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PREM 19/2631

SECRET

MT
Box 217

PART 3

Confidential Filing.

The Exchange Rate
Exchange Control Policy.
Inflow Controls.

ECONOMIC
POLICY

PART 1 : May 1979
PART 3 : JANUARY 1987

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~3.2.87~~		~~16.5.88~~					
~~10.2.87~~		~~17.5.88~~					
~~19.2.87~~		~~18.5.88~~					
~~25.2.87~~		~~6.6.88~~					
~~26.2.87~~		~~17.6.88~~					
~~3.3.87~~		~~27.7.88~~					
~~8.5.87~~		~~9.12.88~~					
~~3.7.87~~		~~10.1.89~~					
~~14.10.87~~		~~3.4.89~~					
~~27.11.87~~		~~18.5.89~~					
~~4.12.87~~		18.5.89					
~~16.12.87~~							
~~21.12.87~~		PART 3					
~~22.12.87~~		ENDS					
~~3.3.88~~							
~~8.3.88~~							
~~11.3.88~~							
~~13.3.88~~							
~~23.3.88~~							
~~25.3.88~~							
~~28.3.88~~							
~~29.3.88~~							
~~7.3.88~~							
~~7.4.88~~							
~~4.5.88~~							

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PART 3 ends:-

A. Walters to AT 18.5.89

PART 4 begins:-

A. Walters to PM 13.6.89

Paul Gray

ANDREW TURNBULL 18 May 1989

EXCHANGE RATE vs MONETARY TARGETS

In your memo of 15 May, you do not draw a crucial distinction and describe precisely what you specify as an exchange rate regime. You talk of "linking" (para 3). But the nature of the link and the institutional structure in domestic markets is the crucial issue. I would define a truly fixed (hereafter fixxed) exchange rate regime as one in which there are no bands (other than the commercial commission deviations) and no realignments.

There are great advantages of a fixxed rates system. From the history of the Currency Boards, we know that price and exchange rate stability can be delivered if (a) the metropolitan country has a stable monetary policy, (b) the institutional structure of the member country is made consistent with the fixxed requirement, and (c) the member country is willing to bear the consequences of sharp adjustments in response to monetary and real changes.

(I did some research on such fixxed systems and published a summary in my article on Currency Boards in New Palgrave 1988.)

As you know, I was a moving spirit in fixxing the Hong Kong dollar with respect to the US dollar. I was rather nervous about (a) since it looked likely that US would inflate somewhat but could see no alternative. The institutional structure (b) of a Currency Board was put in place and operated quite well just as we knew it could. As for (c), it is difficult to imagine a country with more flexible and open markets.

Of course in all but name, and allowing for seigniorage, a fixxed system operates like a currency union, and in the EC framework it would be, dominated by the Dmark as the metropolitan currency. This is very different from the ultimate union envisaged in the Delors Report where policy will be set not by the Bundesbank but by some European board of appointees.

A CB Dmark dominated system is technically viable and would have many advantages in reducing transactions cost. Whether it would give price stability (point (a)), compared to a monetary control system, is more dubious [See **Vaubel** attached]. We all thought that the United States would not inflate in the 1950s and 1960s, as we tied ourselves to the dollar - how wrong we were. I suspect that the political changes in Germany will eventually have their effects on monetary policy. Similarly, on point (c), I do not think European countries have flexible enough labour and other markets to take the full force of the adjustments required without unacceptable levels of unemployment and disruption, or more ominously, trade barriers and capital controls. As for (b), it is clear that the Banque de France is not willing to relinquish monetary sovereignty to the Bundesbank (hence the demand for symmetry, etc).

I adduce that we are not (yet?) ready for anything like a viable fixxed system. But what about a "little fixity" as in the ERM. Here, I will not repeat my usual arguments about capital mobility and their perverse effects on the adjustment process. (My forecasts in 1987-8 turned out to be correct). I would assert again that the ERM, as at present constituted, is not viable except with controlled credit and exchange markets. (You will recall that capital flows shattered Bretton Woods in the 1960s.)

Now consider the rationale for my "time is ripe" definition. If there are free markets, the ERM will have to change radically. The two possibilities (excluding re-imposition of controls) are:

(i) movement to fixxed rates based on the Dmark;

(ii) a widening of the bands so that they become reference zones - or eventually a free float.

The middle ground is untenable.

I conjecture that (ii) is far more likely than (i). Fixxity requires institutional change whereas floating or "reference bands" do not.

We can live with all the forms of reference band systems that are likely to emerge. Essentially, our exchange rate would be free to move as much as we wished. Thus we have been good Europeans and achieved our preferred monetary arrangements.

If, in the most unlikely event the Rest of Europe goes to (i), there are a number of options. Of course we could also become fixxed and we know the consequences of that. Perhaps the most interesting and likely, but least researched, is if we play the role of Canada to the US of Europe. I suspect that it will do us little harm.

ALAN WALTERS AW

cc Professor B. Griffiths
Charles Powell
Paul Gray

Sir Alan
with best regards
Roland Vaubel

COMMENTS

Roland Vaubel

Manfred Wegner's description and appraisal of the European Monetary System (EMS) shows only one side of the coin: its success in reducing exchange rate fluctuations among the member currencies participating in the exchange rate mechanism (ERM). What is the other side of the coin? Let us compare the years before and after the establishment of the EMS.

1. *Nominal and real exchange rate variations vis-à-vis (eight) other major OECD currencies have on average increased more for the ERM currencies than for the other OECD currencies or the other European OECD currencies* (Ungerer et al., 1986, Tables 22 and 25).

2. *Nominal effective exchange rate variations have on average decreased less for the ERM currencies than for the other European OECD currencies* (Ungerer et al., 1986, Table 28).[1]

3. *The average annual rate of depreciation vis-à-vis the Deutschmark has on average decreased less for the ERM currencies than for other major European OECD currencies* (calculated from Lehment, 1987, Table 2a).

4. *Expected exchange rate changes as proxied by the standard deviation of long or short-term interest rates have increased among the ERM currencies; they have grown a little less, but since 1979 have been larger than among the other major OECD countries* (Ungerer et al., 1986, Tables 43 and 44; Harbrecht, Schmid, 1987, Figures 12 and 15).

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1 This cannot be explained by the fact noted by Wegner that "a number of European countries such as Austria and Switzerland are quasi-members of the EMS, and others such as the United Kingdom have tacitly accepted exchange rate targeting in recent years." (III, 2nd paragraph).

Studies in International Economics and Institutions
Vosgerau (Ed.) New Institutional Arrangements for the World Economy

5. *The weighted average of the inflation rates decreased much more slowly, and in 1986 was still a little higher, in the ERM countries than in the rest of the OECD* (Scheide, Sinn, 1987, Table 1; de Grauwe, 1987, Table 1; 1985, Figure 4; Collins, 1987, Table 2; Harbrecht, Schmid, 1987, Figure 3). It also decreased more slowly in the EMS than in the other *European* OECD countries although it is still lower in the former than in the latter group (Scheide, Sinn, 1987, Table 1; de Grauwe, 1987, Table 1).

6. *If the seven years before and after the establishment of the EMS are compared, the standard deviation of inflation rates shows an increase among the ERM currencies but a decrease among the other major OECD currencies* (Collins, 1987, Table 2). *Over the whole life of the EMS*, the dispersion of inflation rates has also been much larger among the ERM currencies than among the major OECD currencies (Collins, 1987, Table 2; Harbrecht, Schmid, 1987, Figure 5; de Grauwe, 1985, Figure 3). For the more recent past, this is not true any longer (Collins; Harbrecht, Schmid, ibid.) but there remains the fact that *inflation convergence took longer in the EMS than in the rest of the OECD.*

7. *From December 1978, bid-ask spreads vis-à-vis the Deutschmark increased for the average of ERM currencies, and they increased more for the ERM currencies than for an average of other major European OECD currencies* (Lehment, 1987, Tables 4a and 4b).

8. *Since the establishment of the EMS, all old members of the EEC*[2] *have experienced larger growth rates in their trade with non-ERM countries than with other ERM countries* (de Grauwe, 1985, Table 2).

9. *Real growth of investment and GDP was much slower in the ERM countries than in the other OECD countries; compared with 1973-78, it declined more in the ERM countries than in the other major OECD countries;* in the other

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2 As de Grauwe points out, this is not true for Denmark and Ireland which joined the EC customs union at a later stage and may still have been benefiting form entry-induced trade creation.

European OECD countries, investment has even increased (de Grauwe, 1987, Table 1).[3]

To sum up: the exchange rate mechanism of the EMS does not seem to have contributed to reducing nominal effective exchange rate variations, inflation and inflation differences of the member currencies, or to increasing intra-ERM trade, investment and growth in the member countries.

The EMS exchange rate arrangement is a cartel of national money producers with a price leader. Cartels are inherently unstable; ceteris paribus, they raise prices (here: the price of holding money) and reduce the output (here: real money balances). The EMS money supply cartel is neither a necessary nor an efficient step on the way to a common European currency.

Whether such a single European currency should be "the final objective of the Community", as Wegner suggests, is an open question to which politicians and economists cannot know the answer. It depends on the trade-off between price level stability and transaction costs. As I have argued elsewhere (Vaubel 1987), only individual money users possess the knowledge and incentive required to make that choice. The optimal way of finding out whether currency union is efficient and, if so, of bringing it about is unrestricted currency competition or "choice in currency" (Hayek 1976). The European Currency Unit (ECU) can be instrumental in this process, especially if its weights are permitted to respond to revealed currency preferences (Vaubel 1987).

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3 "The disinflationary stance and the high real interest rates of the 1980s" emphasized by Wegner do not explain this difference, since disinflation was faster in the other OECD countries.

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CONFIDENTIAL

FILE LOR

SIR ALAN WALTERS

cc Professor Griffiths
Mr. Powell
Mr. Gray

EXCHANGE RATE v. MONETARY TARGETS

John Redwood's Question in the House on Thursday invited the Prime Minister to draw the conclusion that pursuit of an (undeclared) exchange rate target in 1987-88 led to loss of control over money, and in turn to the present increase in inflation in the UK. The Prime Minister shares this diagnosis of the current inflationary conditions but wisely avoided the temptation in the House to condemn the Government's past conduct of economic policy.

John Redwood was, of course, inviting the Prime Minister to express a view not just on the events of the last eighteen months but on the inherent superiority of money targets over exchange rate targets. In your minute on "When the time will be ripe", you contemplate a time when the UK might join the ERM, albeit one behaving rather differently from the present. This indicates that you do not take the view that money targets are superior in all circumstances.

There is a substantial economic literature about the choice of money v. exchange rate targets. Economists seem to agree that inflation can be controlled either directly by controlling money or indirectly by linking via the exchange rate to an economy which does. Whether to adopt one or the other course seems to depend on:

(i) the nature of the economy, e.g. size in relation to other trading partners, openness of trade and capital markets;

(ii) the most likely source of shocks, e.g. demand for money, or the foreign price level.

The conventional conclusion is that for small open economies, e.g. Benelux, Denmark, with a dominant trading partner an exchange rate target provides the better regime. For a large, relatively closed economy such as the US a money regime is better.

The UK lies between these two models, being of medium size and with a widely distributed pattern of trade. While oil was a big feature in UK trade, we were vulnerable to change in the oil price and hence the desirable real exchange rate.

I would argue that over a number of years there is relatively little to choose for the UK between the two regimes. Provided Germany remains a low inflation country, pegging to the DM, or minimising depreciation against it would limit inflation, particularly of our traded goods. Equally an MO regime can produce low inflation.

The events of the last eighteen months do not, in my view, amount to a conclusive case against an exchange rate regime. Certainly, using one (or a shadow one) we got things wrong. I attribute this to a failure to anticipate that the DM would be weak; or, even worse, to a failure to recognise DM weakness even though we were having to do quite daft things to hold the £ down against the DM.

But errors of that kind can be made using monetary targeting. Suppose EFTPOS takes off and makes a dent in cash holdings in the economy. While this shift in the demand for cash was taking place, we could mistake low growth in MO for low activity/inflation and keep interest rates too low. We certainly got caught out by a shift in the opposite direction when targeting broad money.

Whatever regime one operates, one must constantly cross check with other indicators. If there is a money target, account must be taken of the exchange rate; if an exchange rate target, account must be taken of monetary conditions.

My conclusion is that for the UK there is relatively little to choose between the two types of regime; and that we should warn the Prime Minister not to interpret the disastrous mistakes of the past eighteen months as evidence that a monetary target is inevitably better than an exchange rate target (it demonstrates that one can mess things up in either regime).

It would be very helpful if you could set out which regime you think is better for the UK; and the factors which lie behind that judgement. If you think a money regime is still better for the UK, what would need to change to tip the balance.

ANDREW TURNBULL

15 May 1989

PRIME MINISTER

EXCHANGE RATE MANAGEMENT

You will want to see the attached two notes from Alan Walters, each covering similar issues.

The first note on intervention at Flag A sets out Alan's worries about intervention if there is downward pressure on sterling. He seeks your authority to discuss with the Treasury and Bank the imposition of explicit constraints on intervention activity.

The second at Flag B repeats the worry about intervention in relation to the policy being adopted by the Bundesbank. But Alan goes on also to argue that any external pressure to increase UK interest rates should be resisted.

I would offer two quick thoughts on this:

- in recent months you have adopted an asymmetric view on intervention. You have opposed intervention if the market has been pushing sterling up, but you have been content with modest intervention to prevent sterling going down. Alan favours symmetry, with no intervention in either direction. I continue to see a case for a degree of asymmetry, and would have worries about a completely "hands off" approach if there was downward pressure on the exchange rate.

- on interest rates, I do not dissent from the view shared by Alan and the Treasury that at present the stance of monetary policy in relation to the domestic inflation problem is right. But we need to keep that assessment continually under review and we certainly cannot rule out the possibility of the need for an interest rate increase; the separate note in the box on economic statistics next week points to a surprisingly large b

reduction in the latest unemployment figure, and - as we discussed when you saw Cecil Parkinson yesterday - further upward pressure on wage increases may also necessitate offsetting monetary action.

On handling, the issues raised in these two notes by Alan also inter-relate with his note on ERM that Charles has put separately in the box. Perhaps it would be sensible for you to talk through all these issues with Alan, before he discusses the intervention issue further with the Treasury and the Bank.

Content to proceed on that basis?

PRCG.

(PAUL GRAY)

12 May 1989

DA2ABA

SECRET 25

PRIME MINISTER 12 May 1989

PS
Prr

INTERVENTION

Last Tuesday the Bank intervened about $185 million in trying to contain the rise of the US dollar. The main rise was against the Dmark which, because of the Bundesbank's past policy, has been particularly weak. No doubt because they have intervened heavily over past months to no avail, the Bundesbank did not intervene at all. Nor did the Bank of Japan. There was certainly no concerted intervention by the G5 countries.

I can see no justification for our intervention. It had no discernable effect on the out-turn of the market. Nor should one expect any substantial effect since, relative to transactions, the sums were trivial. (Incidentally, the media reported it as a $300 million intervention.) But it may well have given a wrong signal to the market, namely that we have some sort of dollar/Dmark target. I believe it was a mistake.

As far as I can detect, there are no guidelines on intervention. Although there is a clear understanding that a policy of "large interventions" (e.g. over $500 million) should be cleared with you, apparently there is no policy or strategy on our use of intervention. I suspect that, notwithstanding the "understandings", it could easily get out of control. To the player, intervention has many of the addictions of gambling - the feeling always that one only needs to stake a little more, and a little more, to make a big killing.

I advise that we put more explicit constraints on intervention - similar to those we employed in 1981-83. May I have your permission to explore this with the Treasury and Bank?

ALAN WALTERS

SECRET

SECRET 24a-b PG a
PA

PRIME MINISTER 11 May 1989

THE Dmark, THE DOLLAR AND STERLING

It is becoming increasingly clear to the Bundesbank (and, I believe I suggested this to you some two months ago) that it (and, above all, Pohl) have greatly misjudged monetary policy. The monetary aggregates are all over the top, inflation is rising (the wholesale price index was over 6 per cent on a year-on-year basis), and there is very large exodus of capital. Per contra, Alan Greenspan has conducted a most responsible monetary policy and has laid the foundations for low and stable inflation for the next two years.

Currencies reflect these policies. The dollar soars, the Dmark sinks.

I conjecture that the Bundesbank will be driven eventually to tighten monetary policy through increases in interest rates. If the increases exceed 100 basis points, this will cause a decline in the Dmark exchange rate of sterling.

I am concerned about the reaction of the Treasury and Bank to these conditions. The immediate reaction is to use <u>intervention</u> to test sterling's decline against the Dmark. As you know, I think that running down our reserves by buying sterling on a market that is falling because of a fundamental change in monetary conditions in Germany is simply a recipe for losing money. If not sterilised, the intervention has the effect of a monetary squeeze. If sterilised, it is useless.

The next reaction is likely to be that we should put our <u>interest rate</u> up <u>pari passu</u>. This, like unsterilised intervention, will increase the severity of our present monetary restraints.

SECRET

This would be wrong. Last week the Treasury and Bank agreed that the present monetary squeeze was the right degree of severity for our domestic inflation problem. There is no reason why we should distort our policy and economy in response to the Bundesbank's past mistakes and their present attempts at redress. For example, if the Bundesbank increased rates by 150 to 200 baris points (not beyond the range of the feasible) and we followed with similar rises (to 15 per cent), I believe that such a policy would be very likely to induce a recession - perhaps a severe one - in 1990-1. (It would also create great dissention in the EMS; France in particular would hate to see a rise in interest rates.)

In short, we should stick to our present monetary stance. It is broadly right. And we should take any effects of a putative German squeeze on our exchange rate.

AW

ALAN WALTERS

SECRET

PRIME MINISTER

GROUP OF SEVEN MEETING

You may like to glance at the following documents:

Flag A - the official G7 communiqué;

Flag B - the Chancellor's speaking note to this morning's Interim Committee session on the world economy;

Flag C - his speaking note for this afternoon's session on debt.

The material in the communiqué on debt is far from ideal, but does not seem as bad as some of the earlier media reports suggested.

PRCG.

PAUL GRAY

3 April 1989

PM3ALU

04/03/1989 03:30 BRITEMB WASHDC 202 898 4572

cc EST
Sir P. Middleton
Mr Lankester
Mr Mountfield
Mr H.P. Evans
Mr H. Bush
Mr Walsh
Mr Gray No 10

A

April 2, 1989

STATEMENT OF THE GROUP OF SEVEN

The Finance Ministers and Central Bank Governors of Canada, France, the Federal Republic of Germany, Italy, Japan, the United Kingdom and the United States met on April 2 in Washington for an exchange of views on current global economic and financial issues. The Managing Director of the IMF participated in the multilateral surveillance discussions.

The Ministers and Governors reviewed their economic policies and prospects based on the agreed arrangements for economic policy coordination. Growth over the past year exceeded expectations and the pattern has been supportive of global adjustment. Inflation remained generally moderate in 1988 but inflationary pressures have recently appeared in a number of countries. External imbalances have been reduced in those countries with the largest imbalances, although recently the pace of adjustment has slowed. Exchange rates have generally been stable.

The Ministers and Governors agreed that sustained non-inflationary growth is essential to dealing with global economic problems and remains the central objective of the coordination process. The success of these efforts depends on continued progress in controlling inflation and gradually reducing external imbalances. While the Ministers and Governors welcome the reduction in external imbalances achieved last year, they stressed that further progress in this area is required.

Based on this assessment of the current situation, the Ministers and Governors concluded that continued efforts are required. In countries with fiscal and trade deficits, especially the United States and also Canada and Italy, further reductions in budget deficits are needed to complement monetary policies in achieving better domestic and external balance and sustained non-inflationary growth. The major surplus countries should pursue economic and structural policies that will sustain adequate growth of domestic demand without inflation and facilitate external adjustment. All countries must pursue structural reforms which will help to sustain non-inflationary growth. The exchange rate stability over the past year has made a welcomed contribution to, and been supported by, the progress achieved in sustaining the global expansion and reducing external imbalances. The Ministers and Governors agreed that a rise of the dollar which undermined adjustment efforts, or an excessive decline, would be counterproductive, and reiterated their commitment to cooperate closely on exchange markets.

Ministers and Governors reiterated the importance they attach to steady progress in the Uruguay Round towards greater trade liberalization. They stressed the danger to the global adjustment process of protectionism and committed themselves to resisting these pressures wherever they arise. A more open international trading system is essential to the sustained health of the global economy.

In reviewing the international debt situation, the Ministers and Governors recognized the progress which had been made in several countries, but noted with concern that serious problems remain. Noting the encouragement in their Berlin communique for further development of the debt strategy, they discussed recent proposals by several countries.

The Ministers and Governors agreed that the key principles of the case-by-case, growth-oriented debt strategy remained valid. However, they believed that for countries undertaking fundamental and convincing economic reforms in cooperation with the IMF and World Bank, the debt strategy should be strengthened by placing greater emphasis on voluntary debt and debt service reduction in agreement with the commercial banks as a complement to new lending. They believe this could make an important contribution to efforts to resolve international debt problems by significantly reducing new financing needs to more manageable levels and reducing the stock of debt over time.

They encouraged the IMF and World Bank to continue in their respective roles to work with debtor countries on economic reform programs essential for lasting progress and to place greater emphasis on measures to attract new investment -- noting the role of MIGA in this connection -- and to foster repatriation of flight capital.

They also encouraged the IMF and World Bank to take, in accordance with their established principles, appropriate steps to support efforts to reduce the debt burdens of countries which are committed to substantial economic reforms. This support should be accomplished by setting aside a portion of policy-based loans to facilitate debt reduction transactions. In addition, the two institutions should examine the establishment of limited interest support for transactions involving significant debt or debt service reduction. The concrete negotiations on debt and debt service reduction are a matter for the debtor countries and the commercial banks.

The Ministers and Governors affirmed the key role of commercial banks in resolving debt problems. They further concurred that diversified financial support from the banks is needed to support sound economic reform programs through a broad array of new lending and debt/debt service reduction mechanisms. In order to encourage a broader range of voluntary debt and debt service reduction transactions, the Ministers and Governors encouraged the commercial banking community to consider negotiating waivers of restrictive clauses in existing commercial bank lending agreements for a given period. They also agreed to review, consistent with maintaining the safety and soundness of the financial system, regulatory, tax, and accounting practices with a view to eliminating unnecessary obstacles to debt and/or debt service reduction transactions.

The Ministers and Governors also encouraged the IMF to continue to collaborate actively with the Paris Club.

The Ministers and Governors emphasized the importance of a growing global economy. They concluded by calling on all parties to work cooperatively and promptly to put into place the elements discussed to strengthen the international debt strategy.

B

CHANCELLOR'S SPEAKING NOTE FOR THE INTERIM COMMITTEE

MORNING SESSION, MONDAY, APRIL 3, 1989

OVER THE PAST YEAR THE WORLD ECONOMY HAS BEEN MUCH STRONGER THAN [redacted] EXPECTED. THIS IS MOST EVIDENT IN THE GROWTH RATES OF THE MAIN INDUSTRIAL COUNTRIES. BUT ELSEWHERE TOO, PERFORMANCE HAS BEEN ENCOURAGING, WITH THE GROWTH OF WORLD TRADE PARTICULARLY STRONG. OF COURSE, PROBLEMS REMAIN--PARTICULARLY FOR SOME HEAVILY INDEBTED DEVELOPING COUNTRIES. THIS AFTERNOON I WILL DISCUSS THE DEBT PROBLEM. THIS MORNING I WANT TO CONCENTRATE ON POLICIES AND PERFORMANCE IN THE INDUSTRIAL COUNTRIES, WHICH IS CLEARLY A MATTER OF

VITAL IMPORTANCE TO THE HEALTH OF THE WIDER WORLD ECONOMY.

AFTER THE NIGHTMARE OF THE 1970S, SOUND FINANCIAL POLICIES HAVE BROUGHT INFLATION RATES BACK TO THE LEVELS OF THE 1950S AND 1960S. AND THE EMPHASIS UPON MARKET MECHANISMS, TAX REDUCTIONS, DEREGULATION AND COMPETITION IS RESULTING IN AN IMPROVED UNDERLYING SUPPLY PERFORMANCE OF OUR ECONOMIES.

HOWEVER, THERE ARE CLEAR SIGNS OF A RE-EMERGENCE OF INFLATIONARY PRESSURES, IN PART, AS A BY-PRODUCT OF SOME OF THE SUCCESSES WE HAVE ACHIEVED. AND ALTHOUGH SUPPLY PERFORMANCE HAS IMPROVED, WE HAVE BEEN GOING THROUGH A PERIOD WHEN IN A NUMBER OF COUNTRIES DEMAND HAS NONETHELESS BEEN

GROWING EVEN FASTER THAN SUSTAINABLE SUPPLY AND, AS A RESULT, PUTTING INCREASING PRESSURE ON CAPACITY.

BUT WHEREAS THE INFLATIONARY PRESSURES OF THE 1970S EMERGED FIRST IN A SURGE IN COMMODITY PRICES AND IN UNIT LABOUR COSTS, WITH COMPANY PROFITABILITY SUFFERING AS A RESULT, WHAT WE HAVE RECENTLY SEEN IS A WIDENING OF PROFIT MARGINS, WITH GROWTH IN UNIT LABOUR COSTS REMAINING LOW; AND ALTHOUGH OIL PRICES HAVE RISEN SHARPLY IN RECENT WEEKS, NON-OIL COMMODITY PRICES HAVE SHOWN LITTLE CHANGE OVER THE PAST NINE MONTHS.

THE MAIN SOURCE OF INCREASED DEMAND IN THE INDUSTRIAL COUNTRIES HAS BEEN THE STRENGTH OF FIXED INVESTMENT. BUSINESS

INVESTMENT IN THE MAIN INDUSTRIAL COUNTRIES MAY HAVE RISEN BY 12 PER CENT LAST YEAR, ABOUT THREE TIMES AS MUCH AS SHOWN IN THE OECD FORECAST PUBLISHED IN DECEMBER 1987.

IN TIME THE STRENGTH OF FIXED INVESTMENT MUST BE GOOD NEWS FOR THE SUPPLY CAPACITY OF OUR ECONOMIES. IN THE SHORT-TERM, HOWEVER, THE MOST STRIKING EFFECT IS THE PRESSURE IT PUTS UPON THE CAPACITY OF THE CAPITAL GOODS INDUSTRY.

THE RE-EMERGENCE OF INFLATIONARY PRESSURES HAS BEEN MET BY A TIGHTENING OF MONETARY POLICY. THREE MONTH INTEREST RATES FOR DOLLARS AND DEUTSCHEMARKS ARE BOTH ABOUT THREE PERCENTAGE POINTS HIGHER THAN A YEAR AGO, WHILE STERLING RATES ARE ABOUT FOUR

I APPRECIATE THAT HIGHER WORLD INTEREST RATES ARE UNWELCOME TO THE DEBTOR NATIONS. BUT THERE CAN BE NO COMPROMISE IN THE BATTLE AGAINST INFLATION. I BELIEVE THAT

PERCENTAGE POINTS HIGHER. I AM SURE THIS IS THE CORRECT RESPONSE. THE CREDIBILITY OF MONETARY POLICY HAS BEEN INCREASED BY ITS PROMPT AND VIGOROUS USE.

HOW QUICKLY AND HOW FAR TOTAL SPENDING WILL REACT TO THE RISE IN SHORT-TERM INTEREST RATES REMAINS UNCERTAIN. THERE ARE SOME SIGNS THAT THE IMPACT OF MONETARY TIGHTENING ON COMPANY SPENDING MAY BE LESS THAN ON PREVIOUS OCCASIONS. COMPANY SECTOR FINANCES ARE IN A MUCH HEALTHIER STATE THAN IN THE 1970S; AND INCREASED COMPANY SECTOR SAVING AND LIQUIDITY WILL PROVIDE A CUSHION AGAINST THE EFFECTS OF HIGHER INTEREST RATES, BLUNTING THE IMPACT OF MONETARY POLICY ON INVESTMENT. TO THE EXTENT THAT THIS OCCURS, THE IMPLICATION IS THAT IF

, AS THEY MUST BE,

INFLATIONARY PRESSURES ARE TO BE HELD AT BAY MONETARY POLICY HAS TO BITE MORE SHARPLY ON <u>PERSONAL</u> SPENDING.

IT MAY WELL BE THAT THE TIGHTENING OF MONETARY POLICY THAT HAS TAKEN PLACE IN RECENT MONTHS WILL BE ENOUGH TO DOUSE THE INFLATIONARY PRESSURES. BUT WE CANNOT BE SURE.

THERE ARE ALSO IMPLICATIONS FOR FISCAL POLICY. AT A TIME WHEN PRIVATE SECTOR INVESTMENT IS MAKING INCREASING CLAIMS UPON THE TOTAL SAVINGS OF OUR ECONOMIES IT IS VITAL THAT GOVERNMENTS DO NOT ADD TO THIS PRESSURE. THOSE COUNTRIES THAT CONTINUE TO HAVE LARGE BUDGET DEFICITS DO NEITHER THEMSELVES NOR ANYONE ELSE ANY FAVOURS. INDEED IT CAN BE ARGUED THAT IN PRESENT

CIRCUMSTANCES ANY BUDGET DEFICIT IS UNWELCOME.

NOR SHOULD WE BE SURPRISED, AT A TIME WHEN SAVINGS AND INVESTMENT PATTERNS ARE CHANGING RAPIDLY, THAT IMBALANCES BETWEEN COUNTRIES OCCUR. THESE HAVE THEIR COUNTERPART IN CURRENT ACCOUNT SURPLUSES OR DEFICITS ON THE BALANCE OF PAYMENTS. THERE IS NO REASON WHY THEY CANNOT SAFELY PERSIST FOR SOME TIME PROVIDED THAT SOUND MONETARY AND FISCAL POLICIES ARE PURSUED.

MY REMARKS HAVE BEEN DIRECTED TO THE ECONOMIES OF THE MAIN INDUSTRIAL COUNTRIES IN GENERAL. BUT OBVIOUSLY THEY APPLY TO THE UNITED KINGDOM IN PARTICULAR. INDEED IN MANY WAYS WE SEEM TO BE A HARBINGER OF DEVELOPMENTS ELSEWHERE.

THROUGHOUT THE EIGHTIES WE HAVE EXPERIENCED MANY OF THE MAJOR STRUCTURAL CHANGES AHEAD OF OTHER COUNTRIES--AND IN A MORE PRONOUNCED FASHION. WE WENT INTO A DEEPER AND EARLIER RECESSION IN 1980 AND 1981. WE HAVE SEEN A LONGER AND STRONGER RECOVERY. WE WERE IN THE VANGUARD OF DEREGULATION--PARTICULARLY PERHAPS IN FINANCIAL SERVICES--AND OF SUPPLY SIDE REFORM, AND THIS HAS SHOWN UP IN A MUCH IMPROVED GROWTH IN BUSINESS INVESTMENT--SECOND ONLY TO JAPAN IN THE 1980S, WITH A RISE OF 17 PER CENT LAST YEAR AFTER 10 PER CENT GROWTH IN 1987.

WE ALL KNOW SAY'S LAW, THAT SUPPLY GENERATES ITS OWN DEMAND. WHAT WE HAVE EXPERIENCED SEEMS TO BE AN OVERSHOOTING

VERSION OF SAY'S LAW, WITH SUPPLY CREATING MORE THAN ITS OWN DEMAND.

THE RESULT HAS BEEN THAT OVER THE PAST YEAR OR SO THE RISE IN UK DEMAND HAS BEEN EVEN MORE PRONOUNCED THAN ELSEWHERE. AND INFLATIONARY PRESSURES BEGAN TO EMERGE EARLIER, PARTLY REFLECTED IN A MOVE INTO SUBSTANTIAL CURRENT ACCOUNT DEFICIT.

MONETARY POLICY HAS BEEN TIGHTENED DECISIVELY AND WE ARE SEEING A CLEAR IMPACT ON CONSUMER SPENDING; IN PARTICULAR, THE HOUSING BOOM, A MAJOR CHANNEL FOR INCREASED BORROWING, HAS ~~BEEN [illegible]~~ SUBSIDED. UK HOUSEHOLDS ARE ~~PARTICULARLY~~ UNUSUALLY SENSITIVE TO CHANGES IN SHORT-TERM INTEREST RATES WITH INTEREST PAYMENTS SUBSTANTIALLY IN EXCESS OF INTEREST RECEIPTS.

THIS SUGGESTS THAT MONETARY POLICY IS PARTICULARLY APPROPRIATE IN THE UK CONTEXT. EVEN SO, WE HAVE ALSO HAD A CLEAR AND UNEQUIVOCAL TIGHTENING OF FISCAL POLICY. LAST YEAR WE HAD A PUBLIC SECTOR DEBT <u>REPAYMENT</u>--A BUDGET SURPLUS--OF £14 BILLION, OR ABOUT 3 PER CENT OF GDP. AND IN MY BUDGET LAST MONTH I PLANNED FOR A FURTHER DEBT REPAYMENT OF EQUIVALENT SIZE DESPITE MAKING FURTHER TAX REDUCTIONS.

IN CONCLUSION, IT IS IMPORTANT TO SEE TODAY'S WORLD DEVELOPMENTS IN THE CONTEXT OF THE PROGRESSIVE IMPROVEMENT IN OUR ECONOMIC FORTUNES DURING THE EIGHTIES STEMMING FROM THE PURSUIT OF STEADY, CONSISTENT POLICIES. THE MESSAGE IS THAT WE NEED TO CONCENTRATE ON KEEPING INFLATIONARY PRESSURES AT BAY;

AND CONTINUE WITH THE STRUCTURAL POLICIES THAT HAVE CONTRIBUTED SO MUCH TO THE IMPROVED PERFORMANCE OF MOST OF OUR ECONOMIES.

C

(1A)

CHANCELLOR'S SPEAKING NOTE FOR THE INTERIM COMMITTEE
AFTERNOON SESSION, MONDAY, APRIL 3, 1989

[EMBARGOED: NOT FOR USE OR QUOTATION BEFORE 4.00PM WASHINGTON TIME]

ONCE AGAIN THE DEBT PROBLEM IS HIGH ON OUR AGENDA. IT IS IMPORTANT TO GET IT IN PERSPECTIVE. MANY DEVELOPING COUNTRIES HAVE MANAGED THEIR ECONOMIES WELL AND HAVE INCREASED THEIR INVESTMENT. BUT OTHERS HAVE NOT, AND THESE INCLUDE MANY--THOUGH NOT ALL--OF THE HEAVILY INDEBTED MIDDLE-INCOME COUNTRIES; THEY HAVE SEEN SOARING INFLATION, CONTINUING CAPITAL FLIGHT AND LITTLE NEW INVESTMENT. THESE PROBLEMS HAVE BEEN CONCENTRATED PRIMARILY IN LATIN AMERICA: DEVELOPING COUNTRIES IN ASIA--INCLUDING OF

COURSE THE NEWLY INDUSTRIALISING ECONOMIES-- GREW BY 9 PER CENT IN 1988, WHEREAS DEVELOPING COUNTRIES IN LATIN AMERICA GREW BY LESS THAN 1 PER CENT.

THERE ARE ALSO, OF COURSE, THE SPECIAL PROBLEMS OF THE VERY POOR AND HEAVILY INDEBTED COUNTRIES IN SUB-SAHARAN AFRICA, AN ISSUE I RAISED AT THESE MEETINGS TWO YEARS AGO. I WELCOME THE FACT THAT $1 BILLION OF THE DEBT OF THESE POOREST COUNTRIES HAS ALREADY BEEN RESCHEDULED ON THE CONCESSIONAL TERMS AGREED AT THE TORONTO SUMMIT.

YESTERDAY IN THE G7 WE AGREED ON A FURTHER EVOLUTION OF THE DEBT STRATEGY IN RELATION TO THE MIDDLE INCOME DEBTORS. BUT THE KEY ELEMENTS OF THE EXISTING STRATEGY MUST BE MAINTAINED.

FIRST, THE PRIMARY RESPONSIBILITY FOR SOLVING THEIR ECONOMIC PROBLEMS MUST LIE WITH THE DEBTOR COUNTRIES THEMSELVES. IN THE WORDS OF THE IMF'S WORLD ECONOMIC OUTLOOK, "DOMESTIC POLICY REFORM IN THE COUNTRIES WITH DEBT PROBLEMS REMAINS THE MOST CRITICAL ELEMENT."

SECOND, IT IS FOR INDIVIDUAL DEBTORS TO NEGOTIATE WITH THEIR CREDITORS HOW BEST TO MANAGE THEIR DEBTS. FOR THE MIDDLE INCOME DEBTORS THIS PRIMARILY MEANS NEGOTIATIONS BETWEEN THE COUNTRIES CONCERNED AND THE COMMERCIAL BANKS--TO WHOM WELL OVER HALF OF THE DEBTS ARE OWED. THIS IS NOT AN AREA WHERE GOVERNMENTS OF THE INDUSTRIAL COUNTRIES SHOULD STEP IN AND TRY TO IMPOSE A SOLUTION--OR WORSE, TAKE OVER RESPONSIBILITY FOR THE DEBTS THEMSELVES.

SINCE 1982, THE EXPOSURE OF COMMERCIAL BANKS TO THE BAKER 15 HAS RISEN BY 17 PER CENT--AND THIS CALCULATION MAKES FULL ALLOWANCE FOR THE DEBT REDUCTION THAT HAS SO FAR TAKEN PLACE, PRINCIPALLY VIA DEBT/EQUITY SWAPS. BUT THE EXPOSURE OF GOVERNMENTS, EXPORT CREDIT AGENCIES AND THE INTERNATIONAL FINANCIAL INSTITUTIONS HAS RISEN BY 107 PER CENT, OVER SIX TIMES AS FAST.

A MAJOR CONTRIBUTION HAS COME FROM PARIS CLUB RESCHEDULINGS: SINCE 1982 THE PARIS CLUB HAS RESCHEDULED A TOTAL OF $83 BILLION OF DEBT, OF WHICH $27 BILLION WAS INTEREST.

THIS INJECTION OF FUNDS BY GOVERNMENTS AND IFI'S HAS GIVEN THE BANKS THE TIME TO REBUILD THEIR BALANCE SHEETS, WHILE RECEIVING INTEREST PAYMENTS VIRTUALLY IN FULL. THE DANGER OF A SYSTEMIC COLLAPSE OF THE BANKING SYSTEM HAS BEEN AVERTED. SO THE NEXT PHASE OF THE DEBT STRATEGY CAN GIVE GREATER EMPHASIS TO DEBT REDUCTION. THIS SHOULD NOT REQUIRE A SIMILAR TRANSFER OF RISK FROM THE PRIVATE TO THE PUBLIC SECTOR.

DEBT REDUCTION IS CLEARLY A MATTER FOR THE DEBTOR COUNTRIES AND THE COMMERCIAL BANKS TO NEGOTIATE THEMSELVES, AT A TIME WHEN THE BANKS HAVE MADE SUBSTANTIAL PROVISIONS AND WHEN THE SECONDARY MARKET PRICES FOR THESE DEBTS STAND AT SUBSTANTIAL DISCOUNTS.

6A

IT WAS IN THIS CONTEXT THAT, AT THEIR MEETING YESTERDAY, THE FINANCE MINISTERS AND CENTRAL BANK GOVERNORS OF THE MAJOR INDUSTRIALISED COUNTRIES PROPOSED THAT A PORTION OF EXISTING IMF AND WORLD BANK LENDING COULD BE SET ASIDE TO HELP FINANCE DEBT BUYBACKS FOR CERTAIN INDEBTED COUNTRIES. LET THERE BE NO MISUNDERSTANDING; THIS IN ITSELF CAN MAKE ONLY A MODEST DENT IN THE STOCK OF ACCUMULATED DEBT. BUT IT GIVES A CLEAR SIGNAL TO THE BANKS, AND MAY HELP TO PROVIDE A CATALYST FOR THEM IN THEIR NEGOTIATIONS WITH DEBTOR COUNTRIES. AT THE SAME TIME, THE GOVERNMENTS HAVE ~~AGAIN~~ AGREED TO REVIEW THE TAX AND REGULATORY FRAMEWORK IN EACH OF THEIR COUNTRIES TO SEE WHETHER THESE PRODUCE UNNECESSARY OBSTACLES IN THE WAY OF NEGOTIATED DEBT REDUCTION.

7A

AS THE G7 STRESSED YESTERDAY, THESE PROPOSALS APPLY TO "COUNTRIES UNDERTAKING FUNDAMENTAL AND CONVINCING ECONOMIC REFORMS". THE EMPHASIS SHOULD IN PARTICULAR BE ON STRENGTHENING STRUCTURAL REFORM, REMOVING OBSTACLES TO INWARD INVESTMENT, SIGNING THE MIGA CONVENTION AND IMPLEMENTING A PROGRAMME OF DEBT/EQUITY SWAPS, PARTICULARLY IN CONJUNCTION WITH A PRIVATISATION PROGRAMME.

OF COURSE, THESE CONDITIONS DO NOT EXCLUDE CREDITOR COUNTRIES WHO WISH TO PROVIDE ADDITIONAL ASSISTANCE BILATERALLY FROM DOING SO.

WHILE IT IS RIGHT THAT WE SHOULD BE ADDRESSING THE PROBLEMS OF MIDDLE INCOME

DEBTORS IN THIS WAY, WE MUST NOT FORGET THAT THE MAJORITY OF THE WORLD'S POPULATION, AND OF THE POPULATION OF DEVELOPING COUNTRIES, LIVES IN COUNTRIES WHICH HAVE MANAGED THEIR AFFAIRS PRUDENTLY. IT WOULD BE VERY WRONG FOR THE INTERNATIONAL FINANCIAL INSTITUTIONS TO REWARD THOSE COUNTRIES THAT HAVE, IN GENERAL, NOT PURSUED APPROPRIATE ECONOMIC POLICIES IN THE PAST, AT THE EXPENSE OF THE BETTER PERFORMERS--THIS WOULD BE "ADVERSE SELECTION" WITH A VENGEANCE.

IMF QUOTAS

FINALLY, I TURN BRIEFLY TO IMF QUOTAS AND SDRS. THE FUND'S LIQUIDITY IS CURRENTLY AS STRONG AS IT HAS EVER BEEN, AND ITS RESOURCES ARE AT AN ALL-TIME HIGH. INDEED, THE FUND'S FINANCES ARE STRONGER THAN THEY

WERE AFTER THE LAST QUOTA INCREASE IN 1983. IT IS A SHORTAGE OF STRONG ADJUSTMENT PROGRAMMES RATHER THAN A SHORTAGE OF RESOURCES THAT HAS KEPT FUND LENDING LOW. THERE IS, HOWEVER, NO NEED TO REACH A DECISION ON THE SIZE OF ANY QUOTA INCREASE AT THIS MEETING.

NOR DO I SEE ANY CASE FOR AN SDR ALLOCATION. THERE IS NO SHORTAGE OF LIQUIDITY IN THE WORLD ECONOMY, AND THE WORRIES ABOUT WORLD INFLATION MAKE THIS A SINGULARLY INAPPROPRIATE TIME TO CONSIDER ADDING TO LIQUIDITY VIA AN SDR ALLOCATION.

THE MAJOR CONTRIBUTION WHICH THE INDUSTRIALISED COUNTRIES CAN MAKE TO THE DEBT STRATEGY IS TO PROVIDE THE RIGHT ENVIRONMENT IN THE WORLD ECONOMY: THIS

10A

MEANS OPEN MARKETS, AND SUSTAINED NON INFLATIONARY GROWTH. IN THIS CONTEXT THE GATT TALKS TAKING PLACE IN GENEVA THIS WEEK ARE OF THE FIRST IMPORTANCE, AND I URGE ALL SIDES TO ENSURE THAT THESE TALKS REACH A SUCCESSFUL CONCLUSION.

PA

PRIME MINISTER

NEW EXCHANGE RATE INDEX

Today marks the introduction of a new effective exchange rate index for sterling. So in parallel with this evening's market report you may like to see the summary (also attached) of the changes implied by the new index.

There are two main changes:-

i. More up-to-date and sophisticated trade weights are used. This reduces the weighting of the United States and increases that of Germany.

ii. The base date has been updated from 1975 to 1985. Although the attached article does not bring this out, as a very rough rule of thumb you can take it that the rebased index is some 20 points higher than the old one; so whereas sterling was at around 77-78 on the old index the closing level tonight on the new index is 97.9.

Derek [signature]

Duty Clerk

Paul Gray

3 January 1989

MJ2DAQ

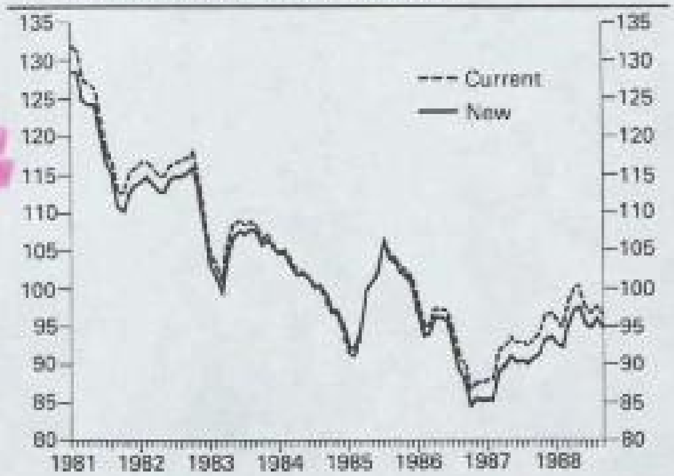
The new exchange rate index

A new official effective exchange rate index (ERI) for sterling is to be published by the Bank of England from 3 January 1989. The change was first announced in the November edition of the *Bank of England Quarterly Bulletin*. This article explains why a change is being made, and describes the new index.

An effective exchange rate index measures the value of a currency against a 'basket' of other currencies. For convenience this average exchange rate is expressed as an index with the base date, 1975 in the case of the existing ERI, equal to 100.

1985 = 100

Current and new exchange rate indices



Source: Bank of England

The present ERI

The weight of each currency in an ERI basket can be calculated in different ways, giving different results. The weights in the current ERI were calculated by the International Monetary Fund (IMF) using its Multilateral Exchange Rate Model (MERM – see *Economic Progress Report*, March 1981 and October 1984). The weights are so designed that a 1 per cent increase in the index will have the same effect on the UK's visible trade balance whatever combination of exchange rate changes brings it about. Though this may seem to be precise there is a great deal of uncertainty about the economic relationships in the MERM used to derive the weights, and the data used in the calculations have become increasingly out-of-date.

The new ERI

In July the IMF started to publish new effective exchange rate indices for 16 industrialised countries in *International Financial Statistics*. The index published for the UK will form the basis for the new ERI. The weights used reflect the relative importance of other countries as competitors to the UK in both domestic and overseas markets, and are constructed using disaggregated data for manufacturing trade in 1980. The new index will be a significant improvement on the present ERI in that it will be better at 'capturing' competitiveness effects, based on more recent data, and use a methodology which does not rely on the uncertain economic relationships of the MERM.

The table compares the new weights with those used in the present index. The major changes are a fall in the weight of the US dollar from 24.6 per cent to 20.4 per cent, and a rise in the weight of European Community currencies from 47.5 per cent to 55.6 per cent, largely due to the increase in the weight of the deutschemark from 14.1 per cent to 20 per cent. These differences reflect both changing trade patterns and the different methods of calculation.

Base date

The base date for the new ERI is 1985=100, as compared with 1975=100 for the existing index. A change in base date influences the scale of the index. Percentage changes between dates in the index are unaffected. It does not, of itself, require any alteration to the weights used in the calculation. The chart shows movements in the new ERI alongside the existing ERI, which for ease of comparison has been rescaled to 1985=100.

Percentage weights in new and old official ERIs

	New	Old
United States	20.44	24.63
Germany	20.01	14.08
France	11.75	10.39
Japan	8.83	13.67
Italy	7.66	7.18
Switzerland	5.48	3.00
Belgium	5.25	4.04
Netherlands	5.00	4.80
Sweden	3.79	3.73
Republic of Ireland	2.42	4.05
Spain	2.02	1.86
Canada	1.90	1.51
Denmark	1.45	1.09
Finland	1.45	0.85
Norway	1.31	2.11
Austria	1.24	1.00
Australia	–	1.99

CF - p.a. No further action for the present.

PRCG 13/12

PRIME MINISTER

Following your talk with Robin this morning, he mentioned to Peter Middleton, when he saw him on another matter today, your concern on intervention policy. He did not mention Brian's name.

Peter said that all the official advice going to the Chancellor, from both Treasury and Bank, including from Eddie, was against sustained official intervention. Thought has been given, on a contingency basis, to the possibility of "a burst" of intervention if the effective rate reached 80. The intervention would, be to test the strength of the upward surge, not to provide a ceiling! But nothing has, I think, been decided.

We will clearly need to be in close touch with HMT if the rate rises towards 80 to ensure you are consulted before anything is settled.

N.L.W.

N. WICKS

9 December 1988

What is 'a burst'? If a large amount of intervention quickly, it would be disastrous. So is continued daily intervention. It makes no sense to push up the interest rate & then try to keep down the exchange rate

MRMAAS

NLW - for information

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-270 3000

Direct Dialling 01-270 ....

Sir Geoffrey Littler KCB
Second Permanent Secretary

2 August 1988

Dear Nigel,

You sent to me with your letter of 29 July a copy of Pascal Lamy's enquiry from you about our ideas on the Ecu.

When I found you were away this week, I thought it best to reply to Pascal today on your behalf, given that our announcement this morning about Ecu Treasury Bills is directly relevant to his enquiry.

I enclose a copy of the letter and note I have sent to him.

Copies to Roger Lavelle and John Kerr.

Yours,

Geoffrey

(Geoffrey Littler)

Nigel Wicks Esq CBE,
No 10 Downing Street
LONDON SW1.

UK Ecu Treasury Bill Programme

You may be interested in the following announcement made this morning in London.

2. The Chancellor of the Exchequer, the Rt Hon Nigel Lawson MP, announced that a programme of UK Ecu Treasury Bills would be launched in the Autumn. This will widen the options for managing the UK's reserves and help develop the Ecu market.

3. The programme will be conducted by the Bank of England and full details of the arrangements will be announced during September. It will take the form of a series of tenders, starting in the autumn, probably initially at monthly intervals. Monthly tenders are expected to be for an amount of up to Ecu 500 million, possibly comprising bills of different maturities (eg one, three and six months). In the first instance it is expected that the programme will build up to a total outstanding of some Ecu 1-2 billion. The instrument will be similar to a conventional Treasury Bill, but denominated and payable in Ecu : subscription at the tender will be in Ecu and the bills will be repaid at maturity in Ecu. Arrangements will be made to ensure secondary market liquidity in the bills, and provision will be made for normal settlement.

TELEX TO:

PASCAL LAMY
CHEF DE CABINET DU PRESIDENT
E.C. COMMISSION

TELEX NO: COMEU B 21877

DATE: 2 AUGUST, 1988

FROM:

GEOFFREY LITTLER
LONDON

Begins:

DEAR PASCAL

NIGEL WICKS WROTE TO ME ABOUT YOUR LETTER TO HIM OF 26 JULY AND PROMPTLY THEN LEFT LONDON ON TOUR WITH THE PRIME MINISTER.

I THOUGHT I HAD BEST REPLY AT ONCE ON HIS BEHALF BECAUSE WE ARE TODAY MAKING AN ANNOUNCEMENT IN LONDON WHICH IS RELEVANT TO YOUR ENQUIRY.

I AM THEREFORE SENDING YOU WITH THIS NOTE A COPY OF A MESSAGE WHICH IS BEING SENT TO ALL MEMBERS OF THE MONETARY COMMITTEE AND WHICH EXPLAINS OUR INTENTION TO LAUNCH AN IMPORTANT SERIES OF ISSUES OF ECU TREASURY BILLS BEGINNING THIS AUTUMN.

THIS IS AN EXAMPLE OF THE KIND OF PRACTICAL ENCOURAGEMENT OF THE PRIVATE ECU AND MARKETS IN IT WHICH WE SEE AS A POSITIVE WAY FORWARD.

