

SECRET

6 July 1982

Econ Pol.

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ALAN WALTERS

PRIME MINISTER

INTEREST RATES

Prime Minister

You may wish to raise this
with the Chancellor tomorrow:
MUS 6/7

1. In my view it is imperative that we continue to implement the policy of reducing interest rates. We were set to begin the process some two weeks ago and were held up by the reaction to the surge of American interest rates. But that is now over. American interest rates have started to fall and we have all the favourable circumstances for edging our dealing rates down and so bringing base rates down from 12½% to 12%.
2. The market has been looking for a reduction of interest rates and has been pressing down on inter-bank rates and increasing the price of gilts. The dealing rates in Band 3 and Band 4 have already come down. One would expect to see a reduction in base rates by the end of the week or, at the very latest, by the beginning of next week, unless some dramatic event intervenes.
3. All the Treasury are agreed that interest rates should come down. Our monetary aggregates are tight, particularly the monetary base and M1. Even the wayward £M3 is being brought back into line. The low growth rate of these aggregates must be the main argument for reducing interest rates.
4. The tightness of money is also underlined by the high effective exchange rate. On a purchasing power parity basis, there should have been some erosion of our exchange rate. Instead it has stayed high, probably too high. Of course we have depreciated against the dollar but this is primarily due to the unprecedented monetary squeeze that has been going on in the United States in recent months. It would be a great mistake for us to try and defend sterling against the dollar parity under these conditions. Our policy should be to pursue a course which is right for us domestically, and not to follow slavishly whatever the Americans, or any other foreigners, do.
5. The only opposition to the policy of reducing interest rates comes from the Governor and, more reluctantly, the Deputy Governor. I believe that they still hanker after an exchange rate target. Indeed

/it has been

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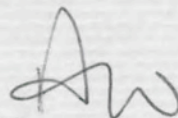
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Indeed it has been widely reported in the City that the Bank is in fact operating such a target. However the Deputy Governor, I know, has been brought reluctantly around to the view that there is no powerful case for trying to keep interest rates at their present level. There may, however, be some pressure coming from the Governor to the Chancellor in opposition to the policy of reducing interest rates. The Treasury are, however, unanimous in supporting the reduction. I propose to meet the Governor with Treasury officials on Thursday to see if we can clear the ground for future policy decisions.

6. You may wish to talk to the Chancellor about interest rate policy on the flight to Rome. I attach a letter which I addressed to Terry Burns, who has shown it to the Chancellor.

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