PO-CH/NL/0409
PART H

Part H.

SECRET

(Circulate under cover and notify REGISTRY of move[ment])

Begins: 22/6/88.
Ends: 13/7/88.

PO -CH /NL/0409

PART H

PO -CH /NL/0409
PART H

Chancellor's (Lawson) Papers:

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

DD'S: 25 Years

[signature]

9/1/96.

CABINET OFFICE PAPER

The following Cabinet Office papers have been taken off the file. If you require access to these papers please contact the Cabinet Office.

Reference	Date Of Paper
MISC 133 (88) 10th Meeting	Wed 29 June 1988

SECRET

1. Since the 1985 FRN is st— below par, we will not call it, but currency or a small buy?

From : D L C Peretz
Date : 22 June 1988

CHANCELLOR

cc CST
EST
Sir P Middleton
Mr Anson
Sir T Burns
Sir G Littler
Mr Lankester
Mr Scholar
Mrs Lomax
Mr Turnbull
Mrs M Brown
Mr Gieve
Mr Grice
Mr Mowl
Miss O'Mara
Mr L Watts
Mr M Williams
Mr N Williams
Mr Cropper

Ch
2 1(a) & (b) seem sensible.
An ecu borrowing has some clear attractions:
- encourage growth of private ecu mkt
- helps get it based in London
- it's easier/cheaper to get in mkt when don't need to borrow.
But, nonetheless, it looks a bit odd to me.
Smallest meeting?
AA

Yes N.

PERETZ TO CX 22 JUN

FOREIGN CURRENCY BORROWING STRATEGY

We need to take stock again of the official foreign currency borrowing position, for various reasons. The reserves have risen by a further $7 billion since the beginning of December (when we completed our last review). We need to take a decision this summer on whether or not to exercise the call option on the 1985 $2½ billion FRN. And the Bank have tabled a proposal for establishing a HMG ecu Treasury bill programme in London.

Progress since last review

2. Mr Kelly's minute of 13 November set out the foreign currency borrowing strategy we suggested we should adopt in the light of the substantial increase in the reserves during 1987. You agreed that we should step up prepayment of foreign currency debt, particularly bank debt; that we should withdraw the ½% interest rate benefit to public sector borrowers under the exchange cover scheme, realising this would be likely to reduce our borrowing from the European Investment Bank dramatically; that we should continue to buy in small amounts of our FRNs discreetly for as long as it made sense; and that we should continue to plan on the basis of initiating a HMG sovereign note programme at some point.

3. Since the beginning of December we have repaid $2.1 billion ahead of schedule, and virtually all our dollar bank credits have now been repaid. We have also acquired $100 million of the 1985 FRN and $303 million of the 1986 FRN.

4. As to new borrowing, after a transitional period before the new exchange cover rules came into effect, the UK public sector has borrowed only $85 million from Community institutions and future borrowing from this source is expected to be minimal.

Further debt repayment

5. Despite this, the reserves now stand at a record $54 billion, spot and forward. We have therefore sought together with the Bank of England to identify whether there are further prepayment possibilities.

6. **Calling the $2½ billion FRN.** We can first exercise the call option on the 1985 $2½ billion FRN on 7 October this year. As things stand at the moment this would generate interest savings, since the marginal return on our investments is less than we are paying on the floating rate notes. The corresponding reduction in the reserves would also allow us to reduce the EEA credit exposure to individual banks which, with the rapid build up of the reserves in the past year, is becoming a genuine concern.

7. As important, the market is expecting us to call the issue, since everyone can see that it could be refinanced more cheaply in other ways. This expectation is reflected in the price at which the notes are currently trading. So not to exercise the option would reflect badly on the professionalism of our debt management. We therefore recommend that we take a decision in principle now to exercise the call in full in October. We do not need to take a final firm decision on this until early August : the principal paying agent should be given at least 65 days' notice of either a partial or a full redemption.

8. **Other prepayments of market debt.** The Bank of England have reviewed carefully the $0.9 billion outstanding of non-EIB debt that is prepayable. We agree with the following recommendations :-

i) the $500 million US commercial paper programme by the South of Scotland Electricity Board should be run down to $250 million. We do not want to run this programme off entirely, since there is some merit in maintaining the UK name, and related rating, in the US commercial paper market. We will need to consider the remainder of the programme again when privatisation is closer.

ii) a $250 million privately placed FRN for the Severn Trent Water Authority should be repaid. It would in any event have to be unwound before privatisation.

iii) we would like to prepay the $150 million Salomon loan to BNFL, but since BNFL do not have access to the NLF for replacement finance, we only recommend this if we can arrange replacement sterling finance from the EIB at an acceptable interest rate. We think this should be possible.

9. **Prepayment of borrowing from the Community institutions.** $5.2 billion of existing borrowing takes the form of project finance borrowed by various public sector bodies from the EIB. There is a good case for seeking to repay some of this. We do not at present need the borrowing, and in fact are paying out more in interest than we can earn on the reinvested proceeds. There is also a specific need to break government links with the industries shortly to be privatised : water and electricity. It should be noted that we have already prepaid $310 million of the most expensive EIB borrowing over the last twelve months.

10. However, there are a number of difficulties. First we have an interest in maintaining a reasonably good relationship with the EIB, in case we ever wish to run up borrowing from them again. The UK currently accounts for 10% of the EIB's total portfolio. Second, early repayment of these loans will require the borrowers, under the normal rules, to pay premia to the EEA. These premia offset the lower interest rate on the replacement sterling loan so that the borrower is no better off as a result of early repayment.

These premia currently amount to around £20 million for the water industry alone. We could well be unable to resist a corresponding increase in the authorities' EFLs. Third, we would in any event want to avoid too large an outflow from the reserves concentrated over a short period.

11. We think it would help to sugar the pill with the EIB if we were to focus repayments on those industries - water and electricity - due for privatisation, when a change in the loans will in any event be required, using that as the main rationale. The sums concerned amount to just over $1 billion for the water industry, and around $1½ billion for electricity. In fact some of the industries concerned may well wish to maintain a link with the EIB after privatisation. We have nothing against this, but it would have to be on private sector not public sector terms. This means the exchange cover arrangement - and the EEA's involvement - would need to come to an end. It might be that the EIB would be happy to replace the existing foreign currency loans with sterling loans, post-privatisation, but we have not yet discussed this with them.

12. Given the possibility of the loans continuing, but in different form, after privatisation, the negotiations with both the EIB and the industries themselves for breaking the link with the EEA are likely to be quite complicated. They may also become bound up with discussions about the capital structure of the new companies. We suggest, therefore, that we start negotiations now, although it is likely that most of the prepayments will fall in 1989 rather than 1988.

New borrowing

13. Against this background, there is clearly no need to undertake any significant new foreign currency borrowing for the time being. There is, however, always an argument for setting up new facilities when not needed : that is the way to get the best terms. And we should remember that our gross reserves are still not high in relation to those of comparable countries, measured in terms of trade flows, especially given the importance of sterling as an investment currency.

14. So we have considered together with the Bank the possibility of taking the opportunity this summer to establish some form of new HMG short-term note programme. The attraction is that we ought to be able to raise such notes at no effective cost, since we judge we could reinvest the proceeds at a profit, or at least break even; and that we could establish a programme now of minimum viable size, which it would be possible to run up in future if we needed to do so. The case is not a strong one, but worth considering.

15. **Choice of currency**. There are really only three options : dollars, DM, or ecu.

i) **dollars** have the advantage of being fully useable in intervention (no problems with the Fed of the kind we have with the Bundesbank); and easy to invest. The Bank judge that if we were to launch a dollar note programme in New York (where we would probably get the best terms) we could probably invest the proceeds at a turn of $^1/_8$th% or so. However, their judgement is that the initial programme would need to be large - around $4 billion - to differentiate it properly from others; and we could have difficulty investing dollars at present on that scale without relaxing the standards we apply to the credit risk the EEA takes in respect of individual banks. Moreover, if the programme were launched in New York it would be difficult to extend it to currencies other than the dollar.

ii) borrowing in **DM** would have a variety of advantages. Given our objectives, DM would be a more useful intervention currency to have (despite the problems with the Bundesbank). But there would be difficulties in mounting a DM note programme. There is no existing market in short-term DM paper, and the investment opportunities in DM are limited. Moreover, we would feel bound to consult the Bundesbank before establishing any such programme, as we would expect them to consult the Bank of England in mounting a borrowing operation in sterling.

iii) this suggests the case for considering a borrowing in ecu, and the Bank have examined this possibility in detail (paper attached). Since the Bank paper was written, the European Commission have issued a 500 mecu bond which they hope will form a benchmark in that market but sovereign issues of short-term ecu paper have so far been very small. Ecu have some of the advantages of DM, as an intervention currency, with less complication vis-a-vis the Bundesbank. There would be no need to consult anyone before establishing such a programme. The Bank believe that because of its novelty a much more modest programme than they would recommend in dollars would be appropriate : no more than 1-2 billion ecu to start with. And they believe it would be possible to reinvest such ecu on a break even basis. Establishing a ecu bill market of this kind in London would in itself help to promote a more active market in which we could invest the private ecus we raised, and those we already hold as a result of past intervention.

16. Of these three possibilities, the case for ecu borrowing looks the strongest at present. And it is worth noting that if we issued notes in ecu initially, it would be possible to build on the same technique in future to borrow other currencies, including DM if the Bundesbank could be brought to agree.

17. Our view in MG is that on reserve management grounds, which is the basis on which we have to judge this proposition, there is a case for considering it, though the arguments are not strong. Essentially, the case for comes down to :

- there would be no cost

- it might prove useful in future

- it would help stimulate a better market in which to invest our ecu reserves (at the same time as increasing the amount we have to invest).

And the arguments against are :

- possible difficulty of presentation, at a time when we will be repaying early our 1985 FRN (though I doubt whether this would be too difficult in practice).

- are the benefits large enough to warrant the effort?

18. We should also note that establishing a HMG ecu facility of this kind could help give London an important edge in the private ecu market. We could establish the infrastructure for the programme in such a way as to make it easy for other EC governments to use the same machinery if they wished to do so : for example by appointing Community central banks as paying agents, and a selection of EC commercial banks as market makers. And launching the facility would give us a useful "communautaire" point to make at EC meetings.

19. If we did want to go ahead with this proposal we would need to consider **timing and mechanics** further. The best timing would be to announce call of the 1985 FRN in August, creating an environment in which people feared a shortage of UK government foreign currency paper. Then we would announce the new ecu facility in September, probably only giving a few days notice of the first auction.

20. Meanwhile, we would need authority to consult potential market makers on a very discreet basis. It would be worthwhile underlining the quality of the note programme by adopting a distinctive title and structure. The Bank think this could be achieved by calling the paper "UK ecu Treasury Bills" and by modelling the programme along the lines of our sterling Treasury Bill issues. However, it will require secondary legislation to be able to use the name "Treasury Bill".

Conclusion

21. I would hope you can agree to the proposals in paragraphs 5-12 of this minute that we should :-

a) call the $2.5 billion FRN this summer. The market would be puzzled were we to do anything else.

b) proceed on other possible debt repayments as suggested in paragraphs 8-12 .

22. But I imagine you will want to discuss with us and the Bank the idea of launching an ecu bill programme, as described above and in the attached note by the Bank of England.

DLCP

D L C PERETZ

cc Mr George - Bank of England
Mr Plenderleith - "

mjd 4/192An

UNCLASSIFIED

FROM: A P HUDSON

DATE: 23 June 1988

~~LF~~ 27.6

PMP

CHANCELLOR

cc Mr A C S Allan

INVITATION FROM COMMONWEALTH SECRETARIAT TO SPEAK ON DEBT

I spoke to Sir Peter Marshall, the Deputy Secretary General of the Commonwealth, this morning. He had spoken to Alex last week.

2. He is interested in providing you with a forum for a speech on debt before the Summer holidays. His suggestion is that the event should be at the Royal Commonwealth Society. There could be a buffet lunch, followed by a speech from you at, say, 1.30, with the event to finish by 2.30. Given 7-10 days' notice, he is confident of being able to organise a good audience. He is happy for us to suggest some dates.

3. Shall we discuss this at Potential Press Notices on Tuesday (28 June)?

4. For the record, Sir Peter's phone number is 839-3411. His Director of Public Affairs is Prue Scarlett, on 930-6733.

APH

A P HUDSON

44/6

FROM: AMANDA HIGGINS

DATE: 24 JUNE 1988

1. MR MOUNTFIELD
2. CHANCELLOR

cc: PS/Economic Secretary
Sir G Littler
Mr Lankester
Mr H P Evans
Mr Bottrill
Ms Life
Mrs Wiseman
Mrs Thomson

CALL BY FRANK JUDD, DIRECTOR OF OXFAM, 28 JUNE 1988

Mr Judd wrote to you on 19 May enclosing a briefing paper for MPs and peers on African debt and a case study on debt and poverty in Zambia and asked for an opportunity to discuss Oxfam's work with you.

2. Your briefing for this meeting consists of:

(i) Toronto Summit Agreement on Sub-Saharan African debt.

(ii) Line to take on Oxfam's briefing paper and Zambia study.

(iii) Copy of Mr Judd's letter of 19 May and enclosures.

A J HIGGINS

CONFIDENTIAL

SUB-SAHARAN AFRICA

CHANCELLOR'S INITIATIVE: TORONTO SUMMIT AGREEMENT

TORONTO SUMMIT

1. **What was agreed at Toronto?** The seven major industrialised nations [US, Japan, Germany, France, Italy, Canada and UK] agreed that when the official debt of certain very poor and heavily indebted countries was rescheduled in the Paris Club they themselves would adopt one of three options. They would either

(i) reduce the debt outstanding by one third, charge market interest rates on the remainder, which would be rescheduled over, for example, ten years

(2) reschedule the debt outstanding at a reduced interest rate over, for example, a fifteen year period

(3) reschedule the debt over a longer period, for example 25 years.

2. **How does this compare to the Chancellor's initiative?** The Chancellor's initiative urged all creditor countries to

- convert old aid loans into grants
- reduce interest rates on official debt
- reschedule interest rates over very long periods.

The Chancellor's Initiative would have resulted in greater relief for the debtor, but was unacceptable to the US for 'political, budgetary and legal reasons' and other countries had reservations about reducing interest rates.

3. **Which countries will adopt which option.** We think that the French will choose (1), the UK, Italy and Canada (2) and the US and Japan (3). The Germans have not made a final decision. In the Paris Club we shall urge as many countries as we can to reduce interest rates.

4. **When will the Toronto agreement be implemented?** Official debt is resch^ed^uled in the 'Paris Club' of creditors. All creditors will have to work out in detail how the three options could be implemented so as to balance the costs and risks borne by creditors in the three groups. The Summit hoped that this work would be completed by December.

5. **So will interest rates for poorest countries be reduced next year?** The new ground rules will be applied as countries come to the Paris Club for rescheduling to the countries which are eligible and to the debt that is eligible.

6. **Which countries will be eligible?** The criteria are poverty, indebtedness and adherence to an agreed IMF or possibly World Bank adjustment programme. At Toronto the criteria used by the World Bank in selecting countries for the Special Programme for Africa seemed suitable but it will be for the Paris Club to decide the details - how poor, what degree of indebtedness etc.

7. **What debt will be eligible?** The Paris Club agrees this at the time of the rescheduling. Generally for the poorest it is principal and interest falling due during the following twelve months or period of a current Standby Arrangement. It will therefore be some time before all the debt of these countries is covered, but the cash flow improvement will take effect from the date of the rescheduling.

8. **Will conversion of aid loans into grants continue?** In Sub-Saharan Africa the UK has nearly completed this process: we have converted or written off a figure approaching £300 million and of the countries eligible only Zambia remains. Onc^e^ normal relations resumed with Fund Zambia too could benefit. Other countries which still have old aid loans outstanding have recently indicated that they will introduce or increase retrospective terms of adjustment (RTA): the US has brought in legislation which would permit RTA, but has not yet done any and France has said it will do more. We estimate that outstanding aid loans to low income African countries total about $7½ billion.

Line to take on Oxfam briefing paper and Zambia study

1. Welcome your support for my proposals for Sub-Saharan Africa and for sending us a copy of your briefing paper and case study.

2. Like to clarify several points:

(i) **Nordic proposal** - Oxfam urges full HMG support for this.

Background

There are about 7 low income debt distressed countries in sub-Saharan Africa which have market rate loans outstanding at the World Bank although their economic position has now deteriorated so that they are only eligible for IDA borrowing. Some of these loans are at fixed rates higher than the Bank's current rate. Although the loans represent only a very small proportion - about 5% - of these countries' debts, now that reductions in official market rate debt of these countries has been agreed, it is arguably anomalous for the IBRD to continue to collect debt service at full market rates. The Nordic countries therefore proposed setting up a fund through which donors would meet the cost of servicing these loans. This has received little support from other donors and the staff regard it as effectively dead. The UK has not supported it because the funds would have to come from within the current aid budget and ODA believe that these are better used for direct import financing. However, you proposed at the Spring Meetings that, as a more modest measure, the fixed rate loans should be converted to floating rates.

Line to take

Understand that Bank staff regard this scheme as effectively dead, since it received very little support. But I proposed a more modest measure at the Spring meetings by which those debts which are at fixed rates would be converted to current floating rates where this was advantageous.

LINE TO TAKE

(ii) IDA loans to be on grant terms

There has been a campaign, taken up by the Labour Party, for writing off of IDA loans as part of your sub-Saharan African initiative. We have resisted this on the grounds that it would not help those most in need, since recycling of IDA funds enables then to continue to be directed the countries which are currently the poorest. This is a variation which would give the benefit only to new borrowers. But again, it would in later years deprive new potential borrowers of funds.

Line to take

IDA terms are highly concessional and new borrowers would have no repayments to make for 10 years. If, after that period they continue to be among the poorest, they will benefit from relending of those repayments. If not, then it would be right to redirect the reflows, just as reflows from eg South Korea can currently be used to lend to the poorest.

(iii) **Wass report**. Analysis mirrors many of our own conclusions, but estimate of financing gap of $2 billion higher than that of many other experts.

(iv) **Soften terms of IMF adjustment policies according to UNICEF report 'Adjustment with a Human Face'**. Conditionality not too harsh. Primarily responsibility of governments concerned to ensure that the effect of adjustment on income distribution is not adverse for the poor. IBRD helps countries incorporate into their structural adjustment programmes a redirecting of social spending to the needs of the poor, as well as developing compensatory programmes.

(v) **Aid loans from European Development Fund should be converted into grants** - In past these loans have tended to have been made to relatively better off countries - need to concentrate support on poorest countries, who will benefit from an EC £70 million programme of fast-disbursing grants. This will include recycling of EDF loan repayments over next 2 years to finance vital imports.

(vi) **UK aid inadequate**: UK aid programme well over £1 billion. This figure has been maintained in real terms since 1982. The cost of implementing concessional interest rates will be additional to the agreed aid provision. High quality of UK aid recognised. UK sixth among OECD donors and fourth largest within EC.

(vii) The Oxfam paper 'Debt and Poverty: a case study of Zambia' seeks to balance Zambia's present economic situation primarily in the developed world in particular the IMF. The paper is flawed by their evident bias and by internal inconsistencies. We cannot accept his main recommendation, that the UK should resume grant aid to Zambia in advance of an IMF programme. Sensible economic adjustment policies are a precondition of UK programme aid as only such policies can ensure the effective use of the money.

3. Points of Detail on the paper prepared by the Post and by ODA are attached.

Reference ....

1092

From: J T Roberts

Date: 8 March 1988

cc: Mr Chakrabarti

Mr Hudson

OXFAM: ZAMBIA

Thank you for showing me John Clark's piece (attached). It is journalistic and impressionistic, bad, as you would expect, on the macro-economics, but probably essentially correct, where you would expect Oxfam to be correct, on the poverty aspects.

2. The paper gives some vivid examples of what we already knew, namely that urban living standards and the standards of public social sector provision in both urban and rural areas fell consistently in the late seventies and early eighties. Indeed, the World Bank were among the first to point out the falling purchasing power of budgetary provision for health and education and they made preparations for sectoral adjustment lending to help stem the decline and to improve sectoral resource allocation. It is nice to have Oxfam endorsement of the strategy of refocussing public expenditure in the social sectors on primary health and education.

3. Most of the hard evidence of falling living standards predates the auction period. John Clark climbs onto the popular Zambian band-waggon of blaming the auction for inflation and for a sudden further decline in living standards. Just as popular Zambian folk lore he fails to recognise the importance of the sudden terms of trade fall, the budgetary and monetary mis-management and the Zambian government's insufficient endeavours in keeping the IMF on side which led to the suspension of large potential inflows of quick disbursing aid. Clark does, however, make the valid point that adjustment prior to that time had been badly planned and without proper concern for the social consequences. Mind you, everything in Zambia is badly planned, not just adjustment.

4. I would draw your attention to the account of the food riots of December 1986 given in pages 20 and 21 which strikes me as giving a highly authentic account of what happened. It was a good case in point of badly planned adjustment.

5. Clark is much weaker on the consequences of adjustment and relative price changes for the rural areas. He doesn't have much evidence. It would be useful to know more about how the rural poor were affected. It is simply not good enough simply to repeat the understandable complaints of rural people about the rising price of fertiliser without, at the same time, discussing rising output prices and (probable) rising rural wage rates.

6. The paper ends, as one would expect, with a plea for unconditional British aid to Zambia and an apologia for the National Economic Recovery Programme. Clark may have to rewrite this bit of the paper, now that the Zambian government, too, has begun to find NERP defective.

J. T. Roberts

J T Roberts
Economic & Social Division / 8 March 1988

Reference ....

"DEBT AND POVERTY: A CASE STUDY OF ZAMBIA": BRIEFING ON OXFAM REPORT FOR EC HEADS OF MISSION MEETING ON 26 MAY

1. However respectable certain conclusions of the report are, eg the call for an end to net negative transfers, and the need to tailor structural adjustment programmes to minimise hardship to the poor, Mr Clark's arguments are simplistic, confused and riddled with inconsistencies. The overall impression is that this cannot be taken as a serious attempt to analyse Zambian debt problem and its economic ills, and the report's pretension to be such is in fact down right irresponsible. A few examples:

(a) In his introduction Mr Clark states that (p 3) "the collapsing world price of copper rather than Zambian Government's mismanagement, lies at the root of the economic crisis". But later we are told (p 15) that the reason this collapse had such a disastrous effect was because of the "Zambian Government's failure to correct colonial imbalances" - ie to diversify the export base away from the copper monoeconomy through the development of manufacturing industry or supporting agriculture. Yet (p 6) the author also tells us that even if Zambia did diversify she would meet a "brick wall of protectionism in most Northern markets" and "impenetrable barriers to trade". Apart from the fact that to exporters here its the over-valued kwacha which seems more of an impenetrable barrier, Mr Clark then undermines his own position in the rather hysterical section on "Foreign Takeover" when he describes how, during the IMF period, Zambia lost its sovereignty and "its land was used to supply crops to Europe"!

(b) His anti-IMF bias and refusal to ascribe any responsibility to the Zambian Government is clear in the discussion of the maize subsidy (p 25). He acknowledges that the subsidies "are perhaps of doubtful value economically" and that "the Govenment would have succeeded in removing this subsidy if there had been a clear and workable mechanism for doing so" and that the problem was that the subsidy was removed "in one go". But although it was the Govermnent's decision and not the IMF's to do this it is the IMF which gets the blame: "The IMF was widely regarded in Lusaka as being obsessive about the subsidy issue. It should be borne in mind that subsidies represent only 7% of the Government's budget (in 1985)...." In fact in 1985 it was about 12% and is now 14%.

(c) In the section "A New Path Forward" Mr Clark eulogises about the NERP and never addresses the fact that the good intentions are unlikely to be realised because of GRZ's administrative incompetence. There is also in this section real evidence of a complete failure to grasp economic reality. Commending the internal reforms, he mentions that "interest rates have been brought down to 15-20%" and that "in a bid to control inflation, the exchange rate has been fixed at K8 = US$1". But inflation in Zambia will only be controlled by reducing the budget deficit and growth of the money supply, and lowering interest rates will actually exacerbate the problem.

He continues in this irresponsible vein to say that (p 42) "The substantive elements of the new economic programme is the ceiling imposed on debt service. This will lead to an improvement in the foreign exchange situation which would help Zambia immensely if it were well used." For a start, there is no evidence that it is as yet being well used, but to suggest that building up enormous arrears and cutting off donor inflows by sticking to this debt service limit is helping Zambia's development is really warped thinking.

(d) Finally, his "Recommendations for Action" amount basically to a call for massive increased donor finance but entirely without conditions (p 45): "A determined international effort should be made to meet Zambia's financing gap in support of the new reform programme, even if donors don't agree with the whole

/package."

DE 18-77

package." Amazing naivety - as if programme aid was like awarding a gold star for effort! IFI and official bilateral lending is an investment like the lending of any commercial bank and donors must have evidence that the money will eventually be paid back. Only if they are convinced by the whole programme's potential for developing the economy enough to support repayments can they be expected to commit funds.

K Smith

2 June 1988

JM.CX

SECRET

Mary Rut[illegible]
One or 2 minor
changes, otherwise content.
Pse let me know
urgently re
[illegible] done [illegible]
provisional [illegible] after para 9 (x).

FROM: J MACAUSLAN
DATE: 27 JUNE 1988

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Phillips
Mr Monck
Mr Odling-Smee
Mr Turnbull
Miss Walker

Ch/ NB X in para 9 of cover note. Changes figures in yr 3. Other drafting changes sidelined. Now content to circulate under PS letter? MPW.

Ch/ as far as I can see the effect is +£1800m in 91-92. I shall check with GEP in morning. MPW 28/6

PRE-CABINET MEETING WITH PRIME MINISTER

We discussed this morning your meeting with the Prime Minister on Wednesday.

2. I attach (Annex) suggested amendments to the paper. Your Office is having a clean version printed out.

3. I also attach a revised version of the table, which you would like to annex to the paper. I hope this reflects the comments made at the meeting this morning.

4. The final attachment to this minute shows the Cabinet remits for the 1986 and 1987 Surveys, along with the form of words that was agreed this morning for this Survey.

5. I think you intended that your Office should send the paper, along with its annex table (but not the Cabinet remits) across to No 10 this evening. [No point - Paul G has gone home! Will have to go first thing tomorrow]

6. You may want to take with you Mr Turnbull's note of 17 June ("Objectives for the 1988 Survey") and my note of 13 June ("Survey Prospect 1988"), and Mr Luce's submissions on running costs of 13 and 21 June.

7. The Chief Secretary will want to refer to Annex D of my note of 13 June if questioned about the bids for individual departments.

8. But, in short, the bids are as follows. There are estimating savings on IBAP, ECGD and superannuation. But there are also large estimating bids on health, social security and net payments to the EC, and smaller ones on defence, regional assistance and legal aid. The net totals of estimating bids, along with a rough addition for effects in Scotland and Wales, are:

	£ billion	
+1.6	+2.7	+5.1

There are large discretionary policy bids on Defence, Health, Social Security, Education, Housing, Transport and Home Office. These, along with other smaller policy bids (including the Northern Ireland bid) and a rough addition for the effects in Scotland and Wales, total:

+5.0	+6.7	+7.9

(This split views all the bids except the major estimating bids as discretionary: the justice of that is rough.) Other non-departmental bids (nationalised industries, local authority relevant current, VAT on new construction etc) total:

+2.0	+2.5	+3.9

9. We have previously focused on the GE assessment of the likely outcome. This included the effects of the loss of the negative EFLs of the nationalised industries due for privatisation (especially water and electricity). The figures for departmental bids do not include this effect. But, on reflection, we think that failure to include this effect in the total of bids would give a false impression. I have therefore amended the figures in the paper for the Prime Minister and in the annex table to include these effects.

10. We envisage the following timetable for the next stages. In the light of any feedback from your meeting with the Prime Minister on Wednesday, we will prepare a draft paper for the Chief Secretary to put to Cabinet. We will submit that, we hope, on Friday. You will probably want to get it to the Prime Minister in the second half of next week. We will also prepare briefing

for Cabinet. MP/EA will (on the same timetable) be preparing a paper on the economic outlook for you to put to Cabinet.

11. If you would like any more briefing for the meeting with the Prime Minister, please let us know.

JM

J MACAUSLAN

JM.CXA

SECRET TAKEN ON

ANNEX

AMENDMENTS TO DRAFT PAPER FOR PRIME MINISTER

Paragraph 1, line 5: for "37.4 per cent", read "37.7 per cent" (the FSBR figure).

Paragraph 2: you proposed deleting the first 3½ lines, down to "... and 1990-91, was ...". The rest of the paragraph could then be added at the end of paragraph 3, reading "2¼ per cent, and are thus consistent with ... offering ... But this is very close ... with that objective".

Paragraph 3: you wanted to insert "in effect" after "need" in line 1. In line 3 you wanted to delete, "well".

Paragraph 4: the figures in the second sentence should be £8¼ billion, nearly £12 billion, and £17 billion (see cover note). To meet the Chief Secretary's point about pressures over the medium term that will be difficult to resist, eg the elderly poor, you could insert in line 4, after "the threat of more to come":

> "- not to mention the pressures to do more for particular groups that will inevitably emerge in future Surveys."

Paragraph 5, line 6: "by" should read "to".

Paragraph 6: You could insert a new second sentence:

> "The Annex shows what the consequences would be if they were accepted in full."