THE UK MEMBERS WILL TAKE THE OPPORTUNITY AT THE NEXT MONETARY COMMITTEE MEETING OF INVITING DISCUSSION. THEY ARE ALSO PLANNING TO PUT A PAPER TO THE COMMITTEE LATER ON DEVELOPMENT OF THE ECU GENERALLY.

WITH WARM REGARDS

(Signed) GEOFFREY LITTLER

Ends.

SECRET

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

27 July, 1988.

FOREIGN CURRENCY BORROWING

The Prime Minister was grateful for the Chancellor's minute of 26 July, which they discussed briefly at their bilateral today. The Prime Minister is content for the Chancellor to proceed on the lines proposed.

I am sending a copy of this letter to John Footman (Bank of England).

Paul Gray

Alex Allan, Esq.,
HM Treasury.

SECRET

ps1/80A 22 SECRET 23 24

Prime Minister

Content to repay early the Floating Rate Notes and re-finance with an ecu bill programme and by running down the forward Reserves?

RACG 26/7

cc Bl ef a

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

PRIME MINISTER

FOREIGN CURRENCY BORROWING

I have been considering the management of our foreign exchange reserves and our official foreign currency debts. I propose that we should repay early the $2.5 billion Floating Rate Notes (FRN) which we issued in September 1985 and which now looks expensive borrowing; and that we should finance this partly from the proceeds of a new ecu bill programme, and partly from our forward foreign currency reserves. We would need to notify our agent at the beginning of August if we are to prepay the FRN this Autumn, and the obvious date to announce our plans is 2 August, when we shall be publishing the July reserves figures.

Case for repaying FRN early

Under the terms on which we issued the FRN, we have the option of repaying ahead of schedule ("calling" the notes) at three monthly intervals from October of this year until the FRN finally matures in 1992.

Our dollar reserves currently earn at the margin around ¼ per cent below the London Interbank Bid rate (LIBID) for dollar deposits. We pay LIBID on the $2.5 billion FRN itself, so at present by borrowing via the FRN and holding the dollars in the reserves we are incurring a slight loss. When we took up the loan, we thought this cost was warranted in the interests of strengthening our reserves. But the reserves, which then stood at $14 billion, have now grown to just below $50 billion.

The market itself realises that prepayment would theoretically save us a significant sum (around $30 million over the remaining life of

6

the FRN) and that it should still be possible to make worthwhile interest savings even if we were to re-finance the borrowing so as to maintain the reserves at their current level. The price at which the notes are trading - around par - reflects investors' belief that we will exercise our call option. I believe it is sensible to do so.

Financing the repayment

The FRN would not actually be repaid until October, but I believe we should announce our intentions on how the repayment would be financed at the same time as we announced that we are planning to exercise the call option.

We could repay the loan out of the spot reserves, which now stand at record levels. But that might well be regarded as imprudent at a time when we are in substantial current account deficit. An alternative would be to finance the prepayment from fresh foreign currency borrowing in the Government's own name. But it would be unattractive to launch a new issue of anything approaching $2.5 billion in size, either as a fixed rate Eurodollar bond or in the form of floating rate US short-term notes - the two markets in which we could get a substantial interest rate saving. Issues of this size, even by a sovereign borrower, would give quite the wrong signals about the UK's external position and our need for finance. In any case, present market conditions are far from ideal for launching a dollar issue.

However, I am attracted to the possibility of launching a more modest ecu bill programme in London in the early Autumn. I want to discuss this in more detail with the Bank, but I have in mind issues of around the equivalent of $200-250 million a month building up over a period of six months to something over $1 billion; the amounts could be varied flexibly later, as we wished.

There are two main reasons for undertaking an ecu bill programme of this kind. First, it should help establish London as the centre of the ecu market, which is at present located principally on the Continent; a London-based programme, dependent on the active involvement of UK houses, should generate greater domestic interest in the ecu and help focus the market firmly in London. Second, we could present it as a practical step towards greater European co-operation in monetary affairs, and very much in line with your own comments at Hanover on the need to develop the role of the private ecu. There would be no net cost from undertaking an ecu bill programme: we should earn roughly as much from investing the proceeds as we have to pay on the borrowing.

I propose that the notes should be called "UK Ecu Treasury Bills". This should help in marketing, by underlining their quality. It will require an Order subject to negative resolution.

The remainder of the prepayment of the FRN would then be financed by running down our (unpublished) forward book, which at the end of June stood at around $5½ billion. We would explain that we had deliberately built up the forward book in anticipation of prepaying the FRN, as a sensible act of reserves management. We would, as usual, refuse to answer any other questions about our operations in the forward market.

Timing

We need to tell our principal paying agent (Morgan Guaranty) by 3 August, if we intend to call the FRN in October. While the decision should remain confidential until the agent informs the note holders at the beginning of September, there is, as always, some risk of a leak. I therefore propose we should announce we are calling the FRN at the time we publish the July reserve figures on 2 August, making it clear that we intend to finance the repayment by means both of an ecu bill programme to be launched in the Autumn and by running down our forward reserves.

d

If you have any queries about these proposals, we can discuss them at our bilateral on Wednesday. I am copying this minute to the Governor of the Bank of England.

NL

[N.L.]

26 July 1988

SUBJECT
cc MASTER.

SECRET

Cite SRW

21A

mtg record

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

6 June 1988

Dear Alex,

INTEREST RATES

The Chancellor came to see the Prime Minister this morning to discuss the position in the markets. He said that, following last week's half percent interest rate increase, the exchange rate had continued to fall a little further. But the position had then stabilised, and remained calm this morning. He had concluded, however, that a further half percent interest rate increase would be appropriate in order to tighten monetary conditions; he saw considerable attraction in making adjustments of half percent, rather than waiting for the possible need for a larger adjustment.

After a brief disussion, it was agreed that the Bank of England should signal a half percent interest rate increase at noon today, and that it would be necessary then to keep the position in the markets - and the possible need for any further adjustments - under review.

Yours,

Paul

(PAUL GRAY)

Alex Allan, Esq.,
HM Treasury.

SECRET

Prime Minister

As agreed I have sent this to the Treasury. PA

PRCG 16/5

EXCHANGE RATES

My rt. hon. Friend and I entirely agree that we must maintain a firm monetary policy and a downward pull on inflation. Indeed, I totally agree with all my rt. hon. Friend's budget speech - every bit of it. That is more than the rt. hon. Gentleman, the Leader of the Opposition, does.

The rt. hon. Gentleman asks about exchange rate policy. It is part of total economic policy. But he will note that we have taken down interest rates x times in the last x months. In current circumstances, of course, this is meant to have a downward pull on the sterling exchange rate. We look at these things regularly and use the levers available, as seems right in the circumstances.

But it would be a great mistake for speculators to think at any time that sterling is a one-way bet.

Reserves - level of

Daily Trade in Xchange markets - level of,

Lowest published figure of reserves c 1976

Bryan Gould famous question - why not peg /low of \$1.50

- cannot have - unfortunately - people like that on front bench now,

Table of Xchange Rates

Transcript of Last night BBC2 News Night John Redwood v John Smith

when J.S. said Labour would strengthen credit control - was knocked for 6 by John Redwood did little more than reverse the rapid rise in share prices of the previous year. Certainly, business confidence does not seem to have been greatly affected, and growth in the seven major industrial countries as a whole this year is likely to be only slightly lower than last year.

But Black Monday was also a warning. The world's three largest economies—the United States, Japan and Germany — have made a number of the policy adjustments necessary to reduce the imbalances which have for so long afflicted them, and there is evidence that the measures they have taken are starting to bear fruit. But there is still a long way to go; and meanwhile there is the constant danger that the process of adjustment, and with it the world economy as a whole, could be gravely damaged either by further wild gyrations in the dollar exchange rate or by a lurch into protectionism.

Success in reducing these imbalances depends on countries putting the right fiscal and monetary policies in place, and keeping them there. But the necessary adjustments are much more likely to be achieved if the objective of greater exchange rate stability is given an explicit role in the process of international co-operation, as has been the case for well over two years now. I can assure the House that we shall continue to play our full part.

MONETARY POLICY

Meanwhile, the maintenance of sound money and prudent public finances will keep us in the best possible position to weather any storms we may face, either at home or abroad.

The medium-term financial strategy, now entering its ninth year, will continue to provide the framework for reducing the growth of money GDP, and hence inflation, over the medium term. These will be achieved by maintaining firm monetary discipline, buttressed by a prudent fiscal stance.

Achieving the gradual eradication of inflation requires a steady reduction in monetary growth in the medium term. While I shall continue to take account of broad money, or liquidity, as last year there will be no explicit target. For narrow money, M0, the target range for 1988-89 will be 1 to 5 per cent., as foreshadowed in last year's MTFS.

Short-term interest rates remain the essential instrument of monetary policy. Within a continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure downward pressure on inflation.

Exchange rates play a central role in domestic monetary decisions as well as in international policy co-operation. I believe that most business men have welcomed the greater exchange rate stability over the past year. It is important that they also accept the financial discipline inherent in this policy.

PUBLIC SECTOR FINANCES

As I pointed out a moment ago, a sound monetary policy needs to be buttressed by a prudent fiscal stance.

At one time, it was regarded as the hallmark of good government to maintain a balanced budget; to ensure that, in time of peace, Government spending was fully financed by revenues from taxation, with no need for government borrowing. Over the years, this simple and beneficent rule was increasingly disregarded, culminating in the catastrophe of 1975-76, when the last Labour Government had a budget deficit, or public sector borrowing requirement, equivalent in today's terms to some £40 billion.

This profligacy not only brought economic disaster and the national humiliation of a bail-out by the IMF; it also added massively to the burden of debt interest, not merely now but for a generation to come.

Thus, one of our main objectives, when we first took office in 1979, was to bring down Government borrowing. We steadily reduced the public sector borrowing requirement from the 5¼ per cent. of GDP we inherited to only three quarters of 1 per cent. in 1986-87. Today, I am able to tell the House that in 1987-88, the year now ending, we are set to secure something previously achieved only on one isolated occasion since the beginning of the 1950s: a balanced budget.

Indeed, we have gone even further. It looks as if the final outturn for 1987-88 will be a budget surplus of £3 billion. Instead of a PSBR, a PSDR: not a public sector borrowing requirement, but a public sector debt repayment. And, incidentally, even if there had been no privatisation proceeds at all, the resulting PSBR, at a half of 1 per cent. of GDP, would still have been the lowest in all but one year since the beginning of the 1950s.

Some two thirds of this substantial undershoot of the PSBR I set at the time of last year's Budget is the result of the increased tax revenues that have flowed from a buoyant economy; while the remaining third is due to lower than expected public expenditure, again the outcome of a buoyant economy: less in benefits for the unemployed, higher receipts from council house sales, and improved trading performance by the nationalised industries.

A balanced budget is a valuable discipline for the medium term. It represents security for the present and an investment for the future. Having achieved it, I intend to stick to it. In other words, henceforth a zero PSBR will be the norm. This provides a clear and simple rule, with a good historical pedigree.

In the very nature of things, there are bound to be fluctuations on either side from year to year. It is in this context that I have to set the precise fiscal stance for the year ahead, 1988-89.

I have already announced, in the Autumn Statement last November, a £2¾ billion increase in public expenditure plans for 1988-89, with resources allocated to programmes up by over £4¾ billion. This means that, over the coming year, we will be spending at least £1,100 million more on health than in the year now ending, at least £900 million more on education, and at least £500 million more on law and order.

These large increases in public expenditure programmes for the coming year will be financed partly from the saving in debt interest resulting from the reduction in Government borrowing. Debt interest payments now account for about three quarters of a percentage point less of GDP then they did only three years ago. This may not sound very much, but it implies a saving of some £3 billion a year. And the balanced budget path I have set out in this year's MTFS will help to reduce debt interest payments still further.

We have thus secured an enviable virtuous circle in public finance: lower borrowing and lower tax rates create both the scope and the incentive for the private sector to

DCAAJE

NOTE FOR THE RECORD

The Prime Minister met Sir William Clark this morning, at his request, to discuss the Government's position on the exchange rate. Mr. Archie Hamilton was present.

Sir William said that he, and other backbenchers, were increasingly worried about the growing rumours in the press concerning a difference in view between the Prime Minister and the Chancellor of the Exchequer over interest rate policy. The Prime Minister said these press reports had been blown up out of all proportion. It grieved her that the backbenches were believing them. The Chancellor had run the economy brilliantly. It was quite misleading to concentrate on the one factor of the exchange rate. Sir William agreed that there was much media hysteria. But the press reports of divergent views was damaging the Party's record. The Prime Minister agreed that such reports were playing into Mr. Kinnock's hands. Sir William said that he did not believe there was a rift between the Prime Minister and the Chancellor. The issue now was how to kill the stories. The Prime Minister said that the Chancellor of the Exchequer was the last person she wanted to leave the Government. They thought the same on so many issues. But exchange rate policy was only one facet of total economic policy. Certainly there could be intervention to stop the speculators. But the size of the foreign exchange market was enormous - some $100 billion, compared to our reserves of $8 billion. Another lever for dealing with speculation against the pound was interest rates. But these levers were very limited in view of the size and strength of the foreign exchange market. She supported the Chancellor 100% in the totality of the economic policy. It was wrong to pick out one element, like the exchange rate, and exclude others. Economic policy was a totality. The suggestion that the authorities could control everything in the market was futile. She supported the Chancellor in every single facet of his Budget speech. The

Government would use interest rates and intervention as was appropriate. The speculators should not be allowed to think that sterling was a one way bet. The Leader of the Opposition was the speculator's friend when he demanded detailed specification of the Government's exchange rate tactics.

Sir William then asked whether the Prime Minister might not say that she agreed with the totality of the Chancellor's policies, including his exchange rate policy. The Prime Minister replied that the Government did not, in that sense, have an exchange rate policy. Certainly, the authorities tried to smooth out exchange rate fluctuations in the interests of securing an orderly market. But their instruments were limited. She discussed exchange rates and intervention in interest rates frequently with the Chancellor. The Prime Minister then told Sir William that the tapes had now reported that base rates had been cut by ½%. That was an example of how the authorities used the interest rate to affect the exchange rate. It should never be forgotten that the economy had performed with immense success.

After some further discussion in the same vein, Sir William said he would ask a Question that afternoon which would permit the Prime Minister to kill the rumour that she and the Chancellor differed on economic policy, specially exchange rate policy. He then enquired about the EMS. The Prime Minister said it was unfortunate that the question of the EMS had been raised. The economy had done well outside the EMS. Sir William confirmed that he was not in favour of our entry. The Prime Minister said that entry [into the ERM] would certainly sacrifice some freedom of action.

N. L. W.

(N.L. WICKS)

<u>17 May 1988</u>

1. Prime Minister will, I am sure, endorse the Chancellor's handling of the economy, which of course includes management of the exchange rate, over the last 5 years. Under his stewardship the economy has maintained continuous, steady, low inflationary growth and brought higher living standards, lower taxes and higher social spending.

2. You will be grieviously disappointed if you think the Prime Minister is going to discuss exchange rate management tactics across the floor of the House; she won't; it simply isn't on.

3. I can't say what she will say in answer to Questions when I don't know what those questions are and I don't intend to indulge in hypothesis.

4. Have the Prime Minister and Chancellor met over the last 24 hours? - they meet very regularly, and on average usually every day.

5. Will there be an agreed statement? As I have indicated, the Prime Minister has already endorsed the Chancellor's management of the economy, which includes exchange rate policy.

BERNARD INGHAM

17 May 1988

PA - Exchange rates.

UNCHECKED.

JOHN REDWOOD/JOHN SMITH - INTERVIEWS ON EXCHANGE RATE POLICY

Transcript from: BBC 2 TV, Newsnight, 16 May 1988

INTERVIEWER: (John Snow) ... I'm joined now by John Redwood who is a former Head of the Prime Minister's Policy Unit at No 10, Conservative MP, and John Smith the Shadow Chancellor. John Smith, where would you put this political row on the Richter Scale, do you think we're in as serious a state as we were at the time of Westland a couple of years ago, where are we?

SMITH: I think we're getting rather near to it. If Westland was about say 8 on the Richter Scale this is about 6 and rising I would say. Because I've not seen in recent years such a public unavoidable dispute encouraged almost by a Prime Minister in which she thoroughly deposes her Chancellor of the Exchequer and almost humiliates him. He started off by saying that he was shoadowing the Deutchemark at £1 to 3 Deutchemarks and he said if it rose above that it was unsustainable and bad for business. It's now heading up towards 3 marks 20fenincks and there he is, with his policies cut away from behind him, with the Prime Minister when she's asked directly in the House of Commons does she stand behind the Chancellor refusing to answer the question. So I mean it really is a very serious political question that the Prime Minister who last week said that she didn't think any of her Cabinet could even succeed her goes around assassinating each one in turn.

INTERVIEWER: John Redwood, do you recognise that this does cast serious doubt on the Government's credibility and cohesion on a central item of economic and financial policy?

REDWOOD: No I don't think it's as serious as that at all. This Government has a tremendously successful economic policy and visitors from all over the world are still pouring into London to find out how you can combine high growth, high productivity, low inflation and economic transformation of the kind we've seen. There has been a very small disagreement over the details of exchange rate policy. Of course the Labour Party would like to ferment that . But all those who wish to have a clear and firm statement of exactly what the Government is going todo next are friends of the speculators. Because the only people who will benefit from that degree of certainty are the people trying to make a packet out of foreign exchange speculation.

INTERVIEWER: Do you recognise the thrust of what Will Hutton's report was saying just now that actually Britain is committed to an exchange rate management policy, that is on the whole Mr Lawson's policy but very much not Mrs Thatcher's?

REDWOOD: I think the Government has entered into discussions and some agreements with other countries but I don't think it's as tight and as precise and mechanistic as the report was suggesting. And I think the Prime Minister is right to say to the Chancellor from time to time do not intervene too much in the exchange markets and buy currencies which are dear with your currency which is cheap because that way you lose money. You have to balance these things.

INTERVIEWER: John Smith, are you clearly on one side or the other of this argument? Are you with Mrs Thatcher or Mr Lawson?

SMITH: I'm with Mr Lawson in one limited respect - that I think he's right about not allowing the £ to rise high. I'm not with him in that he has caused by giving away far too much money in the Budget and by allowing a domestic credit expansion which is out of control to allow inflationary factors to be such a factor that he is in a dilemma now, a dilemma of his own creation, between having high interest rates and low interest rates - but that's his problem. But on the point you asked me directly yes, Mr Lawson is much more likely the right than Mrs Thatcher. But who's going to win - Mrs Thatcher's going to win. She always wins in this Government. So we're going to have a Chancellor a week or two from now who has been constricted, humiliated, insulted by his own Prime Minister. Now it must be a matter for him whether he continues in that situation. But if he does he will probably be recommending to Britain which he doesn't himself believe in.

INTERVIEWER: But do you recognise the Governemtn's commitemtn and indeed the Government's achievement on curbing inflation and recognise that there is a dilemma here for the Government? I mean lowering interest rates would fuel inflation and so would intervening to save the £ to try to keep the £ down?

SMITH: Over the last decade one of the important factors in reducing inflation throughout the whole western world has been the reduction of commodity prices. I mean that's probably the most important factor in all the countries. And Britain's inflation rate is not all that spectacular compared to some of our competitors. But in this dilemma about you know whether you raise or lower interest rates I wish the Chancellor ahd thought about that and the Prime Minister had thought about that before they allowed domestic credit to expand in the way they did deliberately before the last election and before they gave away all the money they did in the last Budget. Because really I mean I if they had not done that they wouldn't have been faced by some of the dilemmas now. What is going to happen though is that if they allow the £ to get up to too high a value and we end up with higher interest rates British industry is going to be crucified once again.

INTERVIEWER: John Redwood, would you like to respond to that point and particularly to the point made by many industrialists that we spoke to this evening who all on the whole agreed with Mr Lawson's point that what matters here is a stable exchange rate that can give exporters a clear prospect for the future?

REDWOOD: Well responding to John Smith, and it's interesting that Labour not only want to help speculators by making absolutely clear to them what the course of the £ will be and what the Government will do, they themselves don't know whether they want higher interest rates because they're worried about credit expansion or lower interest rates because they're worried about the £.

SMITH: We want lower interest rates.

REDWOOD: But you just said that on the other hand you were very worried about credit and presumably therefore you want rates to go up.

SMITH: No I would use other methods. We want lower interest rates. I've no doubt about that.

REDWOOD: So you want to impose credit restrictions and controls?

SMITH: We might well do actually and that might be a far more sensible way of doing it than by sacrificing British industry by ....

REDWOOD: But that cuts demand down from British industry,it means the British people and British companies can no longer buy what they want. That seems to be an absurd course of action to be recommending.

INTERVIEWER: There John Redwood, John Smith we must end..

CONFIDENTIAL

File

DSG

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary 16 May 1988

I attach the form of words discussed earlier this evening by the Prime Minister and the Chancellor for use at Prime Minister's Questions tomorrow.

Paul Gray

Alex Allan, Esq.,
H.M. Treasury.

CONFIDENTIAL

EXCHANGE RATES

My rt. hon. Friend and I entirely agree that we must maintain a firm monetary policy and a downward pull on inflation. Indeed, I totally agree with all my rt. hon. Friend's budget speech - every bit of it. That is more than the rt. hon. Gentleman, the Leader of the Opposition, does.

The rt. hon. Gentleman asks about exchange rate policy. It is part of total economic policy. But he will note that we have taken down interest rates x times in the last x months. In current circumstances, of course, this is meant to have a downward pull on the sterling exchange rate. We look at things regularly and use the levers available, as seems right in the circumstances.

But it would be a great mistake for speculators to think at any time that sterling is a one-way bet.

PRIME MINISTER

MG

MARKETS

It has been an active day in the markets today with strong upward pressure on sterling, as shown in the attached Market Report. In New York the pound was continuing to trade above $1.89 and DM3.18 this evening.

You will see that intervention has been very heavy. The Treasury have kept me in touch with developments. At one stage there was a plan to undertake a further heavy bout of co-ordinated intervention during the afternoon, if the Bank (whose idea it was) were confident this would have the effect of driving the rate down. I cautioned against. In the event, this operation did not proceed.

The reasons for sterling's strength seem to have been:

(i) reactions to yesterday's Bank of England Quarterly Bulletin - extract attached - in which the Bank made clear they would prefer to see interest rates higher and the exchange rate lower. The market has taken this as a clear indication that interest rates will not be reduced, and indeed could be raised, which has made operators more bullish about sterling;

(ii) the never-ending story of your alleged disagreements with the Chancellor continues, with emphasis being placed on your alleged antipathy towards intervention;

(iii) the continuing perceived politico-economic strength of the UK plc.

The Chancellor is having a major meeting with Bank and Treasury officials on Monday morning to consider next steps. He may then want to have an urgent word with you.

If the upward pressure continues, we face the familiar three options:

(i) do nothing and let the exchange rate find its own level;

(ii) take another half point off interest rates;

(iii) engage in further tactical intervention if market circumstances are thought favourable.

I understand that the Chancellor is resolutely opposed to letting the exchange rate go significantly higher. He may be becoming a prisoner of his own words in recent weeks about a higher exchange rate being unsustainable.

He is therefore likely to see the choice resting between more intervention and a half point off interest rates. I think it is an open question which of these he will opt for.

My view - and that of Brian Griffiths - is that it would not be right to make a further cut in interest rates. The whole "feel" at the moment is that the monetary position is too loose - the MO figures are high, credit is still growing fast and so on. Another half point off would trigger another cut in mortgage rates, so further boosting both the housing market and personal consumption.

So the question then becomes whether conditions are appropriate for further intervention. The arguments against intervention are well rehearsed. And the thing we must avoid above all is getting trapped in a position where we are seen to be defending figures of $1.90 and DM3.20 - which the markets probably see as their next "target". If I could borrow your phrase, it is no good trying to buck a strong market trend. So the only circumstances in which substantial intervention might be appropriate is if the markets became uncertain and there is a reasonable expectation that a heavy burst of intervention might actually take the rate down.

This has to be a matter of tactical judgment at the time. As of now I think it unlikely that intervention will do the trick. But I don't think we should immediately rule out the possibility of, say, a concerted $500 million operation early next week if the market conditions are favourable. The ~~political~~ potential inflationary consequences of this - and indeed of several such operations - would in my view be much less serious than a further interest rate cut.

I agree. I fear ½% operations rather would not stop the rise.

You may want to reflect on the options over the weekend. Depending on the conclusions he reaches on Monday morning, the Chancellor may want to have an early word with you. This should not pose too much of a problem in diary terms.

PRCG.

PAUL GRAY

13 May 1988

PMMAYS

The appreciation of sterling since the beginning of the year, both against the deutschemark and in effective terms, represents a tightening of monetary conditions, which has been in part offset by lower interest rates. A net tightening was a necessary response to concerns about potential inflationary pressure, associated in part with the continuing buoyancy of domestic demand and growth of liquidity. It should exert a cumulatively pervasive restraining influence on wage settlements and profit margins, as well as on many import prices. Experience shows that a firm exchange rate can provide an effective counter-inflationary discipline in an open trading economy like the United Kingdom, which remains more susceptible to inflationary tendencies than many others despite the progress made in reducing rigidities in labour and goods markets in recent years. Nevertheless, the combination of a stronger currency and lower interest rates does not represent an ideal response to current concerns and a different balance would be desirable if it could be achieved. Moreover, exchange rate stability remains desirable in its own right, with benefit to industry, and will continue to be sought so far as is possible without jeopardising the counter-inflationary thrust of policy.

PRIME MINISTER PA

EVENING MARKET REPORTS: 9 MAY

You will see the evening report reports intervention of some £145 million today. I understand this was on the taking of two main bouts. Although some recent modest intervention activity has been prompted by the Treasury, I gather today the initiative came from the Bank who thought they would be able successfully to knock speculative activity on the head. In the event, they were unsuccessful, and Sterling is up at 3 on the day.

Another factor in the day's events in the markets has been renewed speculation about the Chancellor's future, which is said to have reinforced the upward pressure on Sterling!

Patricia A Parkin

pp PAUL GRAY Duty clerk.

9 May 1988

psl/28A

1. Mr Adylian – to see
2. C.F. RA – endings roles

CHANCELLOR'S INTERVIEW WITH "THIS WEEK NEXT WEEK"

24/4/88

PRCC 26/4

The main points from the Chancellor's interview with "This Week Next Week" were:

The gap between rich and poor

"I am getting a lot more tax from the better off, and not just in absolute terms but in proportionate terms too."

"I am also very concerned that the poor should be better off, and the poor being better off matters more than what the gap happens to be between rich and poor."

"I don't determine what the gap is ... It may be that as a result of [our policies] the gap does widen, [but] it's not that we're deliberately saying that it [the gap] must widen".

Charitable giving

"What I do think is important, however, is that those who are well-off should show a sense of social obligation, and I am very glad indeed that, since we took office, charitable giving has something like doubled in real terms."

"I think it is very important that [charitable giving] should supplement [parts of public health provision]."

"[The principle of giving money to the NHS via a lottery] doesn't offend me in any way. Many countries do that I believe."

Inflation

"Low inflation is what we've got and I am determined that it shall not go up. Our ultimate aim is certainly the total eradication of inflation, but it may take a little while".

"We have now got it down to 3½ per cent: that's not low enough, but I am quite sure that ultimately we will get it down lower and ultimately eradicate it".

"It may bob about a little bit, but the underlying trend will be downwards - that is the purpose of the policy".

When the interviewer put it to the Chancellor that the Prime Minister and the Governor placed a higher priority on driving down the rate of inflation than he did, the Chancellor replied:

> "No I don't think there is any difference on that score at all".

Exchange rate

On the decision to let the pound rise through 3DM, the Chancellor denied that the management of the change had been "disorderly"; he said:

> "It was unfortunate that [it] was discussed as much as it was in public, because these are very market-sensitive matters"

Asked about the Prime Minister's public comments, he said:

> "I do think that one needs to be very careful about how one talks about these matters in public ... That incident was unfortunate but that is all behind us".

On "bucking the market", he said:

> "Inevitably the authorities ... do influence the market ... What is absolutely true is that if you try and buck economic fundamentals, then you are likely to come unstuck, but of course very often [foreign exchange] markets are not reflecting economic fundamentals at all".

On exchange rate stability he said:

> "We are certainly - and the Prime Minister has said this as well - ... interested in the maximum possible exchange rate stability, within the context of sound anti-inflationary policy".

On the exchange rate itself, he said:

> "I certainly do not want to see the exchange rate appreciate further. I think that that would be, as I have said on a previous occasion, unsustainable. And an unsustainable appreciation does nobody any good and is damaging for business and industry".

On intervention, the Chancellor said:

> "Intervention ... can certainly induce inflationary forces into the economy if it is not sterilised. ... But every

single pound of intervention in 1987-88 was fully funded, fully sterilised, and therefore injected no inflationary forces into the economy at all".

The Chancellor was asked if stability of exchange rates implied instability of interest rates. He said:

"No, if anything the reverse is the case. If exchange rates are highly volatile, then you are likely to get more interest rate movements, rather than fewer".

91/G.LCLD.4512.026

PA - Exchange rates

FROM: MS V F BRONK

DATE: 8 April 1988

MR PERETZ

cc Mr Grice
Miss O'Mara

FRATIANNI PAPER ON EUROPEAN MONETARY SYSTEM

I attach a copy of the above paper which was discussed by Alan Walters in the 'Financial Times' of Wednesday 6 April. I understand that the Chancellor's Office and No 10 have asked to see it.

Vyvien Bronk

MS V F BRONK

cc PPS — 2 copies (will you send to No 10?)
Sir P Middleton o.r.
Sir T Burns
Sir G Littler
Mr Scholar o.r.

THE EUROPEAN MONETARY SYSTEM: HOW WELL HAS IT WORKED?

by

Michele Fratianni
Indiana University
Graduate School of Business
Bloomington, Indiana 47405

Paper to be presented at the Cato Institute's Sixth Annual Conference "Dollars, Deficits, and Trade: The Changing World Economy," Washington, D.C., February 25-26, 1988.

I. INTRODUCTION

The Treaty of Rome makes no reference to monetary union or specific exchange-rate arrangements. In 1968 Raymond Barre, then EC Commissioner, wrote a proposal advocating tighter consultations of member governments concerning macroeconomic policy, and in particular monetary policy. The celebrated Werner Report of 1970 was an outgrowth of Barre's ideas. Although this report set monetary union as the ultimate Community objective, it was careful to emphasize preconditions in the form of coordinated policies and the establishment of narrower margins of fluctuations around exchange rate par values. The so-called snake arrangement, instituted in 1972, was believed to be the Werner Report in action. In fact, from the Werner Report the "snake" system borrows only the idea of reducing currency fluctuations without setting a machinery to coordinate policies. The "snake" failed.

The decision taken in 1978 by Chancellor Schmidt and President Giscard d'Estaing to create a "zone of monetary stability" came as a surprise, not only to the general public, but also to central banks. Samuel Brittan (1979) speculated that the birth of the EMS had less to do with a desire for monetary stability than a Franco-German reaction to the weakness of the dollar and the unreliability of the Carter Administration. Whatever the reasons, the European Monetary System became a reality on March 13, 1979.

Several authors predicted failure, or at leat modest success. Cohen (1981, p. 21) stated that "the potential for an inflationary bias is there and, unlike the hypothethical reverse danger of a deflationary bias, could well become serious in practical terms... Any disciplinary effect of the joint float on a deficit member would probably be more than offset by the 'safety valve' of access to the credit facilities." Fratianni (1980, p. 165) predicted that "the EMS is destined to become an adjustable-peg system. How well this system will fare depends on the disparity of inflation rates and timeliness of parity adjustments. The current disparity of inflation rates and underlying policies among EEC countries suggests frequent realignments. Yet history teaches us that decision makers perceive parity changes as costly political decisions and, therefore, postpone taking action." Vaubel (1980) identified in the EMS the emergence of "egalitarianism, collectivism, and etatism" and worried about the built-in moral hazard incentives and inflation bias.

The EMS has not failed. Many economists and policymakers consider it a success, partly on the strength of the evidence I review in this paper. Yet, the relevant question is not whether the EMS has survived or done well according to some absolute criterion, but whether it has performed better or worse than an alternative exchange-rate regime. Needless to say, this is a demanding task because of the difficulty of holding ceteris paribus. In Part II of the paper I compare the performance of the EMS countries both with its own pre-EMS history and with non-EMS countries. Methodologically, this exercise can be likened to a comparison of unconditional expectations; hence its limitations. In Part III of the paper I consider the workings and merit of the EMS relative to the free floating alternative. While there is a considerable amount of theoretical work on the relative desirability between an EMS-type arrangement and free floating--with and without credible monetary authorities--the empirical work bearing on this proposition is still in its infancy. I have relegated to Part IV concluding comments and speculations concerning the motives of each EMS country in being part of this arrangement.

II. THE RECORD

Exchange rates

There have been eleven parity changes or realignments during the life of the EMS, seven of which occurring during the first four years and four in the subsequent four years (cf. Table 1). In the approximately eight-year period going from March, 1979 to January 12, 1987 --date of the last parity change--the Italian lira experienced the largest parity depreciation, 45 percent, vis-à-vis the Deutsche mark; the Dutch guilder the smallest depreciation, 4 percent (cf. Table 2).[1]

[1] The parity realignment of 2.6 percent between the Irish pound and the French franc was the smallest parity change in absolute.

--insert Tables 1-5 here--

Did these parity changes evolve to take into consideration inflation differentials within the EMS countries? In Tables 3 and 4 I have shown cumulative bilateral inflation rate differences--over the period 1979-1986--measured by percentage changes of the wholesale price index and the consumer price index, respectively. Italy, again, has had the highest inflation differential in relation to Germany (64 and 84 percentage points, respectively); the Netherlands the smallest (1 and 3 percentage points, respectively). A comparison of Table 2 with Tables 3 and 4 reveals that bilateral depreciations were positively associated with a higher domestic inflation rate.* This positive association, however, was far from being complete, leaving room for real exchange rate changes (cf. Table 5). In particular, the French franc, the Italian lira and the Irish pound have had sizeable real appreciations vis-a-vis the other EMS currencies. With respect to the DM, the FF has appreciated 8 percentage points, the Lit 38

* The co-movement between nominal exchange rate realignments and inflation rate differentials were tested by regressing the cross-section data of Table 2 (Exr) on the cross-section data of Tables 3 and 4 (wpi and cpi, respectively):

$$Exr = -5.59 + .65 \cdot wpi \qquad SEE = 10.3$$

t values (2.45) (9.86)

$$Exr = -6.8 + .50 \cdot cpi \qquad SEE = 9.6$$

(3.17) (10.7)

percentage points, the Lit 38 percentage points, and the Irish pound 35 percentage points.[a]

One interpretation of the EMS is that monetary authorities of the participating countries do not understand the EMS to be a fixed-exchange rate arrangement, but rather as one aimed at preventing high variability of exchange rates. High variability implies that exchange rate movements have a large unexpected component. Risk-averse individuals will move resources away from the riskier trade sector to the less risky non-traded sector. Hence high variability of exchange rates--despite the existence of future or forward markets--hampers the growth of trade.

Ungerer et al.(1986) give detailed evidence about exchange-rate variability within the EMS countries, within the non-EMS countries, and between them. Here are the salient results of this study. First, intra-EMS exchange rate variability--both nominal and real--declined after the creation of the EMS. This is particularly so for bilateral exchange rates, evidence that corroborates the earlier study by Rogoff (1985) who had instead concentrated on predictability, showing that the variance of the forecast error of the risk-neutral rational expectations model was lower during the first five years of the EMS than during the preceding five years. In contrast, non-EMS exchange-rate variability went up after the creation of the EMS.

[a] These were the real exchange rate changes based on the consumer price index.

Much more subtle is the evidence concerning the interaction between EMS and non-EMS countries. On the basis of the IMF's multilateral exchange rate model there is little evidence in Ungerer el al. to suggest that the pre-EMS period behaves differently than the post-EMS period.* As an alternative, I computed the standard deviation and the coefficient of variations of the annual percentage change of the effective exchange rate as defined by the OECD (see below for a description of the data) for the seven EMS countries, three European non-EMs countries--Austria, the United Kingdom and Switzerland-- and three non-European countries--Canada, Japan and the United States. The results, presented in Table 6, indicate a sizeable increase in variability for two of the EMS countries--Belgium and the Netherlands-in contrast to the rather stable pattern in non-EMS countries. This fact suggests that part of the gain in reduced exchange-rate variability within the EMS countries was eroded through a higher variability of exchange rates between EMS and non-EMS countries.*

--insert Table 6 here--

Why has there been a significant decline in the growth rate of intra-EMS trade after 1979, in relation to

* Cf. Tables 28 and 29 in Ungerer et al. (1986).

* In support of this point Ungerer et al. (1986, table 22) show that the coefficient of variation of bilateral exchange rates, measured with respect to non-EMS countries' currencies, rises from 36.3 in the period 1974-78 to 46.7 in the period 1979-85 for the average EMS countries, and from 39.6 to 42.8 for the average non-EMS countries.

both its own past and to non-EMS trade growth, despite the achieved lower (within the EMS) exchange rate variability?*

De Grauwe and Verfaille (1987) tackle this issue by testing a cross-sectional model of bilateral export flows, the determinants of which being the growth of demand of the importing country, the growth of output supply of the exporting country, exchange-rate variability, the nature of the trade arrangement between the pairs of countries and an indicator of protectionism, the latter quantified by cumulative percentage overvaluation of the currency of the importing country. Overvaluation is defined in terms of productivity-adjusted real exchange rate. The main findings are that the slowdown in the growth of output in the EMS and the slowdown in the integration process had a larger impact

* Vaubel(1987) reports the following trade statistics

	Average yearly growth of exports and imports, 1979-1984	
Old EEC members	with EMS countries	with non-EMS countries
Belgium	0.3	4.9
France	1.3	5.3
Germany	1.4	4.4
Netherlands	0.4	3.9
Italy	0.4	2.2
New EEC members		
Denmark	2.8	2.5
Ireland	5.9	3.8
United Kingdom	4.1	4.9

Source: IMF, Direction of Trade.

Denmark, Ireland and the United Kingdom, the new members of the EEC, have experienced larger trade growth rates with the EEC countries than the old members. The late entry into customs union may explain in part the difference in performance; there is, however, the possibility, only applicable to the United Kingdom, that the EMS arrangement has in fact retarded trade growth within the EEC.

on intra-EMS trade growth than the beneficial effect of lower exchange-rate variability. What remains to be explained, according to the authors, is "whether the EMS arrangement might have induced both low exchange rate variability and low growth of output."

Inflation rates and money growth

Proponents of the EMS have pointed to the reduction in inflation rates in the EMS countries as a sign of the system's success. Statements of this kind need to be carefully scrutinized in two ways. First, is the inflation rate during the EMS period significantly lower than in the pre-EMS period? Meaningful statistical inferences cannot be made by simply comparing two periods. Naturally, these periods will differ by the number, size and nature of the shocks, as well as by the exchange-rate regime under consideration. Only under the heroic assumption of equivalent shocks can we attribute to the exchange-rate regime the decline in the inflation rate. To relax in part the assumption of homogeneous shocks--and this is the second point--one can compare the performance of the EMS economies with economies which are "similar" to the EMS economies, except for the exchange-rate regime.

In Table 7 I have reported the average inflation rates--measured in terms of the consumption deflator--of the eight EMS countries, the EMS average, and the averages of the non-EMS countries for the pre-EMS period 1974-1978 and the post-EMS period 1979-1986. The data are annual and come from the diskettes of the OECD, <u>Economic Outlook</u> N. 41 (June 1987). The aggregation over countries was made by multiplying the country's growth rate by the country's weight based on GNP share calculated in 1982 prices and exchange rates.[7] In addition to the two sample averages, Table 7 shows the difference between the two periods and indicates whether this difference is significantly different from zero.[8]

--Insert Table 7 here--

The essential point emerging from the table is that the small two percentage point decline in the inflation rate in the EMS is not statistically significant, whereas the large declines in the other six countries are. These results may not do justice to the drastic disinflation that has taken place in the EMS countries in the last three years, and indeed the outcome would drastically change if we ignored the first four years of the EMS. Belgium had an

[7] These weights are: Belgium = 1.1, Denmark = 0.7, France = 7.0, Geramny = 8.5, Ireland = 0.2, Italy = 4.5, Netherlands = 1.8, Austria = 0.9, United Kingdom = 6.3, Switzerland = 1.2, Canada = 3.9, Japan = 14.0, United States = 40.9.

[8] The following t statistic was employed:

$$t = (x_1 - x_2)/[std(1/n_1 + 1/n_2)^{1/2}]$$

where $std = [(n_1 * var_1 + n_2 * var_2)/(n_1 + n_2 - 2)]^{1/2}$, x_1 = sample average of the pre-EMS period, x_2 = sample average of the EMS period, var_1 = variance of the pre-EMS period, var_2 = variance of the EMS period, n_1 = number of observations in the pre-EMS period, and n_2 = number of observations in the EMS period.

inflation rate of 1.4 per cent in 1986 compared to to an inflation rate of 7.1 per cent in 1982; Denmark 3.6 per cent compared to 9.8 per cent; France 2.2 per cent compared to 10.6 per cent; Germany -0.4 per cent compared to 4.7 per cent; Ireland 3.7 per cent compared to 14.7 per cent; Italy 6.0 per cent compared to 15.7 per cent; and the Netherlands 0 per cent compared to 5.1 per cent.

Different considerations can be made with respect to the growth rate of the money stock which slows down significantly in Belgium, Germany, Italy and the Netherlands, whereas it rises in the other three European non-EMS countries (again Table 7). The incompleteness of money data for Denmark and France, however, prevents us from making statistically relevant comparisons between EMS and non-EMS aggregates. As an alternative to the money stock I considered the growth rate of the monetary base, which has the advantage of closely reflecting the policy actions of the central banks.* In Table 8 I report the sample averages of the annualized growth rate of the monetary base of each EMS country and their relative growth rates, defined by the difference of the country's growth rate and the growth rate of the EMS aggregate excluding the country in question.

--insert Table 8 here--

* These are quarterly data obtained from the International Financial Statistics (line 14) of the IMF.

Italy and Ireland experienced significant (but at the relatively high 20 per cent confidence level) declines in the growth of the monetary base; France, in contrast, had an increase in the relative growth. The interplay of these forces within the EMS was such to leave the EMS monetary base growth in the 79-86 period virtually unchanged with respect to the pre-EMS period.[10]

--insert Table 9 here--

Interest rates

Integration of the finacial markets implies that, in the absence of expected real exchange rate changes, real rates of interest cannot differ among countries. Rogoff (1985) shows that the difference between German and French and German and Italian short-term real interest rates increased during the EMS period. Furthermore, the conditional variance of these interest rates--based on two alternative ways to proxy the expected rate of inflation--rose as well in the post-EMS period.[11] Giavazzi and Pagano (1985) present evidence that the spread between offshore and onshore interest rates widens and becomes more variable when an expectation of a parity realignment sets in. Tying the

[10] There is a slowdown in the growth rate of the monetary base of the "rest of the world" but it is not statistically significant. It should be noted that the growth rate of the monetary base has large variances in all countries, a fact that explains why apparently large drops in the sample means do not result statistically significant.

[11] Cf. Table 5.

evidence produced by Giavazzi and Pagano with that of Rogoff one arrives at the conclusion that the reduced variability of the exchange rates cannot be credited to coordinated monetary policy, but rather to the existence of capital controls that have effectievly put a wedge between German interest rates, on the one hand, and French and Italian interest rates, on the other hand. Goodhart (1986), on the strenth of this evidence, argues implicitly against the entry of the United Kingom in the EMS, because the crucial role of London as a major financial center requires freedom of capital movement. Put it differently, if the cost of joining the EMS is the application of exchange controls, the EMS is not worth it.

The evidence on interest rates cited above was based on data going up to 1984. What has happened more recently? The most important development is the exchange liberalization process that has taken place both in Italy and France, forcing the real interest rates in these countries to rise relative to those abroad. I have calculated in Table 9 the short-term real rate of interest using two alternative data sets: the annual data of the OECD and the monthly three-month Treasury rates published by the Harris Bank's Weekly Review. In both instances I have assumed that individuals were blessed with perfect foresight as to the next period's rate of inflation. While the two data sets yield different quantitative results, qualitatively they concur in pointing to a narrowing of the differentials.

The narrowing of the interest-rate differential is consistent with the hypothesis that countries like France and Italy have used the exchange rate as an exogenous variable and have adopted a policy of letting their domestic currencies appreciate in real terms vis-à-vis the Deutsche mark.

--insert Table 9 here--

Economic growth and unemployment

How have the EMS countries performed on the real side of the economy? The evidence is very clear concerning unemployment, less so about output growth. Unemployment rates have increased substantially in the post-EMS period: in each of the EMS countries the increase is statistically significant at the five percent level (cf. Table 10). But this is also true for the other three European countries, which are not part of the EMS, in contrast with the experience of the Canada-Japan-US group. The unemployment story does not carry over, however, to the growth of real gnp where the slowdown is statistically significant for France, Ireland and the Netherlands. It should be noted that the growth rates of output in the 74-78 period were low to begin with, making the economic slowdown even more pronounced.

--insert Table 10 here--

The nature and size of the real slowdown in Europe is very controversial and the subject of ongoing research. One critical issue is whether the higher unemployment results from high real wage rates (Classical explanation) or from inadequate spending (Keynesian explanation). It should be noted that unemployment in Europe is largely concentrated among the young and the unskilled, particularly in well-defined geographical areas. In a recent paper Drèze et. al. (1987) argue that European unemployment exhibits both Classical and Keynesian characteristics. These economists propose a series of supply-side measures aimed at reducing the high wedge between the private cost of labor, inclusive of taxes, and the social cost, i.e., net of tax. But they also propose Germany, France and the United Kingdom to generate additional government spending to expand productive capacity--which is currently almost fully used--in the future.[18]

From the perspective of our paper the above discussion highlights that the EMS is a monetary arrangement, not a fiscal one. Indeed there is evidence that fiscal policies among the EMS countries were more divergent after 1979 than before.

[18] The proposal entails higher public debt today and more taxes in the future. The higher public debt today serves to induce an intertemporal substitution of labor away from the future (when the economy will be at full employment) and towards the present (when resources are unemployed).

III. AN INTERPRETATION OF THE EMS

The EMS was created to achieve "a zone of monetary stability in Europe" that would eventually culminate into the establishment of a European Monetary Fund. Central banks have interpreted "a zone of monetary stability" to mean: (1) lower variability of exchange rates, and (2) lower and converging inflation rates among EMS countries.

The evidence presented in Section II of the paper can be summarized as follows. The EMS has been successful in reducing nominal and real exchange rate variability. Yet, intra-EMS trade growth has fallen. It is conceivable that trade growth would have fallen even more with more exchange rate variability. As to inflation, the facts are more ambiguous. The achieved reduction in the inflation rates turns out to be not as significant as the reduction in inflation rates among non-EMS countries, when the entire post-EMS period is considered. If, instead, one isolates the 1982-86 period the story becomes much more favorable for the EMS. Finally, there is some evidence that France and Italy have used the EMS as a disinflationary mechanism, by letting their currencies appreciate in real terms vis-à-vis the Deutsche mark and their real rates of interest rise relative to the real rates of interest prevailing in Germany.

Two questions immediately come to mind. Why would France and Italy accept the discipline of the EMS in preference to appropriate domestic disinflationary policies? Why would Germany be part of a scheme that makes it a potential importer of inflation? The rest of the paper is devoted to answer these two questions.

Credibility hypothesis

The key issue underlying the first of the two questions is whether or not membership in the EMS facilitates disinflation relative to an independent policy of disinflation. High-inflation countries may find it worthwhile to join an EMS-type arrangement because of the benefit derived by linking their currencies to that of a low-inflation country. These benefits stem from the reputation the low-inflation country's central bank has earned in the market place.

A central bank with little or no reputation faces an inflation rate higher than would prevail if the central bank had committed itself to a credible strategy of disinflation.[13] This central bank can borrow reputation by

[13] There is one branch of the literature on reputation that considers conditions under which policy shifts are credible (e.g., Barro and Gordon 1983), while another branch emphasizes that the central bank is free to follow discretionary policies and determine its level of credibility (e.g., Cukierman and Meltzer 1986). According to the latter view it is not clear that the EMS enjoys a comparative advantage in generating reputation over an independent monetary policy of disinflation.

commiting its country's currency to a policy of real exchange rate appreciation with respect to the currency of a low-inflation, credible, central bank. The EMS can be interpreted as an arrangement of this type, with relatively high-inflation France and Italy borrowing reputation from low-inflation Germany.

Giavazzi and Pagano (1986) explore theoretically the advantage of high-inflation countries of tying their hands, as far as monetary policy is concerned. The critical point for these economists is not whether the EMS is an effective disciplinary force, but whether the high-inflation countries gain from the arrangement. The gain of reputation is only one aspect of joining the EMS; high-inflation countries have also to consider the losses in competitiveness implied by real exchange rate appreciations. The Giavazzi-Pagano model postulates that monetary authorities prefer more output to less output, value a positive rate of inflation because it creates revenues, but dislike inflation variability because of its adverse effects on output. The latter responds positively to real exchange rate depreciation and inflation "surprises". Finally, the real exchange rate of the high-inflation countries appreciates between realignments, but returns to its initial value at the time of a realignment (i.e., changes in parities are set equal to cumulative inflation differentials). Under these conditions, the EMS is worth joining if the authorities do not seek to extract revenues from inflation, an intuitive outcome. Equally intuitive is the result that the payoff of joining the EMS is ambiguous if the authorities value the inflation tax; the final outcome depending on the relative strength of the seigniorage, the present value of output loss due to inflation variability, and the tightness of the EMS regime.

Unfortunately, there are no empirical measures of the three forces that are critical in the determination of EMS membership. It is only through revealed reference that we can deduce that the seigniorage incentives are small enough, relative to the gain in reputation, to have made it worthwhile for France and Italy to remain in the EMS so far.

Benefits to the supplier of reputation

Let us turn to the second question raised earlier: What does Germany gain by being in the EMS? As a supplier of monetary credibility Germany provides an externality for which it appears there is no quid pro quo. Furthermore, the policy of high-inflation countries to export inflation makes the maintenance of low inflation at home more difficult. Once in the EMS, there is the additional problem of whether or not Germany would be able to dictate her terms; and if so, under what conditions.

The recent theoretical analysis by Begg and Wypsloz (1987) provides us with a useful vehicle to discuss these issues. In this paper there are two interacting economies--

one with high-inflation and the other with low-inflation--contemplating several alternative exchange-rate regimes. In these economies authorities want to minimize deviations of output from potential output and price inflation from desired inflation, subject to the following macroeconomic structure. To begin with, financial markets are integrated in the sense that differences in real rates of interest are equal to the expected real depreciation of the currency with the higher real interest rate. Aggregate demand responds positively to real exchange rate depreciation, and negatively to real rates of interest at home and abroad. Core or expected inflation adjusts slowly to changes in the actual inflation rate. The latter is a weighted average of changes in domestic prices and real exchange-rate depreciation: the depreciating country importing inflation from the appreciating country. Changes in domestic prices are determined by the expected inflation rate and output deviation from potential output. Finally, and importantly, one economy starts with a higher inherited inflation rate than the other.

The two countries can interact either with each monetary authority pursuing an independent policy or through an EMS-type arrangement. Two types of EMS are considered. There is a soft version, EMS(S), where exchange rates are fixed just before the economies have to adjust to steady state values of zero inflation and zero output deviation; and a hard version, EMS(H), where the economies have to commit themselves to fixed exchange rates in the early going. The relative merits of the independent strategy, EMS(S), and EMS(H) are best appreciated with reference to Figures 1 and 2, which are adaptations of equivalent figures in Begg and Wyplosz.

The horizontal axis of Figure 1 measures the difference between the inflation rates of high-inflation France and low-inflation Germany; the vertical axis the world (i.e., the two countries') average inflation rate. The indicated ellipses represent the preference mappings of the two countries. Points F1 and G1 indicate the best positions for France and Germmany, respectively. In words, Germany prefers to have a lower world inflation than France; France's "best" is achieved, not only with a higher world inflation rate, but also with Germany inflating relative to France. The vertical lines EMS(H) and EMS(S) refer to the two types of EMS arrangements.

