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PART C

TREASURY AND CIVIL SERVICE COMMITTEE (TCSC) HEARING ON INTERNATIONAL MONETARY CONDITIONS AND EXCHANGE RATE POLICY, 31 JANUARY 1983

Begins: 28/1/83 DD: 25 Years

Ends: 1/2/83 1/9/95

PO -CH /GH/0095
PART C

28/1/83

Bank provisions for bad debts

Points to make

(i) Obviously banks have to make the provisions they think proper against individual loans to problem countries, taking account also of the views of their supervisory authority (the Bank of England).

(ii) The circumstances may vary from loan to loan, depending on the details, existence of guarantees (eg from ECGD) etc.

(iii) It is not a matter of writing a loan off completely or not at all. And a loan can be written down one yar and up the next if circumstances change.

(iv) The position on the tax treatment of provisions was set out in a letter of 17 January from the Revenue to the British Bankers Association (which has now been published). [Copy attached. It is believed banks are now generally content with the situation.]

TCSC BRIEFING

28/1/83

Draft Speaking Note

Role of the IMF (and central banks) in encouraging new bank lending to problem countries

I am aware that the IMF has played an intermediary role in several recent negotiations about sovereign debt rescheduling or restructuring. This is a natural role for the Fund, because before giving its approval to an economic adjustment programme of a member state the Fund needs to satisfy itself that adequate external financing will be available in support of the programme. [I am also aware that central banks, including the Bank of England, have encouraged bankers to cooperate with the Fund].

For commercial banks I believe the process is a helpful one also. They can find (and have found) value in the opportunity to get a direct explanation and reassurance from the IMF about the economic programmes borrowers have agreed to implement. Each bank may also find it valuable to know that its own new lending will be matched by others as well as

the Fund. In these circumstances new lending by a bank can help to improve the quality and security of its existing loans.

I accept that for the Fund to involve itself in negotiations between sovereign borrowers and commercial banks is something of a new departure, as I believe the Fund Management would be

the first to acknowledge themselves. My impression for what it is worth is that these initiatives have been generally welcomed by debtors and creditors alike in difficult circumstances. I have it in mind that this is a development which it might be useful to have some discussion about in the Fund, with a view to lending the recognition and support of member Governments to initiatives by the Managing Director of the kind which he has already taken [in relation to Mexico, Brazil, Argentina and most recently Yugoslavia]; and to encouraging longer term arrangements for continuing cooperation.

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28/1/83

<u>The IMF as intermediary between sovereign borrowers and private sector lenders</u>

<u>Speaking Note</u>

The Fund has not explicitly explored the idea of long term borrowing from institutions - only contingency market borrowing which would be short or medium term. The Fund would have to think long and hard before entering into a greatly expanded role which, as proposed, would involve intermediating both maturity and risk simultaneously. In the last resort, of course Government's and tax payers would have to be the ultimate guarantors. [If raised. Any proposal to use to Fund's gold as collateral would be a very contentious issue on which agreement could not be expected].

Doubts about proposals of this kind relate also to the distortions which any large scheme of official financial intermediation would introduce in international finance. It removes the element of commercial judgement that should properly fall to the private sector lenders. They would simply look straight through the IMF to the strength of the ultimate guarantors (member governments and tax payers). The result could easily be to divert or deter normal commercial flows. There are also all the difficulties that a central institution could face in deciding which countries could borrow and which specific uses funds should be put to in the borrowing countries. These decisions are taken much more efficiently and effectively in the market.

<u>Role for IBRD</u> (for defensive use if raised)

Essentially this would amount to little more than an agreement to step up the IBRD's normal activities. But these are already subject to constraints. First there is the constraint of the

IBRD's gearing ratio; and second there is the IBRD's rule that any loans have to be made for specific worthwhile projects of reconstruction and development (except in special circumstances). Any changes to these rules would put the IBRD's credit standing at risk. [Issues of indexed bonds would seem a superfluous inducement to investors, would not fit alongside other IBRD bonds, and might increase the difficulty of marketing existing IBRD bonds given the uncertain impact that indexed borrowing would have on the Bank's future liabilities.

Background Note

Professor Williamson has suggested that the IMF might take a greatly expanded intermediary role. His idea appears to be that some organisation like the Fund would tap long-term money from private institutions in industrial countries, who in return would receive claims on the Fund denominated in SDRs, and indexed using an average of prices in the five major currency countries. On his proposal the collateral would consist of the Fund's gold, or bonds supplied by member countries. Dr Bray has suggested the scheme might be run by the IBRD if not the Fund.

The first paragraph of the speaking note above reflects Mr Anson's report of the IMF position (telegram No 36 of 21 January).

28/1/83

Schemes to guarantee or refinance existing bank loans from official funds

Some time ago the IMF/IBRD Development Committee set up a Task Force to examine problems related to non-concessional flows to the less developed countries. The Task Force considered several ideas for new guarantee facilities, including a French proposal for a Multilateral Partial Guarantee Framework for extending partial guarantees to international banks on behalf of countries on the threshold of creditworthiness.

However, in their report to the Development Committee the Task Force decided not to recommend that these ideas be pursued, essentially because their consultations with commercial banks revealed that there was little prospect that a new mechanism of this sort would in fact generate additional lending. There may be some scope for multilateral institutions, such as the World Bank and the main Regional Development Banks, to make greater use of their existing powers to guarantee commercial loans in addition to lending in their own right but in the past there has been little demand for them to do so.

More recently a number of further schemes have been canvassed outside Government. For example, a Refunding Facility was suggested in a Financial Times leader on 13 September, which would issue long term bonds with an IMF guarantee, using these funds to purchase debts at a discount.

Line to take

One difficulty with some of this family of ideas is that they tend to cut across IMF conditionality. If conditionality is decreased there is a danger that guarantees will be called. More generally schemes of this sort seem liable to give the wrong signal about the respective roles of international institutions, banks and adjustment by developed countries. If a commercial fee were changed, as it should be, there would seem real questions to do with the extent to which the largest banks would be interested in some proposals in this field if (for example) they felt able to look after themselves in rescheduling operations.

The best way forward is first to tackle individual country problems on a case by case basis. Secondly insofar as the problem is a general one we need to make the existing institutions work better. This means in particular more resources for the IMF and closer liaison with the commercial banks in the establishment of programmes for problem countries. It may mean the Fund getting in earlier and leaving shorter gaps if a programme breaks down. This approach is not easy but it seems right in principle, and it avoids the hazards of attempts to establish major new bureaucracies in short order. The role the IMF has been taking recently in cooperating more closely with commercial banks over problem countries is on balance a helpful development.

INTERNATIONAL BANKING SITUATION

Since November the main preoccupation of the markets has shifted from Mexico to Brazil, which has been forced by its acute cash shortage to follow a rather similar path. The Brazilians, by protesting too much that their situation was under better control than the Mexican one and by mishandling their relations with the commercial bankers, initially created some confusion. They have, however, now put the organisation in place for a fairly speedy conclusion to negotiations with the banks, and the response to their package of financing measures has been encouraging. Larosière has swung firmly behind the Brazilians' request and on Monday 24 January adopted the same tactics towards the banks as he did for Mexico, telling them that he would only recommend the Brazilians adjustment programme to the IMF Executive Board if he had confirmation from the banks that they had fully committed themselves to the financing package. The negotiations on most parts of the package for Argentina have been concluded except for final details of rescheduling of 1983 maturities.

The Venezuelans and the Chileans both have payments difficulties, but the root causes are rather different from the rest. Venezuela has a history of incompetent administration of its international financing, recently compounded by some loss of confidence in the domestic banks. It has sensibly decided to shift from a policy of reliance on short-term debt to funding with longer maturities but has handled the implementation poorly. Its once ample reserves are being dissipated in the process and now the prospects for the oil price threaten to worsen the situation. Chile's domestic difficulties have led to a crisis in their domestic banks; a number of these are either being liquidated or taken over by the government in a way which seems to treat foreign creditors rather badly. Most of Chile's foreign debt has been contracted by private borrowers which makes it harder to find a collective solution.

There is some concern lest the domestic crisis spills over and infects their relations with foreign creditors.

In Eastern Europe, negotiations are in progress on restructuring 1983 maturities of Poland and Romania, although in the case of Poland, this is restricted to commercial bank debt until the conditions for the resumption of talks on official debt are met. Meanwhile, Poland enjoys de facto a 100% moratorium on official debt. The Yugoslav situation is more untidy with Yugoslavia reluctantly accepting the need to restructure its debt within a package (including new money), largely put together at the instigation of the IMF and the US authorities and involving international institutions, governments and commercial banks. Details for the countries mentioned are given in the attached table and the country notes; there are also notes on East Germany and Hungary, which could also run into financing difficulties.

Confidence within the international markets is improving despite some unhelpful new developments, like the Chilean difficulties. The ability of the system to deal with shocks of this kind, demonstrated by the experience of the last half year, seems for the time being at least, to have removed the fear of a widespread collapse of the system and to encourage confidence that major debt problems can be dealt with. Swift action by the authorities in providing inter-government or BIS/central bank assistance to Brazil in conjunction with firm handling by Larosière of the IMF relationship, both with the borrowers and the private lenders, has shown that official response to Mexico earlier on was not a flash in the pan but a demonstration by the authorities not to allow panic to cause or spread instability. A symptom of the restored resilience of the market against this background is the way it took in its stride this week the announcement that a US bank (Seafirst Corporation of Seattle) with large loan losses in the energy sector and considerable exposure to Latin America, had been given a $1.5 bn credit to strengthen it by a consortium of major US banks; this news last summer would have rung alarm bells throughout the international and US domestic banking markets.

Nevertheless, there is still some tension which will last until the agreements on the financing packages for the problem countries have been signed, probably within the next couple of months. Whether that tension lessens very much thereafter must depend on a number of other factors. The direction of the oil price in the wake of the disarray in OPEC is now hanging over some of the heavily indebted countries. If there is a substantial and rapid decline it will threaten the revenue of Mexico, Venezuela and some other countries like Nigeria and Indonesia which could be vulnerable. It could also have an adverse impact on energy-related borrowers in Canada and the US with the risk of a knock-on effect on some of their domestic banks.

Other debtor countries dependent on imported energy like Brazil will benefit from the improvement in their balance of payments and that prospect ought in principle to improve their creditworthiness. As well as this direct benefit, they could also be helped by any resulting general stimulus to the world economy which could reinforce the recovery expected later this year. However, there is a danger that the impact on Mexico and the other heavily indebted oil producers will lead to a more generalised deterioration in the financing climate. The banking community in the past has not always differentiated adequately between sovereign borrowers and if this were repeated then other Latin American countries would also find themselves under the same cloud.

In conclusion, the crisis has so far been successfully contained and we now have to nurse the recovery to cautious confidence. There are still risks. The appetite of the banks for international lending is expected in any event to be reduced. The outcome will be improved by signs of recovery in the major economies and any other indicators that the adjustment programmes agreed with the IMF can and will stick. Agreement in the forthcoming Interim Committee meeting on a substantial increase in Fund quotas will also do much to restore nerves.

