Part. B.

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B

...ellor's (Howe) Papers:

...D ECONOMIC TRENDS
...THE 1983 BUDGET

Disposal Directions: 25 Years

23/9/82.

RECORD OF A DISCUSSION BETWEEN SECRETARY SHULTZ AND THE CHANCELLOR OF THE EXCHEQUER AT 5.30 P.M. ON 20TH SEPTEMBER, 1982 IN THE STATE DEPARTMENT, WASHINGTON

Present:-

Chancellor of the Exchequer	Mr. George Shultz (Secretary of State)
Sir Oliver Wright	Mr. Allen Wallis (Under Secretary for Economic Affairs)
Mr. D.M.D. Thomas	Mr. Robert Morris (Deputy Assistant Secretary for Economic Affairs)
Mr. J.O. Kerr	Mr. Thomas Niles (Deputy Assistant Secretary for European Affairs)

US AND UK ECONOMIES

Mr. Shultz invited the Chancellor to continue their discussion at Chequers in May by up-dating him on current developments in the UK economy.

2. The Chancellor described recent favourable developments. The inflation rate was dropping fast, indeed faster than predicted; the current estimate was that it would fall to 6½ per cent by the end of the year. Interest rates were down 5½ per cent from their peak a year ago. The 1982/83 PSBR was on track to meet the FSBR forecast of 3½ per cent of GDP. But recovery was still proving elusive. The recession had bottomed last summer, but growth in output since then had been only patchy.

3. The Chancellor added that one obvious restraint on recovery was the continuing high level of real world interest rates. The markets clearly remained concerned at the scale, and upward trend, of the US deficit. If they could be convinced that the Administration were in fact determined to put in place sufficient fiscal action, or expenditure cuts, to bring the deficit back to a declining path, the benefits that would be felt in reduced interest rates would be welcome not only in the US but throughout OECD, and perhaps particularly in

the developing world. The tax increases in the 1981 UK Budget, by demonstrating a commitment to hold borrowing down, had brought our interest rates for much of last year to well below the world level, and indeed a full four percentage points below the US level in spring 1981. But the world level remained too high, and US action to bring it down was an urgent requirement.

4. Mr. Shultz argued that there was no necessary direct causal connection between the size of the US deficit and the level of US interest rates. Interest rates had fallen steeply in August. Moreover a high proportion, perhaps as much as $100 billion, of the current deficit represented only the costs, on both sides of the account, of unemployment that had risen from 6 per cent to 10 per cent. There was a counter-cyclical argument for not pressing too hard for reductions in the deficit. The Chancellor argued in reply that what mattered was the view taken by the markets. The August fall in US interest rates had perhaps reflected hope that, with the Tax Bill, the Administration were now more concerned to hold down borrowing. Mr. Shultz agreed that it was essential to create and foster confidence that the deficit would fall. A point worth stressing was that the rate of increase in expenditure as a proportion of GDP was now declining.

Siberian Pipeline

5. Mr. Shultz then raised the issue of the pipeline. He found it wholly unsatisfactory that the Alliance had so far been unable to agree on a common analysis of East/West trade issues, and a common set of ground-rules to be applied across the board. It was intellectually unsatisfactory that the Europeans seemed to be suggesting that they might take a harder line in COCOM if the US were to take a softer line on the pipeline. The ground rules to be applied on each issue should be based on a common perception of the strategic interests involved. Obvious elements in the ground-rules should be that there should be no subsidies to the Soviet Union, and no transfer of key technology, including certain oil and gas technology. A detailed process of analysis - not a horse-trade -

was required, and the sooner it started, the better. Mr. Shultz added that he fully recognised that the Foreign Secretary accepted the case for early and substantive talks: in making that case to the Chancellor he was perhaps "preaching to the choir". But it was an important sermon.

6. The Chancellor said that he entirely agreed that substantive discussions were urgently required. The Foreign Secretary was indeed working to ensure that they took place among the Five, and first reports of the discussion in today's Foreign Affairs Council were encouraging. The UK's, and the Prime Minister's own personal, attitude to the Soviet Union was very much in line with that of the US Administration: our performance against the NATO 3 per cent target was second to none, and the burden of our defence expenditure as a proportion of GDP was second only to that of the United States. The search for an agreed analysis on East/West trade issues must however take full account of existing trade relationships, including of course sales of grain. The present rupture within the Alliance was acutely damaging: it could and should have been avoided, and must be repaired forthwith.

7. Sir Oliver Wright added that the problem of the pipeline was perhaps symptomatic of a wider NATO problem. Since the late 60s, the Alliance had consciously pursued a policy of simultaneously seeking both more assured deterrence, and detente. But some allies had become more emotionally and/or materially attached to the pursuit of detente than the strengthening of defence and deterrence. A collective reassessment was overdue.

8. Mr. Shultz said that he was very pleased by what had been said. He looked forward to seeing the Foreign Secretary in New York, and was grateful for his efforts to set up a meeting there on the pipeline. It was however essential that participants should not come looking for some cosmetic solution, some face-saving way of getting people off the hook. The requirement was to make real progress towards an agreed analysis.

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9. The meeting ended at 6.00 p.m.

J.O. KERR
23 September 1982

Distribution:-

PS/Chief Secretary
PS/Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens (o.r.)
Mr. Burns
Sir Anthony Rawlinson
Mr. Littler
Mr. Carey
Mrs. Hedley-Miller
Mr. Lavelle
Mr. Kemp
Mr. Bottrill
Mr. Hawtin
Mr. Ridley

Mr. Scholar (No.10)
PS/Secretary of State : FCO
PS/Secretary of State : DOT
Mr. Goodall : Cabinet Office

Sir Oliver Wright : Washington

Sir John Graham : UKdel NATO

Mr. Uffen : UKdel OECD

24/9/82

RECORD OF A DISCUSSION BETWEEN THE CHANCELLOR AND SECRETARY REGAN AT 9 A.M. ON 20 SEPTEMBER 1982 IN THE US TREASURY, WASHINGTON.

Present:-

Chancellor	Secretary Regan
Sir Oliver Wright	Mr. MacNamar
Mr. Burns	Mr. Leland
Mr. Anson	Mr. Harlow
Mr. Kerr	

US and UK economies

Mr. Regan said that the third quarter figures would show US GNP flat. The savings rate had risen, and consumer spending fallen. But the outlook for the fourth quarter was very much better, with the likelihood of a considerable pick-up in consumer sales. From then on growth should be steady, though slow. Inflation had been successfully curbed: in this quarter the inflation rate, on an annualised basis, would be below 4 per cent.

2. The Chancellor described the UK performance on inflation. After two months of no increases, the annual rate was now down to 8 per cent, and likely to be much lower by the turn of the year. Yet recovery remained painfully slow and patchy. It was important to get interest rates down further.

3. Mr. Regan said that high interest rates in the US undoubtedly constituted a brake on renewed activity, particularly by the construction industry. If the prime rate could be got below 12 per cent, the picture would change dramatically. Mr. Burns suggested that a prime rate of around 12 per cent would still entail very high real interest rates, given the good inflation prospect. Mr. Regan however argued that the prime rate was "the wrong ball to watch". Fed figures in May had shown that 80 per cent of loans at

the 48 largest banks were being made at below the prime rate. The effective cost of borrowing in the commercial paper market was probably now around 11/11½ per cent, and this was the rate of most relevance to major firms. The prime rate was that paid by the small businessman. Mr. Burns thought that even so real interest rates looked high. Mr. Regan, concurring, thought that borrowers were paying a premium of 2 or three percentage points on interest rates as a result of the unusual degree of volatility in the money markets which had emerged only since the mid 70s.

4. The Chancellor wondered whether there might be a parallel between the current US experience and that of the UK in 1980/81, when sterling M3 had risen steeply, and we had decided to broaden the range of target indicators, also taking account of the exchange rate. Fiscal action to reduce the deficit had been crucial to retaining market confidence. The current strength of the dollar also caused him some concern: there must be a risk of uneven future depreciation.

5. Mr. Regan said that the dollar's strength reflected current uncertainties in Latin America, particularly Mexico. It might take some six months before the situation clarified, and an outflow started. As for the fiscal deficit, the Administration would have to tacklethe entitlement programmes. Public disclosure of this imperative would not be permitted until after 2 November, for there were 38 million pensioners with the time, and the inclination, to vote. But the Greenspan Commission would report on 15 November; and there would be a window of opportunity for action on social security spending before summer 1983. It might indeed be possible to get things moving in the short pre-Christmas Congressional session which would start on 29 November. Provided action were taken promptly, it should be possible to cut outlays by some $10/15B in fiscal year 1983, and by $20/30B in subsequent years.

6. The Chancellor asked about the possibility of fiscal action, mentioning the tax increases in the 1981 UK Budget. Mr. Regan said that Congress would be resistant to major tax increases. The

effects of the recession, and reduced inflation, would mean that revenue in the current financial year would be some $30/40B below forecast. Conceivably it might be possible to advance the increase in the rate of payroll taxes due for 1986. But action on the expenditure side to reduce the costs of social security was the urgent requirement: a one-year freeze on benefit rates would save some $11/12 billion. Yet there were obvious political constraints: the next unemployment figures would breach the 10 million barrier.

International issues

7. The Chancellor referred to the issues discussed at the IMF/IBRD Annual Meetings in Toronto, and handed over an aide-memoire (copy attached). He was particularly concerned that decisions on increased Fund quotas should not be delayed, and thought that an increase to some SDR 90/100B would be appropriate. The fund proposed by Mr. Sprinkel might be a useful addition, perhaps linked to the GAB, but was not an alternative to a substantial increase in IMF quotas. It was also important to maintain IDA lending. Mr. Regan referred to conservative hostility on the Hill, and Mr. Leland said that the IMF's image of respectability, and stress on conditionality, had been dented by the $6B loan to India. Mr. Regan said that he personally accepted that the Sprinkel proposal, on which a paper would shortly be produced, was not a substitute for an increase in Fund quotas. The US would produce a considered position before the January G5 meeting in Germany.

8. Mr. Regan asked for the UK assessment of the current German situation. Sir Oliver Wright said that the SDP/FDP Government had been on the way out for some considerable time. For the SDP it had been frustrating to have the responsibility of Government but not the power to spend as the Party would wish. But the initiative for the final split had apprantly come from the FDP, in the form of Lambsdorff. The prospect of a CDU/FDP Government now, and perhaps a CDU-only Government after an election in March, need cause no concern: rather more alarming was the prospect that the SDP would

move left, particularly on politico-military issues, eg tactical nuclear weapons. The Chancellor agreed that there was no apparent risk of a switch to irresponsible economic policies in Bonn. Mr. Leland wondered whether Franco-German relations would turn sour, andthe German commitment to EMS weaken. The Chancellor thought not.

9. The Chancellor then raised the issue of the pipeline. In his view, trading relationships with the Soviet Union, on an appropriately wary basis and not of course extending to the military sphere, were positively desirable, provided that they did not involve any preferential treatment for the Russians. It should be possible for NATO to agree an overall policy. His impression at Versailles was of a trans-Atlantic understanding that moves by the Europeans on the East/West credit issues would be accompanied by US acceptance that the pipeline contracts could not be broken. It was important that a new understanding be reached in the forthcoming New York talks. Mr. Regan was pessimistic about New York. The US position would be that, since the Russians had not backed off over Poland, the West should not back down over sanctions. If the Europeans disliked the particular form of sanctions now in force, it was up to them to produce alternative proposals. Mr. Leland said that, in getting the European act together, the UK would have to play a key role, since the French were hostile, and the Germans now lacked authority. And there should be no rescheduling of Polish debt.

10. The Chancellor then referred to the further trans-Atlantic disagreement over steel. It was important that the multilateral arrangements negotiated with the Commission should stick. Mr. Regan said that the US steel industry had double-crossed Secretary Baldridge. But the Administration would do their best to ensure that the deal stuck. The problem was the way in which Congress had written the law.

11. The Chancellor referred to the Argentine, and thanked Mr. Regan and Mr. MacNamar for their assistance in the negotiating process in Toronto. He was however concerned that the Argentine supervisors had not been withdrawn from British firms in accordance with the

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understanding reached. Mr. MacNamar undertook to pursue this with the Argentine authorities.

12. Mr. Regan said that the situation in Mexico had not improved, and theIMF team did not appear to be making progress. How the Mexicans were getting by without drawing on the facilities which had been arranged was a mystery: they appeared to be surviving by levitation.

Bilateral issues

13. The Chancellor recalled that he had twice raised with Secretary Regan the question of unitary taxation as applied by several individual US states. The US Solicitor-General had helpfully submitted an *amicus curiae* brief in the Chicago Bridge case which asked the Supreme Court to find unitary taxation unconstitutional. Apparently, the Chicago Bridge case was no longer seen as the right one on which to test the issues; and the Supreme Court was more likely to pronounce substantively in a second case, involving the Container Corporation. It would be helpful if an *amicus curiae* brief could be submitted in that case too.

14. Mr. Regan said that the US Administration entirely shared the UK view on the issues at stake. It might well be right to put in a further brief.

15. The meeting ended at 10.05 a.m.

J.O. KERR

24 September 1982

FROM: TERRY BURNS

24th September, 1982.

MR. KERR

SUMMARY OF WASHINGTON DISCUSSIONS

Yesterday we discussed the possibility of the Chancellor circulating a note of his conclusions from his Washington trip. This could have my minute to him attached to it by way of background. I agreed to provide a summary of my own reactions.

2. My overall conclusions are as follows:

(i) That US recovery is unlikely to be rapid. It is likely to be quite different to other post-war cycles, as the administration is determined to maintain a strong anti-inflationary stance. The range of forecasts for growth from the fourth quarter of this year seems to be between 2 and 4½ per cent; I would be inclined to a number close to the bottom of that range.

(ii) Inflation has come down more rapidly than expected and further progress is likely. There are a number of people who are talking of inflation running at 4-5 per cent next year. Given the recent behaviour of commodity prices and costs in general this seems to me to be quite possible.

(iii) There is a clear determination to do something about the budget deficit although this will have to wait until after the 2 November elections. Even then there is a major danger that the action will be insufficient. Some of the proposals mentioned for dealing with the social security fund problem still look small relative to the overall magnitude of the problem when a deficit of 5 per cent of GDP is being widely predicted for 1983-84.

(iv) There is a clear perception in some quarters that a more flexible approach to monetary policy is desirable. I share that view. A ceiling of 5 per cent growth for narrow aggregates may not be enough at a time of even

/modest

modest recovery and falling inflation. But the authorities need to maintain their credibility if they are to assure the financial markets that this is not a relaxation of monetary conditions but a different interpretation of what is involved in establishing the correct monetary conditions.

(v) Both in the US and UK there is an important need to adjust the cost structure of the economy to the tighter monetary discipline and lower inflation rates. This is particularly true for labour costs. As a result of the slowness of labour costs to adjust there has been a great squeeze on profitability which urgently needs to be reversed.

(vi) Given this outlook for the US economy the outlook for the non-oil developing countries is very poor. The adjustment process that is being required of them by the urgencies of their debt position could lead to an important contraction of the market for our exports.

3. There is widespread recognition within the administration of the problems they face; slow growth, budget deficits and the interpretation of the monetary aggregates. But I was struck by the degree of uncertainty that existed about how to resolve these problems whilst maintaining credibility in the overall thrust of policies and the support of Congress.

4. I feel that it is important that

(i) they take substantial action to correct the budget deficit;

(ii) they continue to try to get interest rates down. This may involve some flexibility in the interpretation of monetary aggregates;

(iii) they are realistic about the prospects for recovery. There is nothing to be gained by over-optimism at this stage;

/(iv)

(iv) the industrial countries do not force an over-rapid adjustment programme upon the non-oil LDC's. Their task is daunting and will feed back on the industrial countries.

(TERRY BURNS)

24/9/82.

NATIONAL INSURANCE SURCHARGE - POSSIBLE TIMING OF ANNOUNCEMENTS

This note discusses timing considerations relating to the announcement of any decision to consolidate the present temporary ½ per cent NIS reduction. It does not discuss the merits of such a decision.

2. The background is that unless steps are taken the present running rate of NIS of 2 per cent will go back to 2½ per cent from next April. Retaining the rate at 2 per cent would cost gross about £650 million in 1983-84, of which it is assumed that £250 million would be recovered from the public sector by way of a reduction in public expenditure plans leaving a net cost of £400 million in respect of private sector employers. This net cost might be seen against the background of the £1½ billion fiscal adjustment for 1983-84 shown in the MTFS (though this of course will be overtaken by the Autumn forecast).

3. There are two questions for consideration :-

a. Should a decision be taken, and an announcement made, as part of the Autumn clutch of announcements, or should this be held until the Budget; and

b. If a decision to consolidate is taken in the Autumn when more precisely should the announcement be made?

The Autumn or the Budget?

4. The main reason for holding up a decision until the Budget would be to retain open the option for other use of this £400 million. It would "buy", for instance, 2 percentage points over and above Rooker/Wise, valuable in a year when there are likely to be - already one - a lot of pressures to do something for individuals. It is not necessarily the case that the priorities as seen in the Autumn will be the same as those seen at Budget time. A consolidation decision in the Autumn would reflect in the Autumn Statement as an increase in the PSBR shown or, for a given PSBR, a reduction in the "fiscal adjustment" shown.

5. Against this there are arguments which point in the direction of an early announcement of a decision to consolidate - assuming that decision itself is justified by the Autumn forecast and prospects as then seen. These include :-

a. The pressures are building up to do something to help industry. An early announcement of consolidation could help to reduce these.

b. Bringing a decision, and the announcement, into the October/November public expenditure etc discussions could be helpful in pursuading colleagues to go for lower totals than would otherwise be the case.

c. If a decision and announcement were left until the Budget, and then that was in favour of consolidation, there would be administrative complications rather on the lines of those this year in making the change.

d. If a decision were left until the Budget, and the administrative complications then faced, there would be pressures to do more than just consolidate the $\frac{1}{2}$ per cent, and give a substantive further reduction.

e. An Autumn decision and announcement makes clawback from the public sector very much easier, and ensure it could be reflected in the public expenditure totals then published.

6. Finally there is the question of the interaction with the NIC changes, which certainly have to be announced in the Autumn. A statement in the Autumn on NIS would enable and indeed force NIS and NIC to be seen together, whereas a Budget Statement would distance them. This however is an argument which points both ways; opinions vary as to whether or not tying up NIC is sensible or otherwise. **The fact that NIS and NIC might each need separate early legislation is also a link.**

Early or late Autumn

7. If it were agreed that consolidation should be decided upon and announced in the Autumn, there are a number of possible occasions, thus :-

a. During the Blackpool Party Conference.

b. In the House around the end of October or beginning November - either during an opposition mounted debate on the economy likely for October 20 or during the economic debate on the Address, likely for 9 November.

c. In the Autumn Statement, probably the last week in November or the first week in December.

8. The Party Conference possibility is mentioned for completeness, but does not seem worth examining in detail; first because the Conference is almost on us, and second because to make an announcement in that form might risk accusations of "insult to the House".

9. As between (b) and (c) the arguments are fairly finely balanced. Both courses could be consistent with having the point in play during the public expenditure discussions, and both courses would permit clawback from the public sector to be reflected in the public expenditure figures in the Autumn Statement (though course (b) makes this a little easier than course (c) which could probably mean leaving some rough edges). The essential differences seem to be :-

a. Course (b) would mean the consolidation had to be justified in terms of a change from the prospect from that seen at the time of the Budget, while course (c) could justify the announcement by reference to the new forecast then being published.

b. Course (b) would distance the announcement from the NIC announcement, though it is a matter of opinion whether this is a good thing or bad thing - see paragraph 6 above.

c. Course (b) would give more time for the necessary legislation, which might be helpful for the business managers in the House.

d. It is desired to play down the importance of economic announcements during the Autumn, so as to avoid appearances of "mini Budgets" and the like. This argument, however, again points both ways. Course (b) would make the Autumn Statement less important and would therefore tend to play it down; but on the other hand it would of itself be an announcement, and a freestanding one, and could be seen as a "measure" of some kind.

Tentative conclusion

10. Notwithstanding the administrative untidiness, on balance the Treasury's interest seems to point to keeping options open until the Budget if this is possible. But it may not prove possible, and if there are very strong pressures for something in the Autumn then an announcement of consolidation may become necessary and indeed cost-effective in this context. Assuming consolidation appeared acceptable (in the light of the Autumn forecast) then as between an announcement around the end of October/early November or an announcement in the Autumn Statement, the Autumn Statement (course (c) in paragraph 7) appears preferable.

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FROM: ROBIN HARRIS
DATE: 27 September 1982

CHIEF SECRETARY

cc Chancellor
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Mr Ridley
Mr French

POLITICAL DISCUSSION: 28 SEPTEMBER 1982

... The Chancellor has asked me to circulate the attached cuttings from "The Times" and the "Standard" of Friday 24 September. He has commented that Ministers will need to discuss how to handle the "tax cuts" story which they contain.

RH

ROBIN HARRIS

27 September 1982

THE

Howe ready to make £3,000m cut in taxes

By Frances Williams, Economics Correspondent

Big cuts in income tax are in prospect next spring. The rapid fall in inflation and booming North Sea oil revenues mean that Sir Geoffrey Howe, the Chancellor of the Exchequer, can afford to make concessions worth £3,000m to £4,000m, equivalent to 3p to 4p off the basic rate, and still claim to be keeping to the spirit of the Government's medium-term financial plan.

Some indication of how big the tax cuts are likely to be will appear when the Chancellor makes his autumn economic statement in late November or early December. That will, for the first time, include revenue projections as well as spending plans for the coming year.

The tax cuts will almost certainly come by raising personal tax allowances by more than the amount necessary to compensate for inflation, rather than through a reduction in the basic rate.

Mrs Margaret Thatcher's pledge of a 25p in the pound basic rate has been jettisoned. Senior Treasury ministers have emphasized publicly that raising the personal allowances to take the lowest paid out of tax is their chief priority.

The Cabinet is united behind the need for big income tax cuts in the spring. With the next election very much in mind, ministers have focused on two overriding necessities: to move some way towards fulfilling their promises to reduce the burden of taxation, which has increased sharply since they took office; and to ensure a rise in people's incomes in the approach to the poll next autumn or in the spring of 1984.

Most ministers are convinced that the only hope for real economic recovery lies with the traditional remedy of a demand stimulus and have little faith in the Treasury line that falling interest rates and inflation will bring about spontaneous recovery.

But even the hardliners say that lower taxes are necessary to create the incentives needed for growth, as Mr Leon Brittan, Chief Secretary to the Treasury, made clear on Wednesday.

Almost all the cash available next spring is likely to go on income tax cuts although, as a sop to industry, the Chancellor may well announce in the autumn statement his intention to make permanent the extra temporary ½ per cent cut in the employers' national insurance surcharge, at a cost of about £600m in a full year.

The unexpectedly rapid drop in inflation has increased the Chancellor's room for manoeuvre in three main ways: by reducing the increase in public spending, especially index-linked social security benefits which account for a quarter of spending; by cutting interest charges on government debt; and by narrowing the gap between spending and revenue because both are growing more slowly than predicted.

The drop in inflation has eased considerably the Treasury's task in holding the line on public spending in the autumn review now under way, in the face of bids from spending departments totalling £5,000m over the planned total of £121,000m. That is because the cash originally allocated will buy more goods and services than was expected.

Discussions between the Treasury and spending departments are due to continue into next month. Talks have still to be held with the Ministry of Defence, for example, on post-Falkland expenditure.

Finally, analysts believe that North Sea oil revenues are likely to be much better than published government estimates suggest.

THE STANDARD

Friday, September 24, 1982. 15p. Incorporating the Evening News

CITY PRICES

Falling inflation, oil profits point way to give-away Budget to help business

HOWE'S HINT: SPRING TAX CUTS

SIR GEOFFREY HOWE

by Charles Reiss

CHANCELLOR Sir Geoffrey Howe today opened the door to a tax-cutting giveaway Budget next Spring.

One of his top objectives, he said, would be to help trade in Britain to "grow more effectively."

The way to do that, clearly, was to lighten the load of tax on industry and businesses—and leave more money in people's pockets.

That is what Tory MPs are now confidently expecting Sir Geoffrey to do.

They believe he is bound to offer a large cut in income tax to fulfil one of the Government's key pledges.

Next Spring could be Sir Geoffrey's last chance before the next election.

The Chancellor, in an interview, was at pains to stress that he was not going to throw away the gains made by his tight money policy over the last four years in some pre-election bonanza.

"I am totally convinced that would be as misguided as the last Labour Government showed it to be."

But his colleagues believe he now has room for a substantial give-away without damaging his economic strategy.

The money is there partly because of the sharp drop in inflation.

On top of that, cash from North Sea oil, still pouring in at an increasing rate, will present the Chancellor with more to give away if he chooses.

Next year's Budget, Sir Geoffrey said, would be framed "to ensure the ground we have gained by keeping a tight control of public borrowing is not lost.

Rock-solid

"But it would also be," he went on, "to find ways that will relieve the pressure on the trading sector of the economy in a manner most likely to help it begin growing more effectively."

Sir Geoffrey has the choice of a straight cut in income tax or raising personal allowances.

At one time, the Government was pledged to cut the basic income tax rate to 25p in the £ but that has long since faded out as a practical possibility.

Mrs Thatcher will, however, want to go into the next election with a rock-solid case to show that she has performed as promised and achieved a real reduction in taxes since Labour's day.

Apart from the purely political pressures, Ministers are still concerned that the long-awaited economic upturn is not clearly under way.

It had, so far, been only "faltering and patchy," Sir Geoffrey admitted today.

There, too, tax cuts will help.

SIR GEOFFREY HOWE

From: M E QUINLAN
28 September 1982

MISS O'MARA

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Sir Douglas Wass
Sir Anthony Rawlinson
Mr Le Cheminant
Mr Burgner
Mr Gilmore
Mr Kemp
Mr Kitcatt
Mr Pearce
Mr M Hall
Mr Traynor
Mr Ridley
Mr Harris

PAY PRESENTATION : CBI AND NICG

Following the last sentence of your minute to me of 24 September I have written informally to Mr Driscoll of the NICG drawing special attention to the CBI presentation; and I have spoken to Mr Richard Worsley at the CBI end. He tells me that virtually all the nationalised industries have seen the presentation, but mostly not at Chairman level. He will watch out for opportunities of putting it over at that level also.

M E QUINLAN

PERSONAL AND CONFIDENTIAL

C.

ROBIN HARRIS
28 September 1982

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Mr Ridley
Mr French

FT LEADER ON LONG TERM PUBLIC EXPENDITURE

... The attached FT leader contains an intelligent, balanced approach. My own instincts would be for getting the substance of the Treasury LTPE paper into the public domain (it was leaked some time ago via Blake, of course) as soon as possible - not least in order to detract attention from the CPRS paper.

It is also worth adding that 'improving services' (via private provision, choice etc), not just restraining the momentum of public spending, might perhaps be worth inserting as a major theme in future public statements on the subject. I remain convinced that the LTPE exercise could be a political winner, if we manage to distance ourselves from the CPRS report. Crudely stated:

> "If just under present trends, your tax bill would have to rise to X by 1990: how could you afford a Labour/SDP government which wanted to spend more and make less use of opportunities for private provision?"

RH

ROBIN HARRIS
28 September 1982

FINANCIAL TIMES
BRACKEN HOUSE, CANNON STREET, LONDON EC4P 4BY
Telegrams: Finantimo, London PS4. Telex: 8954871
Telephone: 01-248 8000

Tuesday September 28 1982

Social welfare under question

IT IS perhaps one of Mrs Thatcher's greatest political achievements that she has, over the past three years, succeeded in blunting the British electorate's expectations of what government economic policy can deliver. Admittedly the government's recent relative popularity owes more to its handling of the Falklands crisis and to Labour's ineptitude than to its management of the economy.

But these factors alone cannot explain away the conjunction of more than three million unemployed and the findings of recent Gallup polls which show that the Conservatives have lost only one per cent of the voters' support since the last election, compared with a fall of 10 per cent for Labour.

