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File E

NOTE FOR THE RECORD

MEETING WITH THE CHANCELLOR AND TREASURY OFFICIALS

The Prime Minister discussed with the Chancellor today the prospect for the economy over the next few months; the scope and timing of any reductions in interest rates; and possible dates for the UK to join the exchange rate mechanism (ERM). The meeting was also attended by Sir Peter Middleton, Sir Terry Burns and Mr Scholar (Treasury) and by Professor Griffiths (No. 10 Policy Unit).

The Chancellor said that following his meeting with the Prime Minister last week, he had discussed the economic situation with both Treasury officials and with the Governor and Deputy Governor of the Bank of England. Most economic indicators now suggested a slowdown in the real economy after the unexpected resilience exhibited in the first half of the year. But it would be some time before inflation fell decisively. Both the recent oil price increases and the forthcoming wage round, threatened to keep inflation up at a higher level than had been expected in the summer.

Accordingly, while it would soon be appropriate to cut interest rates, that point had not yet been reached. An early cut would give the wrong signal to financial markets, and even more important to wage negotiators.

On the date for ERM entry, setting aside the uncertainty and instability caused by events in the Gulf, most of the conditions necessary had now been met. Inflation was still expected to turn down before the end of the year; the exchange rate was at an acceptable level; the monetary indicators were coming under firmer control, so that a cut in interest rates might soon be justified in any case. The UK should join the ERM as soon as possible, if it were not for the situation in the Gulf. If the Gulf confrontation was going to be long drawn out, there was no reason to delay entry. On the other hand, if the position deteriorated and war broke out, the impact on oil prices, the exchange rate etc would be unpredictable. But if the Government were to delay entry for too long the opportunity would be lost: and the £ value might drop substantially.

The Prime Minister said the fundamental reason for joining the ERM was to use the Deutschemark as a kind of gold standard. No other "spine" was available to the UK at present. The Government should join to inject the necessary spine and discipline into the anti-inflationary stance. But entry had to be at a reasonable exchange rate - not a level artificially buoyed up by high interest rates. The gap between developments in unit wage costs in the UK and those in principal competitors in the ERM was worrying. Entry now would also mean joining at a time of very high inflation, well above that of our competitors, and when the Government was clearly not yet on top of the inflation problem. The Madrid conditions required the UK to be getting inflation down. Entry now would look like reliance on the ERM and an inability to cope with our own inflation problem.

There was also some uncertainly about the deutschmark and how the German authorities would pay for the higher than expected costs of absorbing the East German economy. A rise in German interest rates might cause the £ to fall and require higher UK interest rates to keep within the bands. That would bring an increased risk of recession. A combination of 15 per cent interest rates; a central rate of 3 Dm; and high wage settlements when we joined the ERM would bring unacceptable risks of recession.

The following were the main points made in discussion.

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(i) At a central rate of around 3 Dm = £1, the £ would be closer to its historic average level. It was wrong to think that depreciation of the exchange rate would improve competitiveness. It would only make the problem of accelerating wage settlements worse. To keep wage levels down, it was essential to keep a firm exchange rate in place.

(ii) The tradable sector might well strive hard to hold on to its existing market share. It could choose to absorb pressure through lower profit margins. A high rate against the $ would also lower import prices. Any easing of the squeeze on companies through action to lower the exchange rate, was bound to delay the date at which inflation was brought back under control.

(iii) Any reduction in interest rates, without an announcement that the UK was joining the ERM, would risk a sharp fall in the £. Although Phillips and Drew were expecting an entry into the ERM to be delayed until next year, most City authorities still expected entry in the autumn. It might therefore be sensible to consider a reduction in interest rates only at the same time as the UK joined the ERM.

(iv) The outlook on inflation had worsened in the short term because of the higher oil prices. The Treasury's best estimates were that the August figure might be between 10.2 and 10.4 per cent; the figure for September within the same bands; with the figure for October showing a reduction to somewhere between 9.8 and 10.0 per cent, and the November figure showing a further 1/2 per cent fall in the year-on-year rate. But all these figures were subject to a wide margin of error and the assumption of no further rise in oil prices. In order to meet the minimalist interpretation of the Madrid conditions, the possible d

entry date to ERM would have to be put back from October - it was now unlikely there would be any fall in the inflation rate between August and September.

(v) Entry to the ERM involved a shift in the focus of the anti-inflationary stance from monetary policy to the exchange rate. It might be difficult to sustain the anti-inflationary stance if the £ appreciated to the top of its bands so that an interest rate cut was demanded. There would have to be a willingness to revalue in those circumstances. And that might be difficult if it happened in the early months of joining the ERM.

(vi) On the other hand, there was no reason to expect any repeat of the bad experience from shadowing the Dm in 1987. This time the exchange rate stance would be overt and clear, and would represent a real and known challenge to wage negotiators. The Government must be ready to change the parity if it judged that was the best way to maintain the anti-inflationary stance. However, provided entry was on the wide 6 per cent margins, there was no reason on the basis of the last few weeks experience to expect that there would be any difficulty in keeping the £ within the bands.

(vii) It would be difficult to go on maintaining the credibility of the Government stance if throughout the early autumn expectations of entry into ERM were consistently thwarted. If entry were to be delayed, very careful consideration would need to be given to the presentation of the Government's anti-inflationary stance. Again, the course of events in the Gulf was a particularly difficult factor.

Summing up the discussion, the Prime Minister said the main priority must remain the defeat of inflation. However, the

Government must avoid any policy action that could unduly raise the risks of recession. There must be concern about entering ERM with 15 per cent interest rates, with a rate of 3 Dm and with high wage settlements. However, she appreciated the risk which the Chancellor saw in a reduction in interest rates before the UK joined the ERM. There were attractions in taking action on both interest rates and ERM entry at the same time. It was also clear that a minimalist interpretation of the Madrid conditions would require the Government to be seen to be over the peak of the inflation rate. That was expected towards the end of this year. It was not possible to take a decision on ERM entry dates at this stage. It would then be necessary for the Treasury to consider practical possibilities up to the end of the year. Towards the end of the year the picture both in the Gulf and on German interest rate might be clearer.

BHP

(BARRY H. POTTER)
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