INTERNATIONAL FINANCIAL SUPPORT PACKAGES

A: LATIN AMERICA

	MEXICO	BRAZIL	ARGENTINA	VENEZUELA	CHILE
Estimated debt outstanding (end-1982)	$83 bn	$81 bn	$39 bn	$28 bn	$18 bn
Payments arrears	Moratorium on public sector principal payments (from August 1982) during negotiation of restructuring	Moratorium on public & private sector principal payments (from January 1983) during negotiation of restructuring	-	-	-
	$1.3 bn principal and interest on private debt	-	$2.5 bn principal and interest on public and private debt	$84 mn which authorities have undertaken to pay off	-
Rescheduling negotiations	$19.5 bn public sector maturities reportedly falling due 23.8.82-31.12.84 (requested)	$4.0 bn public & private sector maturities falling due in 1983 (requested)	$5.5 bn public sector maturities overdue on 1.12.82 and falling due from then to 31.12.83 (requested)	$5.9 bn public sector short-term debt being refinanced - not strictly "rescheduled" (in progress)	$2.8 bn private commercial bank maturities falling due in 1983 and 1984 (request imminent)
Terms					
: LIBOR + (%)	+ 1 7/8	+ 2 1/8 - 2 1/2	+ 2 1/8	1-1 5/8	N/A
: Prime + (%)	+ 1 3/4	+ 1 7/8 - 2 1/4	+ 2	1 1/4 - 1 1/2	N/A
: fee (%)	1	1 1/2	1 1/8	?	N/A
: grace period (years)	4	2 1/2	3	0 - 2 1/2	N/A
: maturity (years)	8	8	7	2 - 7	3-5?
New money from banks	Target $5 bn for 1983 o/w over $4.7 bn committed by 24.1.83	Target $4.4 for 1983 o/w $1.1 bn committed by 24.1.83	Target $1.5 bn for 1983	-	not yet known
		$2 bn bridging loan apparently obtained	$1.1 bn bridging loan signed 31.12.82 ($600 mn drawn by 10.1.83)		
Official assistance				-	-
: BIS	$925 mn (almost fully drawn)	$1.2 bn (fully drawn)	$0.5 bn agreed		
o/w UK	($140 mn)	($110 mn)	(NIL)		
	$925 mn parallel US facility	$250 mn parallel SAMA facility			
: Governments	$2 bn requested	$1.5 bn (US Treasury)	-		
o/w UK	($150 mn)				
: IMF	SDR 3.4 bn (EFF) SDR 0.2 bn (1st credit tranche) (both approved December 1982)	SDR 4.2 bn (EFF) SDR 0.2 bn (1st credit tranche) (approval of both end-Feb?) SDR 0.5 bn (CFF) (approved Dec 1982)	SDR 1.5 bn (standby) SDR 0.5 bn (CFF) (both approved January 1983)		SDR 0.5 bn (standby) SDR 0.3 bn (CFF) both approved January 1983)

B: EASTERN EUROPE

	POMANIA	YUGOSLAVIA
Estimated debt outstanding (end-1982)	$11 bn	$20 bn
Payments arrears	Principal payments temporarily suspended (from January 1983) during negotiation of restructuring	90-day deferral of principal payments falling due to 31.3.83 (from 18 January 1983) during negotiation cf restructuring
	-	-
Rescheduling negotiations	$2 bn in 1981 arrears and 1982 maturities (signed) $1.1 bn of 1983 maturities (requested)	$1 bn medium/ long-term debt maturities in 1983 rolled over (proposed) $2 bn short-term maturities rolled over for 18-24 months (proposed)
Terms		
: LIBOR + (%) : Prime + (%) : fee (%) : grace period (years) : maturity (years)	N/A	N/A
New money from banks	-	$1 bn proposed
Official assistance		
: BIS o/w Bank of England		$0.5 bn requested ($3C mn?)
: Governments o/w UK		$1.3 bn £78 mn
: IMF	SDR 1.1 bn (standby) approved June 1981 o/w SDR 450 mn drawn; SDR 368 mn to be available in 1983; balance in 1984 H1	SDR 1.7 bn (standby) approved o/w SDR 554 mn in 1983 (last year)

EASTERN EUROPE

East Germany - GDR

1 Total convertible currency indebtedness has been as high as perhaps $16 bn but is probably now declining, at some considerable cost in terms of economic disruption. Existing undrawn credit facilities are sizeable but have nevertheless fallen quite sharply. GDR is unable to raise substantial new credits from Western banks. Figures recently released by the BIS show that gross debts to BIS banks (excluding banks in West Germany) have declined from over $10 bn at the end of December 1981 to $8 1/2 bn at the end of September 1982. The decline has been achieved partly by running down reserves and partly by savage cutbacks in imports, which cannot be sustained indefinitely. Payments delays and approaches to suppliers for longer than normal credit terms have become more frequent. We understand, in confidence, that an approach for assistance in raising a DM financing credit equivalent to some $1.5 bn was made to the West German government. The French have been requested to accept some deferment of repayment obligations. Serious debt servicing problems (and perhaps rescheduling) are still possible. ECGD has introduced tighter market limits but is still on cover.

Hungary

2 Total convertible currency indebtedness was $7.4 bn at the end of June 1982 having fallen from $8.7 bn at the end of December 1981. Hungary has been helped over short-term liquidity problems this year by several tranches of bridging finance from the BIS in which the Bank of England participated (without official guarantees). The amount outstanding at any one time has varied but is currently $300 mn of which the Bank share is 6.7 per cent. In response to a deteriorating convertible currency balance of payments position, and under the aegis of the IMF, the Hungarians introduced a number of measures, including devaluations and increases in consumer prices, and have also raised interest rates. The convertible currency current account, in consequence, is now in rough balance. On

8 December the IMF Board approved an economic adjustment programme providing $0.6 bn over 13 months. However, Hungary still faces a substantial debt burden over the next few years and will need further IMF programmes until debt is reduced to more manageable levels. The country will remain highly vulnerable to the weakness of banking confidence in Eastern Europe until large enough current account surpluses are achieved to repay some maturing debt and rebuild reserves. ECGD commitments are modest and under tight control.

Poland

3 Total convertible currency indebtedness is about $25 bn. Bank and official creditors both negotiated rescheduling agreements in respect of debts due in 1981. Following the declaration of martial law in December 1981 virtually none of the $10 bn convertible currency obligations falling due in 1982 has been paid. On 3 November this year the banks signed a rescheduling agreement covering 95 per cent of the $2.4 bn repayments of principal due in 1982. Under the agreement half the interest due in 1982 is to be lent back in the form of new three-year credits. Western official creditors agreed after the imposition of martial law not to resume talks on official rescheduling for the time being and did not attempt to negotiate a rescheduling agreement for 1982. In practice, the effect of this refusal has been to allow Poland to stop all payments, thereby gaining 100 per cent de facto relief on both principal and interest. We (and many other Western creditors, but excluding the US and France) would like to have a rescheduling agreement in place, so as to receive payment of at least some of the debt. The Poles are expected to begin negotiating the rescheduling of 1983 commercial bank maturities in early February. To some extent Polish insolvency has been discounted by the banks, many of which have written off a proportion of their loans, but total default would still impose a burden. ECGD is off cover.

Romania

4 Total convertible currency debt is about $11 bn. In July the Paris Club agreed the general terms of a rescheduling of 80% of

debts due in 1982. Bilateral agreements have now been signed with most creditor countries (including the UK). The separate negotiations on the rescheduling of bank debts were completed in December and the Romanians have now approached the Paris Club and commercial banks to propose rescheduling 75% of 1983 maturities. Governments have already agreed in principle to consider this provided that access to IMF resources remains open and banks are also likely to reach an agreement before too long. A substantial adjustment in the Romanian economy, and continuing access to IMF funds, should eliminate the need for reschedulings in subsequent years. ECGD is off cover.

Yugoslavia

5 Total indebtedness is about $20 bn. Notwithstanding an IMF upper tranche programme, Yugoslavia failed to come to grips with increasingly severe payments imbalances resulting from high growth and investment rates in the late 1970s. With reserves largely exhausted, an international package is being devised under IMF auspices to provide Yugoslavia with new credit whilst restructuring existing debt. To cope with the Yugoslav insistence that they will not reschedule, other euphemisms are being employed. Imports have been cut drastically and other recent economic measures include devaluations and increases in prices and interest rates. The IMF has now reached agreement on a tight programme, for the third year of the current standby agreement. This is the key to the proposed financial package which includes a $500 mn bridging facility by the BIS (backed partly by gold and partly by central banks) and some $1.3 bn in government credits as well as further IMF and IBRD monies. HMG's contribution to the government credits will be in the order of $125 mn (part of which is likely to serve initially as collateral for the Bank of England participation - expected to be around $30 mn - in the BIS bridging operation). The commercial banks are being requested to roll-over some $3 bn of maturities this year and to provide a further $1 bn in new money. Yugoslavia has, at their suggestion, sought a 90-day deferral of maturities to give more time for discussions. The indications are that a financial package is feasible, though its adequacy will depend on the success of the IMF programme . ECGD has a substantial exposure to Yugoslavia, but is now virtually off cover except for short-term business.

LATIN AMERICA

1 Argentina

Total indebtedness at end-1982 was an estimated $39 bn. Financial sanctions between the UK and Argentina were lifted jointly in September. Following subsequent negotiations, Argentina reached agreement in early November with the four main UK clearing banks on the settlement of debt arrears built up while the sanctions were in force. Other UK banks also subsequently began to receive payments from the Argentines. We understand that these arrears have been more or less settled. This paved the way for the signing of a $1.1 bn banks' bridge loan on 31 December and enabled discussions to continue on a further $1.5 bn medium-term loan (which bankers expect to be finalised by end-February) and on the rescheduling of $5.5 bn of public sector debt maturities overdue on 1.12.82 and falling due from that date to 31.12.83. Official support has come from the IMF in the form of a 15-month Standby Arrangement worth SDR 1.5 bn and a CFF for SDR 520 mn. These were approved at an Executive Board meeting on 24 January. As well as fulfilling normal performance criteria, drawings under the programme after end-July are subject to the removal of existing discriminatory restrictions (which in effect means the remaining restrictions against UK interests). A $500 mn BIS facility has been arranged but does not involve UK participation. Despite the rapid international response to Argentina's financial difficulties, there are widespread fears that the unstable domestic political situation will conspire to make the IMF programme unworkable and thus jeopardise furtner bank loan disbursements which are conditional on continued access to Fund resources.

2 Brazil

Total indebtedness at end-1982 was an estimated $81 bn. Following difficulties, particularly in October, in obtaining medium-term finance in the wake of the Mexican crisis, the authorities turned to official bodies, international organisations and banks for emergency loans to see them through the remainder of 1982.

Official support has included credits of $1.5 bn from the US Treasury; $1.2 bn (UK participation of $110 mn) from the BIS, supplemented by a parallel facility of $250 mn from the Saudi Arabian Monetary Agency (SAMA); and an SDR 500 mn CFF from the IMF. A request for an SDR 4.2 bn 3-year EFF should be approved by the IMF Executive Board by end-February. International banks, which had provided bridging finance totalling $2 bn, were approached on 20 December for a four-project package consisting of: (i) $4.4 bn in new money (for the whole of 1983); (ii) the rescheduling of $4.0 bn of 1983 maturities (both public and private sector); and the restoration of (iii) trade-related credit lines and (iv) interbank facilities to the higher of their exposure to Brazil at 30. 6.82 or 31.12.82. Whilst projects 1 and 2 have received a good response from banks (commitments respectively of $4.1 bn and $4.3 bn), the restoration of credit lines has been more difficult. There are also fears that the Brazilian forecast of a trade surplus of $6 bn is over-optimistic and as a result banks could well be approached for further financing later in the year.

3 Chile

Total indebtedness at end-1982 was an estimated $18 bn (two-thirds private sector). The economy is deep in recession (real GDP fell by 13% last year). Reserves have fallen sharply from $3.3 bn at end-1981 to $1.9 bn at the end of last year, largely as a result of the difficult conditions in the euromarkets and speculation against the peso. A two-year IMF Standby (SDR 500 mn) and a CFF (SDR 297 mn) were approved by the IMF Board on 10 January. However confidence in the country is low as a result of Chile's domestic financial crisis which came to a head on 13 January when the authorities announced the liquidation of two banks and a finance house and the "intervention" of a further five banks. After initial doubts as to their intentions the Chilean authorities have indicated that they would deal responsibly with the foreign liabilities of these institutions ($3.8 bn) - possibly in the context of the renegotiation of commercial banking debt which is currently being sought. This is likely to affect some $2.8 bn in maturities falling due this year and next. The question of new money from banks is also likely to be raised and initial meetings were being held in the week ending 28 January. With debt service amounting to $3.6 bn on medium and long-term public and private sector debt, and with an additional $4 bn short-term debt to be rolled over, agreement with the bankers will need to be reached if Chile is to avert a wider rescheduling.

