be necessary on certain days to contemplate intervention at the substantially higher level than was normal before the recent shift in sentiment about sterling which you and I

discussed at our meeting on 6 December. The disclosed fall in the reserves could well be substantial. At the same time we will persist with our recent tactics in the money market, and would therefore leave the unpublished interest band unchanged for the time being at 9-11%.

Yours ever

Gordon.