PO-CH/NL/0409
PART C

Part. C.

SECRET

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Begins: 22/2/88.
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PO -CH /NL/0409

PART C

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PART C

Chancellor's (Lawson) Papers:

THE RETAIL PRICE INDEX,
RESERVES AND THE
GOVERNMENTS ECONOMIC
PROGRAMME OF 1988

DD's: 25 Years

[signature]

9/1/96.

ea.2div/lb.24.2

SECRET AND PERSONAL

FROM: PAUL DAVIS
DATE: 22 February 1988

1. MR BOTTRILL
2. CHANCELLOR

cc: See attached list

JANUARY TRADE FIGURES

The January trade figures will be published at 11.30 am on Monday 29 February. They will show a deficit on visible trade of £1505 million. Combined with an unchanged CSO projection of the monthly invisibles surplus of £600 million, they give a projected current account deficit of £905 million in January compared to a revised deficit of £410 million in December. The increased deficit reflects a recorded fall in export volumes of 8 per cent since December and a 2 per cent fall in import volumes. The terms of trade were unchanged between December and January.

Main points

2. **Current account**

£ million

	1986 Year	1987 Year	1987 Q1	Q2	Q3	Q4	Nov	Dec	1988 Jan
Manufactures	-5307	-6542	- 730	-1581	-2109	-2122	- 748	- 640	-1482
Oil	4056	4184	1159	1016	936	1073	332	346	359
Other goods	-7212	-7267	-1640	-1752	-1936	-1939	- 640	- 716	- 382
Total visibles	-8463	-9625	-1211	-2317	-3109	-2988	-1056	-1510	-1505
Invisibles	7519	7132	1707	1723	1902	1800*	600*	600*	600*
Current balance	-944	-2493	486	-605	-1222	-1153	-456	-410	-905

*Invisibles figures since October are projections

3. The large January current account deficit should be treated with extreme caution since this is the month in which the Single Administrative Document and a revised trade classification were introduced. Exports appear very low in January, (seasonally adjusted the largest fall month-on-month since the 1979 haulage strike). Customs say that there is no firm evidence that the low January export figure was caused by trade being pushed forward to December or back to February. Examination of the number of documents processed and the timing of shipments, however, provide some circumstantial evidence of

distortion to exports. There is as yet no evidence that imports were affected - although Customs had difficulties with valuation and double-counting. We shall need to wait several months, however, to judge whether there was in fact any distortion as a result of the new Customs procedures. We may never know whether any distortions reflected the Customs change or other factors such as ~~New Year gales or~~ difficulties with seasonal adjustment.

4. The attached annex explains the revisions to the trade classification (SITC revision 3) which was implemented in the January figures and has caused some changes to previous years' data. Additionally, a new round of seasonal adjustment was carried out on all series.

V suspicious

5. **Exports**

	percentage change			
	Jan on Dec	Latest three months on previous three months	Latest three months on same period a year earlier	1987 on 1986
Total value	-9½	-2½	4	9½
Total value excl oil and erratics	-7½	-1	6½	10½
Total volume	-8	1½	3	6
Total volume excl oil and erratics	-7½	0	4½	7½
Manufactures volume (excl erratics, OTS basis)	-8	0	8	9
Fuels volume (OTS)	-5½	13	3	-1
Basic materials volume (OTS)	16	2½	-11	7
Food, drink and tobacco volume (OTS)	-9	-9½	-13	0

5. Export volumes, excluding oil and erratics fell by 7½ per cent in January, reflecting large falls in exports of manufactures (excluding erratics), food drink and tobacco and fuels although there was a large rise in exports of basic materials. In the three months to January exports of manufactures (excluding erratics) were still 8 per cent higher than a year earlier with substantial growth in exports of cars and other consumer goods. Exports of non-manufactures (excluding fuels), however, are well below their exceptionally high levels of a year ago.

6. Given the uncertainty over the quality of the January figures they provide no new information on the underlying trend in exports. There is no reason to suppose that there has been any significant change in the recent upward trend.

7. Imports

	percentage change			
	Jan on Dec	Latest three months on previous three months	Latest three months on same period Year earlier	1987 on 1986
Total value	-2	½	9	10
Total value excl oil and erratics	-1	1½	11	10½
Total volume	-2	1½	11	7½
Total volume excl oil and erratics	-½	2	12	9
Manufactures volume (excl erratics, OTS basis)	3½	3	16	10
Fuels volume (OTS)	-19	2	6	1½
Basic materials volume (OTS)	-3	-8½	-9½	10½
Food, drink and tobacco volume (OTS)	-11	6½	5½	½

8. Import volumes, excluding oil and erratics, fell by ½ per cent in January. Imports of manufactures rose, but imports of fuel, and food, drink and tobacco and basic materials fell sharply.

9. The path for imports continues to be erratic, but the underlying trend still appears upwards. In the three months to January on a year earlier there were strong rises in imports of intermediate goods, semi-manufactures and capital goods, reflecting the continuing rise in domestic output, stocks and investment. Consumer goods (excluding cars), however, grew by 16 per cent over this period reflecting buoyant retail sales, while car imports were sharply higher in January.

Geographical area

10. The value of exports to developed countries rose by 4½ per cent in the three months to January compared to the previous three months reflecting a 13 per cent increase in exports to Japan, a continued recovery in exports to the USA though exports to the EC fell by 8 per cent. Exports to developing countries fell by 8½ percent over this period, motivated by a 13 per cent fall in exports to oil exporting countries.

Trade prices

percentage change
latest three months on previous three months

	Export prices	Import prices	Terms of Trade
Manufactures (excl erratics)	½	0	
Food, drink, tobacco	- ½	- ½	
Basic materials	1	- ½	
Fuel	-13	-8	
Total (BOP basis)	- 1½	-1½	0
Total less oil (BoP basis)	0	- ½	½

11. In the three months to January the total terms of trade was unchanged compared to the previous three months whilst the non-oil terms of trade rose by ½ per cent (as measured by unit value indices). Over this period the terms of trade may have been boosted by sterling

appreciation which appears broadly to have offset the effect of rises in non-oil commodity prices. At the same time falls in the oil price worsened the total terms of trade. (NB: the published series are unit value indices, which can present a misleading picture over a period of time due to their use of 1980 weights).

Assessment

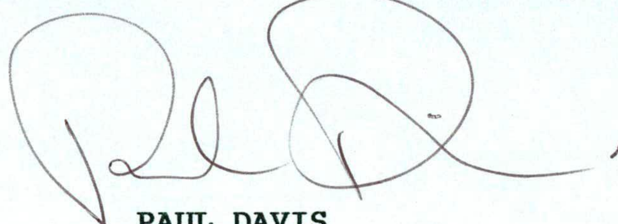
12. The revised current account deficit of £2.5 billion in 1987 as a whole is in line with the forecast published at the time of the Autumn Statement. The first complete 1987 estimate, however, will be known on 11 March, when the invisibles balance for the final quarter will be published together with any revisions to previous quarters. We are inclined at this stage largely to discount the low January export figure. The continued high level of non-oil import volumes, however, suggest the trend is still upward.

Market expectations

13. The market expectation is for a current account deficit of around £350 million in January. The January deficit is therefore very much larger than anticipated by the City.

Press briefing

14. I would be grateful for clearance of the attached press briefing.



PAUL DAVIS
EA2

SECRET AND PERSONAL
UNTIL 11.30 am MONDAY 29 FEBRUARY

DRAFT BRIEFING FOR IDT

Positive

1. Current account deficit in 1987 as a whole currently estimated at £2.5 billion in line with the forecast published at the time of the Autumn Statement

2. **Export order books** CBI February Survey showed balance of firms reporting order books above normal at historically high level.

3. Manufacturing industry performing well. Volume of manufacturing exports (excluding erratics) 8 per cent higher in three months to January than a year ago. Output up 5½ per cent comparing fourth quarter with a year earlier.

Defensive

1. January current account distorted It is possible that the introduction of new Customs procedures on 1 January 1988 may have encouraged firms to switch shipments from January to December or February. Prudent to wait until later months figures available before deciding whether January pattern of trade distorted.

2. January current account deficit erratic. Largest month-on-month fall in export volume since 1979 haulage strike. Monthly figures highly volatile - fall ~~totally~~ inconsistent with other evidence eg February CBI survey shows balance of firms reported export order books above normal at historically high level.

3. Current account deficit still growing. January deficit of £0.9 billion erratic. Recent figures highly volatile, never consider one month's figures on their own.

4. Current account deficit forecast to rise further in 1988. projected deficit in Autumn Statement of £3½ billion only ¾ per cent of GDP - much smaller than imbalances in US, Germany and Japan (currently 3-4 per cent of GDP/GNP) and UK deficit in mid 1970s (also 3-4 per cent of GDP). Latest outside forecasts (including NIESR and LBS) show similar deficit in 1988.

at a time of slow growth in many of our major export markets.

5. Current account deficit no longer "temporary" as Chancellor earlier claimed. Deficit reflects strong growth of UK domestic demand and activity in 1987; import growth will slow as domestic demand growth moderates. Good supply performance has meant only small deficit as percentage of GDP: boosted exports but also output to domestic market and should allow manufacturers to take advantage of rising world trade.

6. Capacity constraint threatens current account performance. [CBI January quarterly survey reported only 35 per cent of firms working below capacity - lowest balance since survey began, but 87 per cent report capacity adequate over next year.] CBI concludes that economy not overheating and no evidence of significant labour or raw materials shortages developing. New export order books and deliveries responses consistent with continued growth in manufacturing exports. February survey shows balance of firms reporting export orders above normal at historically high level.

7. Rise in current account deficit confirms economy overheating? No. See preceding answer.

8. Motor industry trade deficit worsening [SMMT figures show UK trade deficit on cars and parts £0.1 billion worse in third quarter of 1987 than a year ago, following first half improvement]. In 12 months to January car exports up 27 per cent on previous year while imports down ½ per cent. Car output up 11 per cent in 1987 compared to 1986.

8. Trend in imports strongly upwards and rising faster than exports. Recent figures for import and export volume very erratic, but not surprising imports growing relatively strongly given rapid growth in UK domestic demand and activity. Rise in imports not confined to consumer goods; rising imports of materials, semi-manufactures; imtermediates and capital goods reflect rising output stockbuilding and investment, rather than surge in consumer spending.

9. Fall in export optimism. [CBI January survey showed sharp deterioration in export optimism with balance turning negative.] CBI still expects export orders and deliveries to rise in next four months. February survey shows balance of firms reporting export order books above normal at historically high level.

10. Export growth projected to slow in 1988: UK projected broadly to maintain volume share of total world trade in manufactures, continuing improved performance which has been evident since 1981, following decades of decline.

11. Sterling's recent strength threatens competitiveness -fall in exchange rate needed. Not at all. Competitiveness still better than in 1984 and 1985 before the fall in oil prices.

12. Competitiveness worse than in 1978. Misleading to look at competitiveness too narrowly. Supply performance of UK manufacturing industry much improved since late 1970s as demonstrated by UK maintaining share of total world trade in manufactures since 1981, following decades of decline.

13. Effect of stock market fall on overseas assets. Position has been affected on both sides of account by movements in financial markets and by exchange rate changes but too soon to be precise about effect on net overseas asset position or income from these assets. Note that share prices generally back only to end-1986 levels, which is date to which latest published net overseas assets figures relate.

35/3 JRF 3323/011

FROM: **PAUL DAVIS**

DATE:

Distribution as per
Monthly trade note

REVISIONS TO TRADE CLASSIFICATION - SITC REV3

Revisions to the Standard International Trade Classification (SITC) will come into effect with the publication of the January current account press notice on 29th February. Revised figures for earlier years will also be included together with new seasonal adjustment for all series.

2. The major change to the aggregate statistics is the exclusion of most gold trade from the OTS figures. Under the previous classification - REV2 - several types of gold were included in section 9 of the OTS figures, including some financial gold. In principle only commodity gold should be included in the trade figures, with financial gold included in the capital account of the balance of payments. Hence an adjustment was made to the BOP figures to eliminate the effect of trade in financial gold on the trade balance. REV3 adopts a more direct approach by excluding all financial gold transactions from the figures. The effect of the changes is to reduce the level of exports and imports, as shown below, but to leave the trade balance virtually unchanged.

BOP VALUE £ million

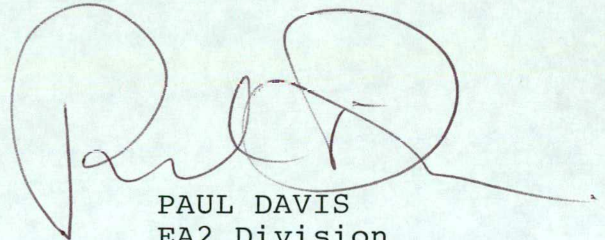
EXPORTS	REV2	DIFFERENCES DUE TO GOLD	REV3
1908	47422	- 275	47147
1981	50977	- 309	50668
1982	55565	- 309	55330
1983	60776	- 78	60698
1984	70367	- 104	70263
1985	78111	- 123	77988
1986	72843	- 165	72678
1987	80089	- 467	79622
IMPORTS			
1980	46061	- 267	45794
1981	47617	- 299	47318
1982	53234	- 228	53006
1983	61612	- 51	61561
1984	74751	- 92	74659
1985	80289	- 111	80178
1986	81306	- 165	81141
1987	89913	- 666	89247

3. Other changes to the figures will affect the allocation between categories. The main change is the reallocation of armaments from section 9 to finished manufactures (section 8). This improves the manufactures balance by £0.7 billion in 1987. The table below shows the effects on the BOP series. The remaining changes in the classification are at a detailed level and do not lead to a change in the distribution between categories.

£ million

TRADE IN MANUFACTURES BOP VALUE

	EXPORTS		IMPORTS		BALANCE	
	REV2	REV3	REV2	REV3	REV2	REV3
1980	34889	35124	29432	29550	+5458	+5574
1981	34917	35260	30334	30430	+4583	+4830
1982	37330	37837	34959	35115	+2372	+2722
1983	40174	40622	42437	42578	-2264	-1956
1984	46590	46972	50468	50594	-3878	-3622
1985	52271	52666	55273	55456	-3002	-2790
1986	54486	54927	59977	60233	-5491	-5307
1987	60841	61556	68093	68097	-7253	-6542



PAUL DAVIS
EA2 Division
35A/3 x5384

From : D L C Peretz
Date : 22 February 1988

2.989

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara

discussed HMT/Mr Scholar + Bank

INTERVENTION

We thought you might like a note marshalling some of the arguments that can be used for buying different foreign currencies to defend DM3, should that be necessary.

Arguments for intervening (any currency)

2. i) The January trade figures (to be published on 24 February) may not be good - to judge from the export figures. There is a strong "smoothing" case for preventing any rise in the £ before then, and for acquiring some ammunition.

ii) Since the end of December we have had an underlying fall of around $700m in the combined spot and forward reserves - representing net foreign currency payments for MOD and other departments financed by running down the forward book. There is a case for making good this reserve loss when we have an opportunity.

Arguments for buying dollars

iii) Since we stopped market intervention in mid-December we have successfully switched $200m of our $ portfolio into DM (the Bundesbank know about $175m of this); and $450m into yen.

iv) Over the past 2 months we should have been buying $s in the market to cover MOD's forward $ needs (for Trident etc), but have not done so. To make up this backlog and

other dollar payments for Government departments financed from the Reserves we should now buy around $100m in the market. Dollar payments for Trident will tend to rise in future (at present MOD buy only 18 months forward) and this would be an argument for buying further dollars in advance.

higher

Arguments for buying DM (for use with the Germans)

v) We have an agreement with the Bundesbank that we will buy DM forward, for the BAOR, regularly, in small amounts. In fact we have not done this over the last two months, and have a backlog of perhaps $600m worth of DM purchases to make up. However the understanding is that we will only do this with the Bundesbank's consent. The Bank think it unlikely that with the $ weaker the Bundesbank would actually agree to purchases in current circumstances of more than, say, $20m a day. If we did larger amounts it would, however, be a point to make after the event.

vi) It would presumably help with the Germans vis-a-vis the DM/$ rate if we bought equal quantities of DM and $s.

$, DM, FFr equally

vii) It would also help in relation to ERM concerns if we bought French francs as well - and this would be justified by the extra return we get on French francs, even if there is to be a small devaluation after the Presidential election. To be really helpful in the ERM, however, we would need to buy Belgian francs : the BFr is currently at the bottom of the narrow band ($1^3/_4$% below the Guilder) and the Belgians intervened themselves last Thursday, selling $100m of DM.

Buying ecu

viii) Buying ecu would be harder for the Germans to object to. Mechanically, we might have to buy DM or $s first and then quickly switch into ecu. The main difficulty is

that of acquiring ecu in sufficient volume. Obviously the more central bank intervention there is in ecu the easier this will become, and we are exploring with the French possible longer-term proposals in this area. But this will not help with the immediate problem.

Conclusion

3. The question is : if we have to intervene, what mixture of currencies should we go for. One possibility, which would fit reasonably well with a combination of the arguments above, would be :-

a) As many ecu as we can acquire (recognising that this may be a limited amount) and ? some Swiss francs and Yen.

b) The remainder divided roughly

- 50% dollars
- at least 25% DM
- up to 25% Ffr

parity. 1/3 1/3 1/3

1. Eddie needs instructions
1s: $½bn in $ (Far East & NY)
2. Switching out, short-term views
3. [illegible]

4. Our net dollar portfolio is now some $3/4bn less than before Christmas, because of payments made (iv) above) and the switch into DM and Yen (iii) above). So on this mix we could buy a total of at least $1½bn of currencies before we had built our net $ portfolio up again to where it stood in mid-December.

5. There could of course be an operational need to intervene to prevent the £ going through DM3 at very short notice. We were lucky this morning, but another piece of "good" news could easily trigger a speculative attack - particularly so as there is not much action elsewhere in the currency markets. So it would be helpful to be able to give the Bank guidance as soon as possible.

(½)

½ ½ ½

DLCP

D L C PERETZ

the department for Enterprise

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

The Rt Hon Norman Lamont MP
Financial Secretary
HM Treasury
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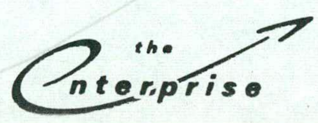
Our ref PS7ACE
Your ref
Date 22 February 1988

The MISC 133 secretariat, after consultation with departmental deregulators, have now drawn up a complete future work programme for the Group. We still have much to discuss; in order to fit all the agreed papers into the programme, an additional meeting has been scheduled for May. I hope that you are happy with this arrangement.

I am copying this letter to all members of the Group.



TIMETABLE OF DISCUSSION FOR FUTURE MEETINGS OF MISC 133

4th Meeting (24th February)

1. Impact of planning regulations on business (DoE)

2. Role of deregulation in consumer protection policy (DTI)

3. Impact of SSP and SMP on business (DHSS/DE)

4. Deregulation in DE

5. Deregulation in MAFF

5th Meeting (22 March)

1. Role of deregulation in health and safety at work (DE)

2. Streamlining the system of business licensing (EDU)

3. Interaction between EDU and DTI Market Divisions (EDU)

4. One Stop Shops: Progress Report (EDU)

5. Inland Revenue general

6th Meeting (26 April)

1. Effect of tax/benefit systems on enterprise (Tsy/DHSS)

2. Impact of the VAT system on business (Tsy)

3. Role of deregulation in environmental protection (DoE)

4. Deregulation in Customs and Excise

7th Meeting (Early May)

1. Interface between tax/NI arrangements. (Tsy/DHSS)

2. Industrial Training Boards (DE)

3. Regulations in food manufacturing and food safety (MAFF/DHSS)

4. Deregulation in the DHSS

5. Deregulation in DoE

8th Meeting (Late May)

1. Encouragement of self-employment and flexible working (DE/Tsy/DHSS)

2. Implementation costs of the Financial Services Act (DTI)

3. Changing the Culture: Progress Report (EDU/OMCS)

4. Deregulation in HO

9th Meeting (June)

White Paper

FROM: P MOUNTFIELD
DATE: 22 February 1988

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Anson
Mr Lankester
Mr Evans
Mr Cuplin
Mrs Case
Mr Walsh
Mr Segal
Miss Higgins

Ch
/ Content with suggested Press line?
JT 22/2

OK

THE WASS REPORT: 'FINANCING AFRICA'S RECOVERY'

This Report to the UN Secretary General will be published on Wednesday. It estimates Africa's financial needs at $5 bn a year - a much higher figure than any other recent forecast. It commends measures already taken (including your own debt initiative and ESAF) but says that much more is needed, including additional bilateral aid. The Report will attract some initial public attention, and then probably sink without trace. I suggest below, a possible Press line.

Background.

2. You will remember being consulted when the Secretary General first established this 'expert group' a year ago, following a resolution at UNGA 1986. You decided then not to make a British nomination, so that you could better distance yourself from the group's findings if necessary. Despite this, the Secretary General himself chose Sir Douglas Wass for the job. And, without in any way taking instructions from us, he has been punctilious in keeping us informed of progress. He has just sent me an advance copy of the report, which is to be released at 5.00pm GMT, on Wednesday. I attach the Press Notice, and the published summary: the rest of the Report is available if needed.

Contents

3. The main point of the report is its identification of a financing gap of $5 bn a year for Sub-Saharan Africa as a whole (including Nigeria). This is a much higher figure than has appeared in any previous analysis, but it claimed to be 'necessary simply to restore the prospects for development and growth as of the early 1980s'. The emphasis is on growth, and the whole Report is predicated on the adoption of adequate adjustment programmes. To that extent we could and should applaud it. It goes on to say that existing initiatives (including your own, which gets an honourable mention) 'should go a long way towards filling the gap we see'. But it ends up with an estimate of an additional $1 bn of bilateral and multilateral aid and $1 bn of additional debt relief. The former seems unrealistic in present circumstances; the second will happen 'by default' eventually if donors do not concede it now.

Handling.

4. The Report has been played long (I suspect deliberately) and will not specifically be debated in any early United Nations gathering. It will no doubt be used as background at the Spring Meetings, and perhaps at the OECD Ministerial, if it has not been forgotten by then. But it does not pose any immediate problems of political handling.

UK Attitude.

5. I think we can afford to be generous in general terms, welcoming the analysis, emphasising the elements it has in common with our own, gently questioning the size of the financial gap, and casting doubt on the realism of the estimates it contains. We could if necessary work something of this kind into your speech for the April meetings.

Immediate Press Line.

6. I suggest this should be limited to the following points:

a. Only just received; studying carefully.

b. UK was amongst the earliest to draw attention to the emerging problem of African debt. That was precisely why the Chancellor made his proposals last April. Since then we have also thrown our weight behind the ESAF, and the World Bank proposals for cofinancing.

c. At first sight, the group's estimate of the financing gap ($5 bn) seems much higher than anything publicly quoted before. UK certainly recognises the need, but doubts whether other creditors/donors will be prepared to contribute on the scale suggested. Our own programme is already heavily biased towards Africa.

e. Will now need to digest the Report thoroughly and discuss it with our partners. No early decisions expected.

7. May we proceed on these lines, please?

PM

P MOUNTFIELD

mjd 1/79A

SECRET

pup

FROM: A C S ALLAN
DATE: 23 February 1988

MISS O'MARA

cc PS/Economic Secretary
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Peretz
Mr R I G Allen
Ms Goodman

FEBRUARY RESERVES FIGURES

The Chancellor was grateful for your minute of 19 February. He feels we should aim to publish only a small net change, for instance something like the true underlying fall of $28 million. He sees no point at all in going to $200 million: the MOD forward purchases should be clearly be financed from the forward book.

A C S ALLAN

CONFIDENTIAL

pup.

FROM: A BOTTRILL
DATE: 23 FEBRUARY 1988

SIR P MIDDLETON

cc PPS
Sir T Burns
Mr Sedgwick
Mr Owen

JANUARY TRADE FIGURES

You will recall that you asked that a very full check should be completed on the January trade figures. The current state of play is:

(i) Document counts. Examination of export documents by DTI and Customs shows some bunching of exports in late-December followed by a fall in early January - but any distortion should have worked out within the January export month. No useful documentary evidence is available for imports, most of which are entered direct to the Customs computer.

(ii) Incorrect documents. DTI is unaware of any checks by Customs on the extent to which exports or imports may have been delayed at the ports in January as a result of shippers having incorrect documents. I have asked them to check with Customs.

(iii) Delays on the Continent. DTI is also unaware of any contacts between Customs and their EC counterparts about delays to the UK-bound shipments at continental ports. Again, I have asked them to check with Customs.

(iv) Processing delays. Customs apparently suffered some computer processing delays in early-January but these were all recovered by overtime working, and there are no January documents still waiting to be processed.

(v) Ferry workers' strike. This did not affect the January export or import figures but will affect February.

2. We are to meet DTI statisticians tomorrow to discuss the figures further. Customs representatives will also be present, and I will report any new information.

A Bottrill

A BOTTRILL

CONFIDENTIAL

FROM: J S HIBBERD
DATE: 23 FEBRUARY 1988

CHANCELLOR OF THE EXCHEQUER

cc : Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame A Mueller
Mr Byatt
Mr Scholar
Mr Monck
Mr Culpin
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr A Turnbull
Mr R I G Allen
Mr Bottrill
Mr S J Davies
Mr Melliss
Mr C Mowl
Mr Pickford
Mr Bush

Tony Diggle

NATIONAL INSTITUTE ECONOMIC REVIEW

The February National Institute Economic Review comes out at 9 pm on Wednesday, 24 February. It contains, among other things, the Institute's latest forecasts for the UK and world economies.

2. The main features of the new forecast are:

- **UK GDP growth** (output measure) of 4.7 per cent in 1987 (5.2 per cent non-oil) and 2.9 per cent in 1988 (3.3 per cent non-oil). The forecast for 1988 is higher than their November forecast of 2.4 per cent (2.8 per cent non-oil). However, the increase in growth stems mainly from the upward revision to activity in 1987. The Institute still forecasts a marked slowdown in growth through 1988. GDP is expected to rise by 1.8 per cent in the year to 1988Q4 compared to 1.5 per cent in the November forecast.

- **RPI inflation** at 4.5 per cent in 1988Q4.

fst
nier-nov87

- The **current account** in deficit by £4.2 billion in 1988, compared to £2.7 billion in 1987.

- A negative **PSBR** of £2 billion in 1987-88, and £2.6 billion in 1988-89, assuming, as the Institute did in November, tax cuts of £3 billion in the 1988 Budget.

- **World oil prices** rising to $18¾ per barrel by 1988Q4.

The Forecast in detail

3. **Consumer spending** is forecast to grow by 4.3 per cent in 1988. This is broadly in line with the growth in real personal disposable income (4.4 per cent), and the savings ratio is expected to average the same in 1988 as in 1987 (just over 6 per cent). **Total fixed investment** is forecast to rise by about 5 per cent. Within this total, growth in **private housing investment** is forecast to pick up to 9½ per cent, after an estimated 7¼ per cent in 1987. **Private business investment** is expected to grow at about the same rate as in 1987, ie 7 per cent. The National Institute forecast a 7 per cent increase in **manufacturing investment**. This outlook discounts the December DTI Investment Intentions Survey (conducted pre-stock market crash) which predicted an 11 per cent increase in manufacturing investment in 1988. It also discounts the optimistic outlook in the January CBI Survey. The Institute's forecast for **investment by distribution and service industries** is for a 6¼ per cent increase, close to the analogous DTI Investment Intentions Survey projection.

4. The Institute acknowledges a better than expected export performance last year, partly attributed to gains in competitiveness during 1986. Given the loss of competitiveness through 1987, export growth is not expected to be so strong this year. Nevertheless, the prospect for **manufactured exports** is better than their model alone would suggest. They are forecast to increase by 8 per cent in 1988. This is against the background of world trade growth of about 3½ per cent in 1988. (The Institute's world trade forecast looks on the low side. It seems to assume that the strong growth in trade in the second half of 1987 will slow abruptly in early 1988.) UK competitiveness is

expected to deteriorate gradually next year. The sterling index is assumed to fall back to 74-75 range by end-1988, from the high values at the beginning of 1988. **Manufactured import volumes** are expected to increase by almost 12 per cent in 1988.

5. The **current account** deficit is projected to widen from £2.7 billion in 1987 to about £4¼ billion in 1988. This deterioration is entirely accounted for by a worsening balance on visible trade.

6. There is a significant change in the National Institute's employment forecast compared to November. Then it predicted a fall of ½ per cent between 1987Q4 and 1988Q4. The latest forecast sees an increase of 1¼ per cent over the same period. UK **unemployment** is expected to fall steadily through this year, before stabilising at 2.3 million by end-1988.

7. On wages and earnings, the National Institute notes recent signs of increased demands from unions for a larger share of the gains from rising productivity and profitability. It also points to pressure for some public sector catch up on recent private sector earnings. **Earnings growth** is forecast 8 per cent in 1988. **Wholesale price** inflation is expected to turn out at about 4½ per cent by 1988Q4, and **consumer price** inflation at 5 per cent. **RPI inflation** is projected at 4½ per cent for 1988Q4. Rising kimport costs account for some of this increase.

Medium Term Prospects

8. The Institute offers four sets of medium term projections up to 1992. The **central case** is a continuation of the short term prospect, with tax cuts in line with assumed fiscal adjustments. In this case the economy decelerates sharply with growth averaging 1.2 per cent a year (1.5 per cent, excluding oil) over the period 1989-92. Consumer price inflation rises steadily to over 6½ per cent by 1992. The current account is in persistent and, the Institute say, unsustainable deficit of £6½ - 7½ billion. Unemployment stabilises at 2.2 million throughout the period.

9. The first variant on this central projection assumes no tax cuts in the 1988, nor in any subsequent, Budget. Growth averages ¾ per cent a year (1 per cent excluding oil). There is a negative PSBR, averaging 1 per cent of GDP, throughout the medium term. The current account remains in persistent deficit, though it declines to £3½ billion by 1992. The **second variant** is the same as the first, but imposes a 10 per cent devaluation in the second quarter of this year (in the context of full EMS membership and with no change in interest rates). The current account is worse in 1988 and 1989 (the J-curve effect), but is in virtual balance by 1992. Inflation picks up to 7 per cent in 1989 and stays there for the rest of the period. Growth slows down throughout the next four years, to virtually zero by 1992. The **third variant** is the same as the second, but achieves the required depreciation by a 2 point cut in interest rates. Growth is boosted in 1988 and 1989 (by increased consumer spending and investment), but slows down to zero by 1992. The current balance deteriorates to a deficit of £6-7 billion in 1988 and 1989. Thereafter the current account deficit declines slowly. The PSBR rises to £6 billion by 1992. There is no "better performance" variant.

The Institute's Appraisal

10. The Appraisal section normally attracts press attention. The Institute notes that an injection of demand now could cause overheating, with associated balance of payments difficulties and wage inflation pressures. They argue that it is the composition of demand growth, rather than growth itself, which is the main problem. The Institute suggests that public sector demand could increase faster, at the expense of private demand, with less danger of capacity constraints and balance of payments problems. Real interest rates are also seen as too high, and likely to lead to inadequate investment and research and development. The high exchange rate, as a counter inflation strategy, is described as only delaying inflation. It is likely to lead to wider current account deficits and a greater inflationary stimulus when the "dam bursts".

11. The Institute, thus, urge for no income tax cuts in the forthcoming Budget. They argue instead for devaluation, presumably engineered by lower interest rates, though they do not say so explicitly. This reflects their fear that the balance of payments is now the problem.

Other Articles

12. There are a number of other articles in the Review. A commentary on these is at Annex A.

Lines to take on the Forecast

Positive

(i) The National Institute project healthier growth in 1988 than they did in November. This reflects reappraisal of underlying strength of economy, and a series of upward revisions to growth and to forecasts that have proved too pessimistic.

(ii) Interesting to note, too, that Institute acknowledge better export performance than they expected.

(iii) Also welcome more optimistic outlook for employment and unemployment than in their November Review.

Defensive

(i) **Medium term prospects gloomy, with slow output growth and persistent current account deficits?** Medium term forecasting even more hazardous than short-term forecasting. The Institute, itself, in an article in the November 1987 Review (The British Economy Since 1979), notes how wrong their medium term projections, prepared in the early 1980s, turned out to be. There are no variants which take account of better performance in recent years than Institute expected.

(ii) **Composition of demand growth worrying - too much consumption, not enough investment and public sector spending. Risk of overheating.** Private business investment picked up in 1987. DTI Investment Intentions Survey (December) and January CBI Survey suggest buoyant outlook for manufacturing investment in 1988. National Institute seem to discount this, though not clear why. Investment by distribution and service sector also likely to grow in 1988. No serious signs of overheating.

Tim Hibberd

J S HIBBERD

TABLE 1:

COMPARISON OF NIESR AND FSBR FORECASTS

	NIER NOVEMBER FORECAST		AUTUMN STATEMENT FORECAST		JANUARY INTERNAL FORECAST	
	1987	1988	1987	1988	1987	1988
per cent changes on previous year						
Gross domestic product (output measure)	4.7	2.9	4	2½	5	3
Consumers' expenditure	4.9	4.3	5	4	5	4½
Total fixed investment	3.1	5.2	5½	4½	3½	6½
General government consumption	0.4	1.8	½	½	½	1½
Change in stockbuilding (contribution to GDP)	0.3	0.2	0	0	0	0
Exports of goods and services	6.3	4.2	5½	2	5½	3
Import of goods and services	7.9	7.6	6½	5	7	6½
Manufacturing output	5.6	3.8	5	3½	6	4½
World trade in manufactures	3.0	3.4	3½	3½	4½	4¾
RPI in Q4	4.1	4.5	4	4½	4	4½
Current account (£ billion)	- 2.7	- 4.2	- 2½	- 3½	- 2½	- 4½
PSBR (£ billion financial year)	- 2.0	- 2.6	1	1	- 3	- 3½

ANNEX A - OTHER ARTICLES IN NIESR FEBRUARY 1988

This annex comments on other articles that appear in the February Institute Review.

2. The first, by Prais and Wagner, **(Productivity and Management: the Training of Foremen in Britain and Germany)**, continues the series of comparisons of aspects of productivity in Britain and Germany. Previous articles have revealed that production workers in Germany are generally more highly skilled than in the UK. This article additionally finds that:

(i) Germany produces seven times as many formally qualified foremen (meisters)as the UK;

(ii) courses for German meisters take three times as many hours to complete as their UK equivalents, and cover a wider range of subjects including occupationally specific topics;

(iii) German meisters are more likely than UK foremen to possess a technical or craft qualification (indeed they are necessary to get on a meister training course).

Prais and Wagner argue that the better qualified German meisters reinforce the contribution that the more highly skilled German production workers make to higher productivity in Germany. They manage a greater number of operatives, carry out more routine maintenance tasks to keep more sophisticated production lines running, and take responsibility for work scheduling.

3. Prais and Wagner make the point that relatively compressed earnings differentials in the UK provide less incentive for British workers to attain foreman status. In Germany, where differentials are wider, training is normally undertaken in employee's time at evening class with the fees generally met by the government. In the UK training is generally in the employer's time (with no deduction from

the employee's pay) on day or block release, with the employer paying part of the fees and the MSC the rest. This may well result in the underprovision of training in the UK, where the employer cannot be sure of getting a return to his investment if the employee moves job. Prais and Wagner urge unions and employers to accept a widening of differentials in the UK to provide incentives to individuals to undertake training. They also argue for greater national support of appropriate evening classes. They do not, however, address the problem of how best to proceed if such a widening is difficult to attain. Nor do they address how best to apportion the burden of training costs between public and private funds.

4. An article by Andrew Blake and Martin Weale **(Exchange Rate Targets and Wage Formation)**, derives policy rules for the determination of interest rates, exchange market intervention, and fiscal policy; and uses the National Institute model to investigate how money GDP growth might have been steadily reduced over the period 1975 to 1984 using these rules. Two sets of results are presented:

(a) with wages determined by the wage equation on the National Institute model (adjusted to give an immediate full impact of price inflation on wages);

(b) with "reformed" wages, ie with wages assumed to respond much more quickly to labour market conditions than they have historically done.

The fiscal policy instruments used on this exercise were the VAT rate and the rate of National Insurance contributions.

5. In case (a), fiscal policy is set in an apparently perverse way: fiscal policy is actually eased in response to higher inflation, in order to get the benefit of the direct effect of tax changes on the price level (and hence on wage settlements). With fiscal policy set in this way, great reliance has to be placed on tight monetary policy in order to achieve reductions in the rate of growth of money GDP. The counterfactual history of the economy in this case shows results in some respects similar to what actually happened. In particular, the exchange rate rises in 1980 to a level close to that actually experienced at the time, in order to get the economy back on track

after the inflationary shocks experienced in 1979. One interesting difference is very much higher interest rates and massive foreign exchange intervention in 1976 in response to the pressure on sterling at the time.

6. Under case (b) the fiscal policy rule is no longer perverse, and with fiscal policy being tightened in response to inflationary pressure there is much less weight placed on monetary policy to bring down growth in money GDP. There is no longer the same need for high interest rates and a high exchange rate, following the inflationary shock of 1979. This case shows much lower exchange rate throughout, with unemployment by 1984 only about half of the level actually experienced. Thus the article makes a familiar point about the relation between pay and jobs in a rather unfamiliar way.

7. A third article by Professor A J Brown **(World Depression and the Price Level)**, studies the behaviour of the price level in industrial countries over the course of the trade cycle. The data cover a period of over one hundred years. Measured either by unemployment, or by the fall of total output below its estimated trend, the 1980-82 recession is judged to be the deepest of this whole period except for the great depression of the early 1930s. Yet, whereas prices and wages declined during previous world recessions, during the last recession they continued to rise. This is interpreted as evidence of an increasing inflexibility of both wages and prices in industrial countries.

8. Finally, an article by Anderson and Desai **(Modelling Manufacturing Imports)** presents preliminary results from a technical econometric investigation of UK demand for manufactured imports. Further work is to be done. But some interesting results have emerged, most notably on the different marginal propensities to import associated with various components of demand. They are summarised in the table below:

	Change in imports per £100 million change in demand £m
Consumers non-durable expenditure	22
Consumers' durables expenditure	30
Gross investment	20
General Government consumption	24
Exports (excluding N oil and gas)	27

FROM: **MRS M HENSON**
DATE: 24 February 1988

1 Andrew
2 pmp

CHANCELLOR'S OFFICE	12/2
CST OFFICE	36/2
FST OFFICE	43A/2
EST OFFICE	52/2
SIR P MIDDLETON	78A/2
MR CULPIN	90/1
MR PICKFORD	97/2
MR P SEDGWICK	39/3
MR J ODLING-SMEE	45/2
MR R I G ALLEN	93/2
MISS SINCLAIR	89/1
MISS O'MARA	109/G
MR S BROOKS	43/3
MR A HUDSON	13/2
MS C EVANS	44/1
MR PATTERSON	98/2
MISS SIMPSON	99/2
MR H BUSH	95/2
MR J CARR	112/G
MS S WALKER	97/3
MR MILLS	42/3
MR N HOLGATE	110/G
MR CURWEN	98/2
MR S PRICE	41/3
MR BUCKLEY	90/2
MS HATTER	112/2
MR CROPPER	17/2
MR TYRIE	15A/2
MR M CALL	117/2
THE DUTY CLERK	10 DOWNING STREET
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MR D H ROBINSON	DEPT OF FINANCE AND PERSONNEL ECONOMICS DIVISION RM 249A STORMONT BELFAST 3S15
MR P MAKEHAM	DTI Rm 601c 1-19 VICTORIA STREET LONDON SW1
MR T BIRD	RM 536A, DHSS, NEW COURT, CAREY STREET, LONDON SE1
MR N BAXTER	DEPT. OF EMPLOYMENT EPA1 LEVEL 5 CAXTON HOUSE TOTHILL STREET LONDON SW1

RELEASE DATES FOR ECONOMIC STATISTICS IN MARCH

I attach the release dates for economic statistics in March.