4 Mexico

Total indebtedness at end-1982 was an estimated $83 bn. Concerted international co-operation in helping to resolve the country's external financial difficulties and early indications of the willingness of the new administration, which took office on 1 December 1982, to adopt sound economic adjustment measures facilitated IMF approval of a 3-year EFF and a first credit tranche drawing, totalling SDR 3.6 bn, on 23 December. With the aim of closing Mexico's financing gap in 1983, the IMF's Managing Director had earlier asked commercial banks to lend $5 bn in new money (over $4.7 bn had been committed by late January) and had also requested a total of $2 bn (over $1.8 bn committed) in official export credits from various governments (including the UK). Under the $925 mn BIS bridging facility (UK participation of $140 mn), which had been linked, inter alia, to progress on an IMF arrangement, all but $70 mn of the third (and final) tranche had been drawn by 20 January. Following an agreed extension for four months to 23 March 1982 of an original 90-day moratorium on public sector capital repayments due to banks, the authorities submitted formal rescheduling proposals to the Advisory Group of banks in early December. Under the proposals, principal payments on public sector debt outstanding at 23 August 1982 and falling due between then and end-1984 would be rescheduled over up to 8 years. Plans to reschedule private sector debt are expected to be announced shortly. Looking to the future, major uncertainties over the Mexican's ability to adhere to the IMF's tough programme targets are reinforced by the likelihood of a further reduction in the price of oil, which accounts for some 75% of the country's exports. Any serious under-performance in relation to the IMF programme would risk unwinding the current international financial rescue operation.

5 Venezuela

Total indebtedness at end-1982 was an estimated $28 bn. With oil accounting for 95% of exports and 60% of fiscal income the weakness in the oil market led to severe strains in Treasury finances last year. Together with the country's difficulties in the euromarkets this has led to sustained speculative pressure on the Bolivar and a sharp fall in reserves. Confidence in the country has also been badly shaken by the collapse of the Banco de los Trabajadores (the Trade Unions' bank) which was brought under the control of the government in late November. Venezuela is currently attempting to refinance \$2.4 bn of short-term debt maturing by end-March and intends to refinance a further \$3.5 bn by the end of this year (out of a total of \$8.7 bn). The programme started quite successfully in October but has run into difficulties following a series of late payments by some state agencies, in particular the development agency CVF (which has been declared in default). In view of the danger that the refinancing programme could collapse as a result the authorities have said they will ensure that the \$84 mn of CVF arrears will be settled. International reserves totalled around \$11 bn at end-1982, but foreign exchange reserves in the hands of the Central Bank were only some \$2.5 bn - leaving Venezuela insufficiently liquid to sustain heavy repayments as a result of refinancing shortfalls or to cope with further capital outflows without, for example, gold sales.

AMJ

28/1/83

WORLD ECONOMIC PROSPECTS

Points to note

i. World activity has yet to pick up. Depressed activity is part of cost of eliminating rapid inflation. But inflation has come down faster than expected - from 12 per cent in 1980 to 6 per cent (latest annual figure) for the major countries.

ii. Latest OECD/IMF forecasts have been revised down but still expect modest recovery throughout 1983 with US growing at or below 2 per cent. Japan's growth of 3½ per cent is based largely on domestic demand. Output in Europe remains broadly flat with no strong recovery.

iii. Elusive recovery demands a careful analysis of economic developments and the impact of policies but essential to maintain firm medium term economic policies and to resist calls for excessive reflation.

iv. Monetary policy should take account of a wide range of factors when assessing targets. But as economy recovers monetary growth should not allow any renewed upsurge in inflation.

v. On fiscal policy, recession inevitably pushes up cyclical component but firm action is necessary to reduce structural deficit and put budget deficits on a convincing declining medium term path. All countries have responsibility here but especially the US.

vi. Despite modest recovery the US budget deficit, which may exceed $200 bn this year, is unlikely to fall markedly without fiscal retrenchment given the desire to reduce taxes and maintain prospective spending plans for defence and social programmes. Encouraging signs here but proposals have yet to be implemented.

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vii. Agree with view of Institute of International Economics (Williamson) that policy co-ordination is necessary to ensure stability and recovery. As world trade prospects are poor low inflation countries with sound (internal and) external positions should explore short term flexibility, to encourage domestic recovery, but essential to maintain counter-inflationary thrust of medium term policies. Such policies should ensure convergence to durable non-inflationary growth.

viii. Dollar's fall and yen appreciation since November has recently reversed somewhat. Gradual realignment needed so as not to destabilise financial markets. Prospective current account imbalences, growing US deficit and Japanese surplus, may usher in further exchange rate volatility. Important major countries take account of the international repercussions of their policies.

ix. International financial system calmer now but remains delicate and requires adherence to firm policies by major SDR countries. Developing countries are adjusting, eg programmes adopted by Mexico, Brazil and Argentina while IMF expects NODC's current account deficit to fall to Ø70bn in 1983 against Ø90bn in 1982 and around Ø100bn in 1981. Adjustment must continue together with the provision of adequate finance by IMF and other lenders. Lower interest rates should ease debtors difficulties.

Background

1. Real GNP growth in the industrial countries is estimated to have fallen slightly in 1982. The protracted nature of the recession reflects poor real income growth, higher savings ratios, sluggish investment and continued stock adjustment to depressed levels of activity. The industrial world has also been affected in the past year by reduced demand from developing countries who have faced increasingly tight financial constraints.

2. The latest IMF and OECD forecasts see output picking up during this year and growing by 1-2 per cent. The US, Germany and Canada all experienced a sharp fall in output last year while Japan achieved reasonable growth and output in Europe as a whole stagnated. Growth prospects for 1983 have been revised down with the US growing by perhaps 1½-2 per cent, Japan by 3½ per cent but little revival in Europe. World trade fell last year for the first time since 1975. Both IMF and the OECD predict a mild recovery in world trade this year.

3. Early but tentative signs of the recovery in prospect are slowly beginning to appear now that inflation and interest rates have come down. Higher consumers' expenditure, positive stockbuilding and construction investment are the likely sources of growth this year. In the US housing starts, usually a good forward indicator, and retail sales picked up at the end of last year, and the leading indicators have continued rising. The fall in business confidence in Europe may have bottomed out as expected production levels increased while in Germany orders improved in the last two months of 1982.

4. <u>Unemployment</u> has continued to rise throughout the industrial world except Japan but may begin to level out this year. The major economies now face an unemployment rate of around 9 per cent by end-1983, with no early prospects of any reduction.

5. Inflation has come down much faster than expected as wage costs have moderated and import prices have remained weak. Consumer price inflation for the major countries has been halved, falling from 12 per cent on average in 1980 to 6 per cent for the 12 months to November 1982. A wide range however still exists with inflation in Italy at 16½ per cent compared to the 9-10 per cent in Canada and France, with the UK at 5½ per cent, Germany and the US at 4½ per cent and Japan with 2½ per cent.

6. The fall in inflation together with weak private credit demand has allowed some reduction in interest rates. From their earlier peak of 15-16 per cent 3-month money market rates in the US have fallen to around 8 per cent now. Elsewhere interest rates have also fallen but to a lesser extent. In Italy nominal rates remain near 20 per cent, against 12½ per cent in France, 6½ per cent in Japan and 5½ per cent in Germany. Real interest rates have eased but remain high compared to past experience.

7. The narrowing of the interest rate differential in favour of the US and large prospective US current deficits contributed to the depreciation of the dollar's effective rate from November to mid-January. This fall was matched by a stronger yen (up 18 per cent against the dollar)and DM. Since then the dollar has partly recovered - as expectations of lower US interest rates faded - and some of the earlier appreciation of the yen and the DM, in particular, have been reversed.

8. After moving towards rough current balance in 1981 forecasts show a growing aggregate deficit for the major countries dominated by the prospective US deficit. The US deficit is expected to be around $30 billion for this year. In contrast, despite a minor deficit last November, the Japanese current account surplus is forecast to grow steadily and reach over $11 billion for 1983 while Germany is expected to have a small current account surplus.

9. Current accounts of NODCs are expected to fall again this year to $70 bn (equivalent to 14 per cent of total exports) compared to $90 bn in 1982 (20 per cent) and around $100 bn in 1981 (22 per cent). This represents considerable adjustment given their adverse terms of

trade and depressed export markets. Financial constraints have been much tighter than expected. According to IMF estimates net bank lending to NODCs fell from $\$53\frac{1}{2}$ bn in 1981 to only $\$25$ bn in 1982, a fall of some $\$30$ bn, and this year it could be lower. Most major debtors, Brazil, Argentina, Mexico are adopting adjustment programmes. The possibilities for major international defaults have receded but adjustment must continue together with adequate finance from the IMF and other financial institutions.

Policies

10. The task for policy is to ensure that a durable recovery is established without rekindling inflation. This implies probably some short-term flexibility in the operation of policies, particularly by those countries which though low inflation have achieved some room for maneouvre, but also a commitment to prudent medium-term strategy, particulkrly for those countries where structural budget problems could undermine the recovery. Important that policies of major countries are co-ordinated and seek to converge towards sustainable non-inflationary growth. Williamson's call for policy co-ordination is welcome but a general widespread relaxation of policy would inevitably mean higher inflation and thereby prejudice the recovery.

11. The appropriate stance of monetary policy is proving difficult to assess, particularly in the US at a time of institutional change and changing liquidity demands. The Federal Reserve Board has suspended its M1 target and adopted a more flexible approach but some have argued its stance is now too lax. M2 growth in the last four months of 1982 was broadly in line with revised higher targets of $9\frac{1}{2}$ per cent. The Fed is considering returning to the original targets for this year though no final decision has been announced.

12. Monetary growth in Germany for 1982 remained within the 4-7 per cent target and this target is to be continued this year. In France monetary growth after being well above the $12\frac{1}{2}$-$13\frac{1}{2}$ per cent target early last year has decelerated recently and the out-turn for 1982 may have been close to target. For this year France has adopted a tighter single figure target of 10 per cent. Canada has recently abandoned monetary targets but aims to keep its exchange rate closely in line with the US dollar.

13. The reduction of budget deficits has been hampered by the recession. The industrial economies' deficits have risen from 2 per cent of GDP in 1979 to 4 per cent last year and may remain at that level during 1983. Only Japan and the UK have reduced their deficits although Germany has managed to offset much of the effects of recession by tight discretionary policies. The Japanese announced a Yen 2 trillion reflationary package in October, but the budget for fiscal 1983 (starting in April) still projects a reduction in the central government deficit compared to the likely fiscal 1982 out-turn. Expansionary policies in France and particularly the US have contributed along the depressed activity to the overall increase in fiscal deficits.

14. Since 1979 the US Federal deficit as a proportion of GNP has increased from $\frac{1}{2}$ per cent to 4 per cent. Much of this increase is due to the effects of the recession. However even with some recovery existing policy is unlikely to reduce the deficit which could exceed \$200 bn this fiscal year (FY83). The basic dilemma facing the US Administration remains the same one of reconciling rising expenditure on defence and social programmes with the desire to cut taxes.

15. President Reagan's State of the Union speech, delivered on 25 January, proposed major steps to reduce the budget deficit. They included a freeze on federal expenditure, a structural reform of the social security system (following the report of the Greenspan Commission which proposed savings of \$169 bn over the next seven years), cuts of \$45 bn in the growth of defence expenditure and tax increases contingent on progress in reducing the deficit. The US Administration has put the fiscal deficit at over \$200 bn this fiscal year. For FY84 the freeze would reduce the likely deficit from \$230 bn to \$188 bn but the plans would still leave the deficit higher than expected in the longer term. The final 10 per cent tax cut in July this year is still to be implemented. The precise details of this package and its feasibility can be assessed when the budget forecast is published at the end of January but it provides encouraging signs of the Administration's desire to tackle budget problems.

QUOTAS AND GAB - INCREASING THE FUND'S RESOURCES

28/1/93

Points

1. The Fund's key role in adjustment means that it must have adequate resources. In Toronto I advocated an increase in quotas of at least 50%. Events since then have suggested a need to increase the quotas as quickly as possible. The UK has taken the lead in trying to accelerate the negotiation and ratification of the review. In view of the progress made in the Executive Board on increasing quotas and the priority attached to strengthening the Fund's resources, I have proposed bringing forward the date of the Interim Committee from April to 10-11 February.

