



SECRET AND PERSONAL - ADSO

15a-b

The Governor

Bank of England
London EC2R 8AH

4 October 1990

The Rt Hon Margaret Thatcher MP
Prime Minister
10 Downing Street
London
SW1A 2AL

Dear Prime Minister,

I am very sorry not to be able to attend your meeting this afternoon but John Major and I have come to the conclusion that it is probably wiser, from the security point of view, that I should stick to my established programme for my tour to Japan and the Far East. I hope, however, that it may be useful if I try to summarise my views to you on paper.

I think that entry into the ERM on the right terms will be seen as a strong policy signal by the market and this will, in turn, provide a good chance of an outstanding result and success for the Government. I mean by this that the exchange rate will strengthen and will provide an opportunity for an early, but justifiable and sustainable, cut in interest rates. Such an outcome cannot obviously be guaranteed and it is possible that the exchange rate will not rise immediately and the interest rate cut might consequently have to be delayed, although it is my personal opinion that it will not have to be delayed long.

I regard the chances of a reversal for policy - namely, a fall in the exchange rate putting upward pressure on interest rates - as small. I do, however, think that there is a risk that the policy signal to the markets would be seen to be weak if an emphasis on lower interest rates is made by cutting them first, or at the same time, as ERM entry. The markets would be confronted with two

conflicting but simultaneous influences; strengthening of the exchange rate arising from ERM entry and weakening of the exchange rate flowing from the lower interest rate. In this situation I think there will be only very little chance of seeing the exchange rate strengthen and the best that we could hope for would be that it would be reasonably steady.

But there is a strong chance that such a move would produce downward pressure in the exchange market and this would increase the risk of pegging into the ERM at a rate which locked inflation into the economy. A prior or simultaneous lowering of interest rates would certainly complicate the entry negotiations, create confusion in the financial markets with consequent accusations that we had bungled an important policy move and there would be a chance, that we could not ignore, that we would have to reverse the interest rate cut.

I see the fall in interest rates as a deserved and justifiable dividend from entering into the ERM and one that could well be distributed quite promptly after the event. I do think, however, that we should avoid distributing the dividend before we have been seen to have "earned" it.

I am copying this letter to John Major.

Yours ever,
Robin



10 DOWNING STREET

From the Private Secretary

Prime Minister

Mechanics of ERM Entry

The Treasury's note raises three separate issues

(i) The form of words

Option 1A, suggests "time is rapidly approaching...." This is hopeless. What does Bernard say between 3pm and 10pm? Could be misinterpreted as meaning within the next three weeks. You must say we have applied today.

(ii) Is the new central rate specified?

The Treasury would prefer not so that discussion in Monetary Committee is not preempted. The case for is that it will condition market expectations and reduce risk that ex. exchange rate moves strongly in either direction, thereby minimising need for intervention

(iii) Should interest rates be cut then or later?

The argument for is that it allows a full statement of Government policy and gives the market all the information it needs in one go. The argument against, set out in the Governor's letter, is that the risks are asymmetrical. A fall in the exchange rate in response to the cut would do more damage than a rise on the back of the announcement. I have now come down in favour of later as otherwise sterling is dangerously exposed between 3pm when the cut is announced and 10pm when statement is issued following consultations with partners. If the cut is announced at 3pm I think it would be better to announce the proposed rate as well in order to minimise scope for fall.

Central note

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