2. Any enquiries please contact Mrs Henson on 270-5212, 99/2 HM Treasury.

Meena Henson
MEENA HENSON

RELEASE DATES OF ECONOMIC STATISTICS IN MARCH 1988

WEEKS 1 & 2

Day	Date	Time	Release
Wednesday	2	11.30	UK official reserves (Feb)
Friday	4	11.30	Housing starts and Completions (Jan)
Monday	7	11.30	Retail Sales (Jan-final)
"		"	Credit business (Jan)
Wednesday	9	21.00	Employment Gazette
Thursday	10	11.30	CBI/FT Survey of distributive trades (Feb)
Friday	11	11.30	Construction output (4th qtr)
"		"	UK Balance of Payments (4th qtr)

RELEASE DATES OF ECONOMIC STATISTICS IN MARCH 1988

WEEKS 4 & 5

Day	Date	Time	Release
Monday	21	11.30	Manufactures' and distributors' stocks (4th qtr-rev)
Tuesday	22	11.30	Cyclical indicators for the UK economy (Feb)
Wednesday	23	11.30	Construction - new orders (Jan-prov)
Thursday	24	11.30	Personal income and expenditure (4th qtr)
"		"	Industrial and Commercial Companies (4th qtr)
Friday	25	11.30	Balance of Payments Current account and overseas trade figures (Feb)
"		"	Tax and Price index (Feb)
"		"	Retail price index (Feb)
Monday	28	00.30	CBI Monthly Trends Enquiry (March)
Tuesday	29	11.30	UK banks' assets and liabilities and the money stock (Feb)

RELEASE DATES OF ECONOMIC STATISTICS IN MARCH 1988

WEEK 3

Day	Date	Time	Release
Monday	14	11.30	Retail Sales (Feb-prov)
"		"	Producer price index numbers (Feb-prov)
Tuesday	15	11.30	Index of output of the Production industries (Jan)
Wednesday	16	11.30	Public Sector borrowing requirement (Feb)
Thursday	17	11.30	Capital expenditure by the manufacturing and service industries (4th qtr-rev)
"		"	Labour market statistics: unemployment and vacancies (Feb-prov); average earnings indices (Jan-prov); employment, hours, productivity and unit wage costs; industrial disputes
Friday	18	11.30	Building Societies monthly figures (Feb)
"		"	Gross domestic product (4th qtr-prov)
"		"	Provisional estimates of monetary aggregates (Feb)

Mrs M Henson
HM Treasury
1 Parliament Street
London SW1P 3AG
01-270-5212

Leland B. Yeager
Draft, 6 Feb. 1988
For CATO, 25 Feb. 1988

DOMESTIC STABILITY vs. EXCHANGE-RATE STABILITY

Purchasing Powers and Exchange Rates

In accepting the title assigned for this paper, I do not mean to agree that the two stabilities _necessarily_ conflict. Often, to be sure, they do. Countries that clung to the fixed gold parities of their currencies in the early 1930s, including France and other members of the European gold bloc until 1936, suffered worse contagion of the world depression than if they had let their currencies depreciate. Other countries mitigated the contagion by accepting relatively early depreciation, as Great Britain and the Sterling Area countries did in 1931 and as Spain did around the same time.

Experience with the Bretton Woods system of fixed exchange rates after World War II provides many examples of countries suffering imported inflation in consequence of attempts to maintain fixed rates despite bullish speculation on their currencies. The upward floats of the German mark in September 1969 and May 1971, of the Swiss franc in January 1973, and of the Singapore dollar in June 1973, to mention just a few cases, were attempts, belated attempts, to ward off the further import of inflation. The worldwide spurt of monetary inflation in the early 1970s, followed in due course by accelerated price inflation, traces largely to attempts to keep dozens of currencies from rising against the U.S. dollar. This last-ditch defense of the Bretton Woods system finally collapsed early in 1973. The world economy would have fared better in the 1970s and afterwards

(I could so argue) if policymakers had voluntarily abandoned the Bretton Woods system years earlier, before the worst damage had been done.

None of this is to say that floating exchange rates guarantee domestic monetary stability. A floating rate can soften the domestic impact of monetary instability originating abroad, but no economist known to me ever argued that floating rates would provide insulation against all foreign disturbances. None ever argued that they would make sound monetary institutions and policies unnecessary. My own chief argument for abandoning the Bretton Woods system was that doing so would largely relieve national monetary authorities--or the more responsible among them--of balance-of-payments problems and other international complications and allow them to concentrate more nearly fully on achieving stability for their own countries. I did not hail the collapse of Bretton Woods when it actually occurred, for I regretted the particular way it came about and recognized that it represented no intellectual conversion on the part of policymakers.

Neither exchange-rate stability nor purchasing-power stability guarantees the other (for example, a domestically stable currency would fluctuate against unstable foreign currencies). The two stabilities could be compatible, however: rates could be fairly stable among currencies of dependably stable purchasing powers.

Volatile and Misaligned Exchange Rates

Today's world exhibits both types of <u>in</u>stability. It is most conspicuous in exchange rates. Bilateral rates have fluctuated 10 and 20 percent over weeks and months and sometimes several percent from day to day or even within days. Over hours, days, months, and perhaps even years, gross capital transactions--transactions to reshuffle asset portfolios, including speculative transactions--have far overshadowed trade in goods and services. The <u>daily</u> volume of

foreign-exchange trading in the United States, Britain, and Japan alone is estimated to total nearly $200 billion (WSJ, 28 Dec. 1987, p. 24).

One apparent source of rate volatility is "noise" (cf. Black 1986). High-technology communications and data-processing bring facts and figures and rumors to the attention of traders more frequently and in more discrete bits than in the past, causing frequent shifts in noise-oriented trading decisions. The special role of the U.S. dollar as the predominant transactions, vehicle, reserve, and intervention currency places it in a particularly conspicuous and vulnerable position. Participants in sensitive markets must eagerly watch each day's economic and political news and must not only form their own interpretations but must also wonder what other people's interpretations are likely to be. No wonder quasispeculative capital movements, and exchange rates in consequence, are as volatile as they are.

Official market intervention, though ideally smoothing exchange-rate movements, contributes to the noise. It is an unsettled issue whether intervention, together with news and rumors of its being started, altered, or suspended, has made exchange rates more or less volatile on the whole than they otherwise would have been. (My 1976, chapter 14, discusses how intervention might increase volatility and surveys episodes in which it apparently did.) For several years I have been collecting stories from the Wall Street Journal and other financial publications purporting to explain hour-to-hour, day-to-day, and week-to-week jumps in exchange rates. Remarkably often the stories point to changes in intervention and to rumors and supposed clues about it, including statements and offhand remarks of government officials. I wonder how the foreign-exchange market would have behaved without such disturbances.

Floating rates have exhibited not only short-run volatility but also medium-run misalignments, resulting--critics plausibly allege--in distorted patterns of trade and production and in wasteful shifts of resources between domestic industries and export and import-competing industries. Only in a tautological, pollyannistic sense can one say that the exchange rate of the dollar has been "right" all along, even at its trough of mid-1980, its peak of early 1985, and its current depressed level.

Superficial Advice

It is superficial to conclude that we should have kept exchange rates fixed fifteen years ago and that we should fix them again now. Prodigious efforts to keep them fixed simply collapsed. But if those efforts had somehow prevailed a while longer, what even more immense foreign-exchange crises would have destroyed the system in the face of the even more unstable "fundamentals" of the 1970s and 1980s, including the oil situation and swollen national budget deficits! (One can plausibly argue, however, that even OPEC's predation was largely triggered by worldwide inflation tracing, in turn, to last-ditch defense of the Bretton Woods system.) More recently, even efforts to peg exchange rates loosely within fuzzy and unannounced ranges--the Louvre accord of February 1987--collapsed later that year. What is the point of saying that something should have been done or should now be done if in fact it could not and cannot be done?

It is superficial to argue against floating exchange rates by deploring the apparent consequences first of the strengthening and then of the weakening of the U.S. dollar in the 1980s. A legitimate comparison between floating and fixed exchange rates must refer to otherwise similar circumstances--if, indeed, circumstances could have been kept otherwise similar. It is illegitimate to compare actual

experience with a situation lacking the circumstances (such as those of the U.S. government budget) that made the dollar swing as widely as it in fact did. If we want to consider how things would have worked out with the dollar prevented from rising to its peak of early 1985, for example, we must specify how its appreciation would have been prevented. Monetary expansion acccomplished either by unsterilized exchange-market intervention or by Federal Reserve policy would have inflated prices of domestic goods relative to prices of internationally traded goods--would have lowered the latter prices relatively--and so would have have affected resource allocation and the country's trade balance in a way similar to what in fact occurred. Preventing dollar-strengthening capital inflows, conceivably by direct controls, would have relieved domestic producers of internationally traded goods from some adversity; but it would have allowed interest rates to rise and government deficit spending to crowd out some interest-sensitive investment activity, including housing. (See, in part, Gradison 1986 and Frankel 1985).

Where Lies the Absurdity?

It seems absurd to let so pervasively influential a price as a country's exchange rate jump around in response to investors' and speculators' changeable whims about their asset-holdings. It seems absurd that changes in and expectations and rumors about monetary and fiscal policies, trade policies, and market interventions should be allowed to exert such quick, magnified, and pervasive effects. But we should be clear about just <u>what</u> is absurd. It is not the free flexibility of exchange rates (they are not <u>freely</u> flexible anyway). It is not the free-market determination of prices on the exchange markets.

The absurdity consists, rather, in what those prices are the prices *of*. They are the prices of national fiat moneys expressed in each other, each lacking any defined value. The purchasing power of each national money depends on confrontation between a restricted quantity of it and the demand for holdings of it. At bottom, the unit of account in the United States is whatever value supply and demand fleetingly accord to a scruffy piece of paper, the dollar bill. The value of each money thus depends on conjectures about the good intentions of the government issuing it and about its ability to carry through on its good intentions. These conjectures are subject to sharp change, quite understandably.

It is an absurd system in which people cannot count on money's future purchasing power. Money's value simply emerges as the by-product of the monetary authorities' doing whatever seems best to them month by month and day by day. It is an absurd system in which the Federal Reserve gets badgered daily with diverse unsolicited advice in *Business Week* and the *Wall Street Journal* by such people as Alan Blinder, Paul Craig Roberts, Irving Kristol, Milton Friedman, and miscellaneous editorial writers.

Given this fundamental absurdity, it is irrelevant to propose mere changes in the details of how governments manipulate exchange rates. (The proposal for "target zones", it seems to me, is hardly more than a superficially attractive combination of words, words calling for all of the advantages and none of the disadvantages of both floating and fixed exchange rates.)

A fundamental solution would give defined values to currencies. A meaningful definition of a currency's value must consist of something more than a specified rate of exchange against one or more foreign currencies, each of which continues to lack a defined value. The most familiar and plausible kind of meaningful definition would

Commodity Money

Should gold be the single defining commodity? I agree with those who say that the world should never have gone off the gold standard, which means that the nations should never have blundered into World War I. I fervently wish we could repeal World War I and all its many evil consequences, but I don't see how. Restoring the special historical circumstances under which the gold standard appeared to flourish (but only for a very few decades) would have to include restoring certain attitudes that seemed more prevalent in public affairs before 1914 than now. Those attitudes favored limitations on government activity and restraint on seeking special advantage through the instrumentality of government. Without a return to liberal attitudes and self-restraints, a restored gold standard would not work well and would hardly endure. After all, the gold standard is simply a particular set of rules for monetary institutions and policy; and these rules are no more inherently self-enforcing than any other set of monetary rules. Even today, before we have gone back to a supposed gold standard, there is reason to suspect that what some of its supporters are advocating is not a real but a pseudo gold standard, to echo a distinction made by Milton Friedman (1961).

The durability of a particular set of monetary rules will depend in large part on its performance characteristics, and those of the gold standard are far from ideal. (I waive discussing the difficulties of a _transition_ back to gold; uncoordinated steps by individual countries would surely work badly.) A unit of account defined as the value of a quantity of a single commodity like gold is preposterous in the same general way as, though perhaps in lesser degree than, a unit coinciding with a unit of a fiat medium of exchange like the dollar bill. Like fiat money, gold has an unstable

value in relation to other goods and services. The stock of gold is historically given and cannot rapidly accommodate changes in demand. The demand for it, under a gold standard, arises primarily from its use as coins and, especially, as a reserve and redemption medium for other forms of money; it is largely a monetary demand rather than a purely industrial or consumption demand. That demand shifts with changes in money-holding and reserve-holding practices, with the availability of near-moneys, and with other financial innovations.

The value of gold-based money is thus conventional or artificial only in lesser degree than the value of fiat money. The effective size of a gold-defined unit of value, like that of the fiat dollar bill, is defined poorly and is maintained only precariously. It is changeable in a way just not true of other units, like the meter or kilogram.

When, furthermore, the supply-and-demand situation calls for a change in the value of the money unit (that is, in the general price level) and if the supply of money is not cleverly manipulated to accommodate the demand for it, then monetary disequilibrium persists, bringing macroeconomic pains (Yeager 1986). In particular, prices and wages are not and cannot be flexible enough in the downward direction quickly to correct an excess of the demand for money holdings over their supply. And even if they were flexible enough, the associated rise in the real value of outstanding debts would cause trouble. A catch-22 plagues a system exposed to emergence of excess demand for or excess supply of money: it is damned both if prices <u>are</u> flexible enough and if they are <u>not</u> flexible enough to correct monetary imbalance quickly.

Money of Stable Purchasing Power

These considerations recommend seeking a system that would maintain balance between the demand for and supply of money at a

stable general price level. The old issue of money of stable purchasing power is ripe for reconsideration. A tentative judgment in its favor would have to be thrown out if no satisfactory way of <u>implementing</u> it turns out to be available. Before considering implementation, though, I want to review arguments for and against regarding a stable unit as an ideal.

Money whose value is under no pressure either to rise or fall is money whose actual quantity is in balance with the quantity demanded. By that very token, the economy employing it escapes the pains of monetary disequilibrium. Why monetary disequilibrium can be so painful and its avoidance so important hinges on certain distinctive characteristics of money, notably that it, among all goods, lacks a market of its own and a single price of it own on which the pressures of supply-demand imbalance can come to a focus and work effectively to maintain or restore equilibrium. The importance of this point is far out of line with how briefly it can be stated. (Admittedly, statement is not explanation; again, see my 1986).

A more familiar line of argument for stable money--which can be challenged, as I recognize below--draws analogies between the unit of account and units of weights and measures. A seriously unstable unit impairs the meeting of minds between borrowers and lenders and other transactors. Economic calculation and the coordination of economic activities are at stake; for the unit of account is used pervasively in proposing the terms of transactions, in assessing costs and benefits, and in business and personal planning. Imagine the difficulty of constructing and equipping a house if the foot varied capriciously in size. The absurdity of unstable money is like

letting the length of the meter fluctuate according to supply and demand in the market for meter sticks. A stable unit, in contrast, provides a sound basis for economic calculation and contracting.

Objections to the Goal of Price-Level Stability

One objection to seeking a stable unit of account rejects the analogy between such a unit and units of weight and length and other physical magnitudes. The kilogram and meter are widely applicable across time and space, and any redefinitions made are mere refinements (e.g., definitions of the meter as one ten-millionth of the distance between the equator and the north pole, then as 1,650,763.73 wavelengths of the radiation of krypton 86, and currently as 1/299,792,458 of the distance that light travels in one second). The definition of a unit of value in terms of a price index or basket of commodities, however, must concern itself with the quality characteristics of each commodity, the terms of its delivery satisfying the rules of specified commodity exchanges, and other such technicalities. If changes in supply and demand conditions affecting commodities in the bundle defining the unit of value should require respecification of that bundle, it might be more difficult to keep the new and old values exactly equal at the time of redefinition than in the case of redefinition of the meter. The definition of the unit of value has a subjective aspect, furthermore, that is absent in the definition of physical units.

All this may be true, but it amounts to mere quibbles. Of course analogies between physical units and a value unit are just that, analogies, and not exact correspondences. So what? People do regard the unit of account--the money unit, under our existing system --as the unit for measuring values. They so use it every day. They so use it in trying to quantify prospective costs and benefits of purchases and sales and other activities and in forming and carrying

out plans. Its use plays a vital role in coordinating the activities of different persons. People do not care about the dollar size or gold-unit size of a particular price, income, debt, or accounting magnitude except as it indicates value in relation to a much wider set of goods and services. A unit of greatly variable purchasing power subverts people's calculations and degrades the information supposedly conveyed by prices and accounting. If we take seriously the burgeoning literature on various subtle damages wrought by inflation, we should appreciate the importance of a stable unit.

Admittedly, the choice of a particular price index or bundle of goods and services for defining the unit is bound to be somewhat arbitrary, but we should not exaggerate the difficulty. What sorts of goods and services to consider, and even criteria for weighting them, should command a broad consensus. A real distinction holds between unmistakable change in the value of money as shown by <u>any</u> reasonable indicator and, on the other hand, genuine doubt about any trend in its purchasing power as some prices hold steady, others rise, and still others fall under pressures specific to their own markets. Maintenance of such doubt would count as achievement of a stable unit and would reflect avoidance of any severe monetary disequilibrium.

Another objection to maintaining a stable unit is the argument against price-fixing. Prices, even including the value of the money unit, should be determined on free markets rather than determined by authority. Freely flexible prices and wages have functions to perform. (Anderson 1929 loosely alludes to such an argument, as do Rothbard and Garrison in their separate articles in Rockwell 1985.) Yes, but this is properly an argument for free-market determination of individual prices and wages, not against appropriate specification of the unit of account. Adopting a stable unit would aid, not

impair, the working of markets. (I sympathize with advocates of the gold standard when they are criticized for supposedly advocating price-fixing. The critics should recognize the difference between fixing some ordinary price and adopting a quantity of gold as the unit of account. Consider an analogy: offering a specific definition of a unit of length, the meter, is not properly open to criticism of the sort that would be justified against governmental decrees about the length of trouser legs and the dimensions of rooms in houses. Instead of being criticized for recommending a defined monetary unit, gold-standard advocates might better be criticized for the particular definition they recommend.)

Still another line of argument insists that cheapening of real costs of production through the rise of productivity ought to show up in declining prices (and conversely for a deterioration in productivity). David Davidson expounded such arguments with the aid of examples. A policy of stabilizing the price level would deprive a creditor of any share of the gains from a general rise in productivity, while someone who had borrowed for productive purposes would unfairly keep the entire gain for himself. Or consider two owners of farm land, only one of whom had leveraged his holding by debt. A general rise in the output of land would tend to depress the prices of its products and so not unambiguously press the money value of the land itself either up or down. A monetary policy of stabilizing the product price level, however, would raise the land's money value; and the leveraging landowner would gain differentially, which also seemed unfair to Davidson. Presumably money should be stabilized, if at all, in terms not of products but of labor and other factors of production. (Davidson 1906. Davidson and Knut Wicksell debated such issues over many years in the pages of

Ekonomisk Tidskrift. I have not yet had access to the issues after 1908; but Uhr, 1960/1962, pp. 270-305, summarizes the debate.)

Admittedly, one may think up cases and propound ethical judgments according to which the holder of a nominal claim should share, through a change in the price level, in the gain or loss caused by a rise or fall in productivity. It is hard to see, however, how detailed conditions, varying from case to case, can be taken into account by monetary institutions and policy. It is unreasonable to burden the monetary system with the task of preserving justice between debtors and creditors and between other groups of the population in the face of multifarious changes in productivity and other conditions. No single institution can do that.

A monetary system should do what it can reasonably be expected to do, and other institutions should undertake tasks more suitable for them. Savers need not restrict themselves to buying interest-bearing securities of fixed nominal value; they can diversify. They can try to take account of prospective changes in productivity by investing in equities. Likewise, would-be borrowers need not borrow only in nominal terms; they can sell stock or obtain loans with equity participations. A sound monetary system with a stable money unit can help provide such opportunities by facilitating the development of financial intermediation. In and by itself, a monetary system cannot solve all sorts of problems.

George Selgin (in personal correspondence) supposes the technological cheapening of some particular good whose price figures significantly in the general price level. As a matter of arithmetic, the price level then falls (unless monetary institutions or policy resist this spontaneous tendency). The cheapened good is not and has not been in excess supply, for its producers have cut its price.

painlessly, in line with its reduced cost. The technological advance presumably raises the output of the affected good or of other goods into whose production factors have been released. Thus the real volume of transactions to be lubricated increases, and so does the associated demand for real cash balances. That increased demand is more or less accommodated automatically, however, through money's rise in purchasing power over the cheapened good. The arithmetical decline of prices on average must not be seen as evidence of monetary disequilibrium being corrected, perhaps sluggishly. Monetary expansion to resist this price decline would have "injection effects", probably including the distortion of interest rates, and so would itself be a source of disturbance to market equilibrium.

Such effects were apparently the reason why F. A. Hayek, in early publications, was skeptical about price-level stabilization. Keeping prices constant following an increase in productivity requires banks to expand money and credit by lowering their interest rates. The loan rate that might keep prices from falling is likely to initiate a cumulative and unhealthy investment boom, and the increase in the loan rate that might stop it is likely to reverse it into a downturn, which would require an interest-rate cut before the downturn gains momentum. Hence, an interest-rate policy to stabilize the price level would entail rises and falls around the original or normal level of prices. These oscillations might spawn a growing collection of unfinished and abandoned capital processes, and the waste involved might even overshadow the initial rise in productivity. (Hayek 1931/1935/1967, Lecture IV; see also the discussion by Uhr 1960/1962, p. 283.)

Such arguments seem to take it for granted that pursuing a money unit of stable general purchasing power means manipulating the quantity of a fiat money, or of what would be a fiat money except

c[illegible]y for the price-level rule. Whether this supposition about how the policy would be implemented is necessarily valid will be examined later in this paper.

Of course a particular good affected by a technological advance tends to fall in price relative to other goods and services and so to fall in price as expressed in a unit of stable general purchasing power. If the index or bundle defining the pricing unit happens to include the affected good, then its price still falls. (It is legitimate to use the terms "price index" and "bundle" almost interchangeably here, for a price index involves a bundle whose total price is being compared over time.) The individual prices of the bundle's other components rise, however, in such a way that the price of the bundle as a whole remains unchanged. This is a straightforward implication of how the unit is specified. The appropriateness of such a specification is what is at issue.

What are the alternatives? Defining the unit as an amount of some single commodity exposes the whole range of goods and services to price inflation if that commodity, say gold under the gold standard, happens to be the one affected by technological advance. That possibility is one of the reasons for defining the unit by a broad bundle in which no single commodity carries a heavy weight.

In reality, all sorts of micro changes are continually occurring, raising the real or relative prices of some goods and lowering those of others. In such a context, it is hard to see what kind of monetary environment is preferable to the one provided by a unit of stable general purchasing power. Selgin's counterexample, like those of Davidson mentioned earlier, seems tacitly to presuppose a fiat money managed in some ideally clever way so as best to suit each particular constellation of circumstances as it arises and is perfectly and instantly diagnosed. But such an instruction to the

monetary authorities cannot be operational. It would provide a poor basis for the orientation of expectations and for confident calculations by market participants.

Sometimes it is said that while influences on the price level coming from the side of money should be avoided, influences from the side of goods should be allowed their full natural scope. General changes in productivity, as distinguished from changes affecting only a particular good, enter into this argument. A gentle downtrend in prices would be the natural consequence of generally rising productivity.

I wonder whether such ideas do not rest on some underlying money illusion, some unarticulated belief that money has a value of its own, a value in a profoundly true sense, distinct from its purchasing power as mirrored in the price level. (Davidson 1906 and Anderson 1917/1922, especially p. 57, did try to distinguish, though not in a way intelligible to me, between the value of money and its purchasing power, the reciprocal of the price level.) On such a notion, situations may arise in which money remains stable in value while goods in general are becoming dearer or cheaper in real terms, and both their individual prices and their average price level should be allowed to reflect these real changes.

Well, rising productivity cheapens some goods relative to others (notably, consumer goods relative to human effort), but it can hardly cheapen goods and services in general relative to goods and services in general. It seems reasonable to expect each good's price to express its value relative to others, which is what pricing in a unit of stable general purchasing power does. The money-side/goods-side distinction does not bear much weight, for growth over time in the physical quantities of goods and services to be traded operates as much on the money side as on the goods side. It leads people to

raise their demands for holdings of money, which exerts a deflationary effect, unless the supply of nominal money is somehow made to keep pace with the growing demand for it.

Money in Adversity

Something more needs to be said about the case of an adverse supply shock, one like or worse than the international oil shock of 1973-74. Prices directly affected rise, and keeping the average level steady means pressing other prices down. Because many of those other prices exhibit downward stickiness, the necessary deflationary process will depress production and employment as well. Far from indicating an excess supply of money, the initial price rise shrinks the money supply in real terms, and a contraction of the nominal money supply in addition would aggravate the deflationary damage to the economy.

Considerations like these have led Robert Hall to recommend a quasiautomatic policy aiming at a stable price level only as a long-run target, while tolerating strictly temporary deviations from the target level. (See Hall 1986 and my comment that follows there.)

If a major calamity or a great war should require distributing the adversity or burden widely throughout the population, an inflationary tax on cash balances and on nominal incomes can hardly be ruled out a priori as one of the means to be employed. (Apparently Wicksell, toward the end of his life, modified his call for price-level stabilization to allow for some such cases of extreme scarcity of goods; see Uhr 1960/1962, pp. 300-305.)

A country's monetary institutions, like its other institutions, cannot be constructed with guaranteed robustness in the face of external calamities. Institutions should serve the relatively normal conditions in which they have a good chance of surviving and flourishing. It can even be argued that stable money provides a

better basis for government borrowing and money issue in rareemergencies than money that commanded little confidence in the first place. (One argument made by advocates of the gold standard in Russia during discussions in the late nineteenth century about reforming the country's floating paper currency was that a gold standard would provide a sound starting point, a standard to go off of, in some future war.)

Implementation

Some objections to the goal of money of stable purchasing power are really objections to more or less tacitly assumed methods of implementing the policy. Critics (e.g. Anderson 1929) often assume that efforts to stabilize the price level would work only through money and credit manipulation by the Federal Reserve. "Austrian" economists worry about "injection effects" or "Cantillon effects" of expanding the money supply to keep the price level from sagging in a technologically advancing and otherwise growing economy. New money impinges first at particular points in the economy, where it distorts the price signals that guide resource allocation. In particular--so goes one familiar story--injection of new money is likely to lower interest rates below the real, natural, or equilibrium rate and so lead business investors to embark on capital-construction projects that will eventually turn out to have been unwise. This is supposedly what happened in the United States in the 1920s: although monetary expansion was not extreme enough to cause actual price inflation, it prevented what would otherwise have been a healthy decline in prices; and through interest-rate distortions in particular, it set the economy up for the great depression that followed (Rothbard 1975).

Three things, it seems to me, are unsatisfactory about this line of objection. First, it relies on a dubious business-cycle theory (Yeager 1986, pp. 378-382). Secondly, it does not demonstrate the quantitative importance of the effects alluded to, nor does it demonstrate the harm done by fairly steady mild monetary expansion even if that expansion did serve as a marginally significant way of making the savings of the economy available for investment purposes. Third, it unwarrantedly presupposes that new money is put into the economy in particular ways that lower interest rates and skew resources into business investment.

If inserting new money in the assumed channels did have real and quantitatively important effects of the asserted kind, those particular channels might be avoided. For example, newly created money could serve as a supplement to government tax revenues, perhaps ideally to finance tax reductions.

Prominent arguments against price-level stabilization center around lags. Lags are likely to occur between incipient monetary disequilibriums and their reflection in the price index on which the central bank may be targeting. Lags occur between index movements and the adoption and impact of corrective policy actions. By the time these actions take effect, they may no longer be appropriate. Thus, attempts to heed a price-index rule might turn out more destabilizing than stabilizing.

This difficulty would presumably bedevil a policy of large, sharp changes, not a steady policy. Policymakers might further circumvent the problem of lags by watching sensitive commodity prices, growth rates of monetary aggregates, industrial production, and possibly even interest rates and exchange rates and other early indicators of monetary disequilibrium pressing on the target price level and by promtply countering such pressure. The rule imposed on

the monetary authorities should insist that any such early indicators of disequilibrium serve that purpose only and not be erected into goals rivaling the price-level target. Perhaps, too, the salaries of the money managers might be calculated so as to penalize departures from the target level of the specified price index.

Their instructions might be reinforced by saddling the monetary authorities with an obligation to <u>do</u> something at the initiative of private parties. They might be required to maintain two-way convertibility between dollars and whatever quantity of gold would command a physically specified basket of goods and services. This (changeable) quantity would be calculated, perhaps every day, from the actual market prices of gold and of the specified goods and services. The system would be a commodity-basket standard rather than a gold standard; and something other than gold, perhaps specified securities, might more conveniently serve as the redemption medium. (This suggestion is inspired by but is not the same as Irving Fisher's 1920 proposal for a "compensated dollar".) Even more so than a gold standard, this system would deprive the monetary authorities of any substantial discretion. It would seem to circumvent the problem of lags. It would also circumvent the supposed problem of injection effects; for instead of being injected and withdrawn through the loan market, money would be injected and withdrawn at numerous points in the economy almost automatically as arbitrageurs acted to profit by, and thus nip in the bud, discrepancies between money's actual and defined values.

Standard worries about lags envision a central bank managing a fiat money with its ordinary policy weapons, notably open-market operations. The supposed problems of lags and injection effects and, perhaps more important, the danger of governmental abuse of money might better be overcome by the more radical reform of privatization.

Having been abolished, government money could no longer serve as unit of account.

The government might designate a new unit and promote its general voluntary adoption by using it in its own accounting, taxation, contracting, wage payments, and other operations. The new unit would be defined as the total value of a bundle of suitably chosen goods and services. If the standard bundle were rather comprehensive, the general level of prices expressed in the unit so defined would be approximately stable. Thus endowed practically by definition with a stable purchasing power, the unit of account would no longer fluctuate capriciously according to changing demand for and supply of the medium of exchange.

The issue of notes and checkable deposits would be left to private banks (which might well also offer checking privileges against equity mutual funds). The quantity of these media of exchange would accommodate itself to the demand for them at the price level corresponding to the definition of the unit of account; imbalances, showing up in incipient movements of the price level and in the spread between interest rates on deposits and on banks' earning assets, would trigger corrective arbitrage. This automatic maintenance of equilibrium between demand for and supply of media of exchange at a stable price level would prevent price inflation and major recessions.

It is unlikely that the privately issued notes and deposits would be directly redeemable in the actual goods and services defining the unit of account, for that practice would be too awkward for all concerned. Instead, their issuers, disciplined by competitive pressures, would stand ready to redeem them in convenient redemption property (gold or, more probably, agreed securities) in amounts having the same total value in bundle-defined units of

account, at actual market prices of the day or hour, as the denominations of the notes and deposits to be redeemed. Most redemptions would probably take place at clearinghouses, where banks acquiring notes issued by or checks drawn on other banks would routinely present them them for settlement against their own obligations presented by others. Net balances at the clearinghouse would be settled by transfers of the agreed redemption medium. The necessary calculations and operations would be carried out every business day by professionals, and the ordinary person would no more need to understand what determined the purchasing power of the unit of account than he needs to understand what determines the purchasing power of the dollar nowadays. (The proposed system is described in Greenfield and Yeager 1983. Further published and unpublished articles provide clarifications and answer objections. The present paper hardly offers scope to make a convincing case for the system. It can only emphasize that alternatives are available which circumvent several of the most prominent objections to seeking <u>government</u> money of stable purchasing power.)

Conclusion

Situations can arise in which exchange-rate stability and domestic monetary stability are incompatible objectives. Then, it seems to me, the case is persuasive for giving priority to domestic stability. Domestic and exchange-rate <u>in</u>stability can easily go together, as current experience all too clearly shows. The current volatility of exchange rates is hardly puzzling, given the undefined character of the national monetary units among which the foreign-exchange market determines relative prices. A reform must occur first and fundamentally on the national level. Achieving stable money along private-enterprise lines is eminently feasible as a matter of economics. Although such a reform is outside the range of

immediate political feasibility, that fact should not discourage our considering it. The force of ideas can eventually change what is politically feasible. By providing a sharp contrast with our existing unsatisfactory system, furthermore, far-out reform ideas can help us perceive and evaluate existing features that we might otherwise take so much for granted as not even to recognize them.

As long as national currencies remain distinct fiat units, absurd units whose management comes under the shifting influences of government irresponsibility and political pressures, there just are no such things as long-run or medium-run or "fundamental" equilibrium exchange rates between them. Actual rates necessarily are short-run market-clearing rates pushed around by fleeting pressures. Barring reform of the currencies themselves, attempts to manipulate exchange rates will do more harm than good. The misalignments and volatility we observe nowadays may be disillusioning, yet nothing is clearly preferable to letting exchange rates continue to float until we undertake fundamental monetary reform.

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TRADE AND INVESTMENT PERFORMANCE UNDER FLOATING EXCHANGE RATES: THE U.S. EXPERIENCE

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ABSTRACT

Trade and Investment Performance Under Floating Exchange Rates: The U.S. Experience

Contrary to the arguments of several scholars, we have failed to find either a conclusive theoretical case or clear empirical evidence of an effect, harmful or otherwise, of exchange-rate variability (as measured by either short-term volatility or long-run misalignment) on overall levels of international trade. In this paper, after reviewing the theories and evidence on this issue, we go on to consider the impact of exchange-rate variability on direct foreign investment. We summarize and amplify upon the scant theoretical literature of this issue, and proceed to test U.S. data for the presense of such an impact. We find none.

1. Introduction

Since the move to a managed floating exchange rate system in 1973, world financial markets have been characterized by large movements in nominal exchange rates. These movements have been accompanied by large swings in real exchange rates, reflecting the fact that nominal exchange rate variations have not closely followed changes in relative prices of traded goods. The short-run variability of exchange rates--whether measured in real or nominal terms, bilateral or effective terms--has been substantially higher in the post-1973 period than it was under the Bretton Woods system (Frenkel and Goldstein, 1986). Further, exchange rate variations have been much greater than the early advocates of floating had expected. For example, in an influential article, Harry Johnson (1969, pp. 19-20) argued that the allegation that a flexible rate system would result in unstable rates ignored "the crucial point that a rate that is free to move under influences of changes in demand and supply is not forced to move erratically, but instead will move only in response to such changes in demand and supply...and normally will move only slowly and predictably." 1/

This paper assesses the causes of exchange rate variability and examines its consequences for trade and investment. Following Williamson (1985), we distinguish between two concepts of variability--(i) short-term volatility and (ii) longer-term misalignment. Volatility involves short-term (monthly, weekly, or even hourly) fluctuations in exchange rates as measured, say, by their absolute percentage changes during a particular period. In contrast, misalignment is a subjective concept and as such difficult to quantify. Misalignment has been

defined as a departure over a substantial period of time of the exchange rate from its "fundamental equilibrium value" (i.e., the exchange rate that yields a cyclically adjusted current account balance equal to normal private capital flows--those capital flows which exist in the absence of undue restrictions on trade and special incentives to incoming or outgoing capital) (Williamson, 1985; Crockett and Goldstein, 1987). For example, the value of the U.S. dollar in 1984 and early 1985 was considered by many commentators to be considerably higher than justified by the fundamentals; hence, the value of the dollar was perceived by these commentators as bound to come down. The problem with getting a grip on misalignment is, as Crockett and Goldstein (1987) have observed, the difficulty entailed in measuring such concepts as a "substantial" period of time, the "cyclically adjusted" current accont balance, "normal" private capital flows, "undue" restrictions on trade, and "special incentives" on capital flows.

The remainder of this paper is divided into four sections. In the next section we discuss the main explanations of exchange rate behavior provided in the recent literature, for if exchange rate variability has been in some sense "excessive," it must have been unpredicted by theories of exchange rate determination, or at least inconsistent with the stylized explanations posited by those theories. Section 3 provides a conceptual discussion of the possible costs of exchange rate variability and misalignment. These main costs are usually associated with allocation effects on trade and investment. We argue that, theoretically, the costs of exchange rate variability on trade and investment are ambiguous. Section 4 presents empirical results of the

effects of exchange rate variability on trade and direct investment in the U.S. economy. Our results do not support the hypothesis that exchange rate variations (defined in terms of either short-term volatility and longer-term misalignment) have hampered trade and investment in the U.S. economy. Concluding comments are contained in Section 5.

2. Explanations of exchange rate behavior

Why have exchange rates moved so much and why for such long periods of time? In what follows, we review six explanations of exchange rate behavior. Before doing so, however, several observations are in order.

The first pertains to the characterization of the present international exchange rate regime. At the outset, we described the current system as one of managed floating--not one of freely floating currencies. This is because most countries (almost all of them developing countries) adhere to pegged exchange rate arrangements while a number of countries (including the eight members of the European Monetary System) follow limited flexibility vis-à-vis a single currency or group of currencies. 2/ Further, even among the floating currency countries, exchange rates have not been permitted to float cleanly, as evidenced by recent efforts to talk the U.S. dollar up or down (sometimes within the same day), informal agreements among the Big Five (the Plaza Agreement, the Louvre Accord), and large interventions by central banks. Indeed, intervention strategies have differed among countries and over time, ranging from free floating, to short-term smoothing, to heavy intervention aimed at achieving a targeted rate.

The second observation is that the world operating environment since 1973 has differed substantially from the period characterizing the Bretton Woods period. As Shafer and Loopeska (1983) argue, floating rates should not be blamed for the slowdown in world growth and trade which accompanied the move to managed floating. Specifically, they note that the rapid growth of the economies of Europe and Japan in the 1950s and 1960s was, in part, a catching up after World War II and was unlikely to be sustained; that the floating rate period inherited international disequilibrium and inflation; and that the world economy suffered two oil price shocks during the floating rate period. Also, the post-1973 period has been characterized by developments that contributed to exchange rate variability. These include the technological advances in communications that provide fast, high-volume linkages among world financial markets, enabling events in any one market to have an almost instantaneous impact on other markets. This rapid advance in communications technology has not surprisingly been accompanied by a relaxation of controls on capital movements.

Finally, as Frenkel and Goldstein (1986) note, exchange rates are financial asset prices and, therefore are flexile and forward looking--unlike many goods prices which are sticky and backward looking (reflecting previous contractural agreements). 3/ Volatility is to be expected in an auction market such as the exchange market under floating rates simply because of continuous surprises. Nordhaus (1978, p. 250) made this point explicitly: "In those pure auction markets where prices are the main shock absorber, considerable price volatility is the result. These conditions generally prevail in raw foods and commodities

markets, in markets for many financial instruments such as common stocks, or when a regime of pure floating exchange rates exists. Such volatility is an intrinsic feature of real world auction markets--markets in which there are incessant surprises due to weather, changes in taste, inventions, political upheaval, inflation, recession, and boom, etc." Indeed, Harberler (1986, p. v) argues that it is the ability of flexible exchange rates to absorb shocks which has eased quantity and price adjustments in goods and labor markets. Further, Obstfeld (1985) argues that it is doubtful whether the fixed exchange rate system would have survived the changed world environment since 1973 without the imposition of controls on capital movements and restrictions on trade.

The auction market characteristic is important, but it certainly does not account fully for the magnitude of exchange rate movements. In order to understand why instability may be an inherent characteristic of flexible rates, we turn to a brief overview of theories of exchange rate behavior.