The independent strategy, free floating, is denoted by N. as in Nash. Relative to N, France would like Germany to inflate more and, consequently, would prefer a higher world inflation. Germany, instead, would wish to distance herself more sharply from the French inflation rate, and would prefer a higher world inflation than it is implied by free floating (this result is ambiguous in the analysis). The shaded area represents the gain from cooperation. In

Figure 1 the vertical line EMS(S) runs through the shaded area. The critical assumptions there are that German aversion to inflation is low, initial inflation differences are high and the Phillips Curves are relatively flat in the sense that inflation is moderately sensitive to changes in output. Clearly EMS(S) is preferred to free floating and EMS(H). This is the case that is most consistent with casual observations of today's EMS.

Suppose Germany's aversion to inflation is very high, inherited inflation differences are small and the Phillips Curves are steep in the sense that inflation is very sensitive to changes in output. This outcome is depicted in Figure 2. EMS(H) is preferred to free floating: the high German aversion to inflation raises the desire to reduce disparities rapidly. But there is an intermediate case-- not shown in Figure 1-- where the shaded area would be to the right of EMS(S). Germany would prefer free floating to either EMS arrangement.

One of the key messages of the Begg-Wyplosz analysis is that free floating cannot be dismissed as an inferior solution to the EMS. The incentives of the low-inflation country to participate in the EMS depends on the weight authorities assign to inflation as well as on the initial conditions. As the authors put it (p.38) "an EMS formed to fight inflation might disintegrate once unemployment, not inflation, was the main concern, especially if both the success on inflation and the extent of the unemplyment problem were unanticipated at the date the bargain took place to hammer out the operating rules of the EMS."

There are other payoffs for Germany for being in the EMS. The models we have considered give monetary authority the exclusivity to set priorities for the economy as a whole. In reality there are conflicts within branches of the executive. Germany, as represented by the Ministry of Finance, is more favorable to a DM real depreciation than Germany represented by the Bundesbank (see Tsoukalis (1987)). Indeed, as I have already mentioned in the introduction, Chancellor Schmidt's original decision to join the EMS--against the opposition of the Bundesbank--might have had less to do with monetary unification than searching for an expedient way to diffuse the brunt of heavy speculative flows into Germany (Brittan 1979). It is not surprising that German authorities have consistently pushed for the integration of financial markets, with France and Italy relaxing exchange controls. The unfolding of tighter financial integration ought to raise the substitutability between DM-denominated assets and assets denominated in French francs and liras. The benefit for Germany will be less vulnerability to changes in U.S. economic policies.[14]

[14] The asymmetries noted by Giavazzi and Pagano (1985) will have then disappeared.

Evidence on Reputation

Giavazzi and Giovannini (1987) address the issue of how important reputation has been in the EMS. These two authors test for the empirical size of reputation by employing the famous Lucas (1979) critique to econometric practice in a positive manner. Since the institution of the EMS represents a new policy regime, it follows that any well specified model of inflation estimated before the EMS will tend to overpredict inflation during the EMS period for counrtries borrowing reputation, and underpredict for reputation-supplying Germany. Giavazzi and Giovannini estimate vector-autoregressive models which act as "idealized" reduced-form equations for changes in the price level, nominal wages, and output. These variables are postulated to depend on their lagged values, money growth, changes in the relative price of imported raw materials and changes in the relative price of imported finished goods, as well as on a smattering of country-specific dummy variables.

The authors find only one significant change in the over-all values of the estimated coefficients before and after the establishment of the EMS; and that occurs for the French price inflation. As Giavazzi and Giovannini admit it (p.16), "this result might suggest that the EMS has not brought about any of the changes in expectations that we describe in the sections above, except for the price equation in France." Since the authors do not provide statistics about the relative forecast accuracy of the models before and after the EMS, the issue of the effectiveness of the regime change cannot be explored more deeply.

What we are left with are graphs of the actual and predicted values of the models in the post-EMS period. These graphs, in the absence of formal statistics, become the evidence upon which the reputation hypothesis is evaluated. The graphs for Danish and German inflation "appear" to be consistent with the hypothesis. Germany, besides importing inflation from the other EMS countries, seems to be a loser on the real side of the economy as well: the systematic negative error of forecast in the output equation is consistent with the EMS having exerted a deflationary force on Germany.[18] This conclusion runs counter to the popular notion that Germany is a deflationary force on the system.

[18] The following table facilitates the interpretation of the empirical results of Giavazzi and Giovannini. The signs represent the systematic differences betweens actual and predicted values in the post-EMS period. Systematic is defined in a visual sense, that is, when it is obvious that the actual values are consistently above or below the predicted values. The question mark indicates inconclusiveness, again from an optical perspective.

	Denmark	Germany	UK	France	Italy
price change	-	+	-	- (after 82.II)	?
wage change	-	+	-	-	?
output change	+	- (after 82.IV)	+	-	+ (after 83.II)

Curiously enough, the United Kingdom appears to have been able to have the cake and eat it too, with systematic negative forecast errors in the inflation rate and positive forecast errors in output. This result, at face value, vindicates Mrs. Thatcher's insistence in not being part of the EMS.

Bundesbank leadership

There is virtual unanimity in the literature that, despite the intentions of the founding fathers to create a democratic institution, the EMS behaves as if Germany were a price leader (cf., for example, Sarcinelli 1986). The theoretical justification for this outcome emerges from Figure 1, where Germany can set her preferred inflation rate (point G2) that is consistent with both countries being better off relative to the N solution. The alternative of France setting her preferred inflation rate (point F2) is not consistent with an improvement over the N solution. The implication is that France would accept the German inflation rate.

Having accepted the German inflation rate, however, does not prevent the high-inflation France and Italy from complaining and setting up strategies to alter the institutional mechanism of the EMS. This is no more evident than on the issue of intra-marginal interventions. Official interventions in the exchange markets of participating countries are automatic and unlimited at the compulsory intervention rates, but are subject to prior authorization within the margins. Central banks extend to one another credit lines to finance the interventions (Very Short-term Financing Facility). Rules governing the use of these credit lines reflect the competing interests of debtor countries, who want adequate financing, and creditor countries, who worry about the money-creation consequences of interventions. Micossi (1985) points out that only a minor fraction of total interventions has occurred at the compulsory intervention limits. Since Germany seldom intervenes intra-marginally, some authors have concluded that that the burden of adjustment within the EMS has fallen on weaker-currency countries (e.g.,Tsoukalis (1987).

France has been more than vociferous in denouncing the dominant role of Germany. In January 1987, before the latest realignment, France refused to intervene as the franc fell to the compulsory intervention floor; the Bundesbank had to intervene. Inspired by France, the Finance Ministers of the EC in September of 1987 modified the rules governing interventions and their financing.[14] The key change concerns

[14] Masera (1987) outlines the principal institutional changes of the September 12-13, 1987 decision by the EC Council of Finance Ministers: in addition to the change discussed in the text, there is a time extension of the Very Short-term Financing Facility, a larger role given to the "official" ECU, and an engagement to monitor exchange rates, external imbalances and monetary conditions in each of the EMS countries. The decision was written with unusually guarded language.

the access of weak-currency countries to automatic credit through the Very Short-term Financing Facility. Mr. Balladur, the French Finance Minister, has interpreted the change as meaning "a presumption of automaticity" (an oxymoron?), whereas Mr. Poehl has interpreted the September decision as giving the Bundesbank the discretion to decide case by case on its merit, the criterion being that "the main pre-condition will be that it does not threaten price stability in Germany" (The Economist 1987). It is too early to judge whether the institutional innovations pushed by France, and backed by other countries, will nudge the Bundesbank to alter its monetary policy. Much will depend on the Bundesbank's ability to sterilize interventions in the exchange markets.

IV. CONCLUDING COMMENTS

The European Monetary System has not failed. The potential for an inflationary bias predicted by many economists has not materialized. So much is clear. Less clear is the matter of whether the EMS has been a success. The evidence marshalled in this paper indicates that the EMS has achieved lower exchange rate variability. Yet, intra-EMS trade growth has declined. The reduction in inflation rates, greatly praised by proponents of the EMS, turns out to be modest when compared to the reduction achieved by other countries. The stronger evidence pertains to the willingness of high-inflation France and Italy to have used the EMS as a disinflationary mechanism. The real value of the franc and the lira has appreciated in relation to the mark, while the wedge between German real interest rates, on the one hand, and French and Italian real interest rates, on the other hand, has shrunk. The early reliance of France and Italy on exchange controls has given way to later efforts to open up their financial markets.

The preference of France and Italy to join the EMS, over a domestically driven disinflation, suggests that the Banque de France and Banca d'Italia are relatively weak institutions, lacking the reputation of the Bundesbank. By committing themselves to a policy of real exchange rate appreciations, France and Italy use the reputation of the Bundesbank in lowering the inflation rate at a lesser cost than would be possible through an independent monetary policy.

EMS participation poses a complex problem to Germany. As a supplier of credibility the Bundesbank receives no reward from the EMS. In fact, the workings of the EMS make it "natural" for Germany to import inflation from high-inflation countries. On the other hand, the EMS makes it possible for the Deutsche mark to have smaller real appreciations than would be true under free floating. This competitive advantage may justify why the German government has been more favorable towards the EMS than the Bundesbank.

The EMS may generate another benefit for Germany: the integration of financial markets in Europe and, hence, smaller German vulnerability to changes in foreign economic policy, especially U.S. policy.

Belgium, Luxembourg, the Netherlands and Denmark are small countries that have embraced, to different degrees, a Deutsche mark standard. The United Kingdom has refused to join the EMS for fear of losing independence of monetary policy. The evidence reviewed in this paper does not indicate that the United Kingdom has lost by staying out. Ireland, a small country not linked to the Deutsche mark area, remains a puzzle as to its gain from EMS participation.

The EMS so far has run as a German-dominated system. There are pressures to make the arrangement more democratic. It is too early to predict any fundamental changes. However, should democratization come about without an adequate amount of shared reputation, a great deal of the raison d'être of the EMS would have disappeared.

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TABLE 1
Exchange Rate Realignments
Within the EMS

	DM	HFL	FF	BFR	LIT	DKR	IRL
24 Sept. 1979	+2.0	---	---	---	---	-2.9	---
30 Nov. 1979	---	---	---	---	---	-4.8	---
23 Mar. 1981	---	---	---	---	-6.0	---	---
5 Oct. 1981	+5.5	+5.5	-3.0	---	-3.0	---	---
22 Feb. 1982	---	---	---	-8.5	---	-3.0	---
14 Jun. 1982	+4.25	+4.25	-5.75	---	-2.75	---	---
21 Mar. 1983	+5.5	+3.5	-2.5	+1.5	-2.5	+2.5	-3.5
22 Jul. 1985	+2.0	+2.0	+2.0	+2.0	-6.0	+2.0	+2.0
7 Apr. 1986	+3.0	+3.0	-3.0	+1.0	---	+1.0	---
4 Aug. 1986	---	---	---	---	---	---	-8.0
12 Jan. 1987	+3.0	+3.0	---	+2.0	---	---	---

Source: Commission of the European Communities

Note: The numbers are percentage changes of a given currency's bilateral central rate against those currencies whose bilateral parities were not realigned. A + denotes an appreciation and -a depreciation. On March 21, 1983 and on July 22, 1986 all parities were realigned.

BFR = Belgium/Luxembourg franc, DKR = Danish kroner,
DM = Deutsche mark, FF = French franc, LIT = Italian lira,
IRISH £ = Irish pound, HFL = Netherlands guilder.

TABLE 2

Percentage Change in Bilateral
Parities from March 13, 1979 to January 12, 1987

	BFR	DKR	DM	FF	LIT	IRISH £	HFL
BFR		2.94	-27.18	10.13	18.30	7.48	-23.29
DKR			-30.12	7.19	14.75	4.54	-26.23
DM				37.31	45.48	34.16	3.89
FF					8.18	-2.64	-34.81
LIT						-10.82	-41.59
IRISH £							-30.77

Note: A + denotes a devaluation and - an appreciation of the currency shown in the column heading with respect to the currency shown in the row heading.

BFR - Belgium/Luxembourg franc, DKR - Danish kroner,
DM - Deutsche mark, FF - French franc, LIT - Italian lira,
IRISH £ - Irish pound, HFL - Netherlands guilder.

Source: Ungener et al. (1986, Table 6) and SanPaolo, ECU Newsletter, January 1987.

TABLE 3

Cumulative Bilateral Inflation Differential
Measured by the Wholesale Price Index
Over the Period 1979-1986

	BFR	DKR	DM	FF	LIT	IRISH £	HFL
BFR		28.1	-4.3	37.9	59.3	33.1	-2.9
DKR			-32.4	9.8	31.2	5.0	-31.0
DM				42.2	63.6	37.4	1.4
FF					21.4	-4.8	-40.8
LIT						-26.2	-62.2
IRISH £							-36.0

Note: A positive (negative) number indicates that the inflation rate of the country shown in the column heading is cumulatively higher (lower) than that of the country shown in the row heading.

BFR = Belgium/Luxembourg franc, DKR = Danish kroner, DM = Deutsche mark, FF = French franc, LIT = Italian lira, IRISH £ = Irish pound, HFL = Netherlands guilder.

Source: IMF, IFS, Yearbook 1987.

TABLE 4
Cumulative Bilateral Inflation Differential
Measured by the Consumer Price Index
Over the Period 1979-1986

	BFR	DKR	DM	FF	LIT	IRISH £	HFL
BFR		17.7	-18.8	27.0	65.0	69.6	-15.8
DKR			-36.5	9.3	47.3	31.9	-33.5
DM				45.8	83.8	68.8	3.0
FF					38.0	22.6	-42.8
LIT						-15.4	-80.8
IRISH £							-65.4

Note: A positive (negative) number indicates that the inflation rate of the country shown in the column heading is cumulatively higher (lower) than that of the country shown in the row heading.

BFR = Belgium/Luxembourg franc, DKR = Danish kroner, DM = Deutsche mark, FF = French franc, LIT = Italian lira, IRISH £ = Irish pound, HFL = Netherlands guilder.

Source: IMF, IFS, Yearbook 1987.

TABLE 5
Percentage Change in Bilateral
Real Exchange Rate Realignment
From March 13, 1979 to January 12, 1987

Wholesale Price Index

	BFR	DKR	DM	FF	LIT	IRISH L	HFL
BFR		-25.16	-22.88	-27.77	-41.00	-25.62	-20.39
DKR			2.28	- 2.61	-16.45	- 0.46	4.77
DM				- 4.89	-18.12	- 3.24	2.49
FF					-13.22	2.16	5.99
LIT						15.38	20.61
IRISH 1							5.23

Consumer Price Index

	BFR	DKR	DM	FF	LIT	IRISH L	HFL
BFR		-14.76	- 8.38	-16.87	-46.7	-62.12	- 7.49
DKR			6.38	- 2.11	-32.55	-27.36	7.27
DM				- 8.49	-38.32	-34.64	0.89
FF					-29.82	-25.24	7.99
LIT						4.58	39.21
IRISH 1							34.63

Note: A positive number indicates a real depreciation of the country's currency shown in the column heading with respect to the country's currency shown in the row heading. The real exchange rate changes were obtained by subtracting the cumulative inflation differences of Table 3 and Table 4 from the cumulative nominal parity changes shown in Table 2.

BFR - Belgium/Luxembourg franc, DKR - Danish kroner,
DM - Deutsche mark, FF - French franc, LIT - Italian lira,
IRISH £ - Irish pound, HFL - Netherlands guilder.

TABLE 6
Variability of the Annual Growth
of the Effective Exchange Rate

EMS countries	period 1974-78 standard deviation	period 1974-78 standard deviation / mean	period 1979-86 standard deviation	period 1979-86 standard deviation / mean	F ratio
Belgium	1.40	0.53	4.68	3.78	11.15
Denmark	1.61	3.36	3.68	1.77	5.19
France	5.73	3.31	3.77	2.04	0.43
Germany	2.15	0.45	3.32	1.14	2.38
Ireland	2.02	0.63	4.25	1.81	4.43
Italy	4.31	0.44	3.03	0.82	0.50
Netherlands	0.91	0.28	3.42	1.81	14.09
Sum EMS	1.55	5.33	2.72	13.69	3.07
Austria	1.34	0.49	1.54	0.74	1.34
Switzerland	6.50	0.61	3.14	1.07	0.23
United Kingdom	5.17	0.83	6.00	11.64	1.34
Sum Euro non-EMS	4.11	1.44	4.18	16.27	1.04
Canada	6.16	2.21	2.98	1.31	0.23
Japan	9.83	1.88	10.51	2.18	1.14
United States	4.64	5.31	1.42	1.35	0.09
Sum non-Euro non-EMS	2.41	5.34	4.81	2.77	3.99

Source: OECD, Economic Outlook N. 41 (June 1987) data diskettes.

Note: F ratio is the ratio of the variance of the 79-86 period to the variance of the 74-78 period. The value of the F(7,4) statistic at the 1 percent level = 14.98; at 5 percent level = 6.09.

TABLE 7
EMS vs. Non-EMS Countries:
A Comparison of Inflation and
Money Growth Rates

Countries	Annual Percentage Change Consumption Deflator 74-78	79-86	Difference	Annual Percentage Change Money Stock 74-78	79-86	Difference
Belgium	8.54	5.53	-3.01**	11.77	6.14	-5.63*
Luxembourg	7.49	6.03	-1.46	-	-	-
Denmark	10.37	7.79	-2.58	-	15.87	
France	9.93	8.57	-1.36	-	9.79	
Germany	4.66	3.43	-1.23	8.83	5.92	- 2.91*
Ireland	14.87	11.00	-3.87	17.14	10.96	- 6.18
Italy	16.12	13.17	-2.95	19.05	12.89	- 6.16*
Netherlands	7.65	3.75	-3.9 *	12.07	7.05	- 5.02**
EMS Countries	9.04	7.10	-1.94	-	-	-
European non-EMS Countries[a]	12.40	7.15	-5.25*	4.91	11.63	6.72*
Non-European Countries[b]	8.04	5.24	-2.80**	10.30	8.75	-1.55**

Source: OECD, Economic Outlook N. 41 (June 1987) data diskettes.

a = Austria, United Kingdom and Switzerland

b = Canada, Japan and the United States

* Statistically different from zero at the 5 percent significance level (t distribution, 11 degrees of freedom)

** Statistically different from zero at the 10 percent significance level (t distribution, 11 degrees of freedom)

TABLE 8
Growth of the Monetary Base in the EMS Countries
(Quarterly Data 1974:2-1986:4)

	Own Growth Rate			Relative Growth Rate		
Countries	74-78	79-86	Difference	74-78	79-86	Difference
Belgium	6.00	2.40	-3.60	-1.38	-5.3	-3.92
Denmark	11.58	12.37	0.79	4.39	5.06	0.67
France	0.34	8.19	7.85	-9.88	1.04	10.92***
Germany	4.84	4.00	-0.83	-3.86	-5.37	-1.51
Ireland	16.83	7.59	-9.24***	9.59	0.13	-9.46***
Italy	21.46	13.97	-7.49***	17.44	8.03	-9.41*
Netherlands	8.88	5.78	-3.10	1.69	-1.82	-3.51
Sum EMS	7.32	7.46	0.14			
Rest of the World	8.07	7.25	-0.82			

Source: International Monetary Fund, International Financial Statistics, line 14, various issues

Note: The first three columns refer to the annual percentage change of the monetary base of the indicated country; the second three columns refer to the difference between the country's growth rate and the rest of the EMS'. Rest of the world is defined as the weighted sum of Canada, Japan, the United Kingdom and the United States.

* Statistically different from zero at the 5 percent significance level (t distribution, 49 degrees of freedom)

*** Statistically different from zero at the 20 percent significance level (t distribution, 49 degrees of freedom)

Table 9
EMS vs. non-EMS Countries:
A Comparison of Real Interest Rates

OECD Data

	1974-1978		1979-1986			
	mean	std	mean	std	t stat	F ratio
Belgium	1.31	2.03	6.11	1.35	-4.61	0.44
France	-0.13	1.32	3.61	3.49	-2.14	6.99
Germany	1.33	1.27	4.27	1.91	-2.80	2.26
Ireland	-4	2.99	3.17	4.51	-2.90	2.28
Italy	-1.58	2.2	3.65	4.73	-2.13	4.62
Netherlands	-1.09	1.75	4.02	1.44	-5.26	0.68
EMS countries	0.08	1.04	4.04	2.63	-2.96	6.40
European non-EMS countries	-2.85	1.95	3.51	2.48	-4.48	1.62
Non-European Countries	0.1	0.28	2.45	1.12	-4.23	16.00

HARRIS BANK Data

	1974-1978		1979-1986			
	mean	std	mean	std	t stat	F ratio
Belgium	0.206	3.718	5.87	3.08	-63.06	0.69
France	-1.26	2.07	4.18	4.25	-57.43	4.22
Germany	0.22	2.34	3.25	2.61	-45.16	1.24
Ireland	N.A.					
Italy	-4.49	7.94	1.51	5.44	-34.11	0.47
Netherlands	N.A.					
UK	-4.91	6.25	3.18	5.78	-50.54	0.86
Canada	-0.98	3.09	4.42	2.76	-69.55	0.80
Japan	-2.65	5.41	2.84	3.87	-44.99	0.51
USA	1.7	2.2	3.44	86.12	-0.98	1532.37

Source: OECD, Economic Outlook N. 41 (June 1987) data diskettes; and Harris Bank, Weekly Review, various issues.

t statistic: the critical values with 11 degrees of freedom (OECD Data) are 2.2 (5 per cent) and 1.8 (10 per cent); with 154 degrees of freedom (Harris Bank Data) 1.98 (5 per cent) and 1.65 (10 per cent).

F statistic: the critical values with (7,4) degrees of fredom (OECD Data) are 14.98 (1 per cent) and 6.09 (5 per cent); with (92,62) degrees of freedom (Harris Bank Data) approximately 1.71 (1 per cent) and 1.46 (5 per cent).

TABLE 10
EMS vs. Non-EMS Countries:
A Comparison of Output Growth
and Unemployment Rates

Countries	Annual Percentage Change Of Real GNP			Unemployment Rate		
	74-78	79-86	Difference	74-78	79-86	Difference
Belgium	2.31	1.42	-0.89	5.25	10.75	5.5 *
Luxembourg	1.18	2.28	1.1	0.37	1.24	0.87*
Denmark	1.55	2.31	0.76	5.16	8.69	3.53*
France	3.03	1.52	-1.51**	4.42	8.41	3.99*
Germany	2.00	1.74	-0.26	3.54	6.30	2.76*
Ireland	3.77	0.55	-3.22*	7.72	12.56	4.84*
Italy	2.12	1.99	-0.13	6.38	9.14	2.76*
Netherlands	2.55	1.04	-1.51***	5.15	11.45	6.3 *
EMS Countries	2.38	1.66	-0.72	4.62	8.18	3.56*
European non-EMS Countries[a]	0.99	1.70	0.71	3.46	7.76	4.3*
Non-European Countries[b]	2.81	2.54	-0.27	5.76	6.57	.81

Source: OECD, Economic Outlook N. 41 (June 1987) data diskettes.

a - Austria, United Kingdom and Switzerland

b - Canada, Japan and the United States

* Statistically different from zero at the 5 percent significance level (t distribution, 11 degrees of freedom)

** Statistically different from zero at the 10 percent significance level (t distribution, 11 degrees of freedom)

*** Statistically different from zero at the 20 percent significance level (t distribution, 11 degrees of freedom)

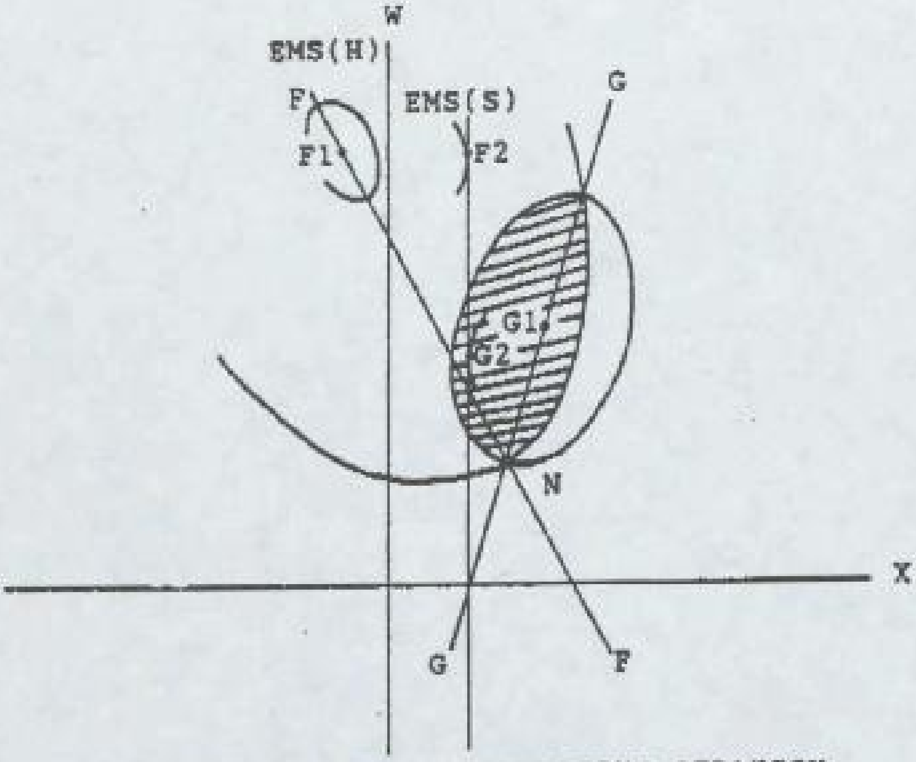

FIGURE 1: SOFT COOPERATIVE STRATEGY

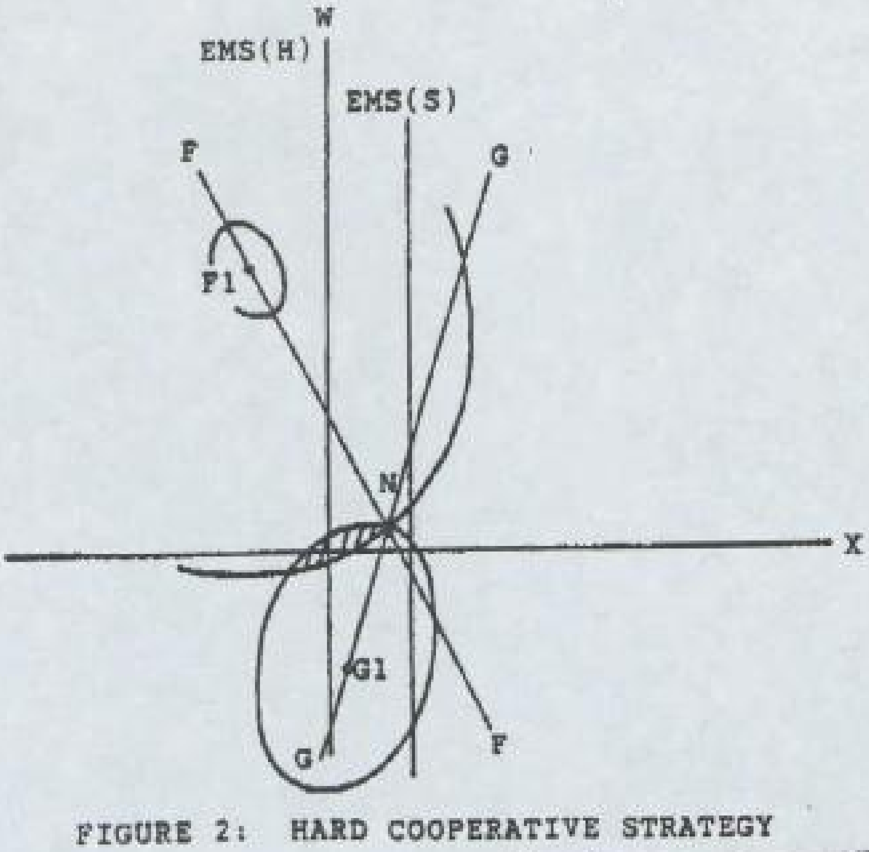

FIGURE 2: HARD COOPERATIVE STRATEGY

X= FRENCH INFLATION RATE MINUS GERMAN INFLATION RATE
W= AVERAGE OF FRENCH AND GERMAN INFLATION RATES

PMMAUY

RA

PRIME MINISTER

mrs

CHANCELLOR'S EVIDENCE TO THE TCSC

I had a verbal report on the Chancellor's evidence to the TCSC this afternoon. From what I have been told, I doubt if this will present any difficulties for Questions tomorrow. The immediate effect of his comments was substantially to strengthen sterling; it rose to DM3.12 and $1.88, and is still fluctuating around those levels in New York this evening.

The main points bearing on the exchange rate issue that came up were:

- the Chancellor contrasted the present position with the early 1980s, when high inflation demanded shock treatment;

- nonetheless he seems to have repeatedly stressed that the objective of monetary policy was the control of inflation;

- he seems to have made various references to the desirability of exchange rate stability, but, as far as I can gather, at no point implied that this was other than subordinate to counter-inflation policy. At various points, he argued that exchange rate stability supported and buttressed the fight against inflation, and presented the policy of greater stability over the last year as desirable in breaking industry's expectation of continued depreciation;

- at one point he referred to a policy of "stability rather than volatility";

- he presented the decision to allow the exchange rate to rise above DM3 as a necessary tightening of monetary policy in order to counter inflation;

- as the Governor had done on Monday, he stressed that all monetary policy instruments would be used as appropriate;

- he repeated his earlier phrase about action speaking louder than words;

- he refused to be drawn into short term market tactics, and emphasised that the authorities never commented on this;

- when pressed on the ERM, he used the old phrase about not joining until the time was ~~right~~ ripe;

- Giles Radice pressed him to explain your comment about not bucking the market. The Chancellor tried to turn the question back on him, but when Radice pressed and subsequently asked what you had meant by it, the Chancellor responded that Radice had better ask you. This might conceivably come up at Questions tomorrow; if so, I suggest your line should be that, while there were advantages in greater exchange rate stability, the overriding priority is to defeat inflation and this can be prejudiced by ~~offers~~ efforts to resist strong market pressure pushing exchange rates up;

- the one point where the Chancellor seems to have differed from the Governor was in saying he did not accept the Governor's remarks that last year's intervention had had nothing to do with the Louvre Accord.

The Treasury will be providing a suggested line to take at Question Time later tonight.

RRCG.

PAUL GRAY
30 March 1988

Reference ....

CHANCELLOR
CHIEF SECRETARY
FINANCIAL SECRETARY
PAYMASTER GENERAL
ECONOMIC SECRETARY
SIR PETER MIDDLETON
SIR TERENCE BURNS
SIR GEOFFREY LITTLER
MR SCHOLAR
MR ANSON
MR ODLING SMEE
MR PERETZ
MR CULPIN
MR SEDGWICK
MR S J DAVIES
MISS O'MARA
MR PICKFORD
MR R I G ALLEN
MR HUDSON
MRS RYDING
MR POLIN

1. Mr. Wicks - to see.
Not Seed

2. RA - Exchange rate policy

MR ~~GRAY~~ NO. 10

I attach a copy of the uncorrected transcript of the Governor's evidence to the TCSC yesterday

C Evans
29.3

CODE 18-77

5167

HOUSE OF COMMONS

MINUTES OF EVIDENCE

TAKEN BEFORE

THE TREASURY AND CIVIL SERVICE COMMITTEE

MONDAY 28 MARCH 1988

Evidence heard in Public Questions 153 - 241

USE OF THE TRANSCRIPT

1. Members and prospective witnesses to whom the transcript is sent in strict confidence, under the authority of Mr Speaker and the Committee, are asked to note that the text is unpublished and that its use should be governed by the guidelines in the following paragraphs.

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MONDAY 28 MARCH 1988

Members Present:

Mr Terence Higgins, in the Chair
Mr Anthony Beaumont-Dark
Mr Nicholas Budgen
Ms Joyce Quin
Mr Giles Radice
Mr John Townend
Mr John Watts
Mr David Winnick

EXAMINATION OF WITNESSES

THE RT HON ROBIN LEIGH-PEMBERTON, Governor; MR E A GEORGE, Executive Director; and Mr John Fleming, Economic Adviser to the Governor, Bank of England, examined.

Chairman

153. Mr Governor of the Bank of England, the Committee would wish first of all to congratulate you on your re-appointment and to give you a warm welcome this afternoon to our proceedings, which are, of course, part of our normal annual report on the Chancellor of the Exchequer's Budget. As you know, we took evidence from officials last week and we shall be taking evidence from the Chancellor on Wednesday, but we are very glad indeed that you have been able to come along this afternoon to give us your views on a number of aspects of the Chancellor's Budget. May I first of all ask you two things: first, whether you wish to make any opening statement and secondly, if you would be kind enough to introduce your colleagues for the benefit of the shorthand writers?

(Mr Leigh-Pemberton) Yes, Mr Chairman. May I thank you very much for your kind welcome and congratulations. I do not think I really want to make an opening statement on this occasion;

I know you do not like them. I see from last year's record that my opening statement was a little shorter than some of my answers, but in the circumstances I think it is probably more helpful for you to go straight into question and answer. Secondly, I have brought with me Mr George, Executive Director in charge of Home Finance and Mr Fleming, the Economic Advisor to the Governor.

154. Both you and Mr George and Mr Fleming are all most welcome. I think perhaps we might then proceed straight away to questions. The matters we are dealing with are of course quite complex and therefore it may be to some extent that the questions will overlap, but perhaps I might begin by referring to some of the evidence which we received last Wednesday: question number 151 from Mr Paris, who, in answer to the question about whether the PSBR was being fully funded and in particular whether the situation with regard to intervention in the exchange markets had also been sterilised,replied saying that the position starting from the beginning of the financial year to February showed a surplus of funding over the borrowing requirement plus exchange market intervention of £5.7 million. We have, as you well know, on previous occasions considered the various factors which might lead to an increase in the money supply, and we therefore would be grateful if first of all you could tell us, given the background which I have just mentioned, what you think the factors are which are leading to an increase in the money supply at the present time.

(Mr Leigh-Pemberton) Well, as far as over-funding is concerned, Mr Chairman, may I say that, as we see it at the moment, we are up to the end of February over-funded. That is over-funding both for PSBR plus the exchange market intervention, but it does not follow from that that we shall be over-funded by the end of the year. The difficulty about this question is that we do not know until after the end of March exactly what the target is, but we make a point of trying to fund - make a full, proper fund - as near as we can to what that target is likely to be, and we still believe that we can probable be within half a billion pounds one way or the other of the PSBR plus exchange market intervention by the end of the year. Insofar as you say does this contribute to the increase in the money supply, the level of exchange market intervention has that effect unless it is sterilised by funding, and we see no reason why we should not succeed in sterilising the intervention that has taken place in the last year probably by the end of the year, but I think you know it has now been stated policy that we should not aim to do this necessarily within the actual financial year but should do it as soon as appropriately possible. The reason for that is that it is very difficult to actually conduct the operations within the months in question and secondly, it is not to be known, of course, whether some of the intervention money may not be required for the opposite process later on in the year, if by any chance we have to intervene in the opposite direction. I do not say that is likely, but it is one of the reasons why we think it better not to have an absolutely barrier-type target at the end of March.

155. If we assume that both items are fully funded, what do you see as the source of monetary creation in these circumstances?

(Mr Leigh-Pemberton) Well, at the present moment the source of monetary creation will be the increase in bank lending which we get in the monthly figures, and that has been averaging at about £3 billion a month during the last year, with an exceptional high point, I think, in January, slightly lower in February, but other than that, given the fact that the Government has a PSBR, it is difficult to see that there is a serious source of increase in money supply from other sources.

156. Could you then tell us what weapons you have available to control the money supply in these circumstances?

(Mr Leigh-Pemberton) We have always got available the interest rate instrument and if I may take the question meaning what instruments do we have at our disposal, you say, to control the money supply - to operate monetary policy ....

157. Yes.

(Mr Leigh-Pemberton) At any given moment I take the view that we have really three essential elements or instruments at our disposal. One: the exchange rate itself; two: intervention; and three: the movement of interest rates, and I regard all those three as being available instruments for policy purposes.

158. Do you think they are adequate to control the expansion of credit which you referred to a moment or two ago?

(Mr Leigh-Pemberton) Yes; they have to be, because there are not other instruments, and whether they are adequate or not will turn, of course, on the - I was going to say the severity with which they are applied. I do not feel anxious that they are not adequate.

159. Except if we look at the Red Book, for example, we find that M4 is growing at some 16.5 per cent, and the latest statistics for M0 show it growing at 5.3 per cent. Does that give you any concern on prevention grounds?

(Mr Leigh-Pemberton) The growth of M0 at 5.5 is just within the target range for the current year, which would be just outside the target range for the coming year, which has been set at one to five. We think that we shall be able to keep M0 within the target range of one to five in the coming year. The growth of M4 at 14 or 15: it seems a large figure, but it has been more or less at that level during the last year and we do not regard that as unsatisfactory.

Chairman: I turn now to Mr Townend, who is concerned about some other aspect of the matter.

Mr Townend

160. Can you tell us, Governor, what does the Bank feel is the cost of Britain's apparent inability to reduce the level of inflation below four per cent?

(Mr Leigh-Pemberton) I personally think that the answer to that question lies not so much in the monetary situation but in something which is much deeper within our society. The chief thing, I think, is labour immobility. I think that the increase in earnings and in wage settlements that we see each year in this country does represent one of the most serious difficulties we have in controlling inflation. If one goes on to ask why do we have these sort of increases or settlements, which are higher than other countries, I think it goes back to very practical problems which confront employers, namely, the difficulty of getting or retaining skilled labour unless these sort of increases are conceded in wage negotiations. Now, this moves on further to lack of training to produce skilled labour and the difficulties that flow from some of the housing policies in this country. If I may be anecdotal for the moment, I can think of an employer in south-east England who told me that he did not wish to concede - let us say it was a six per cent across the board increase plus other bonuses, but if he did not concede it his neighbours certainly would, and he would lose his best people. I think that is very much at the heart of our difficulties. I think the second point is that we have inherently in this country an indifference towards inflation at the four to five per cent figure, which does not prevail in Germany or in Japan. The origin of that indifference may be that while people regarded inflation at anything above, say, twelve per cent as obviously dangerous, what is wrong with around four or five per cent? It is not doing anybody any harm, is the sort of feeling I think a lot of people have. One overlooks at that sort of rate the fact that the value fo money will halve within, I think it is something like, fourteen or fifteen years. There is a sort of barrier here, and I have given my answers, which are based on what we will call a social or political approach rather than monetary. It could be done by monetary means by much harsher application of monetary policy, from which there would flow a degree of restriction on the economy and a lack of growth which would probably to a degree be as self-defeating, but the problem for us is to get this balance which would produce sustained, non-inflationary growth. That is the objective to which our policy is aimed.

161. Are you saying that the only effective anti-inflationary discipline we have is a monetary squeeze?

(Mr Leigh-Pemberton) No, because I think we have got to address our minds to all the remedies that are at our disposal. The remedies to the two main underlying factors which I have described I have to admit are longer term in their effect - above all the training of skilled labour. Some of the changes in housing legislation could come through more quickly possibly, and therefore have quicker results, but if we wish to see immediate effects on a projected inflation rate of four or five per cent, then I think it has to be done through monetary policy.

162. Would you agree, Governor, following on your reply, that the Government has a part to play as far as public sector wage settlements are concerned? Surely you would not be putting forward the view that the recent settlement of the YEB wage claim that nearly doubled the rate of inflation had to be at that level because otherwise they would lose all their staff.

(Mr Leigh-Pemberton) No, I think that is true, and I would readily take your point about some of the public sector pay awards. Ten per cent for local authority manual workers, for instance, may have some justification, but it has obviously had its effect on rates and therefore upon costs.

163. Could I draw your attention to a speech that you made in January of this year at Tayside, when you said, "But the national indicators do tell us that the growth of domestic demand immediately before the stock market crash was significantly stronger than many had thought - indeed, unsustainably rapid. So far, the indicators for the period since October suggest no diminution in this rapid growth." Is this still your view, Governor, and are you worried that the economy might now be overheated?

(Mr Leigh-Pemberton) I do not think that the rate of growth in the first quarter of this year is comparable to the one that prevailed either in the quarter just before the stock market crash or the fourth quarter of last year. If you remember, originally there was great anxiety that the stock market crash would have an effect on the real economy and the projections I think that were put forward for growth in calendar 1988 in the Autumn Statement were brought down from three to two and a half per cent for that reason. Now the projection is back to three, because the effect of the stock market crash has been seen to be very limited on the real economy, whatever the effect on the financial markets. I do not think that the overheating pressure, however, is as great now as it was either in January or, as we saw from hindsight - and to a degree I was speaking then from hindsight - in the second half of last year.

164. So wwould you say that the Budget overall has reduced your worries about overheating?

(Mr Leigh-Pemberton) Yes. I think the important element in the Budge is a tight fiscal stance. It is projecting a level of growth for the economy in the coming year at three per cent, which seems to me consistent with sustained, reasonable levels of growth. Insofar as there are tax reductions, which impliedly increase the spending power of individuals, and therefore the potential of demand, I think you remember the Chancellor said that he much regretted that he would not be able to reduce taxation as a share of GDP, and therefore, although there is a big reduction in the rates of income tax, the overall level of take of income tax is about the same or a little bit more than last year.

So I think the budget is consistent with the Government's policy of sustained non-inflationary growth.

165. Are you not worried, then, about the very large rise in consumer credit?

(Mr Leigh-Pemberton) I am not worried about that from the prudential point of view, although I think it is a source of concern to the Bank in terms of the monetary expansion side. That is one of the reasons why we continue to adopt what is fundamentally a very cautious monetary stance. I think one has got to remember that the overall volume of this consumer credit is modest in comparison with the overall volume of general bank lending. For instance, I believe at any given moment the total stock of credit on credit cards is about the same as the monthly growth in bank lending overall.

166. It is rising rapidly - credit?

(Mr Leigh-Pemberton) No, I do not think it is. May I just ask Mr Fleming?

(Mr Fleming) I do not have the figures, but the growth of the credit element which is not simply the delays before settlement before interest is chargeable is smaller for consumers than it is for other sectors' borrowing from the Bank.

167. Have you read that rather interesting article today in The Telegraph by the former Treasury Minister, in which he comments on this and advocates the reimposition of hire-purchase controls? Can you see a time when this might be one of the instruments that the Bank feels is necessary to use?

(Mr Leigh-Pemberton) No, I do not think so. I do not think the reimposition of any physical controls is really a practical proposition in the modern context, largely because of the impossibility of the enforcing of it. One may introduce some regulations which affect the hire-purchase companies but it will be possible for borrowers to bypass them in some way or another - even by going offshore.

168. You mean the main defence against overheating is the interest rate?

(Mr Leigh-Pemberton) The main defence against overheating is a tight monetary policy, the components of which, in many given circumstances, would be both the level of the exchange rate and the level of interest rates.

Chairman

169. I think as there is quite widespread concern about the situation with regard to consumer credit, if you do have figures perhaps you might let us have a note on that; similarly on the prudential point as far as ratios are concerned in relation to the expansion of credit. Perhaps it would be helpful.

(Mr Leigh-Pemberton) I can answer the point prudentially, Chairman, I think, in that I feel quite confident in asserting that the levels are by no means a source of anxiety either to us, as bank supervisors, or to the banks, in that this is actually very sound lending. The recovery rate is higher than, for instance, commercial lending, and the danger to the prudential position of the banks from this is very modest. As far as the actual volume is concerned (I am sorry I do not have the figures in my mind), I am not under the impression that it is rising very fast in terms of consumer credit (that is, for personal borrowing outside the housing market).

Chairman: I think it would be helpful if we could have those figures.

Mr Beaumont-Dark

170. Governor, taking your last question - and I agree with

you about the hire-purchase controls and so forth - is there not a problem that if you control credit in that sense and consumer spending by way of high interest rates it means, as at the present time, high interest rates which affect, obviously, imports favourably but can help to crucify home manufacturers. Is there not a paradox in saying the only way to control consumer spending is interest rates - ie exchange rates - that help our imports but damages our exports?

(Mr Leigh-Pemberton) There is a paradox in this respect. While one might think it would be desirable to limit certain categories of credit - namely, say, for consumption - and undesirable to limit credit for investment in industrial expansion, the difficulty is that one cannot, in fact, differentiate between the two in treatment. This is part of the continuing dilemma and source of need of active judgment by the authorities to strike the right level of monetary tightness to ensure that we do not have overheating as a result of excessive consumer demand and yet, at the same time, we are not making life too difficult for our industrialists from their own competitive position.

171. Do you not think, then, that bearing in mind what you and I know of the Midlands, when there was a certain period in 1980 when interest rates stayed high and the pound burgeoned on and the manufacturing industry melted like snow in the sun, that there is a danger of that happening now, with the pound going on and on and with interest rates staying so high?

(Mr Leigh-Pemberton) I do not think that situation obtains now.

172. Have you spoken to industrialists about that?

(Mr Leigh-Pemberton) I am afraid I do not have to speak to them; they speak to me very forcefully! I understand their position because they could be forgiven for pleading for monetary conditions that make life less challenging for them. I have to say that the answer to that is that a response to that plea is short-sighted. You compare today with the events of 1980/81. Those were conditions, I acknowledge, which were extremely severe, but I am one of those who believe, in that context at that time, that that sort of severity was necessary simply to convince the country, and business, that the country's inflationary policy was for real. The situation in 1988 is not, by any means, the same as that. After all, we have got inflation down to a much lower figure - 3 to 4 percent, perhaps - compared with a figure of 15 percent that prevailed at that time. There has been, admittedly, a harsh but severe, rationalisation of industry which has made industry much more competitive. I cannot accept that it would be either in the interests of industry or of the country that we should relax the present monetary stance and risk the resurgeance of inflation in the name of enabling industry to be more competitive. To improve competitiveness by devaluation is a short-term move. Experience in the past, surely, illustrates that. Secondly, it lands industry within a given period of time in increased costs as the cost of imported raw materials and half-finished goods - whatever has to be imported - goes up in relation to Sterling. It also relaxes what is the necessary continuous incentive to become more efficient and more competitive. I think it is perfectly reasonable to say to the industrialist, "You may feel an increase in costs of 3 to 5 percent is to be avoided"; indeed it is, because a 5 percent inflation rate is, in many respects, a 5 percent increase in costs, particularly against our international competitors. It is very interesting to observe what Japanese industry has achieved in the last year or two where their exchange rate has, in fact, strengthened enormously against the US dollar and they have managed to absorb it. I do not say that we necessarily want to do things in exactly the same way the Japanese do, but there is a remarkable example there of how industry becomes more competitively efficient against a background of high exchange rate and tight monetary conditions.

173. If I could take your points: you say that you do not blame manufacturers for not wanting it less challenging. No one is challenged more than Jaguars. If you saw their (as you must have done) profit figures against their turnover, no one has done more than Jaguars, but because of the messing about of the pound and because certain powerful people do not seem to care what the pound goes to, are we not in danger of heading into a situation where the most successful will lose heart? When you talk about stability, yes, stability is what manufacturers - and you and I know manufacturers in the Midlands I think, between us - want, but we have the Bank of England, and other people, shoving up interest rates in February on the grounds of the anti-inflationary policy. Then, lo and behold, after a certain amount of full and frank discussion in two Houses in London interest rates are allowed to come down again. Do you not think, seriously, that if we go on as we are now, industrialists, at least, need to know where they are, because this 5 or 6 percent up or down in the pound against the deutschmark and the dollar is hugely damaging when companies are trying to export, because why the hell should they not stay selling at home? Export is not fun; it may be necessary but it is not fun.

(Mr Leigh-Pemberton) I understand the force of all that argument, but it comes back to the necessary stance that we feel we have to take as part of the fundamental counter-inflationary policy. You mentioned the interest rate movements in the last two months and the movements in the exchange rate. Interest rates came down quite sharply after the stock market crash last October. They came down because the authorities felt it was necessary to maintain confidence and a degree of liquidity in the markets after that setback, and in anticipation of what was thought likely to be a reduction in activity in the economy as a result of that crash. In fact, as I said earlier, that did not really materialise; the effect on the real economy as very limited. It follows from that, arguably, therefore, that the reduction in interest rates last Autumn were, in fact, over-generous in terms of the monetary conditions at that time, because they were related to a danger that never materialised. It certainly was the position, both of the Treasury and the Bank, that at the beginning of this year - or, indeed, towards the end of last year - that if it were possible to raise interest rates to get a better structure of interest rates against domestic monetary expansion we should do so, provided we do not make it too difficult to maintain the pound with the range we have been aiming for in the previous year. That opportunity occurred in February, in our judgment, and I think we were proved to be right. The fact that interest rates were able to come down in March, of course, was a consequence of a different change in policy, namely the acceptance of the inevitability of the pound going up by between 3.05 and 3.10 DM as happened, as you know, a fortnight ago. I accept the implications of this for industrialists, but I must adhere to the fundamental policy stance, and I think what we have done flows logically from that earlier stance.

Chairman

174. While one might accept the argument against policy depreciation, of course the consequence which you mentioned, that

would not necessarily mean one would advocate a policy of appreciation, which is what is happening at the moment.

(Mr Leigh-Pemberton) No. I do not know there is any specific desire, necessarily, to have appreciation. The difficulty that obtained within the early part of this year was that the upward pressure on the pound meant that either we had to accept an increase in the exchange rate value of the pound or, alternatively, we had to defer what were necessary steps domestically in terms of domestic monetary policy - ie an adjustment in interest rates in a way that would have been prejudicial to the overall counter-inflationary objective policy.

This was the position, the dilemma we found ourselves in, and we tried to hold the range within which we had been operating throughout most of last year and into this year, but, as you know, the pressure the week before the Budget became really too great and was inconsistent with our policy, and we had to allow the pound to rise.

Chairman] Thank you. Mr Watts has some other questions on interest rates.

Mr Watts

175. Governor, earlier you referred to the role of interest rates in controlling money supply and the Chancellor in his Budget statement said short term interest rates remained an essential instrument of monetary policy. How precisely do relatively small movements in short term interest rates act upon monetary conditions?

(Mr Leigh-Pemberton) I do not think they do operate very precisely. It is one of the things that is most difficult for us to analyse and to understand - what is the immediate and obvious impact of the change in interest rates. But I do feel quite sure that they have the following influences. First of all, they have an influence on expectations - they make people feel that the situation is going to be tighter. Secondly, they have an effect on wealth - the assets that you hold. Government stocks, for instance, will fall in capital value and, therfore, impliedly your potential wealth is less; therefore you may take the view that your spending power is less. It also has an effect on income because in so far as you may have to pay interest on your house or something lese like that you pay more on that and have less left over for other purchasing purposes. So that in all sorts of ways the movement of interest does affect the overall tightness of the economy and, in fact, people's expectations. So that I have no doubt the effect is there and these movements in the short term interest rates do remain our main and most effective weapon, as the Chancellor said.

176. As to the three effects that you specified, with the possible exception of expectations where a small movement might act as a warning shot, do not the other two - the wealth effects andd income effects - require fairly large movements of interest rates before they actually have an impact? In the course of the past year no doubt the rate of interest on my mortgage has varied both up and down; I cannot say I am particularly aware of that, I have left my repayments at a level figure as I imagine many people would.

(Mr Leigh-Pemberton) I think that is fair comment, but equally I have no doubt that there is an effect at some stage or some margin, and I expounded on this at some greater length in the Mais lecture which took place towards the end of last year if one wants to follow that in any greater detail.

177. There might be some interesting follow-up reading. Does the Bank attempt any quantitative assessment of the relationship between short term interest rates and the growth of money supply by whatever measure one might choose?

