SECRET

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PART A

REFLATION AND BALANCE OF PAYMENTS

DD's 25 years N Aziz 7-12-95

10-12-82

PO -CH /GH/0153
PART A

Permanent Secretary
H M TREASURY

Sorry about Y — I forgot. D

DW

On X, AHL thinks is the constitutional point of a large revenue raising capacity being subject to repeated parliamentary approval — but he will investigate further.

On Y on page 4; if you were referring to the power to switch from standard to higher rate, this was in fact in Peter Kitcatt's paper on the fiscal situation.

NRS
12/12

? Why not make the Economic Regulator a <u>permanent</u> power in the next Budget

F

SECRET

(Budget)

For Information:

Sir D Wass
Sir L Airey
Mr Atkinson
Mr Littler
Mr F Jones
Mr Byatt
Mr Unwin
Mr Dixon
Mr Griffiths
Mr Todd
Miss Barratt
Miss Hamilton

Mr Howard - Customs & Excise

49/5.12

THE REGULATOR POWERS

It now seems unlikely that a fiscal package will be needed before the Spring Budget. But as a contribution to contingency planning we thought we should bring up to date the stock note on the use of the regulator powers. This has been done in the attached document prepared jointly by FP 2 & 3 and Customs and Excise. It explains the nature of the regulator powers and the administrative and Parliamentary considerations affecting their use.

2. The table attached to the document shows the main effects of the full use of the regulator assuming an operative date on January 1, 1979. There is a time lag in collection of VAT revenue and the PSBR would not benefit until financial year 1979/80. (The small PSBR worsening caused by VAT in the first quarter is because the contraction of demand leads to reduced revenue receipts). On the other hand, company liquidity would improve temporarily in the final quarter of the current financial year as companies built up their VAT receipts - presumably this would reduce bank borrowing so that the monetary impact of the VAT regulator might be claimed as favourable from the first month of its introduction. In practice a January 1 operative date would cause some problems, especially in relation to the excise duties. As explained in paragraph 18 of the paper, the alcoholic drinks and hydrocarbon oil duties are normally altered on the same day that a change is announced so as to prevent forestalling, and the tobacco products duty a few days later. However, in the case of the alcoholic drinks and tobacoo trades an announcement would fall squarely within the Christmas period, which is almost invariably the time of heaviest demand, and a regulator increase with immediate effect would inevitably be disruptive and provoke strong protests from the trade. It is therefore likely that we would have to follow the precedent of the December 1976 operation and apply the regulator increases from 1 January, but with special restrictions on clearances from bond to prevent forestalling in the intervening period after the announcement, troublesome and distortive as these have proved. On the other hand, there are no similarly compelling

reasons why any increase in the hydrocarbon oil duties should be delayed. Therefore Customs would probably wish to propose that any such increase should operate either from 6pm or midnight on the date of the announcement. There might be some forestalling of VAT increases, but a short period of grace for traders, including a clear weekend is normally allowed. In the circumstances Customs would be prepared to live with a slightly longer period than usual.

3. There are three regulators: one applying to the duties on drink, petrol, derv and rebated oil; one to the duty on tobacco; and one to VAT. The PSBR and RPI effects on the full use of the regulator powers are summarised in the table below. There would be little immediate reduction in the borrowing requirement but the fact that the regulator was being used might do something to reassure the financial markets and the public that the Government was taking appropriate measures in the light of a deteriorating situation. The fact that the impact on borrowing in the final quarter would be minimal might not be regarded as necessarily significant in these circumstances:

SUMMARY OF EFFECTS OF FULL USE OF REGULATOR FROM 1 JANUARY 1979

	1978/79 PSBR & the Qtr?	1979/80 PSBR	RPI Impact Effect
	£m	£m	%
Tobacco and drink 10 per cent increase	-70	-360	0.8
Oil duties 10 per cent increase	-50	-190	0.1
VAT standard rate to 10%	+20	-760	0.9
Higher rate to 15%	-	- 90	0.1
Total	-100	-1400	1.9

Procedure

4. All three regulators are subject, in the case of an increase, to affirmative resolution procedure. They come into operation immediately, but must be confirmed within a specified number of days: VAT and tobacco regulators require Commons approval within 28 sitting days while an order under the main economic regulator (covering drink and oil) requires approval within 21 calendar days.

Scope of the powers

5. The regulators may be activated separately or together and some selectivity is possible within each of them. Full use of the exise duties regulators would permit the immediate raising of the duties on tobacco, drink and oil by 10 per cent. Full use of the VAT regulator would permit the immediate raising of both or either VAT rates by 25 per cent of those rates, ie from 8 per cent to 10 per cent in the case of the standard rate and from 12½ per cent to 15 per cent in the case of the higher rate. It should be noted that petro l is rated at the higher rate so that if both petrol duty and VAT higher rate were to be increased the price of a gallon of petrol would rise in total by 5.2 p.

Timing

6. Customs and Excise prefer seven days notice for advance preparation. A VAT charge should come into effect on a Monday so as to give traders a weekend in which to re-price.

Duty Deferment

7. We have been under pressure to grant duty deferment to the drinks trade, and we in Treasury have thought that there was a case for conceding this concession. Like VAT it is arguable that the effect

would be to reduce bank borrowing. The problem is the revenue loss - which is most important when the concession is first introduced since it applies to all duty payable, not simply the increase. A change in the course of a financial year would provide a useful opportunity since it would not affect receipts in the following financial year, and attention is likely to focus on that year. However, Customs see a number of formidable difficulties. We shall be discussing this issue further with them as the deferment problem might act as a constraint on the use of the drinks duties as a normal Budget measure.

? Do it now?

8. The situation with regard to taxation of cars is worth noting. As you know we have been toying here with the case for recommending an increase in taxation of cars on the grounds that the demand for cars seems to be buoyant and there is a high import content. A paper for FPC on the industrial implications of selected indirect tax changes is being discussed with Customs - and the car industry will be included in this review. Meanwhile if the VAT regulator were used to raise the standard rate of VAT from 8 to 10 per cent this would apply to cars. If further revenue were needed it would be possible, under separate order making powers given to the Treasury in the Finance (no.2) Act 1975, to switch cars from the standard to the higher rate of VAT. If at that time the higher rate was also increased from $12\frac{1}{2}$ to 15 per cent this would have the effect of achieving very much the same as doubling the car tax from 10 per cent to 20 per cent. An order under section 17 of the 1975 Act would require Commons ratification within 28 sitting days.

I wasn't told about this in October when we were thinking of this card thing.

9. Switching cars from VAT at 8 per cent to 15 per cent would have a negligible effect in the short run on the RPI (which uses secondhand values rather than the price of new cars) and would reduce the PSBR by about £250m. By about 12 months, however, the RPI would have been increased by 0.4 per cent.

10. The attached note is circulated for information only. It now goes back on the shelf as a contribution to contingency planning.

ahl

[A H LOVELL]
FPG
5 December 1978

THE REGULATOR POWERS

JOINT NOTE BY FP GROUP AND H M CUSTOMS AND EXCISE

1. Against the possibility that the Chancellor will decide at very short notice to use his Regulator powers, this note describes the nature and extent of those powers, and the important administrative/timing constraints to which they would be subject.

I. NATURE AND EXTENT OF THE POWERS

2. Though commentators and others frequently refer loosely to 'the Regulator', there are in fact three distinct regulators, the Economic Regulator and the Tobacco Products Duty Regulator applying to the excise duties and the VAT Regulator.

Excise Duty Regulators

3. The main excise duty Regulator (usually known as the "Economic Regulator") empowers the Treasury to increase (or reduce) by Order the principal excise duties other than tobacco by up to 10 per cent. The power derives from Section 9 of the Finance Act 1961 as amended by Section 8 of the Finance Act 1964. The duties are sub-divided into three groups, namely alcoholic drinks, oil, and other duties (betting etc). A surcharge or a rebate may be applied selectively, at different rates up to a maximum 10 per cent, to one or more of these groups. It is not, however, possible to increase duties on some groups and to reduce them on others, or for a surcharge and rebate to co-exist at any time. Orders under the Economic Regulator are subject to affirmative resolution procedure, and must be confirmed by the House of Commons within 21 calendar days in the case of a surcharge (21 sitting days in the case of rebate).

4. The powers covering the Economic Regulator have to be renewed annually and would otherwise expire on 31 August. In practice, the Regulator power is not suitable for use during the passage of a Finance Bill and is used only between Royal Assent (usually end-July) and Budget Day (in March or April). When it has been used, it has been standing practice to consolidate any surcharge (or rebate) into substantive rates in the next Budget and to renew the Regulator power so as to "free" it for further use. The Regulator was last used for the alcoholic drinks duties (but not for oil) in December 1976 and the consequent increases in duty were consolidated in the Finance Act 1977.

5. There is a separate Regulator for the excise duty on tobacco products, which derives from Section 6 of the 1976 Act. This Regulator is more flexible than the Economic Regulator and empowers the Treasury to increase or decrease by Order any of the rates of duty on different tobacco products by up to 10 per cent, eg distinction can be made between the specific and the ad valorem elements in the duty on cigarettes and different products (cigarettes, cigars, pipe tobacco etc) may be treated differently. Orders imposing an increase are subject to the affirmative resolution procedure and must be confirmed by the House of Commons within 28 sitting days (a decrease in rate attracts the negative resolution procedure). The Regulator power is not subject to annual renewal, but an Order ceases to be in force after one year unless a further Order is made. The tobacco products duty Regulator was used along with the Economic Regulator in December 1976, with consolidation of the increases in duty again in the Finance Act 1977.

VAT Regulator

6. The VAT Regulator powers enable the Treasury by Order to increase (or reduce) the rates of VAT by up to 25 per cent of those rates. The powers stem from Section 9 of the 1972 Finance Act (as amended by Sections 17 and 20 of the Finance (No 2) Act of 1975). An Order can apply both to the standard rate and the higher rate, or to only one of them, and it can be make different provision for each: ie it is possible to increase (or reduce)

one rate by a higher percentage than the other or even to reduce one while increasing the others. Orders under the VAT Regulator powers must, in the case of an increase of rate or rates, be approved by the House of Commons within 28 sitting days. (In the case of a decrease of rate or rates negative resolution procedure applies).

7. Unlike the Economic Regulator, the VAT Regulator powers are not subject to annual renewal. However, an Order made under Section 9(3) of the Finance Act 1972 can only remain in force for one year from the date on which it takes effect unless a further Order is made. Any Order which continues, varies or replaces a previous Order must refer to the rate (or rates) of VAT appearing in the substantive legislation. The VAT Regulator powers were last used in July 1974, to achieve a reduction in the standard rate of VAT from 10 per cent to 8 per cent. This was consolidated in the autumn Finance Bill, subsequently enacted as the Finance Act 1975.

8. Orders under the Economic Regulator power can have immediate effect, but in the case of the VAT Regulator it is essential to give the large number of traders involved enough time to re-price and the same applies to a lesser degree to the tobacco products duty Regulator.

II. MACRO-ECONOMIC EFFECTS

9. The attached table sets out the estimated effect of maximum use of the three Regulators on the revenue flow and PSBR and on the critical domestic macro-economic variables, viz retail prices, GDP and unemployment. The estimates are broad order of magnitude.

10. For the purposes of the table an operative date of 1 January 1979 is assumed. The figures are based on simulations carried out earlier this year. These are to be revised in January and it is possible that there may be significant changes. The simulations are carried out on the basis of the following assumptions: floating exchange rate, free earnings and no change in money supply. The PSBR differs from the ex ante estimates of the yield because of the second round effects on tax revenue and government expenditure of changes in output and prices. The combined effect of using both Regulators would be to reduce the PSBR by £100 million in the remainder of the current financial year and by £1.4 billion in 1979/80. This would be at a cost of nearly a 2 per cent increase in the RPI.

11. The practical effects of using the excise duty regulators would be to put about 6p on the price of a packet of 20 cigarettes, almost 1p on a pint of beer, an average 6p on a bottle of wine, 34p on a bottle of spirits and $3\frac{1}{2}$-4p on a gallon of road fuel. The full year revenue yield would be of the order of £615 million and the overall effect on the RPI would be about 1 per cent. Full use of the VAT Regulator would mean a rise in the standard rate from 8 per cent to 10 per cent, and in the higher rate (which includes petrol) from $12\frac{1}{2}$ per cent to 15 per cent. (The maximum permissible higher rate would in fact by 15.125 per cent, but clearly this would be awkward in practice). The full year revenue yield would be of the order of £1,075 million, and the addition to the RPI would be around 1 per cent.

12.Use of the VAT Regulator raises the RPI less for given effects on revenue and PSBR than the excise duty Regulators. For approximately the same increase in RPI the VAT Regulator raises half as much revenue again, in a full year, as the excise duty regulators.