A useful starting point for considering theories of exchange rate determination is the portfolio balance model. 4/ The model is built around the determinants of net outside supplies of stocks of assets denominated in different currencies and the demands for them. Individuals are assumed to allocate their wealth, which has a given total value at each moment, among alternative assets, including, most generally, domestic and foreign money and domestic and foreign securities. Assets denominated in different currencies are viewed by investors as perfect substitutes--i.e., uncovered interest rate parity

holds. Thus, if one country has a higher expected monetary growth rate and consequently a higher expected inflation rate, assets denominated in its currency will carry an interest-rate differential that is equal to the expected depreciation in its exchange rate. Expectations play a key role in the determination of equilibrium. Another component of the portfolio model is that goods of different countries are essentially perfect substitutes and there are virtually no barriers to instantaneous (price) adjustment in goods markets. The assumptions with respect to both asset prices and goods prices will be relaxed below.

a. Rational speculative bubbles

By treating exchange rates as financial asset prices, the portfolio approach draws attention to the substantial influence of expectations. A number of writers, including Mussa (1976), Frenkel and Mussa (1980) and Dornbusch (1980) have argued that the exchange rate market, as any asset market, is efficient; a market is considered to be efficient when prices reflect all available information, including expectations about economic policies. Consequently, the behavior of exchange rates is affected in an important way by new information that is continuously being processed by economic agents. Short-term fluctuations in exchange rates, according to the efficient markets view, are to be expected if the forces which lie behind exchange market equilibrium are themselves subject to substantial short-term fluctuation. As Mussa (1976, p. 203) has stated, "under a floating exchange rate regime, private agents must continuously revise their expectations of the future behavior of money supplies and other relevant variables in forming their expectations about the appropriate level of the nominal exchange rate." Continuous

revisions in expectations make for continually changing exchange rates. Indeed, if exchange rate variations were exclusively determined by new and unanticipated information, the exchange rate would follow a random walk--today's exchange rate would be the best predictor of expected future exchange rates.

Note that if expectations are continuously revised in the same direction for a substantial period of time--for example if expectations of interest rates are modified repeatedly in the direction of higher and higher rates, reflecting an expected progressive tightening of monetary policy--the efficient markets view gives rise to what is referred to as rational speculative bubbles. Consequently, the efficient markets framework can account for both short-term volatility in exchange rates and longer-term movements, although the latter do not imply deviation from any fundamental equilibrium value.

b. Irrational speculative bubbles

The efficient markets view assumes that private agents process all information in a rational manner. Therefore, the market equilibrium exchange rate reflects the underlying economic fundamentals. By contrast, the irrational speculative bubbles story views economic agents as myopic. McKinnon (1976) had argued that exchange rate instability might be caused by an inadequate supply of private capital available for taking net positions in either the forward or spot markets on the basis of long-term exchange rate expectations. Thus, as Artus and Young (1979, p. 678) observed, the McKinnon hypothesis indicates that "cyclical variations in the demand for foreign exchange originating from trade or financial activities that may be sustained for a number of

years may lead to large exchange rate movements because of a lack of investors with both the funds and the willingness to take a longer-run open position."

Krugman (1985) has recently applied the McKinnon hypothesis to the context of the "high" value of the U.S. dollar of late 1984 and early 1985. According to Krugman, "the case for a [speculative bubble]...is in fact the argument that there is insufficient speculation" (1985, p. 106; original italics). Krugman's argument runs as follows. The large U.S. trade deficits of the mid-1980s had produced a situation where the dollar was unsustainably high. The dollar was bound to fall in value, but investors' expectations were irrational. Had these expectations been rational, recognizing that the fact that the dollar needed (on the basis of long-run fundamentals) to come down, the expected future depreciation of the dollar would have inhibited the holding of dollar-denominated assets, thereby putting downward pressure on the value of the dollar. Instead, market participants paid "more attention to the higher [relative] yield on dollar securities than to the forces which [would] eventually weaken the dollar. Thus, the dollar [was] high because investors [paid] too little attention to the prospect of future exchange rate changes, not too much" (Krugman, 1985, p. 106). The market had reached a consensus that the dollar would come down slowly. If the long-term fundamentals pointed to the need for a rapidly falling dollar, then the market had overreacted to the then-existing interest differential due to a lack of forward-looking speculation, producing an irrational speculative bubble. Krugman used this argument to predict correctly that "the dollar must at some point

plunge" (1985, p. 107). 5/ Assuredly Krugman's expectations proved to be more accurate than the representative market expectation; we are not sure, however, that this fact establishes that speculation was either irrational or insufficient.

c. Overshooting: the case of sticky prices

Overshooting, can occur in any portfolio model in which some markets do not adjust instantaneously. For example, Branson (1976), Dornbusch (1976) and Kouri (1976) have focused on the slow speed of price adjustment in the goods market to explain exchange rate instability; this reflects the view that goods prices are backward looking in the short to medium term while exchange rates are flexible and forward looking. The sticky price argument runs as follows: An unanticipated change in the nominal money supply produces an increase in the real quantity of money because prices do not adjust promptly. As a result, real interest rates fall, leading to an incipient capital outflow and a depreciation in the real exchange rate which is proportionately more than the change in money (Dornbusch, 1986, p. 213). With lower real interest rates, the demand for goods picks up. In parallel, real exchange depreciation causes a substitution from foreign goods in favor of home country goods in both the domestic and export markets. Over time, as goods prices increase, the real money supply will contract and the real exchange rate will appreciate until real equilibrium is regained.

As Frankel (1986) has argued, if the market is foresighted, it anticipates that the expansion in demand will set prices in motion above their previously expected path. Assuming rational expectations, the

anticipation of further exchange rate appreciation must be sufficient to offset the interest rate differential between domestic and foreign rates, so that opportunities for profits do not exist by holding either domestic or foreign assets. The fact that following the monetary innovation the exchange rate fell below the level that was expected in the long run, accounts for the exchange rate overshooting.

d. <u>Overshooting: the case of asset accumulation</u>

Now assume flexible goods prices but relax the assumption of perfect substitutability between domestic and foreign assets. Consequently, the variable that is not free to adjust instantaneously is the level of domestic claims on foreign assets. Next assume, for purposes of illustration, an expansionary domestic fiscal policy leading to cumulative current account imbalances. In the context of the Mundell-Fleming framework, the fiscal expansion results in a rise in domestic interest rates, an excess supply of foreign assets and an appreciation of the currency. Frankel (1986) and Dornbusch (1987) have shown that the accumulated net external indebtedness that accompanies the current account deficits will decrease the level of domestic claims on foreign assets eventually undoing their initial excess supply and with it the appreciation of the domestic currency, but the currency will not just fall back to its original value since the current account deficits result in reduced income from net foreign assets. As Dornbusch (1987, p. 7) has argued: "The reduction in net external assets means that following a period of deficits, the current account cannot be

balanced simply by returning to the initial real exchange rate. Now there will be a deficit from the increased debt service. Therefore, to restore current account balance, an overdepreciation is required."

Both of the overshooting hypotheses are able to account for exchange rate variability and long-term movements in rates. Short-term variability arises because both hypotheses emphasize the role of news. For example, as Artus and Young (1979, p. 679) observe with respect to the current account story: "Market participants--continually reassess their views of the needed exchange rate change on the basis of actual current balance developments without always being able to discount properly the effects of temporary divergences in economic cycles, J-curve effects of exchange rate changes, and so forth." Moreover, the fact that the overshooting hypotheses are able to explain short-term and long-term movements in the exchange rate should not be taken to imply that the exchange rate deviates in any way from its equilibrium value (a la Williamson (1985)). Levich (1985, p. 1018) makes this point explicitly: "[The] definition of overshooting draws a distinction between short-run and long-run equilibria while retaining the notion that the exchange rate is priced fairly at all times, a perfect reflection of all information."

e. The safe-haven hypothesis

Dooley and Isard (1987) extend the portfolio balance model, focusing on international portfolio shifts. In particular, the safe haven approach "departs from other portfolio balance models of exchange rates by shifting attention away from the financial characteristics of assets....Instead, the approach emphasizes that variations over time in

the prospective income streams on physical capital in different countries can generate changes in observed holdings of claims to those income streams, giving rise to desired net international capital flows and associated changes in relative prices and exchange rates" (Dooley and Isard, 1987, p. 71). Consequently, the exchange rate is determined in such a manner as to give rise to a current account deficit equal to the rate at which foreigners wish to acquire claims on the domestic country. As such, the approach stresses the "safe-haven phenomenon" whereby the strength of the U.S. dollar in the first half of the 1980s is ascribed to the perceived relative strengthening of the U.S. economic and political situation. The transmission of such perceptions included a shift of bank lending from less developed countries to the U.S. capital market and increased direct investment in the United States. One important implication of the safe-haven hypothesis is that the choice between a fixed or flexible exchange rate regime may not have a very significant influence, ceteris paribus, on the variability of the real terms of international competition, as characterized by the relative prices of tradable goods and the real balance of trade" (Dooley and Isard, 1987, p. 79).

f. Demand shifts and other influences

Stockman (1987a, 1987b) provides a thorough, textbook-like review of explanations of exchange rate movements, summarizing most of the foregoing approaches and adding other detailed cases. His analysis includes shifts of demand in each country for internationally traded goods, and other real shifts, but does not include irrational bubbles. He concentrates solely on shifts of fundamentals like those in the

previous three cases just considered. The result adds to the richness and complexity of the issues we are considering, and calls into question any approach that considers only one or two influences on exchange rates.

Stockman develops an equilibrium model of the determination of exchange rates and prices of goods. 6/ Changes in relative prices of goods, due to supply or demand shifts, induce changes in exchange rates and deviations from purchasing power parity. According to Stockman (1987a, p. 12), "repeated disturbances to supplies or demands...thereby create a correlation between changes in real and nominal exchange rates. This correlation is consistent with equilibrium in the economy, in the sense that markets clear through price adjustments."

A number of important policy inferences can be drawn from the equilibrium model of exchange rates. For purposes of this paper, the relevant inferences are that changes in exchange rates do not cause changes in relative prices but are themselves dependent variables driven by fundamentals, i.e., by exogenous variables. Further, the issue of whether exchange rate variability has detrimental effects on the economy--either through its effects on trade or investment--is not the relevant question "because the exchange rate is an *endogenous* variable. The right question is whether the underlying disturbances to the economy are 'good' or 'bad,' so (of course) the answer lies with the disturbance" (Stockman, 1987a, p. 17, original italics). We would add that if "fundamentals" refer to consumer preferences, comparative advantage, other supply conditions, and comparative rates of inflation among different trading partners, then the associated changes in

exchange rates are efficient, i.e., they increase world output. Whether these changes affect trade and investment (as they sometimes would) is less interesting than whether other changes in exchange rates affect trade and investment.

3. Effects of exchange rate variability

In the light of the discussion in the preceding section of the causes of exchange rate volatility, we would prefer, so far as possible, to divide changes of exchange rates into the part due to fundamentals and the part due to other factors, i.e. to misguided speculation. Ideally we would like to represent each such influence accurately by a right-hand-side variable in a regression; these variables would be exogenous, while exchange rates, trade, and investment would be a subset of the jointly determined (endogenous) variables of a comprehensive model. The regression, in that case, would be one of the reduced form equations, with, say, direct investment as the dependent variable. Besides the difficulty in trying to specify and measure the relevant exogenous variables, however, we are faced with the impossible task of finding a measure of the speculative influence. Consequently we need a proxy for it, and the only proxy available is exchange rate variation not explained by the exogenous variables that represent fundamentals. Although this residual variability is not the fundamental cause of whatever effects we might observe in trade and investment, it can be viewed as the proximate cause, in its role as a proxy for misguided speculation. We can then address the question of what happens if governments adopt policies that stabilize exchange rates around the equilibrium rates determined by fundamentals. Would trade increase, and

would international investment be larger or better allocated as a result? This approach has two clear advantages. First is the practical consideration just mentioned--that we can measure exchange-rate variability whereas we cannot measure the amount of misguided speculation. Second, if all of the variability not explained by specified exogneous variables is due to irrational speculative bubbles or to other such causes, it is not clear that this variability should be considered exogenous; there would be no prima facie reason to suppose that treating it as exogenous would bias the analysis. Of course, not all the fundamentals can be measured, so that some bias may result from our approach; but we see no alternative.

In a recent paper with Ulan (Bailey, Tavlas, and Ulan, 1987), we reviewed many of the arguments for and against the proposition that short-term exchange rate volatility reduces trade because of the risks and costs it involves. 7/ The argument that it does hamper trade is simple and almost self-evident: because contracts to sell goods, movement of the goods themselves, and payments for them rarely all coincide, there will be an element of exchange risk in foreign trade. This risk is equivalent to a cost to a risk-averse trader; and the trader will sometimes bear an actual cost to avoid it. Although this cost may be small for short-term transactions (because transactions costs are low for foreign exchange), the bid-ask spread widens with volatility; also, forward exchange markets exist for only about a year or so into the future. Being like transportation cost, in that it affects trade in both directions, it will tend to reduce a country's exports and its imports.

However, the arguments are not all on one side. For example, exporters may gain knowledge through trade that would help them anticipate future exchange rate movements better than can the average participant in the foreign exchange market. If so, the profitability of this knowledge could offset the risk of exchange rate volatility. If they wish to hedge longer-term investment or other transactions, rather than use the forward exchange market, they can borrow and lend in local currency to offset their other commitments. For example, a plant in a foreign country can be financed mainly with local capital, so that the investor limits his exchange risk in the basic investment. An additional counter-argument, of especially great weight, is that we have to specify the alternative to volatility. If the volatility is due to fundamental factors influencing the exchange rate, intervention by the authorities to reduce it would be unsustainable and eventually disruptive. To achieve a reduction of apparent, observed volatility, they would have to intervene with exchange controls or other restrictions on trade and payments. That could be more harmful to trade, and reduce it more, than would unrestrained movement of the exchange rate.

Furthermore, volatility of a single exchange rate is a poor measure of the risk of trade with the country involved, due to portfolio considerations. In general, a firm will be involved in trade with several countries, and so will have a mixed portfolio of foreign claims and obligations. What additional exposure in one country adds to the risk of the portfolio depends both on the variability of the direct bilateral exchange rate and on its correlation with other exchange

rates. Hence, the effect of exchange rate volatility on trade cannot be determined a priori, but is an empirical question.

If the effect of exchange rate volatility on trade is uncertain, the effect on investment flows is even more so. (In fact, we have found very little systematic published or unpublished discussion of this effect.) Besides not being sure whether exchange rate volatility reduces trade, if it does we cannot be sure whether this effect would tend to increase or reduce international direct investment. A reduction in trade might mean more concentration on the home market by exporting firms, or it might mean that multinationals dispersed their production more completely into overseas markets and exported less from their major production plants in the home country. The first of these two cases would mean less international investment, presumably, whereas the second would mean more. This uncertainty augments the uncertainty due to the ambiguous effect of exchange rate volatility on trade.

This point came out clearly in a recent paper by Cushman (1985), the one empirical article dealing with direct investment as a function of exchange rate volatility that we were able to find. Cushman notes that actual trade is more complex than simple models would suggest. Although a firm may export a good whose inputs consist exclusively of domestic goods and services, its trade may also involve intermediate goods in various ways. The effect of exchange rate volatility, or other factors, on the location of economic activity (i.e., on the location of value added) can therefore be complicated, and that complicates the analysis of investment flows. This consideration gives further scope for the effect to run in either direction.

Cushman's analysis emphasized, as did ours (1987, op. cit.), that a businessman or portfolio investor will balance risk against expected profit when he plans a transaction. Suppose, as Williamson (1985) suggests, that floating exchange rates result in significant "misalignments"--real exchange rates pushed out of line by temporary capital movements. Potential direct investors across national boundaries may share this view. Those who feel able to anticipate future changes of misaligned exchange rates will take this expectation into account in calculating expected and risk-adjusted rates of return (see Frankel, 1986). If the profit expectation were uncorrelated with the risk, the effect of risk itself would be predictable for each transaction, taken separately. However, the Williamson argument is that misalignments are more frequent and more serious when exchange rates, freely floating, are volatile than when they are not. If so, risk will be postively correlated with expected profits for many transactions, so that the net effect is indeterminate until one has the specific numbers and the degree of risk aversion.

These points help highlight the central importance of the notion of misalignment to the analysis. If all variability of exchange rates were due to variation in the fundamentals, such as independent, unpredictable changes in monetary and fiscal policy in different countries, exchange rates would approximate a random walk. Without misalignment, there would be few opportunities for profitable anticipation, by traders or direct investors, of future exchange rate changes. Although some firms or households may believe that they can foresee shifts in such fundamentals, only in a few exceptional cases would the ability to do so

be related to a firm's volume of foreign trade or investment. (Also, it would be harder to argue, as a rule, that the effects on trade and resource allocation, if any, of this type of exchange rate variability was harmful and distortive.)

Because it appears that "variability" has implicitly been almost synonymous with misalignment in much of the previous conceptual work on this issue, we have based our discussion on misalignment and on short-term volatility. With that approach, exchange rate variability can affect trade in either direction. Its effect on direct investment is still more uncertain, inasmuch as it could go in either direction even if the effect of variability were to reduce trade. With the consequences of both short-term volatility and misalignment on trade and investment conceptually uncertain, we turn to some empirical results concerning the effects of these two measures of exchange rate movements on trade and investment in the case of the U.S.

4. Exchange rate movements and U.S. export and investment performance

In recent years, a number of empirical studies dealing with the post-1973 period have been produced that examine the issue of whether short-term exchange rate volatility hampers trade. Only one study has investigated the relationship between volatility and investment. To our knowledge, not a single empirical study has examined the effects of misalignment, per se, on either trade or investment.

Most recent empirical studies have supported the proposition that short-term volatility does indeed impede trade (Cushman (1983); Akhtar and Hilton (1984); Kenen and Rodrik (1986); Maskus (1986); Thursby and

Thursby (1987); and De Grauwe and de Bellefroid (1987)). The coverage of these studies has been impressive. They have encompassed both total and bilateral trade flows, differences in sampling data (i.e., time series and pooled time series cross-sectional), bilateral and trade-weighted measures of exchange rates, real and nominal exchange rates, and a range of industrial countries. Studies which have rejected the hypothesis that volatility has adversely impacted on trade include the IMF (1984), Gotur (1985), and several papers with which we have been associated--Bailey, Tavlas, and Ulan (1986); Aschheim, Bailey, and Tavlas (1987); and Bailey, Tavlas, and Ulan (1987).

In the most comprehensive of our studies--Bailey, Tavlas, and Ulan (1987)--we tested for the impact of exchange rate volatility on real exports of 11 OECD countries, using for most countries two measures of volatility for both real and nominal exchange rates. 8/ In all, over the managed floating period we presented 33 regression equations. In addition to exchange rate volatility, the factors which were posited to affect exports of these countries were real GDP in partner industrial countries, real export earnings of oil producing countries, and relative prices (defined as the ratio of the dollar-denominated export unit values of each country relative to the dollar-denominated export unit values for the IMF's "industrial country" aggregate). Of the 33 regressions estimated, only 3 showed a significant and negative impact of volatility on exports. These 3 regressions each involved real volatility. So perhaps real volatility is the culprit. Considering

only those equations with real exchange rate volatility variables, that still left only 3 instances out of 16 in which exchange rate volatility negatively and significantly affected real exports.

Despite the diversity of empirical results, some generalizations can be drawn from the current status of empirical work. First, most studies (including our work) that find a significant effect for volatility on trade find it only for real exchange rate volatility. But as our aforementioned results indicate, even in the case of real volatility the evidence is anything but overwhelming. Second, of the studies that do find a negative effect of exchange rate volatility on trade, most do so using bilateral trade data (e.g., Cushman (1983); Akhtar and Hilton (1984); Maskus (1986); and Thursby and Thursby (1987)). Thus it may be that volatility affects the pattern of trade, but not its overall level. Regarding the aggregate trade studies that find a negative impact of volatility on trade, Kenen and Rodrik (1986) examine the effects of exchange rate volatility on imports--not exports. Still, in only 4 of the 11 countries examined did the results show a negative and significant impact. On the other hand, De Grauwe and de Bellefroid (1987) find less ambiguous effects of volatility on exports. However, their study does not include a relative price term. In their words: "The reader may wonder why no relative price (or competitiveness) variables appear in the equation. The reason is that we concentrate here on the determinants of the long-run growth rates of trade....Over very long periods...these relative price effects are likely to have disappeared" (De Grauwe and de Bellefroid, 1987, p. 195). The theoretical motivation behind this argument escapes us.

At the very least, the effect of relative prices should have been empirically tested. By failing to do so, it is likely that the results obtained by De Grauwe and de Bellefroid comingled the effects of relative prices with exchange rate volatility, obtaining an exaggerated or spurious impact for the latter.

The final generalization to be drawn from empirical work is that the primary determinants of trade are real output in trading partner countries and the terms of trade. In this context, equations (1a), (1b), and (1c) in Appendix Table 1 provide estimates on the determinants of U.S. export volumes over the managed floating rate period. 9/ Equation (1a) shows that some 93 percent of the variance of real exports from the United States is explained by real output in other industrial countries, real export earnings of oil exporting nations (a proxy for their ability to buy other nations' exports), and relative export prices between the United States and its industrial country trading partners adjusted for exchange rate changes. (Thus, relative prices reflect real exchange rates in terms of traded goods.) 10/ Equation (1b) adds the volatility of the real effective exchange rate to the previous specification. While the coefficient is negative, it is insignificant and does not change the coefficients of the other variables. Because the relative price term is adjusted for exchange rate changes, it may be that the relative price term is biasing the volatility coefficient toward zero. Accordingly, in equation (1c) we drop the relative price term while retaining the volatility term. The coefficient on the latter

variable remains insignificant; meanwhile, the significance of the coefficients on the other remaining variables declines while serial correlation increases, suggesting misspecification problem.

If short-term volatility of the exchange rate has not adversely affected U.S. exports over the managed floating period, what about exchange rate misalignment, defined as the difference between the real effective exchange rate (REER) and the real "fundamental equilibrium" exchange rate (FEER)? As Frenkel and Goldstein (1986) have noted, there is an assortment of problems associated with measuring an equilibrium exchange rate; any such measure is bound to be only an approximate one. Undaunted by the difficulties, Williamson (1986) provides estimates of the FEER and the REER over the period 1976:1 through 1984:4. We have updated Williamson's estimates of these two series based on data contained in Williamson (1986). The effects of deviations from the equilibrium exchange rate (i.e., REER minus FEER) are provided in equations (1d) through (1f). Equation (1d) is merely the specification in (1a), but estimated over the now shorter estimation period. Equation (1e) adds the misalignment series; the misalignment variable is insignificant and has a positive coefficient. Finally, equation (1f) drops the relative price term while retaining the misalignment variable. The latter remains insignificant; meanwhile the properties of the equation (coefficients on other variables, serial correlation) deteriorate, again suggesting that misspecification results from dropping relative prices.

As noted, with the exception of Cushman (1985), empirical work dealing with the determinants of direct investment in the U.S. economy

in recent years is nonexistent. 11/ Indeed, Cushman's paper dealt with bilateral direct investment outflows from the United States to five countries over the period 1963 through 1978; thus his data were drawn largely from the managed rate period. In what follows, we present results on the determinants of aggregate direct investment inflows into the United States over the quarterly interval, 1976:1 through 1986:1 (see the notes to Table 2 for the reason why we began with 1976:1), testing for the effects of short-term exchange rate volatility and long-term misalignment on real direct investment inflows.

We use a stock adjustment model to estimate the determinants of real direct investment--manipulation of the stock adjustment model results in a lagged dependent variable as one determinant of direct investment. In addition, we posit that direct investment is determined by the expected performance of the U.S. economy--proxied by "anticipated" real GDP in the United States--by real relative export prices (the same variable which was used in the equations for export volumes), by the real interest rate differential between long-term rates in the United States and those in the main trading partners of the United States, and by an oil shock term, aimed at capturing the effects of the oil price hike of the late 1970s. More detailed explanations of the variables used and the empirical results are reported in Table 2. These variables also happen to be variables that help determine real exchange rates, through their effects on trade and investment. With such variables in the equations, the regression coefficients for exchange rate variability and misalignment capture the effects of speculative errors for given fundamentals.

A general observation concerning the empirical results is that the explained proportions of the variances of the regressions are considerably below those obtained for the export equations. Equation (2a) presents our basic specification. Anticipated real GDP, the real interest rate spread series, and the lagged dependent variable all have positive (as expected) and significant coefficients. The oil price shock series also has a positive coefficient, but it is only marginally significant; the implication is that the oil price shock of the late 1970s increased direct investment into the United States either in accord with the safe-haven hypothesis or as part of the financing of the enlarged trade deficit. The relative price (real terms of trade) series has a negative coefficient (as expected) and is significant.

Equation (2b) tests for the impact of short-term exchange rate volatility on direct investment; the coefficient on the volatility variable is marginally significant, and positive. In equation (2c) we drop the relative price term in order to test whether its inclusion in equation (2b) was biasing the impact of the volatility term. (This is the same procedure that we undertook for the export equations.) The volatility term has a negative coefficient in equation (2c), but is insignificant. Finally, equations (2d) and (2c), with and without relative prices, respectively, test for the impact of the misalignment series. In equation (2d) the misalignment series is marginally significant, but with a positive coefficient. In equation (2e) it is negative and insignificant. In sum, we were unable to find any adverse

impact of either exchange rate volatility or misalignment on real direct investment into the United States during the managed floating rate period.

5. Conclusions

We have argued that exchange rates vary both because of long-term fundamental influences and because of speculative and other transitory influences. These influences, especially the latter, are unpredictable, and they vary more sharply at some times than others. Consequently the volatility of exchange rates is itself variable, and one can easily understand the rationale for an international policy regime that aims to reduce it.

To the extent that the size and variance of movements in exchange rates have been unpredictable, have they also been harmful? Advocates of fixed exchange rates posit that exchange rate variations are harmful because they entail resource allocation effects on trade and investment. For the U.S. economy, our results indicate that exchange rate variations have not had significant effects on trade and direct investment. Of course we doubt whether a fixed exchange regime would have been able to survive during a period which has included huge disturbances, such as the two oil price shocks to the world economy. Our results on investment are exploratory, and may be revised if progress should be made on the difficult specification problems involved. The issue is empirical, and must eventually be resolved by testing the various claims against the data.

Footnotes

1/ Perceptively, Johnson also recognized that exchange rates would be stable only as long as "underlying economic conditions (including government policies)" remained stable (1969, p. 17, italics supplied).

2/ See Tavlas (1987). However, as Goldstein (1984, pp. 3-4) reports, most of world trade is conducted at unpegged currencies.

3/ Frenkel and Goldstein (1986, p. 647) also point out that exchange rate changes have been smaller than changes in other asset prices such as national stock markets and short-term interest rates.

4/ The portfolio balance model is an extension of the vintage 1970s' monetary model. As Krueger (1983, p. 50) observes, "at the present time it is difficult to distinguish an adherent of the monetary approach from the author of a portfolio balance model." An important bridge between the two approaches was provided in the article by Frenkel and Rodriguez (1975), which incorporated the treatment of asset accumulation and current account determination within the monetary approach. For an interesting appraisal of the monetary approach, see Boughton (1987).

5/ A hard landing was also predicted by Marris (1985).

6/ Disequilibrium theories of the exchange rate are based on sluggish adjustment of nominal prices and imply that the correlation between real and nominal exchange rate changes is exploitable by government interventions in the foreign exchange market (Stockman, 1987a, p. 13).

7/ See also Yeager (1976) for a discussion of the issue.

8/ The countries examined were Australia, Canada, France, Germany, Italy, Japan, New Zealand, the Netherlands, Switzerland, the United Kingdom, and the United States.

9/ Equations (1a) through (1c) are estimated over the quarterly period, 1975:1 through 1986:1. We began the estimation period in 1975:1 because exchange rate volatility is entered with an eight-period (i.e., two-year) lag, taking us back to 1973:1, the beginning of managed floating. We ended the estimation period in 1986:1, because, as of this writing (end-1987), export earnings of oil exporting nations (a term in the equations) is available only through 1985:4. Because that term is entered with a one-quarter lag, we were able to estimate through 1986:1.

10/ See the notes to Table 1 for additional details.

11/ Cushman observed that, "Empirical work concerning exchange rate uncertainty on direct investment is rare" (1985, p. 298). The few studies that Cushman was able to find were published during the 1970s.

Table 1. Effects of Exchange Rate Variability on U.S. Export Volumes

Equation	Constant	Real OECD GDP	Relative Export Prices	Real Oil Revenues	Exchange Rate Variability: Short-term volatility	Exchange Rate Variability: Long-term misalignment	Rho	$\bar{R}^2$	D.W.	Estimation Period
(1a)	-2.46 (3.0)	1.05 (7.9)	-0.77 (5.9)	0.11 (2.5)			0.62 (4.6)	0.926	1.70	1975:1-1986:1
(1b)	-2.23 (2.6)	1.02 (7.0)	-0.72 (4.8)	0.12 (2.5)	-0.84 (0.7)		0.62 (4.1)	0.923	1.75	1975:1-1986:1
(1c)	0.70 (0.4)	10.55 (1.9)		0.08 (1.4)	-1.64 (0.9)		0.89 (12.5)	0.900	1.73	1975:1-1986:1
(1d)	-2.18 (1.9)	1.01 (5.5)	-0.73 (4.8)	0.09 (1.8)			0.69 (5.1)	0.908	1.65	1976:1-1986:1
(1e)	-2.24 (2.0)	1.02 (5.7)	-0.78 (4.3)	0.09 (1.8)		0.0005 (0.4)	0.67 (4.8)	0.906	1.67	1976:1-1986:1
(1d)	0.54 (0.2)	0.59 (1.6)		0.04 (0.7)		-0.0003 (0.2)	0.93 (16.1)	0.889	1.44	1976:1-1986:1

Sources: IMF, International Financial Statistics; Morgan Guaranty Bank; Williamson (1985; 1986); and authors' calculations.

Notes: Numbers in parentheses are t-ratios. Real OECD is real GDP (current period) in national currency units for 11 industrial country trading partners converted to U.S. dollars at 1985:1 exchange rates. Relative prices is the dollar-denominated export unit value index divided by the IMF's "industrial couantry" export unit value series. It is entered with a two-quarter lag. Real oil revenues is the dollar value of oil exporters' export earnings (as provided by the IMF) deflated by the dollar-denominated export unit value index of the "industrial nations" taken as a whole to represent the real purchasing power of the oil exporters as it relates to industrial country exports. It is entered with a one-quarter lag. Short-term exchange rate variability is the absolute value of the quarterly percentage change in the real effective exchange rate (as constructed by Morgan Guaranty Bank). It is estimated by using an eight-period (t-1 through t-9) second-degree Almon lag. Long-term exchange rate misalignment is the deviation of the real effective exchange rate (REER) from the fundamental equilibrium exchange rate (FEER) as constructed by Williamson (1985). Williamson (1985) provides data on REER and FEER for the period 1976:1-1984:4. For 1985:1-1986:1, figures for REER and FEER have been updated by the authors, extrapolating data on the basis of figures contained in Williamson (1986). The export volume series (IMF) was seasonally adjusted using the X-11 ARIMA technique. Rho was estimated using a maximum likelihood procedure.

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Table 2. Effects of Exchange Rate Variability on Real Direct Investment Into the United States (1976:1-1986:1)

Equation	Constant	Anticipated Real GDP	Relative Export Prices	Real Interest Rate Spread	Lagged Dependent Variable	Oil Shock Dummy	Short-Term Volatility	Long-Term Misalignment	Rho 1	Rho 2	$\bar{R}^2$	DW
(2a)	-3.00	0.87	-2.95	0.08	0.54	0.21			-0.44	-0.40	0.522	2.03
	(1.4)	(2.2)	(3.1)	(2.0)	(3.2)	(1.4)			(2.1)	(2.1)		
(2b)	-1.15	0.68	-4.00	0.14	0.49	0.35	9.45		-0.55	-0.47	0.555	2.08
	(0.5)	(1.9)	(3.3)	(2.4)	(3.0)	(2.1)	(1.4)		(2.7)	(2.6)		
(2c)	-3.39	0.81		-0.04	0.63	0.17	-6.96		-0.36	-0.28	0.411	1.89
	(1.1)	(1.6)		(0.9)	(3.0)	(0.8)	(1.1)		(1.5)	(1.3)		
(2d)	-2.74	0.93	-4.35	0.06	0.45	0.27		0.02	-0.41	-0.42	0.566	2.16
	(1.4)	(2.4)	(3.5)	(1.3)	(2.5)	(1.8)		(1.8)	(1.8)	(2.3)		
(2e)	-2.00	0.72		-0.03	0.53	0.28		-0.001	-0.22	-0.20	0.384	1.85
	(0.7)	(1.3)		(0.4)	(1.9)	(1.3)		(0.1)	(0.7)	(0.8)		

Sources: Data Resources, Inc.; Federal Reserve Board; IMF, International Financial Statistics; Morgan Guaranty Bank; Williamson (1985; 1986); and authors' calculations.

Notes: Numbers in parentheses are t-ratios. Dependent variable is nominal direct investment inflow into the United States (Federal Reserve Board's flow of funds series, seasonally adjusted) divided by the GDP deflator. Anticipated real GDP was constructed by regressing the logarithm of real U.S. GDP on its past values in periods t-1 through t-13, using a second-degree Almon polynomial distributed lag with no end-point restrictions. The predicted series made by that regression was used as the anticipated series. Relative export prices is the same series used in Table 1; as with the regressions contained in Table 1, it is entered with a two-quarter lag in the regressions reported above. Real interest rate spread is the differential between the real average market yield on U.S. Government ten-year bonds (constant maturity) and the real average yield on long-term government bonds of major U.S. trading partners. The spread series is from Data Resources, Inc., U.S. model databank. Because it is available beginning only in 1976:1, all the above regressions were estimated beginning in 1976:1. The oil shock dummy variable is a shift dummy representing the second oil price shock. It equals unity from 1979:2 through 1980:2, and it equals zero for all other observations. The volatility and misalignment series are the same as used in the equations in Table 1. Rho 1 and Rho 2 were estimated using a maximum likelihood procedure since the widely used Cochrane-Orcutt procedure results in inconsistent parameter estimates in the presence of lagged dependent variables—see Aschheim and Tavlas (1988). We are grateful to John Wilson of the Federal Reserve Board for providing us with the nominal direct investment series.

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DRAFT

The Uneasy Relation between the Budget and Trade Deficits

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Popular and political perceptions about the relation of the U.S. budget and trade deficits are based on the observation that both deficits have been unusually high during the past several years. Our professional perception of this relation is based on the combination of an accounting identity and a plausible hypothesis about the chain of effects that might lead an increased budget deficit to increase the trade deficit.

There two perceptions, however, provide neither an adequate understanding of this relation nor a sufficient guide for economic policy. The observed combination of large budget and trade deficits may have been a coincidence, in that both deficits may have been due to unrelated changes in other conditions. The two pillars of our professional understanding of this relation are more useful but are not sufficient. This paper summarizes our professional understanding of this relation and concludes that much of what we "know" about this relation is not consistent with the available evidence.

The Accounting Identity

For several years, economists have been trying to educate politicians and journalists (without much success) about the implications of a basic accounting identity. This identity demonstrates that the foreign balance of any country in any year, an amount equal to the exports minus the (broadly-defined) imports of that country, is also equal to saving by

that country minus investment in that country. In other words, a country will have a trade surplus if saving is higher than domestic investment, and it will have a trade deficit if saving is less than domestic investment. This identity has a number of important implications:

-- A change in conditions or policies that increase exports or reduce imports will not increase the trade balance unless they also increase the balance of domestic saving and investment. Specifically, trade policy, by itself, may affect the level, product composition, and bilateral balances of trade but cannot change the balance of total exports and imports. Most politicians, unfortunately, either do not understand this implication or they are using a more general concern about the trade balance as cover for policies that serve some sectoral interest.

-- For our purpose, the more relevant implication is that a change in conditions or policies that increase the government-sector deficit will increase the trade deficit by an equal amount, unless such changes also affect private saving or

investment. This identity, thus, provides a basis for expecting a strong positive relation between the government-sector balance of receipts and expenditures and the foreign-sector balance of exports and imports.

The several implications of this identity are important to understand. As it turns out, however, the expected relation between the government-sector balance and the foreign balance is not consistent with the available evidence.

An examination of the relevant data for the two most recent U.S. recovery periods provides some insights about why the relation between the government sector balance and the foreign balance has not been stable. Table 1 summarizes the relation between the U.S. foreign and domestic balances during the recovery from the recessions of 1974-75 and of 1981-82, periods during which other economic conditions and policies were quite different.

The recovery from the recession of 1974-75 illustrates the usual cyclical pattern. From 1975 through 1979, net foreign investment by the U.S. declined substantially, despite a strong increase in the government balance from a record peacetime deficit to a small surplus. During this recovery, in other words, there was a strong <u>negative</u> relation between the foreign balance and the government balance. Other characteristics of

this recovery were also rather typical. The private saving rate declined gradually during the recovery, and the private investment rate increased sharply. The single condition most closely associated with net foreign investment is the level of private domestic investment. In brief, the U.S. invests more abroad when it invests less at home and vice versa.

Table 1 The Relation of U.S. Foreign and Domestic Balances

Year	F	=	X	-	M	=	S	+	G	-	I
					Percent of GNP						
75	1.4		10.1		8.7		19.2		- 4.1		13.7
76	0.5		10.0		9.5		18.2		- 2.2		15.6
77	-0.4		9.6		10.1		17.8		- 1.0		17.3
78	-0.4		10.1		10.6		18.1		- 0.0		18.5
79	0.1		11.7		11.6		17.7		0.5		18.1
82	0.0		11.4		11.5		17.6		- 3.5		14.1
83	-1.0		10.4		11.3		17.5		- 3.8		14.7
84	-2.4		10.2		12.6		18.0		- 2.8		17.6
86	-2.9		9.2		12.1		16.4		- 3.3		16.0
86	-3.4		8.9		12.3		15.9		- 3.5		15.8

<u>Notes</u>

F net foreign investment,
X exports plus capital grants received by the U.S.,
M imports plus transfer payments and interest payments by the government to foreigners,
S gross private saving plus the statistical discrepancy,
G total government sector (federal, state, and local) surplus (+) or deficit (-)
I gross private domestic investment.

Details may not add to totals because of rounding.

Source: U.S. Bureau of Economic Analysis, <u>Survey of Current Business</u>

The recovery from the 1981-1982 recession reflects a quite different pattern. From 1982 through 1986, net foreign investment by the U.S. declined substantially, although the government deficit share of GNP was roughly stable. During this recovery, in other words, there was no apparent relation between the foreign balance and the government balance. The decline in the foreign balance through 1984 was primarily due to a strong increase in domestic investment. The continued decline in the foreign balance in 1985 and 1986, however, was primarily due to an unusually strong decline in the private saving rate, a condition that has yet to be explained.

These comparisons indicate that changes in the government balance have not been the primary causes of short-term changes in the foreign balance. A comparison of the comparable recovery years 1979 and 1986, however, illustrates the expected relation: net foreign investment by the U.S. in 1986 was lower than in 1979 by about 3.5 percent of GNP, in combination with a reduction of the government balance by about 4 percent of GNP. This last comparison indicates that the large recent decline in net foreign investment by the U.S. was due, not to an increase in the government deficit, but to the fact that the deficit did not decline as is usual during the current recovery through 1986.

The longer-term U.S. experience, as well as cross-country comparisons, does not indicate <u>any</u> significant direct relation

of the foreign balance and the government balance. Figure 1 illustrates the U.S. data from 1947 through 1986. Figure 2 (courtesy of Mike Darby[1]) illustrates the cross-country data, based on the 1970-84 averages. In both cases, there is a very small positive relation between the foreign and government balances, but in neither case is this relation significant. How does one reconcile the strong positive relation between these balances that is suggested by the accounting identity with the very weak and insignificant direct relation indicated by the empirical data? One step at a time.