In the first indent, insert "assumed" before "trend". You proposed for the second indent:

> "General Government expenditure (excluding privatisation proceeds) would grow faster than its average rate of growth since 1978-79, thus marking an end to the progress we have made in reducing the real growth rate of public spending."

TAKEN ON

On reflection, the fourth indent might better read:

"- there would no longer be a prospect of a continuing decline in the tax burden (excluding the North Sea)"

In the section at the end of paragraph 6, you could insert before "undermined" in line 6:

"compromised the attempt to shift the balance between the public and private sectors"

<u>Paragraph 7</u>: to get across the distinction between savings to offset bids (for industry and agriculture) and net reductions (on employment), the last sentence could read:

"... and, with unemployment falling fast and at its lowest since 1981, we should look for net reductions on the <u>employment</u> programme where, far from savings being offered, increases are sought."

<u>Paragraph 8</u>: there could be a new paragraph 8 as follows:

"8. Within the total bids, running costs bids are also high. They would imply a rise in Civil Service costs of 5 per cent in real terms in 1989-90, and an increase in Civil Service numbers to more than 600,000 by 1991-92."

JM.CX.Tab

SECRET

ANNEX TABLE

PUBLIC EXPENDITURE AND TAX 1978-79 TO 1991-92

	General Government Expenditure excluding privatisation proceeds			Non-oil tax burden
	1	2	3	4
	Total (£bn)	Real growth %	Proportion of GDP (%)	% of GDP
1978-79	74.8		43.2	34.3
1979-80	90.1	3.1	43.2	35.2
1980-81	108.9	1.8	46.0	36.2
1981-82	121.0	1.1	46.4	38.7
1982-83	133.0	2.6	46.8	38.2
1983-84	141.3	1.5	45.9	37.8
1984-85	152.3	3.3	46.2	37.9
1985-86	161.0	-0.3	44.5	37.0
1986-87	169.4	1.9	43.9	37.5
1987-88	176.4	-0.6	41.7	37.7
1988-89	187.9	1.7	41.2	37.7
1989-90	202.8	3.8	41.7 (40.7)	37.9
1990-91	214.6	2.2	41.6 (40.0)	38.2
1991-92	227.1	2.7	41.7	38.5

Notes Figures assume: (and everything else as in FSBR

~~1)~~ concession of all bids ~~and debt interest and national accounts adjustments of £26.1/25.5/25.0/24.7 billion in the four years from 1988-89.~~

~~2) deflators from 1988-89 to 1991-92 of 4.5/4.0/3.5/3.0% (as in FSBR)~~

~~3) money GDP of £456/486/516/545 billion (as in FSBR)~~

Figures in brackets in column 3 show the ratios of GGE to GDP shown in the FSBR.

Lloyds Bank

News Release

Press Office
Corporate Communications Division
71 Lombard Street London EC3P 3BS

Telephone: 01-626 1500

Ch

Alex Allan - it seems the teenage scribblers no longer can comment on the economy - but that has not made their contributions any less famous! Jim

AA

EMBARGO: NOT FOR PUBLICATION UNTIL MONDAY, 4 JULY 1988

1/7/88: Amazing! PMP

GOVERNMENT URGED TO APPOINT MINISTER FOR WOMEN

A Minister of State at the Home Office should co-ordinate policies for women, says Christopher Johnson, Chief Economic Adviser of Lloyds Bank, writing in the Bank's Economic Bulletin for July.

Such a "Minister for Women" is necessary to ensure a more active policy, promoting work opportunities for women - not only on the grounds of social equality but also as a supply-side measure to improve the quality of Britain's labour force, he says.

"If the women of Britain cannot make progress at a time when they are in possession of both Buckingham Palace and Number 10 Downing Street, when can they?" he asks.

The Minister could pull together activities now spread out among a variety of Government departments, including Employment, Education, and Trade and Industry. The Home Office would be the logical base for such a Minister as it already covers race and sex discrimination.

Mr Johnson also says that women's education needs to be less centred on biology and languages and more towards physics and engineering.The proportion of women graduates needs to be increased to meet the shortage of maths and science teachers.

more/....................

TOTAL P.02

GOVERNMENT URGED TO APPOINT MINISTER FOR WOMEN ..../2

On the jobs front, employers could do more to provide flexible work opportunities, with women working part-time at senior levels, particularly during the early years of motherhood.

The Government should provide more local finance for creches, nursery schools, and care facilities for the old and mentally sick, so as to make it easier for women to go out to work.

The 1990 changes in family taxation will help some working women, but the benefit system still discourages part-time earnings by wives of unemployed men and single-parent mothers, who need the money most.

And Mr Johnson points out that only 22 per cent of civil honours in the UK were awarded to women in the June list. "The Honours List should be used to more to encourage achievements by women," he concludes.

- ends -

Further information:

Christopher Johnson
Chief Economic Adviser
LLOYDS BANK

Tel: 01-626 1500 ext 1115 (work) or 01-340 4970 (home)

mg1.bw/docs/2-1.7

SECRET

FROM: MISS M O'MARA
DATE: 1 July 1988

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Peretz
Mr Gieve
Mr Williams
Mr Polin

a
OK? AA

— OK with amendments indicated

RESERVES IN JUNE

I attach for your approval the draft press notice and accompanying press briefing on the June Reserves, prepared by Mr Polin

2. We are publishing an underlying rise of $84 million, on the lines the Chancellor agreed (Mr Allan's minute of 28 June). This is very close to the "true" underlying change this month. The market is expecting no change in June, so our slight rise will come as no surprise.

3. Table 1 shows that, unusually, last month we borrowed $56 million under the exchange cover scheme. This represents a loan drawn down from the EIB by BNFL who, as an industry classified to the private sector, do not have access to NLF finance.

4. Table 2 shows other countries' market intervention which was quite extensive during June. The strength of the dollar led the US to sell $520 million against DM and the Bundesbank to sell $1,466 million but despite the weakness of the yen/dollar rate, the Japanese stayed out of the market throughout June. The Canadians made heavy dollar purchases of approaching $3 billion at the beginning of the month, when with other high interest-bearing currencies, they attracted large capital inflows before attention then switched to the US dollar.

5. The EMS has begun to show signs of tensions for the first time in recent months. The band has stretched to 2 per cent and the Belgians are becoming isolated at the bottom. The Spanish, Italians and Danes (who also bought large quantities of yen) bought DM on a substantial scale during June.

MOM

MISS M O'MARA

TABLE 1 - RESERVE TRANSACTIONS FOR JUNE 1988

		$ million	
		Spot	**Forward**
1.	End May levels	48533	5655
2.	Transactions in June		
(i)	Market	+ 530	
(ii)	Swaps	-1485	+ 1485
(iii)	Maturities	+ 1215	-1215
(iv)	Other Bank customers	-132	-2
(v)	Government		
	(a) departments' expenditure	-76	-307
	(b) public sector debt interest	-68	-
	(c) HMG Debt interest	-68	-
(vi)	Interest on the reserves	+ 168	
TOTAL INTERVENTION		**+ 84**	**-39**
(vii)	Public sector borrowing under ECS		
	(a) borrowing	+ 56	
	(b) repayment	-154	
	net	-98	
CHANGE IN THE RESERVES		**-14**	**-39**
3.	End June levels	48519	5616

SECRET

TABLE 2 - OTHER COUNTRIES' SPOT MARKET INTERVENTION+

June 1988

($ million equivalent)

	Dollars	OTHER CURRENCIES (including EMS)
Ireland	+ 81 -35 agst DM	+ 144 DM
Belgium	-384	-23 DM + 26 ECU -28 Yen -6 SwFfr
France	-26 -20 agst DM	-
Italy	-91 -20 agst DM	+ 678 DM + 68 ECU
Netherlands	-260	-
Germany	-1466	-
Denmark	+ 7 -20 agst DM	+ 293 DM + 310 Yen + 33 £ + 76 SwFfr
Spain	+ 466 + 60(Forward) -52 agst SwFfr -43 agst Yen -6 agst Dfls	+ 986 DM
Sweden	-380 -25 agst DM	-45 DM -64 Yen
Norway	-350	-
Switzerland	-120	-
Japan	-	-
Canada	+ 2865 -23 agst DM	-
US	-520 agst DM	-
Greece	-56	-
Austria	-40 agst DM	-
Portugal	-138	+ 4 DM

+ On a done date basis. UK figures in previous table are on a dealing month basis.

FROM: I POLIN

DATE: 1 July 1988

1. MISS O'MARA mom 1/7

2. ECONOMIC SECRETARY

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THE RESERVES IN JUNE 1988

The reserves announcement for June will be made on Monday 4 July at 11.30 am. This month's announcement reports a fall in the reserves of $14 million and an underlying rise of $84 million.

Ian Polin

I POLIN

Mr Gray - No 10
Mr Cassell - Washington (after publication)

Mr Foot)
Mr D J Reid)
Mr J Milne) - B/E
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Mrs Jupp)

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DRAFT PRESS NOTICE

THE RESERVES IN JUNE 1988

The UK official reserves fell by $14 million in June. Accruals of borrowing under the exchange cover scheme amounted to $56 million; repayments of such borrowing amounted to $154 million. After taking account of foreign currency borrowing and repayments, the underlying change in the reserves during June was a rise of $84 million. At the end of June, the reserves stood at $48,519 million (£28,449 million*) compared with $48,533 million (£26,374 million+) at the end of May.

Note to Editors

2. The underlying change is the result of a variety of transactions, both debits and credits, including, for example, transactions for Government departments and with other central banks, and interest receipts and payments. The underlying change should not therefore be taken as an indication of market intervention during the month. The above figures can also be obtained from the Reuters Monitor (Code TREA).

---

* When converted at the closing market rate on Thursday 30 June £1=$1.7055

\+ When converted at the closing market rate on Tuesday 31 May £1=$1.8402

3. New borrowing under the public sector exchange cover scheme was as follows:

British Nuclear Fuels PLC, \$56 million.

Repayments of such borrowing were:

British Coal, \$103 million; British Telecommunications PLC, \$18 million; Electricity Council, \$9 million; British Nuclear Fuels PLC, \$8 million; North West Water Authority, \$5 million; British Steel, \$2 million; Strathclyde Regional Council, \$2 million; Anglian Water Authority, \$1 million; British Railways Board, \$1 million; Fife Regional Council, \$1 million; North of Scotland Hydro Electricity Board, \$1 million; South West Water Authority, \$1 million; Others, \$2 million.

THE RESERVES IN JUNE 1988 : PRESS BRIEFING

Factual : Main features of markets in June

	1 June (cob)*	Month's High		Month's Low		30 June (cob)*
£ ERI	77.3	77.9	(1st)	74.7	(27th)	75.2
$/£	1.8255	1.8380	(1st)	1.6950	(27th)	1.7055
DM/£	3.1526	3.1745	(1st)	3.0930	(27th)	3.1044
$ ERI	93.8	97.7	(30th)	93.4	(8th)	97.7
DM/$	1.7270	1.8285	(27th)	1.7100	(7th)	1.8202
Yen/$	125.25	133.95	(30th)	124.75	(10th)	133.77

*cob = close of business.

The mood towards sterling became distinctly bearish at the beginning of June but confidence was partly restored by two increases in base rates (on 2 and 6 June). The pound initially bore the brunt of return flows to the dollar in the wake of better-than-expected US trade figures published on 14 June, but continued to be underpinned by the high level of UK interest rates and rose to DM3.1480 on 22 June when base rates were increased by a further 1/2%. UK trade data were much worse than expected and the pound dipped sharply following their publication on 27 June, reaching the month's lows before making a brisk recovery in anticipation of a further rise in UK base rates. The market was initially disappointed with the 1/2% increase announced on 28 June, but concluded a further rise could be expected in the wake of the increase in the Bundesbank's discount rate and sterling ended the month on a steadier note.

Although the dollar benefited from the weakness of sterling at the beginning of the month, its advance was restricted by press reports of large sales of dollars by the Bundesbank. A feeling developed that central banks did not wish to see the dollar move higher and, as a result, it drifted back to the month's lows in spite of a statement by Greenspan that a further decline would be harmful for US trade performance. The dollar advanced strongly on the significant improvement in the US trade deficit published on 14 June and reached the month's highs on 27 and 30 June, ending the month bullishly.

Previous reserve changes

(i) At beginning of January 1987, reserves stood at $21,923 million; at end of December 1987, they stood at $44,326 million, a rise of $22,403 million (including 1987 revaluation of + $2,879 million).

(ii) The underlying rise in reserves in 1987 totalled $20,475 million.

(iii) Reserve changes from beginning of 1988 have been:

		$ million		
		Underlying change	Total change	Level of reserves at end period
1988	January	+ 38	- 1,233	43,093
	February	- 25	- 166	42,927
	March	+ 2,225	+ 1,713	47,519+
	April	+ 514	+ 338	47,857
	May	+ 814	+ 676	48,533
	June	+ 84	- 14	48,519

+after revaluation of + $2,879 million.

(iv) October 1987 underlying change of $6,699 million was largest ever.

(v) ~~Reserves peaked in May at $48,533 million.~~
May 1988 reserves of $48,533 million were highest [illegible]. ~~[illegible]~~ ~~[illegible]~~ ~~[illegible]~~

Who knows whether peak is yet to come

Level of official debt

Now stands at $17.6 billion at end March* (latest published figure, Financial Statistics, June 1988, Table 10.6). (In May 1979 was $22 billion.)

*at end March market rates.

POSITIVE

1. Reserves remain very strong after substantial underlying increase of $20 billion in 1987. Reserves now stand at $49 billion, just below highest ever level seen last month.

2. Level of official debt has been reduced substantially. At beginning of 1987 was $19.3 billion and at end of March 1988 was $17.6 billion. (In May 1979 was $22 billion.)

DEFENSIVE

(A) **POLICY**

1. **Exchange rate policy:** Government maintaining firm monetary policy to ensure downward pressure on inflation. Exchange rate policy is part of total economic policy. Government uses available levers, both interest rates and intervention, to affect rate as seems right in circumstances.

2. **Exchange rate stability runs counter to anti-inflation strategy?** Not alternative strategy. Most of time exchange rate stability reinforces anti-inflationary strategy. As Chancellor told Interim Committee of International Monetary Fund (IMF) on 14 April, if conflict between objectives for inflation and exchange rates emerges, priority must be given to inflation - but, in practice, this dilemma occurs only infrequently, and over medium term, exchange rate stability reinforces anti-inflationary strategy.

do we need this?

3. ~~**Has sterling passed its peak?** As Prime Minister told House, 17 May (OR Vol 133 No 152 cols 794-798) "... it would be a great mistake for any speculator to think at any time that sterling was a one way bet."~~

4. **Recent gyrations in exchange rates show impossible to achieve genuine stability?** Government's main priority is to bear down on inflation. Within context of anti-inflationary strategy, policy remains to seek to achieve reasonable exchange rate stability, which has ~~[illegible]~~ in fact been secured: $/DM rate only [3½]% above level a year ago.

5. **Tactics:** As Prime Minister reminded House on 17 May, available instruments - interest rates and intervention - will be used as seems right in circumstances. But not sensible to reveal operational details or be more precise.

6. **Is Government operating floor and/or ceiling for sterling/deutschemark rate?** Not helpful to talk about any particular level.

7. **Confidence in sterling likely to deteriorate as result of growth in current account deficit?** Government's position perfectly clear. Will not bail out excessive increases in domestic costs by allowing exchange rate depreciation.

8. **Current account deficit could be reduced by depreciation of sterling?** Not Government policy to ~~depreciate~~ allow exchange rate depreciate ~~to try~~ to increase UK competitiveness. Would be inflationary. Restraint of unit costs - which is in industry's own hands - key to competitiveness. ks

9. **Were dollar exchange rate targets and/or a budget for intervention set at Toronto?** No comment. Toronto Summit endorsed G7's statement in April that either excessive fluctuation of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that becomes destabilizing to adjustment process, could be counterproductive by damaging growth prospects in world economy.

10. **Increased international monetary co-ordination?** Toronto Summit communique stated that to sustain present non-inflationary growth a commitment to enhanced co-operation would be required. Key to credibility and confidence. Progress in international co-ordination is contributing to process of further improving functioning of international monetary system.

(B) **INTERVENTION**

11. **Why raise interest rates four times in June rather than intervene?** ~~Judgement of best course at time.~~ Clear that ~~a rise in interest rates and~~ a tightening of monetary conditions was appropriate.

12. **Value of intervention as instrument?** Has important role to play in checking unsustainable fluctuations in exchange rates which do not reflect underlying fundamentals.

13. **Intervention inflationary?** Only poses inflationary threat if not funded. Government made clear intervention will be fully funded as in 1987-88 so that effect on liquidity sterilised.

14. **Details of intervention?** Policy never to discuss.

15. **Have other countries been intervening over last month/recently?** Never discuss details but well known there has been concerted intervention over recent days.

16. **Have Bank been switching out of dollars?** Never discuss detailed reserves transactions.

17. **Treasury and Civil Service Select Committee (TCSC) report, published 25 April, recommended "intervention should not be used to maintain an exchange rate incompatible with underlying economic forces".** As Treasury's reply to Select Committee made clear, Government agrees exchange rates should reflect fundamentals, as G7 communique in April made clear. Under Plaza Agreement and Louvre Accord, intervention aimed first at achieving this position, then maintaining it. Fluctuations in foreign exchange markets do not necessarily reflect fundamentals. Position of G7 endorsed at Toronto Summit on 20/21 June.

(C) INTEREST RATES/MONETARY POLICY

18. **Monetary policy:** Object of monetary policy to maintain monetary conditions that keep downward pressure on money GDP and hence inflation. Inflation now down to levels of 20 years ago, despite strong and sustained upswing in real growth. Short term interest rates will continue to be held at levels necessary to keep monetary conditions on track. Will not take risks with inflation.

19. **Interest rate policy?** As Chancellor said in Budget speech: "Within continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure downward pressure on inflation."

20. **Why raise interest rates on 28 June?** A further tightening of monetary conditions in line with action taken earlier this month. Interest rates risen 2 per cent since beginning of June.

21. **Increase in interest rates on 28 June response to record trade deficit?** Deficit [~~not a problem.~~] Readily financeable. Interest rate decisions not taken on basis of any single factor.

22. **Why taken steps which will put upward pressure on sterling at time of record trade deficit?** [~~No sign of overwhelming upward pressure on sterling following interest rate moves.~~] [But] Government has stated repeatedly its determination to keep monetary policy tight in order to bear down on inflation. Interest rate decisions take account of all factors influencing monetary conditions, including exchange rate. Rate is now lower than a month ago.

23. **Recent interest rates increases will damage industry?** [Comments by Director General of CBI, on 22 June.] Industry has more to fear from resurgence of inflation. 1% rise in interest rates, even if sustained for whole year, raises costs by only quarter of amount of 1% rise in pay settlements.

24. **Further interest rate increases on the way?** Never speculate.

25. **Government applies formula whereby interest rates moved by 1 per cent for each 4 per cent opposite change in exchange rate, or 1/2% for each 5 pfennig change in DM/£ rate?** No. Interest rate decisions taken within continuous and comprehensive assessment of monetary conditions, taking all evidence into account. Exchange rate key indicator of monetary conditions, but not only factor.

(D) **EUROPEAN MONETARY INTEGRATION**

26. **UK membership of exchange rate mechanism (ERM)?** Matter kept under continual review. Will join when Government considers time is right.

27. **Recent interest rate moves would not have been necessary if UK had been in ERM?** Joining ERM would not be soft option. Countries within ERM frequently change their interest rates.

28. **Sterling's recent fluctuations would not have occurred if UK had been in ERM?** Countries within ERM not protected from realignments.

29. **Join ERM by 1992?** No fixed timetable. Will join when time is right.

30. **Proposals for European Central Bank and common European currency?** [European Council 27/28 June set up Committee to study and propose concrete stages leading towards economic and monetary union. No specific reference to European Central Bank or common currency.]

UK's own position perfectly clear. Proposals for common currency/ European Central Bank presuppose readiness to surrender national control over monetary policy and that all Member States pursuing same economic policy. Not in prospect. Should focus on useful technical ideas for strengthening the EMS and promoting wider use of private ecu already under consideraton.

31. **Capital liberalisation Directive adopted on 24 June brings UK membership of the ERM closer?** ~~No.~~ Position on ERM membership made clear by both Chancellor and Prime Minister on numerous occasions.

32. **When will capital liberalisation be implemented?** By 30 June 1990 for most countries. Some, including UK, already completely liberalised. Spain, Ireland, Portugal and Greece have until 1992, with possibility of extension to 1995 for last two.

TABLE 3 - TOTAL PUBLISHED RESERVES

$ billion

	Total reserve changes during month		Level at end of month
USA	- 0.8	(end May)	42
Japan	+ 0.4	(end May)	87
Germany	- 6.1	(w/e 15 June)	54
France	- 1.1	(end May)	68
Italy	- 2.7	(end April)	58
Canada	- 0.2	(end May)	13
United Kingdom	Negligible	(end June)	49

Notes

1. The figures for Germany, France and Italy were originally published in local currencies; they have been converted to dollars at appropriate exchange rates.

2. Figures not strictly comparable because of different valuation conventions for eg gold.

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Personal

To Rt Hon David Howell MP

(T & T)

Thank you for your letter of 2 Feb. and enclosure.

~~[illegible]~~ As usual, you see things far more clearly than the overpaid commentators.

Obviously, interest rates have to be at an adequate level – and it is interesting, I think, that over the past

(over

five years, during which
time the economy
has performed spectacularly
well, base rates have
averaged a little over 10 per
cent — but I see no
grounds whatever for panic
action of any kind!

THE RT. HON. DAVID HOWELL, M.P.

HOUSE OF COMMONS
LONDON SW1A 0AA

2 July 1988

The Rt.Hon.Nigel Lawson MP
House of Commons
London SW1A OAA

Personal

Dear Nigel,

I was pleased to see your reported strictures about city 'consensus' opinion and city commentators.

In fact,by no means all the opinions I hear in financial markets are in line with what is alleged to be the overall 'city' view. But there do seem to be four or five voices who always get reported and who always have something negative to say - which is why they get the coverage, I suppose.

It is interesting to note that these prominent gurus have been spectacularly and regularly wrong about the performance of the economy over the last four years.

You may like to glance at something I said earlier last week on the same theme. An extract was carried in the press which gave the false impression that I was critical of current official policy (as I am sometimes!). But as you will see my criticism was in practice aimed at the scribblers - who will persist in ignoring what is really happening in the economy.

I suspect the key item they are missing at the moment is the underlying trend towards much stronger personal savings habits. In my view the personal savings ratio could well be twice as high as the misleading official figure implies, meaning that the problem of excess consumer demand should steadily correct itself.

I hope that it will be on this front - the further transformation of this country into a high personal savings society - that you will concentrate,rather than be distracted by any nonsense about the policy of tax cuts being misplaced,or about the need for sky-high interest rates,which would not really address the problem.

With best wishes

Yours ever

David

THE RT. HON. DAVID HOWELL, M.P.

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Remarks by The Rt.Hon.David Howell MP to the London Oil Analysts Group

Conference at The Hilton Hotel,Park Lane, on Tuesday ,June 28th at 1 pm.

Immediate release

Inflation,Interest Rates and Oil

Like Pavlov's dogs the city commentators and gurus,almost to a man or woman,have been demanding in unison higher short term interest rates in the wake of the latest trade figures.

That is their automatic reaction to these statistics. It seems as though they know no other.

Yet it is highly questionable whether a sharp rise in interest rates is either the right or necessary response in these circumstances.

Higher interest rates will have zero effect on buoyant consumer demand. Not only would it take far more than one or two percent change to make any mark on borrowers in this area, but rates are actually coming down anyway as credit card companies begin to compete vigorously.

In the mortgage market,the effect of any increase is no more than the mildest check on housing demand. The effect on prices generally will be to push them up slightly.

The main sufferers will be industrial investors who have been re-equipping their factories and building new enterprise at a commendable pace.They are the people on whom our future export performance depends . And they will be the ones whom an interest rate increase hurts.

Thus the net impact will be to damage our trade performance further, whilst having very little influence on the internal economy - a triumph indeed of perverse economic policy.

There may be other reasons at other times for switching interest rates up or down as part of coordinated efforts amongst the leading nations to stabilise world economic conditions and currencies. If sterling rested on a clear policy framework it would be easier to see when such changes were justified.

But the interest rate weapon is at best a weak device for controlling the development of the national economy in the short term and far too much faith is placed in it by the so-called experts. The monetary base deserves much more attention,in as far as it can be defined.

In today's conditions the worst domestic inflationary dangers come from 1) continuing supply and technology bottlenecks, 2) from inadequate personal savings and 3) from higher imported commodity prices.

On the first, the Government is doing its utmost - more than any post-war predecessor - to overcome these supply-side problems. That is why the policy of tax cuts has been entirely correct and should continue (within the context of a balanced budget).

On the second, the pattern may now be shifting to a higher savings ratio. The statistics here are very suspect and savings may be already much higher than realised.

On the third,while there may be a temporary upward blip in cereal prices due to the American drought, the medium term trend is still firmly downwards.

As for oil,which is such a major influence on this front, everything points to continuing soft and low prices. That is what supply conditions dictate. That is what the main producers (especially the Saudis) want for the moment, and that is what is going to happen.

In these conditions it would be far better to leave our already high interest rates where they are,rather than make a reflex reaction to a month's bad figures. Concentration on longer term objectives has been the Conservative Government's greatest virtue. It would be a tragedy to throw it over under the pressure misguided short-term clamour.

ends

FINANCIAL SECRETARY TO THE TREASURY

Alex

I attach

(a) The Young minute to the PM.

(b) The MISC 133 minutes

(c) The MISC 133 brief for the FST

You will see from (b) that Lord Young's summing up gave fair weight to the FST's position and everything is still to play for

J.

ANNEX A

MISC 133(88)33: IMPROVING UNDERSTANDING BETWEEN GOVERNMENT AND BUSINESS

Note by the Parliamentary Under Secretary of State, Department of Trade and Industry.

Proposals

MISC 133 is being asked to endorse the recommendations of the Steering Group to increase the amount of interchange with business through secondments, non-executive directorships, business experience schemes and private sector involvement in training. In particular it is asked to:

- agree to the establishment of a central facility in OMCS
- note the implication for contingent liabilities of an increase in non-executive directorships
- invite EDU to draft a section for the White Paper to be discussed at the end of July.

Line to Take

- support the general thrust of the recommendations to increase interchange (1)
- acknowledge that **much is already done** and further increases in secondments and directorships cannot be achieved without considerable effort and **extra cost**
- these costs must be found from existing provision
- acknowledge the **sensitivity** of interchange for the Treasury and Revenue Departments, the possibility of conflicts of interest and issues of **propriety**
- argue for **departmental discretion** in developing programmes not central targets
- **question** the need for a **central facility** in OMCS. What specific, quantifiable **benefits** would a central facility bring? Open to question **which Department** would be best "home" for central facility; OMCS better placed for some aspects, but **DTI** or **DE** have better business contacts (2)

- there can be **no decision** on a central agency without **assurances** on the availability of **resources.** Additional work in OMCS this year would involve a claim on the **Reserve.** Future funding for OMCS a matter for the **1988 Survey**
- Treasury and OMCS **reviewing position** on **contingent liabilities** for **non-executive directorships**
- note the Prime Minister's instruction for careful appraisal of risks before accepting **contingent liability;** parliamentary proprieties require **advance notification** to Parliament of contingencies above £100,000.
- support the recommendation to **evaluate** interchange
- suggest **delayed launch** until **business support** assured.

BACKGROUND

MISC 133 in February this year considered a note on Changing the Whitehall Culture and invited Richard Luce and Francis Maude to report back with detailed proposals. A steering group of officials, chaired by EDU, took the work forward and produced this report. Both Treasury and Inland Revenue were represented on the steering group.

The report suggests a programme with three main elements: Ministerial and senior management commitment to business awareness and interchange supported by emphasis in personnel management procedures such as Annual Reports and Succession Planning; greater interchange with the private sector through increased numbers of secondments (widening the catchment area of both businesses ie small firms, and civil servants, ie more grades, involved), increased numbers of civil servants taking up non-executive directorships, and other exposure schemes; and increased private sector involvement and business awareness content in training courses.

To implement the programme the report recommends a central facility in OMCS to co-ordinate departmental programmes, boost and publicise the programme, help departments make contacts with business, monitor progress and report to Ministers. It also recommends a major publicity launch to business, early in 1989, building on the interest stimulated by the White Paper in October.

The costs of the programme are estimated at between £0.6m and £1.5m in the first year rising to £0.7m to £2.2m in the third year. Most of these will fall to departments generally but some £350,000 per annum would be required for the central facility in OMCS, publicity and evaluation.

The Treasury and the Revenue Departments support the general thrust of the recommendations to increase interchange. However the report does not give sufficient credit for what has already been achieved nor does it recognise that departments will have different priorities. The Treasury ranks highly amongst departments on secondments (21 in total but a high proportion of total staff numbers). Though Inland Revenue and Customs and Excise are low on the list in Annex C to the report, the Inland Revenue employ some 120 consultants in its Information Technology Division in line management positions and Customs and Excise focusses its effort on attachments to Community Institutions and to Overseas Governments under ODA and FCO programmes. With both the Revenue departments the nature of their functions requires them to be in close day to day contact with all types and sizes of business. Business awareness is, therefore, already deeply embedded in their cultures.

For all these departments, secondments and non-executive directorships raise questions of propriety. Because of the regulatory rules involved particular care needs to be exercised in identifying areas of work suitable for inward secondees. There are also obvious risks of conflicts of interest and non-executive directorships sit uncomfortably alongside the business appointments rules where Treasury is supposed to clear every appointment with rival companies. There is an obvious risk of complaint from competitor organisations that some commercial advantage is being obtained or that commercially sensitive information is being made available.