III. ADMINISTRATIVE/TIMING ASPECTS

VAT Regulator

13. The starting point for considering the administration of any change of VAT rate is that, apart from time for minimal advance preparation within Customs and Excise, time has to be given between the date of announcement and the date of operation for traders (especially retailers) to adjust to it. Two of the special retail schemes call for a stocktaking at the time of a change of rate and one of the others requires a certain amount of bookwork (a so-called "scheme adjustment") to be done. Altogether about 90,000 retailers are covered by these requirements. Moreover, whether or not a retailer is using one of these schemes, he will wish to reprice his existing stock to take account of his changed tax liability. For some retailers (eg chemists) this is a sizeable job, and in some cases (eg in the grocery and hardware trades) the retailer may depend on advice from his linked wholesaler in doing it. For this reason it has always been the practice to allow a week-end to intervene between the announcement of the change of rate and its coming into effect. In a "normal" Budget situation the announcement is on a Tuesday and the change would come into effect on the following Monday. That gives the retailers five clear days, including the weekend. If substantially less than that were given there would be strong and, Customs and Excise think, justified complaints from the retailers and their organisations, though if an announcement had to be made in "crisis" conditions, Customs and Excise believe that the five clear days could be reduced to three provided always that the weekend were included. Monday - ie immediately following the weekend - is from the retailers' point of view the preferable day for a change to come into effect. There would also be advantage, if possible, in effecting a change on the first day of a month.

14. Because of the risks and difficulties explained in paragraphs 15 and 16 below Customs and Excise prefer to have seven days' notice before the announcement of the use of the VAT Regulator. However, they recognise that this may not always be possible and

subject to these risks and difficulties the minimum time Customs and Excise would need between the decision to use the Regulator power and the announcement is two complete working weekdays. This means that, for example, they would need to have a decision by 10 am on a Tuesday in order to prepare for an announcement at or about 4 pm on a Thursday of a change to take effect on the following Monday. For a 15 per cent rate, the appropriate "VAT fraction" - ie the VAT as a fraction of the tax-inclusive price - is $\frac{3}{23}$ and the Public Notice, in leaflet form, explaining the change ought to include a ready reckoner for the use of this fraction. Given two complete working days' notice, and again subject to what follows, this Public Notice could be made available to Customs and Excise staff in VAT offices and for over-the-counter distribution to callers there immediately after the announcement. (Following standard Budget practice, Customs and Excise would start to print supplies of the Notice under non-security conditions as soon as possible after the announcement, for postal distribution to traders in the course of the next week or so).

15. Achievement of this objective within two complete working days depends on the availability (at HMSO or at Customs and Excise) of facilities for urgent printing under security conditions. Sufficient facilities are normally available, and the simultaneous announcement of the use of the VAT Regulator and of the excise duty Regulators would not of itself present problems; but at any given time it would be necessary to check the situation in case there should be some other major project in hand absorbing the resources.

16. Achievement of this objective at such short notice requires the use of domestic Customs and Excise distribution facilities brought into action specially for the purpose, and the cost of distributing security material in this way is much higher than the cost of doing so by more conventional methods. The timetable would also mean that some staff in overtime grades would have to be called on to work overtime and it would be necessary to warn

them of this possibility on the working day before the decision to go ahead was actually taken (with the possibility that they might have to be compensated if the requirement did not materialise). This too would mean extra expense for Customs and Excise and/or for HMSO. There are in any case special dangers of things going wrong in a "crash operation"; and given also the possible effects on cash limits, Customs and Excise would hope that they would not be asked to conduct such an operation unless it were really impossible to give them longer notice.

Excise duties

17. As with VAT, Customs and Excise would prefer seven days' notice of the announcement of the use of one or both of the excise duty Regulators. This would allow for normal printing and postal distribution of notices to Collectors. However, subject to paragraphs 15 and 16 above, Customs and Excise could undertake a special exercise to distribute material if a firm decision is taken as late at 10 am one working day before the Ministerial statement, eg by 10 am Wednesday for an announcement on a Thursday. It would still be open to Ministers to decide at the last moment not to proceed or to decide between options for which the necessary notices had already been printed and despatched. But unless Customs and Excise go to print by 10 am on the day before the announcement, they could not be sure of getting the notices out to traders and instructions to staff. In serious "crisis" conditions notices and instructions could be dispensed with and Customs and Excise could operate on the basis of a decision at noon on the day of the announcement, but this would undoubtedly lead to confusion and complaints from traders.

18. These timetables would allow changes to the drinks duties to take effect from midnight on the day of the announcement, changes to the oil duty to take effect from 18.00 hours on the same day (provided the Ministerial statement was certain to be completed by 17.30 hours) and changes to the tobacco products duty to take effect a few days later (if the VAT Regulator was used, on the same day as in the change in VAT rate).

REGULATOR APPLICATION ON 1 JANUARY 1979

Regulator Power	Full year revenue yield 1979/80 £m	Net receipts 1978/79 £m	Net receipts 1979/80 £m	PSBR (1) (2) 1978/79 £m	PSBR (1) (2) 1979/80 £m	RPI Impact effect (per cent)
EXCISE DUTIES						
VAT inclusive Price increase						
Tobacco Full Regulator + 5.8p per 20 cigarettes	245	40	245	- 40	-230	0.5
(Specific Duty Regulator only + 2.9 per 20 cigarettes)	(120)	(20)	(120)	(- 20)	(-120)	(0.2)
Alcohol						
Beer + 0.8p a pint Wine + 5p-7p a bottle Spirits + 34p a bottle	145	25	145	- 30	-130	0.3
Oil						
Petrol + 3.4p a gallon Derv + 3.8p a gallon Rebated + 0.25p a gallon	225	50	225	- 50	-190	0.1 (3)
Total Excise Duties (4)	615	115	615	-120	-550	0.9
(With specific duty regulator only on tobacco)	(490)	(95)	(490)	(-100)	(-440)	(0.6)
VAT						
Standard Rate 8% to 10%	950	10	940	+ 20	-760	0.9
Higher Rate (Inc Petrol) 12½% to 15% (5)	125	-	125	-	- 90	0.1
TOTAL VAT (4)	1075	10	1065	+ 20	-850	1.0

(1) Assumes floating exchange rate, free earnings and no change in the money supply.

(2) The PSBR effect - even for 1979-80 is less than the full-year revenue yield because the tax increases depress GDP and this causes an offsetting reduction in the yield of all taxes.

(3) The RPI effect shown might be doubled by indirect effects which work through as the industrial costs of the duty increase are passed on to consumers.

(4) The effects estimated are not strictly additive. The effect of combining these measures is, however, relatively small except when changes are made to both excise duty and VAT rates. In that event, largely because of the consequential effect on the ad valorem element in tobacco taxation, the full year revenue yield might be increased by up to £100 million and the RPI by about 0.2 per cent.

(5) Full use of the VAT Regulator on the higher rate would produce an awkward percentage rate; its near-maximum use to produce a conventional (15%) rate has therefore been assumed.

CONFIDENTIAL

BF 14/12

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10 DOWNING STREET

CHANCELLOR OF THE EXCHEQUER REC. - 1 DEC 1975 ACTION COPIES 10

Mr Downey
PS/PMG
PS/CST
PS/FST
PS/MST
Sir D Wass
Sir B Hopkin
Sir D Mitchell
Mr A Lord
Sir D Henley
Mr Posner
Mr Barratt
Mr Fogarty
Mr Corey
Lord Kaldor
Mr F Jones
Mr Baldwin
Mr Couzens
Mr Lieener
Mr Littler
Mr Bailey
Mr Lavelle
Mr Anson
Miss M Brown
Mrs Hedley-Miller
Mr Ham
Mr Turnbull

THE PRIME MINISTER

Personal Minute

No. M163/75

CHANCELLOR OF THE EXCHEQUER

The Timing of Reflation

I read Harold Lever's minute of 20 November with considerable interest. It develops an idea which he put forward at Cabinet recently and on which I am sure you will want to reflect. It may be premature now to take decisions about reflation next year: but the Cabinet are due to return to the subject early in the New Year and this is of course one of the possible options which the Cabinet had in mind when agreeing to the approach to the I.M.F. This approach was on the understanding that the Government's future freedom of manoeuvre would not thereby be restricted solely on account of the drawings.

I am sending a copy of this minute to Harold Lever.

HW

1 December 1975

CONFIDENTIAL

Mr Unwin

SECRET & PERSONAL

(Budget)

SIR DOUGLAS WASS

Thank you. DW. 5/12

A CARETAKER BUDGET

You may care to glance at the attached note by Mr Beighton which expands on the concept of a "care and maintenance" Finance Bill to which you referred in your note to the Chancellor last week.

2. You will see that maintenance would in fact entail a good deal of care, and that the concept is not too far removed from the minimal kind of Budget you yourself had in mind. Revalorisation of personal allowances and the residual CTAs would pose particular problems. The combined cost of conceding the former and failing to remove the latter would approach £1.5 billion. However, Mr Beighton's conclusion is that four days for all stages (with Opposition cooperation) would be feasible.

J B UNWIN
4 December 1978

SECRET & PERSONAL

4/78

SECRET & PERSONAL

MR ~~UNWIN~~ cc Mr Lovell

A CARETAKER BUDGET

We thought it might be useful if I listed the measures which would have to be included in a care and maintenance Budget whose purpose was to do no more than enable the tax system to continue until such time as a new Government introduced a substantive Budget.

2. Income tax rates and allowances. These would be fixed for ~~1978-79~~ 1979-80 at their ~~1977-78~~ 1978-79 levels. The question which arises is the indexation of the personal allowances. Had we a fully indexed tax system then the neutral course might be to allow the indexation to go ahead, but with only partial indexation neutrality should imply overriding the statutory requirement and keeping the allowances at their current level. However the Government might well decide otherwise: however the Opposition felt, they could hardly oppose, though they might argue that other fixed points should be increased correspondingly.

3. Child tax allowances. This is the most difficult question. Without any legislation these allowances will revert to their level in 1975-76 (£240/£275/£305). However to abolish them would not only be controversial with the left wing but require two pages of detailed legislation dealing with the consequentials. Another consideration is that the Revenue will have issued PAYE code numbers showing no CTAs and to reintroduce them at any level would be very burdensome. The best course might be to extend the ~~1977-78~~ 1978-79 provisions for another year but empower the Revenue to take no steps to implement the extension for a period of months.

4. Social Security Pensions Act consequentials.* This provision is essential simply because pensions will start being paid from next April under the 1975 Act and Treasury Ministers have so far refused each year to make the necessary consequential provisions. This would require a page of detailed legislation which in substance would not be controversial and which one would hope would not give rise to party points if the debate was understood to be on a non-controversial basis. However we would want to ask the Revenue if they could live without the provision if they could be certain of a second Finance Bill later in the year.

* I understand this is largely technical — Tax legislation has not been amended to take account of the 1975 Social Security Act under which earnings-related pensions will be paid for the first time from next April.

5. Corporation tax rates and fractions. No problem should arise in continuing the present levels.

6. Mortgage interest relief ceiling. This has to be fixed annually. It should not be controversial to leave it at £25000 provided the personal allowances had not been indexed.

7. Continuation of economic regulator powers. Although these powers (which have been continued every year since 1961) do not expire until the end of August it would seem prudent to include them in a caretaker Bill in case any subsequent Bill had not received the Royal Assent by then.

8. These provisions would require about 3-3½ pages of legislation - a page less if the Social Security Pensions Act consequentials could be omitted. There would be no Amendment of the Law Resolution and hence no possibility of new clauses being debated or added. We ought to allow four days for all stages including printing and the necessary procedure resolutions.

9. There are three other items which have already been agreed as essential for the 1979 Finance Bill but which could probably be omitted from a caretaker Bill.

10. Trustee Savings Bank interest. The exemption of TSB interest has to be withdrawn when the banks leave the public sector. However the change is not due to take place till November so that the provision could be left for a second Bill. If necessary it would even be possible, though undesirable, to validate the removal of the exemption retrospectively in 1980.

11. Petroleum revenue tax. PRT is charged in six-monthly accounting periods, starting 1 January and 1 July. The Government has announced that increases in the rate and reductions in various allowances from 1 January will be included in the Finance Bill. If the new Government wished to pursue these increases it would be able to do so either in a second Bill if introduced quickly or in a separate Oil Taxation Bill (to which the Provisional Collection of Taxes Act would still apply). Alternatively it could proceed at a slower pace after reviewing what was proposed, at the expense of an increase in the 1978-70 PSBR of the order of £100 million.

12. Stock relief: write off of deferred tax. This was foreshadowed in last year's Budget speech, but would be far too technical for a caretaker Bill even if done on a minimum basis. It could also be controversial with the left wing.

