PO CH/GH/159
PART A

PO CH/GH/159
PART A

Relaxation of exchange
control Measures
1979.

24.7.79

DD's 25yrs NAzis
13-3-97.

CLOSED

1979

PS/CHANCELLOR OF THE EXCHEQUER

cc Mr Couzens
Mr Hancock
Mr Unwin
Mr Ilett

BUDGET SPEECH: DRAFT DATED 6 JUNE

This is to confirm our request to amend the 2nd line of E 9 to read: "is that access will be freely permitted to official exchange etc."

(To speak of "automatic access" could be taken to imply that, within the ration, investors need no longer apply to the Bank of England as remains necessary for a central check on whether a project is a genuine direct investment).

I also mentioned that the words "conducted by UK merchants" in line 8 of E 6 should no longer be in square brackets.

C H W HODGES
7 June 1979

MB 2

copy to
Mr. Hodgk
& Mr. Gill

Draf
date
6 J.

D

E EXCHANGE CONTROL

E.1 Before I come to my main proposals, I propose to deal with the question of exchange control.

E.2 Outward capital flows from the UK are more tightly controlled than those from any other major industrialised country. Sterling is at present relatively strong. This flows partly from the realisation that, as a result of North Sea oil, the UK is relatively better placed to deal with present world oil problems. Moreover I am determined to pursue firm fiscal and monetary policies which will make exchange control support for sterling less necessary. This is therefore an appropriate time to start liberalising our exchange controls in accordance with our obligations under the EEC Treaty and I have consulted the Commission

/about the

EXC/34/04 (F) 3

about the decisions I am announcing today.

There is ~~anyway~~ a strong case now for giving both companies and individuals wider freedom of choice, and for reducing the distortions and costs which controls are bound to impose on economic decisions.

E.4 We intend to move in this area one step at a time, and, in this initial stage, we are placing emphasis on direct investment. A Press Notice will be issued today giving details.

E.5 I have decided that the main relaxation is That ~~to be~~ automatic access will be freely permitted to official exchange up to £5 million per project per year for new outward direct investment. This should allow the majority of UK firms who invest overseas all the sterling finance they are likely to want. The two-thirds

/rule, which

restricts the re-investment of profits earned overseas, will be abolished. This greater freedom in the financing of direct investment abroad does not, as is sometimes feared, threaten jobs in the United Kingdom. The weight of evidence is that, if as a result overseas investment is increased, our position in world export markets will in general be strengthened. [And inasmuch as greater outward flows of stering hold (bri down the exchange rate, they increase the price competitiveness of our imports and exports. This, too helps add to jobs and output.]

E.6 There should also be some easement of th controls affecting individuals. I am therefo making significant relaxations in the rules concerning travel and emigration allowances,

/overseas property,

overseas property, and cash gifts and payments to dependants. And sterling finance will once more be permitted for third-

Delete [ ]

country trade [conducted by UK merchants]. In the field of portfolio investment, I am taking two steps at this stage. I am abolishing the requirement to maintain 115 per cent cover for overseas portfolios financed by foreign currency borrowing; and official exchange will henceforth be available for meeting interest payments on such borrowing.

E.7 As time goes by, I shall be studying further proposals for a gradual relaxation of control. Announcements will be made when conditions are appropriate. The pace of relaxation will obviously be influenced by the effect of international events on sterling as well as by the speed with which we can solve the economic problems that face us.

[E.8 In our external policy we have to take account of our official external debts. These at present amount to $22 billion - a massive increase on the $8 billion which the previous Government inherited in 1974. It is the Government's intention to reduce this burden of external debt substantially during the life of this Parliament.]

E. EXCHANGE CONTROL

E.1 Before I come to my main proposals, I propose to deal with the question of exchange control.

E.2 Outward capital flows from the UK are more tightly controlled than those from any other major industrialised country and in a world of floating exchange rates, the current regime is clearly an anachronism.

E.3 Sterling is at present relatively strong. This flows from the realisation that, as a resul of North Sea oil, the United Kingdom is relatively better placed to deal with the presen wolrd shortage. This is therefore an appropriat time to start liberalising our exchange controls in accordance with our obligations under the EEC Treaty. There is anyway a strong case now for giving both companies and individuals

/wider freedom

wider freedom of choice, and for reducing the distortions and costs which controls are bound to impose on economic decisions.

E.4 We intend to move in this area one step at a time, and, in this initial stage, we are placing emphasis on direct investment. A Press Notice will be issued today giving details.

E.5 I have decided that the main relaxation is to be a ration of £5 million per project per year for new outward direct investment. This should allow the majority of UK firms who invest overseas all the sterling finance they are likely to want. The two-thirds rule, which restricts the re-investment of profits earned overseas, will be abolished. This greater freedom in the financing of direct investment abroad does not, as is sometimes feared, threaten jobs in the United Kingdom. The weight of evidence

/is that,

is that, if as a result overseas investment is increased, our position in world export markets will in general be strengthened.

E.6 There should also be some easement of the controls affecting individuals. I am therefore making significant relaxations in the rules concerning tavel and emigration allowances, overseas property, and cash gifts and payments to dependants. [And sterling finance will once more be permitted for third-country trade (conducted by UK merchants).] In the field of portfolio investment, I am taking two steps at this stage. I am abolishing the requirement to maintain 115 per cent cover for overseas portfolios financed by foreign currency borrowing and official exchange will henceforth be available for meeting interest payments on such borrowing.

X

New para

/E.7 As time goes

E.7 As time goes by, I shall be studying further proposals for a gradual relaxation of control. Announcements will be made when conditions are appropriate. The pace of relaxation will obviously be influenced by the effect of international events on sterlin as well as by the speed with which we can solve the economic problems that face us.

E.8 In our external policy we have to take account of our official external debts. These at present amount to $22 billion - a massive increase on the $8 billion which the previous Government inherited in 1974. It is the Government's intention to reduce this burden of external debt substantially during the life of this Parliament.

EXC/34/04 (E) 2

11

FINANCIAL SECRETARY TO THE TREASURY

Copy No 11 of 16 copies

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir L Airey
Sir F Atkinson
Mr Couzens
Sir A Rawlinson
Mr Unwin
Mr Hancock
Mr Ridley
Mr Cropper

What ~~about~~ about

BUDGET SPEECH

DH. 8/6.

As requested, I enclose a redraft of section E of your speech, on exchange control.

You will note that, in paragraph E5 I have deployed the argument that we should use the revenue from North Sea oil to create overseas investments which can produce a stream of future income which will ultimately replace overseas earnings from North Sea oil, in place of the passage advertising the virtues of bringing (or keeping) down the exchange rate. Treasury officials are particularly unhappy about the latter formulation, and I believe that the new variant is prefe[rable].

You will note that I have omitted the square brackets round paragra[ph] E8. I am advised that both Treasury and Bank of England officials place great weight on a statement such as this which makes our position as an international borrower clear.

NIGEL LAWSON
7 June 1979

3/6/6

E EXCHANGE CONTROL

E.1 Before I come to my main proposals, I I propose to deal with the question of exchange control.

E.2 Sterling is at present relatively strong, and I expect it to remain so. This strength flows partly from the realisation that, as a result of North Sea oil, the UK is better placed than most of our competitors to deal with present world oil problems. Moreover I am determined to pursue firm fiscal and monetay policies which will maintain confidence in the currency. This is theref an appropriate time to start dismantling our apparat of controls on outward capital flows, which is more restrictive than any other major industrialized count: finds it necessary to maintain. I believe the case is overwhelming, in this context as in others, for giving both companies and individuals wider freedom of choice, and for reducing the distortions and costs which controls are bound to impose on economic decisions. These costs bear particularly heavily on smaller companies.

E.4 We intend to move in this area one step at a time, and, in this initial stage, we are placing emphasis on direct investment overseas. A Press Notice will be issued today giving details.

V.h. C/fte.

E.5 I have decided that the main relaxation is to be automatic access to official exchange up to £5 million per project per year for new outward direct investment. This should allow the majority of UK firms who invest overseas all the sterling finance they are likely to want. The two-thirds rule, which restricts the re-investment of profits earned overseas, will be abolished. This greater freedom in the financing of direct investment abroad does not, as is sometimes feared, threaten jobs in the United Kingdom. The weight of evidence is that, if as a result overseas investment is increased, our position in world export markets will in general be strengthened, to the benefit of output and jobs in the country. Moreover, additional investment overseas today will yield an income that will benefit the current account of the balance of payments in the future, when the overseas earnings from North Sea begin to decline.

E.5A During the sterling crisis of 1976, the last Government stopped the use of sterling by UK merch to finance third country trade. This restriction, which has caused a loss of international business to British merchants, will now be abolished.

E.6 I have also decided that there should be some immediate easement of the controls affecting indivi I am therefore making significant relaxations in the rules concerning travel and emigration allowanc overseas property, and cash gifts and payments to dependants. In the field of portfolio investment, I taking two modest steps at this stage. I am abolishing the requirement to maintain 115 per ce cover for overseas portfolios financed by foreign currency borrowing; and official exchange will henceforth be available for meeting interest payments on such borrowing.

E.6A As the House knows the liberalisation of exchange controls is also one of our obligations under the EEC Treaty. I have accordingly [informed] consulted the Commission [of] about the decisions I am announcing toda[y]

E.7 As time goes by, I intend to ~~make~~ take further ~~proposals~~ steps for the progressive dismantling of exchang[e] control. Announcements will be made when conditions are appropriate. The pace of relaxation will obviously be influenced by the effect of internationa[l] events on sterling as well as by the speed with which we can solve the economic problems that face us.