The Treasury is not convinced of the need for a central facility of the size suggested (1 Grade 5, 2 Grade 7s, 2 HEOs, an EO and supporting clerical staff) which would cost just over £220,000 a year. There should be departmental discretion to put forward programmes which meet their own priorities rather than centrally imposed targets and within their agreed running costs provision. Central targets would only serve to add further pressure to running costs. Domestic Treasury, for example, would find it difficult to increase the number of secondments and non-executive directorships without extra cost for which there will be little return.

If there is value in a central agency it is likely to be in the "marriage-broker" rôle for departments without the contacts to arrange secondments and non-executive directorships. But it is not obvious that OMCS are best placed to handle this. The training element and monitoring of secondments does fall to them and we would expect them to manage this within existing resources by re-ordering priorities. There may, however, be more appropriate locations if it is decided to have a central facility - DTI and Department of Employment, for instance, both have established contacts with business. It should however be possible to manage the scheme effectively within existing resources and without a dedicated central unit.

If nevertheless it is decided to have a central facility, there can be no decision on its location and when it is set up without assurances on the availablility of resources. OMCS claim that they have no resources to undertake this new work and any work started this year would involve a claim on the Reserve. Future funding for OMCS would be a matter for the 1988 Survey. Departmental programmes should all be contained within existing resources.

MISC 133 are asked to note the implication for contingent liabilities of endorsing an increase in non-executive directorships. Giving civil servants indemnity against the risk of director liabilities would create an as yet unquantified contingent liability, which would almost certainly have to be report to Parliament in advance. Treasury and OMCS are now reviewing the position on this and will report to Ministers. The issue has to be considered against the background of a) the Prime Minister's standing instruction that there should be a careful appraisal of the risks before contingent liabilities are accepted and b) the need to follow parliamentary proprieties which require non statutory indemnities that risk payment of £100,000 or more to be reported to Parliament in advance by Minute giving 14 clear sitting days during which Members may object.

Implementation of the programme depends as much upon commitment to it by business as upon commitment by Whitehall. It would be advisable to ensure that there is likely to be a favourable response from a number of key businesses before undertaking a major publicity launch. Reactions to the White Paper should be assessed before commitments are made as to the timing and size of the launch.

dti

the department for Enterprise

CH/EXCHEQUER 7/7
REC. 7 JUL 1988
ACTION FST
COPIES TO

PRIME MINISTER

6/7/88

IMPROVING UNDERSTANDING BETWEEN GOVERNMENT AND BUSINESS

I am writing to inform you and Cabinet colleagues about proposals that have been developed in the Ministerial Group on Deregulation (MISC 133) for giving further impetus to improving understanding between Government and business. These will figure prominently in the Deregulation White Paper planned for the Autumn. At our meeting on 29 June, the Group endorsed a report drawn up by officials, under the aegis of my Enterprise and Deregulation Unit working closely with OMCS. In summary, the report's main recommendations involve building on current opportunities for bringing civil servants and people in business closer together by:

a) involving a wider range of civil service grades and regional staff in secondment opportunities;

b) more involvement of smaller and medium-sized firms (for inward and outward secondments);

c) developing a wider range of types of secondment - both ways - including short period project work;

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d) more effort to identify jobs suitable for good calibre inward secondees;

e) developing other forms of attachments to firms and aiming to increase substantially the number of civil servant non-executive directors and the number of participants on the <u>Whitehall and Industry</u> scheme;

f) better marketing and deployment of existing training courses to improve business awareness, for example, developing specific business awareness training and seminars, directed to staff whose jobs impinge on business;

g) more flexible use of different means of recruitment;

h) more attention to career planning and annual reporting, to recording and using outside experience.

2. This would not be done by the centre prescribing targets for Departments to achieve. Though some elements will be common to all, Departments will set their own action programmes to fit their function and priorities and to which they will be committed. Some Departments, for example, attach importance to interchange with other parts of the public sector, such as local government and the health service, and with other Governments and international organisations. Priorities for training programmes in particular will need to be looked at carefully: again, what can be achieved centrally is limited because the great majority of civil service training is done by Departments.

3. The Group did agree though that, in order to keep up the momentum across Whitehall, a central facility was required to boost and promote the overall approach, to help Departments as necessary to implement their action programme, to draw together reports to Ministers on progress across Departments and evaluate results. There was general agreement that this should be located in the OMCS. Norman Lamont was concerned, however, about the financing of this facility and Richard Luce will need to reach agreement with the Treasury on the additional resources required (up to £350k per annum and 9 staff) to get this off to a good start.

4. Colleagues have agreed that Departments should draw up costed and timed programmes for further consideration by Ministers. The general shape of these needs to be available by mid-September, so that the broad content of the programmes can be reflected in the White Paper.

5. Perhaps the most important conclusion of our meeting was the recognition that we must be personally committed to this enhanced programme. I hope therefore that Cabinet colleagues as well as members of MISC 133 will give this personal backing within their Departments.

6. Business itself will need to be convinced that there is something in all this for them. No interchange programme will succeed without the commitment of business and I am sure that I can depend on colleagues to explore within their own Departments ways of using their existing business contacts to bring this about.

the department for Enterprise

7. I am copying this minute to Cabinet colleagues, members of MISC 133 and Sir Robin Butler.

DY

D Y

6 July 1988

Department of Trade and Industry

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SECRETARY OF STATE FOR EMPLOYMENT

Caxton House Tothill Street London SW1H 9NF
5803

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Paul Gray Esq
Private Secretary
10 Downing Street
LONDON SW1

6 July 1988

Dear Paul

OUTLOOK FOR RPI

... I enclose a numbered copy of the latest DE note.

Copies also go to Alex Allan (Treasury), Sir Peter Middleton (Treasury), Neil Thornton (Trade and Industry), Sir Bryan Hayes (Trade and Industry), Ms A Large (CSO), John Footman (Bank of England), and Paul Cuthbert-Brown (CO).

Sincerely

Beverley

BEVERLEY EVANS
Private Secretary

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Pmg

PERSONAL AND CONFIDENTIAL

OUTLOOK FOR RETAIL PRICES: JUNE AND JULY 1988

1. The annual rate of inflation for June, as measured by the 12-month change in the retail prices index, is expected to increase to 4½ per cent, or just over, from the 4.2 per cent recorded for May. The figures for June will be released on Friday 15 July

2. Between May and June prices are expected to have increased by almost ½ per cent (compared with no change between the same months last year). The effects on the all items index is expected to be most notable for price increases of non-seasonal food, motor vehicles, petrol and clothing. The third tranche of higher electricity and gas price increases will also be reflected. A further drop in seasonal food prices, following the fall in May, is anticipated.

3. For July the annual rate of inflation is expected to increase towards 4¾ per cent. The overall level of prices is likely to remain unchanged between June and July, whereas a fall of 0.1 per cent was recorded between the corresponding months last year. The final tranche of the effects of higher prices for electricity and gas will feed through in July. Seasonal food prices are expected to drop sharply, and prices for durable goods and for clothing and footwear are expected to fall because of summer sales.

4. There is speculation that the mortgage rate will rise by 1-2 percentage points for 1 August. A rise of 1 point would add around 0.4% to the all items index.

Percentage change in the RPI

		12 months all items		over 1 month all items	all excluding seasonal food
		%	Our forecast	%	%
1988	March	3.5		0.4	0.4
	April	3.9		1.6	1.6
	May	4.2		0.4	0.4
FORECASTS					
	June	4½	4.5	⅓–½	⅓–½
	July	4½–4¾	4.7	0	0–¼
	Aug.		5.7 (variant)		

STATISTICS D
DEPARTMENT OF EMPLOYMENT

JULY 1988

91/G 4578/003/cc

Covering SECRET

FROM: J W GRICE

DATE: 8 July 1988

SIR T BURNS

(Too clean a distinction between s-t volatility & l-t misalignment)

(prob. confusion between ex post & ex ante)

cc Sir G Littler
Mr Scholar
Mr H P Evans
Mr Peretz (o/r)
Mr Odling-Smee
Mr Sedgwick
Mr S W Matthews
Miss O'Mara
Mr Pike
Mr N Williams
MAMC: D5

FOREIGN EXCHANGES: VOLATILITY, EFFICIENCY AND STERILISED INTERVENTION

A little while ago you asked Mr Peretz if we would produce a note revising the evidence on the above topics. The present note is in response. I am afraid that it has taken an unconscionable time to produce it so to save further delay, I am sending it to you direct without having first circulated it within MG. This is regrettable because Miss O'Mara, in particular, has a wealth of experience in this area. So I hope that she will not feel inhibited from commenting.

2. The note is quite long but there is a summary of the main points and conclusions. It is classified only because the post-Louvre intervention figures in table 4 are secret and I could not immediately think of a way round this problem.

3. Looking back over the arguments, two points stand out in my mind:

(a) most of the evidence suggests that short term exchange rate volatility has little or no restraining effect on the volume of trade. Given the availability of forwards, options and so on, this is not very surprising. What is slightly disturbing, therefore, is that last year's CBI survey of attitudes towards the exchange rate revealed a sizeable proportion of firms, particularly of smaller ones, who claimed to be "very concerned" by volatility.

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We do not know if this is because they cannot use hedging devices, because of cost or administrative difficulties, or whether they are simply not aware of the possibilities. The answer to this question has policy implications. If we have a chance to persuade someone to look at this area in more detail - perhaps NEDO or the CBI - the results might be useful;

(b) when you commissioned the work, you said that you had a feeling that later experience suggested that some modification was required to the Jurgensen Group's views on the efficacy of sterilised intervention. You felt that sterilised intervention might have effect, at least for several months, if markets see it as a threat of unsterilised intervention to come, if they do not heed it. I think my own view is that Jurgensen was not far from the truth but that the sterilised/ unsterilised distinction is no longer a very useful one. In most countries, the textbook definition of sterilisation - neutralising the effects of intervention on the monetary base - is of no great relevance because the authorities do not run their monetary policies by this mechanism. In the UK, this definition is of no relevance because we sterilise the base effects day-by-day and the EEA is required by law to do so. But even if we widen the definition to mean neutralising the effects of intervention on the wider monetary aggregates, it still falls short of what is needed. It seems clear that exchange rates do not depend only upon relative growth of monetary aggregates but upon the wider policy stance of the authorities concerned and upon their expected policies in future. Accordingly, a more important concept may be credibility. What post-Jurgensen experience suggests (and, for that matter, pre-Jurgensen experience too) is that intervention within a consistent policy stance by the respective authorities will be successful. If the market perceives that there is a prospect of an inconsistent policy stance moving towards a more credible position, then intervention can buy time for the adjustment to occur. If the intervention is sufficiently heavy, quite a lot of time can be bought: months, at least. But if the policy stance is not consistent with

among other things

the direction of the intervention, then no amount of it is liable to have much effect, no matter how heavy. Whether the intervention is sterilised or not may have some bearing on this issue of credibility. But it is not the only dimension or even necessarily the most important one.

JWG

J W GRICE

SECRET

Summary and Conclusions

S1. This note deals with three critical and inter-related aspects of the foreign exchanges:

(a) the extent and effects of variability and longer term misalignment;

(b) the extent to which the foreign exchanges can be regarded as efficient;

(c) the efficiency of sterilised intervention.

S2. It is widely perceived that the foreign exchanges are excessively volatile, at cost to domestic economic performance. But it is important to distinguish between short term variability in this regard and longer term misalignment. There is little evidence that short term variability in exchange rates holds back trade seriously, probably because of the devices available to mitigate or remove its disruptive effects. What complaints there are on this score tend to come from smaller firms so that there is an important question as to why such firms do not make use of forwards, options and so on to protect themselves. Further enquiries in this area might be fruitful.

S3. Longer term misalignment is a different matter. There certainly seems to be long periods when "everyone knows" that a currency is too high or too low and yet the exchange stubbornly refuses to move in that direction. It is not very clear why these situations occur but it may be associated with short term extrapolative expectations on the part of traders. They may well believe that a currency is too high and that it will decline in the medium term but still believe that it will rise next week because it rose last week. Since the medium term is only a succession of recent weeks, it may be a long time coming . This is not rational behaviour so the above can only be a description and not an explanation of exchange rate movement. But evidence from expectations surveys does suggest that it may be quite a good description. What is not in doubt is that the domestic costs of misalignment are substantial and persuasive. Unlike with short term volatility, there are no means available to firms to mitigate the effects.

S4. There is a wealth of evidence that the foreign exchange markets are not efficent. Misalignments are only one facet of this, albeit an important one. Spot rates are more likely to follow a random walk than what is predicted by the forward markets: there is little or no tendency for real exchange rates to regress towards the purchasing power parity level so that there is little natural tendency towards correction of trade imbalances. The problem is not one of excessive activity in the foreign exchanges - so a transactions tax of the sort Tobin and others have proposed would not be effective. What seems to be missing are sufficiently strong numbers of speculators with stabilising expectations prepared to take positions and push rates to their efficient levels.

S5. All of this suggests that there is a potential role for governments in the foreign exchanges to repair these influences, if they can. It seems clear that governments can affect exchange rates by their policies, from which it follows that unsterilised intervention will have effect since it is tantamount to a change in monetary policy. So far as sterilised intervention is concerned, the position is more complicated. In principle, such intervention could work by substituting foreign currency assets for domestic currency ones - or vice versa - in private portfolios, provided that the two classes of assets are not regarded as having different degrees of risk so that they are not substitutes. But the relative risk premium involved appears to vary sharply in size over time, even to the extent of changing sign. In practice, therefore, limited use could be made of sterilised intervention if this were the only mechanism involved. The authorities would not know from one time to the next what scale of effect their operations would have or even the direction of their influence.

ambiguous

?

S6. So sterilised intervention is most likely to work by way of anouncement effects: either pointing the market to information that it has missed concerning the appropriate level for rates or, more plausibly, underlining. Evidence from periods in the last ten years, when intervention has been heavily used, points to it being a fragile tool but one which is nonetheless useful in the right circumstances. The key to its successful usage seems to be that it be part of a credible policy stance overall. If the policy stance is a credible one, one the markets can interpret as being in line with the objective of the intervention, or if it is perceived that policy movements are towards a credible stance, then intervention can be effective. In the latter case, intervention can buy time, perhaps preventing unnecessary turbulance in the exchanges whilst the policy adjustment is taking place. If the intervention is sufficiently heavy, the amount of time bought can be quite long - even a matter of months.

Point also is, what have savers to lose from sterling rather than?

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THE FOREIGN EXCHANGES

This note looks at the evidence concerning critical aspects of the workings of the foreign exchanges. Section A considers the question of the volatility that the exchanges have displayed - whether the degree of variations has been excessive and what the effects have been. Section B looks at the related question of how efficient the foreign exchanges have been. In the light of this evidence, section C assesses the case for intervention and, in particular, the probable efficacy of sterilised intervention.

A. The Variability of the Foreign Exchanges

2. Since exchange rates moved into a floating rate regime in the early 1970s, there has been a widespread perception that movements in rates have been larger than had been expected. Some have drawn the conclusion that Friedman's stabilising speculator has been absent and that accordingly the movements in exchange rates have been excessive. It seems clear, however, that the debate has been clouded, until recently, by the failure to distinguish between short term volatility - exchange rate variations on, say, a monthly basis - and medium and longer term misalignment. In the latter case, the phenomenon in question would be the tendency of the exchange rate to move well away from its warranted level for a prolonged period of time. These two occurrences would be expected to have quite different effects and need to be analysed separately.

3. Short-term Volatility. There are a number of possible measures of short term volatility: measures of absolute (percentage) changes, measures of changes relative to a perceived trend, measures of deviations of outturns from prior forward rates and so on. Each of these has a slightly different interpretation but perhaps the most commonly used measure is the standard deviation of monthly percentage changes. It is useful, on this basis, to put the behaviour of exchange rates into context. The following table - taken from information in Marston [30] - shows the volatility of various exchange rates in comparison with that of consumer prices, commodity prices and equities over the period July 1973 to December 1985:

Table 1

Volatility Comparisons: Standard Deviation of Monthly Percentage Changes

	United States	United Kingdom	Germany	Japan
Nominal Exchange Rates				
: Against the Dollar	n/a	0.0255	0.0288	0.0274
: Effective Rate Index	0.0166	0.0195	0.0113	0.0229
Real Exchange Rates*				
: Against the Dollar	n/a	0.0271	0.0302	0.0274
: Effective Rate Index	0.0176	0.0197	0.0118	0.0208
Ratio of Consumer Prices to US Prices	n/a	0.0081	0.0039	0.0094
Equity Index	0.0398	0.0597	0.0315	0.0294

Commodities:

Copper	0.0481
Tin	0.0546
Cotton	0.656
Wheat	0.0646

4. There are a number of points to be drawn from this data:

a) exchange rates are generally more volatile than goods prices. Relative goods prices are quite stable so that the volatility in nominal exchange rates is generally matched by similar levels of variation in real exchange rates;

b) on the other hand, the degree of volatility experienced in exchange rates is not out of line with that of financial assets generally. In all of the major countries, the exchange rate is far less erratic from month to month than equity prices;

c) commodity prices, as against final prices, are yet more volatile. The monthly fluctuations in metal prices are around twice those in the major exchange rates.

5. It is quite clear that the movement from fixed to floating exchange rates did result in a marked increase in short term variation. Table 2 uses Marston's data, this time on a quarterly basis because monthly data for the fixed rate period is not readily available.

Table 2

Volatility Comparisons over Time: Standard Deviation of Quarterly Percentage Changes in Real Effective Exchange Rates

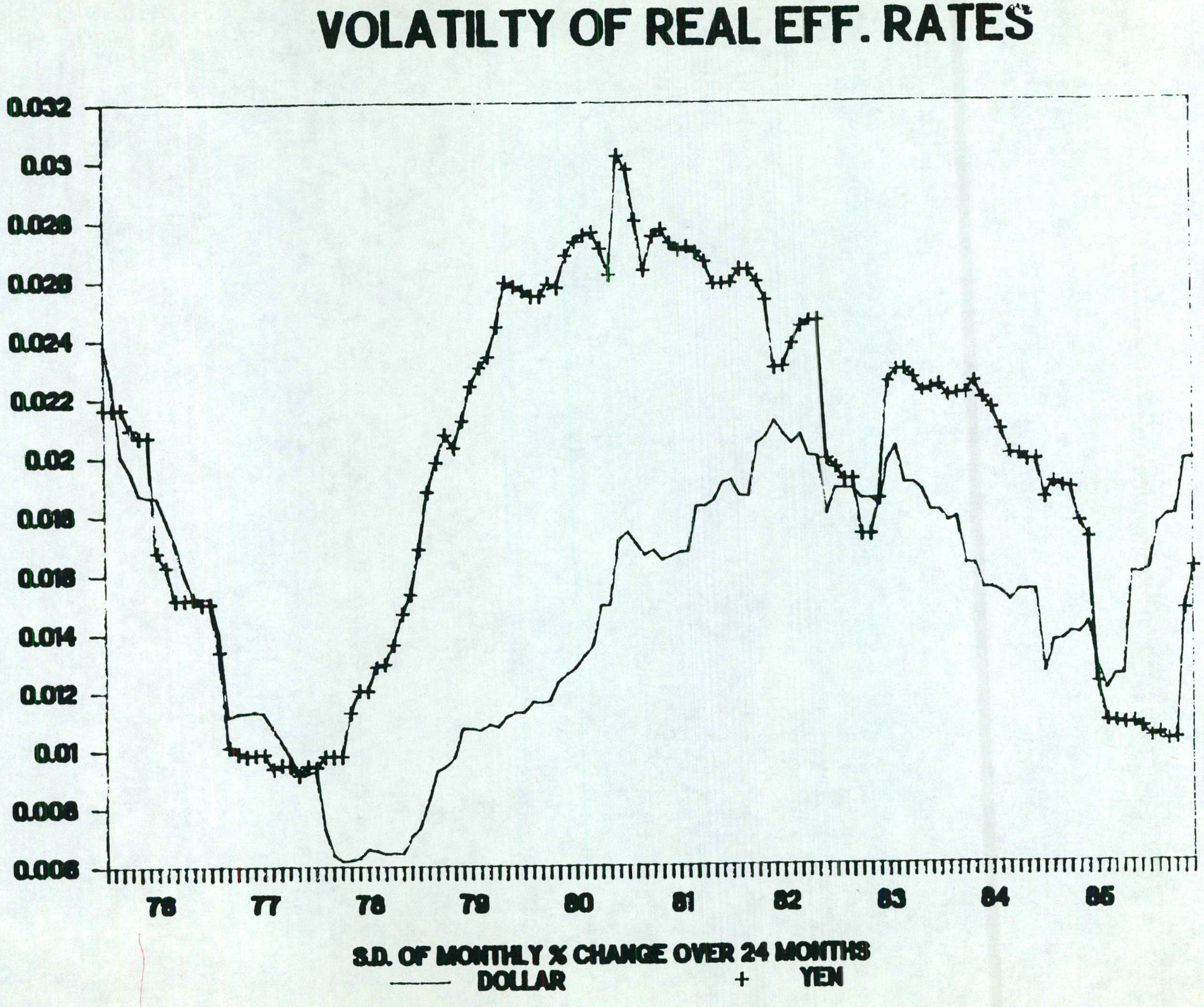
	United States	**United Kingdom**	**Germany**	**Japan**
Fixed Rates (1960 Q1 - 1971 Q1)	0.0066	0.0162	0.0141	0.0070
Floating Rates (1973 Q2 - 1985 Q4)	0.0281	0.0391	0.0193	0.0377

Marston shows, however, that after this quantum leap there is no clear trend in short term variation over time during the floating period. Chart 1 gives the standard deviation of the monthly percentage changes in the yen and dollar real effective rates as at each point over the previous 24 months. The degree of volatility has varied but not in any systematic way. In particular, there is no evidence that volatility has declined as the volume of transactions has increased over time or as operators in the market have accumulated experience of its workings.

6. But it is a separate question as to whether this type of short term variation matters. Any grounds for concern would stem from the increase in uncertainty caused to traders. An exporter would not know when he produces his goods whether he will receive a windfall gain or loss on the real value of the foreign currency he will acquire when he sells his product. The cost of this uncertainty may act to reduce the incentives to trade. Even so, the effect may not be very important:

(i) many large traders will be multinationally based companies. To such concerns, fluctuations in national currencies may not be of as much importance as to companies based only in one country;

CHART 1



- 4 -

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Source Marston op cit

(ii) there are a wide range of instruments available even to small companies at quite low cost: forward exchange contracts, currency futures, currency options, back-to-back loans, currency swaps. All of these can be used to reduce or eliminate the currency exposure to which short term exchange volatility can give rise;

(iii) Bailey et al [3], [4] have argued that exchange rate volatility may have the property of encouraging trade, by increasing the opportunity for profits. Those heavily engaged in trade are likely to maintain a close knowledge of economic conditions in their counterpart countries. This investment will put them at an advantage compared to other non-trading operators in the foreign exchanges and, on balance, over time, should enable them to make profits. Whilst at first sight this argument may seem far-fetched, it is notable that an increasing number of companies regard their treasury departments as profit-centres, rightly or wrongly, and not just as existing to reduce risk.

It is! [illegible] authors (Zaitek)

7. Whether in practice, given all of these considerations, short term volatility has affected trade is necessarily an empirical question. Those results that are available are mixed; but the weight of the evidence is that any effect is small or negligible. Thus, for example, the first comprehensive study - by Hooper and Kohlhagen [22] - concluded that there was "absolutely no significant effect of exchange risk on the volume of trade." This strong conclusion needed to be modified as more data became available and, as importantly, as the effects of real exchange rate volatility were examined as well as nominal volatility. On this basis, Cushman [10] found some evidence of a weak effect on trade volumes. Kenen and Rodrik [26] consider multilateral trade-flows, rather than bi-lateral flows as in most of the previous studies, for eleven developed countries. For the majority of these, they, too, concluded that volatility had a small negative effect on trade. But for a few countries their results showed a significant inverse relationship. Perhaps the only study to find strong effects was that of Akhtar and Hilton [2] who looked at Unites States' and German aggregate exports and imports. They found that daily volatility of the mark against German trading partner currencies had an important effect

on both imports and exports. But even these results were not wholly straightforward because, on the same definition of volatility, US export volumes were apparently only slightly reduced by exchange rate fluctuations and US imports not at all. Part of the puzzle was resolved when Gotur [19] pointed out methodological flaws in the Akhtar and Hilton procedures. Making corrections for these, exchange rate volatility would seem to have only the same marginal effects on German trade volumes as had already been found for the US. The twin papers by Bailey et al [3], [4], likewise concluded that for most countries volatility effects were marginal and, occasionally, mildly stimulative to trade.

8. Any reasonable assessment of this evidence would have to conclude that short term exchange rate fluctuations were at most a nuisance for international trade but no more than that. One recent study, however, has been much discussed and makes for a potentially more serious indictment of volatility. In a careful study, De Grauwe [11] not only finds evidence that volatility depresses trade but, just as importantly, considers why his work unearths such effects when, in general, other studies have not. De Grauwe presents two reasons for the difference:

a) he uses cross-sectional as well as time-series data. This allows him to look, for example, at the separate effects of factors such as changing trading relationships. For example, if two or more countries are moving towards customs union, one would expect their trade to increase, perhaps at the expense of trade with countries outside the union. Exchange rate volatility may still depress trade within the customs union countries but the effect would be masked by the stimulative effect of unification;

b) more importantly, De Grauwe believes that the effects of exchange rate movements take time to emerge. His data is concerned with exchange rate fluctuations which last for at least a year. It is fluctuations of this kind which he claims adversely affect trade.

9. In practice, it seems likely that it is the second factor which pushes De Grauwe towards different conclusions from those of other

studies. But as noted earlier, this is a rather different kind of phenomenon from that of short run exchange rate variability. This is therefore a convenient bridge to examination of longer term misalignment problems.

10. Longer Term Misalignment. Most of the factors which can operate to alleviate the effects of short term variability, noted in paragraph 6, above, are unlikely to do so in the case of an extended and large misalignment. Short run problems derive essentially from the uncertainty produced about future, and fairly near-term, spot exchange rates and means can be found to insure against the effects of this uncertainty. Longer term misalignment gives rise to difficulties because the exchange rate sticks at the "wrong" level, perhaps with a degree of permanence which allows some certainty. Such certainty is of no use to economic agents faced with consequences of the misalignment.

11. It is not easy to give a sharp definition of what constitutes a misaligned exchange rate.* This is partly because the question is necessarily one of degree but also because of the difficulty of deciding what is the equilibrium or sustainable exchange rate for a country faced with a particular underlying balance of payments prospect. On the other hand, there have clearly been times when on any definition major exchange rates have moved and remained well away from the levels which could either be justified by reference to the economic fundamentals or be sustained in the long run. Perhaps the two most notable examples are sterling's 45 per cent appreciation between July 1976 and February 1981 and the dollar's 40 per cent rise between 1981 and 1985.

12. It is reasonably clear from these episodes what kinds of costs misalignments of this kind tend to generate:

a) most basically, there is a shift in resource allocation between domestic industries and foreign competitors. The effect

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* Giving a precise definition to misalignment does become important to those who have proposed institutional schemes to avoid or minimise misalignments: see, for example, Williamson [41]. The proposed definitions have sometimes had to be legalistic and convoluted to a quite grotesque degree.

of an overvalued exchange rate is to reduce the return to domestic producers and increase that to overseas competitors. In consequence, domestic capital will tend to shift away from the affected areas even if at the long run sustainable exchange rate, domestic producers are the more efficient. Conversely, an undervalued exchange rate will subsidise inefficient domestic producers enabling them to continue in business;

b) there will also be undesirable shifts of resources within the economy, between the tradeable and non-tradeable sectors. An overvalued exchange rate will depress the rate of return to producers in the tradeables sector relative to that on production which is principally non-traded. Resources will therefore move to the sheltered sector even though there has been no change in the consumption wants of the economy overall. Indeed, it has long been recognised that there will be effects for consumers as well as for producers (Johnson [24]). As resources shift into the non-tradeable sector, either their relative price must fall sufficient to induce increased consumption of non-tradeables or, if prices are sticky, there will be unemployed resources. In effect, in the latter case, there will be too many dislocated car workers seeking to become window cleaners for them all to be employed;

c) both of the effects discussed above will be distortionary and welfare reducing. But the impact will be magnified by hysteresis - inertia in the system due to the relatively large costs of starting up or closing down a business. Faced with an overvalued exchange rate, a domestic firm may remain in business for a while whilst making losses if it is relatively efficient and if it believes that it can make adequate profits at what looks to be the long run sustainable exchange rate. But if, as time goes on, the misalignment shows no signs of disappearing or begins to worsen, the firm may decide to cut its losses and go out of business. Once this has happened and physical and human capital have been dissipated, the firm may well not start up again, if and when the misalignment eventually corrects itself. Conversely, a relatively inefficient foreign competitor may at first baulk at taking the short run opportunity presented by the favourable exchange rate. Although it may feel able to compete with the domestic industry at the moment, it may not be prepared to make the heavy investment required to do so, if it expects not to be able to compete at the long run sustainable exchange rate. On the other hand, if it sees the domestic opposition flaking off as the misalignment continues, it may be prepared to incur the entry costs. With the domestic firms semi-permanently now out of competition, the foreign firm may continue to make satisfactory profits, even when the misalignment ends. In this case, the outcome will be a semi-permanent increase in the foreign trade share even though the foreign firm was inefficient relative to the domestic one. Baldwin and Krugman [5] found evidence that such an effect had been a widespread consequence of the dollar's misalignment. Bean [6] came to the conclusion that exchange rate deviations had had similar pervasive and long term effects on UK trade flows;

d) at the heart of the problem is the increase in uninsurable uncertainty which the misalignment causes. No one knows when the misalignment will end and this generates a difficult environment for the suppliers of both capital and labour. The problem also extends to microeconomic policymaking. It is not likely to be easy to distinguish those industries which are depressed just because of misalignment and which may, therefore, merit temporary support, from those who are failing because of long run trends in comparative advantage;

e) finally, the misalignment is likely to create pressures for protectionist measures. To the extent that such pressure succeeds that in itself will be bad. But in addition even if ultimately the pressure does not succeeed, the very possibility that it may adds a further dimension of uncertainty. A firm in a sector affected by an overvalued exchange rate has to predict not only when the misalignment will end but also, in the interim, how much protection, if any, it can rely upon to shield it.

