

Subject a Master

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cc: Prof. Griffiths

10 DOWNING STREET

From the Private Secretary

8 January 1986

Dear Cabel,

BASE RATES

The Prime Minister this morning discussed with the Chancellor, the Governor and Mr. George the position on interest rates.

The Chancellor and the Governor explained that market interest rates had moved up in the last two days for a combination of reasons. First, there were fears that the exchange rate might depreciate further, against the background of expectations of lower oil prices and concern about the high rate of growth of costs in the UK. Secondly, there was concern about the high rate of growth of bank lending, which included a large element of personal lending, both for housing and for general consumption. Market confidence had also not been helped by signs that the Government was in disarray over the Westlands affair. It had been expected that the clearing banks would themselves wish to increase base rates. But they were in fact reluctant to do so, preferring to wait to see how the markets moved: their own financial position did not require an increase at present. The difficulty was that if the Government appeared to hang back it would give an appearance of dither and indecision, which would increase the risk of a further increase in interest rates. An increase now could not be presented as responding to the clearers, but the Government could say that it was responding to the market.

The Prime Minister expressed concern that if the Government responded now to what seemed to be somewhat hysterical market pressures, the market would take interest rates higher still and the Government would be in a similar position again next week. This had been the experience on several occasions in the past. All present agreed that the risk of further market pressure certainly existed, but as Mr. George argued, a move now was needed as a matter of damage limitation.

The Prime Minister accepted that the authorities should signal an increase of 1 per cent in base rates. The Prime Minister emphasised, and the Chancellor and the Governor agreed, that any further market pressures for higher interest rates should be firmly resisted.

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I am sending a copy of this letter to John Bartlett
(Governor of the Bank of England's Office).

Yours ever,

David,

David Norgrove

DM

Mrs. Rachel Lomax,
H. M. Treasury.