E.8 In our external policy we have to take account o[f] our official external debts. These at present amount to $22 billion - a massive increase on the $8 billion which the previous Government inherited in 1974. It is the Government's intention to reduce this burden of external debt substantially during the life of this Parliament.

CONFIDENTIAL

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16

FINANCIAL SECRETARY TO THE TREASURY

Mr. Hodges

MR HANCOCK

cc Principal Private Secretary
PS/Chief Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir L Airey
Mr Couzens
Mr Barratt
Mr F Jones
Mr Dixon
Mr Middleton
Mr Butt
Mr Gill
Mr Hodges
Mrs Lomax
Mr Allan
Mr Horton
Mr McIntyre
Mr Ridley
Mr Willetts - Bank of England

EXCHANGE CONTROL AND OUTWARD DIRECT INVESTMENT

The Financial Secretary was grateful for your minute of 6 June covering the exchange control contribution to the Budget Brief.

PCD

P C DIGGLE
7 June 1979

Mr Hancock 4/17

CHIEF SECRETARY TO THE TREASURY

PRINCIPAL PRIVATE SECRETARY

cc. Financial Secretary
Minister of State (C)
Minister of State (L)
PCC Members
MEG Members
Miss Brown
Mr Kemp
Mr L J Taylor
Mr Jeremiah
Mr Ridley
Mr Cropper
Sir William Pile I/R
Mr Lovelock C&E

BUDGET SPEECH - DRAFT OF 6TH JUNE

The Chief Secretary has seen this revised draft and has commented that he still thinks that the wording on page E1 makes it appear too much that exchange control relaxation was determined by EEC obligations rather than by the Government's own convictions.

X

A C PIRIE
7th June 1979

cc Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D. Wass
Mr. Couzens
Sir L. Airey
Sir F. Atkinson
Sir A. Rawlinson
Mr. Jordan-Moss
Mr. Littler
Mr. Dixon
Mrs. Hedley-Miller
Mr. Unwin
Mr. Ridley
Mr. ~~Llett~~
Mr. McIntyre
Mrs. Diggle

5

18

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

7 June 1979

TP 30/79

Dear Keith

EXCHANGE CONTROLS

Thank you for your letter of 1st June. It is helpful to have your views on portfolio relaxation and I shall of course take careful account of these in our further studies over the months ahead.

As regards your suggestion about raw material supplies I have much sympathy with the industrial and strategic case you mention. In practice, however, I believe that the £5 million ration should go a long way to meet the needs of companies for both exploration and exploitation. But there are still uncertainties about our external position, and I should therefore prefer to see how things look after the Budget before deciding on any extension on the initial package of relaxations. Whether introducing a special raw materials scheme would then be a good move may, of course, depend on how soon we could envisage complete liberalisation for outward direct investment, in parallel perhaps with a first major relaxation on the portfolio front.

I am copying this letter to the Prime Minister, the Secretaries of State for Foreign and Commonwealth Affairs and for Trade, the Governor of the Bank of England and Sir John Hunt.

Yours

Geoffrey

(GEOFFREY HOWE)

The Rt. Hon. Sir Keith Joseph, Bt., MP.

EF1

SECRET

19

MR HANCOCK

cc for: Financial Secretary
Mr Couzens
Mr Jordan-Moss

cc to: Mrs Hedley-Miller
Mr Ilett
Mr McIntyre
Mr Armitage (T Sol)
Mr Dawkins (B/E)

EXCHANGE CONTROL AND THE EUROPEAN COMMISSION

We have promised the Chancellor a draft letter today addressed formally to the President of the Commission about our planned relaxations. I understand that Commissioner Tugendhat did not raise with him, when telephoning on 6 June, the question of addressing a letter instead to Mr Ortoli; but we envisage a copy being sent to the latter under a personal note from the Chancellor.

I attach a draft and, because of shortage of time, it is in the form of the draft telegram to UKRep which I have asked FCO to send today. It includes a final paragraph, which I think advisable, about a continuing authorisation under Article for our remaining restrictions on items due to be liberalised under the Capital Movements Directives. That is based on the language of a letter to M. Ortoli of 16 December 1977 from the UK Permanent Representative about the relaxations made with effect from 1 January 1978 and will, I hope, be found adequate from the legal standpoint.

C H W HODGES
8 June 1979

CHANCELLOR OF THE EXCHEQUER

Copies as above

I hope that you will feel able to sign a letter to Mr Jenkins on the lines of the draft incorporated in the attached telegram - subject to any further advice we may receive about the text from UKREP in Brussels. Our aim would be to ask UKREP to deliver the text of the version that you finally approve on Tuesday. Signed copies, both of the main letter and of a copy with a personal covering letter to Mr Ortoli, could follow the next day by diplomatic bag - this is the usual drill.

/I notice

20

2. I notice that in his revision of this section of the Budget Speech (minute dated 7 June) the Financial Secretary has included the sentence, in paragraph E.6 A: "I have accordingly informed the Commission of the decisions I am announcing today". The Commission would obviously prefer you to say that you had consulted them, not just informed them. I quite understand the reasons why this might be difficult. I have therefore asked Mr Fitchew whether he thinks that the Commission would be upset if you went no further than "informed". He sees no need for you to say "consulted" if that is unwelcome. He points out that the Commission can scarcely expect to dictate the text of your Budget Speech to you. But in their own press notice is is probable that they will say that they were consulted; and I do not think that it need worry us if they do.

D.H.

D J S HANCOCK
8 June 1979

Registry No.
DEPARTMENT

reach addressee(s) 21

SECURITY CLASSIFICATION	PRIORITY MARKINGS
~~Top Secret~~ Secret ~~Confidential~~ ~~Restricted~~ ~~Unclassified~~	~~Flash~~ Immediate }* ~~Priority~~ ~~Routine~~

(Date)

Despatched

PRIVACY MARKING

~~In Confidence~~

~~En Clair~~.
~~Code~~
Cypher

[Security classification —if any] SECRET

[Privacy marking —if any]

[Codeword—if any]

Addressed to UKREP BRUSSELS

telegram No. (date)

And to

repeated for information to

Saving to

Draft Telegram to:— UKREP BRUSSELS

No.

(Date)

And to:—

Repeat to:—

Saving to:—

Distribution:—

Copies to:—

NOTHING TO BE WRITTEN IN THIS MARGIN

Following for Fitchew from Hodges, Treasury.
Below is the text of a draft letter from the Chancellor of the Exchequer to the President of the Commission. It reflects what has already been said to Commission representatives. The final paragraph seems necessary and is based on the language of Sir Donald Maitland's letter to Ortoli of 16 December 1977 abou the relaxations made from 1 January 1978. It is proposed that the letter should be delivered on Budget Day and that the Chancellor should send a copy to Ortoli with a personal note.

Please comment as soon as possible. We shall let you know of any amendments at this end.

Text of draft begins:-

X Following the meeting in London on 5 June between representatives of the Commission and of the United Kingdom Treasury, I am writing to inform you of the decision by Her Majesty's Government to make, from 13 June 1979, substantial relaxatio of Exchange control which I shall be announcing in my Budget speech in the House of Commons this afternoon. Since the details are complex, I enclose a copy of the Press Notice to be issued by the Treasury, which sets out quite fully the measures of liberalisation to be taken.

My officials have reported to me the Commission's hope that our relaxations could include two specific measures favouring investment in the Community: unlimited access for UK residents to official exchange both for direct investments in other countries of the Community and also for portfolio investments in quoted bonds issued by Community institutions. As was explained at the meeting on 5 June, however, the first proposal would introduce, possibly for only a short period pending full liberalisation of direct investment, an unwelcome discriminatory complication into a regime which it is one of our aims to simplify; while the second is one which we have frankly not yet had time since taking office to consider among the range of options to be studied during the summer. You will understand that we need to look carefully for the best way ahead before making our first important step towards relaxing controls in the more volatile and difficult field of portfolio investment.

If the outlook for sterling remains good, we may well judge it possible to move [quite soon] to [unlimited] use of sterling resources for outward direct investment in any part of the world, [perhaps even before the end of 1979.] As to Community bonds, I can assure you that this proposal will be fully considered along with other proposals for achieving greater liberalisation of outward portfolio investment. This will be part of the detailed studies which I am setting in train after the Budget and about which we hope to be in touch with the Commission later this year.

The Government of the United Kingdom consider that, for the time being, the protective measures which will remain after the relaxations to be announced on 12 June are justified by the terms of Article 108 of the Treaty establishing the European Economic Community and by the balance of payments chapter of that Treaty as a whole, and therefore trust that the Commission will continue the authorisation of those measures under the terms of Article 108(3) in their Decision 78/154/EEC of 22 December 1977."

(12803) Dd.643296 150m 8/69 .W.B.Ltd. Gp.863
(13541) Dd.643727 200m 12/69 G.W.B.Ltd. Gp.863

NOTHING TO BE WRITTEN IN THIS MARGIN

7
23

Chief Secretary
cc Financial Secretary
Sir Douglas Wass
Mr. Couzens
Mr. Jordan-Moss
Mr. Hancock
Mr. Hodges
Mr. Dawkins (B/E)
Mr. Fitchew, UKREP

NOTE FOR THE RECORD

Mr. Christopher Tugendhat telephoned the Chancellor on 6th June. He urged the Chancellor, in the exchange control package to be included in the Budget, to exempt from exchange control outward portfolio investment in Community bonds. He put forward two arguments in support; firstly, of the other Community countries which retained exchange controls, both Denmark and Italy maintained such a specific exemption; and secondly, this would be a tangible expression of the constructive approach to Community matters which the new Government had shown, and which had been well received by other member states.

