

SUBJECT cc MASTER



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10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

14 June 1990

Dear John,

BILATERAL WITH THE CHANCELLOR

The Chancellor discussed the exchangerate mechanism with the Prime Minister yesterday evening.

I would be grateful if you could ensure that this letter is only seen by those with a strict need to know.

The Prime Minister said that she no longer had reservations about the UK joining the Exchange Rate Mechanism (ERM). The issue was when was the right time to join.

The Prime Minister said she had three particular concerns. First, it might be better to join at a time when key economic indicators, such as the RPI or the underlying rate of inflation, and wage settlements, were beginning to move in the right direction.

Second, GEMU might disrupt the stability of the ERM: it might be useful to wait and see how the Deutschmark settled after GEMU.

Third, there was expected to be an immediate bonus upon entry which could be taken in terms of a higher exchange rate or lower interest rates. But there was a risk that some months later, the markets might look less favourably upon sterling - for example if there were bad trade or inflation figures. It would be important to avoid having to raise interest rates at politically sensitive times during next year.

The Chancellor said Treasury officials were advising that the economic fundamentals were sufficiently satisfactory to permit the UK to enter ERM on the wide bands at a convenient opportunity. However, he had not yet reached a view on what the best time would be taking into account wider political considerations.

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In the light of the Prime Minister's comments, the Chancellor undertook to prepare a paper on the timing of entry into ERM and the factors which needed to be taken into account.

Separately, as I mentioned to you over the telephone, the Prime Minister indicated she would be interested to see the Treasury's month-by-month projection for the RPI over the next six months. (She is already aware of the wide margins of error attached to such forecasts.)

It might also be helpful if the Prime Minister could have an indication of the timing of wage rounds: is there any particular month or so which is important between now and mid-Autumn in terms of detecting any change in sentiment in wage settlements?

Yours ever,
Barry

BARRY H POTTER

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

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