



Subject cc Master

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10 DOWNING STREET

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From the Principal Private Secretary

4 October 1990

Dear John,

EXCHANGE RATE MECHANISM

Prime Minister and the Chancellor of the Exchequer discussed possible entry in the ERM. Also present were Sir Peter Middleton, Sir Terry Burns and Mr. Wicks (HM Treasury) and Mr. George (Bank of England).

There was agreement that conditions in the economy, whether judged by monetary indicators or indicators of activity, were such that a reduction in interest rates would be justified sometime in the next few weeks. But it was also agreed that to make such a reduction independently before any move on ERM risked causing the exchange rate to fall. Lower interest rates and a lower exchange rate posed an unacceptable risk to inflation.

The discussion then turned to whether a reduction in interest rates should be made simultaneously with the announcement of ERM entry, or whether entry should be announced and with the reduction in interest rates to be held back, to be implemented, it was hoped, a few days later if there were no adverse reaction to the announcement.

Mr. George said that the Governor's letter of 4 October set out the case for the second course. The Bank felt that a simultaneous announcement would convey a weaker message. In addition the risks were not symmetrical; if after the announcement the exchange rate rose, the case for a cut in interest rates would be strengthened. However, there was a probability, albeit a low one, that the balance of the upward pressure from the entry announcement could be outweighed by the consequence of the lower interest rate. If the exchange rate fell it would risk locking in at a lower central rate, with adverse consequences for inflation. It would be better to hold back the interest rate cut until the response to entry could be gauged.

The Prime Minister argued for acting simultaneously. She wanted to avoid the impression that the cut in interest rates was a bonus flowing from ERM entry - it was better to present it as fully justified by domestic conditions, with ERM entry providing an essential underpinning of counter inflationary policy. After

discussion it was agreed that the announcement of ERM entry and an interest rate reduction of 1 per cent should be made together.

Discussion then turned to the mechanics of putting this into effect. At this point the meeting was still envisaging that the announcement should be made in the Prime Minister's speech to the Party Conference. The Prime Minister did not think the formulation of "the time is rapidly approaching when we will join" suggested in Option 1A of the Treasury note of 4 October provided sufficient clarity. It would be better to say that the Government had decided to join over the following weekend and would be applying to do so at a central rate of X with margins of 6 per cent. One possibility would be to set a figure; another to say it would be close to present market rates. Either way, it was important to give the market a clear indication of the Government's intentions.

The meeting then considered the pros and cons of acting on Friday, 12 October, the day of the Prime Minister's speech to the Conservative Party Conference, or of accelerating the timetable to the next day, Friday, 5 October. The later announcement would come after the RPI figure for September (expected to be 10.9 per cent), and would to some extent divert attention from it. But the balance of advantage lay with acting as soon as possible. The exchange markets were stable, and the current exchange rate of DM 2.93 was very close to what we would like the central rate to be. It avoided the artificiality of inserting the announcement into a Party conference speech and allowed proper media follow up to be organised. It was agreed that 5 October was preferable.

There was an inconclusive discussion on the best time of day to make the announcement.

Summing up the meeting, the Prime Minister asked the Chancellor and officials to do further work on the modalities of an announcement the next day. This should cover:

- (i) the text of the announcement
- (ii) the timing of the announcement
- (iii) the arrangements for convening the Monetary Committee
- (iv) the media arrangements
- (v) people to be contacted.

The meeting ended at 1700 and reconvened at 1915. Sir Peter Middleton reported on the results of the work done. It was recommended that an announcement should be made by the Chancellor at 1600, after the official close of European foreign exchange markets (and with it the intervention obligation of Central Banks). This would indicate that monetary conditions justified a cut of 1 per cent in interest rates and that to maintain a tight monetary policy the UK would be joining the ERM - the proposed central rate being close to DM 2.95 with 6 per cent margins.

The statement would be released to the tapes, and a press notice issued. A form of words for the No.10 Press Office would be prepared, plus a statement for the Prime Minister to use to camera in Downing Street at around 1715. The Chancellor would undertake a series of press interviews.

Mr. Wicks reported that he had sounded out Signor Sarcinelli, the Chairman of the Monetary Committee. The latter envisaged that UK entry would be welcomed, and he was ready to convene a meeting of the committee at short notice. Mr. Wicks suggested it would be better to try to secure this on Friday evening even though it meant warning people of an impending move earlier in the day (only the Chairman would be told in advance of the interest rate cut).

Mr. George said he proposed to talk to selected Central Bank Governors in the morning.

Concluding the discussion, the Prime Minister said it was agreed that sterling should now enter the ERM, and that this should be done in conjunction with a 1 per cent cut in interest rates. The arrangements suggested above were endorsed. The Treasury should refine the text of the announcement; prepare drafts of the statement for her and the No.10 Press Office, prepare the necessary Q & A material; and draw up a list of all those to be contacted and the times to do so.

I am copying this letter to Mr. George (Bank of England).

Yours sincerely
Andrew

ANDREW TURNBULL

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HM Treasury.