Whether the electorate will show the same apparent tolerance of unemployment if the social security safety net is the subject of draconian cuts is another matter. The initial public reaction, in so far as one can detect it, to the Central Policy Review Staff's recently leaked suggestions for radical cuts in the welfare state has been less than euphoric. And it is instructive to consider, in the same context, the fate of West Germany's Free Democrats in this weekend's election in Hesse.

No doubt they lost their representation in the state parliament primarily as a result of the unattractive manner in which they deserted the coalition with Mr Schmidt's Social Democrats. But it seems probable that some voters were also frightened by the Free Democrats' sweeping proposals for cuts in welfare spending.

Debate

Mrs Thatcher's belief in fiscal rectitude is such that she can be relied on not to let the CPRS ideas be quietly swept under the carpet. So they are bound to give rise to continuing debate.

In one sense there is nothing surprising or, in the view of some economists, inherently undesirable about public expenditure taking 45 per cent of Britain's gross domestic product. That is not high by the standards of other developed countries. And a rising demand for services such as health, education and retirement benefits is a natural concomitant of rising incomes.

Trouble arises, however, because these public sector services are peculiarly resistant to productivity improvement. Resources are easily misallocated because market signals do not operate. There are, in addition, longer term demographic problems which are beginning to impose pressure on pension systems throughout the developed world. A decreasing number of workers is having to support a growing number of retired people.

Everywhere politicians have been inclined to turn a blind eye to the long-term actuarial consequences of vote-winning social security gestures. The problems of supporting levels of public spending that looked acceptable in a period of economic growth begin to look daunting in a world of flat demand and financial upheaval.

Better placed

Britain is in many ways better placed than other developed countries. Its financial troubles are less severe. And the pension system is in less trouble than, say, that of the U.S. where the level of funding is desperately low in relation to pension liabilities. But unemployment is relatively high and looks like remaining so for some time. Successive British governments have also chosen to spend more on defence, as a percentage of gross national product, than any other Western nation apart from the U.S.

A genuine ideological debate now looms. On one side are those who believe that the whole welfare structure is precisely what makes it so difficult for the European economies to adjust to the shocks that have confronted them since the first oil crisis in 1973. On the other, stand those who believe that social maintenance expenditure is the one stabilising factor in an otherwise bleak economic and social landscape.

The long-standing post-war obligation to provide a comprehensive social insurance guarantee has always rested on the assumption of continuing economic growth. Any politician willing to declare openly that the assumption must be questioned deserves some admiration. But it is simply not good enough to conduct the debate in private on the basis of an unpublished Think Tank document. Let us at least have a Green Paper before going farther down the road.

IMMEDIATE

2-sided Meeting Record

1. MR LITTLER
2. CHANCELLOR

I suggest you need read only this minute and Annex A; the other Annexes cover ground with which you are very familiar. 29/9

FROM: J G PEET
DATE: 29 September 1982

cc Mr Byatt
Mrs Hedley-Miller o/r
Mr Bottrill
Miss Court
Mr Edwards
Mr Peretz
Mr Butt (UKREP)

VISIT BY M. ORTOLI, 30 SEPTEMBER

1. Vice-President Ortoli is coming over for discussions with you tomorrow afternoon, arriving probably between 5.00 and 5.15 p.m. He has said that he wishes particularly to continue the conversations you had in Toronto. But he may well raise a number of other issues. The annexes to this minute contain background on some of the possible topics of discussion, as follows:

(i) UK Budget problem (Annex A)
You will almost inevitably touch on this, both on the longer terms negotiations and on the difficulties over 1982 refunds. It would be interesting to discover Ortoli's views on the idea of a review of the Community's finances, including the question of possible new own resources on which the Commission have been reflecting.

(ii) Macro-economic issues and forthcoming ECOFIN business (Annex B).
It would be most helpful if we could keep Ortoli's general approach on the same lines as he set out in the Budget Discipline Paper which ECOFIN discussed in July. This would be the right context in which to set forthcoming ECOFIN discussion of the Annual Economic Review. Evidently preliminary work on this within the Commission tends to the view that the outlook is exceptionally gloomy; in these circumstances some people within the Commission may argue that there could be scope for certain countries to adopt more expansionary policies.

Ortoli may refer to the work which is continuing on investment, which is to be discussed in Brussels by the Economic Policy Committee tomorrow and also by the

Co-ordinating Group on Monday. The Commission themselves are likely to put forward a paper on investment, which may be available before the October ECOFIN. Once again, we have been trying to set discussion of investment very much in the context of the need to create the right general macro-economic climate, for which control of inflation remains the most important element.

Finally, you may like to express the hope that the Jumbo Council scheduled for November also reflects the thinking of the Budget discipline paper. In this context, Mr Richard's Directorate-General of the Commission (DGV) may need to be restrained by DGII - we have recently seen two papers commissioned by DGV from "experts" which had a markedly expansionist and interventionist flavour, and Mr Byatt wrote to Ortoli to point out that they were not at all consistent with other Commission papers or with the Economic Policy Committee's views.

(iii) Sterling and the EMS (Annex C)
Ortoli may well refer to the desirability of our joining the ERM. In any case, it might be of interest to know how he sees the system developing given the current strains within it.

(iv) IMF issues and the intervention study (Annexes D and E)
These are less likely to figure in your discussions, but the annexes contain some background notes should they do so.

2. There are two other possible topics which you might like to refer to. First, you may well discuss the economic situation in France when considering the outlook for the EEC as a whole; and in this

context, you might like to sound out Ortoli on recent reports that the French have been contemplating the possibility of tightening their exchange controls. There may indeed have been informal discussions between the Commission and the French on the subject. The second broad area of interest could be the whole question of the future of the CAP, particularly in the light of recent indications that agricultural expenditure is picking up. You might like to discover how Ortoli sees the Commission's approach to next year's price fixing developing.

3. Mr Littler will be available to support you. Vice-President Ortoli will be accompanied by M. Verrue, his Deputy Chef de Cabinet.

J G PEET

ANNEX A

UK BUDGET PROBLEM

M. Ortoli does not lead on this subject within the Commission. But his voice is sometimes influential and it could be useful, time permitting, to register briefly with him the three points noted below. The Chancellor may also like to hand M. Ortoli a French version of our new glossy brief on the budget problem (French and English versions attached).

- Our concern about the continuing argument over 1982 refunds. French attempts to unstitch or qualify the 25 May agreement, by reducing the effective net refund to the UK and prejudicing forthcoming discussions on the 'overpayment', seem to us highly un-communautaire. Such arguments play into the hands of anti-Community lobbies in the UK. Does M. Ortoli have any suggestions?

- The urgent need for a lasting solution to the budget problem which can be seen to be fair. /Hand over French version of glossy brief./ The UK has indicated its willingness to remain a net contributor, but only on a modest scale. The British people have never accepted, and will never accept, that they should make a substantial contribution to financing agricultural surpluses in countries more prosperous than the UK itself.

- Proposal for review of Community's financial arrangements. You have heard suggestions that a fundamental review should be launched in the autumn. UK willing in principle to go along with this. But review must not detract attention from urgent need to find lasting solution to UK budget problem. And terms of reference must not carry any commitment on subject of new own resources. Need for extra own resources not yet proven. Difficult in any event to see how net contributor countries could possibly agree to new own resources unless some way is found of limiting their financial liabilities and containing growth of expenditure on agriculture.

CONFIDENTIAL

ANNEX B

MACRO-ECONOMIC ISSUES

POINTS TO MAKE

(i) World economic situation remains difficult. Most major countries (US, Japan, Germany and UK) have made significant progress in reducing inflation but recovery of world output and trade seems likely to be slow.

(ii) Growing mutual agreement among major countries on need for firm monetary and fiscal policies to reduce inflation and interest rates creating more stable world economic environment.

(iii) International financial situation a source of concern at Toronto, but important not to be alarmist. Lower inflation and interest rates should in due course help both sovereign and corporate borrowers, but there will be a need for a continued careful watch over the banking system.

(iv) Performances of European economies still divergent in important respects but welcome growing signs of governments' readiness to tackle budgetary and structural problems despite political difficulties.

(v) Commission's July paper on 'Budget Discipline and Economic Convergence' with its emphasis on curbing deficits and reining back public spending provideda useful initial starting out for this autumn's discussions in ECOFIN. Hope it can be reflected in Annual Economic Review in December.

(vi) Recovery of investment will be important if upturn in European economies is to be sustained. Await Economic Policy Committee opinion on Commission's June paper, but own view is that first essentials are lower inflation and interest rates leading to lower costs and improved profitability.

(vii) [If raised - Aware that Danish Presidency may wish to call a Jumbo Council to discuss unemployment. An important subject but firm measures to reduce inflation and continued efforts to improve

the working of markets offer better prospects of a sustainable improvement in employment that short-term demand boost or indiscriminate special measures./7

(viii) /If raised - Fifth Medium-Term Programme raised important issues last year. Agree on need for medium-term policy focus but important that this should lay enough stress on monetary and fiscal discipline if inflation is to be reduced and resources are to be freed for private sector./7

Background

M. Ortoli will probably want to sound the Chancellor's views about the prospects for economic recovery in the world economy over the coming months and the scope for policy action by European countries. The outlook for activity has deteriorated since the summer but some upturn in the major countries still seems likely next year. We shall want to maintain policies to ensure that the recovery is sustainable and not rapidly dissipated in renewed inflation. We shall be looking to the Commission to stress this when formulating its budgetary guidelines for member countries this autumn.

Economic developments and prospects

2. Output in major countries has recovered only very slowly and partially in the past six months from last winter's recession. There has been modest growth in the US in the past two quarters and a better performance by Japan but output in Germany and Italy has been falling and growth in France may now have petered out. Growth in the EC as a whole is likely to be less than 1 per cent this year compared to the Commission's summer forecast of 1½ per cent. Next year however, European economies might grow by 2-2½ per cent alongside recovery in the US.

3. Inflation in the four major European countries averaged 10 per cent in the year to July compared to 6½ per cent in the US and 2 per cent in Japan. The rate in Germany was 5½ per cent, in the UK 8 per cent (and falling) but in France and Italy it was still 12 per cent and 17 per cent respectively. This divergent performance

emphasises the need for continued efforts to persevere with counter-inflationary policies to create a stable economic environment in Europe.

4. Unemployment has continued to rise in Europe, as in the US, reaching rates of around 11-13 per cent in the UK, France, the Netherlands and Ireland compared to slightly less than 8 per cent in Germany. Even with resumed growth next year there seems little prospect of an early reduction in unemployment.

5. Current balances for the major countries as a whole have moved back to equilibrium with a continued surplus in the US and a growing surplus in Japan. In Europe, Germany has tended to move towards surplus in recent months but the UK surplus has dwindled and France has moved into increasing deficit ($6 billion in the first half of 1982).

6. European interest rates have eased only moderately since the summer - typically by 1-1½ per cent compared to the 4 per cent fall in US rates. Three-month money market rates remain around 8 per cent in Germany, 11 per cent in the UK, 14½ per cent in France and 18½ per cent in Italy. (See separate brief on EMS exchange rates).

Monetary and fiscal policies

7. European experience with monetary control has been mixed. The UK and Germany have kept monetary growth within or close to their target ranges of 8-12 per cent and 4-7 per cent respectively. In France, however, M2 grew at an annual rate of 17 per cent in the 6 months to June, well above the 12½-13½ per cent target for the year as a whole.

8. Experience with fiscal policy has also been mixed. In France, Italy and the Netherlands this year's deficits seem likely to be larger than originally anticipated. The French have announced a budget deficit equivalent to 3 per cent of GDP next year, but firm decisions on public spending as well as the social security budget are still needed. The Germans have projected a lower deficit for 1983 than 1982 but worsened output prospects will face whichever

party is in power with the need for further pruning to achieve this. The new conservative government in Denmark is struggling with a particularly difficult fiscal situation and the prospective conservative coalition in the Netherlands seems likely to have to do likewise.

9. The Commission in its July paper on Budgetary Discipline and Economic Convergence argued that budget deficits needed to be at least stabilised and in many countries reduced as a share of GDP. It said this should be achieved primarily through lowering public spending but higher taxes, higher social security contributions and higher charges for public services might also be necessary. It stressed the need for a medium-term framework for fiscal policy and the need to avoid monetising deficits. Belgium, Denmark, Ireland, Italy and Greece were all singled out for criticism for their fiscal policies.

Finance Council discussions

10. The October Finance Council will probably provide a further chance to discuss the general orientation of policies in the Community. We should probably aim to build on the July discussions of the Fiscal Discipline paper and try to see that this thinking is reflected later in the autumn in the EC budgetary guidelines.

11. The October Council should also have an EPC opinion on the Commission paper on investment. This was generally acceptable since it concentrated mainly on fundamentals such as lowering costs and improving profitability rather than government intervention.

12. M. Ortoli may also raise the Danish Presidency's desire for a Jumbo Council. These have not been a great success in the past, and we should probably be politely discouraging. He may also raise the question of the Fifth Medium-Term Programme which Ministers shelved last autumn, in particular disavowing M. Ortoli's own ambitious foreword. The new tone among his masters in Paris, however, may make M. Ortoli more circumspect this autumn. There is no need to re-open the dispute.

ANNEX C

STERLING AND THE EMS EXCHANGE RATE MECHANISM

Background

1. The most recent EMS realignment was on 12 June when the Deutschemark and Dutch florin were revalued by 4¼%, the lira was devalued by 2¾% and the French franc was devalued by 5¾%. After enjoying a quieter spell in July, the system came under renewed pressures in August with the market expecting further devaluations of the French franc and the Danish krone. The announcement of the French $4 bn euro-dollar credit has caused some of the pressure on the franc to be deflected, but the market seems still to expect a devaluation in the next six months unless French fiscal policy is further tightened.

2. Since the end of the Falklands crisis and the June EMS realignment, the pound has been fairly stable against EMS currencies. Against the Deutschemark it has remained in a range of DM 4.26 - 4.31.

Points to make

3. We support the aims of the EMS but the only way to make progress towards exchange rate stability is through greater success of all EEC countries' counter-inflationary policies. Within the last 12 months there have been three EMS realignments which illustrate the tensions which arise when some countries [eg. France] do not pursue sufficiently counter-inflationary policies.

Defensive

4. Mr Ortoli is likely to press for the UK to join the EMS exchange rate mechanism, adducing the recent stability of sterling in effective terms as reason for so doing.

5. Market confidence in sterling has led to ten months of exchange rate stability for the pound in effective terms. With the EMS currencies also comparatively stable since the June realignment, sterling/EMS exchange rates have shown little variation in recent months. This is obviously to be welcomed. But the principal threat to this stability is

the build-up of pressures within the EMS for realignments. These pressures can cause the entire band to move against outside currencies like sterling. All EMS countries must, like the UK, follow policies which command market confidence if exchange rate stability is to prevail.

6. The UK's status as an oil producer means there is a tendency for sterling to move in the opposite direction from other EMS currencies at times of oil price changes. Sterling's role as a reserve currency and London's as an international financial centre creates difficulties in linking with another major currency like the Deutschemark, so we would need to be particularly careful to ensure that conditions were right for sterling's participation.

7. Participation in the EMS exchange rate mechanism is kept under review.

ANNEX D

IMF ISSUES

Points to make

(i) Progress made at Toronto in narrowing range for size of increase in quotas under Eighth Review. Hope that agreement can be reached around SDR90-100 billion. This depends partly on US readiness to compromise but also on some European countries lowering their sights.

(ii) Important to agree on straightforward and fair quota distribution system if spring deadline for decisions is to be met. UK, along with Germany and at least to some extent other Europeans, sees merit in allocating increase in quotas in line with calculated quota shares.

(iii) Fund's liquidity position currently adequate but possible pressures next year and in future years stress need for progress with third tranche of SAMA loan, possible borrowing from other surplus countries or from the markets, as well as need for progress on quota review.

(iv) Welcome opportunity that forthcoming Staff paper will present to review GAB. Important that liquidity of major countries' reserve positions in the Fund should be maintained.

(v) US proposals for a special fund to help countries whose liquidity problems pose a risk to stability of system, still need fleshing out. Important to work through existing institutions, secure adequate conditionality and not delay Quota Review.

Background

Eight quota review

Ministers agreed at Toronto to try to reach decisions on the size and distribution of the quota increase by the time of the Interim Committee meeting at the end of next April. Views on size narrowed:

with the exception of the US most countries were prepared to settle for an overall increase of from 50 per cent (Germany, UK) to 100 per cent (France, Belgium, Italy, and Denmark). The Netherlands and Ireland favoured an increase of between 60% and 100%. The question now is whether the US will be prepared to accept a 50 per cent increase or slightly more, and if so whether some of the Europeans will be ready to lower their demands.

2. On <u>distribution</u>, there seems to be general agreement on the need to bring actual quotas more into line with calculated quotas, but there is some divergence of views within the EC on how much of the increase should be allocated selectively. The UK view, shared ostensibly by Germany, is that the full amount should be distributed pro rata with calculated quotas; Netherlands and Denmark say "a substantial part"; Italy says "at least a third"; Ireland says "the main emphasis" should be on selective adjustments.

<u>Fund Liquidity</u>

3. Total Fund lending outstanding is currently SDR15½ billion, of which SDR7 billion is borrowed resources. Current undispersed commitments amount to SDR8½ billion, of which SDR5½ billion is borrowed resources. This takes account of likely commitments to Mexico, but the implication is that by next April SDR12½ billion out of SDR16½ billion borrowed resources would have been committed. Programmes for Uruguay, Hungary and Argentina are also in the offing, and the Fund's liquidity could be quite hard pressed even with the third SDR4 billion tranche of the SAMA loan.

4. In the longer term, commitments up to 1985 might total SDR20-25 billion, although this would involve rolling over many existing Standby programmes, resurrecting EFF programmes and agreeing programmes for countries such as Poland, China and Portugal. This is to some extent a "worst case", but clearly implies continued pressure on borrowed resources. We have taken the line that the Managing Director should be encouraged to go to surplus countries eg Kuwait, the Emirates and Singapore. EC countries, reviewing the post-Mexico liquidity position, would probably also recognise the need for further bilateral borrowing, but they would not be inclined to tap the private markets.

General Arrangements to Borrow

5. The GAB has been eroded significantly in real terms since its establishment in 1962 and the Fund Staff is writing a paper about it in connection with the Quota Review. EC countries have shown little enthusiasm for any increase in the GAB, largely out of reluctance to see their own contributions rise, but there seems to us a good case for reviewing it. It is important that the reserve position of major countries in the Fund should remain liquid, particularly when as in the case of the UK this position is increasing. Even the US was forced to mobilise its reserve tranche in the late 1970s, and drawings by 2 major countries at once could quickly strain the Fund's own liquidity position.

6. The Monetary Committee is to discuss IMF issues on 8 October, and a Commission paper by M. Szasz picks up some of these points on the Fund's liquidity, the erosion of the GAB and the fact that Fund lending has become increasingly concentrated on developing countries. It is true that industrial countries have not turned to the Fund since the second oil shock, but it would be unwise to rule out the possibility in future.

US Proposal for an Emergency Fund

7. The US proposal for a special lending facility to make funds available to countries' whose liquidity problems proposed a threat to the system, was generally coolly received at Toronto. Mr Sprinkel has now circulated a short paper spelling out a few more details of what the Americans have in mind, and this will be discussed by G5 Deputies in mid-October. The US appears to be thinking of making substantial funds available to particular countries - in excess of what they would be able to draw under their normal quotas. It wants high conditionality to be attached to this lending which would typically be repaid in five years. The money would be made available at market interest rates on medium-term lending, and the US would be looking to countries with strong reserve positions to provide the funds.

8. Mr Sprinkel's clarification has only recently been received, and we have not yet considered a detailed reaction to it. The stress on high conditionality and market interest rates seem to move in the right direction. The involvement of the Fund rather than the BIS, should probably make it easier to monitor countries' performance. The Mexican case, however, is showing how difficult it is to link the provision of emergency short term liquidity with agreement on an adequate adjustment programme. The terms on which these new funds would be made available will need detailed scruitiny, as will the possible cost of UK participation.

9. There is almost certainly no need to go into any of this with M. Ortoli, but merely to mention that we are studying the US proposals.

ANNEX E

EXCHANGE MARKET INTERVENTION STUDY (JURGENSEN GROUP)

Background

At the G-7 meeting in Toronto Ministers endorsed the draft outline report and work programme covering the intervention study. The intention is that the report itself should be available to Deputies by the end of January. They will then concentrate on a number of specific policy issues: does volatility matter, what constitutes a 'disorderly market' and when should there be intervention. Ministers will review this work at the time of the Interim Committee meeting in April next. No decisions have yet been taken about possible publication of a report. The likelihood is perhaps that some form of report will be published though necessarily of a fairly anodyne character.

2. The most recent meeting of the Group took place in Frankfurt on 20-21 September. It will be meeting each month* until its work is completed. M Ortoli should be fairly well abreast of developments since there is a Commission participant (M Mingasson). The Frankfurt meeting was primarily concerned with discussion of the 'country reports' which seek to outline the general evolution of the attitude of participant governments to intervention since 1973, relating them to economic policies as a whole. There was also some discussion of the so-called empiric studies and one or two of the case studies (of specific episodes intended to illustrate particular aspects of intervention experience). This work should make it possible for the Secretariat to prepare an analysis of the range of objectives behind intervention: in broad terms the French and Japanese emerge as those most prepared to back their view of an appropriate rate against the market. It is likely that the empiric studies of such matters as the efficiency of the market, and attempts to analyse the effects of intervention, would be capable of being grouped together under some such general heading as "Does the market know best?". The particular UK contribution in this area has been to consideration of the

* The next meeting will take place in London on 21-22 October.

relevance of profitability as a criterion for intervention: an initial paper analysing and casting a good deal of doubt on this proposition was well received.

3. The US participants have not gone as hard as one might have expected, now we have got down to detailed work, to question the cases for intervention presented so far. It is possible that they are keeping their powder dry or have differences of views within the administration. But above all their relaxed stance may well reflect a judgment that the study can do them no harm and could be used opportunistically as a card with the Europeans or to justify a switch to greater intervention if the dollar weakened. On present form they could well argue that the case for intervention varied according to institutional conditions and was in any event fairly peripheral.

Points to make

4. M Ortoli can be expected to have fairly extreme views on the extent to which volatility of exchange markets is linked to absence of US intervention. It is doubtful how far any exchanges on this issue with him would be useful.

5. Our view is that moderate intervention can have a role to play in helping to maintain orderly markets at times of exchange rate adjustment. But following an appropriate mix of domestic financial policies is the key to securing external confidence. Excessive intervention in defence of an inappropriate rate can be just as harmful as the 'benign neglect' of exchange market developments.

6. At this stage there is little to add to the observation in your IMF speech:

> "We must take care that the study does not become a purely academic exercise in analysis: it would be regrettable if each country regarded it simply as a device for justifying its present practice: the object of the exercise should not be to achieve, or justify, a widening of differences, but a meeting of minds."

RESTRICTED

FROM: J.O. KERR
30 September 1982

cc: Mr. Littler
Mr. Carey
Mr. Peretz

PS/Governor

MR. LAVELLE

CHANCELLOR'S MEETING WITH THE GOVERNOR : 24 SEPTEMBER

The Bank have pointed out that my record of last Friday's discussion at No.11 is defective in two respects. In paragraph 5 (Mexico) the second sentence should read:-

> "It was remarkable that drawings on the BIS facility had so far been so small."

and in paragraph 8 (Yugoslavia) the last sentence should refer to the "United States", not to the "Fed".

J.O. KERR

19/11/82

National Economic Development Council

NEDC(82)58

SECTORAL REPORT: FOOD, DRINK AND PACKAGING MACHINERY

Memorandum by Mr Kenneth Durham, Chairman of the Food, Drink and Packaging Machinery Sector Working Party

1 SECTOR PROFILE

The sector divides into two main sub-groups:-

processing machinery (for example, for breweries, bakeries, confectionery and dairy plants) and

packaging and bottling machinery (for filling and sealing cans and bottles and for wrapping and cartoning of food, pharmaceutical and hardware products)

Large multi-national groups are predominant in the former while the latter consists mainly of small companies with annual turnovers between £1m and £3m. While a number are subsidiaries of larger holding companies there are also many family businesses or small partnerships.

The sector as a whole employs about 25,000 people (having declined from about 31,000 in the mid 1970's) and in 1980 total sales were £367 million, of which 50 per cent was exported. Total imports in 1980 were valued at about £177m and accounted for just over 49 per cent of the home market.

The data on the industry's output and trade performance covering the period 1972 to 1980 (set out in Annex 1) shows that long term erosion of market share is a key problem for both elements of the sector. At home, imports have made substantial inroads reducing UK producers' share to about 60 per cent for processing machinery and 44 per cent for packaging machinery compared with 75 per cent and 60 per cent respectively in the early 1970s. Overseas the UK share of OECD exports has also declined.

2 THE WORK OF THE SWP

Against this background the SWP has given priority to encouraging sector companies both to improve their marketing and machinery development effort in order to reduce the volume of imports and to compare their policies and and practices on marketing, design, production and industrial relations with those of major overseas competitors in order to identify the scope for action to improve international competitiveness.

In particular, work has been undertaken on the following key themes:

2.1 Maker/User Collaboration. Marketing and Machinery Development

Following an investigation and report (jointly with the Food and Drink Manufacturing EDC) in 1977 into the reasons behind the disturbing growth of machinery imports the SWP convened a series of 'maker/user' meetings to encourage follow up action by companies on particular problems highlighted in various sectors of the market.

The cumulative impact of this report and the series of follow up meetings can be gauged from the following:-

- the machinery makers gained a sharper appreciation of the distillers' need for a total line engineering supply capability, and hence for them to collaborate with UK makers of complementary line equipment in order to compete more successfully against Continental European suppliers;

- a survey of the bottling lines in the whisky distilling industry was presented to the UK machinery makers.

Unfortunately the early promise of this meeting as a stimulus to improved relationships and greater market share for UK suppliers has not yet been fulfilled. In recent contact through the Scotch Whisky Association the distillers have indicated their disillusionment with the unsatisfactory response by UK equipment makers to the points for action highlighted at the 1980 meeting. The SWA's views are being circulated for comment to the relevant British machinery makers and, in the light of the feedback obtained, the SWP will decide what further initiative it can usefully take to promote improved performance in this sub sector of the industry.

2.1.5 Other important developments under this heading include a research project (supported by 20 sector company subscribers) to document the technical/commercial characteristics and UK users' views on a dozen types of imported food processing and packaging equipment (not currently made in the UK) with the aim of encouraging British companies to develop competitive substitutes or manufacture under licence. Also, the 'maker/user' work is now being extended to cover the pharmaceuticals sector in collaboration with the Pharmaceuticals SWP.

2.2 Company Performance Improvement and International Comparisons

There have been two inter-related strands to the SWP's work on this important theme.

2.2.1 In early 1979 the SWP published its booklet "A Participative Approach to Productivity Improvement".

The document reflected the SWP's belief that it is for each company to conduct for itself a systematic and (on many issues) joint management/union review of all aspects of its operations, including design, marketing, product development, purchasing and finance as well as production. The booklet proved of considerable interest to several other SWPs who have issued modified versions of it to their own sectors.

In late 1979 the SWP issued a follow-up questionnaire to company managements in order to gauge the booklet's impact and, more generally, to find out whether and how companies regularly reviewed the scope for productivity improvement. Analysis of the response (from 30 companies - 20% of total approached) revealed the following key points:-

- that many companies have some form of productivity improvement scheme;

- that these schemes, while frequently based on the value-added concept, are mainly geared to the performance of direct production workers and not of all employees;

- that only about half of the companies have any form of joint consultative framework for discussing productivity improvement issues;

- that many managements do not seriously involve the workforce in their efforts to improve productivity;

In all cases the discussion led to some positive conclusions for follow up action by participants. The nature of the conclusions naturally varied from company to company. In one case enquiries about the impact of the meeting revealed that:-

- there was felt to be much greater resultant awareness among shopfloor workers of the international competitive environment. Facts presented by an impartial external source had been accepted.

- there was an improved awareness among management of certain aspects of competitors' performance.

- the top management recognised and accepted that the workforce now looked to them to initiate follow-up change. They also felt that the ambassador presentation had created a more receptive atmosphere for change.

