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PRIME MINISTER

We are meeting tomorrow to take stock of the present monetary position and the implications both for interest rates and the timetable for ERM entry. Since we met last week, I have considered the position with the Governor and the Deputy Governor as well as Treasury officials. It may be helpful if I try to set the scene in this minute.

The present economic position

2. There are increasing signs that the measures we have taken to tighten economic policy are having their desired effect on the economy. Monetary conditions have improved with slower money growth and a higher exchange rate. Economic activity has slowed: retail and business demand are sluggish or falling and asset prices have peaked. But inflation and earnings are still high. And the trade deficit is still large and showing little signs of improvement.

3. A higher oil price complicates the picture. The price for Brent oil is presently \$26-28. This will add to the deflationary impact on demand provided that there is no relaxation in monetary policy. But there will be higher prices in the short term. And the clear lesson of the 1970s is that the right way to deal with a jump in oil prices is a restrictive policy. We should not be seeking to accommodate this potentially inflationary shock by relaxing monetary policy; that would mean that the oil price would feed into the general price level.



4. Before the oil price rise, the June forecast pointed to GDP growth of around 1 per cent in both 1990 and 1991, with domestic demand rising about $\frac{1}{2}$ per cent in each year. The RPI was expected to peak at 10.2 per cent in August and fall to an average 9.4 per cent in the fourth quarter of 1990 and 6.4 per cent in the fourth quarter of 1991.

5. It is early days to assess how higher oil prices and the course of events in the Gulf will affect this prospect. The RPI will clearly go over 10 per cent with the higher petrol price, but should fall after September. Underlying inflation will follow a similar path, with a shallow fall from then on till the effects of higher oil prices are overcome. The risk of one or two quarters of negative growth has increased correspondingly.

Interest rates

6. Against this background it is clearly time to consider when we should start to reduce interest rates. I am clear that we must proceed cautiously. We have invested heavily, both politically and economically, in the counter-inflation strategy. Getting inflation decisively down must be the priority. To achieve that we must keep and be seen to keep, money tight. That means keeping the price of money (and the return to savers who we still need to encourage) high.

7. Though capacity utilisation remains high, the risk of some recession next year certainly cannot be ruled out. That is the counterpart of three years of excessively high growth. But it is not the only risk: there is still a risk that we shall make very little impact on our inflation rate, which remains well above the average for our competitors. Moreover, the risks are asymmetric. The costs would be far greater if we relaxed policy too soon or by



too much; we should then be faced with the unwelcome prospect of raising interest rates again.

8. So I think we should rule out more than a very modest easing of interest rates over the next few months and set our faces against an immediate reduction. Three factors in particular are crucial.

9. First, we need to be clearer how other countries are likely to adjust their policy stance in reaction to higher oil prices. We have just seen a rise in Japanese interest rates. If there is a general move to tighten policy I hope we could avoid doing the same because sterling is sustained by the expectation of continued high UK rates. But such action overseas, partly through its effect on exchange rates, would reduce the scope for easing we might otherwise have had.

10. Second, the monetary figures need to be moving decisively in the right direction and by the required amount. M0 in August (4.9 per cent) was just inside the target range. But we are likely to go outside it again in September. And the broader aggregates, though coming down, remain well into double figures - the 12 monthly rate for M4 in July was still over 16 per cent.

11. Third, there is a vital point of perception. We must not be seen to be more worried about recession than inflation at a time when policy has only just begun to show clear signs of working, when the money supply is just within an unambitious target range, when the rest of the world can remember our past mistakes in accommodating oil price increases and when we are on the threshold of a new round of wage bargaining.

12. We also need to consider how our approach to interest rates may interact with the timetable for ERM entry.



ERM entry

*and
included
Cameron
implication*

13. The major event since we considered the position before the holidays has been the Middle East crisis and the impact on oil prices. Uncertainty over how the position will resolve itself is undoubtedly a major new factor that we need to consider. But I suggest it would be helpful to consider the timetable and terms for our ERM entry in three stages. First, in practical terms what are the timetable possibilities? Second, how have recent developments affected the position, in particular regarding our earlier judgements about the range and rate of entry? And then third, how is all this affected by continuing uncertainty about the position in the Gulf?

(i) Possible Dates

14. Practical considerations do substantially limit the available timing options between now and the end of the year. A good many dates are ruled out by events like the September G7/IMF meetings, the Party Conferences, the Special European Council, Prorogation/State Opening, the Autumn Statement, electricity privatisation, and the December European Council/IGCs.

15. If we were to join in good time before the IGC at the end of the year the two best dates from a practical viewpoint would be 14 September and 5 October. Following our last discussion with you, we have worked out detailed timetables for both dates.

16. So I suggest that we need to look tomorrow at the case for entry in mid-September/early October against the possibility, to put it no stronger, that the alternative might be waiting until the New Year.

(ii) Recent Developments

17. Earlier in the summer a major concern was that the then market exchange rate might be rather too low as an entry point. A related worry was that if entry was then followed by appreciation we might find ourselves under pressure to reduce interest rates which we judged inappropriate on domestic grounds.