2. The Chancellor said that at this stage, this suggestion was academic. It was not one of the options which the Government had taken into account, and it was too late to change the package. He had thought that the Government would have earned approval in the Community by a general relaxation of exchange controls. Community bonds in any case fell in the portfolio category, at which the Government would be looking separately later. He reminded Mr. Tugendhat that one of the Government's objectives in the package was to reduce administrative costs. An exemptic for Community bonds would introduce unwelcome complications.

3. Mr. Tugendhat agreed that a general relaxation would be well received; but the Community would still view with a particularly benevolent eye positive discrimination in its favour. The Chancellor said that in presenting the exchange control package, he would refer to our

13/6

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Community obligations, and to the fact that the Commission had been consulted. He would see that this idea was looked at in the context of further steps which the Government intended to take to a slower timescale. He added that the Americans had pressed us not to introduce discriminatory exchange controls. He thought it unlikely that he would be able to attend the Finance Council on 18th June, but the Chief Secretary would be going. He hoped that Mr. Biffen would have the opportunity of telling Mr. Ortoli what he had just told Mr. Tugendhat. Mr. Tugendhat thought that nothing but good could come of this. Mr. Tugenhat offered the good offices of the Commission in supplying information about the exemption for investment in Community bonds operated by other member states.

MAH

(M.A. HALL)

8th June.1979

25 8

MR BATTISHILL

cc Chief Secretary
Financial Secretary
Minister of State - Commo
Minister of State - Lords
Mr Couzens
Mr Unwin
Mr Hodges

BUDGET SPEECH - EXCHANGE CONTROL

A few suggestions on Section G - draft of 8 June.

Paragraph G3

2. Remove the square brackets round the last sentence and amend to read: "A Press Notice will be issued today giving details and copies are being made available in the Vote Office."

Paragraph G5

3. In 1976 the use of sterling by banks as well as merchants was stopped. In view of that, it would be better to express this paragraph as follows:-

> "During the sterling crisis of 1976, the last Government stopped the use of sterling to finance third country trade. This restriction has caused a loss of international business to British merchants, and I am taking the opportunity to restore the facility to them as soon as the details can be worked out."

Paragraph G7

4. On the choice between consulting the Commission and informing them, please see my minute to the Chancellor of today's date.

Paragraph G8

5. Amend the first sentence to read: "As time goes by, I intend to take further steps in the progressive dismantling of exchange controls." The point is that the Chancellor does not have to make proposals to the House of Commons - he can just do it.

D.H.

D J S HANCOCK
8 June 1979

11b/6

EF2 269

SECRET

1. Mr.HANCOCK DH 11/6.

2.CHANCELLOR OF THE EXCHEQUER

cc for: Financial Secretary
Sir Douglas Wass
Mr Couzens
Mr Jordan-Moss
Mrs Hedley-Miller
Mr Unwin

cc to: Mr Ashford
Mr Ilett
Mr McIntyre
Mr Dawkins (B/E)
Mr Armitage (T Sol)
Mr Petrie (FCO/EID)
Mr Fitchew (UKRep, Brussels)

EXCHANGE CONTROL AND THE EUROPEAN COMMISSION:

LETTER TO MR ROY JENKINS

The revised draft below embodies some changes which I think improve the first draft I submitted on 8 June. The Bank suggested re-ordering the middle bit so as to deal with the Commission proposals one after the other. Mr Fitchew (UKRep) gave me a number of helpful suggestions, particularly for giving the approach a more personal flavour, eg. as in the second paragraph and the beginning of the fourth.

Mr Fitchew thought it would be most desirable for the actual letter signed by the Chancellor to be in the bag to UKRep on Monday 11 June. Perhaps the FCO could at the same time telegraph the text as agreed, in order to reduce any risk of not getting the substance delivered to Mr.Jenkins' office shortly before the Budget is opened.

C H W HODGES

10 June 1979

CONFIDENTIAL

84/04F

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FINANCIAL SECRETARY TO THE TREASURY

MR HANCOCK

cc Principal Private Secretary
PS/Chief Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir D Wass
Sir L Airey
Sir F Atkinson
Mr Couzens
Mr Barratt
Mr Byatt
Mr F Jones
Mr Cassell
Mr Dixon
Mr Middleton
Mr Unwin
Mr Gill
Mr Hodges
Mrs Lomax
Mr Allan
Mr Ilett
Mr Ridley
Mr Dawkins)
Mr Walker) B of E
Mr Sangster)

BUDGET PRESENTATION OF EXCHANGE CONTROL PACKAGE

The Financial Secretary discussed your minute of 4 June with you and Messrs Middleton, Hodges and Ilett on the morning of 6 June and came to the following conclusions about the presentation of the package of exchange controls in the Budget speeches and associated literature and briefing. I regret that this note is so long after that meeting: the delay has meant that there have been some minor changes in the package, but I do not think that this materially alters the stance upon which the Financial Secretary decided.

It was agreed that reasoning based on the premise that the exchange control relaxations would help prevent this country catching the "Dutch disease" should be avoided; while the Financial Secretary sees some merit in the argument, it is not one that he would want

EXC/84/04 (F)

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to use publicly and prefers instead to contend that the revenue from north sea oil should be used to build up overseas investments whose future earnings can provide a stream of foreign-generated incom which will ultimately be able to replace the revenue from North Sea oil. In this way the exchange control relaxations can be presented as good house keeping.

You felt that some comentators would probably draw the inference that the purpose, or at least a consequence of, the exchange

? control package would be to increase exchange rate competitiveness.

In discussion, the Financial Secretary said that he rejected the macro-economic arguments in favour of exchange control described in your paragraphs 4 to 7; and felt that it was impossible to use these arguments while rejecting the case for import controls.

? Officials felt that, by pointing to the trade distortions/retaliation which woul caused by current account defence of the balance of payments, it was possible to draw a distinction in favour of retaining capital account exchange controls; but the same argument could be used to justify a continually tightening exchange control regime.

Turning to the micro-economic side, the Financial Secretary felt that small firms had been particularly badly affected by exchange controls. You explained that, while there was little conclusive evidence of this - certainly not from the balance of payment statistics - there was a considerable weight of circumstantial and case work evidence that supported this view. It was easy to see that large firms, with sophisticated corporate finance departments would be able to arrange financial projects in such a way as to circumvent the controls.

The Financial Secretary advised scepticism on the size and type of outflow to be expected from the exchange control relaxations. This was sensible given the necessarily speculative nature of both the Treasury and Bank forecasts of the outflows and their heavy dependenc on the strengh of sterling, itself an unknown confidence-related factor.

Comment on the future of exchange controls should rely heavily on the uncertainty of the effect of the present package so as to justify a gradualist approach. In the uncertain climate caused by the vunerability of the dollar this was prudent and could be so presented. Anticipation of further measures, however, would pave the way to measures to liberalise portfolio investment and explain why it was not possible to do so immediately. This would help keep the dollar premium low, and preferably on a declining course. There would be a difficult problem ahead when overseas investors faced overnight losses when the premium was effectively abolished - essentially the villa owner's problem writ large. A steady drift downwards would help reduce this problem. There should be no attempt therefore to disguise this approach.

Internally it would be useful to monitor the effect of Budget packag expecially in terms of directly generated outflows, but the Financia Secretary accepted that this would be very difficult, especially in the short term.

During a discussion of the contrast between the monetary consequence of controlling the exchange rate by intervention or by liberalising exchange controls, it was agreed that, for the same exchange rate path, the monetary effect of an interventionist policy would inflate the money supply while exchange control relaxations would restrain it. However, in the context of a strict domestic monetary policy based on monetary targets, it was not clear that the contrast would be quite so sharp. It might be fairer to think of these polic accompanied by fixed and floating exchange rates respectively, so that the interventionist case worsened inflation (although producing a desirable switc in the use of resources), while the exchange rate relaxation case increased competitiveness. In the real world it was this consequence of an interventionist policy which most worried the Financial Secreta

In presenting the package the counter-inflationary aspect of exchange control liberalisation (by the monetary rather than the competitiveness route) might be stress.

The Financial Secretary invited officials to construct the defence and justification of the exchange control package on the basis of this discussion, and said that he would use some of this material in his contribution to the Budget debates.

PCD

P C DIGGLE

11 June 1979

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EF 1

Secretary of State for Industry

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01 212 7676

June 1979

The Rt Hon Sir Geoffrey Howe
Chancellor of the Exchequer
HM Treasury
Downing Street

cc Mr Jordan Moss
Mr Widdup
Mr Gill

Sent 11/6.
Mr Haycock
PS/CST
PS/FST
PS/MST (C)
PS/MST (L)
Sir D. Wass
Mr Couzens
Mr Barratt

Dear Geoffrey.

Walter Salomon, whom I think you know, spoke to me yesterday about rumours that there is to be only a partial relaxation of exchange control. Obviously I told him nothing but he was urgent that this would be a mistake. I told him that he could write to me and here is a short letter from him, together with a short memorandum and a copy of a recent report of the Economist Intelligence Unit.

I send this on to you because Salomon is a successful banker, so far as I know, and his opinion is perhaps worth having.

There is no need of course to reply to me and certainly not to him. I shall just tell him that I have sent the papers on.

Yours
Keith

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KING'S HOUSE
36 - 37 KING STREET
LONDON EC2V 8DR
TEL. 01-606 4033

6th June, 1979

My dear Keith

It was nice talking to you on the telephone today, but I am somewhat concerned that you may be overtaxing your strength, rushing around like mad and never having any relaxation. If your health were to suffer it would be a bad thing for this country because people like yourself simply cannot be spared. At the risk of sounding repetitive, I want you to know that if at any time I can give you a relaxing holiday under pleasant circumstances on my boat I would be only too happy to do so.