LJHB

L J H BEIGHTON

1 December 1978

cc PS/Paymaster General
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir Douglas Wass
Sir Bryan Hopkin
Sir Derek Mitchell
Mr Lord
Mr Pliatzky
Mr Airey
Mr Baldwin
Mr Barratt
Mr Couzens
Mr F Jones
Mr Jordan-Moss
Mr Posner
Mr Downey
Mr Turnbull
Mr Britton

PRINCIPAL PRIVATE SECRETARY

REFLATION AND THE BALANCE OF PAYMENTS - MES(76)12

flag D

There are a number of points in the official brief submitted in Mr Turnbull's minute of 2 February on which I would wish to enter a reservation.

2. The first and less important point relates to paragraph 5. The time lags involved in <u>any</u> scheme are very uncertain and this is particularly true of a scheme of import controls which has not previously been introduced in peacetime (as distinct from merely retained - as the wartime controls were until the 1950s). As the CSO studies show, the employment lag with respect to changes in output vary between one month and twelve months (with an average of six months) and it is impossible to calculate <u>when</u> the changes in output take place, since various traders would in varying degrees anticipate the demand, as soon as the controls are announced. In fact increases in production due to such anticipations are <u>more</u> likely to occur with import controls than with increased demand resulting from other policy measures such as fiscal reflation or exchange depreciation. (When Mr Barber in the 1972 Budget reduced taxation by £1,800 million /in a full year/ this was fairly quickly followed by a reduction in unemployment, but it is not clear whether this was due to anticipation of future demand or to the effects of the earlier measures from the previous year.) What is certain is (according to the Department of Trade) that quotas as against, say, exchange depreciation, have very quick effects on <u>imports</u>. According to Mr Britton's note of 30 January (paragraph 26) 50 per cent of the effects would come through in the second quarter after their

flag E

introduction, and 100 per cent after three quarters. Depending on anticipations the change in output due to import substitution may either precede, be simultaneous with, or succeed by a time lag, the change in imports. I agree that the effect of the import controls scheme would be less if a terminal date were set from the beginning; but that is an objection against setting a terminal date, rather than to import controls as such. (The present brief does not explicitly deal with the question of retaliation which formed an important part of the Chancellor's argument in the House last week. Here I merely wish to point out that any alternative policy may equally be frustrated by imitation or retaliation which come to the same thing. From the point of view of the foreign manufacturers the loss incurred due to the elimination of our balance of payments deficit comes to the same irrespective of the method which we adopt for the purpose.)

3. While we are thus uncertain how quickly or slowly the employment effects of import controls would come through, there is no such doubt that when they do come through the effects will be pretty large. Hence any statement which refers only to what happens "in Year 2" is not only uncertain but also misleading, if it does not at the same time refer to the full effect of a quota scheme on employment. As Mr Britton's paper has shown, a cut that would improve the current balance by £2 billion in 1979 would reduce unemployment by 1.1 per cent for that year. On the other hand a cut which will reduce the imports of finished manufactures to, say, their 1970 level would mean a cut in 1976 imports of £3½ billion that theoretically would generate a large balance of payments surplus by 1979 and reduce unemployment (on a linear projection) by 4 percentage points - which is probably 1 percentage point below the minimum possible level. Assuming that the maximum reduction of unemployment is to 3 per cent (for 1979) an import cut of £2½ billion would be called for (the equivalent of 30 per cent of the imports of finished manufactures in 1976) and this would be sufficient to reduce ex ante imports by £6 billion in 1979 at 1979 prices - i.e., it would be more than sufficient to eliminate the balance of payments deficit in 1979. The possibilities of increasing employment through import cuts are indeed very large - theoretically much larger than the amount of unemployment available, or what equilibrium in the balance of payments requires. Even if we cut the import of finished manufactures to only their 1972 level

(which was 50 per cent higher than the 1970 level, but something like one-quarter below the 1976 level) we need an initial cut in imports of £2 billion that would go a very long way to restoring full employment (i.e., it would reduce unemployment by over 500,000) and would eliminate the balance of payments deficit by 1979. In comparison to this statements relating to the modesty of the employment effects "in 1977" are largely irrelevant, because nothing practicable can produce large employment effects within that period.

4. However, my main objection to the brief refers to paragraph 7, where I do not think that the alternatives are clearly or fairly put. There is certainly no guarantee that you can achieve full employment within any measured time span without a very large deficit in the balance of payments, whatever the exchange depreciation resorted to. In fact one could assert the very contrary, that it is impossible to restore both full employment and the balance of payments by 1979 or 1980 while maintaining free imports, whatever combination of fiscal and exchange rate policies are adopted. Mr Britton (in his supplementary minute of 3 February) has also shown that to bring employment down to 3 per cent by measures of fiscal reflation would imply a balance of payments deficit of £11 billion instead of £5 billion in 1979. As against that the elimination of the £5 billion deficit in that year by fiscal measures (i.e., by deflation) would require an ex ante cut in the PSBR (whether through tax increases or expenditure cuts or some combination of the two) of £4.8 billion in the Budget of 1977 - corresponding to an "ex post" cut of £1.3 billion in 1977 and of £3.8 billion in 1979 - and would push up unemployment by 2 per cent in 1979, i.e., from an anticipated $1\frac{1}{4}$ million to $1\frac{3}{4}$ million.

flag F

5. Hence to rule out import controls necessitates, in my view, the use of deflationary measures if the balance of payments is to be restored. There is no other alternative. Such deflation will in any case be forced on us if these forecast deficits materialise and as a result we are forced into further official borrowing.

6. Mr Britton's note also shows that it is quite impossible to restore the balance of payments by any viable exchange depreciation strategy by 1979. The cumulative improvement in the balance of

payments of an 8 per cent effective devaluation (involving a 2.2 per cent cut in real wages attained in the first two years) would only be £2.4 billion by 1980, which is only a small fraction of the cumulative deficit of £18 billion for that period, and the consequential reduction in the balance of payments deficit in 1979 is only from £5 billion to £4.4 billion. However, on Mr Britton's calculations an 8 per cent devaluation would eliminate the balance of payments deficit by 1980 if combined with adequate deflationary measures to prevent any fall in unemployment below the $1\frac{1}{2}$ million envisaged for 1976. This combination of a large ($7\frac{1}{2}$ per cent) cut in real wages with the maintenance of heavy unemployment is not a politically feasible option - even if the Treasury's rather sanguine predictions on the effects of changes in competitiveness on the balance of payments were correct.

7. With regard to the path to full employment, I do not believe that the target of "3 per cent unemployment by 1979" is at all attainable in any other way except by import controls. According to Mr Britton's projections (which I gather do not as yet incorporate the latest forecasts) unemployment is expected to be the same in 1980 as in 1976 and only one-half per cent, or 110,000, lower in the two intervening years 1978 and 1979. If on the other hand we limited the imports of finished manufactures to the 1972 level this would have a cumulative effect on unemployment of 200,000 by 1977, 400,000 by 1978 and something like 550,000 by 1979 - i.e., the policy would be consistent with a 3 per cent, or 700,000, unemployment target for 1979.[1]

8. Paragraph 11 invites the Chancellor to stress "that we must not rely on repeated depreciations to put right the weaknesses in the economy". However, so long as the income elasticity of the UK demand

(1) Mr Britton also assumes that import controls will "raise the RPI" on account of the scarcity of imported manufactures by something like 1 per cent for each billion cut in imports. In my view there is no basis whatever for any such assumption - indeed if wages are controlled through incomes policy, the effect of increasing domestic output and employment through import substitution will lower the RPI, as a result of increased productivity. (This counter-cyclical movement of prices in relation to wages has been a common feature of all post-war cycles.)

for imported manufactures is greater than unity (or indeed is greater than the 0.6 which is the assumed income elasticity of world demand for UK goods) no single depreciation, however large, could restore the position more than temporarily. The argument therefore implies that depreciation in itself reduces the income elasticity of demand for imported manufactures. But there is no empirical evidence for this whatever.

NK

NICHOLAS KALDOR

4 February 1976

1 MR DOWNEY Gs7

2 PRINCIPAL PRIVATE SECRETARY

cc PS/Paymaster General
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir Douglas Wass
Sir Bryan Hopkin
Sir Derek Mitchell
Mr Lord
Mr Pliatzky
Mr Airey
Mr Baldwin
Mr Barratt
Mr Couzens
Mr Jones
Mr Jordon-Moss
Mr Posner
Lord Kaldor

REFLATION AND THE BALANCE OF PAYMENTS - MES(76)12

Introduction

1. We assume the Chancellor will want to keep the discussion very much at a strategic level and that above all he will want to secure endorsement of his views on general reflation and generalised import controls.

2. He will not want to let the discussion go too far into the pay limit for the next round as this will be on the agenda for MES next week. Three papers will then be provided, one arguing the general case for a low limit, the second on the form of the limit and the third setting out the effects on families, pensioners, etc, of different pay limits and of revalorisation. If the Chancellor is asked to substantiate his statement in para 7(c) that a "lower pay limit does not imply a further fall in living standards", he should say the question will be gone into in full at the later meeting. By way of interim briefing, a table at Annex A sets out the movement of real take home pay for limits of 8% and 3%.

flag A

3. The Chancellor will also want to avoid becoming bogged down in the details of the forthcoming package of selective measures. He should say that he will shortly be putting forward a paper to his colleagues following the meeting with the TUC representatives. A table showing the main candidates is at Annex B.

flag B

General Reflation and Generalised Import Controls

4. The Chancellor is thoroughly familiar with the arguments against general reflation on the present outlook and no further briefing is required. The same is true of generalised import controls, though in addition to the arguments deployed in the paper, the Treasury feel that import controls would adversely affect our ability to finance the large deficits which would remain even after the introduction of controls.

5. Some of the colleagues may query the figure for the unemployment effect of import controls. The work done in the summer (as the Chancellor knows this exercise is currently being reworked) showed a GDP effect of a scheme which reduced imports by £1.75 billion as 1.2% of GDP in Year 2 with a reduction in unemployment of 52,000. This latter figure is highly uncertain, hence the broader formulation in the paper "at most 100,000". There are two main reasons why the figure for unemployment is so small. First, there would inevitably be an administrative delay in putting an import control scheme into effect while importers established their quotas (during this period ~~they~~ there could in fact be some forestalling and hence additional imports). Secondly, even when the quotas were in force, there would be a lag before orders for frustrated imports were diverted to home suppliers and then a further lag ~~for~~ before these additional orders generated new recruitment. In order words, import controls are subject to much the same lags as general reflation. It should also be noted that the estimates of the unemployment effect assumed that the scheme is thought, from the start, to be permanent. If, in order to secure international acceptance of an import control scheme it were necessary to name a terminal date, many importers would prefer to take the strain on stocks and though the balance of payments improvement would be greater the benefit to unemployment would be even smaller.

6. Reference may be made to a Labour Party Home Policy Committee document which claimed that the effect on unemployment of import restraint (the proposal was actually for a tariff on imports of manufactures) would be as much as 320,000 by the winter of 1976-77. These estimates failed to take adequate account of the time lags and the Treasury estimate of the effects of this scheme was a reduction of 60,000 in 1977.

7. There are, however, two issues on which the Chancellor is vulnerable and on which further briefing is required:

i. The return to full employment envisaged in para 2ii is slow and there is in any case no guarantee that it can be achieved.

ii. To rule out import controls implies use of depreciation to correct the balance of payments.

The path to full employment

8. Some of the colleagues may argue that the path set out by the Chancellor is unacceptably slow and that we should aim to get unemployment down from its peak of about 1½ million to about 600,000 by mid-1978. We think it would require a growth rate of about 7% per annum between second-half 1976 and second-half 1978 to achieve a reduction in unemployment of between a half and three-quarters of a million by second-half 1978. The rate of growth implied for manufacturing industry would be even higher. The Chancellor may answer by saying that he accepts that a fast rate of growth is needed but that a rate as fast as this is probably unattainable and to attempt it would damage the economy rather than strengthen it. It would lead to bottlenecks and shortages and hence a sucking in of imports which would further damage the long run prospects of industry. The resulting deterioration in the balance of payments could check the progress being made in reducing the level of unemployment before it had been brought down to a tolerable level. If statements by Mr Prior and Mr C Jenkins that unemployment will stay at 1 million or more for the next five years are raised, the Chancellor should say that this is <u>not</u> necessary and that his policies will aim to prevent it. He will also want to stress that a successful return to full employment is dependent on putting right the balance of payments, which in turn depends on further deceleration of inflation and the strengthening of our industrial base.

The balance of payments

9. It may be argued that on present policies the balance of payments is expected to deteriorate in 1976 and show no tendency to improve thereafter. In these circumstances the Chancellor would have to resort to depreciation if he had ruled out import controls.

10. The Chancellor can accept that there could well be large deficits in 1976 and 1977 and he should warn his colleagues that, against the background of continuing deficits, we must expect the fall in the exchange rate to continue. This could well be beyond depreciation which has been assumed in the forecasts and lead to a real improvement in competitiveness. The latter would have a number of consequences, some good, some bad. On the one ~~bad~~ hand, it would generate increased output and employment, and should provide some benefit to the balance of payments in the medium term. On the other hand the initial impact on the balance of payments would be adverse and real depreciation would add to the pressure on domestic prices.