From the accounting identity

$$F = S + G - I,$$

the effect on F of an increase in G is

$$\partial F/\partial G = \partial S/\partial G + 1 - \partial I/\partial G.$$

As mentioned earlier, one should expect a strong positive relation between the foreign balance and the government balance only if private saving and investment are not strongly related to the government balance. The observed direct relation between the foreign balance and the government balance will be the sum of these three effects. If the Ricardo-Barro effect ($\partial S/\partial G$), for example, is equal to -1, an increase in government borrowing is offset by an equal increase in private saving, with no effect on either foreign or domestic investment. Similarly, if an increase in government borrowing displaces an equal amount of domestic investment ($\partial I/\partial G = 1$)

Figure 1 U.S. Foreign and Government Balances, 1947-86

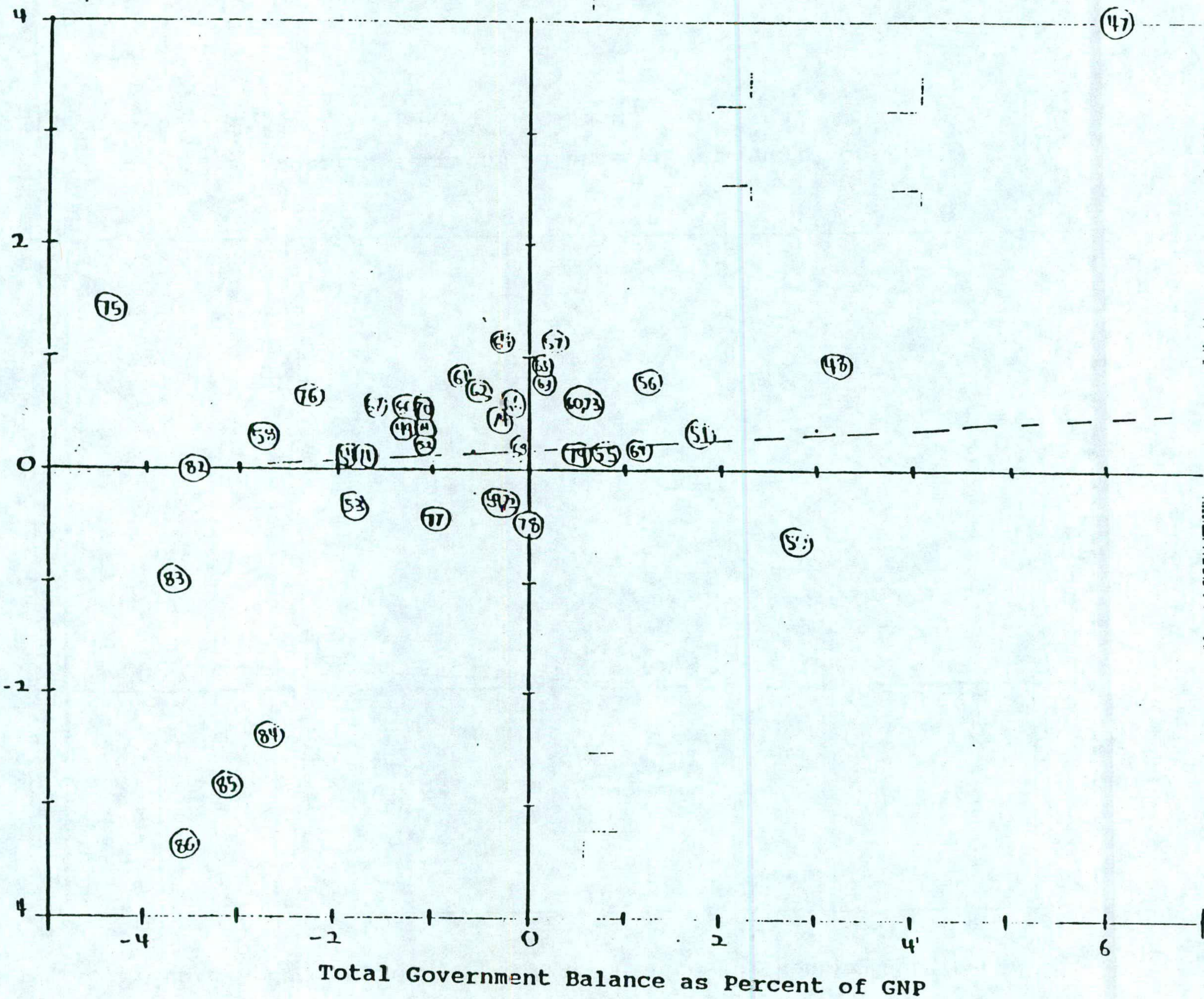
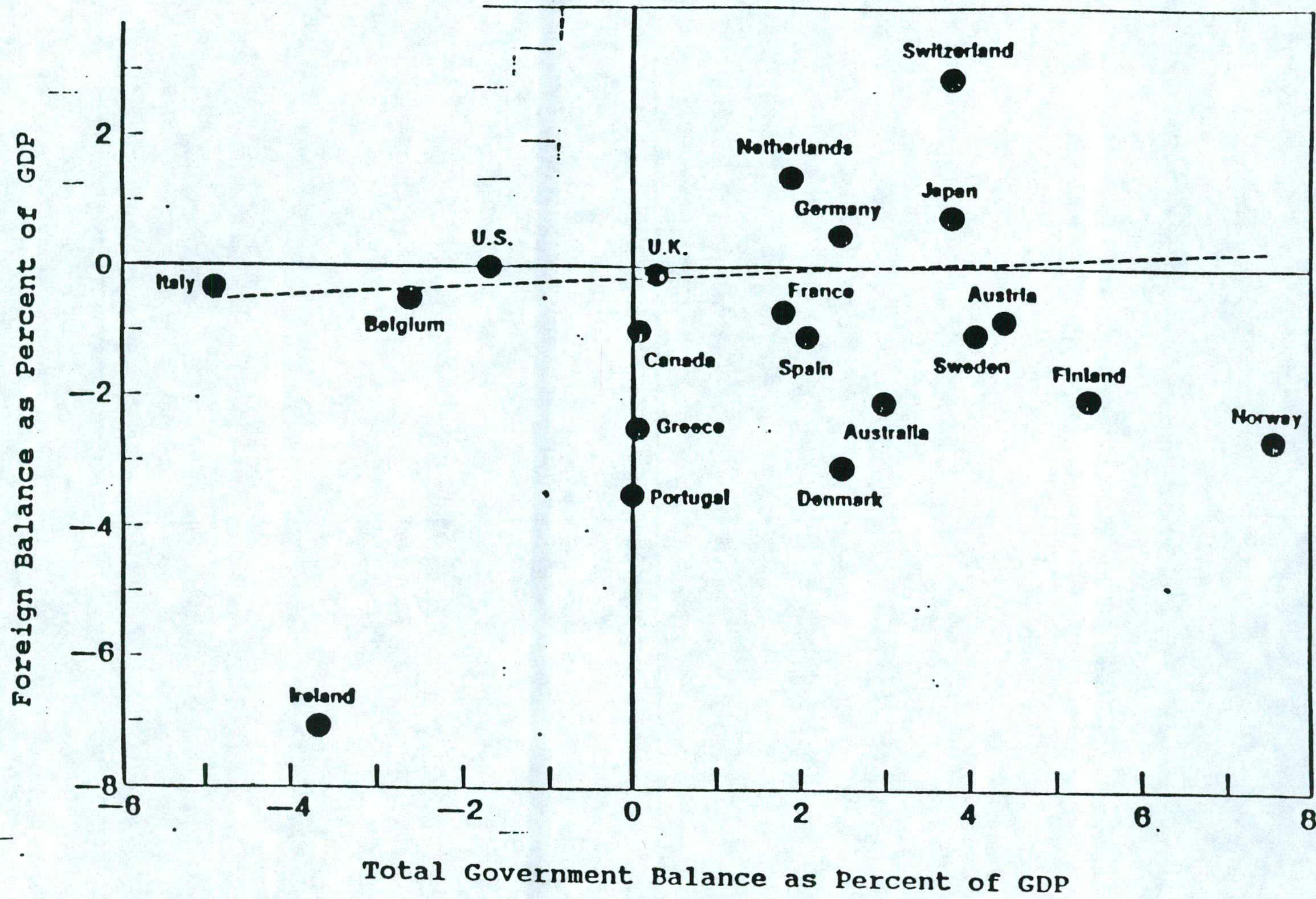


Figure 2 Foreign and Government Balances by Country, 1970-84



with no effect on private saving, changes in the government balance will have no effect on the foreign balance. Some of the more serious controversies among economists involve the magnitude of these two "crowding-out" effects. I do not expect to resolve these controversies.

The results of the simple first-difference regressions reported in Table 2, however, provide an important insight about why the government balance in the U.S. does not appear to have had a significant effect on the U.S. foreign balance: specifically, the marginal effect of changes in the government balance on changes in private saving minus the marginal effect on domestic investment appears to be close to -1. In other words, most of the changes in the government balance appear to be have been offset by changes in private saving and domestic investment, with little effect on the foreign balance.

Table 2 Marginal Effects of Changes in the Government Balance

Dependent Variables	F	S	I
Samples			
1947-1980			
Annual Change	-.07	.07	.11
Marginal Effects	.06	-.27	.67
r^2	.021	.335	.539
1947-1986			
Annual Change	-.16	.00	.13
Marginal Effects	.05	-.24	.71
r^2	.015	.239	.544

Note: All variables deflated by nominal GNP.

Moreover, the marginal effects of changes in the government balance do not appear to have changed significantly during the 1980s. For the total postwar period, thus, almost all the variation in the U.S. foreign balance appears to have been due to changes in U.S. private saving and investment that were independent of changes in the government balance.

The constant terms in these simple first-difference regressions also deserve attention. Both samples indicate a small secular decline in U.S. foreign investment and a small secular increase in U.S. domestic investment. This reflects the gradual decline in the real post-tax return on foreign investment relative to the return on U.S. domestic investment--a condition, in turn, that reflects the relative increase in the foreign capital stock after the destruction of World War II. The small corresponding secular decline in the U.S. trade balance, thus, was due more to a realignment in the relative capital stocks than to a relative decline in the U.S. government balance or the "competitiveness" of U.S. firms.

Since 1980, however, U.S. private saving has been lower and U.S. domestic investment has been higher than would have been anticipated based on the prior postwar sample. From 1947 through 1980, for example, there was a small secular increase in the private saving rate, a condition that was sharply reversed in the 1980s. The reasons for the sharp decline in the U.S. private saving rate since 1980 are not clear, but

this decline was probably associated with the large increase in the real value of financial assets. The relative increase in U.S. private investment through 1984 was most directly attributable to the reduction in the effective tax rates on new business investment in the 1981 tax legislation--a condition that was unfortunately reversed by the 1986 tax legislation. The resulting sharp decline in the U.S. foreign balance during the 1980s, in summary, appears to have been primarily due to conditions other than the decline in the government balance. The "twin deficits" of the 1980s, in brief, appear to have been a coincidence of unrelated conditions, rather than the result a significant relation between the trade and budget deficits.

The Plausible Hypothesis

The economist's characteristic hypothesis about the relation between the foreign and government balances is based on the following sequence of effects: real budget deficits increase real interest rates, which increase the real exchange rate, which increases the real trade deficit. This might best be described as "the Feldstein chain," after Martin Feldstein's 1983 explanation of this relation.[2] The problem of this hypothesis, however plausible, is that the evidence for each link in this chain is extraordinarily weak. One point at a time.

There is ample theoretical reason to expect increased government borrowing to increase real interest rates by some amount, except in the extreme case in which the increased borrowing is fully offset by increased private saving. The best tests of this relation, however, fail to find any significant effects of past, current, or future government deficits on rates.\3 A characteristic focus on net saving, rather than on the total stock of debt, has led many economists to expect a larger effect. A focus on how government borrowing changes the total supply of debt, however, provides a more accurate perspective on the magnitude of the potential effects on interest rates. The following example illustrates this point. Assume a total world supply of debt of $20 trillion and a real interest rate of 4 percent. An increase in the real government debt of $100 billion, in this case, increases the total supply of debt to $20.1 trillion, a 0.5 percent increase. In the absence of an increase in the world demand for debt, this increase in the supply of debt would increase real interest rates by only 2 basis points on a consul or about 5 basis points on a 10 year bond, plus a smaller portfolio effect specific to the debt of the borrowing government. A precise estimate of the effect of a given increase in government debt would have to control for the conditions affecting the total world demand for debt and the supply of debt by the world's private sector and other governments, a task that is now beyond

the most sophisticated econometric techniques. Variations in the other conditions that affect the world demand for debt and the supply of debt by others apparently swamp the small effects of the large recent U.S. government deficits on real interest rates. This conclusion should surprise only those who continue to use a model based on saving and investment flows, rather than the stock of debt to analyze these effects.

The theoretical relation between real interest rates and real exchange rates is more complex than is usually recognized. Specifically, the difference between the current and forward exchange rate with respect to another currency tends to equal the difference between the domestic and foreign interest rates. In other words, an increase in domestic interest rates will increase the current exchange rate by an equal amount only when the forward exchange rate does not change, such as when the increase in the interest increase is expected to be temporary. This relation, called the "covered parity" condition, is strongly consistent with the evidence and was about the same in the late 1970s and the early 1980s.\[4] In both periods, changes in the current and forward exchange rates were closely related, the reason why there has been so little relation between interest rates and exchange rates. Moreover, there does not appear to be any significant direct effect of budget deficits on exchange rates.\[5]

Finally, the relation between the real exchange rate and the real trade deficit is also more complex than is usually recognized. A lower real exchange rate reduces the foreign price of domestic goods and services but it also reduces the foreign price of domestic assets. A lower exchange rate will reduce the trade deficit, thus, only if it increases the foreign purchases of domestic goods and services more than it increases their purchases of domestic assets. This is generally the case, because a lower real exchange rate also reduces the present value (in other currencies) of the expected earnings from domestic assets, offsetting the effect of a lower foreign price of these assets. For foreign investors who want some earnings in the domestic currency, however, a lower real exchange rate reduces the price of domestic assets without reducing their value. And, if the lower exchange rate is expected to be temporary, the higher mobility of financial capital flows than of trade flows may lead to a temporary increase in the real trade deficit. In general, a lower real exchange rate will reduce the real trade deficit, but one should not expect a close relation between these conditions.

In summary, the characteristic explanation of the relation between the budget deficit and the trade deficit is plausible, but the evidence for each link in this chain of effects is surprisingly weak. One should not be surprised, therefore,

that there does not appear to be a significant direct relation between these two deficits.

What to Do?

The "twin deficits" of the 1980s represent only one problem: the increase in private and government consumption, financed in part by borrowing abroad, will not provide a stream of returns to finance the increased debt. A reduction in the growth of either private or government consumption relative to the growth of output will be necessary to resolve this problem, and the choice between these two approaches will be the central political issue for some years. The trade deficit, by itself, is not a problem. Given the U.S. economic policies during the early 1980s, we were much better off with a large trade deficit; in the absence of a larger flow of goods and services from abroad, U.S. domestic investment would have been much lower and real interest rates would have been somewhat higher. If U.S. economic policies during this period were correct, the increased trade deficit should have been regarded as a desirable, albeit not anticipated, effect of these policies. The trade deficit has become a problem only because popular and political perceptions have misattributed this deficit to "unfair" foreign trade practices, with the consequent increase in actual and potential protectionist actions by the U.S.

The remaining problem, however, is serious and will become more serious the longer we delay in addressing it. This problem is the result of the growth of total debt relative to the growth of output, not the small but growing proportion of this debt owed to foreigners. The primary challenge will be to focus on the budget deficit, not the trade deficit. A recession, for example, would increase the budget deficit but would probably reduce the trade deficit. In contrast, a reduction in the capital gains tax rate would probably reduce the budget deficit but would increase the trade deficit.

Moreover, it is important to focus on measures to reduce the budget deficit that the least adverse effects on economic growth, whatever their effects on the trade deficit. The primary candidates for government spending restraint, I suggest, are those programs that increased most rapidly during the Reagan years--defense, medical care, and agriculture. Defense spending (adjusted for general inflation) is now about two-thirds higher than in 1978 and about 20 percent higher than the peak Viet Nam War spending in 1968, and there is reason to question whether the value of this record peacetime buildup was worth the cost. In effect, our large share of the defense burden of the West is one of our largest exports, but is one for which we are not compensated. At the margin of current spending for medical care, there does not appear to be any relation between most dimensions of health status and

medical care, and most of the incremental benefits accrue to the providers of medical care. Our agricultural programs are a national scandal, and most of the benefits of these programs accrue to owners of farm land (and their creditors). Spending for these and other smaller federal programs could probably be reduced by some amount without significant effects on our national security, health status, private consumption, or economic growth.

Some increase in tax revenues is necessary only if our politicians choose to maintain the current path of total federal spending. The choice among alternative means to increase tax revenues, however, is very important. As much as possible, revenues should be increased by continuing to broaden the tax base, rather than by increasing tax rates. As much as possible, tax measures should be designed to restrain private consumption, rather than private saving or domestic investment. Again, the effects of such measures on the trade deficit should be irrelevant. An increased tax on domestic business investment, for example, would reduce the trade deficit by more than the decline in the budget deficit, but at the expense of U.S. economic growth.

One might hope that some presidential candidate (in addition to Bruce Babbitt) would at least address these issues. In any case, a new administration of either party can avoid these hard choices only at the expense of increasing the

problem for some later administration. A sustained reduction of the budget deficit may or may not reduce the trade deficit but is necessary to reduce the growth of total debt. Our objective, in summary, should be to put our own fiscal house in order without concern for the consequent effects on exchange rates and the trade deficit.

Footnotes and References

1. Figure 2 is reproduced from a paper by Michael Darby, "The Shaky Foundations of the Twin Towers," (Washington: U.S. Department of the Treasury, October 2, 1987).

2. This position was first summarized in the 1983 Economic Report of the President (Washington: U.S. Government Printing Office, 1983), Chapter 3.

3. The best studies of this issue are by Paul Evans, "Do Large Deficits Produce High Interest Rates?" American Economic Review, March 1985 and "Interest Rates and Expected Future Deficits in the United States," Journal of Political Economy, February 1987.

4. For the relation between exchange rates and interest rates, see Eduardo Somensatto, "Budget Deficits, Exchange Rates, International Capital Flows, and Trade" in Phillip Cagan (ed.), Contemporary Economic Problems (Washington: American Enterprise Institute, 1985).

5. For a direct test of the relation between exchange rates and budget deficits, see Paul Evans, "Is the Dollar High Because of Large Budget Deficits?," Journal of Monetary Economics, November 1986.

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Address by

Manuel H. Johnson
Vice Chairman

Board of Governors of the
Federal Reserve System

before

Conference on Dollars, Deficits,
and Trade

Sponsored by the Cato Institute

Washington, D.C.
February 25, 1988

"Current Perspectives on Monetary Policy"

It is a pleasure for me to address this sixth Annual Monetary Conference of the Cato Institute. The focus of the conference--on deficits and trade as well as on consequences and rules of alternative exchange rate regimes--is important and certainly timely.

The title of my talk listed in your program is "Current Perspectives on Monetary Policy." One way of addressing this topic would be to discuss the specifics of the Federal Reserve's current concerns and goals for policy in 1988. However, Chairman Greenspan has addressed these points at the Humphrey-Hawkins hearing before Congress just this week and I see no need to repeat his statement.

Instead, what I would like to talk about today relates to the more fundamental long-term goals of monetary policy and how we can proceed to reach these goals--particularly under current domestic and international monetary arrangements.

Clarifying the goals of policy is especially important in our current monetary environment in which essentially every currency in the world is directly, or indirectly, on a pure fiat standard.

We have learned a great deal about the appropriate goals of monetary policy in recent years. We know, for example, that under fiat arrangements, price stability is an achievable goal and should be a principal objective. A policy that fosters steadiness and predictability in the general price level is essential for genuine non-inflationary economic growth.

We have also learned that sharp unanticipated changes in monetary policy can be disruptive to the economy. Accordingly, the pursuit of price stability should also seek to minimize such short-term disruptions to economic activity.

Among monetary experts, there probably is little disagreement on these policy goals. However, there is currently a good deal of disagreement on how to best achieve these objectives.

Until a few years ago, there was a growing consensus among monetary economists that the best way to conduct policy was to target monetary aggregates as an intermediate objective. It appeared that the quantity of money was a superior target for the Fed to use in order to achieve price stability and to promote stable economic activity.

Unfortunately, in recent years it has become evident that the relationship between the monetary aggregates and income has become less predictable. Various measures of the velocity of money, for example, have experienced large deviations from trend during the 1980's. Indeed, over this period the decline in velocity for most monetary aggregates has been unprecedented in the post-war era. And, as yet, this decline is not fully

understood. Consequently, future movements in velocity remain uncertain.

There are several factors that have contributed to this deterioration in performance of the monetary aggregates. While it is probably premature to draw any definite conclusions, it appears that the interaction of deregulation, disinflation, and sizable movements in interest rates have worked to alter the behavior of money supply measures. Due to these factors, money growth is much more sensitive to changes in interest rates and opportunity costs than was previously the case. Since this increased sensitivity works to lessen the predictability of the relationship between money and GNP, these aggregates become less reliable as policy targets.

Admittedly, it is probably too early to conclude that the monetary aggregates will not be useful in the future as policy indicators or targets. But even if stable, predictable velocity re-emerges, it will take an extended period before enough confidence and credibility can be mustered so that money

supply measures can be used as the sole intermediate target of policy.

Given this (at least temporary) deterioration in the performance of the monetary aggregates, what alternative indicators are available for implementing policy? Also, what properties should they possess?

First, useful indicators should be accurately measurable and readily available. Second, they should respond to changes in Federal Reserve policy actions. And third, they should be reliably related to the ultimate goals of monetary policy.

Given these guidelines, there has been some interest recently in the use of nominal prices of certain financial instruments traded in auction markets as indicators for policy. More specifically, information contained in the term structure of interest rates (yield curve), the foreign exchange market, and certain broad indices of commodity prices has proven useful in the formulation of monetary policy.

Other things equal, all of these indicators should provide signals as to when monetary policy becomes expansionary (easy) or restrictive (tight). For example, should one observe the simultaneous occurrence of a steepening yield curve, increasing commodity prices, and a depreciating dollar, then it may be inferred that monetary policy most likely has been expansionary.

However, this approach certainly is not foolproof and when such indicators are followed in isolation they can sometimes prove to be misleading. Also, they are not always independent from each other and can be affected by expectations of policy change.

Yet despite these caveats, preliminary evidence is promising enough to suggest that these indicators may prove useful in the formulation of policy. If nothing else, they provide useful information that should not be ignored.

The use of market determined prices as policy indicators (or informational supplements) is an appealing

strategy for several reasons. First, the data measuring these variables are readily available, literally by the minute. These market prices provide observable, timely, and more accurate information than is provided by other sources. There are no problems with revisions, seasonal adjustment procedures, or shift adjustment corrections that plague quantity or volume data. And the strategy does not rely on unobservable variables such as real interest rates that depend on accurate measurements of future price expectations.

Second, the strategy is premised on the notion that market prices encompass the knowledge and expectations of a large number of buyers and sellers. And while it is true that individual market participants may be irrational, this is not likely to be the case for the market as a whole. Therefore, these prices, reflect the consensus of opinion about the current and expected future values of these financial instruments. As such, they serve as communicators of changing knowledge of market conditions.

Third, since there is evidence that the broader price measures such as the CPI or GNP deflator are slow to reflect new information, changes in monetary policy should be reflected in these financial auction market prices well before they affect the broader price measures. Thus, there is reason to believe they may give advance warning of impending change for important concerns such as inflation.

It is worth noting that monitoring financial markets in conjunction with one another to piece together a consistent interpretation is not novel. During the period when England had gone off the gold standard in the early nineteenth century, for example, Classical monetary writers monitored such indicators to assess central Bank policy. There is a passage in the famous Bullion Report published in 1810 in which this is clearly documented. Because financial innovations had occurred and accurate and timely monetary statistics were not available at the time, these monetary analysts argued that the Central Bank should use financial market prices as guides to policy.

In the time remaining I cannot possibly give you a detailed analysis of all the research pertaining to the yield curve, the foreign exchange rate, or commodity prices. Nor can I provide any simple prescription on how these indicators should be interpreted. Suffice it to say that there are some difficulties associated with each of these indicators as separate forecasting tools. But when examined together, they often yield valuable insights in evaluating the stance of monetary policy and particularly in assessing movements in expectations of inflation.

The Yield Curve

With respect to money and bond markets, empirical evidence suggests that expansionary monetary policy is often reflected in a more positively sloped yield curve whereas a yield curve that becomes inverted (negatively sloped) often reflects a restrictive policy stance. Inverted yield curves, for example, have preceded most recessions in the post-war era. Indeed, the results of one recent study indicated that the

spread between the Fed funds rate and the long bond rate out-performed three other important variables as an indicator of the impact of monetary policy on future real economic activity.

Most analysts do believe that there is useful information reflected in the yield curve. And there are theoretical reasons and evidence to suggest that this spread reflects expectations of future short-term yields as determined in part by expectations of future inflation. These observations imply, of course, that it is not the level of interest rates but the spread that may serve as a useful indicator of the stance of monetary policy.

But one cannot perfectly predict the affects that a change in policy will have on the yield curve; hence this indicator should not serve as a single target of policy. The yield curve is affected by a number of other factors such as, changes in Treasury funding policy, altered risk premiums, tax policy, as well as changes in liquidity preference.

Commodity Prices

There is also, some empirical evidence to suggest that broad indices of commodity prices respond to changes in monetary policy and tend to lead changes in broader measures of inflation.

The reliability as well as the quantitative importance of these empirical relationships, however, have not been firmly established. And little evidence exists that indicates the Fed can accurately control such indices. Moreover, commodity prices are volatile and are influenced by a number of factors not related to monetary policy. Accordingly, commodity prices are probably more valuable as an indicator of monetary policy than as a target.

The Foreign Exchange Value of the Dollar

It has long been recognized that the foreign exchange value of the dollar can also provide useful information for monetary policymakers. The exchange rate often indicates the stance of U.S. monetary policy relative to that in other

countries, and therefore offers a gauge of relative monetary expansion or contraction.

For example, if the dollar is depreciating while the yield curve is steepening and commodity prices are rising, policy is likely expansionary and perhaps overly so.

On the other hand, if the dollar is depreciating while commodity prices and the yield curve are stable, the dollar may reflect restrictive foreign monetary policy or other external factors.

Moreover, if the dollar was declining and the yield curve was steepening but commodity prices remained stable, this could reflect an outflow of foreign funds from the U.S. bond market for reasons other than inflationary expectations.

Monitoring exchange rate movements to supplement other indicators, of course, is not foolproof. The exchange markets are volatile and intervention can (at least temporarily) often distort signals from this market. Morever a great deal of information

about foreign economic performance and policy is required to properly assess this market.

It should also be pointed out that exercises in international coordination of monetary policy--which necessarily implies a move to more stable exchange rates--suggests that the information content of foreign exchange rates is lessened. While stable exchange rates are desirable, stability removes information from this market. After all, it is (theoretically) possible to have either rapid inflation or rapid deflation with stable exchange rates.

Accordingly, information provided by commodity prices and yield curves may assume more importance in analyzing inflationary expectations should coordination be used to stabilize exchange rates.

Summary

To sum up, in spite of several caveats and in the absence of reliable alternative indicators, financial auction

markets can provide useful information to the process of monetary policy formulation. I believe the strategy outlined here provides a framework for focusing monetary policy on the conditions for price stability. And price stability is a goal that should direct our attention to these markets.

Thank you.

SECRET

From: Sir G.Littler
Date: 25 February 1988

MR ALEX ALLAN

c.c. PS/Econ. Sec.
Sir P.Middleton
Mr Scholar
Mr Peretz
Mr R I G Allen
Miss O'Mara
Ms Goodman

FORWARDS

Your reply of 23 February on the February reserves figures is fine as far as the underlying figure is concerned and we will work to that. But your comment on MOD forwards is puzzling, and as agreed with you orally I am setting out where I think we stand on this and related matters.

MOD Forwards

2. The basis of the MOD arrangement is that they want to have certainty of sterling valuation of foreign costs by the time they have to fix their estimates for the financial year ahead. For this 18 months or so does the trick.

3. Our agreement with MOD is that the Bank of England has a rolling monthly contract with them to supply DM and $ for agreed average estimates of 90% of their monthly requirements 18 months ahead. Our standard practice is more or less immediately to match the resulting obligation by an equivalent forward deal in the market - just as the standard practice with spot sales to Government departments is to neutralise the effect on the reserves by matching them with equivalent spot purchases in the market. But we leave ourselves an unspecified leeway to retard/accelerate

our taking up of matching forward cover in the market, according to our judgment and decisions on intervention and on the reserves figures we wish to publish in the light of market conditiions.

4. Other things being equal, in a single month we will be meeting an obligation to MOD from 18 months earlier and incurring a new one (probably of commensurate amount) to mature 18 months hence; more or less simultaneously we will be closing a forward position with the market and opening an appropriately-timed new one. (In fact we normally do this by buying spot and swapping forward, rather than by outright forward purchase: the two come to the same thing). Our end-month spot reserves will not be affected; nor will our total end-month forward book (except for marginal variations of amounts between MOD's needs now and in 18 months' time). During the month, of course, there will always be transitional variations in the spot book as forward swaps mature and before they are renewed.

5. I hope this is consistent with your comment, and that the Chancellor has the same understanding. We can, if we choose to do so, mismatch our MOD obligations and our claims on the market for a period; but I think it clarifies our judgment and daily management if we regard the MOD operations as a rolling closed element, and regard deliberate variations in the forward book as being just that and quite separately determined.

6. On this basis, we have built up since the beginning of 1987 a block of MOD forwards, varying a bit in size from month to

month, of around $4.5 billion equivalent, i.e. $4.5 billion of the increase in the EEA total forward position with the market is offset by equivalent forward deals with MOD.

The General Forward Book

7. The build-up of the forward book last year was of course only in part attributable to the MOD element, substantial though that was. We added a further $4.5 billion equivalent in the process of abating the increases in spot reserves published in some of the months of very heavy intervention. This has brought the net forward position (after subtracting the position with MOD) up to around $5.5 billion from a little under $1 billion at the beginning of 1987.

8. We do not at present have a direct strategy for the general forward book, or at least not one that affects current decisions (there is an underlying strategic concept of holding some average level of forward book - in normal times in the past $1 billion or so but changed values might suggest $2 billion now - as a cushion to be varied at need; we are way above that level - we should certainly be willing to revert to the underlying concept, but I see no reason why we should be anxious to do so on any particular time-scale). In practice the changes in the forward book are currently driven by what we want to show of the result of our spot interventions - they are simply the cushion.

Past Figures

9. Finally perhaps I could pick up the question the Chancellor recently asked Mr Peretz about past history of the forward book.

SECRET

below

We have given figures going back to 1980, but I have to confirm that I think it would not be proper for us to give the Chancellor figures for the period of a previous administration. You may think these are merely statistics - the real point is that they are definitely not publicly available, and they do reflect on the administration's choice of presentation of events. It may indeed be a consolation that the dramatic recent figures would be held back from a future administration! — ?

X

Yes

(Geoffrey Littler)

Ch

I am not at all convinced of X*, but probably not worth a row. The real sensitivity is the 1976 figures, when spot + forward currency reserves were negative for a time.

AA

(*it has nothing to do with advice given to previous administrations)

as was well known in the market @ the time (i.e. the fact that the published reserve figs greatly understated the extent of the swaps supporting £). It was only the precise figures that were known and, you say, scarcely worth a row.

2/3/88

DOLLARS AND DEFICITS: SUBSTITUTING FALSE FOR REAL PROBLEMS

A. James Meigs

Paper for Cato Institute Sixth Annual Monetary Conference
DOLLARS, DEFICITS, AND TRADE: THE CHANGING WORLD ECONOMY
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Washington, D. C.

Today, people are bewitched, bothered, and bewildered by the talk about the twin deficits. Concentrating on the budget deficit and the trade deficit, as many do these days, diverts attention from more serious problems. The more serious problems that I plan to discuss are: the growth in government spending and the rise of protectionism in international trade.[1]

Concentrating on the deficits also diverts attention from other serious problems. Paul Craig Roberts, for example, says, "The .. overemphasis on reducing the budget deficit, if necessary by tax increases, is distracting world policymakers from the real problems that threaten economic stability -- principally monetary policy as well as a U.S. tax system that continues to discourage private saving." (Roberts, 1988, 38) I agree that these are important problems too, but they are not part of my assignment for today.

Growth of government spending and rising protectionism impose enormous costs on people of the United States and the rest of the world, and both are extremely difficult to resist. They do not confront us with urgent crises; they are more like a drug habit. They depress world economic growth by impairing the allocation of world resources year in and year out. Both are peculiarly intractable or insidious problems because both provide rich opportunities for public officials and legislators to confer large benefits on a few people while imposing small costs on many.

As economists of the public choice school have taught us, the incentives facing legislators are heavily biased toward increasing spending on individual programs. No legislator expects to be rewarded for cutting a program that benefits his constituents. We all can see that now, but we have not yet learned what to do about it. That is what makes controlling public spending so difficult.

With their opportunities for increasing expenditures now somewhat limited by a dearth of revenues and by public disapproval of deficits, legislators find protectionism a more fruitful field. Kenneth Brown says, "It has long been recognized that trade barriers owe much to our political system, which favors policies that confer large benefits on few people and impose small costs on many." (Brown 1987, 97). He also argues that rent-seeking officials who formulate and administer trade policies prefer where possible to work through country-by-country negotiations and quantitative restraints rather than going the wholesale route through the General Agreement on Tariffs and Trade. Jan Tumlir made similar observations at the last Cato Conference he attended. (Tumlir, 1984).

Nevertheless, the popular discussion continues to regard the key problems as: 1. the U.S. budget deficit, as opposed to the level of government spending, and; 2. the U.S. trade deficit, as opposed to the level of restraints on international trade. Those do look like crises to some observers.

This substitution of false problems for real problems tends to make a large fraction of public policy discussion largely irrelevant. What is even worse is that some of the measures proposed for reducing the two deficits would exacerbate the other problems. Thus, tax increases to reduce the budget deficit would weaken what little discipline there now is over expenditures in the federal government. Attempting to reduce the trade

deficit by retaliating against "unfair" trade practices of other nations or by curbing imports with direct restraints would, by definition, increase protectionism.

The Costs of Government

Why the level of government spending, rather than the budget deficit, is the real problem is that the level of government spending determines what fraction of the community's resources is allocated by the state. However the spending is financed, the resources taken for government spending are not available for disposition by the individuals in the community. The problem is the size of the fraction of total output of the community that is allocated, supposedly on our behalf, by government officials as opposed to being available to us as individuals to decide how to use.

It is very difficult to measure the benefits of governmental activities to society as a whole, not to mention to the people who contribute the resources employed. According to George Stigler:

> Our national income accounts value governmental activities at their cost of operation, so every porkbarrel bridge on an untravelled road is valued at cost along with wise and farseeing actions such as NSF grants of money to economists for research designed to eliminate poverty, not least for economists. The growth of functions of government transforms output from goods and services valued by the market to goods and (mostly) services valued by the legislature, the chosen voice of the people(Stigler, 1988, 9).

Furthermore, budgeted expenditures are only a very rough approximation of the problem from the point of view of who determines the allocation of resources. Governments have become adept at evading spending limits by

requiring indviduals and firms to make expenditures for, say, antipollution equipment or other governmentally mandated items that never show up in the official budget. George Stigler points out that protectionism, too, illustrates how government can achieve large redistributions of income from consumers to certain favored producers without ever reporting the transfers in the budget or in any other governmental account (Stigler, 1988, 9).

Government obviously is an inferior mechanism for allocating resources. For example, there are large deadweight losses in redistributing income, which can actually exceed the net income being transferred. In one of George Stigler's examples, he estimates that the total deadweight loss of protecting beet sugar farmers is about 18 cents per pound of sugar, or more than four times the gain received by the farmers (Stigler, 1988, 10). He estimates that these and other efforts to redistribute income -- one of the principal activities of modern governments -- reduce efficiency of the total economy.

> Over the past half century [Stigler says], the rate of growth of gross national product per unit of capital and labor employed has declined (let us call this measured efficiency). Partly that decline is attributable to the failure to include the returns in social welfare from research, safety, environmental and income redistribution policies. Surely another large part of the decrease in measured efficiency is due to the large and still rising deadweight losses included in carrying out these social welfare programs. (Stigler, 10).

Reducing the share of government spending in total gross national product would increase the growth rate of total output, consumption, and saving in the long run, by improving allocation of resources. As I suggested

earlier, it would be an understatement to say that the allocation of resources by the Congress and the rest of the federal government is likely to be sub-optimal, by any standard. That leaves us with two possible courses of action, if we want to facilitate economic growth through fiscal policy. One way would be to improve the government's decision machinery. Public-choice economics and experience with the 1974 budget reforms indicates that this approach has a very low probability of being effective, although any effort in that direction might help. The other possible course would be to reduce the share of national resources processed through the federal government's creaky machinery. That was proposed in the 1981 Reagan Economic Recovery Program, but was not carried through.[2]

Why Is Spending So Difficult to Control?

We have recently seen the Annual Pre-Christmas Budget Charade. Public discussion focussed on the budget deficit as though it was the objective of the exercise, while paying little attention to the multitude of decisions allocating nearly a quarter of the Gross National Product. This was an excellent example of the way the deficit diverts attention from more important problems. The yearend frenzy mainly revealed the incapacity of the Congress for making rational budgeting decisions of the sorts described in the public finance textbooks and on the editorial pages. No wonder financial markets around the world displayed a decline in confidence in the U.S. economy and its managers.

The Congressional Budget and Impoundment Control Act of 1974, which was supposed to give the Congress the tools for managing the budget in a more business-like way, succeeded only in camouflaging a giant swap meet with an intricate overlay of machinery. The so-called budget reform

replaced what once had been a reasonably orderly process that kept the budget roughly in balance for many years before the process began to decay in the 1960s.

The decay of budgetary control in the Congress was well described by Allen Schick and his collaborators in Making Economic Policy in Congress (Schick, 1987, Caiden, 1987, and Ellwood, 1987). According to them, strong committee chairmen used to oversee budgets that grew incrementally from year to year while the rate of growth was held down by the accepted role of the chairmen and their committees as guardians of the public purse. These powerful legislators distributed the annual expected increase in revenue resulting from economic growth among the various departments and functions of the federal goverment. But they did not often attempt to distribute more revenue than they expected the tax system to yield. This internal discipline was eroded in the late1960s with the opening up of the budget process, demands for a greater social role for government, the growing independence of individual members of Congress, the proliferation of new committees and subcommittees, and a decline in the influence of party leadership. As Schick says, " . . many of the reforms that 'democratized' Congress in the late 1960s and early 1970s opened it to increased pressure for benefits from the federal government." (Schick, 258)

The deficit is now the most effective constraint we have on growth of federal expenditures, depressing as that statement may be to people who wish the government would conduct its business in a more forthright way. No matter how pitifully Congressmen and lobbyists may writhe and wail today, the money for bold new spending programs simply is not in sight, unless other programs can be cut or the public can be persuaded to accept tax increases.[3]

In his paper, "The Domestic Budget after Gramm-Rudman -- and after Reagan," John Weicher points out that growth of the domestic budget was dramatically reduced during President Reagan's administration (Weicher, 1987). However, this slowing in growth of expenditures could be temporary, as the willingness of the Congress to control expenditures certainly has been diminishing, and there are tremendous upward pressures built into the major entitlement programs. On the side of moderating spending growth, he says, "The tax reform passed in 1986 will make future tax increases more obvious and therefore, more difficult politically; the continuing large budget deficits will put downward pressures on federal spending." (Weicher, 270) Virtually eliminating bracket creep by indexing the income tax to the price level and by bringing the top rate down, will deprive the government of an inflation revenue dividend.