In another case the presentation was recognised by the company participants as a valuable catalyst in enabling them to bring major sources of shopfloor dissatisfaction and frustration out into the open for discussion. The new group formed by the meeting expressed determination to seek solutions to the problems raised by re-convening at regular intervals to seek agreement on changes to improve relationships and performance.

In a third case the conslusions reached included the need to match the superiority of the overseas competitors in their use of computers for production planning, machinery design etc.; the willingness of top management to initiate joint discussions on what could be done within the company to improve performance in the light of the overseas reports; and the need to encourage and enable shopfloor and other staff to involve themselves in decision-making within their own place of work.

In several cases the SWP's representatives were invited and accepted the invitation to return to make a further presentation either at a second plant within the company group or to a different cross section of people within the same plant.

While this project has achieved something of a 'breakthrough' in that the SWP's findings are now reaching and being discussed by a much wider range of people within some (albeit the larger) sector companies, there still remains a majority of companies whose MDs have yet to respond positively to our proposals for 'in-company' presentations; and we intend to persist with our efforts to overcome the barriers of suspicion and apprehension which currently limit the SWP's access to these companies.

2.3 <u>Government/Industry Interface</u>

The 'Maker/User' and 'Productivity' themes have rightly been the SWP's major but not sole preoccupation. A number of aspects of the Government/Industry interface have been considered with a view to trying to influence successive Governments to be more 'industry supportive'. In this sphere the SWP has contributed, with others, to improvements in ECGD arrangements and to the maintenance/expansion of Government financial support for machinery innovation through schemes such as the PPDS and MAPCON. The SWP has continued to draw the attention of sector companies to the various forms of support available and it is understood that combined PPDS, Requirements Boards and MAPCON support of £1.66 million has been allocated towards machinery development projects within the sector valued in excess of £6.5 million.

Also, the SWP will further expand its current communications effort, specifically in the form of presenting and discussing its findings with cross sections of employees within individual companies. This has been established as the most effective way of influencing attitudes and stimulating action to improve performance.

National Economic Development Office 19 November 1982

Restricted

ANNEX 1. THE SWP's SELECTED PERFORMANCE INDICATORS

ALL AT 1975 PRICES

PROCESSING MACHINERY

	1972	1973	1974	1975	1976	1977	1978	1979	1980
SALES £m	116.3	114.3	115.9	120.8	112.5	117.2	106.9	104.3	99.9
EXPORTS £m	48.5	52.9	56.7	71.0	56.0	56.1	66.2	63.5	47.4
IMPORTS £m	21.9	29.2	29.6	23.5	23.0	27.4	41.6	37.8	32.9
TRADE BALANCE £m	+26.6	+23.7	+27.1	+47.5	+33.0	+28.7	+24.6	+25.7	+14.5
HOME MARKET £m	89.7	90.6	88.8	73.3	79.5	88.5	82.3	78.6	85.4
UK SHARE HOME MARKET %	75.6	67.8	66.7	67.9	71.1	69.0	49.5	51.9	61.5
EXPORTS AS % OF SALES %	41.7	46.3	48.9	58.8	49.8	47.9	61.9	60.9	47.4

PACKAGING MACHINERY

	1972	1973	1974	1975	1976	1977	1978	1979	1980
SALES £m	74.4	85.8	92.9	84.3	77.7	78.0	78.7	71.6	65.1
EXPORTS £m	30.9	29.8	30.6	33.6	33.0	32.9	29.9	29.6	28.3
IMPORTS £m	28.2	38.6	45.0	35.8	36.9	39.8	45.4	46.4	46.6
TRADE BALANCE £m	+2.7	-8.8	-14.4	-2.2	-3.9	-6.9	-15.5	-16.8	-18.3
HOME MARKET £m	71.7	94.6	107.3	86.5	81.6	84.9	94.2	88.4	83.4
UK SHARE HOME MARKET %	60.7	59.2	58.2	58.6	54.8	53.1	51.9	47.4	44.1
EXPORTS AS % OF SALES %	41.5	34.7	32.9	39.9	42.5	42.2	38.0	41.3	43.5

Notes to table

Figures in £ millions at constant 1975 prices; Source: Department of Industry. Changes in UK share of Home Market and in Export/Sale ratio are expressed in terms of percentage points. It should be noted that the categories of machinery covered by the sales figures (Business Monitor) do not correspond exactly with those covered by the export and import figures (overseas trade statistics).

Restricted

(PWP)

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Nu No. 10 [illegible]

No: but I've alerted them.

Chancellor

MR BIFFEN'S SPEECH

There is an exceedingly gloomy speech which John [Bi]ffen will release through Central Office, embargoed Saturday. [I] will obtain a copy (covertly) tomorrow morning. I was a [li]ttle unhappy about some of its wording, read to me [by] a Central Office spy over the phone. It is just [pos]sible that I may ask you to intervene, when I've seen text.

Don't hesitate

RH

C. I have negotiated with Mr Biffen's office, without revealing that I have this text, procured sub rosa by Robin. They will put to Mr B the changes I've marked, and let me know how he reacts — [illegible]

2/12/82

need do nothing. If he doesn't, I'll alert you. The text has to be finalized by noon.

[illegible]

NEWS SERVICE

Release time: 19.00 Hours/SATURDAY 4th December 1982 787/82

Extract from a speech by the Rt Hon John Biffen MP, (Oswestry), Lord President of the Council and leader of the House of Commons, at the Scottish Young Conservatives Conference at the Peebles Hydro, on Saturday 4th December 1982.

We are still in the deepest international recession for 50 years. There is no sure sign yet of any significant recovery. Business forecasts - including the latest from the CBI - predict only modest increases in economic activity in 1983. We shall have to live with the problems of recession for some time yet.

But to say that an upturn does not seem imminent is not to say that it will not come. Eventually there will be a return to greater economic activity embracing the whole western world no less than the United Kingdom. That is the experience of all past business and economic cycles. The difficulty is knowing when the next cycle will open. Our political instinct tells us that it is "when" rather than "if" which is the crucial question.

Similarly we cannot predict precisely where an upturn will originate, or at what point in our national economic activity the upturn will first become discernible.

But I will make one further observation. In the 1930s the industries which led the way into recession - for example coal, shipbuilding and heavy engineering - were not the industries which lead the eventual recovery. Similarly we must not look to the casualty wards of the present recession to provide the pathfinders of the next recovery.

With that in mind, what should a responsible Government do? Essentially the politicians should keep off the grass. A stable economic framework is the best for tomorrow's commerce and industry. That framework needs no unnecessary controls - relating to pay, prices, dividends or foreign exchange. Above all it needs a realistic balance between Government spending and revenue so that we do not have a lurch towards greater public deficits. "Sound money" is not the echo of a bygone Victorian age: it is the precondition for an innovating economy finding the wealth and markets to sustain tomorrow's jobs.

END.

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR
AGENDA

EBS/82/232

CONFIDENTIAL

December 13, 1982

To: Members of the Executive Board

From: The Secretary

Subject: General Arrangements to Borrow (GAB) - Revision and Enlargement

There is attached for the consideration of the Executive Directors a copy of the communication dated December 11, 1982 from the Chairman of the Deputies of the Group of Ten on the principal conclusions reached by the G-10 Deputies at their meeting of December 10, 1982

The subject of borrowing arrangements has been tentatively scheduled for discussion at an Executive Board meeting on Friday, December 17, 1982.

Att: (1)

Lamberto Dini
Chairman of the Deputies
of the Group of Ten

Paris, December 11, 1982

Dear Mr. de Larosière:

Attached is my understanding of the principal conclusions reached by the G-10 Deputies at their meeting of December 10, 1982, which you may wish to use in connection with the Executive Board discussion on the GAB.

Sincerely yours,

L. Dini

Attachment

Mr. J. de Larosière
Managing Director
International Monetary Fund
Washington, D.C.

G-10 Deputies Meeting of December 10, 1982

Conclusions

At their meeting of December 10, 1982 in Paris, the Deputies of the G-10 reached certain conclusions in principle regarding the main elements of a revised and expanded GAB. It was their view that the expanded GAB would continue to perform its present functions for participants, but provision would be made for the use of the GAB resources to finance purchases from the IMF by non-participants in certain circumstances.

The main conclusions were as follows:

1. Quotas would remain the principal source of IMF resources to meet the ordinary balance of payments financing requirements of its members. The broad purpose of the GAB would remain to supplement the IMF's resources, if needed to forestall or cope with an impairment of the international monetary system.

2. The size of the GAB would be raised from the equivalent of about SDR 6.4 billion to SDR 15-20 billion. The participants' credit commitments will be denominated in SDRs. Any agreement with other countries on the provision of financing to the IMF in parallel with the GAB would augment the amounts available.

3. The credit commitments of individual participants should be broadly reflective of their size and roles in the international economy and of their ability to provide financing to the IMF. It was agreed that participants' shares in the arrangement should be appropriately adjusted in light of these principles.

4. Conditions and procedures for activation for purchases from the IMF by participants would remain unchanged. The revised GAB could be activated to finance purchases by other members if the following criteria were met:

(i) that the IMF was faced with an inadequacy of resources to meet appropriate requests for conditional financing;

(ii) that this inadequacy of resources arose from an exceptional situation associated with requests from countries with balance of payments problems of a character or of aggregate size that could pose a threat to the stability of the international monetary system.

In considering proposals for activation of the GAB for non-participants, the participants would consult among themselves for the purpose of ascertaining whether the above criteria were met. Such consultation would not extend to the examination of specific programs for use of Fund resources, which remains the responsibility of the Executive Board.

Activation of the GAB for the benefit of non-participants would need to pay due regard to potential calls on the arrangements for the purpose of financing purchases by participants.

5. Credit extended to the IMF under the GAB would earn interest at a rate equal to 100 per cent of the combined market rate used to determine the SDR interest rate. The 1/2 per cent transfer charge now levied would be abolished.

6. There was some discussion regarding the relationship with other potential lenders willing to provide resources in parallel with the GAB. It was assumed that lending under such parallel arrangements would be available to finance purchases by GAB participants as well as non-participants, and that parallel lenders would have the same access to GAB resources as participants.

7. The revised and expanded GAB will be reviewed at the time of the Ninth General Review of Quotas.

8. It was recognized that implementation of the above conclusions would require amendments of the GAB decision; it was considered desirable that, in the interest of speed, the amendments should be kept to a minimum. Regarding the criteria for activation for the benefit of non-participants, it was left open whether they should be included in the decision or whether they should be expressed in some form of understanding among participants.

9. It was understood that the revision of the GAB along the lines indicated above was contingent upon reaching satisfactory agreement on the other issues relating to the Eighth Quota Review.

AGRICULTURE HOUSE · KNIGHTSBRIDGE · LONDON SW1X 7NJ

01-235 5077

Deputy President

17 December 1982

MR TURNBULL
PS CHANCELLOR
PS EST
MR BURNS MR MONCK
MR MIDDLETON MR WILLETTS
MR SEDGWICK

The Hon Nicholas Ridley, AMICE, MP
Financial Secretary
The Treasury
Parliament Street
SW1P 3AG

Dear Nicholas,

Enclosed are the papers which we promised you when we met earlier this week. I hope you will find them interesting in view of the time you gave to listening to Stanley Passmore and his ideas on monetary mechanisms and their effect on the economy as a whole, particularly as illustrated by past experiences.

I found the discussion between you both fascinating and was glad to have the chance to meet again after quite a long time.

I understand the 'Strasbourg problem' is outstanding but hope some arrangement will be able to be achieved fairly quickly.

Do hope to be able to meet again perhaps in the constituency to be able to talk about farming.

If the papers throw up any queries or require further explanation please let me know.

C P RIGHTON

PAPERS BY MR. S. W. PASSMORE - SUMMARY

Many economists, particularly Keynesians, have expressed doubts about the popular view that an increase in the money supply leads to a proportional increase in money spending, which equals price times the quantity of output (Paper 1). For this to hold true the income velocity of money must remain constant from one period to the next.

Mr. Passmore defined the income velocity as the ratio of money Net National Product to a definition of money he calls Z (Paper 2) which is a broader definition than PSL2. Using this definition he shows (Paper 3) that it is possible over long time periods to identify an equilibrium velocity; equilibrium in the sense that it is a value the economy will tend towards in the absence of large shocks.

Such a shock would be a marked increase in the rate of inflation or the onset of a depression. Thus Mr. Passmore shows that as inflation moved into double figures in the early seventies it was accompanied by a rise in the income velocity of money to a new plateau. This behavioural change was caused, he hypothesizes, by expectations of a period of high inflation. It follows that if people expect the rate of inflation to fall they adjust their behaviour causing a fall in velocity.

Mr. Passmore's main point is that current monetary policy is not making allowance for this adjustment - which appears to be happening (Paper 3) - as people come to expect lower rates of inflation. Consequently a tight monetary policy becomes significantly tighter than anticipated and deflation becomes inevitable. Put another way, once people believe the rate of inflation is falling the restrictions on the growth of the money supply, particularly M3 which is only one narrow measure of money, should be relaxed. Mr. Passmore draws on the German experience in the 1920's (Paper 4) to support this view.

One of the reasons why the Government has refused to follow such a policy is because it would reduce interest rates which would lower the pound as long as world (chiefly U.S.) rates remained high. In addition, monetary targets (however mistaken) have become a source of international confidence in the pound. Mr. Passmore recognises this concern, and indeed acknowledges that a declining pound has often been a contributing factor to the inflationary process. However, he argues (Paper 5) that sterling is now overvalued - a view that must strike a familiar note - and that a reduction is necessary to help British industry. Further, in the current recession a modest fall (8-10 per cent) would not produce more than a minor addition to the rate of inflation.

This problem of reconciling confidence in lower rates of inflation and an expansionary monetary policy is confronted by Mr. Passmore. He argues (Paper 6) that confidence in future price stability can better be achieved by controlling the PSBR. Control of the money supply should only become the prime objective when the income velocity of money has dropped back to its equilibrium level.

"MONETARISM"

The central tenet of monetary theory is that there is a connection between the quantity of money in an economy and income, the total quantity of assets, transactions, or prices. Most recent work concentrates on income partly because, together with prices, better figures are available, but also because there is reason to believe from what estimates can be made, that it bears a closer relation to money than the other variables.

The earliest accurate estimate of the quantity of money in any country was made by Isaac Newton for the year 1688. Newton was Master of the Mint and his remarkable abilities in Mathematics, Astronomy, Optics and Physics, in addition to his interest in the Coinage, made him an exceptionally qualified person for this task. The adoption of milled coins in 1663 and the recoinage of silver in 1696 gave him a unique opportunity to produce his estimate which was £19.7 millions in England and Wales. There were no banks or bank notes in 1688, neither the Bank of England, the New West India Co., the South Seas Co., Sword Blade Co., or the Land Bank being in existence at that time. Although there were Goldsmith "Bankers" who issued notes these had no legal standing and were not recognised by the Courts. Newton's Estimate cannot be equalled for accuracy until nearly the 20th Century. Using modern terminology, the monetary situation at that time can be expressed:

$$\text{Specie} = \text{Coin} = \text{Monetary Base} = M_1 = £M_3 = M_3$$

so avoiding the question as to what constituted money.

By a fortunate coincidence Gregory King estimated that in the same year income in England and Wales was £48 M (as adjusted by Deane and Cole to modern accounting conventions). In spite of his somewhat eccentric attention to detail, his estimate has withstood nearly 3 centuries of critical examination.

In 1980 the average value of M_3 was £68,120M and national income £166,405M.

£ MILLIONS	1688	1980
Money	19.7	68,120
Income	48	166,405
Ratio	2.44	2.44

Thus both income and money have increased about 3,500 times. The population of the UK in 1980 is just about 10 times that of England and Wales in 1688 so income per capita has grown by a factor of 350. Perhaps prices have risen about 35 times and thus real income by a factor of 10, in so far as comparisons over such a period of time can be made.

Turning to most recent times the following figures appear:

(T Millions)

	Annual Average $£M_3$	National Income	Ratio
1977	41,800	111,178	2.66
1978	47,800	127,210	2.65
1979	54,320	145,166	2.67
1980	62,350	166,405	2.67

.../...

Year to Year % Changes

	Average £M_3	Income	Annual Average Prices
1977/78	14.7	14.4	8.3
1978/79	13.3	14.1	13.4
1979/80	14.7	14.6	17.9

These two examples clearly show that for the periods selected changes of income and money are closely related, much more so than money and prices, contrary to most current opinion which assumes that simply controlling the money supply will control inflation.

Matters are not that simple, and require a study of the behaviour of the income to money ratio ("Velocity"); which is not constant, as the above examples imply; in order to understand the factors which determine it, and also what constitutes "money"; which today is not as simple as in 1688.

THE DEFINITION OF MONEY

Various income concepts have been used for velocity comparisons, most commonly National Income (Net National Product - N.N.P.), G.N.P. and G.D.P. G.N.P. and G.D.P. take no account of capital consumption (depreciation); G.D.P. also excludes Net Property Income from abroad. There is a significant difference in the growth of these quantities as the table shows.

Ratio	G.N.P. / N.N.P.	G.D.P. / N.N.P.
1913	105	96
1938	108	104
1957	110	108
1980	116	116

Intuitively N.N.P. bears a closer relationship to monetary aggregates than the other two concepts; it is also the quantity used by Friedman and Schwartz in the Monetary History of the U.S.A. and I have used it throughout. I have used the series from C.H. Feinstein "Expenditure and Income of U.K." for ~~National~~ years before the current Blue Book, which the series is designed to continue back in time. Until recently, what constitutes money in relation to monetary theory has not been widely discussed by economists. The opinion is not clear of Keynes. Friedman uses currency with the non-bank Public and Commercial Bank Deposits, excluding Government Deposits. (This definition is almost the same as that of £M_3 in U.K.) He excludes Mutual Savings Bank Deposits and Saving and Loan Associations (similar to building societies in U.K.) the latter because "deposits" with them are legally shares, as indeed are most of the "deposits" with UK Building Societies.

Friedman says that the precise definition of money is not a matter of principle but a question to be judged empirically. As will be seen, there is reason to consider this question in more detail.

At present the Bank of England publish six monetary aggregates. Monetary Base (M.B.), M_1, £M_3, PSL_1, PSL_2.

Monetary Base consists of current outside of the Bank of England and bankers' deposits at the Bank of England.

At 18.2.81 Monetary Base consists of:-	£M
Currency in circulation with public	£9,943
Currency in bank tills	914
Bankers' deposits	602
	£11,459

The main component is the note issue, the size of which depends mainly on the public's propensity to hold notes and coins rather than other types of money, and, to a lesser degree, on the need of banks to hold notes to meet customers' demands for withdrawals.

Bankers' deposits at the Bank of England are required by clearing banks to meet clearing settlements in accordance with current Bank guidelines.

It is difficult to see how Monetary Base could be used as the subject of monetary control without subjecting the banking system to severe and erratic strains.

In theory it would be possible to exercise control of the money supply solely through bankers' deposits, by requiring a fixed percentage of clearing banks' assets for deposits to be deposited with the Bank of England. This would amount to direct control of bank assets. But in this case, Building Societies and Savings' Banks would be outside the system and there would be a tendency for these and other monetary assets to increase. so circumventing the control.

M_1 consists of currency with the public plus sight (demand) deposits in the banking sector. A series is published from 1963. The chart shows the ratio of N.N.P. to M (velocity of M_1), and the yield of consols. Since 1963 the velocity of M_1 is closely related to interest rates. It seems highly likely that a careful investigation would show that most variation in velocity could be attributed to this factor (possibly the interest rate other than that on consols with a suitable lag).

Latane (quoted by Friedman in The Monetary History of the USA) found just this in the U.S.A. This result seems highly plausible, as high interest rates would cause holders of money to spend extra effort in managing their affairs so as to have as little money as possible in non-interest-bearing forms.

For the period 1919-1963 the total of London Clearing Bank current accounts plus currency with the public, (a very similar aggregate to M_1, but lacking the current account of Scots, Irish and miscellaneous banks which are not available) shows the same relationship, although when interest rates are lower than about 5% the connection is rather weak.

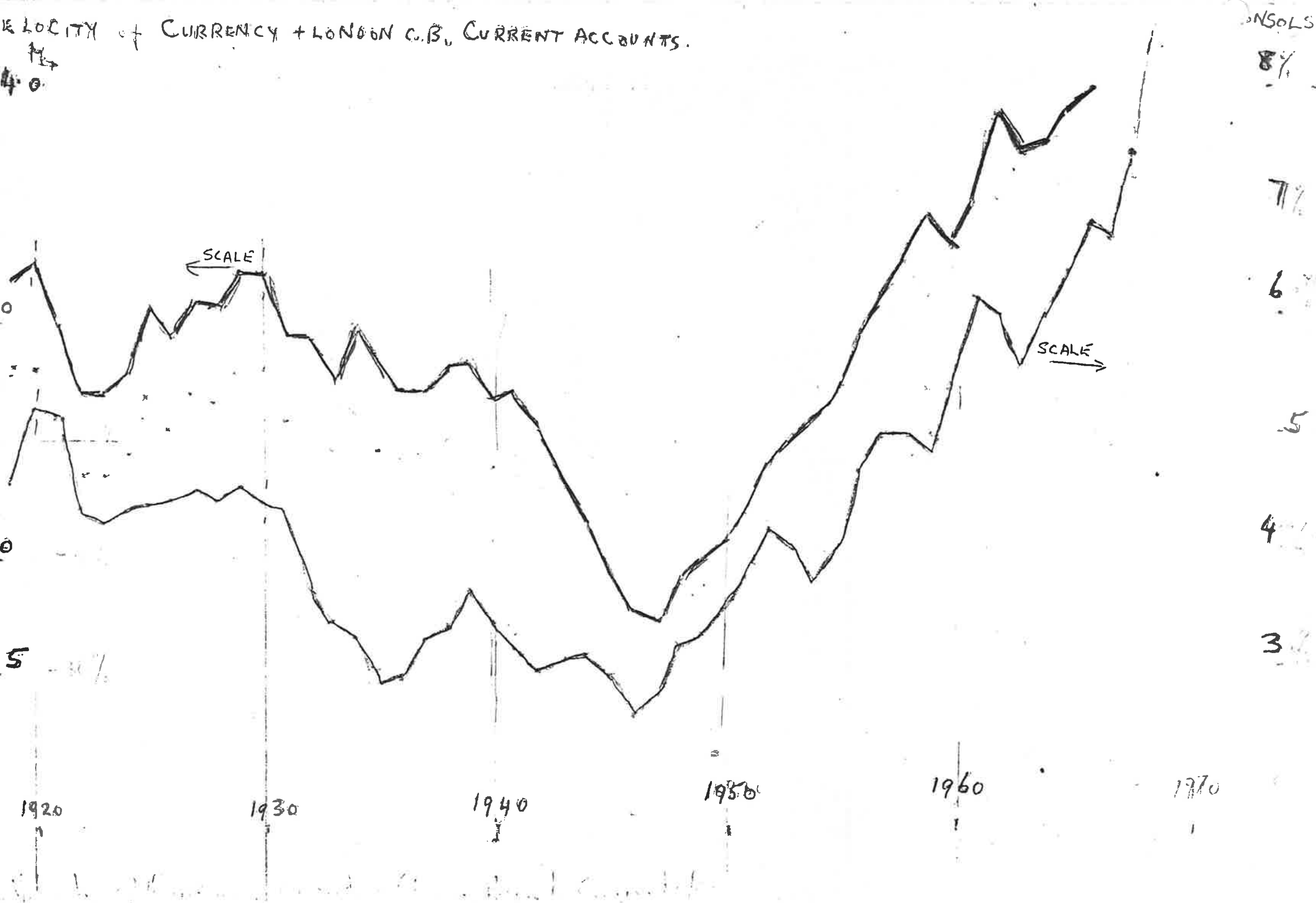
Sterling M_3 consists of currency held by the public plus the overseas sterling deposits of residents, including Public Sector Deposits. (these only account for 2% of the total) M_3 is the same plus residents' deposits in other currencies. Figures for £M_3 are available from 1963 and M_3 from 1955. It is possible to produce a series compatible with M_3 back to 1880. There was little difference between £M_3 and M_3 in 1963 and probably even less before; foreign currency deposits have only become of significant magnitude since that date.

Which series is best? It can be argued that non-sterling accounts should be excluded on the grounds that the UK government has no responsibility for, or influence on, the creation of other currencies, (although it could and at times has restricted holdings of residents). The contrary argument is that insofar as holders consider it as part of their money (they should be included).

PSL_1 is a rather wider total than £M_3 as it includes Treasury bills, deposits with local authorities and finance companies, bank bills and certificates of tax deposit, but excludes bank deposits with an original maturity greater than 2 years. Otherwise, is subject to the same limitations as £M_3.

The definitions of money described above may be subject to much criticism. Trustee Savings' Bank deposits are not included, although the T.S.B. have joined the London Clearing House. And apart from the original six London Clearing Banks and the newly joined Nat. Girobank and the Co-op Bank, none of the others can clear cheques except through a clearing bank, yet their deposits are included in £M_3. Many holders view building society deposits as money; they can at least partly be withdrawn on demand and to some holders are more accessible than banks as they open for longer hours and on Saturdays. The same is true of National Savings Bank deposits, which can, up to a limit, be withdrawn on demand at any Post Office. Other anomalies could be instanced. Clearly £M_3, along with the others, has many shortcomings as a definition of money.

The widest monetary aggregate published by the Bank of England is PLS_2. The underlying principle of the concept is sterling monetary assets with an original maturity of less than a year, but lack of data requires bank deposits to be included with an original maturity under two years. The principal components in addition to currency and bank deposits are: Building Society and Savings Banks deposits, National Savings Securities and Local Authority deposits. An annual series is available from 1963. The velocity is compared with that of £M_3 on Chart IV. Its velocity is rather less stable than that of £M_3. But if Saving Certificates are added a quite different result is obtained, and if foreign currency deposits of residents (the same as the difference between £M_3 and M_3) are added as well, the velocity of the resulting aggregate shows less variability than that of any other aggregate. For the sake of clarity I will call it Z. I have compiled a similar aggregate from 1880 to 1979. Although slightly different in composition, it gives almost exactly the same totals for the 1960s. This enables a compatable series to be extended back to 1880. The Bank of England exclude Saving Certificates because their early encashment entails a loss of potential interest. Saving Certificates are cashable on demand at about 8 days notice. Given the large size of PSL_2 approximately double that of £M_3, holders may well feel that they make up part of their liquid assets. In spite of the foregoing £M_3 has undoubtedly had more of the quality of "money" than Z and it is useful to consider the course of all three aggregates £M_3, M_3, and Z.


VELOCITY of CURRENCY + LONDON C.B. CURRENT ACCOUNTS.
4·0
3·0
2·0
1·5
SCALE
SCALE
CONSOLS.
8%
7%
6
5
4
3
1920
1930
1940
1950
1960
1970

CONSOLS
YIELD
%
17
16
15
14
13
12
11
10
9
8
7
6
5
SCALE
SCALE
VELOCITY
M1
6·0
5·0
4·0
3·0
1965
1970
75
1980

CHART V

P A P E R 3

MONETARY VELOCITY

Chart I shows the growth of National Income and two monetary aggregates, M_3 and Z since 1880. Chart II shows the ratio of income to M_3 and Z (velocity) which enables their relationship to be seen in more detail. Chart III shows the velocity of M_3 and Z from 1952 and the velocity of £M_3 from 1963, the earliest year for which figures for it are available. The velocity of Z is double scale to enable a more direct comparison to be made. The difference between £M_3 and M_3 was small in 1963 and probably even less before that date.

Over the 100 years from 1880 M_3 has multiplied by a factor of 114, Z by 178, and income by 160, of which a factor of roughly 30 is accounted for by the rise in the price level.

Clearly velocity is not constant; but its changes show a consistent and understandable behaviour. All the increases in velocity are caused by income increasing faster than money, none are caused by a reduction in money.

The decreases, however are of two distinctly different sorts, deflationary and inflationary.

On six occasions 1881-4, 1889-92, 1907-8, 1920-2, 1925-6 and 1929-32 reduced velocity was caused by reductions of income during recessions, and all of them were accompanied by increasing unemployment and either a reduction in the rate of monetary growth or an actual reduction IN THE QUANTITY OF MONEY.

