SUBJECT CC MASTER

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From the Private Secretary

28 August 1990

Dear John,

The Prime Minister discussed the economic situation with the Chancellor on his return from leave yesterday evening.

I should be grateful if this letter could be seen only by those with a strict need to know.

The Prime Minister noted that some commentators had been predicting a rapid slowdown in UK economic activity, even before the oil price increases. In the light of both the oil price increases and the further appreciation of the exchange rate, she was concerned about the possible risk of recession. There was a case for an early cut in interest rates, though not by as much as the 2% advocated in the Sunday Times on 26 August.

Also, because of the recent volatility in exchange rates; sterling's re-emergence as a petro-currency; and greater uncertainty about the robustness of the Deutschmark (not least because the costs of absorbing the East German economy seemed to have been underestimated), she was not persuaded that it was right to go into the ERM within the next few weeks.

The Chancellor said he had not yet had time to assess the full impact of the recent rise in oil prices on the economy. There was indeed growing evidence that the economy was more sluggish, including the latest CBI survey to be published the next day. Both narrow and broad indicators now showed some deceleration in money supply growth. And the short term impact of the oil price rise itself, and the recent appreciation in the exchange rate, had tightened the monetary stance further.

His preliminary view was that a modest cut in interest rates might well soon be justified by monetary conditions. But, despite the deceleration, MO was still outside its target range: it would be sensible to wait for further evidence on both the tightness of the present monetary stance and the behaviour of monetary aggregates, including the monthly figures for August, before reaching a firm view. Treasury officials had been asked to undertake an urgent re-assessment of the monetary position and the implications for interest rates.

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Although the oil price increase had led to an appreciation of sterling, both against the dollar and, more modestly, against European currencies, it was still within the range the Treasury considered would be appropriate when the UK joined the ERM. He considered that the fundamental case for joining the ERM with wide margins within the next few weeks remained valid: nonetheless Treasury officials had been asked for a re-assessment of the best timing for UK entry to the ERM.

The Chancellor noted that before any cut in interest rates, the link with UK policy on the timing of entry to the ERM would need to be considered very carefully.

The Prime Minister said she was content to go ahead next week with a further discussion on the economic prospects; the scope and timing of any interest rate reductions; and the right entry date to the ERM. (The meeting has since been confirmed for the morning of 4 September.) The Prime Minister was also content for the Chancellor to discuss the position with certain Bank officials, and for senior Treasury officials to attend next week's discussion.

Yours ever,

Barry

Barry H. Potter

John Gieve, Esq.,
H.M. Treasury.