Costs of Budget Deficits

Mickey Levy, David Meiselman, and others have pointed out that the budget deficit tells very little about what U. S. fiscal policy is, if it can be said that this country has a fiscal policy. Levy, for example, says that ". . deficits per se, as the residuals of tax revenues and spending, provide only limited and ambiguous information about fiscal policy. Failure to recognize this has tended to over-simplify and mislead fiscal policy analysis, in part by focusing only on the aggregate demand impact of a change in the deficit." (Levy, 1987, 14). To appraise fiscal policy, therefore, one must examine all of the component parts on both the expenditure and revenue sides of the budget.

David Meiselman says in various papers and in congressional testimony that in order to appraise the costs of government programs we must also

analyze how the programs are financed. In a general equilibrium framework, he says, one must consider the resource costs of the expenditure programs, the distortions in resource allocation introduced by the programs, and the additional distortions and costs introduced by the means of financing. Each method of financing from taxes, through borrowing, to inflation involves costs and distortions that can only be evaluated by comparing them with the alternatives available (Meiselman, 1981)[4]. Therefore, a budget deficit is not automatically the least desirable method of financing expenditures. A given dollar change in the deficit could make the United States better off or worse off, depending on which tax or expenditure measures caused the change. Some taxes are worse than others, and could be worse than the deficit they are supposed to reduce. (See also Darby, 1987, Levy,1987, and Roberts, 1988.)

Although gallons of ink and buckets of crocodile tears have been expended on the hypothetical dangers of reducing a budget deficit through cutting spending, I do not think we need to review those arguments here. First, rapid deficit reduction seems to me to be extremely unlikely. And, second, the conventional macroeconomic theories explaining the impacts of changes in budget deficits on income are now in too much disarray to be used as bases for policy. (See Levy, 1987, and Meiselman, 1981.) The coup de grace to the orthodox Keynesian analysis of the role of deficits in fiscal policy that many of us were taught when we were young and impressionable came in the early 1980s, when some economists feared that the U.S. deficit would prevent the economy from recovering from the 1981-1982 recession.

Increasing taxes to reduce the deficit would weaken restraint on spending. That would be a high price to pay. Yet many presumably knowledgeable people in the business community and in the economics

profession disagree. The editors of Fortune, for example, say, "It would be wonderful if the budget deficit could be narrowed without raising taxes. Wonderful but impossible. Politicians of both parties demand more taxes as the price for less spending." [emphasis added] (Fortune 1987, 36)

It is little short of fatuous to expect Congress to use the proceeds of a tax increase for deficit reduction. As Congress is currently organized, there is no way for a President to enforce an agreement with the Congress that expenditures would be cut in exchange for Presidential approval of a tax increase, other than to shut down the government by refusing to sign a yearend mammoth continuing resolution. Remember 1982, when President Reagan thought he had an agreement that Congress would reduce spending by two dollars for every dollar of tax increase that he would approve. He agreed to one of the largest tax increases in U.S. history, but the Congress reneged on the agreement to cut spending. There just is no organized entity in the Congress, such as a corporation, that can make binding contracts or be held accountable for breaking promises.

If the deficit is to be reduced by tax increases, we also must consider the effects of various taxes on incentives to work, save, and invest. These are the additional financing costs and distortions in Meiselman's table of costs and benefits in fiscal policy. They are not trivial, as we found when marginal tax rates were reduced after 1980.

This leaves us to consider the costs of tolerating budget deficits, because that is what we are most likely to do for some years in any case. If the deficit is the most effective constraint on growth of federal spending, as I believe it is, we must ask whether other costs associated with deficits would offset that one advantage.

Herbert Stein takes a philosophical view that the deficit reflects the will of the people:

> The U. S. government prefers to put some of the burden of current American private consumption and public expenditures, including defense, on the future, by running a large budget deficit. You and I may think that is unwise policy, but it seems to reflect the revealed preference of the American people --revealed by their votes in the 1980 and 1984 elections (Stein, 1987).

Most arguments that budget deficits increase the capital inflows from abroad that we will discuss later depend on strong interest-rate effects of budget deficits. Yet it has been extraordinarily difficult to demonstrate empirically that budget deficits raise interest rates. Many people argue that deficits should raise interest rates but they have a difficult time proving it. (See Brunner, Levy, Meiselman, Darby, Evans).

An ingenious recent effort by Paul Wachtel and John Young does demonstrate that announcements of unanticipated changes in projected deficits affect interest rates in the expected direction on the day of each announcement (Wachtel and Young, 1987). Announcements from the Congressional Budget Office have more influence on interest rates in their tests than do announcements from the Office of Management and Budget. Wachtel and Young say, "A $1 billion change in the projected deficit leads to an average 0.30 basis point increase in interest rates for the CBO announcements and 0.18 basis points for the OMB announcements." (Wachtel and Young, 1987, 1010) People in financial markets seem to act as if they know where the true power centers are. Or it may be that market people think the CBO staff has the better forecasting track record of the two agencies.

Having spent years observing securities dealers and traders at close range, I believe that the Wachtel and Young results are consistent with typical dealer reflexes of reacting quickly to new clues as to the size of future Treasury auctions. Dealers are preoccupied with flows of funds and securities. However, I want to see more evidence before concluding that Wachtel and Young have found a clear, dependable relationship between deficits and interest rates, where so many other researchers have failed.

My reason for not expecting to find strong interest-rate effects of changes in budget deficits is based on analyzing the problem in terms of stocks, rather than in terms of flows. Considering demands and supplies of stocks of assets suggests that current and prospective budget deficits have less influence on interest rates than is implied by many popular arguments for reducing the deficit. As Karl Brunner argued at the 1985 Cato Monetary Conference:

> The direct link between deficits and interest rates [in conventional flow analysis] . . suggests a massive effect on nominal and real rates of interest. The stock analysis conveys a very different sense. Deficits modify interest rates only indirectly. They gradually increase the stock of real debt and interest rates respond to this increase in the stock. But this increase in the stock relative to the inherited stock is modest compared to the savings-deficit proportion. We should expect therefore a smaller impact on interest rates by deficits than is typically suggested by a flow approach (Brunner, 1986, 715).

Professor Brunner does not mean that the deficit is irrelevant. What matters most is what happens to the size of the stock of real public debt in comparison with the real stocks of all other assets. He goes on in the same

article to make several subtle, insightful points about the dangers and costs of a large real public debt. Among them is a possible increase in the risk premium in long-term interest rates as debt grows, because investors will be uncertain about what the government will eventually do about the debt. Investors do not know whether the government will ignore the debt, or levy new taxes, or monetize the debt. This is just one example of what we might take as a general observation. People in financial markets worry much more about what governments and central banks may do about a change in a budget deficit or a trade deficit than they do about any direct effects of either deficit on corporate earnings or interest rates.

The Brunner argument implies that a reduction in the U. S. budget deficit is highly unlikely to produce the large, predictable reduction in real interest rates that many analysts seem to expect today. That is where I stand.

Causes and Costs of Trade Deficits

Several hypotheses are used to explain the U. S. trade deficit and to defend various policies to deal with it. For covenience in discussion, I group them in three general views: The Pure Trade View, The U.S. Capital Vacuum Cleaner View, and The U.S. Investors' Paradise View. There are, of course, numerous combinations and permutations of these general cases. Dr. Niskanen will discuss connections between the two deficits in more detail later but I must also mention some of them here because the budget deficit plays a prominent role in some explanations of the trade deficit.

In the Pure Trade View, competitiveness problems, trade barriers abroad, consumer preferences for imported goods, and Americans' powerful propensity to consume both private and public goods cause the people of this

country to import more than we export. Then we have to borrow abroad to pay for the excess of imports over exports (See Benjamin Friedman, 1987).

In the U.S. Capital Vacuum Cleaner View, the U.S. budget deficit raises interest rates and pulls in capital from abroad, as people in other countries finance the U. S. budget deficit. The trade deficit appears as the mirror image of the capital flows; goods from other countries are exchanged for U. S. securities and other assets. The United States is then charged with depriving Third World countries and others of the capital they need to develop and to work out of their debt problems.

Michael Mussa has said, "To the extent that large actual and prospective deficits of the U.S. government have contributed to a higher level of real interest rates, therefore, they have contributed to these [debt] problems and hence to the crisis in the international financial system. In effect, one could argue that the large fiscal deficit of the U.S. government and the governments of the other industrial countries has crowded developing countries out of the world credit market and has forced up interest rates on their already outstanding loans." (Mussa, 1984, 94).

When the dollar was rising between 1980 and 1985, the budget deficit was blamed for attracting foreign capital and thus for causing the dollar to appreciate. (See Levy, 21). Appreciation of the dollar, in turn, was said to increase the current accounts deficit through its effects on prices of U.S. imports and exports. Therefore, some analysts concluded that it would be necessary to reduce the budget deficit in order to reduce the trade deficit.

After the dollar began to fall again, however, the budget deficit was blamed for the fall. To halt the decline in the dollar, therefore, other analysts, or the same ones, decided that it was imperative for the United States to reduce its budget deficit.[5] It doesn't seem reasonable to me that

budget deficits of roughly the same size should cause the dollar to rise at one time and to fall at another time.

In the U. S. Investors' Paradise view, the new economic policy regime introduced by the Reagan administration in the 1980s increased the real after-tax return on investment in the United States and reduced risks. Depressing political and economic developments in the rest of the world at the same time contributed to the relative attractiveness of the United States for investors in other countries and for U. S. residents as well, especially commercial banks. In this view, the capital inflows represent a classic response to the situation of a country whose domestic investment opportunities exceed its domestic savings. Japan and Germany, in contrast, are behaving like countries whose domestic savings exceed their domestic investment opportunities. Capital thus flows from Japan and Germany to the United States, benefiting investors and entrepreneurs on both sides of the oceans. (See Darby,1987, and Economic Report of the President, 1985).

The trade deficit probably is mutually determined, as David Meiselman argues, by both capital flows and competitiveness factors. There is something to the loss-of-competitiveness argument in the case of the U.S. automobile and steel industries. By the slippery canons of balance-of-payments accounting, a very large part of the U.S. trade deficit can be accounted for by net imports of steel and autos alone. The managers and unions in these industries did not recognize for a long time that they were in a world market. They acted as though they had a secure national market in which all increases in their costs could be passed on to their U.S. customers. As in other long-run evolutionary processes, it is difficult now for them to turn back the calendar. U.S. consumers have learned to like, and to trust, imported cars, even in the face of price differentials and trade restraints.

Many U.S farmers and the legislators who try to help them with price supports and other subsidies suffer from a similar lack of realism about the opportunities and problems of participating in a global economy. By pricing U.S. farm products out of world markets, U.S. policymakers have contributed to the decline in our farm exports.

Costs of Protectionism

Advocates of protection argue that trade deficits injure U.S. producers of internationally traded goods. But what is there about the XYZ industry, say, that would justify the cost of special protection in a highly developed economy like the United States? The supporters of the XYZ industry do not actually have to answer that question; the political system now permits the XYZ industry to extract the cost of protection from the whole population without weighing all of the costs and benefits to everybody else. This is where the problems of controlling spending and resisting protectionism are similar.

We are all familiar with studies of the costs to consumers and others of protecting particular industries. Jan Tumlir, however, stressed what I believe is an even more important cost. He was concerned with the essential role of trade in creating and maintaining an international price system.

> For that reason [he said] . . I find it difficult to work up much interest in tariffs, which both history and theory show to be quite innocuous protective devices, at least when stabilized. Once in place, they do not interfere with changes in relative prices. My main concern is with quantitative restrictions, which have the effect of paralyzing the price system in their area of application (Tumlir, 1984, 357).

Unfortunately, quantitative restrictions are the ones that are most in vogue today among politicians, officials, and the representatives of producer groups. Politicians and producer groups like them because their costs cannot be measured easily. And, as Kenneth Brown argues, officials charged with formulating and carrying out trade policy like quantitative restrictions because they are labor intensive; they require endless negotiations and renegotiations to establish and to police quotas on individual products and with numerous countries (Brown, 1987).[6]

Other advocates of protectionism argue that large trade deficits cause intolerable changes in U.S. industrial structure. Some feared between 1980 and 1985 that the United States was in danger of losing its industrial base and that we were becoming a nation of short-order cooks and sales clerks. It is now clear that these arguments were grossly overstated. The United States is not being deindustrialized.

However, worldwide changes in industrial structure, or in the location of economic activities, are taking place with the inexorable force of geological processes, but much faster. Exchange-rate manipulation and the whole panoply of protective devices are puny defenses against fast-forward continental drift. Nancy Kane argues, in the case of the textile industry, that we are now seeing shifts in global location in response to technological and other influences that are similar to the shifts that occurred within the Continental United States much earlier (Kane, 1988). (See also Tatom,1987, McKenzie, 1987, Kane, 1987, and Brown, 1987.)

In the economic expansion following the 1981-1982 recession, U.S. domestic demand grew faster than U.S. production. Imports made up the difference. In this sense, imports were blamed for holding growth of U.S. GNP down. To Americans who were not accustomed to viewing international

trade as more than a minor blessing, or annoyance, the surge of imports was unsettling. The times seemed out of joint. Perhaps the most mystifying of all to them was the rise of the dollar on exchange markets. By 1985, it was easy to consider the "overvalued dollar" as the cause of domestic ills ranging from farm mortgage foreclosures to unemployment in the Rust Bowl.[7]

Inexplicable Exchange Rates

Karl Brunner tied exchange rates to the twin deficits in a description of European reactions to U. S. policies at the 1985 Cato Monetary Conference:

> . . the [budget] deficit seems to be the cause of double-digit nominal interest rates and the highest real rates since the 1930s. Such interest rates produce apparently an "overvalued dollar" encouraging imports and lowering our exports. This pattern reduces, so we hear, our welfare, as it lowers domestic employment and output below the otherwise achievable level. And the close interdependence of national capital markets transmits the effects of the "high interest policy" pursued by the U.S. government, represented by a "loose" fiscal and "tight" monetary policy, to all major nations. This vision offers European officials an excellent opportunity to blame U.S. policy for their economic troubles (Brunner, 1986, 709).

Although Professor Brunner thought these ideas deserved sarcastic treatment when he spoke in February 1985, they were being treated as a serious diagnosis by the U.S. Congress and the U.S. Treasury. A blizzard of complaints from U.S. manufacturers and farmers convinced legislators and officials that something must be done and quickly.

As we know, concerns about the domestic economy and fears that the trade deficit would lead to more protectionism caused the Reagan administration to intervene in exchange markets to push the dollar down in 1985. Until then, the administration had faithfully observed a policy of not intervening, as announced in the 1981 Reagan Economic Recovery Program. Secretary of the Treasury James Baker announced the reversal of the exchange-intervention policy at the Hotel Plaza in New York City in September 1985. Although the Plaza Agreement with the Group of Five met loud world applause, it reminds me of another fateful turn in U. S. policy, the broadening of the U.S. role in Vietnam in 1963.

Richard Holbrooke has argued that history would hold the United States accountable in one way or another, even for things beyond Washington's control, after American officials encouraged the generals' coup that deposed South Vietnamese President Diem in November 1963. He said, "Washington, in short, had found the worst possible level of involvement -- deep enough to be held responsible, not skillful enough to find a government that could be effective in the war against the Viet Cong."(Holbrooke, 1987).

In the Plaza Agreement, I believe Washington again found the worst possible level of involvement, deep enough to be held responsible, not skillful enough to achieve its objectives in exchange markets. Ever since, the United States and its hapless partners have been lurching from one misadventure in exchange markets to another. Agreement has been piled on agreement as the dollar alternately appears too strong or too weak to satisfy the officials of the Group of Seven and their critics. Of course, this is not a question of skill alone. The U.S. government is being held accountable for things that are beyond Washington's control.

The decision to deal with the threat of protectionism by attempting to devalue the dollar is ironic because devaluation itself could be called "instant protectionism". It was intended to discourage imports, by increasing the dollar prices of imports and to encourage exports by reducing their prices in foreign currencies. Called "beggar-thy-neighbor" policies during the 1930s, devaluations intended to influence a nation's trade balance were disavowed in the Bretton Woods Agreement at the end of World War II.

Furthermore, exchange-rate manipulation, as an alleged substitute for protectionism, has been costly. One of the costs has been an increase in market uncertainty as exchange traders agonize over each rumor about central bank actions and secret agreements among the Group of Seven. And the price information that people the world over need for allocating resources has been as badly corrupted as it would be by the trade restraints that troubled Jan Tumlir (Meigs, 1977, 1987).

Professor Yeager will discuss the choice between domestic and international stability later, but I must touch on it also. If the exchange interventions by the United States and its collaborators had been fully sterilized, that is, offset by central-bank sales and purchases of domestic assets, they should not have resulted in perceptible changes in domestic monetary policies. But what do we see?

There have been large changes in rates of monetary growth in Japan, Germany, and the United States since the resumption of exchange-market intervention in 1985. We probably will never know how much exchange-rate management caused monetary policies to differ from what domestic conditions would have indicated. In the most recent swing, beginning in

early 1987, when the authorities became serious about halting the decline of the dollar, monetary expansion has accelerated in Japan and Germany and has decelerated in the United States. If these trends persist, the dollar probably, but not certainly, will eventually rise against the yen and the Deutschemark. The U. S. authorities may call this the result of policy coordination. They have wanted the governments of Japan and Germany to stimulate their economies and the others have wanted the United States to cool its economy. This tentative evidence indicates that the United States and its partners at least risk some damage to domestic stability in exchange for effects on exchange rates and a reduction in the U.S. trade deficit.

Should We Reduce the Capital Inflow?

Advocates of reducing the U. S. trade deficit should realize that doing so would also reduce the inflow of capital from abroad. Do we really want to do that? If so, why? U.S. Governors and Mayors who now go to Europe and Japan with delegations of boosters to attract investors to their territories may not have heard that they might be boosting the trade deficit by encouraging capital inflows.

Some analysts see the capital inflow as building a debt burden for future generations of U.S. citizens. C. Fred Bergsten, for example, was quoted in The Wall Street Journal on 16 December 1987 as saying, "The borrowing binge of the '80s leaves a legacy in terms of annual debt service to foreigners equivalent to about 1.5% to 2% of the whole gross national product. That's a permanent cost that will be levied on ourselves, our children and our grandchildren."

How would this be different from the burden of domestic debts? Why does it matter who holds the debt (or equity)? Benjamin Friedman and others say that much of the foreign capital is used for consumption rather than for investment in productive facilities, leaving Americans with more debt and fewer assets. But this merely reflects the U.S. saving rate, which is lower than saving rates in other countries. If the foreign capital had not come in, would Americans have consumed less, or would they have invested less? The answers are not obvious.

The total capital stock available to U.S. workers and businesses for any given U. S. saving rate, surely must grow more rapidly with an inflow of capital from abroad than it would without the capital inflow, even though some of the imported capital may be consumed instead of being invested in productive facilities. The greater growth of the capital stock therefore, must be reflected in a greater growth of total U.S. product (and consumption) than we otherwise would have. Isn't the "burden of debt service" then met out of the greater product? Why is indebtedness to foreigners bad?

Why should it matter to a U.S. worker who owns the plant? The foreign owners receive the marginal product of their capital, but American workers, and various state, local, and federal taxing authorities, get the rest of the product of the enterprises in which the capital is employed. The total product is certainly greater than it would be without the capital. Moreover, Japanese and European plant managers are now bringing improved management techniques to this country, just as American managers of plants in other developing countries were said to do in the past.

Herbert Stein simply argues that the United States will not be made poorer by paying a return on capital from abroad, "because the income will

be earned by capital that would not have been here without the prior inflow of funds from abroad."(Stein, 1987) He says that the inflow could continue indefinitely or until rates of return fall in the United States in relation to rates of return elsewhere. That sounds eminently reasonable to me

We may wish that Americans saved more. But a savings rate is not an appropriate policy variable. For who knows what is the right level of saving? For believers in free markets it should be the level of saving that would result from the free exercise of individual preferences in a world in which the incentives to save or consume were not distorted by governmental tax and other activities. This suggests that we should examine how our system of taxes and income transfers influences national saving. Some public tax and other policies bias peoples' choices toward consumption and away from saving. The supply siders argue for reducing such constraints. This is part of the problem of financing public expenditures in the least damaging way.

The growth of consumption reflects the free choices of millions of U.S. residents. Should they be prevented from consuming so much, and should they be forced to save more? People in the rest of the world should be so lucky. Nevertheless, some analysts are so worried about the low U.S. saving rate that they would recommend an element of compulsion in order to increase it. Brian Motley and Marc Charney, for instance, recommend in a recent piece that growth of domestic demand should be slowed in order to increase domestic saving. Although they believe a decrease in federal expenditures would help, they think that would be difficult to do. "Alternatively," they say, "an increase in taxes or some cutback in federal transfers would reverse the rise in the share of national income accruing to the private sector."(Motley and Charney, 1988) That is a great example of

how distaste for deficits could lead to an increase in government spending (assuming I am correct in expecting a revenue gain to be used for increasing expenditures rather than for reducing the deficit).

We could say that Americans are consuming a larger share of current income now than in the past because they have built up vast stocks of human capital and consumer durable goods and because they have great confidence in their prospects. After all, the U.S. economy has provided 14.5 million new jobs since 1982, while employment in Europe and Japan has been nearly static. The family that borrows to pay for current consumption or for investment in housing or education or durable goods does take on a burden for the future. But why should this be considered irrational?

There is one more extremely interesting line of argument deploring capital inflows,or rather deploring growth of U.S indebtedness to people in other countries. It has been developed especially well by Benjamin Friedman (Friedman 1986 and 1987). Professor Friedman argues that increasing indebtedness to foreigners has worrisome implications for the independence of U.S. economic policy and for the nation's ability to achieve a rising standard of living. "At the most obvious level," he says, "net debtor status implies the need not just to service debt obligations owed abroad but to nurture foreign leaders' confidence in the nation's ability to meet its obligations, and hence their willingness to hold them." (Friedman, 1986, 146) Furthermore, it worries him that the accumulation of U.S. assets held abroad during 1978-1984 was almost entirely due to private rather than governmental holders. I don't understand why he would consider governments to be more reliable than private investors as holders of U.S. assets.

Finally, Benjamin Friedman is afraid that foreigners' portfolio preferences will differ from those of American investors and thus will

influence asset returns here. In particular, he expects growing participation of foreign investors in U.S. financial markets to require a greater premium of expected returns on long-term debts over expected returns on short-term debts than has been true in the past.

Profesor Friedman's analysis of capital-market effects of foreign investment in the United States does not suggest to me that investors in other countries are going to impose any seriously onerous requirements on the U.S. government or on private borrowers in this country. They want the same market conditions that American investors want, primarily reasonable stability in economic policies and strict observance of their property rights. They must also consider exchange risk, which behooves U.S. policymakers to see what they can do to bolster confidence in the domestic and international purchasing power of the dollar.

Michael Keran argues that there are three major actions by the U.S. government that could trigger a loss of foreign confidence in U.S. economic policy and thus could cause foreign investors to want to get out of U.S. assets (Keran, 1988). The first of these would be any actions that would increase budget deficits (Investors have already discounted lack of progress in reducing deficits, he says). Given the widely professed fear of deficits in the world, Dr. Keran is probably right. If his argument makes future Congresses more cautious about increasing spending that would be all to the good. The policymakers should not necessarily assume that tax increases advertised as reducing budget deficits would sit well with foreign investors. They are as much interested in after-tax returns on investment as are American investors.

The second policy error that Dr. Keran says would shake foreign investors' confidence would be the passage of strongly protectionist trade

legislation and a threat to impose capital controls. That would be devastating. It illustrates the need to avoid being stampeded by the twin deficits into doing anything so foolish.

The third error on Dr. Keran's list would be a perception that the Federal Reserve was following an inflationary monetary policy. That too would be devastating to investor confidence, not only abroad but at home. However, I ruled that problem out of consideration at the beginning of this paper. I plan to take it up again later, maybe, but not now.

Conclusions

Misplaced concern over budget deficits and trade deficits tempts the government and its official and unofficial advisors to let down their guard against more important problems, especially the growth of government spending and the rise of protectionism in international trade. This same concern also tempts them to endorse policies to deal with the deficits that would do more harm than good. Among these harmful policies are proposed tax increases -- which would merely increase the size of the government and have damaging effects on incentives as well -- and various proposed trade restraints -- which would damage U.S. consumers and other members of the global economy.

Controlling growth in federal spending and the rise of protectionism ~~are~~ is difficult because our political system makes it possible for legislators and officials to confer large benefits on well-organized interest groups while imposing small costs on the unorganized majority. As George Stigler says, "It is a small, diffused and unenterprising special interest group that does not find some accommodation in the political scene." (Stigler, 1988, 11) Perhaps that is the price of democracy. I hope not.

As I argued earlier, I believe exchange-rate intervention is especially damaging, because it increases risks in financial markets and markets for goods and services by impairing price information. The costs in terms of global misallocation of resources are simply incalculable, but they must be very large.

A currency that is subject to direct, arbitrary, unpredictable interventions by governments is less desirable to hold as a store of international purchasing power than it would be if its exchange value were determined solely by free market forces. Therefore, because of the uncertainty engendered by attempts to manipulate exchange rates, the dollar may now be lower than it otherwise would be. This provides foreign investors an opportunity to acquire U.S. equities, land, and other direct investments at bargain prices. Thus, the dollar policy may actually now be supporting the capital inflow and contributing to the trade deficit.

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[1] This paper grew out of a topic suggested by Milton Friedman. It benefited greatly from his comments on an early draft. At the risk of being drummed out of the ranks of respectable scholars, I must say that in some sections I can hardly tell which words are his and which are mine. David Meiselman, Phillip Vincent, Kenneth Ackbarali, Noreen Doyas, Lynn Reaser, Nancy Kane, Rod Swanson, and Steven Hess also provided helpful suggestions. None of these people should be held responsible for any analytical or factual errors in the paper.

[2] The Reagan administration succeeded in slowing growth of the share of Federal expenditures in GNP, but the share was larger in the administration's final year than in the first year.

[3] A Wall Street Journal story on a Congressional vote to override President Reagan's veto of a highway bill said, for example, "While the Democrats had the muscle to save a traditional program like highway spending, it has become almost impossible, politically and economically, to launch big new spending programs." And, later in the same piece, "Democrats feel obliged, along with the President, to continue to bring deficits down." (Birnbaum 1987).

[4] Much of this section is based on long conversations with Professor Meiselman. I have no hard copy documentation to show what I borrowed from him.

[5] For a typical financial press statement on the twin deficits when the dollar is falling, see Peter Torday (1988) in the Wall Street Journal, who says, "Calls for Washington to boost the dollar through firm action aimed at cutting its budget and trade deficits have been widespread for months but haven't been heeded by the Reagan administration or Congress."

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[6] For a fascinating account of using quota agreements in a long, costly, futile campaign to protect the U.S. textile and apparel industries from producers in Third World and Newly-Industrialized-Countries see Lardner, 1988.

[7] In 1987 and 1988 the relative rates of growth of U.S. domestic final demand and imports reversed. Although imports remain high by past standards, domestic demand started to grow faster than imports, contributing to a recovery in U.S. manufacturing.

RA7.68

SECRET

pmp

FROM: A C S ALLAN
DATE: 2 March 1988

SIR G LITTLER

cc PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Peretz
Mr R I G Allen
Miss O'Mara
Ms Goodman

FORWARDS

The Chancellor was grateful for your minute of 25 February. He does not think there is any difference between your views and his. His comment on MOD was a response to Miss O'Mara's point in paragraph 2 of her minute.

A C S ALLAN

52

REVIEW OF ECONOMIC STATISTICS

BF next PEM whatever prop

MANAGEMENT IN CONFIDENCE

From: SIR PETER MIDDLETON

Date: 8 March 1988

CHANCELLOR

cc Chief Secretary

Ch
Next PEM whatever? yes
AA

not just macro

REVIEW OF ECONOMIC STATISTICS

You are aware of the acute problems we are having (and have had for some time) on macroeconomic statistics. It has got to the point where I, and other senior Treasury officials involved, think a thorough review of Government macroeconomic statistics is called for. I recently held a meeting with DTI, Department of Employment, Bank of England and CSO, the major suppliers and processors of macroeconomic statistics, to discuss this proposal. Everyone acknowledged that there were serious problems and readily endorsed the idea of a review.

2. We will probably need to consult Ministers before proceeding with a review because some of them are very sensitive about their statistical empires. I have written to Sir Robin Butler seeking his views and enclosing the proposed terms of reference for the review. They have been agreed by all those at my meeting. A copy is attached.

3. We all attach the greatest priority to sorting out this highly unsatisfactory situation.

P E MIDDLETON

REVIEW OF GOVERNMENT ECONOMIC STATISTICS:

DRAFT TERMS OF REFERENCE

To examine the present inter-departmental arrangements for the production of Government statistics relating to UK national income, expenditure and output, the balance of payments, financial accounts, investment, the labour market, productivity and prices; and to make recommendations for achieving improvements in the standards of coverage, quality and coherence sought by users on a cost-effective basis (including costs that fall outside Government).

td8 CONFIDENTIAL

FROM: A M DOLPHIN
DATE: 8 March 1988

1. MR SEDGWICK

2. CHANCELLOR

cc: Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lankester
Mr Scholar
Mr Evans
Mr Odling-Smee
Mr R I G Allen
Mr Bottrill
Mr Davies
Mr Hibberd
Mr Matthews
Mr Mowl
Mr Pickford
Mr Owen
Mr Young

Mr Cassell - Washington

RECENT FORECASTS OF THE WORLD ECONOMY

The attached note compares recent forecasts of the world economy from the IMF and the OECD (and the latest GATT world trade forecast) with the draft FSBR forecast.

2. The IMF forecast shown is the draft "World Economic Outlook". An updated version of this forecast will be published at the time of the Spring meetings. The OECD forecast is a very early version of the forecast that will be published in June in the "Economic Outlook". The GATT world trade forecast has already been published.

3. The forecasts are similar. Real GNP growth in the major seven is expected to slow down in 1988, while inflation remains moderate. There is nothing in these new forecasts from the international institutions to make us want to change the proposed figures for the FSBR.

A.M. Dolphin

TONY DOLPHIN

COMPARISON OF RECENT FORECASTS OF THE WORLD ECONOMY

1. The attached tables compare the draft WEP FSBR forecast with the latest OECD forecast and with the IMF's latest forecast shown in the draft Spring World Economic Outlook. There are some gaps because the OECD and IMF documents do not show full details of their forecasts.

Assumptions

2. The forecasts are based on a range of policy assumptions. The OECD and IMF assume the continuation of present policies and unchanging nominal (OECD) or real (IMF) exchange rates. The FSBR implicitly assumes some changes in US monetary policy (even though this will not be disclosed in the FSBR).

3. The forecasts are based on world oil prices ranging from $13½ - $18 per barrel in 1988. (The FSBR assumes $14 for the average North Sea price.) None of the forecasts incorporates any significant changes in real non-oil commodity prices in 1988 or in 1989.

Overview

4. GNP growth in the G7 in 1988 is expected by all three forecasts to be 2.6 per cent but, whereas the WEP and the OECD expect a further slowdown in 1989, the IMF expect a pick up in growth to 2¾ per cent. The latest WEP and the IMF forecasts have similar inflation forecasts. The WEP is pessimistic on total world trade growth when compared to the OECD forecast, though the recent GATT report foresees only 4 per cent trade growth in 1988 - slightly below the WEP estimate. No one other than the WEP has yet produced a number for growth of world trade in manufactures in 1988.

Individual countries*

5. For the United States the WEP is the most pessimistic on real GNP growth, especially in 1989, reflecting an assumed tightening of monetary policy. The WEP is also relatively pessimistic about prospects for net exports and this is reflected in the current account forecasts.

6. There is general agreement that growth in Japan has picked up to around 4 per cent a year - slightly above potential. Inflation is expected to remain low and little current account adjustment is expected.

7. The forecasts for Germany reflect continued pessimism about growth prospects, despite general agreement that inflation will stay low. Relatively modest domestic demand growth is part of the reason why the current account surplus is expected to remain large.

* The only information in the FSBR on individual countries is in the text of paragraphs 3.12 to 3.21. There are no figures for individual countries in the tables.

Main forecast aggregates for Major Seven plus world trade

		Annual percentage changes			
		FSBR WEP	OECD	IMF	GATT
Nominal GNP	1986	6.2	6.2	6.2	
	1987	6.0	5.9	5.7	
	1988	6.1	5.8	5.6	
	1989	5.5	5.6	5.9	
Real GNP	1986	2¾	2.7	2.7	
	1987	3	3.0	3.0	
	1988	2½	2.6	2.6	
	1989	2	2.3	2.8	
Consumer prices	1986	2		2.2	
	1987	2¾		2.8	
	1988	3		3.1	
	1989	3		3.1	
Total world trade volume	1986	4¾	4.5	4.5	4½
	1987	4¼	5	4.7	4
	1988	4¼	5½	5.4	4
	1989	3¼	5	4.5	
World trade in manufactures	1986	2			
	1987	5½			
	1988	5			
	1989	3¼			

Note: FSBR figures are for 1989H1 rather than 1989 as a whole.

Detailed forecasts for the three major economies

UNITED STATES

Annual percentage changes

		FSBR WEP	OECD	IMF
Nominal GNP	1986	5.6	5.6	5.6
	1987	6.0	5¾	6.0
	1988	5.7	5½	5.7
	1989	5.4	5¾	6.5
Real GNP	1986	2.9	2.9	2.9
	1987	2.9	2¾	2.9
	1988	2.1	2¼	2.5
	1989	1.6	2¼	2.9
Real domestic demand	1986	3.6	3.6	3.6
	1987	2.1	2½	2.5
	1988	1.2	¾	1.2
	1989	1.1	1¼	2.3
Consumer prices	1986	2.2		2.2
	1987	4.0		3.7
	1988	4.0		4.1
	1989	3.8		3.8
Current balance ($ billion)	1986	-141	-141	-141
	1987	-165	-163	-161
	1988	-158	-140	-139
	1989	-145	-113	-128

Detailed forecasts for the three major economies

JAPAN

Annual percentage changes

		FSBR WEP	OECD	IMF
Nominal GNP	1986	4.3	4.3	4.3
	1987	3.7	4	3.7
	1988	5.3	6	5.4
	1989	4.7	6	5.3
Real GNP	1986	2.5	2.5	2.5
	1987	3.9	4	3.8
	1988	4.0	4¼	3.7
	1989	3.3	3½	3.7
Real domestic demand	1986	4.1	4.1	3.9
	1987	4.9	5	4.7
	1988	5.1	5½	5.3
	1989	3.5	4	4.4
Consumer prices	1986	0.6		0.6
	1987	-0.1		0.1
	1988	1.1		1.1
	1989	1.2		1.4
Current balance ($ billion)	1986	86	86	86
	1987	85	87	87
	1988	85	86	77
	1989	89	81	75

Detailed forecasts for the three major economies

GERMANY

		Annual percentage changes		
		FSBR WEP	OECD	IMF
Nominal GNP	1986	5.6	5.6	5.6
	1987	4.1	4	3.8
	1988	3.9	3¼	3.7
	1989	3.7	2¾	3.7
Real GNP	1986	2.5	2.5	2.5
	1987	1.7	1¾	1.7
	1988	1.7	1¾	1.7
	1989	2.0	1¼	1.7
Real domestic demand	1986	3.7	3.7	3.7
	1987	2.9	3	2.8
	1988	2.2	2½	2.7
	1989	2.8	1½	2.0
Consumer prices	1986	-0.5		-0.4
	1987	0.5		0.2
	1988	1.1		1.1
	1989	0.9		2.2
Current balance ($ billion)	1986	38	38	38
	1987	46	44	44
	1988	54	44	42
	1989	50	39	42

dti

the department for Enterprise

PERSONAL

Sir James Cleminson MC DL
Chairman BOTB

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1P 3AG

British Overseas Trade Board

1-19 Victoria Street
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01-215 7877

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Direct line 01-215 4934

Our ref
Your ref
Date 9th March 1988

Dear Nigel,

EXCHANGE RATES

I should let you know that I am extremely worried at the current rise in the strength of sterling.

I have spoken to David Nickson, who is making a speech in Cambridge today and will refer to the exchange rate problem in terms which I fully support. I sincerely hope that you will be able, in your Budget, to produce an economic package which will enable you to reduce interest rates and thereby bring sterling back to the 3 Deutschmark level or below.

During a visit to Birmingham and the Midlands last week, I met several worldwide exporters who repeatedly tackled me on the strength of sterling and their ability to compete in both US and European markets. I felt able to respond robustly so long as we were at the 3DM level and was able to carry some conviction. I feel, however, as I am sure you must, that the present levels are "over the top" in so far as our export efforts are concerned.

I apologise for troubling you at such a busy time and would not have done so had I not been so concerned.

In David Young's absence abroad, I am sending copies of this letter to Kenneth Clarke and Alan Clark at the DTI and to David Nickson.

Yours ever

James.

SIR JAMES CLEMINSON

SJ2AJW

SECRET

Pz

From : D L C Peretz
Date : 9 March 1988

MR A ALLAN

cc Sir P Middleton
Sir T Burns
Mr Scholar
Miss O'Mara.

MARKETS : INTERVENTION

I should record that, as you asked, I confirmed with Mr Foot in the Bank after yesterday afternoon's blip in sterling that the Bank's tactics in the foreign exchange market in the event of a further rise should remain as previously agreed - and as discussed between the Chancellor and Deputy Governor on the afternoon of 7 March.

2. I also confirmed that if, to meet the tactical objective, the Bank had to deal to some extent in dollars they should do so. We could consider whether or not to switch into other currencies later. The Bank will however tell us first if they see it becoming necessary to deal in this way in London. Their view at present is that so long as the amounts are relatively modest it is not technically difficult to switch any dollars bought into a mixture of French francs and ecu, and that there is some advantage vis-a-vis other central banks in doing this immediately, so that it can be reported as a single transaction. Switching out of dollars later on might be harder to explain to the Fed.

DLCP

D L C PERETZ

SECRET

MG EVENING REPORT

FOREIGN EXCHANGE MARKETS

Monday 14 March 1988

Previous close		Today opening 8.30am	Today close 4.00pm	close 17/3/87	%change $/currency since Plaza	since Paris	since 16 October 1987
77.4	£ERI	77.3	77.2	72.1	-5.9	11.7	4.9
1.8535	$/£	1.8550	1.8485	1.5976	34.5	21.0	11.1
3.0790	DM/£	3.0793	3.0781	2.9295	-21.1	10.3	2.7
1.4867	ECU/£	1.4874	1.4865				
93.3	$ERI	-	93.4		-33.1	-10.2	-6.8
1.6612	DM/$	1.6600	1.6652	1.8337	70.6	9.7	8.1
127.32	Yen/$	127.07	127.07		87.7	20.8	12.4

Apr $14.95 May $15.10 Jun $15.17 Spot Brent Apr $14.45 May $14.65 Jun $14.75

UK RESERVE TRANSACTIONS ($million)

(a) Today	This month so far	Total since 1 Apr 87		(b) Estimated end-month position *
4	2624	30897	Market intervention	2620
8	-122	-7565	Off-market transactions	-156
12	**2502**	**23332**	**TOTAL**	**2464**
			Net borrowing	-515
			Valuation changes	0
			TOTAL CHANGE IN RESERVES	**1949**
			MOD forward foreign currency needs	-264

(a) Spot and forward transactions on a done date basis.

(b) Spot transactions only on a value date basis, as in published figures.