Now with regard to the point which I raised in our conversation, I don't know to whom I should address myself and you have kindly agreed to pass on my views to whomsoever they may concern.

The general consensus of opinion is that probably at the same time as Sir Geoffrey publishes his Budget, the Government will introduce relaxations on the foreign exchange control side. According to what is being said on the grapevine, this will be done in stages and it is on this point that I am seriously concerned.

In case you have not already seen it, I am enclosing herewith a copy of a Report which has been produced for friends of mine by The Economist Intelligence Unit and from which I have deleted my friends' name. Whilst the Report is quite factual in its recommendations and comes down on the side of the abolishment of exchange control, they want to do it in stages, and with this I totally disagree. However, one must remember that in all probability the Report was made by academics with little or no practical experience.

I, for one, believe from a practical point of view that if one is to be really effective and gain the maximum benefit, a total abolishment should take place immediately and not in stages. I have set out in a brief memorandum, a copy of which is enclosed, my arguments in support of this view. You have known me long enough to be sure that I would not lightheartedly put forward a suggestion of this nature but I have had experience of these matters for more years than I care to remember, which is more than can be said for the people in the Treasury, or even for most of those from whom outside advice has been obtained. In fact, the views expressed in the memorandum should fall in very much with the philosophy of the Prime Minister.

I am, of course, always available for a discussion should you require any further explanation.

I don't want to put the following in a letter which might fall into other hands, but it is a little story from practical experience:

You will recall that during and after the War we had meat rationing and one day my wife told me that she had seen in the newspaper that rationing was now to be abolished. Her immediate reaction was that from now on we would not be able to buy any more meat. I tried to persuade her that what would happen would be just the contrary - there would be so much meat about that people would not be able to afford it.

As we all know, wives rarely believe their husbands, and she was no exception, but events proved me right.

I am sure you will understand the analogy with regard to the problem which we are now discussing.

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WHS//

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MEMORANDUM

on

THE ABOLISHMENT OF FOREIGN EXCHANGE CONTROL

1. Exchange Control was introduced almost forty years ago and has nowadays come to be accepted as a natural abuse of personal liberty. It has cloaked some of the misdoings of Government, slowed down our effectiveness in international trade and created a vast and totally unnecessary bureaucracy.

2. It is important that these controls be abolished forthwith.

3. From a psychological point of view, a total abolishment would create an atmosphere which would make people think twice before transferring money abroad if not for proper commercial reasons.

4. The fact that the apparatus had been totally dismantled would make it almost impossible to re-introduce foreign exchange control in an effective manner for a very long time.

5. Whilst there might be an initial outflow of foreign exchange, a re-cycling process would take place and it is more than likely that through the re-establishment of confidence over a period of time more money would flow back than had flowed out.

6. It is likely that there would be a temporary loss in our foreign exchange reserves, with which loss the Bank of England, by making the necessary stand-by arrangements, is totally equipped and able to deal.

7. The exchange rate might be temporarily affected by the Pound sterling finding a slightly lower level. That would be desirable from the point of view of our exports.

8. If money were to go out it would be an anti-inflationary measure and this too would be highly desirable under the present circumstances.

9. There have been in recent history examples of countries which have totally abolished their foreign exchange control, and I am referring to the Argentine, Chile, and Israel. I myself have not done any research on this but from sources in which I have every confidence I understand it has been highly successful.

10. Last but not least, in taking these measures we would comply with our undertaking given under the Rome Treaty and in respect of which we are now in default.

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EIU Report

... THE EFFECT OF
EXCHANGE CONTROLS IN THE UK ON OVERSEAS INVESTMENT

October 1978

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AN APPRAISAL OF THE EFFECT OF EXCHANGE CONTROLS IN THE UK ON OVERSEAS INVESTMENT

CONTENTS

AN APPRAISAL OF THE EFFECT OF EXCHANGE CONTROLS IN THE UK ON OVERSEAS INVESTMENT

SUMMARY OF RESULTS AND RECOMMENDATIONS

The attached study, commissioned as a wide ranging investigation into the effects of UK Exchange Controls on overseas investment by UK companies (and individuals) and the earnings associated with such investment, makes recommendations especially relating to the relaxation of exchange controls on direct investment abroad.

UK overseas investment since World War II has been modest compared with its own historical standards (page 7). Invisible earnings from such investment have grown less rapidly than the earnings from the other invisible sources (page 8). So that on present trends there will soon be a net outflow of funds in this category (page 12). Exchange controls are ordinarily concerned with the short term effects on reserves and balance of payments (page 22) while the longer term receives little attention.

Estimates of the effects of relaxing controls show that after an initial outflow from reserves, the earnings from increased overseas investment would soon make this new level of investment self financing (page 38). Invisible earnings from such investment would, as a consequence, ensure that overseas investment continues to make positive contributions to the UK balance of payments.

One remarkable feature of UK Exchange Controls is the lack of discussion on their overall value to the UK (page 22). Some argue that the controls prevent the export of capital and thus increase investment within the UK. The report concludes that this argument is not supported by the evidence and is therefore illfounded. In fact it is possible that greater freedom to invest overseas may well lead to an increase rather than a limitation of investment within the UK (page 42).

The report concludes that although the initial effect of relaxing exchange controls (already constructively administered by the Bank of England within the existing limitations) would be a reduction in reserves, this change would be temporary. Furthermore, any such reduction could be moderated firstly by a gradual relaxation and secondly by allowing forms of relaxation which encourage direct investment to be financed by methods involving no immediate reduction in reserves. Encouraging the use of equity - i.e. share exchanges (page 34) is one such method. On the one hand, the use of foreign currency reserves would be minimised and on the other, the UK investor would have an additional tool available to achieve investments that might not otherwise be possible. Share exchanges in certain countries (e.g. the USA) postpone the incidence of capital gains tax and encourage the holding of equity. The use of equity in this way would expand the international activities of the City of London and further supplement invisible earnings from that source.

OVERSEAS INVESTMENT AND THE UK ECONOMY

1. An overall view

The recent economic history of the UK is one of continuous control over overseas investment. Since the institution of exchange controls on investment at the beginning of the Second World War, they have been in force with only minor relaxations which were usually soon reversed. To give historical perspective to the effects of these controls it is necessary to consider a fairly long time period.

This is necessary because exchange controls are deliberate hindrances to the free international movement of capital. Without taking a premature view of the desirability of such free movement, comparison with periods where restrictions were of less importance or completely absent is evidently worthwhile. As will be described below, the most vigorous period of UK overseas investment occurred in the nineteenth and early twentieth centuries and was concluded by the First World War. Comparisons of the present day UK economy with its situation at such a remote point in the past are clearly of limited value. Nevertheless the conditions which prevailed in the international economy after the First World War and before the Second World War make this a highly distorted period. For the first half of this period the economy was suffering the after effects of the First World war, for the second half of the period the widespread international depression and financial disorder reduced all forms of private investment, domestic and overseas.

Additionally, it is the nature of investment that any one act of investment may not give rise to significant returns for a number of years. In any one year the receipts from overseas investment are constituted from many separate acts of investment at differing points in the past. To form any view of the overall value of overseas investment it is necessary to consider a number of years together. The twentieth century has seen many disruptions in the international economy which make any subdivision more or less atypical, again a long view is required in any attempt to identify the underlying patterns.

The purpose of this section of the report is to provide such a long view of British overseas investment. The timespan covered falls into three parts: firstly the period from after the Napoleonic wars to the First World War; the inter-war period; and finally the period from the Second World War to the present day. It is not possible to disaggreate investment into its component parts for the early part of this period, accordingly discussion of the relative size of these different components is postponed. For the moment aggregate investment and the returns to aggregate investment are the central theme.

In the conventional National Income accounting framework, the returns to aggregate investment are grouped as a part of invisible overseas earnings under Interest, Profit and Dividends (IPD), the definition of this item is presented more completely below. Consideration of the significance of IPD fell within the terms of reference of the Committee on Invisible Exports under the chairmanship of Sir Thomas Bland. This committee, which reported in 1967, was asked "to investigate Britain's invisible earnings and to make recommendations about how to increase them further"[1].

The committee's analysis of the historical material showed that "it was not until the second half of the nineteenth century that the complex machinery of British overseas earnings attained its full momentum, and investment revenues began their most powerful growth. Until 1870, these moved in parallel with the income from shipping. From that point on they rose sharply, and by 1913 had left shipping returns at a third of their level, far behind. It is clear that by the last decades of the nineteenth century the cycle of investment and income had become a self generating process and had achieved a momentum of its own. In each year investment yields were devoted, where necessary, to the coverage of deficits in the overall current account and were then fed back into the pool of capital assets abroad. Thus augmented, the investment reservoir yielded a greater return in the following year, and the pattern was again repeated. A 'revolving' fund seemed to have taken shape. The combined efforts of traders and investors had led to the creation of a financial mechanism of apparently immense durability and of crucial value to the balancing of the country's

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1 "Report of the Committee on Invisible Exports" 1967, page 11.

external accounts. Nothing less than a catastrophe, it seemed, could have torn this great structure down"[1].

Unfortunately, the First World war was such a catastrophe. The committee's conclusions on their examination of Britain's historical trading records are of interest. Over the period 1825-1965 they concluded:

"1. Britain, as far back as the statistical records go and probably even farther, has had a continuing deficit on visible trading account. Only seven out of the past 175 years have shown a trading surplus.

2. Over the same extended period, Britain has had a continuous surplus on her invisible trading account. If government spending abroad is excluded from the figures this invisible surplus has always been big enough to offset the deficit on visible trade.

