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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

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5 July 1989

ECONOMIC PERFORMANCE AND PROSPECTS

The Prime Minister had a meeting this afternoon with the Chancellor, Sir Peter Middleton, Sir Terry Burns and Professor Brian Griffiths to discuss economic performance and prospects. The papers before the meeting were the recent Treasury note on the recent rise of inflation and the Treasury economic forecast for June 1989.

I should be grateful if you would ensure that this letter is copied only to those with a clear need to know.

The recent rise of inflation

Opening the discussion, the Prime Minister said she wished to consider whether there were any indicators or factors that should have been identified in recent years that would have pointed to the need to take action to tighten policy at an earlier stage. She was struck by the charts in the Treasury paper showing that UK inflation relative to that in other countries had risen significantly since around 1985. She wondered whether we had mistakenly disregarded signals which, although not completely accurate, had been telling us that some corrective action was needed. For example, was it right to have ignored the signals coming from the growth of broad money?

In discussion, the following main points were raised:

(i) as compared with the other major countries, the UK had had a tighter fiscal policy. We had also had higher interest rates in real terms. It had, however, been more difficult for this country to reap the benefit of lower oil prices because of the off-setting effect which had followed from sterling's depreciation;

(ii) unambiguous signals of the correct policy response were never available at the time decisions had to be taken. Looking back over the last three to four years, there had been good reasons for ignoring at the time the signals coming from the continuing fast growth of broad money; there was no doubt that this indicator had given the wrong signals in the early 1980s. Even with the benefit of hindsight, there was no one indicator that had pointed to the conclusion that policy was too lax. However, it was now clear that the general stance of monetary policy over recent years should have been tighter.

(iii) one factor of major importance had been the impact of financial deregulation. Its effects had been more far-reaching than expected and this meant that a tighter stance of monetary policy was needed to achieve a given downward pressure on inflation. The effect had been exacerbated against the background of substantial exchange rate depreciation during the period from 1981-1986.

(iv) one of the difficulties with MO was that it tended to be a coincident indicator and was not a good predictor, although this view had been challenged in the recent work by Stephen Hannah. But it was also argued that, had MO been successfully kept within its target range during the last couple of years, the rate of inflation would have been kept lower.

(v) there was some evidence to suggest that monetary policy had been too lax from around 1985. But from 1987 onwards, there was a strong case for the view that renewed inflation was caused by attention having been taken away from domestic monetary conditions in favour of aiming to keep the exchange rate stable.

(vi) the period of shadowing the ERM had led to very heavy intervention to hold the sterling exchange rate down. It was questioned whether the process of adding to the Reserves had been fully sterilised and funded; and if it had, whether the process would have automatically rendered intervention ineffective. On the other hand, it was argued that sterilisation was not undertaken contemporaneously and could have an important short-term effect in the markets; it was also wrong to view the exchange markets in a mechanistic way and intervention could have important psychological effects.

(vii) whatever the precise position on intervention, it was clear with hindsight that interest rate policy had been wrongly constrained by exchange rate considerations.

Summing up this part of the discussion, the Prime Minister said that, although there were differences of emphasis on certain points, there was general agreement that

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over recent years the stance of monetary policy had not been sufficiently tight.

Treasury economic forecast

The Chancellor said that the position set out in the forecast was not encouraging. The moral from the first part of the discussion was to err on the side of caution in ensuring that monetary policy was kept sufficiently tight.

In discussion, the following main points were raised:

(viii) domestic indicators were still worrying, with MO remaining above its target range and continued strong growth of broad money. To be confident of achieving a substantial reduction in inflation over the next two years it was necessary to consider a further tightening of monetary policy now. There was no way of squeezing out inflation without a degree of pain.

(ix) the exchange rate had depreciated significantly in recent weeks. Although there had been some recovery over the last couple of days, if there was a renewed threat of significant further depreciation it would be important to tighten conditions via an increase in interest rates. There was no need to act now, but this response should certainly not be ruled out for the future.

(x) it was extremely difficult to assess the present position of the economy. But despite the indicators now published showing continuing growth in May, there was strong impressionistic evidence that the economy was now on the turn. This was certainly true of the housing market, and substantial evidence was coming through also from the retail sector. Action now further to raise interest rates carried a major risk of pushing the economy into a substantial down-turn. On that view, the important point was to maintain the present level of interest rates for a sufficiently long period rather than to raise them further at this stage.

(xi) there were further major risks involved in a further interest rate increase now. It would have the effect of raising mortgage rates and add a further ratchet to the upward pressure of wages. The RPI consequences would have a very serious psychological impact, undermining confidence in the Government and in turn undermining confidence in the markets. The overall impact could be devastating. There was a major prize to be achieved in the psychological battle against inflation by holding present interest rates so that the expected significant e

drop in the RPI could come through in August.

(xii) once the reduction in the RPI had been achieved, there was a strong case for taking a further look at the general coverage and methodology of the RPI; the existing Advisory Committee arrangements did not work well. One possibility would be to ask the OECD to prepare a recommended standard.

Summing up the discussion, the Prime Minister said that, although a further increase in interest rates could not be ruled out and the position would need to be kept under review in the normal way, she saw major difficulties with such a step in the near future.

PAUL GRAY

Alex Allan, Esq.,
H.M. Treasury

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