* On conventional assumption of no further market intervention.

OTHER COUNTRIES MARKET INTERVENTION ($million equivalent)

Belgium	-	Germany	-	Italy	-78DM,-96$
Denmark	-	Holland	-	Japan	-
France	-	Ireland	+16$	US	-

MARKET COMMENT

Markets were very active today as they await tomorrow's Budget. In New York sterling slightly firmed across the board as markets expected a non-inflationary UK budget.However,it eased in the Far East on a "Observer"report that the UK would introduce a sterling range following the Budget of DM2.93 to DM3.07.It began in London on an easier note but quickly firmed as markets focused on the apparent disagreement on policy between the Chancellor and Prime Minister.Speculation was also rife over whether sterling would eventually be capped.Sterling saw some profit taking this afternoon causing it to ease.It closed down 0.2 on the index,down 1/2 cent on the dollar,but only down slightly against the Mark since Friday's close.The dollar was on the sidelines for most of the day but it lost some ground against the Yen.

Rates at 5.50PM: $1.8550 DM3.0839 DM/$1.6625 Y/$126.75

Ian Polin

HONG KONG	**Previous**	**Today**	**Change**
Hong Kong dollar	7.804	7.8025	0.0015
Hang Seng Index	2595.45	2584.68	-10.77
3 month interbank rate	4%	3 9/16%	DOWN 7/16%

NAME: I.C.Polin
TEL NO: 270-5556

SECRET

SECRET

MONEY MARKETS — Monday 14th March 1987

INTEREST RATES

	£ Interbank Today	£ Interbank Change	Eurodollar Today	Eurodollar Change
7 days	8 3/8	0	6 5/8	1/16
1 mth	8 11/16	-1/16	6 3/4	0
3 mth	8 27/32	-3/32	6 3/4	-1/16
12 mth	9 9/32	-5/32	7 1/4	0

BILLS

	Today	Change
3 Month Treasury Bills	8 19/32 - 8 17/32	1/32

BANK MONEY MARKET OPERATIONS

	Purchases/Sales £ m	Rates	Discount Rate on Eligible Bank Bills
Band 1 (0-14 days)	275	8 3/16 - 1/2	8 7/16 - 5/16
Band 2 (15-31 days)	Treasury bills due on 18 March		8 1/2 - 15/32
Band 3 (32-63 days)			8 9/16 - 17/32
Band 4 (64-91 days)			8 19/32 - 17/32
TOTAL BILLS	275		
Repurchase			
Lending			
TOTAL OPERATIONS	275	against a surplus £ 300 m	

US RATES

	3 month CDs		10 yr Tsy Bond		20 yr Tsy Bond	
Today/Change	6.63	-0.02	8.29	-0.06	8.58	-0.05

STOCK MARKET

	FT Ind-Ord		FTSE		Gilt index	
Today/Change	1460.0	10.1	1819.5	7.9	90.83	0.23

MARKET COMMENT

GILTS opened firmer with shorts up 3/8, mediums 1/2 and longs 3/4.There was some early buying but by mid morning conditions were quieter with little reaction to the Retail Sales and DTI numbers, pre-Budget lines seemed to have been drawn. Prices edged back up when U.S. Bonds improved after a dull opening, but there was no follow through and the close was 1/4 below the best at longs as Sterling eased. At the close shorts and mediums were up 3/8 and longs 1/2-5/8.

INDEX-LINKED lost early gains to closed unchanged.

EQUITIES improved during the morning although exporters were nervously easier on the continuing strength of the pound.

C. Davey

NAME: C A Davey
TEL NO: 270 4613

SECRET

GILT-EDGED MARKET Monday 14th March 1987

Transactions basis, cash values (#m); sales + purchases -

ISSUE DEPARTMENT: MARKET TRANSACTIONS

	Today	March
Gross sales shorts		
Gross sales mediums		14.9
Gross sales longs and undated		
Gross sales index-linked		82.0
Part paid calls		
Buying in non-next maturities	-0.1	-76.8
CRND: Market transactions	-2.6	-73.4
TOTAL 'GROSS' SALES	-2.7	-53.3
Buying in of next maturities		38.4
Redemptions	-0.2	-2.5
TOTAL TRANSACTIONS WITH MARKET	-2.9	-17.4

	Future calls
Sales required to meet March target of # 370 m	423

PRICES/YIELDS OF GILT-EDGED STOCKS

	Yesterday's close	Change from yesterday's close	
	Par yield (per cent)	Price (#/32)	Yield (%)
Shorts	9.048	6	-0.05
Mediums	9.207	12	-0.06
Longs	9.088	16	-0.06

REPRESENTATIVE STOCKS

	Price (#/32)			Yield (per cent)	
	Today		Change	Today	Change
8% Treasury 1992	96	16	10	9.04	-0.10
8 3/4% Treasury 1997 'C'	97	22	14	9.11	-0.07
11 3/4% Treasury 2003/07	121		18	9.36	-0.05
2 1/2% Index-Linked 2016	95	20	2	3.80	0.00
3% Treasury Loan, 1992	84	28	-2	7.19	0.02
8% Treasury Convertible 1990	101	19	11	7.24	-0.16

GILT FUTURES

		Open	Close	Volume
Long Contract	June	123.03	123.00	17125
Medium Contract	March	97.05	97.16	

NAME: C A Davey
TEL NO: 270 4613

SECRET

FROM: SIR T BURNS
DATE: 14 MARCH 1988

CHANCELLOR

cc Sir P Middleton
Sir G Littler
Mr Scholar

EXCHANGE RATE POLICY

This note reviews some aspects of exchange rate policy in the light of recent events. It is in four sections:

- a discussion of the nature of the foreign exchange market and why it is important for the authorities to make their policy towards the exchange rate clear;

- a review of monetary conditions and the case for greater exchange rate stability;

- some comments on recent events and statements;

- some options for the next few weeks.

2. It is a review of the issues but could be used in part if, at some stage, we want to put together a note for wider circulation. I would be grateful for any reactions.

The Foreign Exchange Market

3. The foreign exchange market is driven in part by expectations. Expectations of appreciation will push up the exchange rate and vice versa.

4. In the very long term fundamentals are dominant but in the shorter term substantial fluctuations can take place.

5. Misalignments of exchange rates can persist for long periods. The feedback mechanism of exchange rates to trade balances only operates slowly; indeed in the shorter term it can be perverse - the familiar J-curve.

6. Although the authorities cannot control exchange rates precisely they can have a substantial impact on expectations. This stems from the influence they have on some of the most important factors determining exchange rates - the budget deficit, interest rates and intervention. Not surprisingly the markets give weight to what they interpret as the authorities' preferences in generating their own expectations.

7. For example, suppose markets suspect that the authorities may engineer a higher exchange rate to impose greater disinflationary pressure on the economy. Markets know that the authorities have some scope to raise interest rates to bring this about. Markets attempt to ~~forestall~~ anticipate this and in the process push up the exchange rate.

8. At times the immediate desires of the authorities can be overwhelmed by capital flows. Very often this happens when markets try to anticipate the future actions of the government. For example if a large trade deficit emerges it may lead to expectations that at some stage the authorities will accept or bring about a depreciation if the alternative cures (for example budget tightening, higher interest rates or borrowing) are seen as unlikely.

9. Because the preferences of the authorities are so important to markets there is much to be gained by giving a clear lead. At one stage it was thought that with floating exchange rates the best way of giving this lead was to operate a strict regime of monetary targets. This would pin down inflationary expectations and lead to stabilising speculation. Two problems have emerged. One is that the signals from monetary growth figures have been ambiguous because of the changes brought about by changes to the financial system. The second is that once

markets realise that substantial fluctuations can persist their emphasis shifts to guessing short-term speculative movements.

10. In the absence of a reliable monetary anchor to stabilise expectations there is a strong case for the authorities making their policy towards the exchange rate clear. At times this will require reinforcing action - for example by interest rates and intervention - but for long periods the effect of expectations will be supportive as long as the underlying situation is sustainable.

11. It follows that it is simplistic to talk about not "bucking markets". Market expectations and behaviour are not independent of the authorities for the reasons outlined above. The behaviour and desires of the authorities are powerful influences on those markets. Maybe it is not possible to control exchange rates within very narrow ranges. But this does not mean that the only alternative is a completely passive attitude. What is necessary is a strategy for dealing with market pressures; decisions about the acceptable range of fluctuation; how to respond to fluctuations; and what to say.

Monetary Conditions and Exchange Rate Volatility

12. Exchange rate fluctuations have an impact on monetary conditions. Ceteris paribus, an exchange rate appreciation will tighten monetary conditions and put downward pressure on money GDP and inflation. For this reason we have given a substantial weight to exchange rates in monetary policy decisions for many years. In successive editions of the MTFS the importance of exchange rate behaviour has been emphasised. Increasingly other countries have made similar policy statements - see Greenspan in his recent evidence; and the Gleske of the Bundesbank.

13. In some respects, therefore, a higher exchange rate can be seen as a substitute for higher interest rates. But there is an important difference. As compared with higher interest rates,

tightening monetary policy through a higher exchange rate puts more pressure on the tradeable sector and less on the non-tradeable sector, particularly construction. As a result the balance of payments situation will be worse.

14. Of course, in many situations exchange rates and interest rates move together and a tightening of policy through higher interest rates will exert some of its influence through the higher exchange rate it brings. But as we have seen fluctuations of exchange rates take place independently of interest rate changes.

15. The experience of recent years is that exchange rate volatility is damaging. Some of this volatility is due to differences in the conduct of economic policy. But some is because of the mechanisms outlined earlier.

16. The damage emerges in two forms. One is the adverse effect upon companies of periods of "high" and "low" exchange rates and the costs of dislocation as they are forced to change the emphasis of their business from the domestic to external sectors. The second is the adverse effect on investment because of the fear of companies that unexpected fluctuations are possible. This leads them to taking low risk decisions which do not involve sinking large amounts of capital in countries that might become uncompetitive.

17. There is a great deal to be said for doing what can be done to achieve greater exchange rate stability. Absolute stability may be impossible - but that is no reason for complete abdication.

18. This is what lies behind the G7 statements in recent years and why they have attempted to conduct policy in a way that will contribute to exchange rate stability once they were satisfied that rates had been brought back from the absurd previous levels.

Recent Events

19. Over the past year sterling has been very stable against the DM - and since April has been in the range of 2.95 to 3.00DM. This has brought considerable benefits. In particular it is likely to have encouraged investment in the UK aimed at the European market. The greater expectation that sterling would avoid major fluctuations reduces the risk premium inherent in the exercise.

20. Substantial intervention has been necessary. But this has not been allowed to feed into faster expansion of MO; and it has been fully funded over the course of the year so there has been no addition to liquidity from this source. With a low PSBR there has been no difficulty in financing substantial intervention. It follows that in neither respect has intervention been an inflationary force. Obviously if the exchange rate had been higher there would have been greater disinflationary pressures - but that is another matter and it is doubtful if the effects would have been permanent.

21. In time the 3DM level is likely to be a reasonably tough anti-inflationary discipline and is expected to bite with increasing force.

22. But it became clear last week that the scale of the pressure was greater than could be coped with by intervention. And there was no scope for reducing interest rates as we already had concluded that, if anything, monetary conditions were on the easy side. Sterling was allowed to go through the 3DM level.

23. This should have been presented as an adjustment within the general policy of increased stability. At some stage it may be necessary to respond by lower interest rates or more intervention. And because the exchange rate would be higher there should be less inhibition about using interest rates.

24. This is not what has happened. The markets have been given the impression that we are anxious to see a higher exchange rate as an antidote to inflation. This is quite different from the suggestion that there was no room for easing monetary conditions.

25. The response of the markets to various Ministerial statements is one piece of evidence that markets take an interest in the statements of the authorities. If they now believe that we wish to see a much higher exchange rate they will gradually push upwards testing for a response. A rise to an unsustainable level now will not only put unnecessary and damaging pressure on manufacturing industry and the investment that seems to be in the pipeline. It will also increase the chance of a reversal later. Once the pressures emerge for depreciation it may be more difficult to stop them if a momentum has built up.

26. It is important to recognise that the present situation is very different from 1980-81 when sterling rose so sharply. There is no inconsistency between what was allowed to happen then and what we would prefer now. The circumstances then were very different: inflation was almost 20 per cent; North Sea oil was having a big impact; it was important to assert credibility for a non-accommodating policy stance; there was a [case] for a shock to expectations generally; and it was impossible to be sure for several months that broad money was giving the wrong signals. British industry is in much better shape now. What it needs is more investment, [not more streamlining;] and for that you need stability and confidence, not shocks.

27. There is of course still some worry about high earnings growth and settlements contributing to it. No doubt a high exchange rate would help but at a cost in confidence and investment. Surely it is much better to maintain stable monetary conditions; to keep controlled high interest rates and emphasise that we will not "accommodate" by exchange rate depreciation.

Options

28. It is vital that we have no more statements implying that we are actively seeking a higher exchange rate. But on its own that will not be sufficient to restore confidence about the continuity of policy.

29. There are two broad options for the weeks immediately ahead: to accept a revaluation but dig in at a higher level (say 3.10 or 3.15DM); or to return to an approach of trading off interest rates and the exchange rate with the objective of maintaining a constant degree of monetary tightness.

(i) **An effective revaluation**

So far we have tried to interpret recent events as an effective revaluation. This means emphasising that we continue to be interested in pursuing a policy of greater exchange rate stability with particular emphasis on the rate against the DM. The choice may be between a new ceiling of 3.10DM or 3.15DM. Alternatively we could think of an inner limit of 3.10 and an outer limit of 3.15. It would require a determination to resist any movement towards the chosen ceiling through intervention and lower interest rates. If it became impossible to resist the move through 3.10 we would fight again at 3.15.

The difficulty with this approach is that it could involve substantial intervention and a significant interest rate cut. But this is not an overwhelming objection and at some stage I do not rule out some profit-taking if interest rates are reduced - but this obviously depends on the response to the Budget. It also requires supportive statements (or at minimum an absence of negative statements) from No 10. Effectively we would end up with a higher exchange rate but maybe lower interest rates than preferred.

If this worked in the weeks ahead it might be possible to eventually get back to a rate closer to 3DM with interest rates at between 9 and 10 per cent.

(ii) <u>**A less precise target range**</u>

The main alternative is a return to the approach of trading off interest rates and the exchange rate with the objective of maintaining a steady degree of monetary tightness. The main advantage of this approach is that it offers some flexibility whilst we seek to re-establish public perception of the importance of the exchange rate. And it should be relatively easy to make the case that we have to give a significant weight to the exchange rate in determining monetary conditions.

The old ready reckoner implied a trade-off of 1:4 between interest rates and exchange rate changes. Immediately before uncapping we thought that monetary conditions were too easy, say, by the equivalent of ½ on interest rates. This implies room for ½ per cent off interest rates at 3.09-3.12, and a further ½ per cent at 3.15-3.18.

The main disadvantage of this approach is that it involves a return to a much less precise objective for sterling and is manifestly different from behaviour over the past year.

30. However, as it happens, in practical terms both approaches lead to the same conclusion for the next interest rate move: that it should be seriously considered at any rate from 3.09DM upwards.

31. There are also strong political arguments for an interest rate move. There is now some doubt about the nature of policy, and a quick move would assert the importance of the exchange rate - if not its primacy.

32. Finally, I do not want to exaggerate the differences between the two approaches. the first is a more discrete version than the second; and both can be described as "managed floating". Either version is a long way from the approach of "free-floating" and accepting whatever gyrations of exchange rates are thrust upon us.

T BURNS

CONFIDENTIAL

cc as below

Mr Waller
Mr Moore

Mr Gray spoke to me about this. He will tell PS/SOS at DoE to hold off pressing this while shipbuilding discussions are progressing. So no action pro tem.

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

My ref:

Your ref:

The Rt Hon John Major MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

CHIEF SECRETARY	
REC.	15 MAR 1988
ACTION	Mr Instone - with attachment
COPIES TO	Cx. Mr Anson,
	Mr Monck, Mr Burgner
	Mr Hamilton, Mr Moore
	Mr Turnbull, Mr Waller, Mr Call

15 March 1988

Dear John

SUNDERLAND: SHIP BUILDING CLOSURES - DECLARATION OF AN ENTERPRISE ZONE

I believe - and should be grateful for your agreement, and that of colleagues - that we should establish an Enterprise Zone in Sunderland, as a response to prospective closures by British Shipbuilders. The details are given in the accompanying paper. — not attached
You will be familiar with the problems of Sunderland - 24 per cent male unemployment; Assisted Area status; Programme Authority status; an inclusion of parts of its areas within the boundaries of Tyne and Wear UDC. But British Shipbuilders' closures (news of which, I understand, has already percolated to the local media) will put still further pressures upon the town, with consequent calls for us to act.

Assisted Area and Programme Authority status, with the activities of the Tyne and Wear UDC, and English Estates North, already represent a very high level of public sector intervention in Sunderland. The area does have considerable potential - as the success of Washington New Town, and the investment by Nissan, demonstrate. We need to avoid fostering a dependency economy, and to encourage indigenous enterprise and initiative - as well as to attract new inward investment. In my view an EZ, with its emphasis on deregulation and investment, is a natural supplement to existing activity, which will meet that aim, as well as providing a significant marketing tool. The success of the nearby Hartlepool EZ shows what can be achieved even in the most difficult North East conditions.

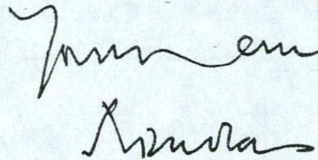
My publicly announced stance is now against creating further EZs, but I have left open the possibility of exceptions. I believe in this case that an exception would be fully justified. I am also conscious that it would appear inconsistent to establish an EZ at Inverclyde, which faces similar problems, but not in Sunderland where the prospects of success are perhaps better.

100%
RECYCLED PAPER

The cost of an EZ would be about £2 million above the total of the current initiatives (which are being borne either on DOE programmes through the UDC, in whose area it will fall, and through DTI's provision for Regional Selective Assistance to industry). But none of the £2 million would require additional public expenditure. I would need some increase in Vote provision, for rate rebates, but that would be a transfer payment. An EZ could be expected to generate an additional 100-350 net permanent jobs (depending on displacement assumptions) and (whatever the displacement assumption) to reduce the public sector cost per job generated.

I would be grateful for your early agreement to this. David Young and I would clearly need to be ready to announce that, subject to approval by the European Commission, we are giving serious consideration to an EZ, in time for the announcement of the British Shipbuilders redundancies. If possible, the announcement should be made simultaneously with that for Inverclyde, though our consultations with the EC would not have progressed so far, and we would have to put in appropriate qualifications.

I am copying this to the Prime Minister, other members of E(UP) and Sir Robin Butler.



NICHOLAS RIDLEY

BRITISH EMBASSY
35 rue du Faubourg Saint-Honoré · 75383 Paris Cedex 08
Telephone 42 66 91 42

pmp.

Ms Moira Wallace
APS/Chancellor for the Exchequer

Your reference
Our reference
Date 16 March 1988

Chf Sorry this is such a faint copy. We'll try and get a more legible copy of Le Figaro. Do you [want] translations of any of them? mpw 16/3

Dear Moira,

1988 BUDGET: FRENCH PRESS COVERAGE

Summary (PS German version now behind)

1. Widespread coverage in nearly all Paris based dailies, with emphasis on radical tax reform against a favourable economic background. Right wing (Figaro) and neutral (les Echos, La Tribune de l'Expansion) press coverage almost wholly favourable, left wing (Libération) slightly more grudging and a little snide, as may be Le Monde (also centre left) this afternoon.

Detail

2. There is good coverage of the budget in this morning's press with the emphasis on tax reform, particularly the reduction and simplification of income tax, against a favourable economic background. Main articles themselves follow. Highlights are:

i. Le Figaro (right wing). Broadly factual account at the front of the financial section, under the heading «spectacular reduction in income tax: the 1988/89 budget... introduces an income tax reform without parallel in the West»

In a short commentary, Le Figaro says «the Thatcher government has, once again, shown a boldness rare in Europe», and contrasts the new top rate of income tax with that in France (56.8%) and Germany (56%).

ii. Libération (centre-left). Full page article with photograph of Chancellor and dog. «The most fundamental and most daring budget since Magaret Thatcher came to power». Emphasis on tax reform against the background of high tax revenues, the result of «the exceptional dynamism of the British economy». Description of income tax reform, reform of tax on married couples («a feminist budget»), forestry changes and allowances for perks. Reference too to criticism of too little being done for the NHS. «But these criticisms will not succeed in unbalancing a government strengthened by a string of economic successes.....eighth year of sustained growth, budget surplus, inflation under control, unemployment

iii. Tribune de l'Expansion (financial daily). Front page box headed «fiscal revolution in Great Britain» and major inside article beginning «Great Britain has won the fiscal jackpot». «Nigel Lawson......outlined the most ambitious fiscal reform in the Western world... thanks to the exceptional performance of the British economy». Emphasis on income tax reform, changes in company tax, inheritance tax and capital tax. Emphasis on tax simplification. A fiscally neutral budget, with revenue surplus directed at investment as much as consumption. «In short, Lawson has struck firmly but fairly».

iv. Les Echos (financial daily). Front page box plus inside article. «A radical reforming budget.» Emphasis on income tax and help for small and medium enterprises. Factual account of other tax changes and increases on excise duties. References too to some city disquiet at the effect on domestic demand and inflation.

3. Le Monde (centre left) appears this afternoon. If past experience is anything to go by, it will be more grudging in its praise than some of the others.

Yours sincerely,

Michael Jay

M H Jay
Counsellor (Financial & Commercial)

EXP: EMBASSY PARIS 1988-03-16 10:36 G3-48 S #4

LE FIGARO

16 MAR 1988

Londres : baisse spectaculaire de l'impôt sur le revenu

Le budget 1988-1989, présenté hier, instaure une réforme fiscale sans équivalent en Occident de l'impôt sur le revenu, ramené à deux taux : 25 % pour le taux de base et 40 % pour les revenus élevés.

LONDRES :
de notre correspondant

Nigel Lawson, le chancelier de l'Echiquier, avait promis que la petite mallette rouge du budget contiendrait cette année une surprise de taille. Il a tenu parole, annonçant une réforme radicale de l'impôt sur le revenu.

Principaux bénéficiaires du nouveau système d'imposition : les tranches de revenus les plus élevés qui seront désormais taxées au taux unique de 40 %. Le taux de base est lui aussi réduit et passe de 27 à 25 %, confirmant la promesse faite par Margaret Thatcher au cours de sa dernière campagne électorale.

« *Cette réforme* [illegible] *donne l'un des systèmes d'imposition du revenu les plus simples du monde* », a déclaré le chancelier de l'Echiquier devant la Chambre des Communes hier. La réforme de Nigel Lawson comporte plusieurs aspects qui bénéficieront à l'ensemble des Britanniques. Mais c'est dans les quartiers aisés de la capitale que l'on a, hier soir, sablé le champagne.

Le système en vigueur jusqu'à présent comporte en effet six tranches d'imposition : le taux de base pour les revenus inférieurs à 17 900 livres par an (un peu plus de 180 000 francs) et cinq tranches pour les hauts revenus allant de 40 à 60 %.

La réforme du chancelier de l'Echiquier prévoit une simplification de ces barèmes avec deux tranches seulement : le taux de base, désormais à 25 %, et dont le plafond sera relevé à 19 300 livres par an (près de 200 000 francs) et le nouveau taux unique de 40 % pour les hauts revenus.

Excellente santé

Une réforme qui se traduira par une réduction d'impôts d'un peu moins de cinq livres par semaine pour un ménage gagnant 12 500 livres par an, mais qui rapportera plus de deux cent cinquante livres par semaine aux contribuables dont le revenu annuel dépasse 100 000 livres. Le chancelier a cependant promis que cette réduction n'est qu'une première étape. Son objectif à long terme : ramener le taux de base à 20 %.

La réforme de Nigel Lawson a provoqué un émoi considérable sur les bancs de la Chambre des Communes. Pour la première fois de mémoire de député, la session a dû être interrompue à deux reprises pendant le discours du chancelier pour ramener l'ordre. Cette réduction spectaculaire de l'impôt sur le revenu domine naturellement son budget, marqué également par la baisse de l'impôt sur les petites entreprises et l'annonce d'un excédent budgétaire de trois milliards de livres pour l'exercice fiscal 1988-1989.

Ce surplus des finances publiques, unique au monde, reflète l'excellente santé de l'économie britannique, selon le chancelier de l'Echiquier, qui a promis que désormais un budget équilibré serait « la norme » et non plus l'exception. Pour la [illegible] année consécutive, le chancelier de l'Echiquier a annoncé une croissance supérieure à celle de l'ensemble des pays européens.

Pour 1988, Nigel Lawson reste modérément optimiste, prévoyant un taux de croissance de 3 %, une inflation de 4 % et une baisse supplémentaire du chômage.

A Londres, la City a accueilli avec une satisfaction prudente les principaux points du budget : « *Les marchés sont toujours un peu sceptiques face à des réductions d'impôt aussi importantes* », déclarait hier Kevin Boakes de la banque Midland Montagu. « *L'excédent budgétaire de trois milliards de livres nous semble prudent, mais la réduction des impôts risque de provoquer une nette augmentation de la consommation et donc une aggravation du déficit extérieur.* »

L'audace Thatcher

En ramenant le taux maximum de l'impôt sur le revenu à 40 % et en réduisant le nombre de tranches d'imposition à deux, le gouvernement de Margaret Thatcher a une nouvelle fois fait preuve d'une audace peu commune en Europe.

Pour mémoire, il suffit de rappeler qu'en France le taux maximum de l'impôt sur le revenu est actuellement de [illegible] [illegible] RFA la réforme fiscale [illegible] sion envisage d'abaisser le taux maximum [illegible]

[illegible]

Par ailleurs, la progressivité obtenue par l'accumulation d'un nombre important de tranches modifie sensiblement la [illegible] que règle le contribuable.

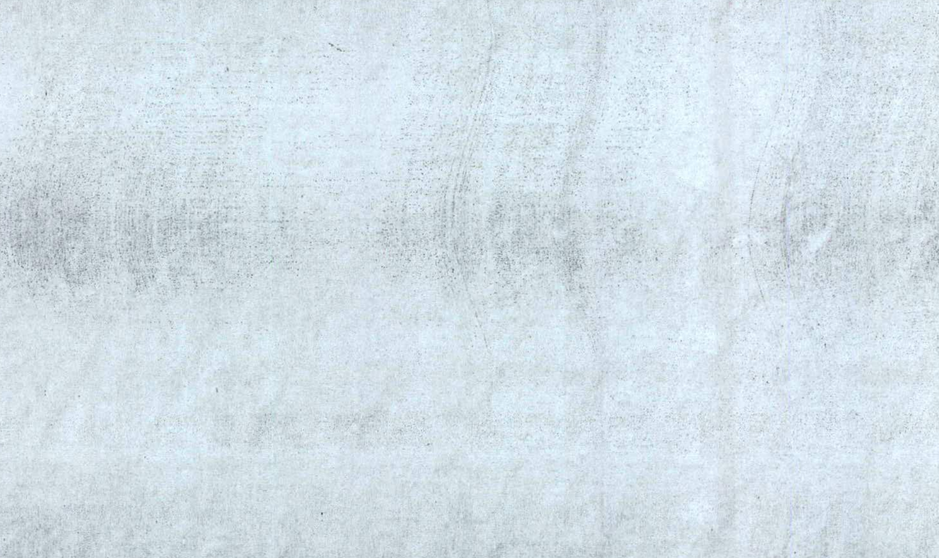
La RFA n'a pas renoncé non plus à un système de tranches multiples, en particulier pour les dix millions de foyers soumis au barème progressif [illegible]

[illegible]

G. P.

LE FIGARO

Londres : baisse spectaculaire de l'impôt sur le revenu



G. P.

LIBERATION

EXP: EMBASSY PARIS 1988-03-16 10:30

ECONOMIE

GRANDE BRETAGNE

THATCHER : MY BUDGET IS RICH

Sous une avalanche de quolibets, le ministre britannique des Finances, Nigel Lawsoı présenté hier à la chambre des Communes un budget excédentaire. Croissance fort privatisations aidant, il s'est même payé le luxe de baisser et de réformer les impô

[illegible] 1988

LIBERATION

Londres, de notre correspondante.

Nigel Lawson a battu hier, malgré lui, un bien embarrassant record. Il a fallu une heure trois quarts au chancelier de l'Echiquier (ministre britannique de l'Economie et des Finances) pour présenter laborieusement son cinquième projet de loi de finances devant une chambre des communes déchaînée. Contretemps sans précédent dans cet exercice codifié et rituel que représente le traditionnel « Budget day », la séance a dû être suspendue à deux reprises pour permettre au président de la Chambre de ramener le calme dans les rangs de l'opposition. Car le nouveau budget est le plus fondamental, le plus osé depuis l'arrivée au pouvoir de Margaret Thatcher, en 1979. L'événement a tenu en haleine les contribuables britanniques, mobilisés, à la maison comme au bureau, devant leurs écrans de télévision, où était retransmis en direct le son de cette mémorable séance — mais pas les images, les caméras n'étant toujours pas autorisées à pénétrer dans l'enceinte de la Chambre des communes, et ce jusqu'à l'automne prochain. Les chaînes avaient déployé le dispositif de choc des grands jours : commentateur politique chevronné, courbes et graphiques, invités. Cet après-midi pluvieux était presque en proie à la fièvre des grandes soirées électorales.

Le budget de Nigel Lawson révolutionne le calcul de l'impôt sur le revenu. Les conservateurs ont certes eu le mérite de tenir la promesse faite aux élections du mois de juin dernier : l'impôt sur le revenu a été réduit de 27 à 25 % pour tous les salaires inférieurs à 19 300 livres sterling par an. Nigel Lawson n'a pas manqué de rappeler qu'au moment de l'arrivée des conservateurs au pouvoir il y a huit ans, l'impôt sur le revenu était de 33 % et que ces 25 % représentaient le taux le plus bas depuis la guerre. « Les gouvernements travaillistes avaient pour habitude de réduire l'impôt sur le revenu avant les élections. Nous avons tenu une promesse de longue date », a souligné Nigel Lawson qui a promis que, dès que les circonstances le permettraient, les conservateurs s'engageaient à rabaisser l'impôt à 20 %. Pour réaliser une baisse aussi spectaculaire, Nigel Lawson disposait il est vrai d'un « trésor de guerre » de près de 10 milliards de livres, contrepartie de l'exceptionnel dynamisme de l'économie britannique en 1987 et de l'importance des revenus des privatisations (5,5 milliards de livres). Le chancelier de l'Echiquier s'est aussi offert le luxe de présenter, pour la première fois depuis la guerre, un budget excédentaire de quelque 5 milliards de livres.

Mais c'est la réforme et la simplification radicale du calcul de l'impôt sur le revenu annoncées par Nigel Lawson qui ont causé la fureur des députés travaillistes. Tous les revenus supérieurs à 19 300 livres sterling seront soumis à un taux d'imposition unique de 40 %. Les tranches croissantes ont été abolies, ainsi que le plafond maximal, qui était de 60 % pour les revenus supérieurs à 41 200 livres sterling. Une nouvelle accueillie aux cris de « Shame, shame » (honte) scandés par les députés de l'opposition. Le speaker débordé a dû suspendre la séance pendant dix minutes.

Autre grande réforme : le budget 88 sera féministe. Nigel Lawson a décidé d'accorder l'indépendance aux épouses. Pour la première fois depuis 180 ans, les femmes vont pouvoir déclarer leurs revenus séparément de ceux de leur mari. Petite concession du ministre pour faire avaler l'amère pilule : l'impôt indirect sur les voitures de fonction a été augmenté et pour les entreprises les repas d'affaires ne seront plus exonérés d'impôt. De plus, le chancelier a annoncé la suppression des exonérations fiscales pour les riches Londoniens qui placent leur argent en achetant des forêts en Ecosse. Au grand soulagement de l'opposition ! « Cette réforme fondamentale, a tenu à conclure le ministre, nous dote d'un des systèmes fiscaux les plus simples du monde ». « L'équation, ironisait-on côté travailliste, est simple en effet : plus on est riche, mieux on s'en tire ».

Il ne restait plus aux laissés pour compte de ce budget, aux chômeurs, qu'à se ruer avant 18 heures vers les comptoirs réconfortants des pubs. Le ministre a annoncé qu'à 18 h 01 tapantes, le prix allait augmenter d'un penny pour la pinte de bière, de quatre pence pour la bouteille de vin et de quatre pence également pour le paquet de cigarettes.

L'accouchement de ce budget révolutionnaire ne se fera pas sans douleur. Aux cris de l'opposition ont fait écho ceux des infirmières et du personnel médical, qui observaient hier, principalement à Londres, des arrêts de travail sporadiques. Depuis le début de l'année, le personnel des hôpitaux britanniques réclament en effet l'injection de fonds supplémentaires dans les caisses du NHS (National Health Service), les services de santé britanniques, malades. « Le budget 1988 donne l'argent aux riches qui n'en ont pas besoin », protestait une infirmière hier soir. Et le Royal College of Nursing, l'un des syndicats d'infirmières, calculait que le budget de Nigel Lawson apporterait aux infirmières une aubaine de 1,50 à 3 livres sterling supplémentaires par semaine sur leur fiche de paie. Neil Kinnock, le chef du parti travailliste, condamnait hier soir ce « budget de la colère qui va alimenter le ressentiment envers les privilégiés ».

Des critiques qui ne réussiront pas à désarçonner un gouvernement blindé par les francs succès économiques qu'il peut maintenant aligner. Nigel Lawson a fait hier la liste des réalisations de son gouvernement : la Grande-Bretagne entre dans sa huitième année de croissance à un rythme soutenu. Le budget de l'Etat est excédentaire. L'inflation devrait continuer à être maîtrisée. Même le chômage est passé au début de l'été dernier au-dessous de la barre symbolique des trois millions et continue de chuter lentement, mais régulièrement. C'est à son fidèle lieutenant, Nigel Lawson, que Margaret Thatcher doit sa victoire confortable aux élections du mois de juin dernier. Une victoire qui donnait hier au chancelier cette marge de manœuvre nécessaire pour oser un budget aussi téméraire.

Pascale HUGUES

LES ECHOS
10 MAR 1988

Budget britannique : allégement et simplification des impôts

Le taux maximal d'imposition des revenus est ramené à 40 % et la fiscalité des PME, allégée pour favoriser la création d'emplois.

RATIONALISATION du système d'imposition, allégement des taxes sur les revenus, Nigel Lawson a présenté, hier après-midi, à la Chambre des Communes un budget radicalement réformiste. Il propose de réduire à 25 % contre 27 % depuis avril 1987 le taux minimal d'imposition et à 40 % au lieu de 60 % le taux le plus élevé. En outre, le nombre de tranches est ramené de 6 à 2, ce qui est à la fois une simplification de fond et un allégement sensible pour les revenus supérieurs.

Par ailleurs, le chancelier de l'Echiquier, interrompu à plusieurs reprises par l'opposition travailliste, a annoncé des mesures en faveur des petites et moyennes entreprises dont une réduction de deux points à 25 % de l'impôt, niveau le plus bas depuis l'après-guerre. En outre, M. Lawson a décidé de supprimer la taxe de 1 % sur le capital des sociétés nouvellement fondées. Mesure qui devrait favoriser la création de nouveaux emplois.

En revanche, l'impôt sur les grandes sociétés reste inchangé à 35 %, mais elle avait été allégée lors de l'exercice précédent. Le gouvernement britannique fait toutefois un effort en faveur du secteur pétrolier en aménageant le régime fiscal appliqué aux nouveaux champs d'exploration qui, à partir du 1er juillet, n'auront plus à verser de royalties.

Le budget 1988-89 qui entre en vigueur le 1er avril prochain prévoit également un relèvement des taxes sur les cigarettes, l'alcool, les boissons ainsi que sur l'essence à l'exception des carburants sans plomb, le gouvernement ayant l'intention de favoriser l'achat de nouvelles voitures.

Le coût de l'ensemble de ces mesures a été estimé par le chancelier à 4 milliards de livres, qui a précisé que la part de la fiscalité dans le PIB demeurera inchangé.

Taux de croissance prévu : + 3 %

Bien accueilli par les marchés où la livre gagnait encore quelques pfennings face au mark, hier, en fin de journée, le cinquième budget du chancelier jouit d'une toile de fond économique favorable : M. Lawson a estimé à 3 % le taux de croissance cette année, un taux d'inflation de 4 %, mais un déficit de la balance des comptes courants de 4 milliards de livres.

Le moment était donc propice pour Margaret Thatcher et son équipe de mettre en œuvre les promesses, faites lors de la campagne électorale du printemps dernier, de ramener le taux d'imposition inférieur sur les revenus à 25 %. Elle peut en outre se targuer désormais d'appliquer l'un des systèmes fiscaux les plus simples des pays industrialisés. De quoi satisfaire les classes moyennes, fidèles supporters de la Dame de fer.

Reste que l'allégement des taxes a de quoi favoriser une propension déjà très forte des ménages, à consommer, elle-même à l'origine d'une inflation qui demeure plus soutenue au Royaume-Uni que dans les autres pays de l'OCDE. Les milieux financiers pourraient réagir avec quelques inquiétudes à cette réalité, qui sera sans doute cette année la première préoccupation du gouvernement Thatcher.

P. M. C.

LA TRIBUNE DE L'EXPANSION

RE

Deux ans après les Etats-Unis

La Grande-Bretagne fait sa révolution fiscale

Simplification et allègement de l'impôt direct : telle est la réforme fiscale annoncée mardi par Nigel Lawson à l'occasion de la présentation du budget. La livre s'est envolée.

■ La Grande-Bretagne a opéré hier sa révolution fiscale. Une révolution d'une ampleur au moins comparable à celle réalisée aux Etats-Unis il y a deux ans par l'Administration Reagan. Fort de ses succès économiques, le chancelier de l'Echiquier a pu en effet, à l'occasion de la présentation du budget 1988/1989, annoncer quelque 4 milliards de livres (42 milliards de francs) de réductions d'impôts tout en conservant un excédent budgétaire de 3 milliards de livres. La réforme est avant tout celle de la simplification puisque seules deux des six tranches de l'impôt sur le revenu sont

Nigel Lawson

maintenues. Le taux de base, qui concerne 90 % des contribuables, revient de 27 % à 25 % tandis que le taux maximal passe de 60 % à 40 %. Le taux d'imposition des petites entreprises sur leurs bénéfices revient à 25 % comme — dans la plupart des cas, du moins — le taux d'imposition des revenus du capital.

Simplificatrice, la réforme est également neutre au plan économique puisque le taux des prélèvements obligatoires ne varie pas.

Par ailleurs, l'articulation des diverses mesures tend à favoriser davantage l'investissement que la consommation, ce qui est judicieux au moment où l'économie britannique frise la surchauffe. Les marchés ne s'y sont pas trompés : aussi bien la Bourse que la livre étaient à la fête mardi en fin d'après-midi.

Aux Pays-Bas, le cabinet de centre droit a également annoncé une réforme de la fiscalité directe qui sera progressivement mise en œuvre d'ici à 1990.

En ce qui concerne les entreprises, le taux général de l'impôt est ramené de 42 % à 40 % sur les bénéfices inférieurs ou égaux à 250.000 florins. Il est abaissé à 35 % pour les profits dépassant ce seuil. Cette décision a provoqué une protestation des petites entreprises qui se trouvent pénalisées.

Pour les particuliers, la réforme se traduit par un double mouvement : simplification et abaissement des taux. Les revenus les plus élevés seront ainsi taxés au taux maximal de 60 % (au lieu de 72 %).