The inflationary reductions of velocity are of a directly opposite nature, due to a large (in relation to recent experience) increase in the money supply. The two smallest drops of this sort were in 1894-6 and 1932-3, both of which periods followed a decade or more of declining prices and signalled the change to an upward drift in prices. In both cases income increased but money substantially more, leading to periods of very low interest rates.

Retail Price Index	1913 = 100
1880	103
1895	81
1913	100
1920	240
1933	137
1937	152

The drop in velocity from 1913-14 marked the start of inflation in World War I, during which the price level doubled. The drop from 1918-19 was caused by rapid expansion of the money supply leading to a renewed upsurge in prices to 1920 before the collapse in 1921-2.

World War II saw the largest drop of velocity recorded, from 1941-46, and led to price inflation that has continued to the present day, with only a brief break in the late 1950s.

The only subsequent fall in velocity up to 1980 occurred from 1971-4 when an unprecedentedly large increase in the money supply occurred, and led to the very high rates of inflation experienced since.

A major feature revealed by the charts is the change to a lower level after 1920. Why did velocity not return to its pre- 1914 level after the war, as it did in the U.S.A? The explanation is to be found in the following quotation from Hawtrey "A Century of Bank Rate".

"The enormous war borrowings of the Government had upset the balance in the market between Government securities and all other forms of investment. It had been necessary to attract into Government securities the main body of savings. Up to 1914 Government securities had been sought mainly as a reserve investment, readily marketable and well adapted as collateral for bank advances. Once this essential reserve had been provided, the investor turned to securities of high yield, relying on his own judgement or an expert advisor to select them without any serious sacrifice of safety, though possibly at some sacrifice of marketability.

The exigencies of war led the Government to offer a yield which obliterated all these nice distinctions. And after the war, when securities with these characteristics amounted to thousands of millions, their scarcity value had been destroyed."

The quantity of Gilt Edged held by the public outside the monetary system in 1913 was sufficient to account for the change. Of the £661M outstanding in 1913, £323M was held by banks and savings banks, the other £338M being held by the public. During the war the market price of consols fell sharply, undermining their quality as a monetary reserve. This resulted in the public's unwillingness to hold more cash and bank deposits; in other words restrained the rise in velocity that otherwise might have taken place, and indeed did in the U.S.A.

The very low velocity in 1947, or in other words, the huge amount of money and liquid assets in the hands of the public, was the exact opposite of the position after the first war. During the decade 1947-1957 M_3 increased by only 9% or under 1% a year on average. In spite of the very low increase in the money supply, inflation continued during this period - the price index rose by 62% and was only prevented from rising even faster by the retention of war-time controls and rationing much longer than in most other countries. 1957 brought monetary velocity back to a stable value, henceforth income was very closely linked to money as the charts clearly show.

This point is confirmed by a passage in F.W. Paish "Studies in an Inflationary Economy" written in 1958.

"The rise in retail prices has slowed down in recent months and is now believed to have come to an end...... Above all it would seem that the last vestiges of concealed inflation have now been squeezed out of the British economy. The last of the physical controls have been abandoned; and it is now doubtful if such financial controls as remain are now having any important effect....... the post war British inflation is over."

What can be said about the reduction of velocity in 1980-81? The high rate of inflation during the first war and during the 1970s led to abnormally high values of velocity, although the rise in the first war was masked by the contrary influence of the decline in the status of Government debt described by Hawtrey. The reduced expectation of inflation in 1981 clearly led to the reduction of velocity in 1981, as it did in 1921. Although the rate of monetary growth continued high in 1981, I think it is clear the decline is of the first deflationary type rather than the second inflationary type. It is difficult to see how far the fall will continue as inflation remains at a historically high level, although it may be noted that the 1921 and 1929-32 declines were both of considerable size and both continued for about four year. This shows that fixing targets for monetary growth without consideration of the likely change in velocity during the next years or two may be a dangerous policy.

Failure to understand that velocity would fall from its abnormally high level of 1976-80 is the reason that the Government was unwilling or unable to keep to its targets for monetary growth. It seems quite possible that the same thing will happen in 1982. The increase in prices is forecast at say 10% average for 1981-2, a 2% increase in output would imply a 12% increase in income, and the target for the growth of £M_3 is 6-12% in a year. This leaves no margin for a reduction of velocity even at the higher rate of monetary growth. The past record gives little reason to be confident that velocity will not fall again in 1982.

1981

The Treasury estimates Real G.D.P. as 98% of 1980.
The R.P.I. rise year on year average is 12.5%

Thus Money G.D.P. 1981 = 1.1025 of 1980 assuming that N.N.P. shows the same increase, 1981 N.N.P. is £182,800

Velocities (against N.N.P.)

	M_1	£ M_3	M_3	PSLZ	
1977	5.38	2.66	2.40	1.30	)
1978	5.06	2.64	2.38	1.30	) Money figures from
1979	5.14	2.68	2.46	1.30	) the series in the 1981
1980	5.60	2.65	2.43	1.31	) Dec. B. England Bulletin
1981	5.58	2.49	2.20	1.23	)

The Lower velocities (except of M_1), in my view due to lower inflationary expectation, which are a reversal of the extraordinary rises from 1974-6, explain several phenomena, at least in part:

1. The Government's inability (or unwillingness) to control £M_3 in line with their stated target;

2. The inaccuracy of nearly all recent economic forecasts

The only years since 1880 with a fall in VM_3 as large as the change 1980/81 are 1920-21, 1921-2 and 1931-32. 1943-4 shows as large a drop, but that is a very different phenomenon (i.e. suppressed inflation in wartime, when most consumer goods and servies were unobtainable, or rationed, overseas trade disrupted and millions of persons in the Services).

In 1942-43 the drop was a disturbance (wartime deficit financing) reducing velocity below its stable value.

In 1920-22 the drop was due to severe depression caused by a reduction in the money supply and in part by a similar severe decline in the U.S.A.

In 1930-31 the drop brought velocity to an unprecedentedly low figure.

In contrast, the fall from 1980-81 is from an abnormally high value of velocity.

All three declines (1942-3 being a different specie) were accompanied by rapidly increasing unemployment.

The M_1 velocity demonstrates once again that its behaviour is quite different from that of wider aggregates and is almost entirely determined by interest rates, with a lag of about one year.

Written Jan 1982

EXTRACT FROM "THE DAILY TELEGRAPH" JANUARY 1982

ENOUGH CASH AROUND FOR RECOVERY - BURNS

"There is enough money in the British economy to support a satisfactory recovery and the faster costs and prices decelerate, the sooner and the faster real activity will recover, Terry Burns, chief economic adviser to the Treasury, said yesterday.

In a speech to the Industrial Society Dr. Burns appeared to hold out little encouragement for advocates of reflation in the March Budget, but he added that Treasury forecasts of growth this year may be pessimistic. He said that there was little the Government could do to promote the beneficial effects of a slow-down of inflation and costs. It largely depended on the reactions of industry and wage bargainers.

But Dr. Burns revealed that last year's Budget and subsequent interest rate reductions were indirectly meant to lower the exchange rate and so take pressure off companies.

Underlining the Government's commitment to a disciplined financial framework, consistent with a further reduction in inflation, Dr. Burns said: "The current growth of money gross domestic product, at around 10-11 p.c. is enough to support a satisfactory recovery provided it is not wholly taken up by higher inflation."

There were now signs that the general balance of the economy was improving as resources have been switched from the personal sector to companies and recent indicators bear out that the trough of the recession was passed in the second quarter of the year.

The Treasury forecast in December that real growth would be 1 p.c. this year but "there may be a greater chance of this being exceeded than the economy falling short of it" he said.

Earnings growth remained a major uncertainty but a cautious view was that some further slow down would take place. After the effects of a lower exchange rate had worn off, the effects of the Government's counter inflationary policy and better pay behaviour should predominate, leading to further falls in inflation this year."

"Enough Cash for Recovery" - Dr. Burns

Is this true??

In 1921-2 and from 1932-3 velocity continued to fall after unemployment started to drop. (see table). Will the same course of events follow 1981? The rapid rise in unemployment is very similar to the previous occasions, what is completely different is that in 1980/81 velocity fell during price inflation, whereas 1921 saw a very large fall in prices, as did the period 1929-1932.

Dr. Burns, if correctly reported, makes no allowance for a change of velocity, which,it is now clear, occurred in 1981, and may well continue into 1982. "enough money"? when velocity of $£M_3$ in 1980 was twice that of 1933, and the highest it has been for over 100 years. Even the lower value of 1981, if my estimate is correct, is higher than at any time back to at least 1880, excepting only the years since 1976. When this factor is taken into account, there was in fact only half the money in the economy in 1980 that there was in ~~1982~~. 1933

In both the 1920-21 and 1929-32 recessions, velocity continued to decline after the peak of unemployment. The rise in unemployment in 1979-81 occurred during a period of rising prices whereas the two previous recessions saw substantial price falls, in spite of this difference, in view of the high value of velocity Since 1977, it seems quite possible that the previous pattern may be repeated and velocity fall to a lower value in 1982.

From: Feinstein

	Unemployment: Thousands	Annual Average %	Velocity $£M_3$
1920	391	2.0	1.91
1921	2,212	11.3	1.56
1922	1,909	9.8	1.39
1923	1,567	8.1	1.42
1924	1,404	7.2	1.49
1925	1,559	7.9	1.61
1926	1,759	8.8	1.54
1927	1,373	6.8	1.61
1928	1,536	7.5	1.59
1929	1,503	7.3	1.62
1930	2,379	11.2	1.59
1931	3,252	15.1	1.45
1932	3,400	15.6	1.39
1933	3,087	14.1	1.31
1934	2,609	11.9	1.45
1935	2,437	11.0	1.42
1936	2,100	9.4	1.41
1937	1,776	7.8	1.43
1938	2,164	9.4	1.48
1939	1,340	5.8	1.57
1940	710	3.3	

$£M_3$ is the Government's chosen monetary aggregate.

$V£M_3$ never over 2.0 (except 1918 2.03) since 1880, and possibly long before,

1933 VM_3 =1.31 (1980 - $V£M_3$ = 2.63), i.e. twice the money in the economy in

1933 in relation to income as in 1980.

R. January 1982

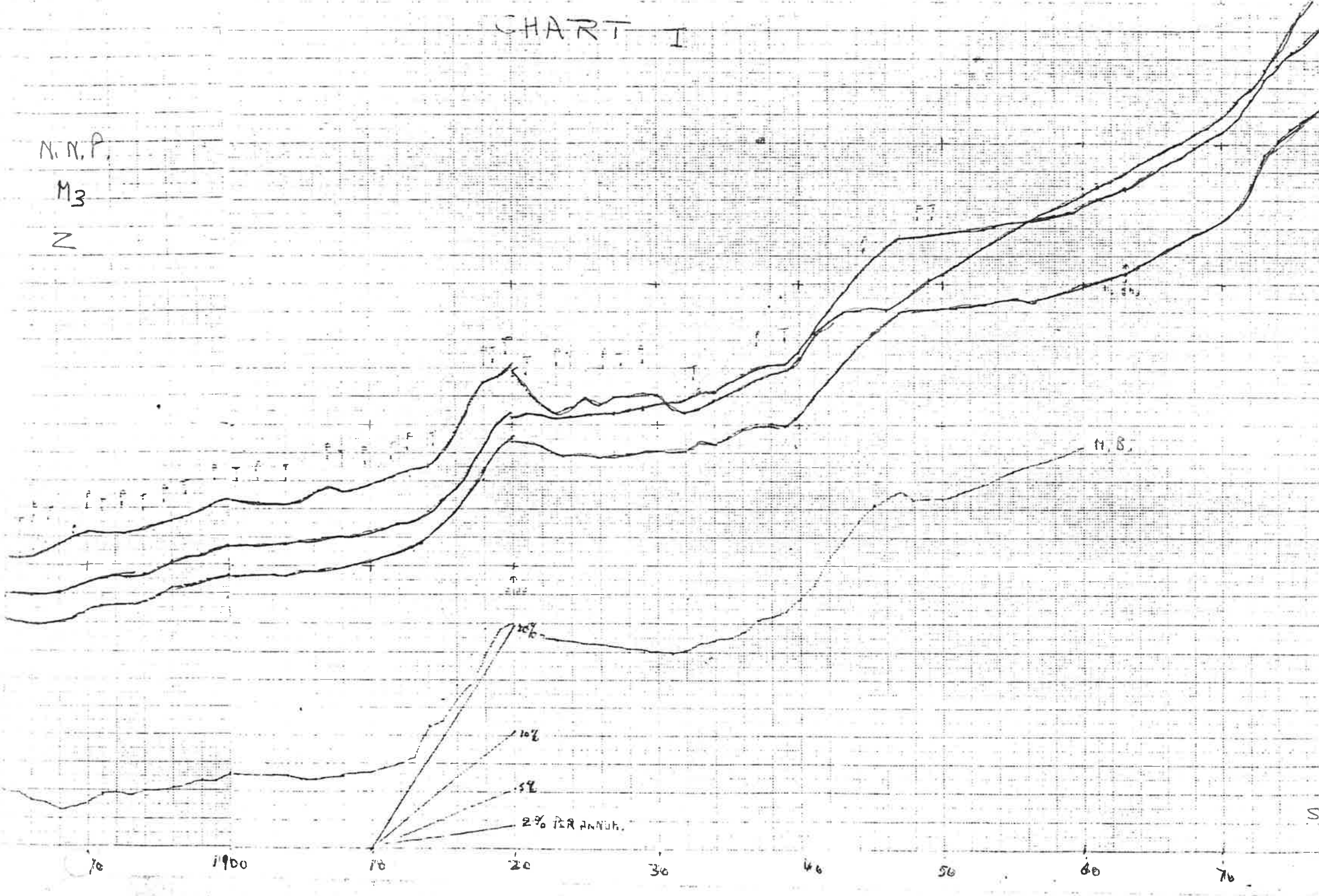


CHART I
N.N.P.
M3
Z
M.B.
20%
10%
5%
2% PER ANNUM.
1900
10
20
30
40
50
60
70

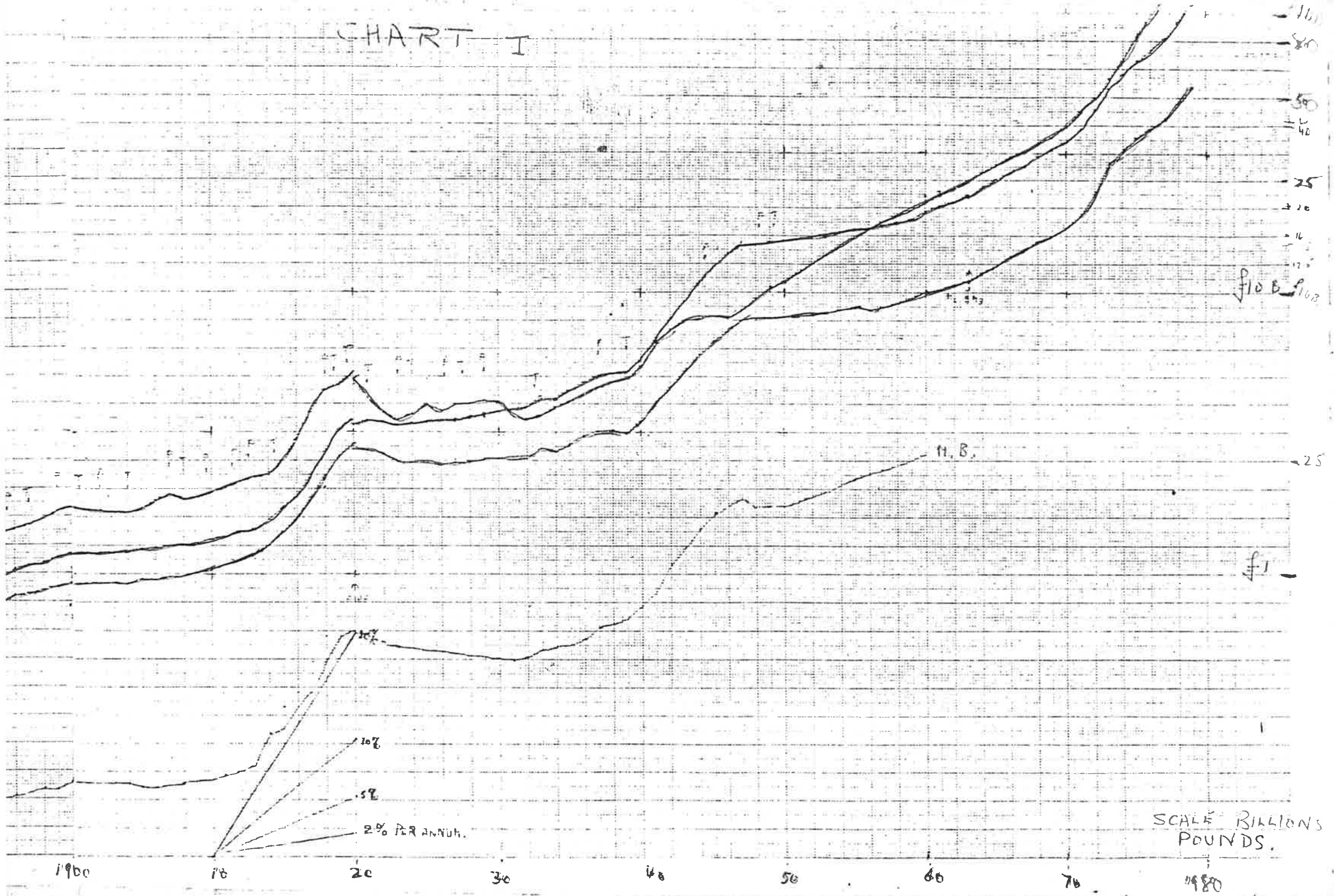


CHART I
M. B.
£10 B
£1
10%
10%
5%
2% PER ANNUM.
1900
10
20
30
40
50
60
70
1980
SCALE: BILLIONS POUNDS.
160
80
50
40
25
20
16
12
2.5

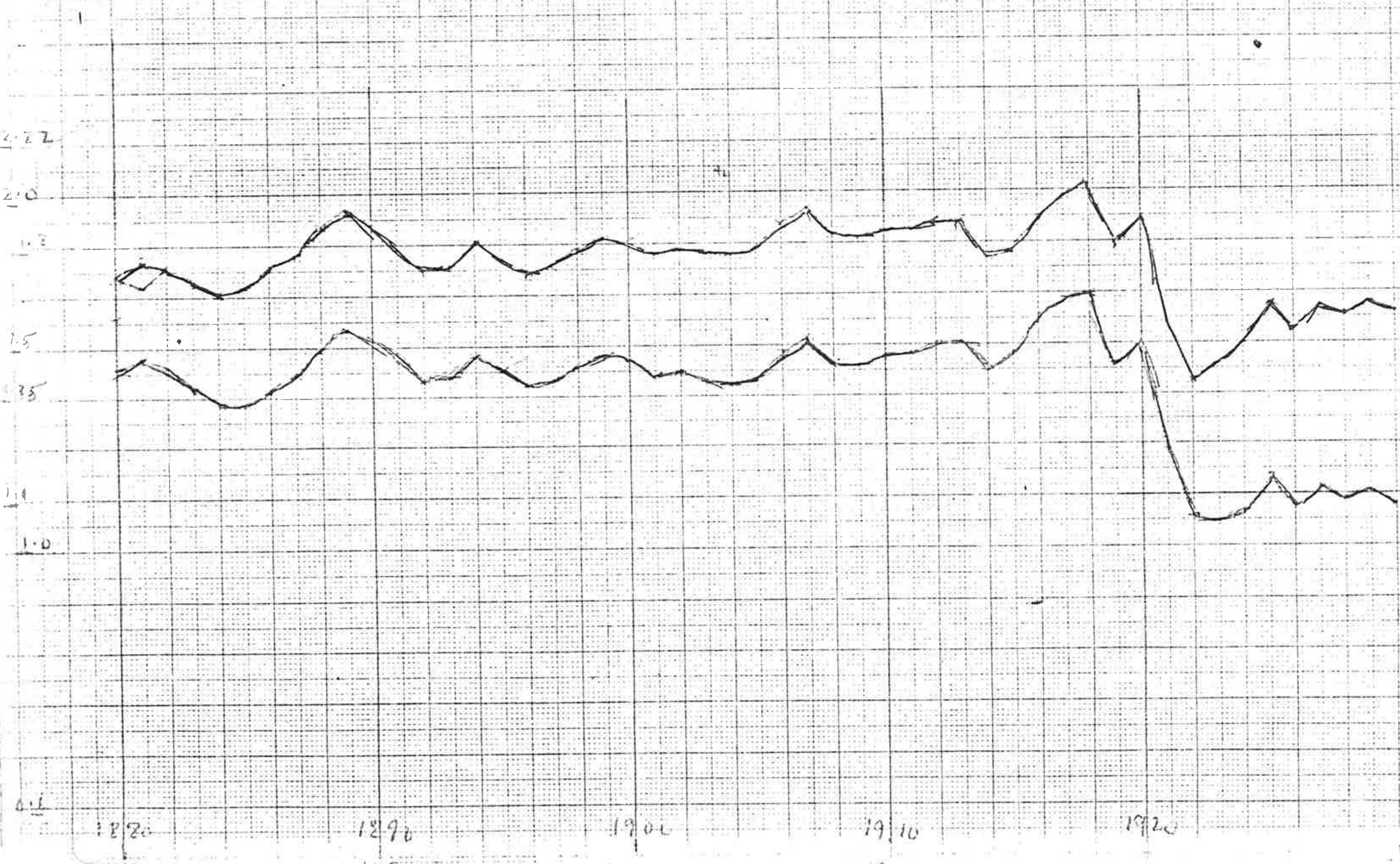


CHART II
1880 - 1930
VELOCITY M3
VELOCITY Z
SCALE
LOGe V
2.0
1.5
1.0
1880
1890
1900
1910
1920

CHART II

1930 - 1981

VELOCITY M_3
VELOCITY Z

LOG
SCALE

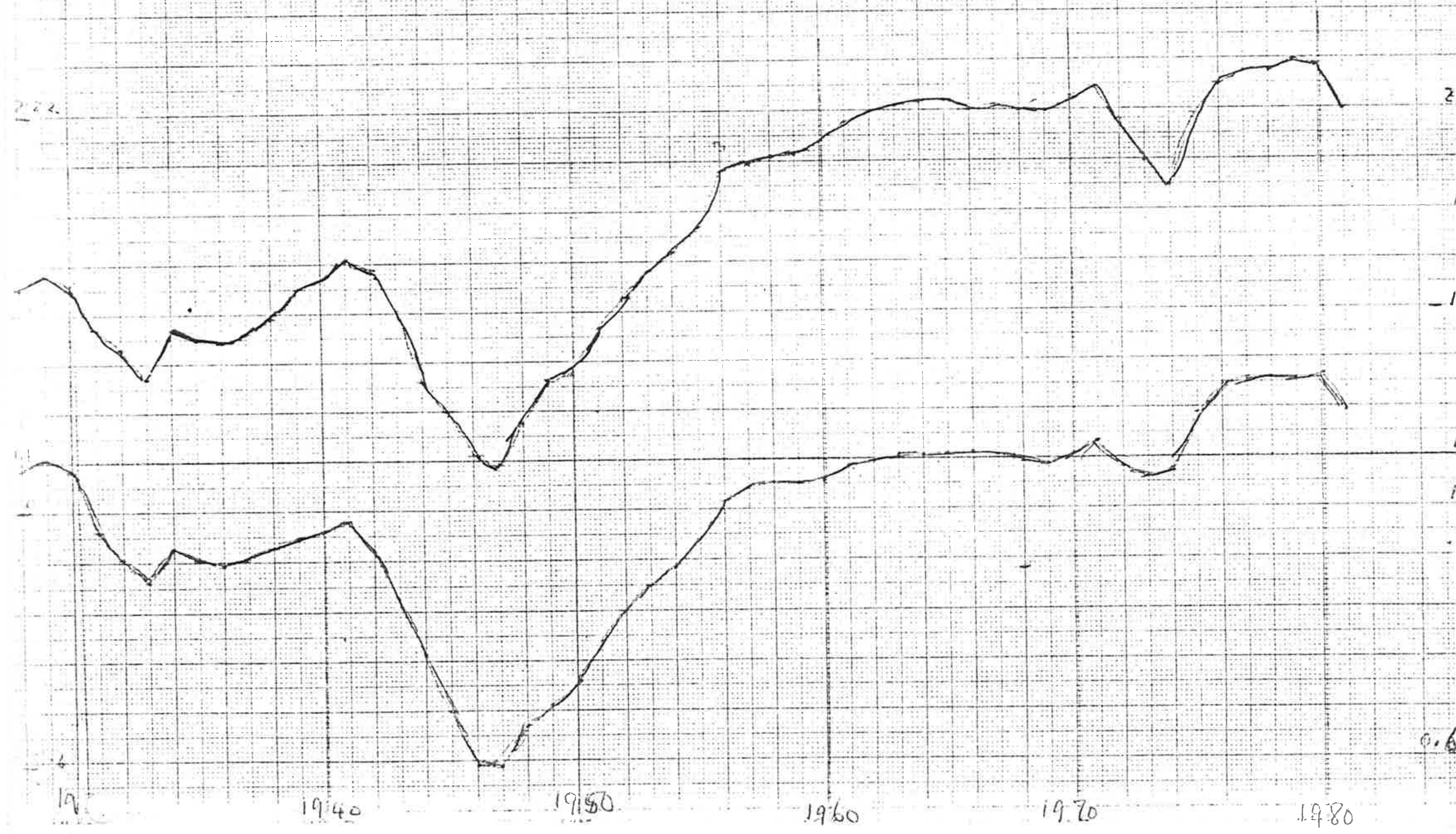
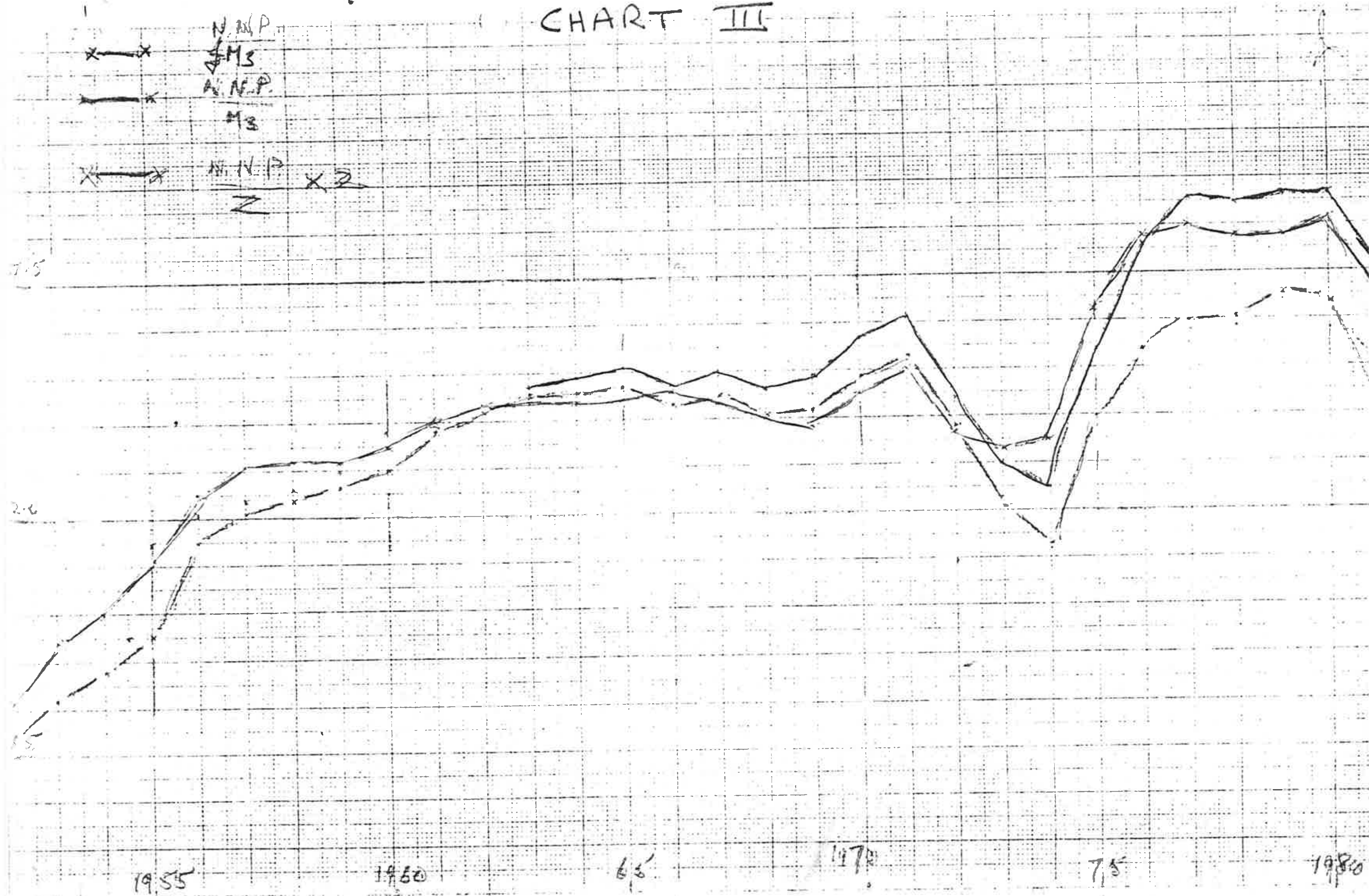


CHART III



It is suggested in the paper on Monetary Velocity, that velocity decreases with an abatement of inflation. One of the most spectacular inflations and most rapid recovery of monetary stability afterwards, occurred in Germany in 1923-4. It is certainly the best documented thanks to Brešciani Turroni in his excellent book "The Economics of Inflation".