11. But the Chancellor should stress that we must not rely on repeated depreciations to put right the weaknesses in the economy. It is essential to get to the heart of the problem which is a higher rate of inflation than our competitors and the weakness of our manufacturing industry. Pay restraint is essential if the former is to be overcome; and to put right the latter it is essential to implement the Government's industrial strategy.

The Recession

flag C

12. Attached at Annex C is a note on pointers to the economic upturn. This will enable the Chancellor to substantiate his claim in para 2(i) that the worst of the recession has past.

A Turnbull

A TURNBULL
2 February 1976

SECRET

ANNEX B

EXPENDITURE ITEMS IN PACKAGE

		Cost (£m)				
A.	Items Recommended	1976/77	1977/78	Later	Total	Effect on Employment
1	Training (apprentices)	14	24	4	42	(20-25,000)
2	Temporary Employment Subsidy	14½	-	-	14½	55,000
3	School Leaver Recruitment Subsidy (extension)	¼	-	-	¼	1,500
4	Development Commission	1	-	-	1	300
5	Industry Schemes	6	7	7	20	?
6	Construction	20	-	-	20	4,000
		55¾			93¾	say 85,000 (including training places)

		1976/77	1977/78	Later	Total	Effect on Employment
B.	Other Proposals					
1	Training (non-craft etc)	3	6	1	10	(10,000)
2	Temporary Employment Subsidy	45	-	-	45	20,000
3	School Leaver Recruitment Subsidy (doubling)	1½	-	-	1½	?
4	Job creation - to end September	15	-	-	15	13,000
	- to end year	30	-	-	30	27,000
5	Job centres	2	2	1	5	-
6	Industry schemes	15	18	17	50	?
7	Construction	10	-	-	10	2,000

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Tob Cons 2.

cc. £60 m [illegible]
22 [illegible]
1. £60 [illegible]

1.90.
260 [illegible]

B.

ANNEX C

POINTERS TO ECONOMIC UPTURN

World Recession: Position still tentative but some encouraging signs:

(i) USA 1975 Tax cuts extended, New York propped up, and energy prices to come down. 5½-6 per cent growth expected by most forecasters.

(ii) JAPAN signs of rising production in autumn, but a rather hesitant trend since.

(iii) EUROPE a moderately encouraging picture. Domestic demand appears to have picked up modestly in Germany and France, although unemployment may still be on a rising trend.

In all, signs that the world recession has bottomed out are now fairly clear.

Domestic Recession: tentative but encouraging signs

(a) Export volume rose 7 per cent in the fourth quarter, compared to ½ per cent for imports. Food, materials, chemicals etc growing rapidly; manufacturing exports more sluggish.

(b) Housing starts speeding up again. In the three months to November total starts rose 7.8 per cent over the preceding three months, all in the public sector.

(c) In the three months to November industrial production rose 1.6 per cent and manufacturing production 1.2 per cent.

(d) The CBI report that in December more firms reported an increase than a fall in value of total new orders over the latest four months - the first time for 18 months.

(e) The fall in GDP slowed down in Q375, with a fall of ½ per cent compared to 2½ per cent in Q275. Total final expenditure (the sum of consumption and investment - public and private - and exports) actually rose ½ per cent, and destocking fell back and may have passed its peak.

cc P.S. to PMG
CST
FST
MST
Lord Kaldor

SECRET

SIR ~~DOUGLAS~~ WASS Principal Private Secretary. cc Sir B Hopkin
Mr Lord
Mr Pliatzky
Mr Barratt – Downey
Mr Turnbull

I have made a number of changes, but the structure follows the Chancellor's outline. AW. 27/i

REFLATION AND THE BALANCE OF PAYMENTS

I attach a redraft of the Chancellor's paper on the lines discussed at Second Secretaries this morning.

2. I have shown the paper in draft to Mr Barratt. He is broadly content but has asked me to register two points on his behalf.

i. Like Sir Bryan Hopkin, he would have preferred to retain as one of the objections to general import controls the fact that we should be jeopardising access to credit needed to finance our external deficit.

ii. He would like to omit the words in square brackets in paragraph 8 iii. on selective import controls.

S. Wilkes

PP. G S DOWNEY
27 January 1976

SECRET

MES (76)12

DRAFT PAPER TO MES

REFLATION AND THE BALANCE OF PAYMENTS

1. At Cabinet on 6 November it was agreed that there should be further discussion of the issues of reflation and the balance of payments early in the New Year - CC(75)46 conclusions. In this note I summarise the present position and invite my colleagues to agree to certain policy conclusions.

Economic Background

2. i. **Short term**

The counter-inflation policy is succeeding. There have been no exceptions to the pay limit and we are broadly on course for bringing the year-on-year price increase down to about 10% by the end of 1976. The balance of payments improved substantially last year with the current account deficit (£1.7 billion) less than half that of 1974 (although much of this improvement was attributable to the U.K. recession). There are now ~~some~~ several signs that we ~~have~~ passed the ~~bottom~~ worst of the recession a couple of months ago: for example, industrial production in November rose for the third month running. On the other hand, unemployment is still rising, as we knew it would.

It has to be recognised that reflating domestic demand - whether by tax cuts, public expenditure increases, or import controls - would have virtually no effect on unemployment this year, given the lags between decisions and their effect on output, and between output and employment. Any successful policy of demand management must accept these lags.

But we cannot - and should not - do nothing in the face of the unemployment situation. The TUC have made it plain that they could not secure the support of their constituent unions to a further round of pay restraint if we failed to react to the rising unemployment. In these next few months we should therefore lend our energies towards devising schemes to save jobs, expand training and increase investment. Such measures can be quick acting and meet the needs of the immediate situation. It would be appropriate to announce a further batch of measures in the very near future and I shall have proposals to put to Cabinet in the next few days.

ii. Medium term

Because of uncertainty about the world situation the pace of recovery cannot be predicted with any confidence. But assuming that unemployment starts to fall in the second half of 1976 and that there is no setback to the recovery of the world economy, I would hope that unemployment could be back to, say, 3% [illegible] 700,000) ~~(600,000)~~ by the end of 1979, provided that by then we can get our balance of payments right.

is 3% 600,000 or 750,000?

Even without any ~~further~~ stimulus, the recovery of demand in 1977 could well be rather faster than our industry can comfortably handle, and could worsen our balance of payments deficit. The present decline in investment and stocks (both with a high import content) will be reversed: and the terms of trade are likely to turn against us with an increase in commodity prices. Any substantial reflation now would add to the speed of the upswing and ~~would~~ might simply reproduce the error made by the Conservatives in 1972 which brought the economy to a halt in 1973. Indeed, if the pace of recovery were faster than presently forecast for 1977 this could well result in ~~a higher equilibrium level of unemployment than we should otherwise be able to achieve~~.

X

our running into supply bottleneck problems before unemployment had been brought down to a tolerable level.

In the light of the current prospect, therefore, we cannot afford ~~general~~ a significant reflation now or in the Budget. ~~Clearly~~, If ~~demand does not recover~~ ~~unemployment continues~~ to rise sharply in the spring and ~~summer~~ early summer, we shall have to look at ~~this again later in the year, though even then, we should not be able to ignore the balance of payments constraints~~ the situation again.

though I would not rule out some ~~modest raising of the tax thresholds / personal tax reductions~~ if I could be sure that the T.U.C. would agree to a low pay limit in 1976/77;

Our room for manoeuvre would~~, of course,~~ be increased if the next pay limit offered a substantial further fall in our inflation rate in 1977. A further cut in the rate of inflation would not only improve our balance of payments directly by increasing our competitiveness, but would also increase the willingness of our creditors to lend to us. Moreover, it would restore confidence at home and encourage higher investment.

Import Restrictions

3. We have already recognised that **selective** import controls may help to save some jobs ~~in the short term~~ where a particular industry or firm is threatened with extinction by severe foreign competition.

Such controls, even if applied for a short time, have a useful ~~in protecting employment and~~ protecting function, enabling an industry to survive during the recession, ~~although might always~~ ~~providing they do not provoke retaliation or imitation on a scale which cancels this advantage~~

4. This is not true of **general** import controls ~~which are intended to~~ as an instrument for reducing unemployment. ~~As with~~ Like other measures of general reflation, eg tax cuts, these are slow in taking effect because of the lengthy lags. For example, Treasury calculations suggest ~~if we were to aim at cutting~~ to cut imports by, say, £1½-2 billion, unemployment would hardly be reduced in the first year and would fall by at most 100,000 in the second. ~~But~~ Even this gain would ~~only~~ not be secured ~~if~~ unless:-

i. the controls won the acquiescence of our trading partners and did not provoke retaliation or emulation. This is unlikely so long as our balance of payments is improving and our rate of unemployment is broadly in line with that of our competitors. Controls would be strongly resisted at present as a means of exporting unemployment, especially if introduced explicitly on employment grounds.

ii. industry responded by re-organising itself, making itself more efficient and getting new investment on stream, rather than by ~~relaxing~~ easing up behind a wall of protection ~~even further in the comfort of a protected market. Even then~~ To have the incentive to re-organise and meet the unsatisfied domestic demands for imports, industry would need to be assured that the controls would ~~have~~ to last (~~and be expected to last~~) for ~~a minimum~~ four or ~~of~~ 5 years.

5. In present circumstances ~~I am sure~~ these conditions are not satisfied. We should encounter retaliation and would almost certainly have to commit ourselves to the removal of the controls within a year or two.

Pay Policy

6. From every point of view the most valuable ~~improvement~~ development in our policy would be a ~~lower~~ pay limit lower than the £6 in the next round. ~~Which~~ This would eliminate the remaining gap between our inflation and that of our main competitors, the US and Germany. Our various measures to improve industrial performance should also help. This would provide the best basis for the fastest possible return to full employment.

7. The TUC may accept a lower limit if

a. we are seen to be taking active steps at the micro level to reduce unemployment in the short term: the TUC themselves have publicly ruled out general reflation and general import controls.

b. they ~~see real prospects of increasing employment~~ are satisfied that unemployment will fall substantially in the medium term and that we are acting on investment towards this end.

c. we offer to ~~It is reasonable to compensate for the~~ maintain the same take-home pay ~~they are persuaded that~~ lower money earnings through tax reliefs as they would otherwise have obtained by a higher money increase ~~will open up the opportunity of some compensation through tax reliefs~~, as I am sure they will. A lower pay limit does not imply a further fall in living standards. What ~~it does imply~~ matters is a reduction in industrial costs and an improvement in investment and exports on which future growth ~~and employment~~ jobs ~~depends~~ depend.

Conclusion

8. I invite my colleagues to agree that on present information we should :-

i. accept that, given the present outlook, ~~general~~ a significant reflation is not possible;

ii. press ahead urgently with such measures as we can at the micro level;

iii. rule out general import controls, at least for the time being, though ~~we should be~~ we remain prepared to ~~look at~~ consider selective import controls ~~in~~ if the circumstances of a particular firm or industry appear to justify them;

iv. make every effort to secure a low pay limit, using the offer of ~~some~~ compensatory tax reliefs during the negotiation; ~~but~~ and

v. reconsider our position later in the year if the expected ~~recovery~~ fall in unemployment does not materialise.

TOP SECRET

1

cc PS/Paymaster General
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir Derek Mitchell
Sir Bryan Hopkin
Mr Lord
Mr Pliatzky
Mr Airey
Mr Baldwin
Mr Barratt
Mr K Couzens
Mr F Jones
Mr Jordan Moss
Mr Posner
Mr Downey
Mr Turnbull

PRINCIPAL PRIVATE SECRETARY

REFLATION AND THE BALANCE OF PAYMENTS

As the Chancellor is aware, in order to fulfil the Cabinet's remit of 6 November for a discussion early in the New Year, MES is to consider the issues of reflation and the balance of payments. The Secretary of State for Employment and the Secretary of State for Trade may be circulating a paper for the meeting. I attach a draft paper for the Chancellor to consider, commenting on their proposals and setting out his own conclusions.

Leave in information of staff.

2. The Chancellor has obtained the agreement of the Secretary of State for Employment to holding this discussion in a fortnight's time. This is welcome. It will permit MES to concentrate on the options for policy on prices and on the future of the Vehicle Excise Duty at its meeting on Tuesday 27 January. Then in the following week, MES can discuss the closely-linked questions of the form of the pay limit in the second round of pay policy and economic strategy at the same time as the issue of reflation and the balance of payments.

3. If the Chancellor is content with the attached draft of his paper for MES, he will wish to consider whether he should show it in draft to the Secretary of State for Employment and the Secretary of State for Trade before circulating it to the Committee.

