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PRIME MINISTER

... I attach the note I promised on the options for our entry into the ERM.

2. As you will see, it suggests that the main 'windows' for entry are before the party conference and after the 1991 Budget. If we decide to go in early, there is also a choice between July or September/October.

3. There are arguments for holding back until next year but dangers as well. The headline rate of inflation at any rate should be lower than and we could be contemplating a reduction in interest rates for domestic reasons. It might also reduce the risk of the pressures on sterling reversing before an election with consequent upward pressure on interest rates. However, I think these economic arguments would carry much more weight if we were proposing to enter with the narrow band which, of course, we are not. Entering early with wide margins should allow us to keep monetary conditions tight for long enough to get inflation moving down and give us the flexibility to take temporary adverse market pressures on the exchange rate rather than on interest rates.

4. On the other side, I think there are strong market reasons for joining early rather than late. Our joining has been anticipated by the markets. Sterling has risen despite some unpromising economic news, particularly on the money supply, inflation and the balance of payments, and much of its strength reflects the markets' perception that the Government no longer has reservations about the principle of joining the ERM; the issue is



solely one of timing. The higher exchange rate has not only provided a welcome tightening in our monetary stance. It has reduced the risk that, at present interest rates, the exchange rate might seek to move outside the top of a wide band after entry.

5. A somewhat higher exchange rate still would suit us quite well. As we have decided to join with wider margins there is scope for a further rise in the sterling rate before we should be under pressure either to reduce our interest rates or revalue. Alternatively, if there was strong upward pressure on the exchange rate from present levels we might be able to contemplate a small reduction in interest rates. If this were justifiable it would, of course, have benefits for the RPI.

6. Conversely, I would certainly be very apprehensive about postponing entry beyond the party conference and the Mansion House speech in the following week. I think that to bypass both these events would badly disappoint expectations. As a result, we could face a falling exchange rate and upwards pressure on interest rates in the run-up to the Autumn Statement, the IGC and the new Parliamentary session. That would bring political as well as economic difficulties. However, in addition, I do think there are real political gains to be made from taking the initiative with an early entry.

7. I have discussed the timing with Sir Peter Middleton and Sir Terence Burns who believe that we face a favourable set of conditions and that we should take advantage of them while the markets are on our side. Provided we join with wider margins (as I am sure we should) these market factors are more important than the precise monthly profile of inflation. I will be sending you our latest forecast next week but I expect it will show the headline RPI peaking a little above 10 per cent in August. The

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underlying inflation rate should also peak then at around 7½ per cent and then decline gradually.

8. Against this background there is a lot to be said for seizing the initiative and going for a date in July. I have considered, therefore, whether that is ruled out by German Monetary Union. The initial effects of union on the German economy are already largely discounted in the markets and the full effects will continue to develop gradually over a long period.

9. However we cannot rule out the possibility that GMU will unsettle market conditions early on. Whether and to what extent that occurs should become apparent fairly quickly so July 20th remains a possible date and I may wish to come back to you with a proposal to take that opportunity. In any event I believe we should plan for a time before the Party Conference when we might hope to combine favourable market circumstances with a favourable political opportunity.

10. I am anxious that no hint of our discussions on this should reach the press so I am sending copies of this only to Sir P Middleton, Sir T Burns, Mr Wicks and Mr Scholar.

[J.M.]

26 June 1990

THE TIMING OF STERLING'S ENTRY INTO THE ERM

This note lists the considerations relevant to the timing of sterling's entry into the ERM. It assumes, for the reasons described in the Chancellor of the Exchequer's minute to the Prime Minister of 8 June, that entry would be at the wider (6%) band. Very different considerations would underlie a decision to enter the narrower band.

2. It is helpful to consider possible times for entry within two broad time bands:

- between now and next year's Budget (earlier entry);
- thereafter (later entry).

Earlier entry boils down to entry:

- between now and the end of July (pre-recess);
- between the beginning of September and the end of October (or probably in practical terms before the beginning of the Conservative Party Conference on 9-12 October) (September/early October).

November and December would be more difficult: Autumn Statement; electricity (distribution companies) privatisation in November; IGC begins in December. Dates in February are ruled out by electricity (generating companies) privatisation, and more generally it would be difficult to join in the period between Christmas and the Budget.

Earlier or later entry?

3. The main arguments in favour of earlier entry are as follows:

- (i) The Government is pledged to enter: with wide margins delay is unnecessary. Dates which presently seem open could be closed by unforeseen developments in the economy or elsewhere.
- (ii) The longer the delay, the greater the likelihood of cynicism about our firmness of purpose and the consequent risk of unwelcome downward pressure on the exchange rate. This in turn could make it harder to join at the right exchange rate.
- (iii) The longer entry is delayed, the longer the delay in receiving the benefits from the financial discipline which ERM membership brings, in particular a firmer exchange rate would be welcome on monetary policy grounds and it could help to influence the autumn pay round.
- (iv) The longer entry is delayed, the greater the difficulty of maintaining credibility of entry into the wider, as opposed to the narrower, band.

4. The main arguments in favour of later entry are:

- (i) It could reduce the pressure for premature reductions in interest rates.
- (ii) The benefits of entry in terms of a higher exchange rate and reduced pressure to raise interest rates might begin to wane after we have been in the ERM for a while, leaving a risk of having to raise interest rates

at a politically sensitive time, for example if inflation or trade figures were bad.

- (iii) It would have greater credibility if inflation was on a clear downward trend.

If earlier, when should entry be?

5. There are two options for early entry, pre-recess or in September/early October.

6. The arguments in favour of entry before the recess are:

- (i) Sterling is in calm waters and at an appropriate level for entry. There can be no certainty that this will continue until after the recess. Indeed, as time goes by disappointment about non-entry might have adverse market consequences.
- (ii) It would coincide, and could be so presented, with the beginning of Stage 1 which the UK Government support.
- (iii) It would send the Government's supporters home for the recess with an element of political uncertainty dispelled.
- (iv) It would forestall any Labour parliamentary motion just before the recess criticising the Government's failure to enter.

7. The arguments in favour of entry in September/early October are:

- (i) The economic and market effects of GEMU are already with us and will continue to develop over a long

period. But any turmoil after July 1st should have been wholly dispelled by September if not by end-July.

- (ii) Parliament would not be sitting and the presentation time would be much easier.