German prices rose at an increasing rate from 1914 until August 1923 and then roughly doubled each week until stabilisation, which may be given as 16/11/23, the date of the first issue of the Rentenmark. Thereafter the currency was stable both as measured by the price index and on the foreign exchanges until the disasters of the 1930s.

Because of the great scale of the change, other economic variables are dwarfed and the relationship between inflation (or prices), money and government deficits can be seen almost in isolation from other factors, such as real income.

After stabilisation one million million (10^{12}) pre-war marks in paper were equal to 1 Tentenmark and later to 1 Reichsmark, both being of the same gold value as the pre-war gold mark.

Value in Gold Marks (millions) of

Date	Paper Marks Currency	Rentenmark in circulation	Total	Price Index in Gold 1913 = 100
1913 Average			6,070	
16/11/23	93	0	93	139 November
30/4/23	400	501	901	
31/12/23	496	1,049	1,545	126.2 December
31/3/24	690	1,760	2,456	120.7 March
31/7/24	1,211	1,803	3,014	125.2 May

After declining to 1½% of the 1913 circulation in real terms during a period of less than a year, legal currency increased by a factor of thirty, (3,000%!) during a period of price stability. A similar result is found if bank deposits are examined. Six Berlin Banks had deposits (valued in gold) of 905 millions at 1/1/24 and 3,585 millions at 31/12/25. Clearly price stability was not produced by restricting the money supply.

The factor which stands out in stark contrast is the change in Government Finances. In the last ten days of October 1923 only 0.8% of expenditure was raised by taxes. This was the end result of the failure to raise adequate revenue by taxation from the start of the war in 1914. In the financial year 1924-25, receipts were 7,757 millions, expenditure 7,220, budget surplus 737 millions.

The whole disastrous episode shows that once the confidence in a currency to maintain its value has been seriously undermined by inflation, the only method to restore confidence is to balance the budget, and that once this is done the velocity of money decreases and further money must then be issued to prevent a severe recession.

The position in the UK today is similar. Inflation has not risen to anything approaching the German experience, yet it has gone far enough in the last decade for the same phenomenon to occur. The rise in velocity during 1974-6 is now being reversed; prices which increased faster than the money supply in that period

are now rising slower than the money supply. This is evident in change from 1980 to 81, but it remains to be seen how much longer this trend will continue. This is why the Government has been forced to allow the money supply to expand more than it planned, why unemployment is higher than anticipated, and why inflation has continued, albeit at a reduced rate, to be higher than was hoped for in 1979.

O

The Austrian Crown 1922/23

After a depreciation of a currency has been going on for some time, traders and consumers begin to realise that holding money involves them in a loss and as a result take steps to avoid this by buying goods, property and other real investments, such as art, furniture etc. This bids up price (P) even faster than the monetary issue (M) is increasing, or to put it in other words velocity increases. And the real value of money in circulation (M/P) decreases.

When inflation is halted the opposite occurs. Once the fear of money losing its value has been averted the public holds on to money, rather than squander it on goods they don't really want, and over a period of time rebuild their holdings of notes and bank deposits. As a consequence the quantity of money can be increased without inflationary results, indeed it must be increased if a very severe deflation is not to result.

A good example of this process at work was during the stabilisation of the Austrian Crown in 1922-3. Over a period of 15 months following the stabilisation of the currency the note circulation quadrupled, as may be seen in the Chart and Table. An examination of the chart indicates that the halting of inflation can hardly be attributed directly to halting the increase of the note issue. As was clear at the time, the decisive action was that taken to balance the budgets which was achieved before the end of 1923. A foreign loan helped the government to tide over the gap, but this was not an essential element as may be seen in the case of Germany a year later, where stabilisation was achieved without foreign assistance.

After November 1922 the Central Bank stopped lending to the Government, all further increases in the note issue were backed by 100% Foreign Exchange.

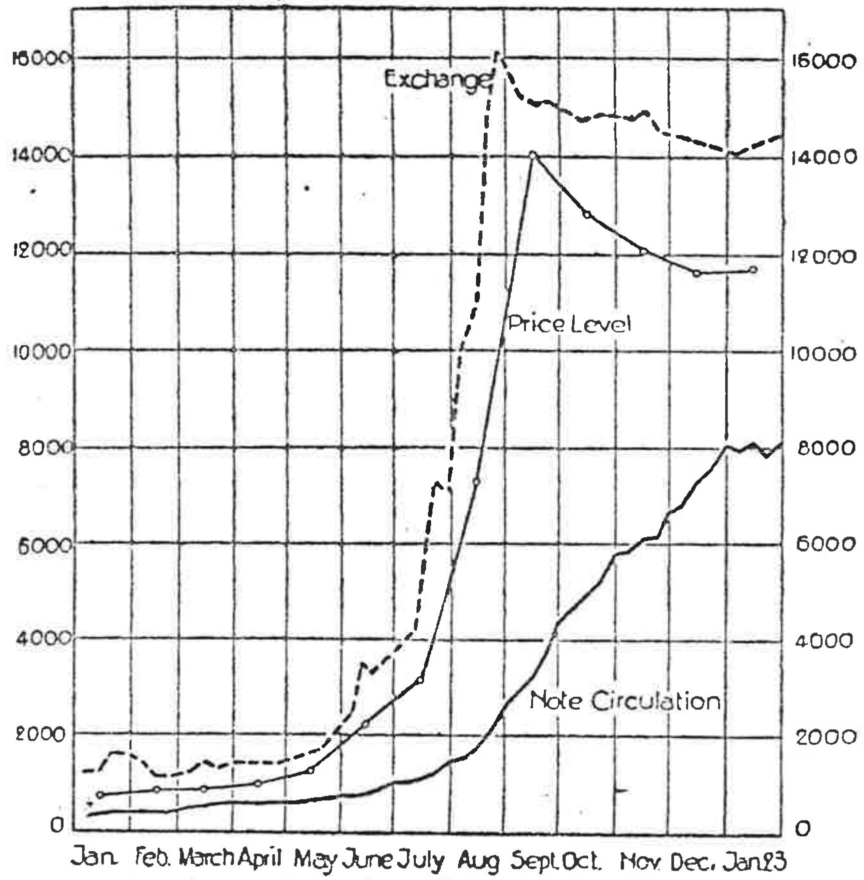
The Austrian Crown

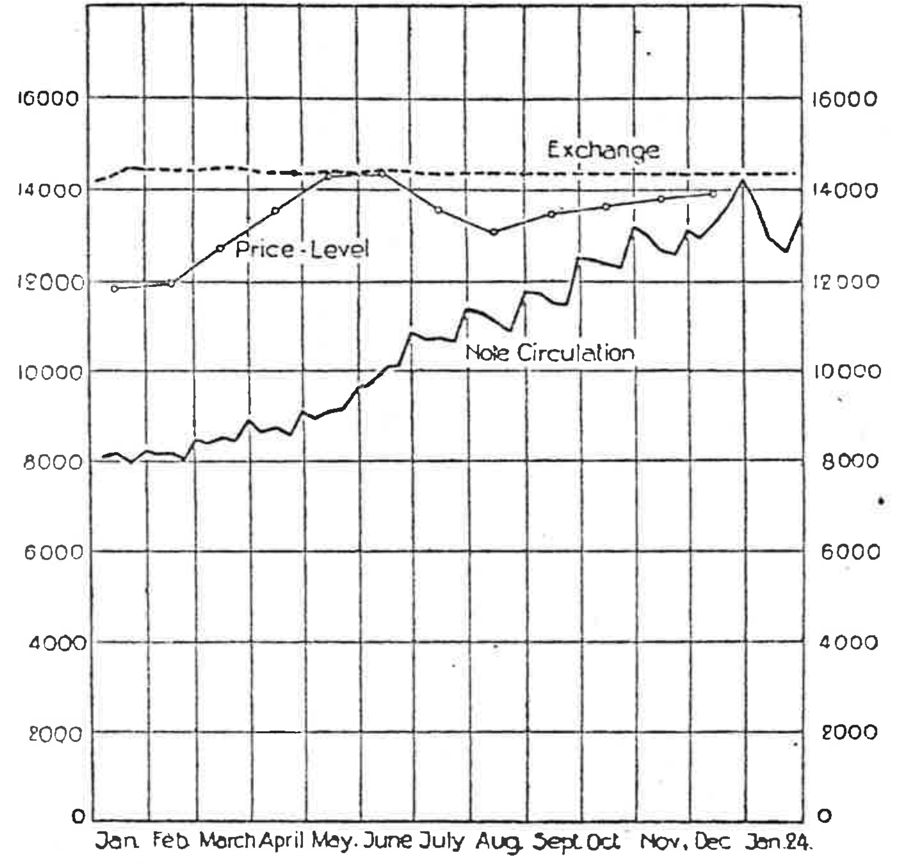
Indices 1914 = 1

Date	Currency in Circulation M	Prices P	Real Money M/P
15/ 6/1921	94.4	119	0.79
15/ 1/1922	387	830	0.47
15/ 9/22	3402	14153	0.24
15/12/22	7423	11737	0.63
15/12/23	13364	12860	1.04

Source: The Austrian Crown by Walre De Bordes

INDICES 1914 = 1.





The French Franc 1914-1936

The inflation suffered by the Franc during and after the 1914-18 war was comparable in magnitude to that in the U.K. during the 1970s. From 1914 to 1926 prices multiplied about six times in France, in the U.K. from 1970 to 1982 prices multiplied by a factor of 4.5.

In the U.K. bank rate was at high level throughout, with a maximum of 17% whereas in France the discount rate on commercial paper never exceeded 7.5% and that for only 6 months in 1926 (falling to 5% in 1927 and 3.5% in 1928) the interest rate on Government stocks reached 16.5% in the U.K., but in France was only a little over 6%.

Chart I shows that prices rose rapidly during the war, this was paraleled by price rises in both the U.S.A. and U.K., though in France the rise was somewhat larger. After the war when support for the Franc was removed its exchange value rapidly dropped followed by wide fluctuations to a low of 50F = $1 in July 1926.

The rise in retail prices was broadly related to the increase in the note circulation, while the wholesale index is clearly more influenced by the exchange rate as would be expected as it includes many internationally traded raw materials.

Chart II shows Budget receipts and Expenditure. As gradually became clear during this period, it was impossible to stabilise the exchange rate and halt inflation until the Budget was balanced. Once this was achieved and maintained by the determination of Poincaré in 1926, the Franc rose on the exchanges and was fixed at about 25F = $1 by the Bank of France taking in Foreign Exchange in return for notes, that is to say increasing the money supply.

ChartIII shows the purchasing power of the Franc against the Pound and Dollar.

The Franc was stabilised at a value which put its Purchasing Power Parity at about 70% of its prewar value. This resulted in the Bank of France rapidly acquiring a very large exchange and Gold reserve and enabled France to weather the first years of the depression with little strain, but the determination to maintain the Gold value of the"Poincaré Franc" resulted in the French economy coming under very severe strain after the devaluation of the Dollar (From $20.67 to $35 on Gold), which to French exporters was the equivalent of the exchange rate rising by 70%. Unemployment became severe and social tensions caused political and social disorders leading to the devaluation of the Franc, together with the other "Gold Bloc" countries in Europe, in Sept 1936.

In marked contrast to the U.K. today, inflation and exchange fluctuations caused very little unemployment which never exceeded 100,000 (admittedly a doubtful figure) in the 1920's; serious unemployment only occurred when due to external devaluations, the Franc became relatively overvalued.

Conclusions

An overvalued currency is a major cause of unemployment. A Balanced Budget is an essential to halting inflation once prices have risen substantially. Reducing a Budget deficit (PSBR) does not by itself cause unemployment.

Increases in the Money Supply and the Price level are roughly comparable. Inflation can be halted without a strong exchange rate (High P.P.P.).

Source: E. Dulles, The FRENCH Franc.

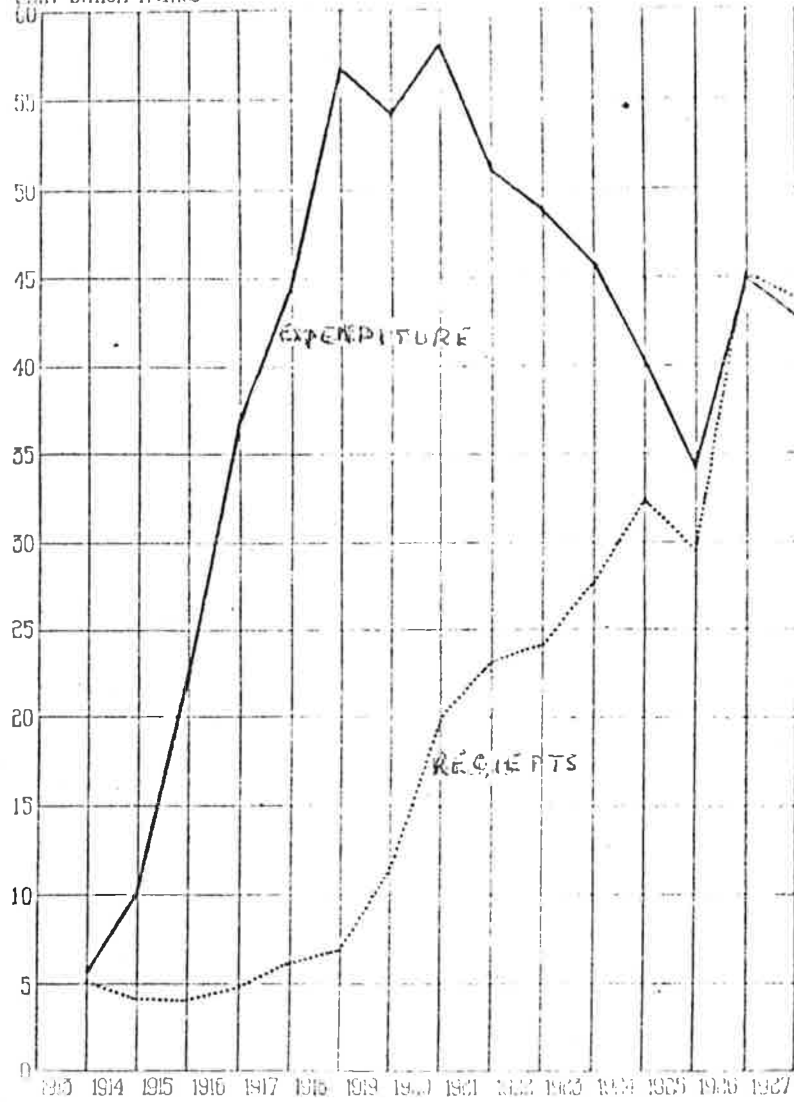


CHART ~~XX~~II

BUDGET RECEIPTS, EXPENDITURES, AND DEFICITS, 1913 TO 1927[1]

[1] See Appendix for figure.

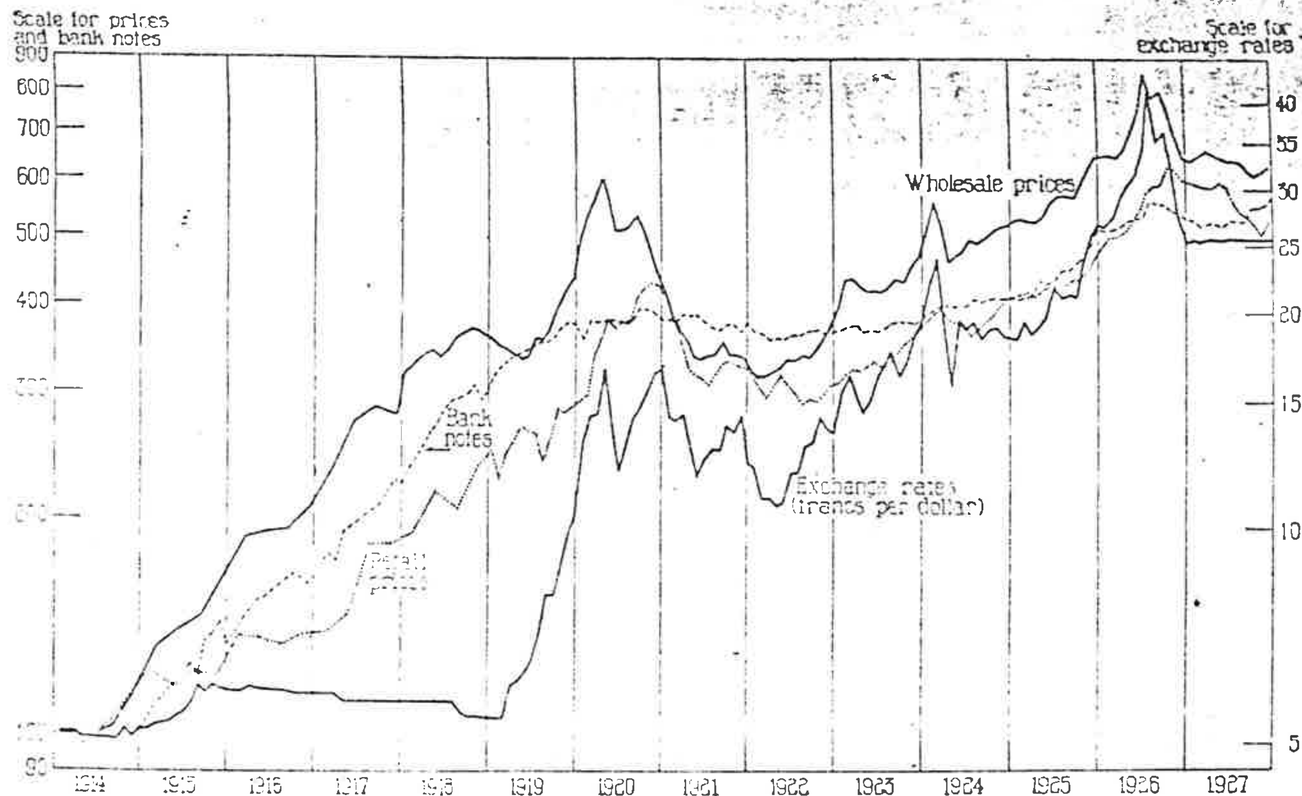


CHART I

THE VALUE OF THE FRANC AND BANK NOTE CIRCULATION, 1914-1927[1]

[1] See appendix for figures; the chart is on a logarithmic scale.

COMPARISON OF ECONOMIC INDICATORS OF FRANCE 1926-27 AND UK 1979-80

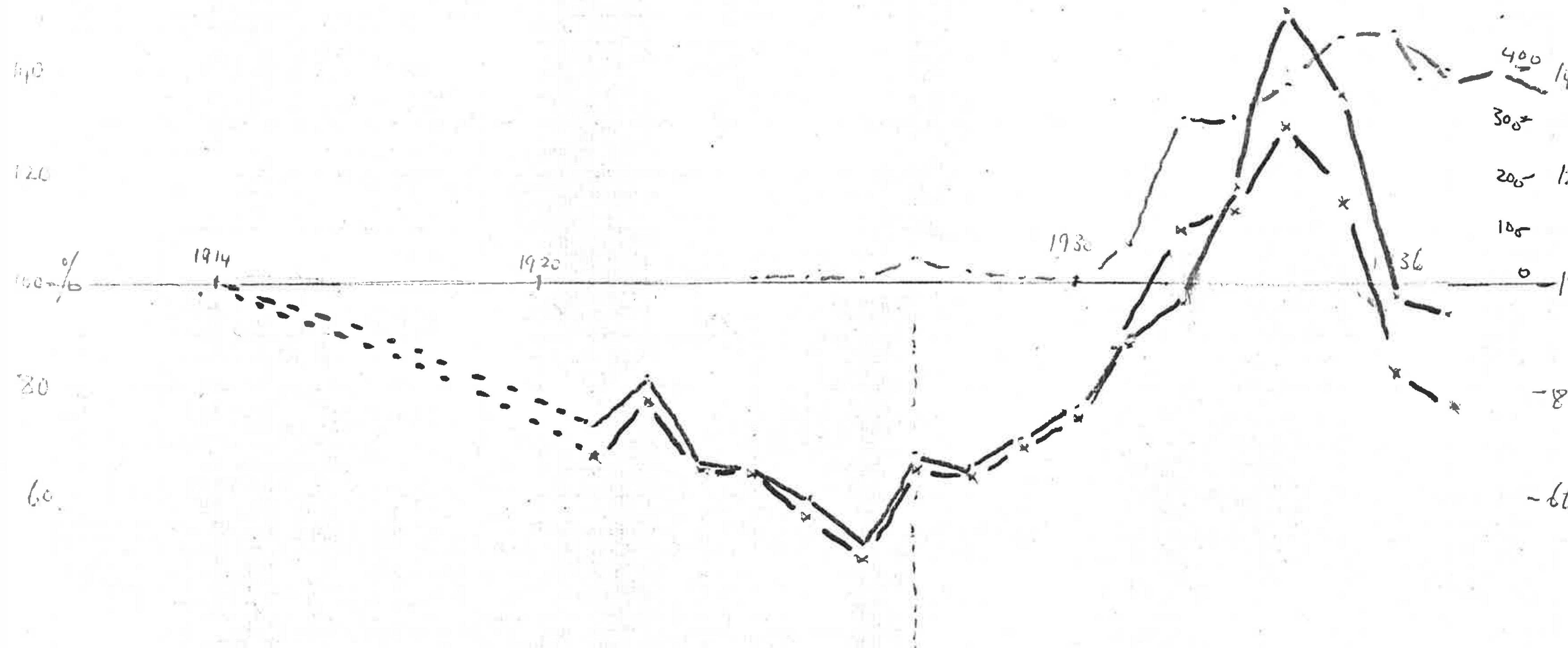
		FRANCE July 1926	FRANCE Change	FRANCE December 1927	UK July 1979	UK Change	UK December 1980
PRICES							
12 month Inflation Rate	%	+36.3[a]		-12.7	+15.6		+15.1
Increase in RPI over the 18 month period	%		-8.9			~~+19.6~~ +20.3	
INTEREST RATES							
France: Discount Rates on Commercial paper UK: MLR	%	7.5		4.0	14		14
FISCAL BALANCE							
France: budget for fiscal years 1926 & 1927 (millions) UK: PSBR (millions) (Deficit - or surplus +)		-FF 4,340		+FF 699	-£12,611		-£12,244
UNEMPLOYMENT							
France: Demands for employment not satisfied[b] UK: Unemployment		7,682		27,603	1,392,000		2,150,000
Increase over the period			+19,921			+758,000	
MONEY SUPPLY							
Note circulated (millions)		FF 56,022[c]		FF 56,551	£ 9,305		£ 10,411
Increase			+1%			+12%	
France: Deposits of 4 main banks[d] UK: Sight deposits		FF 22,418		FF 26,405	£18,587		£ 20,802
Increase			+18%			+12%	
EXCHANGE RATE							
$1=		FF 36.22-49.22		FF 25.40	£ = $2.37		$2.37

NOTES
(a) Bulletin de la Statistique generale de la France
(b) Bulletin du Ministre du Travail
(c) Banque de France
(d) Societe Generale
Credit Lyonnais
Comptoir d'escompte de Paris
Societe generale du Credit industriel et commercial

CHART III   1914 = 100   PURCHASING POWER.

F.F. : £

F.F : $



UNEMPLOYMENT '000

DEC. 1926 STABILISATION OF FRANC.

SEPT. 1931 DEVALUATION OF POUND

APRIL – DEC 1933 " " DOLLAR

SEPT 1936 " " FRANC

SOURCE LEAGUE OF NATIONS YEARBOOKS.

PAPER 5

PURCHASING POWER PARITY

Purchasing power parity (P.P.P.) is a concept which provides a measure of a country's competitive position. The idea in principle is simple. Starting from any given point in time a country's competitiveness can be improved either by a depreciation of its currency at given domestic and foreign prices, or by a change of its price level relative to foreign prices at a exchange rate. Thus to obtain an indicator of competitiveness one needs to allow for price changes at home and abroad in addition to changes in the exchange rate. This is what P.P.P. does.

Clearly the P.P.P. between two currencies cannot change significantly without having important economic consequences.

A country whose currency has a high P.P.P. relative to another is likely to meet strong competition both in its export markets and from imports. If the pressure is heavy it will lead to reduced output and unemployment. Those in full employment will benefit from lower prices and so experience a rise in their real standard of living.

A low P.P.P. has the reverse effect, a booming export trade and a strong demand for labour. If accompanied by a strict monetary policy it is likely to produce a large balance of trade surplus. This is what happened in W. Germany during the 1950s and 60s. If monetary policy is lax, it will lead to imported inflation, and heavy internal demand will tend to prevent a trade surplus developing. This has been the position at times in the U.K. since the war, especially in the mid 1970s.

Graph 1 shows that the purchasing power of the £ relative to the $ fluctuated within a fairly narrow band about the 1929 relationship for a very long period before 1949. The sudden leap in its value at that time appears to indicate that the 1949 devaluation was overdone by at least 10%, and from 1950 to 1977 the £ was undervalued compared to the eighty years before. The change in 1977, due to U.K. oil, was a return to a more normal range of values after a period in which unusually, we did not have a substantial energy base. For most of the previous century, coal was just as important to the U.K. as oil now is: before the First World War and between the wars, coal formed 10% of U.K. exports. Moreover, up to the 1940s, U.K. income from overseas investments was considerable: in 1913 the U.K. had about £4,000 million in overseas assets (the equivalent today in relation to national income would be about £250,000 million). These assets were mostly used up in paying for the 1939-45 war.

Where sharp divergences from historically more normal values of the £ compared to the $ occur, as in 1932, 1950-51 and 1979-80, powerful economic forces are generated which tend to bring the parity back to those more normal values. Through all the changes of over 100 years the purchasing power parity has always tended to return to the mean value. This now appears to be happening again.

The strengthening of sterling after 1977 brought the P.P.P. of the $:£ to an unprecedentedly low value and was a powerful contributory cause of the increasing unemployment in 1980-81.