DW

DOUGLAS WASS

22 January 1976

DRAFT OF A PAPER BY THE CHANCELLOR TO MES

REFLATION AND THE BALANCE OF PAYMENTS

1. At Cabinet on 6 November it was agreed that there should be further discussion of the issues of reflation and the balance of payments early in the New Year - CC(75)46 conclusions. In this paper I set out my own view of the prospect and the policies we should adopt.

Economic Background

2. Since our earlier meeting in Cabinet there has been no new official forecast though I expect to have one in a few week's time. Recent indicators suggest, however, that the economic outlook will not be very different from that which we were then envisaging. There are some signs that we have passed the bottom of the recession; for example, industrial production in November rose for the third month running to a level nearly [ ]% higher than in May, its low point. We expect output to continue rising throughout 1976.

3. There is a substantial lag before the increase in output will feed through to employment. Unemployment will probably go on rising into the second half of 1976, though there should be a significant decline thereafter.

4. The balance of payments improved substantially in 1975. The current account deficit, at £1.7 billion, was less than

half that of 1974. But this was largely due to the recession and no significant further improvement is expected this year or next: indeed, the prospect is one of renewed deterioration once the recovery of domestic demand gets under way.

5. The present round of pay policy has so far been successful and there is a good prospect that the year-on-year rate of inflation will be down to single figures by the end of 1976.

Policy Implications

6. The main constraint on policy arising from this economic prospect is the problem of financing the balance of payments deficit over the next 2 or 3 years. Although the IMF facilities will help in 1976, I see no prospect of financing subsequent deficits unless our domestic policies command the support of the IMF and our other overseas creditors. A continuation in the downward trend in the rate of price increases would help greatly. But our creditors are also likely to expect to see progress towards the elimination of the external deficit.

7. Thus, as I said in my paper C(75)114, the scope for any change of policy is limited. Despite the outlook for a continuing temporary rise in unemployment, any substantial reflation would undermine the gains we have achieved with such difficulty and merely represent a repetition of past mistakes.

It would increase the rate of growth of demand in 1977, which is already likely to be more than we can cope with, and would open us up to additional foreign competition which would further damage our manufacturing base - and all for little or no gain in employment in 1976. It would worsen the balance of payments and the borrowing requirement, and could well put the financing of the external deficit beyond our reach. If this happened we should be forced to cut back sharply, with highly disruptive consequences.

8. In recent bilateral discussions I have found the TUC leaders thoroughly realistic in recognising the force of these constraints. On the other hand they are - as we must be - deeply disturbed about the prospect of a further rise in unemployment. They recognise that there is, in fact, little that can be done to affect the level of employment during 1976 because of the lag between fiscal action and employment, but they are anxious to be reassured that the Government will pursue policies which will bring unemployment down to more acceptable levels within the next 2-3 years.

Trade Restrictions

9. Some would say that the way forward to reduce unemployment without damaging the balance of payments is to introduce a wide range of generalised trade restrictions. I must warn my colleagues that in my view this course would be neither effective nor negotiable. The measures would arouse such international hostility that we could not hope to keep them

for more than a year or perhaps two. This would be much too short a time for them to have any significant effect on unemployment or to provide any opportunity of improving our industrial competitiveness. If we were to aim at cutting imports by (say) £1 billion, the Treasury estimate that unemployment would hardly be reduced in the first year and would fall by at most 100,000 in the second. But to count even on this gain would be unrealistic because:-

a. We could expect other countries to retaliate against our exports or emulate our move towards protectionism - and there is no doubt that in the long run action of this kind would be against our interests as a major trading nation. ~~Moreover~~ Some of the saving on imports would in practice be met from home production which would otherwise be exported.

b. Even with the adoption of trade restrictions we should still have a substantial deficit to finance, yet the adoption of such restrictions would jeopardise access to external credit, bilateral, multilateral and from the market. In particular, we should be denying ourselves access to further IMF facilities: indeed, to the extent that our existing facilities have not been drawn, they could well be withheld.

c. As members of the EEC, we would need the approval of the Council under Article 109 of the Treaty of Rome and I see no prospect of achieving this.

d. Although we have recognised that selective import controls may have a part to play in the circumstances of a particular industry, generalised trade restrictions, far from fostering industrial recovery, are more likely to lead to widespread inefficiency.

<u>The Way Forward</u>

10. For all these reasons, I believe that generalised trade restrictions should be rejected in present circumstances. In my view a more viable policy lies in continuing our attack on inflation to bring our costs into line with those of our competitors, and in a regeneration of industry to provide the springboard for a higher growth rate.

11. To continue the momentum of our counter-inflation policy it will be essential to obtain a second round of pay increases substantially below the £6 limit used this year. It should be our aim to impress on the unions that such a limit is in their own interests. Among the arguments we can use are the following.

i. A low limit would reinforce success in the attack on inflation and get down to the 6% area by the end of 1977. This is the obvious next step if we are to get back to earlier more moderate inflation levels instead of just holding the gains already achieved. This is the more necessary because there is a real risk that after 1976 world inflation will turn up again. Without this further effort we could soon find ourselves back in double figures. Inflation needs to be decisively beaten if all our objectives, including high levels of employment and the present standards of the social services, are to be secured.

ii. A low limit would raise the sustainable level of employment by encouraging movement of resources into the right sectors: exports and investment. It would be a big step towards getting down to the inflation levels of our competitors and staying there, so helping exports and competition with imports. It would give a big boost to industrial confidence and stimulate investment by that route. It would also improve consumer confidence, especially in areas which involve taking on new borrowing obligations like housing and cars. It would reduce the risk of stop-go.

iii. Overseas as at home there would be a valuable confidence effect which would show up in a better trend on the exchange rate and a greater readiness to invest here and lend to us.

iv. All this would put us in better shape to profit from the 1977 boom and get some sustainable growth out of it without another collapse.

v. In short a low pay limit is essential if we are to break out of the economic box in which we have found ourselves and put the Government in a position to transform our economic scene by the end of this Parliament. We would have gone a long way towards bridging the gap till the oil comes into flood. The £6 limit if it holds will have saved us from disaster. Another similar limit would prevent a slide-back. But a limit well below this would be a major step forward.

12. I am sure that the country now recognises these arguments and is prepared to accept a further round of wage restraint. But we cannot be insensitive to the big social problems of / living standards and unemployment which will remain with us for a year or two. General reflation is ruled out because of our present balance of payments difficulties, and the TUC recognise this. A low pay norm does not, in fact, imply a further decline in living standards. It would, of course, slow down the

recovery of real incomes but at the same time it would present us with the opportunity to do something to offset this adverse effect by fiscal means.

13. Nothing in the present situation should stop us from doing more to take the worse edge off unemployment. I am currently exploring such possibilities as increased training, some further employment subsidies, some temporary public construction works and some new selective schemes to increase investment. Such measures have real economic merit, for example by relieving bottlenecks in the upturn, and the TUC set great store by them.

14. Thus in the short term we are doing all we reasonably can. So far as the longer term is concerned, we have to secure improved competitiveness and increasing industrial strength to expand output and take up the unemployment. The pace at which this can be achieved is highly uncertain and it would therefore be foolish to commit ourselves irrevocably to an unemployment target. We cannot insulate this country from the world economy, and this would be equally true if we adopted generalised trade restrictions. Having taken such action as we can to ameliorate the worst effects of the slump, the key to recovery is to hold our nerve until we see clear signs of output reviving and, in the wake of that, unemployment beginning to fall. When this happens much of the present anxiety will disappear.

(Energy)

SIR DOUGLAS WASS

CO-ORDINATING GROUP 4 DECEMBER

I attach a note on yesterday's Co-ordinating Group meeting.

2. Nothing of great moment, but you may find the annexed note on the Danish Government's latest measures interesting. The contrast with our own approach is a pretty startling one.

3. I spoke at some length about the development of our own policies, centering on the 15 November statement. There was great interest, and a long discussion, but, as I have commented in the note, I sensed a feeling that the other participants preferred to be spectators at our game rather than actually engaged in it.

4. As you will see, the next meeting of the Group is tentatively scheduled for 14 January. Italy will be in the Chair.

J B UNWIN
5 December 1979

Mr Unwin

Thank you.

The exclusion of energy from the Danish wage-regulating index rests, I suppose, on the proposition that wages should be compensated only for movements in the GDP deflator. Their index already excludes indirect taxation.

AA - 5-12

DW

5/12

NOTE FOR THE RECORD

Co-ordinating Group: Brussels - 4 December

I represented Sir Douglas Wass at the Co-ordinating Group meeting in Brussels on 4 December. Others present were:-

Netherlands	-	Rutten
Luxembourg	-	Bruck
Ireland	-	Cromien
France	-	Le Roux
Germany	-	Schlüter
Denmark	-	Borglam-Jensen
Belgium	-	Thuysbaert
Commission	-	Morel, Emerson and Van Den Bempt

O'Cofaigh (Ireland) took the Chair for the last time.

Annual Economic Report 1979-80

2. Textual comments were invited and the Commission amendments at Annex A circulated. Apart from a few detailed points from other delegations, the main suggestions were those which I tabled and circulated in the paper at Annex B. I explained that apart from the changes to page 20 (the UK guidelines), which in part were the same as those proposed by the Commission, my amendments reflected the view that the report was generally too optimistic about the prospects of moving to a more relaxed budgetary stance in 1980 and that the necessity to be satisfied that inflationary pressures were being contained needed greater emphasis.

3. After some discussion the substance of my amendments was accepted on the following basis:-

Page 1: New sentence to be added at end of page stressing the need to be satisfied that inflation is being contained;

Page 6: accepted subject to manuscript changes marked on Annex B;

Page 21: accepted subject to manuscript changes marked on Annex B.

I also indicated acceptance of the Commission amendment to the second from last sentence of the UK guidelines on page 20, while insisting on my own revise of the remainder.

4. By way of implicit criticism of the Commission's publication of the Report prior to consideration by the Finance Council I raised the question of procedures for further handling. Mr Christofas explained that the Council would publish the text with the agreed amendments and, after submission to the jurists/linguists, would present the amended text to the Finance Council on 17 December. It was also hoped to have it ready for COREPER next week.

Recent Developments

5. Taking the Commission document of 21 November "The Economic Situation in the Community" (presented to the Dublin Council) as our background text, there was a general discussion of recent developments in which Jensen and I took the lead.

Denmark

6. Jensen introduced the interesting note at Annex C which describes the Danish Government's 4 December anti-inflation package, following the temporary freeze imposed at the beginning of November. He added little to what is contained in the note, but answered questions. The French and Germans queried the exclusion of energy prices from the new index, pointing out that the indirect effects were probably as large over time as the direct and would presumably not be covered. Jensen admitted the technical difficulties but took the view that this was no reason for not having a try.

7. I asked about union acquiescence. Would the unions wear the new measures, particularly given the tampering with the indices and the indexation arrangements? If so, what was the secret? Jensen explained that both blue and white collar unions had accepted the proposals, although they had had to be bought by some douceurs in the form of price, dividend and rent controls, some redistributive tax proposals, and proposals for profit sharing and employee participation in management. On the whole he displayed remarkable confidence in the chances of the package's success.

UK

7. For the UK, picking up from Sir Douglas Wass' account at a previous meeting of UK policies starting with the Budget, I gave a fairly full account of developments leading to the 15 November package and of the package itself. I stressed the presentational impact of the package as an unambiguous affirmation of the Government's determination to stick to its anti-inflation policies and referred also to the 1980-81 expenditure White Paper and to the consideration being given to the possibility of a medium-term financial plan. On the former I registered a doubt as to whether the (already substantial) cuts would be sufficient; and I invited any views on the latter. I also gave a brief account of the main features of the 22 November Industry Act Forecast.

8. There was great interest and many questions. Some were on the forecast (easily dealt with); others (reflecting some concern) on the key question of how deep and long the recession would have to be before the Government's monetary policies succeeded in getting pay settlements down and achieving the aim of mastering inflation. Jensen in particular pressed on the absence of any incomes policy and others referred to the need for reaching some understanding with the unions. I dealt with these on familiar lines, making much of the importance of changing expectations, and also drew attention inter alia to this week's NEDC meeting and the range of measures (Competition Bill, decontrols, industrial relations legislation etc) for improving the supply side of the economy.

9. Only Emerson rose to the bait on the financial plan. And his intervention was essentially to register interest and ask to be kept in touch with developments. On the whole the reactions round the table to our policies generally were apprehensively favourable, with a flavour of being glad that the UK were conducting the experiment in this fashion rather than themselves.

Other Countries

10. In a quick tour de table of the other members little of note or novelty emerged. The general tone was less gloomy than might have been expected, although it was stressed that a great deal depended on world developments and on the performance of Germany herself. On Germany,

Schlecht presented a pretty favourable picture, with 2½ to 3% investment led growth next year and union acceptance that the increased oil bill meant substantially less to be handed out in wages. I had the feeling that several participants (notably Italy and Denmark) were putting on a braver face than the facts warranted and that there was little reason to revise upwards the Commission's sombre assessment of the outlook next year.

