

SECRET AND PERSONAL

(a-b)



SUBJECT  
cc: MASTER

DA

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

27 June 1990

Dear John,

UK ENTRY INTO THE ERM

At today's bilateral the Chancellor and the Prime Minister discussed possible dates when the UK might join the Exchange Rate Mechanism.

I would be grateful if you could ensure that no copies of this minute are taken and that it is seen by others only with your personal authorisation.

The Chancellor said there was no perfect date for entry - there would always be some uncertainty about the state of financial markets at any time. But he was convinced that entry could not be delayed until next year - which might be the year of a general election. The Government could not afford turbulence as the pound bedded down within the ERM.

Dates for entry later this year were not satisfactory either. To go in as late as December before the Inter-Governmental Conference would look like an act of political necessity. To join in November might look a little better - but as the public expenditure round and the Autumn Statement might be deemed unsatisfactory by markets, entry at that time would be regarded as an act of weakness.

In his view the choice lay between entry in September and at the end of July. The few Treasury senior staff consulted were unanimous that the underlying economic conditions were satisfactory given it was agreed policy that the UK should enter the ERM on the wide bands. There was a strong case for entry in July. It would represent an unexpected yet strong political initiative by the Government; it would close out the risks of a fall in the exchange rate from the current level which was right for entry; and it would remove the prospect of a Labour Party debate on entry before the end of the session. Many of the same arguments applied to entry in September; but there was greater risk of less favourable market conditions. The pound had risen as the Government's popularity had increased in recent weeks; but there was a risk of less favourable market conditions if entry were delayed.

The Madrid conditions on inflation would not strictly have been met with entry in July. But inflation would peak soon and

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then come down. Moreover the Madrid conditions had been constructed on the assumption of entry on the narrow bands - not the wide bands now proposed. And in any case attention would focus on the favourable reaction to entry, not on whether the strict Madrid conditions had been met. The date of entry had to be judged as much on political as economic criteria.

The Prime Minister said the UK should join the ERM once its economic policies were seen to be working and the Government was clearly on top of the economic problems. If the UK entered when RPI inflation was rising to around 10%, it would be clear that the Madrid conditions had not been met; and it would look like the UK was clutching at entry as a support. The Prime Minister would prefer to join the ERM when interest rates could be reduced on the basis that the economic fundamentals were right, not simply as a result of a short term "honeymoon" benefit of entry into ERM. The Chancellor had suggested that there were institutional or other obstacles in the way of particular entry dates: but if the economic fundamentals were right, then the time would be right and such obstacles could be brushed aside. The Prime Minister accepted that it would be difficult to calibrate any honeymoon period and thus reach a precise judgement on optimal dates of entry. In her view the UK must be able to join the ERM on the merits of the Government's stewardship of the economy. Such an approach might be consistent with entry as early as September or dates later in the year.

Summing up a brief discussion, the Prime Minister said time had not permitted all the issues to be explored. It would be necessary to return to the discussion soon.

*Yours ever,  
Barry*

BARRY H. POTTER

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HM Treasury.