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LONDON SW1A 2AA

From the Private Secretary

5 October 1989

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Dear John,

INTEREST RATES

It may be helpful to record the outcome of the Prime Minister's discussions with the Chancellor on 3 and 4 October.

At the earlier meeting the Chancellor said there was uncertainty about the likely scale of any move by the Germans to raise their interest rates on 5 October. However, if the Germans were to implement a 1 per cent increase he felt it would be necessary for the United Kingdom to make a parallel move, notwithstanding the obvious difficulties. It was agreed, however, that efforts should be made to obtain further information about the Germans' intentions, and to reconsider the matter the following evening.

At the subsequent discussion on 4 October the Chancellor reported that it had been a very difficult day in the foreign exchange markets, with strong downward pressure on sterling, notwithstanding heavy intervention support. The latest information was that the Germans were likely on 5 October to raise their discount rate by 1 per cent, with probably the same increase in the Lombard rate. Against that background, he had concluded that the United Kingdom would have to raise interest rates also by 1 per cent. As to timing he would greatly prefer to defer a United Kingdom move until the Germans had made their announcement. But one difficulty with this course of action was the danger of further very strong downward pressure on the sterling during the period before the announcement.

Following a brief discussion it was agreed that, should the Germans raise their discount rate by 1 per cent on 5 October, the United Kingdom should make the same increase. It would not be appropriate to seek to give any signal to the markets overnight on 4/5 October of this intention. But consideration would be given on the morning of 5 October to whether the Bank of England would have to give a signal to the money markets during the course of the morning that it would not be undertaking dealings until the Germans had announced their intentions.

*Yem,
Paul*

PAUL GRAY

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