13. Experience of the sterling and dollar over-valuations suggests that the costs of misalignment are substantial. All of the above costs were features of these episodes though some costs were more pronounced in one than the other. This conclusion about longer term exchange rate deviations is in some contrast to that for short run exchange rate volatility, where the bulk of the evidence suggest that it is little more at most than an irritation to trade. This conclusion concords with the evidence from the survey carried out by the CBI in 1987 on attitudes to monetary and exchange rate policy [8]. The great majority of exporting firms (86 per cent) claimed that the level of sterling was "very important" to their operations. A much smaller proportion of firms felt that exchange rate stability was very important. This is consistent with the finding that 87 per cent of firms used forward and/or option markets to reduce the effects of short term sterling variability. It is notable, however, that there was a strong inverse correlation between size of firm and concern about variability. It may be that small firms are less able to use cover facilities than larger ones. Whether this is because they find the costs prohibitively high, either directly or because of the administrative costs involved, or that there is a lack of awareness of these possibilities is not clear. This might be a fruitful area for further enquiry.

B. The Efficiency of the Foreign Exchanges

14. The previous section provides something of an indictment of the practical operation of freely-floating exchange rates. There have been periods of prolonged mislignment at substantial cost to the economies involved. So there is a prima facie case for government intervention of some sort in the foreign exchanges. The present section looks more rigorously at the evidence regarding the efficiency of the foreign exchange markets, in the sense of whether they take account of available information about the future and discount it in the current exchange rate. This is important both because of its implications for whether there is a role for the government in the foreign exchanges and because of its bearing on the efficacy of intervention, to be discussed in the next section.

15. The "efficiency" that we are concerned with here was discussed by the Jurgensen Report [25].

> "The Working Group examined in detail the extent to which exchange markets are "efficient" in the sense that they take account of all information which is relevant for the determination of exchange rates. If exchange markets rapidly and fully assimilated such information and translated it into appropriate spot and forward rate levels, there would be less reason for monetary authorities to intervene directly in the markets. Efficient exchange markets would not, for example, allow repetitive bandwagon-type exchange rate movements to emerge." (Paragraph 61).

16. Jurgensen's empirical work was based on the following hypothesis. If: (a) transactions costs are minimal; (b) all information is used by market participants; and (c) assets in different currencies are perfect substitutes in private portfolios then the forward exchange rate will be the best available predictor of the future spot rates.

17. It should be noted that failure of forward rate to serve as a useful prediction could in principle be due to non-fulfilment of any one of the above three conditions. But observation suggests that transactions costs in the foreign exchanges are very small, at least for a large class of powerful investors. So, in practice, testing the predictive power of the forward rate is equivalent to a joint test of the other two conditions. It is useful to think of the anatomy of the test in this light. If investors are risk-neutral then they will buy or sell foreign currency just to the extent that the rate of return on foreign currency and domestic assets is equalised. So the expected depreciation of the foreign currency should be equal to the excess of the interest return on foreign currency assets over domestic ones. This interest rate differential will equal the forward discount on the currency. So if domestic and foreign currency assets are perfect substitutes, ie. there is no risk premium attaching to either, the forward discount should equal the expected depreciation of the foreign currency. This forward rate itself should equal the expected future spot rate.

18. Now expected future spot rates are unobservable so a direct test of this proposition is not possible. But actual rates do become available. If foreign exchange particpants are efficient in using all of the relevant information, they will not make systematic mistakes in their expectations about future rates. It follows, therefore, that the forward rate will be an unbiased predictor of the future spot rate. If this is not the case then either the foreign exchanges are not efficient or foreign and domestic currency assets are not perfect substitutes. The latter would be the case, for example, if investors were risk averse so that they would require a higher return on foreign currency assets than on domestic ones. There would then be a risk premium between the two returns. To throw some light on this question, we consider three different sources of relevant information:

a) evidence from the behaviour of spot rates;

b) evidence from the behaviour of forward rates;

c) evidence from market forecasts.

19. Evidence from the Behaviour of Spot Rates. Generally speaking, nominal interest rates have not been equal in different countries and these interest rate differentials have been reflected in forward rates, different to the spot ones. It follows, therefore, that if forward rates are an efficient predictor of future spot rates, the current spot rate will probably not be. Yet there is a growing body of evidence that exchange rate movements are well described by a random walk, in other words that the current spot rate is the best future predictor. Meese and Singleton [32] produced reasonably clear findings of this kind for a wide range of bilateral exchange rates. The evidence is yet clearer when account is taken of the fact that exchange rate variations are usually heteroscedastic, ie. that the magnitude of the variability is not constant over time but tends to be episodic (see Cumby and Obstfeld [9] and the evidence in Marston, already cited.) When the statistical techniques are adapted to allow for this, the evidence for a random walk seems very persuasive, Phillips [36].

20. Even more disturbing is the fact that the finding of random walk behaviour appears to carry over to the real exchange rate as well as the nominal one. The worry in this connection is the implication for purchasing power parity. If the real exchange rate moves randomly, then there will be no tendency for purchasing power parity ever to be attained. Economists have long known that purchasing power parity did not hold even remotely in the short run. Officer's discussion and survey ten years ago [35] makes that clear. Even on 1970s data, Krugman's study [27] gives support to this conclusion. On the other hand, there has always been an expectation, or at least a hope, that purchasing power parity would hold as a long run property. Indeed, many theoretical models are based on this premise. Nevertheless, studies by Roll [38], Frenkel [17], Adler and Lehman [1], Hakkio [21] have all failed to reject the hypothesis of a random walk.

21. It is arguable that the above studies, which typically used monthly data over only a few years, were not considering sufficiently long data spans to pick up what may be only a long run property. Following this argument Frankel and Meese [16] take a very long sample: 116 years of annual data for the United States and the United Kingdom. Over this period, they are indeed able to reject the notion of a random walk but not to the extent of generating much confidence. Their results show a tendency for real exchange rate deviations from purchasing parity to be eliminated but at only 14 per cent a year. With such a weak tendency, it is not surprising that random shocks can prevent parity emerging for periods of many years.

22. Evidence from the Forward Rate. The above evidence against the efficiency of the foreign exchanges is negative: if current spot rates forecast future spot rates, current forward rates cannot. This is not logically watertight and, in any case, the more direct evidence is that from testing the predictive power of the forward rate itself.

23. There was a time when it looked as if the forward discount could be considered as an unbiased predictor of actual depreciation. Mussa, in 1979 [33], surveyed the then available studies and reached

just this conclusion. The basic test is contained in the regressive equation:

$$\Delta e_{t+1} = a + \beta fd_t + \varepsilon_{t+1}$$

where

Δe_{t+1} is the depreciation of the exchange rate by t+1
fd_t is the forward discount at t for the exchange rate at t+1
ε_{t+1} is a random error.

If the foreign exchanges are efficient β should equal one and Mussa believed the evidence was consistent with this. But as more evidence became available and more powerful and appropriate techniques were brought to bear, it became clear that this conclusion could not be sustained. By 1985, Levich [28] was able to cite numerous studies which rejected the forward rate as an unbiased predictor. In many cases β was either insignificantly different from zero or, occasionally, negative. In other words, the forward discount sometimes pointed the wrong way.

24. It is not difficult to see why these findings should have emerged. Whilst the dollar was strong, US interest rates were generally higher than those in other countries. So the forward rates were persistently pointing to a fall in the dollar when for a number of years the dollar continued to rise. Much the same was true of sterling during its rise between 1976 and 1981.

25. Evidence from Market Forecasts. Leaving aside the possibility of systematic risk premia, which are discussed in the next section, it is less easy to see why the forward rate is such a poor predictor. In the normal model without risk, speculators ought to force the dollar up so far that it is likely to depreciate in line with the forward rate despite its interest rate advantage. If that does not happen, as would seem to have been the case with both the dollar and sterling, there are logically two possible explanations:

(i) there may simply not be enough speculators. Their hearts are generally in the right place but they are too timorous to back their hunches;

(ii) there are sufficient or more than enough speculators but their activities are de-stabilising rather than the reverse.

26. The policy implications of these two possibilities are quite different. But diagnoses of both kinds have been made. Tobin [40], for example, believes that there is too much speculation which is predominantly of a de-stabilising type. He therefore proposes an exchange market transactions tax in order to reduce the volume of speculative froth. By contrast, McKinnon [31] concludes that there is just too little speculation to reach the desirable position. If that is true, then obviously Tobin's transactions tax would make matters worse.

27. Frankel and Froot [15] threw some light on this issue by looking at market forecasts. They considered three sets of data:

a) since 1981, the Economist "Financial Report" has conducted a survey of longer term exchange rate expectations (3-12 months) amongst market participants every six weeks (the "Economist data");

b) American Express Bank Review has also conducted surveys of foreign exchange expectations, though at irregular intervals, since 1976. Again these are longer term expectations (the "Amex data");

c) Money Market Services has carried out weekly surveys of expectations amongst currency traders since 1983. These are for shorter time horizons (1 week to 3 months) (the "MMS data").

28. The Frankel/Froot test consists of looking at the following equation:

$$E\,(e_{t+1}) - e_t = \phi + \theta\,(\bar{e}_t - e_t)$$

where

e_t is the exchange rate

and $\bar{e}_t$ is the rate implied by purchasing power parity.

Here the critical parameter is θ. The left hand side measures the expected appreciation of the exchange rate over the next period. If θ were zero, this would mean the expectation was independent of the current deviation from purchasing power parity. Negative values of θ would mean that expectations, if acted upon, would be destabilising; any current deviation from purchasing parity would be expected to increase in the next period. Positive values would indicate stabilising expectations, in the sense of anticipated movements towards purchasing parity. This test, of course, depends upon calculating the current purchasing power value for the exchange rate. But the results do not seem to be very sensitive to the exact measure used.

29. Their results can be summarised as in the attached table:

Data Set	Horizon	θ	t-value
MMS	1 weeks	-0.0283	3.53
	2 weeks	-0.0299	3.78
	1 month	-0.0782	5.94
	3 months	-0.0207	1.41
Economist	3 months	0.0233	1.78
	6 months	0.0600	3.77
	12 months	0.1750	8.10
Amex	6 months	0.0315	1.56
	12 months	0.1236	4.48

One point to bear in mind about these results is that they suggest expectations are not rational. As noted earlier, spot exchange rates evidently follow close to a random walk. So, the best expectation would be no change next period, implying θ = 0. Not surprisingly, therefore, Dominguez [12] is able to show that these expectations, which for the most part, are for changes significantly different from zero, are systematically falsified by events. In Bilston's terms [7], therefore, speculation is excessive. Generally, speculations would do better to assume no change in spot rates.

30. But the more important feature of these results is the change in sign of θ between the short and the longer horizons. The regressions are in logarithmic terms so that the coefficients can be interpreted as percentages. Accordingly, from the MMS data, if the dollar is currently 10 per cent over-valued against purchasing parity, then the currency traders reckon its over-valuation will be extended by 0.28 per cent in the next week and by 0.78 per cent in the next month. In sharp contrast, the expectations are for a 10 per cent current over-valuation to be partially corrected in the next year - by 1¾ per cent on the Economist data or by 1¼ per cent on the Amex data.

31. It is possible on the basis of this information to speculate on the nature of bubbles in the foreign exchanges. First, it seems likely that the two sets of expectations are being driven by different factors. Traders' short term anticipations are probably based on defensive conforming herd behaviour; to the extent that analysis is used at all, it may well be "technical" analysis: chartism or momentum analysis. It is not wholly surprising that the prescription then comes out as "what goes up keeps on going up". For the longer term, foreign exchange participants are more likely to take into account the "economic fundamentals" - hence the apparent willingness to believe that misalignments will be partly corrected. But, of course, the long term is only the succession of short terms. If the traders back their short term expectations, these will become partially self-fulfilling. As the exchange rate continues to move away from purchasing parity, the longer term countervailing projections will become discredited, decreasing their weight in the traders' judgements. Eventually when, because of some external shock, the increasing misalignment ends, the "fundamentals" forecasts will come back into favour, adding extra weight to the push back towards or beyond purchasing power parity.*

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* It is interesting to see this process illustrated by the annual review of foreign exchange forecasts in the August editions of Euromoney. It compares "technical" forecasts with econometric ones. As the dollar rose in the early 1980s, the chartists were generally more accurate because the fall in the dollar constantly predicted by the econometric models steadfastly refused to occur. The reviews became more and more decisive about the superiority of technical forecasts. After the dollar's correction in 1985, not forecast by the chartists, "fundamental" forecasting has been looked upon more favourably.

C. The Role and Working of Intervention

32. The overwhelming evidence from the previous sectionsis that the foreign exchanges are not efficient. That means that there is a prima facie role, if they can, for governments to act to render foreign exchanges more efficient and produce a welfare-superior outcome. The nature of the inefficiency also has a bearing upon the role for intervention.

33. A first distinction to make is between unsterilised and sterilised intervention. There is not a great deal of controversy about the potency of unsterilised intervention. It seems apparent that governments can influence at least the nominal exchange rate if they wish by sufficiently aggressive changes in monetary policy. Unsterilised intervention is just one mechanism by which such changes can be implemented. It makes little macroeconomic difference whether the government influences interest rates by changing the supply of domestic currency liquidity by domestic open market operations or by official transactions in foreign currency for domestic currency. Swiss experience provides a good practical example because, there, there is no developed domestic money market. Nevertheless, the Swiss authorities have no difficulty in making their monetary policy effective, using foreign exchange transactions to achieve their interest rate and liquidity objectives. For other governments, which have a choice between domestic open market or reserves operations, the decision will have a bearing on the shape of their financial portfolios and upon the pattern of their interest rate and currency exposures. This will be important but independent of the macroeconomic considerations.

34. The main question then becomes whether there is scope for influencing the foreign exchanges by sterilised intervention, with minimal domestic monetary policy consequences. It may be worthwhile at this point saying something about the definition of sterilised intervention. Textbooks, usually American ones, regard sterilised intervention as that which is not allowed to affect the monetary base. On its own, intervention changes primary liquidity, the monetary base, as the authorities sell or buy domestic currency for foreign currency. Sterilisation consists of engaging in other open market operations to offset the monetary base effects of the

intervention. Now, operationally, this definition is not a very helpful one. For the textbooks go on to assume that governments set their monetary and interest rate policies by varying the monetary base - hence the importance in their terms of whether the intervention is sterilised or not. But in practice, virtually no national authorities operate their monetary policy via monetary base control. In the UK, for example, the textbook definition is pretty irrelevant; by law, EEA operations have to be financed each day by countervailing transactions in Treasury bills. But whilst this means that in the textbook sense all UK intervention is sterilised, it does not entail that there are no domestic monetary consequences. A better distinction is probably a more general one - unsterilised intervention is deemed to be that which is allowed to affect domestic interest rates: sterilised intervention is that where other operations by the authorities prevent this from happening. It is this sense that the distinction is used below.

35. The Jurgensen Report suggested that sterilised intervention might have an effect via three separate routes:

a) the intervention could serve to point markets in the right direction: "If markets are inefficient in the sense that they fail to assign appropriate weight to information on macroeconomic variables in determining exchange rates, action to influence the exchange rate through intervention could be an effective component of macroeconomic policies. In this case, intervention could have an impact through its influence on expectations..." [Para 66];

b) it could serve as guidance about official policy: "Intervention may also on occasion express an attitude towards foreign exchange markets". In that case: "Intervention will normally be useful only when complementing and supporting other policies". [Statement by Finance Ministers, para 4d];

c) by changing the relative supplies of domestic and foreign currency assets in private portfolios. This would have an effect only if the private sector is not indifferent between such asset classes. If, instead, they were regarded as perfect substitutes, then altering the relative supplies of the two would obviously make no different to private sector behaviour.

36. Of these channels of influence, the first two both depend upon announcement or information effects. These are discussed further below. The third is different, relying upon differential asset characteristics rather than any announcement impact. It is hard to avoid the impression that the Jurgensen Report was in two minds about the practical efficacy of this mechanism. No doubt in part this is due to its need to draft round differences in emphasis within the views of its members. But it may also reflect the conflicting nature of the evidence.

37. One important block of information relates to the speculative efficiency of the foreign exchanges. If domestic and foreign currency assets are perfect substitutes (ie. no direct effect from sterilised intervention) then there should be no systematic risk premium on foreign currency assets. That means that, over a period, the return from assets in one currency should not systematically differ from that available on comparable assets in other currencies. But the evidence overwhelmingly argues against this proposition, as the previous section discusses. That was true in 1983 when the Jurgensen Group reported and the evidence which has accumulated since points in the same direction. This is powerfully suggestive that assets in different currencies may not be perfect substitutes, a property of which sterilised intervention could take advantage.

38. It matters, however, why the speculative inefficiency comes about. If, for example, it occurred merely because foreign exchange participants were irrational - either ignoring relevant information or placing the wrong weight upon it - then that would not support the case. It needs as well for there to be systematic risk premium, which drives the wedge between the returns to different currencies. Such a premium does not need to be constant but it does need to be predictable. The difficulty for the Jurgensen Group was that they could find no evidence of such risk premia.

39. Subsequent work has not helped much either. The main approach has been to try to relate the apparent risk premium econometrically to the factors which one might expect would influence it. Rogoff [37] looked at the extent to which excess returns on Canadian dollar investment over US investments could be related to the relative supplies of the two currency assets, on the basis that the perceived

risk of each currency would increase with the size of the assets denominated in it. He was unable to find any significant relationship. Frankel and Engle [14] applied similar tests to give major currencies against the dollar but again concluded that there was at least no simple relationship. Obstfeld's work [34] for the deutschemark against the dollar, 1975-1981, was equally negative.

40. More recently, the general conclusion has been that the risk premium varies over time because the variance of the returns to particular currencies itself varies over time. The idea is that if a currency is perceived to become more risky (in the strict sense that the range of possible returns is perceived to have widened for the same centrally expected return), then investors will want a premium on their expected return to compensate them for this increased risk. It seems clear that the variance of exchange rate returns does change over time. A number of studies, notably Cumby and Obstfeld [9] and Giovannini and Jorion [18] have been able to reject the hypothesis of constant variance, given the evidence of the ex post returns to various currencies. Support for this thesis comes from the options data from which it is possible to extract the subjective riskiness with which various currencies are regarded at any point in time. Studies by both Lyons [29] and Hsieh and Manas-Anton [23] leave little doubt that the subjective estimates of risk in the various currencies also change over time.

41. On the other hand, attempts to relate the variance of returns to the apparent risk premium itself have met with mixed results. Giovannini and Jorion [18] were unsuccessful in finding a systematic relationship. Taylor [39], however, was a little more successful. In his model, the risk premium is regarded as a latent variable which helps to explain the observation that the forward rate is not an unbiased predictor of future spot rate. This latent variable is then modelled by reference to the past volatility of asset returns in the two countries relevant to the bilateral exchange rate. By this means, Taylor is able to generate estimates of the risk premium over time. These estimates are plausible but they do not seem very robust and, indeed, change sign quite abruptly from year to year. Chart 2 presents his estimates, as an example, of the risk premium between sterling and the dollar.

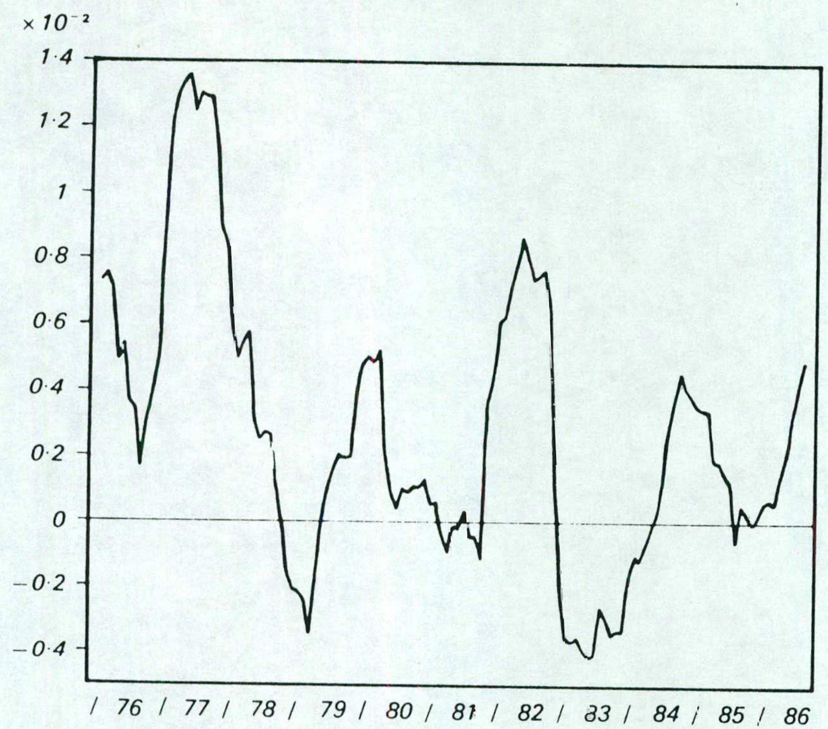

Chart 2 Risk Premium on Sterling vs Dollar, Taylor's Estimates

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42. From the point of view of implementing a policy of sterilised intervention, Taylor's results are a mixed blessing. Such intervention works by replacing foreign currency assets in private portfolios with domestic assets. Since Taylor shows that there is generally a risk differential between the two kinds of assets, sterilised intervention will have some effect. But because the risk premium is varying and sometimes changing sign, the effectiveness of such intervention will vary over time, even to the extent of changing the direction of its influence. In principle, using a model such as Taylor's would enable the authorities to predict what the scale and direction any sterilised intervention would have. But in practice, it is difficult to see that the predictions would be very good - relationships of the type Taylor derives are notoriously fragile - so that the authorities would be working in the dark. It would be little comfort to know in arrears that sterilised intervention designed, say, to support sterling had actually had the opposite effect because the risk premium had changed sign unexpectedly.

most [illegible] [illegible]

43. All of this suggests that the main use of sterilised intervention must rely upon its announcement effects: pointing the market in the right direction and underlining the thrust of official policy. In assessing how large such impacts have been, formal econometric analysis is likely to be of limited value. A more fruitful approach is likely to be one of case-studies; the examination of episodes where intervention has been an important feature. The present paper considers three such episodes:

(i) the Carter dollar defence package in 1978;

(ii) the G5 intervention in September 1985 against the dollar;

(iii) intervention to support the dollar in the post Louvre period, February 1987 onwards.

In the discussion, the sterilised/unsterilised distinction used will be the wide one noted in para 34 above. Unsterilised intervention will be that which is deemed to alter domestic monetary policy : sterilised intervention is that which does not.

a. The Carter Dollar Defence Package, 1978

44. Although the 1978 episode is now a decade into the past, it is still worthwhile recalling it, for two reasons. First, the main elements of the story seem very clear and with a strong bearing on the points at issue. Second, the episode is illuminated by Greene's incisive study [20], carried out by a senior official of the New York Federal Reserve Bank. The main points of the story are as follows:

(i) the dollar had been increasingly weak throughout 1978 reflecting market disquiet about the direction of the Carter Administration's economic and other policies;

(ii) by the last week of October selling of the dollar became heavy. Carter's announcement of an anti-inflation programme on October 24 was greeted with incredulity and the US authorities needed to sell $1 billion worth of marks. Nevertheless, over the next four days the dollar dropped by 5 per cent against the mark and by 2 per cent against the yen, despite repeated heavy intervention to support it;

(iii) on 1 November, the dollar defence package was announced. The United States amassed about $30 billion of intervention resources by means of swaps and the "Carter Bonds" whilst the Fed raised the discount rate by 1 per cent - the first ever increase of this size. Within the first half hour, the dollar had risen by over 8 per cent against the mark on US sales of less than $70 million of marks;

(iv) thereafter there were no further monetary policy initiatives but the intervention continued. In November, US intervention totalled over $3½ billion but led only to further modest rises against the mark and the yen. In December, the dollar fell back by 6 per cent against the mark and 5 per cent against the yen despite supporting intervention in excess of $3 billion.

45. Perhaps the most striking feature of this episode is the lack of correlation between intervention, sterilised in the sense of

not being allowed to lead to a monetary policy change, and the movements of the dollar. Heavy intervention both in the last week of October and in December did not prevent sizeable dollar falls. By contrast, very light intervention early in November, accompanied by a tightened monetary stance, was enough to send the dollar soaring. One might be tempted to conclude from this that the intervention itself was irrelevant and that it was the market's perception of the monetary stance alone which mattered. That would probably not be quite right. It is difficult to believe that, without the announcement of the $30 billion dollar support package on 1 November, the discount rate increase alone would have had the same effect on the dollar. The market saw intervention out of this warchest as a threat by the US authorities underlining the intended dollar impact of the monetary tightening and holding out the prospect of more to come. So Greene's own conclusion is probably the right one. Intervention out of the dollar defence package allowed a period of time for the US authorities to sort out an appropriate monetary policy - the intervention kept the dollar afloat throughout November. The trouble was that this window of opportunity was not utilised; monetary policy was not appropriately tightened further and by December the market drew its own conclusion. As Greene says: "If this time [the interval afforded by intervention] is not put to productive use, then intervention alone, no matter how large or how well coordinated, will not be effective".

b. The G5 Intervention Against the Dollar, September 1985

46. A somewhat different perspective on intervention is provided by the events of 1985. Obviously one difference is that the intervention was designed to press down the dollar rather than to support it. But perhaps a more important one is that in 1985, the dollar was obviously misaligned. Many people in the market had been saying - in some cases for years - that the dollar was much higher than could be warranted by either the various national economic performances or by the policies pursued by the various national authorities. But these same participants were evidently unwilling to back this judgement with their money, preferring to wait for someone else to start the dollar's decline off. By contrast, the dollar's weakness in 1978 seemed to be fully justified by fundamental

considerations. If there were any in the market who believed that the dollar was undervalued in 1978, then that was a far from unanimous view. If official intervention has a role in "pointing the market in the right direction", therefore, the autumn of 1985 would have been very propitious.

47. The key event in the episode was the G5 statement on 22 September:

> "The Ministers and Governors agreed that exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has been the case. They believe that agreed policy actions must be implemented and reinforced to improve the fundamentals further, and that in view of the present and prospective changes in fundamentals, some further orderly appreciation of the main non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when it would be helpful."

Following the statement, the ensuing concerted intervention against the dollar was fairly heavy though not massive - on BIS figures $13 billion over the rest of the calendar year. Nevertheless the dollar fell substantially. Within 10 days it had fallen by about 5 per cent against the other major currencies on average and by a larger amount, some 11 per cent against the yen. By the middle of the next year, the trade weighted index had fallen a further 15 per cent and the yen/dollar rate had risen by another 25 per cent.

48. Different interpretations have been put upon this episode. Those who see it as supporting the efficacy of intervention draw attention to two factors:

(i) the fact that the intervention was fully coordinated assured the markets that different national authorities would be working in tandem and not against each other;

(ii) the national authorities seemed wholeheartedly committed to reducing the dollar. In particular, for the first time the United States joined in the intervention with a capacity to sell an indefinite quantity of dollars if the circumstances demanded it. But whilst these factors are doubtless important they do not themselves make the case for the effectiveness of sterilised intervention. No doubt the dollar would have fallen anyway on the apparent readiness of the authorities in concert to bring about that result. But that leaves open the question of whether the intervention had any additional effect beyond the impact of the G5 announcement itself. Or, turning the issue around, would the announcement itself have had any effect if the market believed that the authorities intended to implement their policy only by sterilised intervention and not changing their monetary policies, as necessary?

