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7 January 1982

ALAN WALTERS

PRIME MINISTER

Top copy returned to Alan Walters. 9/1/82.

NOTES FOR YOUR MEETING WITH THE GOVERNOR

1. The unpublished band of interest rates is 14-16%. The dealing rate is effectively at the lower limit of the band at fourteen and three-eighths.

2. If the dealing rate is at the lower end of the unpublished band, and the market guesses roughly where that unpublished band is, then this is an indication to the market that the Bank expects interest rates to rise. So the market will expect an increase also.

3. The Bank may give a number of reasons why they do in fact expect interest rates to rise. Among the factors are a possible rise in American interest rates, a coal miners strike, ASLEF trouble, etc. Yet there are powerful reasons why they should not. The monetary aggregates, and even the wayward M3, were very reassuring last month. However, the Bank may argue that the January ones may be more worrying. Most convincing, however, is the fact that the exchange rate is very high, at approximately 91.5.

4. All the normal indicators point to a fall in interest rates. The Bank's objections are really of the form that we may possibly have to raise interest rates later to deal with a coal miners strike or some other such contingency. But the essence of the new system is that there be flexible interest rates. If we do not reduce interest rates because of fears that we may have to raise them later, then we will never reduce interest rates.

5. What is really important is that the dealing rate comes down. This is the rate which the market observes and to which base rates will eventually adjust. Moving the band down half a percentage point will give room for a similar reduction in base rates from fourteen and three-eighths to thirteen and seven-eighths percent.

6. I am quite convinced that technically the Bank could do this immediately by suitable indicators to the market, through the usual nods and winks that it is so proud of. But if they want to achieve this reduction in their own inimitable way, then I see no powerful argument against giving them a little time to do so.

/7. The Bank

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7. The Bank, however, will continue to be constrained with respect to interest rates in a downward direction if we leave the band at 13½-15½%. I think it would be a good idea to propose to the Governor that we move the band down again in a week or two's time so that there is room for the market effects to reflect themselves in the dealing rate.

8. The Governor may object that he expects interest rates to rise. Our argument is, if they do rise, then the dealing rate can go up to the top of the band and we'll consider moving the band upwards. This is the basic idea behind flexibility of interest rates.

9. The Governor may confuse the issue by arguing that the Bank is merely interpreting the expectations of the market with respect to interest rates. This is misleading. The market knows that the Bank is the major influence on interest rates and the market forms its expectations from what it can devine about Bank and Government policy. From recent evidence the market would adduce that the Bank (and the Government) are concerned to keep money tight with respect to the narrow aggregates and to maintain an exchange rate well over 90. But that expectation is generated largely by the Bank's policy and not by the markets.

AW

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