Also, what if we didn't go in - sterling might go down

18. Since then, sterling, though fluctuating, has appreciated. I regard that as a welcome development. If present conditions persist we could join at a rate either just above or just below 3DM. This seems about right for a central rate in the ERM. The Governor and the Deputy Governor would both strongly support joining at around this rate. It would reinforce counter-inflationary pressures in the short term. And I believe it would be sustainable. I know that some industrialists are saying that the rate is now too high. But I suspect that many of them are focusing on the rising dollar rate which appeared a few days ago to be approaching \$2. But the dollar is not directly affected by ERM entry and is at present appreciating. It does not affect the case for concluding that something like the present DM rate is adequately, but not excessively, tight; it is broadly in line in real terms with the average for the 1980s as a whole, and is well below the rate in the early 1980s.

Worth defining?

and why? trade deficit?

NO

19. Moreover, if sterling retains its strength we shall no longer need to consider the possibility of joining on an asymmetric basis, with the central rate and margins set such that there was more room for sterling to rise than fall from current market levels.

20. In considering an appropriate central rate we also need to bear in mind developments within Germany. As was to be expected the path towards reunification is proving bumpy. The cost is likely to add to the pressure for higher German interest rates



which might come also from higher oil prices and inflation pressures in West Germany. But unification has not had any major exchange rate effect thus far and seems unlikely to lead to major disruptions in the currency markets.

21. I should emphasise that the present strength of sterling is based on three things. High interest rates, the expectation of joining the ERM and to a lesser extent the oil price. Of these, the expectation of our early entry into the ERM is very potent. Sterling fell sharply on Friday on rumours that we should not wish to join at a rate as high as 3DM. We shall remain vulnerable on this account until we join. And, of course, sterling will be especially vulnerable if it is thought that our prospective entry has been put off beyond the remainder of the year. If sterling fell we would require higher interest rates to sustain policy which is very unattractive; alternatively, we would have higher inflation next year.

less volatile now

22. If we did join soon at the sort of rate I have suggested we could still face upward pressure. Should that happen, we should be protected by wider margins, the case for which is strengthened by present uncertainties. A 6 per cent margin would cover the size of change we have seen over the past month.

23. Moreover, if sterling did rise towards its upper limit we should be in a position to consider a reduction in interest rates. This would be a much safer course than attempting to cut rates before entry, which in addition to the disadvantages I have already outlined, might be seen as a deliberate attempt to weaken sterling prior to entry. The Governor and the Deputy Governor see this as a serious risk.

only if monetary conditions warranted it

24. A less helpful development relates to the short term inflation performance and prospects. The oil price effect we have already seen means that the summer RPI peak will be later than we



*As always
with
Treasury
predictions*

would have otherwise have hoped. That clearly has a bearing on one of the Madrid conditions. But higher oil prices will affect our European partners too and should not increase the differential — *but it is already very large.*

Yes

25. In this context we need to consider whether to maintain the line that an improvement in inflation performance is required before we join the mechanism. There are of course strong arguments for holding to that approach. But there are also points the other way. Joining the mechanism would give a clear signal to private sector wage bargainers and, by supplementing a policy of tight money, help to bear down on underlying inflationary pressures. And once we are in the mechanism we will have much greater security that, as and when we judge it right on domestic grounds to reduce interest rates, those lower rates — and their impact on the headline RPI — will be acceptable to the markets.

*Not a
0% margin*

26. A further consideration is how the timing of ERM entry relates to the wide debate on EMU. So far our hard ECU campaign has gone as well as we could reasonably have hoped. But it is still a major uphill task. And this week we will have to resist attempts to sweep our proposals aside at the 4 September Monetary Committee and 7-8 September informal ECOFIN Council. We will have to take stock of these discussions as we prepare for the run-up to the special European Council at the end of October and the December IGCs. But my present view is that we will have an even harder hand to play if we remain outside the ERM right through this period.

(iii) Middle East Uncertainties

27. In an ideal world we would certainly be looking for different circumstances in which to join the ERM than a position where major international hostilities could break out. Should the worst happen, it clearly could lead to turbulence in international



financial markets. There might for example be substantial movements in the dollar and other currencies still to come, though oil is not such a potent influence on sterling as it has been in the past..

28. Much depends on the nature of the conflict in the Gulf. If we face a long drawn out affair, the case for early entry is strong. We should be better placed to handle turbulence whilst maintaining a well judged domestic policy from within the ERM. And we should not risk disappointing market expectations about our entry. It is only if there is the prospect of immediate hostilities that we might wish to retain the added freedom of manoeuvre that we have outside the ERM - and even then we should need to be sure that this is not misunderstood as a desire to be free to relax the counter inflationary policy.

29. In short, in the absence of the Gulf conflict, I should be recommending entry at the earliest date. This view is shared by both Bank and Treasury officials. We might consider how the Gulf situation affects this when we meet tomorrow.

[J.M.]

3 September 1990