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Prime Minister

Please see Alan Walters' note, attached, which dissents from the Chancellor's view that we should not reduce dealing rates at this critical moment. Agree no immediate downward move but review the position next week?

MLS 21/5

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

20 May 1982

Michael Scholar, Esq.,
No.10 Downing Street

Dear Michael,

Yes MT

The Prime Minister might welcome a note on recent developments in the financial markets and on the prospects for interest rates as we see them.

You will recall that following the Budget, base rates were reduced to 13 per cent, and by the end of March three-month interbank rates had come down to around 12½ per cent. After the invasion of the Falklands market rates rose to just over 14 per cent, though as confidence returned they had fallen back by the end of last week to between 13 - 13½ per cent. There has been no change in base rates. Throughout this period we have sought to steady rates in both the domestic and external markets, allowing the exchange rate and interest rates to fluctuate. The Bank's shortest dealing rate in the money markets has been at around 13⅛ per cent. Apart from the immediate reaction to the news of the invasion - about which I wrote to you on 6 April - exchange market intervention has been on a limited scale.

Meanwhile, the prospects for lower interest rates have improved because:-

(i) progress in reducing inflation is rather better than expected;

(ii) the borrowing requirement has been turning out lower than expected;

(iii) the narrow aggregates have been substantially undershooting the target rate - the increase in M1 over a year earlier is only 4½ per cent. The broad aggregates have decelerated more than expected - £M3 in April was about 12½ per cent higher than a year earlier;

(iv) US interest rates have until recently been falling, and the bulge in M1 appears to be working itself out;

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(v) after the initial reaction, and until this week, the exchange rate had withstood a great deal of uncertainty over the Falklands surprisingly well; and

(vi) the level of activity in the economy appears to be a little weaker than expected at the time of the Budget.

Finally, the markets themselves have indicated, by their reaction to any good news, their view that lower interest rates are in the pipeline.

There are of course a number of considerations, apart from the immediate concern with the Falklands, counselling caution:-

(a) the continuing strength of bank lending, which shows no signs of abating, and our expectation that the growth of the broad aggregates could accelerate over the next few months as the exceptional surplus in the CGBR reverses itself and the heavy funding of recent months slackens;

(b) US interest rates, where optimism about further falls seems currently to be evaporating. The position on the US Budget is still very uncertain and is causing continuing concern in both the US bond market and at the shorter end.

In assessing immediate tactics, of course, the Falklands issue is still the major factor. We do not want to risk a foreign exchange crisis along with our other problems. And this points to continuing caution. For obvious reasons, the markets are this week displaying some nervousness. Since Friday the three-month interbank rate has risen ½ per cent to around 13¾ per cent, gilt prices have fallen over £1, the exchange rate has declined against the dollar from $1.82 to under $1.78, or from 90.4 to 88.6 in effective terms. The FT index has fallen from 590 to 555. The markets are certainly not expecting any immediate downward move on interest rates: they would regard one as rash, and this could well have an adverse effect on confidence at a particularly critical time.

The Chancellor does not however take the view that no move on interest rates can be countenanced while the Falklands dispute continues. When we pass through the current period of acute tension, while the uncertainties are at their greatest, he will certainly want to review the position to see how far it would be possible to revert to bringing interest rates down in line with good monetary and financial news. But his present view is that caution has served us well in recent weeks, and still seems the best policy.

Yours ever,

John Kerr.

J.O. KERR