CONFIDENTIAL AND PERSONAL

Cf- pc.

PRIME MINISTER

MARKETS

You will see from the attached note from Alan Walters that he is unhappy about today's developments. This is as you expected, and I have sought this evening to explain to Alan your thinking and your reasons.

You and the Chancellor are agreed on the appropriate action for the next 24 hours or so. But the point may well come over the next few days where the issue "are we defending DM3" has to be faced. Alan's comments in the last paragraph of his minute below are very relevant here. This may well be something you will need to discuss further with the Chancellor later this week or next week.

[illegible] (Duty Clerk)

pp Paul Gray

4 October 1989

CONFIDENTIAL AND PERSONAL

c;markets (MJ)

CONFIDENTIAL

PRIME MINISTER 4 October 1989

INTEREST RATES AND RECESSION

Base rates are to be raised to 15 per cent tomorrow, ostensibly in response to the Bundesbank rise of 1 per cent, but in reality in reaction to a threatened fall below DM3.00. We have spent some $1.2 billion so far today and no doubt we'll spend more in New York and Tokyo propping it up temporarily at 3.01 or so. This intervention is apparently designed to give the Chancellor the fig leaf of saying that he was not raising interest rates in response to a fall actually below DM3.00.

We have been caught yet again by the market's expectations of our Pavlovian reaction to the Dmark rate - intervention followed by an increase in base rates. We remain on a de facto DM standard of DM3.00 - where we started in 1987. Then it generated inflation: now it induces a recession. The cycle is complete.

The building societies and banks are likely to move quickly to increase mortgage rates (they have already withdrawn most of their fixed rate offers) by some 2 per cent or more. ? PRCG This will have serious political repercussions. The direct effects of borrowing costs on corporations will be more muted, but the indirect effects on orders etc will be quite severe.

I am fairly certain that the present squeeze was more than adequate to get the inflation rate into the "comfort zone" by the next election. And this recent increase in interest rates will have little or no effect on inflation before the Spring of 1991. But it will be very likely to induce a serious recession in 1990 which will persist into 1991.

CONFIDENTIAL

The pattern of events, like a Greek tragedy, is painfully familiar. And as long as we are seen to be defending parties, the pattern will be repeated over and over again as I have often argued so many times before.

As far as the immediate situation is concerned, I do not think that, at this juncture, there is any choice by to go along with the Chancellor's recommendation. But if sterling drops again - even to say 2.80 - it would be worth considering whether one must go up to 16 or 17 per cent base rates to defend the parity from falling further. Such high rates would devastate the economy and your electoral strategy. In such circumstances we must let the pound go.

ALAN WALTERS

chex.jp/jg/57

cc Budd

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

2 October 1989

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul

BALANCING ITEMS

... I attach a note on balancing items in other country's overseas accounts and on what we are doing to reduce ours.

Yours

JG.

JOHN GIEVE