49. Feldstein [13], indeed takes the view that the intervention had little or no effect. His case rests on the following points:

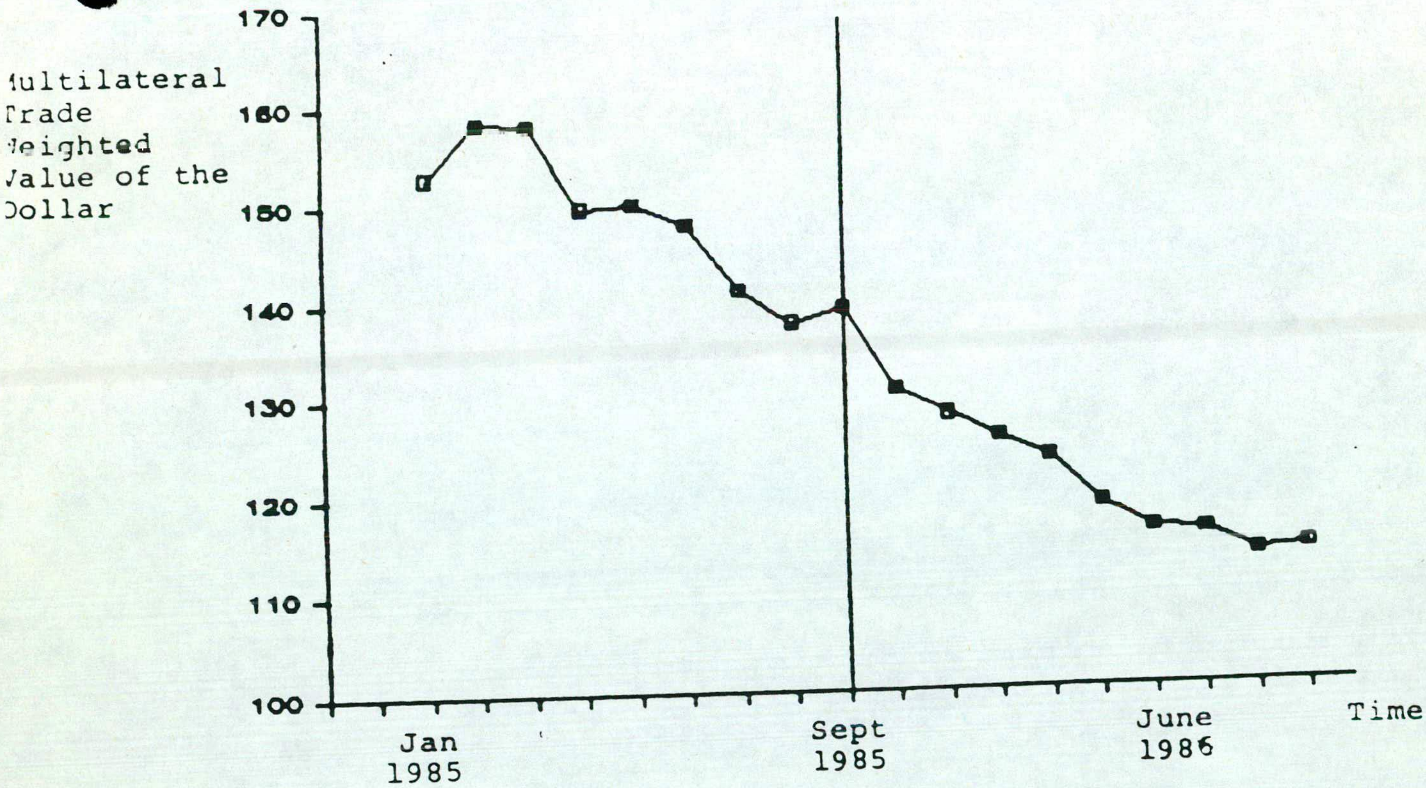
a) if the dollar was misaligned in 1985, it was (at long last) already being corrected well before the G5 announcement. Chart 3 shows the dollar's trade weighted index over the relevant period. Its index peaked in February 1985 and then declined erratically but with a definite trend. By the time of the G5 announcement, it was already some 15-20 points below the peak;

b) the trend decline in the dollar after the announcement was no greater and, if anything, less pronounced than before. The apparent sharp reaction immediately afterwards was no bigger in perspective, than the fall the dollar suffered in April 1985. It is true that the dollar had rallied gently just before the announcement and it is logically possible that the rally would have been extended in the absence of the announcement. But, at best, that can only be a matter of conjecture;

c) the Federal Reserve was loosening its monetary stance throughout 1985. M1 was allowed to increase well above its target range, and the discount rate was successively reduced

CHART 3

The Multilateral Trade Weighted Value of the Dollar



Source Feldstein, op.cit.

from 8 per cent to 7½ per cent over the year. Federal funds rates were allowed to decline by more than 1 per cent. At the same time, the Japanese were tightening their policy stance at least in the first part of the year. Consequently, the intervention that took place must be considered as partially, if not largely, unsterilised and there is little dispute that unsterilised intervention is effective.

50. On balance, it is hard to see that there is much in the 1985 episode to support the contention that sterilised intervention has much impact in its own right. It cannot be ruled out that the dollar would not have declined, or as quickly, without it. But it seems more likely that the more powerful factor was the shared view of the various authorities that the dollar ought to decline. That and the implied threat that they would take concerted policy action to bring it about probably made the bigger impression on the market.

c. The Post-Louvre Experience, 1987

51. After the Plaza G5 announcement in 1985, the dollar continued to decline steadily throughout 1986. The Federal Reserve allowed US interest rates to decline and the monetary aggregates accelerated. With domestic activity slackening and no immediate signs of inflation, this seemed an appropriate response. For the first part of 1986, other G7 countries also tended to reduce their interest rates but generally by less than the US authorities. So the interest rate differential in favour of the dollar was declining but generally remained supportive.

Table 3

Interest Rate Differentials against the Dollar*

per cent

	1986				**1987**			
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
D-mark	3.0	2.1	1.4	1.1	1.8	3.0	3.0	3.5
Yen	1.6	2.0	1.3	1.3	2.0	3.0	3.2	3.7
Sterling	-0.3	-0.1	-0.1	-0.3	-0.2	-0.1	-0.2	-0.2

* 3 month rates. + indicates in favour of the dollar.

52. By late 1986, the story was beginning to change. US domestic considerations still called for an easy monetary policy. But the Fed was starting to worry about the inflationary consequences of the falling dollar. Trading partners were also worrying about the effects on their tradeable sectors but at the same time were not prepared to reduce their own interest rates for domestic reasons. In January 1987, the dollar came under intensified pressure and resulted in heavy concerted central bank intervention. Quickly afterwards the Louvre Accord followed (22 February), the communique announcing a decision to "cooperate closely to foster stability of exchange rates and current levels".

53. There are a number of sub-episodes in the post-Louvre experience:

(i) immediately after the Accord, the market was deeply suspicious of the authorities' willingness to make it work. By the end of March, heavy selling of the dollar developed, particularly for yen. Table 4 shows the behaviour of exchange rates, interest rate differentials and reported G7 intervention in favour of the dollar* It is clear that intervention was massive. Whilst the G7 meeting on April 8 endorsed the Louvre Accord, there were no new initiatives or indications of how its objectives would be met and this led to further heavy sales of dollars. Although this was countered by further massive intervention, the dollar fell; by end-April, it had fallen by nearly 7 per cent against the yen and by smaller amounts against sterling and the deutchemark from Louvre levels. Note that actual interest rate differentials were moving gently in the dollar's favour over this period. It was future policy that the markets were worried about;

(ii) selling pressure on the dollar tailed off fairly abruptly early in May. The market was impressed by Nakasone's directive to the Bank of Japan to ease its monetary stance and Volcker's

---

* These reported figures cannot be considered as complete estimates of the size of official operations. They exclude off-market customer transactions as well as forward transactions. Nevertheless, they provide a good indication of the scale and pattern of central banks' intervention.

mg2.cc/mg2/Slg.1.8.7

TABLE 4 EXCHANGE RATES AFTER THE LOUVRE

	Exchange Rates				Interest Rate Differentials (%)**				
	Dollar ERI	Dollar/ D-mark	Dollar/ Yen	Sterling/ Dollar	Dollar Interest Rate (%)	Dollar/ D-mark	Dollar/ Yen	Dollar/ Sterling	Reported G7 inter-vention $ bn
1987 Jan	105.5	1.86	154	1.51	6.2	1.6	1.9	- 4.9	11.5
Feb	103.9	1.82	153	1.53	6.4	2.4	2.4	- 4.5	1.6
Mar	103.3	1.83	151	1.59	6.5	2.5	2.4	- 3.6	17.0
Apr	101.0	1.81	143	1.63	6.8	2.9	2.9	- 3.0	20.5
May	100.4	1.79	140	1.66	7.3	3.4	3.5	- 1.6	6.9
June	101.8	1.82	144	1.63	7.2	3.4	3.4	- 1.8	1.1
July	103.3	1.85	150	1.61	6.9	3.0	3.2	- 2.3	1.4
Aug	103.3	1.86	148	1.60	7.0	3.0	3.3	- 3.0	- 2.4
Sep	100.8	1.81	143	1.65	7.6	3.5	3.8	- 2.6	3.3
Oct	100.6	1.80	143	1.66	8.5	3.7	4.6	- 1.5	10.4
Nov	96.5	1.68	135	1.77	7.6	3.6	3.7	- 1.4	6.1
Dec	93.9	1.63	128	1.83	8.0	4.3	4.1	- 0.8	11.8
1988 Jan	93.0	1.66	128	1.80	7.2	3.7	3.3	- 1.8	4.4
Feb	95.0	1.70	129	1.76	6.8	3.4	3.0	- 2.4	0.7
Mar	93.6	1.68	127	1.83	6.8	3.4	3.0	- 2.0	2.3
April	92.7	1.67	125	1.88	7.1	3.7	3.3	- 1.2	2.9
May	93.0	1.69	125	1.87	7.4	3.8	3.6	- 0.6	- 0.1
June	94.8	1.76	127	1.78	7.7	3.8	3.9	- 1.1	1.7

* Three Month Eurodollar

** Positive indicates in favour of the dollar simultaneous indication that the Fed was tightening its stance, because of exchange market conditions. The Bundesbank also acted to ease its position. As the summer went on, economic data progressively buttressed the dollar's position. Domestically, the US economy began to appear stronger than had been thought and symptoms of inflationary pressures emerged. So the potential dilemma for the Fed between domestic and external considerations was eased. By contrast, the economies of Germany and Japan still looked soft, again with advantage for the dollar. By August, the dollar had recovered most of its losses in the spring with net intervention over the period at trivial levels. Such was the confidence in the dollar that this was achieved despite falling interest rate advantages;

(iii) from the middle of September, a worsening trend for the dollar set in. Officials did little to dispel rumours that the Bank of Japan was tightening its policy whilst the Bundesbank began to raise its dealing rates. Cumulatively poor US trade figures reinforced the impression that the US authorities would not defend the current level of the dollar. An apparent public squabble between the US and German authorities did nothing to enhance the impression that there would be a concerted policy towards exchange rates. When world equity markets dropped sharply on and after October 19, the first effect was for some temporary support for the dollar as currency traders positioned themselves defensively. But, when it became clear that US interest rates would fall more sharply in response than in most other major economies, at the end of October heavy selling of the dollar began again. Intervention to counter this selling was heavy, though rather less so than in the Spring of 1987. Nevertheless, it was not sufficient to stop a sizeable fall in the dollar going on into the first week of November;

(iv) this bout of dollar selling ended with President Reagan's announcement on November 10 that he did not want to see the dollar fall further. He was able to follow this up almost immediately afterwards by a favourable prognostication about progress towards federal budget deficit reduction. But by the end of the month, this looked somewhat over-optimistic. There were no further significant policy initiatives in either the US or in the other major economies. Consumer confidence in the United States fell sharply in October and November, making foreign exchange participants feel that a loosening of US monetary policy was more likely than a tightening. At the same time, domestic demand in other countries, particularly Japan, was perceived to be more buoyant than expected, discouraging expectations of a looser policy stance in those countries. On December 22, the G7 countries reaffirmed the basic principles of the Louvre Accord, specifically stating that a further dollar decline could be counter-productive. But the market was disappointed that there were no new policy initiatives and further intense downward pressure on the dollar continued to year end. Further heavy and concerted heavy official intervention did not stop another dollar slide;

(v) by contrast, immediately after the new year, the dollar rallied strongly. Intervention was large - on the same scale as in December - but only in the first two days of the year. But it was accompanied by a variety of official comments that new initiatives were under way to make the G7 statement effective. European interest rates fell on January 5 and a stream of economic data suggested that US activity was strengthening to a surprising degree. This added credence to Federal Reserve avowals that it intended to defend the dollar at present levels. Subsequently, to end May 1988, the dollar has been relatively stable, underpinned by similar factors.

54. Abstracting from the detail of the post-Louvre experience, two features stand out:

a) between February and May 1987, <u>very</u> heavy intervention did succeed in keeping the dollar reasonably stable (though the dollar/yen rate fell and recovered by a non trivial amount), preventing what arguably would have been an unnecessary depreciation in the interim. But policy adjustments were being made in this period and, fortunately, developments in the US economy made this process easier. Greene's conclusion about the 1978 dollar defense package seems to carry over to this later episode. Intervention can buy time for the appropriate policies to be put in place : very heavy intervention can evidently buy a considerable time, providing there are some signs that the policy adjustments will be made;

b) the experience between September and December 1987 suggests that this last proviso is important. Intervention through this period was very substantial - though, admittedly, not quite on the same scale as in the Spring. But it could not prevent a dollar slide. For the most part, markets did not believe that the policy changes would be made that were needed to underpin the dollar. This conclusion is pointed up by its sharp recovery at the beginning of January. Backed by evidence that policy would be modified as necessary, the concerted intervention had quite a dramatic effect.

D. Conclusions

55. Looking at all three espisodes together, the main point to come out perhaps is the importance of credibility. When the intervention was carried out accompanied by policies which are consistent with the direction of the intervention, then it tends to be effective. Moreover, even when policy is not yet consistent but is being adjusted towards one more in line with the aims of the intervention, the intervention can be useful in buying time for the process to be completed. What intervention does not seem able to do is to provide an extra degree of freedom allowing authorities to pursue divergent domestic and external monetary policies. Attempts to do so, even when the intervention is heavy, usually fail.

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PMP.

CHANCELLOR OF THE EXCHEQUER
HONI SOIT QUI MAL Y PENSE

Ch/

I've had a word with Nick M about your question behind. He is not optimistic that they will be able to come up with any better answers on the wider question – no satisfactory numbers, though they will keep an eye out for any relevant information that would cast any light on this

MPW.

45/B.rj.2182/012

RESTRICTED

FROM: N MONCK

DATE: 8 July 1988

CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Sir P Middleton
Mr Byatt
Mr Burgner
Mr Waller
Mr Meyrick
Mr Romberg
Mr Anson

Thanks. It seems that the question has been interpreted somewhat narrowly. There is also a question of where expanding businesses locate their expansion. This is probably more important than relocation in the narrow sense. What do we know about this? 2. Incidentally, I v. much agree with X.

RELOCATION OF BUSINESS TO THE REGIONS

You were prompted by a claim made at the Paymaster's lunch with Robert Fleming that market forces were driving businesses to relocate away from the south east to ask what facts and figures we have about this.

2. The short answer is that we do not have satisfactory figures and cannot make any really reliable assessment of the claim. This note summarises the results of the enquiries we have made with the CBI, DTI and DOE (who know nothing), as well as one outside study and some recent anecdotes from the press. Annex A contains some figures for the causes that might be expected to produce relocation even if we have none for the effects. Ideally we would look at statistical series long enough to make it possible to remove the impact of cycles, which seem to affect both the causal indicators and the effects. But we do not have them. The note is therefore distinctly sketchy.

__CBI__

3. The manager of the CBI's Employee Relocation Council says that "the relocation of companies is on the increase". Like many other sources, she attributes this to several related causes: high costs in London or the south east (labour and office rents and now the NBR, scarce and expensive housing, and skill shortages).

4. The CBI points out that the cost to companies of moving people is high, averaging about £10-12,000 a head (covering fees, stamp duty, transport, insurance, temporary accommodation, and allowances for disturbance etc, but excluding mortgage subsidies etc). These are only paid to the fraction of employees who move with the company, but redundancy payments may be needed for the rest. These costs, as well as the non-cost factors mentioned at the end of Annex A have to be set against the cost savings.

5. The CBI say roughly 70 per cent of moves are short distance (up to 30 miles). Around 20-25 per cent are between 30 and 100 miles.

"**Black Horse Relocation**"

6. This is compatible with findings in a study* by Black Horse Relocation that 54 per cent of the moves by some 300 clients, who may or may not be representative, were from central London to places south of the Bristol to Wash line. One in ten moved to the north of it; but 14 per cent moved from the north to the south. The tone of the study is rightly cautious but helpful in suggesting that "the North will ultimately benefit from the corporate market", although it also says that "few companies move into inner city areas". Annex B reproduces the Summary and Key Findings. We plan to check these findings against another study of moves out of central London by Jones Lang Wootton when we get it.

DTI

7. The DTI say that two potentially relevant statistical series - the VAT register and the DE census of employment register cannot for various reasons be used reliably, at least without excessive checking, to produce the systematic figures we ideally need. The DTI's own figures are also inadquate. They used to keep data about closures, including the reasons such as relocation, but no longer do so as a result of "lifting the burden". They have a so-called Regional Data System which covers manufacturing industry only. But they say only two of their regions have had enough staff to handle data about the source of transfers to Assisted Areas. It seems clear that the DTI should either devote more resources so that they get the output of decent figures or scrap the collection of unusable figures. Although my first reaction was to favour the former, the latter is probably preferable if the availability of figures would, as I suspect, have no effect on policy.

X

8. Failing figures, the DTI have asked their regional offices for impressions. The south east region confirm that there is a lot of relocation within the south east, often from areas of staff shortage towards the south or west. There is serious concern among businessmen about the pressures of operating in the region, but these have not yet produced large numbers of relocations outside the south east. They have heard of some companies - both domestic and overseas-based - who see the choice as between the south east and Continental Europe rather than other parts of the UK.

* "Corporate Relocations within Great Britain (Where major companies moved from, to and why, in 1987)"

9. The West Midlands Office thought there was an increasing amount of migration from the south east, particularly to the south of the region - Redditch, Solihull and South Warwickshire. (You may have seen the report this week that Barclays are moving 1,000 jobs to Coventry.) The other regions have seen no general evidence that relocation out of the south east is speeding up, though some think this is happening in financial services, eg back office operations moving to Bristol in the case of Lloyds Bank and some movement to Leeds. Several do, however, report an increasing number of enquiries, as opposed to actual moves, from the south east. This applies to the West Midlands, the North East, the North West. There was no clear evidence from Scotland or Wales.

10. To sum up, for various reasons we have no hard quantitative evidence. In particular we cannot say how far the softer evidence reflects cyclical behaviour. But there is a good deal of impressionistic evidence suggesting that the Robert Fleming proposition may be becoming true on a very modest but perhaps growing scale, though most of the relocation remains in the south east and East Anglia. I don't think this amounts to sufficient basis for saying anything in public. But if any Minister wanted to do so, it should be done very cautiously and attributed to some non-Government source such as the Black Horse study.

NM

N MONCK

Annex A

REASONS FOR RELOCATING

A1. This Annex quantifies some factors that might prompt a business to relocate from London or Roseland (Rest Of South East England). On many subjects quantified information is available only for the Civil Service, which may not be representative of business employers. Paragraph A8 also lists some of the reasons why businesses might not be relocating.

A2. Office Rents are lower outside London. Roughly (£/sq foot):

City	40
Victoria	25
Provincial South East	6 - 18
Elsewhere	3 - 10

A3. London Weighting. Housing costs may be putting pressure on pay. First time buyers' household average annual outgoings on net mortgage payments are £5,000 in London, £4,000 in Roseland, roughly double the amount in the North. After allowing for higher incomes of two-earner households, this absolute differential suggests additional mortgage costs of about £1,000 per earner. Private sector London Weighting allowances are typically £500 - £1,000 in outer areas, and up to £3,000 in Central London. (Pay Group are about to start a review of Civil Service London Weighting.)

A4. Labour Markets are tight in the South East. 1986 data for Civil Service administrative officers showed resignation rates of 10 - 16% in the South East, 4 - 7% elsewhere.

A5. But conditions can vary considerably within the region between local labour markets. Unemployment in Crawley is 3%; in Thanet 17%.

A6. Employees' Attitudes to Relocation: Housing Costs. We have some information for 1987 about first time buyer households but it is inconclusive. Such households should feel poorer in London/Roseland: over one third of net incomes goes on net mortgage payments in comparison with a quarter in the North. However, perhaps because of a higher proportion of two-earner households, disposable household income after net mortgage payments is still about 35% higher in London/Roseland than in the North. This may be offset wholly or in part however by higher prices/costs (eg commuting costs).

A7. The Kilbride Evaluation. The study of the 1981 relocation of the Overseas Development Administration to East Kilbride found an overall net positive value of £15m to the move. The main areas for savings were: rents NPV £11m; rates NPV £7m; and London Weighting NPV £10m. There were also additional costs of NPV £6m for 30 extra staff to compensate for two-site working; NPV £4m for dislocation; and NPV £4m for communications. The move broke even after about six years.

A8. Reasons for Not Relocating. Inertia may be a reason for not considering a move. But substantive reasons for not moving might include:

(i) a belief that a South Eastern location has a higher productivity rate - dynamism, competitive pressure;

(ii) access to specialised business services;

(iii) better communications.

(iv) reluctance of key staff to move out of South East/ shortage of skilled staff at destination.

(v) reluctance to have multi site working if part of the firm would have to stay in London/Roseland.

Extract from:

Corporate Relocation Within Great Britain

Where major companies moved from, to and why, in 1987

1. Summary

The findings of this report indicate that in 1987 there was much corporate relocation activity radiating outwards from London. Companies cite the high cost of doing business in the Capital as the primary reason.

This migration resulted in outwardly-directed ripples of relocation activity which spread northwards; with companies in London moving out to the South initially, and onwards from there.

A large number of employees are being asked to move with their companies, particularly white-collar employees. Over the next decade, these employees and their companies will make a significant contribution to the economic growth and social development of their new locations.

This ripple of corporate migration, originating in London, will be instrumental in balancing the nation's wealth between, and within, the North and South.

While the relocating companies are moving outwards in only small, progressive steps, the overall direction of the movement indicates that the North will ultimately benefit from the corporate migration.

2. Key Findings

1. Significantly more companies moved out of London to the South than to, or within, any other region in 1987.

2. Most companies leaving London retain a presence there.

3 Most companies leave London in order to save money. They leave other areas, however, most often as a result of a reorganisation.

4. Few companies move into inner-city areas.

5. Financial incentives such as local government grants do little to entice companies to move to an area.

6. Lower housing costs and a higher quality of life are important attractions for companies looking for a site in the North.

7. When selecting a new location, companies give considerable importance to its proximity to existing company sites. In the South, however, companies are often constrained by the scarcity of available sites.

(Black Horse Relocation Survey)

FROM: P WYNN OWEN
DATE: 8 July 1988

1. MR BURGNER
2. FINANCIAL SECRETARY

Given the E(CP) conclusions, it would probably be right to send a message to Treasury staff on a Heads of Division circulation. The draft at Annex A (which I have very slightly amended) seems appropriate.
TB 4/7

Ch, I suppose we have to do this, for Caesar's wife reasons. I suspect it will strike most Tsy staff as otiose.
25 8/7

cc Chancellor 2
Chief Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Anson
Mr Monck
Mr Phillips
Mr C D Butler
Mr Odling-Smee
Mr C Allan
Mr Burr
Mr Flanagan
Mr Call
Mr Tyrie

DEREGULATION: "PERSONAL MESSAGE"

You took the chair for the second item at MISC 133 on 13 June, a progress report on deregulation from the Minister of State for Scotland. In summing up, you said that "the Minister of State for Scotland was to be congratulated on sending a personal message to all Scottish Office staff emphasising the importance of deregulation. The Group wished to encourage any Minister who had not so far sent such a message around his department to do so in the near future". This submission discusses the pros and cons of sending such a message to Treasury Heads of Divisions.

2. Attached at **Annex B** to this submission is the standard draft for such messages circulated by EDU. As you can see, it is not particularly appropriate to this department. Treasury does not regulate businesses, it is not responsible for much legislation (the Revenue and Customs undertake CCAs and so on for the Finance Bill), it does not provide any services to business, and there are not even regular contacts with business. This suggests that a message to staff might not be appropriate. A general exhortation is unlikely to have much impact unless it is seen to relate directly to the work undertaken by its recipients.

3. You may, nonetheless, feel that it is worth getting any marginal improvement possible in awareness of deregulation. A draft message is attached at **Annex A** which you might like to consider

sending. This attempts to suggest some concrete actions which could be undertaken within Treasury, but which are primarily aimed at improving the deregulatory performance of other departments.

4. If you decide to send such a message we think it would be a case of overkill to send it to all staff. EOG have recommended that a note to Heads of Divisions (Assistant Secretaries) would be more appropriate. The message would go out under cover of a Heads of Division Notice (a recognised vehicle for general communication within the Treasury), which would request that divisional staff be put in the picture as necessary.

5. If a message is to be sent to Heads of Treasury Divisions you may think it odd that a similar message is not also sent to Divisional Heads in the Revenue departments. In both Customs and the Inland Revenue the importance of deregulation is appreciated - for example, the 1987/88 Customs Board's Report will devote one complete chapter on the subject. The Inland Revenue have just put round, with your agreement, this year's departmental statement to all their staff which draws full attention to the need to reduce burdens on business. Both departments, therefore, doubt whether such a message is necessary or appropriate. But, if you decide that one should be sent, we suggest that it is in the form of acknowledging the good work already done on deregulation. The suggested draft at Annex A is, therefore not suitable, but Customs and the Inland Revenue could provide suggested drafts if you wish.

Philip Wynn Owen

P WYNN OWEN

ANNEX A

DRAFT MESSAGE FROM THE FINANCIAL SECRETARY

ENTERPRISE AND DEREGULATION

The Treasury has a~~n~~ strong interest in improving the performance of the supply-side of the economy. One element of this, currently being given special attention by the Government, is to reduce regulation and encourage enterprise so that business can grow, create wealth, and provide jobs.

2. Departments have, for some time, been asked to ensure that full account is taken of the impact of policy proposals on business (largely through the system of Compliance Cost Assessments, or CCAs). They have also been asked to try to ensure that services supplied to businesses are efficiently and effectively delivered.

3. I very much hope that the Treasury will continue to do what it can to encourage this work, whenever the opportunity arises. For example, Departments could be asked for copies of their CCAs when seeking Treasury approval for new policies or for new projects. In many cases, more efficient delivery of services to business, and reduced regulation should mean that departments need fewer resources, ~~and lead~~ as well as leading to a reduction in the burden on businesses.

4. Please do all you can to take this forward.

(NORMAN LAMONT)

ANNEX B

ENTERPRISE AND DEREGULATION

THE PRINCIPLES

It is the Government's policy to reduce regulation and encourage enterprise so that business can grow, create wealth and provide more jobs. We, in the Department of can achieve this by:

* ensuring that full account is taken of the impact proposals may have on business when new policies are developed or past policies are reviewed
* improving our understanding of business problems at all levels in Departments
* ensuring that the services supplied to business by Government are efficiently and effectively delivered
* removing regulations and requirements which are no longer necessary, irrelevant or just too costly to business to justify their intended benefit
* improving our relationship with business through training, greater consultation on our ideas and how they are presented.

We want to encourage individuals and groups in business to take up challenges and opportunities. This can be hampered through the lack of incentives or access to the necessary support. We are here to help and stimulate initiative and innovation. Any contribution we make is therefore a vital ingredient in meeting this aim.

CONFIDENTIAL

1. Tonathan
2. BF 18/7 or with advice

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

My ref:

Your ref:

CH/EXCHEQUER
REC. 12 JUL 1988 12/7
ACTION CST
COPIES TO

The Rt Hon Malcolm Rifkind MP
Scottish Office
Dover House
Whitehall
LONDON
SW1

11 July 1988

Dear Malcolm

ENTERPRISE ZONES AND THE EUROPEAN COMMISSION

The European Commission have recently decided to rectify what they regard as an anomaly in the treatment of enterprise zones for the purposes of calculating state aid levels. Under EC state aid guidelines, different forms of state aid for the same project are normally added together ("cumulated") against an overall limit on grant. So far we have been able to escape including enterprise zone benfits in this calculation. When the enterprise zone experiment was set up, the rules on cumulation had not been formulated and we told the Commission at that time that enterprise zones were an experiment and the benefits available were not part of regional policy or directly connected with over existing policy. However, following the introduction of other similar schemes in other member states, Commission have tightened their view and now insist that enterprise zone benefits should be taken into account. The Commission propose that this cumulation should apply to all new projects, whether in new or existing zones. At present, discussions with the Commission are delaying their approval of the Inverclyde enterprise zone. I am therefore anxious that we should take an early decision on our response.

I do not see that our case for resisting the Commission on this matter has much strength. The argument based on the experimental nature of EZs is slight, now that the earliest zones have been in existence for seven years and successive administrations have increased the number of zones fourfold. Moreover, resistance now would inevitably delay the designation date for Inverclyde and could restrict our freedom to announce further zones should we wish to use this policy option in exceptional circumstances, as we agreed last year. Finally, we have to recognise that the Commission have the right, under Article 93.1 of the EEC Treaty to open a review of the experiment, which whatever else it might do, would probably prevent us from designating further EZs until the review is complete.

CONFIDENTIAL

On the other hand, the method proposed by the Commission of calculating the extent of the aid available in EZs is not likely, as far as I can see, to present us with serious problems in the EZs in assisted areas. They propose that the calculation be based on some percentage of the net grant equivalent (NGE) value of the project and have in mind the relatively modest figure of 6%. The effect would be that the notional value of the EZ benefits would be taken into account and any offer of regional selective assistance (RSA) when added to that value, would be adjusted to ensure that the total did not exceed the ceiling for aid set by the Commission.

I consider therefore that we should indicate to the Commission that, provided we can agree upon the percentage of NGE to be used, we would accept the principle of adding EZ benefits to RSA in future cases with a view to ensuring that the total aid available should not be allowed to exceed the ceilings set by the Commission for aid in assisted areas. I would expect officials to seek to agree with the Commission the actual value to be attributed to the EZ benefits and in doing so to ensure that the figure is as low as possible.

