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

10 February 1982

M. Scholar, Esq.,
Private Secretary,
10, Downing Street

Dear Michael,

I promised to let you have, before the Prime Minister's dinner at the Bank tonight, some additional briefing on market developments to supplement the note which I sent to you on 3 February. The markets have since had to digest a good deal of bad news, most of it of US origin.

Last Friday the US money supply (M1) announcement was of a fall of $1.4 billion, a move in the right direction but still less than the market had hoped for. Only a small part of the $9.8. billion rise of three weeks ago had been reversed. The Fed also released the minutes of its December meeting which indicated that its target for the first quarter of this year has been tightened. The Fed funds rate (the rate banks pay when bidding amongst themselves for reserves) has been rising, and is now around 15¼ per cent compared with 13½ per cent two weeks ago. The 3 month euro-dollar rate has risen to about 16¼ per cent from about 15½ per cent at the end of last week.

On Monday, the US Federal Budget was announced. The deficit for the year, ending in September, is put at $100 billion and at $92 billion for the year beginning in October. No major tax raising measures were announced, and there appeared to be no effort to respond to those who regard the fiscal deficits as too large to be consistent with the monetary targets.

On Friday, the cut in BNOC's oil price of $1.50 was announced and, as further evidence of a weakening oil market, price cuts by Iran and Kuwait were reported.

The announcement of an increase in £M3 of 1½-1¾ per cent in January was a disappointment to the market which had been looking for figures closer to 1 per cent. Although the figure for bank lending is not published until tomorrow week, analysts have correctly guessed that the figure will be around £1½ billion. Of this, lending to the personal sector was over £½ billion.

UK markets have withstood this flow of adverse news reasonably well. The exchange rate against the dollar has fallen from $1.86 last Thursday to $1.85 at noon today. But sterling has

/been

been reasonably firm against European currencies; and the effective rate was 91.7 at noon today, unchanged from the close on Thursday.

Interbank rates have firmed a little, the 3 month rate rising from 14½ per cent last week to 14¾-⅝ per cent today. The Bank's dealing rates have been unchanged this week, remaining at 13⅞ in Band 1, 13 13/16 Band 2 and 13¾ in Band 3.

The gilts market has been somewhat weak, and though it has picked up a bit today it still shows losses of about ¼ over the past three days. The new short tap, whose issue was delayed until Monday in order to avoid the turbulence of US developments over the weekend, was priced at 93¼ but now stands at 92⅞.

Incidentally, I have just heard that Volcker, testifying to Congress today, suggested that the growth of M1 over the year as a whole could acceptably be in the upper half of the target range, and that in the immediate future it could acceptably be above the range. His intention was presumably to reassure the markets that the Fed will not be trying to get M1 back within the target range straightaway. Although this may calm fears about US interest rates, we have seen no reactions so far.

Yours ever,

John Kerr.

J.O. KERR