Chart II shows the P.P.P. of three currencies against the D.Mark. [illegible] shows clearly that the D.Mark was undervalued during the 1960s which, [illegible] with a tight monetary policy caused W.Germany to have a thriving expor[illegible]

PURCHASING POWER PARITIES

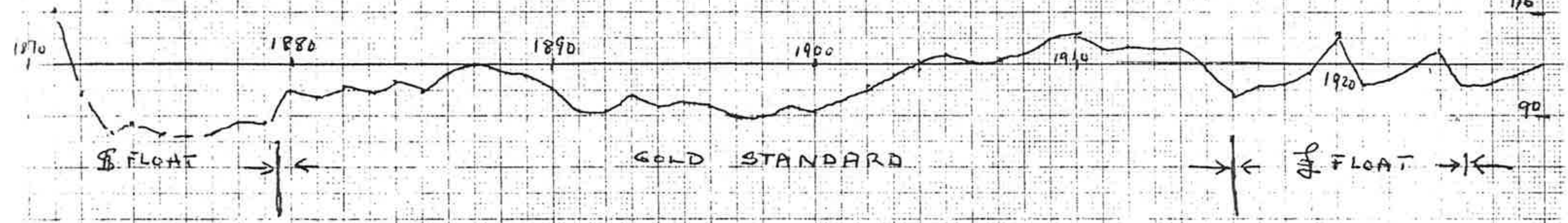
YEAR	$: £	$: DM	FF : DM	DM : £	FF : £
1976	112.2	98.2	94	114.3	108
1977	105.8	91.8	88	115.3	102
1978	95.9	83.8	89	114.5	102
1979	81.8	78.4	94	104.3	98.5
1980 1st Qtr	77.9	82.6	97	94.3	84
2nd Qtr	75.3	85.2		88.4	
3rd Qtr	72.0	84.8		84.9	
4th Qtr	72.4	93.3		77.6	
1981 1st Qtr	75.1	102.3	103	73.4	75.8
2nd Qtr	81.4	112.4	108.2	72.5	78.5
3rd Qtr	92.5	121.7	102.6	76.0	78.0
4th Qtr	89.5	112.6	101.5	79.5	80.7
1982 1st Qtr	95.2	117	96	77.7	74.6
5/11/82	98.3	128	95	76.8	72.9

Note Comparisons across the columns are meaningless. Par values are arbitrary only relative values within columns are relevant.

Prices Retail Price Index for UK.
Consumer Price Index of US.
Consumer Price Index for W. Germany and France.

Charts I, II, III, IV are all constructed from annual average prices and exchange rates.

PURCHASING POWER PARITY $: £ . CHART I



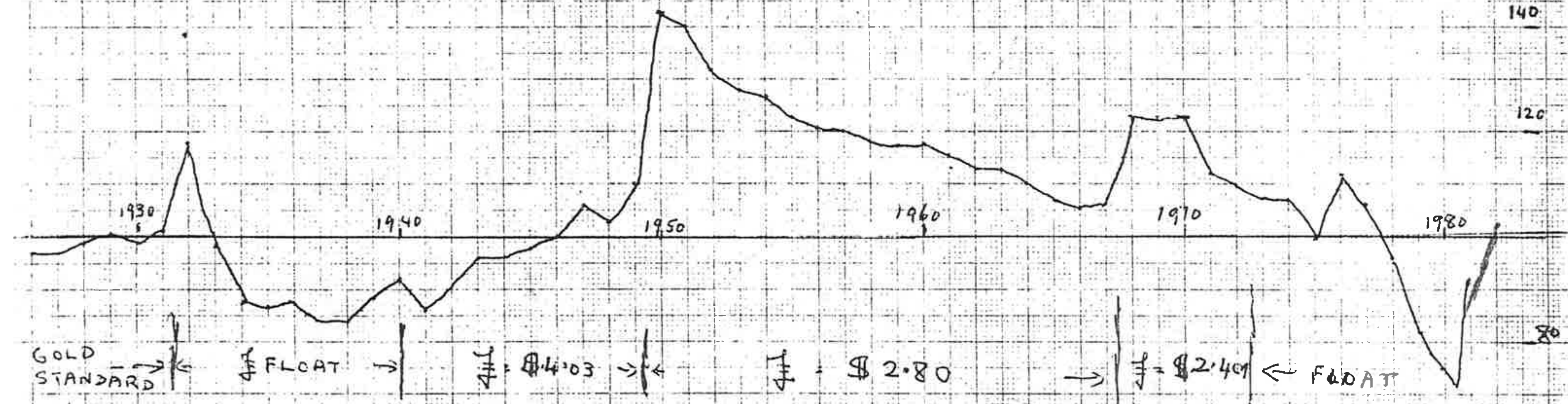


CHART II
P.P.P. against the D. Mark of
U.S. Dollar
£ Sterling
French Franc
D-MARK UNDERVALUED
D-MARK OVERVALUED.
150
140
130
120
110
100
90
80
70
1960
1970
1980

CHART III
P.P.P. of U.S. Dollar against
D. Mark
150
140
130
120
110
100
90
80
70
DOLLAR OVERVALUED
DOLLAR UNDERVALUED
1960
1970
1980
120
110
100
90
80
70

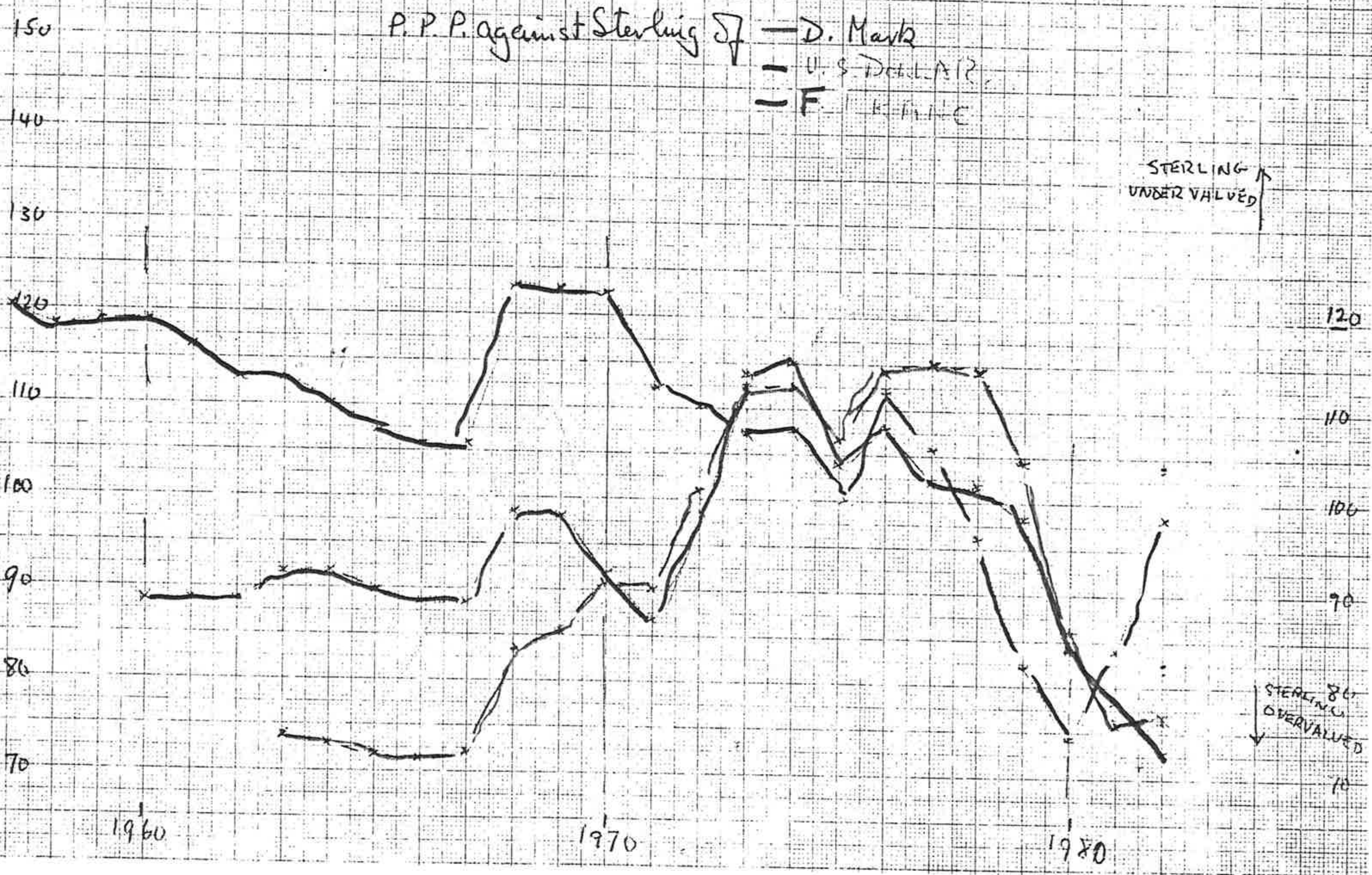


CHART IV
P.P.P. against Sterling of
D. Mark
U.S DOLLAR
F
STERLING UNDER VALUED
STERLING OVERVALUED
150
140
130
120
110
100
90
80
70
1960
1970
1980

THE NATIONAL DEBT

PAPER 6

"The Bank of England was incorporated by a Charter under the great seal dated 27th July 1694. It at that time advanced to the Government the sum of £1,200,000 for an annuity of £100,000, or for £96,000 a year interest at a rate of 8% and £4,000 for the expense of management.

The credit of the new Government established by the Revolution, we may believe, must have been very low when it was obliged to borrow at so high an interest."

Adam Smith. The Wealth of Nations.

Since the national debt was first put on a formal basis by the founding of the Bank of England, it has been the subject of many books, as library shelves bear witness. More recently it has been generally considered an obscure academic matter of little practical importance.

After the Napoleonic wars the national debt reached the then gigantic sum of £861M, well over twice the national income. During the following hundred years some fitful progress was made in reducing it, but, more importantly, the interest on the bulk of it was reduced to 2½% so that by 1914 the cost of servicing it had dropped to a modest burden on the budget.

The first war led to a huge increase, from £661M in 1914 to £5,871M in 1919 and £7,831M in 1921 so that the burden of interest was a very severe load on the taxpayer during the 1920s. Considerable effort was made to reduce the cost, culminating in the conversion of War Loan to 3½% in 1932.

The Second War caused the debt to increase from £7,131M in 1939 to £23,635M in 1946 and £25,630M in 1947, a burden comparable to that after the two previous wars, though good management ensured that the rates of interest at which it was contracted were quite modest.

After 1947 it grew slowly to £33,442M in 1971 and then rapidly to £95,314M in 1980. In real terms the result is quite different, from 1946 the real value fell with inflation, to 1973, since when there has been little change although the nominal value of the debt has trebled.

This phenomena is remarkably similar to the monetary theory of a stable real demand for money applied to the national debt. It seems that the public, both as individuals, and through the medium of financial institutions such as banks and insurance companies, will not absorb more than a certain real amount of Government Debt. The table shows the National Debt at 31st March each year and the real value (at January 1974 prices) using the RPI, the third column shows the real value of $£M_3$. The variability of the real National Debt is clearly much less than that of $£M_3$. Between 1973 and 1980 the ratio of the highest to lowest real values of Debt is 1.10 and of real $£M_3$ 1.37.

In mathematical terms if P is the price index and D debt,

$$\frac{1}{P}\frac{dD}{dt} = \frac{d}{dt}\left(\frac{D}{P}\right) + \frac{1}{P}\frac{dP}{dt}\cdot\frac{D}{P}$$

This identity expresses the fact that the real value of debt borrowed equals the increased real value of the debt plus the real inflationary tax on the par value of the debt.

The fact that since 1973 the real value of the debt has remained approximately constant $\frac{d}{dt}(D/P) = 0$ while its nominal value is rapidly increasing implies that the percentage by which the debt increases in a year equals the rate of inflation.

$$\frac{1}{D}\frac{dD}{dt} = \frac{1}{P}\frac{dP}{dt}$$

Why was the Government able to borrow such large sums on previous occasions without causing massive comparable price rises and without offering interest rates much of 5%. indeed often less?

The Napoleonic Wars followed a long period of currency stability, the guinea was fixed at 21s in 1717 on Newton's recommendation and remained in circulation throughout the war; though rarely seen, it was not valued over 21s. The premium on gold bullion reached 40% in 1814, but this was confined to London dealers, the silver coinage although very worn, was made of silver and so approximated to its intrinsic value.

Nearly all the public assumed a return to convertability of bank notes, which were never made legal tender, yet everywhere accepted at face value.

The first war occurred after a century of stability. The gold standard was universal and London was the undisputed financial centre of the world. Surprisingly the outbreak of war caused a panic on the New York Stock Market, emergency currency was issued to safeguard the liquidity of the American banking system. There was fear of the dollar depreciating because the submarine menace prevented the shippent of gold to London to settle adverse balances as money was withdrawn to Europe. As a hundred years before, gold and silver coins reamined in circulation, the note issue was greatly expanded and enormous sums borrowed at up to 5% interest.

In spite of substantial price rises, the public remained confident that the gold standard would be restored, as it was in 1925, though only for bullion in 400 oz bars.

The second war began after a period of unprecedented low interest rates (Bank Rate remained at 2% after 1932); the memory of the first war and its aftermath the recession and fall in prices in 1920-21 was still fresh in the memory of persons over the age of 40 (i.e. most of those in a position to take financial decisions). The outcome was very different, but a long history of roughly constant prices meant that confidence in the gilt edged market was sustained.

The position today is very different. Prices are about 30 times higher than in 1913 or 20 times the 1938 level. Much of the rise having occurred in the last decade. Few believe that the general price level will ever fall substantially, most expect that price inflation will continue indefinitely, as it has since 1933, and the idea of a real standard, such as the gold standard, seems to have disappeared from the field of political discussion.

It is widely thought that because the national debt is of modest real magnitude in comparison to past years that a budget deficit can safely be met by borrowing. This is similar to the arguments advanced by German economists, bankers and politicians during the hyper inflation of the early 1920s; because the real value of the note issue was falling they indignantly rejected the notion that the inflation was the result of the astronomical increase in the note issue.

As can be seen from the following tables, nearly half the national debt is in fact held in such a manner that the holders regard it as near cash; the same was true in 1964.

The difference between increasing debt and printing money under the present circumstances is not as definite and distinct as is often thought.

The relationship between the national debt and the price level, together with the uncertainty as to the likely behaviour of monetary velocity in the next year or two (1982/83) suggest that it may be more advantageous to concentrate on controlling the P.S.B.R. rather than trying to control the growth of £M_3 or indeed any other monetary aggregate. This does not mean that control of the money supply is not of importance but rather that it is unlikely to be achieved without reducing the P.S.B.R. in view of the likelihood that about half of it will in fact be represented by liquid assets of one sort or another.

Another result of moderating the increase of debt would be a tendency to lower interest rates, and to make a larger proportion of monetary growth available to industry for productive investment.

When monetary velocity has dropped to a value close to those usual in the past, controlling £M_3 or perhaps better an aggregate such as PSLZ, will become an essential part of economic policy.

£ Millions

	(1)	(2)	(3)
1970	33,079	46,320	22,280
1	33,442	43,040	23,080
2	35,840	42,870	24,895
3	36,885	40,800	28,800
4	40,457	39,430	31,320
5	46,404	37,330	28,065
6	56,585	37,570	24,780
7	67,166	38,210	22,840
8	79,179	41,280	24,170
9	86,885	41,250	24,540
1980	95,314	37,790	23,040
1	113,036	39,800	24,220
2	117,959	37,638	

(1) National Debt at 31st March

(2) Real value of National Debt at 31st March) Jan 1974 values

(3) Real value of Sterling M_3 at 31st March) using March price levels.

NOTE 'A' 30the June 1981

Government debt held as part of PSLZ

			£ Millions
Notes and coins with public			10,256
Lending to public sector by banking sector			17,568
Trustee Savings Banks	Local Authority Debt	1,304.2	
	Govt. Securities	2,139.6	
	with Nat.Debt Office	1,027	4,470
Building Societies	Government Securities		5,865
National Savings	Certificates	9,794	
	Premium Bonds	1,476.1	
	B.Saving Bonds	393.7	
	Stamps etc.	10.9	
	N.S. Bank ord. a/c.	1,732.1	
	N.S. Bank investment a/c	2,626.1	16,033
Cert. of Tax Deposits held by individuals & Cos.			381
Treasury Bills held by individuals & Cos.			139
		TOTAL	£54,712M

National Debt 30th June 1981 £113,000M (Estimate) 48.5%
Percentage of Debt as "money"

1964 - Government debt held as part of PSLZ

				£ Millions
ank of England	Issue Dept	2,601		
	Banking Dept	251		2,852
London Clearing Banks	Treasury Bills	790		
	Govt. Securities	1,098	1,888	
Scottiah anks	Treasury Bills	19		
	Governments	198	217	
Allowance for 'other' anks not available?			140	2,245
Discount Market	Treasury Bills	453		
	Governments	438		891
National Savings including N.S.B. and T.S.B.				7,888
Building Societies "Investments" presumably mostly gilts.				631
			TOTAL	£14,507
ational debt 31.3.64				30,226

Percentage of debt as money 48%

5 o'clock

Got to go to the Hse.

Back

Alan Wright 477 3013
Leo Van Houtven 477 3095

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

cc Mr Walters
Miss S. Lyons } EOG.

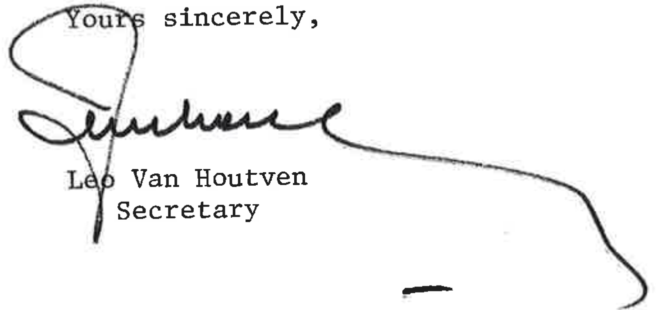
DEC 21 1982

Dear Mr. Chairman:

As the Chairman of the Interim Committee you will wish to be aware of the arrangements which have been made by the Fund for the Chairman of the Committee in attending meetings. A copy of the arrangements approved by the Executive Board is enclosed for your information.

Should you have any questions concerning the implementation of these arrangements, please do not hesitate to contact me or my deputy, Mr. Lang. Alternatively, you may wish to designate a member of your staff to inform himself of the administrative details.

Yours sincerely,



Leo Van Houtven
Secretary

Enclosure

The Right Honorable
Sir Geoffrey Howe, QC, M.P.
Chancellor of the Exchequer and
Chairman, Interim Committee of the
Board of Governors on the
International Monetary System
H.M. Treasury
Parliament Street
London SWIP 3 AG
England

Excerpt from EBAP/74/245, 9/26/74, "Interim Committee - Financial Arrangements", approved by the Executive Board on September 26, 1974, at EBM/74/132, 10/23/74.

Chairman of the Interim Committee

The Chairman of the Committee in attending meetings of the Committee away from his normal place of residence (and other meetings which he considers necessary to the work of the Committee) would be entitled to reimbursement for the cost of his hotel accommodations plus the travel allowances in accordance with the rules applicable to Governors. He would also be entitled to reimbursement for reasonable representation expenses and for any miscellaneous direct expenses such as cables, telephone calls, etc., incurred in connection with the work of the Committee.

Section 14(a) of the By-Laws of the Fund provides that:

"Governors and Alternates shall receive reimbursement for reasonable expenses incurred in attending meetings of the Board of Governors."

Currently Governors received their actual transportation expenses to and from the place of the meetings and $140 for each night that attendance at the meetings requires them to spend away from their normal place of residence; this amount is reduced to $25 for each night when accommodation is included in the price of transportation.

Per night allowance is considered to cover hotels, meals, and all incidental expenses, such as inoculations, gratuities, insurance, airport taxes, excess baggage, local taxes and cost of taxis other than to and from transportation terminals.

RESTRICTED

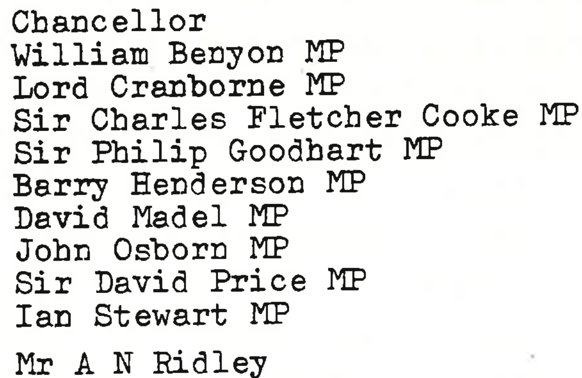
A.20

FROM: ADAM RIDLEY
22 December 1982

CHANCELLOR

25TH MEETING WITH BACKBENCH MPS,
TUESDAY, 21 DECEMBER 1982
NO 11 DOWNING STREET

Present:


Chancellor
William Benyon MP
Lord Cranborne MP
Sir Charles Fletcher Cooke MP
Sir Philip Goodhart MP
Barry Henderson MP
David Madel MP
John Osborn MP
Sir David Price MP
Ian Stewart MP

Mr A N Ridley

Opening the meeting, the Chancellor explained that, while he would not wish to hold people to any fixed agenda, he would hope that they would comment at some point on their ideas for his next Budget. Before they did so, they would need to bear in mind that the £1 bn fiscal adustment suggested in the Autumn Statement was not a misleading figure - he did not have £bns more tucked away in his back pocket.

2. Mr Benyon opened what was to become a long discussion about unemployment. What did the Chancellor really think the prospect was? In particular could he offer any of the hope which was so needed? The Chancellor observed that the position would remain a very difficult one, with little likelihood of any significant downturn. The main source of hope lay in the prospect for a real upturn in the world economy. As colleagues would know, 1982 had seen a very serious check to the world economy, first because of high US interest rates and latterly because of the financial problems of major countries such as Mexico and Brazil. Happily the forecasters still tended to see the likelihood of some real growth in 1983, and of "substantial growth" in real demand in the UK. Indeed there were many countries which almost saw the UK in a modest locomotive rôle. Mr Benyon asked if it were not possible to nudge the figures down more by well-targetted expenditure, for example on housing. The Chancellor

agreed that this could be done, indeed was being done, but underlined that the impact would not be very large in relation to the jobless total.

3. John Osborn recalled the lessons of three years of debate in the Council of Europe and with European Parliamentarians, which he juxtaposed with the tremendous problems now encountered in Sheffield. It was vital that the Government should inject some hope. It was essential to be able to reduce the level of unemployment to 2½ or 1½ million within the next two to three years. For this reason he greatly welcomed the moves to job-splitting, urged that a shorter working week - without higher labour costs - was essential, and observed that it was particularly important to find gainful employment for the young. There was something absurd about carrying on in the middle of the new industrial revolution when hours worked still averaged well over 40 for those in full-time employment, and much overtime was also being worked as well, much of this reflecting the inhibiting impact of employment legislation and employers were needing far fewer men. The Chancellor observed that, while agreeing with part of Mr Osborn's analysis, in particular the possibility of special measures which did not add to industrial costs, note had to be taken of the tremendous obstacles raised by the unions and others (alas including the voluntary organisations) who made it so difficult even to put to full use the measures already in place. Mr Christopher of the Inland Revenue Staff Federation had been telling him only the day before of the unwillingness of NACRO to implement the new community works scheme at the present low proposed levels of remuneration. Sir Philip Goodhart expressed agreement, observing how dangerous had been the French initiative to shorten hours but, in effect, increase costs. He went on to observe that there might, however, be possibilities for a further and not expensive development of the job release scheme. By introducing into it an element of job-splitting, an older worker might half-retire, and allow the other half of his split job to be taken up a young worker. This might aborb another 50-100,000 people.

4. Sir David Price observed that it was dangerous to approach

the present employment problem as a transient one. All the industrial economies were going through a period of fundamental change, the like of which had never been seen before, not least because many of the traditional sectors still had vast opportunities for manpower reductions and productivity improvements. In his view it would be no easier to seek expanding employment in the services sector than in manufacturing, and the only way out would be to look to the endless opportunities for more work in the "caring side of employment". He was not advocating a crude expansion in public sector manpower, but rather something on the lines of the job-splitting philosophy, in which many workers in the commercial sector would only work about 60% of the time, and spend the other 40% in voluntary and creative activities. The Chancellor commented that, while it was surely right to see industrialised countries entering a new era, this did not mean that one should take so pessimistic a view of employment prospects. As productivity increased, that would generate additional wealth and incomes, and the money thus earned or saved would have to be spent elsewhere, and this must unavoidably generate new demand for new activities. A classic example of this in recent years lay in the growth of the leisure industries, for example boat manufacture and related services.

5. Sir Charles Fletcher Cooke then made some pregnant comments about the black economy. He had recently read in a reputable paper that only 60% of those registering for unemployment were known to be registering for their vote. This was a lower figure than can be allowed for, even allowing for their probable social origins, and it implied that there was much healthy black market activity going on. The Chancellor commented that there was undoubtedly a large grey area, and that there was an immense range of black activities which were doubtless flourishing in it. However one had to acknowledge a certain schizophrenia, in that it was difficult to decide how far to be angry that people were abusing the tax and social security systems or how far they were being praiseworthily active in generating wealth and incomes. In the background lay, of course, the dismal consequences of over-taxation.

6. Lord Cranborne mused about the 1979 Manifesto promise to reduce taxes, observing that for him the target was now not the basic income tax rate, but raising thresholds. The Chancellor asked for the general view on this issue, and all those present agreed that thresholds were more important than basic rates. Mr Madel added that this should be without prejudice to giving help to industry, and that it was important the Budget should explain why the local authorities had underspent so much - a fact which made it difficult to sustain the position of refusing to increase spending on other infrastructure areas.

7. Lord Cranborne reverted to the employment issue. The present period was like the 19th Century in that vast numbers of real jobs were being lost alongside the new ones being created. It was right to palliate this painful process; but in so doing it was vital not to forget the need to prepare positively for the longer term future. To that end, there was surely a need for a much serious effort to match the education of the workforce to future needs. Barry Henderson observed that by far the most important objectives in the next Budget were continuing with fundamental and beneficial policies already in place - lower interest rates and lower taxation levels designed to reduce labour costs. Thresholds were particularly attractive in the latter context. Looking at the problems of growth and development in the deprived regions, he expressed anxiety about the emphasis of past regional policies on assisting a narrowly defined portion of the classical industrial sector; and enquired how far it would be possible to do more to identify opportunities of import substitution, where it was unlikely that every opportunity had been noticed by British manufacturers. The Chancellor agreed strongly that the need for a more positive approach to reconquering the internal market, and described briefly the current initiatives on public purchasing, the little Neddies and referred to the dismal record of the motor industry, which was seeking a cut in car tax to raise demand in its market at a time when the total British market for cars was at the highest level as it had ever been.

8. Mr Benyon asked about the case for reintroduction of exchange controls in view of the threat of the pre-electoral outflow of funds stimulated by the Shore Programme, and the

threat that interest rates might otherwise have to rise to intolerable levels. Surely it was better to contemplate the reimposition of exchange controls. The Chancellor, supported by others, observed that the reintroduction of exchange controls would be unlikely to deal with the main problem, which lay in commer .al "leading and lagging", and the change in sterling's position in foreign exchange markets outside the UK. He added that the mere possibility of the reintroduction of exchange controls would, if known, aggravate an already bad position. It was difficult to see any viable policy other than attempting to ride out such a crisis.

9. The discussion then reverted to Lord Cranborne's anxieties about education. The Chancellor commented it was absurd, in a way, that the MSC had had to reinvent the technical college, with its new scheme for technical training institutions. Mr Madel thought that the Government's achievements in the training area were in truth remarkable by any objective standards, and that more could be done provided that the opposition of the teachers could be overcome. The Chancellor agreed, reporting that a number of other countreis were beginning to look with real interest at the UK's policies.

10. Sir Philip Goodhart observed that the job-splitting initiative need to be supported by a public sector lead. He was well aware that this could not easily be reconciled with the policy of reducing public sector manpower. The Chancellor observed that there was a way through, which started from the fact that the manpower targets of central government were expressed in terms of full-time equivalents. He then summed up in closing the meeting, urging those present to suggest him any particular ideas they might have for the Budget. Sir David Price observed that there was a very strong case for doing a little more for the blind, and that at the risk of stretching the criteria for mobility allowance presently in force, something should be possible through that route.