2. There is widespread agreement that the quota increase should be substantial. Now that there is agreement on increasing the resources of GAB, my own view of an increase of about 50% in quotas would provide the Fund with adequate resources to help prospective borrowers. I would not expect the finally agreed quota increase to be too far from that figure.

3. On distribution, I attach great importance to a method that is uniform, fair and systematic and which allows quota shares to change in an orderly way over time to reflect more clearly member's positions in the world economy. These issues are under review and we hope to reach agreement in the Interim Committee. It is difficult to go in detail at this stage of the negotiations, particularly since important questions of national interest are at stake. However, if members display a willingness to compromise, I am hopeful that the outstanding problems can be resolved.

4. Ministers of the Group of Ten have agreed that the General Arrangements to Borrow should be increased from SDR 6.4 bn to SDR 17 bn. Moreover in future the GAB will be available not only to participants but to any member with a conditional programme at times when the Fund is faced with an inadequacy of resources associated with balance of payments problems of a size threatening the international monetary system.

5. The enlarged GAB represents the special contribution of the G10 to the solution of current difficult international financial problems. It is a useful step towards restoring confidence within the international financial community. It underlines the fact that our existing institutions are showing themselves capable of adapting and that the way forward is by building on this process of adaptation. There has been much talk of a new Bretton Woods but now is not the time to uproot the existing insitutions.

6. At present our contribution towards the GAB is denominated in sterling. The new GAB commitment will be denominated in SDRs. This will require legislation and accordingly I will be asking the House for authority to make some amendments to the 1979 International Monetary Fund Act.

Background

7. On size the Executive Board's report to the Interim Committee will indicate that almost all (ie all except the US) could support an increase in quotas to SDR 100 bn. Ldc directors have stated that SDR 100 bn must be a minimum. G10 directors support the range SDR 85 - 100 bn, with all except the US seeing a 50% in these as the practical minimum. The US have shown a marked reluctance to go over SDR 85 bn, usually citing Congressional difficulties. The US may simply be adopting a negotiating posture but agreement in the Interim Committee will presuppose a willingness for the US to go above SDR 90 bn.

8. On distribution, there is general agreement that the Australian method of distribution should be applied as the basis ie in order to reflect better the relative economic positions of member countries, the increase should be distributed in proportion to each member's share in the total of calculated quotas. There is equally general agreement that this purest method of distribution should be diluted by some degree of equiproportionally. The precise size of the equiproportional element is still to be decided that many directors

10-15) favour the range of 20-50%. The UK could accept any point in this range but the needs of the Japanese (who want the minimum equiproportional element) will have to be borne in mind.

9. Cost to UK. The various capital transaction involved in paying the increased subscription (whether in SDRs or sterling) do not score either as public expenditure or as increasing the borrowing requirement. The initial effect of paying in SDRs or having sterling used is to increase the reserves since our reserve position with the Fund rises. These transactions do, however, have small second round interest rate consequences which indirectly affect the borrowing requirement via debt interest.

10. The UK share in the GAB will be 10% of SDR 1.7 bn. If the UK accepted a GAB call, as with use of sterling, our reserve position with the Fund would rise (ie we would become larger creditors of the Fund). This would be treated as any other increase in reserves ie it would not affect the PSBR or public expenditure. However second round interest rate effects would mean a rise in debt interest payments and consequent possible rise in the PSBR. If, however, GAB commitments carried a market rate of interest, there would not be a PSBR effect.

Legislation

11. The 1979 IMF Act appears to be defective in making no provision for subscription payments other than in own currency: the relevant section refers to subscriptions being paid out of the NLF. In relation to the forthcoming quota increase we will want to take powers to make payments not only in sterling but in SDRs held by the Exchange Equalisation Account. This would seem to involve amendment of Section 1 of the Act followed by recapitulation of the powers to make future increases by statutory instrument.

12. Section 2 of the 1979 Act is widely drawn to permit loans "in accordance with the Fund's borrowing arrangements". However on present form it looks as if we shall need (as with quotas) to take provision for subscription in foreign currencies or SDRs as well as in own currency. In any event it is evident that new lending oblications will be denominated in SDR and this alone would require new primary powers.

13. In addition to the agreement on the GAB, G10 ministers agreed to continue discussions with the Saudis on what form of association with the GAB the Saudis were seeking. In particular they would discuss whether the Saudis were prepared to set up a credit arrangement with the Fund on comparable terms to the GAB participants. Discussions were held on 2 January in London with Habermeier, Diniand the Saudis.

14. The question of access is still being looked at. A decision will not be required at the Interim Committee but it is already beginning to look as if the outcome will be that no member loses access in cash terms. For ldcs this will be a decisive element in the Review. This should provide a satisfactory outcome for them since the ldc group as a whole will after the Review have a considerably/ higher share of quotas than their relative economic position in the world entitles them to.

28|1|83

CONDITIONALITY - FUND'S ROLE IN ADJUSTMENT

Points

1. Fact that deficit caused by external factors beyond a country's control does not remove need for appropriate policy changes. Deficits cannot be allowed to grow unsustainably. Therefore need in the current circumstances for strong adjustment measures to achieve viable balance of payments.

2. Fund conditionality has been applied fairly rigorously in last two years but we judge that present degree of conditionality is about right. Fund does show sensitivity to specific national social and political priorities so as not to discourage early resort to the Fund.

3. Donor governments and banks, as well as the Fund, must recognize their mutual responsibilities in meeting ldc external financing needs. Fund lending is not intended to displace commercial bank loans but to be a catalyst for their continuation.

4. At Versailles we acknowledged special responsibility of major countries to take account of international consequences of their national policies. Fund surveillance under Article IV procedures have also been evolving in this direction. We believe these principles of surveillance are broadly right but its implementation might be made more effective eg by locating more clearly where burden of adjustment should be.

Background

5. The Fund's conditionality guidelines were reviewed in 1979 to pay the regard to the domestic social and political objectives of members. However, following pressure from major countries (including the UK) the Fund staff tightened conditionality during 1981-82 e.g. by more frequent use of prior actions (ie exchange rate changes) as preconditions and mid term reviews. Developing countries, in contrast, argue that the present degree of conditionality is too harsh particularly in the failure automatically to modify programmes in the case of adverse developments beyond a member's control. We have argued that appropriate conditionality is necessary to promote effective adjustment and to ensure that use of Fund resources is only temporary.

6. Following the 50% quota increase in 1980 and the enlarged access finance of SDR 9.3 bn, Fund lending rose to record levels in 1981 of net commitments of SDR 12.1 bn. The Fund was both supporting considerable adjustment efforts by non-oil developing countries and was doing so in a way which efficiently recycled substantial resources from the structurally surplus countries to deficit countries. But many countries (especially in Latin America and in East Europe) were still putting off necessary adjustment, and continuing to borrow heavily from the Euromarkets to finance growth. So too were many of the non gulf oil exporters whose ambitious development plans were expected to be financed from growing oil revenues. It is these two groups that are now coming to the Fund. Their quotas and debts are large and the support they need from the Fund is substantial, often over an extended period.

7. There are currently 25 SBAs in place for a total of SDR 6.9 bn; of these 4 are inoperative. There are 7 EFFs for a total of SDR 17.8 bn; all are operative (see Annex).

ANNEX

USE OF FUND RESOURCES

	1981	SDR bn 1982
Net commitments (ie SBA/EFF)	12.1	2.4*
CFF, First Credit Tranche, Buffer stock purchases	1.5	3.0Ø

* Gross commitments were SDR 6.5 bn of which: Mexico 3.4 bn.

Ø includes SDR 0.5 bn for Brazil.

1982 as a whole saw a marked slowdown in the rate of commitment lending compared to 1981. However, following the approach by Mexico to the Fund in the autumn, it became clear that the rate of lending would speed up again although the bulk of lending will fall in 1983.

Current Fund Programmes

SBA

Barbados
Chile
Costa Rica
El Salvador
The Gambia
Guinea
Haiti
Honduras
Hungary
Liberia
Madagascar
Malawi
Mali
Morocco
Panama+
Romania
Senegal+
Somalia
S Africa
Sudan+
Thailand
Togo+
Turkey
Uganda
Yugoslavia

EFF

Dominica
India
Ivory Coast
Jamaica
Mexico
Pakistan
Peru

+ inoperative

28/1/83

SDR ALLOCATION (including method of payment)

Points to Make

1. Widespread agreement that the quota subscription should be in reserve assets (ie SDR or hard currencies).

2. Recognise that many countries are interested in further SDR allocations but this should be looked at in the context of IMF studies of the adequacy of global liquidity. We ourselves have an open mind on the merits of a further SDR allocation. We would welcome a review of the latest trends in world inflation and liquidity to see whether a new allocation would command support.

3. [If necessary] The risk of reigniting inflation is probably less than it was. The slowdown in bank recycling will need to be carefully monitored. But the primary need is for conditional rather than unconditional liquidity, and we should not be deflected from recognising this.

Background

4. Under the Articles, members are required to subscribe 25 per cent of a quota increase in SDRs; except that the Board of Governors may prescribe, by a 70 per cent majority, that the 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. Virtually all Executive Directors have agreed in principle that 25% of the increase in quotas should be paid in reserve assets.

5. However, many of those who in the last couple of years advocatedfurther SDR allocations (ie most of the membership except for the G5) have taken this opportunity to press for a further discussion on the merits of an SDR allocation. The agreement to subscribe either SDRs or hard currencies is therefore being given on two understandings. The first is that members in difficulties can promptly draw the reserve tranche thus created. The second is that the next Interim Committee will ask the Executive Board to review latest trends in world inflation and liquidity and report back to the Governors as a matter of urgency so that they could consider at the next Annual Meeting whether a new allocation of SDRs was called for at that time.

6. This seems a sensible compromise. It should avoid the Interim Committee being distracted from the prime concern of securing an appropriate increase in the Fund's resources.

7. It is not known whether the views towards an SDR allocation of the US (whose support is crucial for achieving the necessary 85 per cent majority) or of other G5 members have changed. If allocations are to be resumed, the likely starting date would be January 1984. We could expect arguments that the first allocation should roll up the allocations, which might have been made in 1982 and 1983. If this is conceded the first allocation would be unlikely to be less than SDR 12 bn with further allocations of SDR 4 bn in later years, ie the same annual rate as in the period 1979-1981.

FUND LIQUIDITY

28/1/83

Points

1. Although the Fund has both unused ordinary resources and credit lines for the very immediate future, more will be needed in the period before the Eighth Quota Review is implemented (and the new GAB borrowing arrangements put in place).

2. The Fund should finalise arrangements soon for a third SAMA tranche of SDR 4 billion.

3. The Fund should continue to explore similar medium term borrowing from others who have not so far lent enlarged Access resources although we recognise that prospects here are not good. We would support market borrowing only if borrowing from official sources were inadequate.

Background

4. Since Toronto concern has grown about the Fund's immediately available resources before the Eighth Quota Review is put in place. The Fund currently has just over SDR 10.1 billion of uncommitted ordinary resources which should be just adequate for the next 18 months. However it has now only SDR 1.7 billion of uncommitted borrowed resources to finance Enlarged Access programmes. Brazil (SDR 2.8 billion) will more than absorb this. Without the third SAMA tranche a commitment gap of SDR 3.5 billion therefore, will emerge by April. For 1983-84 the staff's estimates of commitments of borrowed resources for members with quotas of less than SDR 800 million is SDR 3.4 billion (including, for example, Egypt, Pakistan, Zaire, Philippines, Portugal and Turkey). This would raise the commitment gap to SDR 7 billion. Some of these commitments may not materialise but a number of the OPEC high absorbers (Nigeria, Indonesia) are potential borrowers as well. Further commitments to members with quotas over SDR 800 million cannot be precluded.

5. This makes it particularly urgent to secure the third SAMA tranche of SDR 4 billion. (In 1981 the Saudis indicated their intention to consider a further commitment for the third year if their balance of payments and reserve position permitted). During his visit to Saudi Arabia with the Chancellor (7-9 January) the MD intended to discuss the third tranche with the Saudis. No definite conclusion was reached - the Saudis gave the impression that for them the main question was enhanced resources for the Fund (whether by the third tranche or parallel Saudi lending alongside the new GAB appeared a secondary question). Habermeier (Fund Treasurer) with Dini met the Saudis in London on 28 January to continue the contacts on GAB matters and will no doubt have sounded then out further on the third tranche. There seems a reasonably good chance of securing the third tranche in the coming months.

6. We have also been encouraging the Managing Director to approach other non-G10 potential leaders, such as Kuwait (SDR 2 billion) and the Emirates (SDR 1 billion) neither of which contributed under the Enlarged Access policy. The Kuwaitis have given a definite 'no' (their domestic financial system and stock market are in some disarray). The Fund are 'not optimistic' about the UAE either.

7. Therefore we cannot rule out a further approach to the G10 countries (i.e Germany, Japan and ourselves) for loans to tide the Fund over until the proposed new implementation date of mid-1984 for the Eighth Quota Review although the Fund may be reluctant to do this given the recent GAB decision. But we do not want to ease the pressure on the Saudis or other non-G10 lenders at this stage. Therefore the less said about this the better. We want to avoid giving the impression that the UK would agreed to lend more than the forecast SDR 150mn already committed.

8. Programmes breakdowns will reduce the need for borrowed funds. We may be able to wait and see which programmes fail and live with an uncovered commitments gap during late 83 - early 84 provided that the Fund is fully ready to go to the market of the GAB/quote increase in delayed. In the event that the Fund had inadequate resources

because of a shortfall from official sources, we would support direct market borrowing. If the Fund does go to the markets, it should do so from a position of strength well ahead of any immediate financing need.

9. The Fund may also explore the idea of selling sterling on an ad hoc basis in the operational budget. There has been a grater than expected use of ordinary resources in recent months and usable currencies have been substantially reduced (by SDR 1 billion) over the period.

Gold

28/1/83

Points

1. Gold still has something of a role in the international monetary system as a store of value, even though it is no longer convertible at a fixed price. It still has a place in national reserves. However there is no official price for gold and currencies are not measured in terms of it.

2. It would not serve any useful purpose to fix the price of gold rather than let it find its own level now that it does not play any formal part in the international monetary system. In any case, in present circumstances there is no prospect that this could be achieved by co-ordinated official action.

Background

3. There are number of reasons why we would not want to remonetize gold:

(a) The supply of gold might not provide sufficient world liquidity to finance the growth of world trade. If there were not enough gold it would be necessary to raise its price, which is potentially just as inflationary as providing additional liquidity in any other way (eg SDR allocations).

(b) Gold ownership is concentrated in the hands of a few developed countries. Compared with our major partners (other than Japan) the UK has little of it (about 25% of our reserves).

(c) The lion's share of gold production is in South Africa (60 per cent) and the USSR (25 per cent).

(d) It would be very difficult to fix the price of gold.

4. There was some revival of interest in gold in the US in 1981 as a result of the US Gold Commission. In particular, supply side advocates (such as Laffer), fearing that high interest rates would frustrate the economic expansion promised as a result of tax cuts, argued that there could be no serious anti-inflation policy until gold convertibility was restored. However, the Commission (which included Sprinkel, Wallich and Reuss) was weighted against gold proponents and certainly orthodox fiscal conservatives are much more sceptical about gold than 'supply

siders'. The Commission's report could not conceal these deep divisions and the majority recommendations came down firmly against convertibility. The report in effect made any positive move on gold a non-starter.

IMF: SOUTH AFRICA

28/1/83

Points

1. I regret the leaking of the confidential Executive Board minutes. Confidentiality is important if potential borrowers are to be frank with the Fund and if Executive Directors are to be able to offer their best judgement in the Board.

2. I am sure that we were right to treat the application on its technical merits. Indeed on the substance of the requests all but one of the Executive Directors who spoke addressed themselves only to the technical merits of the proposals. For us, to have acted otherwise would have undermined the underlying principle of the Fund that all members are treated in a uniform way.

3. The Fund is effectively prevented under its guidelines from setting conditions of a political sort. Moreover many Fund members, from Africa and elsewhere, realise that if overtly political conditions are set for South Africa today, they may themselves face political conditions tomorrow.

Background

4. The Fund approved SBA and CFF totalling SDR 1bn on 3 November, the UK supporting. The confidential minutes of the Board meeting have been leaked and were published in the 'F.T.' on 25 January. The minutes also form the basis of a letter to the Chancellor from the Anti Apartheid Movement, to which we are preparing a reply.

5. The minutes inevitably reflect the sensitivity of the South African request but do not bear out the allegation that the Fund's rules were bent to help S. Africa. We supported the South African requests in a low key and balanced way since we were satisfied that they met the Fund's criteria. There was a brief but unsuccessful attempt at the beginning of the meeting to get the request postponed. The US, Germany, France and Netherlands supported (Japan did not speak). The Canadian and Belgian

constituencies supported and the Italians did so with reservations. The opposition was led by Saudi Arabia, Libya and Iran - oil producing members who are unlikely to need Fund money and have therefore less to lose if Fund conditionality is politicised - while the African constituencies seem to have shown some embarrassment at being dragged along.

SPEAKING NOTE ON

OPTIMAL CONTROL

28/11/83

State of Play at the Treasury

Officials are currently gaining experience using optimal control methods with the Treasury model. Understand that there is to be a discussion on this with the Academic Panel next month.

Too early to say how this work will fit into the business of policy advice within the Treasury. But, like all technical questions associated with the Treasury model, it is a matter for the professional judgement of the officials concerned.

Optimal control and International Financial Policy

The type of experiments that I understand Dr Bray advocates might be of some interest, but I would not wish to give work of this type any priority within the Treasury. Neither would I want to attach significance to the results that they might produce. An important reason for my scepticism is that it is generally agreed that economic models are a very imperfect guide to explaining movements in exchange rates and capital flows. This would be especially true if the experiments incorporated hypothetical changes in the way governments behaved or the way in which the international financial system was organized.

BACKGROUND NOTE

In June 1982 Dr Bray wrote to the Chancellor suggesting Treasury participation in an exercise using an interlinking of national economic models 'to specify any policy modifications needed to secure improvements from international harmonization'.

The Chancellor replied to Dr Bray on 19th July, copy attached, stating our misgivings about the proposal. These seem to have been shared by others, and nothing further came of it.

More recently the Clerk of the TCSC wrote to officials asking the Treasury to co-operate in an exercise using optimal control methods on the Treasury model to investigate the efficacy of exchange rate targets. We suspect that this proposal was inspired by Dr Bray. The response was negative on the grounds that 'Treasury model runs cannot be understaken for the Committee'.

cc: CST
FST
EST
Sir D Wass
Sir K Couzens
Mr Burns
Mr Middleton
Mr Littler
Mr Britton
Mr Lavelle
Mr Cassell
Mr Kemp
Mr Ridley

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

14 July 1982

Dr. Jeremy Bray, MP
House of Commons

Dear Jeremy

You wrote to me on 21 June inviting views on the possible establishment of a technical working party to pursue the scope for securing convergence of national economic policies by the five SDR countries through the application of policy optimisation methods.

The procedure you outline on page 4 of your paper involves the selection by international agreement of exchange rates to maximise the wellbeing of the group of countries as a whole. This approach places a reliance on Governments' ability to control exchange rates which I do not entirely share. It also seems to carry the implication, which again seems to be debatable, that exchange rates are the only way by which policy decisions in one country affect welfare in others. More generally, although officials are seeking to keep abreast of developments in this area, my understanding is that formal policy optimisation has yet to prove itself at the national level: this reflects some general scepticism about formal methods of decision-taking and the reliability of the available macro-economic models.

As you mention in your letter of 8 July, Deputies met in Washington last week to consider the follow-up to this aspect of the Versailles Summit: you asked if you might be given a first-hand account of how things went. I am not sure that there is in fact anything of substance which could be added at this stage to what officials said at the TCSC hearing on 12 July. These are very early days, but I recognise, and will bear in mind, the particular interest you have in this area.

Love

Geoffrey

GEOFFREY HOWE

FROM: R G LAVELLE
DATE: 28 January 1983

JOU:
In some ways it's a pity we've lost the original 5 Toronto principles. They were crisper. But they did need to be amplified + brought up to date. So this will do fine. (I've not tried to modify its oral style (will do that on delivery) – but only to check its substance + wording. Perhaps you'd give it a final glance

CHANCELLOR

cc: Economic Secretary
Sir D Wass
Mr Burns
Mr Littler
Mr Middleton
Mr Carey
Mr Kemp
Mr Odling-Smee
Mr Bottrill o/r
Mr Peretz
Mr Hall
Mr Ridley

TCSC 31 JANUARY: OPENING STATEMENT

I attach a revised draft for your opening remarks on Monday.

2. The opening section has been redrafted by Mr Littler in the light of your comments on the earlier version. We have sacrificed much of the factual material in paras 8-13 of the old draft in the interests of a crisper statement. The effect is to give more prominence to the strategy you wish to adopt as Chairman of the Interim Committee.

3. Much of the essential message of the latter is an updating of Toronto (relevant passage attached). But as 'management of recovery' becomes the dominant theme, some reordering seems helpful. The main reason that this time we have a four-point rather than a five-point plan is that the need for adjustment and the role of the Fund were treated as separate points in Toronto (points 1 and 5) but we amalgamated here (point 3, paras 12-14).

4. I have toned down, incidentally, the dismissive quality of the reference to intervention (now in para 9). This is not because the work of the Jurgensen Group makes me doubt that intervention is 'a very minor side issue' (to quote Dr Emminger in full). But at the Group's last meetings the US participants seemed a little more forthcoming than usual in this area. It is just possible that the US could, partly under the influence of host responsibilities at Williamsburg, also decide to say a kinder word for it there. This might be on the basis that as inflation and destabilising

interest rates come down, and as there are moves towards more internationally oriented policies (including monetary policies taking account of exchange rates), intervention could perform an enhanced if modest smoothing role. If so, this could be another little confidence-builder.

R G LAVELLE

~~Statement to the Treasury by the Chancellor~~

The International Financial System: Current Tasks

[Statement by the Chancellor of the Exchequer to the Treasury and Civil Service Select Committee of the House of Commons on 31 January]

~~TCSC: DRAFT OPENING STATEMENT ON 31 JANUARY~~

Mr Chairman, it may be helpful to the Committee if I were ~~to~~, at the start of today's hearing, to say something about the way in which I see the problems of the international financial system at the present time.

A new Bretton Woods?

~~itself gives~~ does not give the right kind of signal as to what is in practice needed.

2. There have been suggestions that there is a need for "a new Bretton Woods". I share the concern which prompts this suggestion - ~~the~~ a concern for greater stability and order in international financial relationships as a basis for renewed economic progress. We all want lower inflation, less volatile exchange rates and a more orderly system of international lending and borrowing. But ~~I have to say that~~ I think the suggestion for a new Bretton Woods ~~is misconceived~~. It implies a need for new objectives, new methods, new international financial institutions. It pays too little attention to the reasons why international financial markets, and exchange rates in particular, have been so volatile in recent years. And too little attention to what practical steps can be taken to remedy that.

3. The Bretton Woods system provided a basis for stability through the discipline it imposed. As long as the United States dollar remained dominant and the economy on which it was based set a pattern of reasonably well maintained currency value, the system was effective. But those conditions were eroded in the 1960s. And as too many countries sought to maintain ambitious growth rates without sufficient discipline, the world has lived for ~~the~~ a past decade on ~~the~~ increasingly insecure foundations of inflation and rising indebtedness.

A new framework

I of course accept that

4. The world will not achieve stability again until we create a satisfactory framework ~~of~~ and discipline which ensure more consistent policies and restore confidence in currencies ~~has been restored. And it is~~ But it is no longer conceivable that such a framework should be built upon one currency. on Bretton Woods lines. 18 months ago, at the annual IMF meeting, I suggested that we must in future seek stability through the cooperation of the major countries whose currencies make up the SDR: the United States, Japan, France, Germany and the United Kingdom. We still have a long way to go, but the notion that these five countries bear a special responsibility to the rest of the world is increasingly recognised. And it is also increasingly recognised that they must exercise that responsibility by seeking parallel or convergent economic and financial policies within their own boundaries which will serve to maintain the values of their currencies, absolutely and in relation to each other. Now, of course, that does not imply ~~There is no suggestion of~~ a rigid strait-jacket. Nor is it meant to imply ~~reasonable to hope~~ that complete arrangements will be settled quickly, or made effective without difficulty. But I am sure this is the practical way forward.

Problems of transition

5. Our immediate priority, in the short term, is to nurture the process of recovery in a very difficult period. At ~~5. Meanwhile, alongside the aim for future stability, we have to tackle the problem of managing a difficult period of recovery.~~ ~~In~~ last year's annual IMF meeting in Toronto identified several of the goals we should be seeking now I said that the world was passing through a difficult transitional phase as economies adjusted to lower inflation. It is true of the world economy, as of our own, that a price has to be paid for ~~the damaging mistakes of the last~~ errors spread over more than a decade. It has long seemed to me that The ~~sooner we face that~~

more ready and willing we are to accept that conclusion,

~~necessity and pay the price~~, the less onerous it will be and the sooner we shall have the chance of restoring sustainable growth.

6. There are now growing signs of recovery, earlier in some countries than in others, but its pace will not - and should not - be too rapid. As different countries successively begin to overcome their own problems of imbalance and inflation, world recovery as a whole should gain strength. But there are important dangers against which we need to guard, and in respect of which some important practical steps need to be taken.

A strategy for the recovery

7. Let me now try to summarise the broad strategy which, speaking now as Chairman of the IMF Interim Committee, I believe we will need to follow over the ~~coming~~ months and years ahead. It is essentially pragmatic — and I make no apology for that. The dual aim, which is now pretty widely shared, is so to

~~8. We must~~ ~~this time~~ manage the recovery so that it is sustained without rekindling inflation and so jeopardising the stability of the international financial system. and At the same time we must to ensure that those countries with particularly severe debt problems are restored to economic health. /8 I will pick out four elements of the strategy for recovery that seem to me particularly important.

9. First, major countries need to continue collectively to pursue prudent monetary and fiscal policies. This is the key to stability. It was underlined by the undertakings made at last year's Versailles Summit on the pursuit of convergent policies. This, rather than artificial capital controls or

massive intervention, is the way to reduce exchange rate volatility. Intervention has a role to play, but essentially I think Dr Emminger was right to refer to it as a side issue, and to say that we should concentrate on promoting better underlying conditions. This is the way to make the multi-currency reserve system work.

10. <u>Second</u>, within the overall framework of prudent policies, countries need to ensure that the balance of their individual policies is right. In some countries where inflation has been brought down, where the budget deficit is under control and the external position strong, there may be scope ~~to ensure~~ for a rise in ~~that~~ domestic activity ~~fully~~ to sustain the recovery. In others continued firm policies may be needed. Nowhere would it be wise to let up in the fight against inflation

11. A particular responsibility rests with the United States. Their success in reducing inflation has been impressive. But the rising budget deficit - if unchecked - could risk a renewed surge in prices and interest rates just as recovery ~~gathers pace~~ is getting under way. Mr Martin Feldstein, Chairman of the Council of Economic Advisers, has said: 'I don't see how we can have a healthy economic recovery unless we have deficits coming down and coming down substantially'. (Wall Street Journal, 30 November 1982.) I welcome th~~e moves that~~ President Reagan's recognition, ~~announced last week in his State of the Union Address,~~ last week, of the need to restrain the growth in the federal deficit. ~~The~~ But the figures are staggeringly large, and the task ~~is~~ formidable ~~and~~ the He will need the full co-operation of Congress if the deficit is to be put, as it plainly must be, for the health of the world economy, on a convincing declining path.

12. Third, there is the need for adjustment by major debtors, the ~~size~~ scale of whose ~~problems~~ difficulties has at times threatened to overwhelm the international financial and banking system. Here, the IMF has a crucial role. As Chairman of the Interim Committee I intend to do my utmost to see that the Fund has the resources to play its role effectively.

13. We made a welcome start earlier this month when the Group of Ten industrial countries agreed to increase the General Arrangements to Borrow from SDR 6.4 billion to SDR 17 billion and in addition to make credits available to the Fund for lending to non-participants if major payments imbalances threaten the stability of the international monetary system. Next ~~month~~ week in Washington, we shall be seeking to put in place a further element in the package by agreeing to a substantial increase in Fund quotas at the Interim Committee meeting which I have asked to be brought forward from April.

14. Active adjustment policies supported by IMF finance should help substantially to restore confidence and encourage continued private banking flows which are essential to many developing countries. ~~though I would add that~~ Adequate supervision and prudent individual risk assessments are also essential components of a stable system, and it is clearly part of our present task to ~~esta~~ build — at this stage often by working more or less informally and from case to case — on the important progress made in this area in recent years.

15. ~~My~~ The fourth ~~point, in~~ element of the strategy for the recovery ~~,~~ is the need to avoid protectionism. I do not believe that the way to solve payments problems and exchange rate fluctuations

is through increased restrictions on trade which can only impoverish us all.

Conclusion

16. Mr Chairman, I am grateful to you for allowing me to set out briefly to the Committee how I see the major international issues that confront us. My main conclusion is that we cannot look at the system in the abstract or seek remedies for real difficulties in artificial mechanisms. There is no substitute for collective agreement ~~and implementation~~ among countries on sound [illegible] policies, and their translation into individual practice. And There is ~~also~~ no realistic alternative to the pragmatic approach of building on the existing international institutions and ensuring they are effective.

But this is a task to which the world's financial authorities must be seen to apply themselves with all diligence and a proper sense of urgency. ~~Certainly~~ That certainly is the approach of the ~~British Government~~ Her Majesty's Government

PM 31/1/83

THE INTERNATIONAL FINANCIAL SYSTEM: CURRENT TASKS

[Statement by the Chancellor of the Exchequer to the Treasury and Civil Service Select Committee of the House of Commons on 31 January.]

Mr Chairman, it may be helpful to the Committee if I were, at the start of today's hearing, to say something about the way in which I see the problems of the international financial system at the present time.

A new Bretton Woods?

2. There have been suggestions that there is a need for "a new Bretton Woods". I share the concern which prompts this suggestion - a concern for greater stability and order in international financial relationships as a basis for renewed economic progress. We all want lower inflation, less volatile exchange rates, a more orderly system of international lending and borrowing. But I think the suggestion for a new Bretton Woods does not give the right kind of signal as to what is in practice needed. It implies a need for new objectives, new

methods, new international financial institutions. It pays too little attention to the reasons why international financial markets, and exchange rates in particular, have been so volatile in recent years. And too little attention to what practical steps can be taken to remedy that.

3. The Bretton Woods system provided a basis for stability through the discipline it imposed. As long as the United States dollar remained dominant and the economy on which it was based set a pattern of reasonably well maintained currency value, the system was effective. But those conditions were eroded in the 1960s. And as too many countries sought to maintain ambitious growth rates without sufficient discipline, the world lived for a decade on increasingly insecure foundations of inflation and rising indebtedness.

A new framework

4. I of course accept that the world will not achieve stability again until we create a satisfactory framework and disciplines which ensure more consistent policies and restore confidence in currencies. But it is no longer conceivable that such a framework should be built upon one currency, on Bretton Woods lines. 18 months ago, at the annual IMF meeting, I suggested that we must in future

seek stability through the cooperation of the major countries whose currencies make up the SDR: the United States, Japan, France, Germany and the United Kingdom. We still have a long way to go, but the notion that these five countries bear a special responsibility to the rest of the world is increasingly recognised. And it is also increasingly recognised that they must exercise that responsibility by seeking parallel or convergent economic and financial policies within their own boundaries which will serve to maintain the values of their currencies, absolutely and in relation to each other. Now, of course, that does not imply a rigid strait-jacket. Nor is it meant to imply that complete arrangements will be settled quickly, or made effective without difficulty. But I am sure this is the practical way forward.

Problems of transition

5. Our immediate priority, in the short term, is to nurture the process of recovery in a very difficult period. At last year's annual IMF meeting in Toronto I identified several of the goals we should be seeking now. I said that the world was passing through a difficult transitional phase as economies adjusted to lower inflation. It is true of the world economy, as of our own, that a price has to be paid for errors spread over more than a decade. It has long seemed to me that

the more ready and willing we are to accept that conclusion, the less onerous it will be and the sooner we shall have the chance of restoring sustainable growth.

6. There are now growing signs of recovery, earlier in some countries than in others, but its pace will not - and should not - be too rapid. As different countries successively begin to overcome their own problems of imbalance and inflation, world recovery as a whole should gain strength. But there are important dangers against which we need to guard, and in respect of which some important practical steps need to be taken.

A strategy for the recovery

7. Let me now try to summarise the broad strategy which, speaking now as Chairman of the IMF Interim Committee, I believe we will need to follow over the months and years ahead. It is essentially pragmatic - and I make no apology for that. The dual aim, which is now pretty widely shared, is so to manage the recovery that it is sustained without rekindling inflation and so jeopardising the stability of the international financial system; and at the same time to ensure that those countries with particularly severe debt problems are restored to economic health.

8. I will pick out four elements of the strategy for recovery that seem to me particularly important.

9. First, major countries need to continue collectively to pursue prudent monetary and fiscal policies. This is the key to stability. It was underlined by the undertakings made at last year's Versailles Summit on the pursuit of convergent policies. This, rather than artificial capital controls or massive intervention, is the way to reduce exchange rate volatility. Intervention has a role to play, but essentially I think Dr Emminger was right to refer to it as a side issue, and to say that we should concentrate on promoting better underlying conditions. This is the way to make the multi-currency reserve system work.

10. Second, within the overall framework of prudent policies, countries need to ensure that the balance of their individual policies is right. In some countries where inflation has been brought down, where the budget deficit is under control and the external position strong, there may be scope for a rise in domestic activity to sustain the recovery. In others continued firm policies may be needed rather longer. Nowhere would it be wise to let up in the fight against inflation.

11. A particular responsibility rests with the United States. Their success in reducing inflation has been impressive. But the rising budget deficit -if unchecked - could risk a renewed surge in prices and interest rates just as recovery is getting under way. Mr Martin Feldstein, Chairman of the Council of Economic Advisers, has said: 'I don't see how we can have a healthy economic recovery unless we have deficits coming down and coming down substantially'. (Wall Street Journal, 30 November 1982.) I welcome President Reagan's recognition, in his State of the Union Address last week, of the need to restrain the growth in the federal deficit. But the future figures are strikingly large, and the task formidable. He will need the full co-operation of Congress if the deficit is to be put, as it plainly must be for the health of the world economy, on a convincing declining path.

12. Third, there is the need for adjustment by major debtors, the scale of whose difficulties has at times threatened to overwhelm the international financial and banking system. Here, the IMF has a crucial role. As Chairman of the Interim Committee I intend to do my utmost to see that the Fund has the resources to play its role effectively.

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14. Active adjustment policies supported by IMF finance should help substantially to restore confidence and encourage continued private banking flows which are essential to many developing countries. Adequate supervision and prudent individual risk assessments are also essential components of a stable system, and it is clearly part of our present task to build - at this stage often by working more or less informally and from case to case - on the important progress made in this area in recent years.

15. The <u>fourth</u> element of the strategy for the recovery is the need to avoid protectionism. I do not believe that the way to solve payments problems and exchange rate fluctuations is through increased restrictions on trade which can only impoverish us all.

Conclusion

16. Mr Chairman, I am grateful to you for allowing me to set out briefly to the Committee how I see the major international issues that confront us. My main conclusion is that we cannot look at the system in the abstract or seek remedies for real difficulties in artificial mechanisms. There is no substitute for collective agreement among countries on sound policies, and their translation into individual practice. And there is no realistic alternative to the pragmatic approach of building on the existing international institutions and ensuring they are effective. But that is a task to which the world's financial authorities must be seen to apply themselves with all diligence and a proper sense of urgency. That certainly is the approach of Her Majesty's Government.

31/1/85

BRIEFING FOR TCSC: 31 JANUARY

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Section A: World Exchange Rate System (and sterling)

(i) The exchange rate and interest rates in recent weeks — TABLE AT BACK.

(ii) Trade figures; speaking note

(iii) Competitiveness

(iv) Macro-economic policy and the exchange rate

(v) Exchange rate "overshooting"/overvaluation/misalignment

(vi) Dr Emminger

(vii) Exchange controls

(viii) Intervention

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(x) International exchange rate coordination (and Versailles initiative)

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(xii) Major currencies exchange rate fluctuations since 1976: background note

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Section B: International Debt Problems

(i) Nature and causes of current problems, and the way ahead

(ii) Banking Supervision

(iii) Lender of last resort

(iv) Information about international indebtedness

Perm Sec. OF
Under Secy: Fin. Economy Unit
Asst Secy: External [illegible]

(vii)

31/1/83

BIS SUPPORT OPERATIONS

1. Why was a Treasury indemnity required when the BIS arranged credit facilities for Mexico and Brazil?

The BIS financed these loans from its own resources but with a right of recourse to participating member central banks, including the Bank of England. The Bank of England's contingent liability under this arrangement is $140 million for Mexico and $110 million in respect of Brazil. These sums are too large for the Bank to meet from its own resources so the Treasury has provided the Bank with indemnities in respect of these commitments.

2. Under what statutory power have the indemnities been given?

The ~~powers~~ indemnities have been given under the Treasury's common law powers to give guarantees and Parliament has been informed by White Papers (Cmnd 8651 and Cmnd 8779 covering Mexico and Brazil respectively). If it were necessary for the Bank of England to invoke the indemnity, the Treasury would need to present an Estimate or a Supplementary Estimate seeking provision to cover the payments. Authority would rest on the Estimate and the confirming Appropriation Act.

3. Does the Treasury intend to seek specific legislation to give indemnities in respect of similar BIS facilities? [for use if pressed]

It is an important principle of Parliamentary control of expenditure that authority for expenditure on a continuing function should not rest solely on the Appropriation Act, but should be covered by specific statutory authority setting out the powers and duties involved. The Treasury has undertaken to observe this principle where the amounts are significant and the liabilities are likely to continue for several years. The Treasury is accordingly considering the need to seek statutory powers to give indemnities of this kind in future.

FROM: DAVID PERETZ
31 January 1983

MF

CHANCELLOR

cc Mr Littler
Mr Middleton
Mr Odling-Smee
Mr Monck
Mr Bailey } without attachments
Mr Graham

TCSC THIS AFTERNOON: SUPPLEMENTARY BRIEFING

I attach the following additional material for this afternoon:-

(i) A note by Mr Monck on the relationship between the Treasury and Bank generally, and in banking supervision (attaching a copy of the 1946 Act). The relationship on the EEA and exchange market intervention is covered in Brief A(viii) (viii).

(ii) A table of the largest (trough to peak) currency appreciations since 1975 (for the major currencies). Sterling comes fourth.

(iii) A revised version of briefing A(iv) (the role of the exchange rate in macro economic policy).

(iv) A note of recent forecasts for World inflation.

(v) A note on the US balance of payments, and relationship with the budget deficit.

(vi) A copy of Mr Anson's telegram 36 of 21 January (about the Williamson ideas for the IMF to intermediate more in international financial flows).

(vii) A defensive note about the Mexico and Brazil BIS operations, and the Treasury indemnities to the Bank of England.

Coming - we hope!

(viii) Copies of references to exchange rate policy in TCSC reports over the last 2 years.

2. Mr Carey has sent you separately a note on Argentine loans.

DLP

D L C PERETZ

(i) 21/1/83

RELATIONS WITH THE BANK: BRIEFING

Relations in General

The relationship is close and works well. There is frequent consultation at all levels, not only between the Governor and me but between our officials.

Disagreements?

2. There is of course agreement on overall objectives. But if there are any disagreements about specific policies we meet and resolve them.

Who Prevails?

3. We do not look at it in that way, or have an adversary relationship. The outcome on particular issues depends mainly on the quality of the arguments. But if a particular issue is not resolved on this basis, it is clearly understood that economic policies are determined by Ministers. That comes out clearly from the memorandum which the Bank prepared for the Committee in April 1980.

Banking Supervision

4. The Treasury is responsible for the Banking Act 1979 and hence for general issues of policy relating to banking supervision, though of course the Treasury would take very close account of the Bank of England's advice. However, the responsibility for supervising institutions in the UK under the Act rests on the Bank of England (subject to a right of appeal to the Chancellor against the Bank's refusal to recognise or license an applicant for authorisation). This means that the detailed operation of the Act is a matter for the Bank, not the Treasury. The Bank is in general required to maintain strict confidentiality on information provided for supervisory purposes. But it is empowered to disclose information to the Treasury where in the Bank's view disclosure would be in the public interest or the interest of depositors.

RELATIONS BETWEEN THE TREASURY AND THE BANK

Background

The relationship was described in a memorandum prepared by the Bank for the TCSC in April 1980. It was published and a copy is annexed.

The Bank of England Act (1946) *

2. Paragraphs 2-4 describe the 1946 Bank of England Act which brought the Bank "under public control" and empowered the Treasury to give the Bank directions after consultation with the Governor. The power has not been used but its existence makes it clear that the Treasury has the last word in any disagreement and implies that Treasury Ministers have a responsibility for the Bank's actions.

3. Paragraph 12 of the memorandum recognises that

> "Economic policy is the responsibility of the Government and is determined by Ministers."

But the following paragraph outlines the Bank's role as a source of advice on policy as well as an executor in the monetary and financial field.

4. The main duties of the Bank, apart from banking supervision, are not well defined in the statutes.

The Bank's Executive Role

5. Its main functions are:

- managing the money and gilts markets;
- managing the Exchange Equalisation Account;
- acting as banker to the Government;
- the note issue;
- prudential supervision of the banking system under the 1979 Banking Act.

1979 Banking Act

6. Paragraphs 9-11 of the annex set out the position.

* Copy attached (without schedules)

<u>Reports</u>

7. The Bank is required to report annually to the Chancellor on its supervisory operations under the Banking Act. The report, which is not very informative, is presented to Parliament.

8. The Bank produce an annual report and Accounts.

9. The Bank's Quarterly Bulletin contains a mass of detail about the Bank's operations in the money and gilts markets, as well as texts of documents and speeches on a wide range of practical and policy subjects.

Memorandum by the Bank of England

THE RELATIONSHIP BETWEEN THE BANK OF ENGLAND AND THE TREASURY

1. The relationship between the Bank of England and the Treasury (in practice close and effective) owes little to specific legislative provisions. It may nevertheless be helpful to refer at the outset to the principal legal instrument governing their formal relations, which is the Bank of England Act 1946, and to certain other legislation which governs specific areas of the Bank's activities.

The Legal Position

THE BANK OF ENGLAND ACT 1946

2. This formalised the Bank's position as a public institution by vesting the Bank's stock in the ownership of the Treasury. The Bank had, however, for many years prior to the 1946 Act seen it as its duty to direct its operations to the service of the public interest and to subject itself to the ultimate authority of Government in matters of monetary and economic policy. The 1946 Act gave a statutory basis to this established position in two ways—

(i) the power to appoint the Court of Directors—including the Governor and Deputy Governor—was vested in the Crown. These appointments are made on the recommendation of the Prime Minister, after consultation with the Chancellor of the Exchequer; but the appointees are given a degree of independence by the fact that they serve for a fixed term.

(ii) the Treasury was empowered to give such directions to the Bank as, after consultation with the Governor, it thinks necessary in the public interest. Subject to any such directions it was provided that the affairs of the Bank were to be managed by the Court in accordance with the Bank's Charter.

3. The purpose of the power of direction was explained by the then Chancellor (Dr Dalton) in the Second Reading Debate on the Bill. It was not designed to permit "any day-to-day interference by the Government or the Treasury with the ordinary work of the Bank . . ." but to make "plain that in the last resort, as between the Treasury and the Bank of England, the Treasury has got to have the last word, after due consultation with the Governor of the Bank, in any case of disagreement".

4. The power to give directions was expected to be used only in "exceptional and unusual cases". No occasion for the use of the power has yet arisen.

5. Though this is not explicitly covered by the Act, Dr Dalton also undertook that the Bank would publish an Annual Report.

6. The most important part of the Bank's work lies in the execution of domestic and external monetary policy, and in the formulation, together with the Treasury, of the future lines of policy. This responsibility, which is described in paragraphs 12–19 below, finds no reflection in the Act, apart from the reference to the general power of direction noted above.

Other Legislation

7. Certain of the Bank's more specific activities, however, some of which are performed on behalf of the Treasury, are governed in whole or in part by specific statutes, the main Acts in question being listed in the attachment to this note. These activities include the management of the note issue and of the Exchange Equalisation Account, and the Bank's functions as banker to the Government, as issuer and registrar of Government stocks and issuer of Treasury bills. The Exchange Control Act, 1947, under which the Treasury delegated to the Bank responsibility for the central administration of exchange control, remains in existence, although the apparatus of controls was abolished last year by a General Exemption Order made under the Act.

8. Following recommendations by the Select Committee on Nationalised Industries, the full costs of some of the activities which are carried out for Government are recovered from Government and these recoveries are currently subject to cash limits negotiated with the Treasury.

9. The Bank's role in supervising the banking system is also now governed by specific statute. Prior to the Banking Act 1979, this role derived essentially from the customary authority of the Bank as the Central Bank. (Formal powers were given by the Bank of England Act 1946 to the Bank to "... request information from and make recommendations to bankers ..." and, if so authorised by the Treasury, to "... issue directions to any banker for the purpose of securing that effect is given to any such request or recommendation ..."; but these powers have never been invoked.)

10. The Banking Act 1979, marks a decisive change in giving the Bank clearly defined statutory powers and duties in relation to the supervision of deposit-taking institutions in the UK authorised under the Act. In particular, the Act provides for authorisation, as a licensed deposit-taker recognised bank, to be operated by the Bank as the appointed authority. There is a right of appeal to the Chancellor of the Exchequer against any decision by the Bank to refuse or revoke a licence or a recognition, or to grant an authority different from that for which the institution applied, or to give directions.

11. The Bank is required to prepare an annual report on the exercise of its powers of supervision under the 1979 Act. The report will be published by the Bank and laid before Parliament by the Chancellor.

The de facto position

THE PROVISION OF POLICY ADVICE

12. Economic policy is the responsibility of the Government and is determined by Ministers. Policy decisions are, however, the end product of the assimilation and discussion of studies, forecasts, advice and proposals available to Ministers from a wide range of sources, in which processes the Bank of England has a role to play which can be distinguished from that of Government departments.

13. The Bank provides Ministers with a separate and independent source of advice not only on domestic and external monetary policy, which are areas of particular concern to the Bank, but on financial and related economic policy generally. This advice is made available to Ministers in a number of ways. There are close day-to-day contacts between the Bank and the Treasury at official level and these are supplemented by the Bank's participation in official inter-departmental committees. In addition, a particular feature of the Bank's position is the ability of the Governor to put forward directly points to which the Bank attaches importance, primarily in his regular contacts with the Chancellor but also on occasion to the Prime Minister and other Ministers.

14. The Bank's distinctive contribution to the formulation of policy derives from its operational involvement in the financial markets, and its consequential close relationships with and knowledge of the financial institutions, and from its specialisation in monetary economics and statistics. The Treasury's distinctive contribution stems from its responsibility for overall coordination of macro-economic policy and the relationship of that policy to the Government's wider objectives.

