

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

You are meeting the Chancellor tomorrow morning at 1100 for the regular bilateral discussion.

Items for discussion include:

- (i) release of key economic data this week;
- (ii) report back from the ECOFIN discussion;
- (iii) possibly ERM entry dates.

(i) Release of key economic data

As my separate note in the Box records, the revised figures on invisibles will be published tomorrow. While the invisible surplus estimates have fluctuated, the sharp downward revision will be unexpected. It suggests overall deterioration over the last six months on the balance of payments current account.

The release of the RPI figure on Friday will be even more difficult. City expectations are for a year on year RPI increase of around 10.2 to 10.3 per cent: the actual figure of 10.6 per cent - which is all on the underlying inflation rate - will be received as further bad news.

As you know sterling has recently been rather weak. With no move on entry into the ERM this weekend, there must be a risk of further downward pressure by the end of the week.

The Chancellor's statements on the radio last weekend were helpful. You may wish to discuss what further action is desirable in terms of aligning expectations more closely with reality over the next few days.

(ii) ECOFIN

The Chancellor will report back on the ECOFIN discussions. (paper at Flag A). You have already seen the telegrams. The UK press interpretation is of a clear victory for the Chancellor's proposals. So too, and more remarkably, is that of much of the European press.

However the Chancellor is likely to give a less "up-beat" account. There seems to have been less a conversion to the Chancellor's proposals than a growing resistance to the Delors scheme. And, even then, the focus is on delay in the transition to stage 2 with other member states continuing to favour a single currency as the ultimate objective. However, there is more interest in the 'hard ecu' idea.

Very broadly, three groups of countries have emerged:

- (i) the French, Belgians and Italians want to proceed with Delors more or less on schedule;
- (ii) the Germans, Dutch and Irish are moving against the basic Delors scheme. Poehl seems to be the decisive factor here, following his speech in Munich.
- (iii) the southern group - Spanish, Greeks and Portuguese - have become aware of the costs for their economy of a single currency without massive regional transfers: they too oppose EMU before convergence of their economies with the north. And they are supportive of the hard ecu - as a mechanism for achieving stage 3.

In short, as you suggested earlier, there has been a realisation by the rich countries that a rapid move to a single currency would impose great costs (regional transfers); and by the poorer that, without prior convergence of the economies, the strains could be intolerable.

You will want to ask the Chancellor where he thinks we go from here

- how can we exploit the divisions which have opened up and get the others to lower their sights?;
- are there any further steps which could be taken to advance the UK proposal?

(iii) Possible ERM entry dates

The Chancellor's other paper (Flag B) is intended to fulfil the remit from last week's discussion that he should look for alternative later dates for entry beyond 5 October.

The Chancellor's line is not to fix upon any particular date. He wants to weigh up movements on the key economic indicators, including month to month RPI inflation, before putting forward a specific alternative. None of the five dates up to 16 November is impossible: it is more difficult beyond that because of electricity privatisation and then Christmas.

He will press for 5 October, all the more strongly now that sterling is coming under pressure. Treasury interpretation of the recent drift in sterling is that the Chancellor's statement last Friday deflated expectations of early ERM entry; and that sterling has been falling accordingly (resisted with some intervention).

There have been no fundamental changes since your earlier meeting. Recent data on retail sales and weekly M0 confirms the slow-down in the economy. Gulf uncertainty remains.

But, the position on the "basic" Madrid condition, if interpreted to mean a fall in the UK underlying inflation rate, is less clear. The Chancellor (para 4) notes there could be no clear fall until the November figure is published in mid December. So implicitly he is not worried about meeting the condition before entry into the ERM. However, a small fall in the published RPI year on year increase could take place before

that - enabling earlier entry consistent with the commonsense interpretation of the Madrid condition.

Brian Griffiths' minute (attached at Flag C) makes the point that expectation of entry has now shifted till later in the year. If the recent fall in sterling represents a one-off adjustment to the later entry date, then there is no reason to fear a further slide on ERM grounds. But other data - BoP and RPI - could cause a further weakening.

(BARRY H. POTTER)

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