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PRIME MINISTER

3 July 1990

ERM

You would take a substantial, if not enormous, risk in accepting the Chancellor's advice by surprising the markets and entering the ERM in July. The latest monthly profile for inflation is quite shocking - with figures for the next three months being all over 10%. If we were to join the ERM now and then the published rate of inflation was seen to rise in July and August the markets would be bound to question our real motives for joining. It would look as if we had something to hide and that the inflation outlook was far worse than we have so far published. It could well provoke a sharp fall in the pound.

You are known to stick to your word. As a result the Madrid conditions really matter. It is important, therefore, that we do not go in until inflation has peaked, and has started to come down. This means that the very earliest entry date should be on the publication of the September RPI figure, which would be in October. Even on this occasion, however, inflation would still be 10%, which would be far from ideal.

The Chancellor, however, does have a point about the exchange rate. What we need to avoid is a run-up to the Party Conference, or - a Party Conference week during which there would be speculation about sterling and possibly a sharp fall. So far the Chancellor has been extremely successful in talking the rate up by being so bullish about entry into the ERM. You might suggest to him that you see no possibility of the rate falling providing he stresses that the first of the Madrid conditions must be met, namely that we will enter when we have succeeded in controlling inflation.

My own personal view is that when the rate of inflation is seen to have peaked it will be quite hard for us not to enter the ERM - and indeed we could well get bounced into doing so by the markets. As a result the ideal timing might be the first publication of an RPI

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figure following the peak. Although this is something of a gamble, it would nevertheless make sense to most private sector forecasters who are predicting a substantial fall in inflation in the coming 12 months.

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