Convergence and Coordination

11. Little discussion except agreement on the need for virtue. The references in the Dublin communique were noted and Emmerson said that the Commission hoped to circulate soon the long delayed Commission paper on coordination. The agenda for the next Finance Council would be discussed at COREPER and the question of follow up on convergence would not doubt arise.

Budget Contributions

12. No discussion whatsoever. I kept off.

Next Meeting

13. Probably on 14 January, with Italy in the Chair.

JBU

J B UNWIN
5 December 1979

Distribution:

Sir D Wass
Sir K Couzens
Mr Jordan-Moss
Mr Barratt
Mr Byatt
Mr Middleton
Mrs Hedley-Miller
Mr Ashford
Mr Turnbull

Mr Folger
Mr Mercer
Mr Thomson
Mr Fitchew - UKREP
Mr Fretwell - FCO
Mr Balfour - B/E
Mr Appleyard - Paris
Mr Boyd - Bonn
Mr Adams - Rome
Mr Ryrie - Washington

(Amendments by Commission handed round at Coordinating Group on 4 December).

Annex A

3.12.1979

Amendments to Annual Economic Report 1979/80 proposed by the Commission

Denmark

Line 1 : delete "significant".

Line 3 : replace "Despite the recent adjustments" with "Although aided by the recent adjustments".

between line 9 and 10 : introduce sentences "In this regard steps must be taken to ensure that automatic indexation does not cause the impact of the higher cost of imported raw materials to be passed on to nominal incomes. For this reason, an alteration in the nature of the indexation system would seem to be highly desirable".

Germany

replace 3rd and 2nd from last sentences from and with:
"The rate of increase of central bank money is at present close the lower limit of the range of 6 to 8 % set last year by the Bundesbank. For the year to come, the Bundesbank has fixed a target rate of growth of 5 to 8 % from the fourth quarter of 1979 to the same quarter of 1980 - so as to keep, on the monetary side, to a relatively limit margin for price increases.

last sentence : replace "Such a policy" with "This policy".

Italy

13th line : delete ", which implies a slight reduction as compared with 1979 (14,6 %)".

United Kingdom

13th line : replace sentence beginning "Exchange controls ..." with "In addition exchange controls except those relating to Zimbabwe/Rhodesia have been abolished ".

17th line : delate "much". ✓

accepted

2nd from last sentence : replace "by adjusting the target rate for the growth of monetary supply" with "by relaxing the stance of monetary policy". ✓

(Handed round by JBU at Coordinating Group on 4 December)

Annex B

DRAFT ANNUAL ECONOMIC REPORT 1979-80

Amendments suggested by the UK

<u>Page 1</u>: Revise last sentence of penultimate paragraph to read:-

"Provided it is clear that monetary objectives are being achieved and inflationary pressures successfully contained it may become possible in 1980 to maintain a significant momentum of growth ...".

<u>Page 6:</u> Revise first two sentence of last paragraph to read:-

"Provided this is achieved there ~~may~~ should be some room for manoeuvre for policy to develop. Control over monetary aggregates should be kept steadily to present strict policies, but, provided inflationary expectations are decisively abated, it may become possible and desirable

omit to move [in the course of 1980] to more supportive budgetary policy, if also investment and consumption were weaker than expected".

<u>Page 20</u>: Revise lines 13 to 17 to read:-

"Exchange controls, except those relating to Zimbabwe-Rhodesia, have been removed. Taking into account the effects of the new monetary and budgetary policies, domestic demand is expected to weaken in 1980 and the deficit on the current account of the balance of payments should be reduced".

<u>Page 21</u>: Revise (ii) to read:-

"Provided it is clear that a durable reduction in inflation has been achieved, it ~~may~~ should become possible to adjust policy [in the course of 1980] into a more actively supportive posture ...".

(Handed round at Coordinating Group on 4 Dec) Annex C

DANISH ECONOMIC POLICY MEASURES
December 4, 1979

In order to combat unemployment and inflation and in order to obtain a substantial and progressive improvement of the balance of payment the Danish Government yesterday announced and to-day submitted to Parliament a comprehensive package of proposals for legislative action.

With the aim of reducing domestic inflation and improving external competitiveness it is proposed that firm legislation on prices and incomes should supplement the temporary freezes imposed at the beginning of November. Regarding wages and salaries substantial modifications of the indexation system are proposed. Thus prices on energy items such as heating, gasoline and electric power will no longer go into the calculation of the wage regulating index. Furthermore it is intended to preclude wage and salary adjustments on account of the effects on consumer prices of the recent devaluation of the Danish krone. In addition special measures will be in force with the aim of preventing wage drift. Regarding other kinds of income there is proposed restrictive legislation on prices, profits, rents and dividends.

It is expected that the measures outlined above will bring about a reduction of the rate of growth of nominal incomes by approximately one half. The laws will expire by the end of February 1981 together with the present wage and salary contracts (fixed by law this spring as negotiated agreements could not be obtained). It is, however, the intention of the Government that the reduced growth rate shall be maintained through the following years.

Slower growth of incomes and costs will - together with the krone devaluation - give strong impetus to exports and may at the same time help to reduce imports. However, it is also thought necessary to increase taxation in order to reduce demand in general and to facilitate the shift of resources towards industries in international competition. Some of the proposed tax measures (such as a tightening of the rules on deduction of interest expenses by the assessment of taxable income) will not become effective until 1981. Other proposals will on the other hand yield additional tax revenue of more than one billion Dkr. already in 198o, and this will come on top of last summer's energy tax package at the same time as large reductions of state and local authority spending become effective.

Lower growth of incomes, higher import prices and tighter fiscal policy will - taken together - have a strong impact on consumer purchasing power and this tendency will be reinforced by continued efforts to reduce consumer borrowing.

As a result domestic demand is by now expected to go down by 1-2 per cent in real terms from 1979 to 198o. The reduction is expected to be particularly strong regarding private consumption (3-4 per cent down). Public expenditure is expected to grow only slightly in 198o (1 per cent in real terms).

In order to assure an equitable distribution of the gains and losses following from the proposed policies the package also comprises measures which directly aim at changing the distribution of income and wealth. Among other things it is proposed that Parliament should adopt a resolution requesting the Government to prepare bills on profit sharing and employees' participation in management.

16
3
7.

National Economic Development Office

Millbank Tower, Millbank, London SW1P 4QX
Telephone 01-211 5386 or 01-834 3922

Director General
Geoffrey Chandler CBE

Mr Butt Mr ~~Kesnott~~
for advice please.
PG 2/7

27th June 1980

PERM. SEC'S. OFFICE	
Advice	MR ~~DIXON~~
Copies to	MR RYRIE
	MR MIDDLETON
	MR UNWIN
	+ 1

Dear Douglas,

COMMITTEE ON FINANCE FOR INDUSTRY

I wrote to you on 28th May, following the meeting of the Group of Four which you could not attend, at which the CFI Chairmanship, terms of reference, and work programme were discussed.

We have now heard informally from the TUC that John Baring is likely to be acceptable as Chairman, but that this will need to be formally agreed at the meeting of the TUC's Economic Committee on 9th July. I know that he is acceptable to the CBI and I assume that this applies similarly to the Treasury. If this is right, the way will be open to appoint him after we have heard formally from the TUC.

I think it would be helpful if in the interim the main parties to the CFI were to make nominations for membership so that we can activate the Committee quickly once the TUC's formal agreement has been obtained. Could I therefore please have your nominations for the three Government seats on this Committee by mid-July? (You will remember that during the last session these seats were occupied by Fred Jones, John Lippitt, and John Burgh, all of whom need to be replaced).

There are two formal points to raise: First, I assume that, as was recently agreed for EDC Chairmen, the appointment would be by me, rather than the Chancellor, though I have no strong feelings on this. Because of the Bank's special position in relation to the committee I would propose to make the appointment "on behalf of the National Economic Development Council and after consultation with the Governor of the Bank of England". I believe that this formula would be acceptable to Gordon Richardson. Second, I would doubt whether in view of the Group of Four discussions it is necessary to seek Council approval for continuing with the CFI. However, I would propose to circulate a short "For Information" note to the August meeting of NEDC setting out the terms of reference and membership of the new CFI. This would repeat what was done at the last reconstitution.

2/...

20.30.6

You may incidentally find it helpful to have a copy (attached) of the revised terms of reference and proposed work programme of the CFI in the form agreed at the Group of Four meeting on 28th May.

Yours ever,

Geoffrey

Sir Douglas Wass, GCB

F (P.L. Appts)

(DN has talked Ch/Ex. We await his news.)

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretar
Mr Ryrie
Mr Middleton
Mr Dixon
Mr Unwin
Mr Butt
Mr Prescott

COMMITTEE ON FINANCE FOR INDUSTRY

You may be interested to know where matters now stand on reconstitution of the Roll Committee, and on the question of the chairmanship.

Terms of Reference

These, and the work programme, have now been agreed by all the parties concerned including the Governor. The texts are at Annex.

Chairmanship

Following our discussion earlier this year, I consulted Murray, Methven, Chandler and the Governor about possible candidates. We considered a number of names. As you know, the Governor's original preferred candidate was Douglas Croham, but you and the Prime Minister thought it would be better to have someone younger. Neither Murray nor Methven had anything against Croham as a person, but both thought that his appointment would look like a "takeover" by the Bank, especially as the Governor had recently joined the Council.

We therefore invited the Governor to make other suggestions and, after further consultations, he has now recommended John Baring who is currently Chairman of the Accepting Houses Committee. We understand that Baring himself would be pleased to take this appointment on.

John Greenborough has confirmed that Baring would be acceptable to the CBI. At one stage, Murray had expressed a preference for an industrialist with experience in the City if possible, but he too is now ready to support Baring. But he has to get the formal agreement of the Economic Committee which does not meet until Wednesday 9 July.

As I told you in another connection I have a high opinion of John Baring and I think he would be a good and effective chairman of this Committee.

Next Steps

Provided you are content with the proposed terms of reference/work programme, and the chairmanship, the next step would be for Chandler to put a note to NEDC inviting the Council to endorse reconstitution. But, because of the difficulties over timing with the TUC, this could not happen until the August NEDC. The formal appointment of the Chairman and members would follow immediately after endorsement by the Council.

It is proposed that the Committee should, in the first instance, be reconstituted for a period of two years, with appointments running concurrently. It is also intended that the composition of the membership should remain unchanged - i.e. four places each nominated by the TUC and the CBI, four City places nominated by the Bank and one for the Bank itself, the Director General and three Government places nominated by the Treasury. (Mr Ryrie proposes to represent the Treasury, and we would offer the Departments of Trade and Industry one seat each).

Previously, the Chairman was appointed by the Chancellor and the members by the Director General. However, it is for consideration whether the appointment of the Chairman should now be made by Chandler, on behalf of the Council, in line with the new arrangements for appointing EDC Chairmen. On the whole I think that this procedure is right. In the meantime, however, NEDO are inviting

the parties informally to start thinking about their respective nominations for the membership.

Because of her earlier interest, you may wish to tell the Prime Minister where matters now stand. You could mention this at your regular meeting with the Prime Minister, or we could let you have a draft note. I would also like to let Greenborough, Murray, Chandler and the Governor know as quickly as possible whether or not Baring would be acceptable to the Government.

DW.

DOUGLAS WASS
20 June 1980

COMMITTEE ON FINANCE FOR INDUSTRY

Terms of Reference

To consider and keep under review the supply of and demand for funds for industry and commerce and factors affecting them, and to report on these matters to the Council.

Work Programme

(a) Financial issues thrown up by EDCs and SWPs.

(b) A continuing examination of regular reports on company finance, having particular regard to (a) profitability and (b) cost and availability of finance, in the light of the current economic situation.

(c) An examination of the financial conditions necessary for industrial recovery in the longer term.

(d) Work arising from the reports of the Wilson Committee, eg on ways of improving the efficiency of the capital market, the provision of equity finance for firms, and so on.

IP 2/54/01

Pl. type/sig.

1. MR ~~DIXON~~ PD 18/6

2. SIR DOUGLAS WASS

cc Mr Ryrie
Mr Middleton
Mr Unwin
Mrs Heaton
Mr Butt o/r

COMMITTEE ON FINANCE FOR INDUSTRY

Following the last meeting of the Group of 4, you asked for a note for the Chancellor setting out where matters stood on the related questions of the terms of reference and the chairmanship for CFI. You subseqnently agreed that we should wait until we had firm confirmation from the TUC of their support for Mr Baring as chairman. I have spoken to Mr Burgner who in turn has spoken to David Lea. Mr Lea apparently confirms that the TUC will support Mr Baring, though this still requires formal endorsement from the TUC Economic Committee which does not meet until Wednesday 9 July. In view of this further slippage, you may feel it would be wrong to delay any further in reporting progress to the Chancellor. A draft minute is attached.

