PA

I must see the Chancellor before Wednesday - because of his statements

PRIME MINISTER

The Deputy Governor, in a telephone conversation with me last week, stressed that it was the Bank's desire to keep within, or as near as possible to, the target sterling M3 range which was their principal~~e~~ motive in their current money market operations.

Given:

1) the move, in the Budget and since, away from excessive dependence on a single indicator of monetary tightness and

2) the real danger of weakening, or even choking off completely, the recovery (a point noted in a number of recent forecasts, including Patrick Minford's Liverpool Group.)

Do you wish to raise with the Chancellor (at your Wednesday meeting)? or separately, with Alan Walters present?) Alan's suggestion that there is no case for resisting the downward trend of interest rates?

MCS

30 November 1981

SECRET

30 November 1981

ALAN WALTERS

> (1)

Prime Minister

MCS 30/11

PRIME MINISTER

INTEREST RATES

1. During the last two weeks there has been considerable downward market pressure on interest rates in the money markets. The Bank has countered the market by keeping interest rates considerably higher than they would otherwise be.

2. The rationalisation for the Bank's policy consists apparently of a number of strands. First, in my judgement least important, they have been concerned to prevent a considerable fall in interest rates because they wish to have a little in hand to do a traditional "Duke of York" operation in selling gilts. If this were the case it would be simply a tactical operation and one would see it unwind after a week or two. The second rationalisation, and the most important, is that they wish to constrain the expansion of bank credit to the private sector. They regard themselves as being constrained to control that expansion and its counterpart in the $M_3$ figures.

3. But I believe that all of us who keep a close watch on these statistics, including people such as Gordon Pepper and Tim Congdon in the City, believe that sterling $M_3$ is seriously flawed as an indicator of monetary stringency. Indeed the Chancellor argued as much in the Budget speech last March. The other indicators, $M_1$, retail $M_1$ and the monetary base (which is least influenced by the Civil Service strike) show that there has been, and continues to be, considerable monetary tightness. For example, the monetary base has grown only by 4% over the last year and only 2% over the last six months and is actually unchanged over the last three months. This view is confirmed by the appreciation of sterling over the last three months. That is consistent with a tightening of the money supply.

4. All these indicators, even including PSL2 in so far as one can remove the distortions, suggest that there is no case for resisting the downward trend of interest rates. The data on bank lending and their effects on $M_3$ are to a large extent the result of

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business which had been outside the banking system being attracted back into the banks. Structural changes in credit markets are no good reason for tightening the money supply, as we found in 1980. Furthermore, maintaining interest rates well above market values will undoubtedly have some significant effect in delaying the cyclical recovery.

30 November 1981 ALAN WALTERS

I understand this evening that Peter Middleton agrees with the position I have outlined above.* It is intended to let short rates come down during the course of tomorrow. It is doubtful if this will have any effect on the exchange rate since that has already been substantially discounted.

ALAN WALTERS

* I am told by the Treasury that it is by no means ?

clear that the Chancellor will agree to the proposal that short rates be allowed to drop on 1/12.