The Commission have also indicated that agreement of the UK Government to the above in the case of Inverclyde and to an average figure for the value of the EZ benefits to each new project there would enable them to agree to the creation of that zone, which is the matter they formally have before them. They would, however, go on to ask that the regional aid ceilings be respected in all EZs in the assisted areas. Alternatively, the Commission have indicated that they could agree to the Inverclyde zone in principle but reserve their position on cumulation and the regional aid ceiling. I regard the first alternative as preferable since the eventual communication from the Commission agreeing to Inverclyde would be a complete package with no loose ends that might invite possible intervention by other member states. Moreover, it would seem to the advantage of the UK to be able to express our agreement to the Commission's proposition in our own terms and not to have to negotiate further.

I should also record that I understand that the Commission are not entirely satisfied with the position that a number of EZs lie outside the assisted areas. They seem, however to be prepared to let that matter rest.

I am copying this letter to Peter Walker and Tom King in view of their responsibilities for EZs in Wales and Northern Ireland. I should be grateful for their and your agreement that, provided officials can agree on the notional value to be used, the UK would accept:-

a. the principle of adding the value of EZ benefits to other aid for new projects in all the EZs in the assisted areas including Inverclyde; and

b. the application of the Commission's ceilings for total aid in EZs in these areas.

I should also be grateful for your agreement that officials should seek the Commission's agreement to the Inverclye zone on those terms.

I am also copying this letter to the Prime Minister, members of OD(E) and Sir Robin Butler.

Yours ever
Nicholas

NICHOLAS RIDLEY

mjd 1/228A

RESTRICTED

CHANCELLOR OF THE EXCHEQUER

FROM: A C S ALLAN
DATE: 11 July 1988

CHANCELLOR

cc Financial Secretary

OK

IMPROVING UNDERSTANDING BETWEEN GOVERNMENT AND BUSINESS

Nigel Wicks seems to have persuaded the Prime Minister to respond to Lord Young's minute (*) by saying she agrees with everything <u>except</u> the idea of setting up a central facility of nine staff in the OMCS to monitor and evaluate all this. Nigel should be minuting out to the Prime Minister's comments later today. He said it would very helpful in carrying this through (**) if you could "independently" minute the Prime Minister expressing much the same concerns. As you will see from the attached back papers, the Financial Secretary had been arguing this line in Misc 133.

... 2. I attach a draft minute.

(* which you saw over the weekend)
(** ie against expected counter-attack from Lord Young)

A C S ALLAN

mjd 1/229A

RESTRICTED

DRAFT MINUTE FROM CHANCELLOR TO PRIME MINISTER

Please type for signature

IMPROVING UNDERSTANDING BETWEEN GOVERNMENT AND BUSINESS

I have seen a copy of David Young's minute to you of 6 July.

I agree with the thrust of the proposals drawn up by the Ministerial Group on deregulation. I am sure it is important for us all to push this hard within our departments, and keep the momentum up. But I do question the need for a central facility of nine civil servants in the OMCS to monitor the programme and evaluate the results. My concerns are not just about the finance: having a new central facility seems to me to add quite unnecessarily to the bureaucracy.

I am copying this minute to David Young and to Sir Robin Butler.

[NL]

mjd 2/129M

RESTRICTED

C.C. FST
Dame A Mueller, Mr CD Butler
Mr Culpin, Mr Burr
PS/IR PS/C+E.

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

PRIME MINISTER

Undated?

11/7/88.

IMPROVING UNDERSTANDING BETWEEN GOVERNMENT AND BUSINESS

I have seen a copy of David Young's minute to you of 6 July.

I agree with the thrust of the proposals drawn up by the Ministerial Group on deregulation. I am sure it is important for us all to push this hard within our departments, and keep the momentum up. But I do question the need for a central facility of nine civil servants in the OMCS to monitor the programme and evaluate the results. My concerns are not just about the finance: having a new central facility seems to me to add quite unnecessarily to the bureaucracy.

I am copying this minute to David Young and to Sir Robin Butler.

ACS Allan

pp [NL]

(approved by the Chancellor and signed in his absence)

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

PMP

CH/EXCHEQUER

REC.	12 JUL 1988
ACTION	FST
COPIES TO	

12/7

11 July 1988

Dear Neil,

P

IMPROVING UNDERSTANDING BETWEEN GOVERNMENT AND BUSINESS

The Prime Minister has seen your Secretary of State's minute of 6 July in which he reports the recommendations of the Ministerial group on Deregulation (MISC 133) for giving a further impetus to improving understanding between Government and business.

The Prime Minister fully supports the main recommendations of MISC 133's report which are summarised in the eight points described in paragraph 1 of your Secretary of State's minute. But she is strongly opposed to the proposal to establish, at a cost of up to £350,000 and with nine civil servants, a "central facility" to help departments implement the action programme proposed by the Ministerial group. She takes this view for the following reasons.

The whole emphasis of administration nowadays, quite rightly, is to devolve responsibility for action on the departments concerned with the minimum of central interference. That certainly is the philosophy behind Sir Robin Ibbs' report on the "Next Steps" and the Agency approach which was endorsed by Cabinet. The central facility in your Secretary of State's minute runs counter to that philosophy. Moreover, the cost involved of up to £350,000 a year and nine staff seems quite disproportionate to the task in hand. There would no doubt be higher priorities if that sum and that number of civil servants were available to OMCS.

The Prime Minister believes that there is a more effective way of achieving the lauderable objectives listed in paragraph 1 of your Secretary of State's minute. She suggests that she should send a firm minute to Cabinet Ministers which says:

"She strongly supports the main recommendations of the Ministerial Group described in paragraph one of Lord Young's minute;

She expects each Cabinet Minister and his Permanent Secretary to establish within three months a programme - quantified to the maximum extent possible and with timetables and milestones - to implement the recommendations of the report;

Departments should report to MISC 133 within six months on that programme and on its initial implementation. She would expect a report from Lord Young on progress and would be ready to see any Cabinet Minister and his Permanent Secretary where that was appropriate;

There should be a further report to MISC 133 six months later (i.e. in a year's time) of further progress; again she would be ready to see the Cabinet Ministers and Permanent Secretaries if that was necessary;

The Prime Minister thinks this approach would be more effective - clearly placing the responsibility for action where it should be - than creating the extra bureaucracy of the "central facility".

The Prime Minister would be grateful if your Secretary of State, in consultation with Sir Robin Butler could prepare a draft minute on these lines for her signature.

I am sending a copy of this letter to Alex Allan (HM Treasury), Eleanor Goodison (Office of the Minister for the Civil Service) and to Sir Robin Butler, but not more widely at this stage.

Yours sincerely

Nigel Wicks

(N. L. WICKS)

Neil Thornton, Esq.,
Department of Trade and Industry.

Preston/minute/4

FROM: R MOLAN

DATE: 11 July 1988

1. MR P G F DAVIS 11/7
2. CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
Sir G Littler
Mr Lankester
Mr Mountfield o/r
Mr Davis
Mr May
Miss Preston
Mr Tyrie
Mr Call

INTERNATIONAL TROPICAL TIMBER AGREEMENT

Lord Young's letter of 14 June to the Foreign Secretary sets out proposals for the future work programme of the International Tropical Timber Organisation (ITTO) which met for the fourth time at the end of last month. A position paper analysing the key issues is attached: this has been prepared in consultation with us at official level but is not, as Lord Young states, an agreed paper as such. The problem is that pressure from environmentalists is driving the ITTO too far towards conservation issues and risks unbalancing the unavoidable tension (not mentioned, explicitly by DTI) between preserving timber resources and maintaining a reasonably free market. We suggest you draw attention to this.

BACKGROUND

2. The International Tropical Timber Agreement was ratified by the UK in 1985 before the deregulatory approach to commodity policy was adopted. It came into force that year but has only just become operative due to earlier disputes over the funding and location of its headquarters. The Agreement has no economic provisions - its purpose is to provide a framework for producers and consumers to discuss trade issues, to improve market transparency and to expand and diversify trade. It also provides scope for the ITTO to set up projects in the field of R+D, forest management etc. But such projects are dependent upon voluntary funding by members and the UK, like many other members, has not provided any finance for this purpose. 10 per cent of total UK imports of wood are tropical

hardwood which is mostly used in the construction or furniture markets.

3. Seven of the objectives of the Agreement are trade-related one but the eighth relates to conservation. It states that the Agreement is intended:

> "To encourage the development of national policies aimed at sustainable utilisation and conservation of tropical forests and their genetic resources, and at maintaining the ecological balance in the regions concerned.

This provision has enabled environmentalist pressure groups to latch on to the ITTO as a means of promoting their views and controlling trade in tropical timber for conservation reasons. In light of this objective the public line taken by DTI Ministers in response to environmentalist lobbying has been that the ITTO has a role to play in dealing with the problem of deforestation.

DTI PROPOSAL

4. Lord Young argues that as this Agreement is unique in containing an environmental objective the UK needs to show a positive approach to conservation issues in the ITTO so as to contain environmentalist pressures within and outside the organisation, so preserving UK trade interests. He fears that "green interests" might press the UK to regulate the tropical timber trade unilaterally. He considers that the ITTO needs a work programme which is aimed at safeguarding tropical timber as a sustainable tradeable resource.

5. To achieve these ends he proposes that:

> (a) the ITTO should be involved in Tropical Forestry Action Plan (TFAP) projects. (The TFAP is a UN sponsored conservation and forestry management programme funded by the UK through bilateral aid.) Lord Young adds that consideration could be given to furthering the ITTO's objective of safeguarding tropical timber as a sustainable resource by calls on the aid programme.

(b) the ITTO should formulate a voluntary code (or codes) of conduct which would seek to ensure that products entering international trade are derived from sustainable resources.

Timber importers are said to be content with this line.

The Agreement is one where mixed competence applies, ie Community participation alongside Member States. EC partners and the Commission have not yet reached a firm position on the ITTO future work programme but their thinking is generally in line with Lord Young's proposals.

OTHER MINISTERIAL REPLIES

6. Mr Patten, replying in his letter of 21 June on behalf of the Foreign Secretary, expressed general contentment with Lord Young's suggested approach. However, he cast doubt on the possibility of the aid programme being used to help the ITTO and suggests that the timber trade might provide funds.

7. Mr Ridley wrote on 30 June indicating agreement with Lord Young's line. He commented that a code of conduct would be a pragmatic step which would avoid duplication of effort by the ITTO and TFAP.

DISCUSSION

8. Lord Young's approach carries the danger that if it is couched solely in terms of a defensive action to placate the conservationists it will only serve to reinforce environmentalist attempts to mould the ITTO to their own purposes. Stressing the alleged "unique" nature of the Agreement may have the same effect. Although the Agreement may be unusual in having an environmental objective written into it, all commodity agreements relating to renewable resources ultimately depend upon resources of the commodity in question being sustained.

9. Undue emphasis on the conservation aspect could also serve to blur the distinction between the ITTO and the TFAP with the danger that ITTO's trade functions, which should take primacy, will be overshadowed. But there is a case for implementing the ITTO's Conservation objective by involving it in TFAP projects where this would be productive and no duplication of effort arose.

10. Although Lord Young's letter does not make the point, DTI officials believe that if money is to be spent in this area the choice lies between increasing bilateral aid for joint ITTO/TFAP projects or making a voluntary contribution to funding ITTO projects. They believe that the aid avenue is preferable in that it will pacify the conservation lobby and limit the ITTO's role to tightly controlled useful projects. But in both cases the money would have to come from ODA and, as mentioned above, Mr Patten has indicated that no further funds are likely to be available.

11. Conservation and trade interests in this issue converge in as much as the need to sustain a resource which will provide materials for future trade is compatible with maintaining the ecology in producer countries. But they diverge in that undue emphasis on conservation could lead to unjustified restrictions on trade thus preventing producer countries from exploiting a comparative advantage. Lord Young's letter does not spell out this latter point when referring to the idea of a voluntary code. Various versions of the code could embrace the payment of compensation to producers for logging less trees, but maintaining their income levels by way of increased royalties, and labelling timber to indicate that it was from a sustainable source. In the latter case the costs of funding these measures would probably be passed on to the consumer. The trade considers that consumers would tolerate a price increase in tropical timber but this makes assumptions on behalf of the consumer whose pockets and choice will be affected. The paper makes the point that substitutes such as soft wood, steel and plastic might be turned to by consumers if prices rise too far.

12. But it is unlikely that the UK will be able to avoid pressures to discuss a code of some sort. The Commission already favour a code as a means of deflecting requests to ban imports of tropical timber and at a recent conference of international forestry experts,

conservationists, UN bodies and the World Bank a call was made for a code. The idea of a code was not discussed at last month's ITTO meeting, but will feature in the next session in November.

13. We understand from DTI officials that their wish to support discussions of a strictly voluntary code, is partially a negotiating ploy designed to spin out talks and steer the conservationists away from calling for more harmful interventions. If such a code was introduced it would not, DTI argue, necessarily be damaging as few countries may honour it. But it would have potential for upsetting trade flows.

RECOMMENDATION

14. Lord Young's proposals are not an ideal negotiating position for the UK but we fear that conservationist pressures during the ITTO's incubation period may have already limited the UK's room for manoeuvre. Statements by other Ministers to the effect that the ITTO should have a prominent role to play in this area have contributed to this. Nevertheless we suggest that the UK's position should be to stress the trade based nature of the ITTO, using Lord Young's proposals for a code only as a fallback position if environmentalist pressures become uncontainable. In that event we could reluctantly accept the code as a negotiating ploy provided that it is voluntary and in discussions every effort is made to prevent trade distortions arising from it. ITTO collaboration with the TFAP is acceptable provided that clear demarcation lines are drawn between the two bodies and any assumption that the ITTO can expect additional resources from the UK aid budget are discouraged. Mr Patten's suggestion that the private sector might provide finance should be endorsed. You could also suggest that greater publicity might be given to the financial support given by the UK to the TFAP so as to deflect criticism by pressure groups.

15. We recommend that you agree to Lord Young's proposals on this basis. I attach a draft reply for your consideration.

16. A separate submission to you today discusses the draft UK response to the Brundtland report which briefly refers to the ITTO.

If you agree to write in the attached terms you may wish to suggest a change to the passage in the response dealing with the ITTO.

pp W. Preston

R MOLAN

aef1.mt/Preston/draft/2

Pse type final.

DRAFT REPLY TO THE SECRETARY OF STATE FOR TRADE AND INDUSTRY

Thank you for copying to me your letter of 14 June to Geoffrey Howe. I have also seen the replies by Nicholas Ridley and Chris Patten.

I am concerned that the UK position should not be compromised by ~~the need to make unjustified~~ concessions to the environmentalist lobby from the outset. I recognise the strength and persistence of this lobby, and the real tension that exists between maintaining the sources of timber and allowing adequate freedom of trade. But there is a risk of ~~unbalancing this tension if we allow~~ allowing the ITTO to be driven too far towards conservation issues, as distinct from trade issues.

I would prefer, therefore, to see the UK position based more firmly on establishing a trade-related programme for the ITTO. However, if the pressures are such that in your judgement ~~these threaten to damage UK trading interests or to turn the ITTO into a predominantly conservationist organisation~~ such a position would be counter-productive, then I would reluctantly ~~I~~ accept that your proposals may need to be adopted as a fallback position.

As you acknowledge, the concept of a code of conduct, voluntary or otherwise, is by no means ideal. It will be important to get the balance right between trade and conservation interests, and avoid ending up with a code which gives such precedence to the latter that trade restrictions arise which ~~have a similar effect to~~ add up to much the same as export restrictions or import quotas. In such an event the costs would inevitably be passed on to the consumer through increased prices. At the same time, Producers would be prevented from exploiting their comparative advantage in a product, which as the developing countries' third highest export earner, ~~will~~ can contribute to the repayment of their debts. The UK should be ready to point out these drawbacks to producers and consumers in any discussion of a code within the EC or in ITTO meetings.

I would not object to ITTO involvement in TFAP projects provided that the demarcation line between the two bodies is maintained. For this reason, undue stress on the conservation element in the Agreement should be avoided. I must endorse Chris Patten's comment that it cannot be presumed that bilateral aid will be available to fund projects, beyond that which is already available to the TFAP. The trade itself may, as he points out, be a likely source of future funding, as it is presumably concerned about protecting its interests. It also occurs to me that greater publicity might be given to our contributions to the TFAP so as to deflect criticism of our position.

I am copying this letter to Geoffrey Howe, Chris Patten and Nicholas Ridley.

NIGEL LAWSON

jc6

From: J ODLING-SMEE
11th July 1988

CHANCELLOR OF THE EXCHEQUER

cc Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Scholar
Mr Sedgwick
Mr S Davies
Mr Hibberd
Mr Melliss
Mr Brooks
Ms Turk
Mr O'Brien
Mr Cropper
Mr Tyrie
Mr Call

PRODUCTIVITY GROWTH IN PRIVATE SERVICES

In his minute of 15 June, Mr Cropper wondered whether productivity growth in services was under-estimated in official statistics. He suggested that the effects on output of changes in information technology may not be correctly recorded in official figures for output growth in services, and hence the economy as a whole.

2. It is certainly surprising that measured productivity growth in the private non-manufacturing sector (including agriculture, construction, energy, and transport as well as distribution and financial and other services) has not grown as rapidly since 1979 as it did before 1973 (see Table 1). This is in contrast with manufacturing, where productivity growth has if anything been faster since 1979 than before 1973.

3. This is also a feature of other OECD countries. A recent OECD study of productivity comments on the paradox of the failure of productivity growth to rise very much in the information-intensive service industries (including distribution, transport and communications, and financial and business services), where there is thought to have been widespread process innovation. Among the possible explanations of the paradox which they offer are the following:

a. productivity growth may be underestimated where there are new or changing products, or where the output is an intangible service of unknown quality

b. low productivity growth may reflect an over-investment in hardware and an under-investment in software and end-user training. There may also be long training and learning periods before employees can use the new technology efficiently

c. the new technology may not have been as important in the service sector as the popular view suggests.

4. We have not so far been able to find any studies which enable us to distinguish between these three, and other possible, hypotheses for the UK. In particular, there are no satisfactory quantitative estimates of the size of any under-estimation of output growth. Levitt and Joyce in their work on measuring public sector output presented some aggregate data for the banking sector which suggested an annual productivity growth rate of about 3½%, which is ½% or so higher than the official estimate. The Liverpool Group have produced a figure of 2.5% for the under-estimation of productivity growth in services. But it is difficult to see how they produced their figures, which do not seem to take into account any under-estimation in the official figures for output growth.

5. On the other hand, if output growth in services and hence the GDP(O) growth rate were seriously under-estimated, the gap between the true GDP(O) growth and GDP(E) growth would be even greater than in the official figures. This suggests that output growth is probably not under-estimated, although it is possible that if quality changes were correctly incorporated in the real GDP(E) measures as well as those for GDP(O), the two would be raised to a similar extent.

more likely

6. The official estimates of productivity growth in services show that it has been more rapid in the UK in recent years than in most

other OECD countries. This again could suggest that the UK figures are not under-estimated, although it clearly does not rule the possibility out.

7. To sum up, there is good reason to suspect that productivity growth in private services may have been higher than the recorded figures suggest. But we are unable to provide any quantification to support this claim at this stage, and it may well not be very important.

J ODLING-SMEE

-CONFIDENTIAL-

Table 1:Non-manufacturing productivity on heads and full-time basis

	Output per head (1980=100)	Output per FTE (1980=100)	Manufacturing output per head
average percentage change per annum			
1963-1973	3.0	4.2	3.8
1973-1979	0.6	1.2	0.7
1979-1987	1.5	2.1	4.0
of which			
1979-1983	0.8	1.7	3.6
1983-1987	2.2	2.4	4.5
% change per annum			
1980	(2.7)	(1.8)	(3.9)
1981	0.6	1.9	3.5
1982	2.6	3.5	6.7
1983	2.7	3.1	8.5
1984	(2.5)	(2.4)	5.5
1985	4.3	4.8	3.3
1986	4.0	4.4	2.3
1987	3.0	3.1	6.8
1988	2.7	3.1	5.6
1989	2.2	2.7	4.6
1990	2.3	2.7	3.6

* Brackets denote negative numbers

FROM: P JEFFERSON SMITH

DATE: 12 JULY 1988

Board Room
H M Customs and Excise
New King's Beam House
22 Upper Ground
London SE1 9PJ
Telephone: 01-620 1313

Ch

We always thought Customs estimates about take-up of unleaded petrol were ludicrously high! Indeed:

(I'm not at all convinced of wisdom of writing: we're not Dept responsible for increasing consumption of unleaded petrol)

AA

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Michie
Mr Cropper

ECONOMIC SECRETARY

PROMOTING UNLEADED PETROL

1. This note gives a progress report on consumption of unleaded petrol, following the widening of the duty differential in this year's Budget. It suggests that some of the blame for sluggish ?? growth rests with Government, and recommends that you write to Ministerial colleagues about further measures that could be taken. One purpose of doing so now would be pre-emptively to resist pressure for an even wider duty differential next year.

Outlets increasing, consumption lagging

2. Since the Budget there has been a considerable increase in the number of garages stocking unleaded petrol, now estimated at over 1400, with 2000 (10 per cent of all UK petrol outlets) expected by the year end. But consumption is lagging, and our regular monitoring of clearances shows that increases associated with the Budget are faltering (see graph attached, which compares actual clearances with the target envisaged at the time of the Budget).

Internal distribution: CPS, Mr Wilmott, Mr Allen, Mr Gaw, Ms French, Mr Boardman

I agree; & if the oil ~~companies~~ companies won't "do their bit" (see X), then SoS should state the abolition of the restriction on what they can do on their forecourts

Obstacles to growth of consumption

3. The Budget increase in duty differential makes unleaded petrol about 6p a gallon cheaper than 4 star leaded petrol, but few garages capitalise on this and display the unleaded pricc on their roadside displays. Displaying prices by the roadside is not compulsory, but most garages do so, and where they do, the regulations require dual display of the 4 star leaded price in both litres and gallons, even if the petrol is dispensed in litres, as most now is. Any other petrol price displayed must also be duplicated in litres and gallons, though the diesel price need not be. Given limited space on roadside displays, this is inhibiting the display of unleaded prices. A powerful source of publicity and trigger to awareness is thus missing.

4. Anecdotal evidence and surveys, such as that reported by Which in July, also suggest that the motor industry and car dealers are still failing to give the public adequate information about whether their cars can run on or be modified to take unleaded petrol. Too often dealer attitudes are lukewarm and advice of doubtful technical quality.

X 5. The oil industry have done their bit, by promoting outlets. They have recently put out the attached press release, which will be helpful if the media pick it up. But what is really needed is a concerted effort to get adjusted the 10m or so cars and vans which could run on unleaded but do not.

Suggested Action

4. DoE are the lead Department in the Government's promotion of unleaded petrol, and chair the Unleaded Petrol Group, which brings together the various interests, within and outside Government. We think their primary objective is growth in the number of garages selling unleaded petrol, rather than in consumption. If they are satisfied with growth in outlets, they may have eased up a little. If consumption remains depressed, we can foresee pressure for an even larger duty differential at future Budgets. Our view is that the existing price differential must rather be exploited to best

effect, to secure significant market share for unleaded petrol. We therefore think it opportune for you to write to your Ministerial colleagues to give a push to further measures to encourage consumption, and a draft is attached.

P JEFFERSON SMITH

DRAFT

ECONOMIC SECRETARY TO COLIN MOYNIHAN, PARLIAMENTARY UNDER SECRETARY DEPARTMENT OF THE ENVIRONMENT

PROMOTING UNLEADED PETROL

In our correspondence about unleaded petrol around Budget time this year, we looked forward to a growth in both outlets and consumption, following the Chancellor's initiative in increasing the duty differential, which made the unleaded product 6 pence a gallon cheaper than 4 star leaded petrol.

Outlets have indeed been increasing rapidly, and the industry now estimates that 10 per cent of UK outlets should be stocking unleaded by the end of the year. But consumption, currently below 1% of the petrol market, is growing at a disappointing rate. I am struck by how low is the public awareness of the advantages of unleaded petrol. UKPIA has just put out a press release captioned "Why motorists turn down £2m a week."

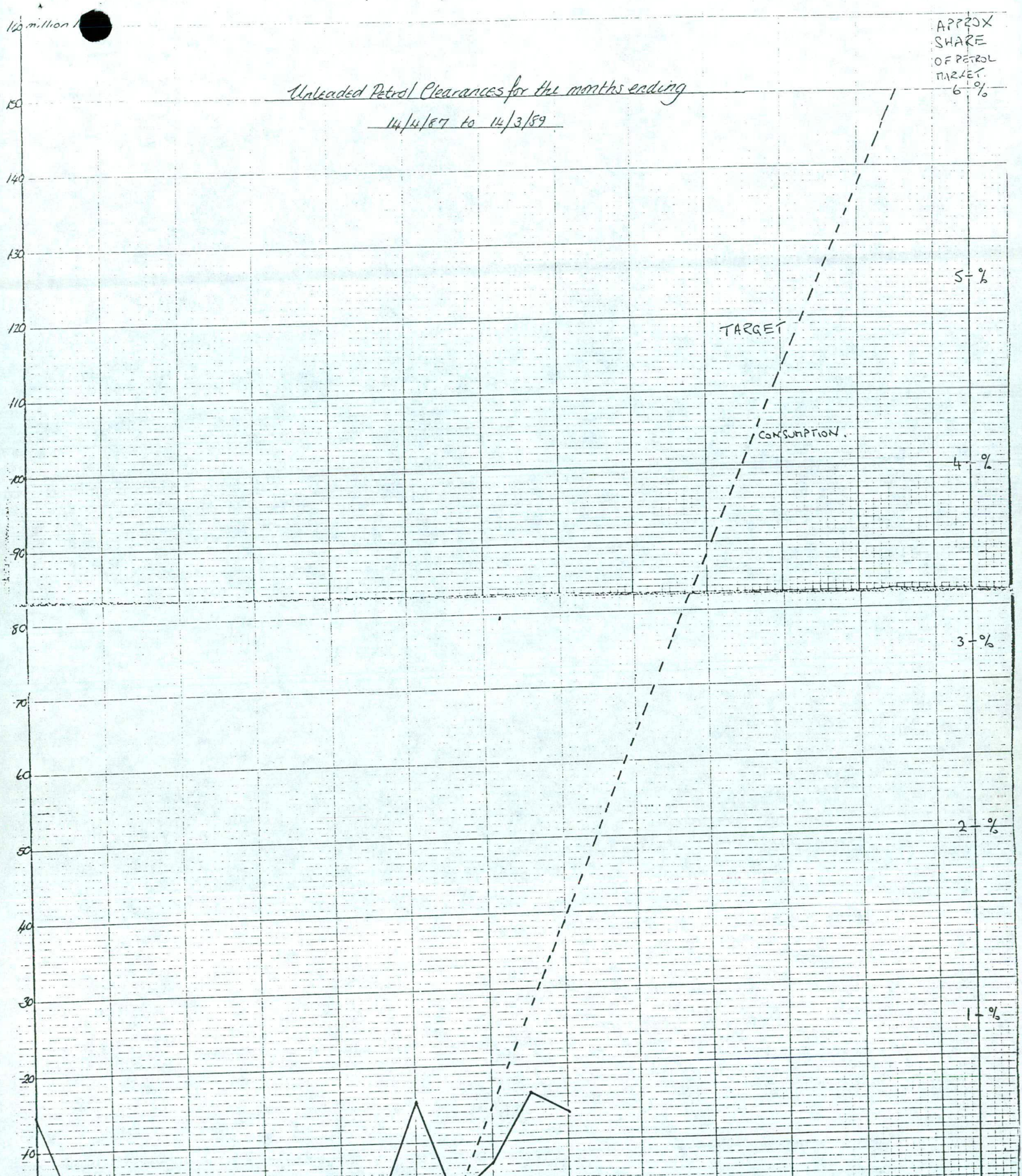
One of the reasons for this lack of awareness is no doubt that very few garages display the price of unleaded petrol at the roadside. Price display would be a powerful encouragement to consumption, and a spur to the unconverted to check with their dealers whether their car could run on or be modified to take unleaded petrol. Its absence may stem from the regulatory requirements of the Price Marking (Petrol) Order. I understand that where a garage chooses to display prices at the roadside the only compulsory element is the 4 star leaded price, but that any petrol price display must be duplicated in both litres and gallons, even where the pumps dispense in litres, as most now do. This surely is a restriction which we could remove.

The quality of advice given out by motor dealers about which cars can run on or be modified to take unleaded petrol also still leaves much to be desired, as a recent Which follow-up survey concluded. There must be more that Government can do to encourage the motor industry and car dealers to get their act together and provide encouraging and accurate advice to enquiries from the public.

The Chancellor has made a substantial structural change to the petrol duty in order to encourage the rapid growth in unleaded petrol use. I am anxious that his initiatives should be seen to be successful. There is still more that Government can do by way of deregulation and exhortation, at little or no cost, and I would be glad to have your reaction to the points I have put forward. This is an area where we cannot afford to miss tricks.

I am copying this letter to Peter Bottomley at Transport, to Peter Morrison at Energy, and to Francis Maude at Trade and Industry.