2. I am assuming that you will wish to add some advice of your own about Mr Baring's qualifications for the job.

3. There will at some stage need to be a press announcement about reconstitution of the Committee. However, this cannot happen until NEDC has had the opportunity to endorse the proposal and, because of the timing difficulties with the TUC, this could not happen until the August NEDC. However, part of the Committee's work programme will be work arising from the Report of the Wilson Committee. This report will be published on Wednesday 25 June. If it was felt** that the announcement of the reconstitution of the CFI should follow close after the Wilson Report, it would be necessary to get NEDC endorsement for reconstitution at its next meeting on 2 July. But this could only happen if the TUC were prepared formally to commit themselves in advance of their meeting of the Economic Committee. You may wish to have a word with Mr Murray about this.*

4. A second procedural point concerns the appointments themselves. Previously, the chairman was appointed by the Chancellor and the members by the Director General. I have suggested that, in line with

*I have not gone into this in the draft

** I do not think this matters too much.
PD 18/6.

77.19.6

the new arrangements for the EDCs, all appointments might in future be made by the Director General on behalf of the Council - though, again, this could not happen until the Council had endorsed the reconstitution itself. As the Committee is a child of the Bank as well as NEDO, the Director General would also need to make it clear that the reconstitution etc was in agreement with the Bank. (You may also wish to send the Governor a copy of the submission to the Chancellor.) In the meantime, NEDO are proposing informally to invite the parties to start considering their nominations for the membership.

M PRESCOTT
19 June 1980

CONFIDENTIAL

TELEPHONE
01 - 601 4444

BANK OF ENGLAND
LONDON EC2R 8AH

29 May 1980

30/5/80 SB

Sir Douglas Wass GCB
HM Treasury
Parliament Street
London
SW1P 3AG

c.c. Mr. Dixon
Mr. Ryrie
Mr. Middleton
Mr. Unwin
Mr. Butt.
+1

My dear Douglas

As you know I have given careful thought to the Chairmanship of the Committee on Finance for Industry and Douglas Croham, who I considered would be an admirable candidate, was my original recommendation. Given that there were some misgivings, I consulted further and I was able at the end of last month to tell Geoffrey Chandler that John Baring would be very ready to become Chairman if asked.

I hope therefore that the result of the next Group of Four Meeting wll be agreement on John Baring to enable the Committee to be reconstituted. He is, of course, now a very senior figure in the financial world.

I am sure Geoffrey Chandler will have been in touch with you about this but I thought that I should write to you to avoid any misunderstanding.

Yours ever

Gordon

pmp

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

From the Minister

EXCHEQUER
10 DEC 1982 M. 10.xii
ACTION Mr Fitchew
COPIES TO CST FST EST MST(C) MST(R)
Sir D Wass
Sir K. Couzens
Mr Littler

CONFIDENTIAL

The Rt Hon Francis Pym MC MP
Secretary of State for Foreign and
Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
LONDON
SW1A 2AL

10 December 1982

Mr Carey.
Mr Lovell
Mr Hawtin
Mr Ridley

FRANCO-SOVIET AGRICULTURAL AGREEMENT

I was very disturbed to see UKREP telegram 4744 of 9 December reporting the latest state of play within the Commission on the Franco-Soviet agricultural agreement.

It is evident from this that the French lobbying, which I referred to in my letter of 29 November to you, is proving to be increasingly effective, and it seems to me there is now a very real danger that the Commission will try to duck the issue for the reasons given in paragraphs 2 and 3 of the telegram. I therefore strongly endorse Sir Michael Butler's suggestion that you should raise this with Thorn and Haferkamp in the margins of next week's Foreign Affairs Council. In particular, I think you should stress to them that we regard this issue as an important test of the Commission's willingness to take a firm stand against persistent and flagrant French transgressions of the Treaty.

I should also say that coincidentally the general question of long-term export contracts will be on the agenda for next week's Agriculture Council, and, whilst I appreciate the need to avoid giving the impression of conducting a bilateral dispute with the French, I think it would be wrong, in this context, if I were not to make at least a passing reference to the Franco-Soviet agreement.

/I would, however, do this ...

CONFIDENTIAL

I would, however, do this in a way which was directed at the Commission and which sought to elicit both a statement of where they now stand and a view of the legality of the agreement. I will also see whether I can get the Germans and the Dutch to weigh in as well. If they can be persuaded to take the lead, so much the better: but, even if they only speak in support of our reservations, that would clearly be helpful.

I am copying this letter to the Prime Minister, to the members of OD(E) and to Sir Robert Armstrong.

PETER WALKER

PWP

Foreign and Commonwealth Office

London SW1A 2AH

John

11 November 1982

Dear Jill

Please find enclosed as requested the item that appeared in 'Komsomolskaya Pravda'', together with a full translation and a reference to the same incident that was broadcast on Moscow Radio's Home Service.

Yours ever

(C P Greenwood)
Assistant Private Secretary

Miss J Rutter
Assistant Private Secretary
HM Treasury

Copy [illegible]

Did Brezhnev die laughing?

...дится на ...ии Бель... существо...

•ТЕЛЕ•ТАЙП•

...«Марше мира советской молодежи».

Ю. КУДИМОВ.

РЕПЛИКА

"РЕЗАТЬ ТАК УРЕЗАТЬ!

У сэра Джеффри Хау украли брюки. Причем украли при обстоятельствах самых необычных — в поезде Манчестер — Лондон.

Кому же понадобились штаны министра финансов правительства ее величества? То ли кто-то из пассажиров решил пошутить в «лучших» традициях английского юмора, то ли оказавшийся поблизости поездной воришка понадеялся, что уж у такого пассажира должны быть при себе деньги, и немалые. Так или иначе, но конфуз вышел изрядный и вызвал едкие и колкие комментарии прессы. Как и после недавнего скандального посещения безработным англичанином резиденции королевы в Букингемском дворце, многие задаются вопросом: а что же делала охрана, на которую из кармана налогоплательщиков ежегодно изымают крупные суммы?

Понятно, что у сэра Джеффри огласка этой истории вызвала особенно неприятные эмоции. В адрес железнодорожников последовал раздраженный упрек в том, что они должны были бы обеспечить порядок в поезде. На что был дан резонный ответ: после нещадных сокращений бюджетными ножницами расходов на национализированный сектор экономики железнодорожный транспорт остался практически без штанов, то есть без штатов, и поэтому трудно добиться даже бесперебойного движения поездов, не говоря уже о порядке в вагонах. Пикантность ситуации состоит и в том, что именно сэр Джеффри проводит жесткий монетаристский курс правительства консерваторов, в результате которого резко сократились государственные расходы на промышленность, образование, медицину, жилищное строительство и другие социальные нужды.

Англичане надеются, что скандал с брюками министра финансов будет для него весьма поучительным. Ведь сэр Джеффри впервые на себе прочувствовал то положение, в которое он и правительство тори поставили английские заводы, транспорт, школы, больницы, муниципалитеты, театры...

...У сэра Джеффри, к счастью, были при себе запасные брюки, и он, как и подобает джентльмену, с честью вышел из щекотливого положения. Но миллионам англичан, которые остались в брюках, обрезанных бюджетными ножницами консерваторов, гораздо труднее выпутаться из своего отчаянного положения.

А. ЛОПУХИН.

КОГДА ВЕРСТАЛСЯ НОМЕР

В Лондоне открылась новая сессия британского парламента. С тронной речью на ней выступила королева Великобритании Елизавета II. В этой речи, которую по традиции готовит правительство, изложена программа консервативного кабинета на предстоящий год в области внутренней и внешней политики.

Правительство не предложило каких-либо конструктивных мер по выводу английской экономики из затяжного кризиса.

В речи прозвучал призыв к сокращению государственных ассигнований в таких важнейших областях, как здравоохранение, образование, жилищное строительство.

(ТАСС).

Варшавского Договора — они недавно вновь подтвердили это на заседании Комитета

Монумент со свалки

Other Reports

'Pravda' on the "parameters of security in the nuclear age" (Text) 'Pravda' publishes an article by Comrade Lvov, "The parameters of security in the nuclear age". The author underlines that observance in practice of the parameters of detente is of particular importance in relations between states that belong to different social systems. There exists only one sensible basis for these relations: peaceful co-existence. However, the problem of international security does not end with the political aspects. There isalso another side of the affair which can acquire, and in certain circumstances does acquire, a truly decisive significance. This is the military aspect of security. The article gives a detailed analysis of Washington's position, which is embodied in the appropriate strategic doctrines adopted in the USA in recent times, ranging from a massive first nuclear strike to limited nuclear wars. (Moscow home service 0200 gmt 29 Oct 82)

Secretary of British CND interviewed "Radio Peace and Progress" broadcast on 31st October (in German 1530 gmt) an interview with Bruce Kent, Secretary of the CND, in which he stated: "Our organization, as well as the movement of peace supporters in general, has to contend with the use of pressure and all sorts of insinuations. As in other West European countries and the USA, an attempt is being made to label those who oppose the nuclear arms race as mediators of Soviet interests. We are resisting such attacks by explaining our position and publishing statements by influential politicians warning against the disaster of present developments, for example the US diplomat George Kennan. In the past he was a "hawk", but now he speaks of the USA's fundamental responsibility for the arms race; or Lord Mountbattan: in his speech in Strasbourg he also blamed the arms race on Washington." Kent also said that the aim of the organization was to try to help people realize the deadly danger of nuclear missiles and recognize the necessity of opposing the production and stationing of these weapons.

Gordon Schaffer interviewed (Excerpt) All people wish to live and raise their children and grandchildren in peace, British public figure, laureate of the Lenin Peace Prize Gordon Schaffer said in an interview to 'Izvestiya'. Pointing out that mankind is now living through the most troubled period since the times of the Cold War, Gordon Schaffer said that every peace worker must now ponder on the question who acts in the interests of peace and who acts against it. It is quite apparent that the Soviet Union uses every opportunity to put an end to the arms race. Meanwhile, the USA is avoiding constructive talks on this question. It does so for the reason that it intends to continue developing and testing ever new types of lethal armaments. It intends to continue the arms race into the new century. These facts show clearly who is for peace and who is for the arms race. Gordon Schaffer said that it must be said that in the West, specifically in Britain, the mass media misinformed people and they quite often fail to understand the mechanics of the events in the world. Meanwhile, it is clear that an impetus to the arms race was given by the USA. After the war Truman and Dullas called a "crusade" against communism. The USA is now pursuing the same policy. . . (Tass in English 1726 gmt 2 Nov 82)

Zagladin's meeting with PCI officials (Text) 'Pravda' informed its readers of the meeting between Vadim Zagladin, member of the CPSU Central Committee and First deputy head of the International Department of the CPSU; and representatives of the Italian Communist Party [PCI] Directorate, Pajetta and Minucci; Rubbi who is a member of the PCI Central Committee; and the PCI Secretary General, Enrico Berlinguer. According to the paper, the exchange of views which unfolded in a climate of sincerity showed that the co-operation in the struggle against imperialism, to prevent war and for the cessation of the arms race was beyond any differences of opinion. It showed that the development of this co-operation presupposes the possibility of discussing as friends and from principled positions the problems which emerge, as well as the rapprochement of positions on the basis of mutual respect and observation of the norms of relations among parties. (Moscow in Italian 1800 gmt 1 Nov 82)

Theft of Sir Geoffey Howe's trousers (Text of report in "International Diary", presented by Vitaliy Sobolev and Oleg Blinov) Reuter reports an incident that alerted the British special services, soon to be debated in the Parliament. Geoffrey Howe, Chancellor of the Exchequer, had his trousers stolen from him on a train. Together with the trousers went £100. Conservative MP Dickens expressed his indignation in the following manner: We spend millions of pounds to ensure security for Cabinet Ministers, but if things like that happen, it is not worth a penny. The thing is that the thief contrived to get into the minister's closed sleeping compartment. Howe, who was upset AFP reports, found consolation in the fact that other passengers on the same train had also had things stolen from them. If one is to cast a wider glance at this incident, it is impossible not to recall the extent to which the present government's financial policy robs all ordinary British citizens. (Moscow home service 1030 gmt 2 Nov 82)

"IF YOU'RE GOING TO CUT, THEN CUT!

Trousers have been stolen from Sir Geoffrey Howe. Moreover they were stolen under the most unusual circumstances - in the London-Manchester train.

No the Russian is correct! [illegible]

Who needed trousers belonging to the Minister of Finance of Her Majesty's Government? Either one of the passengers decided to have a joke in the 'best' traditions of British humour or a petty train thief who happened to be nearby hoped that such a passenger certainly ought to have money on him, and quite a bit at that. One way or another there was a fair amount of embarrassment which evoked caustic and barbed comments in the press. Just as after the recent scandalous visit by an unemployed person to the Queen's apartments in Buckingham Palace, many are asking the question: what were the security people, on whose behalf large sums are annually extracted from the taxpayers' pocket, doing?

