

MEETING RECORD
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From the Principal Private Secretary

3 October 1990

Dear John,

EXCHANGE RATE MECHANISM

Following the discussion on the Public Expenditure Survey, the Chancellor stayed on to discuss the current economic situation and future policy. The Prime Minister asked him for his view on inflation and interest rates, and their implications for entry into the ERM.

The Chancellor said he now expected that the September RPI, which would be announced on the final day of the Conservative Party Conference, would show an annual inflation rate higher than August. He mentioned a figure of 10.9 per cent. Although he hoped this would be the peak, he could not be sure that it was. Much would depend on oil prices. Despite the course of the RPI, he was convinced conditions in the economy had changed in the last two months. The monetary squeeze was clearly biting hard and even if measured inflation continued to rise for a while, the conditions for achieving low inflation were now present. On interest rates, therefore, he believed a reduction could be justified in the next few weeks.

The Chancellor identified three courses of action.

- (i) Interest rates could be reduced independently of ERM entry. He strongly advised against this as it could cause the pound to fall. Low interest rates and a weaker pound would give entirely the wrong signals.
- (ii) Entry into the ERM and a cut in interest rates could be announced simultaneously. The advantage was that the market was given the full picture of the Government's intentions at one go. The disadvantage was that the entry could be misinterpreted as opportunistic, a move solely to gain lower interest rates.
- (iii) Entry could be announced but action on interest rates delayed for a few days. This would allow the immediate reactions to be gauged before committing oneself to lowering interest rates.

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The Chancellor indicated his preference for (iii). The Prime Minister agreed that an early cut in interest rates was justified, that it should be linked to ERM entry rather than free-standing, but she felt (ii) was better. The disadvantage identified could be overcome if, in presenting the move, it was explained that the reduction in interest rates was fully justified in terms of domestic monetary conditions.

On timing, the view in the Bank and Treasury was that the sooner entry was announced the better. They had reached this verdict without knowledge of how matters might develop in the Gulf but it was felt that it would be better for sterling to be in, should hostilities occur. If entry were delayed beyond October, the imminence of hostilities would cause postponement.

The Chancellor therefore recommended that the announcement should be made by the Prime Minister on 12 October in the course of the Conference Speech.

Before deciding finally on a 12 October announcement, the Prime Minister wanted to satisfy herself on the mechanisms. It would involve an announcement several hours just before the London market closed and several hours before US markets closed. The Chancellor agreed to prepare a paper setting out the forms of the words which the Prime Minister might use, the logistics of summoning the necessary Community meetings, and how these could be coordinated with the Prime Minister's speech. This would be discussed at the meeting arranged with the Chancellor on Thursday afternoon. As much of the discussion would be on modalities, Sir Peter Middleton, Mr. Wicks and Mr. George should also join the meeting. (You subsequently informed me that the Governor would still be in the country and would wish to attend.)

The discussion also touched on EMU. The Chancellor reported on his conversation with Beregovoy in Washington on which he had made it clear that there was no prospect of the UK adopting a single currency other than through the market process it had indicated. The French were mistaken if they believed the UK would jump on to the EMU bus at the last minute. The Prime Minister agreed there was no prospect of the UK Parliament legislating for a single currency. The announcement of entry into the ERM should make this clear.

Your sincerely
Andrew

ANDREW TURNBULL

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