S41/1

SECRET & PERSONAL

Re Gavaghan

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10, DOWNING STREET,

WHITEHALL S.W.1

With the Private Secretary's Compliments

SECRET

10 DOWNING STREET

From the Private Secretary

13 January 1983

INTEREST RATES

The Prime Minister had a discussion this evening with the Chancellor and the Governor about this week's events in the exchange and domestic money markets.

Following the discussion, the Prime Minister said that she was strongly opposed to any further rise in domestic interest rates. At their present level, they were, in her view, too high. She hoped that the Bank would make her views known to the clearing banks. Any further rise in rates would destroy the Government's strategy for recovery. It, like the depreciation of sterling, would have an adverse effect on inflation. It would dislodge the Government's public expenditure plans. Finally, on the basis of the experience of the last six weeks, it would not even have the desired effect of stabilising the exchange rate. She noted that real interest rates were at present higher than at any time during the last Government. She could not understand why rates needed to rise when the fundamentals of the Government's economic policy were, as the recent IMF Report had made so plain, sound and correct - on public borrowing and spending and the control of the money supply - and at a time when rates in the rest of the world were coming down. She suspected that one of the principal reasons for the high rates was resistance on the part of the clearing banks to a low interest rate regime, given their dependence for their profitability on the endowment factor. This apart, she thought that rates were rising because the market believed the authorities would resist any further fall in the exchange rate and would initiate, or acquiesce in, interest rate rises to defend sterling. She noted the Governor's view that x the present pattern of rates should hold the position for the time being; that it would be desirable for Ministers to make it plain publicly that, as well as being concerned about higher interest rates, they would also be concerned about a further fall in the exchange rate; and that the recent rise in interest rates owed little to any preferences by the clearing banks in the matter but was, rather, a consequence of the falling sterling exchange rate and market expectations of higher inflation later in the year following this, arguably overdue, realignment of exchange rates which had taken place since November. Finally,

/ the Prime

the Prime Minister endorsed the Chancellor's conclusion that the Government's policy should now be to allow the main pressure to come upon the exchange rate rather than upon interest rates; the soundness of the overall financial position should minimise the dangers of this course.

I am sending a copy of this letter to Tim Allen at the Bank of England.

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury.