c A.W.

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Prime Minister

I think the Treasury are trying to say they're doing their best!

MCS 18/1

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

18 January 1982

Michael Scholar, Esq.,
No.10 Downing Street

Dear Michael,

INTEREST RATES

In his minute on 8 January to the Prime Minister about discussions with the Bank of England on interest rates, the Chancellor reported that there was general agreement on the objective of trying to secure an early further reduction in bank base rates of about ½ per cent. It was also agreed that the Bank would direct its money market operations to this end, but without giving a dramatic signal which might lead the market to think we were prepared to see the exchange rate fall sharply. You might like a report on developments and progress over the past week.

On Friday, 8 January, the prospects for achieving some reduction in interest rates looked reasonably good. The effective exchange rate was at 91.8, the dollar rate at 1.92. Interest rates, e.g. the 3 month interbank rate and the Treasury Bill tender, had fallen slightly. The Bank's aim during the subsequent week was, as a preliminary to a fall in base rates, to induce some easing of interbank rates by "overdoing the help" i.e. tending to provide slightly more assistance than was strictly indicated by the market shortages.

In the event US developments were adverse. The US weekly money supply figure announced on 8 January fell less than the market had expected, and the figure announced on 15 January showed an exceptionally large increase. Whatever the reasons for this, the market reacted with a sharp rise in Eurodollar rates. They rose from 13½ per cent on 8 January to nearly 14½ per cent at one point on 13 January. The 3 month rate is now 14 7/16ths. In consequence the dollar strengthened markedly and the dollar/sterling rate fell to below 1.86 by Thursday. The effective rate was 90.1. The pound weakened only slightly against European currencies. In the domestic markets the climate of expectations was poor, influenced by the miners' ballot and the train strike.

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Although the Bank gave substantial assistance, buying gross £1.8 billion of bills, it was not, in these circumstances, possible to make much headway in reducing rates. To have acted aggressively could have had a very adverse effect in the foreign exchange markets.

By Friday 15 January the 7 day and 3 month interbank rates were still more or less where they had been a week earlier. The Bank's dealing rate was unchanged in Bands 1 and 2. It was however lowered by 1/16 in Bands 3 and 4. This signal - quite important in the move to get base rates down - was noticed by the professionals in the market, and the Treasury bill rate was slightly down on a week earlier.

The gilts market was also depressed. Prices were marginally down over the week; sales were very small and yields are in the 16-16½ range.

The position on the exchange rate is now rather better. The dollar rate is not much changed at 1.87½ but our effective rate is 90.8 tonight. The exchange rate is still affected by higher Eurodollar rates but is beginning to benefit from a more hopeful view of the miners' ballot. This is also affecting the money markets, and the Bank managed to reduce their dealing rate by 1/16 in Bands 1 and 2, and by a further 1/16 in Band 4, today.

The pace of further progress, towards the Government's agreed aim, will be influenced by developments on the foreign exchange and labour fronts.

Yours ever,

J O Kerr.

J.O. KERR

Interest rates - holding up xchange rate,