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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

4 September 1990

Dear John,

MEETING WITH THE CHANCELLOR AND TREASURY OFFICIALS

The Prime Minister discussed with the Chancellor today the prospects for the economy over the next few months; the scope and timing of any reductions in interest rates; and possible dates for the UK to join the exchange rate mechanism (ERM). The meeting was also attended by Sir Peter Middleton, Sir Terry Burns and Mr. Scholar (Treasury) and by Professor Griffiths (No. 10 Policy Unit).

I should be grateful if you could ensure that no copies of this letter are taken without your permission and that the letter is seen only by those with a strict need to know.

The Prime Minister has asked me to record the outcome of the discussion as follows.

It was agreed that the main policy priority must remain the defeat of inflation. At the same time, in its policy actions over the next few months, the Government must take into account the growing risks of a UK recession.

The Prime Minister agreed with the Chancellor's conclusion that, while it would soon be appropriate to cut UK interest rates, that point had not yet been reached. She also appreciated the risks which the Chancellor saw in any reduction in interest rates before the UK joined the ERM. There were therefore attractions in taking action on both interest rates and ERM entry at the same time.

A minimalist interpretation of the Madrid conditions would require the Government to be over the peak of inflation when the UK entered the ERM. That peak, in terms of published annual increases in the RPI figures, was expected towards the end of this year although the course of the figures from month to month was unclear.

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It was not possible to take a firm decision on the ERM entry date at this stage. But it would be right to join when inflation had peaked; and when an interest cut was justified by UK monetary indicators and by further evidence of slowdown in the real economy; and would be consistent with interest rate developments overseas.

It would now be necessary for the Treasury to consider practical dates for entry into the ERM up to the end of this year. The uncertainty and volatility caused by developments in the Gulf would also remain relevant to the timing of entry. But there might be circumstances in which it might be sensible to go ahead with entry, even if a further rise in oil prices generated by developments in the Gulf threatened a second short-term boost to inflation.

Yours ever,

Barry

(BARRY H. POTTER)

John Gieve, Esq.,
HM Treasury.