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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

Subject cc RASTER

12 September 1990

BILATERAL WITH THE CHANCELLOR

The Prime Minister and the Chancellor discussed a number of topics at their bilateral this morning.

I should be grateful if you would ensure that circulation of this letter is restricted to only those people with a strict need to know.

First, the Prime Minister said she was concerned about the political and financial impact of the data on invisibles and the RPI being published this week.

On invisibles, the Government would be criticised for faulty figures. It would need to be made very clear that the revised estimates on the invisibles account represented merely the latest (and no doubt not the last) of a long series of amendments to the projections. The invisibles figures should be seen as an artificial and approximate calculation at all times.

The Chancellor indicated that he had asked the Economic Secretary to enquire into the collection and preparation of the invisibles figures; and to check carefully whether the present arrangements in the CSO could be improved.

The Prime Minister said she had also been surprised by the sharp rise in the August RPI. Some impact from higher oil and beer prices had been expected: but the increases in fruit and vegetable prices and in the price of personal and household goods was surprisingly large. Anecdotal and statistical evidence suggested decline in retail sales and presumably downward pressure on retail prices. It was pointed out, however, that the way in which the RPI was constructed meant that the price of a fixed basket of goods was estimated each month: if people responded by changing the composition of the basket, or simply not buying items at all, that was not reflected in the RPI.

The Chancellor indicated that he had also asked the Economic Secretary to look at the way the RPI figures were collected.

More generally, he was conscious of the need to ensure that the latest data on both the invisibles and the RPI figures were

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carefully presented. Steps were being taken to align expectations more closely with the reality.

Second, the Chancellor provided an account of his meeting at ECOFIN over the weekend. As widely, if a little over-favourably, reported in the press, there had been a considerable movement away from the Delors proposal and towards the UK scheme. Several countries wanted a delay in the introduction of Stage 2 and hence Stage 3; and there was now some support for the UK proposal of a hard ecu, though less for the idea of a new central bank.

It would now be necessary to build on the growing disillusionment with the Delors proposal and the renewed interest in the UK idea. In particular, it would be desirable to look at how more use could be made of the ecu. In addition to the Spanish and Germans, who had spoken in support of the hard ecu proposal, the Dutch and Danes were now much more interested. The Chancellor was making arrangements to see the Dutch and Danes, and the French Finance Minister, shortly. But the degree of support might be muted so long as the UK would not (and could not given the views of Parliament) commit itself to the goal of a single currency).

Thirdly, the Prime Minister and the Chancellor discussed possible dates for the UK to join the ERM. The Prime Minister said that press expectation was now firmly for some delay in ERM entry; but equally, it was thought that the UK would join by no later than the beginning of December. This was likely to be consistent with meeting the "Greenspan" condition - that the UK should join when interest rates were ready to be reduced on wider economic grounds; and it could be consistent with the main Madrid condition - that the differential between UK and European inflation rates should be narrowed. The Prime Minister hoped that it would be possible to reduce interest rates and join the ERM at the same time. As the Chancellor had pointed out, to reduce interest rates before entry would be read as either implying a desire to bring down the exchange rate or that ERM entry had been further delayed.

The Prime Minister said it would be useful to know whether UK inflation was converging or diverging from the average European experience. Accordingly, the Chancellor undertook to produce a note setting out the UK record on actual and underlying inflation as measured by the RPI, and the record on consumer price indices for other countries in the EC.

The Chancellor said he would hope to come forward with a firm proposition on entry at some stage between the beginning of October and the end of this calendar year. All dates up to around the end of November were possible, though the later dates in November might be constrained by electricity privatisation. But some were more advantageous than others. In discussion, 12 October, before Parliament reassembled and before the Mansion House speech, was identified as one particular possibility. It was still difficult to assess whether the September RPI figure (available but not published by 12 October) would show a drop in UK actual or underlying inflation rate.

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Fourthly, the Chancellor indicated that the Defence Secretary was seeking a claim on the reserve for Gulf costs. The Chancellor had indicated that at this stage those costs should be absorbed within the existing defence programme: there was a clause in the agreement between the Treasury and the MOD which indicated that the provision included the costs of conflict of the nature so far seen in the Gulf.

Finally, the Chancellor indicated that he would wish to announce next week new proposals for dealing with the debt of the poorest countries. He would propose changes to the Toronto terms: they would apply to the whole of official bilateral debt and the write off would apply to two-thirds rather than one-third of the debt of the poorest countries. The present eligibility criteria would remain. The Prime Minister said she was broadly content to go along with this proposal as there would be no change to the criteria for the scheme and it would continue to be confined to the very poorest countries. It must not become a mechanism which facilitated additional ill-considered borrowing by these countries.

Barry H. Potter

John Gieve, Esq.,
H. M. Treasury.

SECRET AND PERSONAL



SUBJECT CC MASTER

file
(8/11/90)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

28 August 1990

Dear John,

The Prime Minister discussed the economic situation with the Chancellor on his return from leave yesterday evening.

I should be grateful if this letter could be seen only by those with a strict need to know.

The Prime Minister noted that some commentators had been predicting a rapid slowdown in UK economic activity, even before the oil price increases. In the light of both the oil price increases and the further appreciation of the exchange rate, she was concerned about the possible risk of recession. There was a case for an early cut in interest rates, though not by as much as the 2% advocated in the Sunday Times on 26 August.

Also, because of the recent volatility in exchange rates; sterling's re-emergence as a petro-currency; and greater uncertainty about the robustness of the Deutschmark (not least because the costs of absorbing the East German economy seemed to have been underestimated), she was not persuaded that it was right to go into the ERM within the next few weeks.

The Chancellor said he had not yet had time to assess the full impact of the recent rise in oil prices on the economy. There was indeed growing evidence that the economy was more sluggish, including the latest CBI survey to be published the next day. Both narrow and broad indicators now showed some deceleration in money supply growth. And the short term impact of the oil price rise itself, and the recent appreciation in the exchange rate, had tightened the monetary stance further.

His preliminary view was that a modest cut in interest rates might well soon be justified by monetary conditions. But, despite the deceleration, MO was still outside its target range: it would be sensible to wait for further evidence on both the tightness of the present monetary stance and the behaviour of monetary aggregates, including the monthly figures for August, before reaching a firm view. Treasury officials had been asked to undertake an urgent re-assessment of the monetary position and the implications for interest rates.