(Mr Leigh-Pemberton) Yes. We look each month at not only the figures for MO but also those for M3, M4 and M5, and we do our best to assess what we call monetary conditions from looking at those aggregates and, above all, at the counterparts to those aggregates, what they are made up from and what is the explanation for the increase in bank lending so far as we can obtain it from statistics from the banks. The most important thing, to my mind, is that we should try to determine the extent to which what I would call transactions money (that is, money which seems to be immediately available for people to use for spending purposes) is distinguishable from financial assets which people are likely to hold, namely, say, longterm bank deposits. Now, it is not easy to make these distinctions any more because of the extent to which the changes in the financial system, the payment of interest on current accounts and all those sorts of changes, have blurred that distinction both as far as the bank customer is concerned and as far as the bank statistics are concerned. But, subject to that difficulty, we do our best to make an overall monthly assessment of what the monetary situation is. We have monthly discussions with the Treasury on it, and we form views about what is the correct response to the changes that have occurred as a result of those meetings. This is particularly Mr George's responsibility. I do not know whether I may ask if he would like to add anything to this.

(Mr George) Only one thing, Mr Governor. We do, of course, have in the model that kind of quantitative relationship between interest rates and lending, though I would have to say we woud not have any more confidence than most modellers would have in those results in this field. It is an administrative result. I think the one very important thing about interest rates movements is that their effect tends to depend upon the circumstances in which they are brought, so that if you have quite a small interest rate movement coming into a situation where it is unexpected, it can have a much bigger effect than in a circumstance where a bigger interest rate movement is expected. That is all, as the Governor said, working through the expectations route, so, yes, we do have quantitative estimates of the effect but quite honestly they are not worth a great deal.

178. So they do not really show any stable relationship between movements of interest rates and movements of the growth of money supply?

(Mr George) They show an average result observed over a long past period which all those relationships do.

179. Does the control of the money supply really matter as much as it was once thought to do? I have in mind that over recent years we have seen very rapid growth in money supply by whatever measure, so that £M3 was eventually abandoned as a published target - its growth seemed to outstrip its target year upon year. Yet that does not seem to have had any significant effect on the rate of inflation or inflationary pressures. As Mr Townend was saying in his questions, inflation seems to have gone along at between 3 percent and 4 percent irrespective of what

is done, and the growth of money supply has been much more rapid than that. Does it really matter as much as we once thought?

(Mr Leigh-Pemberton) It does matter because one cannot operate monetary policy without some regard for the level of credit in a country at any given moment. One cannot even operate economic policy without doing that. What is the great difference, I think, between now and when M3 was a formal target, or when monetary targeting was first introduced in the late 1970s, is that in these days we have very real interest rates; in those days that was not the case and, therefore, the growth of any monetgary aggregate threatened a big monetary pressure on the economy. Now, as I have tried to explain today and as I have explained before, it looks very much as though these monetary assets are, in fact, held by individuals and by corporations and, therefore, do not have the same potential monetary danger. That is why we have taken the view that the £M3 figure, for instance, does not give such a direct or convincing picture of monetary conditions that we either target it or necessarily immediately respond to movements in it; but we certainly do not ignore it because it is composed of important counterparts which give a useful picture of what is happening in the monetary situation.

180. Is interest rate policy governed much more now by exchange rate targeting than it is by looking at growth of money supply?

(Mr Leigh-Pemberton) The exchange rate is certainly taken into consideration more, I suppose, than was the case when monetary targeting was first introduced in the late 1970s or early part of this decade.

Chairman

181. It was not taken into account at all then, was it?

(Mr Leigh-Pemberton) I think not really, no. Now I think the correct interpretation of the situation really is that, while the overriding objective of monetary policy is this continuous downward pressure on inflation, the means of producing that policy objective still remains the selection of the three instruments at our disposal: the exchange rate itself, the movement in interest rates, and intervention. Subject to that overriding objective, I think that stability of the exchange rate is very desirable, both in the domestic context and also internationally amongst the G7 major industrial countries. How far one can give any sense of priority to the exchange rate or, above all, to this concept of the stability of the exchange rate, has to depend very much upon the particular circumstances of the time. I think it is a fair judgement to say that we do give as much consideration as we can to the stability of the exchange rate within the context of the overall counterinflationary policy.

Chairman] I think, Mr Governor, the relationship between monetary interest rate policy on the one hand and exchange rate on the other is completely intertwined but I think we would like to change the emphasis a little more. Mr Radice?

Mr Radice

182. Can I start with the balance of payments? The Red Book forecasts a 4 billion current account deficit, yet in the first two

months of this year already we have used up, if the figures are correct, 1.5 billion of that current account deficit. Are you still satisfied with the Government's forecast?

(Mr Leigh-Pemberton) Yes. The Bank of England's view is that, subject to the sort of margin of errors that come into all these forecasts, there is little reason to doubt the Chancellor's forecast at the moment of 4 billion for the year. Now, why do I say this? Well, monthly trade figures are notoriously volatile and I think that the estimates for the first few months of this year, 1988, need to be interpreted with even greater caution than usual, partly because of these changes in customs procedures and partly also because of the possible impact of the ferry operators' strike in early February. Now, the other thing is the size of the deficit reflects a sharp fall in the measured exports in January. I think it is too soon to tell whether this reflects underlying export trends, but if the CBI report which came out today is anything to go by, the suggestion there is that export orders books should recover. I think the other thing to bear in mind, though I think it is very difficult to measure, is the high level of imports recently has contained a degree of capital and half-finished goods which, by definition, or in their own right, might suggest better export performance and lower rate of imports as the year went on. I think it also is possible to surmise that with the gradual fall off in the growth of the economy and a lower rate of growth than we enjoyed in the second half of last year, equally demand for imports may reduce as well. I do not think the first three monthsjustify ---

183. The first two months.

(Mr Leigh-Pemberton) Sorry, the first two months - justify an extrapolation arithmetically.

184. You did quote the CBI and, of course, the CBI forecast a 5 billion current account deficit, so they clearly take a rather more pessimistic view.

(Mr Leigh-Pemberton) They seem reasonably optimistic about their prospects for export performance.

185. So you take their optimistic forecasts but not their pessimistic ones?

(Mr Leigh Pemberton) The Government did also say "within the usual margins of error". I think you would find that the Red Book margin of error put around the balance of payments would stretch from 4 to 5 at least.

186. But I have been reading your Tayside speech, Governor, the one you made in early January, about the need for caution. Are you satisfied that the tax cuts announced in the Budget will not actually increase the external deficit beyond the Red Book forecast?

(Mr Leigh-Pemberton) I do not see why they should. I said earlier that the overall take under income tax is in fact going to be a slightly larger sum in the coming year than in the past year, so that while it is possible to argue that the reductions in income tax increase people's spending power taken as an overall figure of spending power, or a proportion of spending power in proportion to the GDP, I do not think the change in the position is very great. After all, the current account forecast was made in the same context as the overall Budget plan, and we are standing by let me call it the £4 to £5 billion deficit.

187. Just for a moment looking at the composition of the deficit, do you think that it matters that we have a £8.5 billion deficit on manufactured trade?

(Mr Leigh-Pemberton) Yes, I do. I think it is disappointing and it is one of our most important challenges, I think, to try to improve this. This goes to the answer I made earlier on, I think to Mr Townend, about one of the fundamental difficulties about the inflation rate in this country and about competitiveness and about efficiency. I do believe very strongly that we have to try to improve this sort of performance, yes.

188. Can we continue to run a current account deficit at the level of £4 to £5 billion? How long can we continue to run that kind of deficit?

(Mr Leigh-Pemberton) There is not any anxiety about the ability to carry this deficit through, let me say, at least the next two years. I think the level of inflows into the country are on a scale to mean that the financing of that is not a problem. It is a figure that represents about one per cent, I think, of GDP, which is not high as current account deficits go; it is not considered to be dangerous, and I think so long as there is confidence in a thriving, growing economy, there is little reason why a deficit on this scale should not go on being financed by foreigners choosing to invest in the United Kingdom, as is happening at the moment.

189. That sounds like the kind of answer one might expect from an American about the American balance of payments deficit.

(Mr Leigh-Pemberton) The extraordinary thing is that the Americans do succeed in financing their ----

190. But we have had words to say, have we not, about the conduct of the American economy - or the Chancellor has. I do not know if you have.

(Mr Leigh-Pemberton) I think the comments about the US economy are directed at two deficits. We have the difference that we do not have Government deficit on the scale that they do, but I think that is a fair comment.

191. Do you think the Government actually has a balance of payments policy at all, apart from letting foreigners finance it?

(Mr Leigh-Pemberton) I am not quite sure what you mean by saying have they got a policy; if they have a policy which is to the effect that a forecast deficit of £4 to £5 billion is acceptable, yes, that is the policy, and I think it is a workable policy for the year 1988-89. What is more, I think it can go on into subsequent years too. Clearly it cannot go on for ever, and it is at this point, of course, that your question about the contribution of manufacturing industry in the context of diminishing North Sea oil becomes highly critical.

192. Can I turn to the exchange rate. There has been some uncertainty about the Government's exchange rate policy. There was your Tayside speech, where you pointed to how we had succeeded in keeping sterling reasonably steady against the deutschemark, and you obviously thought that was a good thing, and of course, the Chancellor in his speech at the Mansion House last year said that it was an important part of policy to keep the pound steady against the deutschemark, but of course, the Prime Minister said there is no way in which one can buck the market. I wonder how you see the policy.

(Mr Leigh-Pemberton) I think the the policy of trying to keep sterling within a reasonable range against the deutschemark all through last year was a perfectly acceptable move, provided it stood properly within the overall context of our counter-inflationary policy, and throughout last year we were able to achieve this without undue abuse to the other element of our counter-inflationary policy, namely, the domestic monetary situation. It is true that that may have become rather looser than would have been ideal after October, but I have already explained the reasons for that. Now,the need for the change that developed in the early part of this year was that it became more and more difficult to sustain the pound within that deutschemark range without an undue disregard for the other elements of policy, namely, the domestic monetary situation. We could not raise interest rates without unduly strengthening the pound. We had to resort to intervention - again, a perfectly legitimate policy weapon on the right scale and in the right context, but by about the beginning of this month, the upward pressure on the pound was such that we could not really sustain the range which we had operated throughout the last year without either excessive intervention or without an undue inhibition of the need to use the interest rate instrument appropriately, hence the change, and I have said earlier on that I regard it as important that if monetary policy is to be properly implemented, the authorities must have at their disposal, to use flexibly at any time, the three elements: the exchange rate, interest rates and intervention. May I just say this about intervention: intervention is a perfectly legitimate instrument in the exchange rate policy - if I canput it like this - provided it does not become a habit. It is a reasonable instrument to use in the short term to smooth out undue fluctuations, and also to test movements in the market to see whether they really represent a persistent trend or whether they are simply a short-term movement. It became clear at the beginning of this month that the upward pressure on the pound was more than could be sustained by intervention.

193. Can I just get it right? So in the past there was a range between DM2.95 and DM3, was there?

(Mr Leigh-Pemberton) We had a range in mind, the limits of which were never disclosed.

194. But you have just disclosed them, have you not?

(Mr Leigh-Pemberton) I did not, no. I gave no figures.

195. I think you did actually, in an earlier answer to a question.

(Mr Leigh-Pemberton) Well ....

Mr Townend

196. What were they? We should all know.

(Mr Leigh-Pemberton) During the last year we set a degree of value upon obtaining as much stability in the exchange rate as e could. This is desirable, as I say, both in the domestic context and it is also very much part of the understanding internationally amongst the G7 countries, the sort of agreements and understandings we reach, whether it is at the Plaza or the Louvre or as a result of the G7 Statement at the end of December this year, but that approach to exchange rate stability, legitimate in itself, cannot be anything more than subordinate to the overall need of policy, which is a downward pressure on inflation.

Mr Radice

197. Are we still shadowing the deutschemark, then?

(Mr Leigh-Pemberton) We are not shadowing the deutschemark, no. We observe the exchange rate relationship with the deutschemark closely. It is very important for British industry.

198. That does not mean we are shadowing it?

(Mr Leigh-Pemberton) No.

199. We are just observing it. Our policy is one of observation, not of shadowing.

(Mr Leigh-Pemberton) You observe for a purpose, and the purpose of that observation is that the deutschemark exchange rate is a very important component in assessing monetary conditions. That is what we are doing.

200. I have just two more questions. Firstly, you referred to the fact that it was very important that our exchange rate policy should be a non-accommodating one.

(Mr Leigh-Pemberton) Yes.

201. But there was another half of that unwritten agreement with industry, which was that the exchange rate should preserve stability. What industrialists are entitled to say is that you are breaking your part of the agreement because of the lack of stability - that is now emerging at any rate.

(Mr Leigh-Pemberton) I think it is putting it rather harshly to say that we have broken our part of the agreement; we have accepted the value that industry puts on exchange rate stability and we achieve that if we can, but we cannot allow that to become the overriding objective in itself to the prejudice of the general counter-inflationary policy. This will work both ways too, you see, because I should add that exchange rate stability must mean also that we would refuse to accommodate domestic cost increases through depreciation of the exchange rate in just the same way.

202. I realise that, but I have been listening to the Chancellor in his various speeches and he has been telling industry that he wants to keep the pound stable vis a vis the deutschemark and that is why I say there was, if you like, an agreement or a bargain. All right - let us say you have changed the policy now; you have uncapped the poind, or that is the way the financial journalists say it. Could you tell us roughly what the range is now then?

(Mr Leigh-Pemberton) No.

203. What does "stable but not immobile" mean?

(Mr Leigh-Pemberton) All I would say to you is that at any given moment one might have in mind a range in which it is legitimate that the pound might move consistent with counter-inflationary policies, but I am not going to say anything about the sort of figures, because - well, we never do, for obvious reasons.

Mr Radice: Thank you very much.

Chairman

204. I wonder if I might clarify two points. We will obviously need to study very carefully the report of what you have just said. You did suggest the deutschemark rate is important in assessing monetary conditions. If the deutschemark rate goes down in relation to sterling, or put it the other way: if sterling goes up in relation to the deutschemark, does that mean monetary conditions are tighter ?

(Mr Leigh-Pemberton) Yes.

205. Or slacker?

(Mr Leigh-Pemberton) Yes. I think it is fair interpretation that monetary conditions have tightened since the pound reached the level of 308 today. It has been at 311, I think.

206. But that is your assessment of the monetary conditions - is that right?

(Mr Leigh-Pemberton) Mmm.

207. It is not a consequence of your having an interest rate policy which has caused that?

(Mr Leigh-Pemberton) It is a fair assessment of monetary conditions that they are tighter if the pound is stronger in the foreign exchanges in general, and above all against a currency in which we trade so heavily.

208. But I am trying to disentangle whether it is a chicken or an egg we are talking about. If you are saying that monetary conditions are tighter if the sterling appreciates in relation to the deutschemark, that is one thing.

(Mr Leigh-Pemberton) Yes.

209. But it would appear that what actually happened was you tightened monetary conditions with this consequence.

(Mr Leigh-Pemberton) No, I do not think so. What happened was that the inflow of sterling - the upward pressure on the pound - was such that the pound rose from, let us say a figure of about 2.98, 2.99 or from 3.05 up to 3.11. That represents a tightening of monetary conditions of itself and, as a result of that, it was legitimate, it seemed to us, to allow a half a point fall in interest rates after that happened - the one counter-balancing the other. So that one cannot say that it was a rise in interest rates which caused that particular surge in the pound against the dollar. It was not a half a point rise, for instance, in February that caused this increase; it is an overall assessment.

Chairman: I think Mr Budgeon, who has been overheating on the motorway, may wish to come back to this a little later! I think Ms Quinn has some questions, and I would like to clear up one or two loose ends on intervention.

Ms Quinn

210. I would like to ask you if you think the experience over the past year has strengthened or weakened the case for being in the Exchange Rate Mechanism - that is to say in the monetary system?

(Mr Leigh-Pemberton) I do not think it has changed it very much. The case for or against revolves around this matter we have been debating throughout the afternoon, of interplay between your own internal domestic monetary policy and the level of your exchange rate. The members of the Exchange Rate Mechanism themselves would readily acknowledge that in order to keep their currency within the appropriate band they are confronted every now and again with difficult decisions affecting their own domestic monetary policy, requiring a rise or fall in exchange rates that may not be otherwise consistent with their internal situation. This has been just the same dilemma as we have been facing. I do not think that the dilemma will go away if we were to join the Mechanism. At one point the argument for joining the Mechanism, I think, was closely connected with the fact that it would probably assist the pound, it would strengthen it and the pound would benefit from the structure of the Mechanism and we might, as a result of that, be subject to less volatile pressure on our currency and we might then be able to have less volatile interest rate policy. Now we are rather in the reverse, in which the pound is much stronger and it could be, if one was in the Mechanism, one would be facing the problem of going up through the top of the band and we would have to take appropriate steps to prevent that. I do not think, really, the situation in the last year has changed the arguments very much, except it is probably better to be approaching the question from a position of strength rather than from one of weakness.

211. I note that you say that dilemma would not go away if we were part of the Exchange Rate Mechanism. Are you in favour or not of joining the Exchange Rate Mechanism at the present time?

(Mr Leigh-Pemberton) Are you addressing that to me as an individual or to the Bank of England?

Ms Quinn: In whichever capacity you would like to answer - or both.

Chairman

212. Yes to one and no to the other, whichever way round it may be. Assuming there is a distinction.

(Mr Leigh-Pemberton) There were occasions when I was very anxious we should join, but these are in the past when we had a much more inflationary situation in this country, and the need for some sort of discipline, to my mind, was much more important. This is going back a long way. It takes me back, actually, to my first appearance before the Select Committee which was when Mr Radice was a member, when the Clearing Bank Chairman came in to talk about this. Those are bygone days. The position at the moment, I think, is very evenly balanced. It has been described as a political decision and I think that is a very fair assessment of it.

Ms Quinn

213. I think you said last year when you addressed the Committee that you felt that there was a danger that the independence of a country's economy and their monetary policies could be jeopardised by being in the Exchange Rate Mechanism, and that you felt that you hoped that being part of it would not damage the anti-inflationary objectives of the medium-term financial strategy. Do you have any reason to alter your view on that? Do you also think it is possible to pursue expansion policy within the Exchange Rate Mechanism?

(Mr Leigh-Pemberton) I think that, certainly. I think on the whole if one looks over the history of the Exchange Rate Mechanism and the EMS as a whole, it has been a success story. The improved economic performance of the European countries, if you look back over five or six years, has been impressive, both in reducing their inflation rates, in improving their fiscal situation and also in the stability of their relative exchange rates. After all, those are things which are conducive to economic progress. I do not think that joining the Mechanism would have advantageous inflationary consequences for us. (I think part of your question rather implied that.) On the whole the Exchange Rate Mechanism, linked as it is to the deutschemark, is a very strict and highly-disciplined framework. It is, as it were, a counter-inflationary club (?) and it has enabled the members of the Mechanism actually to reduce their inflation rates impressively over the last four or five years. You want to look, perhaps, at the figures for Italy in that context. I am not anxious about it as being a source of inflation. I approve of it as a counter-inflationary structure. The real point is you come back to this dilemma of the requirements of operating your exchange rate within the rules of the Mechanism and the possible conflict with your own domestic monetary requirements.

214. Do you think our interest rates would be lower than present levels if we were full members of the Exchange Rate Mechanism?

(Mr Leigh-Pemberton) I do not know whether they would be at the moment. There may have been times in the past when they certainly would have been, in my view, because I think that the pound would have benefitted from being within the structure at times when the situation was far more volatile and we probably had to have interest rates somewhat higher then in order to protect it in its independent state than would have been necessary had it been within the framework.

215. Finally, the difference on policy that there was within Cabinet on exchange rates, perhaps, is mirrored also by the difference in view as to whether or not we should be in the Exchange Rate Mechanism of the EMS. Can you tell us if you expect a decision on full membership soon or not?

(Mr Leigh-Pemberton) I do not think I can tell you, no. I have got no information, or no views, on that, I am afraid.

Chairman

216. I wonder if I might tidy up, Governor, one or two loose ends on intervention. You will know the Committee has expressed views on exchange rate intervention in the context of smoothing movements in the exchange rate but has come out against intervention which attempts to maintain or change a particular exchange rate. Could you tell us whether in the last year the Bank has only intervened in order to smooth the exchange rate?

(Mr Leigh-Pemberton) I think the Bank has intervened in order to stop undue movements in the exchange rate. We originally felt it was necessary to do this just before the election when there was considerable upward pressure because we felt that that pressure would not prevail through the election, whatever the result was, and to a degree we were right. Therefore, the role of intervention was, as it were, justified in that it simply stopped what would have been a pre-election peak followed by a post-election fall. We were able to do the same sort of thing once or twice subsequently in the year. There was one other particular occasion, but I cannot think of it. In general the purpose of intervention is - and we have operated it in this way - to prevent undue short-term movements and fluctuations and pressure. I acknowledge, however, that there is a difficulty here, because one has to be able to answer the question "Are we dealing with a short-term fluctuation or are we dealing with what is going to prove to be a much more underlying and persistent trend." Once that begins to develop it is very much harder for us in intervening to be effective and it can become expensive in the sense of a great deal of foreign exchange has to be bought. I do not think that during the last year we have intervened in a way that has been unjustifiable within the context of the principle I have just tried to explain, but it clearly became unjustifiable in the context of the pressure that we were experiencing three weeks ago.

217. Are you saying that you have only intervened in order to smooth, taking on one side the problems of defining that precisely?

(Mr Leigh-Pemberton) Yes, because we have smoothed, or we have intervened, in order to prevent in practice rises in the pound which we felt were unlikely necessarily to be sustained. I remember the second example of the pre-general election illustration. It seemed reasonable to intervene to prevent the pound rising in anticipation of the two sets of trade figures that we have had this year, because once they were known it was thought likely that the pound would fall back. When the January figures came out that, surprisingly, did not happen. When the February figures came out, as you know, the pound fell back a couple of pfennigs, but by then we had got up to 3.10, so it came back to 3.08 when the February figures came out.

218. Are you saying the Louvre Agreement did not involve any intervention other than smoothing?

(Mr Leigh-Pemberton) Yes, the Louvre Agreement, you might say -- Yes. I must qualify my answer, Chairman, on that point. It would be being specious to say the Louvre Agreement was concerned solely with smoothing. It was, in fact, concerned with levelling exchange rates and getting stability. No, it was concerned not only with that but also with major policy moves by the countries in question. That larger part of the Louvre Agreement was concerned with that. The exchange rate understanding in the Louvre Agreement I would regard as having been subsidiary to the underlying policy changes. Smoothing, as I say, might be a rather exaggerated word but it was subservient to the policy changes which were part of that Agreement.

219. So you did, under that agreement, actually intervene in order to seek, or maintain, or alter a particular rate?

(Mr Leigh-Pemberton) The United Kingdom did not intervene very much actually within the Louvre Agreement. We did a certain amount but not on a large scale.

220. One final point on this: there have been estimates in the press, in the City and elsewhere, that the loss on the intervention may amount to something like £1 billion. Of course, the Government is not like a plc which has a year-end date when it has to own-up

as to exactly what has happened. Do you think it would be a good idea if we did have a date when we could see exactly what the cost was at any given time?

(Mr Leigh-Pemberton) It would be very difficult to say exactly what the cost is at any particular moment. As a result of currency movements the overall valuation of the exchange equalisation account goes up and down. I think I would like to say here that the purpose of the exchange equalisation account, and our operations in it, are not, as it were, to run a sort of UK unit trust limited which is intended to make as much profit for the United Kingdom as possible - ie to go in for a form of foreign currency speculation; it is to use the reserves for the country's economic policy and also to maintain a level of reserves to meet its overseas demands. So that the fact that at any given moment certain currencies which one holds may or may not be ar the original book value, I think, is not necessarily a fatal function or policy. It is within the nature of the operation.

221. You do not think that the taxpayer is entitled to know at any given moment? The Bundesbank, we understand, does have such an arrangement.

(Mr Leigh-Pemberton) I am afraid I do not know exactly what the details of the Bundesbank position are. Hitherto it has been the tradition that the composition of the exchange account and the price at which purchases have been made have remained confidential. I think it is right that they should and it would make our job almost impossible if the details were disclosed regularly.

Mr Budgen

222. Chairman, I am sorry I did not hear the earlier evidence. I hope I shall not repeat some of the questions put to you, Governor; if I do please tell me to withdraw the questions. Of course, we quite understand that in discussing your policy on exchange rates you are not prepared to tell us what the figures are at any one time, but you concede that you did in the past have a target though you are not prepared to tell us what the range of figures was. Are you prepared to tell us now whether you have a target range for the pound against any other currency, even though you are not prepared to tell us what the figures are?

(Mr Leigh-Pemberton) The answer is that there is no target and, even if there was, I would not wish to disclose the figure.

223. I quite understand you are not prepared to tell us what the figures are. Is there a target range between X and Y?

(Mr Leigh-Pemberton) We will form a view about the range iwthin which we would think it appropriate that the exchange rate might move, but it is a range only in the sense that probably action becomes more intensive as we move to the extremities of the range and less intense as it moves within the middle of the range, but you have to have some idea.

224. If there was not a target in the past, albeit that the numbers of the target were not being disclosed, how could the Chancellor assert that he was delivering exchange rate stability?

(Mr Leigh-Pemberton) Well, I think he was probably seeking to deliver a state of affairs in which the pound fluctuated as little as possible against the other currencies.

225. But without there being any target? I quite understand you could not possibly operate on the foreign exchange markets if everybody knew that when the deutschmark reached a certain stage everybody was going to start piling in in one direction or another. You have plainly to have some system by which you can from time to time catch an odd mug out. But there must have been - there plainly was - an answer by the Chancellor that there was a target, otherwise there was no stability he could promise.

(Mr Leigh-Pemberton) I do not accept the word "target" because I do not think even secretly internally we can have something as tight as a target. If you look at a target, it has a bull and it goes to the outer rings. Now, if that is atarget and it embraces all the range of rings between the bull and the outer ones, if you can remember the military terms now, to a degree that may be a reasonable description but what I think the Chancellor is anxious to do is to reduce to the minimum the volatility of sterling expressed in terms of the foreign currencies. The pound-deutschmark exchange rate at the time of the Louvre was about 2.80, I think, and that was a year ago in February. As far as possible, we have attempted to keep the pound not at 2.80 but somewhere between there and in the 2.90s, but that is about as far as I can go. I cannot - I do not - accept that there is any target.

226. All right. Perhaps we are really talking about words.

(Mr Leigh-Pemberton) I think we are.

227. Can I come now on to your description of the way in which, when the pound rose against the deutschmark, you said that was an indication of tightening domestic policy which then justified a half percent cut in interest rates. Are you saying that exchange rates moved only in response to monetary policy?

(Mr Leigh-Pemberton) No.

228. Then are you saying that this indication of tightened domestic monetary conditions will, when the monetary figures are published for the time just before the reduction in interest rates, show that there was in fact a downturn in the increase in money supply just before that reduction in interest rates?

(Mr Leigh-Pemberton) No.

229. If that is not so, then how are you able to say that there was a reduction in domestic monetary conditions or a tightening of domestic monetary conditions either consequent upon or coincidental with the rise in the value of the pound against the deutschmark which enabled you to say "Okay, it's safe to drop interest rates by half a percent"?

(Mr Leigh-Pemberton) Well, a tightening on the exchange rate of itself over a period of time represents a tightening of conditions in the economy. It means that industry has to become more competitive; it means that - how can I put this most effectively? - if you have a high exchange rate you are making competitive conditions for industry and commerce in the country tighter, more difficult to sell exports overseas, more difficult to accommodate cost increases in one's works and one probably has to accept tighter margins. Now, this represents a tightening of the economic situation.

230. It is not a tightening though in monetary conditions, is it? There is a distinction here. If the pound rises against the deutschmark, then it becomes more difficult for our traders to compete against the deutschmark and to that extent they have to tighten their margins and do all the things that you say.

(Mr Leigh-Pemberton) Yes.

231. Therefore, one set of prices is contained but it has nothing whatever to do with the general monetary conditions. It does not mean £M3 is going to show a major turndown. It does not mean that M0 is going to show a major turndown. It does not mean, for instance, houses are going to stop going up in value by 22 percent in Central London or whatever such figure is, does it? It merely means a particular set of prices which are affected by the relationship that the pound has with the deutschmark are contained. If it meant surely, Governor, as you say, that it was an indication of monetary conditions being tightened, then you would see a coincidental reduction in the increase in all the monetary indicators.

(Mr George) Mr Chairman, could I comment on that? I think here again we are talking about the different use of terminology. The terminology we have consistently used over a very long period is to embrace the kind of financial disciplines that come from the exchange rate within monetary conditions. If you look back at the Red Book presentation we have said consistently that we assess monetary conditions in the light of a whole range of factors, one of which has been exchange rate for always. Of course, I accept that there is no direct implication - no direct implication - arising from a fluctuation in the exchange rate for the growth of the money aggregates in a particular sense. I do not think that is in dispute. There may have been indirect effects to the extent that the financial discipline is tightened through a rise in the exchange rate on one sector of the economy. You may perfectly well have repercussive effects on a demand for money in other sectors of the economy.

232. You would agree it does not, however, stop increases in prices in other domestic areas which are unaffected by the relationship that the pound has at any one time with the deutschmark.

(Mr George) Well, I think not directly but it can have repercussive effects of that kind. For example, it increases the pressure which domestic industry will face in competing with imports. Therefore, it will have knock-on effects of that kind. It may very well hae impacts on the kind of pay settlements that are being reached in the traded goods sector of the economy which will have knock-on effects over the rest of the economy. So indirectly, yes, I think it can have an impact on the domestic monetary conditions, even in your sense.

233. Governor, finally, when you moved from being a politician first to being head of a clearing bank, then Governor of the Bank of England, one of the things that must have interested you as a classicist was the change in language. In politics when there is a small inconvenience everybody describes it as a great national tragedy, obscene, disgusting, dreadful - all those terms. But, on the other hand, in the Bank, when the Bank is seriously worried about soemthing, it expresses its views with extreme caution and great good breeding of life, does it not? If the Bank thought there was going to be hyperinflation next week, it would presumably say "There is some respectable evidence that there may be a slight need for tightening of the domestic monetary conditions", would it not? I see by your smile that you agree. The Bank's Quarterly Bulletin of February is very important, is it not?

(Mr Leigh-Pemberton) Yes.

234. Because when the Bank issues its bulletin in February the Budget judgement has not yet been made and the Bank is able publicly to offer its advice to the Chancellor in language which to the man in the street appears bland and wholly without criticism, but is actually to those who understand it capable of severe criticism, is it not?

(Mr Leigh-Pemberton) We have to be extremely careful in the February issue of the Quarterly Bulletin because one is sensitive that this is the build-up time to the Budget and, therefore, what we say is not only in the normal restrained language but might also actually be that much restrained by consideration of the timing of it. I know you are building up to put something to me.

235. Would you agree with me that, even in terms of the Bank's language, the February Bulletin is a very severe warning of overheating in the economy and, if you look through, just flicking through the first two articles, for instance, on page 5 you point to the strength of domestic demand; on page 6 you raise questions about the sustainability of rapid growth; at the top of page 7 you talk about the evidence from industrial surveys that shortages of some categories of labour are increasingly being felt. Then at the bottom of page 7 you talk about the rapid growth of all the monetary indicators. Then when we come to your economic commentary you deal there with both the international and national economic commentary, but at page 17 you are talking again about the question of the domestic scene and you say growth was particularly strong, you question whether the growth is sustainable; you go on at 18 and 19 to talk about skill shortages, the increase in profits. You go on at 20 ---

(Mr Leigh-Pemberton) Page 18, "inflation remains stable" - you missed that one out.

Mr Budgen: I agree that every now and again you put yourself right with the Chancellor by pointing to something that indicates ....

Chairman: Order. Can we have a question, please?

Mr Budgen

236. But is it not the case that that Bulletin is a massive criticism of the overheating in the economy?

(Mr Leigh-Pemberton) No, I do not agree with that. You take an exaggerated view of our assessment of the situation. We have clearly thought about this very carefully before it was published, as I say, sensitive about the time when it was due to comeout, but I cannot agree with your overall assessment of it. I answered a question earlier about whether in the view of the Bank of England the economy was overheating. I said that we did not take that view.

237. Well, why did you point to all those indications of overheating in your review?

(Mr Leigh-Pemberton) I do not think that they are all of them indications of overheating. They are indications of potential overheating, and they are the sort of things which both the Government and the central bank must be alert to if we are going to avoid overheating, but I do not think they are a concession that overheating is taking place, nor does it follow from what we say there that overheating will take place. In fact, the projections for the year in the Budget suggest that the rate of growth, though healthy, will slow down compared with the second half of last year, and those are projections with which the Bank of England forecasters agree.

Chairman: Mr Governor, you have been very generous with your time. I think we should probably move on. I should mention that the Committee, as you know, has on a number of occasions produced reports on international monetary affairs and has decided that it will cary out a further study into international monetary co-operation in the aftermath of the October crash and the Louvre Agreement. We hope later on that the Bank will be able to provide us with some evidence on those issues. Mr Beaumont-Dark has a couple of questions relating to the Budget and the stock market.

Mr Beaumont-Dark

238. I thought as we had you here we could get your opinion on what has happened. Does the Bank accept that it has the responsibility for improving the market arrangements and market behaviour at the moment, particularly bearing in mind - the Americans had three inquiries; we have had a small one - the "Big Bang" has been a bit of a debacle in some ways, or do you not think so?

(Mr Leigh-Pemberton) The Bank regards itself as having an interest in this matter certainly, and to a degree a responsibility. The responsibility, however, must be shared with the SIB and the other consequences of the provisions for the Financial Services Act, but I think you will have seen how after the stock market fell last October there was very close liaison between the Bank of England and the Stock Exchange, and we have made calls since then for a greater degree of convergence in supervision in the securities markets internationally, rather in parallel to the move we have already made for convergence internationally in banking provision.

239. On the dealing side, do you not agree that, frankly, at times of some volatility the market dealings have bluntly been disgraceful, where quite often dealers have literally pulled the plug rather than make prices, and that if people, particularly small investors, are going to be able to deal, the idea that when the

going gets hot the clever get out is not something that is of great credit to the City. Have you taken an interest in that?

(Mr Leigh-Pemberton) We certainly have taken an interest in that. It is directly the responsibility of the Stock Exchange and ultimately the TSA and through that I suppose the SIB, but I do not know that I accept the anecdotal stuff about pulling the plug.

240. It is not anecdotal.

(Mr Leigh-Pemberton) It is not directly in my line, and I am not really able to say very much about this. mr George may be able to add something, because he is responsible for the supervision of the wholesale markets and therefore is closer to this.

(Mr George) But not, Mr Governor, the equity markets, which is what I think Mr Beaumont-Dark is talking about, but I do think it is fair to recognise that the volume of transactions that took place during the height of that situation was much larger than it normally is. In that sense it is really an exaggeration to talk about the plug being pulled, and I do think it is not reasonable to expect dealing to be as easy and straightforward on a day such as the days of the height of the storm as it is in normal conditions. So I think there are things to be said on the other side, though neither of those are specifically our responsibility, but they are being addressed in the Stock Exchange.

241. Many of us welcome the appointment of the new head of what we call the City Panel, Mr Walker. Mr Kenneth Berrill has not been asked to continue; is this because the law is an ass or so far, bluntly, the law has been enforced with too much zeal?

(Mr Leigh-Pemberton) I think it is a bit of both. I think there are some elements of the Act which have probably proved to be too rigorous and are going to create difficulties. Never mind; that is the Act we have got and we have got to make it work. As the the next stage of the life of the SIB, I would simply say this: Mr Kenneth Berrill undertook a very difficult task. He is in fact 67 years old, and I think a further appointment of four or five years would appear to be probably inappropriate in those circumstances. A change, I think, was consequently inevitable.

Chairman: Mr Governor, those questions have really related to the forthcoming stage rather than the immediate one in some respects, but you really have been immensely helpful this afternoon. We are extremely grateful to you and to Mr Fleming and Mr George for their help. You have been kind enough to say you might let us have some extra information. I wonder, also, if a note on the position with regard to the Bundesbank and the extent to which any losses on the exchange markets are made could be made available since, clearly, the House of Commons has a very clear interest from the taxpayers' point of view in knowing what the costs of the policy may be, so that they can then evaluate them against the results which the policy is producing. Thank you, once again. You have really been extremely helpful to us and we are very grateful.

PA - Exchange rate

CONFIDENTIAL

PRIME MINISTER

GOVERNOR'S EVIDENCE TO THE TCSC

I have had a summary report of the evidence the Governor gave to the TCSC late this afternoon.

The main elements seem to be:

- on monetary policy, he stressed the primacy of exerting downward pressure on inflation. He said that there were benefits to be had from exchange rate stability but only as long as this could be achieved without risks on the inflation front;

- he seemed to face some difficult questioning on the alleged existence of a target range for the exchange rate last year and on the role of intervention. In explaining the recent decision to let the exchange rate go up, he apparently implied at one point that there was a clear target last year which could no longer be held; but in later questioning he denied there was any formal target or range. On the role of intervention he stressed that the purpose was simple for smoothing, but then faced questioning as to whether this had been the sole purpose of last year's intervention activity;

- in discussing the conduct of monetary policy he stressed that the three instruments - interest rates, the exchange rate and intervention - would be used as appropriate;

- he was challenged about his previous support for membership of the ERM. His response was that this was a long time ago when inflation worries were a great deal worse than they are now. He said he thought the judgment on whether membership would be desirable was now finely balanced - and that it was a political matter on which he did not express a view. (This will doubtless cause the Committee to press the same point on the Chancellor on Wednesday);

- in response to questions about the difficulties for industrialists of a high exchange rate he said this was a very short term view, that the over-riding importance for business competitiveness was the control of inflation, and pointed to the response made by Japanese industry to continued strengthening of the exchange rate;

- he was questioned about the growth of consumer credit. He argued that, mortgages apart, the increase had not been a cause for concern. He resisted arguments, eg. by Jock Bruce-Gardyne for controls on the consumer credit, so these were unnecessary and unworkable.

We should be able to judge from tomorrow morning's press which of these comments are most likely to be picked up at Question Time tomorrow. I would guess it is likely to be the role of intervention and the alleged existence of a target range.

Sara Lowe
(Duty Clerk)

pp. PAUL GRAY

28 March 1988

(Treasury draft).

→ PS/Governor
(by fax)
cc Sir P Middleton
Sir T Burns
Mr P Gray (No 10).

Exchange Rate Policy

1. The primary objective of monetary policy is the control of inflation. That depends on the adoption of sound underlying policies;

2. Exchange rates continue to play a central role in domestic monetary decisions, as they have done for many years.

3. Greater exchange rate stability will bring advantages to the economy.

4. The UK will continue to participate in international agreements to bring about greater exchange rate stability.

5. All instruments will be used as and when appropriate. We never discuss market tactics.

SUBJECT
cc MASTER.

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10 DOWNING STREET

LONDON SW1A 2AA

25 March 1988

From the Private Secretary

Dear Alex,

EXCHANGE RATE POLICY

The Prime Minister held a meeting his morning with the Chancellor and the Governor of the Bank of England to discuss exchange rate policy. The Deputy Governor, Sir Peter Middleton, Sir Terence Burns, Mr. Eddie George and Professor Brian Griffiths were also present.

The Chancellor introduced a paper on monetary policy and the role of the exchange rate. He said that there was clear agreement that the primary objective of monetary policy was to bring down the rate of inflation. But against the background of changing world conditions, particularly progressive deregulation of financial markets, it was necessary to adjust tactics in order to ensure that the continuing counter-inflation strategy remained effective. This evolution in recent years had involved taking greater account of the exchange rate; all the major industrialised countries had been moving in that direction. There were clear advantages of greater exchange rate stability once low inflation had been achieved; it imposed a discipline on and gave increased confidence for business planning, and increased international confidence in the British economy. Moreover when all the other major countries were pursuing a policy geared to greater exchange rate stability, if the UK did not behave in a similar way there were dangers of sterling becoming the focus for currency speculation and instability.

Continuing, the Chancellor said that on occasion there could be conflicts between the containment of inflation and the desirability of greater exchange rate stability. This was likely to arise infrequently, but when it did there was no doubt that control of inflation had to take precedence. The aim of intelligent management of the exchange rate was to create favourable expectations amongst market operators so that the markets worked with the authorities and not against them.

In discussion the following main points were made:

(i) It was important to ensure there was sufficient flexibility in the use of the three monetary policy instruments - the exchange rate, interest rates and intervention. Ruling out all freedom of action for any one of these was likely to lead to excessive reliance upon the others.

(ii) In the six years 1981 to 1986 sterling had depreciated both against the deutschemark and in effective rate terms. In the circumstances of that period there had been good reasons for this. But this experience had given rise to an expectation by business that a steady depreciation of the exchange rate was the norm; this led to a serious risk of an inflationary bias in the economy. It was essential that industry understood that the authorities were not prepared to countenance a regular depreciation. In order to achieve credibility on this point the authorities should be seen to be taking action to limit appreciation of the exchange rate.

(iii) There had been periods, for example in 1981 and 1985, when the authorities had stood back from the markets and not pursued an active policy of exchange rate management. On these occasions excessive movements generated by the markets had led to difficulties, and in the end the authorities had needed to step in.

(iv) A major difficulty in pursuing greater exchange rate stability was the need to make judgements about the appropriate or credible levels of exchange rates. This was the more difficult given that substantial shifts were constantly taking place in the relative performance of different economies.

(v) The key requirements for controlling inflation were to pursue sound public finance, to provide incentives and to ensure that business responded to the disciplines of the market. Although greater exchange rate stability was desirable this had to come as a consequence of sound policies, and could not be elevated to the status of an objective in its own right.

(vi) Setting targets for the exchange rate involved gearing UK policies to those being pursued in the other major economies. This presented major risks.

(vii) If foreign exchange intervention was subsequently sterilised through funding policy this should prevent any inflationary consequences. On the other hand the very act of funding intervention could offset its initial impact on the level of the exchange rate.

(viii) The level of UK foreign exchange intervention in 1987 and during the two days prior to the lifting of the DM3 cap had been exceptionally high. It would not be appropriate in future to intervene on such a scale.

(ix) If as a result of the authorities' intervention tactics the market perceived that a precise limit or range was being set for the exchange rate this presented market operators with a one way option. The longer any limit was defended through intervention, the greater was likely to be the subsequent adjustment in the exchange rate.

(x) The Treasury paper had not included a conceivable fourth option of totally free floating. There was no support for such an approach. It was difficult to draw a precise dividing line between the first and second options in the paper, namely (i) taking the exchange rate "into account" and (ii) an explicit statement about the desire for greater stability. But there was a major step involved at some point in this continuum in moving from "taking account of" the exchange rate to "taking a firm view on the right rate".

(xi) It would not be appropriate for the UK to be seen to resile from participation in existing international agreements about seeking greater exchange rate stability.

Summing up the discussion the Prime Minister said it was agreed that the primary objective of monetary policy was the control of inflation. That depended on the adoption of sound underlying policies. Subject to that over-riding point, greater exchange rate stability could bring advantages to the economy. There was a role for foreign exchange intervention, but this should be restricted to a scale very much less than had been carried out over the last year, and the authorities should avoid becoming committed to precise levels for the exchange rate. Monetary policy should be operated so that flexibility was preserved for the possible use of each of the three available instruments, namely movements in interest rates, intervention and adjustment in the exchange rate. The appropriate policy mix had to be reviewed on a regular basis.

I am sending a copy of this letter to John Footman (Bank of England).

Yours,
Paul

(PAUL GRAY)

Alex Allan, Esq.,
HM Treasury.

17

PRIME MINISTER

SEMINAR WITH THE TREASURY AND THE BANK: 25 MARCH

I attach the Treasury paper (Flag A) and a commentary by Brian Griffiths (Flag B).

Nature of the Meeting

I suggest at the outset you say three things:

(i) This is not a decision-making meeting. Its purpose is to have a free-ranging discussion which gets back to the fundamentals of our economic policy objectives and how exchange rate policy fits in to that framework. (Indeed, there could be advantage in your positively resisting trying to reach conclusions that are at all precise - it could be worth having a further meeting after Easter to carry the debate forward.)

(ii) You hope everybody will speak their minds freely. Obviously a common agreed policy has to emerge from this process; but that is best achieved by a full and frank discussion.

(iii) The press have already got to know of the existence of the meeting. It is essential they do not learn anything about what went on during the meeting. (I gather the Chancellor would positively welcome your saying that.)

Starting by going back to the fundamentals of the economic policy, you might want to see how much common ground can be established before getting into the areas of greater tension. The early part of Brian's note provides some questions that could help in this process.

One general line of questioning you might want to pursue is why the "objective" of greater exchange rate stability has been given increasing emphasis over the last couple of years? Why does this now seem more important than it did in, say, 1983? Paragraphs 28-34 of the Treasury paper are not compelling on this.

Logistics

To meet your afternoon timetable, it will be necessary to break for lunch by 1245.

PRCG.

PAUL GRAY
24 March 1988

DASAJM

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B

PRIME MINISTER 24 March 1988

Exchange Rate Policy

This is a helpful paper from the Treasury. After discussing some basic economic issues (e.g. the precise relationship between monetary policy and exchange rate policy, the way foreign exchange markets work, the impact of intervention etc), and our experience over the past year, it then puts forward three options for the future conduct of policy:

(1) using the exchange rate as one indicator of the current thrust of policy ("monetary conditions") but without setting any band for exchange rates;

(2) setting an unpublished band for exchange rates and then the limits of intervention and the conditions under which the band would be changed;

(3) formal membership of the ERM.

It recognises that in practice these points lie on a continuum - which means, in particular, that one might consider points intermediate between (1) and (2).

I shall discuss each section of the paper in turn.

(a) Monetary Policy and the Role of the Exchange Rate

Aim of Monetary Policy

The opening sentence "The aim of monetary policy is to

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control inflation" is absolutely crucial. This has to be the fundamental objective of monetary policy. It is particularly important that this objective is seen as far more important than other objectives which monetary policy might have e.g. para 35 - "it is desirable to have an explicit objective for greater exchange rate stability". Exchange rate stability is clearly preferable to exchange rate instability. But it should always be ranked below control of inflation as an objective of policy.

Q.1. Is there general agreement that the major objective of monetary policy is the control of inflation and that other objectives are subsidiary to this?

Exchange Rate: Indicator or Target of Monetary Policy?

The difference between the exchange rate as an indicator and a target of monetary policy is not clear in this section.

<u>Indicator</u>: interpreting the monetary aggregates has proved difficult during a period of regulatory change in the monetary system. It is useful therefore to include the behaviour of the exchange rate as <u>one</u> indicator of the current thrust of monetary policy. Excessive monetary growth will result in devaluation and inadequate monetary growth in revaluation of the currency. Equally important, however, is that exchange rates also move for <u>many other</u> reasons: eg other countries' monetary and fiscal policies, confidence factors etc.

<u>Target</u>: using the exchange rate as an indicator of policy is very different from using it as a target: this assumes government knows the appropriate level of the rate.

Q.2. Does "giving the exchange rate a substantial weight in monetary policy" (para 9) imply using it as an indicator or making it a target? (The case for the former has been shown but not the latter.)

(b) The Nature of the Foreign Exchange Market

Fluctuations in exchange rates

The paper argues that fluctuations in exchange rates can have damaging effects on the economy (para 14). This is true. But just as important are the damaging effects which result from

(i) major revaluations and devaluations under a fixed exchange rate regime

(ii) the inflations (UK 1977) and deflations (UK 1925) which result from governments setting rates at incorrect levels.

(c) Instruments of Policy

Paras 22-27 deal with intervention. If intervention is sterilised, it will not create inflation in the short term, but it is unlikely to be effective because:

(a) it does nothing to reduce the attractiveness of the currency being bought

(b) if it becomes known that the central bank is intervening, this creates a one-way bet for investors.

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The following quotation is useful:

"Para 46. There was broad agreement among the members of the Working Group that sterilised intervention alone did not appear to have constituted an effective instrument in the face of persistent market pressure" Jurgensen Report on Exchange Market Intervention 1983

(d) Options

The one option not mentioned is clean floating - the opposite case to full membership of the ERM. The choice for the future is between the first and second of the Chancellor's options. This raises the following questions

Q.4. If we had an exchange rate band it would need to be (a) very wide and (b) easily changed to avoid recent problems. In this case why do we need a band at all?

Q.5. If we use the exchange rate as an indicator or target, which rate should we use: the DM or the effective exchange rate?

Conclusion

My own conclusions on this paper are:

a the primary objective of monetary policy must be the control of inflation to which all other goals must be made secondary;

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b governments can have some influence on nominal exchange rates but their influence over real rates (nominal rate adjusted for inflation) is slight;

c exchange rate intervention to counter disorderly markets and prevent bandwagon effects from developing is legitimate; far more dubious is the claim that governments can bring rates into line with "the fundamentals" (whatever that may be - a massive problem of interpretation);

d the reason for the government setting an exchange rate band is not proved;

e if at the meeting the argument moves in this direction, however, it is essential to resolve the following:

- the width of the band (as large as possible)

- the extent and conditions of intervention (rationing amounts of money for this purpose)

- the circumstances under which the band is changed (as frequently as possible).

BG

BRIAN GRIFFITHS

SECRET

PRIME MINISTER

You might like to glance at the table attached from an IMF publication which lists the exchange rate arrangements (floating, pegged, etc) for most countries.

The number of currencies linked to the US dollar is noticeable. In some cases, the link is very close - Panama is the obvious example where there was until the recent troubles, a virtual US dollar economy. In other countries - Afghanistan - the link is much more indirect and there will be only a small part of the countries' foreign exchange transactions linked to the dollar.

There are still several countries, basically the old French empire, linked to the French franc. There are no countries' currencies linked to the pound sterling - but I would not regard that as a bad thing.

N.L.W.

N.L. Wicks

23 March 1988

MJ2CDO

World Debt Tables Available in Two Volumes

The *World Debt Tables* come in two volumes. Volume I contains analysis and commentary on recent developments in international lending to the developing countries; it also provides summary tables for all countries, selected regions, and other groups. The geographic groupings are Africa south of the Sahara; East Asia and the Pacific; Europe and the Mediterranean; Latin America and the Caribbean; North Africa and the Middle East; and South Asia. The other groupings are highly indebted countries, low-income Africa, low-income Asia, middle-income oil importers, and oil exporters.

Volume II contains statistical tables showing the external debt of the 109 countries that report public and publicly guaranteed debt under the World Bank's Debtor Reporting System (DRS). Private nonguaranteed debt is also reported by 22 countries. Thus, the country tables contain reported or estimated data—for 1975 and 1980–86—on public and publicly guaranteed long-term debt, private nonguaranteed long-term debt, short-term debt, and the use of Fund credit. Data for 1970–86 are available to subscribers of the *World Debt Tables* magnetic tape.

The DRS is maintained, and these volumes prepared, by the staff of the International Finance Division, International Economics Department of the World Bank. Copies of Volume I are available for $16.95 and the set of two volumes is available for $125.00 from Publication Sales Unit, the World Bank, 1818 H Street, NW, Washington, D.C. 20433, U.S.A.

problem debtors. "The new provisioning standards are likely to reinforce the banks' reluctance to lend," the report suggests, "although they do not preclude further commitment of new money under rescheduling agreements."

The positive developments include the increase in official lending in response to the initiative of U.S. Treasury Secretary James A. Baker III, the agreement in principle of creditors to support a general capital increase for the World Bank, the financial involvement of the Fund, and the expansion of financing options for commercial banks. These developments give rise "to the hope that debt problems will continue to be managed in a way that maintains the essential path of cooperation between debtors and creditors," according to the World Bank report.

The report discusses how the "menu" of alternative financing options has expanded. For instance, "an estimated $8 billion of debt has been retired through debt-equity swaps over the last three years," according to the World Bank. Secretary Baker highlighted various financing options in his statement at the 1987 Annual Meetings of the World Bank and the Fund. They included increased trade and project loans, onlending of funds to specific end-users, new money bonds, notes or bonds convertible into local equity, exit bonds, external debt conversions, interest capitalization, and balance of payments loans. Other proposals have also been made, with some schemes seeking to capture the discount on developing country debt in secondary markets to reduce individual countries' liabilities.

Outlook for 1988 and Beyond. The total debt of developing countries is projected to rise to $1,245 billion in 1988, compared with $1,190 billion in 1987, largely owing to the effects of exchange rate valuation adjustments on non-dollar debt.