It is understandable that the publicity given to this episode evoked particularly unpleasant emotions from Sir Geoffrey. An annoyed reproach was addressed to railwaymen saying that they should have ensured that there was order in the train. To which a reasonable reply was given: after the merciless cuts inflicted by the budgetary shears on expenditure by the nationalised sector of the economy, rail transport was practically left trewless, that is to say crewless (Tr note. The pun exists in the Russian original), and it was therefore difficult to achieve even the regular running of trains, let alone order in the carriages. The piquancy of the situation consists in the fact that it is precisely Sir Geoffrey who is carrying out the Conservative Government's harsh monetary course, as a result of which State expenditure on industry, education, medicine, housing and other social needs has been cut.

The British hope that the scandal over the Minister's trousers will teach him a good lesson. For the first time, Sir Geoffrey was able to feel on his own skin the situation in which the Tory Government has placed British factories, transport, schools, hospitals, local councils and theatres ...

Fortunately Sir Geoffrey had a spare pair of trousers on him and he, as befits a gentlemen, was able to emerge from a ticklish situation with honour. But for millions of Britons who have been left in trousers cut by the Conservatives' budgetary shears, it is much more difficult to disentangle themselves from the desperate situation.

A Lopukhin

Author, not translator

Stop Press

A new session of the British Parliament has opened in London. Elizabeth II, Queen of Great Britain, made a speech from the throne. In this speech, traditionally written by the Government, the programme of the Conservative Cabinet for the forthcoming year in the area of domestic and foreign policy was laid out.

The Government has not put forward any constructive measures whatever to lead the British economy out of its long-drawn out crisis.

A call to cut State expenditure in such highly important fields as health, education and housing, was sounded in the speech.

(Tass)"

Komsomolskaya Pravda (5 November 1982)

EXCHEQUER
REC. 10 JAN 1983
ACTION Mr Bottrill
COPIES TO CST FST EST
MST(C) MST(R).
Sir A. Rawlinson.
Mr Wilding
?[Mr Carey]
Mr Ridley

Sir D. Wass.
Mr Littler.
Mrs Hedley-Miller.
Mr Lavelle.
Mr Lovell.
Mr Monger

REPUBLIC OF IRELAND: ANNUAL REVIEW FOR 1982

SUMMARY

1. The formation in March 1982 of an unstable minority Fianna Fail administration under Mr Charles Haughey signalled a deterioration in Anglo-Irish relations. The main areas of difference were Northern Ireland and the Falklands (paragraphs 1 - 3).

2. The scandals surrounding Mr Haughey which lowered his popularity (paragraph 4).

3. The November General Election led to a stable Coalition Government under Dr Garret FitzGerald (paragraph 5).

4. EC. Irish thinking evolved towards acceptance of restraints on agricultural spending, with continued insistence on the need to increase the height of the 1% VAT ceiling (paragraph 6).

5. Agriculture. 1982 was a better year for farmers but their incomes are still 40% below the peak of 1978 (paragraph 7).

6. The Economy. Mr Haughey's Government were late converts to fiscal rectitude. The problems are severe but Dr FitzGerald's Government are grasping the economic nettle (paragraphs 8 - 9).

7. UK/Irish Trade. We expect our exports to the Republic to total £2.4 billion for 1982, but there are constraints on the prospects for 1983 (paragraph 10).

8. Hope to see an improvement in Anglo-Irish relations in 1983 but we shall have to work much harder at Anglo-Irish affairs than in 1982 (paragraph 11).

BRITISH EMBASSY,
DUBLIN.

6 January 1983

The Right Honourable
Mr Francis Pym MP
Secretary of State for Foreign
and Commonwealth Affairs
London SW1

Sir,

REPUBLIC OF IRELAND: ANNUAL REVIEW FOR 1982

1. At the beginning of the year the Coalition Government under Dr FitzGerald seemed to be getting into its stride. The appalling hunger strike of 1981 which had so damaged our relationship had ended in September and normal life was being resumed. We and the Irish had constructed the edifice of the Anglo-Irish Inter-Governmental Council and we could look forward to moving towards a fruitful relationship. It did not take long for this happier frame of mind to be shattered. Dr FitzGerald's budget fell at the first hurdle in January when one of the independents, on whom the Coalition relied, voted against the surprisingly ham-fisted proposal to tax children's clothes and footwear. It seemed unlikely that Dr FitzGerald would survive the general election and as it turned out Fianna Fail under Mr Haughey could muster just sufficient support to form a government when the Dail reassembled on 9 March. But this support included three members of the Workers Party and an independent left-winger, Mr Tony Gregory, whose allegiance was bought by promises of considerable

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financial investment in his central Dublin constituency. The new Government did not look robust but its leader was a wiley politician who could be expected to survive where others might fail.

2. I was present in the Dail when Mr Haughey was elected Taoiseach and heard the speech he made at the moment of his resuming office. Although the Northern Ireland problem had not been mentioned in the election, apart from one speech by Dr FitzGerald, Mr Haughey said that it would now become his top political priority. I knew then that we would be in trouble and he lost no time in attacking Mr Prior's proposals for a Northern Ireland Assembly even before he had a clear idea of what they were. At the same time he tried to manoeuvre the US Government on to his side in his hostility to British policy on the North. His visit to Washington on St Patrick's Day, where he addressed various Irish-American gatherings and met the President, was part of this campaign. It was encouraging that the US Administration maintained their sensible line. In addition, he attempted to show that Fine Gael shared his hostility to our policy by leaking a letter which Senator Dooge had written to Mr Prior. The reasons why this was dishonest need not concern us here; the incident served only to hasten a deterioration in our relationship.

3. So by early April and the start of the Falklands crisis our relations were already fairly bleak. The behaviour of Mr Haughey, who personally made Irish Government policy

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in Brussels and at New York as the crisis developed, reflected an anti-British mood. I think it was brought about partly through pressure from the independents (Blaney and Gregory) who held the balance of power and partly from a genuine though misguided belief that he had been let down by our not consulting him about our Northern policy. He claimed that he was entitled to consultation under the terms of the communiqué of the Dublin Summit in 1980, thereby taking no account whatever of the subsequent development of the Anglo-Irish relationship during Dr FitzGerald's Government. Feeling aggrieved, Mr Haughey saw his opportunity to make life difficult for us during the Falklands crisis. After the sinking of the 'General Belgrano', the Republic cut loose from the European Community consensus and pursued an independent policy, particularly in the Security Council, which damaged the prospects for a negotiated settlement and indeed harmed Irish commercial interests and those of the Irish community in Britain. From May until the fall of his Government on 4 November our relationship never got off the floor.

4. The Annual Review would not be complete without a mention of the succession of scandals which had a direct effect in further lowering Mr Haughey's credit rating in public opinion. The most damaging was his Attorney-General's connection with a man wanted for two murders, who was finally run down and captured in the Attorney-General's flat. Shortly afterwards the Minister for Justice was accused of interfering in favour of a police officer, his brother in law, who had been accused

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of assault. Later, shortly before the election, the same Minister faced allegations of having used his influence to quash charges of traffic offences committed by his constituents. By late October Mr Haughey's popularity rating was 22 percentage points below that of Dr FitzGerald.

5. The general election took place on 24 November and a new Government was formed under Dr FitzGerald in coalition with the Labour Party under a new leader, Mr Dick Spring. I think it is a good Cabinet with plenty of talent. And this view was confirmed to me recently by Mr Jack Lynch, who was Mr Haughey's predecessor as leader of Fianna Fail and Taoiseach up to the end of 1979. Dr FitzGerald is approaching his very serious difficulties quite calmly and he can take comfort from the fact that this time his budget, although it will have to be harsh, will be one on which the Opposition will find it difficult to disagree since they produced the figures and he has accepted them.

6. In the European Community the Irish had little compunction in joining most of our other partners in using a majority vote to overcome our linkage between the budget arrangements and the agricultural price fixing. They had assessed the risks of our defection from the Community and decided that even in the event of a British withdrawal they would continue to be members. Officials were shaken when in July a senior official from London suggested that a UK withdrawal could lead to a reconstruction of the Community <u>à six</u>. Subsequent Irish thinking seems to have been evolving towards a less grudging acceptance of restraints on agricultural spending,

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with continued insistence on the need to increase the height of the 1% VAT ceiling in the context of enlargement and UK refunds. They took no part in the French rearguard action against the 1982 refunds, culminating in the agreement of 26 October, and readily understood the need for remedial Council action in December when the European Parliament blocked the deal. As partners, the Irish have been frank in their dealings with us. Their occasional obstinacy has been mitigated by their dislike of being the odd man out, but where their own interests are at stake they have not scrupled to shelter behind larger partners (eg the French over butter).

7. 1982 has been a better year for agriculture, thanks as much to the weather as to the price-fixing. Farm incomes are still 40% behind the peak of 1978 but the burden of indebtedness will be eased by falling interest rates. Some farmers are going to the wall and the sober prospects for agricultural prices (combined with the cash flow effects of the fall in incomes from 1979-81) are inhibiting further investments. Technically achieveable levels of output remain held back by farm ownership problems - age of owners and size of holdings, particularly in the less favoured areas, but the Community regime for sheep has offered opportunities which some farmers have been able to grasp.

8. On the economy, the year began with at least some Fianna Fail politicians claiming that the situation was not as black as Dr FitzGerald had painted it. This professed optimism did not survive their first sight of the books

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when Mr Haughey took over in March, and his Finance Minister, Mr Ray MacSharry, introduced a budget that was almost as severe as that which had brought about the fall of Dr FitzGerald's Government. Nonetheless for his first months in power Mr Haughey still behaved as though there was enough in the kitty to enable him to buy off particular interest groups and it was not until the Government spending cuts of 30 July that he recognised that there was no alternative to a hair-shirt. The Government's four year economic plan, 'The Way Forward', confirmed that Fianna Fail was taking the path of financial rectitude. But its publication came only a fortnight before the Government was defeated and it has slipped away into limbo.

9. The problems which confronted the economy in 1982 were not new: an enormous burden of foreign debt (estimated at about 55% of GNP), a very severe deficit in Government current spending (about £811 million in 1982) and a steady rise in unemployment (from 141,000 in January to 175,000 in December). The measures which the Fianna Fail Government took to reduce the current deficit proved to be inadequate because the yield from taxation fell drastically with the recession. It is now for Dr FitzGerald to grapple once again with the problems which unseated his last Government. There are some favourable trends. The rate of inflation has fallen from 23% last year to a rate of 13% in the twelve months to mid-November 1982; exports, particularly from the new high technology industries, are estimated to

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have increased by 18 1/2%; and the fall in world interest rates makes the burden of foreign debt less crippling. But the most single hopeful factor is the prospect of stable government, at least for a year or two, and Dr FitzGerald's evident willingness to grasp the economic nettle.

10. Our visible exports to the Republic in the first nine months of the year were £2.02 billion, or 48.3 per cent of the market, compared with £1.97 billion and a 49.2 per cent market share for the same period in 1981. This is commendable given the strength of sterling against the Irish pound for most of the year, the fall in total Irish imports of manufactured and consumer goods - areas in which our share is traditionally high - and, not least, the decline in British manufacturing output. We can expect exports to be worth over £2.4 billion for the year, so maintaining the Republic's position as our fifth most valuable overseas market. But there are constraints on our export prospects for 1983; an expected continuation of recession in the Republic and consequent fall in demand for imports, the substantial Irish balance of payments deficit (the UK alone had a surplus of £700 million in visible trade over the Republic in the first nine months of 1982) and the recent introduction of the payment of VAT at the point of entry to the Republic, which is already inhibiting imports, particularly of consumer goods. On the other hand, the depreciation of sterling against the Irish pound by 7.5 per cent in the last two months of 1982 should, if maintained, give our exports a boost. The Republic

/will

will not be a prosperous market in 1983 but it will still be an important one.

11. Looking to next year I would hope to see an improvement in Anglo-Irish relations, at least in the sense of reactivating the Anglo-Irish Inter-Governmental Council and its constituent parts. For example, I think we should try and get the proposed 'encounter' organisation going. But we must expect to be pressed by the Irish Government on the North. The main thrust of their representations is likely to be to urge us to do much more to satisfy the aspirations of the minority community. This will be difficult for us. And the fact that our relationship will be closer will mean that we shall have to work much harder at Anglo-Irish affairs than we have had to do this year when our relationship has been so frosty.

12. I am sending copies of this despatch to the Chancellor of the Exchequer, the Secretary of State for Northern Ireland, the Secretary of State for Defence, HM Ambassador at Washington and HM Representatives at EC posts, UKRep Brussels and to the Head of British Information Services, New York.

I have the honour to be
Sir
Your obedient Servant

Leonard Figg.