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From the Private Secretary

29 March 1990

Dear John,

EXCHANGE RATE MECHANISM

The Prime Minister and the Chancellor had a brief discussion this morning about the timetable for the UK's membership of the Exchange Rate Mechanism of the EMS.

I should be grateful if you would ensure this letter is seen only by named individuals.

The Prime Minister said she had noted the press reports of the Select Committee evidence given the previous day by the Governor of the Bank of England. It was not clear whether these reports were accurate, but she did not take the view that the conditions for the UK's membership had yet been met. Significant further progress was still needed from our European partners. The UK's inflation rate was expected to rise to some 9 per cent over the coming months and we could not contemplate joining the mechanism in these circumstances. It was the Government's own responsibility to get inflation down. Moreover, it was still far from clear what would be the impact of moves towards monetary union in Germany; if this resulted in significant loosening of the monetary stance in Germany that would weaken the case for joining the mechanism. Although the issue of the timing of membership would need to be considered in the run-up to the next election, it would in any event be out of the question to publish a precise date by which the UK would join.

The Chancellor said he fully agreed with the Prime Minister that the UK was not currently in a position to join the mechanism on the basis of 2½ per cent margins; it was also out of the question to set an advance date for joining, which would simply leave the UK at the mercy of the markets. However, he felt it was important to consider carefully in the near future the options for the date of joining; the issue was closely related to the necessary preparations for the Inter-Governmental Conference later this year.

Continuing, the Chancellor said that sterling remained vulnerable in the markets. The markets were getting used to operating on the notion that the present level of sterling required interest rates at the current high levels; this meant that the prospects for bringing interest rates down as and when that was judged appropriate on domestic policy grounds could be jeopardised by the external position. Against that background, and bearing in mind the likely favourable impact of entry to the mechanism on political sentiment and in turn on sentiment in the markets, the prospects for bringing interest rates down while maintaining a firm exchange rate would be maximised if sterling was inside rather than outside the ERM. All this reinforced the need to take a careful look at the options for the date when the UK should join, at a time of our own choosing.

In further discussion the following points were raised:

- the inter-action of ERM entry and the IGC was complex. On the one hand, if by the time of the Conference the UK was still outside the ERM it was unlikely that other Member States would place much weight on the UK's views about the future development of European monetary arrangements. On the other hand, if the UK had joined the ERM by the time of the Conference the UK would then be in the position of arguing that there should be no further significant move towards European monetary integration; but other Member States might nonetheless take the view that, since the UK had at last taken the plunge and joined the mechanism, it would in due course drop its objections to further developments and accept moves towards Stages 2 and 3 of EMU. The Chancellor would shortly be sending the Prime Minister a paper discussing all aspects of the run-up to and handling of the IGC;

- although domestic economic conditions remained difficult to judge there were now significant signs that it could be appropriate to reduce interest rates before too long;

- the significance of external perceptions of the political strength of the Government for the attitude taken by the markets towards sterling should not be underestimated. There could also be a favourable political impact if the Government was to join the mechanism at a time of its own choosing. On the other hand if sterling entered the mechanism while the Government was still facing political difficulties this could have a substantial disruptive effect on the whole ERM.

The Prime Minister said that given diary pressures during the morning it was not possible to pursue the discussion further at this stage. The Chancellor said he would reflect further on the issues and would like to pursue the discussion on another occasion.

Yours,
Paul

PAUL GRAY

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