For the low-income, debt-distressed countries of Africa, the World Bank report stresses the importance of maintaining momentum for restoring growth. The Fund's enhanced structural adjustment facility, the World Bank's special action program, assistance from bilateral donors, and a formula for case-by-case debt relief or a parallel effort in the form of new concessional aid will all be needed.

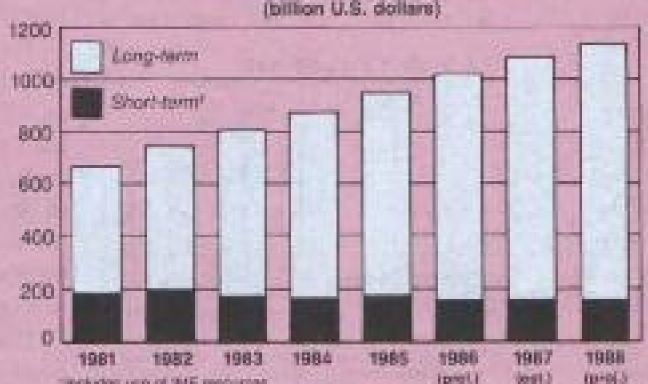
For the middle-income, highly indebted countries, "sharp fluctuations in interest rates in the final quarter of 1987 and the uncertainties generated by the crash of world stock markets left well-founded concerns that [their debt-service] burden would increase further in 1988."

The report observes that signs of "debt fatigue" increased in 1987 because bankers were increasingly reluctant to provide new money and raised loan provisions, and because debtor governments were "less reluctant to allow debt service arrears to accumulate or to use such arrears as bargaining counters with creditors." It also maintains that progress in resolving debt problems is necessary to avoid a breakdown of relations between debtors and creditors. "Such a breakdown would not only inflict great damage on debtors and creditors," cautions the World Bank report, "but, through its effect on international confidence, would undermine the prospects for improved cooperation on which future global prosperity increasingly depends."

The World Bank report also expresses concern about what will happen if a collaborative approach toward debt problems is not found while the present economic expansion in industrial countries, which has completed its fifth year, is under way. "While the cost of incomplete adjustment and stalled growth has hitherto been borne largely by the debtors themselves through forgone income and falling living standards, other costs have been growing—lost demand for the world economy, potentially dangerous political shifts, and a rising threat of economic confrontation. In 1987, these costs touched bank creditors directly through their loss provisions . . . . Increasingly, they will touch others if progress in managing the debt problems is not renewed," according to the report, which concludes that "growth in the debtor countries remains the key. The obstacles holding it back must be addressed urgently."

Developing Country Debt

(billion U.S. dollars)



[1]Includes use of IMF resources

Note: Data are based on reports from 109 countries and reflect the rescheduling of about $45 billion of short-term debt to banks into long-term debt in 1983–86.

Data: World Bank, World Debt Tables, 1987–88 editions.

Latin American Growth Slows in 1987, Inflation Accelerates, Says ECLAC

"Not only did the economic growth rate [of Latin America] decline, but inflation again accelerated markedly, and although the external sector results were more favorable, they were concentrated in a very small number of countries," according to the United Nation's Economic Commission for Latin America and the Caribbean (ECLAC), which released its *Preliminary Overview of the Latin American Economy, 1987* in December.

ECLAC also expresses concern about the effect of low levels of investment on future growth; inflation and income distribution; and the impact of high debt levels and of world economic developments that affect the region's economies.

The report highlights developments in individual countries and discusses trends for oil exporting countries in Latin America—Bolivia, Ecuador, Mexico, Peru, Trinidad and Tobago, and Venezuela—and for non-oil countries. The 15 non-oil countries in the region are Argentina, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Nicaragua, Panama, Paraguay, and Uruguay.

Growth Slows. The aggregate gross domestic product (GDP) of the Latin American countries rose by an estimated 2.6 percent in 1987, according to the ECLAC report, which adds that this rate is "one percentage point lower than the average recorded during the preceding three years."

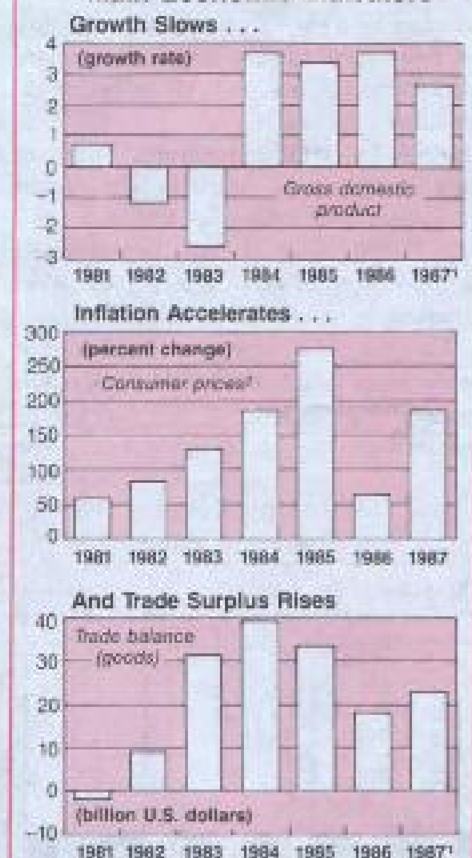
The aggregate GDP of oil exporting countries in the region grew by 1.4 percent in 1987, compared with a contraction of 1.2 percent in 1986. Although Ecuador's oil production and GDP declined and Venezuela's economic growth slowed, Mexico and Bolivia experienced some recovery and Peru continued to sustain a rapid pace of growth.

The aggregate GDP of non-oil exporting countries grew by 3.3 percent in 1987, compared with 6.8 percent in 1986. The ECLAC report highlights the slower growth rates in Brazil's GDP (up an estimated 3.0 percent in 1987, against 8.2 percent in 1986) and Argentina's GDP (up about 2.0 percent in 1987, compared with 6.0 percent in the previous year). Chile, Colombia, and Uruguay sustained growth rates of around 5½ percent in 1987.

In per capita terms, the report states that the aggregate GDP of the region rose by 0.5 percent in 1987, compared with 1.4 percent in the previous year. Nevertheless, the report adds that "the deterioration in living conditions suffered by most of the relatively poorer economies of Latin America continued in 1987." ECLAC estimates that the region's per capita GDP in 1987 was 5.5 percent below the level in 1980, and was similar to that of 1978.

Inflation Accelerates. The pace of inflation for the Latin American region surged to 190 percent in 1987, compared with 65 percent in 1986 and 275 percent in 1985, according to ECLAC figures. "Furthermore, the acceleration of the inflationary process was quite widespread, for consumer prices rose more rapidly than the year before in 13 of the 21 economies for which data are available, and in most of them the increase was considerable," adds the report. (The aggregate rate of inflation is based on country data—mainly for November 1987, relative to November 1986—which are weighted by the population of each country.)

Latin America and the Caribbean: Main Economic Indicators



[1] Preliminary estimates.
[2] Variation from December to December; for 1987, variation from latest available month.
Data: Economic Commission for Latin America and the Caribbean, *Preliminary Overview of the Latin American Economy*

The annual pace of inflation rose particularly sharply in Nicaragua (to a year-on-year rate of about 1,226 percent as of November 1987), Brazil (to 338 percent), Mexico (to 144 percent), Peru (to 105 percent in November 1987), and Argentina (to 178 percent, according to preliminary data as of December 1987). Inflation also accelerated sharply in Venezuela (to 36 percent, as of November 1987).

In contrast, the pace of inflation slowed in 1987 for Bolivia, Costa Rica, El Salvador, Guatemala, Honduras, Jamaica, and Paraguay. The slower pace of inflation in Bolivia (measured by the year-on-year increase of 11 percent as of November 1987, compared with 66 percent in December 1986) was particularly notable since Bolivia experienced a severe case of hyperinflation with prices rising by "over 23,000 percent in September 1985."

Terms of Trade Improve. The aggregate value of Latin American exports rose by 13 percent in 1987, based on a 7 percent rise in unit value and a 5 percent rise in volume, according to ECLAC estimates. At the same time, import value increased by almost 10 percent, with unit value rising by about 4 percent and volume by 5½ percent. "Thanks to the somewhat greater increase in the unit value of exports than in that of imports," the report says "the terms of trade rose slightly, after having gone down in the previous two years." Overall, ECLAC estimates that the aggregate terms of trade improved by 2.4 percent in 1987, compared with a 7.9 percent decline in 1986. The report adds, however, that "the accumulated deterioration during the decade so far [has been] considerable (–14 percent)."

The improvement in the region's terms of trade in 1987 was mainly concentrated in oil exporting countries, which "benefited from the almost 30 percent recovery in the international price of oil," according to the report. Together, these countries registered a 14½ percent improvement in their terms of trade in 1987, against a 29½ percent decline in 1986.

The terms of trade of the non-oil exporting countries—except for Argentina and Chile—deteriorated by about 5 percent in 1987, according to ECLAC estimates, in contrast to the 13 percent improvement a year earlier. The terms of trade worsened particularly for coffee exporting countries.

Current Account Deficits Decline. The aggregate trade surplus of the region rose to almost $23 billion in 1987, compared with $18 billion in 1986 and $33 billion in 1985. The increase in 1987 "sprang almost exclusively from the very large rises in the trade surpluses of Mexico—which almost doubled from US$4.6 billion in 1986 to US$9 billion in 1987; of Venezuela—which rose from US$1 billion to almost US$2.2 billion; and of Brazil—which increased from US$8.3 billion to US$10.8 billion," according to ECLAC estimates. The rise in Brazil's trade surplus, despite the deterioration in its terms of trade, was aided by a strong increase in export volume.

Net service payments for the region, including interest payments, fell by about $1 billion in 1987, to $33 billion, according to ECLAC estimates. Thus, the region's current account deficit fell to $9 billion in 1987, compared with $14.6 billion in 1986, according to the report. This reduction mainly reflected the higher trade surpluses and changes in the current account balances of three countries—Mexico, Brazil, and Venezuela.

External Financing and Debt Rise. The increase in external financing in 1987 reflects a combination of loans negotiated with commercial banks by Mexico and Argentina; official financing from bilateral and multilateral sources; repatriation of funds kept abroad by nationals; and the nonpayment of interest, which is counted as an implicit capital inflow in the balance of payments. "This latter phenomenon was of importance in Bolivia, Brazil, Ecuador, Peru, Costa Rica, Honduras, Nicaragua, Paraguay, and the Dominican Republic," states ECLAC.

ECLAC estimates that Latin America's total external debt rose by slightly more than 4 percent, to about $410 billion, compared with $393 billion in 1986. The "effective" rise in debt was smaller, when the increase is adjusted for inflation and for the fall of the dollar, relative to other currencies, which increases the value of the non-dollar debt. Most notably, this currency effect accounts for over half of the almost $6 billion rise in Brazil's debt.

Recent developments in the debt renegotiation process with both official and commercial creditors were also highlighted by the report. The debt negotiation process with banks was changed, in ECLAC's view, by the debtor countries' "more generalized recourse to temporary moratoriums [on interest payments]" and by larger numbers of creditor banks that have "established reserves to cover the portion of their loans which they consider to be most at risk." There were also a number of innovations, which included the "special commission" for early commitment to rescheduling arrangements and exit bonds, both introduced in the Argentine arrangement with commercial banks. Chile's rescheduling agreement made further use of retiming of interest payments, which reduced its payments to commercial banks. Peru signed several agreements for paying debt service with exports. In addition, a number of countries—Argentina, Brazil, Honduras, Jamaica, and Venezuela—introduced new programs to convert debt into equity. Overall, the terms of rescheduling agreements reached in the past year eased, with lower interest rate spreads and longer maturities.

Prospects. "Great uncertainty continues to prevail as regards the future evolution of the economies of Latin America and the Caribbean," according to ECLAC, which expresses concern about the region's investment levels, and international commodity prices and interest rates. The report also stresses the critical importance of stable growth and reduced macroeconomic imbalances in the industrial countries, which affect exchange rates and world trade. Both regional and international coordination is desirable, concludes the report, adding "the twenty-second session of ECLAC, which will be held in Brazil in April 1988, provides an opportunity to conduct a constructive dialogue on this subject."

Five Major Industrial Countries: Current Economic Indicators

(seasonally adjusted)

	United States	Japan	France	Fed. Rep. of Germany	United Kingdom	Total Five Countries
Real GNP (or GDP)	(percentage change at annual rate)					
Latest quarter over year ago	3.8(Q4)	4.3(Q3)	2.3(Q4)	2.4(Q4)	5.3(Q3)	3.3(Q3)
Latest quarter over preceding quarter	4.2	8.4	1.6	2.9	9.1	5.6
Industrial production	(percentage change at annual rate)					
Latest month over year ago	6.0(Jan)	9.2(Dec)	4.0(Nov)	2.1(Dec)	4.9(Dec)	5.7(Dec)
Latest three months (as indicated) over preceding three months	5.9 (Nov-Jan)	19.1 (Oct-Dec)	2.6 (Sep-Nov)	3.0 (Oct-Dec)	2.7 (Oct-Dec)	8.1 (Oct-Dec)
Consumer prices	(percentage change at annual rate)					
Latest month over year ago	4.4(Dec)	0.7(Dec)	3.1(Dec)	0.8(Jan)	3.3(Jan)	3.1(Dec)
Latest three months (as indicated) over preceding three months	3.6 (Oct-Dec)	0.5 (Oct-Dec)	2.2 (Oct-Dec)	0.5 (Nov-Jan)	4.0 (Nov-Jan)	2.6 (Oct-Dec)
Money supply (M2 or M3)	(percentage change at annual rate)					
Latest month over year ago	3.4(Jan)	11.5(Dec)	9.3(Dec)	6.0(Dec)	22.7(Dec)	7.1(Dec)
Latest three months (as indicated) over preceding three months	3.5 (Nov-Jan)	12.4 (Oct-Dec)	9.3 (Oct-Dec)	5.6 (Oct-Dec)	23.7 (Oct-Dec)	7.9 (Oct-Dec)
Unemployment	(percentage of labor force)					
Latest month	5.8(Jan)	2.6(Dec)	10.5(Dec)	7.8(Jan)	9.4(Dec)	6.1(Dec)
Corresponding month year ago	6.7	2.9	10.5	7.8	11.2	6.8
Trade balance	(billion U.S. dollars)					
Latest month	–12.2(Dec)	9.3(Jan)	–0.2(Dec)	6.7(Dec)	–2.2(Dec)	0.6(Dec)
Corresponding month year ago	–12.7	9.6	0.3	5.1	–1.3	0.2

Note: Data above are as of Wednesday preceding publication date. For specifications and sources of data, see *IMF Survey*, July 13, 1987, page 221

Data: National sources, IMF Bureau of Statistics, and international press and wire services

Exchange Rates and Exchange Arrangements, December 31, 1987

Member (currency)	Exchange Rate Pegged to[1]	Exchange Rate[1]	Exchange Rate Otherwise Determined[2,3]
Afghanistan (afghani)[4]	$	50.60	
Algeria (dinar)[8]	bskt	4.9363	
Antigua and Barbuda (EC$)[5]	$	2.70	
Argentina (austral)[4]			3.75
Australia (dollar)			1.38408
Austria (schilling)	bskt	11.250	
Bahamas, The (dollar)[4]	$	1.00	
Bahrain (dinar)[6]			0.376
Bangladesh (taka)[4]	bskt	31.20	
Barbados (dollar)	$	2.0115	
Belgium (franc)[4,7]			33.1525
Belize (dollar)	$	2.00	
Benin (franc)	F	50.00	
Bhutan (ngultrum)	Rs	1.00	
Bolivia (boliviano)			2.21
Botswana (pula)[8]	bskt		
Brazil (cruzado)[9,10]			71.882
Burkina Faso (franc)	F	50.00	
Burma (kyat)	SDR	8.50847	5.99754
Burundi (franc)	SDR	161.00	113.487
Cameroon (franc)	F	50.00	
Canada (dollar)			1.2998
Cape Verde (escudo)[8]	bskt		
Central African Republic (franc)	F	50.00	
Chad (franc)	F	50.00	
Chile (peso)[4,9,10]			238.14
China (renminbi)[4]			3.7221
Colombia (peso)[10]			263.70
Comoros (franc)	F	50.00	
Congo (franc)	F	50.00	
Costa Rica (colón)[4,8]			
Côte d'Ivoire (franc)	F	50.00	
Cyprus (pound)[8]	bskt	0.438685	
Denmark (krone)[7]			6.0965
Djibouti (franc)	$	177.721	
Dominica (EC$)[5]	$	2.70	
Dominican Rep. (peso)			4.91
Ecuador (sucre)[4,8]			
Egypt (pound)[4,8]			
El Salvador (colón)[4,8]	$		
Equatorial Guinea (franc)	F	50.00	
Ethiopia (birr)	$	2.07	
Fiji (dollar)	bskt	1.44051	
Finland (markka)[11]	bskt	3.946	
France (franc)[7]			5.340
Gabon (franc)	F	50.00	
Gambia, The (dalasi)[8]			
Germany, Fed. Rep. of (deutsche mark)[7]			1.5815
Ghana (cedi)[8]			
Greece (drachma)			125.925
Grenada (EC$)[5]	$	2.70	
Guatemala (quetzal)[4]	$	1.00	
Guinea (franc)			440.00
Guinea-Bissau (peso)			651.63
Guyana (dollar)[4]	$	10.00	
Haiti (gourde)	$	5.00	
Honduras (lempira)	$	2.00	
Hungary (forint)	bskt	33.4051	
Iceland (króna)			35.66
India (rupee)[12]			12.877156
Indonesia (rupiah)			1650.00
Iran, Islamic Rep. of (rial)	SDR	92.30	65.0614
Iraq (dinar)	$	0.310857	
Ireland (pound)[7]			0.596837
Israel (new sheqel)[8]	bskt		
Italy (lira)[7]			1169.25
Jamaica (dollar)			5.50
Japan (yen)			123.00
Jordan (dinar)	SDR	0.387754	0.273324
Kenya (shilling)[8]	bskt		
Kiribati (dollar)	A$	1.00	
Korea (won)			792.30
Kuwait (dinar)	bskt	0.26992	
Lao People's Dem. Rep. (kip)[4]	$	10.00	
Lebanon (pound)			455.00
Lesotho (loti)[4]	R	1.00	
Liberia (dollar)	$	1.00	
Libya (dinar)[13]	SDR	0.383929	0.270626
Luxembourg (franc)[4,7]			33.1525
Madagascar (franc)[10]			1234.27
Malawi (kwacha)	bskt	2.0538	
Malaysia (ringgit)[11]	bskt	2.4915	
Maldives (rufiyaa)			9.3950
Mali (franc)	F	50.00	
Malta (lira)	bskt	3.2081	
Mauritania (ouguiya)			71.60
Mauritius (rupee)	bskt	12.16285	
Mexico (peso)[4]			2203.70
Morocco (dirham)			7.8003
Mozambique (metica)			404.00
Nepal (rupee)	bskt	21.60	
Netherlands (guilder)[7]			1.7775
New Zealand (dollar)			1.51676
Nicaragua (córdoba)[4]	$	70.00	
Niger (franc)	F	50.00	
Nigeria (naira)[4,8]			
Norway (krone)	bskt	6.2325	
Oman (rial Omani)	$	0.3845	
Pakistan (rupee)			17.4937
Panama (balboa)	$	1.00	
Papua New Guinea (kina)	bskt	0.543951	
Paraguay (guaraní)[4,8]	$		
Peru (inti)[4]	$		33.00
Philippines (peso)			20.80
Poland (zloty)	bskt	315.540	
Portugal (escudo)[10]			129.865
Qatar (riyal)[6]			3.64
Romania (leu)	bskt	14.60	
Rwanda (franc)	SDR	102.71	72.3993
St. Kitts and Nevis (EC$)[5]	$	2.70	
St. Lucia (EC$)[5]	$	2.70	
St. Vincent (EC$)[5]	$	2.70	
Sao Tome and Principe (dobra)	bskt	100.00	
Saudi Arabia (riyal)[6]			3.745
Senegal (franc)	F	50.00	
Seychelles (rupee)	SDR	7.2345	5.09953
Sierra Leone (leone)			20.0361
Singapore (dollar)	$	2.00	
Solomon Islands (dollar)	bskt	1.97433	
Somalia (shilling)[4]	$	100.00	
South Africa (rand)[4]			1.92594
Spain (peseta)			109.00
Sri Lanka (rupee)			30.7625
Sudan (pound)[4]	$	4.50	
Suriname (guilder)	$	1.785	
Swaziland (lilangeni)	R	1.00	
Sweden (krona)[14]	bskt	5.846	
Syrian Arab Rep. (pound)[4]	$	11.225	
Tanzania (shilling)	bskt	83.6744	
Thailand (baht)	bskt	25.07	
Togo (franc)	F	50.00	
Tonga (pa'anga)	A$	1.00	
Trinidad and Tobago (dollar)	$	3.61575	
Tunisia (dinar)			0.771737
Turkey (lira)[15]			1020.90
Uganda (new shilling)	$	60.0	
United Arab Emirates (dirham)[6]			3.671
United Kingdom (pound)			0.534331
United States (dollar)			1.00
Uruguay (new peso)			280.25
Vanuatu (vatu)	SDR	142.00	100.094
Venezuela (bolívar)[4,8]	$		
Viet Nam (new dong)[4]	$	15.00	
Western Samoa (tala)			2.31086
Yemen Arab Rep. (rial)[4]	$	9.90	
Yemen, People's Dem. Rep. (dinar)	$	0.345399	
Yugoslavia (dinar)			1244.35
Zaïre (zaïre)			131.40
Zambia (kwacha)	$		8.04
Zimbabwe (dollar)	bskt	1.66306	

$ U.S. dollar
F French franc
R South African rand
bskt Currency basket other than SDR
Rs Indian rupee
A$ Australian dollar

[1]Rates and arrangements as reported to the Fund and in terms of currency units per unit listed; rates determined by baskets of currencies are in currency units per U.S. dollar.
[2]Market rates in currency units per U.S. dollar.
[3]Under this heading are listed those members that describe their exchange rate arrangements as floating independently or as adjusting according to a set of indicators (see footnote 10) and certain other members whose exchange arrangements are not otherwise described in this table. In addition, U.S. dollar quotations are given for the currencies that are pegged to the SDR and for those that participate in the European Monetary System (see footnote 7).
[4]Member maintains dual exchange markets involving multiple exchange arrangements. The arrangement shown is that maintained in the major market. A description of the member's exchange system as of December 31, 1986 is given in the *Annual Report on Exchange Arrangements and Exchange Restrictions, 1987*.
[5]East Caribbean dollar.
[6]Exchange rates are determined on the basis of a relationship to the SDR, within margins of ± 7.25 percent. However, because of the maintenance of a relatively stable relationship with the U.S. dollar, these margins are not always observed.
[7]Belgium, Denmark, France, the Federal Republic of Germany, Ireland, Italy, Luxembourg, and the Netherlands are participating in the exchange rate and intervention mechanism of the European Monetary System and maintain maximum margins of 2.25 percent (in the case of the Italian lira, 6 percent) for exchange rates in transactions in the official markets between their currencies and those of the other countries in this group.
[8]Exchange rate data not available.
[9]Member maintains a system of advance announcements of exchange rates.
[10]Exchange rates adjusted according to a set of indicators.
[11]The exchange rate is maintained within margins of ± 2.25 percent.
[12]The exchange rate is maintained within margins of ± 5 percent on either side of a weighted composite of the currencies of the main trading partners.
[13]The exchange rate is maintained within margins of ± 7.5 percent.
[14]The exchange rate is maintained within margins of ± 1.5 percent.
[15]The central bank establishes its selling rate daily and the buying rate is set at ½ of 1 percent below the selling rate. Commercial banks must use the central bank's selling rate, but are free to set their own buying rate.

Data: IMF Treasurer's and Exchange and Trade Relations Departments

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EXCHANGE RATE POLICY

Monetary Policy and the Role of the Exchange Rate

1. The aim of monetary policy is to control inflation, which has been brought down from an average rate of 15 per cent in the 1970s to 3¼ per cent today.

2. Progress in recent years has been less rapid but it is clear that the trend has been downwards. Inflation over the past two years has been markedly below earlier years. And the forecast shows this improvement being held. Mortgage rate changes introduce additional fluctuations and the underlying trend is clearer if they are ignored.

Inflation

	RPI Total	RPI excluding mortgage payments
1982	8.6	8.5
1983	4.6	5.2
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3. In comparing inflation in the UK and elsewhere it is important to note that:

- lower oil prices helped other countries much more than the UK as sterling fell during that adjustment period;

- the UK has experienced a number of years of sustained rapid growth. It is rare for inflation to fall in those circumstances; indeed it usually goes up.

4. The conduct of monetary policy has been difficult; partly because of changes to the financial system:

- broad money has been a particularly poor indicator throughout the 1980s. Chart 1 (page 3) shows the lack of correlation between £M3 and inflation. This seems to reflect a number of factors. High real interest rates have added to the attractiveness of financial assets in general; increased competition in financial markets has led to rapid growth in private sector liquidity and borrowing; and the growing internationalisation of markets means that demand for broad money is intertwined with international capital flows and exchange rate expectations.

- narrow money (MO) has had a closer relationship with inflation (chart 2) and has a good record as an indicator of monetary conditions. But on its own it is not enough. It does not carry much market credibility; and it only gives a short lead, if at all, to inflationary trends.

5. Exchange rates have become a major complicating factor in the assessment of monetary conditions; they have shown substantial fluctuations - particularly the dollar. Very often the fluctuations are reversed; but not until they have moved a long way and had substantial direct and indirect effects.

6. Exchange rate changes have an important impact on monetary conditions:

- appreciation will tighten monetary conditions. There is a direct effect on import prices; and appreciation squeezes profits of UK manufacturers by constraining their ability to raise prices. Similarly depreciation will loosen monetary conditions;

- exchange rate changes can generate second round effects through their impact on inflationary expectations and wage negotiations.

7. In some respects a higher exchange rate can be seen as a substitute for higher interest rates. But there is an important difference. As compared with higher interest rates, tightening monetary policy through a higher exchange rate will produce a worse outcome for the balance of payments; it puts more pressure on exporters as well as those supplying goods at home who have to compete with cheaper imports; and less on the non-trading sector, particularly construction.

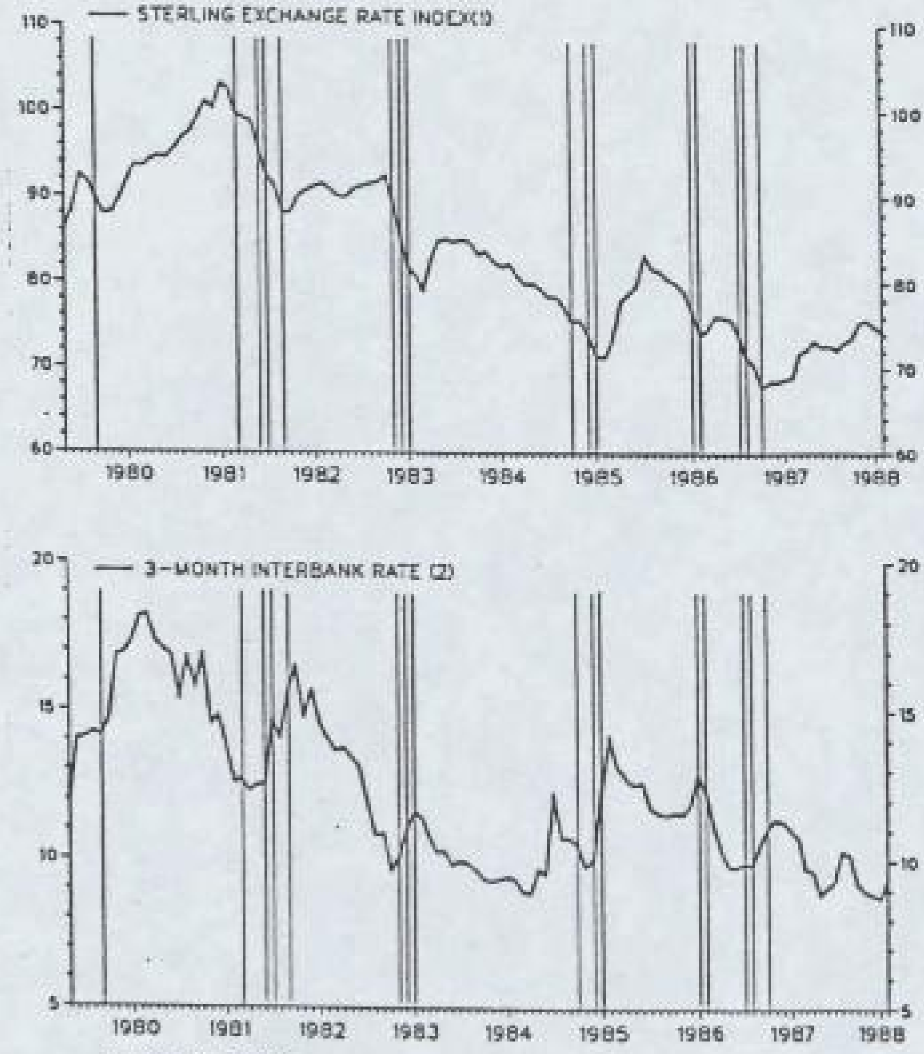
Chart 1

Chart 2

8. Because of the importance of exchange rate fluctuations for monetary conditions we have given a substantial weight to exchange rates in monetary policy decisions for many years. In successive editions of the MTFS the importance of exchange rate behaviour has been emphasised. And interest rate decisions have often been influenced by exchange rate changes. Chart 3 compares the monthly path for the sterling exchange rate index and the 3-month interbank rate since mid 1979. The vertical lines indicate the months in which the exchange rate depreciated by more than 2 per cent. It is evident that this almost always coincides with interest rate increases. The most noticeable episodes were the Autumn of 1981, the Winter of 1982-83, January 1985, and the Autumn of 1986. A similar pattern applies in reverse. The periods of sterling strength coincide with interest rate reductions.

Chart 3

THE EXCHANGE RATE AND 3-MONTH INTERBANK RATE



(1) MONTHLY AVERAGE
(2) END OF MONTH
(3) VERTICAL BARS INDICATE MONTHS IN WHICH THE EXCHANGE RATE DEPRECIATED BY MORE THAN 2 PERCENT

9. The approach to giving the exchange rate a substantial weight in monetary policy decisions is not new. During most of the past 100 years the UK has directed monetary policy towards exchange rate stability - most evidently in terms of the Gold Standard. Nor is the approach unique to the UK. And increasingly other major countries are once again giving exchange rates a major weight in the conduct of policy, generally for the same reasons: the difficulty of interpreting domestic monetary indicators at a time of structural change; and the important direct and indirect effect on inflation, activity and the balance of payments. The Swiss have been successful over long periods in keeping the Swiss franc steady against the Deutschemark. The Germans and Japanese have also had considerable success in managing movements in their currencies. And Hong Kong, one of the freest markets in the world, has successfully operated a fixed exchange rate against the dollar since 1983.

10. Since 1985 the finance ministers and central bankers of the major industrial countries have explicitly recognised the importance of appropriate exchange rates in contributing to better economic balance and restraining protectionist pressures. In the wake of the decline of the dollar following the October stock market crash some commentators suggested that the Louvre agreement was a mistake. But as Paul Volcker observed in a speech in Geneva in November:

> "The argument of some seems to be that the agreement sacrificed appropriate internal economic management to the requirements of a stable exchange rate. That seems to me a misreading of both the nature of the understanding and, more broadly, the need to accord the requirements of exchange rate stability more prominence in economic policy-making."

He went on to say:

> ...the health and vitality of an open international trading order will be importantly dependent over time upon the willingness of governments of large trading countries to reach some realistic collective judgments about the broadly appropriate level of exchange rates. Those judgments will,

in turn, need to influence the design and implementation of domestic policies if they are to be meaningful and durable."

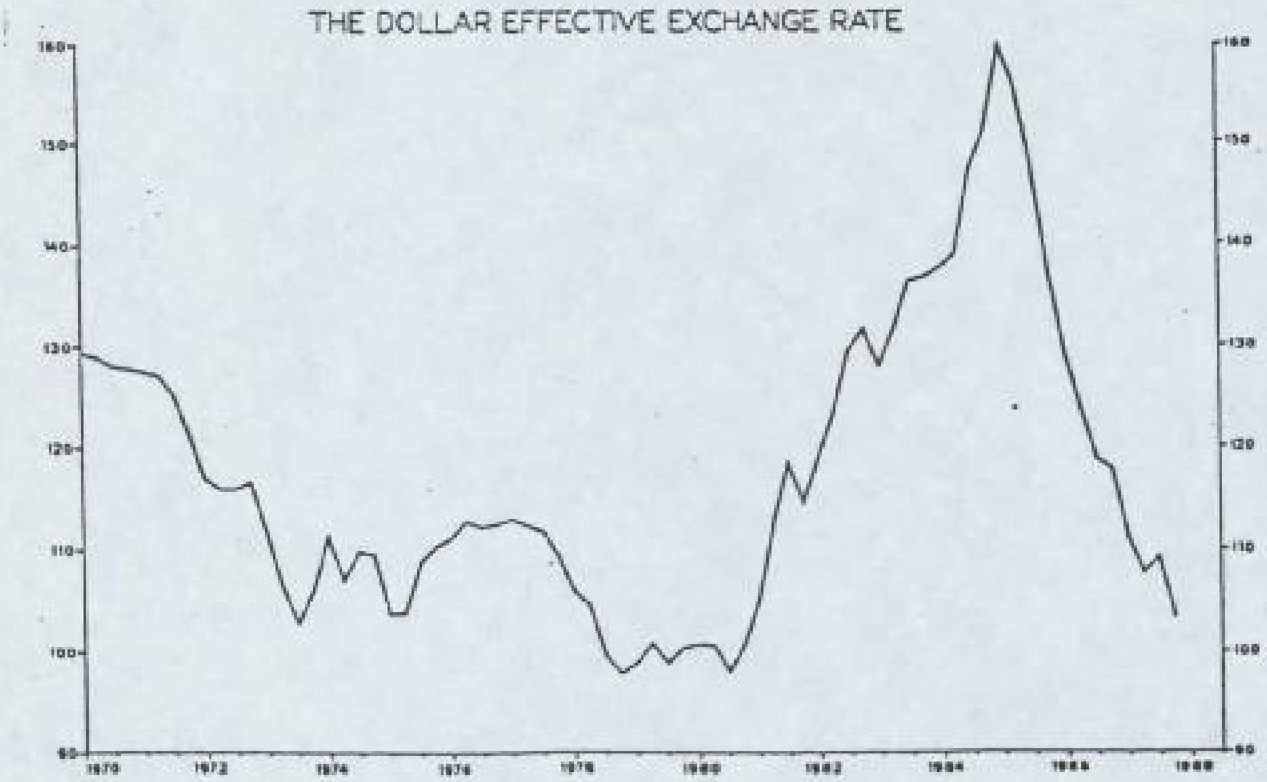
The Nature of the Foreign Exchange Market

11. In deciding the most effective way of taking the exchange rate into account it is necessary to consider the nature and characteristics of the foreign exchange market.

12. Gyrations of exchange rates are nothing new but they have been increased by the global 24-hour markets. Turnover has increased dramatically, but only a small part is related to commercial transactions.

13. In the long run the foreign exchange markets adapt to fundamentals but in the short run they generally do not. There are insufficient speculators who take a long view. Fluctuations away from levels consistent with fundamentals can take place for long periods; and they can be very large. Chart 4 shows movements of the dollar since the early 1970s. The rise and fall of the dollar since 1980 is inexplicable in terms of the underlying fundamentals of the US economy.

Chart 4



14. These fluctuations can be very damaging:

- scarce management time in business is taken up with currency fluctuations;

- swings of exchange rates dislocate businesses as profit rates and selling prices fluctuate;

- and because of the uncertainty companies take low risk decisions and are averse to investing where they fear they might find themselves uncompetitive later on.

15. Although Governments cannot control exchange rates precisely they can give a lead and keep exchange rates closer to fundamentals. They are not all powerful; but neither are they impotent.

16. Indeed, Governments can have a significant effect on exchange rate movements; something that is widely accepted in the markets. Their influence stems from the size and importance of Government; in particular they influence some of the most important factors determining exchange rates - the budget deficit and interest rates. Not surprisingly the markets give weight to what they interpret as the authorities' preferences in developing their own market strategy.

17. Market expectations are influenced by Government behaviour. And as a result they constantly try to find out the Government's policy towards the exchange rate. In these circumstances it is counter-productive to have a complete hands-off policy. It is all too easily interpreted by the markets as a positive desire by the authorities for the exchange rate either to fall (as in January 1985) or - when the pressure is upward - to go on rising. And if other countries are operating a hands-on policy the fluctuations of sterling will be even greater and even more costly as it attracts even larger amounts of speculative funds.

Instruments of Policy

18. Interest rates are the key instrument of monetary policy. They are also the Government's most important instrument for influencing the exchange rate. A higher interest rate will raise the return on holding sterling. It will therefore attract inflows, tending to raise the exchange rate, except when it reflects expectations of higher inflation.

19. If sterling is rising for speculative reasons, and an appreciation appears to be unjustified on fundamental grounds, it is possible to exercise some restraint through lower interest rates. The strengthening of the exchange rate will tend to tighten monetary conditions while the lower interest rate will mean easier monetary conditions. By adjusting interest rates in the face of fluctuations of sterling it is possible to reduce the volatility of exchange rates without monetary conditions becoming too loose or too tight.

20. If the authorities attempt to stabilise the exchange rate through changes to interest rates a conflict of interest can occur. It is possible that the maintenance of exchange rate stability will involve interest rate changes that tighten or loosen monetary policy more than is desirable. In particular for a country with an above average inflation rate it may be pressed to reduce interest rates too much. In practice this dilemma only occurs infrequently. For much of the time it is possible to combine exchange rate stability with suitable interest rates. If the pressure becomes too intense it becomes necessary to accept some change in the level of the exchange rate.

21. It is sometimes argued that economies generate a fixed amount of exchange rate-interest rate instability. If policy is directed towards limiting exchange rate volatility it is suggested that this will be replaced by increased interest rate volatility. But this ignores the impact of policy upon expectations. The reduction of exchange rate volatility may reduce the speculation

surrounding a currency and in time, as credibility is increased, lead to greater stability of interest rates. A comparison of experience between countries and over time lends no support to the hypothesis of a fixed amount of instability. Although the underlying reasons are complex, periods of exchange rate stability are usually associated with less rather than more interest rate volatility.

22. Intervention also has a role to play in helping the Government to counteract potentially damaging short-term movements in exchange rates. Although the total flows across the foreign exchanges are enormous in relation to the funds that Government can deploy to meet its objectives many of the private sector flows are offsetting transactions as market participants hedge positions. In net terms even quite modest sums deployed in intervention can have a useful effect. This is especially true if intervention is co-ordinated between countries. Much of its effect comes through the signals it gives the markets of the Government's wider policy intentions - since the market knows that fiscal and monetary policies can have a powerful effect on exchange rates.

23. Intervention is particularly useful in conditions of sudden surges of buying or selling because it is easily reversible. If offsetting action is limited to interest rates it could lead to unnecessarily large interest rate changes which are undesirable in themselves and in any event can look incompetent. Intervention can avoid some interest rate volatility. And it helps to demonstrate in a subtle way the Government's exchange rate preferences without explicit statements about ranges. It can give a signal without being pinned down to a particular range. And it is possible to vary tactics between currencies, and more or less obviously. Given the markets' interest in the Government's views this can lead to stabilising speculation.

24. The impact of intervention upon monetary conditions is often misunderstood. Obviously if, in the absence of intervention, the

exchange rate would have been higher or lower, there will be some effect on inflationary pressures. But there need be no monetary consequences. In the UK system the Bank of England immediately offsets any effect of the intervention upon the monetary base by its own market operations. And over time we have had a policy of offsetting any effect it might have upon liquidity by funding. Even over the past year when intervention has been very high we have succeeded in fully funding it. As a result there have not only been no monetary effects, but no liquidity effects either.

25. The profitability of intervention is a necessary consideration but this can only be evaluated when the intervention is unwound. Because the swings away from fundamentals can exist for some time there will be accrued losses at particular moments. But the large swings in exchange rates mean that opportunities do emerge for profitable intervention that would only become apparent after several years. It is important to accept that the aim is not to maximise profits from intervention - that would lead us to behave like other short-run speculators. Instead the aim is stabilising intervention that incidentally makes some profit.

26. When a currency is strong intervention serves as an insurance policy. It accumulates reserves that become available if pressures are reversed. If the currency appreciates over the longer term any exchange rate losses should be balanced against the success of the economy and the utility of the increased reserves; and if it is a temporary strength, the intervention will reduce fluctuations and make a profit.

27. There are limits to the effectiveness of intervention. This means that it should not become a way of life, and can only be a subsidiary instrument. But at times it can play an important part. It would be a mistake to have a policy of never using it, particularly when it is one of the few instruments available in a free market economy; but equally it must be used in a controlled way.

Experience over the past year

28. Although the exchange rate has played an important role in monetary policy decisions for many years it has had a greater weight over the past year. There have been a number of reasons:

- in the Autumn of 1986 sterling had been under considerable downward pressure. Interest rates were raised by 1 per cent to halt the slide. The Chancellor said that any further depreciation would be undesirable;

- in the Louvre agreement the major 6 industrialised countries agreed to co-operate to foster increased exchange rate stability whilst working to correct the fundamental reasons for the trade imbalances. In February the Chancellor said that he was more content for sterling to rise than to fall. This was expressed in terms of the DM rate as this is the single most important currency for UK manufacturing industry;

- in the run-up to the General Election in June there was a clear case for restraining the rise of sterling to avoid a speculative bubble emerging that could be very inconvenient for the conduct of policy during the election;

- and in the aftermath of the share price crash on October 19 there was a premium in maintaining as much stability as possible whilst confidence was restored.

29. The apparent importance of the 3DM rate grew out of these events. Once the markets had seen some resistance at 3DM they hesitated to push very hard. And the longer sterling remained within the 2.90-3.00DM range the more reluctant they were to push and we were to see it breached. There were clear gains to industry from stability; and benefits in the form of firmer expectations of the likely scale of exchange rate fluctuations.

30. The cumulative scale of the intervention was greater than would normally be desirable. But it has done no damage to monetary policy because it has been offset by funding. And it has helped to establish the Government's commitment to limiting the scale of fluctuations. So long as that commitment is continued and clearly understood, in future it should be possible to achieve a similar result with much less intervention.

31. It became clear on March 4 that the scale of exchange rate pressure was greater than could be coped with by intervention. And there was no scope for reducing interest rates as we had already concluded that, if anything, monetary conditions were on the easy side.

32. Since then the exchange rate has risen but because there have been tighter monetary conditions it has been possible to reduce interest rates by ½ per cent.

33. In reflecting on the events of the past year it is important to recognise that the present situation is very different from 1980-81 when sterling rose so sharply. There is no inconsistency between what was allowed to happen then and what we would prefer now. The circumstances then were very different: inflation was almost 20 per cent; North Sea oil was having a big impact; public expenditure and the budget deficit were not firmly under control; it was important to assert credibility for a non-accommodating policy stance; there was a need for a shock to expectations generally; and it was impossible to be sure for several months that broad money was giving the wrong signals.

34. It is also important to see the resistance to appreciation as an important component of avoiding excessive depreciation. We are all agreed that a firm anti-inflationary stance requires a commitment not to bail out excessive growth of labour costs by devaluation. If the impression is given that the exchange rate will go wherever it is pushed the market will also assume that a lower exchange rate will be accommodated if confidence is reversed. In these circumstances holding the exchange rate will

involve higher interest rates than would have been necessary if a presumption of stability has been created. On the other hand if it is clearly understood and accepted that cost rises will not be accommodated by allowing the rate to fall, then the same degree of downward pressure on inflation can be achieved with lower interest rates.

Options

35. The discussion in this paper suggests that:

- the Government must continue to give the exchange rate a substantial weight in the conduct of monetary policy;

- in the process it is desirable to have an explicit objective for greater exchange rate stability.

36. There are three main alternative approaches discussed in the remainder of this paper. In practice they lie on a continuum but separating them helps to focus the main points:

- taking the exchange rate "into account" in the conduct of monetary policy;

- an explicit statement about the desire for greater stability combined with a notional but unpublished range;

- full membership of EMS.

Taking the exchange rate "into account"

37. This was the presentation used for much of the 1980s. It means setting interest rates in a purely judgemental way in the light of the behaviour of a range of indicators, including the exchange rate.

38. Advantages:

- helps to balance monetary conditions so that neither excessive loosening nor tightening of conditions;

- avoids unnecessary oscillation of inflation rate;

- some effect in curbing excessive swings of sterling with benefit to industry;

- maximum tactical flexibility by avoiding any question of particular ranges;

- intervention can be limited to smoothing.

39. Disadvantages:

- gives little in the way of a steer to markets. Lose some of gains of stabilising speculation;

- can involve unnecessary degree of exchange rate volatility;

- markets will constantly press for a more explicit statement about exchange rate policy;

- requires considerable judgement in balancing factors;

- only a weak anchor against inflationary expectations, so likely to require higher interest rates.

Greater Stability

40. This is a more formalised approach. It would involve an explicit statement about the desire for stability. We would operate a notional, unpublished range. Interest rates would be adjusted to keep exchange rates within that range, supported by

some intervention. There would be changes to the range if market pressure were sustained so that interest rates were pushed too low, intervention was too great, or MO growth was too fast.

41. There are various degrees of formality, depending on: width of range; frequency of changing range; extent to which change range; amount of intervention before changing range.

42. <u>Advantages</u>:

- clear signals about exchange rate, especially important for business decisions and investment.

- mechanism for reducing exchange rate volatility;

- can be operated to maintain an appropriate degree of disinflationary pressure;

- uses all instruments available;

- range unpublished and therefore no bureaucratic operations involved in changing.

43. <u>Disadvantages</u>:

- less certainty for both business and for inflationary expectations than a published range although more than "taking into account";

- markets will test to find range;

- intervention will be necessary from time to time;

- no obvious way of distinguishing a change of range from a change of policy.

Membership of ERM

44. Advantages:

- makes commitment to exchange rate stability clear. Advantages for industry;

- if realignments are necessary, it is clear that overall policy remains the same;

- simple to explain policy to public and markets;

- useful anti-inflationary discipline;

- if maintenance of the parity is credible it will reduce scale of market pressure during periods of turbulence.

45. Disadvantages

- changes of ranges require discussion with other members of ERM;

- present ERM is dominated by Germany and Deutschemark;

- if the parity comes under question there could be greater pressure at times meaning larger interest changes and intervention;

- could sharpen conflict with other objectives of monetary policy.

Conclusion

46. In a complex world there is a great advantage in explaining and presenting policy in a clear way. A major objective of monetary policy is to give guidance both to the market and to the economy at large. This is why we publish the MTFS.

47. Once a policy has been formed it is essential to explain it and to act in a way that will bring it about. If a policy is made clear markets will support it by forming expectations in relation to Government statements and actions.

48. The original ambition of the MTFS was to conduct monetary policy in relation to monetary targets. For a variety of reasons that has not been possible - and the exchange rate has played an increasing role. There is a lot to be said for conducting policy towards the exchange rate in a way that can be understood. It does not need to be too precise. But if they understand it, see actions confirming it, and believe other policies are consistent with it, markets will respond in a constructive way rather than a destabilising way, and business confidence and hence enterprise will be enhanced.

23 March 1988

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SECRET

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RA

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

23 March 1988

Paul Gray, Esq
No.10 Downing Street
London SW1

Dear Paul,

EXCHANGE RATE POLICY

... I attach a note for discussion at Friday's meeting. I am copying it also to John Footman (Bank of England).

Yours
Alex

A C S ALLAN

EXCHANGE RATE POLICY

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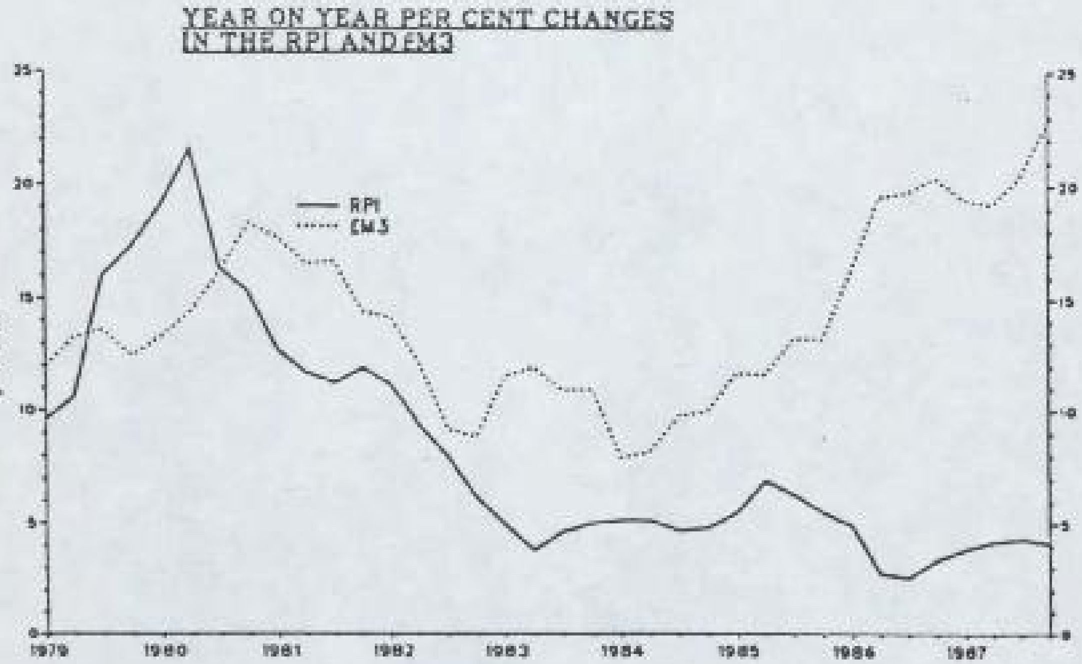

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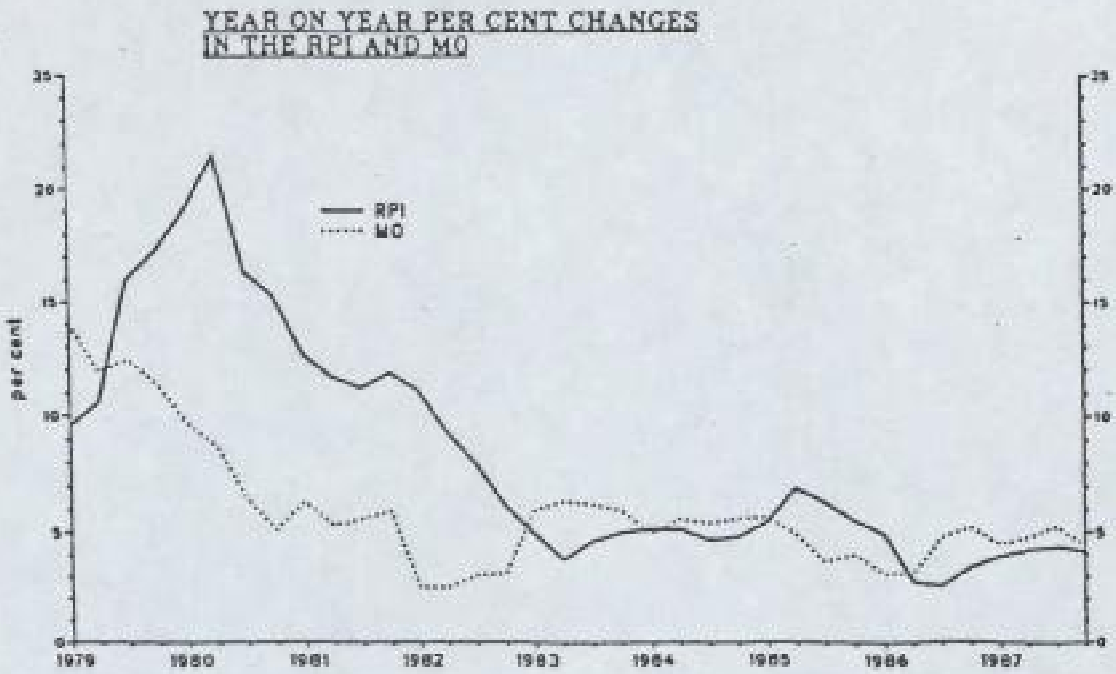

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Chart 3

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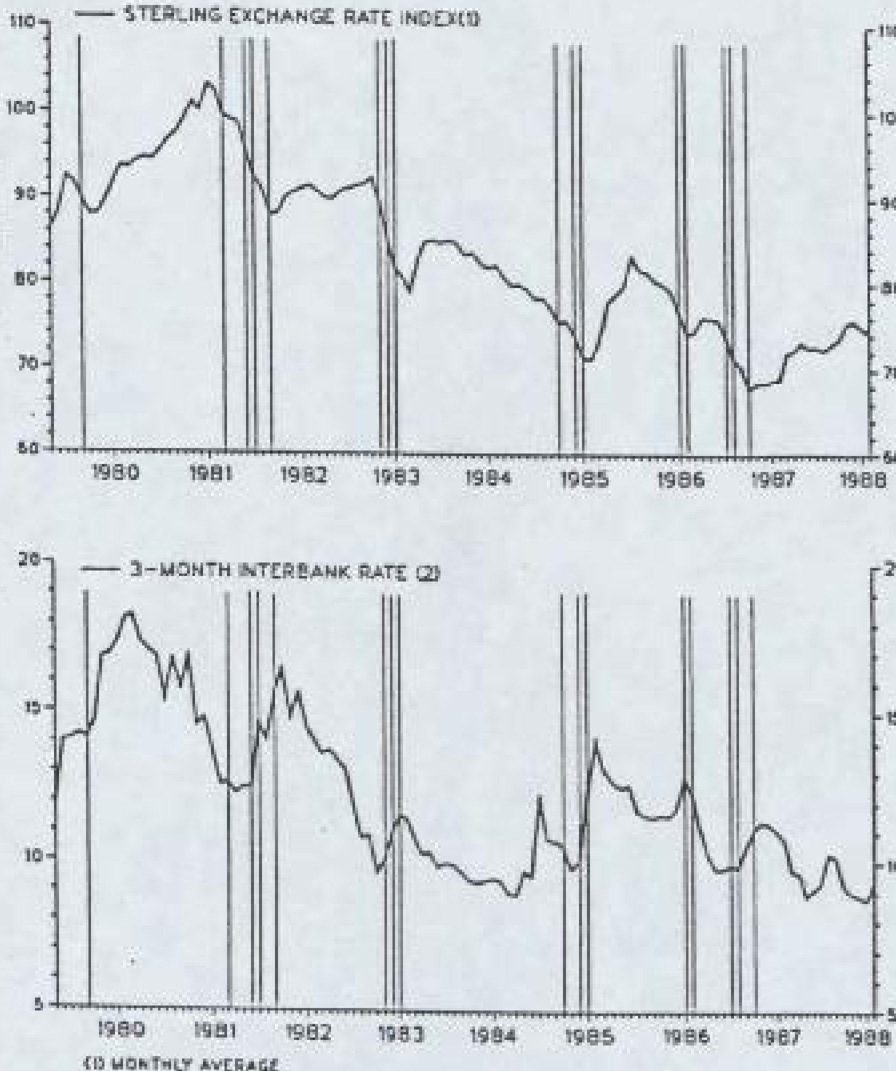

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> "The argument of some seems to be that the agreement sacrificed appropriate internal economic management to the requirements of a stable exchange rate. That seems to me a misreading of both the nature of the understanding and, more broadly, the need to accord the requirements of exchange rate stability more prominence in economic policy-making."

