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New Rachel,

The Prime Minister might welcome a further note on developments in financial markets and the prospects for interest rates.

Until Thursday of last week conditions remained adverse. US interest rates had been high and the US money supply the previous week had shown a large increase. There was continuing weakness in the oil market. At home the latest money figures were regarded as disappointing, indicating uncomfortably high growth of the wide aggregates and of bank lending.

Nevertheless, financial markets stood up encouragingly. Sterling held up well in effective terms and fell less than might have been expected against the dollar, though there is a possibility that sterling could be benefiting from some temporary factors such as the money market tightness created by the tax season. The gilt edged market was moderately firm.

Since Thursday, market conditions have improved significantly. On Friday US interest rates began to ease as fears that the Fed would be tightening conditions receded. The money supply figure announced after hours on Friday showed a large fall.

Domestic markets opened strongly today. Although the DM has strengthened, sterling has changed little in effective terms. Interbank rates have fallen from 14½ per cent to 14¼ per cent. The rates at which bills were being offered to the Bank were reduced significantly, a move foreshadowed by Friday's fall in the Treasury Bill tender. The Bank has reduced its dealing rates by 1/16 to ¼ per cent. In addition £240 million was lent through the discount window, though this is rightly seen as correcting the technical shortage created by the Amersham issue, rather than giving a market signal. The gilts market was also strong today, and the remainder of the short tap was sold at £21.

/The Governor

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The Governor has proposed that the undisclosed band should be realigned from its present $13\frac{1}{2}$ - $15\frac{1}{2}$ per cent to 13-15 per cent. The Bank's dealing rate of 13 $\frac{13}{16}$ per cent is very close to the old lower limit. The Chancellor intends to accept this proposal immediately.

We shall be considering in the light of market developments how far the Bank's dealing rates can safely be lowered further.

Yours ever,

J. O. Kerr.

J. O. KERR

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