(Page 4)

LA TRIBUNE DE L'EXPANSION

16 MAR 1988

16 MAR 1988

Après les Etats-Unis

Révolution fiscale en Grande-Bretagne

Nigel Lawson a surpris les observateurs par son audace. L'imposition des ménages est considérablement simplifiée et allégée. Des avantages sectoriels sont accordés aux entreprises

■ La Grande-Bretagne a touché le « jackpot » fiscal. En présentant, mardi, le budget 1988-1989, le chancelier de l'Echiquier, Nigel Lawson, a en effet dessiné, devant une chambre des Communes médusée, les contours de la plus ambitieuse réforme fiscale du monde occidental. Au total, les multiples mesures annoncées aboutissent à réduire de 4 milliards de livres (42 milliards de francs) les recettes de l'Etat pour 1988-1989, tout en laissant un excédent budgétaire équivalent à celui de 1987-1988, soit 3 milliards de livres.

Pareil résultat a été rendu possible grâce aux performances exceptionnelles de l'économie britannique. Pour l'année 1988, les principales prévisions contenues dans le budget ont été révisées en hausse : croissance de 3 % (après 4,8 % en 1987, et non de 2,5 %), inflation de 4 % (et non de 4,5 %). Seul le déficit des paiements, du fait de l'appréciation du sterling, a dû être révisé en hausse (à 4 milliards au lieu de 3,5). Conséquence : l'excédent budgétaire, qu'on escomptait de 3 milliards, aurait atteint 7 milliards en l'absence de l'impressionnante série de réductions d'impôt intervenue hier.

Qu'on en juge. En ce qui concerne l'impôt sur le revenu, le nombre de tranches est réduit de six à deux. Une simplification encore plus spectaculaire que celle intervenue l'an dernier aux Etats-Unis. Le taux de base de l'impôt, qui concerne environ 90 % des contribuables, est abaissé de 27 % à 25 %. Dans l'avenir, le chancelier prévoit de le réduire jusqu'à 20 %. Pour ce qui est du taux maximal (jusque-là de 60 %), il est ramené à 40 %, supprimant du coup les tranches intermédiaires à 55 %, 50 % et 45 %. On s'attendait généralement à ce qu'il soit simplement ramené à 50 %. Cela signifie que seuls les Britanniques déclarant plus de 19.300 livres (environ 200.000 francs) de revenus annuels — le salaire d'un cadre supérieur — seront imposés à 40 %. Par ailleurs, plusieurs modifications sont intervenues pour améliorer notamment la situation des couples mariés.

Deuxième volet, la fiscalité des entreprises. Le taux général de l'impôt sur les sociétés, qui avait été abaissé à plusieurs reprises dans le passé, reste certes inchangé au taux de 35 %. Cependant, un certain nombre de mesures adoucissent la fiscalité applicable aux entreprises de certains secteurs, notamment dans la prospection et l'exploitation pétrolière. En outre, le taux réduit d'imposition concernant les petites entreprises revient de 27 % à 25 %, soit l'équivalent du taux de base de l'impôt sur le revenu. En contrepartie, un certain nombre de déductions fiscales génératrices d'abus sont supprimées (comme le régime préférentiel applicable aux véhicules d'entreprises).

Troisième volet : la fiscalité des successions. Un seul taux de 40 % viendra se substituer aux quatre tranches actuelles.

Quatrième et dernier volet : la fiscalité du capital. La taxation des revenus du capital rejoint le droit commun. Ils seront désormais considérés comme un revenu marginal. Un système qui, selon Nigel Lawson, accroît considérablement la neutralité du système fiscal. Par ailleurs, l'impôt de 1 % sur le capital est supprimé. Enfin, tous les gains en capital antérieurs à 1982 sont exonérés d'impôt. En ce qui concerne les entreprises, la taxe qui frappait les émissions d'actions nouvelles disparaît également.

En résumé, cette réforme fiscale est avant tout placée sous le signe de la simplification. Quant à ses effets macro-économiques, ils doivent être jugés à plusieurs niveaux. Globalement, malgré la baisse des taux, elle reste économiquement neutre : le taux des prélèvements obligatoires par rapport au revenu national reste, en effet, inchangé. Ainsi, l'importance du cadeau fiscal ne devrait pas avoir d'impact inflationniste sur l'économie.

La principale difficulté résidait, pour le chancelier, dans la nécessité d'éviter une dynamisation excessive de la consommation, dont la vigueur actuelle risque de déboucher, si l'on n'y prend garde, sur une surchauffe. La forte baisse du taux maginal va dans ce sens, puisque les revenus supérieurs ont une propention à consommer relativement faible. Au contraire, dans ce cas, le surplus de revenu disponible devrait aller à l'investissement. De même, il s'agissait de ne pas pousser l'ensemble des entreprises à la facilité salariale en diminuant l'impôt sur les bénéfices. La fleur faite aux seules PME ne présente pas le même risque. Bref, Lawson a frappé fort mais juste. Son discours a d'ailleurs immédiatement déclenché une hausse du London Stock Exchange, ainsi que du sterling.

DANIEL VIGNERON

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FROM: DAVID BELL

TO: MOIRA WALLCE, CHANCELLOR'S OFFICE FAXNO: 004412705589
TREASURY or 004418392029

THE BUDGET: THE GERMAN PRESS

Your call yesterday to Adrian Thorpe

2. I attach a copy of the relevant section from our daily Guide to the local press summarising those points in the Budget proposals which interested German reporters in London. As we expected, the speech came too late for the editorial writers. We can expect some comment in tomorrow's press. We shall fax a summary to you.

3. As I shall be out of Bonn for the rest of the week you should contact Chris Burrows if you have any further requirements.

4. Handelsblatt = HB
General Anzeiger = GA
Frankfurter Allgemeine Zeitung = FAZ
Kölner Stadt-Anzeiger = KStA

electi... is another arms modernisation debate. Shultz will probably be proved right.

Hauser writes in GA, FR on 'EC triangle Bonn-Paris-London & NATO', says FRG has been too one-sided in the past in cultivating Franco-German friendship as "engine of integration" and has not made efforts to include GB in the same manner. After the EC agreement on rebate, there were clear starts by London to cooperate more actively. Thatcher is just as interested as others in EC single market; she is not a passionate European but then she was snubbed by F-G advance agreements. Doubtful whether there is time for FRG, GB & France to draw up security-policy concept which could be basis of NATO's comprehensive concept.

Kohl invites Burt & Kvitzinski to CDU foreign policy congress on 14 April: Rühe will have separate discussions with the two, since US ambassadors are not allowed to appear in public together with Soviet diplomats (Welt, GA, NRZ). StS Rühl writes almost a whole page in Welt on conventional stability, sees USSR a long way away from understanding "necessary consequences" of military stability. Peace researcher Kubbig (Hesse Foundation for peace and conflict research) in review of effects of SDI agreement with Bonn: Little economic effects, wrong technological road, injurious from perspective of disarmament policy (FR). Bonn has earmarked $ 17 m for financing own missile defence system to be deployed in FRG (FR quoting "Panorama", in turn quoting letter by Biehle of 3 June 87). Gerassimov sees "a change for the better" in FRG-USSR relations, says visits to Moscow by Strauss & Späth paved the way (GA).

3] British affairs: Budget gets front page coverage in HB, GA; reports also in FAZ, KStA. No editorial comment. HB under: 'London with budget surplus (of £3bn)' reports on the number of tax cuts, notes Lawson's forecast of 3% real growth & 4% inflation. GA & KStA (AP item): L. announces radical tax reform in one of the most unusual sessions in the history of GB Parliament: many Opposition MPs shouted the Chancellor down, one MP was even ordered out of the chamber. Uproar because of no additional funds for NHS (FAZ which also goes into the tumultuous scenes). Grudinski underlines: 'Top rate of income tax only 40%'; standard rate down to 25%, personal tax allowances to be increased to twice the rate of inflation; husband & wife to be taxed independently. Lawson: GB gets one of the simplest income tax in the world. Despite lower taxes, the new 1988/89 budget will be balanced: PSBR of nil will be the norm in future (FAZ). Welt starts series on the Royal Family, has feature (by Starkmann) on the Prince of Wales today. Nissan Motor to build Design Centre in GB, probably in Sutherland (Welt). Unrest in London & Belfast as shot IRA terrorists are taken from Dublin to Belfast for funeral today (Welt; RP comments).

4] Europe: At business forum in Bonn, Kohl stresses single market, more majority decisions, European central bank ("must be independent"), plans tax relief for business in next term (StZ main item, GA, i.a.); Delors calls on Germans to overcome scepticism on single market, Bangemann confident on latter (speech read out by StS Schlecht) - Welt, KSTA i.a. Stoltenberg received Delors & Christophersen yesterday (Welt). Transport ministers fail to agree: London & EC Commission want liberalisation of freight transport, Bonn compromise rejected (SZ, KSTA, Welt). Comment: FAZ is critical of Bonn ("Does Gov. want the single market only where it doesn't hurt?"). SZ: Contrast in GB behaviour here & their foot-dragging on putting environmental measures into practice (Claassen).

5] Deutschlandpolitik, DDR: Regarding "determination" of where Elbe border runs, E-W German border commission fails to agree, 13-year talks broken off, "signal from above" awaited. Bonn seeks "further basis" for talks with E.Berlin (FAZ). "Reunification before European unity": Todenhöfer in talk with FAZ critical of Wilms and Geissler theses. Constitution prohibits FRG to go into W.European federation without DDR, which is declared aim of Gov. (FAZ). Fack in FAZ's main leader on German Question: those who recommend operative flexibility must realise the price: giving up FRG's ties with W. & endangering freedom. 6 Chancellors have refused to pay this price in last 40 years with good reason.

6] Visits: Saudi Foreign Minister & Defence Minister (latter privately) in Bonn, (Foreign Minister tomorrow) - GA. Pöhl to Japan 24-28 April (Welt). Gandhi wants to visit Bonn, perhaps in June? (FAZ).

MISCELLANEOUS: Ben Ari wants PLO office in Bonn closed (Bild interview). Hearing in Bonn on Mozambique (FR). £ = DM 3.076, $ = DM 1.6609 (FAZ).

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US REACTIONS TO UK BUDGET

SUMMARY

1. FACTUAL AND GENERALLY FAVOURABLE REPORTING IN MAJOR PRESS. INCOME TAX CUTS, THE REDUCTION IN THE NUMBER OF BRACKETS AND THE PROSPECT OF BUDGET SURPLUSES ARE HIGHLIGHTED. SOME REFERENCES TO QUOTE FEUD UNQUOTE BETWEEN CHANCELLOR AND PRIME MINISTER OVER EXCHANGE RATE POLICY. NO EDITORIAL COMMENT YET.

DETAIL

2. THE EAST COAST NEWSPAPERS CONTAIN GENERALLY POSITIVE FACTUAL REPORTS WRITTEN BY THEIR LONDON CORRESPONDENTS. (COPIES HAVE BEEN FAXED TO THE TREASURY PRESS OFFICE.) THE NEW YORK TIMES AND THE WALL STREET JOURNAL DESCRIBE THE BUDGET AS A QUOTE TAX OVERHAUL UNQUOTE. THE CUT IN THE BASIC RATE AND THE REDUCTION IN THE NUMBER OF TAX BRACKETS ARE THE MAIN FEATURES OF MOST STORIES. MOST PAPERS MENTION THE EXPECTED BUDGET SURPLUS. THE WASHINGTON TIMES, FOR EXAMPLE, HIGHLIGHTS THE CHANCELLOR'S ANNOUNCEMENT OF QUOTE A BALANCED BUDGET FOR THE FIRST TIME IN 20 YEARS UNQUOTE AND NOTES THAT SUPPORTERS PRAISED THE TAX CUTS AS QUOTE UNPRECE-DENTED UNQUOTE. THE CHANGES IN THE TAX TREATMENT OF HUSBANDS AND WIVES WERE ALSO WIDELY REPORTED.

3. THE STORIES, WHILE MAINLY FACTUAL, CONTAIN QUOTES FROM UK ANA-LYSTS PRAISING THE CHANCELLOR AND SOME BACKGROUND ON THE UK'S EXCELLENT RECENT ECONOMIC PERFORMANCE. OPPOSITION COMMENTS AND DISRUPTIONS TO THE CHANCELLOR'S SPEECH ARE MENTIONED BUT NOT HIGH-LIGHTED.

4. ALL THE REPORTS MADE REFERENCES TO THE QUOTE FEUD UNQUOTE BETWEEN THE CHANCELLOR AND THE PRIME MINISTER REGARDING EXCHANGE RATE POLICY. THE JOURNAL OF COMMERCE, FOR EXAMPLE, STATED THAT QUOTE THE CHANCELLOR, WHO HAS BEEN INVOLVED IN A VERY PUBLIC DISPUTE WITH MRS. THATCHER DURING THE PAST WEEK OVER BRITAIN'S STERLING POLICY, REAFFIRMED HIS COMMITMENT TO EXCHANGE RATE STABI-LITY UNQUOTE.

5. THERE HAS BEEN NO EDITORIAL COMMENT SO FAR. IF THERE ARE ANY MORE DETAILED ANALYSES OR COMMENTS PUBLISHED IN THE NEXT FEW DAYS THEY WILL BE FAXED TO THE TREASURY PRESS OFFICE.

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MDHIAN 2[illegible]

6. FCO PLEASE ADVANCE TO RICHARDSON (ERD), BROADBENT (EA), PS/CHANCELLOR, PS/FINANCIAL SECRETARY, R. ALLEN, EVANS AND SINCLAIR (HMT), GREEN (BANK), JOHNS (INLAND REVENUE) AND WILMOTT (CUSTOMS AND EXCISE).

ACLAND

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NAD	MR MAUD

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REVIEW & OUTLOOK

Supply-Side Britain

It is now nine years since my predecessor, in his first Budget in 1979, reduced the top rate of tax from the absurd 83% that prevailed under Labor to 60%, where it has remained ever since. At that time, this was broadly in line with the European average for the top rate of tax. It is now one of the highest. And not only do the majority of European countries now have a top rate of tax below 60%, but in the English-speaking countries outside Europe – not only the United States and Canada, but Labor Australia and New Zealand, too – the top rate is now below 50%, sometimes well below.

The reason for the worldwide trend towards lower top rates of tax is clear. Excessive rates of income tax destroy enterprise, encourage avoidance, and drive talent to more hospitable shores overseas.

As a result, so far from raising additional revenue, over time they actually raise less. By contrast, a reduction in the top rates of income tax can, over time, result in a higher, not a lower, yield to the Exchequer. Despite the substantial reduction in the top rate of tax in 1979, and the subsequent abolition of the investment income surcharge in 1984, the top 5% of taxpayers today contribute a third as much again in real terms as they did in 1978-79, Labor's last year; while the remaining 95% of taxpayers pay about the same in real terms as they did in 1978-79.

* * *

That is the language of supply-side economics, and with those words the British chancellor, Nigel Lawson, introduced what surely will go down as a historic tax reform for Mrs. Thatcher's government. After years of resisting the importunings and recommendations of the likes of Professor Laffer, George Gilder and Ronald Reagan, the Tories have embraced a strong and radical tax reform. In a fell swoop Mr. Lawson wiped out the top four brackets of the British personal income tax system and reduced the top marginal rate of income tax to 40%. Britain has returned to the lead in the global swing toward free economies and pro-growth policies based on individual initiative.

Readers of these columns will forgive us if we display just a bit of emotion here. The fact is that it has been vexing and uncomfortable to watch the refusal of 11 Downing Street to move on top marginal tax rates during these long years. It was as if the Tories were making a reproach toward the entire Reagan initiative

satisfaction. The uproar broke out as Mr. Lawson announced he would cut the top marginal rate of income tax to 40% from 60%. Labor members yelled "shame," forcing the chancellor to sit down while order was restored. The sitting earlier had to be suspended for 15 minutes, while the Commons voted to expel one member who'd objected to another important step – the cutting of the basic tax rate two points to 25%. In all, it represented the bitter reaction of an opposition confronted with a government doing what the overwhelming majority of voters had asked.

Policies Mr. Lawson outlined last night will mean – one can judge from the American experience – a quickening fall in British unemployment, now below 10%. Labor will find that it is wrong in suggesting that benefits will be reserved for those earning in the top brackets. Mr. Lawson's budget – the first of Mrs. Thatcher's third term – will produce significant incentives for middle- and lower-income earners. Married couples will receive a fairer deal under the reforms Mr. Lawson announced – the first major change in the taxation of married couples in 180 years. The changes aren't without their flaws. Under the new system the taxation of capital gains will be done at the marginal rate – which means in some cases an increase to 40%. This mistake is analogous to that made in the U.S. reforms. On both sides of the ocean the error will need to be corrected.

The error, though, needn't dim the breakthrough on the concept of reform at the top rates. The budget not only reduces the top rate to 40% but reduces to two from six the number of brackets. The standard rate that was reduced to 25% from 27% covers all income up to £19,300. All income over that limit will now be taxed at 40% – wiping out brackets of 45%, 50%, 55% and 60%. When the Conservatives took power in 1978, the standard rate was 33%. Mr. Lawson vowed yesterday to cut the standard rate to 20% as soon as he can. Tax allowances, or the amount of income that is untaxed, were raised by 8% – double the 4% inflation rate of last year – so a single Briton now won't pay tax on his first £2,605 of earnings.

In some sense it was inevitable that the European tax regimes would start to give way once the deep cuts in the top marginal rates in American income tax took effect this year. As the British start to enjoy the fruits of Mr. Lawson's moves attention will turn to West Germany, where the coalition is working on tax reform at the moment

The Russian

By Bohdan Nahaylo

MUNICH – Just a year after the eruption of national unrest in Kazakhstan, spectacular mass protests in Armenia are highlighting the salience of the nationalities problem in the Soviet Union. Ever since the policy of *glasnost* was proclaimed, Moscow has found it impossible to keep on pretending it has successfully created a harmonious, supranational society out of a Russian empire. Western observers, too, no longer have any excuse to overlook the nationalities question and to rely on a Russocentric approach to the Soviet polity.

Pictures of tens of thousands of Armenians protesting in the streets and squares of their capital, Yerevan, have brought home the strength of national feeling among the peoples of the Soviet Union. But it's time to look to Moscow, where the Soviet leadership is preparing for a special plenum of the Communist Central Committee on the nationalities question to take place soon.

Many commentators have pointed out that the present crisis over the Nagorno-Karabakh region is not aimed at the Russians as such. They note it pits two of the Soviet Union's non-Russian nations – the Armenians and the Azerbajanis – against one another. Armenians are campaigning on behalf of their compatriots across the border in a region, Nagorno-Karabakh, where ethnic Armenians form a majority. The conflict, however, has potential for developing an anti-Russian dimension.

Unsatisfactory Arbiter

Already, Armenians have been expressing their dissatisfaction with the way Moscow has handled the coverage of recent events. Eventually, either the Armenians or the Azerbajanis may well begin questioning Moscow's right to be the arbiter. They may remember who was responsible for drawing up the territorial arrangement in the region in the first place. They may ask why the problem of Nagorno-Karabakh was glossed over for so long.

Moscow's attitude to the long-simmering Armenian-Azerbajani dispute has been typical of its entire approach to the Soviet nationalities problem. For more than 25 years the Armenian inhabitants of Nagorno-Karabakh, supported by numerous compatriots in Armenia, complained of injustices and appealed unsuccessfully to the Soviet leadership for their region to be restored to the Soviet Armenian republic. Last October, the first demonstrations over the issue occurred in Armenian Yerevan. Yet the Kremlin's policy suppressed discussion and hoped the problem would go away of its own accord.

The words of Silva Kaputikyan, a member of the Armenian delegation that met with General Secretary Gorbachev at the height of the recent protests, are important here. She said to the Italian newspaper La Reppublica, "I will tell you what I repeated to myself at that moment: this is the first time in 67 years that Moscow has set eyes on us." On returning home, she reminded the crowds in Yerevan: "Why are we here today? Because somebody has at last allowed us to raise our heads, to come down

enterprise, encourage avoidance, and drive talent to more hospitable shores overseas.

As a result, so far from raising additional revenue, over time they actually raise less. By contrast, a reduction in the top rates of income tax can, over time, result in a higher, not a lower, yield to the Exchequer. Despite the substantial reduction in the top rate of tax in 1979, and the subsequent abolition of the investment income surcharge in 1984, the top 5% of taxpayers today contribute a third as much again in real terms as they did in 1978-79, Labor's last year; while the remaining 95% of taxpayers pay about the same in real terms as they did in 1978-79.

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That is the language of supply-side economics, and with those words the British chancellor, Nigel Lawson, introduced what surely will go down as a historic tax reform for Mrs. Thatcher's government. After years of resisting the importunings and recommendations of the likes of Professor Laffer, George Gilder and Ronald Reagan, the Tories have embraced a strong and radical tax reform. In a fell swoop Mr. Lawson wiped out the top four brackets of the British personal income tax system and reduced the top marginal rate of income tax to 40%. Britain has returned to the lead in the global swing toward free economies and pro-growth policies based on individual initiative.

Readers of these columns will forgive us if we display just a bit of emotion here. The fact is that it has been vexing and uncomfortable to watch the refusal of 11 Downing Street to move on top marginal tax rates during these long years. It was as if the Tories were making a reproach toward the entire Reagan initiative when they might have been expected to carry the supply-side torch in Europe. So the budget Mr. Lawson presented last night represents a major victory—for both sides—in the long debate. The winners will be the British people, at all levels of income, and in all regions of the country.

The pandemonium that met Mr. Lawson's tax cuts is no cause for [...] a quickening fall in British unemployment, now below 10%. Labor will find that it is wrong in suggesting that benefits will be reserved for those earning in the top brackets. Mr. Lawson's budget—the first of Mrs. Thatcher's third term—will produce significant incentives for middle- and lower-income earners. Married couples will receive a fairer deal under the reforms Mr. Lawson announced—the first major change in the taxation of married couples in 180 years. The changes aren't without their flaws. Under the new system the taxation of capital gains will be done at the marginal rate—which means in some cases an increase to 40%. This mistake is analogous to that made in the U.S. reforms. On both sides of the ocean the error will need to be corrected.

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In some sense it was inevitable that the European tax regimes would start to give way once the deep cuts in the top marginal rates in American income tax took effect this year. As the British start to enjoy the fruits of Mr. Lawson's moves attention will turn to West Germany, where the coalition is working on tax reform at the moment (please see editorial below), to Japan, where Premier Takeshita's government is wrestling with similar issues, and to France, where Mr. Chirac, who has so far hesitated on radical reform of the top rates, is now pursuing an uphill struggle for the presidency. All these governments would do well to study the specifically supply-side concepts Mr. Lawson sketched so well.

Germany's Anti-Entrepreneur Tax

As the West German coalition gets ready to make its final decisions on its so-called Tax Reform Act of 1990, a Munich businessman writes: "It is important to draw your attention to a number of weak points which possibly have not been given sufficient importance in previous consultations." He is referring to the prospect that the government will increase taxation of capital gains on income from the sale of entrepreneurial investments. Heretofore such gains were taxed [...]

[...] tion and the beginning of 1990, when it would take effect, many companies would be sold for "purely tax reasons"—i.e., entrepreneurs would bail out while they could take advantage of favorable rates on the gains. The provision would discourage conservative balance sheet policies, since the liquidation of hidden reserves at retirement would be penalized. Many companies, particularly those operating internationally, would be tempted to move to [...]

[...] nationalities question

Many commentato[rs] [...] that the present crisi[s] [...] Karabakh region is [...] Russians as such. [...] two of the Soviet [...] nations—the Armenia[ns] [...] janis—against one ano[ther] [...] campaigning on behalf [...] across the border in [...] Karabakh, where ethni[c] [...] majority. The conflict, [...] tial for developing an [...] sion.

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Globa[...]

Deregulation of financia[l] [...] been moving forward amid [...] debate. But little notice has [...] new *regulatory* efforts tha[t] [...] equally profound effects [...] try's structure. They are sepa[...] to set international standards [...] banks and securities firms.

Efforts to "globalize" secu[...] tion are still in their infancy [...] boost from the world-wide C[...] market crash. American S[ecurities] [...] Exchange Commission Chai[...] Ruder earlier this month atte[...] ing of the 10-nation "Wilton Pa[...] securities regulators in Englan[d] [...] nary discussions. A technica[l] [...] has been put to work.

International banking regul[...] other hand, is well advanced. R[...] tions were issued in Decem[ber] [...] "Basle Committee on Banking [...] and Supervisory Practices." [...] were bank supervisors from the [...] Japan, France, Germany, Ita[ly] [...] Sweden, Belgium, the Netherlan[ds] [...] land and Luxembourg [...]

Britain Introduces a Tax Overhaul Cutting Rates, Number of Brackets

In Budget Message, Lawson Also Indicates He Shifted Monetary Policy's Focus

By PETER TORDAY
Staff Reporter of THE WALL STREET JOURNAL

LONDON—Chancellor of the Exchequer Nigel Lawson announced a tax overhaul that was even more sweeping than expected and that brought Britain closer to recently inaugurated changes in the U.S. and other industrialized countries.

In one of the unruliest budget presentations in British parliamentary history, during which he was shouted down twice by opposition politicians, Mr. Lawson also made clear that he has shifted his monetary policy to focus on interest rates rather than on exchange-rate stability as the chief weapon for fighting inflation.

Nigel Lawson

Describing the budget for the fiscal year beginning April 1, he limited his remarks on exchange rates to saying simply that they "play a central role in domestic monetary decisions." His failure to advocate a stronger role suggested he has failed in his efforts to maintain a tightly controlled course for sterling. As a result, analysts don't expect a reduction in British banks' base rates, currently at 9%.

The chancellor cut the basic income-tax rate to 25% from 27% and pledged the Conservative government to a goal of 20%. He also slashed the top rate to 40% from 60% and reduced the number of tax brackets to two from six. "Excessive rates of income tax destroy enterprise and drive talent to more hospitable shores overseas," Mr. Lawson said.

His tax reforms and simplifications brought Britain closer in line with the U.S. system. The U.S. Tax Reform Act of 1986 cut the number of tax brackets for individuals to two—15% and 28%—from 14 ranging from 11% to 50%, and it cut the top corporate rate to 34% from 46%.

Mr. Lawson yesterday set taxation of capital gains for individuals at the same rate as for income but left both corporate income tax and corporate capital-gains tax unchanged at 35%.

His budget proposals, approved by the British cabinet yesterday morning, are certain to be approved by the Conservative-controlled Parliament. Because of that certainty, some of the changes take effect immediately.

The budget drew a mixed reaction from industry, which praised the tax reductions but criticized Mr. Lawson for not announcing more measures to help business. The package "does little to promote manufacturing industry," said the giant chemicals company Imperial Chemical Industries PLC.

Mr. Lawson also suggested raising personal tax deductions by about twice Britain's 1987 inflation rate of 3.7%. In all, cuts in personal taxes and other tax changes unveiled yesterday would stimulate the British economy by freeing about £4 billion ($7.42 billion).

Britain's healthy economic growth last year helped finance yesterday's tax cuts and also enabled Mr. Lawson to announce the first budget surplus in almost 20 years. He said the government's budget would show a surplus of £3 billion in the fiscal year ending this month. He set the same target for the coming fiscal year, partly based on his prediction that the economy will grow 3% this year after expanding 4.5% in 1987.

But the chancellor's fiscal stimulus, at the high end of most analysts' expectations, could deepen Britain's already deteriorating current-account deficit. With the U.K. expansion showing few signs of abating, the boost from tax cuts "is rather more than the economy should have had," said Bill Martin, an economist with the London stockbrokerage Phillips & Drew. "It's a lethal combination for the balance of payments."

Mr. Lawson forecast that the current-account deficit, which measures trade in goods, services and certain other unilateral transfers, will widen to £4 billion this year from £1.7 billion in 1987. Analysts generally have been predicting the deficit will deepen to £5 billion or even more in 1988.

Additional tax changes include a modest rise in taxes on tobacco, beer, wine and gasoline, as well as measures to boost personal share ownership and support small businesses. The chancellor also ended the duty tax on new share issues and closed or restricted some tax shelters, such as individuals' breaks for company cars.

Heeding oil-industry demands, he announced the abolition of the 12.5% royalty tax for new oil exploration and production projects, both onshore and in the southern natural-gas basin of the British North Sea. Industry analysts said that decision, taken with other budget provisions, would have a broadly neutral tax effect on large oil fields while benefiting smaller ones.

Mr. Lawson proposed changes to give wives independence in tax affairs and to end tax anomalies that penalize marriage. Some shifts involving married couples would happen in the next few months, others not until 1990.

On monetary policy, the chancellor appeared to bow to Prime Minister Margaret Thatcher by failing to declare a policy of keeping sterling inside a narrow range. Though he has never proclaimed the policy outright, he pursued it for more than a year. But last week, after the government let the pound soar, Mrs. Thatcher said Britain wouldn't "buck the foreign-exchange markets" at the cost of higher inflation.

After her statement, Britain is now focusing more on interest rates than exchange rates to quell inflation.

Yesterday, Mr. Lawson stressed that short-term interest rates were the "essential instrument" in monetary policy and would be set at levels "necessary to ensure downward pressure on inflation." Those remarks align the chancellor with Mrs. Thatcher's position that an interest-rate reduction would prove inflationary.

So unless sterling soars sharply above present levels, "I think interest rates will stay where they are" for the time being, said Ian Harwood, an economist with Warburg Securities, a London stockbrokerage.

Mrs. Thatcher last week embarrassed the chancellor by insisting the government wouldn't block the soaring pound. Yesterday, instead of citing exchange-rate stability as the chief weapon in his inflation-fighting arsenal, Mr. Lawson chose to warn business executives that stable exchange rates depend on their resisting potentially inflationary wage demands.

But the chancellor did reaffirm Britain's commitment to greater stability of the world's three leading currencies—the dollar, the West German mark and the Japanese yen. The statement costs him little on the domestic front and minimizes his discomfort over an issue he has championed internationally.

New Scandal Overshadows Swedish Arms Crackdown

By a WALL STREET JOURNAL *Staff Reporter*

STOCKHOLM—Disclosures that Sweden's state-owned arms maker, FFV AB, sold anti-tank guns to off-limits countries have come just as the government is introducing new arms-export rules.

The regulations, drawn up in response to arms-smuggling scandals last year, are aimed at barring the sale of Swedish-made weapons to all but approved countries. A panel would be set up to look into reducing arms exports. In the meantime, arms makers would have to ask government permission to sign arms contracts.

A simmering scandal over FFV's arms exports during the past 25 years has overshadowed the government proposals by revealing a pattern of ignoring arms-export rules. The latest revelation came yesterday, when an FFV spokeswoman confirmed a newspaper report that the company had sold about 450 Carl-Gustaf anti-tank rifles and ammunition to Saudi Arabia between 1978 and 1984 for an estimated $19.4 million.

The government is also investigating FFV's involvement in supplying Carl-Gustaf ammunition to Australian troops fighting in Vietnam in the 1960s and 1970s, as well as reports of a sale to Israel of Carl-Gustaf guns that may have ended up in South Africa.

Britain unveils '88 balanced budget

By James Morrison
THE WASHINGTON TIMES

LONDON — Chancellor of the Exchequer Nigel Lawson yesterday announced a balanced budget for the first time in 20 years, and proposed more than $7 billion in tax cuts in a 1988 revenue package that supporters praised as unprecedented.

Mr. Lawson, the chief treasury official in the ruling Conservative government, also announced a $5.5 billion budget surplus that will go toward repaying Britain's national debt.

He was disrupted twice by opposition parties, which, apparently for the first time in a chancellor's speech, caused the suspension of the House of Commons. Proceedings were temporarily suspended until several hecklers were ejected.

Britain's budget message is a statement of revenue. Its spending program was announced in the fall. The budget faces certain approval in the House of Commons, where the Conservatives hold 375 of the 650 seats.

In his budget message, Mr. Lawson proposed cutting 2 percent off the basic income tax rate that an estimated 95 percent of British workers pay. It would drop from the current 27 percent to 25 percent. Mr. Lawson set a goal for an additional 5 percent cut in the future.

The biggest surprise was Mr. Lawson's proposal to eliminate four higher tax rates for large-income earners, setting a single top tax rate at 40 percent. The current top rate is 60 percent, and applies to those earning more than $76,000. The new rate will start at about $35,000 a year.

He said the tax cut is the seventh in a row in the eight years of the Conservative government under Prime Minister Margaret Thatcher.

Mr. Lawson also announced the elimination of Britain's so-called "marriage tax" that penalizes the earnings of two-income families, and reform of the capital gains taxes, to remove the effects of inflation, among other tax changes.

"In this budget, I have reaffirmed the prudent policies that have brought us unprecedented economic strength," he said.

"I have announced a radical reform of the taxation of marriage that for the first time will give married women a fair deal from the tax system. I have eliminated the long-standing practice of taxing inflationary gains. I have cut the basic rate of income tax, fulfilling our [campaign] manifesto . . . and I have balanced the budget."

Madsen Pirie, president of the free-market Adam Smith Institute, said the budget "is legendary" and tax cuts "show every indication of continuing."

The disruptions of Mr. Lawson's speech started when Alex Salmond, vice chairman of the Scottish Nationalist Party, began shouting objections to his proposals. He was ejected when he continued shouting after the speaker of the House ordered him to stop.

Shortly thereafter, left-wing members of the Labor Party stood and shouted, "Shame, shame, shame!" when Mr. Lawson announced the elimination of the top rates of income tax.

Labor has been campaigning for more money for the National Health Service, a 40-year-old socialized medicine plan that spends some $40 billion a year. The official opposition party wanted Mr. Lawson to spend most of Britain's budget surplus on the health service, instead of cutting taxes.

Ton Brown, Labor's budget spokesman, said, "I don't think I've ever witnessed a budget that is so unfair. He never even mentioned the health service. That is a disgrace that will divide the nation."

Conservative Terrence Higgins, chairman of the government's treasury committee, warned the Labor Party that its left wing was getting out of control.

"The shouting on the Labor benches was really a very severe impediment of freedom of speech in the House of Commons," he said.

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UK Budget Features Tax Cuts, Surplus

By JANET PORTER
Journal of Commerce Staff

LONDON -- The government unveiled plans Tuesday to slash some income tax rates and still show a surplus during the next fiscal year.

Some minor changes in businesses taxes are planned, but nothing that would affect businesses as much as individuals.

The £171.8 billion (US$317.8 billion) budget announced to Parliament reflects Prime Minister Margaret Thatcher's commitment to an enterprise economy.

The tax reforms, for example, show the government's determination to ensure that top wage-earners stay in Britain rather than move to the United States, Canada, Australia, New Zealand or other European countries where upper tax rates are considerably lower.

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Buoyant revenues generated by a booming economy enabled Chancellor of the Exchequer Nigel Lawson to slash the top rate of income tax to 40% from 60% and lower the lowest income tax bracket to 25% from 27%.

Even with those £4.25 billion (US$7.9 billion) in cuts, there still will be enough left to pay some old government debts and show a surplus for the fiscal year that starts April 6, Mr. Lawson said.

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The economy is expected to grow by around 3% in 1988, below the 1987 level of 4.5% but close to the recent average.

The rate of inflation, which averaged just over 4% in 1987, is projected to remain around the same level this year while unemployment should continue to fall.

The balance of payments current account, which moved into deficit last year after seven successive years of surplus, is likely to show a shortfall of around £4 billion ($7.4 billion) in 1988 — equivalent to less than 1% of gross domestic product, Mr. Lawson told the House of Commons.

"Given the strength of the economy in general, and of our public finances in particular, not to mention our massive net overseas assets, I foresee no difficulty in financing a temporary current account deficit of this scale," he said.

For only the second time since the early 1950s, the government has achieved a surplus budget. This totaled £3 billion ($5.5 billion) in 1987-88, considerably larger than most analysts had estimated.

Despite the tax reductions and planned spending increases for health, education and law and order, Mr. Lawson said he had opted for caution in the coming fiscal year and plans to aim for another surplus of around £3 billion. However, the long-term objective is a balanced budget, he said.

The chancellor, who has been involved in a very public dispute with Mrs. Thatcher during the past week over Britain's sterling policy, reaffirmed his commitment to exchange rate stability.

TOTAL P.05

In Britain, Tax Overhaul and a Feud

By HOWELL RAINES

Special to The New York Times

LONDON, March 15 — Britain's annual Budget Day, always a time of suspense in the House of Commons, arrived today with an extra fillip of drama because of a feud between Prime Minister Margaret Thatcher and her strong-willed Chancellor of the Exchequer, Nigel Lawson.

The dispute on monetary policy overshadowed Mr. Lawson's announcement of a dramatic plan to simplify Britain's income tax code. The new system, due to take effect in June, reduces the number of rates in Britain's complex tax code to two, from six; awards the most affluent Britons a 20 percent cut, and trims the basic income tax rate to its lowest level since 1938.

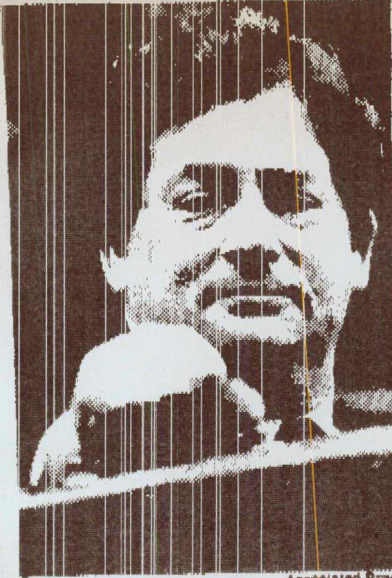
Under the new system, the basic tax rate will fall to 25 percent, from 27 percent, and the top rate will fall to 40 percent, from 60 percent. Intermediate tax brackets of 45, 50 and 55 percent for high earners will be eliminated altogether.

New Income Level at $35,700

The new 40 percent top rate will apply to people making more than $35,700. Under the old system, the top rate of 60 percent applied to people making more than $72,800.

Before a rowdy session of the Commons, Mr. Lawson said, "This major reform will leave us with one of the simplest systems of income tax in the world." And he added that his goal for future budgets was to lower the basic rate to only 20 percent.

Opposition reaction was furious. For the first time in modern memory, a Chancellor's speech was stopped by disruptions. It was delayed 15 minutes when a member of the Scottish Nationalist Party was expelled from the chamber for calling the budget an "utter obscenity." Labor members later caused a 10-minute suspension by chanting "Rich man's budget!"



Associated Press

Nigel Lawson, Chancellor of the Exchequer, carrying the traditional budget box, before speaking in the House of Commons.

Since the Conservatives hold 374 of 650 seats, approval of the new tax system by the Commons is considered a certainty. And there is no question that Mr. Lawson and Mrs. Thatcher are in full agreement on what he called his "radical tax-reforming budget."

But there is lingering political uncertainty over whether an unresolved dispute with the Prime Minister over monetary policy could lead to Mr. Lawson's resignation within a few months after submitting a budget intended to place him in the first rank of postwar Chancellors.

As architect of five previous Thatcher budgets, Mr. Lawson has won a reputation as a budgetary genius for his ability to cut taxes while reducing inflation to the current annual rate of 3.3 percent and giving Britain its first balanced budget in almost two decades. Indeed, Mr Lawson today announced the nation's first budget surplus in almost 20 years.

A Battle of Leaks

But since last Thursday, Thatcher and Lawson aides have been engaged in a battle of leaks over who would have control over monetary policy, a question brought to a head when the pound surged against the dollar and the West German mark.

In the Commons last week, Mrs. Thatcher, stressing the Government's anti-inflation policy, rejected market intervention, through selling pounds or reducing interest rates, as a way of making the pound less attractive to investors and speculators. This was widely interpreted as a slap at Mr. Lawson, who favors an informal policy of intervention to hold the pound below a ceiling of 3 marks, fearing a stronger pound could hurt British exports by pushing up their price.

