PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

You are discussing the ERM with the Chancellor tomorrow. I have already provided a brief on the policy issues (FLAG A) covered in his paper (FLAG B).

The more interesting issue is that of timing. It may be useful to offer a few preliminary thoughts.

BACKGROUND

Both Alan Greenspan and Alan Walters have given broadly the same advice. Entry to the ERM is a political necessity; and properly timed and managed, it can give economic benefits. Both indicated that it would be desirable to wait a few months until the impact of GEMU and the position of the Deutschmark is clearer.

Alan Walters also made the point that, while there should be a short term economic bonus from joining the ERM, that would tend to unwind - with a danger of the exchange rate coming under pressure later on. So timing of the ERM is important in the context of the next election.

The Chancellor's position is not clear. Treasury officials have identified as technical possibilities dates from as early as next month. Press reports seem to indicate their preferred timing may be September/October of this year.

THE WAY FORWARD

It is too early to have a satisfactory discussion on timing. But it may be useful to refer now to factors that would need to be taken into account. These are many and varied in nature - internal, external, economic and institutional. They might be grouped as follows.

(i) **The timing of the next election**. Alan Walters' view was that too long a gap between entry to the ERM and the timing of the election risked the exchange rate and interest rates coming under pressure from capital outflows at the time of the election.

(ii) **The stability of the ERM**. This will be related to the stability of currencies both within the ERM and any wider international volatility in exchange rates - particularly the dollar and the yen. An important factor will be GEMU and whether the Deutschmark has reached a settled position after absorption of East Germany.

(iii) **The state of other financial markets.** For example, if world stock markets were showing volatility or at least instability, e.g. in Japan, that would restrict the freedom of manoeuvre. So would any actual or prospective shifts in world interest rates.

(iv) **The current UK economic indicators**. First it can be argued that these have to be, at least, pointing in the right direction. Secondly they ought to be converging towards, not diverging from, the broad EC average. Most important are the Retail Price Index (and the underlying rate of inflation) and wage settlements. Also relevant will be the latest assessment of demand and output growth. For example, it might be argued that early evidence of greater realism on wage settlements is necessary before the exchange rate can be constrained. Entering at too high a rate with domestic costs still accelerating will in the short term risk serious reversal for industry and rising unemployment.

(v) **Institutional Constraints**. The German election in December is likely to lead to some instability within the ERM in the weeks preceding the election, particularly if the outcome looks unclear. Developments on the IGC and EMU are also relevant.

(vi) **Timing Constraints**. The UK can only join over a weekend when the markets are closed. Discussions with central bankers would be necessary on Saturday and Sunday. Certain weekends are not practical because of other commitments and European Summits.

CONCLUSION

A possible conclusion to a discussion might be that the Treasury should now prepare a paper looking at options on timing and how the above and other relevant factors influence possible entry dates.

Are you content for Brian Griffiths to attend the discussion?

Yes md

BHP

BARRY H. POTTER
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