15. The top management structure of the Bank has recently been reorganised. One of the objectives of the reorganisation was to reinforce the Bank's capacity to discharge its responsibility for implementing domestic and external monetary policy on behalf of the Government and to give financial and economic advice over the wide spectrum of issues with which contemporary economic policy has to deal.

The execution of policy

16. Once decisions on economic policy have been taken, the Bank is primarily responsible for executing the monetary aspects of that policy through its operations in the financial markets, and through the administration of direct credit controls when these are in operation.

17. The Government's domestic monetary policy objective is currently, and has since 1976 been publicly defined in terms of a target rate of growth for the money supply (now Sterling M3). The achievement of that objective is closely linked with fiscal policy, on which the Bank accordingly offers advice, and for the rest depends largely on the use of monetary instruments. The Bank seeks to affect the trend of the money supply by operations in the money markets, which in turn influence short-term interest rates, and in the gilt-edged market where the aim is to finance the Government's borrowing needs as far as possible outside the banking system. Day-to-day operations in these markets, within the

overall policy framework agreed with the Government, are very much a matter for the Bank itself, although the Treasury is kept in close touch with developments. The more important changes of direction, however, are discussed in advance with the Treasury and by the Governor with the Chancellor. This would be true, for example, of changes in the Bank's Minimum Lending Rate, when the Bank's decisions require the approval of the Chancellor.

18. The Bank also initiates proposals, for consideration by Treasury Ministers, on the amount, timing and terms of new issues of Government stocks and then conducts the issue operations. Similarly it decides on the appropriate size for the weekly issue of Treasury bills and conducts the tender for them.

19. As the Treasury's agent in managing the Exchange Equalisation Account, the Bank intervenes in the foreign exchange market, buying or selling sterling against other currencies, and is responsible for investing the assets of the Account. The nature of these operations varies according to the exchange rate policy adopted by Government after advice from the Treasury and the Bank. With floating exchange rates and the Government's commitment to a domestic money supply target, the Bank's intervention role is currently confined to smoothing out what appear to be excessive fluctuations in the value of the pound, rather than attempting to maintain it at any specific level. As in the domestic financial markets, day-to-day tactics in the foreign exchange market are a matter for the Bank, although close liaison is maintained with Treasury officials. The strategic decisions in respect of intervention policy are discussed more closely with the Treasury and by the Governor with the Chancellor.

21 *April* 1980

ANNEX D
(with Bank of England Charter)

CHAPTER 27.

An Act to bring the capital stock of the Bank of England into public ownership and bring the Bank under public control, to make provision with respect to the relations between the Treasury, the Bank of England and other banks and for purposes connected with the matters aforesaid. [14th February 1946.]

BE it enacted by the King's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:—

Transfer of Bank stock to Treasury.

1.—(1) On the appointed day—

(*a*) the whole of the existing capital stock of the Bank (hereinafter referred to as "Bank stock") shall, by virtue of this section, be transferred, free of all trusts, liabilities and incumbrances, to such person as the Treasury may by order nominate, to be held by that person on behalf of the Treasury;

(*b*) the Treasury shall issue, to the person who immediately before the appointed day is registered in the books of the Bank as the holder of any Bank stock, the equivalent amount of stock created by the Treasury for the purpose (hereinafter referred to as the "Government stock").

(2) The Government stock shall bear interest at the rate of three per cent. per annum; and the equivalent amount of Government stock shall, in relation to any person, be taken to be such that the sum payable annually by way of interest thereon is equal to the average annual gross dividend declared during the period of twenty years immediately preceding the thirty-first day of March, nineteen hundred and forty-five, upon the amount of Bank stock of which that person was the registered holder immediately before the appointed day.

(3) The Government stock may be redeemed at par by the Treasury on or at any time after the fifth day of April, nineteen hundred and sixty-six, after giving not less than three months' notice in the London Gazette of their intention to do so. ?

(4) After the appointed day, no dividends on Bank stock shall be declared but in lieu of any such dividends the Bank shall pay to the Treasury, on every fifth day of April and of October, the sum of eight hundred and seventy-three thousand, one hundred

and eighty pounds, or such less or greater sum as may from time to time be agreed upon between the Treasury and the Bank.

(5) The incidental and supplemental provisions set out in the First Schedule to this Act shall have effect with respect to the Government stock and to the sums payable to the Treasury under the last foregoing subsection.

Court of directors of the Bank.

2.—(1) On the appointed day, all persons who are, immediately before that day, holding office as Governor, Deputy Governor or director of the Bank shall vacate their office, and on and after that day there shall be a Governor, a Deputy Governor and sixteen directors of the Bank, who shall be the court of directors.

(2) The Governor, Deputy Governor and other members of the court of directors shall be appointed by His Majesty.

(3) The provisions of the Second Schedule to this Act shall have effect as respects the tenure of office, qualifications and employment of members of the court of directors and meetings of the court.

Consequential provisions as to constitution and powers of the Bank.

3.—(1) So much of any enactment as limits the duration of the Bank as a body corporate shall cease to have effect.

(2) As from the appointed day every member of the court of directors of the Bank shall be a member of the said body corporate, notwithstanding that he holds no Bank stock, and accordingly the members of the said body shall be the members for the time being of that court together with the person who for the time being holds the Bank stock on behalf of the Treasury.

(3) As from the appointed day His Majesty may revoke all or any of the provisions of the charters of the Bank except in so far as they incorporate the Bank, and thereafter, subject to the provisions of this Act, the Bank shall be constituted and regulated in accordance with so much of the said charters as remains unrevoked and such other charters as may from time to time be granted by His Majesty and accepted on behalf of the Bank by the court of directors.

(4) The enactments set out in the Third Schedule to this Act are hereby repealed as from the appointed day to the extent specified in the third column of that Schedule.

Treasury directions to the Bank and relations of the Bank with other banks.

4.—(1) The Treasury may from time to time give such directions to the Bank as, after consultation with the Governor of the Bank, they think necessary in the public interest.

(2) Subject to any such directions, the affairs of the Bank shall be managed by the court of directors in accordance with such provisions (if any) in that behalf as may be contained in any charter of the Bank for the time being in force and any byelaws made thereunder.

(3) The Bank, if they think it necessary in the public interest, may request information from and make recommendations to bankers, and may, if so authorised by the Treasury, issue directions to any banker for the purpose of securing that effect is given to any such request or recommendation:

Provided that:—

(a) no such request or recommendations shall be made with respect to the affairs of any particular customer of a banker; and

(b) before authorising the issue of any such directions the Treasury shall give the banker concerned, or such person as appears to them to represent him, an opportunity of making representations with respect thereto.

(4) If, at any time before any recommendations or directions are made or given in writing to a banker under the last foregoing subsection, the Treasury certify that it is necessary in the public interest that the recommendations or directions should be kept secret, and the certificate is transmitted to the banker together with the recommendations or directions, the recommendations or directions shall be deemed, for the purpose of section two of the Official Secrets Act, 1911, as amended by any subsequent enactment, to be a document entrusted in confidence to the banker by a person holding office under His Majesty; and the provisions of the Official Secrets Acts, 1911 to 1939, shall apply accordingly. 1 & 2 Geo. 5. c. 28.

(5) Save as provided in the last foregoing subsection, nothing in the Official Secrets Acts, 1911 to 1939, shall apply to any request, recommendations or directions made or given to a banker under subsection (3) of this section.

(6) In this section the expression "banker" means any such person carrying on a banking undertaking as may be declared by order of the Treasury to be a banker for the purposes of this section.

(7) Any order made under the last foregoing subsection may be varied or revoked by a subsequent order.

(8) This section shall come into operation on the appointed day.

Interpretation.

5. For the purposes of this Act—

(a) the expression "the Bank" means the Bank of England;

(b) the appointed day shall be such day as the Treasury may by order appoint, not being later than three months from the date of the passing of this Act.

Short title.

6. This Act may be cited as the Bank of England Act, 1946.

27/1/83

Major Currency Appreciations

		Effective rate (1975 average = 100)
1. Sterling	: November 1976 average	77.5
	January 1981 average	103.2
	% change	+33.2%

		Effective rate (December 1971= 100)
2. Deutschemark	: End-September 1975	116.2
	End-November 1979	159.6
	% change	+37.3%

		Effective rate (December 1971= 100)
3. Yen	: End-December 1975	98.5
	End-October 1978	158.9
	% change	61.3%

		Effective rate (1975 average = 100)
4. Dollar	: 1978 quarter iv average	91.8
	November 1982 average	125.0
	% change	+36.2%

 31/1/83

WORLD INFLATION OUTLOOK

1. Since 1980 inflation, as measured by the GDP deflator has decelerated throughout most of the industrial world falling from 9 per cent for the major economies in 1980 to under 7 per cent in 1982. Estimates of inflation in the developing countries are affected by the wide divergence of inflation rates. Median estimates indicate price increases have fallen from around 15 per cent in 1980 to about 12 per cent in 1982. Amongst oil exporters it has declined from around 13 per cent in 1980 and 1981 to 10 per cent in 1982.

GDP DEFLATORS
(per centage change from previous year)

	1980	1981	1982	1983
Industrial	9.1	8.6	7.2	6.0
o/w major seven	9.1	8.5	6.8	5.5
NODCs (median)	15.1	13.4	11.8	10.0
Oil exporters	12.7	12.9	10.0	9.5

2. Forecasts point to a further fall in inflation for 1983 on average with the rate in the major economies falling to 5½ per cent. Then inflation may start to rise again as earnings pick-up, import prices start to rise and as profit margins are restored. OECD's latest projection envisages some pick-up in inflation on average in the industrial world in the first half of 1984 though in Europe inflation would be about the same as at the end of 1983.

(v)
31/1/83

US FISCAL DEFICITS AND THE CAPITAL ACCOUNT

Large prospective fiscal deficits in the US of around $200bn over the foreseeable future have inevitably been reflected in higher real interest rates. In turn higher real interest rates and a favourable US differential have, inter alia, increased the demand for dollars and pushed up the exchange rate. As a result competitiveness and the trade deficit have deteriorated, and the current account moved into a deficit of around $9billion in 1982 following a $4½ bn surplus in 1981.

After showing a gradual trend towards greater outflows net foreign <u>direct</u> investment turned round sharply in 1981 and registered a net inflow of around $12 bn. Some of those factors responsible for this (which include a favourable US differential and the flight to quality) may reverse and net foreign direct investment may return to rough balance in 1983. However in order to balance the external sector the large prospective current account deficits of around $30 bn for this year will inevitably mean the US is a capital importer once one has also taken account of e.g. indirect investment and banking flows. These capital inflows will help finance the fiscal deficit.

<u>Summary Balance of Payments ($bn)</u>

	1979	1980	1981	1982[1] H1	1983
Current Account	-½	1½	4½	6½	-30[2]
Foreign direct investment	-13	-5½	12½	12	na
Official capital	-4	-4½	-5	-4½	na
Other capital flows (net)/balancing items	18	9	-12	-14	na

1. At annual rate
2. Forecast

Source: OECD December 1982.

FROM: M E CORCORAN
1 February 1983

PRINCIPAL PRIVATE SECRETARY

Mr Peretz first

cc PS/Chief Secretary
PS/Economic Secretary
PS/Financial Secretary
Sir Douglas Wass
Mr Burns
Mr Littler
Mr Middleton
Mr Unwin
Mr Kemp
Mr Odling-Smee
Mr Lavelle
Mr Peretz
Mr Allen
Mr Hall
Mr Norgrove

TCSC: HEARING ON 31 JANUARY

I attach a transcript of yesterday's hearing which we have just received. I should be grateful if you could arrange to let me have any amendments to the evidence which the Chancellor would like to see made. I should be grateful also if other witnesses would let me have any amendments which they feel should be made. They should be restricted to the correction of inaccuracies in the reporting and of matters of fact.

2. A copy will be placed in the House of Commons Library tonight. I am therefore sending it to Mr Hall as well as to you and other witnesses, in case there are further questions. We are having further copies made, should any other recipients want one.

M E Corcoran

M E CORCORAN

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