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PRIME MINISTER

MEETINGS ON ECONOMIC POLICY: 3 AND 4 SEPTEMBER

You are meeting the Chancellor (plus senior Treasury officials) for a further discussion on the economy on Tuesday 4 September. An internal meeting with Andrew Turnbull and Brian Griffiths is arranged for Monday evening.

You discussed the two issues for these meetings with the Chancellor earlier this week.

When should interest rates be reduced; and by how much?

Should the UK join the ERM in the next few weeks as planned earlier?

I will submit the Chancellor's note when it arrives on Monday [Flag A]. But he is likely to propose a modest cut in interest rates and ERM entry in mid September, with early October as the fall-back date. At Flag B is the background note on economic indicators you saw earlier - an update is given below. At Flag C is a note from Brian Griffiths.

Economic background

The note at Flag B indicates the broad outlook for the UK economy. Output growth is expected to fall back in the second half of 1990 and remain low in 1991. Inflation is still likely to peak in the early autumn and fall only slowly thereafter; but, after the oil price increase, it will remain at a higher rate than previously expected until end 1991. Over this period the balance of payments will improve a little but remain in substantial deficit.

Recent published information has indicated that a slowdown is in prospect.

i) The CBI monthly enquiry indicated falling output, orders and price expectations (i.e. a moderation of inflationary pressures) for manufacturing.

ii) The latest cyclical indicators from the CSO, though by no means reliable, also suggest a sharp down turn in both the co-incident and short-term leading indicators.

iii) Both the CBI and NIESR forecasts - the latter an unfriendly organisation - suggest lower output growth and higher inflation over the next eighteen months.

While there seems little doubt the economy is now heading into a downturn, the critical issues to probe at the meeting are the following.

A. How rapidly will domestic demand fall? And how quickly will overseas demand drop back, in response to the depressing effect on world trade of higher oil prices and (potentially) higher interest rates?

B. How far and fast will UK wage negotiators adjust: will the usual stubborn behaviour prolong inflation and lead to higher unemployment?

C. How serious is the risk that the first two effects combined will lead to a sharp UK recession?

Interest Rates

The Chancellor was understandably cautious earlier this week. But he does consider that interest rates might soon be reduced. Before taking a decision he wants to await further developments on monetary conditions - the UK monetary aggregates on the one hand, and international interest rates on the other.

The figures for the final week of August suggest that MO is just within the target range, i.e. growing at an annual rate of 4.9 per cent. Financial markets have already worked out the figures, although they will not be published (along with the data on broad money) until 20 September. (Next month's money supply growth figures will be distorted by last year's postal dispute.)

Overseas, Japanese interest rates were raised yesterday to 6 per cent. There are no indications of others following - though that cannot be ruled out. Germany might be attracted to an early interest rate increase for domestic reasons using the oil price increase as a convenient excuse. In the US however interest rates are more avoiding a fall than delaying an increase.

Some Treasury officials are cautious and doubt whether even a ½ per cent reduction in UK rates can yet be justified. In part this is because of narrowing interest rate differentials against our competitors: in part, it is because an interest rate cut is a perverse response to a new inflationary threat (higher oil prices).

But the Chancellor would be prepared to cut interest rates by as much as 1 per cent soon (on the back of the MO data), and depending upon international developments - but only if the UK is within the ERM. He is concerned that any cut in interest rates before the UK joins the ERM might be read as suggesting delay on entry. (The sensitivity of the exchange rate to this factor was demonstrated today.) The exchange rate might then fall quite rapidly, particularly if the petro-currency premium status had been further dissipated by oil price developments.

Date of ERM Entry

In short, the Chancellor makes a practical policy link between a reduction in interest rates and joining the ERM.

The starting point on the ERM must be the earlier decision to join before the General Election (bearing in mind the Opposition

policy on the ERM), when the Madrid conditions were met. The Chancellor had earlier targeted September/October - which you had agreed to consider further. The issues now are whether to go ahead with this proposed timing; and what the appropriate rate should be on entry.

Timing

First, it is useful to remember the advice from Alan Greenspan. He favoured entry - but only when warranted by inflation having turned down; and money supply growth showing deceleration. An interest rate cut to accompany ERM entry would then be justified by monetary conditions, not made necessary by the action of ERM entry. Until towards end-July, my own view was that ERM entry should probably therefore not go ahead until around the turn of the year (i.e. not very different from Alan Walters' advice in May).

