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## PRIME MINISTER

... I have been reflecting further on our conversation. You asked about the price prospect. I enclose the Treasury's July forecast. It is prepared for internal purposes, especially for public expenditure and is not published. You will find the price forecast in Chapter 6 and the forecast monthly profile in Table 6:3.

2. Against this background, can I turn again to the options I advanced on the timing of our entry into the ERM? It goes without saying that I agree that we should not join the ERM in order to gain from a possible short term honeymoon period. That would be very silly and counter-productive. It is the fundamentals that concern me, as I know they do you.

3. The fundamentals are of two sorts. First the prospect. Second our policy stance.

4. Given the prospect set out in the forecast, we shall need to maintain and preferably reinforce the stance of monetary policy. This may require high interest rates for some time. And we must try to keep the exchange rate at present levels or higher. If it drops we shall certainly need high interest rates for longer.

5. Of course, there are risks in joining ERM early - as there will be whenever we join. I know you are particularly worried by the view of a number of economists that our interest rate differential with the DM could lead to substantial capital inflows



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and force a premature reduction in interest rates. But I think two developments have greatly reduced that risk.

- (a) The present strength of the exchange rate is in anticipation of our early entry into the ERM. So much of the expected pressure may already have occurred.
- (b) We are proposing to join with wider margins so the rate could rise considerably further - possibly above 3 DM - without a threat to our interest rates.

In any event, as a last resort we have the ability to revalue. We are after all new members and this would not be a disaster.

6. The positive advantage to be gained from early entry is that it would give new impetus - which the forecast suggest it needs - to counter inflation policy. We would face the next pay round with a stance which would be perceived as both clearer and firmer. We should seize the political and economic initiative which we could maintain throughout the summer and autumn. There would be less risk that the exchange rate would fall back through disappointed expectations and the private sector would realise that there could be no bail out through exchange rate depreciation. By reducing expectations of inflation in this way, it would help to get inflation itself turning down decisively.

7. The risks of waiting are that the exchange rate may indeed fall back and that we should face a difficult winter in which we should find ourselves on the defensive both on the economy and on Europe as we approach the IGC. As I indicated when we spoke, I am very apprehensive of such a market reaction if we delay too long. If it happened it would be a grim prospect for us.

8. I know you are concerned about joining when inflation is still rising and when it will be asserted that the Madrid



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conditions are not yet met. I am also concerned about this. But we must be realistic about what we can achieve. Though inflation should peak in the summer, it may not come down much for many months. We cannot wait too long without losing all the political advantages of entry. I believe we can answer questions on the Madrid conditions by pointing out:

- (a) our entry is on wide margins; *- This does not give the certainty on foreign rds which the present assumes*
- (b) inflation will peak in the summer and we are confident of the direction it is going;
- (c) the other conditions have pretty well been met.

9. Of course the Opposition will try to play up the change of line but I have no doubt that the overall reaction will be positive and our entry and its implications will be the dominant interest. I am sure that early entry will not be seen as a defensive move; indeed that will be much more likely if we enter late in the year after sterling has fallen (and when our inflation rate will still be little better than it is now).

10. The greater danger if we delay entry is that the pound will fall and further worsen the prospect for inflation. I cannot say that if we wait into the winter, that is bound to happen. But I do believe the odds are unacceptable. *It could continue to rise and thus give us a higher value on entry.*

11. I remain convinced, therefore, that it would be a mistake to put off entry towards the end of the year. Before the Party Conference looks the best and safest economic prospect to me. It would also offer the greatest political dividend and enable us to use the major speeches of the autumn to spell out the implications of membership - particularly for pay. And, on balance, I still favour a surprise move in July and believe we can carry this off. We could capitalise on the widespread belief that inflation will



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peak in the summer. Indeed, we should reinforce this belief. And we should present it as a positive move to strengthen domestic policy that is also in keeping with our European commitments.

12. I am sorry to persist where I know you are cautious and I understand the reasons for your concerns. But I am sure the advantage lies in grasping this nettle speedily.

[J.M.]

2 July 1990