AN

A N RIDLEY

Distribution: Ministers
Advisers
Ian Stewart MP
Alastair Goodlad MP

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE D15,

December 22, 1982 - 82/237

The Chairman's Summing Up at the Conclusion of the
Discussion on General Arrangements to Borrow -
Revision and Enlargement
Executive Board Meeting 82/162 - December 17, 1982

This has been a useful discussion on a possible revision and enlargement of the General Arrangements to Borrow. It has been a real discussion with an animated interchange and questions, and it has led to a better understanding of the subject. The meeting gave an opportunity to the non-Group of Ten members of the Board to provide some preliminary and sometimes personal reactions and to ask for clarification of the extremely useful document prepared so skillfully by the G-10 Deputies and Mr. Dini.

I shall try to draw together some of the threads of the discussion under two headings: principles, and questions.

Principles

First, all Directors without exception stressed the fundamental principle that has always guided the Fund, namely, that quotas should remain the principal source of IMF resources. In this respect, all Directors felt that an extension of the GAB would be no substitute for an adequate increase in Fund quotas. The idea of a "trade-off" between a GAB enlargement and a quota increase was not considered appropriate. Mr. Erb's latest intervention made it clear that the United States believes that there should be an adequate increase in Fund quotas to deal with ordinary problems and requests for assistance from the Fund. The U.S. authorities, of course, have their own view of what an adequate increase is. Quite separately, they wish to establish better arrangements for enabling the Fund to borrow resources in the event of special cases of extreme strain in the system. The purpose of the proposal by the U.S. authorities is therefore not to make possible a smaller increase in quotas, but to supplement the ordinary resources of the Fund when it becomes necessary to cope with an impairment of, or a threat to, the international monetary system. A number of Directors reaffirmed their views on the need to proceed with a substantial increase in quotas, and they gave details of the quantities that they had in mind.

Second, speakers strongly stressed the need to treat member countries in a nondiscriminatory way and to keep the integrity of the Fund's decision-making process intact. In this respect, I would like to note several points:

First, as several speakers have recalled, the proposed enlargement of the GAB is meant to provide a lending facility to the Fund, and not to member countries, in particular circumstances. It is a means for resolving the Fund's liquidity problems.

Second, in any event, the determination of the need to borrow by a particular country, the extent of its access to Fund resources, and the assessment of its program would remain the responsibility of the Executive

Board alone. In this respect, the observation in paragraph 4 of the Group of Ten's conclusions to the effect that in the event of a proposed activation the GAB consultation would not extend to the examination of specific programs for use of Fund resources, which remains the responsibility of the Executive Board, was welcomed by Executive Directors.

Third, there were a number of questions on the possible difference of treatment between participants and nonparticipants, and also between participants themselves, arising from the conditions for activation set out in paragraph 4 of the Group of Ten's conclusions. Some Directors felt that paragraph 4(ii) might restrict the activation of the GAB to a small list of large countries whose mere size might pose a threat to the stability of the system, thus excluding activation on behalf of smaller countries, particularly, said some, in view of the rather broad language used in defining the circumstances in which the agreement might be activated. In this connection the staff and Executive Directors from G-10 countries explained that paragraph 4(ii) was intended to mean that the Managing Director could be led to make a proposal for activation of the GAB if a group of countries or a group of requests, each of them individually being perhaps for a limited amount, were in his view to trigger a liquidity problem for the Fund and to pose a threat to the international monetary system. Mr. Polak and Mr. Joyce referred to the way in which the interpretation of the concept of the impairment of the system has evolved since the General Arrangements came into existence in 1962.

Questions

Some of the main questions are the following:

(1) Is it appropriate to confine the assessment of the criteria for activation of the GAB (namely, the appraisal of the inadequacy of resources in the Fund and of the threat to the stability of the system) to a group of lenders? What would be the consequences if a decision could not be reached among the members of that group, or if the decision was negative? Would such a situation affect the ability of the Fund to resort to other means of financing in order to meet requests that did not trigger the activation of the enlarged GAB? Mr. Malhotra in particular raised this sort of question very strongly.

(2) What arrangements are contemplated for the parallel lenders so far as involving them in the decision-making process is concerned? What procedures could be worked out for this purpose?

(3) Would there be predetermined quantitative limits on possible uses of the expanded GAB by participants? The answer to this question is "no."

(4) Would the extension of the GAB to nonparticipants lapse automatically if the enlarged access were to be phased out, or at the end of the first review period? The answer to this question is also "no." It is really set out in paragraph 7 of the Group of Ten's conclusions.

We now need to work more on this project. Some Directors, in particular Mr. Finaish, asked what the next step will be. This is, of course, subject to the views of Directors, but I suggest that we should take stock of the discussion we have had today and that the Executive Board should proceed without waiting for a second session of the Group of Ten. I suggest that the staff should prepare a paper setting out in legal and technical language the procedures needed to translate into action the principles agreed upon by the Group of Ten. The staff will also clarify a number of points on which questions have been raised, and on which, in some cases, alternatives need to be worked out. We could discuss this paper on January 5; Directors would thus be in a position to inform their Governors in time for an early session of the Interim Committee.

I have so far mentioned the questions raised by Executive Directors. I have not stressed the positive reactions, not only by the G-10 Executive Directors, but also by Directors from a number of other constituencies, who felt that as long as the expansion of the GAB is well understood to be intended to supplement the Fund's resources, and as long as it does not circumvent the fundamental principles mentioned by Executive Directors, the proposal should be examined with the greatest care and in a spirit of cooperation. I hope that in the coming weeks we shall be in a position to report to our authorities that serious progress has been made.

December 30, 1982

Forms of Association with the GAB

This memorandum outlines various ways in which a member of the Fund (or its central bank) which is not a G-10 member, but which is willing to provide supplementary resources to the Fund on GAB terms, could be associated with the GAB.

I. Direct Participation

Paragraph 3 of the GAB Decision permits a member, or an official institution of a member, to be accepted as a participant, if (i) "the Fund shall so agree and no participant object", and (ii) the prospective participant undertakes a credit commitment of at least SDR 100 million. The terms and conditions governing participation are set out in the Decision itself. There would be no need for a separate agreement between the member and the Fund or for an amendment of the GAB Decision, although it would be appropriate to delete the reference to "the main industrial countries" in the Preamble to the Decision.

Participation in the GAB also implies participation in the consultative and decision-making arrangements set forth in the 1961 Letter between the Minister of Finance of France and his counterparts in the other nine participating countries. The understandings in this Letter regarding the procedure by which the original participants would reach decisions on proposals to activate the GAB served as the basis for the establishment of the G-10, as a forum in which the main industrial countries could discuss and coordinate their approach to important issues affecting the Fund and the international monetary system. Acceptance of a new participant into the GAB need not involve a change in the composition of the G-10, as such. By appropriate modifications in the arrangements set out in the 1961 Letter, consultations among GAB participants could be limited to activation proposals and other matters arising under the GAB. The existing members of the G-10 could continue to meet and discuss other issues, not as GAB participants but as the main industrial countries.

II. Association on the Swiss Model

A second possible form of association could be along the lines adopted for Switzerland, suitably modified to fit the case of a member. The main features of the 1964 Association Agreement with Switzerland, the effectiveness of which has been extended to July 15, 1985, are as follows:

(a) Like the credit commitments of participants under the GAB, the Swiss commitment of the equivalent of SF 865 million is a revolving credit, which can be used only in connection with use of the Fund's resources by GAB participants.

(b) The credit commitment under the Association Agreement may be activated by a proposal of the Managing Director. Whenever the Managing Director proposes activation of the GAB for the benefit of a participant he may, after consultation with the Swiss authorities, also propose that Switzerland make resources available for the same participant. If the Managing Director's proposal under the GAB is duly accepted by participants and approved by the Executive Board, Switzerland is obliged to carry out his proposal under the Association Agreement, unless the Swiss authorities cite balance of payments grounds.

(c) One major difference from the credit commitments under the GAB is that the Association Agreement contemplates that Switzerland will lend directly to the GAB participant needing assistance, in accordance with an "implementing agreement" between itself and the participant. The repayment terms are to correspond as far as practicable to those of GAB loans. The Fund accepts no responsibility or liability regarding the performance by the borrower of its obligations under an implementing agreement.

(d) On the basis of the Association Agreement, representatives of Switzerland (officials of the Swiss National Bank) have been attending G-10 meetings as observers. They take part in the discussionns. However, they do not participate in the process prescribed in the 1961 Letter for reaching decisions on proposals of the Managing Director to activate the GAB, even though when the GAB is activated Switzerland is bound to carry out a parallel proposal made by the Managing Director under the Association Agreement.

The technique under which Switzerland makes loans directly to a GAB participant, in conjunction with the use of the Fund's resources financed by GAB loans, has proved to be cumbersome. Because of this the Association Agreement has been invoked only twice, in the earlier years of its effectiveness. In connection with two more recent activations of the GAB the Fund has entered into bilateral borrowing agreements with the Swiss National Bank under which that Bank has undertaken to lend the Fund up to a stated amount for the specific purpose of financing purchases under a stand-by arrangement with a GAB participant, in conjunction with an activation of the GAB. The terms and conditions of the loans were comparable to those of GAB loans. The credit commitments under these agreements were not of a revolving character.

III. Parallel Credit Agreements

One feature of the Swiss Association with the GAB is that, as a nonmember, Switzerland has not been accorded reciprocal access to the resources of the GAB. The G-10 Deputies have proposed that a member

making a parallel credit arrangement with the Fund should be entitled to have access to these resources on the same terms as GAB participants themselves. It is possible to develop a form of parallel arrangement appropriate for a member, by combining this feature with features adapted from the arrangements made with Switzerland. Principal aspects of such a parallel arrangement were outlined briefly in SM/82/239, December 28, 1982, and are discussed in more detail below:

(1) The "parallel creditor" would enter into a bilateral agreement with the Fund, in the form of a line of credit under which the Fund would be able to borrow in the same circumstances as under the GAB, and on comparable terms. Thus, the agreement would remain in effect for the full current period of the GAB and would be renewable for further periods in the same manner as GAB credit arrangements. Renewal would not be obligatory, but the member would cease to have the status of a parallel creditor if it were to terminate the agreement. The credit line would have a revolving character similar to GAB arrangements. The amount of the credit line would be available for use in connection with purchases by any member of the Fund, including both GAB participants and nonparticipants, in respect of which the Fund could borrow under the GAB. The credit line could also be drawn upon to refinance loan claims of participants and other parallel creditors that are encashed prior to maturity on balance of payments grounds. As for the terms of the parallel loans themselves, it does not seem essential that these should be identical to those of GAB loans; rather, comparability could be determined on the basis of the financial, legal and other provisions of the parallel credit agreement, taken as a whole.

(2) The above outline of conditions for use of the parallel credit line assumes that the GAB Decision will be amended to permit the use of GAB resources to finance purchases by the parallel creditor, and to refinance early encashment of the creditor's loan claims on balance of payments grounds, on similar terms to those applicable to purchases and early encashment of claims by participants. A possible amendment to this effect is presented in SM/82/239.

(3) The parallel credit agreement would contain a procedure for its activation similar to that applicable to GAB credit arrangements, i.e., the Managing Director, after consultation with the parallel creditor, would submit a proposal for calls in respect of a request by a member seeking to use the Fund's resources. The proposal would be made in conjunction with similar proposals to participants and any other parallel creditors, although the Managing Director would not be obliged to include a parallel creditor in each case.

The balance of payments and reserve position of individual GAB participants is taken into account in determining the participants to which proposals will be made, and it is assumed that similar account would be taken of the balance of payments and reserve position of a parallel creditor.

(4) The precise modalities of consultation need to be examined and discussed with the different parties involved before any firm conclusions are reached as to what is most appropriate. There is also the related question of the nature of the creditor's obligation to respond to proposals for calls under its credit line. The Association Agreement with Switzerland provides that Switzerland will accept a proposal for calls in those cases where GAB participants have accepted and the Executive Board has approved activation of the GAB. The Swiss authorities attend meetings of the GAB participants as an observer, but they have no vote in the decision-making process. It is thus evident that the arrangements could take different forms. For example:

(i) The parallel creditor would be individually consulted by the Managing Director before he makes a proposal under the parallel credit arrangement but the creditor would be free to accept or reject the Managing Director's proposal. Under this approach there would be no participation of the parallel creditor in the consultations among the GAB participants.

(ii) A parallel creditor would commit itself to make available the amount specified in the Managing Director's proposal, if the corresponding proposal under the GAB was accepted by the GAB participants. Under this approach, the parallel creditor would be consulted by the Managing Director as under (i) but, in addition, the parallel creditor would be included in the consultations associated with the activation of the GAB. The participants could agree that the creditor would be invited to take part as an observer, if it so wished, in meetings of participants to consider such activation. Provision for this could be included in some form of understanding supplementing the 1961 Letter.

(iii) The participation referred to in (ii) could possibly be extended so that the parallel creditor would be able take part in the decision-making process as if it were a participant. This would require an amendment to the 1961 Letter. Like the involvement in the consultative process referred to in (ii), the participation in the decision-making process would need to be agreed among the participants.

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SM/82/249

December 30, 1982

To: Members of the Executive Board

From: The Acting Secretary

Subject: Draft Report to the Interim Committee on the Eighth General Review of Quotas

The attached draft report of the Executive Board to the Interim Committee on the Eighth General Review of Quotas has been scheduled for discussion at 3:00 p.m., on Tuesday, January 4, 1983.

Att: (1)

Other Distribution:
Department Heads

DRAFT

INTERNATIONAL MONETARY FUND

Report of the Executive Board to the Interim Committee of the Board of Governors on the International Monetary System on the Eighth General Review of Quotas

December 29, 1982

I. Introduction

1. The communique of the Interim Committee, issued after its 19th meeting held in Toronto, Canada in September 1982, stated that:

> "There was widespread support in the Committee on the urgent need for a substantial increase in quotas under the Eighth General Review. The Committee reiterated its view that quotas must remain the primary source of financial resources for the Fund's operations and that, therefore, the Review should result in an increase in quotas that would be large enough to enable the Fund to perform its functions in an effective manner in the 1980s. The Committee also reiterated its view that the occasion of an enlargement of the Fund under the Eighth General Review should be used to bring the quotas of members more in line with their relative positions in the world economy, taking account of the case for maintaining a proper balance between the different groups of countries. The Committee also asked the Executive Board to assess the adequacy of existing arrangements to deal with major strains in the international financial system.
>
> The Committee urged the Executive Board to pursue its work on the issues of the Review as a matter of high priority, so that the remaining issues on the size and distribution of the quota increase could be resolved by the time of the Committee's next meeting in April 1983."

2. Since the last meeting of the Interim Committee, the Executive Board has considered (i) the size of the overall increase in quotas; (ii) the distribution of the overall increase, including the position of countries with very small quotas in the Fund; and (iii) the mode of payment for the increase in quotas. This Report presents views expressed in the Executive Board on each of these three aspects of the Review, with the aim of focusing the discussion by the members

of the Interim Committee and to facilitate early agreement on the Eighth General Review. Section V provides a short summary of the main issues dealt with in this Report.

II. Size of the Overall Increase

3. Most Directors are of the view that members' needs for balance of payments financing, especially of a conditional nature, will be large through much of the 1980s. In order to enable the Fund to deal effectively with the problems of adjustment that are within its competence, and that are likely to be encountered in the 1980s, these Directors support a correspondingly large increase in quotas under the Eighth General Review. A number of these Directors have indicated that a doubling in the size of the Fund to the order of SDR 125 billion is needed. Many Directors consider that an overall increase ranging from SDR 90 billion to SDR 100 billion (i.e., an increase ranging from approximately 50 per cent to 64 per cent of present quotas of SDR 61.1 billion) would be acceptable. A few Directors believe that the size of the payments imbalances of recent years can be expected to diminish, and that their distribution might, later in the decade, move toward countries less likely to use Fund resources, implying a lesser need for balance of payments financing from the Fund. These Directors believe that a somewhat smaller increase in quotas, say, to an overall size of the order of SDR 85 billion, would suffice.

4. The proposal to extend and enlarge the Fund's existing standing borrowing arrangements (GAB) is generally favored by Executive Directors.

However, they continue to stress the importance for the Fund to rely on members' subscriptions as the primary source for the financing of its operations and transactions. In this connection, a number of Directors believe that unless the overall increase in quotas would be relatively large, it would be difficult for the Fund to maintain its financial role in the international monetary system without continued recourse to borrowing after the new quotas come into effect.

Those Directors who feel that the payments imbalances will tend to diminish later in the decade, believe not only that the Fund's need to borrow will be reduced, but that the Fund is likely to borrow mainly to meet exceptional increases in demand on its resources; the proposed enlarged borrowing arrangements would help provide for any such contingencies during the 1980s.

III. Distribution of Overall Increase

5. The Executive Board has had extensive discussions on the distribution of an overall increase in quotas, and broadly agrees that the increases of quotas under the Eighth General Review should lead to a distribution of quotas that better reflects the relative economic positions of members. The quota calculations, based on the revised quota formulas that were agreed by the Executive Board in August 1982, are generally regarded as reasonable indicators of the relative economic positions of countries in the world economy. Furthermore, most Directors agree that an increase in quotas should be distributed using a method that would apply uniformly to all members. There was also general

agreement that each member should receive a meaningful increase in its quota under the Eighth General Review.

6. As regards the extent to which present quotas should be adjusted in order to reflect better the relative economic positions of members, the Executive Board has found it useful to refer to a broad statistical measure of adjustment. This measure is referred to below as the adjustment coefficient, and it indicates for each member the percentage reduction in the difference between its share in present quotas and its share in calculated quotas. Many Directors are of the view that the distribution of quotas, and the appropriate size of the adjustment coefficient, would be easier to decide if the size of the overall increase in quotas were larger rather than smaller.

7. As regards the methods that could be used to distribute an increase in quotas, most Directors felt that the distribution of a part of a given total increase based on each member's share in the total of calculated quotas would be acceptable. Under this method, such changes in quotas directly reflect members' relative economic positions, as indicated by the calculated quotas. Furthermore, the percentage rate at which each member's share in present quotas moves towards its corresponding share in calculated quotas would be the same, i.e., the adjustment coefficient is the same for all members, which most Directors found to be a desirable feature of this method of distributing quota increases.

Other methods of distributing increases in quotas were also considered. Some of these methods provide for a progressively larger increase in quotas the greater the difference between a member's share in present quotas and its share in calculated quotas. Consideration

was also given to methods that based increases in quotas on the positive (absolute) differences between members' calculated quotas and present quotas. Some of these other methods of distribution produced relatively large changes in many members' shares in quotas, but they all raised objections because the adjustment coefficient is not the same for all members.

8. The Executive Board also considered the means of assuring a meaningful increase in quotas for each member. A large number of Executive Directors believe that, in addition to any allocation in proportion to members' shares in calculated quotas, each member's present quota should be increased by the same percentage, i.e., by providing for an equiproportional increase in quotas. These Directors are of the view that an equiproportional increase in quotas, which has been an important part of all previous increases in quotas, is simple in concept and straightforward in its application; when combined with increases in quotas based on members' shares in calculated quotas, all members move towards their shares in calculated quotas at the same, though slower, rate. A few Directors believe that instead of an equiproportional increase in quotas, members should receive a minimum increase in quotas which would apply only to those members whose shares in calculated quotas would not yield an increase equal to or greater than the minimum increase. Most Directors did not accept this method, partly because it is complicated to apply and also because the adjustment coefficient is different from member to member.

9. The relationships between various overall increases in quotas, and their distribution based on (i) amounts to be allocated in the form of

an equiproportional increase in quotas and (ii) the remainder to be allocated in proportion to members' shares in calculated quotas, are shown in the Tables appended to this Report. Each Table shows, for different sizes of the Fund, varying sizes of the equiproportional increase and the corresponding sizes of the adjustment coefficient. The changes in the shares in the Fund of groups of countries, following the country classification presented in IFS, are also shown. For ease of reference, the quota calculations for individual members that are summarized in the Appendix are shown in a separate document which is being circulated concurrently.

10. As regards the size of the adjustment coefficient, the views of the Executive Directors have ranged from relatively low to relatively high coefficients, with the views of a number of Executive Directors tending to range around the mid point of the coefficients shown in the Appendix Tables.

A few Directors, stressing the need to avoid unduly abrupt changes in the quota shares of members and to ensure that each member receives a meaningful increase in its quota, favor an adjustment coefficient of the order of 8 per cent in a Fund size of SDR 90 billion (and corresponding coefficients of 9.7 per cent in a Fund size of SDR 100 billion and 12.8 per cent in a Fund size of SDR 125 billion). This implies that 75 per cent of the overall increase in quotas would be distributed in the form of an equiproportional increase. A few Executive Directors have indicated that in view of the relatively large differences for most members between their shares in present and calculated quotas, and taking into account the Fund's need to maximize the additions to

its holdings of usable assets, it would be appropriate to achieve the maximum rate of adjustment to members' shares in calculated quotas on this occasion. This would imply that there would not be an equiproportional increase in quotas. An overall increase in the Fund to SDR 90 billion would yield a maximum adjustment coefficient of 32.2 per cent--i.e., the difference between each member's share in present quotas and its share in calculated quotas would be reduced by almost one-third. For a Fund size of SDR 100 billion, the maximum adjustment coefficient rises to 39 per cent, while for a Fund size of SDR 125 billion, the maximum adjustment coefficient comes to 51.2 per cent, (See Col. (7) of Appendix Table 2, and 3).

A few other Directors have expressed the view that the adjustment coefficient could reasonably be of the order of at least half the maximum rate of adjustment--i.e., an adjustment coefficient of at least 16 per cent in a Fund size of SDR 90 billion and 19.5 per cent and 25.6 per cent in a Fund size of SDR 100 billion and SDR 125 billion, respectively, (Col. 3 of Appendix Tables 1, 2, and 3). A number of Directors believe that a rather faster rate of adjustment would be desirable in present circumstances. These Directors suggest adjustment coefficients ranging between 20-25 per cent for a Fund size of SDR 90 billion, and most of these Directors stress that coefficients in the upper half of this range would produce acceptable results in terms of distribution of quotas.

11. The share of the non-oil developing countries, taken as a group, falls from its present level in each of the calculations shown in the

Appendix Tables. Several Directors are of the view that for political and economic reasons the share of the non-oil developing countries should not fall in the Fund. A few other Directors hold the view that in coming to an agreement on the size of the adjustment coefficient, account should be taken of the present position in the Fund of the group of non-oil developing countries, and, as noted in the last communique of the Interim Committee, that account should be taken of "the case for maintaining a proper balance between the different groups of countries." Many Directors, however, continue to feel that quota increases should be based on members' individual positions and not on the positions of groups of members; these Directors believe it is inappropriate to impose arbitrary constraints on changes in the shares of certain groups of members in quotas and votes.

12. The Executive Board has also discussed the position in the Fund of the very small quota countries--i.e., those with quotas that at present are less than SDR 10 million. A number of Directors feel that on economic grounds the share in the Fund of this group of countries should be raised slightly, after taking account of the increase in quotas that might be agreed under the Eighth General Review. The additional increase in quotas, above the overall increase in the size of the Fund that would be agreed, would be very small. Other Directors feel that it is important to maintain uniformity of treatment of members in distributing increases in quotas. They also feel that a special adjustment in the very small quotas could result in these members satisfying their needs for Fund resources because they could also use the less conditional facilities, which do not involve upper

tranche conditionality as regards their use of the Fund's resources. A few Directors feel that it might be appropriate to examine the matter further in the light of the increases in quotas that might be agreed under this Review, and particularly in the context of any rounding procedures that might be adopted as regards those increases.

IV. Payment for Increases in Quotas

13. The Executive Board has discussed the mode of payment for the increases in quotas. The Articles of Agreement provide that each member which consents to an increase in quota shall "pay to the Fund twenty-five per cent of the increase in special drawing rights, but the Board of Governors may prescribe that this payment may be made, on the same basis for all members, in whole or in part in the currencies of other members specified, with their concurrence, by the Fund, or in the member's own currency... The balance of the increase shall be paid by the member in its own currency."

14. Most Directors believe that twenty-five per cent of the increase in quotas should be paid in reserve assets. Most of these Directors would prefer that the reserve asset payment be in the form of SDRs. A reserve asset payment made in SDRs provides the greatest enhancement of the liquidity position of the Fund, improves the Fund's income position when the rate of remuneration is lower than the SDR rate, as at present, and it also promotes the use of the SDR in Fund operations and transactions. However, approximately one-fifth of the total SDRs allocated are presently held by the General Department of the Fund and over 60 per cent are held by the industrial countries. Furthermore, approximately

90 members do not have at present sufficient SDRs to pay to the Fund 25 per cent of an increase in quotas of the order presently discussed. In these circumstances, a relatively large number of members would need to buy SDRs, perhaps mainly from the Fund itself, to pay them to the Fund. Consequently, many Directors believe it may be appropriate to give members an option to pay 25 per cent of the increase in quotas in SDRs or in the currency of another member prescribed by the Fund, with the concurrence of the issuer. These Directors recall that in all previous increases in quotas, except one, 25 per cent of the increase was paid in reserve assets, and the liquidity position of the Fund was, thereby, strengthened to the maximum extent. The granting of the option requires a decision of the Board of Governors taken by a 70 per cent majority of the total voting power.

Directors who support the payment of a reserve asset, point out that such a payment will under existing decisions either create a reserve tranche position for a member, or enlarge the paying member's existing reserve tranche, by an amount equal to the reserve asset payment. Thus, reserve asset payment to the Fund results only in a change in the composition of a member's reserves, and does not represent a net drain on a member's reserves. They also emphasize that a member can draw on its reserve tranche without challenge to its representation of balance of payments need.

15. A number of other Directors believe members should not be required to pay 25 per cent of the increase in quotas in reserve assets. They point out that some members do not hold sufficient official foreign assets (SDRs and foreign exchange) to make a reserve asset payment to

the Fund in connection with the increases in quotas of the size that are presently under consideration. In these circumstances, and also considering their views on the need to supplement reserves, these Directors believe that a decision to allocate SDRs in the fourth basic period would be the most suitable way to enable members to make a payment of 25 per cent of the quota increase in SDRs. They consider that in the absence of a decision to allocate SDRs, members should be given the option to pay the increase in quotas wholly in their own currency.

V. Summary of Main Issues

16. The main outstanding issues discussed above with regard to the Eighth General Review may be summarized as follows:

1. As regards the size of the overall increase in quotas, most Executive Directors hold the view that an increase in the size of the Fund to between SDR 90 billion and SDR 100 billion would be acceptable, although many prefer a Fund of SDR 125 billion.

2. On the distribution of the increases in quotas, most Directors agree that quotas should be distributed in accordance with members' shares in calculated quotas, after providing for an equiproportional increase that would help ensure a meaningful increase in quotas for all members. In determining the extent of the adjustment in members' shares in quotas, most Directors believe that the adjustment coefficient should fall within a range of the order of 16 to 25 per cent for a Fund size of SDR 90 billion, and the adjustment coefficient would be correspondingly larger for larger overall increases in quotas.

3. As regards the mode of payment for the increase in quotas, most Directors believe that 25 per cent of the increase should be paid in reserve assets, and members should be given the option to pay in SDRs or in currency specified by the Fund, with the concurrence of the issuer. Other Directors take the view that there is a need to supplement reserves; in the absence of an allocation of SDRs, they believe members should also be given the option to pay increases in quotas wholly in their own currency.

Table 1. Alternative Illustrative Distributions of the Overall Increase in Quotas (Fund of SDR 90 Billion)

(In per cent)

	Present quota shares (1)	Apportionment of overall increase into equiproportional/selective increases 75/25 (2)	50/50 (3)	38/62 (4)	30/70 (5)	22/78 (6)	0/100 (7)
1. Equiproportional increase, per cent of present quota 1/		35.7	23.7	18.0	14.3	10.6	--
2. *Adjustment coefficient* 2/	--	*8.0*	*16.1*	*20.0*	*22.5*	*25.0*	*32.2*
3. Distribution of shares (per cent of total)							
Industrial countries	61.3	61.7	62.2	62.4	62.5	62.6	63.0
Non-industrial countries	38.7	38.3	37.8	37.6	37.5	37.4	37.0
Of which:							
Major oil-exporting countries	10.9	11.2	11.4	11.6	11.7	11.7	12.0
Non-oil developing countries	27.8	27.1	26.4	26.1	25.9	25.6	25.0

1/ The equiproportional increase plus the increase allocated to the member with the lowest ratio of calculated to present quota (Lao, P.D.R.) provide the smallest increase, in per cent of present quota, of 36.7, 25.8, 20.8, 17.5, 14.2, and 4.6 per cent, respectively, in Cols. 2 through 7 in the table.

