

MR. GRAY

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cc Professor Griffiths

You are trying to set up a meeting with the Chancellor and the Treasury Knights to discuss their paper on the reduction in inflation. When I spoke to Peter Middleton recently he was anxious that this meeting should not only reach agreed conclusions on the past but should attempt to formulate agreed descriptions of policy for the future.

On the history, I suggest the following issues:

- (i) Broad money - was it quite such a bad indicator? Could one really afford to ignore it once its growth got over 20 per cent p.a? Is there any inclination in the Treasury to rehabilitate it, even if not to the extent Tim Congdon advocates?
- (ii) Narrow money - was it a good indicator? Was the problem that it gave good signals but we failed to act upon them? Or did it behave, as many have feared, only as a concurrent indicator, giving no advance warning of inflationary pressures?
- (iii) Intervention - what was the impact of sterilised intervention?
and etc.
- (iv) RPI versus GDP deflator - when the Prime Minister queried the Chancellor's use of the RPI excluding mortgage interest as an indicator of underlying inflation, he argued that the growth of the GDP deflator was closer to the adjusted RPI than the actual RPI. I am sceptical of this but we should be able to find the answer from the Treasury forecast.

- (v) The 4 for 1 rule - was this a dangerous formula to adopt? When the exchange rate is showing a tendency to appreciate a 'balancing' cut in interest rates may be deemed to sustain a given monetary pressures overall. But for the personal sector the two things reinforce rather than neutralise each other. The cut in mortgage interest rates boosts the growth in real income from the appreciation of the exchange rate. The same is true in the downward direction though it could be argued that with inflation as high as it is there should be a bias towards restrictiveness.
- (vi) Shadowing EMS - the Prime Minister's interpretation of the results of the shadowing initiative assumes that we would have expressed the same output pressures had we been inside the ERM. Is it not more plausible to assume that once an upward realignment had taken place, eg. from a DM 3.00 to DM 3.12, that that would have been the end of the matter as far as the markets are concerned?

For the future, we need to coalesce around the Prime Minister's latest formulation on ERM. This still leaves a great deal of latitude on the timing of entry. We do not want the Chancellor and Foreign Secretary making public statements implying a decision will be taken sooner rather than later and the Prime Minister the opposite.

So long as we are outside the ERM we need to reach an agreed understanding on the priority to be given to exchange rate stability. There is a balance to be struck between hawkish words which may subsequently have to be eaten, and giving sufficient reassurance of firmness to the markets. Is it possible to devise a statement with which both the Chancellor and the Prime Minister feel comfortable.

AS
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28 June 1989

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