3. It is clear, therefore, that Britain is and has been for well over a century and a half as a much a commercial and financial nation as a manufacturing nation"[2].

This illustrates the past importance of invisible earnings, a large part of which resulted from overseas investment.

It was not a part of the committee's task to detail the investment flows which gave rise to these invisible earnings during the peak years before the First World War. However, studies of the period have reported investment increases during this same period. Figures collected by Imlah show his estimates of British foreign investments growing by 53 per cent from 1870-1875[3]. Table 1 gives net foreign investment as a percentage of expenditure generating GNP culminating in an annual average figure of 6.9 per cent in the decade immediately before the First World War. At this point it is estimated that total overseas assets seem to have accounted for nearly a quarter of the national capital, whereas after the Second World

1 Op cit page 169. 2 Op cit page 19. 3 A.H. Imlah "Economic Elements in the Pax Brittanica". Page 72.

War they probably accounted for no more than 8 per cent of national capital[1].

Table 1. Net Foreign Investment by the United Kingdom; 1865-1959 (annual averages in £ mn)

	Net foreign investment	Percentage share of foreign investment in GNP*
1865-1874	56	4.8
1875-1884	42	3.1
1885-1894	72	4.9
1895-1904	41	2.2
1905-1914	161	6.9
1920-1929	124	2.4
1930-1939	-50	-1.0
1940-1949	-487	-4.8
1950-1959	150	0.8

* GNP in this context is defined as expenditure generating GNP, i.e. the sum of consumers expenditure, public authorities expenditure, gross capital formation in fixed assets and net foreign investment.

Source: "British Economic Growth 1688-1959", Phyllis Deane & W.A. Cole.

In the inter-war period net interest and dividends remained at about their pre-war level in current prices; in real terms their value was falling sharply over the period[2]. The period is described by Bland thus:

> "In the First World War of 1914-18, and in the ensuing 20 years of economic blight, at least £1,000 million of the 1913 stake of £4,000 net capital was lost, sold, sequestered or destroyed during the war, or dissipated in the economic disarray of the 1920's and 1930's. By 1939 it had proved possible to restore the net asset position to the £4,000 million holding of 26 years before. In the Second World War which immediately followed, a further £1,000 million was sacrificed, and unquantified disinvestment continued into the 1950's"[3].

1 Deane and Cole (op cit) page 307. 2 Bland (op cit) page 19. 3 Bland (op cit) page 169.

The depressed picture of overseas investment was mirrored by the "low and relatively constant"[1] level of domestic investment throughout the inter-war period. The figures given in Table 1 also show the quantification made by Deane and Cole of the disinvestment in the immediate post-World War II [illegible] period, followed by a resumption of net foreign investment at a low level.

The period from 1958 onwards marks the end of the interval throughout which the aftermath of the Second World War caused major dislocations in activity. As discussed below, at this time a number of currencies including sterling became convertible and the international economy entered an interval of sustained high growth.

The year to year fluctuations in the net position of the UK in terms of foreign investment have been considerable since 1959, even grouping a number of years together as in Table 2 is of limited benefit. The figures contained in Table 2 are not directly comparable with those in Table 1 for a number of reasons but do give a useful indication of overall magnitudes. After offsetting overseas investment in the UK public sector against net private sector investment, net UK investment overseas in most years has been negligible with the exception of the most recent past where some substantial inflows have occurred. Evidently these figures are highly aggregated and the result of many inward and outward flows undertaken for a diversity of reasons. Nevertheless, it is clear that the UK is no longer a significant net investor overseas. This is confirmed by movements in the net worth of the UK private sector overseas which rose from £5,100 million in 1966 to £6,200 million in 1976, after allowing for inflation this is a substantial decline[2]. When the official position is included, as it was in the figures for UK total overseas assets quoted on page 6 above, over the same period an excess of assets over liabilities of £1,500 million became an excess of liabilities over assets of £1,600 million.

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1 Deane & Cole (op cit) page 267. 2 CSO "UK Balance of Payments 1966-76".

Table 2. UK Investment Overseas and IPD
(annual averages £ mn)

	Net private sector investment	Overseas investment in UK public sector	Interest profits & dividends	Receipts from services
1959-1961	53	+51*	250	31
1962-1964	123	+27	375	-40
1965-1967	88	+26	400	13
1968-1970	39	-17	462	327
1971-1973	196	+134	787	530
1974-1976	-472	+166	1,128	1,214

* Annual figure for 1961.
Source: CSO United Kingdom Balance of Payments.

Also shown in Table 2 are the inflows of IPD in the invisible section of the balance of payments on current account. The figures for receipts due to services are also given to form some basis for comparison.

Although IPD has almost quadrupled during this time, when set against the major increase in receipts from services, this can only be a disappointing performance, albeit not unexpected given the limited growth of investment. The relative decline in the flow of IPD was noted by the Bland Committee.

"It was only in the early 1950's that these incomes exceeded even the nominal value of those received in 1913. In real values they were worth, even in 1965, less than half the 1913 income. Measured against the objective yardstick of gross national product, they equalled 8.5 per cent of the latter in 1913 and no more than 1.5 per cent in 1965"[1].

Since that time there has been a further fall, in 1976 IPD represented just over 1 per cent of Gross Domestic Product. This was due to a decline in real terms of 12 per cent from the 1966 level. Unless there is a change in these trends net IPD will soon be reversed in its direction in the balance of payments, becoming an outflow rather than an inflow.

1 Bland Committee (op cit) page 170.

2. The disaggregation and definition of investment

As noted above on page 7, it is not legitimate to compare figures derived from recent official statistics with those compiled from more diverse historical material. The construction of the historical figures for the period before adequate official information became available was a lengthy and difficult process. It was beyond the scope of this study to devote great effort to the construction of series in the post-1958 period which corresponded closely to earlier definitions. Accordingly the definitions of terms used throughout this report are in line with those currently employed in official UK sources.

The most important subdivisions of UK overseas investment are the two categories of portfolio investment and direct investment. Direct investment refers to an investment that is made to add to, deduct from or to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise. Other investments in which the investor does not have an effective voice in the management of the enterprise are portfolio investments. Outward direct investment comprises net investment by UK companies in their overseas branches, subsidiaries and associated companies. In the presentation of this series in official UK sources transactions of government departments and foreign owned insurance companies are excluded; as are the transactions of oil companies, due to the international nature of their operations. However the transactions of a number of public corporations, for example the British Steel Corporation and British Airways, are included. The estimates of direct investment include the parent's share of the unremitted profits of the subsidiary or associated company, the net acquisition of share and loan capital, changes in branch/head office indebtedness and changes in inter-company accounts.

Overseas portfolio investment by UK residents includes UK participation in new issues of sterling loan stock raised by overseas public authorities and companies in London (net of redemptions of similar stock). Other overseas portfolio investment by UK residents consists of net purchases (or sales) of overseas government and municipal loan stock and net transactions of the stocks and shares of overseas registered companies.

The subdivision of overseas investment is completed by the two categories of investment by oil companies and miscellaneous investment, this latter category including purchases and sales of real estate abroad.

The returns on these various types of overseas investments are grouped together in the Balance of Payments Statistics under the interest, profit and dividends, (IPD) items of invisible earnings. IPD credits and debits include all interest, profits and dividends accruing to UK residents from non-residents after deduction of local taxes and after allowing for depreciation. Profits and dividends include the earnings of overseas affiliates of UK registered companies; profits retained abroad by overseas affiliates are included in the flows of IPD and offset in the capital accounts. The two categories of IPD of most importance here are Direct Investment income and Portfolio Investment earnings.

Direct Investment income includes interest on intercompany debt, profits from branches overseas and earnings from subsidiaries overseas. It includes the direct investor's portion of reinvested earnings, which is also treated as an investment flow to the affiliate. In contrast, the published estimates of income from portfolio investments relate solely to remitted amounts of dividends and interest due to UK residents on their holdings of overseas government and municipal loan stock, and stocks and shares of overseas registered companies (including overseas sterling stock issued in London). More than half of this income is received by UK financial companies as a result of their portfolio investment.

The above definitions of the categories of overseas investment and its earnings correspond to those currently employed in the compilation of UK Balance of Payments statistics, and will be adhered to throughout this study. Any major divergences from these definitions which arise as the consequence of the variety of sources employed will be noted as they occur. Finally, it should be borne in mind that formally collected information on invisible earnings only became available after the Second

World War, and, moreover, the distinction between direct and portfolio investment (and their separate earnings) was not present in official sources until 1958.

3. The relative importance of direct and portfolio investment

The historical background presented above dealt only with investment in the aggregate, that is, no attempt was made to distinguish direct investment from portfolio investment.

The statistical breakdown into these categories has only been available since 1958 and only a relatively short timespan can be considered. Before 1958 there is little information, nevertheless the Bland committee were moved to comment that "it seems clear that portfolio investment has been of declining importance since 1914"[1]. The main authority on this period, for example, indicates that some 30 per cent of overseas investment was in government and municipal loans[2]. This type of security is unequivocally a portfolio investment by our definition on page 9. Thus when corporate securities held as portfolio investments are included, total portfolio investment must have formed the major part of overseas investment.

The figures shown in Table 3 indicate the development of direct overseas investment by the UK private sector since the late 50's. Between the first and last time periods given in that table, net direct investment was growing at approximately 7 per cent per annum, after allowing for inflation. Over this same interval the net receipts from this investment were only growing at 4 per cent per annum, again after allowing for price changes. This may be attributable to the nature of the direct investments undertaken in that non-pecuniary returns were being sought in some instances. More probably the divergence could be attributable to international variations in interest rates, etc.