But the latest monetary and other indicators, including the effective tightening of the real monetary stance because of higher oil prices, inflation and the exchange rate appreciation, suggest those conditions are now likely to be met earlier. (Inflation will be at a higher level; but the pattern of a peak rate in the early autumn and reduction thereafter is likely to be broadly the same.) In effect, setting aside the exchange rate volatility generated by the Gulf, recent indicators have strengthened the fundamental case for joining the ERM in the autumn.

Second, the policy need now is to avoid recession, while bringing down inflation. Both point to a need for lower wage settlements. And a firm commitment to the present high exchange rate should be beneficial in bringing down wage settlements.

There is no reason to be optimistic: wage negotiators in the UK are notoriously stubborn - over-influenced by current RPI figures and so-called comparable settlements. The second year of pay deals at Ford and Vauxhall linked to the RPI will give some

embarrassingly high headline settlements. All this strengthens the case for ERM entry as the means of sustaining the high exchange rate.

Third, however, there is a powerful consideration which may argue for delay - the uncertainty generated by the Middle East. Markets had been relatively calm for a few days until sterling fell sharply today on rumours of a UK interest rate cut and postponed entry to the ERM. They could soon turn more volatile. Hostilities, particularly if the Saudi Arabian oilfields seemed threatened, could quickly boost oil prices and push sterling outside its ERM range (though that would not have been the case so far if we had joined in July). Other countries might raise interest rates. Treasury officials are divided: some argue it is not appropriate to join when exchange markets are fluid; others emphasise the inevitable uncertainty of economic events.

Fourth, the Chancellor's argument about the link between interest rates and ERM works in another way. Just as we cannot cut interest rates until inside the ERM, we cannot join the ERM until an interest rate cut is justified. That argues for entry a little later than next month - if we are to avoid a perverse response to the oil price increases.

To sum up, the fundamental arguments under the "Madrid-Greenspan-Walters" conditions point to entry in the autumn - providing the right entry level can be achieved. But how should the uncertainty in the Gulf be weighed? Is it sufficiently significant to call for postponement of entry - bearing in mind both that there are said to be no other suitable dates this year and the timing of the Election? (The Chancellor is also persuaded that delay beyond October would have to be formally announced and the exchange rate would then fall. This, of course, reflects expectations generated by the Treasury.)

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The rate

What margins should be chosen and what placing within those margins? The wider 6 per cent margin is now justified - given the likely greater volatility of the exchange rate because of a possible rise in German interest rates; sterling's re-emergence as a petro-currency; and the recent fluctuations of the lira and peseta. The real issue is where within those margins sterling should be placed.

The Chancellor earlier favoured an asymmetric entry point, giving sterling more room to appreciate than depreciate. Treasury officials accept that is no longer appropriate. Instead they want to go in at a mid-point of £1=3 DM, i.e. close to the current actual rate.

Privately, I suspect the Chancellor thinks this rate is too high. With the downturn in world trade in prospect and therefore increased price competition on tradeable goods and services, such a rate could put intense pressure on UK exporters and domestic producers facing import competition. (Over the last twelve months the nominal DM exchange rate has risen: while our unit wage costs have risen by 7 per cent more than in Germany.) At 3 DM=£1, the CBI will be very unhappy.

There are arguments for a lower central rate of around £1=2.90 (or 2.95) DM. That would still be sufficient to put severe pressure on wage negotiators, without making those pressures prohibitive. It would acknowledge that there is a petro-currency element in sterling's present high rate against the Deutschmark. It would avoid the political argument that, after a three year delay, the UK had joined the ERM rate at the level originally pursued by Nigel Lawson.

But it would be difficult to engineer an asymmetric entry point in the other direction i.e. more room for depreciation than appreciation. (So the range could be set at 6 per cent margins around 2.90 (or 2.95) DM, even though the starting rate would be

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above that.) However if entry is combined with an interest rate reduction this might be got around.

Way Forward

The aim on Tuesday should be to decide on the size and timing of the interest rate reduction; and - if agreed - target entry dates to the ERM.

There is a strong case for announcing both decisions together. If interest rates are reduced at the same time as ERM entry, that should reduce the exchange rate and bring it closer to an acceptable mid point.

The possible dates are 14 September and 5 October. The Treasury is likely to favour 14 September (delaying if interest rates developments elsewhere require.) My own view is this is too soon - but 5 October is a real prospect:

- it will give longer for other countries to decide their interest rate stance;

- it avoids appearing 'soft' on imported oil price inflation; and

- it should allow the petro-currency premium to dissipate further.

But final decisions must depend upon events in the Gulf, and an oil price and (other) interest rate developments.

BHP

BARRY H. POTTER

31 August 1990

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