He went on to say:

> ...the health and vitality of an open international trading order will be importantly dependent over time upon the willingness of governments of large trading countries to reach some realistic collective judgments about the broadly appropriate level of exchange rates. Those judgments will,

in turn, need to influence the design and implementation of domestic policies if they are to be meaningful and durable."

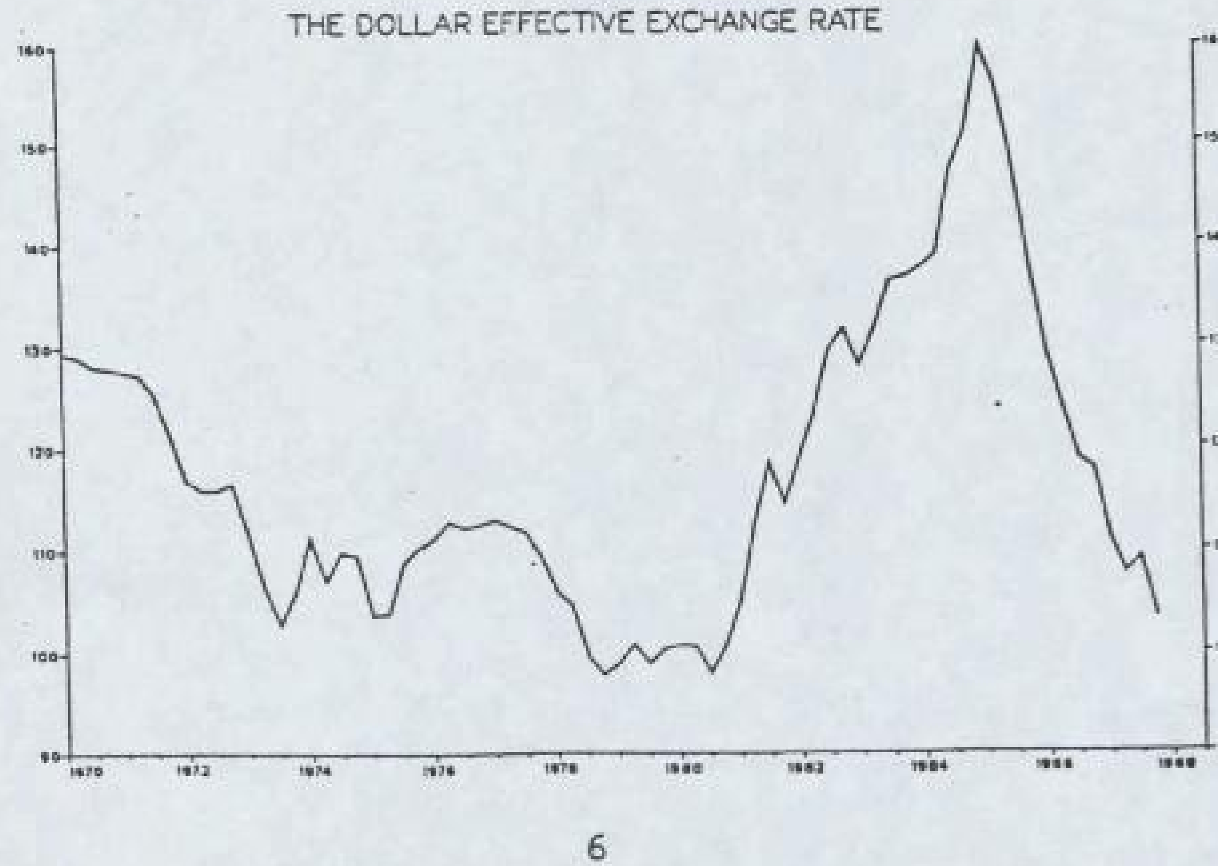
The Nature of the Foreign Exchange Market

11. In deciding the most effective way of taking the exchange rate into account it is necessary to consider the nature and characteristics of the foreign exchange market.

12. Gyrations of exchange rates are nothing new but they have been increased by the global 24-hour markets. Turnover has increased dramatically, but only a small part is related to commercial transactions.

13. In the long run the foreign exchange markets adapt to fundamentals but in the short run they generally do not. There are insufficient speculators who take a long view. Fluctuations away from levels consistent with fundamentals can take place for long periods; and they can be very large. Chart 4 shows movements of the dollar since the early 1970s. The rise and fall of the dollar since 1980 is inexplicable in terms of the underlying fundamentals of the US economy.

Chart 4



14. These fluctuations can be very damaging:

- scarce management time in business is taken up with currency fluctuations;

- swings of exchange rates dislocate businesses as profit rates and selling prices fluctuate;

- and because of the uncertainty companies take low risk decisions and are averse to investing where they fear they might find themselves uncompetitive later on.

15. Although Governments cannot control exchange rates precisely they can give a lead and keep exchange rates closer to fundamentals. They are not all powerful; but neither are they impotent.

16. Indeed, Governments can have a significant effect on exchange rate movements; something that is widely accepted in the markets. Their influence stems from the size and importance of Government; in particular they influence some of the most important factors determining exchange rates - the budget deficit and interest rates. Not surprisingly the markets give weight to what they interpret as the authorities' preferences in developing their own market strategy.

17. Market expectations are influenced by Government behaviour. And as a result they constantly try to find out the Government's policy towards the exchange rate. In these circumstances it is counter-productive to have a complete hands-off policy. It is all too easily interpreted by the markets as a positive desire by the authorities for the exchange rate either to fall (as in January 1985) or - when the pressure is upward - to go on rising. And if other countries are operating a hands-on policy the fluctuations of sterling will be even greater and even more costly as it attracts even larger amounts of speculative funds.

one way bet

Instruments of Policy

18. Interest rates are the key instrument of monetary policy. They are also the Government's most important instrument for influencing the exchange rate. A higher interest rate will raise the return on holding sterling. It will therefore attract inflows, tending to raise the exchange rate, except when it reflects expectations of higher inflation.

19. If sterling is rising for speculative reasons, and an appreciation appears to be unjustified on fundamental grounds, it is possible to exercise some restraint through lower interest rates. The strengthening of the exchange rate will tend to tighten monetary conditions while the lower interest rate will mean easier monetary conditions. By adjusting interest rates in the face of fluctuations of sterling it is possible to reduce the volatility of exchange rates without monetary conditions becoming too loose or too tight.

20. If the authorities attempt to stabilise the exchange rate through changes to interest rates a conflict of interest can occur. It is possible that the maintenance of exchange rate stability will involve interest rate changes that tighten or loosen monetary policy more than is desirable. In particular for a country with an above average inflation rate it may be pressed to reduce interest rates too much. In practice this dilemma only occurs infrequently. For much of the time it is possible to combine exchange rate stability with suitable interest rates. If the pressure becomes too intense it becomes necessary to accept some change in the level of the exchange rate.

21. It is sometimes argued that economies generate a fixed amount of exchange rate-interest rate instability. If policy is directed towards limiting exchange rate volatility it is suggested that this will be replaced by increased interest rate volatility. But this ignores the impact of policy upon expectations. The reduction of exchange rate volatility may reduce the speculation

surrounding a currency and in time, as credibility is increased, lead to greater stability of interest rates. A comparison of experience between countries and over time lends no support to the hypothesis of a fixed amount of instability. Although the underlying reasons are complex, periods of exchange rate stability are usually associated with less rather than more interest rate volatility.

22. Intervention also has a role to play in helping the Government to counteract potentially damaging short-term movements in exchange rates. Although the total flows across the foreign exchanges are enormous in relation to the funds that Government can deploy to meet its objectives many of the private sector flows are offsetting transactions as market participants hedge positions. In net terms even quite modest sums deployed in intervention can have a useful effect. This is especially true if intervention is co-ordinated between countries. Much of its effect comes through the signals it gives the markets of the Government's wider policy intentions - since the market knows that fiscal and monetary policies can have a powerful effect on exchange rates.

23. Intervention is particularly useful in conditions of sudden surges of buying or selling because it is easily reversible. If offsetting action is limited to interest rates it could lead to unnecessarily large interest rate changes which are undesirable in themselves and in any event can look incompetent. Intervention can avoid some interest rate volatility. And it helps to demonstrate in a subtle way the Government's exchange rate preferences without explicit statements about ranges. It can give a signal without being pinned down to a particular range. And it is possible to vary tactics between currencies, and more or less obviously. Given the markets' interest in the Government's views this can lead to stabilising speculation.

24. The impact of intervention upon monetary conditions is often misunderstood. Obviously if, in the absence of intervention, the

exchange rate would have been higher or lower, there will be some effect on inflationary pressures. But there need be no monetary consequences. In the UK system the Bank of England immediately offsets any effect of the intervention upon the monetary base by its own market operations. And over time we have had a policy of offsetting any effect it might have upon liquidity by funding. Even over the past year when intervention has been very high we have succeeded in fully funding it. As a result there have not only been no monetary effects, but no liquidity effects either.

25. The profitability of intervention is a necessary consideration but this can only be evaluated when the intervention is unwound. Because the swings away from fundamentals can exist for some time there will be accrued losses at particular moments. But the large swings in exchange rates mean that opportunities do emerge for profitable intervention that would only become apparent after several years. It is important to accept that the aim is not to maximise profits from intervention - that would lead us to behave like other short-run speculators. Instead the aim is stabilising intervention that incidentally makes some profit.

26. When a currency is strong intervention serves as an insurance policy. It accumulates reserves that become available if pressures are reversed. If the currency appreciates over the longer term any exchange rate losses should be balanced against the success of the economy and the utility of the increased reserves; and if it is a temporary strength, the intervention will reduce fluctuations and make a profit.

27. There are limits to the effectiveness of intervention. This means that it should not become a way of life, and can only be a subsidiary instrument. But at times it can play an important part. It would be a mistake to have a policy of never using it, particularly when it is one of the few instruments available in a free market economy; but equally it must be used in a controlled way.

Experience over the past year

28. Although the exchange rate has played an important role in monetary policy decisions for many years it has had a greater weight over the past year. There have been a number of reasons:

- in the Autumn of 1986 sterling had been under considerable downward pressure. Interest rates were raised by 1 per cent to halt the slide. The Chancellor said that any further depreciation would be undesirable;

- in the Louvre agreement the major 6 industrialised countries agreed to co-operate to foster increased exchange rate stability whilst working to correct the fundamental reasons for the trade imbalances. In February the Chancellor said that he was more content for sterling to rise than to fall. This was expressed in terms of the DM rate as this is the single most important currency for UK manufacturing industry;

- in the run-up to the General Election in June there was a clear case for restraining the rise of sterling to avoid a speculative bubble emerging that could be very inconvenient for the conduct of policy during the election;

- and in the aftermath of the share price crash on October 19 there was a premium in maintaining as much stability as possible whilst confidence was restored.

29. The apparent importance of the 3DM rate grew out of these events. Once the markets had seen some resistance at 3DM they hesitated to push very hard. And the longer sterling remained within the 2.90-3.00DM range the more reluctant they were to push and we were to see it breached. There were clear gains to industry from stability; and benefits in the form of firmer expectations of the likely scale of exchange rate fluctuations.

30. The cumulative scale of the intervention was greater than would normally be desirable. But it has done no damage to monetary policy because it has been offset by funding. And it has helped to establish the Government's commitment to limiting the scale of fluctuations. So long as that commitment is continued and clearly understood, in future it should be possible to achieve a similar result with much less intervention.

31. It became clear on March 4 that the scale of exchange rate pressure was greater than could be coped with by intervention. And there was no scope for reducing interest rates as we had already concluded that, if anything, monetary conditions were on the easy side.

32. Since then the exchange rate has risen but because there have been tighter monetary conditions it has been possible to reduce interest rates by ½ per cent.

33. In reflecting on the events of the past year it is important to recognise that the present situation is very different from 1980-81 when sterling rose so sharply. There is no inconsistency between what was allowed to happen then and what we would prefer now. The circumstances then were very different: inflation was almost 20 per cent; North Sea oil was having a big impact; public expenditure and the budget deficit were not firmly under control; it was important to assert credibility for a non-accommodating policy stance; there was a need for a shock to expectations generally; and it was impossible to be sure for several months that broad money was giving the wrong signals.

34. It is also important to see the resistance to appreciation as an important component of avoiding excessive depreciation. We are all agreed that a firm anti-inflationary stance requires a commitment not to bail out excessive growth of labour costs by devaluation. If the impression is given that the exchange rate will go wherever it is pushed the market will also assume that a lower exchange rate will be accommodated if confidence is reversed. In these circumstances holding the exchange rate will

involve higher interest rates than would have been necessary if a presumption of stability has been created. On the other hand if it is clearly understood and accepted that cost rises will not be accommodated by allowing the rate to fall, then the same degree of downward pressure on inflation can be achieved with lower interest rates.

Options

35. The discussion in this paper suggests that:

- the Government must continue to give the exchange rate a substantial weight in the conduct of monetary policy;

- in the process it is desirable to have an explicit objective for greater exchange rate stability.

36. There are three main alternative approaches discussed in the remainder of this paper. In practice they lie on a continuum but separating them helps to focus the main points:

- taking the exchange rate "into account" in the conduct of monetary policy;

- an explicit statement about the desire for greater stability combined with a notional but unpublished range;

- full membership of EMS.

Taking the exchange rate "into account"

37. This was the presentation used for much of the 1980s. It means setting interest rates in a purely judgemental way in the light of the behaviour of a range of indicators, including the exchange rate.

38. Advantages:

- helps to balance monetary conditions so that neither excessive loosening nor tightening of conditions;

- avoids unnecessary oscillation of inflation rate;

- some effect in curbing excessive swings of sterling with benefit to industry;

- maximum tactical flexibility by avoiding any question of particular ranges;

- intervention can be limited to smoothing.

39. Disadvantages:

- gives little in the way of a steer to markets. Lose some of gains of stabilising speculation;

- can involve unnecessary degree of exchange rate volatility;

- markets will constantly press for a more explicit statement about exchange rate policy;

- requires considerable judgement in balancing factors;

- only a weak anchor against inflationary expectations, so likely to require higher interest rates.

Greater Stability

40. This is a more formalised approach. It would involve an explicit statement about the desire for stability. We would operate a notional, unpublished range. Interest rates would be adjusted to keep exchange rates within that range, supported by

some intervention. There would be changes to the range if market pressure were sustained so that interest rates were pushed too low, intervention was too great, or MO growth was too fast.

41. There are various degrees of formality, depending on: width of range; frequency of changing range; extent to which change range; amount of intervention before changing range.

42. <u>Advantages</u>:

- clear signals about exchange rate, especially important for business decisions and investment.

- mechanism for reducing exchange rate volatility;

- can be operated to maintain an appropriate degree of disinflationary pressure;

- uses all instruments available;

- range unpublished and therefore no bureaucratic operations involved in changing.

43. <u>Disadvantages</u>:

- less certainty for both business and for inflationary expectations than a published range although more than "taking into account";

- markets will test to find range;

- intervention will be necessary from time to time;

- no obvious way of distinguishing a change of range from a change of policy.

Membership of ERM

44. Advantages:

- makes commitment to exchange rate stability clear. Advantages for industry;

- if realignments are necessary, it is clear that overall policy remains the same;

- simple to explain policy to public and markets;

- useful anti-inflationary discipline;

- if maintenance of the parity is credible it will reduce scale of market pressure during periods of turbulence.

45. Disadvantages

- changes of ranges require discussion with other members of ERM;

- present ERM is dominated by Germany and Deutschemark;

- if the parity comes under question there could be greater pressure at times meaning larger interest changes and intervention;

- could sharpen conflict with other objectives of monetary policy.

Conclusion

46. In a complex world there is a great advantage in explaining and presenting policy in a clear way. A major objective of monetary policy is to give guidance both to the market and to the economy at large. This is why we publish the MTFS.

47. Once a policy has been formed it is essential to explain it and to act in a way that will bring it about. If a policy is made clear markets will support it by forming expectations in relation to Government statements and actions.

48. The original ambition of the MTFS was to conduct monetary policy in relation to monetary targets. For a variety of reasons that has not been possible - and the exchange rate has played an increasing role. There is a lot to be said for conducting policy towards the exchange rate in a way that can be understood. It does not need to be too precise. But if they understand it, see actions confirming it, and believe other policies are consistent with it, markets will respond in a constructive way rather than a destabilising way, and business confidence and hence enterprise will be enhanced.

23 March 1988

Pie 6

PRIME MINISTER

You might like to glance at the table attached from an IMF publication which lists the exchange rate arrangements (floating, pegged, etc) for most countries.

The number of currencies linked to the US dollar is noticeable. In some cases, the link is very close - Panama is the obvious example where there was until the recent troubles, a virtual US dollar economy. In other countries - Afghanistan - the link is much more indirect and there will be only a small part of the countries' foreign exchange transactions linked to the dollar.

There are still several countries, basically the old French empire, linked to the French franc. There are no countries' currencies linked to the pound sterling - but I would not regard that as a bad thing.

N.L. Wicks

23 March 1988

MJ2CDO

Exchange Rates and Exchange Arrangements, December 31, 1987

Member (currency)	Exchange Rate Pegged to[1]	Exchange Rate[1]	Exchange Rate Otherwise Determined[2,3]
Afghanistan (afghani)[4]	$	50.60	
Algeria (dinar)[6]	bskt	4.9363	
Antigua and Barbuda (EC$)[5]	$	2.70	
Argentina (austral)[4]			3.75
Australia (dollar)			1.33408
Austria (schilling)	bskt	11.250	
Bahamas, The (dollar)[4]	$	1.00	
Bahrain (dinar)[6]			0.376
Bangladesh (taka)[4]	bskt	31.20	
Barbados (dollar)	$	2.0113	
Belgium (franc)[4,7]			33.1525
Belize (dollar)	$	2.00	
Benin (franc)	F	50.00	
Bhutan (ngultrum)	Re	1.00	
Bolivia (boliviano)			2.21
Botswana (pula)[6]	bskt		
Brazil (cruzado)[9,10]			71.892
Burkina Faso (franc)	F	50.00	
Burma (kyat)	SDR	8.50847	5.99754
Burundi (franc)	SDR	161.00	113.487
Cameroon (franc)	F	50.00	
Canada (dollar)			1.2998
Cape Verde (escudo)[6]	bskt		
Central African Republic (franc)	F	50.00	
Chad (franc)	F	50.00	
Chile (peso)[4,9,10]			238.14
China (renminbi)[4]			3.7221
Colombia (peso)[10]			263.70
Comoros (franc)	F	50.00	
Congo (franc)	F	50.00	
Costa Rica (colón)[4,8]			
Côte d'Ivoire (franc)	F	50.00	
Cyprus (pound)[6]	bskt	0.438885	
Denmark (krone)[7]			6.0965
Djibouti (franc)	$	177.721	
Dominica (EC$)[5]	$	2.70	
Dominican Rep. (peso)			4.91
Ecuador (sucre)[4,8]			
Egypt (pound)[4,8]			
El Salvador (colón)[4,8]	$		
Equatorial Guinea (franc)	F	50.00	
Ethiopia (birr)	$	2.07	
Fiji (dollar)	bskt	1.44851	
Finland (markka)[11]	bskt	3.946	
France (franc)[7]			5.340
Gabon (franc)	F	50.00	
Gambia, The (dalasi)[8]			
Germany, Fed. Rep. of (deutsche mark)[7]			1.5815
Ghana (cedi)[8]			
Greece (drachma)			125.885
Grenada (EC$)[5]	$	2.70	
Guatemala (quetzal)[4]	$	1.00	
Guinea (franc)			440.00
Guinea-Bissau (peso)			851.83
Guyana (dollar)[4]	$	10.00	
Haiti (gourde)	$	5.00	
Honduras (lempira)	$	2.00	
Hungary (forint)	bskt	33.4051	
Iceland (króna)			35.66
India (rupee)[12]			12.877155
Indonesia (rupiah)			1650.00
Iran, Islamic Rep. of (rial)	SDR	92.30	65.0614
Iraq (dinar)	$	0.310857	
Ireland (pound)[7]			0.596837
Israel (new sheqel)[6]	bskt		
Italy (lira)[7]			1169.25
Jamaica (dollar)			5.50
Japan (yen)			123.00
Jordan (dinar)	SDR	0.387754	0.273324
Kenya (shilling)[6]	bskt		
Kiribati (dollar)	A$	1.00	
Korea (won)			792.30
Kuwait (dinar)	bskt	0.28992	
Lao People's Dem. Rep. (kip)[4]	$	10.00	
Lebanon (pound)			455.00
Lesotho (loti)[4]	R	1.00	
Liberia (dollar)	$	1.00	
Libya (dinar)[13]	SDR	0.383929	0.270628
Luxembourg (franc)[4,7]			33.1525
Madagascar (franc)[10]			1234.27
Malawi (kwacha)	bskt	2.0538	
Malaysia (ringgit)[11]	bskt	2.4915	
Maldives (rufiyaa)			9.3950
Mali (franc)	F	50.00	
Malta (lira)	bskt	3.2081	
Mauritania (ouguiya)			71.80
Mauritius (rupee)	bskt	12.18285	
Mexico (peso)[4]			2209.70
Morocco (dirham)			7.8003
Mozambique (metical)			404.00
Nepal (rupee)	bskt	21.50	
Netherlands (guilder)[7]			1.7775
New Zealand (dollar)			1.51676
Nicaragua (córdoba)[4]	$	70.00	
Niger (franc)	F	50.00	
Nigeria (naira)[4,8]			
Norway (krone)	bskt	6.2325	
Oman (rial Omani)	$	0.3845	
Pakistan (rupee)			17.4937
Panama (balboa)	$	1.00	
Papua New Guinea (kina)	bskt	0.543951	
Paraguay (guaraní)[4,8]	$		
Peru (inti)[4]	$		33.00
Philippines (peso)			20.80
Poland (zloty)	bskt	315.340	
Portugal (escudo)[10]			129.865
Qatar (riyal)[6]			3.64
Romania (leu)	bskt	14.60	
Rwanda (franc)	SDR	102.71	72.3993
St. Kitts and Nevis (EC$)[5]	$	2.70	
St. Lucia (EC$)[5]	$	2.70	
St. Vincent (EC$)[5]	$	2.70	
Sao Tome and Principe (dobra)	bskt	100.00	
Saudi Arabia (riyal)[6]			3.745
Senegal (franc)	F	50.00	
Seychelles (rupee)	SDR	7.2345	5.09953
Sierra Leone (leone)			20.0361
Singapore (dollar)	$	2.00	
Solomon Islands (dollar)	bskt	1.97433	
Somalia (shilling)[4]	$	100.00	
South Africa (rand)[4]			1.92994
Spain (peseta)			109.00
Sri Lanka (rupee)			30.7625
Sudan (pound)[4]	$	4.50	
Suriname (guilder)	$	1.785	
Swaziland (lilangeni)	R	1.00	
Sweden (krona)[14]	bskt	5.848	
Syrian Arab Rep. (pound)[4]	$	11.225	
Tanzania (shilling)	bskt	83.8744	
Thailand (baht)	bskt	25.07	
Togo (franc)	F	50.00	
Tonga (pa'anga)	A$	1.00	
Trinidad and Tobago (dollar)	$	3.61575	
Tunisia (dinar)			0.771737
Turkey (lira)[15]			1020.90
Uganda (new shilling)	$	60.0	
United Arab Emirates (dirham)[6]			3.671
United Kingdom (pound)			0.534331
United States (dollar)			1.00
Uruguay (new peso)			280.25
Vanuatu (vatu)	SDR	142.00	100.094
Venezuela (bolívar)[4,8]	$		
Viet Nam (new dong)[4]	$	15.00	
Western Samoa (tala)			2.01086
Yemen Arab Rep. (rial)[4]	$	9.90	
Yemen, People's Dem. Rep. (dinar)	$	0.345339	
Yugoslavia (dinar)			1244.35
Zaire (zaire)			131.40
Zambia (kwacha)	$		8.04
Zimbabwe (dollar)	bskt	1.66306	

$ U.S. dollar
F French franc
R South African rand
bskt Currency basket other than SDR
Re Indian rupee
A$ Australian dollar

[1]Rates and arrangements as reported to the Fund and in terms of currency units per unit listed; rates determined by baskets of currencies are in currency units per U.S. dollar.
[2]Market rates in currency units per U.S. dollar.
[3]Under this heading are listed those members that describe their exchange rate arrangements as floating independently or as adjusting according to a set of indicators (see footnote 10) and certain other members whose exchange arrangements are not otherwise described in this table. In addition, U.S. dollar quotations are given for the currencies that are pegged to the SDR and for those that participate in the European Monetary System (see footnote 7).
[4]Member maintains dual exchange markets involving multiple exchange arrangements. The arrangement shown is that maintained in the major market. A description of the member's exchange system as of December 31, 1986 is given in the *Annual Report on Exchange Arrangements and Exchange Restrictions, 1987*.
[5]East Caribbean dollar.
[6]Exchange rates are determined on the basis of a relationship to the SDR, within margins of ± 7.25 percent. However, because of the maintenance of a relatively stable relationship with the U.S. dollar, these margins are not always observed.
[7]Belgium, Denmark, France, the Federal Republic of Germany, Ireland, Italy, Luxembourg, and the Netherlands are participating in the exchange rate and intervention mechanism of the European Monetary System and maintain maximum margins of 2.25 percent (in the case of the Italian lira, 6 percent) for exchange rates in transactions in the official markets between their currencies and those of the other countries in this group.
[8]Exchange rate data not available.
[9]Member maintains a system of advance announcements of exchange rates.
[10]Exchange rates adjusted according to a set of indicators.
[11]The exchange rate is maintained within margins of ± 2.25 percent.
[12]The exchange rate is maintained within margins of ± 5 percent on either side of a weighted composite of the currencies of the main trading partners.
[13]The exchange rate is maintained within margins of ± 7.5 percent.
[14]The exchange rate is maintained within margins of ± 1.5 percent.
[15]The central bank establishes its selling rate daily and the buying rate is set at ½ of 1 percent below the selling rate. Commercial banks must use the central bank's selling rate, but are free to set their own buying rate.

Data: IMF Treasurer's and Exchange and Trade Relations Departments

MO

SECRET

PRIME MINISTER 17 March 1988

Exchange Rate Policy after the Budget

The decision to cut interest rates today by ½% was absolutely right. Yet it also shows that the government needs some simple and clear operating rules for the conduct of exchange rate policy after the budget.

The major options facing us now are:

(i) Explicit Exchange Rate Stability

Return to a position similar to that of pre-4th March: namely,

- a 3.10DM ceiling on the pound,
- substantial intervention if necessary but sterilised over time by gilt-sales
- and the use of interest rates to control the growth of Mo.

It would be unwise to set another rigid ceiling in one currency: once its existence became known in the market it would once again be a one-way bet for speculators. There is no problem with setting a temporary ceiling - but it should not be fixed rigidly and announced publicly.

(ii) A Completely Free Float

The danger with a completely free float - especially just after a period when the government has expressed such definite views on the exchange rate - is the overshooting of the rate due to speculation. Over the past four years we, along with other governments, have created an environment in which the markets have come to expect the authorities to have a view on exchange rates.

If we do and say nothing, we face the prospect of an unexpectedly large movement in sterling. If this represents a permanent view by the market of our currency then there is very little we can do. But if it proved to be temporary - then certain companies would be placed in great difficulty.

Completely free floating is not an ideal policy.

(iii) Controlled floating and interest rate flexibility

A third alternative would be to return to the policy we were conducting pre-Louvre:

- sterling was allowed to float within a band against a basket of currencies (measured by the effective exchange rate),

- limited intervention was used to temper market movements; if intervention looked like becoming heavy the band was changed

- but if monetary conditions were suitable then interest rates would be changed first provided they did not adversely affect monetary growth.

Under this role pressure to buy sterling would lead to an interest rate cut, provided such a cut would not adversely affect the growth of the monetary aggregates and Mo in particular.

Recommendation

This is by far the most attractive of the options we face. Its advantages are that we do our best to avoid overshooting of the exchange rate while at the same time we make no concessions to inflation.

It is this approach - under which the exchange rate had already risen a few percent - which justified today's cut in interest rates of ½%.

Janet Grisom.

pp BRIAN GRIFFITHS

mjd 1/106A

SECRET

CC NLW
13

FA

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

14 March 1988

Paul Gray
No.10 Downing Street
London SW1

Dear Paul,

LINE ON EXCHANGE RATE ETC

The Chancellor feels that if the Prime Minister is asked about the exchange rate at Questions tomorrow, she should respond on the lines:

> "That is something the Chancellor will be discussing in his Budget statement very shortly. I advise the hon. Gentleman to curb his impatience."

If Bernard Ingham is subsequently asked about the exchange rate, the Chancellor feels he should say that this was covered in the Budget Speech, which had of course been fully agreed with the Prime Minister; he has nothing to add to that.

If the Prime Minister is content, I should be grateful if you could pass this on to Bernard Ingham.

Yours
Alex

A C S ALLAN

CHANCELLOR OF THE EXCHEQUER

RA - Exchange rates.

Paul,

As discussed.

Alan

LINE

1. Policy remains the same

   - aim for exchange rate stability within context of monetary policy designed to maintain downward pressure on inflation.

2. Have never said that means complete immobility; adjustments are needed from time to time.

3. But exchange rate stability means

   - won't let exchange rate be pushed to dizzy/unsustainable heights, to the detriment of industry

   - nor will we let exchange rate depreciate to accommodate excessive increases in domestic costs.

Why let rate move now?

Never comment on tactics. Continuous assessment of all factors etc.

Defeated by markets/body-blow to managed floating?

See (2).

Intervention inflationary?

Intervention only poses an inflationary threat if it is not funded, and so adds to liquidity. Government has made it clear that intervention will be fully funded, and there are no difficulties in doing this with Government borrowing so low.

Interest rates?

Interest rates will continue to be set so as to create monetary conditions which maintain downward pressure on inflation. In assessing monetary conditions the Government takes account of a wide range of indicators, including the level of the exchange rate.

PA - Exchange rate policy

Member for Basildon (Mr. Amess) booked the Grand Committee Room to meet those people in a lobby recently — and 17 people turned up. As for the hon. Gentleman's question about the Budget, we shall have to wait until next week.

Mr. Jacques Arnold: When considering Hospital Alert, will my hon. Friend reflect on the fact that a great delegation from my constituency on the matter of Hospital Alert consisted of two constituents and that the delegation to our hon. Friend the Member for Dartford (Mr. Dunn) consisted of one petitioner?

Mrs. Currie: Nevertheless, as my hon. Friend is aware, we take seriously all the points made by his constituents and by the constituents of all other hon. Members. We are putting a great deal more money into the Health Service and are employing a record number of nurses this year. We hope that we may be able to pay them better when the review body has reported.

Mr. Robin Cook: Among the representations on the NHS has the Under-Secretary of State seen the letter from Dr. Mitchell of Scarborough hospital, which scores highest on her Department's performance indicators? Has she noted the conclusions of all the consultants at that hospital, that the rate at which they are expected to discharge patients was "positively dangerous", and Dr. Mitchell's observation:

"it is easy to appear efficient if one is underfunded and understaffed."

Does not that letter from the hospital which, by her own standards is the most efficient, demonstrate why we want more funds for the NHS before more tax cuts for the wealthy?

Mrs. Currie: I have certainly seen the letter in the press. I know that the doctor sent it to the press. We take all such representations seriously. However, I should point out to the hon. Gentleman that the hospital service is not the entire Health Service and that, with the support of many Opposition Members, including the hon. Member for Strathkelvin and Bearsden (Mr. Galbraith) who has expressed his support, we are moving to reform the primary care services as well. In that way we think that we can relieve the pressures on the hospitals.

Central Birmingham Health Authority

14. **Mr. Favell:** To ask the Secretary of State for Social Services what action he proposes to take about the performance of Central Birmingham district health authority as disclosed by the CIPFA database's latest performance comparisons.

Mr. Newton: The CIPFA information relates to 1984 and 1985 and relates to a very limited number of indicators. Performance indicator information for 1985 shows the district performed well on throughput and turnover after standardisation for its complex case mix and the district is broadly in the range of costs of other teaching districts. But the indicators and trends suggest areas for inquiry, and I welcome the fact that the West Midlands regional health authority and Central Birmingham health authority are together monitoring the data on services and costs in the district to ensure that they are being provided as efficiently and effectively as possible.

Mr. Favell: My right hon. Friend will be aware of the constant consultant clamour that has come from the district health authority, which has done so much to undermine the public confidence in the National Health Service. The figures he has given show that the health authority comes 19th out of 23 district health authorities on throughput in beds and 21st out of 23 on patient attendance, yet it receives more money per head of population than any other district health authority in the west midlands.

Mr. Newton: I agree with my hon. Friend that those questions must be considered in relation to the health authority, so I very much welcome the work of the regional chairman in discussing those matters with the district.

PRIME MINISTER

Engagements

Q1. **Mr. Butler:** To ask the Prime Minister if she will list her official engagements for Tuesday 8 March.

The Prime Minister (Mrs. Margaret Thatcher): This morning I had meetings with ministerial colleagues and others. In addition to my duties in the House I shall be having further meetings later today. This evening I hope to have an audience of Her Majesty the Queen.

Mr. Butler: Will my right hon. Friend take time today to reconsider her policies on wider share ownership? Research shows that 17 per cent. of Labour party members now own shares. Will she ensure that other sections of the population are able to enjoy that great privilege?

The Prime Minister: Our policy has been, and remains, a capital-owning democracy, including both the ownership of houses and the ever wider ownership of shares among all sections of the population. Further privatisation will assist in that process. It is a very successful policy and is partly responsible for seeing that the party that believes in a capital-owning democracy is returned to power.

Mr. Kinnock: The Prime Minister will know that we have a record trade deficit and that our balance of payments continues to deteriorate. In those circumstances, is she content to see the pound continue to rise against the deutschmark and the dollar?

The Prime Minister: The only way to deal with that is either to have excessive intervention, which would lead to inflation — and it is not part of our policy to assist inflation; rather it is part of our policy to get inflation down — or to deal with the matter by interest rates, which would not be in the interests of inflation at the present time.

Mr. Kinnock: Is the Prime Minister saying that it does not matter, in her view, how high the pound goes?

The Prime Minister: I am saying that getting and keeping inflation down is the most important thing of all. The right hon. Gentleman is aware that we believe that last month's trade figures were a freak. Indeed, at the same time as last month's figures were announced there was a reduction announced in the deficit of the December figures and a reduction announced in the current account deficit for 1987.

Mr. Kinnock: When we have the highest real interest rates in the industrialised world, when we have that balance of trade deficit, when the balance of payments is continuing to deteriorate, when we have the lowest ever level of personal savings and when we have the highest ever level of personal debt, how long does the Prime Minister think that that condition can continue?

The Prime Minister: If the right hon. Gentleman looks at the figures, he will see that the balance of payments deficit is very small compared with those of a Labour Government. Last year it was £2·5 billion, which is precisely what the Chancellor forecast in the Budget. He was the one forecaster who was spot on.

Sir Fergus Montgomery: Will my right hon. Friend explain why, when we are spending more money than ever before on the National Health Service, there are so many complaints? Will she reiterate that the National Health Service is safe in her hands and can she recollect any time when Budget day was National Health Service day under any Labour Government?

The Prime Minister: I recall very well that the Labour party Budget days and the control and management of its economic policy led to slashing hospital capital expenditure and cuts in the pay of doctors and nurses.

Mr. Steel: Will the Prime Minister condemn the attack on the Panamanian consulate in London last night and will she make it clear that Her Majesty's Government will not recognise General Noriega as head of state?

The Prime Minister: There was an attack, and this morning, my right hon. and learned Friend the Foreign and Commonwealth Secretary called the ambassador into the Foreign Office to make it perfectly clear that differences of opinion must not be fought out on London streets.

Mr. McCrindle: Still on the subject of expenditure within the National Health Service, will the Prime Minister try to find time today to reflect on the fact that, by targeting a relatively small amount of money on the reduction of waiting lists, there has been very considerable success over the past year in reducing them? Will she have further thought as to whether the investment of a relatively small additional amount targeted directly on the acute services might very well bear disproportionate benefits?

The Prime Minister: I am very much aware of what my hon. Friend says. That money, instead of going generally to the improvement of the Health Service, was targeted specifically to get waiting lists down, and this has been very successful. We shall learn the lessons from that method of dealing with increased expenditure.

Q2. **Mrs. Margaret Ewing:** To ask the Prime Minister if she will list her official engagements for Tuesday 8 March.

The Prime Minister: I refer the hon. Lady to the reply that I gave some moments ago.

Mrs. Ewing: Could the Prime Minister, as a mother and a mother-in-law, spare a thought today for the women in my constituency and other parts of Grampian region? Is she aware that the local health board is proposing to close no fewer than six local maternity units, which means that women in my area and other parts of the region will have to travel 60 to 70 miles whilst in labour to the Aberdeen maternity hospital? *[Interruption.]* Since I am sure that this is not the standard that the right hon. Lady would wish for her family, what assurance will she give the women of my area that they will not have a reduction in their standard of care?

The Prime Minister: I know of the hon. Lady's concern, and she was kind and courteous enough to give me notice of her supplementary question. As the hon. Lady knows, there has been a recent review of maternity beds in the Grampian health board area, which has revealed problems there, including the widespread under-use of facilities in the outlying and smaller units; hence the proposal to close some of them. *[Interruption.]* The board has issued a consultative document and asked for comments from all interested parties. The board will consider its proposals again in the light of representations which it has received before reaching a final decision. Any proposals for closure would, of course, require the consent of my right hon. and learned Friend the Secretary of State, who will obviously carefully consider the representations which the hon. Lady and her constituents have made.

Mr. Stokes: Going further afield, does my right hon. Friend not agree that the United Kingdom has every right to hold a military exercise in the Falklands Islands and that the south American countries have no grounds whatever for complaint?

The Prime Minister: Yes. We have not merely every right to hold such an exercise in the Falklands Islands but a duty to see that reinforcement proposals could in fact be carried out, otherwise we should have to keep more of our armed forces down there. It is no one else's business, but is a matter of the defence of the people's rights in the Falkland Islands.

Q3. **Mr. Hardy:** To ask the Prime Minister if she will list her official engagements for Tuesday 8 March.

The Prime Minister: I refer the hon. Gentleman to the reply that I gave some moments ago.

Mr. Hardy: Three or four years and many inexactitudes ago the Prime Minister rejected the request that particular attention be given to the Dearne valley area. Is she aware that we have now had a substantial number of colliery closures: Cortonwood, Wath, Highgate, Kilnhurst, Cadeby, Yorkshire Main and others; that Manvers now faces extinction; that we have lost many jobs in supporting industries in steel; that Guinness and United Glass now propose a disreputable and deceitful closure of the glass works at Swinton, with the loss of 500 jobs? Is it not time that the right hon. Lady began to recognise that the horrid position that we face suggests that the Government should understand that they have a responsibility to the whole nation and not merely to a few favoured areas, of which the Dearne Valley certainly is not a part?

The Prime Minister: The hon. Gentleman will be aware that throughout the last year, and, indeed, for about 18 months now, unemployment has been falling — [HON. MEMBERS: "What?"]. Unemployment has been falling— [HON. MEMBERS: "Where?"]. It has in fact been falling in all regions of the United Kingdom during the past few months.

Q4. **Dame Jill Knight:** To ask the Prime Minister if she will list her official engagements for Tuesday 8 March.

The Prime Minister: I refer my hon. Friend to the reply that I gave some moments ago.

Dame Jill Knight: Has my right hon. Friend seen that, following the reports last week that Haringey council was funding a bookshop selling anarchist literature to five-year-olds—*[Interruption.]*

Note

Discussed with PM who decided to wait for market developments over the next 24 hours before deciding whether to discuss with the Chancellor.

PRCG 3/3

12

PRIME MINISTER

EXCHANGE MARKET INTERVENTION

For most of yesterday and today sterling has been hard up against DM3. Throughout yesterday and today in London it has regularly bounced off that "ceiling" of its own accord but overnight in New York the Bank of England engaged in heavy intervention. I was told last night this might be some $50 million; in the event I learned this morning it had been $400 million. And this afternoon they have intervened a further $50 million when New York opened.

There has been no intervention in London.

Yesterday's intervention in New York was in dollars. But the whole amount has been switched into ecus in London today. This afternoon's intervention has been in DM and FF.

I have made clear to the Treasury your opposition to this policy. I have also probed with them the terms of the Chancellor's authority to the Bank to undertake intervention. They are coy about this. But as far as I can see it amounts to:

- carte blanche for overnight intervention;
- effectively carte blanche for intervention during the day but on the basis that the Treasury is immediately told what is going on.

Following the decision to raise interest rates on 1 February, I wrote to the Treasury (attached) stressing your opposition to intervention to hold sterling below DM3. The Treasury seek to defend last night's action by saying that it will not add to domestic liquidity because we have already over-funded it.

I have warned the Chancellor's office that you may want to have an early word with him about all this. He is free from 5.00 pm today. Would you like us to call him in?

PRCG.

PAUL GRAY

3 March 1988

VC4AUX

2 [SECRET]

10 DOWNING STREET

LONDON SW1A 2AA

CCPG

From the Private Secretary

1 February 1988

Dear Alex,

INTEREST RATES

The Chancellor discussed with the Prime Minister this morning the position in the markets and proposed that the Bank of England should signal a half per cent increase at noon. Given that sterling had fallen during the morning against the dollar and deutchmark he did not expect a half per cent increase to lead to sterling pushing up against DM3. He also did not expect this to lead to any increase in building society rates.

The Prime Minister said she was content for some tightening of the monetary stance. However, if in the event higher interest rates did lead to sterling pushing up against DM3, she would be strongly opposed to any intervention and hence to a boost to domestic liquidity offsetting the impact of the interest rate rise. It was only on this basis that she was prepared to agree to the half per cent interest rate rise.

The Prime Minister also noted that the end January Reserves figure had been reduced by an EMCF revaluation of $600 million. The Chancellor agreed to provide a note setting out the background to this adjustment.

Yours,

Paul.

(PAUL GRAY)

Alex Allan, Esq.,
H.M. Treasury.

SECRET

PRIME MINISTER

G7 STATEMENT

The US budget package has now passed through Congress. The President is holding a meeting at 4pm Washington time (9pm our time) to decide whether he will sign it. The Treasury have no information on whether he is likely to find anything difficult in it.

Assuming that he signs the budget, the G7 statement, in the form that David showed you last night, will be issued tonight at 11pm US time (4am UK time tomorrow morning). There is some internal American reason why they want it out today their time. The Chancellor is ready to give interviews to the Today programme tomorrow.

N.L.W.

MT

N. L. WICKS

22 December 1987

PMMAOC

SECRET

Prime Minister 2

See the second page.

This letter does not answer (because the Treasury can't) the point that you were only told about the agreement on intervention at the last moment.

DGN 21/12.

11

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

David Norgrove Esq
No 10 Downing Street

21 December 1987

Dear David

G7

You wrote to Alex Allan on 18 December about the G7 agreement. There is quite a history to this.

Already in October there were moves within the G7 to try to restore the co-operation which had effectively been damaged during the second and third weeks of that month. Most of the group, including the Chancellor, were thinking in terms of an early G7 meeting and hoping for a reasonably solid agreement. But as bilateral discussions proceeded it became clear: first, that in the common view of the UK, Japan, France, Italy and also (though a little ambivalently) Germany, an effective agreement required a willingness by the US to raise their domestic interest rates (or take other action to finance their external deficit such as foreign currency borrowing); and secondly, that the US were not prepared to accept this condition.

The main task of negotiating on an earlier draft (which covered the points the UK and others believed necessary) was undertaken by Baker and Stoltenberg. On 7 December, in the margins of an ECOFIN meeting, the Finance Ministers of the four European G7 members met and Stoltenberg produced a draft very like the present one as the maximum the US would accept. It was then agreed by the four that such a draft was not good enough for a G7 meeting - indeed it would be better to hold no meeting than one with such a poor outcome. Stoltenberg agreed to try again for two or three key additions and amendments, but offered little hope of success (and this was later shown to be right).

Concern was expressed however that failure to hold a G7 meeting might itself create disappointment and hence market problems. The Chancellor then offered the idea that the statement as it stood, which did record some economic and monetary action of the required kind, might be worth publishing without a meeting. Particularly since G7 meetings have become such media events, it could perhaps be useful to show that consultation was taking place and some relevant action was being taken without the necessity for a meeting. This might also be a useful precedent for the future. The others found this idea attractive - as also did Baker when it was put to him.

The Chancellor continues to see advantage in this arrangement, even though the statement lacks new substance. The idea of a separate understanding about co-operative intervention, intended to operate as soon as the statement has been published, did not emerge until very much later, as a result of discussions between the US, Germany and Japan. On the substantive point the Prime Minister has raised, the Chancellor entirely agrees, and indeed has frequently pointed out, that the need is for the US authorities to be willing to use interest rates to help inter alia to attract the private funds to meet the continued external financing need at current exchange rates. The trouble with letting the dollar find "its own level" is that such a level, if determined solely by a nervous and disappointed market, may in the short term be so low as to cause a good deal of damage to world economic activity, and set off a legacy of new distortions for the future. None of this would help the UK. While the current US policy posture is far from satisfactory, the fact that they are apparently now ready to intervene in support of the dollar may lead them to take more substantive steps later. Meanwhile, any UK contribution to concerted intervention under this agreement would be minimal.

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Yours sincerely

Jonathan Taylor

J M G TAYLOR
Private Secretary

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ECON POL
Exchange Rate
pt 3

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

18 December 1987

G7

The Prime Minister has asked me to write to record that she disapproves most strongly of the G7 agreement on concerted intervention which is now in prospect. She believes it is simply tinkering and that intervention without policy measures to improve the economic fundamentals will be damaging rather than helpful, as she and Secretary Shultz agreed in their recent conversation. My understanding of her views is that the US should be prepared to raise interest rates. But if they do not, the dollar should be allowed to find its own level.

The Prime Minister was also most concerned that she learned about the possible agreement only at 1800 on a Friday evening. She believes that it must have been at least in the wind for some hours, if not days, and she would prefer to have had an earlier opportunity to express her views.

DAVID NORGROVE

Alex Allan, Esq.,
H.M. Treasury.

December 1987

STATEMENT OF THE GROUP OF SEVEN

1. The Finance Ministers and Central Bank Governors of seven major industrial countries have conducted close consultations in recent weeks on their economic policies and prospects in light of developments in financial markets. They reaffirmed their conviction that the basic objectives and economic policy directions agreed in the Louvre Accord remain valid and provide for a positive development of the world economy. They will continue to carry forward their economic policy coordination efforts in 1988 under the arrangements endorsed at the Venice Summit.

2. The Ministers and Governors reemphasized their view that the major external imbalances in the world economy must be corrected. The policies which have been implemented this year are gradually showing the intended effects. In particular, the balance between domestic demand and output in the United States and in Japan and the Federal Republic of Germany has shifted in a direction which promotes external adjustment and in volume terms their trade imbalances are diminishing. The greater stability of exchange rates achieved for much of the past year, following the earlier substantial exchange rate changes, contributed to this adjustment. The marked exchange rate changes over the past few weeks, however, stress the need to strengthen underlying economic fundamentals and to continue policy cooperation.

3. Developments in stock markets since mid October may have some adverse effect on prospects for economic growth for the industrialized countries as a group. The Ministers and Governors believe, however, that with sound economic policies and effective coordination the rate of growth should be substantial. To this end they agreed that appropriate policies for strengthening non-inflationary growth in their countries are necessary.

4. Accordingly, the Ministers and Governors agreed to intensify their economic policy coordination efforts. Their common efforts are directed towards reducing external imbalances. In particular, the United States has secured Congressional action to implement the agreement between the President and the bipartisan Congressional Leadership on a two-year package of additional budget savings that will reinforce progress in reducing the budget deficit. Japan has implemented a major stimulus program to strengthen domestic demand and will see to it that in the FY 1988 budget the expenditure for general public works will not be less than that for the FY 1987 budget including the July supplemental. The Federal Republic of

* Germany is supplementing the previously announced increase in tax reductions in 1988 with new measures to increase investment and will not seek to offset the budget revenue losses arising from recent developments. There have also been coordinated reductions in interest rates in Europe which should contribute to the expansion of domestic demand and reduce trade imbalances. The specific policy intentions and undertakings by each country are set forth in the annex to this statement.