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1 Bland (op cit) page 171. 2 Imlah (op cit) page 79.

Table 3. Net Investment Overseas by the United Kingdom
(annual averages £ mn)

	Net direct investment	Net IPD due to direct investment	Net portfolio investment	Net IPD due to portfolio investment
1959-1961	52	146	-112*	69
1962-1964	82	156	-25	77
1965-1967	100	204	-17	70
1968-1970	186	310	48	44
1971-1973	486	479	-220	18
1974-1976	809	956	-580	-63

* Average of 1960 and 1961.

Source: UK Balance of Payments.

In contrast, the receipts from portfolio investment have been falling, even in current price terms, to the extent that they have even become negative recently. This represents a drastic change in the situation which existed at the peak of UK overseas investment activity, namely immediately before the First World War, when the evidence suggests that the major part of IPD resulted from portfolio investments. The recent pattern of net portfolio investment by the UK, also shown in Table 3, gives an indication why this subdivision of IPD has been of diminishing importance. In only one period of the timespan covered was the net position of the UK such that portfolio investment was positive, in all other periods foreign portfolio investments in the UK exceeded UK portfolio investments overseas. This investment performance was reflected in the net worth of UK portfolio investments overseas, although the net worth of these investments rose from £1,059 million at the end of 1966 to £2,273 million at the end of 1976, after allowing for inflation, this represented a drop in value of 17 per cent.

Thus within an overall pattern of modest net overseas investment by the UK, although the net level of direct investment has not been high, the net level of portfolio investment has been extremely low and frequently negative. The effect of these trends on Britain's invisible earnings is easily predicted: unless the situation is reversed earnings from IPD will decline and eventually become a drain of funds.

So far only the economic benefit of holding foreign currency securities has been discussed, it must not be forgotten that other non-economic advantages can result. Immediately before the Second World War private holdings of foreign currency securities were surrendered to the government and so provided a desperately needed source of foreign exchange. An interest in the enterprise of a foreign country confers advantages in discussions with representatives of that country, and so on.

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THE MECHANISMS OF EXCHANGE CONTROL

1. The evolution of exchange controls in the post-war period

The legislation which established the system of exchange controls which was the forerunner of the present system was embodied in the Exchange Control Act, 1947. This legislation represented a continuation of the controls which were instituted immediately before the outbreak of the Second World War. The first action taken by the Treasury under the war time regulations was to order the registration of all UK owned foreign currency securities expressed in nine different currencies. The Treasury was also empowered to acquire such securities at not less than the current market value. This action represented the inception of the exchange control system which has now been in operation for nearly forty years. Over the years, the legal basis has been changed and the severity of application has varied considerably, but the basic approach has remained unchanged.

The original UK exchange control system operated by canalising all exchange transactions through 'authorised dealers', mainly the Bank of England, the joint stock banks, and a number of merchant banks and acceptance houses. It is still the case that authorised dealers are the only legitimate holders of foreign currencies and securities. The authorised dealers, and they alone, could:

1. buy and sell foreign currencies for sterling;
2. get gold and foreign currencies (in particular dollars) from the Exchange Equalisation Account;
3. transfer sterling between the accounts of UK residents and foreign residents;
4. transfer sterling between the accounts of two foreign residents.

In this context, 'foreign' means outside the 'Sterling Area'. The membership of the Sterling Area has varied considerably over time. On the virtual collapse of the gold standard in the 1930's a number of countries chose to link their currencies to the value of sterling, rather than to the dollar or to gold as did others. The Sterling Area shortly after the outbreak of the Second World War mainly consisted of the British Empire (excluding Canada). UK controls did not restrict payments within the Sterling Area at all, nor did they restrict payments between the outer sterling area and foreigners. In practice the British controls came to distinguish between foreign countries that would accept inconvertible sterling and those that would not; this was the origin of the distinction between 'hard' currency areas (such as the United States or Canada) and 'soft' currency areas. Discrimination was practised to attempt to conserve the UK's limited reserves of hard currencies. This system of controls, as it was originally operated during the Second World War, applied to all exchange transactions both on current account and on capital account.

Immediately after the Second World War, partly due to American insistance, the convertibility of sterling was increased in various ways. These changes came into force at the end of 1946 and by August 20, 1947 the resulting drain on the Sterling Area gold and dollar reserves caused the British Government to reverse the changes, after consultation with the United States government. On October 1, the Exchange Control Act, 1947, came into force. These developments gave rise to the regrouping of the countries of the world under three headings from the point of view of the transferability of sterling. These divisions prevailed until the restoration of convertibility on a wide scale in 1958. These areas may be summarised as follows.

1. <u>The Sterling Area</u>. Within this area unconditional transferability was the rule, payments out of the area required the authorisation of British or local countries depending on the domicile of the payer. However, United Kingdom controls on capital transactions remained strict. This area, also known as the Scheduled Territories, mainly comprised the British Empire.

2. <u>American Account countries</u>. Once sterling reached an American Account the Sterling Area controls did not in general operate. The British Authorities would on demand always convert American Account Sterling into US dollars. The countries in this group consisted of most of North and South America.

3. Transferable Account countries. Countries in this category did not have the right to convert sterling to dollars but did have transferability for current payments to others in this group.

For the early part of this period a further category of Bilateral countries existed but these were subsumed into the Transferable Account countries in 1954; at the same time the restrictions on Transferable Account countries were liberalised. Furthermore the existence of free markets in foreign countries, wherein Transferable Account Sterling was sold against dollars at a discount, led the Chancellor of the Exchequer, in response to events during 1954, to announce that the Exchange Equalisation authorities would extend their operations in these markets. After this announcement the free rate for Transferable Account Sterling was hardly ever at a discount of more than one per cent over the official rate. In other words Transferable Account Sterling became as from February 1954, de facto convertible.

Official recognition of this de facto situation followed in December 1958 when Transferable Sterling was assimilated into American Account sterling under the common label of External Account Sterling. There were now only two varieties of Sterling, External Account and Resident (the latter being sterling held within the Sterling Area). This formal resumption of non-resident convertibility in the UK coincided with resumed convertibility for twelve other European currencies. This progression to full convertibility applied only to current transactions, and was completed in the UK by transition under the IMF rules to its present status in February 1961.

If we now consider the evolution of capital controls, especially in the period after the resumption of convertibility for current transactions, it is found that they have become more extensive, at least in a geographic sense. Throughout the period from 1958 to 1974 the attitude of exchange controls towards some intended capital transaction depended upon the country within which the investment was to be made, specifically was the country a member of the Scheduled Territories. As regards capital transactions with the non-sterling area an exchange control has been in operation continuously, with only mild relaxations quickly reversed. However, the Sterling Area has been characterised by the fact that up to

May 1966 the UK exchange control imposed no impediments to capital movements within the area (except in the case of dollar securities).

The situation with regard to portfolio investment in the non-sterling area is that 'since the war, official exchange has never been made available for portfolio investment in foreign currency securities'[1]. The major source of funds for such investment is the investment currency market, described below page 18, augmented by foreign currency borrowing. There have been few major changes in the operation of this market in the period under review. Two events of note are the introduction of the 25 per cent surrender requirement in 1965, whereby 25 per cent of the proceeds of a redemption or sale of premium worthy securities had to be sold to the Bank of England at the official rate (thereby adding to the reserves), and the changes in 1972 which extended controls over most countries of the sterling area thus swelling the size of the investment pool. The 25 per cent surrender requirement was removed at the beginning of this year.

The policy on the funding of direct investment in the non-sterling area has been mainly to ensure no drain on the reserves. Projects have to cover their foreign exchange costs in a short interval, the present 'super criteria' arrangements, see below page 20, are the current form of this requirement. In 1962 the investment currency market was made available for investment projects unable to meet the conditions for official exchange. Measures taken by the UK government in May 1966 were the first steps in the process of dismantling the distinction between the Sterling Area and the rest of the world, at that time a 'voluntary' programme was announced to confine direct investment in the four most developed Sterling Area countries (South Africa, Australia, New Zealand and Ireland) to projects which promised an early, substantial and continuing benefit to the UK balance of payments. In anticipation of entry into the EEC, a major relaxation of controls on direct investment into the EEC was made in March 1972, up to £1 million of the cost of new projects in the EEC could be financed from official exchange. Additionally, in June 1972, the extension of exchange controls over the Sterling Area coincided with relaxations which enabled the entire costs of permitted outward direct investment to be financed from official exchange.

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1 Bank of England Quarterly Bulletin, June 1977, page 315.

In March, 1974 in an effort to protect the balance of payments, a uniform policy to outward investment was applied. This represented a significant cut back in the use of official reserves in financing direct investment overseas. The relaxations with respect to projects in the EEC were removed, and the Scheduled Territories were reduced to their present membership.

2. The present form of UK Exchange Controls

The bulk of the volume, though not necessarily of the value, of transactions involving resident owned foreign currency securities are portfolio investments made by individuals, companies, unit trusts, investment trusts, etc. For exchange control purposes, portfolio investments are regarded as those made solely with a view to gaining dividends, interest and market value appreciation and where there is no intention of acquiring partial or complete control over the operation and management of a company (direct investment) or expanding the interests of a UK business by the investment (trade investment). Any investment vehicle which would result in a resident gaining an interest of 20 per cent or more of the voting rights of a foreign company would <u>not</u> normally be regarded as a portfolio investment.

