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PRIME MINISTER

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MEETING WITH THE CHANCELLOR, MONDAY 27 AUGUST

You are meeting the Chancellor at 9pm on Monday 27 August.

The background is the changing economic prospects for the UK. There are two pressing policy decisions.

(i) The Chancellor indicated earlier he wished to join the ERM on either 14 September or 5 October. Does he still wish to go for one of these dates? And is it right to go ahead at all in the light of the changed economic situation?

(ii) Does a reassessment of the economic prospects suggest a need for a cut in interest rates? If so, when and by how much?

Economic background

At flag A is a short note on the latest economic indicators. At flag B is the latest Treasury monthly monetary assessment (completed before oil prices had begun to move up).

We discussed the emerging risks of a recession at the end of July. At that point, there was the evidence of a sudden deceleration in MO growth; the fall in retail sales in June; and the CBI survey suggesting falling domestic and export order books.

Since then, following the Gulf crisis, oil prices have risen. Whatever the risks of recession before, they will have increased since.

- The rise in oil prices will give a short-term boost to UK inflation. For a given monetary stance, therefore, (ie MO target range) the higher price level implies a tighter policy.

- The oil price rise will affect all developing countries. Again for a given international monetary stance, growth and world trade prospects are weakened.

- The higher exchange rate has further tightened the UK monetary stance. The ERI has risen to 96.8 today against 94 at end July. The major appreciation has been against the dollar (from $1.86 to $1.95): this helps to offset the rise in dollar oil prices, as well as keeping down the cost of raw materials. But the pound is also up by 5 pfennigs and is higher than a year ago - while unit labour costs have risen by 7% more in the UK than in Germany over that period.

A tight monetary (and fiscal) stance is essential. Inflation has to be squeezed out. A reduction in wage settlements will be particularly important.

Companies must therefore be kept under pressure to cut wage settlements. Profits are being squeezed between rising domestic costs (for manufacturing, the rise in wage costs will far outweigh any benefit from lower sterling raw material prices) and falling domestic and export demand - at a time of record company sector borrowing to be serviced at high interest rates.

The difficult and crucial judgment is how severe the pressure is on industry. In the short-term, price and wage inflation cannot be brought down quickly. So an over rigorous stance would result in lower output, and a risk of recession. (And that has clear political implications).

You and the Chancellor will need to consider just where the economy is now and is going over the next few months, in taking the two critical policy decisions which will determine the severity of pressures on industry.

Interest rates

The arguments in favour of an early cut in interest rates are as follows.

(i) The clear evidence of deceleration in the growth of MO. The figure for July showed an annual increase of 5.5%. Treasury estimate the figure for August should be within the target range at 4.8%. Other indicators of the monetary stance, C

M4, M4 lending and the wider M4 aggregate all indicate some deceleration.

(ii) To bring down the exchange rate a little - though the market response (ie how far) is unclear. To the extent that the exchange rate depreciated it would reduce competitiveness pressures on industry - particularly in favour of exporters and those facing import competition.

(iii) To cut industry's borrowing costs directly

A cut as early as September would mainly feed through into the RPI through mortgage reductions in around January next year. It would not therefore have much impact on the September RPI itself which is crucial to social security uprating etc.

Set against these considerations are three risks in cutting interest rates.

First, the benefit of lower interest rates might leak into higher wages. Wage claims are likely to be buoyed up by high RPI figures for August and September; there might be concern that the lower costs of borrowing for industry would allow firms to be more accommodating. However, the deteriorating export and domestic demand picture will be putting profit margins under intense pressure: the expectation of ERM entry ought also to discourage excessive wage settlements.

Second, a badly timed interest rate cut might undermine the exchange rate. But the fundamentals, including likely reductions in interest rates overseas (particularly in the US) make that unlikely: tactics on timing and amounts of reductions need further consideration.

Third - could there be a misreading of recent indicators so that the economy is more buoyant than it appears? Treasury do not believe so: and neither do other commentators.

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The ERM

What line will the Chancellor now take on the ERM entry? If he continues to favour entry sometime in the next two months, his arguments will presumably run as follows.

(a) The fundamental case for joining the ERM is not changed by recent events. The UK needs a link with the deutschmark to provide the convincing "spine" necessary to demonstrate a tight monetary stance and push down wage settlements. While inflation may show a slightly different pattern now because of oil price increases, that rise will affect all countries (indeed it will have a less substantial impact in the UK because of the relatively favourably exchange rate effect). So the Madrid conditions should be "re-interpreted".

(b) The £ has stayed high and within the range the Chancellor wanted in considering ERM entry. Providing the wider 6% band is applied, there should be sufficient margin to cope with the uncertainties associated with the Gulf situation.

(c) Entry now to the ERM would allow an early cut in interest rates with the advantages described above.

(d) There is now greater logic within the ERM band than in July. Thus the DM and the Belgian franc as strong currencies have moved to the top of the band while the Spanish and Italian currencies - previously kept at the top end by high interest rates - have now sunk lower, reflecting the true underlying economic conditions.

There are a number of arguments against entry at this time.

(i) The rapid change in fortunes of the Spanish and Italians is evidence of some instability within the ERM. Now that they are towards the lower end of the range and their inflation rates remain well above German levels, it is not beyond question that we could see a currency realignment.

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(ii) Sterling's role as a petro-currency has re-emerged within the last few weeks. This is bound to generate some greater uncertainty and volatility in the exchange rate even if we were to join the ERM.

(iii) You may recall that the Chancellor was earlier considering an asymmetrical entry position, ie going in with more room for the £ to appreciate than depreciate. But the logic of the petro-currency is that any asymmetry should be in the opposite direction; that is, we should enter with more room to depreciate (in time) than appreciate. But if that were the case, then ERM entry would not have the disciplinary effect on wage negotiators that is being sought.

(iv) The DM itself may be volatile. In addition to the uncertainty about the absorption of the East German economy, must be added the Gulf difficulties. Germany is particularly vulnerable to interruption of oil supplies.

(v) There is no immediate need to join the ERM in order to sustain the high exchange rate. The Gulf crisis has achieved that: and a strong currency will exercise the discipline necessary on wage negotiators (as in 1980-81).

Conclusion

The discussion might best be seen as a preliminary canter over these two important issues. You are scheduled to discuss the economy again with the Chancellor the following week, on 4 September, preceded by discussions with Brian Griffiths and Andrew Turnbull on Monday 3 September.

BHP

BARRY H. POTTER

23 August 1990