Analysts have predicted that severe strains could result between Mrs. Thatcher and Mr. Lawson if the pound, which climbed to 3.09 marks in European trading today, reaches 3.2 marks.

Underlying the dispute is a long-standing disagreement between the two over whether Britain should join the European Monetary System. Mr. Lawson has become convinced that Britain ought to join the eight European countries, including West Ger-

Continued on Page D7

Continued From First Business Page

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All this has led to speculation that Mr. Lawson might resign in frustration and take a high-salaried job in the City, London's financial district.

Leaders of the opposition Labor Party have tried to increase the 56-year-old Chancellor's discomfort by saying that Mrs. Thatcher has put him in place on exchange rates with "one biff of her handbag" and by predicting that the 1988 budget would be the last of his six budgets.

Pleas on Surplus Ignored

Whether or not it is the last, it was the most dramatic. Mr. Lawson ignored pleas that he use an estimated budget surplus of $20 billion to bail out the troubled National Health Service. Instead, he put two-thirds of that amount into surplus accounts and into financing tax reductions that were frankly aimed at the top 5 percent of taxpayers.

Despite the rough reception the plan received in the Commons, the reaction from financial analysts and conservative economists was glowing. Graham Mather of the Institute of Economic Affairs compared Mr. Lawson's plan, which also included reductions in capital gains and inheritance taxes, to President Reagan's tax-simplification plan of 1986.

"This is going to simplify and streamline the tax system for the rest of the century," Mr. Mather said

Britain Introduces a Tax Overhaul Cutting Rates, Number of Brackets

In Budget Message, Lawson Also Indicates He Shifted Monetary Policy's Focus

By PETER TORDAY
Staff Reporter of THE WALL STREET JOURNAL

LONDON—Chancellor of the Exchequer Nigel Lawson announced a tax overhaul that was even more sweeping than expected and that brought Britain closer to recently inaugurated changes in the U.S. and other industrialized countries.

In one of the unruliest budget presentations in British parliamentary history, during which he was shouted down twice by opposition politicians, Mr. Lawson made clear that he has shifted his monetary policy to focus on interest rates rather than on exchange-rate stability as the chief weapon for fighting inflation.

Nigel Lawson

Describing the budget for the fiscal year beginning April 1, he limited his remarks on exchange rates to saying simply that they "play a central role in domestic monetary decisions." His failure to advocate a stronger role suggested he has failed in his efforts to maintain a tightly controlled course for sterling. As a result, analysts don't expect a reduction in British banks' base rates, currently at 9%.

The chancellor cut the basic income-tax rate to 25% from 27% and pledged the Conservative government to a goal of 20%. He also slashed the top rate to 40% from 60% and reduced the number of tax brackets to two from six. "Excessive rates of income tax destroy enterprise and drive talent to more hospitable shores overseas," Mr. Lawson said.

His tax reforms and simplifications brought Britain closer in line with the U.S. system. The U.S. Tax Reform Act of 1986 cut the number of tax brackets for individuals to two—15% and 28%—from 14 ranging from 11% to 50%, and it cut the top corporate rate to 34% from 46%.

Mr. Lawson yesterday set taxation of capital gains for individuals at the same rate as for income but left both corporate income tax and corporate capital-gains tax unchanged at 35%.

His budget proposals, approved by the British cabinet yesterday morning, are certain to be approved by the Conservative-controlled Parliament. Because of that certainty, some of the changes take effect immediately.

The budget drew a mixed reaction from industry, which praised the tax reductions but criticized Mr. Lawson for not announcing more measures to help business. The package "does little to promote manufacturing industry," said the giant chemicals company Imperial Chemical Industries PLC.

Mr. Lawson also suggested raising personal tax deductions by about twice Britain's 1987 inflation rate of 3.7%. In all, cuts in personal taxes and other tax changes unveiled yesterday would stimulate the British economy by freeing about £4 billion ($7.42 billion).

Britain's healthy economic growth last year helped finance yesterday's tax cuts and also enabled Mr. Lawson to announce the first budget surplus in almost 20 years. He said the government's budget would show a surplus of £3 billion in the fiscal year ending this month. He set the same target for the coming fiscal year, partly based on his prediction that the economy will grow 3% this year after expanding 4.5% in 1987.

But the chancellor's fiscal stimulus, at the high end of most analysts' expectations, could deepen Britain's already deteriorating current-account deficit. With the U.K. expansion showing few signs of abating, the boost from tax cuts "is rather more than the economy should have had," said Bill Martin, an economist with the London stockbrokerage Phillips & Drew. "It's a lethal combination for the balance of payments."

Mr. Lawson forecast that the current-account deficit, which measures trade in goods, services and certain other unilateral transfers, will widen to £4 billion this year from £1.7 billion in 1987. Analysts generally have been predicting the deficit will deepen to £5 billion or even more in 1988.

Additional tax changes include a modest rise in taxes on tobacco, beer, wine and gasoline, as well as measures to boost personal share ownership and support small businesses. The chancellor also ended the duty tax on new share issues and closed or restricted some tax shelters, such as individuals' breaks for company cars.

Heeding oil-industry demands, he announced the abolition of the 12.5% royalty tax for new oil exploration and production projects, both onshore and in the southern natural-gas basin of the British North Sea. Industry analysts said that decision, taken with other budget provisions, would have a broadly neutral tax effect on large oil fields while benefiting smaller ones.

Mr. Lawson proposed changes to give wives independence in tax affairs and to end tax anomalies that penalize marriage. Some shifts involving married couples would happen in the next few months, others not until 1990.

On monetary policy, the chancellor appeared to bow to Prime Minister Margaret Thatcher by failing to declare a policy of keeping sterling inside a narrow range. Though he has never proclaimed the policy outright, he pursued it for more than a year. But last week, after the government let the pound soar, Mrs. Thatcher said Britain wouldn't "buck the foreign-exchange markets" at the cost of higher inflation.

After her statement, Britain is now focusing more on interest rates than exchange rates to quell inflation.

Yesterday, Mr. Lawson stressed that short-term interest rates were the "essential instrument" in monetary policy and would be set at levels "necessary to ensure downward pressure on inflation." Those remarks align the chancellor with Mrs. Thatcher's position that an interest-rate reduction would prove inflationary.

So unless sterling soars sharply above present levels, "I think interest rates will stay where they are" for the time being, said Ian Harwood, an economist with Warburg Securities, a London stockbrockerage.

Mrs. Thatcher last week embarrassed the chancellor by insisting the government wouldn't block the soaring pound. Yesterday, instead of citing exchange-rate stability as the chief weapon in his inflation-fighting arsenal, Mr. Lawson chose to warn business executives that stable exchange rates depend on their resisting potentially inflationary wage demands.

But the chancellor did reaffirm Britain's commitment to greater stability of the world's three leading currencies—the dollar, the West German mark and the Japanese yen. The statement costs him little on the domestic front and minimizes his discomfort over an issue he has championed internationally.

New Scandal Overshadows Swedish Arms Crackdown

By a WALL STREET JOURNAL *Staff Reporter*

STOCKHOLM—Disclosures that Sweden's state-owned arms maker, FFV AB, sold anti-tank guns to off-limits countries have come just as the government is introducing new arms-export rules.

The regulations, drawn up in response to arms-smuggling scandals last year, are aimed at barring the sale of Swedish-made weapons to all but approved countries. A panel would be set up to look into reducing arms exports. In the meantime, arms makers would have to ask government permission to sign arms contracts.

A simmering scandal over FFV's arms exports during the past 25 years has overshadowed the government proposals by revealing a pattern of ignoring arms-export rules. The latest revelation came yesterday, when an FFV spokeswoman confirmed a newspaper report that the company had sold about 150 Carl-Gustaf anti-tank rifles and ammunition to Saudi Arabia between 1978 and 1984 for an estimated $19.4 million.

The government is also investigating FFV's involvement in supplying Carl-Gustaf ammunition to Australian troops fighting in Vietnam in the 1960s and 1970s, as well as reports of a sale to Israel of Carl-Gustaf guns that may have ended up in South Africa.

The Washington Times WEDNESDAY, MARCH 16, 1988 / PAGE A9

Britain unveils '88 balanced budget

By James Morrison
THE WASHINGTON TIMES

LONDON — Chancellor of the Exchequer Nigel Lawson yesterday announced a balanced budget for the first time in 20 years, and proposed more than $7 billion in tax cuts in a 1988 revenue package that supporters praised as unprecedented.

Mr. Lawson, the chief treasury official in the ruling Conservative government, also announced a $5.5 billion budget surplus that will go toward repaying Britain's national debt.

He was disrupted twice by opposition parties, which, apparently for the first time in a chancellor's speech, caused the suspension of the House of Commons. Proceedings were temporarily suspended until several hecklers were ejected.

Britain's budget message is a statement of revenue. Its spending program was announced in the fall. The budget faces certain approval in the House of Commons, where the Conservatives hold 375 of the 650 seats.

In his budget message, Mr. Lawson proposed cutting 2 percent off the basic income tax rate that an estimated 95 percent of British workers pay. It would drop from the current 27 percent to 25 percent. Mr. Lawson set a goal for an additional 5 percent cut in the future.

The biggest surprise was Mr. Lawson's proposal to eliminate four higher tax rates for large-income earners, setting a single top tax rate at 40 percent. The current top rate is 60 percent, and applies to those earning more than $76,000. The new rate will start at about $35,000 a year.

He said the tax cut is the seventh in a row in the eight years of the Conservative government under Prime Minister Margaret Thatcher.

Mr. Lawson also announced the elimination of Britain's so-called "marriage tax" that penalizes the earnings of two-income families, and reform of the capital gains taxes, to remove the effects of inflation, among other tax changes.

"In this budget, I have reaffirmed the prudent policies that have brought us unprecedented economic strength," he said.

"I have announced a radical reform of the taxation of marriage that for the first time will give married women a fair deal from the tax system. I have eliminated the long-standing practice of taxing inflationary gains. I have cut the basic rate of income tax, fulfilling our [campaign] manifesto . . . and I have balanced the budget."

Madsen Pirie, president of the free-market Adam Smith Institute, said the budget "is legendary" and tax cuts "show every indication of continuing."

The disruptions of Mr. Lawson's speech started when Alex Salmond, vice chairman of the Scottish Nationalist Party, began shouting objections to his proposals. He was ejected when he continued shouting after the speaker of the House ordered him to stop.

Shortly thereafter, left-wing members of the Labor Party stood and shouted, "Shame, shame, shame!" when Mr. Lawson announced the elimination of the top rates of income tax.

Labor has been campaigning for more money for the National Health Service, a 40-year-old socialized medicine plan that spends some $40 billion a year. The official opposition party wanted Mr. Lawson to spend most of Britain's budget surplus on the health service, instead of cutting taxes.

Ton Brown, Labor's budget spokesman, said, "I don't think I've ever witnessed a budget that is so unfair. He never even mentioned the health service. That is a disgrace that will divide the nation."

Conservative Terrence Higgins, chairman of the government's treasury committee, warned the Labor Party that its left wing was getting out of control.

"The shouting on the Labor benches was really a very severe impediment of freedom of speech in the House of Commons," he said.

UK Budget Features Tax Cuts, Surplus

By JANET PORTER
Journal of Commerce Staff

LONDON — The government unveiled plans Tuesday to slash some income tax rates and still show a surplus during the next fiscal year.

Some minor changes in businesses taxes are planned, but nothing that would affect businesses as much as individuals.

The £171.8 billion (US$317.8 billion) budget announced to Parliament reflects Prime Minister Margaret Thatcher's commitment to an enterprise economy.

The tax reforms, for example, show the government's determination to ensure that top wage-earners stay in Britain rather than move to the United States, Canada, Australia, New Zealand or other European countries where upper tax rates are considerably lower.

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By HOWELL RAINES

Special to The New York Times

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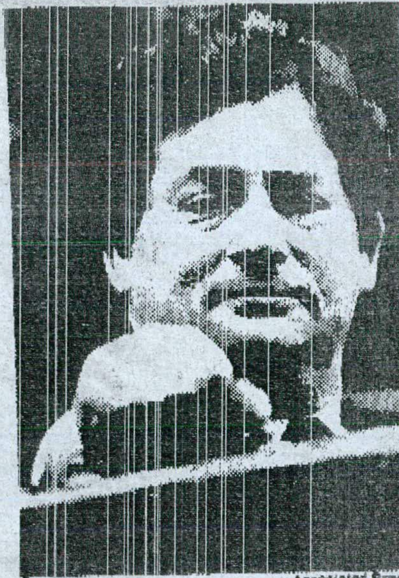

Associated Press

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IOD
Institute of Directors

From the Director General

PWP

Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON SW1P 3AG

16 March 1988

Dear Nigel,

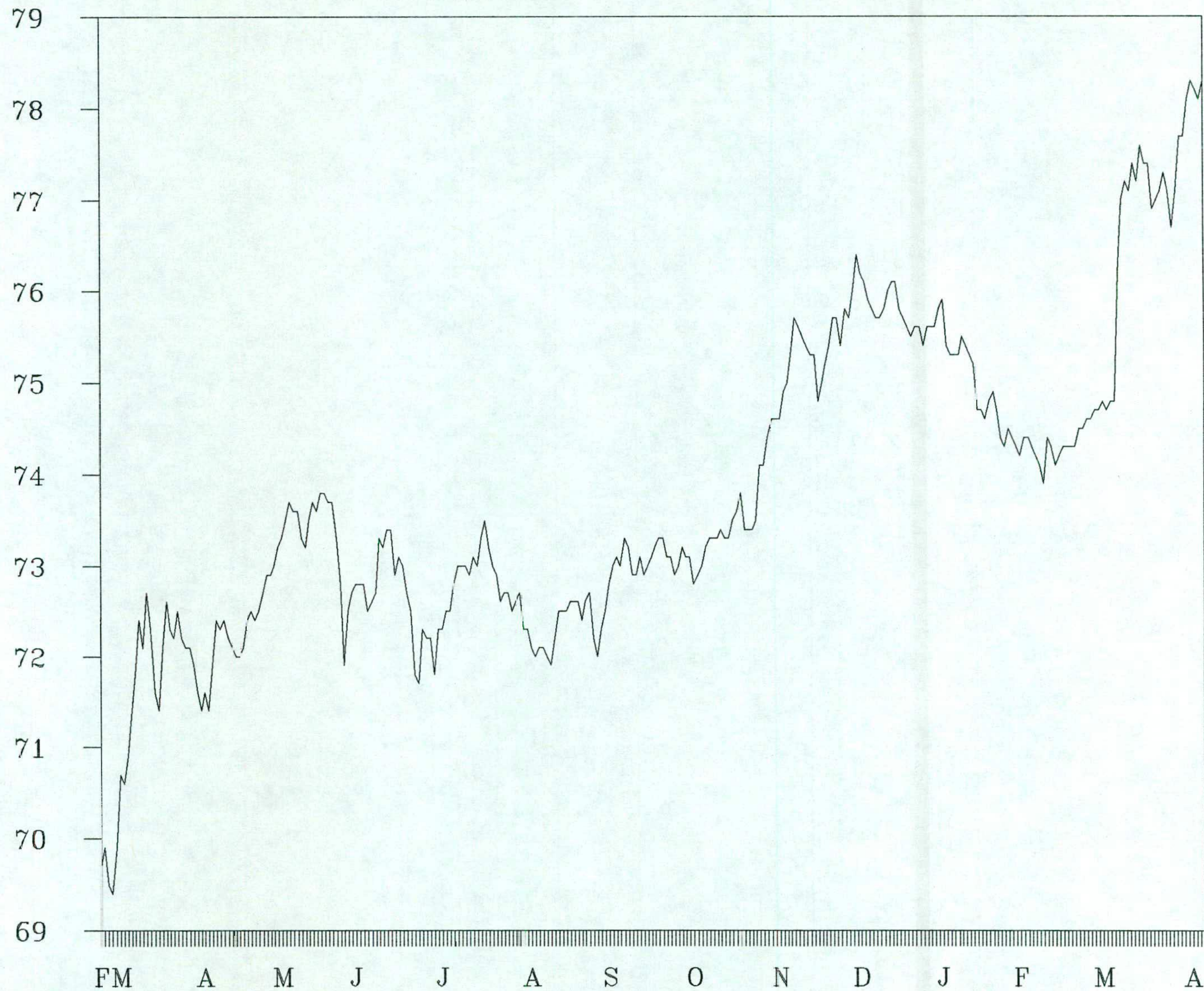
I am just leaving for the U.S. for a few days, but wanted to congratulate you on the Budget.

It represents a tremendous step forward and points the way firmly towards a low tax economy. We are delighted.

Yours ever

John Hoskyns

Institute of Directors 116 Pall Mall London SW1Y 5ED Tel: 01-839 1233 Telex: 21614 IOD G Fax: 01-930 1949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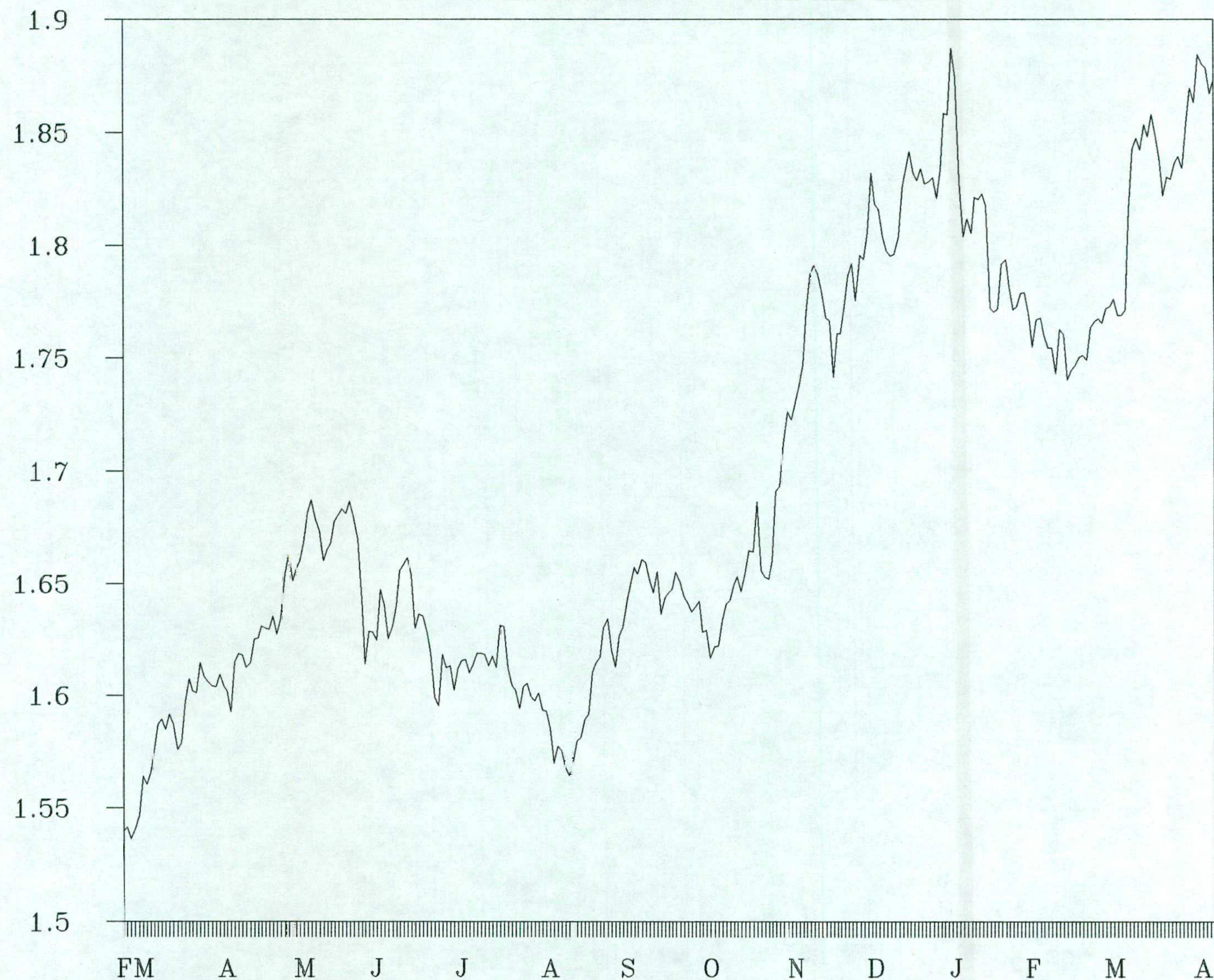
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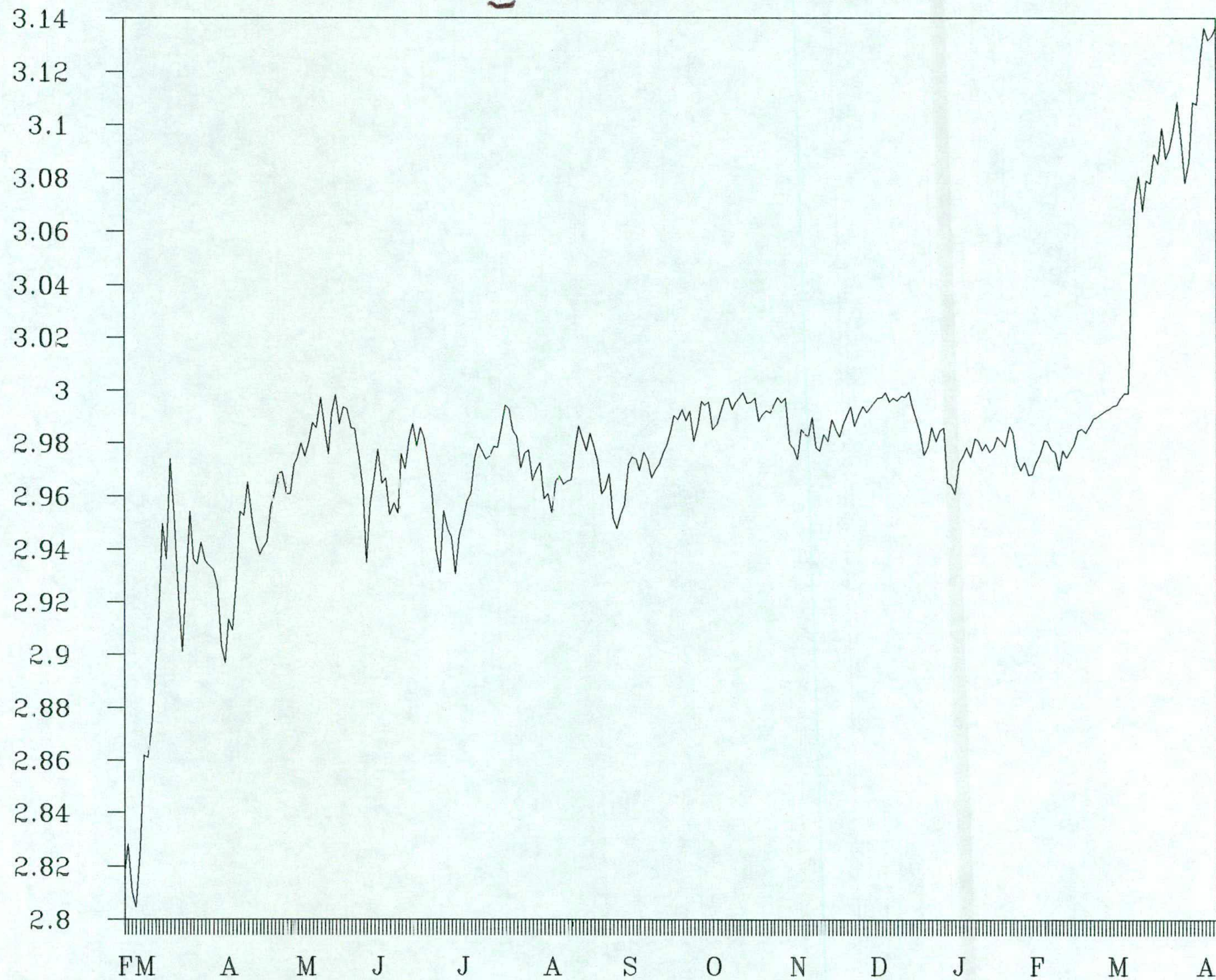

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DOLLAR EFFECTIVE RATE INDEX

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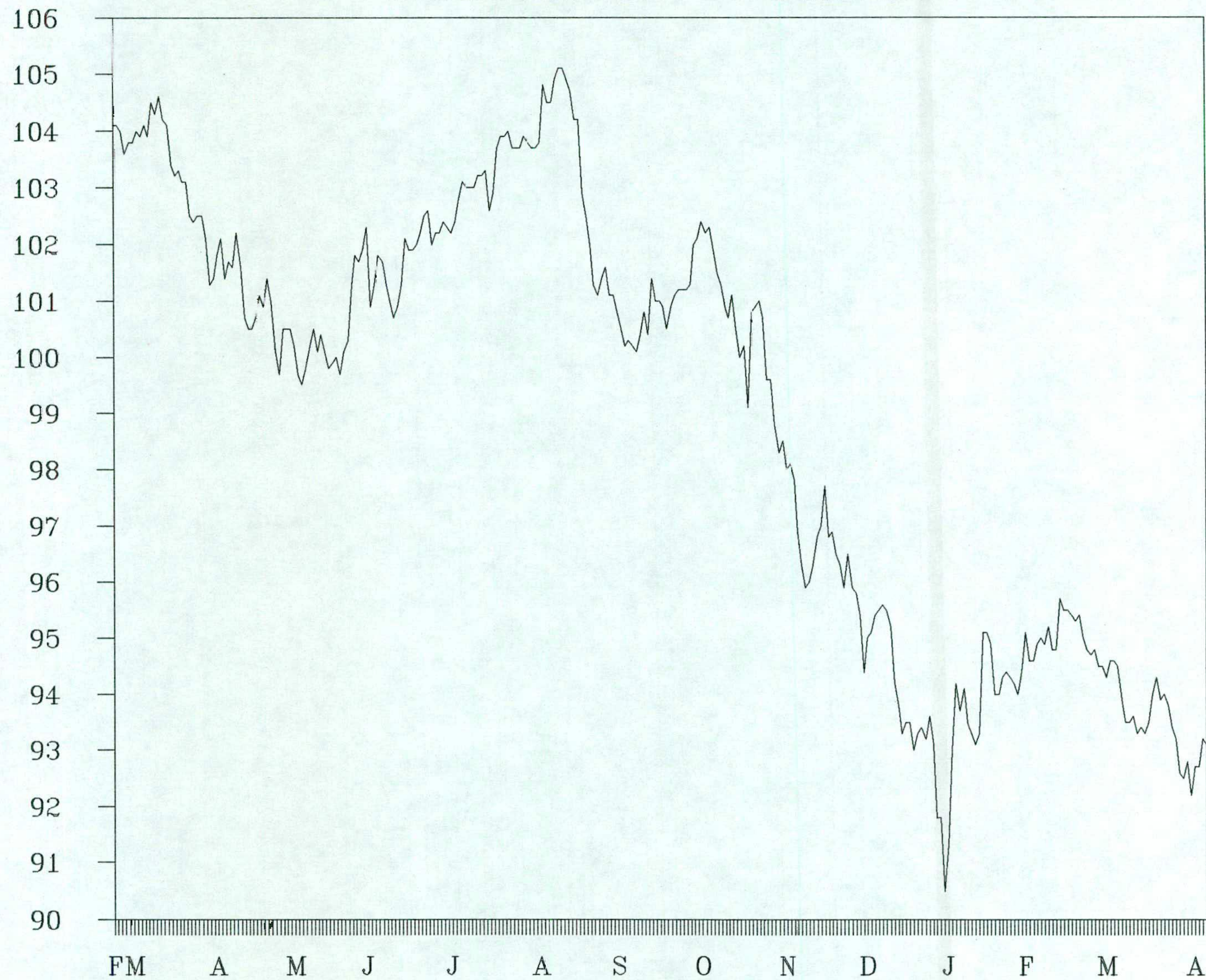

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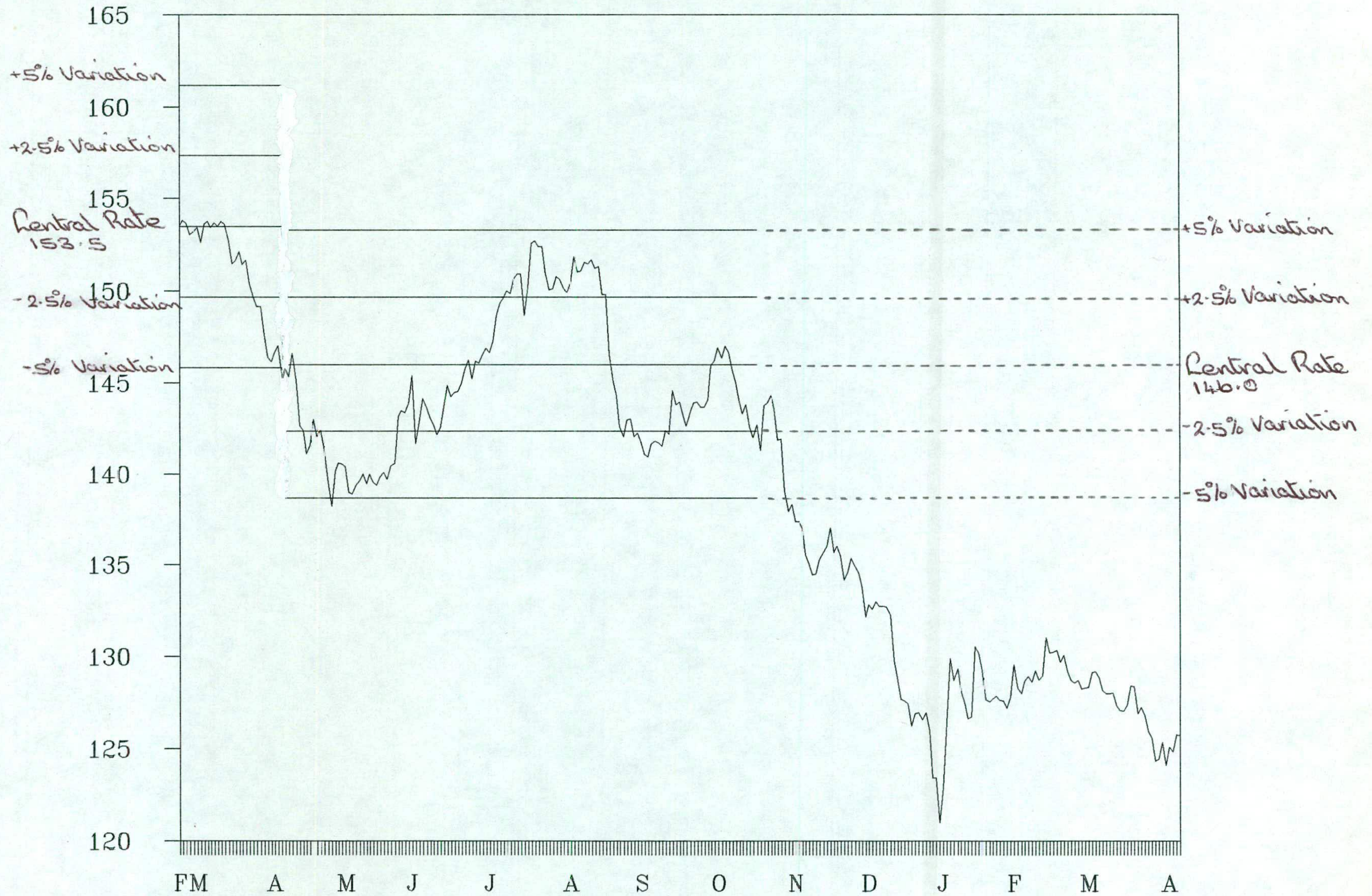

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DEUTSCHEMARK DOLLAR

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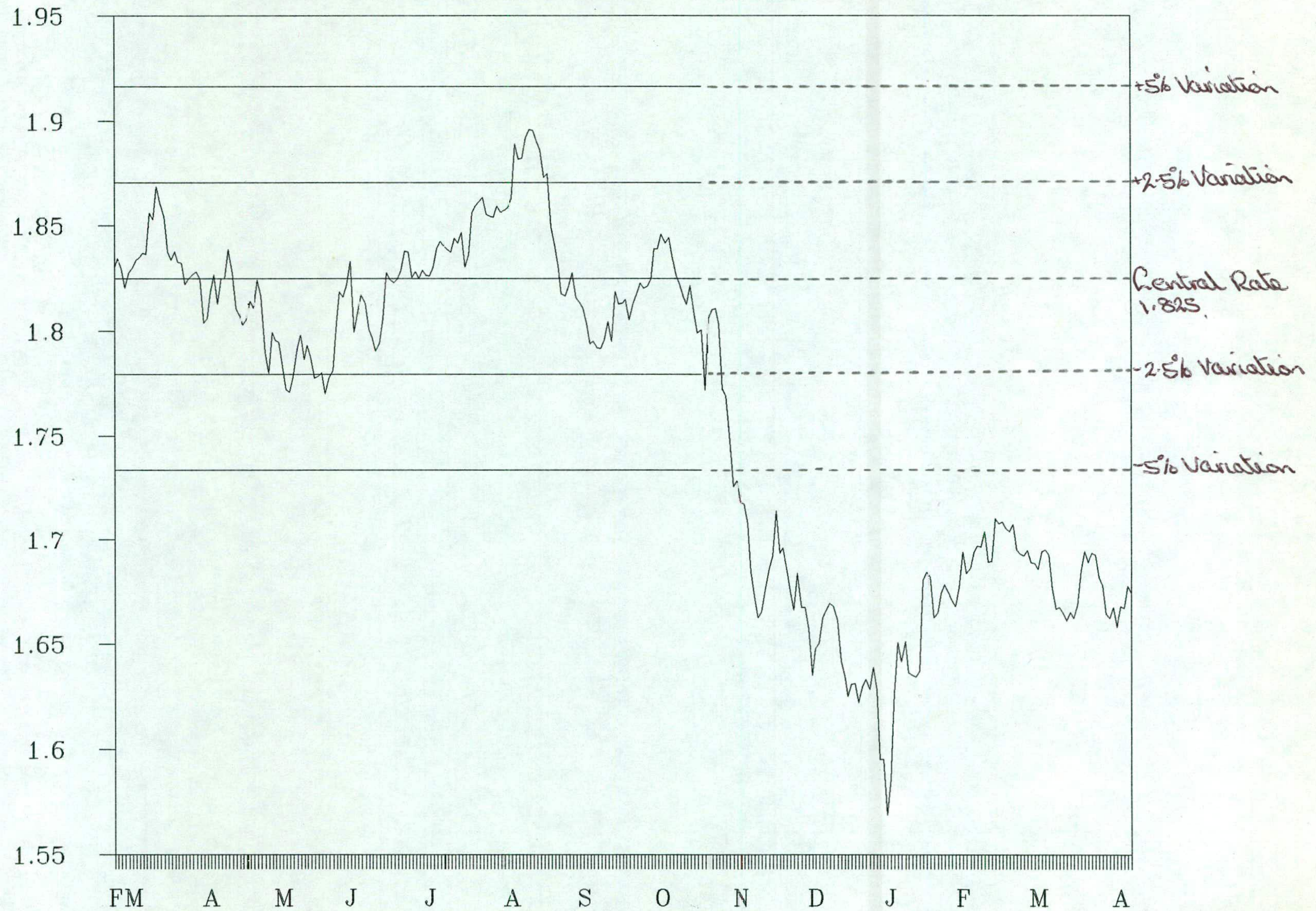

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...rliament ...as misled ...ver seed group sale'

By Richard Waters

THE DEPARTMENT of Education and Science misled Parliament over what would happen to £38m raised from the sale of the National Seed Development Organisation last year, the National Audit Office claimed yesterday.

The £38m, part of the £66m raised from the sale of the organisation to Unilever, did not go to the Exchequer, as the DES had indicated, said the auditors. This has led to a qualification to the Department's annual accounts, published yesterday.

Instead, the money was retained by the Institute of Plant Science Research – a new institute formed out of the remains of the Plant Breeding Institute, part of which was also sold to Unilever.

The diversion of money occurred because, as a charity, the PBI was forced to retain the proceeds of the sale rather than passing them on to the Exchequer.

The DES said yesterday that it had thought that the money could be paid, but that legal advice after the sale indicated that that was not possible.

The £38m has not been lost entirely, though. The DES said that it will halt the annual grant to the institute until the money has been recovered. The grant in 1986-87 was £3m.

Much of the money has already been ploughed into a new laboratory for the institute. This was projected to cost £7m but is now expected to cost over £20m, the auditors said.

The fact that the project is being financed by the £38m, rather than by annual grants, means that it has moved outside Parliament's control, and that MPs have no power to examine the excessive cost, said the NAO.

- The NAO also qualified the accounts of the Home Office over a £16m dispute with the Post Office. The dispute is over the amount paid to the PO for collecting television licence fees on behalf of the Home Office.

The PO claims that it is entitled to £53m for licence fees collected in 1986-87 and 1987-88 – £16m more than the Home Office is prepared to pay.

Daily Telegraph

A sell-off shows loss of £38·5m

By Our Political Staff

THE DEPARTMENT of Education last night criticised by Mr John Bourn, the Comptroller and Auditor General, over a privatisation project which cost the taxpayer £38·5 million.

Mr Bourn "qualified" the department's annual accounts after discovering that the Government had not, as expected, received the proceeds from the sale of the Plant Breeding Institute.

The Institute and the National Seed Development Organisation were bought by Unilever for £66 million in September last year.

But while all the proceeds from the Seed Development Organisation — £27·15 million — were paid to the Government, the £38·5 million for the institute was not.

According to Mr Bourn's highly critical footnotes to the accounts, officials at the department had been told by their legal advisers that the institute was a charity, and sales from its assets would remain with its governors.

Despite this the department told MPs when presenting estimates for the sale that the money, apart from expenses, would go to the Treasury.

Mr Bourn said the governors were using part of their windfall to finance a new laboratory to carry out the work of the institute, effectively putting the money "outside Parliament's control".

Tuesday December 6

THE INDEPENDENT

Charity privatisation cost Treasury £38m

By Anthony Bevins
Political Editor

IN ONE of the most bizarre National Audit Office reports for many years, Parliament was yesterday told that the Government had privatised a charity.

When Sir Keith Joseph, then Education Secretary, told the Commons in February 1986 that the National Seed Development Organisation and part of the Plant Breeding Institute were to be transferred to the private sector, it was thought that the entire proceeds would go to the Exchequer. But, according to John Bourn, the Comptroller and Auditor General, yesterday, Whitehall bungled. Because the institute was a registered charity, £38.85m of the £66m paid by Unilever in September last year had to be handed to the institute's independent governors.

That was duly done in October last year — along with a payment of £137,000 interest for the fortnight during which the proceeds had been held by the department.

It had been hoped that the money could be kept under government control by switching it to the Agricultural and Food Research Council's new Institute of Plant Science Research. But the Charity Commissioners baulked at that and the unprivatised element of the institute was left with a £38.85m windfall. The institute has now agreed to pay for a new laboratory at Norwich, which is perhaps just as well. When the department initially approved the laboratory, its projected cost was £7m. Construction costs alone are now estimated at £16m, with a further £4.6m earmarked for equipment.

It was also revealed by Mr Bourn that apart from the £38.85m lost to the institute, the Exchequer was also missing a further £16m because of a dispute between the Home Office and the Post Office over counter charges for selling television licences. Although talks continue on the pricing of Post Office services, the Home Office has approached the high street banks to persuade them to start selling the licences.

Mr Bourn reported yesterday: "Even though I am advised that its action is not illegal, it seems to me most unsatisfactory that the Post Office has retained £16m of licence revenue. In my view, all revenue collected should in principle have been paid over promptly to the Consolidated Fund without deduction."

What's all this? News to me.

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