5. The Ministers and Governors are of the view that the recent monetary policy decisions and the reduction of interest rates in some countries were appropriate and will contribute to a restoration of stability to financial markets. They agreed that monetary policies should continue to be directed towards providing adequate monetary conditions to achieve strong economic growth in the context of price stability as well as to foster financial market stability.

6. The Ministers and Governors strongly rejected protectionist measures as a means of dealing with present imbalances. Protectionism constitutes a direct and serious danger to world prosperity and equilibrium and would have harmful consequences for those countries which resort to it. They reaffirmed their determination to fight protectionism and to promote an open world trading system.

7. The Ministers and Governors believe that the reduction of world trading imbalances requires cooperative action by other countries, particularly those with surpluses. They expressed particularly serious concern that some newly industrialized economies have failed to take adequate action to deal with large and growing trade surpluses which are exacerbating global imbalances and fostering protectionist pressures. They urged the newly industrialized economies to implement without delay trade and exchange rate policies that will facilitate the reduction of excessive trade surpluses and allow their currencies to fully reflect the strong competitive position of their economies.

8. The Ministers and Governors agreed 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 the adjustment process, could be counter-productive by damaging growth prospects in the world economy. They reemphasized their common interest in more stable exchange rates among their currencies and agreed to continue to cooperate closely in monitoring and implementing policies to strengthen underlying economic fundamentals to foster stability of exchange rates. In addition, they agreed to cooperate closely on exchange markets. The Ministers and Governors stressed the need for consistent and mutually supportive policies and believe that the measures being taken

will accelerate progress towards the increased, more balanced economic growth, and sustainable external positions necessary for greater exchange rate stability.

Annex

Policy Intentions and Undertakings

The Government of Canada's fiscal strategy has succeeded in achieving a drop in the rate of growth of its spending and substantial, on-going declines in the budget deficit. Marked progress has been made in slowing the growth of debt, and towards the medium term objective of stabilizing the debt-to-GDP ratio. Fiscal restraint has been accompanied by impressive growth of domestic demand, output and employment. Major structural initiatives directed at enhancing competitiveness and the underlying potential of the economy have been undertaken, particularly tax reform and the negotiation of a free trade agreement with the United States. Monetary policy remains geared to non-inflationary growth in a climate of orderly exchange markets.

The Government of France has fully met its commitment to reduce its fiscal deficit and tax burden. The fiscal deficit will be reduced by 0.8% of GNP from 1986 to 1988. Over the same period of time, tax cuts will amount to 1.3% of GNP. A further reduction of 45 billion french francs in the fiscal deficit and an additional 45 billion french francs in tax cuts are scheduled in a 1989-1991 three year program which constitutes the long term strategy of the government and will be implemented in the yearly budgets. The privatization program decided upon in early 1987 is being carried out, and its initial objectives have even been surpassed. The full implementation of the program will be resumed as soon as market conditions permit.

The French Government will continue to pursue its adjustment and liberalization policies. New measures to sustain household savings, develop financial markets and improve the competitiveness of firms have been taken. Additional steps will be taken in the same direction in 1988.

The Government of the Federal Republic of Germany has increased the amount of the tax reductions for 1988 and beyond to about 14 billion DM, and will not seek to offset the budget revenue losses arising from recent developments. In addition, the necessary decisions have been taken for the structural tax reform with a further net tax reduction of 20 billion DM from 1990 onward.

In order to strengthen private and public investment, the Federal Government will provide special loans for the next 3 years of about 21 billion DM under preferential conditions. Moreover, it will accelerate investment in telecommunication infrastructure and take initiatives for further deregulation of markets.

The Bundesbank has reduced short-term interest rates substantially during the last few weeks. Monetary policy will

16.12.87 20:25

continue to maintain appropriate conditions for sustained non-inflationary growth.

The Government of Italy has taken restrictive measures in 1987 to halt the deterioration of the balance of payments due to a higher rate of domestic demand in Italy than in other industrial countries. For 1988 the objective embodied in the Finance Bill is to maintain a relatively high level of growth and to keep the average inflation rate constant, while making progress in correcting the public sector imbalance.

In the medium-term, to alleviate unemployment the Italian authorities intend to achieve satisfactory rates of growth while maintaining the balance of payments current account near equilibrium, to stabilize the debt/GDP ratio, and to devote more resources to the financing of productive as well as infra-structural investments, thus improving the quality of public services.

The Government of Japan noted that the Japanese economy is in a vigorous expansionary phase, led by domestic demand growth. The Government will steadfastly continue implementing the 6 trillion-yen-plus package decided on last May, and will see to it that in the FY 1988 budget the expenditure for general public works will not be less than that for the FY 1987 budget including the July supplemental.

The Bank of Japan will follow appropriate and flexible monetary policy supportive of non-inflationary growth and exchange rate stability.

The United Kingdom Government, in the context of the British economy's continued vigorous growth of output and domestic demand, coupled with sound public finances, will continue to strive to reduce inflation by pursuing a prudent monetary policy, while increasing its capacity for non-inflationary growth by further measures designed to free the operation of markets and increase the efficient use of resources, including tax reduction and tax reform. Public expenditure will continue to increase less rapidly than the growth of the economy as a whole, and the government will continue to work for the dismantling of barriers to trade both within the European Community and in the context of the Uruguay round of the GATT.

The United States Government has secured Congressional action to implement the agreement between the President and the bipartisan Leadership of the Congress on a two-year package of budget savings to reduce the U.S. budget deficit. This agreement provides for total budget savings, through a combination of spending restraint and increased taxes, in fiscal 1988 and 1989 of approximately $76 billion.

The budget agreement is part of an ongoing process of deficit reduction provided for under the revised Gramm-Rudman-Hollings legislation. It will reinforce the progress already achieved in reducing the deficit (including a fiscal 1987 cut of $73 billion or 1.9 percent of GNP) that has brought the deficit down to 3.4 percent of GNP from a peak of 6.3 percent.

The Administration will also continue to oppose steadfastly protectionist trade measures, while working for legislation authorizing negotiations to foster a more open and fair system for the international exchange of goods, services and investment.

The Governor

Bank of England
London EC2R 8AH

MT

10 December 1987

Prime Minister 2

I suspect that when and if the decision leaks out that may itself cause some downward pressure on the dollar. ("UK unwilling to take in more dollars.") But that does not undermine the rightness of the decision.

BGN 11/12.

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

Dear Nigel,

I reported to Court this morning the change in intervention policy that we have adopted in the light of your instructions. I did so in broad terms, but I felt it was right that they should be informed about something which was likely, sooner or later, to find its way into the public domain.

The response of the Non-Executive Directors on Court was to express concern about the situation in which the Bank has been placed, and they asked me formally to record their anxiety that the Bank of England should be compelled by an act of policy to renege on an article contained in a formal agreement between itself and other central banks.

I am copying this letter to the Prime Minister.

Yours ever,

Robin

CONFIDENTIAL

fia ?D3BEY
bc PC
DN

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

10 December, 1987.

Dear Alex,

INTERVENTION: PRIME MINISTER'S CONVERSATION WITH MONSIEUR CHIRAC

Monsieur Chirac telephoned the Prime Minister from the south of France this evening to express his concern about the recent change in our intervention policy.

M. Chirac said that he was telephoning to raise a very, very important issue about which he was gravely concerned. Since yesterday, the Bank of England had been selling dollars to buy DMs. If this went on, the EMS would blow up. The mark was going up, and there would be a devaluation of the French Franc. M. Balladur had sent a telegram to the Chancellor of the Exchequer about it. He wanted to repeat that he was very very worried, and would like our purchasing DMs to stop immediately.

The Prime Minister said that, as M. Chirac would know, we had been aiming to keep sterling reasonably stable against the DM. But our intervention had been carried out mainly in dollars, and on an absolutely massive scale. We had been doing it virtually on our own. The Bundesbank and the Bank of France had done very little. We had on our own been financing a substantial part of the United States current account deficit. Our intervention was creating a real risk of inflation in this country. This could not go on, which was why we had taken the decision to change our intervention policy.

The Prime Minister continued that she wanted to make clear that we were not selling dollars but selling sterling in order to buy DM. We understood France's concern that this could add to the strains within the EMS. So we had issued instructions that any purchases of DM should be broadly matched by purchases of French Francs. The Governor of the Bank of England had not yet been able to inform M. de la Rosiere of this. She wanted to reassure M. Chirac that we were taking steps to avoid the problems that he feared of putting the EMS under strain. But our previous intervention in dollars simply could not go on.

CONFIDENTIAL

M. Chirac said that, with the decline of the dollar, there were already big strains within the EMS. That was why our new policy worried him so much. But he understood the point the Prime Minister was making, namely that we were matching our purchases of DMs with purchases of French Francs. He would get on to M. de la Rosiere immediately and tell him to speak to the Governor of the Bank. He would also ask M. Balladur to speak to the Chancellor. The Prime Minister said the purpose of such calls should not be to tell us to stop what we were doing. There was no question of that. We had been supporting the dollar virtually on our own. She would like to see the Bundesbank doing more to support the dollar. We simply could not go on alone. But she wanted to repeat the instructions which we had issued to match purchases of DMs with purchases of French Francs was intended to meet French concerns which she understood. M. Chirac said that he was glad that the Prime Minister understood the problems so well.

I am sending a copy of this letter to John Footman (Office of the Governor of the Bank of England).

Yours sincerely,

Charles Powell

C.D. Powell

Alex Allan, Esq.,
HM Treasury.

JD3BEX

Speaking note for use by the Prime Minister with M Chirac 10/12.

/ Faxed to Bank of England 1840 10/12

We have, as you know, been aiming to keep sterling reasonably stable against the DM. Stability of exchange rates is something we have all endorsed, and it is clearly right that in managing sterling we should look primarily towards the European currencies rather than the dollar.

But our intervention has been carried out mainly in dollars, and it has been massive. It is creating a real risk of inflation, and we on our own have been financing a substantial part of the US current account deficit. It could not go on. That is why we have taken the decision to change our intervention policy.

I do understand your concern that this could add to the strains within the EMS.

So we have decided that any purchases of DM by us will be broadly matched by purchases of FF. The Governor of the Bank of England has as yet been unable to inform M. de la Rosiere. But I hope this will be some reassurance to you.

Prime Minister

Why intervene

Exchange Rate

already. ~~[illegible]~~

We cannot go on day of the day without huge high inflation following. ~~[illegible]~~ not

I have had further words with Lawson, making clear the extent of your concern.

The problem is that the Bank have not been intervening in DM, because they don't want to offend the Bundesbank, but only in dollars, where the effect is less direct. – Nevertheless it acts upon the £ DM exchange rate

The Chancellor is now calling in the Governor & intends to be very firm with

him. He will insist that
the Bank intervene in DM. If
the Governor protests – as he
will – the Chancellor will say
that inter-central-Bank arrangements
will simply have to be over-
ridden. If we were in the
EMS, we would intervene in
DM. If the Governor still
protests, the Chancellor
intends to say that he will
find some-one else to run the
EEA (Exchange Equalisation Account) CDM

SECRET

PRIME MINISTER has seen CDP

EXCHANGE RATE

The Chancellor has now had a meeting with the Governor. It turned out to be fairly difficult. The Governor said that, for the Bank to buy deutchmarks, would give rise to considerable problems with the Bundesbank because it would mean over-riding inter-Central Bank arrangements, and would increase the strains within the EMS. He later confirmed this after having spoken to Poehl. Indeed Poehl apparently expressed great indignation and said that he might need to telephone Chancellor Kohl in Copenhagen and get him to raise the matter with you. The Chancellor takes a dim view of this. If we were full members of the Exchange Rate Mechanism of the EMS, it would be a perfectly natural thing to do. The Germans are exploiting a technicality to make life difficult for us.

However, the Chancellor has agreed that for the remainder of the day we should buy other EMS currencies rather than the deutchmark, while insisting that from Monday we should start buying deutchmarks whatever the Bundesbank say. He has a strong case. At the moment we are virtually single-handedly supporting the dollar while the Germans are doing virtually no intervention. If we start buying deutchmarks, the Germans will be forced to support the dollar as well. This is a point you could use with Chancellor Kohl if he does raise the matter.

That is all what has been said. The reality seems to be slightly different. Since midday our total intervention has been $140 million of which $75 million has been in deutchmarks!

The advice continues to be that to let the pound go through three deutchmarks would be a very major step and damaging in the present slightly fragile state of confidence (revealed at your dinner for the CBI). The feeling is that we shall not go just through but a long way through that barrier.

C.D.P.

CHARLES POWELL

4 December 1987

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SECRET & PERSONAL

PRIME MINISTER   27 November 1987

Exchange Rate Policy

Your interview with the FT, published on Monday, and in particular the section dealing with exchange rates, was a much needed corrective to the Chancellor's recent pronouncements on this subject.

In his three recent major speeches (Washington, Mansion House and earlier this week) he has made it perfectly clear that in his view:

- the move to a regime of managed exchange rates, starting with Plaza and re-emphasised at Louvre, is the foundation for external financial stability in the world economy,

- there is no point in holding another G-7 meeting unless all those involved are prepared to contribute wholeheartedly to the stabilisation of the dollar,

Low

- the idea that exchange rate stability promoted stock market instability, and may even have been a significant factor in bringing about the crash, is "poppycock",

- UK exchange rate policy is to maintain a stable exchange rate against the Dm, regardless of the amount of foreign currency we have to buy or in future will have to sell.

It has now become clear, that over the past two years, the Treasury have been a leading international voice in arguing for managed exchange rates and co-ordinated intervention, and that, having been frustrated in their intention to join the EMS, they have pursued a de facto policy regarding the £/Dm rate as if we were full members of the EMS.

The Louvre agreement and managed exchange rates

This approach originated following the frustration felt by Finance Ministers with the "overshooting" of the dollar in 1984 and 1985. Rather than put the emphasis on tackling the fundamental problem - namely the burgeoning US deficit - they put the emphasis on bringing down the dollar (Plaza) and then on maintaining exchange rate stability (Louvre).

I enclose a recent lecture by Profesor Martin Feldstein of Harvard, who is a distinguished academic and who could never be described as a traditional monetarist (Appendix A). As you will see he is very sceptical of the current approach to managed floating for a number of very good reasons:

- governments can intervene in markets and influence nominal exchange rates but they cannot ultimately influence real exchange rates (changes in nominal rates adjusted for changes in inflation): this is because holding nominal rates involves central banks buying and selling foreign currency which lead to increases and decreases in money and therefore ultimately in prices, which in time change real exchange rates and therefore frustrate the objective of the policy,

- although governments continue to intervene "most economists and central banks that have studied the evidence on this issue have reached the opposite conclusion. A special task force of central bank representations from around the world reported to the IMF in 1983 that their analysis of past experience and of the previous statistical studies indicated that exchange market intervention per se could not be expected to have any sustained effect on the performance of exchange rates." (p.18)

- the greatest risk following present co-ordinated exchange rate intervention is inflation,

- summits and international co-ordination have achieved little success in changing countries' policies, which have been influenced mainly by their concern over domestic factors,

- it would be far better if countries concentrated on pursuing sound domestic policies and resolved international co-operation for trade and national security.

That was the Guildhall speech

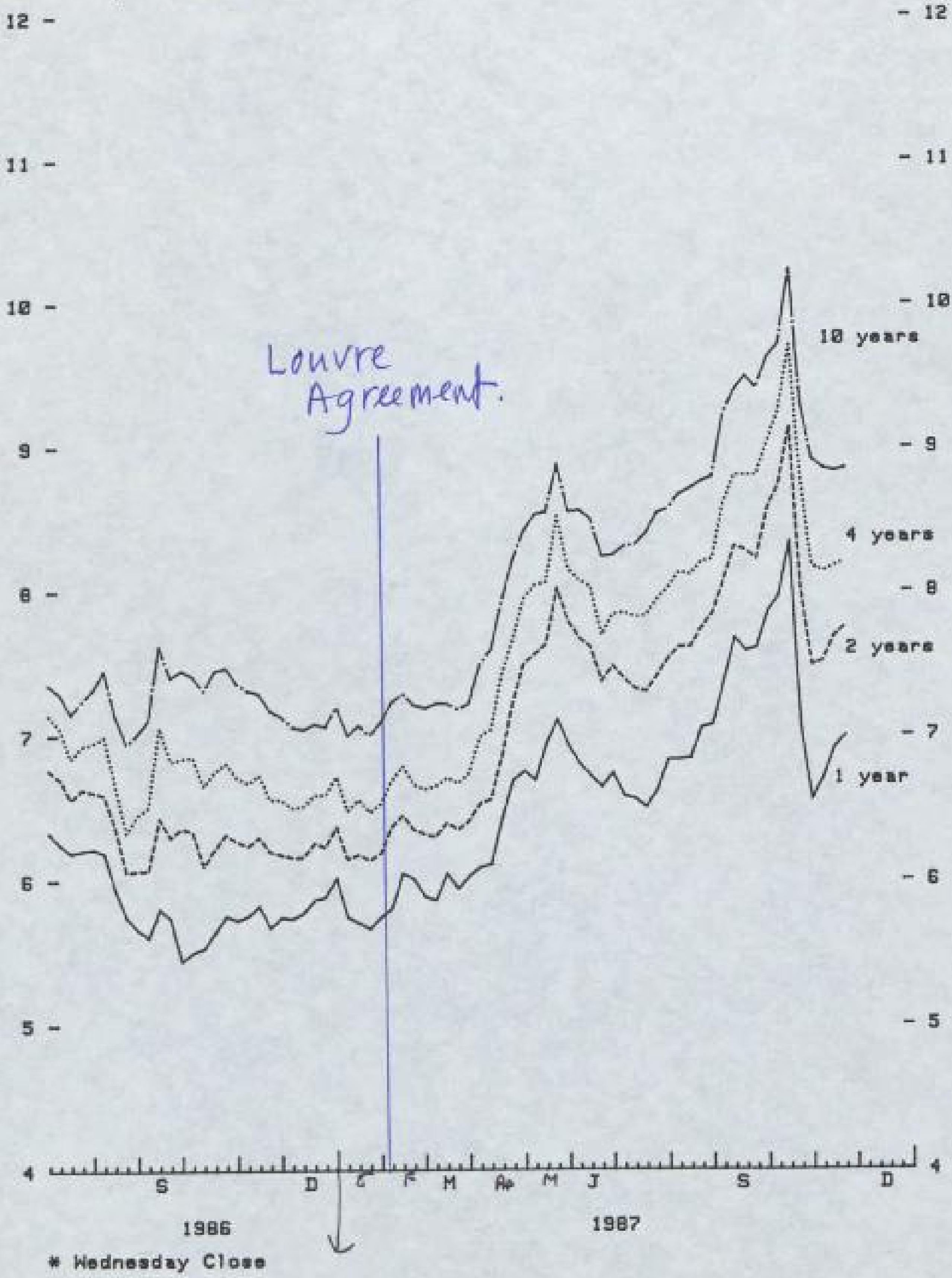
The Louvre Agreement and the stock markets

The Feldstein lecture was written before the stock market collapse.

Yet all of the following criticisms of the Louvre agreement could be sustained and would be very much in sympathy with his general approach:

US TREASURY NOTE/BOND YIELDS * Chart 2

Per cent per annum



* Wednesday Close

- it has resulted in massive foreign exchange intervention which has been inflationary;
- these inflationary expectations pushed up bond yields (see attached graph);
- the reverse yield gap (return on bonds less return on equities) became unsustainable at these new levels;
- this resulted in a market collapse (since 5 October, 29% in London, 26% in New York and 11% in Tokyo),
- which was also accompanied by a major devaluation of the dollar against the Dm and yen.

	£ERI	£/$	£/DM	$/DM	$/YEN
15 October	73.5	1.6650	2.9953	1.7990	141.90
2 November (date of last meeting)	74.6	1.7305	2.9739	1.7185	137.10
25 November	75.7	1.7897	2.9927	1.6722	134.70
% change since 15 October	+ 3.0	+ 7.5	-	- 7.0	- 5.1

UK exchange rate policy

The Louvre agreement has little immediate impact on the UK as the agreement deals primarily with the currencies of those countries with great imbalances (Germany, Japan and the US).

SECRET AND PERSONAL

Far more important as far as we are concerned is the Chancellor's strong commitment to cap the Dm/£ rate at 3 and not to allow it at some future date to fall below 2.80-2.95 when under pressure. The immediate problem we face is the inflationary potential of buying in foreign currency to protect the rate. The problem next year - in view of the differential inflation rates between US and Germany - is more likely to be pressure on the pound.

On the basis of the previous analysis the Chancellor's general approach must be called into question.

Rigidly sticking to the 3 Dm rate has become the cornerstone of the Chancellor's anti-inflationary policy. By not allowing the exchange rate to rise now and by being under pressure to allow it to fall if people start selling sterling, the Chancellor is taking a real gamble with both our own rate of inflation and our own rate of growth.

Conclusion

The stakes in this strategy are very large. At the very least, the issue deserves serious discussion in a larger group than just the Chancellor.

Brian Griffiths

BRIAN GRIFFITHS

Prime Minister

23 October 1987

You may care to have another glance at this before you see Martin Feldstein.

PREC6 13/1

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Rethinking International Economic Coordination

Martin Feldstein*

A Lecture on the Occasion of
The Fiftieth Anniversary of
Nuffield College, Oxford

I am delighted to be here and honored by the invitation to give this lecture celebrating the fiftieth anniversary of Nuffield College. Nuffield will always be a very special place for me. It was when I migrated along the High Street from Brasenose to Nuffield in the autumn of 1962 that I began in earnest my graduate training as an economist. Nuffield provided an excellent environment for a fledgling economist: good lectures and seminars, excellent fellow students, and the frequent discussions about current economic issues that implicitly reminded us why the study of economics was so important.

It was my good fortune to stay at Nuffield for five years, serving as a Research Fellow and subsequently as an Official Fellow. How grateful I am for the unique experience of a graduate social science college with links not only to this great university but also to the government and the business community in London. The combination of high quality technical

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*Professor of Economics, Harvard University, and President of the National Bureau of Economic Research.

economics in the seminar rooms and of stimulating debates about economic affairs in the Common Rooms and at High Table have left a permanent and pleasant impression.

Today I want to talk about an important aspect of economic policy that has been very much in the news: the international coordination of macroeconomic policy and exchange rates. I think that this is a particularly fitting subject in light of the strong links between economics and politics that have always been a part of the Nuffield tradition.

I should perhaps begin these remarks by emphasizing that I am not opposed in principle to international cooperation in all economic matters. I should also add that I do not favor government actions that are designed to promote conflict between national economies that goes beyond the normal conflict that is inherent in ordinary market competition.

I start with these obvious assertions because in my remarks today I shall be stressing the counterproductive consequences of the international coordination of macroeconomic policy.

I do not deny that the economies of the world are linked in a way that makes the monetary and budget policies adopted in one country affect the economic performance of other countries. But I believe that many of the claimed advantages of cooperation and coordination are wrong, that there are substantial risks and disadvantages to the types of coordination that are envisioned, and that an emphasis on international coordination can distract attention from the necessary changes in domestic policy. Moreover, the attempt to pursue cordination in a wide range of macroeconomic policies is likely to result in disagreements and disappointments that reduce the prospects for cooperation in those more limited areas of trade, defense and foreign assistance where international cooperation is actually necessary.*

In stressing the limited scope for international cooperation in macroeconomic policy and in exchange markets, I do not wish to imply that such cooperation is never appropriate. Far from it.

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*My criticisms of international macroeconomic coordination were sketched first in an article that I wrote for the Economist magazine ("The World Economy Today: Sign's of Recovery" June 11, 1983). An earlier version of the present lecture was presented as one of my two 1986 Horowitz Memorial Lectures of the Bank of Israel. The general subject of international economic cooperation (in macroeconomic policy, exchange rate policy, international trade and developing country debt management) was explored at an April 1987 conference of the National Bureau of Economic Research. The conference volume presents valuable survey papers, personal comments by individuals who have had significant experience in government and business, and an extensive bibliography that makes it unnecessary to provide such references in the current talk; my own views are summarized in an introductory chapter. See M. Feldstein, International Economic Cooperation. University of Chicago Press, 1988. See also M. Feldstein, International Economic Cooperation: Summary Report. The National Bureau of Economic Research, 1987.

There are some small and very interdependent countries where such cooperation and coordination should undoubtedly be the general rule. There are also some conditions when the potential gains from cooperation and coordination are such that all countries could expect to benefit from participation. But the active coordination of the macroeconomic policies and of exchange rates among the United States, Japan and Germany will generally be inappropriate. Moreover, as I shall explain in these remarks, the United States is particularly unsuited to participate in an on-going process of economic coordination.

Cooperation and coordination in macroeconomic policy-making have, of course, always been part of the dialogue of international relations. But in the past few years there has been a substantial increase in the emphasis on such active collaboration. The central proposal of the May 1986 Economic Summit Meeting in Tokyo was a call for a mutual "multilateral surveillance" of macroeconomic policies by the major seven countries as part of a new process of achieving a cooperative strategy for guiding individual country policies. This emphasis on the coordination of macroeconomic and exchange rate policies was reaffirmed at the Venice Summit in June 1987 and most recently at the September 1987 annual meeting of the International Monetary Fund and World Bank.

In practice much of the discussion of international coordination has focused on exchange rates. I shall therefore begin by commenting on exchange rate management. I will then turn to the more general subject of the coordination of macroeconomic policies, including budget policies, monetary policies and tax structure policies. At the end, I will have some general comments about the proper role of international economic cooperation and coordination in a wider range of areas and on the links between economic and political cooperation.

The Management of Exchange Rates

After less than a decade of floating exchange rates, the sharp rise in the value of the dollar during the early 1980s caused a renewed interest in the possibility of the international management of exchange rates and even of a return to a system of fixed exchange rates. In the five years beginning in January 1980, the value of the dollar rose more than 80 percent in comparison to the value of the other currencies of the world. Part of the dollar's rise reflected the lower rate of inflation in the United States than abroad and, as such, did not affect the relative competitiveness of American and foreign products in world markets. But even after adjusting for differences in national inflation rates during this period, the value of the dollar rose more than 70 percent in comparison to the value of other currencies.

This rise in the real value of the dollar made it very much more difficult for American firms to sell abroad and very much easier for foreign firms to sell their products in the United States. This was the primary reason why the United States shifted from a trade surplus in 1981 to a massive trade deficit by 1986. Measured in the constant prices of 1982, the U. S. trade balance shifted from a surplus of $50 billion in 1981 to a deficit at the rate of more than $150 billion in 1986. Exports declined over this period while the value of imports rose more than 50 percent. It is not surprising therefore that American businesses and their workers in the wide range of industries hurt by the strong dollar called for government action to stop and reverse the dollar's rise.

The dollar began to fall in February 1985 and by the end of 1986 had reversed about three-quarters of its previous rise. A further fall of the dollar since then has brought it to within about 10 percent of its real value in 1980. The sharp increases in the relative value of the Japanese yen, the German mark and the other European currencies that move with the mark caused a correspondingly sharp reversal of the recently-achieved competitiveness of Japanese and European products. Their export volumes declined and profits sagged. By 1986 the Japanese and European governments were subject to substantial domestic pressures to seek a halt to the dollar's decline.

Between 1981 and the summer of 1985, the Reagan administration argued that the value of the dollar should be left to the market and that it was inappropriate to shift U.S. domestic economic policy or to intervene in currency markets in an attempt to alter the dollar's value. This was a continuing source of conflict with the European and Japanese governments that did not like the dollar's rise because of the inflationary pressures that it imparted to their own economies, the rising real interest rates that resulted from the capital outflow to the United States, and the increased support for protectionist trade policies that was developing in the United States because of the surging U.S. trade deficit.

The meeting of the finance ministers of the G-5 countries (the United States, Britain, France, Germany and Japan) at the Plaza Hotel in New York in September 1985 was a political watershed in this process. Faced with the reality that the dollar had been declining for more than six months, Treasury Secretary James Baker abandoned the previous Treasury position that the strong dollar was a measure of foreign investors' approval of the economic policies of the United States. He acknowledged publicly that the high value of the dollar was a serious problem for American industry. And, most surprisingly and significantly of all, he agreed to participate in coordinated exchange market intervention aimed at lowering the dollar's value.

Immediately after the Plaza meeting the United States did join with other countries in a major exchange market intervention, selling dollars and buying other currencies. The Japanese central bank also raised short-term interest rates temporarily in order to make yen denominated bonds a more attractive investment and thereby to stimulate the demand for the yen.

Exchange rate targeting and economic policy coordination aimed at achieving desired levels of the exchange rates has been a frequent theme of intergovernmental meetings since that time. The first tangible example of this new spirit was the November 1986 joint statement by Treasury Secretary Baker and Japanese Finance Minister Miyazawa in which the Treasury agreed to support the idea of a stable dollar-yen rate in exchange for a Japanese commitment to stimulate their own economy by expansionary monetary and fiscal policies. The finance ministers of the G-7 countries met at the Louvre in February 1987 to assert their belief in macroeconomic coordination and to call for exchange rate stability. They reaffirmed this call at the June 1987 Venice Summit and the September 1987 IMF-World Bank meeting.

In contrast to these assertions, I believe that the dollar must continue to decline because the future trade deficit implied by the dollar's current level will be too large to finance.

Experts estimate that without a further decline of the dollar the U.S. trade deficit will remain at more than $100 billion a year and the current account deficit will grow explosively because of the interest and dividends owed on the U.S. net borrowing from abroad. Only a decline of the dollar can achieve the change in the relative prices of American and foreign goods that can induce American consumers to import less and foreign consumers to buy more American made goods. The more rapid growth in Japan and Europe that the finance ministers continually stress as an alternative to a dollar decline simply cannot be powerful enough to make a significant dent in the U.S. trade deficit. Similarly, while a decline of the American budget deficit would help to shrink the U.S. trade deficit, it would do so by lowering U.S. interest rates which in turn would reduce the value of the dollar; budget deficit decline is not an alternative to dollar decline as a means of shrinking the trade deficit.*

I believe that the pursuit of exchange rate goals is likely to be both futile and economically damaging. I believe that this is true not just in the current circumstances but more generally as well. The primary risk is that the pursuit of exchange rate targets over an extended period of time would increase the rate

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*For a longer but nontechnical discussion of why the dollar must decline, see my "Correcting the Trade Deficit," Foreign Affairs, Spring 1987.

of inflation in every country. An exchange rate policy can also hurt the process of capital formation, weaken the capital goods and construction industries, and delay the recovery of the manufacturing industries that are hurt by an overvalued exchange rate.

Nominal and Real Exchange Rates

To understand the likely effects of an exchange rate policy, it is crucial to distinguish between changes in nominal exchange rates and changes in real exchange rates. The change in the nominal exchange rate between two countries is the change in the actual exchange rate that prevails in the market. The change in the real exchange rate is equal to the change in the nominal exchange rate adjusted for differences in the inflation rates in the two countries.

An example will illustrate this difference and show why it is the real exchange rate that is the important one. One dollar now (October 1987) buys 1600 Mexican pesos. A year from now that might rise to 3200 pesos, a one ~~hundred~~ percent increase in the nominal exchange rate between the dollar and the peso. But the fact that the dollar buys more pesos would not necessarily imply that the dollar buys more Mexican goods at the end of the year than at the beginning of the year. If during the same year the level of prices in Mexico also rose by 100 percent, the dollar would buy the same volume of Mexican goods at the end of the year as it did at the beginning of the year. If moreover there was no change in the price level in the United States, a dollar would also buy the same volume of American goods at the end of the year as it did at the beginning of the year. If the dollar buys the same relative volumes of American and Mexican goods at the end of the year as it did at the beginning of the year, we would say that the real value of the dollar is unchanged. Thus in this example the nominal value of the dollar relative to the peso rose 100 percent but the real value remained unchanged.

In contrast, if the nominal exchange rate rose 100 percent while Mexican prices rose 110 percent, the dollar would buy fewer Mexican goods at the end of the year than at the beginning of the year. In this case, we would say that the real value of the dollar relative to the peso fell even though the nominal dollar-peso exchange rate rose 100 percent.

As these examples indicate, it is the real value of the currency that influences the competitiveness of the country's products and thus its exports and imports. This point is worth emphasizing for two reasons.

First, the political discussions about exchange rate targets, target zones and exchange rate management are always in terms of the nominal exchange rates. Therefore even if the poli[illegible]cally agreed exchange rate targets were achieved and maintained, the relative competitiveness of the countries could change substantially because differences in inflation rates caused the real exchange rates to change. In short, exchange rate management is likely to be misguided because it focuses on the wrong target.

Second, economic policies that change a country's rate of inflation can easily alter nominal exchange rates without changing the real exchange rates. There is therefore a serious danger that an agreement to stabilize exchange rates would lead to increased inflation without any change in the real exchange rates that influence imports and exports.

Consider for example the sharp rise in the real value of the dollar that began in 1980. The dollar rose because American bonds and stocks became more attractive to portfolio investors around the world. The primary reason for this increased attractiveness was the sharp rise in the real interest rate in the United States that resulted from the massive increase in current and projected budget deficits. In addition, the fall in inflation, the 1981 changes in tax rules, and the appreciation in the price of oil all contributed to the rise in the real value of the dollar relative to the currencies of the other major industrial countries.

Blocking or reversing these fundamental factors could have prevented the dollar's rise or caused it to decline at an earlier time. But if the United States had agreed in 1983 to the demands of the French and others who wanted us to stop the dollar's rise, there is no reason to believe that any changes would have been made in these fundamental factors. Instead the easiest way to depress the dollar or stop its rise would have been for the Federal Reserve to ease monetary policy. The easier monetary policy would have temporarily lowered real interest rates and that in turn would have caused a temporary decline in the real value of the dollar. More importantly, the easier monetary policy would produce inflation and the inflation would cause the dollar's nominal value to decline. In the end, there would be no change in the real exchange rate or the trade deficit but a higher price level and a high rate of inflation.

Of course there are two sides to every exchange rate and the relative value of the dollar could have been depressed by a tightening of monetary policy in Europe and Japan that lowered the inflation rates in those countries. There was in fact some tightening of monetary policy in Europe in response to the rising dollar but that process was inevitably limited by the increased unemployment that resulted from such a monetary contraction. Political reality would inevitably have required that a change in monetary policy to stabilize the dollar be an inflationary easing by the United States rather than a deflationary tightening in the other countries of the world.

The current attempts to slow the rise of the yen and the German mark provide a further example of the risk that exchange rate coordination is likely to be inflationary. The process of intervention in both Germany and Japan has led to very rapid increases in the money supply and in overall liquidity. This has increased the fear of inflation and raised long-term interest rates in both countries. Although the governments of Germany and Japan have asked the United States to raise interest rates as an alternative way of maintaining the value of the dollar, the U.S. has been reluctant to do so in the context of a recovery that has already lasted five years and with an election next year. Although the German and Japanese intervention has not yet produced any significant rise in inflation, a continuation of the associated increases in money and overall liquidity for an extended period would undoubtedly begin to do so.

Fiscal Discipline

There are some who argue that a commitment by the United States to stabilize the dollar in 1983 or 1984 would have caused a reduction in the budget deficit and therefore a decline in the real value of the dollar. On the basis of my experience as a participant in the making of American economic policy at that time, I do not believe that an exchange rate agreement would have prod[?]ed such a change in budget policy.

The Reagan Administration was already trying to reduce the budget deficit by a strategy that combined major domestic spending cuts with a conditional tax increase. There is no reason to think that they would have taken a more conciliatory position with Congress in order to deal with the high dollar. Treasury Secretary Reagan apparently believed that the budget deficit had no effect on the dollar. In addition, many experts both inside and outside the government argued that the strong dollar showed only that monetary policy was too tight and therefore argued in favor of depressing the dollar by a monetary expansion.

Although there is no way to be confident about events that did not occur, I believe that if the United States had been committed to stabilize the dollar in 1983 or 1984 it would have done so by a more inflationary monetary policy. The adverse effects of the budget deficit on international trade and domestic capital formation would have persisted but the exchange rate target would have added the additional adverse consequence of raising the rate of inflation.

The present goal of stopping or slowing the decline of the dollar might also be achieved by a change in fiscal policy but doing so would require fiscal changes that would in themselves be undesirable. An increase in the U.S. budget deficit would raise real interest rates, making dollar investments more attractive and increasing the value of the dollar. A reduction of the budget deficits in Germany and Japan would reduce interest rates in those countries and cause their currencies to depreciate. The use of fiscal policies to stabilize the dollar exchange rate would thus exacerbate the long-run budget and capital accumulation problems of the United States and would deny Germany and Japan a desirable short-run fiscal stimulus.

Gains and Losses of an Overstrong Dollar

There are of course some who believe that the real value of the dollar can be influenced by exchange market intervention in which the government buys or sells dollars in exchange for foreign currencies. It is sometimes said that this is more effective if such purchases or sales are done in support of an explicit policy aimed at keeping the exchange rate in relatively narrow bands. Others argue that the psychological effect of intervention is magnified when several countries coordinate their intervention actions. Before considering whether such a policy could be expected to work, it is good to ask whether stabilizing the dollar would in itself have been desirable in the economic context of 1983 and 1984 and would be desirable in today's world economy.

Stopping the rise in the dollar's real value in early 1983 would have reduced the subsequent U.S. trade deficit. Output and employment would have deteriorated less in our export industries and in those firms that compete with imports from abroad. But that is only half of the story. The reduced trade deficit would automatically have meant a reduced capital inflow from abroad. Real interest rates would have been higher in the United States. Investment in plant and equipment and housing construction would have been depressed. The pattern of employment would have been different but there is no reason to suppose that total employment and output would have been higher. Moreover, the lower rate of capital formation would have reduced the growth of productivity.

In short, stopping the dollar's rise earlier would have had both good and bad effects on the American economy. There is no way to know whether the favorable effects on the export industries and firms that compete with imports would have outweighed the adverse effects on capital investment. I believe that in the absence of clear evidence or analysis to the contrary, it is best to assume that the market produces a better solution than government intervention. That is as true about exchange market intervention as it is about so many other aspects of government interference with the market economy.

The same principle is relevant today. If intervention per se could stop the dollar's fall at the present time, that would contribute to U.S. price stability and would maintain a flow of capi[illegible] from abroad that dampens real interest rates and provides the funds to finance additional investment in housing and in plant and equipment. But the high dollar would also limit the improvement in the trade deficit, depressing activity in export industries and those that compete with imports from abroad. Ultimately, moreover, the dollar's adjustment would have to occur and would have to be larger because the dollar had contributed to a greater accumulation of net debt from the United States to the rest of the world.

Exchange Market Intervention

This discussion implicitly assumes that government intervention in the foreign exchange market could actually change the evolution of the dollar's real value. In contrast, most economists and central banks that have studied the evidence on this issue have reached the opposite conclusion. A special task force of central bank representatives from around the world reported to the International Monetary Fund in 1983 that their analysis of past experience and of the previous statistical studies indicated that exchange market intervention per se could not be expected to have any sustained effect on the performance of exchange rates. Even the apparent success of coordinated intervention in the past seven months have left most economists and central bankers convinced that exchange rate intervention can have only a very temporary effect on exchange rates.

In considering the potential effects of exchange rate intervention it is crucial to distinguish between the so-called sterilized and unsterilized intervention. All intervention aimed at reducing the dollar's value consists of buying foreign short term securities for dollars. This automatically increases the supply of dollars and is therefore equivalent to an easing of monetary policy. By definition, in "sterilized" intervention the American government adds the further step of selling an equal amount of U.S. government bonds and thereby reducing the money supply by the same amount that the currency intervention increased it. At the end of the sterilized intervention, the government has reduced the supply of foreign securities and increased the supply of dollar securities but left the U.S. money supply unchanged. By contrast, the so-called unsterilized intervention increases the supply of dollars and therefore is an easing of U.S. monetary policy.

The distinction is important because "sterilized" intervention is a pure substitution of dollar securities for foreign securities in the world financial market while unsterilized intervention is also an easing of U.S. monetary policy. Experts agree that unsterilized intervention can affect the real exchange rate in the short run and the nominal exchange rate in the long-run because the increase in the American money supply lowers the real interest rate in the short run and raises the U.S. price level in the longer term. In contrast, since sterilized intervention leaves the money stock unchanged, there is no reason to expect a change in real interest rates or the price level.

Although substantial past experience and economic logic both imply that sterilized exchange market intervention cannot be expected to have a sustained effect on exchange rates, the fall of the dollar in the year after the G-5 finance ministers meeting at the Plaza Hotel in September 1985 and the relative stability of the dollar since the Louvre meeting in February 1987 have led some government officials and others to attribute significant power to coordinated exchange rate intervention. I believe that that is a misreading of the recent experience. There is in fact no evidence that the G-5 Plaza meeting or the subsequent coordinated intervention had any lasting effect on the dollar's rate of decline. In the days immediately after the G-5 meeting there was a four percent decline in the dollar's value. But the rate of decline of the dollar during the subsequent year was no greater than it had been in the six months before the G-5 meeting.

Although the relative stability of the major exchange rates in the seven months after the Louvre meeting may reflect in part a reluctance of market participants to confront the central banks, especially since the Bank of Japan has shown a willingness this year to intervene on a massive and unprecedented scale, the dollar has also been buoyed by the unanticipated rise in the price of oil (which strengthens the dollar because the United States is less dependent on oil imports than Japan and Germany), by the sharp rise in U.S. interest rates, by the reduction in the U.S. trade deficit and by the continued strength of the American economy. The experience since February 1987 should not be taken as evidence of the efficacy of intervention, let alone of the possibility of achieving a sustained shift in exchange rates through intervention alone. When the market participants become confident that the dollar must fall further, intervention will be unable to prevent that decline.

The Coordination of Macroeconomic Policies

Coordinated exchange rate intervention is only one aspect of the potential coordination of macroeconomic policies. Indeed there are many who accept that exchange rate intervention per se is powerless and who therefore argue for a more general coordination of monetary and budget policies. The Tokyo Summit in May 1986 emphasized such macroeconomic coordination and called for a new "multilateral surveillance" procedure managed by the International Monetary Fund. Although the details of this multilateral surveillance procedure were left vague, it was interpreted as an extension of the previous meetings between the IMF and the G-5 finance ministers. In the future the finance ministers of the seven major industrial countries would examine a variety of indicators of macroeconomic policy and performance and take steps to modify those policies when they were deemed by the group to be unsatisfactory. This coordination of economic policy is advocated as a way of achieving more rapid economic expansion, of avoiding balance of payments problems that restrict domestic demand, and of reducing the international level of real interest rates.

The first such multilateral surveillance session was held in conjunction with the IMF annual meetings in September 1986. The agenda was predictable. The United States called on Japan and the European countries to expand their economies more rapidly in order to increase their imports from the United States. The Europeans and Japan called on the United States to reduce its budget deficit and to slow the decline of the dollar relative to their currencies, an inherently self-contradictory request. No serious agreements were reached. The Germans explained that their economy was expanding rapidly, that their monetary policy was if anything too loose already, and that a tax cut was scheduled for 1988. The Japanese noted that they were moving gradually toward fundamental changes in their economy that had previously been described in the Maekawa Report and that would eventually increase domestic demand and make Japan less dependent on exports. Treasury Secretary Baker said the United States was committed to eliminating the budget deficit over the next five years as promised in the Gramm-Rudman-Hollings legislation and that the Administration would make recommendations for spending reductions to achieve that end. In short, every country said that it would go on doing just what it had been doing. And, despite the subsequent pronouncements at the Louvre meeting and the Venice summit, each country continued to pursue what it saw as its own interest, generally unaffected by the "international coordination" process.

Only when the Government of Japan became convinced in early 1987 that the sharp rise in the yen-dollar rate during 1986 would create a serious downturn for the Japanese economy did Japan abandon its goal of budget deficit reduction and adopt a package of fiscal and monetary stimulus. The budget called for tax cuts and a massive increase in government spending that produced a fiscal stimulus equal to about two percent of gross national product. This was backed up by an easing of monetary policy that significantly reduced long-term interest rates. The key point is that the Japanese decision to increase government spending and reduce interest rates was motivated not by the desire for an agreement with the United States but by the increasing evidence of the weakness in their own economy and the need for stimulative domestic policies to prevent a serious domestic recession. It is wrong to regard the shift in Japanese policy as the result of international coordination or pressure.

This is borne out by the experience of Germany which, even with high unemployment and a zero inflation rate, has not adopted expansionary policies because of a government decision to give primacy to preventing inflation and to reducing domestic labor market rigidities. Despite the pressure from the United States (as well as from the Free Democratic members of the current coalition government in Germany and Germany's key trading partners in Europe) the government of Germany has remained unwilling to provide either a fiscal stimulus or an easing of monetary policy. Real and nominal interest rates rose in 1987 and no fiscal expansion was enacted. The tax cuts scheduled for 1988 are less than one percent of GNP and are intended to be offset by other revenue increases and by reductions in government outlays. Germany also refrained from any significant active intervention in exchange markets.

The $60 billion dollar decline in the U.S. budget deficit between 1986 and 1987 was also not the result of international actions but of domestic politics and the peculiarities of budget accounting. Approximately half of the budget deficit reduction reflects special nonrecurring features of the 1987 budget, including a large one-time surge in tax revenue that resulted from the realizations of capital gains in 1986 in anticipation of the recently enacted future rise in the capital gains tax rate. Much of the remaining deficit reduction reflected changes enacted in 1984 and 1985. Moreover, the Congress that enacted the spending cuts and earlier tax increases did so for purely domestic reasons and never regarded this as part of a plan to elicit cooperative behavior from other governments.

This failure of the summit and other international coordination discussions to achieve any changes in domestic economic policies should not be seen as a surprise or as a reflection of the fact that the process of explicit coordination only began in 1986. It should be seen as the most likely outcome of all such meetings.

Constitutional Limits on American Participation

A primary reason why such macroeconomic policy coordination cannot work as envisioned is that the United States is constitutionally incapable of participating in such a negotiation. The separation of powers in the American form of government means that the Secretary of the Treasury cannot promise to reduce or expand the budget deficit or to change tax rules. This power does not rest with the President or the administration but depends on a legislative agreement between the President and the Congress. In this sense, the United States participation in any macroeconomic coordination process is fundamentally different from the participation of a country with a parliamentary system in which the prime minister or the prime minister's representative can commit to a change in the nation's economic policy.

It is sometimes suggested that an American Treasury Secretary or President, although incapable of promising the enactment of specific budget legislation, could promise that the American government would support a particular legislative proposal. Such a suggestion ignores the negotiating nature of the relation between the President and the Congress. The President cannot propose the legislative package that he expects Congress to enact and he cannot disclose the extent to which he is willing to compromise on specific issues.

Because it is impossible for the United States to reach an international agreement on specific budget, tax or spending policies, any actual agreement would have to call for a change in U.S. monetary policy. International macroeconomic coordination could thus be a recipe for the wrong policy change in the United States. For example, if the United States had entered into an agreement in 1983 or 1984 to shift policy in a way that reduced the value of the dollar, the agreement would have required an inflationary increase in the supply of money. Moreover, even such an agreement would be beyond the legal authority of the Treasury Secretary or the President since it would require the agreement of the independent Federal Reserve.

For the United States, the constitutional and legal restrictions on international policy agreements reinforce the economic fact that there is little potential gain to the United States from international coordination. Because exports are a relatively small share of U.S. gross national product, a more rapid expansion of demand in other countries has a very small effect on demand and production in the United States. Similarly the small share of imports in U.S. GNP and the ability of the United States to borrow readily in world markets meant that the United States can expand demand at home without worrying about the resulting impact on its trade deficit and balance of payments.

In short, the United States lacks both the incentive and the legal ability to participate in the type of international macroeconomic coordination that is so widely advocated.

Although the other major industrial countries appear to have a greater incentive to participate in international macroeconomic coordination, I believe that incentive is more apparent than real. Uncertainties about the actual state of the international economy and uncertainties about the effects of one country's policies on the economies of other countries makes it impossible to be confident that coordinated policy shifts would actually be beneficial. The Germans still remember and regret their agreement to serve as a "locomotive" for worldwide expansion after the Bonn

Summit meeting. Today the Germans argue that foreign pressure for more expansionary German policy exaggerates the potentially favorable effects of such a change on foreign economies and ignores both the underlying strength of German demand and the need to achieve structural reforms in the German labor market as a precondition for reduced unemployment. A few years ago U.S. Treasury Secretary Regan argued that foreign pressure for the U.S. to reduce its budget deficit was misplaced because budget deficits do not influence interest rates, exchange rates and capital flows. When there are fundamental disagreements about the way the world economy works, there is little reason to believe that coordinated policy will produce improved performance.

The difficulties of coordination and the risk that coordination will be counterproductive do not imply that there is no scope for international macroeconomic coordination. Smaller countries with very interdependent economies are more likely to benefit than larger countries in which trade is a relatively small share of national income. Economic coordination therefore makes more sense within Europe than between Europe, the United States and Japan. Similarly, the potential for successful coordination becomes greater as the state of the international economy becomes less satisfactory. Coordination therefore makes more sense if there is a major world-wide slump than if the goal is to reduce minor business cycle fluctuations.

It is important to remember that to a very great extent a nation has the ability to achieve its economic goals by itself. Although the levels of demand, inflation, and interest rates in one country do affect the economies elsewhere, a country can manage its own monetary, budget and tax policies to offset many of the effects from abroad. Thus changes in domestic monetary policy can counteract the contractionary or inflationary pressures from abroad and structural tax policies designed to encourage investment can offset the effects of a worldwide rise in real interest rates.

Moreover, although fortuitous foreign economic policies can sometimes make it easier to achieve some domestic goals, those same policies often make it harder to achieve other goals. For example, although the rising dollar in the early 1980s and the accompanying increase in the U.S. trade deficit raised demand in Europe and reduced the balance of payments pressures that had discouraged domestic expansion, the dollar's rise also created inflationary pressures in Europe and the trade deficit brought with it a capital outflow that raised European interest rates.

There is also a serious risk that economic summits and ministerial meetings will inhibit appropriate changes in national economic policies. Governments may not take the politically painful steps that they should because they believe that foreign actions will make such policies unnecessary or because they want to use their own lack of action as part of a bargaining strategy to induce desired policies on the part of foreign governments. Thus the assertion at the Louvre ministerial and at the Venice summit that the dollar will stop declining may have contributed to a complacency that reduced pressure on the German government to provide adequate domestic stimulus and that may even have contributed to the failure of the American Congress to make greater progress in reducing future budget deficits.

Concluding Remarks

It is unfortunately easy and often politically convenient to exaggerate the potential gains from international economic coordination and to understate the ability of a nation to guide its own economic destiny. It would be a serious mistake if the pursuit of international economic cooperation in exchange markets and in macroeconomic policy management became an excuse for not pursuing appropriate domestic policies.

Moreover, although international cooperation in macroeconomic policy-making sounds like a way to improve international relations more generally, there is the serious risk that it would have the opposite effect. An emphasis on international interdependence instead of sound domestic policies makes foreign governments the natural scapegoats for any poor economic performance. Pressing a foreign government to alter its domestic economic policies is itself a source of friction and the making of unkeepable promises can only lead to resentment.

It would in general be far better if the major industrial countries concentrated on the pursuit of sound domestic economic policies and reserved the pursuit of international cooperation for those subjects like international trade and national security in which cooperation is truly essential.

Cambridge, Mass.

October 1987

CONFIDENTIAL

PRIME MINISTER

INTERVENTION

The Chancellor held a meeting this afternoon with the Bank about our intervention policy and interest rates, and I have had a brief report. The background is intervention in the last 24 hours of some $660 million, much of it in DM. The US deficit in August was only a little better than the record deficit in July, and $1 billion or so worse than market expectations.

Eddie George was apparently concerned about the continuing scale of the intervention and its effect on financial conditions. But, generally, there was not too much concern about funding policy: apparently the short-fall in funding against intervention is being offset by reductions in the forecast PSBR. (A surplus for this year is now forecast.) Most of those present felt that it would be wrong either to reduce interest rates or to allow sterling to rise against the DM. The Chancellor concluded that there should be no change of policy at least until after the Autumn Statement. We should continue to intervene. His Private Secretary told me he thought that the Chancellor would not want in fact to change policy even after the Autumn Statement.