PETER LILLEY



Unleaded Petrol Clearances for the months ending
14/4/87 to 14/3/89
160 million l
150
140
130
120
110
100
90
80
70
60
50
40
30
20
10
APPROX SHARE OF PETROL MARKET.
6 %
5 %
4 %
3 %
2 %
1 %
0
TARGET
CONSUMPTION.
14/4/87
14/5
14/6
14/7
14/8
14/9
14/10
14/11
14/12
14/1/88
14/2
14/3
14/4
14/5
14/6
14/7
14/8
14/9
14/10
14/11
14/12
14/1/89
14/2
14/3
14/4

UNITED KINGDOM PETROLEUM INDUSTRY ASSOCIATION

6 July 1988

PRESS RELEASE For immediate release

WHY MOTORISTS TURN DOWN £2M A WEEK

British motorists are throwing away £2 million a week by not switching to unleaded petrol, it was claimed today.

And it is all because they don't realise that cars re-tuned to use unleaded will also run on ordinary petrol as well.

"It is a basic misunderstanding and it is costing the motorist a fortune", says Ian Berwick of the UK Petroleum Industry Association.

"Although sales are rising, there are still seven million cars that could run on unleaded petrol with just a minor re-tune.

"Since the Budget unleaded is nearly 6p/gallon cheaper than 4-star and the number of service stations selling it has doubled to 1,464 and should pass 2,000 by the end of the year."

The Association urges motorists to check with their car manufacturer or main dealer to see if their cars can be adjusted.

Enquiries to: Dr I D G Berwick, Director General
Mr A H Fox, Executive Director 01 240 0289

Unleaded petrol– the fuel for now

Unleaded petrol is not only easier on the environment – it can be easier on your pocket, too. But getting information about whether your car can use unleaded fuel isn't so easy

In his March budget, the Chancellor of the Exchequer put up the duty on leaded petrol by around 5p per gallon, and left the duty on unleaded unchanged – a measure we'd pressed him to take (see *Which?*, February 1988). In theory, unleaded petrol should now cost less than 4-star leaded. To find out if that change has filtered through to the pumps, we checked the prices at 70 garages in Greater London, East Anglia, the Midlands and Scotland for the same week in April. Only a few garages weren't reflecting the full price difference at their pumps (though we have heard since of other garages not offering any great saving on unleaded). On average, in our survey, unleaded petrol was just over 6p per gallon cheaper than 4-star; and 2.4p less per gallon than 2-star.

But, as our survey of motorists for the February report showed, people are worried about the implications of 'going unleaded'. Will it damage their car? Will they be able to use leaded petrol as well, if they can't find somewhere selling unleaded?

A growing number of new cars can use either leaded or unleaded, just as you choose, without any adjustment. Many others can easily be converted to run on both unleaded and leaded – usually it's a simple matter of having the engine timing retarded by a few degrees, so it ought to be a cheap and quick job. Yet unleaded *still* makes up a tiny fraction of all petrol sales in the UK – just 0.41%.

Despite this, the number of petrol stations stocking unleaded has grown, since the beginning of this year, from around 600 to over 1,000 – but the low level of sales is bound to slow down the growth in unleaded's distribution. If the UK Government's target of widespread availability of unleaded by October 1989 is to be met, it's clear that demand is going to have increase vastly. The Chancellor's taken the first step to encourage people to use the fuel. Now it's up to motorists to find out if their car can run on unleaded – and dealers to make it easy for them to do so.

Finding out about your car

A month or so after the Budget, we re-ran an exercise we carried out for our February report on unleaded petrol. We asked 10 people to ring up the manufacturer of their car, their own franchised dealer and two other dealers franchised to that make, to ask whether their car could run on, or be adjusted to run on, unleaded petrol.

Last time, we found, the results 'discouraging'. And again, this time, even on the most basic question of whether a car could run on unleaded petrol without adjustment, not all our motorists got the same advice from everybody.

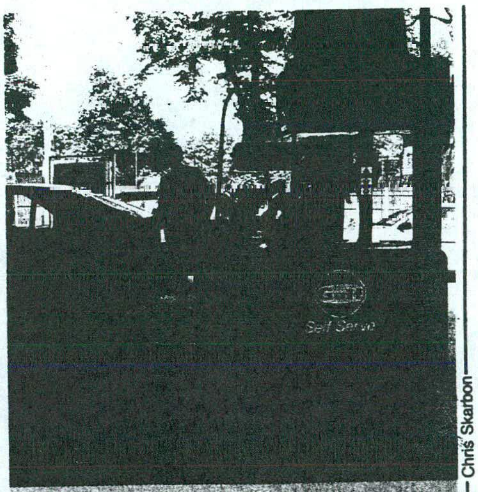
In the wake of the Budget and significant advertising in the press by the petrol companies, we had hoped that car manufacturers and all their dealers would have got their act together – and started offering consistent and accurate advice on using unleaded petrol. The quality of *some* of the advice is fine: the owner of a Nissan car in the E category (see Box) was told, correctly, by the manufacturer and all three dealers that his car can run on either leaded or unleaded petrol without adjustment. But of our ten volunteers, some got advice they felt much less confident about following – and that applies to owners of new cars just as much as those owning older models.

Out of 20 enquiries about R-cars (see Box) owners were told on four occasions that their cars could use unleaded without adjustment – a potentially costly mistake. On four occasions, drivers of L-cars were told their cars could be adjusted – they can't. And the owner of a Montego – an L-car – was told by two dealers that it could be converted by fitting a catalytic converter at a cost of £300-500. These are already fitted to some cars to reduce exhaust emissions, and *these* cars must use unleaded (ie, U-cars: see Box), as leaded petrol damages the catalysts. But fitting a converter won't do anything to change the nature of an engine which cannot run on unleaded and cannot be adjusted to do so.

If the experiences of our volunteers are anything to go by, the manufacturers are, on the whole, giving out accurate advice. But the advice offered by dealers leaves something to be desired.

As things stand, it's up to the manufacturers to make sure that all of their dealers know about the cars they're selling, and about their older models. Some seem to have done a good job of giving their dealers comprehensive and accurate information on the subject. Others however, have had far more limited success. Our disappointing experience may be because some of our volunteers weren't put through to their dealer's service department.

Ideally, you should be able just to make a phone call and find out if your car can be adjusted, but at the moment it looks as if you're safer to take your car to your dealer. Or, as a last resort, you could ring up the technical department of your car's manufacturer or importer. When you phone, you should have full details of your car, including its engine number or type to hand.



Chris Skarbon

Wrong information from a dealer

Stephen Locke runs a 1986 Citroën BX14E. It's a relatively new car – so he was disappointed to discover from Citroën UK's technical department that it can't run on unleaded petrol, nor can it be adjusted to do so. (Some Citroën BXs can run on unleaded, with adjustment, but not this particular model). But he was much more disappointed at the information he got from his local dealers where he had been a customer for years – they replied, without hesitation, that the car could run on unleaded, with a timing adjustment, at a cost of £38 plus VAT. If he had had the work done, he would certainly have been wasting his money, and quite possibly risking engine damage by using unleaded.

A second dealer gave a similar answer, and offered to do the job for £25.50 plus VAT – though they did point out that, if the engine 'pinked' on a subsequent road test, it might not be possible to use unleaded. Initially, a third dealer thought the car could be adjusted, too, and changed his mind only after consulting his papers to check the price. So, if you ask your dealer for advice, make sure he checks the records properly.

The RULE code

R REFER TO DEALER before using unleaded petrol. Can be adjusted to use unleaded petrol, or can use it with special precautions, eg using leaded petrol every fifth tankful. Do not use unleaded without consulting your dealer, or manufacturer. Over half the cars on the road at the end of 1987 were in this category.

U Must only use UNLEADED petrol. Applies to cars fitted with catalytic converters.

L Must only use LEADED petrol. Using unleaded petrol will result in serious engine damage to these cars. This applied to around a third of cars at end-1987, but the proportion is declining.

E Can use EITHER unleaded or leaded petrol. Can run on either fuel without any adjustment – around one in 10 cars at the end of 1987. A list of E-cars on the road in late 1987 was published in *Which?*, February 1988, p78.

HOWELL 13/7

Ralph Howell,

House of Commons,
London SW1A 0AA

13th July 1988

Rt Hon Nigel Lawson MP
Chancellor of the Exchequer

Dear Nigel,

I wrote to you on 17th May asking fcr information on the Economic Progress Repcrt of February regarding food and cereal prices. I cannot trace having received a reply and look forward to receiving this information at an early date.

Yours ever
Ralph

14/7

HM TREASURY — MCU

RECD	15 JUL 1988
ACTION	Ms. S. Symes.
SIGNATURE	
REF No.	

PERSONAL AND CONFIDENTIAL

SECRETARY OF STATE FOR EMPLOYMENT

Caxton House Tothill Street London SW1H 9NF

Telephone Direct Line 01-273 5803
Switchboard 01-273 3000 Telex 915564
GTN Code 273 Facsimile 01-273 5124

Paul Gray Esq
10 Downing Street
LONDON
SW1A 2AA

13 July 1988

Dear Paul,

RETAIL PRICES INDEX

... I enclose a copy of our note and draft press release on the Index of Retail Prices due to be released at 11.30 pm on Friday 15 July.

Numbered copies also go to Alex Allan (Treasury), Sir Peter Middleton (Treasury), Neil Thornton (Trade and Industry), Sir Brian Hayes (Trade and Industry), Andrea Large (CSO), John Footman (Bank of England), and Paul Cuthbert-Brown (CO).

Sincerely
Beverley Evans

BEVERLEY EVANS
Private Secretary

PERSONAL AND CONFIDENTIAL

13/7/88

2

GENERAL INDEX OF RETAIL PRICES : JUNE 1988

The annual rate of inflation, as measured by the 12-month change in the retail prices index, rose to 4.6 per cent for June from the 4.2 per cent recorded for May.

2. The overall level of prices was 0.4 per cent higher in June than in May. This compares with no change in the levels recorded for the corresponding months last year. Prices for motor vehicles, non seasonal foods, petrol and clothing were higher in June and the third tranche of the recent price increases for electricity and gas took effect. Seasonal food prices were on average lower.

3. For July the annual rate of inflation seems likely to increase towards 4¾ per cent. The overall level of prices is likely to remain unchanged between June and July, whereas a fall of 0.1 per cent was recorded between the corresponding months last year. The final tranche of the effects of higher prices for electricity and gas will feed through in July. Seasonal food prices are expected to drop sharply, and prices for durable goods and for clothing and footwear are expected to fall.

4. There is speculation that the mortgage rate will rise by 1-1½ percentage points for 1 August. A rise of 1 point would add around 0.4% to the all items index.

Producer Prices

5. The latest figures on prices for materials and fuels purchased by manufacturing industry suggest an acceleration in inflationary pressures. After seasonal factors have been taken into account these prices have risen by 5 per cent in the three months to June compared with no change over the previous nine months. This is in part due to higher costs for the food industry: normally these costs would fall in the summer months. The annual rate of increase in these manufacturers' costs rose to over 5 per cent for May and was 5 per cent for June.

6. The annual increase in the price index for home sales of manufactured products rose to 4.6 per cent for June (the highest rate for 2 years) from 4.3 per cent for May. Higher meat prices contributed to a monthly increase of 0.3 per cent in this index.

Tax and Prices Index

7. The tax and price index increased by 2.5 per cent in the year to June compared with 2.1 per cent is recorded for May.

International comparisons

8. The latest 12-month percentage changes in consumer prices in the main OECD countries and the averages for all EEC and OECD countries are as follows:-

	UK	FRANCE	FEDERAL GERMANY	ITALY	NETHER -LANDS	JAPAN	USA	CANADA	OECD Averages	EEC Averages
1987										
Q2	4.2	3.4	0.1	4.2	-1.0	-0.2	3.8	4.6	3.9	3.0
Q3	4.3	3.4	0.6	4.9	0.2	0.1	4.2	4.5	3.7	3.3
Q4	4.1	3.2	1.0	5.3	-0.1	0.4	4.5	4.2	4.0	3.3
1988										
Q1	3.3	2.4	0.8	5.0	0.5	0.6	4.0	4.1	3.6	2.4
Q2	4.2									
1988										
January	3.3	2.4	0.7	5.0	0.6	0.7	4.0	4.1	3.5	2.9
February	3.3	2.4	0.9	5.0	0.5	0.6	3.9	4.1	3.5	2.9
March	3.5	2.5	1.0	4.9	0.6	0.5	3.9	4.1	3.6	3.0
April	3.9	2.5	1.0	5.0	0.7	0.0	3.9	4.0	3.5	3.0
May	4.2	2.5	1.1	4.9	0.7	-0.1	3.9	4.1	3.5	3.1
June	4.6									

STATISTICS DIVISION
DEPARTMENT OF EMPLOYMENT

13th July 1988

RPI/jly-88 CONFIDENTIAL

FROM: R DEANE
DATE: 13 JULY 1988

P.N.S 13.vii

1. MR P N SEDGWICK
2. CHANCELLOR OF THE EXCHEQUER

cc : PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Paymaster General
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame A Mueller
Mr Scholar
Mr Lankester
Mr Monck
Mr H Phillips
Mr Odling-Smee
Mr C W Kelly
Mr Sedgwick
Mr S J Davies
Mr Gieve
Ms Seammen
Mr Bush
Mr Mowl
Mr Pickford
Mr de Berker
Mr Hudson
Mr Patterson
Mr Cropper
Mr Tyrie
Mr Call

THE JUNE RPI (to be published at 11.30 am on Friday 15 July)

The RPI rose to 106.6 in June. The annual inflation rate was 4.6 per cent, a rise from 4.2 per cent in May. Excluding mortgage interest payments, the June figure rose to 4.7 per cent from 4.4 per cent the previous month.

2. The RPI rose by 0.4 per cent between May and June, it was unchanged between May and June last year. The price increases were fairly widely spread but were notably higher for motoring and energy (as the third tranche of gas and electricity price increases came through).

3. The outcome for June was only a little higher than expected, last month we forecast 4.5 per cent. We can expect another rise in inflation next month, probably to just under 4¾ per cent. The final tranche of the electricity and gas price increases will come through next month. The outlook further ahead will be heavily influenced by mortgage interest rates. Mortgage interest rates will probably rise by 1 to 1½ per cent in August. A one per cent rise will add around 0.4 per cent to the all-items index.

The actual outturn of inflation has been higher than that forecast in the Budget, as the table below shows. The figure excluding MIPS is higher than the increase in the all items index.

RPI Inflation
Percentage increase on previous year

	Budget Forecast		Actual	
	Total	Total ex. MIPS*	Total	ex. MIPS*
April	3.6	3.9	3.9	4.2
May	3.9	3.9	4.2	4.4
June	4.2	4.1	4.6	4.7
July	4.2	4.2	4.7+	4.9+

* Excluding mortgage interest payments.
\+ Current forecast.

About 0.1 per cent of the under-estimate is due to the gas price rise taking place in April, rather than July as in previous years. But prices generally have risen faster than we expected.

5. City forecasters on average are again expecting a smaller rise in inflation between May and June than actually occurred; their expectations of the increase in the level of the RPI range between 0.1 and 0.4 per cent. The actual increase is 0.4 per cent.

6. **Point to Make**

- As noted in Chancellor's speech to Cities of London and Westminster Annual Luncheon, bound to be fluctuations in RPI - and the rise in mortgage rates will inevitably impart a temporary blip. But commitment to bear down on inflation is absolute as recent increases in interest rates testify.

Robert Deane

ROBERT DEANE
EA1 DIVISION
X 5401

CHANCELLOR OF THE EXCHEQUER

Ch

Terry has made a few changes, including some to take account of Peter's points, which you may want to reverse.

I have marked a few v minor points on this version (marked up original below).

AA

Thanks. A few final changes.

CONFIDENTIAL

From: SIR PETER MIDDLETON

Date: 13 July 1988

SIR T BURNS

cc Chancellor
Mr Scholar
Mr Odling-Smee
Mr Sedgwick

A fair pt, tho' shd we not argue that we have already shown this: we have.

PAPER FOR THE PRIME MINISTER

I have two comments on your note, both of which I am sure will come up when we see the Prime Minister.

2. First, we appear to have lost sight of the objective of stable prices, at least for the foreseeable future. If we get back to the centre of the M0 ranges shown in the MTFS as a reasonable measure of the need to tighten policy, could we not then expect to be on a track which will lead to lower inflation than 4% during this administration? It follows that I should like to see the reference in the final paragraph changed from the need to ensure no easing in the anti-inflationary stance to one in which we have a strengthening of the position.

3. Second, I did not find the juxtaposition of paragraphs 26 and 27 very helpful. You can hardly say that running a larger public sector surplus over the medium term in response to a medium term change in private sector savings and investment behaviour is a return to demand management - at least of the sort practised in the 1960s. Nor need it mean foregoing the benefits of lower taxation. It simply limits the extent to which taxes can be reduced in the interests of fiscal prudence.

But I disagree with the second, & see no reason to amend this bit.

There is something in the first of these two pts (tho' not as much as Peter thinks: what are Sir TB's views?) & we could certainly put the words I have marked in square brackets.

P E MIDDLETON

Chancellor,
I attach my latest version of this note - with a table and chart.

Are you content for it to be in this form or would you like it expanded?

CONFIDENTIAL

ECONOMIC SITUATION

Output and Demand

1. The economy has continued to perform well. We seem to be heading for another year of 4 percent growth.

2. It is now widely acknowledged that supply performance has improved. The clearest sign is that productivity continues to grow at an exceptional rate. The supply reforms introduced since 1979 have been largely responsible for this improvement.

3. Even so demand growth has outpaced the sustainable rate of output growth. And by even more than we expected at Budget time despite the maintenance of high real interest rates and the tightness of fiscal policy. This rapid growth of demand has been accompanied by a further deterioration of the current account of the balance of payments. There has also been some worsening of indicators of domestic monetary conditions; for example MO and house prices.

4. It is now clear that the stock market crash has not had the adverse effects on spending that many people feared - thanks large part to the prompt action taken by the authorities of the major nations in reducing interest rates.

5. In addition the huge inflow of capital into the UK over the past year has increased domestic demand and contributed to the current account deficit. This inflow is a reflection of confidence in UK economic performance but it has increased the problems of economic management.

6. Some of the domestic demand growth is welcome. Higher profitability and fuller utilisation of capacity have produced a long overdue investment boom which, in time, will improve supply capacity and improve track performance in the future.

7. More worrying has been the continued rapid growth of consumption. The personal sector savings ratio appears to have declined further.

8. But this falls short of a full explanation - the situation is complicated by the poor quality of the statistics; it may mean that consumption, investment, or exports could all be stronger than is being measured.

9. We expect some slowdown of domestic demand and output over the next year especially in the light of the recent monetary tightening - but inevitably there are major uncertainties.

Inflation

10. Inflation as recorded by the RPI is expected to rise to 5½ per cent by end of this year. It may peak in mid-1989 at over 6 per cent before declining during the second half of the year. By 1990 the forecast shows inflation back to about 4 per cent.

11. The inflation profile is heavily influenced by changes to the mortgage rate: this is a damaging anomaly as a tightening of monetary policy initially puts up measured inflation. Mortgage rate effects may be adding more than 1 per cent to recorded inflation in mid-1989. Excluding mortgage interest rates, inflation shows a much flatter profile (see table 1).

12. World commodity prices are also having an influence on inflation. They have been rising very rapidly, albeit from a very low level. It is not only in the UK that analysts underestimated the effect of the stock market crash.

13. General cyclical pressures are also pointing to higher inflation: it is normal for inflation to shadow the economic cycle but with a lag.

14. The task now is to make doubly sure that we keep downward pressure on the underlying inflation rate.

15. We have wanted to tighten domestic monetary policy for some time now. But this was hampered by the strength of sterling and the dangers of an exchange rate 'bubble' emerging. Since the pressure on sterling has eased it has been possible to increase interest rates by 2½ per cent, and they may well have to go higher. We will need to watch carefully the trend of MO.

16. It is important to dampen the housing boom which has been an important factor in credit creation. Higher mortgage rates are a crucial part of the tightening of monetary policy.

17. Some argue that higher interest rates will do nothing to slow growth of credit. But they have an important effect on mortgage monthly payments which will absorb spending power. And higher interest rates mean a higher return to savers which should act as an incentive.

18. The projections for the next year or so have some clear similarities with the inflation 'blip' in 1985 - some temporary increase in general inflationary pressures combined with the short-term adverse consequences for the RPI of higher mortgage rates.

Balance of Payments

19. The forecast shows a current account deficit for this year - and the next two years, although distant-year forecasts are highly uncertain - of close to 2 per cent of GDP. The sharp deterioration this year has a number of aspects: the rundown of oil revenues; the rapid growth of UK domestic demand relative to other countries; and the pressure on industrial cost competitiveness stemming from the large capital inflows and the strength of sterling.

20. This outlook for the current account coincides with a progressive tightening of fiscal policy. For this year it now seems we will have a public sector debt repayment of £7 billion. Even excluding privatisation proceeds we look like having a Budget surplus.

21. It follows that the current account deficit is the counterpart of a private sector deficit; in other words the investment being undertaken by the private sector exceeds its own internally generated savings. Part of the investment is being financed by a net inflow of capital from overseas.

22. This pattern is unfamiliar. The UK private sector has hitherto been in sustained surplus since the early 1950s. (Between 1946 and the early 50s there was a private sector deficit following the exceptionally high liquidity accumulated during the war).

23. But in a world of mobile capital there is no iron law that some countries run private sector surpluses and others private sector deficits. The pattern can change and depends upon the investment opportunities available as well as savings behaviour.

24. A large part of the move into deficit reflects a rising investment ratio. This can be attributed to higher productivity, higher profitability and higher utilisation of capacity.

25. Part of the deficit also seems to reflect a lower private sector savings ratio, and particularly a sharply declining personal sector savings ratio. We expected low inflation to reduce the savings ratio but have been surprised by the extent of the fall. The buoyant housing and mortgage market has almost certainly played a part. Our view is that there are some temporary factors at work. In time we will see some correction.

26. Part of the strength of investment and the weakness of savings is probably cyclical. It is a reflection of the surprising strength of demand both at home and overseas. The tightening of monetary policy to keep underlying inflation on a downward path should, in time, reduce the current account deficit. But part of the current deficit may reflect medium-term trends in savings and investment behaviour and be sustained for some years. But by its nature a private sector deficit is unlikely to become very large. Its scale is limited by the willingness of lenders to finance it and of borrowers to take on increasing debt service obligations.

27. If this is the case what is the role of government? One theoretical possibility is to run even larger budget surpluses to compensate for the private sector deficit. But this amounts to a return to demand management and means foregoing the lasting supply side benefits of lower taxation. It would also in practice lead to irresistible pressure for long-term Public Expenditure.

28. A second possibility is to encourage a lower exchange rate. This would be a serious error; it would be inflationary and disrupt the smooth flow of international capital. We must make clear that we reject this route.

29. A third possibility is a return to credit controls in an attempt to increase private sector savings. But this would be impossible given today's flexible and innovative financial markets.

30. The conclusion must be that we should concentrate on keeping our own house in order and in particular making sure that there is no easing of our anti-inflationary stance. It may be uncomfortable for us that the private sector runs a current account deficit, but it will correct itself in time and any attempt by us to act to correct it risks making things a good deal worse by destroying confidence.

July 1988

Table 1

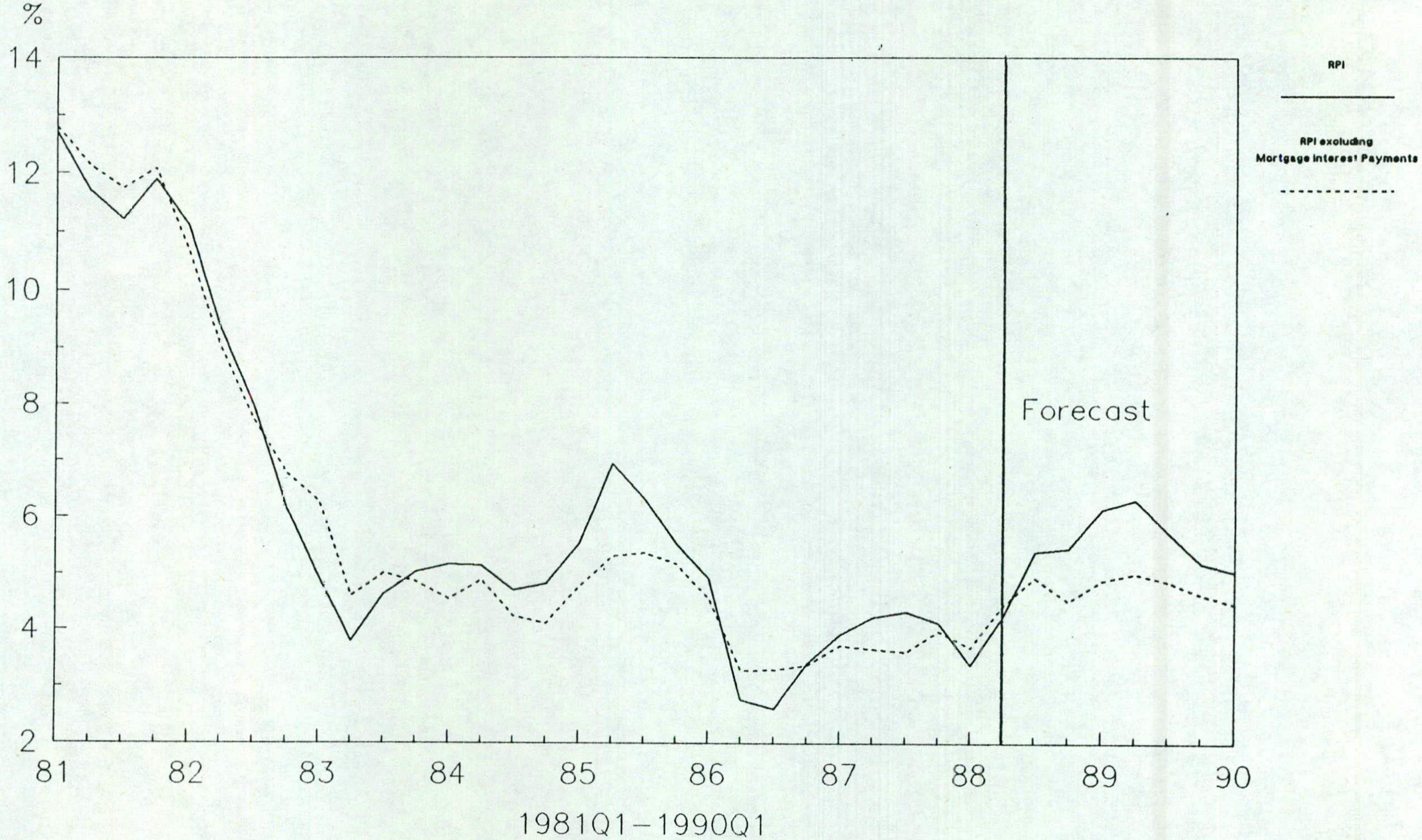
Inflation

	RPI Total	RPI excluding mortgage payments
1982	8.6	8.5
1983	4.6	5.2
1984	5.0	4.4
1985	6.1	5.2
1986	3.4	3.6
1987	4.1	3.7
1988 F	4.6	4.4

(F: forecast)

RPI and RPI EXCLUDING MORTGAGE INTEREST PAYMENTS

4 QUARTER CHANGES



Forecast Values from variant on June Internal

Chancellor,

I attach my latest version of this note - with a table and chart.

Are you content for it to be in this form or would you like it expanded?

CONFIDENTIAL

ECONOMIC SITUATION

Seems OK to me (with a few changes, marks, & without graphs); don't see clear need for one with some supplementary graphs. Pst spk re this.

Output and Demand

1. The economy has continued to perform well. We seem to be heading for another year of 4 percent growth.

2. It is now widely acknowledged that supply performance has improved. The clearest sign is that productivity continues to grow at an exceptional rate. The supply reforms introduced since 1979 have been largely responsible for this improvement.

3. Even so demand growth has outpaced the sustainable rate of output growth. And by even more than we expected at Budget time despite the maintenance for most of the time of high real interest rates and the tightness of fiscal policy. This rapid growth of demand has been accompanied by a ~~further~~ sharp deterioration ~~of~~ in the current account of the balance of payments. There has also been some worsening of indicators of domestic monetary conditions; ~~for example MO and house prices.~~ and MO growth is currently well above the top of its target range.

4. It is now clear that the stock market crash has not had the adverse effects on spending that many people feared - thanks large part to the prompt action taken by the authorities of the major nations in reducing interest rates.

5. In addition the huge inflow of capital into the UK over the past year has increased domestic demand and contributed to the current account deficit. This inflow is a reflection of confidence in UK economic performance but it has increased the problems of economic management.

6. Some of the domestic demand growth is welcome. Higher profitability and fuller utilisation of capacity have produced a long overdue investment boom which, in time, will ~~improve~~ enhance supply capacity and improve ~~track~~ economic performance. ~~in the future.~~

7. More worrying has been the continued rapid growth of consumption. The personal sector savings ratio appears to have declined further.

8. But this falls short of a full explanation - the situation is complicated by the poor quality of the statistics; it may mean that consumption, investment, or exports could all be stronger than is being ~~measured.~~ officially recorded.

9. We expect some slowdown of domestic demand and output over the next year especially in the light of the recent monetary tightening - but inevitably there are major uncertainties.

Inflation

10. Inflation as recorded by the RPI is expected to rise to 5½ per cent by end of this year. It may peak in mid-1989 at over 6 per cent before ~~declining during the second half of the year. By 1990 the forecast shows inflation back to about 4 per cent~~ resuming its downward trend.

