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PRIME MINISTER

MEETING WITH THE CHANCELLOR

I attach the Chancellor's paper for tomorrow's discussion on the economy. It arrived after your meeting this evening with Andrew Turnbull, Brian Griffiths and me.

The paper starts well. It makes the case for caution on interest rates which reflects the views we reached this evening. I think we share the Treasury's conclusion that there should be no more than a modest cut in interest rates over the next few months; that there could be no immediate cut in interest rates; and that it would be necessary to watch UK monetary conditions, other countries' interest rate policies and developments in the Gulf carefully in deciding on timing and amounts of interest rate changes.

The second half of the paper is more disappointing.

a. Paras 14 to 16 on possible entry dates to the ERM are narrow in scope. The paper identifies only two possibilities - 14 September and 5 October, even though later paragraphs in effect acknowledge a possible need for postponement beyond October. You need to press the Chancellor to identify a range of possible dates up to the turn of the year - and quite possibly beyond.

b. The critical judgement in paragraph 18 - apparently endorsed by the Bank - is that we should join at a central rate of around DM3 = £1. It is of course critical that a strong monetary stance is maintained to counter the inflationary pressures (which have been augmented by the recent oil price increases). But equally there is a deflationary pressure imparted by a high exchange rate within a given monetary stance. An entry point of DM3 could make our competitiveness position not just challenging but, in practice, very

and it is only maintained by 15%.

b

difficult indeed - at a time when world trade is likely at best to stagnate. As earlier minutes have pointed out, some in the Treasury - including the Chancellor - have some sympathy for a lower entry point.

c. Paragraph 21 argues that there are three factors sustaining the high exchange rate - high UK interest rates, expectation of entry into ERM and the oil prices. It is asserted that entry into the ERM is particularly important. The implicit argument is that any apparent backsliding would lead to a precipitate fall in the exchange rate. This is a crucial judgement in the Chancellor's case: the counter argument would be that the high interest rates combined with uncertainty in the Gulf and the United Kingdom's oil advantage might well sustain the present rate.

d. Finally, in paragraph 25 the Chancellor (again) argues that the Madrid conditions can be slackened. Quite why the Treasury is pursuing this is unclear: paragraph 5 still suggests that the RPI should peak in September so that entry into ERM as early as October would be consistent with meeting the Madrid conditions. Paragraph 25 may be based on the assessment that this will not happen. We need the Treasury's best reassessment of the month to month pattern of inflation. But any 're-interpretation' of the Madrid conditions still seems unwise, if a persuasive anti-inflationary stance is to be maintained.

No / why?

The overall assessment in paragraphs 27 to 29 acknowledge that the Gulf situation is the key uncertainty. That conclusion was also reached at this evening's internal meeting in No. 10. But it is difficult to understand the argument behind paragraph 28. The logical explanation in the second half must be an expectation that hostilities would cause the pound to fall: it is by no means clear why this should be so. The response would

why?

C

be in part a political reaction to United Kingdom participation in military action; but it would also be economic - and any damage to oil supply capacity in the Middle East ought to raise the value of sterling.

BHP

BARRY H. POTTER

3 September 1990
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