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Prime Minister

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ALAN WALTERS

PRIME MINISTER

MCS 31/1

MONETARY POLICY AND INTEREST RATES

You will have seen the first estimates of the monetary aggregates in Banking January. They show that our monetary conditions remain, if anything, rather on the tight side. The monetary base since mid-February is growing at an annual rate of only 3.2 per cent and M1 has increased by only 0.7 per cent during the month of January, which is an annual rate of only about 9 per cent. (Although the larger increases in the middle of the year mean that the annualised rate since mid-February is 11.1 per cent.) This again shows something of a tightening in our monetary conditions. And sterling M3 has actually fallen in Banking January.

The increase in interest rates in December and January have not yet had time to percolate through to our monetary aggregates. But it does suggest that we may be entering another phase of considerable monetary stringency. The lags in the reaction of our monetary aggregates to these interest rate increases, compared also with the low rates of inflation in the prices of traded goods, will mean that real interest rates are uncomfortably and unduly high.

The exchange rate has made a long overdue adjustment. The exchange rates of sterling are now broadly consistent with those which I suggested in my memorandum of March last year, (and are indeed a little lower.) I am quite convinced that the present exchange rate cannot be adduced as evidence of any marked monetary laxity. On the contrary, it reflects relative purchasing power of parity, and of course an additional element concerned with the political uncertainties of pre-election period. In addition there is always the joker of oil prices.

In my judgement there is a risk of undue monetary stringency in the coming months. We should, therefore, be looking for the opportunity to bring interest rates down, not in any dramatic fashion, but by using such market opportunities as develop.

There is a real danger that if we try to force interest rates down, the market will interpret this as a pre-election bonanza of the usual kind. We should, therefore, to avoid validating the market's

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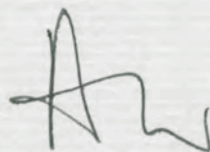
natural cynicism about politicians in an election year, take the opportunity only when there is a pronounced negative slope to the money market yield curves. Then we can plausibly show that the market, rather than the Government, thought it was appropriate to reduce interest rates in this pre-election period.

Because of the "defend-sterling" syndrome of the markets, any reduction in interest rates will be difficult to achieve unless the market thinks that it is consistent with the policy on sterling. But it can be done. What is required is that the Bank spread the word in the City that the Government does not wish to tighten our monetary conditions and that some reduction in interest rates would be entirely consistent with our monetary policy.

The grounds for this have already been laid, both by what the Chancellor said and your Weekend World interview and your speech in Glasgow. A reduction in base rates of 1 per cent will demonstrate confidence in our policy.

I have talked this over in general terms with Peter Middleton in the Treasury. I have discussed this with Eddie George and he agrees that there is no evidence at all of monetary laxity, although, being cautious, he would prefer to wait and see whether there is any evidence of monetary stringency.

In my view it is worthwhile your reminding the Chancellor that you do not want inadvertently to impose a monetary squeeze during the next few months. Although the danger is not present and urgent, it may appear so in a matter of weeks. We want to avoid the sharp lurch which may be necessary to offset an indvertent squeeze. That we can do by taking an opportunity to reduce interest rates in the weeks ahead.



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