

Ponie Pinto

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You might wish to call a
meeting on this early
next week - but that
can await developments.

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PRIME MINISTER

17/4.

17 April 1986

SHOULD SHORT-TERM INTEREST RATES BE BROUGHT DOWN?

Bank base rates have fallen since the Budget from 12.5% to 11%. Last week, there was strong pressure in the market for rates to come down by a further 1%, and it was only Bank of England intervention which kept short-term rates up. Already, three-month inter-bank rates now stand at 10.5% - which suggests a 0.5% cut in base rates.

1% at the maximum

9 15/16 %

Arguments for bringing rates down

- i. Real rates of interest are still high - 6% or so - compared with the 3% we were used to in the 1950s and 1960s.
- ii. The recent growth in broad money may look more worrying than it really is. Admittedly the figures do look bad:

Annualised growth rates in year to:

	<u>February</u>	<u>March</u>
£M ₃	14.8	16.4
£M ₃ + building societies	13.9	14.5

But as £M₃ includes interest-bearing instruments which people hold when interest rates are high, its rapid growth may perversely be a result of high rates.

- iii. It would endorse the market's judgment.
- iv. The exchange rate has remained firm and might rise further, especially as the next move in oil prices is more likely to be up than down.

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Arguments against bringing rates down

- i. Narrow money (M_0) has been growing more rapidly, although still within its target range

Annualised growth of M_0 during:

<u>Banking March</u>	<u>Last 3 mths</u>	<u>Last 6 mths</u>	<u>Last 12 mths</u>
+0.5	+5.1	+3.9	+3.6

- ii. House prices have been growing more rapidly over the past 6 months (see attached chart). The economy is buoyant, growing at a steady 3% or so a year.
- iii. Inflation looks like falling until the spring of 1987. But to keep it to 3.5% or lower throughout 1987, we need to keep a pretty tight grip on financial conditions. We do not want to repeat our mistake in the winter of 1984, when we relaxed too much. Base rates got as low as 9.5% in December 1984, only for confidence to collapse so they were driven up to 14% by the end of January 1985.
- iv. Bank lending is still going ahead rapidly (17% up in the past year). There is a lot of liquidity about.
- v. With the uncertainties on the oil price, we need to allow for the risk that the PSBR overshoots.

Conclusion

- The Bank were right to resist market pressures for a fall in rates last week. We recommend that further pressure should be resisted; though if it becomes intense, we may have to concede 0.5% - but no more.
- If the pound were rising to an effective rate of 80 - possibly as a result of a concerted action by the US and

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Japan to reduce their interest rates - this would not be sufficient reason, in itself, to reduce our rates as well. The problem for both Japan and the US is faltering growth; for us it remains inflation.

3. There are signs (eg increases in reserves and persistent press comment) that the Chancellor sees entry to the EMS as the only way of making real headway in reducing rates, with the window for entry being our Presidency of the EEC.

Beware!

Brian Griffiths

BRIAN GRIFFITHS

David Willetts

DAVID WILLETTS

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ANNUAL HOUSE PRICE INFLATION

CHART XVI