The major source of finance for portfolio investment is the investment currency market. Investment currency is a pool of foreign currency completely separate from the UK's official reserves which consists of foreign currency which has arisen from the sale of foreign currency securities and which is eligible to be retained for personal reinvestment purposes. It also consists to a lesser extent of the foreign currency sale proceeds of eligible private properties abroad. Investment currency may be needed by UK residents for the purchase of foreign currency securities for portfolio purposes or of private property abroad, because the Treasury are not prepared to release foreign currency from the country's official reserves for such purposes. Investment currency may also be used for direct investment but the premium attached to investment currency usually means that other sources of funds, such as borrowed foreign currency, are preferred.

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The premium payable in the investment currency market is quite simply governed by supply and demand, the buyer paying the premium and the seller receiving it. The premium has fluctuated considerably over the years but in general reflects the strength or weaknesses of the UK economy in terms of the rest of the world. In that the country's economic performance has generally been poor, investment currency has fairly consistently commanded a sizeable premium. The investment currency rate, and thus the premium, represents free negotiation in transactions in reinvestable currency in the light of existing supply and demand conditions and the rate can fluctuate violently at times.

Portfolio investments in foreign currency securities unquestionably account for the bulk of the transactions involving the use of investment currency. To the lesser extent that it is used for financing direct investment, this demand will be minimal when the demand for investment currency is heavy (and the premium consequently high), such demand represents a direct drain on the size of the currency pool as the proceeds of disinvestment can no longer be sold back to the market to obtain the premium. The only significant offsetting factor to this drain is any accrual by way of the appreciation in value of the underlying assets. It should be noted that all income on securities in the form of interest or dividends has to be sold on receipt for sterling at the official market rate.

The Bank of England will permit institutional investors and other professional dealers in securities to borrow foreign currency for an indefinite period to purchase a portfolio of securities instead of insisting on the use of investment currency. Permission given in this connection normally carries with it the condition that a surplus, based on a valuation every three months, of at least 15 per cent in excess of value of the loan outstanding at any time must be maintained. This surplus may be held in the form of premium worthy securities, in investment currency or by virtue of appreciation in the value of the loan portfolio itself. Consequently as values fluctuate purchases of investment currency or premium worthy securities will be required from time to time to provide the necessary cover. The borrowing is usually taken from foreign banks or from non-resident owned deposits with UK banks but it may also be effected by back to back loans (see below).

Before discussing the application of controls to direct investment it should be noted that the regulations do not distinguish between portfolio and direct investment; this distinction is made by the authorities when application for any transactions in foreign currency securities is made. In general a direct investment is one in which the investor takes an active part in the management and operation of the business in which the investment is made. The investment would normally be expected to be one which represented an overseas extension of an existing business in which the investor had proven experience or where a diversification was reasonable in terms of the capacity and previous activities of the investor. There are occasions when a UK commercial enterprise might need to make an investment in, say, a non-resident company simply to protect its existing business or to foster new export business. In these cases, the investment would of necessity involve either participation in the management or operation of the overseas company or even a sizeable participation in the equity of the company. This type of investment is known as a trade investment and would be dealt with in the same way as a direct investment, each application being processed by the Bank of England. Under current practice, the Bank of England would normally find an application to make an outward direct investment acceptable provided that the investment was not construed to be of a portfolio nature, that it was a reasonable extension abroad of business carried on within the UK and that it had no detrimental balance of payments aspects. In such cases permission would be conditional upon the particular method of financing.

The only projects which have any significant access to foreign currency at the official rate are those projects which meet the so-called 'super criterion'. Where the total cost of an export orientated investment will be entirely recovered by actual net accruals to the official exchange reserves within 18 months of the investment being made (or within 3 years in the case of investments in the EEC) application can be made for 'super criterion' treatment. If such an application is successful, permission will be given for the cost of the investment to be financed with official exchange up to £250,000 (£500,000 for investments in the EEC) or 50 per cent of the total cost whichever is the greater. Any balance would have to be financed in the same way as 'non-criterion' investment. It will be appreciated that a comparatively small proportion of investments will fall into this category, and, generally speaking, only marketing outlets which will involve a relatively low outlay and high benefits from cutting marketing costs and increasing exports, could be expected to meet the criteria. If funds are not available under this criteria, which is the case for the majority of investments, then there are a number of other methods of financing available.

a. Foreign currency borrowing. The bulk of overseas direct investments are financed wholly or in part by foreign currency borrowed from a non-resident or from a UK bank. Service costs, at a reasonable rate, can be met with official exchange. The borrowing can be repaid with the liquidation proceeds of the investment, with official exchange to the extent that foreign exchange benefits attributable to the investment have been received in the UK, with foreign currency purchased from the investment currency market, or by refinancing with further borrowing.

b. Counter loans or 'Back to Back' loans. It is possible that a foreign based multi-national company may be willing to lend foreign currency to a UK company in return for equivalent sterling loan facilities in the UK. This arrangement is commonly known as a 'back to back' loan and is normally allowed provided it does not furnish the non-UK company with cheap finance or borrowing outside the rules normally applied to such organisations. Both sides of the loan would be examined to ensure that funds were not being provided at below market rates.

c. Investment currency. Though available, this is little used as a source of funds due to the attached premium. If the situation changed and the premium fell, say to 10-15 per cent, investment currency might become attractive in comparison with borrowing foreign currency.

d. Overseas subsidiaries profits. After an overseas subsidiary has repatriated the required 2/3 of its profits, applications to use the balance of the profit as a loan to the UK parent for an outward direct investment would be considered.

In addition to the above there are other possible sources of finance such as share exchanges and exports free of payment. However, the four categories listed above are the most important.

3. <u>The objectives of exchange control</u>

As described above, the present system of exchange control in the UK developed from the regulations enforced during the Second World War. Understandably, at such a time there was little need to justify the establishment of controls but in the succeeding period there has been little debate on the effects or the overall value of controls. It might seem that the rationale for exchange controls is obvious, on the other hand the majority of other economic policy measures generate discussion as to their merits and demerits, their impact on their intended objectives and on the economy in general. Exchange control is a deliberate market distortion that has received remarkably little attention, it has seldom been subjected to critical and reasoned attack, it has seldom been defended in like manner.

It is possible to infer from the limited amount of official material concerned with the effects of exchange control three objectives which exchange controls may be seen to be achieving. The first two objectives are inter-related; these are the conservation of the UK's reserves of gold and foreign currencies and the protection of the balance of payments. Together these factors have probably provided the most unchanging motive for the continued retention of controls. The third objective, that of attempting to redirect overseas investment into productive investment in the UK, has been given more or less weight depending upon the economic climate and the political persuasion of the government at that time in office.

The application of such thinking is illustrated in an article produced by the Treasury on overseas investment.

"The net additions to our overseas investments in recent years have been financed in such a way that the reserves have been fully protected and the net effect on the balance of payments of all the identified items connected with international investment - both past and present - has been both favourable and massive ... Such an outcome is virtually guaranteed by ... our exchange control rules"[1].

The favourable and massive effect described is not in dispute; as exchange control rules ensure that the majority of overseas investment is financed by foreign currency borrowing or retained profits overseas, the net effect is to generate an inflow of funds. What is less apparent is the longer term effects of controls on the balance of payments.

The present controls are geared mainly to ensure a minimisation of outward flows of exchange during the early years of an investment and little emphasis is placed on the longer term. There appears to be no stance taken as to whether the UK is undertaking an appropriate level of overseas investment. In the past, as we have seen anbove, the earnings from overseas investment have been of great benefit to the UK balance of payments. It would seem plausible that a system of exchange controls which encouraged overseas investment in the UK and, at the same time, restricted the supply of exchange for outward investment would eventually lead to a reversal of this situation, and the trends towards this position have already been remarked on (page 8). Even if the volume of UK investment overseas is sufficient to prevent the reversal of the flow of receipts arising from investment, UK receipts would still be lower than they might have been.

Also, the accumulation of ever increasing reserves is not of itself an important objective of economic policy. Once adequate reserves have been built up to permit whatever degree of exchange rate management is both feasible and desirable, and to ensure the smooth operation of international transactions, then further additions serve no immediate use. It may be argued that the UK is far from being in the position of holding adequate reserves, but if the volume of overseas investment undertaken by UK enterprises has been and remains depressed below some assumed natural level then the present situation (that the net effect of all overseas investment

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1 Economic Progress Report, September 1976.

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adds to reserves) cannot be maintained indefinitely. Eventually as net payments rather than receipts appear in the invisible account the reserves will suffer. In short, the inter-relations between the reserves and our balance of payments are such that they cannot be perceived as independent objectives.

4. The international context

In comparison with the other major western industrialised countries the UK is unique in the longevity and extensiveness of its exchange controls. After the restoration of convertibility on current account, the majority of nations progressively dismantled capital controls over the new few years. There have been quite frequent instances of capital controls being used at times when unwelcome movements in reserves were taking place, but these have usually been dismantled after a short time. One exception is France which implemented extensive exchange controls after the major internal problems of 1968; although slightly reduced, these controls persist. The Italian government has also often made recourse to exchange controls, some of which remain in force.

One of the greatest supporters of free capital movements is the United States. At this time there are no restrictions on current or capital movements into or out from the United States. A philosophy of free capital movement has long formed the basis for the policies of successive administrations. Even so from 1963 to January 1974 a variety of controls on capital movements were in force. This was throughout a time when sustained current account deficits were beginning to engender pressure against the dollar. The controls included measures to reduce the number of foreign currency securities issued in the United States, measures to reduce bank lending abroad and even measures to restrict direct investment overseas.

