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PRIME MINISTER

31 August 1990

ERM ENTRY AND INTEREST RATE POLICY

The Chancellor will almost certainly raise two major issues in his meeting next week - the timing of entry into the ERM and the possibility of easing the stance of interest rate policy.

The timing of entry to the ERM

We are at present enjoying the benefits of being in the ERM. Following Madrid and the unambiguous statements by yourself and the Chancellor, the market is convinced that we will definitely join the ERM. This certainly is one factor making for a strong pound. Another, which is easily forgotten, is the strength of the Government's commitment to reduce inflation evidenced most of all in 15% interest rates.

While we enjoy the benefits of being de facto in the ERM we are also free of the potential costs which its straitjacket might impose, namely:

- heavy intervention as the exchange rate approached the ceiling;
- higher interest rates as the exchange rate approached the floor;
- a revaluation or devaluation of the sterling fixed parity should that prove necessary.

The Treasury will almost certainly argue that now is the time to

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join. (They have since the Summer of 1985.) Their case will be that:

- (a) It will be a useful feather in the Government's cap before the Party Conference.
- (b) It is a necessary step before the IGC discussion begins.
- (c) Most importantly, the flexibility from being outside could result in a devaluation of sterling and a boost to inflation.

Of these, by far the most important is the last: and on this point the assumptions made by the Treasury as to why the exchange rate might fall need to be examined.

I believe there are strong arguments against entry now.

If the market thought the Government was using the Gulf Crisis as an excuse for staying out, the effect on sterling could be severe. But if ever there was a time when any Government should retain maximum flexibility over the levers of economic policy - rather than tie its hands behind its back - it is when there might be a war. Markets understand this argument - which is why there has been no concerted pressure to join just now with the Gulf Crisis.

Prediction is always risky. But trying to predict the change in the price of oil over the coming weeks is particularly difficult. The worst possible thing to do would be to allow a substantial rise in the relative price of oil, producing a general appreciation of the exchange rate, and requiring in turn the need

for heavy intervention in the foreign exchange market, which as we know all too well runs the risk of renewed inflation.

In addition the uncertainty created by the Gulf Crisis makes the choice of the appropriate exchange rate at which to join an extremely tricky if not impossible business. The current exchange rate is really very high given the current growth of wages. Locking ourselves in at this rate would almost certainly lead to deflation - which could be quite severe - in 1991.

In addition there are two other reasons for not joining in the immediate future:

- (i) entry into the ERM would be more credible if inflation were seen to have peaked and better still was on a clear downward trend. This after all was one of the Madrid conditions. The Treasury have been telling us for some time that this inflation peak is just one or two months away. It would be better to have clear evidence;
- (ii) immediate entry to the ERM will create strong pressure for reductions in interest rates. As the next section argues this would be premature.

### Conclusion

We will join the ERM: we must get the timing right: we must minimise the risks associated with entry: the Gulf Crisis and the possibility of a war is not the time to fix sterling.

### Interest Rate Policy

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Tied up with entry into the ERM is the future course of interest rate policy. Joining the ERM will certainly be viewed as an opportunity to cut interest rates.

Most of the new data being published on the economy points to an unambiguous slowdown in economic activity: sharp drop in retail sales; consumer confidence indicator very low; commercial vehicle registrations sharply down; construction sector very depressed; fall away in export orders. Most encouraging of all the monetary data is now behaving in the same way as the real economy: the growth of Mo is falling and it looks as if Mo could be in its target range very soon; also the growth of bank lending is slowing down.

So far little progress has been made on the inflation front and settlement and earnings growth continue to be high. But the continuation of the higher exchange rate and high interest rates is putting a considerable squeeze on the corporate sector and it is only a matter of time before companies reduce employment much more rapidly.

The current behaviour of the indicators plus the lobbying from the business sector raise the question of when the Government should start easing policy by reducing interest rates.

It is important that when interest rates are reduced, they remain at permanently lower levels. To bring rates down and then push them back up - say next year - would be politically disastrous.

On the present behaviour of the economy there can no longer be any doubt that the policy is working. But very little progress has been made on inflation and investment spending by companies looks to be very resilient. Relaxing policy at this stage would

give quite the wrong signals to companies and the labour market. It is because of this that the market is not now pressing for interest rate cuts.

### Conclusion

It is too soon to start reducing interest rates, even if we joined the ERM immediately. If we did reduce rates, the danger would be that wages would continue to grow at current levels, the growth of total spending be given a boost, and the Government could well be forced to raise interest rates to protect a weakened exchange rate.

It may be that in four, six or eight weeks, the situation will become much clearer, and rates can be cut. But we need a clearer picture before taking action.

At present such a course remains too risky.

### Recommendation

- (i) a final decision on ERM needs to wait till the uncertainty over the Gulf is reduced and inflation is clearly on a downward trend;
- (ii) interest rates should not be cut now because of the confusing signals it would give.

The next few months are crucial in building a strong platform for reducing inflation and lowering interest rates throughout 1991. It would be tragic to buy short term political gain through lower interest rates which could prove counter-productive next year.

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These crucial considerations take precedence over the argument that we must join before the IGCs.

Although the Treasury argues that entry is essential to give us credibility in the IGCs, it could equally be argued that holding our fire will give us greater leverage. Entry now will not make the slightest difference to the battle we shall have in resisting the Delors version of EMU; it will in fact make other Member States think they have us on the run.

Brian Griffiths

BRIAN GRIFFITHS

Prime Minister

- (i) I agree there is little to be said for September entry into the ERM. The choice between Sept and Oct was always marginal; therefore why commit yourself when uncertainty in the Gulf is so great. But
- (ii) I would not rule out October
- (iii) I agree with Brian that if we do not enter ERM, interest rates should not be cut. A major inflationary impulse has entered the system. In 1974 we made it too easy to pass on the higher costs. We should continue the pressure now to prevent the same mistake being made.

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