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13. General cyclical pressures are also pointing to higher inflation: it is normal for inflation to shadow the economic cycle but with a lag.

14. The task now is to make doubly sure that we keep downward pressure on the underlying inflation rate.

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24. A large part of the move into deficit reflects a rising investment ratio. This can be attributed to higher productivity, higher profitability and higher utilisation of capacity.

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26. Part of the strength of investment and the weakness of savings is probably cyclical. ~~It is a reflection of the surprising strength of demand both at home and overseas.~~ The tightening of monetary policy to keep underlying inflation on a downward path should, in time, reduce the current account deficit. But part of the current deficit may reflect medium-term trends in savings and investment behaviour and be sustained for some years. But by its nature a private sector deficit is unlikely to become very large. Its scale is limited by the willingness of lenders to finance it and of borrowers to take on increasing debt service obligations.

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July 1988

Table 1

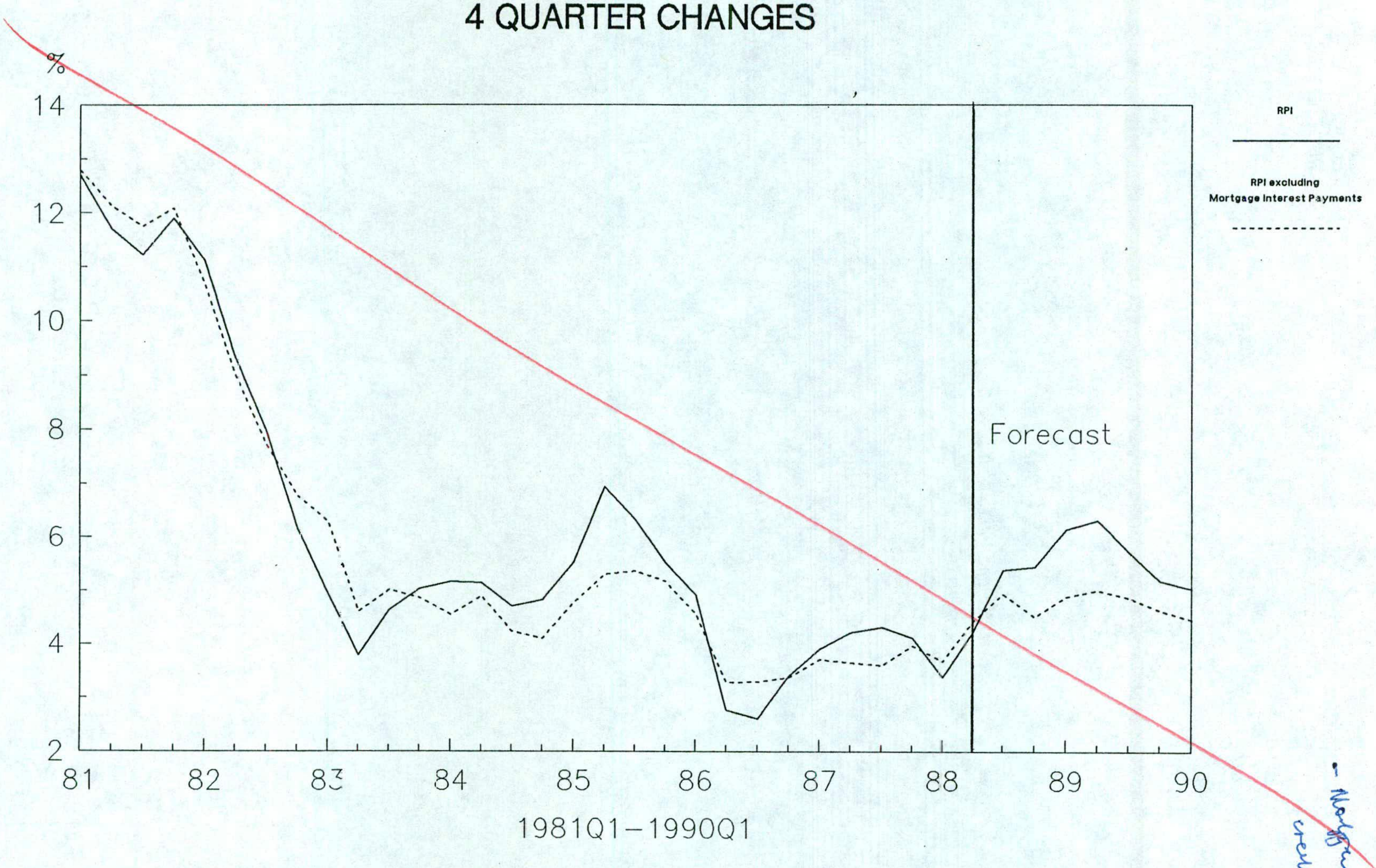
Inflation

	RPI Total	RPI excluding mortgage payments
1982	8.6	8.5
1983	4.6	5.2
1984	5.0	4.4
1985	6.1	5.2
1986	3.4	3.6
1987	4.1	3.7
1988 F	4.6	4.4

(F: forecast)

RPI and RPI EXCLUDING MORTGAGE INTEREST PAYMENTS

4 QUARTER CHANGES



Forecast Values from variant on June Internal

Figures to show what going on
- bank lending
- broad money
- consumer credit
- consumer spending
- Mortgage/w'drawals credit

a ** Some comments & some more. AA

~~Alex~~ This is my first attempt at an outline of a paper for the PM. It would be helpful if I could have some reactions overnight. TB. 11/7/88

SUMMARY

<u>Output and Demand</u>

1. Economy has continued to perform well. Another year of 4 per cent growth.

2. Supply performance has improved. Productivity growth continues at an exceptional rate. Supply policies have had effect.

Ballpoint

V. important. Only ... growth of demand ... cause of bop deterioration. In fact, even if dom. demand had grown @ sustainable rate, we would still have seen bop deterioration.

3. Even so demand growth has outpaced sustainable rate of growth. And by even more than we expected despite high real interest rates and the tightness of fiscal policy. This has ~~led to a~~ been accompanied by further deterioration of the current account of the balance of payments. There has also been some worsening of indicators of domestic monetary conditions; eg MO and house prices.

4. It is now clear that the stock market crash has not had the adverse effects on spending that many people feared - thanks in large part to the prompt action taken by the authorities of the major nations in reducing interest rates.

5. In addition the huge inflow of capital into the UK over the past year has increased domestic demand [and damaged exports by pushing up the exchange rate and reducing interest rates.] This inflow is a reflection of confidence in UK economic performance but it has increased the problems of economic management.

6. Some of the domestic demand growth is welcome. Higher profitability and fuller utilisation of capacity have produced a ~~huge~~ long overdue investment boom which, in time, ~~should~~ will improve supply capacity.

Don't like this formulation, esp [ ]. XR is up a little (hasn't risen much), & more important we don't want to appear to be preaching devaluation. Nor are interest rates all that low now: roughly the average of the past 5 yrs. Point is that cap inflow (good market opportunities in UK, among other things) has a ... counterpart ... deficit.

7. More worrying has been the continued rapid growth of consumption. The personal sector savings appear to have declined further.

8. But this falls short of a full explanation - the situation is complicated by the poor quality of the statistics; it may mean that consumption, investment, or exports could all be stronger than is being measured.

10. We expect some slowdown of domestic demand and output over the next year - but inevitably there are major uncertainties.

esp since ~~tight~~ monetary tightening

Inflation

as recorded by the RPI

10. Inflation is expected to rise to 5½ per cent by end of this year. It may peak in mid-1989 at over 6 per cent before declining during the second half of the year. By 1990 the forecast shows inflation back to about 4 per cent.

11. The inflation profile is heavily influenced by changes to the mortgage rate: this is a damaging anomaly as a tightening of monetary policy initially puts up measured inflation. Mortgage rate effects may be adding more than 1 per cent to (recorded) inflation in mid-1989. Excluding mortgage interest rates, inflation shows a much flatter profile.

[Provide updated version of table in para 2 of FB paper of 23/3]

12. World commodity prices are also having an influence on inflation. They have been rising very rapidly, (albeit from a v. low level) It is not only in the UK that analysts underestimated the effect of the stock market crash.

13. General cyclical pressures are also pointing to higher inflation: it is normal for inflation to shadow the economic cycle but with a lag.

dangerous ?

14. On the other hand the exchange rate has been a restraining influence: this operates directly through import prices; and indirectly through pressure on margins. Both export and import prices have been restrained.

15. The task now is to ~~ensure~~ make doubly sure that we keep downward pressure on the underlying inflation rate.

16. We have wanted to tighten domestic monetary policy for some time now. But this was hampered by the strength of sterling and the dangers of an exchange rate 'bubble' emerging. Since the pressure on sterling has eased it has been possible to increase interest rates by 2 1/2 per cent, and then ~~We do not yet know if that will be enough. We can judge in time by effect on MO. Interest rates~~ may still have to go higher. We will need to watch carefully trend of MO.

17. It is important to dampen the housing boom which has been an important factor in credit creation. Higher mortgage rates are a crucial part of the tightening of monetary policy.

18. Some argue that higher interest rates will do nothing to slow growth of credit. But they have an important effect on mortgage monthly payments which will absorb spending power.

thought that higher returns to savers help as well

19. The projections for the next year or so have some clear similarities with the inflation 'blip' in 1985 - some temporary increase in general inflationary pressures combined with the short-term adverse consequences for the RPI of higher mortgage rates.

tho' distant year f'casts highly uncertain

Balance of Payments

20. The forecast shows a current account deficit for this year - and the next two years - of close to 2 per cent of GDP. The sharp deterioration this year has a number of aspects: the rundown of oil revenues; the rapid growth of UK domestic demand relative to other countries; and the pressure

on industrial cost competitiveness stemming from the large capital inflows and the strength of sterling.

21. This outlook for the current account coincides with a progressive tightening of fiscal policy. For this year it now seems we will have a public sector debt repayment of £7 billion. Even excluding privatisation proceeds we ~~are~~ in ~~broad balance.~~ would we have a Budget surplus.

22. It follows that the current account deficit is the counterpart of a private sector deficit; in other words the investment being undertaken by the private sector exceeds its own internally generated savings. Part of the investment is being financed by a net inflow of capital from overseas.

23. This pattern is unfamiliar. The UK private sector has hitherto been in sustained surplus since the early 1950s. (Between 1946 and the early 50s there was a private sector deficit following the exceptionally high liquidity accumulated during the war).

24. But in a world of mobile capital there is no iron law that some countries run private sector surpluses and others private sector deficits. The pattern can change and depends upon the investment opportunities available as well as savings behaviour.

25. A large part of the move into deficit reflects a rising investment ratio. This can be attributed to higher productivity, higher profitability and higher utilisation of capacity.

26. Part of the deficit also seems to reflect a lower private sector savings ratio, and particularly a sharply declining personal sector savings ratio. We expected low inflation to reduce the savings ratio but have been surprised by the extent of the fall. The buoyant housing and mortgage market has almost

certainly played a part. Our view is that there are some temporary factors at work. In time we will see some correction.

27. Part of the strength of investment and the weakness of savings is probably cyclical. It is a reflection of the strength of demand both at home and overseas. The tightening of monetary policy to keep underlying inflation on a downward path should, in time, ~~correct some of the imbalance~~ reduce the C/A deficit. But ~~some~~ Part of the current deficit may reflect medium-term trends in savings and investment behaviour and be sustained for some years.

Need to inject sense of not unlimited in scale (as Terry said @ this afternoon's meeting)

27. If this is the case what is the role of government? One theoretical possibility is to run even larger budget surpluses to compensate for the private sector deficit. But this amounts to a return to demand management and means foregoing the supply side benefits of ~~the improved public expenditure performance~~ lower taxation. It would also in practice lead to irresistible pressure for higher public expenditure.

Tax cutting ?

28. A second possibility is to encourage a lower exchange rate. This would be a serious error; it would be inflationary and disrupt the smooth flow of international capital. We must make clear that we reject this route.

29. A third possibility is a return to credit controls in an attempt to increase private sector savings. But this would be difficult to achieve without reintroducing exchange controls and would be a major retreat.

Too feeble. Impossible given today's flexible & innovative financial markets

30. ~~The final option is to accept that private sector surpluses or deficits can be sustained without causing damage to the economy and concentrate upon maintaining anti-inflationary conditions combined with a balanced budget.~~

This the wrong note. Something like

"The conclusion must be that we should concentrate on keeping our own house in order, and in particular making sure that there is no easing of our anti-inflationary stance. It may be uncomfortable for us that the private sector runs a current account deficit, but it will correct itself in time and any attempt by us to act to correct it risks making things a good deal worse by destroying confidence

NBL — and there is no place for the higher PSBR

ECONOMIC SITUATION

Output and Demand

1. The economy has continued to perform well. We seem to be heading for another year of 4 per cent growth.

2. It is now widely acknowledged that supply performance has improved. The clearest sign is that productivity continues to grow at an exceptional rate. The supply reforms introduced since 1979 have been largely responsible for this improvement.

3. Even so demand growth has outpaced the sustainable rate of output growth. And by even more than we expected at Budget time, despite the maintenance for most of the time of high real interest rates and despite the tightness of fiscal policy. This rapid growth of demand has been accompanied by a sharp deterioration in the current account of the balance of payments. There has also been some worsening of indicators of domestic monetary conditions; and MO growth is currently well above the top of its target range.

4. It is now clear that the stock market crash has not had the adverse effects on spending that many people feared - thanks in large part to the prompt action taken by the authorities of the major nations in reducing interest rates.

5. In addition, the huge inflow of capital into the UK over the past year has increased domestic demand and contributed to the current account deficit. This inflow is a reflection of confidence in UK economic performance, but it has increased the problems of economic management.

6. Some of the domestic demand growth is welcome. Higher profitability and fuller utilisation of capacity have produced a long overdue investment boom which, in time, will enhance supply capacity and further improve economic performance.

7. More worrying has been the continued rapid growth of consumption. Although the strength of personal disposable income has been a major factor, a declining savings ratio has also played an important part.

8. But the recorded growth of investment and consumption falls short of a full explanation of the growth of demand. The situation is complicated by the poor quality of the statistics and consumption, investment, or exports could all be stronger than is being officially recorded.

9. We expect some slowdown of domestic demand and output over the next year, especially in the light of the recent monetary tightening - but inevitably there are major uncertainties.

Inflation

10. Inflation as recorded by the RPI is expected to average 5½ per cent in the fourth quarter of this year. It may peak in mid-1989 at over 6 per cent before resuming its downward trend.

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X 17. Some ~~urge~~ argue that higher interest rates will do nothing to slow growth of credit. But they have an important effect on mortgage monthly payments which will absorb spending power. And higher interest rates mean a higher return to savers which should act as an incentive to save. Higher interest rates will also restrain the growth of company spending, particularly on stocks.

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£1/4

~~Omit? £1/4 bn is v small relative to margin of error~~ ✓

20. This outlook for the current account coincides with a progressive tightening of fiscal policy. For this year it now seems we will have a public sector debt repayment of some £7 billion. In other words even excluding privatisation proceeds we look like having a Budget surplus.

21. It follows that any current account deficit is the counterpart of a private sector deficit; in other words the investment being undertaken by the private sector exceeds its own internally generated savings. Part of the investment is being financed by a net inflow of capital from overseas. (*) (* The story is, however, complicated by the residual error in the national accounts. The recorded figures show a private sector surplus. On the ~~reasonable~~ assumption that the public sector finances are measured reasonably accurately, either the private sector must be in deficit or the current account in balance.)

? move this to a footnote? yes

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27. If this is the case, what is the role of government? One theoretical possibility is to run even larger budget surpluses to compensate for the private sector deficit. To some degree this is what we have done with downward revisions to the PSBR path in successive edition of the MPTS. But before deciding to make a change in fiscal policy on these grounds, we must be sure that the private sector deficit will be sustained. Trying to adjust the budget deficit to short-term ~~savings~~ swings in private sector behaviour would be tantamount ~~amounts~~ to a return to old-style neo-Keynesian demand management. ~~and means~~ It would also mean foregoing the lasting supply side benefits of lower taxation, ~~It would also~~ and almost certain in practice lead to irresistable pressure for increased Public Expenditure.

Middleton

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amended to reflect Middleton.

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To some degree this is what we have done with downward revisions to the PSBR path in successive editions of the MTFS. ~~But~~ we must be sure that the ~~[illegible]~~ private sector deficit will be sustained. Trying to adjust the budget deficit to short term swings in private sector behaviour.

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30. The conclusion must be that we should concentrate on keeping our own house in order and in particular making sure that we pursue monetary policy in a manner that will deliver our objectives of stable prices ~~there is no easing of our anti-inflationary stance~~. It may be ~~uncomfortable~~ awkward for us that the private sector runs a current account deficit, but ~~it~~ this will correct itself in time and any attempt by us to act to correct it abruptly risks ~~risks~~ making things a good deal worse ~~by destroying confidence~~.

July 1988

30/9

PRIME MINISTER

PREPARATIONS FOR THE 1989 ECONOMIC SUMMIT

29/9/88

The French Sherpa, Jacques Attali, has summoned Sherpas to Paris on Saturday/Sunday 8/9 October for the first meeting to discuss the 1989 Summit. For the agenda, he has suggested:

1. progress in following up decisions taken at the Toronto Summit, and the economic and political situation;

2. possible themes for the 1989 Summit;

3. dates for the four Sherpa meetings which he has suggested;

4. protocol and procedural matters relating to the Paris Summit.

My United States colleague, Allan Wallis, has told Attali, that, in his view, the first two items are not suitable subjects for this first Sherpa discussion. The first - progress with decisions taken at Toronto - is not a proper function for the Sherpas because the Summit should not establish anything resembling a standing directorate. Wallis is also not able to discuss the second item - themes for the 1989 Summit, because of the imminent change in the Presidency.

I agree generally with Allan Wallis. The first item - follow up to the last Summit - would, no doubt, provide material for an interesting chat but is not <u>immediately</u> relevant to the preparation of the next Summit.

On the second item, it is too early to try to identify Summit themes. One important theme will be the cementing of the new Unites States Administration into the broad economic approach of past Summits. But plans to that end have to await the new President and his team and next summer's outlook for the world economy. Another important issue will be trade and agriculture - both because of the Uruguay round and as follow-up to the stress on structural questions which emerged at Toronto. But again much will depend on the new United States Administration. The French may want to use the Summit to launch some international financial initiative, perhaps on exchange rates or international debt. Environmental issues, touched on at previous Summits, may be rather more prominent at Paris. But it is too early to come to judgements here.

The real business for Attali's meeting lies under his last two agenda items. Four Sherpa meetings look to be exhorbitant. Allan Wallis has already said that the US would not be able to field a Sherpa for a meeting Attali suggests for January. In any event, that meeting looks unnecessary. Three Sherpa meetings before the Summit look ample.

Attali's discussion will also provide a useful opportunity to interrogate the French on how they intend to run the Summit. They seem to see it as an ingredient in the celebrations of the Bicentenary of the French Revolution. The French Foreign Minister is reported in "Le Monde" on 9 September as saying:

> "France will be host to next year's Economic Summit on 14 July 1989, the Bicentenary of the French Revolution ... the developing countries should also in some way be associated with these events, so as to give impetus to the dialogue".

I will ask Attali exactly what this means. We will need to ensure, tactfully, that the Summit is run as a time for business and not as a sideshow to the Bicentenary festivities.

I shall, of course, report the outcome of the discussions. But it would be helpful to have any particular points that you, the Foreign Secretary or the Chancellor of the Exchequer would wish to make.

I am copying this minute to the Private Secretaries to the Foreign Secretary, the Chancellor of the Exchequer and Sir Robin Butler.

N.L.W.

N.L. WICKS
29 September 1988

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FRENCH IDEAS ON MIDDLE INCOME DEBT

SUMMARY

1. SLIGHTLY MORE PRECISION ON FRENCH IDEAS. NEXT STEPS APPEAR TO BE TO AWAIT REACTIONS FROM OTHERS, AND TO DISCUSS IDEAS WITH MAIN CREDITOR COUNTRIES.

DETAIL

2. WE ASKED DE ROSEN (TRESOR) TODAY WHETHER HE COULD GIVE US ANY FURTHER DETAILS ON THE FRENCH IDEAS ON MIDDLE INCOME DEBT PUT FORWARD BY MITTERRAND IN HIS UNGA SPEECH YESTERDAY.

3. ROSEN SAID HE HAD NOT YET SEEN THE TEXT OF MITTERRAND'S REMARKS AND MIGHT NOT BE ENTIRELY UP TO DATE WITH THINKING IN THE ELYSEE. BUT HE SAID THAT THE TRESOR'S CURRENT THINKING WAS THAT THE INDUSTRIAL COUNTRIES SHOULD CONTRIBUTE THEIR SHARE OF A NEW (NORMAL) SDR ALLOCATION TO A SPECIAL FUND TO BE MANAGED BY THE IMF. THE FUND WOULD BE USED TO GUARANTEE BONDS OR OTHER INSTRUMENTS ISSUED BY HIGHLY-INDEBTED MIDDLE INCOME COUNTRIES, AT A DISCOUNT, IN EXCHANGE FOR EXISTING COMMERCIAL DEBT. ROSEN SAID THAT THE SCHEME WOULD NEED TO TAKE ACCOUNT OF ADJUSTMENT PROGRAMMES IN THE DEVELOPING COUNTRIES CONCERNED: IE SOME SORT OF CONDITIONALITY WOULD BE BUILT IN.

4. ROSEN SAID THAT THINKING HAD NOT YET GONE FURTHER THAN THIS. THERE WERE CLEARLY A LOT OF DETAILS TO SORT OUT, SUCH AS THE RATIO BETWEEN THE GUARANTEE FUNDS AND THE BONDS. HE THOUGHT THAT THE NEXT STEP WOULD BE TO AWAIT REACTIONS FROM CREDITOR AND DEBTOR COUNTRIES. ON CONSULTATION, ROSEN SAID THAT HE ENVISAGED DISCUSSIONS INITIALLY IN G5 OR G7 AND SUBSEQUENTLY THE PARIS CLUB. HE GAVE NO INDICATION OF ANY SEPARATE CO-ORDINATION WITH THE JAPANESE. HE ADDED THAT THE TRESOR WOULD HAVE LIKED TO HAVE SHARED IDEAS EARLIER, BUT HAD BEEN PRECLUDED FROM DOING SO AS THE PLAN WAS ESSENTIALLY MITTERRAND'S.

5. WE SHALL REPORT SEPARATELY ANYTHING FURTHER WE LEARN FROM THE ELYSEE.

6. ROSEN CONFIRMED, INCIDENTALLY, THAT HE WOULD BE REPLACING SCHNEITER AS FRENCH FINANCIAL COUNSELLOR IN LONDON WITH EFFECT FROM 1 NOVEMBER.

7. FCO PLEASE ADVANCE EVANS, WALSH (TSY), RICHARDSON (ERD), LOEHNIS (B/E)

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MR WICKS NO 10 DOWNING ST

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Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

30 September 1988

Russell Dixon Esq
Assistant Private Secretary to the
Secretary of State for Foreign and
Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
LONDON SW1

Dear Russell

I should be grateful if you could forward the enclosed letter from the Chancellor of the Exchequer to M Pierre Beregovoy.

Yours sincerely

A A Dight

A A DIGHT

chex.md/jt/42

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

30 September 1988

cc. CST
Sir G. Littler
Mr HP Evans
Mr Mountfield
Mr Walsh.
Mr PG. Davis
Mr May
Ms. Burton

M.Pierre Bérégovoy
Minister of Finance
Paris
France

Dear Pierre

Thank you for your message of 6 September about the International Fund for Agricultural Development.

Although I am not the Minister responsible for the UK's relations with IFAD, I understand that the OECD members of the Fund will meet in Hamburg on 1 October to discuss the latest prospects for its replenishment, and I welcome the importance you attach to maintaining the unity of our group.

I am sure that your ideas will be received by others as constructive, but I believe much will depend upon whether there are yet clear indications of future support for the Fund from its OPEC members and particularly from its largest donors.

I am passing a copy of your letter and this reply to Christopher Patten in our Overseas Development Administration, who is the UK Minister responsible for relations with IFAD.

Yours ever

Nigel

NIGEL LAWSON

week 26.9/hpe3 **CONFIDENTIAL**

FROM: H G WALSH
FROM: 30 SEPTEMBER 1988

PS/CHANCELLOR

cc Economic Secretary
Sir G Littler or
Mr Lankester
Mr Evans
Mr Mountfield
Mr Bottrill
Mr Davis
Mr Batt
Ms Life

Effectively, what this appears to boil down to is for G7 etc countries guaranteeing the middle-income debtors' interest payments to the commercial banks. Quite apart from this unacceptable transfer of risk from the banks to the western taxpayers, to what extent is this expected to relieve the debtors' interest payments as claimed by Mitterand ex?

FRENCH (MITTERAND) INITIATIVE ON MIDDLE INCOME DEBT

1. Further to my note of ~~26~~ 21 September, President Mitterand yesterday made a speech at the United Nations General Assembly which puts forward a new French initiative on the debt of middle income countries. A copy of the debt passage is attached to this note (full text not yet available).

2. As earlier envisaged, the proposal is to create a Fund (escrow account) at the IMF to guarantee LDC repayments on commercial loans converted into bonds. This however relates to interest repayments only. Finance would be provided by the developed countries' share of a new general issue of SDRs.

3. Mitterand also proposes:-

(i) stabilisation of export earnings of countries in the southern hemisphere; (Australia ?!)

(ii) some new system of regulation for environmental protection in LDCs;

(iii) a transfer of technology - following the example of the EC's Eureka project; and

(iv) a programme to stabilise rivers in Bangladesh (potentially very expensive).

Comment

4. The details remain obscure and we have asked the Embassy in Paris to find out more. There is a reference to "all debt must be repaid" but no indication of how security of principal is to be achieved - the Miyazawa proposal could therefore run in parallel.

5. A Fund for Mexico alone - whose annual interest repayments are $9 billion - would have to cover $6 billion a year even allowing for a 30 per cent writedown on securitisation. For the Baker 15 as a whole, the amount on the same assumption might be $29 billion a year. So large contingent liabilities are involved.

6. The fact that it is developed countries SDRs only that are involved in the proposed Fund implies that the LDCs get to keep their share of any general SDR allocation as part of the package - perhaps to bolster their reserves. The proposal involves a transfer of risk from the private sector to the public sector despite Berlin G7 agreement to the contrary.

7. There is no reference to conditionality. — but it must clearly be emphasised

8. There is an erroneous reference to the Mexico debt exchange scheme which may annoy both the Americans and the Mexicans. President Mitterand said that the United States guaranteed a portion of the principal on Mexico's commercial loans. In fact it was the Mexicans using their own reserves that did this, although they used US Treasury ZCBs as the mechanism.

9. The Embassy in Paris has been asked to try to find out more about French intentions and how the speech relates to the various statements that Beregovoy made in Berlin.

H.W.

H G WALSH

...at there is no such thing as fate, that man can always master the course of evolution and that it is urgent to do so. I see in the persistence of the current imbalances the most harmful cause of an enormous unhappiness which will, more assuredly than any other danger, push the world towards the endless chaos of war or something even worse.

And yet, international, multilateral or bilateral aid is stagnating or regressing. France -which, of all the industrially advanced countries, allocates the highest percentage of its gross national product to development aid- believes that it has not yet fulfilled its duty : the target of 0.7 % remains its ambition.

Sweden? (but true for G7)

The debt burden, in particular, calls for immediate action. A number of very interesting initiatives have been launched by one country or another. For my part, I suggested to the major industrialized countries, at their Toronto meeting, that they make the terms of repayment considerably easier for the poorest countries. As for France, it has chosen to cancel one third of the debt owed to it by these countries. This significant stride is but the beginning.

For other heavily indebted countries, particularly in Latin America and Africa, debt also represents an intolerable burden and, in certain cases a threat to democracy. In the face of this situation, the international community must show that it can be more realistic and more imaginative. All debt incurred must be repaid, but the cost can be reduced without passing on the burden to the taxpayers of the creditor countries.

Hence, the United States, in a bold move, last year guaranteed a portion of the principal on Mexico's commercial loans. Several countries and many experts have thought of creating a multilateral fund which would lower the cost by guaranteeing the interest payments. Various methods of financing this fund have been put forward.

In France's view, the best technique would be to create a fund in the IMF to guarantee the payment of interests charged on certain commercial loans converted into bonds. This fund would significantly lower the finance charges

X

How does a guarantee lower interest costs? Is it just that G7 credit rating

.../...

payable by debtor countries and would integrate them more actively into world trade.

In order to finance it, the developed countries would set aside their share of a new issue of special drawing rights for use by the developing countries.

I realize that the implementation of this project would represent a significant legal and financial innovation. It would require lengthy preparatory work and many consultations among creditors and with their debtors. However, this alone would seem to be equal to the challenge.

But development has to be based on many other things:

- stabilizing the export earnings of countries in the southern hemisphere, diversifying and increasing the value of their productions. The Uruguay Round must take these into account;

- environmental protection, which was endangered only a short time ago by industrial wastes from the North being disposed of in the South; the international community will have to agree on the regulations and necessary precautions;

- by a massive transfer of technology and know-how from the North to the South. I should like to suggest a new approach, modeled after Europe's Eureka project in which government stimulus, together with initatives freely taken by companies and universities, lead to cooperation on an equal basis;

- by major programs of universal interest which can mobilize our energies to bring help to regions facing catastrophes--natural or otherwise. Stabilizing the rivers that have flooded Bangladesh would be an appropriate place to begin a project of this kind. France, for its part, is ready to contribute.

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