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TO IMMEDIATE UKDEL MELBOURNE

TELEGRAM NUMBER 209 OF 5 OCTOBER

Mes
Mr Scholar
No 10 D.S

FOLLOWING PERSONAL FOR PRIME MINISTER FROM CHANCELLOR OF THE EXCHEQUER.

1. YOU MAY LIKE A FURTHER REPORT ON EVENTS IN FINANCIAL MARKETS.
2. IN ONE OF MY MESSAGES TO YOU FROM WASHINGTON LAST WEEK I MENTIONED THAT IT MIGHT WELL BE NECESSARY TO ALLOW INTEREST RATES TO RISE FURTHER DURING THE COURSE OF THE WEEK, IN THE FACE OF CONTINUED MARKET PRESSURE. HIGH US RATES GAVE US LITTLE OPTION. IN THE EVENT THE BANK OF ENGLAND, IN RELIEVING A LARGE MARKET SHORTAGE ON WEDNESDAY, SUPPLIED FUNDS TO THE MARKET THROUGH BUYING BILLS IN THE RANGE 14 AND THREE QUARTERS - 15 AND THREE QUARTERS PER CENT. THIS BROADLY CONFIRMED THE EXISTING PATTERN OF RATES AND THE OPERATION PASSED OFF QUIETLY, IN LINE WITH THE OBJECTIVES OF THE NEW MONETARY CONTROL ARRANGEMENTS. THE MOVE WAS RECOGNIZED AS A RESPONSE TO WORLDWIDE INTEREST RATE DEVELOPMENTS, AND WAS NOT SEEN AS A DELIBERATE MOVE BY THE GOVERNMENT TO ENGINEER HIGHER INTEREST RATES.
3. ON THURSDAY MORNING THE CLEARING BANKS RESPONDED BY RAISING BASE RATES BY 2 POINTS AND A NEW STRUCTURE OF INTEREST RATES BEGAN TO EMERGE, WITH OVERNIGHT MONEY AT 16 PERCENT AND THREE MONTHS AT CLOSE TO 17 PERCENT, JUST CONSISTENT WITH BASE RATES AT 16 PERCENT. SINCE THEN WE HAVE SEEN THREE DAYS OF RATHER NERVOUS TRADING IN THE MONEY MARKETS, AND IT IS TOO EARLY TO SAY WHETHER THE NEW STRUCTURE HAS YET BEEN CONSOLIDATED, THOUGH TODAY'S DEVELOPMENTS, WHEN RATES EASED SLIGHTLY IN BOTH NEW YORK AND LONDON, WERE marginally ENCOURAGING.
4. THE STOCK MARKET, WHICH WAS PRACTICALLY UNCHANGED ON THURSDAY AND FRIDAY, ROSE BY 14 POINTS TODAY. THERE WERE SOME HOPEFUL SIGNS, TOO, IN THE GILT-EDGED MARKET, WHERE WE WERE ABLE TO SELL sizeable AMOUNTS OF STOCK (POUNDS 315 MILLION IN TOTAL) FOR THE FIRST TIME FOR SOME WEEKS. MOST OF THE STOCK SOLD WAS AT THE SHORT END, BUT THERE WAS ALSO REASONABLE DEMAND FOR MEDIUMS AND LONGS. LATER IN THE WEEK WE SHALL BE MAKING A DECISION ON THE NEXT STOCK TO BRING TO MARKET, WITH THE AIM OF ACHIEVING SUBSTANTIAL FURTHER SALES IN BANKING OCTOBER.

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5. TUESDAY SEES THE PUBLICATION OF THE SEPTEMBER MONEY SUPPLY FIGURES, ABOUT WHICH YOU WILL BE RECEIVING SEPARATE BRIEFING. ALTHOUGH THE POUNDS M3 NUMBER IS LARGE AT 2 PERCENT, THE MARKETS HAVE BEEN LED TO EXPECT A HIGH FIGURE SO IT SHOULD NOT HAVE SERIOUS ADVERSE EFFECTS. (IT WILL OF COURSE BE SEEN AS FURTHER JUSTIFICATION FOR LAST WEEK'S INTEREST RATE MOVE.) THE BUILDING SOCIETIES HAVE NOT YET MADE THEIR DECISION: THEY MEET ON FRIDAY, AND ONE MUST EXPECT THEM TO PUT UP MORTGAGE RATES.

6. THE FOREIGN EXCHANGE MARKETS WERE UNCERTAIN THIS MORNING IN THE WAKE OF THE EMS REALIGNMENT (WHICH WE NEGOTIATED IN BRUSSELS YESTERDAY) BUT HAD SETTLED DOWN BY LUNCHTIME. THERE WERE NO LARGE MOVEMENTS: AND NO HEAVY OFFICIAL INTERVENTION. THE MAIN FEATURES HAVE BEEN:-

(A) SOME WEAKENING OF THE DOLLAR, ON EXPECTATIONS OF FALLING DOLLAR INTEREST RATES. (SEVERAL US BANKS HAVE CUT PRIME LENDING RATES BY HALF PERCENT TO 19 PERCENT) STERLING CLOSED IN LONDON AT DOLLARS 1.8512, A GAIN OF 2 AND ONE HALF CENTS SINCE CLOSE ON FRIDAY.

(B) THE REALIGNMENT ITSELF SEEMS TO HAVE RESULTED IN A SMALL RISE IN THE DEUSCHEMARK AGAINST NON-EMS CURRENCIES SUCH AS THE DOLLAR AND POUND, WITH MORE OF THE REALIGNMENT SHOWING UP AS A FALL BY THE WEAKER EMS CURRENCIES.

(C) THE DEUSCHEMARK IS NOW AT THE BOTTOM OF THE 2 AND ONE QUARTER PERCENT EMS BAND, WITH THE FRENCH FRANC AT OR NEAR THE TOP - SO THAT SINCE FRIDAY THE FRANC HAS ONLY FALLEN, SO FAR, BY ABOUT 4-5 PERCENT AGAINST THE DEUSCHEMARK, ALTHOUGH THE REALIGNMENT PROVIDED FOR A 8 PERCENT FALL.

WITH STERLING ONLY FALLING marginally AGAINST THE DEUSCHEMARK AND RISING AGAINST OTHER CURRENCIES, THE STERLING EFFECTIVE INDEX AT THE CLOSE TONIGHT WAS 88.05 - WELL UP FROM 87.3 ON FRIDAY NIGHT. IN SHORT, THE RECENT TURMOIL SEEMS TO HAVE DIED DOWN.

7. THE RISE IN INTEREST RATES IS OF COURSE A BLOW, BUT NOT ONE THAT WE COULD HAVE AVOIDED. UNTIL THE AMERICANS ARE SEEN TO BE TAKING CREDIBLE STEPS TO REDUCE THEIR DEFICIT, RATES WORLDWIDE ARE LIKELY TO STAY HIGH.

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