I did not at this stage question whether continuing intervention and the present level of interest rates were the right combination. The problem seems to me to lie at least as much with the present objective of keeping the dollar stable against the DM. I put to the Chancellor's Private Secretary the parallel with the late 1960s, when European Central Banks and others shouldered the task of financing the US current deficit. Then the accepted wisdom (among non-Keynesians) was that the intervention needed to keep Bretton-Woods going was in effect allowing the US to export its inflation. I suggested that the pressure on sterling could well be eased if the dollar were now allowed to depreciate against the DM.

CONFIDENTIAL

The Private Secretary of course defended the policy loyally, arguing that the disruptive movements we have seen in exchange rates brought about by the markets could now be avoided by more substantial inter-Government agreements and intervention. But he told me, interestingly, that US Treasury officials had advised Baker at the time of the IMF meeting to look for some further depreciation of the dollar against the DM. There is apparently some belief at the top of our own Treasury that this may happen within a month or two.

All this is clearly something to be talked through with the Chancellor at an early opportunity on your return.

DAVID NORGROVE

14 October 1987

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

3 April 1987

David Norgorve Esq
10 Downing Street
LONDON
SW1

Prime Minister

DGN
3/4.

Dear David

INTERVENTION

The Chancellor thought the Prime Minister might like to see an update of the tables I sent you on 3 March about intervention. They now include the end-March reserve figures, and hence show complete figures for the 1986-87 financial year.

Yours
Alex

A C S ALLAN
Principal Private Secretary

Table 1

CHANGE IN FOREIGN CURRENCY RESERVES, 1979-80 TO 1986-87 INCLUSIVE

$ million

Financial Year	Market Intervention	Off-market Transactions	Total
1979-80	+3,222	+1,040	+4,262
1980-81	+2,031	+387	+2,418
1981-82	-1,753	-319	-2,072
1982-83	-1,431	-2,026	-3,457
1983-84	+2,817	-2,908	-91
1984-85	+1,695	-2,839	-1,144
1985-86	+1,293	-895	+398
1986-87	+6,938	-3,631	+3,307
Total	+14,812	-11,191	+3,621

1. Figures include both spot and forward.

2. Gross reserves also affected by net borrowing and annual revaluation neither of which is shown here.

All due to the last two months and with a lot of nudging from us. M

2252/34

Table 2

MONTHLY INTERVENTION AND OFF-MARKET TRANSACTIONS (SPOT AND FORWARD) APRIL 1985-MARCH 1987

$ million

		Market Intervention	Off-market Transactions	Total
1985	April	+442	-217	+225
	May	+447	-19	+428
	June	+98	+24	+122
	July	+95	-105	-10
	August	+102	-142	-40
	September	+154	-176	-22
	October	-306	-18	-324
	November	+72	-274	-202
	December	-239	-349	-588
	Total	+865	-1276	-411
1986	January	-187	+266	+79
	February	+204	+128	+332
	March	+411	-13	+398
	April	+755	-197	+558
	May	+197	-121	+76
	June	+487	-144	+343
	July	+159	-255	-96
	August	-102	-184	-286
	September	-92	-596	-688
	October	-785	-540	-1325
	November	+448	-301	+147
	December	+466	-270	+196
	Total	+1961	-2227	-266
1987	January	+536	-395	+141
	February	+521	-141	+380
	March	+4,348	-487	+3,861
Financial year totals				
	1985-86	+1293	-895	+398
	1986-87	+6,938	-3,631	+3,307

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SECRET

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

3 March 1987

D Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David

INTERVENTION

At the last bilateral, the Chancellor said he would let the Prime Minister have some further information about intervention. I attach two tables. The first shows the totals for financial years since 1979-80 for market intervention and off-market transactions. The second shows the equivalent monthly figures over the last two years.

So far in March, we have taken in about $250 million in market intervention (in only four dealing days); so for 1986-87 as a whole it looks as if we should end up close to break-even overall.

It also looks as if, despite the sizeable support given in September and October, 1986-87 will show the largest annual accumulation of reserves through market intervention since 1979-80. Equally, it will clearly show the biggest ever loss via off-market transactions. As you know, we are investigating what scope there is to reduce the size of off-market transactions, and are preparing a speaking note for the Prime Minister to use when she next sees Chancellor Kohl.

Yours
Alex

A C S ALLAN

Table 1

CHANGE IN FOREIGN CURRENCY RESERVES, 1979-80 TO 1986-87 INCLUSIVE

$ million

Financial Year	Market Intervention	Off-market Transactions	Total
1979-80	+3,222	+1,040	+4,262
1980-81	+2,031	+387	+2,418
1981-82	-1,753	-319	-2,072
1982-83	-1,431	-2,026	-3,457
1983-84	+2,817	-2,908	-91
1984-85	+1,695	-2,839	-1,144
1985-86	+1,293	-895	+398
1986-87 (to February)	+2,590	-3,144	-554
Total	+10,464	-10,704	-240

1. Figures include both spot and forward.

2. Gross reserves also affected by net borrowing and annual revaluation, neither of which is shown here.

2252/34

Table 2

MONTHLY INTERVENTION AND OFF-MARKET TRANSACTIONS (SPOT AND FORWARD)
APRIL 1985- FEBRUARY 1987

$ million

		Market Intervention	Off-market Transactions	Total
1985	April	+442	-217	+225
	May	+447	-19	+428
	June	+98	+24	+122
	July	+95	-105	-10
	August	+102	-142	-40
	September	+154	-176	-22
	October	-306	-18	-324
	November	+72	-274	-202
	December	-239	-349	-588
	Total	+865	-1276	-411
1986	January	-187	+266	+79
	February	+204	+128	+332
	March	+411	-13	+398
	April	+755	-197	+558
	May	+197	-121	+76
	June	+487	-144	+343
	July	+159	-255	-96
	August	-102	-184	-286
	September	-92	-596	-688
	October	-785	-540	-1325
	November	+448	-301	+147
	December	+466	-270	+196
	Total	+1961	-2227	-266
1987	January	+536	-395	+141
	February	+521	-141	+380
Financial year totals				
	1985-86	+1293	-895	+398
	1986-87 (to date)	+2590	-3144	-554

SECRET

file JD 5

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

26 February, 1987.

Dear Alex,

MEETING OF FINANCE MINISTERS AND CENTRAL BANK GOVERNORS

The Prime Minister has seen the Foreign Secretary's minute of 25 February which discussed the possibility of messages to President Reagan and George Shultz about the G5 and G7.

The Prime Minister agreed with the Foreign Secretary that there would be little point in sending a message to President Reagan in the next day or two, and that at this stage it would be preferable for our Ambassador to be instructed to speak to those who would have influence on the decision. However, I now understand there are signs that the Italians may be regretting their action, and looking for a way out. In these circumstances, it would seem as well not to take action with the Americans at present. But no doubt you will advise if an intervention by the Prime Minister would be useful.

I am sending copies of this letter to Tony Galsworthy (Foreign and Commonwealth Office) and John Footman (Office of the Governor of the Bank of England).

Yours,

David.

David Norgrove

Alex Allan, Esq.,
HM Treasury.

SECRET

GRS 630

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INFO IMMEDIATE WASHINGTON, PARIS, BONN
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G5-G7: JAPANESE REACTIONS

SUMMARY
JAPANESE GOVERNMENT SEE PARIS AGREEMENT AS BENEFICIAL IN PROVIDING SOME STABILITY IN THE SHORT TERM. DISCOUNT RATE LOWERED TO 2.5 PER CENT. NO INTERNAL CONSENSUS ON SCOPE OR FORM OF STIMULATORY PACKAGE, WHICH REMAINS HOSTAGE TO DIET DELIBERATIONS ON THE BUDGET AND SALES TAX. BELIEF THAT IN THE LONGER TERM, EXCHANGE RATE STABILITY DEPENDS ON U.S. WILLINGNESS TO CUT THEIR BUDGET DEFICIT.

DETAIL
2. THE JAPANESE GOVERNMENT ARE GENERALLY PLEASED WITH THE OUTCOME OF THE PARIS MEETINGS. FOR THEM THE MAIN OBJECTIVE WAS TO ACHIEVE GREATER STABILITY OF THE YEN EXCHANGE RATE. IN A PRESS CONFERENCE HERE ON 23 FEBRUARY MR MIYAZAWA SAID THAT THERE HAD BEEN AGREEMENT ON THE FORM AND TIMING OF CONCRETE COOPERAION TO ACHIEVE CURRENCY STABILITY, BUT THAT THIS SHOULD BE DONE WITHOUT PUBLICITY. THE AGREEMENT THAT CURRENT RATES BROADLY REFLECTED THE ECONOMIC FUNDAMENTALS OF EACH COUNTRY WAS IMPORTANT. TO TALK OF STABILITY WAS NOT TO RETURN TO FIXED RATES, THERE COULD BE ADJUSTMENTS IN FUTURE, BUT FURTHER APPRECIATION AT THIS STAGE WOULD BE DETRIMENTAL TO THE PROSPECTS FOR INDUSTRIAL RESTRUCTURING AND INCREASING DEMESTIC DEMAND IN JAPAN.

3. THE JAPANESE DISCOUNT RATE WAS LOWERED TO 2.5% , ITS LOWEST EVER LEVEL, ON 23 FEBRUARY. THE GOVERNOR OF THE BANK OF JAPAN MADE CLEAR IN ANNOUNCING THIS LAST WEEK THAT HE SAW THIS AS THE LIMIT OF THE CONTRIBUTION OF MONETARY POLICY TO THE STIMULATION OF THE ECONOMY. FURTHER MEASURES WOULD HAVE TO COME ON THE FISCAL SIDE.

4. SINCE HIS RETURN MR MIYAZAWA HAS TAKEN THE LINE THAT THE PARIS STATEMENT DID NOT COMMIT JAPAN TO ANY CONCRETE STIMULATORY MEASURES, AND THAT THE SINE QUA NON WAS THE EARLY PASSAGE OF THE BUDGET THROUGH THE DIET. HE CLAIMED THAT THE IMPLEMENTATION OF THE GOVERNMENT'S TAX REFORM PROPOSALS, WHICH ARE THE CENTRAL CAUSE OF DELAY IN PROCESSING THE BUDGET, WOULD HAVE A POSITIVE EFFECT ON DEMAND (THOUGH THE GOVERNMENT'S OWN ECONOMISTS ASSESS THIS AS VERY SMALL). THE PRIME MINISTER HAS STATED THAT THE GOVERNMENT ARE CONSIDERING FURTHER MEASURES TO BE INTRODUCED AFTER THE BUDGET BUT HE IS REFUSING TO SHOW HIS HAND UNTIL ITS PASSAGE IS MORE FIRMLY ASSURED. THE EXTENT OF ANY STIMULATORY PACKAGE IS STILL UNDER INTERNAL DEBATE, AND WE BELIEVE THERE IS NO CONSENSUS ON THIS AT PRESENT. NAKASONE /HAS

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HAS ALREADY TALKED OF BRINGING FORWARD PUBLIC WORKS IN FY 87 AS FAR AS POSSIBLE. MIYAZAWA IS THOUGHT BY SOME TO BE SEEKING SUPPORT, INTERNATIONALLY AND DOMESTICALLY, FOR THE MORE EXPANSIONARY DEMAND

POLICIES WHICH HE ESPOUSED BEFORE HIS RE-ENTRY INTO THE CABINET. THE THAIRMAN OF THE LDP GENERAL AFFAIRS COMMITTEE, ABE, HAS ALSO CALLED PUBLICLY FOR A MEASURE OF REFLATION. MFA AND MITI WOULD PROBABLY SUPPORT SUCH PLANS. THE MAIN OBSTACLE REMAINS THE ATTACHMENT OF NAKASONE AND THE MINISTRY OF FINANCE TO ELIMINATING THE DEFICIT AND THE POLITICAL ONE FOR THE GOVERNMENT OF MODIFYING ITS BUDGET AT THIS STAGE. NAKASONE'S LIKELY VISIT TO WASHINGTON IN MAY PROVIDES A POSSIBLE DEADLINE FOR NEW MEASURES.

5. IN THE BANKING AND BUSINESS COMMUNITY THE VIEW IS BROADLY THAT THE MEETINGS HAVE USEFULLY BOUGHT SOME TIME FOR THE YEN. THERE IS HOWEVER NO UNANIMITY ON WHETHER THE TIME THUS BOUGHT IS A MATTER OF WEEKS, OR OF MONTHS. THE LONGER IT IS, THE EASIER IS WILL BE FOR THE ECONOMY TO MAKE ITS NECESSARY ADJUSTMENTS, AND THE GREATER THE CHANCES THAT THE HOPED-FOR CORRECTION IN THE TRADE IMBALANCE WILL TAKE PLACE. BUSINESSMEN AND OFFICIALS FEAR HOWEVER THAT IN THE ABSENCE OF MEASURES BY THE US GOVERNMENT TO REDUCE ITS DEFICIT, THIS AGREEMENT MAY BE SHORT-LIVED AND THAT THE DOWNWARD PRESSURES ON THE DOLLAR WILL INEVITABLY REASSERT THEMSELVES.

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PRIME MINISTER

G5/G7

The Foreign Secretary's minute below advises you not to send a message to President Reagan about the G5 because he will be so preoccupied with the Tower Commission report, among other things. He recommends instead that our Ambassador should deliver an oral message from you on this together with a reply to the message from Nitze and Perle on SDI.

Charles agrees that it is sensible not to send a message. I suggest you ask that our Ambassador should be instructed to make it clear to all those who will be concerned with this decision that the meetings held over the weekend were fully consistent with the agreement reached with the Canadians and the Italians, and that we are firmly opposed to any changes which would risk expanding the G5 to G7 for all purposes: the G5 has played an important role in international economic affairs and to expand it would risk destroying its value.

Agree? Yes [illegible]

DRN

(DAVID NORGROVE)

25 February 1987

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Prime Minister
CDP
25/2.

PM/87/011

PRIME MINISTER

with DRN.

Meeting of Finance Ministers and Central Bank Governors

1. I have seen Nigel Lawson's minute to you and his recommendations for messages to Reagan and Shultz to resist Italian attempts to get the G5 in effect replaced by the G7. I share Nigel's irritation with Craxi's antics, and his astonishment at Italian threats to call off the Venice Summit. Craxi is almost certainly playing to his domestic audience in a pre-election period. He can rely on the general Italian desire to cut a figure internationally; which is hardly likely to lead the Italians to make good their threat to cancel the Venice Summit. But Italy has many friends in Washington. Craxi may yet get what he wants from Reagan: the effective emasculation of the G5.

2. As Nigel says, our aim must be to resist this. We need to stress to the Americans the G5's proven track record and the value of restricted membership. If we are to succeed, it is essential in my view that the French, Germans and ourselves should speak in Washington with a common voice on G5. We know that Balladur and Stoltenberg are solidly against its dissolution or disappearance. I am not so sure where Kohl and Mitterrand stand. I propose to instruct Sir Julian Bullard to speak to Kohl's office and solicit his support for G5. I am putting this in hand today.

/3.

3. Mitterrand has, however, been equivocal in the past. As in Italy, so in France there are domestic political considerations to bear in mind. The Embassy in Paris have confirmed that Mitterrand will be in Rome today for "private" talks with President Cossiga and with Craxi. I understand that Balladur has advised him to stand firm on the G5. We shall have to see: I have asked our Embassies to report. If Mitterrand declares his support for Craxi, the game is not lost; his Ministers may still persuade him. But it would certainly undermine an approach of our own in Washington. Conversely, if Mitterrand rebuts Craxi, the way is open for us to ask the French to join us in lobbying the Americans.

4. In Washington, both Reagan and Shultz will be distracted this week by the Tower Commission report. Shultz leaves for China on Friday 27 February, and in any case would not, in the Embassy's view, be inclined to involve himself in a matter which he regards as Baker's preserve. That leaves the President; but I do not think you should send a message to him on this issue alone. You may well need to send a reply to the message that Nitze and Perle will convey to you today on SDI. That will give our Ambassador an opening to deliver an oral message from you on G5/7, and I recommend that he do so. At the least, this should make the President cautious in what he says to Craxi, who I expect will be sending further messages to his G7 colleagues about the events of last weekend. On this timetable, we shall almost certainly find ourselves taking action in advance of the French and Germans, but I hope that by the end of the week we shall have some grounds to expect their subsequent support. This lobbying may well leak in Washington back to the Italians; which is a further argument for proceeding in company, or at least for being reasonably confident that others will follow our example.

/5.

5. I hope that my officials will have an opportunity to comment on the text of the message that our Ambassador will deliver on your behalf. The main points are clear enough, but it will need careful presentation.

6. I am copying this minute to Nigel Lawson and to the Governor of the Bank of England.

(GEOFFREY HOWE)

Foreign and Commonwealth Office

25 February 1987

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SECRET

Prime Minister 2

There is much more of substance here than I, certainly, had expected, particularly the quantitative guidance on exchange rate movements.

DRN 23/2

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

MT

PRIME MINISTER

MEETINGS OF FINANCE MINISTERS AND CENTRAL BANK GOVERNORS

There are two aspects of last weekend's meetings in Paris in which you and Geoffrey Howe will be interested: the agreement reached between six of the seven Summit countries, and the Italian demarche.

As to the first, I attach the text of the Communique issued yesterday afternoon. It is, of course, very much along the lines of the draft I showed you last week. Such changes as were agreed are, from our point of view, improvements. Our insistence on not having a meeting unless and until substantive and detailed agreement was virtually in the bag has clearly been vindicated. The only new action is the Japanese ½ per cent interest rate cut (announced on Friday) and the German promise to increase (by an unspecified amount) the size of tax reductions already enacted for 1988. Although not in the Communique, the Japanese Finance Minister, Miyazawa, conceded that the official Japanese growth forecasts for 1987-88 were in his view over-optimistic, and indicated his desire to bring in an "expansionary" supplementary Budget once the main Budget has been passed by the Diet in April or May.

The key paragraph, however, is the last, stating agreement to co-operate to foster stability of exchange rates "around current levels", which is code not only for the Americans ceasing to talk the dollar down but also for readiness to engage in concerted intervention in the foreign exchange markets to achieve this objective. "Current levels" were defined as 1.825 DM to the $ and 153.5 Yen to the $. It was agreed that, depending on market conditions, intervention might be invoked if and when rates diverged by some 2½ per cent on either side, and that a 5 per cent divergence would give grounds for serious concern. No limits of this kind were suggested for the pound, the franc or the Canadian dollar, but I indicated that I would expect sterling to fit into the general climate of stability; and that should we need to intervene we would endeavour to avoid doing so in a way that was contrary to the spirit of the overall agreement.

I should be happy to amplify all this when we next meet. Meanwhile, as far as the UK is concerned, although nothing is without risk, I think we can be well content with an outcome which does not involve us in onerous commitments and which, if successful, could helpfully provide a more stable external background for us in the coming weeks.

In presenting this agreement, I have stressed the following points:

- all the Finance Ministers have agreed that a period of stability is desirable;
- the nature of this agreement is the same as that we reached 18 months ago at the Plaza Hotel in New York;
- we believe that, as then, we are going with the grain of the market;
- the agreement applies to all currencies, though the principal focus - as with Plaza - is the dollar, and the key dollar rates are the $/DM and $/Yen;
- so far as the UK is concerned, I have said many times that I do not want to see sterling fall further; by the same token, I have no desire in current circumstances to see a <u>substantial</u> rise.

I turn now briefly to the Italian problem. Their complaint was about the fact that the G5 met prior to the G7, who would then simply have been asked to rubber-stamp the deal. We had sought to shelter them by keeping the G5 meeting informal, with no press contact, and mingled with several bilateral consultations, including with Italy and Canada. The Canadians accepted this throughout, in spite of Italian attempts to persuade them otherwise.

The eventual decision by Italy not to participate came as a surprise to everyone - and the high drama of the threat to cancel the Venice Summit caused even more astonishment. Craxi's motives, however, are clear. Having succeeded on getting the G7 formally off the ground at the Tokyo Summit, he is now set on getting the G5 abolished. All G5 members are opposed to that - and we and the French have particular reason to fear it. But Jim Baker is fearful that President Reagan will succumb, given the threats Craxi is prepared to make: you will recall that this was precisely how the Italians secured American backing for the G7 in the first place.

I believe it essential that Geoffrey Howe takes an early opportunity of enlisting Schultz's support, and I should be grateful if you would consider conveying a personal message to Reagan. I would at least like to avoid having our position pre-empted, as happened before. Again, I should be happy to discuss this with you more fully when we next meet - though, having discussed this with Baker, I fear time may be short.

I am copying this to Geoffrey Howe and to the Governor of the Bank of England.

NL.

N.L.

RCD 23/2/87.

*This should have been attached to the Chancellor of the Exchequer's letter of 23/2/87 to the Prime Minister.

FINAL

STATEMENT

1. Ministers of Finance and Central Bank Governors of six major industrialized countries met today in Paris to conduct multilateral surveillance of their economies in the framework of the Tokyo Economic Declaration of May 6, 1986 pursuant to which the group of seven Finance Ministers was formed. The Ministers and Governors, using a range of economic indicators, reviewed current economic developments and prospects. The Managing Director of the IMF participated in the discussions.

2. The Ministers and Governors were of the view that further progress had been made since the Tokyo Summit in their efforts to achieve a sustainable, non-inflationary expansion. Their national economies are now in the fifth year of expansion, and the prospects are for continued growth this year, although the level of unemployment remains unacceptably high in some countries. A high degree of price stability has been attained, and there have been substantial reductions in interest rates. Exchange rate adjustments have occurred which will contribute importantly in the period ahead to the restoration of a more sustainable pattern of current accounts.

3. Progress is being made in reducing budget deficits in deficit countries, and fundamental tax reforms are being introduced to improve incentives, increase the efficiency of economies, and enhance the prospects of higher growth. Other important structural reforms are also being carried forward, including deregulation of business to increase efficiency and privatization of government enterprises to strengthen reliance on private entrepreneurs and market forces.

4. These positive developments notwithstanding, the Ministers and Governors recognize that the large trade and current account imbalances of some countries pose serious economic and political risks. They agreed that the reduction of the large unsustainable trade imbalances is a matter of high priority, and that the achievement of more balanced global growth should play a central role in bringing about such a reduction.

5. The Ministers and Governors reaffirmed their concern over continuing pressures for protectionism. They agreed that efforts to deal with economic problems by erecting trade barriers were self-defeating and pledged to intensify their efforts to resist protectionism and reaffirmed their strong support for the new round of trade negotiations. They welcomed the progress made in the preparatory work for the new GATT round and the recent positive conclusions of discussions between the United States and the European Community on bilateral trade issues.

6. The Ministers and Governors recognized that the major industrial countries have a special responsibility to follow policies which foster an open, growing world economy in order to support the efforts of developing countries, especially debtor countries, to restore steady growth and viable balance of payments positions. They noted that the progress achieved by many debtor countries toward these ends have not solved all the problems and stressed the importance of all participants in the strengthened debt strategy reinforcing their cooperative efforts.

7. The Ministers and Governors agreed to intensify their economic policy coordination efforts in order to promote more balanced global growth and to reduce existing imbalances. Surplus countries committed themselves to follow policies designed to strengthen domestic demand and to reduce their external surpluses while maintaining price stability. Deficit countries committed themselves to follow policies designed to encourage steady, low-inflation growth while reducing their domestic imbalances and external deficits. To this end, each country has agreed to the following undertakings.

The Government of Canada's policy is designed to sustain the current economic expansion through its fifth year and beyond. In the budget for 1987/88, the Government has cut the fiscal deficit for the third consecutive year and remains committed to further progressive reduction. Canada will propose shortly an extensive reform of its tax system. It will continue with its policies of regulatory reform, privatization and liberalization of domestic markets. It will vigorously pursue trade liberalization bilaterally with the United States and multilaterally within the Uruguay round. Monetary policies will continue to aim at the reduction of inflation and be consistent with orderly exchange markets.

The Government of France will reduce the central government budget deficit by 1 percent of GNP from 1986 to 1988 and in the same period will implement a tax cut program of the same order of magnitude (1 percent of GNP) with substantial tax rate cuts for corporations and individuals. It will pursue in 1987 its privatization program (with a projected $6 to $7 billions sale of assets) and reinforce the liberalization of the French economy, especially of labor and financial markets.

The Government of the Federal Republic of Germany will pursue policies to diminish further the share of public expenditures in the economy and to reduce the tax burden for individuals and corporations with a comprehensive tax reform aimed at reinforcing the incentives for private sector activity and investment. In addition, the Government will propose to increase the size of the tax reductions already enacted for 1988. The Federal Government will emphasize policies that enhance market forces in order to foster structural adjustment and innovation. Short-term interest rates, although already at a very low level in international comparison, have further dropped substantially during the last few weeks. Monetary policy will be directed at improving the conditions for sustained economic growth while maintaining price stability.

The Government of Japan will follow monetary and fiscal policies which will help to expand domestic demand and thereby contribute to reducing the external surplus. The comprehensive tax reform, now before the Diet, will give additional stimulus to the vitality of the Japanese economy. Every effort will be made to get the 1987 budget approved by the Diet so that its early implementation be ensured. A comprehensive economic program will be prepared after the approval of the 1987 budget by the Diet, so as to stimulate domestic demand, with the prevailing economic situation duly taken into account. The Bank of Japan announced that it will reduce its discount rate by one half percent on February 23.

The United Kingdom Government will maintain conditions for continuing the steady growth of GDP of the past five years and will continue to work to reduce inflation by following a prudent monetary policy. On external account the aim will be broad balance over the medium term. The share of public expenditure in the economy will continue to fall and the burden of taxation will be reduced, while public sector borrowing is maintained at low level. These and other measures to strengthen the supply performance of the economy, such as the privatization programme, will reinforce improvement over recent years in the growth of productivity.

The United States Government will pursue policies with a view to reducing the fiscal 1988 deficit to 2.3 % of GNP from its estimated level of 3.9 % in fiscal 1987. For this purpose, the growth in government expenditures will be held to less than 1 percent in fiscal 1988 as part of the continuing program to reduce the share of government in GNP from its current level of 23 percent. The United States will introduce a wide range of policies to improve its competitiveness and to enhance the strength and flexibility of its economy. Monetary policy will be consistent with economic expansion at a sustainable non-inflationary pace.

8. The Ministers and Governors noted that a number of newly industrialized economies were playing an increasingly important role in world trade. These economies have achieved strong growth based significantly on their access to open, growing export markets. Recently, some have accumulated trade surpluses which have contributed importantly to the present unsustainable pattern of global imbalances, thus increasing protectionist pressures. The Ministers and Governors considered that it is important that the newly industrialized developing economies should assume greater responsibility for preserving an open world trading system by reducing trade barriers and pursuing policies that allow their currencies to reflect more fully underlying economic fundamentals.

9. The Ministers and Governors also agreed to additional refinements in the use of economic indicators for the multilateral surveillance arrangements approved in the Tokyo Economic Declaration. As part of these refinements, they will :

- periodically review medium-term economic objectives and projections involving domestic and external variables. The medium-term objectives and projections are to be mutually consistent and will serve as a basis for assessing national policies and performance ;

- regularly examine, using performance indicators, whether current economic developments and trends are consistent with the medium-term objectives and projections and consider the need for remedial action.

Initially, the objectives and projections will involve the following key variables : growth, inflation, current accounts/trade balances, budget performance, monetary conditions and exchange rates.

10. The Ministers and Governors agreed that the substantial exchange rate changes since the Plaza Agreement will increasingly contribute to reducing external imbalances and have now brought their currencies within ranges broadly consistent with underlying economic fundamentals, given the policy commitments summarized in this statement. Further substantial exchange rate shifts among their currencies could damage growth and adjustment prospects in their countries. In current circumstances, therefore, they agreed to cooperate closely to foster stability of exchange rates around current levels.

Paris, February 22, 1987

GRS 420

CONFIDENTIAL

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FM ROME

TO IMMEDIATE FCO

TELNO 143

OF 241220Z FEBRUARY 87

INFO ROUTINE BONN, OTTAWA, PARIS, TOKYO, WASHINGTON

INFO SAVING UKDEL OECD

MS

G5/G7

SUMMARY

1. VENICE ECONOMIC SUMMIT EXPECTED TO TAKE PLACE. ITALY FAVOURS A NEW PROCEDURE TO PREVENT FURTHER MISUNDERSTANDINGS.

DETAIL

2. WHEN I CALLED ON THE SECRETARY-GENERAL MFA, I ASKED HOW HE SAW MATTERS AFTER THE G6 PARIS MEETING. RUGGIERO REPLIED THAT IT WAS ESSENTIAL TO ARRIVE AT A NEW PROCEDURE WHICH WOULD CLEAR UP THE AMBIGUITIES IN THE AGREEMENT REACHED AT THE TOKYO ECONOMIC SUMMIT. THIS SHOULD BE DONE BEFORE THE VENICE MEETING, WHICH HE WAS CONFIDENT WOULD TAKE PLACE. HE RECOGNISED THAT IT WOULD NOT BE EASY TO DEFINE FRESH PROCEDURES, PERHAPS PARTICULARLY FOR THE FRENCH AND THE AMERICANS WHO SUFFERED FROM INTERNAL DIFFERENCES. BUT TRICKY AS SUCH DISCUSSIONS WOULD BE, WE HAD TO AVOID OPEN DISAGREEMENT IN THE FUTURE. SHERPAS WERE THOSE BEST EQUIPPED TO HANDLE THIS SITUATION FOR GOVERNMENTS, AND HE SEEMED TO BE THINKING OF A SEPARATE MEETING TO PUT SUCH AN AGREEMENT IN PLACE BEFORE THE FINANCE MINISTERS MET IN APRIL. BUT IT WOULD NOT BE EASY, AND THE RESPONSIBILITY OF FINANCE MINISTERS WOULD HAVE TO BE RESPECTED.

?

3. ON THE EVENTS OF THE WEEKEND, RUGGIERO DID NOT COMMENT MUCH. BUT HE DID BELIEVE THAT THE POSITION OF THE ITALIAN GOVERNMENT WAS SUPPORTED BY ALL THE MINISTERS CHIEFLY RESPONSIBLE, AND THAT IT WAS WRONG TO SUGGEST (AS SOME HAVE BEENDOING) THAT INTERNAL POLITICAL DIFFERENCES IN ITALY HAD PLAYED ANY SIGNIFICANT ROLE. WHAT HAD OCCURRED CERTAINLY PRODUCED POLITICAL EFFECTS WITHIN ITALY (HERE HE PRESUMABLY MEANT THE RELATIONSHIP BETWEEN THE VENICE SUMMIT AND THE STAFFETTA: WHO WOULD BE PRIME MINISTER AT THE TIME). HE WAS STRONGLY CRITICAL OF THE FRENCH, IN HAVING ISSUED AN OFFICIAL STATEMENT THAT THERE HAD BEEN NO MEETING OF THE G5 , WHEN THIS WAS KNOWN TO BE THE CASE. HE WAS TODAY CONSIDERING WHAT ADVICE HE SHOULD OFFER TO CRAXI AND ANDREOTTI ABOUT THE LINE TO TAKE WITH MITTERRAND TOMORROW. IT SOUNDED AS IF THERE WOULD BE AN ACCUSATORY PART, FOLLOWED BY A SUGGESTION THAT SHERPAS SHOULD BE ENTRUSTED WITH DRAWING UP AN AGREEMENT ON NEW PROCEDURES.

COMMENT

CONFIDENTIAL

14.

CONFIDENTIAL

4. THERE IS, IN FACT, RATHER MORE DISAGREEMENT BETWEEN ITALIAN MINISTERS ON THIS QUESTION THAN RUGGIERO ADMITS. THE COURSE OF EVENTS ON FRIDAY (MY TELNO 133) CLEARLY INDICATES THAT GORIA WAS RELUCTANT TO ABSENT HIMSELF FROM THE MEETING. SUBSEQUENT COMMENTS BY THE PRIME MINISTER'S OFFICE HAVE BEEN NOTABLY TOUGHER THAN THOSE MADE BY ANDREOTTI, WHOM THE PRESS REPORT AS SPEAKING OF THE VALUE OF THE ECONOMIC SUMMITS AND THE NECESSITY TO CONTINUE WITH THIS SERIES OF MEETINGS.

BRIDGES

YYYY
FCO PASS SAVING TO UKDEL OECD

RFHPAN 5307

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SIR G. LITTLER } HM
MR EVANS } TREASURY.

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2

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ps8/62A

010

SECRET

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

19 February 1987

David Norgrove Esq
10 Downing Street
LONDON SW1

Dear David

I attach the latest draft of the communique for the G5/G7 meetings this weekend. With the manuscript amendments marked - and new, stronger statements from Germany and Japan - the text is now virtually agreed.

Yours
Alex

A C S ALLAN

DRAFT STATEMENT

1. Ministers of Finance and Central Bank Governors of seven major industrialized countries met today in Paris to conduct multilateral surveillance of their economies pursuant to the Tokyo Economic Declaration of their Heads of State or Government of May 6, 1986. The Ministers and Governors, using a range of economic indicators, reviewed current economic developments and prospects. The Managing Director of the IMF participated in the discussions.

2. The Ministers and Governors were of the view that further progress had been made since the Tokyo Summit in their efforts to achieve a sustainable, non-inflationary expansion. Our economies are now in the fifth year of expansion, and the prospects are for continued growth this year, although the level of unemployment remains unacceptably high in some countries. A high degree of price stability has been attained, and there have been susbstantial reductions in interest rates. Exchange rate adjustments have occurred which will contribute importantly in the period ahead to the restoration of a more sustainable pattern of current accounts.

3. Progress is being made in reducing budget deficits in deficit countries, and fundamental tax reforms are being introduced to improve incentives, increase the efficiency of our economies, and enhance the prospects of higher growth. Other important structural reforms are also being made in our economies, including deregulation of business to increase efficiency and privatization of government enterprises to strengthen reliance on private entrepreneurs and market forces.

4. These positive developments notwithstanding, the Ministers and Governors recognize that the large trade and current account imbalances of some countries pose serious economic and political risks. They agreed that the reduction of the large unsustainable trade imbalances is a matter of high priority, and that the achievement of more balanced global growth should play a central role in bringing about such a reduction.

5. The Ministers and Governors reaffirmed their concern over continuing pressures for protectionism. They agreed that efforts to deal with economic problems by erecting trade barriers were self-defeating, and pledged to intensify their efforts to resist protectionism and reaffirmed their strong support for the new round of trade negociations. They welcomed the progress made in the preparatory work for the new GATT round and the recent positive conclusions of discussions between the US and the EC on bilateral trade issues.

6. The Ministers and Governors recognized that the major industrial countries have a special responsibility to follow policies which foster an open, growing world economy in order to support the efforts of debtor countries to restore steady growth and viable balance of payments positions. They noted the progress that had been achieved by many debtor countries toward these ends, but stressed the importance of all participants in the strengthened debt strategy reinforcing their cooperative efforts to resolve international debt problems.

7. The Ministers and Governors agreed to intensify their economic policy coordination efforts in order to promote more balanced global growth and to reduce existing imbalances. Surplus countries committed themselves to follow policies designed to strenghten domestic demand and to reduce their external surpluses while maintaining price stability. Deficit countries committed themselves to follow policies designed to encourage steady, low inflation growth while reducing their domestic imbalances and external deficits. To this end, each country has agreed to the following undertakings.

- The <u>French</u> Government will reduce the Central Government budget deficit by 1[illegible] of GNP from 1986 to 1988 and in the same period will implement a tax cut program of the [illegible]e order of magnitude (1 % of GNP) with substantial tax rate cuts for corporations and individuals. It will pursue in 1987 its ambitious privatisation program (with a projected $ 6 to 7 billions sale of assets) and reinforce the liberalisation of the French economy, especially of labor and financial markets.

?

- The Government of the Federal Republic of <u>Germany</u> will pursue policies to diminish further the share of public expenditures in the economy and to reduce the tax burden for individuals and corporations with a comprehensive tax reform aimed at reinforcing the incentives for private sector activity and investment. This will be in addition to the substantial tax reductions already enacted for 1988. The Federal Government will emphasize policies that enhance market forces in order to foster structural adjustment and innovation. Monetary policy will be directed at improving the conditions for sustained economic growth while maintaining price stability.

? to be made stronger

- The Government of <u>Japan</u> will follow monetary and fiscal policies which will help to expand domestic demand and thereby contribute to reducing the external surplus. The comprehensive tax reform, now before the Diet, will give additional stimulus to the vitality of the Japanese economy. Every effort~~s~~ will be made to get the 1987 budget approved by the Diet so that its early implementation can be ensured.

The Bank of Japan has announced that it will reduce its discount rate by % on (date...)

- ~~<u>The UK</u> Government will continue to work to reduce inflation further by following a prudent monetary policy ; to reduce the share of public expenditure in the economy thus enabling lower taxes to be combined with a declining path for the budget deficit as a percentage of GDP ; to strengthen the supply performance of the economy and maintain the improvement in the growth of productivity ; to promote in the future the steady growth of output and GDP achieved over the past five years ; and will seek to maintain broad balance on external account over the medium term.~~

see revised version attached

- The <u>United States</u> Government will pursue policies to reduce the budget deficit with a view to achieving a $65 billion reduction in fiscal 1988, to 2.3 percent of GNP. For this purpose, the growth in Government expenditures will be held to less than 1 percent in fiscal 1988. As part of the continuing program to reduce the share of Government in GNP from its current level of 23 percent the United States will introduce a wide range of policies to improve its competitiveness and to enhance the strength and flexibility of its economy. Monetary policy will be directed toward permitting the economy to expand at a sustainable non-inflationary pace.

?

8. The Ministers and Governors also agreed to additional refinements in the use of economic indicators for the multilateral surveillance arrangements approved by their head of State of Government in the Tokyo Economic Declaration. As part of these refinements, they will :

- Periodically review ~~<discuss/seek a common understanding on/develop~~> medium term economic objectives and projections involving domestic and external variables. The medium term objectives are to be mutually consistent and will serve as a basis for assessing national policies and performance.

- Regularly examine ,using performance indicators, whether current economic developments and trends are consistent with the medium term objectives and projections and consider the need for remedial action.

~~For 1987~~ Initially, the objectives and projections will involve the following key variables : growth, inflation, current accounts/trade balances, monetary conditions budget performance, <~~interest rates and~~ and exchange rates.>

? insert "and projections"

Move to after para 6

9. The Ministers and Governors noted that a number of newly industrialized countries were playing an increasingly important role in the world economy. These countries have achieved strong economic growth based significantly on their access to open, growing export markets. Recently, some have accumulated trade surpluses which have contributed importantly to the present unsustainable pattern of global imbalances, thus increasing protectionist pressures. The Ministers and Governors considered that it is important that the newly industrialized developing countries should assume greater responsibility for preserving an open world trading system by reducing trade barriers and pursuing policies that allow their currencies to reflect more fully underlying economic fundamentals.

10. The Ministers and Governors agreed that the substantial exchange rate changes since the Plaza Agreement will increasingly contribute to reducing external imbalances, and have now brought their currencies within ranges broadly consistent with underlying economic fundamentals, given the policy commitments summarized in this statement. Further <substantial/excessive> exchange rate shifts among their currencies <could/would> damage growth and adjustment prospects in their countries. In current circumstances, therefore, they agreed to cooperate closely to foster stability of exchange rates <within recent ranges/~~around recent levels~~>

either

REVISED PARAGRAPH ON UNITED KINGDOM

The United Kingdom Government will maintain conditions for continuing the steady growth of GDP of the past five years and will continue to work to reduce inflation by following a prudent monetary policy. On external account the aim will be broad balance over the medium term. The share of public expenditure in the economy will continue to fall and [tax reform will be carried further and] the total burden of taxation reduced, while public sector borrowing is maintained at a low level. These and other measures to strengthen the supply performance of the economy will reinforce improvements over recent years in the growth of productivity.

(ORIGINAL)

T 11/87 refers.

208-H.8

Italian Embassy
14, Three Kings Yard,
London, W.1.

CDP 12/2.

10th February, 1987

Dear Charles,

Following the Ambassador's letter of 29th January, 1987 n. 734, containing the text of a message addressed to the Prime Minister, the Rt. Hon. Margaret Thatcher, MP, by the President of the Council of Minister, Onorevole Bettino Craxi, I take pleasure in forwarding to you the original of the message.

Sincerely Yours

Enrico Augelli

Enrico Augelli
First Counsellor (Economic)

encl.

Charles Powell, Esq.
Private Secretary to the Prime Minister
(Overseas Affairs)
10, Downing Street
L O N D O N SW1

Il Presidente
del Consiglio dei Ministri

Roma, 3 febbraio 1987

Signora Primo Ministro,

la preoccupazione con cui l'Italia segue gli sviluppi nei mercati valutari e l'esigenza di una più stretta vigilanza sono state anche recentemente ricordate in una lettera che il Ministro del Tesoro italiano, Giovanni Goria, ha indirizzato ai suoi colleghi dei Paesi Maggiormente Industrializzati, nello spirito delle intese di Tokyo. Nelle successive settimane, i rapporti fra le maggiori monete hanno continuato ad essere sottoposti a tensioni e il sistema monetario nel suo complesso resta caratterizzato da una prevalente instabilità.

La riunione riservata in programma a Roma il 4 febbraio prossimo, a livello di deputies, costituisce certamente un'occasione molto utile per la ricerca di più ampie convergenze nell'analisi dell'attuale situa-

./.

S.E. Margaret THATCHER
Primo Ministro
del Regno Unito di Gran Bretagna
e Irlanda del Nord

L O N D R A

zione ed, auspicabilmente, nell'adozione delle misure più appropriate per il ristabilimento di condizioni di maggiore normalità nei mercati valutari.

Non possiamo tuttavia escludere che l'ampiezza dei problemi da risolvere renda necessaria anche una riunione a livello ministeriale. In questa ipotesi - non certo remota - penso che ricorrano tutti i presupposti perchè la riunione sia indetta tra i Ministri del Tesoro e delle Finanze dei "Sette", così come stabilisce la dichiarazione economica di Tokyo.

Non vi è infatti dubbio che l'oggetto prioritario dell'eventuale riunione da convocare riguardi il miglioramento del sistema monetario internazionale e le connesse misure di politica economica.

Mi pare peraltro evidente che un diverso formato contraddirrebbe in maniera stridente lo spirito e la lettera delle nostre intese a Tokyo.

Certo della seria considerazione che Ella vorrà riservare a questa mia lettera, Le invio i miei migliori saluti.

file

BM(76)

SUBJECT cc MASTER OPS

cc FCO PC

10 DOWNING STREET

THE PRIME MINISTER

3 February 1987

PRIME MINISTER'S PERSONAL MESSAGE SERIAL No. T13/87.

Dear Prime Minister,

Thank you for your message which was conveyed to me on 29 January by your Ambassador.

I can assure you that the United Kingdom fully recognises your concern and will continue to honour the agreements reached during our Tokyo Summit meeting last year.

As to whether a meeting among Finance Ministers would be practicable and useful at the present time, there will be a good opportunity for discussion later this week at the meeting of officials, which you mention, in Rome on 4 February.

I look forward to seeing you in London next week.

Yours sincerely

Margaret Thatcher

His Excellency Onorevole Bettino Craxi

BM

MR 10/72

COPC

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

Charles Powell Esq
No.10 Downing Street
LONDON SW1

3 February 1987

Dear Charles

MESSAGE FROM SIGNOR CRAXI

... I attach a draft of a short reply for the Prime Minister to consider sending to Signor Craxi's message.

As background, the Prime Minister is aware that there have been G5 contacts recently - led by US, Germany and Japan - with a view to setting up a Ministerial Meeting on 8 February which would (in accordance with the Tokyo agreements) have been of the G7. Matters had reached the point at which the French Finance Minister, who was to be host because Paris was a convenient venue, telexed colleagues, including those of Italy and Canada, to give provisional warning. This proved premature: the Japanese Minister is unable to escape from Tokyo for 8 February, and we now think it unlikely that an early fresh date will be sought. The meeting of officials in Rome on 4 February which Craxi mentions will be an opportunity for all concerned to be brought up to date.

You may incidentally have noticed from Bridges' telegram 65 of 29 January that the Italian Finance Minister had already told Craxi that his message was not necessary!

I am copying this to Lyn Parker (FCO).

Yours ever,

Tony Kuczys

A W KUCZYS
Private Secretary

MR 10/73

BM(76)

DRAFT MESSAGE TO SIGNOR CRAXI

Thank you for your message which was conveyed to me on 29 January by your Ambassador.

I can assure you that the United Kingdom fully recognises your concern and will continue to honour the agreements reached during our Tokyo Summit meeting last year.

As to whether a meeting among Finance Ministers would be practicable and useful at the present time, there will be a good opportunity for discussion later this week at the meeting of officials, which you mention, in Rome on 4 February.

I look forward to seeing you in ~~London~~ London next week.

CDP

3/2.

Econ Pol

Exchange Rate

PT 3

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

Ack 29 January 1987

I enclose a copy of a letter to the Prime Minister from Signor Craxi proposing a meeting of G-7 Finance Ministers to discuss developments in the currency markets. I should be grateful for a draft reply.

I am copying this letter and enclosure to Lyn Parker (Foreign and Commonwealth Office).

Charles Powell

Alex Allen, Esq.,
H.M. Treasury.

DAS.

The Italian Ambassador

Italian Embassy
4, Grosvenor Square
London, W.1.

29th January, 1987

734

My dear Charles,

I take pleasure in forwarding to you, a message addressed to the Prime Minister, The Rt. Hon. Margaret Thatcher, MP., by the President of the Council of Ministers, Onorevole Bettino Craxi, together with a rough translation.

I should be most grateful, therefore, if you could kindly pass on the enclosed message to the Prime Minister.

Sincerely yours

Bruno

Bruno Bottai

Charles Powell, Esq.,
Private Secretary to the Prime Minister
(Overseas Affairs)
10 Downing Street
LONDON SW1

T message

TEXT OF MESSAGE

"Signora Primo Ministro,

La preoccupazione con cui l'Italia segue gli sviluppi nei mercati valutari e l'esigenza di una più stretta vigilanza sono state anche recentemente ricordate in una lettera che il Ministro del Tesoro italiano, Giovanni Goria, ha indirizzato ai suoi colleghi dei Paesi maggiormente industrializzati, nello spirito delle intese di Tokio. Nelle successive settimane, i rapporti fra le maggiori monete hanno continuato ad essere sottoposti a tensioni e il sistema monetario nel suo complesso resta caratterizzato da una prevalente instabilità.

La riunione riservata in programma a Roma il 4 febbraio prossimo, a livello di Deputies, costituisce certamente un'occasione molto utile per la ricerca di più ampie convergenze nell'analisi dell'attuale situazione ed, auspicabilmente, nell'adozione delle misure più appropriate per il ristabilamento di condizioni di maggiore normalità nei mercati valutari. Non possiamo tuttavia escludere che l'ampiezza dei problemi da risolvere renda necessaria anche una riunione a livello ministeriale. In questa ipotesi - non certo remota - penso che ricorrano tutti i presupposti perchè la riunione sia indetta tra i Ministri del Tesoro e delle Finanze dei 'Sette', così come stabilisce la dichiarazione economica di Tokio. Non vi è infatti dubbio che l'oggetto prioritario dell'eventuale riunione da convocare riguardi il miglioramento del sistema monetario internazionale e le connesse misure di politica economica.

Mi pare peraltro evidente che un diverso formato contraddirrebbe in maniera stridente lo spirito e la lettera delle nostre intese a Tokio.

Certo della seria considerazione che Ella vorrà riservare a questa mia lettera, Le invio i miei migliori saluti.

Bettino Craxi."

PRIME MINISTER'S PERSONAL MESSAGE SERIAL No. T11/87

CC MASTER
OPS.
SUBJECT: ECON POL, Ex. Rate pt3

ROUGH TRANSLATION

"Dear Prime Minister,

The anxiety with which Italy is following developments in the currency markets and the need for a much stricter and more attentive observation of these were recently recalled by the Italian Minister for the Treasury, Signor Giovanni Goria, in a letter which he wrote to his Colleagues in the major industrialised countries, in the spirit of the Tokyo agreements. In the weeks which followed, the relations between the major currencies continued to be subjected to great pressure and the monetary system as a whole remains characterized by a prevailing instability.

The confidential meeting scheduled to take place in Rome on the 4th February, next, at the level of Deputies, certainly provides a most useful opportunity in the search for wider convergences in the analysis of the present situation and, hopefully, in the adoption of the more appropriate measures for the return of more stable conditions in currency markets. We cannot, however, dismiss the fact that the extensive range of the problems to be dealt with may also necessitate a meeting at Ministerial level. In this hypothesis - certainly not a remote one - I think that the premises exist for a meeting to be held between Treasury and Finance Ministers of the "Seven", as established by the Tokyo Economic Declaration. There is in fact no doubt that the subject which would have priority in an eventual meeting concerns the improvement of the international monetary system and the related measures of economic policy.

It seems therefore obvious that a different format would be in blatant contradiction to the spirit and the letter of our agreements in Tokyo.

Certain of the careful consideration which you will give to my letter, please accept my very best wishes.

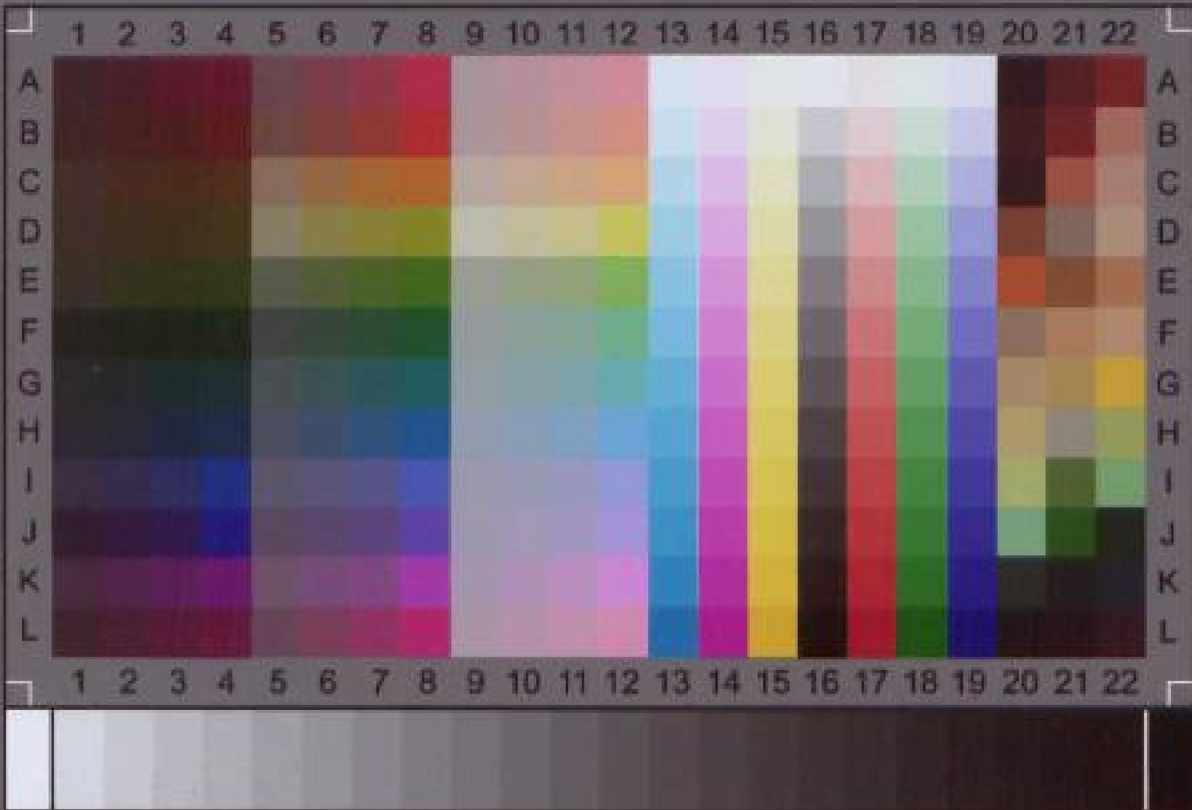
Bettino Craxi."

PART 2 ends:-

PS/Tsy to PS/DTI 11.12.86

PART 3 begins:-

PM Craxi to PM (T11/87) 29.1.87.



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