2/ This figure represents the percentage reduction for each member of the difference between its share in the total of present quotas and its share in calculated quotas.

Table 2. Alternative Illustrative Distributions of the Overall Increase in Quotas (Fund of SDR 100 Billion)

(In per cent)

	Present quota shares (1)	Apportionment of overall increase into equiproportional/selective increases					
		75/25 (2)	50/50 (3)	36/64 (4)	30/70 (5)	23/77 (6)	0/100 (7)
1. Equiproportional increase, per cent of present quota 1/		47.9	31.9	22.9	19.3	14.7	--
2. *Adjustment coefficient 2/*	--	*9.7*	*19.5*	*25.0*	*27.2*	*30.0*	*39.0*
3. Distribution of shares (per cent of total)							
Industrial countries	61.3	61.8	62.3	62.6	62.7	62.9	63.4
Non-industrial countries	38.7	38.2	37.7	37.4	37.3	37.1	36.6
Of which:							
Major oil-exporting countries	10.9	11.2	11.6	11.7	11.8	11.9	12.2
Non-oil developing countries	27.8	27.0	26.1	25.6	25.4	25.2	24.4

1/ The equiproportional increase plus the increase allocated to the member with the lowest ratio of calculated to present quota (Lao, P.D.R.) provide the smallest increase, in per cent of present quota, of 49.6, 35.0, 26.7, 23.8, 19.6, and 6.3 per cent, respectively, in Cols. 2 through 7 in the table.

2/ This figure represents the percentage reduction for each member of the difference between its share in the total of present quotas and its share in calculated quotas.

Table 3. Alternative Illustrative Distributions of the Overall Increase in Quotas (Fund of SDR 125 Billion)

(In per cent)

	Present quota shares (1)	Apportionment of overall increase into equiproportional/selective increases					
		75/25 (2)	50/50 (3)	40/60 (4)	30/70 (5)	22/78 (6)	0/10 (7)
1. Equiproportional increase, per cent of present quota 1/		78.6	52.4	41.9	31.4	22.9	--
2. *Adjustment coefficient* 2/	--	*12.8*	*25.6*	*30.7*	*35.8*	*40.0*	*51.*
3. Distribution of shares (per cent of total)							
Industrial countries	61.3	62.0	62.7	62.9	63.2	63.4	64.
Non-industrial countries	38.7	38.0	37.3	37.1	36.8	36.6	36.
Of which:							
Major oil-exporting countries	10.9	11.3	11.8	11.9	12.1	12.2	12.
Non-oil developing countries	27.8	26.7	25.6	25.2	24.7	24.4	23.

1/ The equiproportional increase plus the increase allocated to the member with the lowest ratio of calculated to present quota (Lao, P.D.R.) provide the smallest increase, in per cent of present quota, of 81.3, 57.5, 48.0, 38.6, 30.9, and 10.0 per cent, respectivel in Cols. 2 through 7 in the table.

2/ This figure represents the percentage reduction for each member of the difference between its share in the total of present quotas and its share in calculated quotas.

CONFIDENTIAL

FROM: R G LAVELLE

DATE: 31 December 1982

MISS RUTTER

cc: Sir K Couzens
Mr Littler
Mr Bottrill
Mr Atkinson
Mr Sheridan

IMF: EIGHTH QUOTA REVIEW - DISTRIBUTION OF QUOTA INCREASE

1. Your minute of 30 December asked for a note on methods of distributing the quota increase.

2. This is not an easy area, and there have over the last year or so been a large number of ideas on how the increase might be distributed. Fortunately, at their last meeting shortly before Christmas, the Executive Board managed to reach a broad consensus on the method by which selective quota adjustments will be made. This is to be Method 3, ie the 'Australian' approach which we have consistently advocated, under which the increase is distributed to all members pro rata with their Calculated Quota Share.

3. For reference, I attach brief notes on some of the discarded methods. They may of course resurface if the consensus falls apart. Also in the Annex are notes on two marginal ideas (a minimum quota for very small countries and an increase in basic votes) which have not been wholly discarded, although their prospects are poor. The Executive Board discussions have spawned considerable technical jargon, and the Annex additionally contains a glossary of some of those which may appear in their Report to the Interim Committee.

4. On the assumption that the consensus holds, the main issue confronting the Interim Committee will be to decide how much of the total quota increase will be distributed selectively and how much equiproportionally. The greater the equiproportional element, the more the shift towards relative economic positions is "mitigated" or diluted. This is demonstrated in the following

tables which set out for the main countries, and country blocs, the effect of (a) none; (b) 25%; (c) 50%; and (d) 75% of the total increase being distributed equiproportionally. The first table assumes quotas are increased to SDR 90bn; the second table to SDR 100bn; figures may be interpolated for intermediate sizes of Fund.

TABLE 1: SDR 90bn

	Present quota share	New quota share, with equiproportional element:			
		0%	25%	50%	75%
US	20.656	19.411	19.722	20.034	20.345
UK	7.189	6.678	6.805	6.933	7.060
Germany	5.299	6.475	6.181	5.887	5.593
France	4.716	5.157	5.047	4.937	4.827
Japan	4.077	5.103	4.846	4.590	4.333
Total industrial	61.293	63.008	62.579	62.150	61.722
Total oil exporters	10.915	11.966	11.705	11.444	11.179
of which Saudi Arabia	3.441	3.627	3.588	3.539	3.490
Total NOLDCs	27.796	25.026	25.718	26.409	27.101
of which:					
China	2.949	2.461	2.583	2.705	2.827
India	2.814	2.212	2.362	2.513	2.663

TABLE 2: SDR 100bn

	Present quota share	New quota share with equiproportional increase: 0%	25%	50%	75%
US	20.656	19.149	19.526	19.903	20.280
UK	7.189	6.571	6.725	6.879	7.034
Germany	5.299	6.722	6.366	6.010	5.655
France	4.716	5.250	5.116	4.983	4.850
Japan	4.077	5.319	5.008	4.698	4.387
Total industrial	61.293	63.364	62.845	62.327	61.810
Total oil exporters	10.915	12.187	11.868	11.550	11.232
of which Saudi Arabia	3.441	3.678	3.620	3.559	3.501
Total NOLDCs	27.796	24.440	25.275	26.110	26.945
of which:					
China	2.949	2.359	2.506	2.654	2.802
India	2.814	2.086	2.268	2.450	2.632

5. As might be expected, those who are relatively underendowed with quota and want more, are arguing for no equiproportional increase. This group includes Japan and many Arab members (but not Saudi Arabia whose claim for a quota increase was fully met at the time of the SAMA loan negotiations last year). At the other end of the spectrum, those countries who are overendowed with quota have pressed for 75% of the increase to be equiproportional. The most prominent members of this group are China and India, but they have attracted the sympathy of Brazil, Indonesia, and the two African constituencies. In between are Germany, Netherlands, Italy, and the Nordics who prefer little or no equiproportional element (ie say 0-25%), the US and ourselves who are in the range 25-50%, and the Saudis and French (about 50%). The exact proportion that members prefer is of course governed to some extent by the size of the quota increase: the larger the total increase, the greater the equiproportional element can afford to be to achieve a given shift in quota shares. But there seems to be a general understanding that - if there is to be an equi-proportional element at all - it would not be less than 25% of the total.

6. A related issue is the effect on members' access to Fund resources. This has not been discussed in detail yet in the Executive Board (and Larosière is anxious that it should not impinge upon, and complicate, discussion at the Interim Committee). Nevertheless, the greater the selective element in the distribution of the quota increase, the more NOLDCs as a group will worry about at least preserving their access in cash terms. If quotas are increased to SDR 90bn, and there is no equiproportional element, the Indians for example would lose over 20% of their quota share. If they are to preserve their access in cash terms, then access for the average member would have to be increased by 20% or more. Conversely if they shed only 10% of the quota share (ie because 50% of the quota increase was distributed equiproportionally) the increase in access for the average member could afford to be correspondingly less.

R G LAVELLE

ANNEX

A. Discarded Methods

1. Method 2. Under this method the actual quota of each member was deducted from their calculated quota and the selective quota increase was distributed pro rata with the resultant differences. The actual quota of 31 members exceeded their calculated quotas: these members were not eligible for a selective increase. Under a variant of this method actual quotas were inflated by an equiproportional increase before being deducted from calculated quotas: this had the effect of excluding further members from a selective quota increase. Method 2 was initially favoured by the US. It tended to produce broadly similar results to Method 3, but was less uniform.

2. Method 4. The essence of this method was that selective increases were limited to those 35-40 members whose share in actual quotas was less than their share in calculated quotas. Selective increases for these members would amount in aggregate to about SDR 10 billion, and the remainder of the quota increase would be distributed equiproportionally. This method benefitted those like the Japanese, Germans, and Middle East oil producers (not Saudi Arabia so much) who were most underendowed with quota.

3. "Minimum Quota Increase". Instead of an equiproportional element, all members, even the most overendowed, would be guaranteed a certain amount of quota increase (the figure of 25% was frequently mentioned). Otherwise the entire quota increase would be distributed selectively, using Method 2 or Method 3. This produced a relatively undiluted shift towards calculated quotas, because all but a handful of countries earned a 25% quota increase. But the drawback was that it was not a uniform method.

B. <u>Dormant Ideas</u>

4. Minimum Quotas. 17 members (mostly small Caribbean Islands) have quotas of SDR 10 million or less. Their plea for special treatment in the quota review, though technically undeserved, nevertheless attracted some support in the Executive Board. The special treatment could take a number of forms, but probably involves very generous rounding up to the next SDR 2.5 million. The sums involved are trifling; but it would be a breach of the principle of uniformity.

5. Basic Votes. At Bretton Woods, each member, irrespective of size, was endowed under the Articles with 250 votes as well as votes derived from quotas. The 250 Basic Votes are equivalent to the votes derived from a quota of SDR 25 million, and are therefore by far the major component of the voting power of a small country. But the overall importance of Basic Votes has shrunk with successive Quota increases. There has been intermittent talk of increasing basic votes, but the necessary change to the Articles would require an 85% majority and it is therefore not likely to be practical.

6. Making the Next Quota Review Selective. The Germans have indicated that if their selective increase is over-diluted at this review, they may press for the next review to contain selective quota adjustments.

Technical Terms

7. Calculated Quota. This is the figure derived from the quota formulae which were overhauled at an earlier stage of the quota review. It is taken to depict "relative economic positions", and it is the key for distributing the quota increase under Method 3.

8. Adjustment Coefficient. This depicts how far a particular distribution technique shifts actual quota shares towards calculated quota share for a given size of fund. For example if quotas are increased by some 50% to SDR 90 billion and the increase is distributed under Method 3 with no dilution, the adjustment coefficient is 32% ie, the share of each member moves almost one-third of the way towards the member's calculated share. If half the increase is applied equiproportionally, the adjustment coefficient is diluted to 16%. If quotas are increased to SDR 100 billion under Method 3 with no dilution, the adjustment coefficient is 39%.

DISTRIBUTION.

FROM: R G LAVELLE

DATE: 6 January 1983

MR KERR

cc: Mr Littler
Mr Sheridan

EIGHTH QUOTA REVIEW: DISTRIBUTION

I attach an extended account of the Australian method which Mr Sheridan has prepared following the Chancellor's query this morning.

R G LAVELLE

"AUSTRALIAN" METHOD OF DISTRIBUTION

Calculated quotas are taken to depict the relative economic position of members in the world economy. They are, however, very different from current actual quotas which reflect to a large extent, historical factors, anomalies and evolution over previous Quota Reviews etc. Calculated quotas are the key for distributing the quota increase under the Australian method.

2. The increase in quota under the Australian method is calculated in proportion to the member's share in the total calculated quotas. The member's share, using calculated quotas as the key, in the increased quotas is added to the current quota. The Australian method thus represents an 'incremental' approach and, if applied over a number of reviews, would act to bring actual and calculated reviews into line.

3. The table below shows that the Australian method represents a move to calculated quotas but does not reflect the shift fully. If quotas are increased by 50% to SDR 90bn and the increase is distributed under the Australian method with no equiproportional element, the share of the member moves almost one third ofthe way towards the member's calculated quota. If half the increase is applied equiproportionally, the move is diluted to about 16%

	Present quota	Calculated	Australian distribution Ø (Fund size of SDR 90bn
US	20.66	16.79	19.41
UK	7.19	5.60	6.68
Germany	5.30	8.95	6.48
France	4.72	6.09	5.16
Japan	4.08	7.26	5.10
Industrial	61.29	66.62	63.00
Oil Exporter	10.92	14.18	11.97
Non oil ldc	27.80	19.20	25.03

Ø Distributes, on basis of calculated quotas, members' shares in the total increase in quotas (ie for a Fund size of SDR 90 bn, the share in calculated quotas in the increase of SDR 29 bn).

ARTICLE VII

Borrowing

GENERAL ARRANGEMENTS TO BORROW

Preamble

In order to enable the International Monetary Fund to fulfill more effectively its role in the international monetary system in the new conditions of widespread convertibility, including greater freedom for short-term capital movements, the main industrial countries have agreed that they will, in a spirit of broad and willing cooperation, strengthen the Fund by general arrangements under which they will stand ready to lend their currencies to the Fund up to specified amounts under Article VII, Section 1 of the Articles of Agreement when supplementary resources are needed to forestall or cope with an impairment of the international monetary system in the aforesaid conditions. In order to give effect to these intentions, the following terms and conditions are adopted under Article VII, Section 1 of the Articles of Agreement.

Paragraph 1. *Definitions*

As used in this Decision the term:

(i) "Articles" means the Articles of Agreement of the International Monetary Fund;

(ii) "credit arrangement" means an undertaking to lend to the Fund on the terms and conditions of this Decision;

(iii) "participant" means a participating member or a participating institution;

(iv) "participating institution" means an official institution of a member that has entered into a credit arrangement with the Fund with the consent of the member;

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(v) "participating member" means a member of the Fund that has entered into a credit arrangement with the Fund;

(vi) "amount of a credit arrangement" means the maximum amount expressed in units of its currency that a participant undertakes to lend to the Fund under a credit arrangement;

(vii) "call" means a notice by the Fund to a participant to make a transfer under its credit arrangement to the Fund's account;

(viii) "borrowed currency" means currency transferred to the Fund's account under a credit arrangement;

(ix) "drawer" means a member that purchases borrowed currency from the Fund in an exchange transaction or in an exchange transaction under a stand-by arrangement;

(x) "indebtedness" of the Fund means the amount it is committed to repay under a credit arrangement.

Paragraph 2. *Credit Arrangements*

A member or institution that adheres to this Decision undertakes to lend its currency to the Fund on the terms and conditions of this Decision up to the amount in units of its currency set forth in the Annex to this Decision or established in accordance with Paragraph 3 (b).

Paragraph 3. *Adherence*

(a) Any member or institution specified in the Annex may adhere to this Decision in accordance with Paragraph 3 (c).

(b) Any member or institution not specified in the Annex that wishes to become a participant may at any time, after consultation with the Fund, give notice of its willingness to adhere to this Decision, and, if the Fund shall so agree and no participant object, the member or institution may adhere in accordance with Para-

graph 3 (c). When giving notice of its willingness to adhere under this Paragraph 3 (b) a member or institution shall specify the amount, expressed in terms of its currency, of the credit arrangement which it is willing to enter into, provided that the amount shall not be less than the equivalent at the date of adherence of one hundred million special drawing rights.

(c) A member or institution shall adhere to this Decision by depositing with the Fund an instrument setting forth that it has adhered in accordance with its law and has taken all steps necessary to enable it to carry out the terms and conditions of this Decision. On the deposit of the instrument the member or institution shall be a participant as of the date of the deposit or of the effective date of this Decision, whichever shall be later.

Paragraph 4. *Entry into Force*

This Decision shall become effective when it has been adhered to by at least seven of the members or institutions included in the Annex with credit arrangements amounting in all to not less than the equivalent of five and one-half billion United States dollars of the weight and fineness in effect on July 1, 1944.

Paragraph 5. *Changes in Amounts of Credit Arrangements*

The amounts of participants' credit arrangements may be reviewed from time to time in the light of developing circumstances and changed with the agreement of the Fund and all participants.

Paragraph 6. *Initial Procedure*

When a participating member or a member whose institution is a participant approaches the Fund on an exchange transaction or stand-by arrangement and the Managing Director, after consultation, considers that the exchange transaction or stand-by arrange-

ment is necessary in order to forestall or cope with an impairment of the international monetary system, and that the Fund's resources need to be supplemented for this purpose, he shall initiate the procedure for making calls under Paragraph 7.

Paragraph 7. *Calls*

(a) The Managing Director shall make a proposal for calls for an exchange transaction or for future calls for exchange transactions under a stand-by arrangement only after consultation with Executive Directors and participants. A proposal shall become effective only if it is accepted by participants and the proposal is then approved by the Executive Board. Each participant shall notify the Fund of the acceptance of a proposal involving a call under its credit arrangement.

(b) The currencies and amounts to be called under one or more of the credit arrangements shall be based on the present and prospective balance of payments and reserve position of participating members or members whose institutions are participants and on the Fund's holdings of currencies.

(c) Unless otherwise provided in a proposal for future calls approved under Paragraph 7(a), purchases of borrowed currency under a stand-by arrangement shall be made in the currencies of participants in proportion to the amounts in the proposal.

(d) If a participant on which calls may be made pursuant to Paragraph 7(a) for a drawer's purchases under a stand-by arrangement gives notice to the Fund that in the participant's opinion, based on the present and prospective balance of payments and reserve position, calls should no longer be made on the participant or that calls should be for a smaller amount, the Managing Director may propose to other participants that substitute amounts be made available under their credit arrangements, and this proposal shall be subject to the procedure of Paragraph 7(a). The proposal as originally approved under Paragraph 7(a) shall remain effec-

tive unless and until a proposal for substitute amounts is approved in accordance with Paragraph 7 (a).

(e) When the Fund makes a call pursuant to this Paragraph 7, the participant shall promptly make the transfer in accordance with the call.

Paragraph 8. *Evidence of Indebtedness*

(a) The Fund shall issue to a participant, on its request, non-negotiable instruments evidencing the Fund's indebtedness to the participant. The form of the instruments shall be agreed between the Fund and the participant.

(b) Upon repayment of the amount of any instrument issued under Paragraph 8 (a) and all accrued interest, the instrument shall be returned to the Fund for cancellation. If less than the amount of any such instrument is repaid, the instrument shall be returned to the Fund and a new instrument for the remainder of the amount shall be substituted with the same maturity date as in the old instrument.

Paragraph 9. *Interest and Charges*

(a) The Fund shall pay a charge of one-half of one per cent on transfers made in accordance with Paragraph 7 (e).

(b) The Fund shall pay interest on its indebtedness at the rates at which it levies charges on segments of its holdings of currency resulting from purchases for which it borrowed and incurred the indebtedness, provided that the rate of interest shall be not less than four per cent per annum on any part of the Fund's indebtedness. Interest shall be paid as soon as possible after July 31, October 31, January 31, and April 30.

(c) Interest and charges shall be paid, as determined by the Fund, in special drawing rights, or in the participant's currency, or in other currencies that are actually convertible.

Paragraph 10. *Use of Borrowed Currency*

The Fund's policies and practices under Article V, Sections 3 and 7 on the use of its general resources and stand-by arrangements, including those relating to the period of use, shall apply to purchases of currency borrowed by the Fund.

Paragraph 11. *Repayment by the Fund*

(a) Subject to the other provisions of this Paragraph 11, the Fund, five years after a transfer by a participant, shall repay the participant an amount equivalent to the transfer calculated in accordance with Paragraph 12. If the drawer for whose purchase participants make transfers is committed to repurchase at a fixed date earlier than five years after its purchase, the Fund shall repay the participants at that date. Repayment under this Paragraph 11 (a) or under Paragraph 11 (c) shall be, as determined by the Fund, in the participant's currency whenever feasible, or in special drawing rights, or, after consultation with the participant, in other currencies that are actually convertible. Repayments to a participant under Paragraph 11 (b) and (e) shall be credited against transfers by the participant for a drawer's purchases in the order in which repayment must be made under this Paragraph 11 (a).

(b) Before the date prescribed in Paragraph 11 (a), the Fund, after consultation with a participant, may make repayment to the participant in part or in full. The Fund shall have the option to make repayment under this Paragraph 11 (b) in the participant's currency, or in special drawing rights in an amount that does not increase the participant's holdings of special drawing rights above the limit under Article XIX, Section 4, of the Articles of Agreement unless the participant agrees to accept special drawing rights above that limit in such repayment, or, with the agreement of the participant, in other currencies that are actually convertible.

...

(c) Whenever a reduction in the Fund's holdings of a drawer's currency is attributed to a purchase of borrowed currency, the Fund shall promptly repay an equivalent amount.

(d) Repayment under Paragraph 11(c) shall be made in proportion to the Fund's indebtedness to the participants that made transfers in respect of which repayment is being made.

(e) Before the date prescribed in Paragraph 11(a) a participant may give notice representing that there is a balance of payments need for repayment of part or all of the Fund's indebtedness and requesting such repayment. The Fund shall give the overwhelming benefit of any doubt to the participant's representation. Repayment shall be made after consultation with the participant in the currencies of other members that are actually convertible, or made in special drawing rights, as determined by the Fund. If the Fund's holdings of currencies in which repayment should be made are not wholly adequate, individual participants shall be requested, and will be expected, to provide the necessary balance under their credit arrangements. If, notwithstanding the expectation that the participants will provide the necessary balance, they fail to do so, repayment shall be made to the extent necessary in the currency of the drawer for whose purchases the participant requesting repayment made transfers. For all of the purposes of this Paragraph 11 transfers under this Paragraph 11(e) shall be deemed to have been made at the same time and for the same purchases as the transfers by the participant obtaining repayment under this Paragraph 11(e).

(f) All repayments to a participant in a currency other than its own shall be guided, to the maximum extent practicable, by the present and prospective balance of payments and reserve position of the members whose currencies are to be used in repayment.

(g) The Fund shall at no time reduce its holdings of a drawer's currency below an amount equal to the Fund's indebtedness to the participants resulting from transfers for the drawer's purchases.

(h) When any repayment is made to a participant, the amount that can be called for under its credit arrangement in accordance with this Decision shall be restored pro tanto but not beyond the amount of the credit arrangement.

(i) The Fund shall be deemed to have discharged its obligations to a participating institution to make repayment in accordance with the provisions of this Paragraph or to pay interest and charges in accordance with the provisions of Paragraph 9 if the Fund transfers an equivalent amount in special drawing rights to the member in which the institution is established.

Paragraph 12. *Rates of Exchange*

(a) The value of any transfer shall be calculated as of the date of the dispatch of the instructions for the transfer. The calculation shall be made in terms of the special drawing right in accordance with Article XIX, Section 7 (*a*) of the Articles, and the Fund shall be obliged to repay an equivalent value.

(b) For all of the purposes of this Decision, the value of a currency in terms of the special drawing right shall be calculated by the Fund in accordance with Rule O-2 of the Fund's Rules and Regulations.

Paragraph 13. *Transferability*

A participant may not transfer all or part of its claim to repayment under a credit arrangement except with the prior consent of the Fund and on such terms and conditions as the Fund may approve.

Paragraph 14. *Notices*

Notice to or by a participating member under this Decision shall be in writing or by rapid means of communication and shall

be given to or by the fiscal agency of the participating member designated in accordance with Article V, Section 1 of the Articles and Rule G-1 of the Rules and Regulations of the Fund. Notice to or by a participating institution shall be in writing or by rapid means of communication and shall be given to or by the participating institution.

Paragraph 15. *Amendment*

This Decision may be amended during the period prescribed in Paragraph 19(a) only by a decision of the Fund and with the concurrence of all participants. Such concurrence shall not be necessary for the modification of the Decision on its renewal pursuant to Paragraph 19(b).

Paragraph 16. *Withdrawal of Adherence*

A participant may withdraw its adherence to this Decision in accordance with Paragraph 19(b) but may not withdraw within the period prescribed in Paragraph 19(a) except with the agreement of the Fund and all participants.

Paragraph 17. *Withdrawal from Membership*

If a participating member or a member whose institution is a participant withdraws from membership in the Fund, the participant's credit arrangement shall cease at the same time as the withdrawal takes effect. The Fund's indebtedness under the credit arrangement shall be treated as an amount due from the Fund for the purpose of Article XXVI, Section 3, and Schedule J of the Articles.

Paragraph 18. *Suspension of Exchange Transactions and Liquidation*

(a) The right of the Fund to make calls under Paragraph 7 and the obligation to make repayments under Paragraph 11 shall be suspended during any suspension of exchange transactions under Article XXVII of the Articles.

(b) In the event of liquidation of the Fund, credit arrangements shall cease and the Fund's indebtness shall constitute liabilities under Schedule K of the Articles. For the purpose of Paragraph 1(*a*) of Schedule K, the currency in which the liability of the Fund shall be payable shall be first the participant's currency and then the currency of the drawer for whose purchases transfers were made by the participants.

Paragraph 19. *Period and Renewal*

(a) This Decision shall continue in existence for four years from its effective date.

(b) This Decision may be renewed for such period or periods and with such modifications, subject to Paragraph 5, as the Fund may decide. The Fund shall adopt a decision on renewal and modification, if any, not later than twelve months before the end of the period prescribed in Paragraph 19(a). Any participants may advise the Fund not less than six months before the end of the period prescribed in Paragraph 19(a) that it will withdraw its adherence to the Decision as renewed. In the absence of such notice, a participant shall be deemed to continue to adhere to the Decision as renewed. Withdrawal of adherence in accordance with this Paragraph 19(b) by a participant, whether or not included in the Annex, shall not preclude its subsequent adherence in accordance with Paragraph 3(b).

(c) If this Decision is terminated or not renewed, Paragraph 8 through 14, 17 and 18(b) shall nevertheless continue to apply

in connection with any indebtedness of the Fund under credit arrangements in existence at the date of the termination or expiration of the Decision until repayment is completed. If a participant withdraws its adherence to this Decision in accordance with Paragraph 16 or Paragraph 19(b), it shall cease to be a participant under the Decision, but Paragraphs 8 through 14, 17 and 18(b) of the Decision as of the date of the withdrawal shall nevertheless continue to apply to any indebtedness of the Fund under the former credit arrangement until repayment has been completed.

Paragraph 20. *Interpretation*

Any question of interpretation raised in connection with this Decision which does not fall within the purview of Article XXIX of the Articles shall be settled to the mutual satisfaction of the Fund, the participant raising the question, and all other participants. For the purpose of this Paragraph 20 participants shall be deemed to include those former participants to which Paragraphs 8 through 14, 17 and 18(b) continue to apply pursuant to Paragraph 19(c) to the extent that any such former participant is affected by a question of interpretation that is raised.

Para 21 - add the following new paragraph entitled "Use of Credit Arrangements for Non-Participants":

"(a) The Fund may make calls in accordance with paragraphs 6 and 7 for exchange transactions with a member that is a parallel creditor or whose institution is a parallel creditor, as if the member were a participant. The Fund may also make requests under paragraph 11(e) in connection with an early repayment of the claim of a parallel creditor under its credit agreement with the Fund due to a balance of payments need, in the same manner as for participants. All the foregoing provisions of this decision relating to calls and requests with respect to early repayment shall apply to calls and requests under this paragraph 21(a).

(b) The Fund may make calls in accordance with paragraphs 6 and 7 for exchange transactions in the conditional tranches or under stand-by or extended arrangements requested by other members that are not participants. All the provisions of this decision relating to calls shall apply, except as otherwise provided in paragraph 21(c).

(c) The Managing Director may initiate the procedure for making calls under paragraph 7 in connection with requests referred to in paragraph 21(b) if, after consultation, he considers that the Fund faces an inadequacy of resources readily available to meet actual and expected requests for conditional financing that reflect the existence of an exceptional situation associated with balance of payments problems of members of a character or aggregate size that could threaten the stability of the international monetary system.

In making a proposal for calls pursuant to paragraph 21(b) and (c), the Managing Director shall pay due regard to potential calls pursuant to other provisions of this decision."