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SUBJECT CC MASTER 6(A-B)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

4 July 1990

Dear John,

UK ENTRY INTO THE EXCHANGE RATE MECHANISM

At today's bilateral, the Chancellor discussed with the Prime Minister possible dates when the UK might join the Exchange Rate Mechanism.

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

The Chancellor said that it was essential to join the ERM before the Party Conference. The exchange rate was high and still appreciating. It was essential to maintain a high rate. The latest forecast from the Treasury Ministers showed the continuing resilience of the economy and the need to sustain high interest rates to rein back growth in money GDP. The forecast also indicated that retail price inflation would remain high until September; but there might be a drop in the year on year RPI that month which would be published in October. If the UK were to stick rigidly to the Madrid conditions before joining the ERM, the Government might have to wait until next year. That was not practical: the UK had to join while the exchange rate could be sustained at around the present level; and the Chancellor was concerned that, while exchange markets were always unpredictable, it might be difficult to sustain the high rate beyond the Party Conference.

He continued to believe that entry in July was attractive, it gave a number of political advantages; the exchange rate was about right; and it would give an early signal to wage negotiators that wage settlements must be brought down.

The following points were made in discussion:

(i) It might be very awkward to join in July. The inflation rate would still be rising and would go higher in subsequent months. It might look like a panic measure which would prejudice keeping the exchange rate up within the wide bands.

(ii) If entry were timed in the early autumn, two possible dates were September 14 and October 5. On the latter date, it might be possible to make an announcement after the Labour Party Conference had closed; that

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would be just before the beginning of the Conservative Party Conference, and at a time when Ministers knew the RPI figure for September (which was expected to show the first fall in the year on year rate). It would be too late to enter the ERM in the weeks leading up to the IGC. That would look like political weakness.

(iii) It would be important to use the Exchange Rate Mechanism to put downward pressure on wage settlements. But that in turn had to imply the exchange rate could not fall very far. That argued for careful positioning of the bands around the exchange rate when the UK joined the ERM: they might be set to give more room for appreciation than depreciation. There was also an argument for having narrower bands than those previously envisaged: one possibility would be to enter on bands of 4 per cent.

(iv) It was also necessary to avoid too high an exchange rate emerging: an excessively high level could damage the balance of payments and put unduly intense pressure on the business sector.

(v) Entry into the ERM would bring forward the date at which interest rates could safely be reduced and thus mortgage rates. On the other hand the longer that entry was delayed, the closer the reduction in interest rates would be to the point when it would have been justified in any case.

(vi) When the UK joined the ERM, it would also be appropriate to announce that the present RPIAC would be wound up and the Government would consider how a replacement index of retail prices might be constructed in line with European practice. It would be necessary for the Treasury to consider in advance how index-linked gilts, pensions, benefits etc. would be handled if the RPI were to be revised.

Summing up the discussion the Prime Minister agreed with the Chancellor that they should reconsider possible dates for UK entry into the ERM at the end of August. Two candidates were September 14 and October 5 - and the practicalities of each should be investigated further. In the meantime Treasury should also consider further the economics of going in with rather narrower bands at 4 per cent initially; other options included going in initially with the wider bands of 6 per cent and reducing them to narrower bands at some later stage. It would be appropriate to announce when the UK entered the ERM that the present RPIAC was being wound up and the Government was investigating the construction of a new retail prices index, more along the lines of European practices.

Yours ever,
Barry

(BARRY H. POTTER)

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