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PRIME MINISTER

Top on Euro Pol: EMS pt 8

BILATERAL WITH THE CHANCELLOR: JOINING THE EXCHANGE RATE MECHANISM

You are meeting the Chancellor tomorrow for a further bilateral discussion on when the UK should join the Exchange Rate Mechanism.

The Chancellor has submitted a further note and the latest Treasury forecast. Page 25 of the forecast is an important backdrop to the discussion: the table shows

(i) the RPI year on year increase is not expected to fall until September (ie. announced in October);

(ii) neither is the underlying inflation rate (column 3) expected to fall before September;

(iii) in July, when the June RPI figure is published, the year on year RPI rate will be rising at or close to 10 per cent.

The Chancellor continues to press for entry to the ERM in July - though not so vigorously as before. There is a distinct hint that he may settle for entry before the Party Conference. Accordingly October 5, the last day of the Labour Party Conference, is the earliest possible date - when the September RPI figure will at least be known to the Government though not yet published.

Chancellor's Paper

The Chancellor's minute takes a slightly different, and rather more persuasive, line than previously. The new information is the Treasury's latest economic forecast. It shows the continued resilience of the economy through the rest of this year and well into next year.

Since the last forecast at Budget time, the Treasury have revised upwards their figures for the growth in domestic demand

for next year; increased the forecasts of money GDP for this year and next; and substantially raised the projections of RPI inflation. Indeed, on the basis of existing policies, there would be very little fall off in the underlying inflation rate until well into next year.

The Chancellor rightly draws the conclusion that the policy stance need to be tightened. A tighter stance means continuing with high interest rates for longer and keeping the exchange rates up. Yet achieving some cut in interest rates is clearly important for wider political reasons; and the latest projections show no cut in interest rates - and therefore mortgage rates - until 1991 Q4 on present policies.

Accordingly, the Chancellor argues that policy considerations now argue for early entry into the ERM. It is necessary to keep the exchange rate high in order to put downward pressure on pay settlements and achieve a more rapid turnaround in inflation. Entry would also allow more weight to be laid on a high exchange rate and less reliance on interest rates - thus permitting an earlier reduction in mortgage rates.

The minute accepts that entry into the ERM next month or early in the autumn would mean the Madrid conditions had not been met. He continues to contend this need not matter - although the arguments in paragraph 8 remain unconvincing.

Assessment

The forecast is an important new consideration. Prospects are rather worse than before - even the PSDR threatens to disappear this year or next. The need to tighten policy even further is clear.

The desirability of entry for political, though not necessarily economic, reasons to avoid over reliance on interest rates, is a vital consideration. Joining the ERM would tighten policy through sustaining the exchange rate and putting downward pressure on wages. It would enable an earlier reduction in mortgage rates.

But none of this is a convincing reason for entry as early as next month. If the UK joined the ERM in July it would be against a backdrop of rising inflation at or near 10 per cent. There is no evidence of any weakness in the exchange rate at the moment - quite the reverse. There is no expectation in the City of entry next month - it is widely assumed the UK will join in the autumn. So there is no reason to consider that the policy stance would be weakened if the UK did not join the ERM until say October - though exchange rates are of course never predictable.

There is a more persuasive case for joining in early October. The Government could just have met the Madrid conditions _if_ the forecast RPI turns out to be correct in September. Rather more persuasive is the policy case for tightening the monetary stance and making it clear to wage negotiators, at the start of the wage round, that they will not be bailed out by exchange rate depreciation. (The Chancellor conveniently ignores that there is quite some scope for depreciation within the wider bands.)

Entry in October would also allow the Government to declare a tougher policy stance against inflation. That could be made clear at occasions like the Party Conference, the Autumn Statement and the Mansion House speech. What were obstacles in the Chancellor's previous paper become opportunities.

Conclusion

The forecast shows the need to tighten monetary policy. An interest rate rise is politically very difficult. Joining the ERM to sustain the present high exchange rate is, in the circumstances, a politically better means of achieving that tightening.

That is not a case for joining in July, however. But you may consider that there is a more persuasive case for considering joining in October. The Chancellor has, however, still not shown that the dangers of backlash next year could be avoided.

BARRY H. POTTER   3 July 1990   c:\wpdocs\economic\erm (slh)