A similar situation can be seen in Germany. Throughout the 60's capital controls were more or less continuously in force mainly to prevent inflows. These measures were strengthened at intervals in an attempt to prevent the revaluation of the mark which eventually took place in the autumn of 1969. Again exchange controls were employed in 1971 at a time when most currencies were experiencing upward pressure as a result of the difficulties of the dollar. These controls were essentially a consequence of the reorganisation of the international monetary system at that time. At present there are no exchange controls of any significance in force in Germany.

Although Germany and the United States are the only major countries identified by the IMF as not operating restrictions on capital payments,[1] only minimal controls operate in a number of countries, for example, Canada, and members of the EEC are committed to the removal of all controls at some future date (see page 45). Japan has maintained capital controls, for much the same reason as did Germany in the 60s and early 70's, although some relaxation has taken place recently.

1 IMF "28th Annual Report on Exchange Restrictions", page 298.

THE IMPACT OF EXCHANGE CONTROLS

1. Introduction

The purpose of this section is to analyse the past movements in various aggregates in an attempt to establish how these movements may have been affected by modifications in exchange controls. Official information of any degree of adequacy does not start until the late 50's, since then there have been various shifts in the way the statistics are presented, nevertheless, a reasonably clear picture of the last twenty years or so is available. In contrast with the first section where the net position of the UK in terms of investment flows and interest flows was discussed, this section does not offset inward flows of foreign funds against similar outward flows; overseas investment here is gross UK outward investment.

2. Portfolio investment

The exchange control modifications directly relating to portfolio investment in the period in question have been few and usually of a nature which discouraged portfolio investment, these changes are described in detail in above. The pattern of UK portfolio investment overseas since 1960 has shown considerable fluctuations. In Table 4 the period from 1960 to 1976 (the latest year for which data is presently available) is shown, there has been investment (an outflow of funds) for 9 of the years and disinvestment (an inflow of funds) for the remaining 8 years. It is difficult to assess whether, over this interval, there has been net investment or disinvestment in real terms but the magnitude of the figures suggest the latter has been the case. In addition to overall portfolio investment, a geographical disaggregation of portfolio investment between the sterling area and the rest of the world has been available. This breakdown was discontinued after 1973, but, as shown over the period in Table 4, the sterling area as a destination for portfolio funds was falling in attraction. The extension, in 1972, of exchange controls on portfolio investments to the sterling area (see above page 17) might be seen as the cause of the large disinvestments in 1972 and 1973. While they may have played a part, two points should be noted. Firstly, up to 1972 there had not been appreciable investment in this area, in 7 years there had been disinvestment, in only 5 investment.

Secondly, the controls extended to the sterling area made it comparable in terms of restrictions to the rest of the world, but at a time when portfolio investments in the sterling area were being run down, large additions to portfolio holdings for the rest of the world were being made. It appears that the fall in attractiveness of sterling area portfolio investments was only in part due to the changes in exchange control, rather these changes accelerated a decline which had been taking place over some time.

Table 4. UK Portfolio Investment by Area
(units: £ mn)

	Total portfolio investment	Portfolio investment in the overseas sterling area	Portfolio investment in the rest of the world
1960	-37	-13	-24
1961	-28	11	-39
1962	-39	-5	-34
1963	5	-8	13
1964	3	-25	28
1965	-94	-50	-44
1966	-83	-39	-44
1967	59	41	18
1968	236	157	79
1969	34	21	13
1970	111	22	89
1971	38	-62	100
1972	605	-121	726
1973	-229	-501	272
1974	-755	na	na
1975	49	na	na
1976	-165	na	na

Source: CSO United Kingdom Balance of Payments.

Official statistics on the breakdown of portfolio investment by area ceased after 1973, therefore the areas which benefited from the fall in importance of the sterling area cannot be identified.

What conclusions can be drawn from the behaviour of portfolio investment? Of the changes that took place in 1965, see page 17, when the 25 per cent surrender requirement was introduced, it is not apparent that this had any effect on investment at the current level of aggregation. The changes in 1972 [illegible] celerated the fall [illegible] rtance of the sterling area [illegible] subject to the above qualifications. As noted above on page 17, there have been no relaxations of controls specific to portfolio investment of any significance during the period, and so the low overall level of portfolio investment is unsurprising.

3. Direct investment

In Table 5 figures for UK direct investment overseas for the last ten years are given. The level of direct investment has been growing steadily, until recently, at quite high rates in current price terms. Even after allowing for inflation, direct investment has been growing over the period shown in Table 5 at an annual average rate greater than 6 per cent per annum. This is a consistently better performance than that of portfolio investment but, in the light of the historical background presented above, far below what has been achieved in the past.

Table 5. UK Direct Investment Overseas by Geographical Area (units £ mn)

	Total	In the EEC	In North America
1966	276	51	61
1967	281	30	85
1968	410	73	114
1969	549	105	89
1970	546	78	185
1971	676	263	156
1972	737	223	161
1973	1,621	519	511
1974	1,575	364	483
1975	1,094	151	308

Source: CSO United Kingdom Balance of Payments.

The major alteration in exchange controls during the recent past was the relaxation of controls for direct investment in the EEC between mid-1972 and mid-1974. During this time direct investment in the sterling area was permitted greater access to funds at the official exchange rate, but further analysis is not possible because official statistics ceased to separate the sterling area after 1973.

The very sharp upswing in direct investment in the EEC shown in Table 5 between 1972 and 1973 cannot all be attributed to reductions in exchange control, even though they were wide reaching. It was officially estimated at the time that 90 per cent of all new investment projects in the enlarged EEC and over 50 per cent by value were likely to be eligible for finance entirely at official rates.[1] Total direct investment more than doubled at this time and direct investment in North America tripled. This increase in North America is not necessarily unrelated to the changes made in respect of the EEC. If funds became more easily available for investment in the EEC, multinationals who were active both in North America and in Europe would be able to devote additional resources to North America from the cost savings they had made in Europe. However, the size and the international character of the increase in 1972-73 suggests that this was part of some cyclical process rather than any direct result of alterations in controls. Also the decision lags involved in formulating and implementing investment projects would lead one to expect some delay before a change in the regulations is exploited to the full.

The situation is improved slightly if the period 1974-75 is considered, when the relaxations referred to above were reversed, see page 18. At this time all overseas investment was in decline, total direct investment fell by some 30 per cent. But as investment in North America fell by 36 per cent, broadly in line with the total, investment in the EEC fell by 59 per cent. It is clear that decision lags are less important in cases of restriction, except for projects for which permission has already been given but have not yet been implemented, a return to the old standards is virtually immediate. On this basis, some 20 per cent of the value of investment may be inhibited by a shortage of funds at the official rate.

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1 IMF "24th Annual Report on Exchange Restrictions", page 499.

...erves and the exchange rate

...oted above (page 22), one of the benefits of exchange control is that ... added to the UK's reserves of gold and foreign currencies. This is ...ly achieved by ensuring that UK overseas investments are financed in ... a way that there is no drain on the reserves, the sources of finance ... expounded below. In September 1976 the Treasury estimated these ...tions to average £2¼ billion per year for the years 1974-75 inclusive. ... is not an inconsiderable figure, for example the UK's official ...rves throughout 1976 at no time exceeded $7.5 billion. On the other ...d, official reserves can be affected by factors which cause movements of ... great magnitude. From January 1977 to December 1977 these same ...cial reserves grew from $7.1 billion to $20.6 billion, mainly as a ...ult of exchange rate movements between the dollar and other currencies. ...hough the additions to the reserves are of value, their size must be ...t in perspective.

...oughout the 1960's the reserve position of the UK was chiefly determined ... the deficit or surplus on the balance of payments current account. From ... to 1970 years of surplus and deficit occurred with about the same ...quency, but periods of deficit were a cause of great concern. For ...mple, in 1967 there was a deficit on current account of £300 million, at ... end of the year official reserves stood at £1,123 million and had ...efitted from inflows from overseas monetary authorities of nearly £700 million. Overall, 1967 was a year of unusual events and it cannot be considered typical for a number of reasons, but other years of large ...icits in the 1960's, in 1964 a deficit on current account of £356 million and in 1968 a deficit of £287 million, created movements in ...serves of large magnitudes. Even though the period included some years of appreciable surplus, for example £104 million in 1966 and £440 million in 1969, the atmosphere which prevailed was of continuing concern about the adequacy of the reserves at times when the UK's international trade performance was poor. The recurrent balance of payments problems of this period provide the economic rationale for the evolution of exchange controls during this time. As shown above, page 16, there were few changes, ...d those that were made tended to increase rather than reduce restrictions.

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Events in the 1970's again generated large movements in UK reserves which made the identification of any changes directly attributable to exchange controls difficult. A common factor in these movements was the position of the balance of payments, four years of large deficits in 1973 to 1976 led to large scale official borrowing to prevent the reserves falling unduly. However, at this time a new factor came into play, the system of pegged exchange rates which had operated since 1958 began to break up. The details and background to the restructuring of the international monetary system in the early 1970's is outside the scope of this report. Briefly, an agreement on a new set of exchange rate parities was reached in December 1971, but this arrangement was disrupted in June 1972 by the decision of the British government to float sterling. This decision resulted from balance of payment pressures and was accompanied by changes in exchange controls[1] which, in retrospect, marked the end of the Sterling Area. Henceforth the importance of internationally pegged exchange rates declined. Soon the majority of currencies were allowed to float, either independently or, like the 'snake', jointly. There is no consensus of opinion on the overall effects of this transition but a few observations can be made. Before floating became widespread the majority of reserves in most countries were held in dollars, this is no longer true. Due to the fluctuations in the value of the dollar with respect to other currencies, a variety of currencies is now preferred. For example the rate of sterling against the dollar varied in 1975 and 1976 between \$2.418 and \$1.637 to the pound. This may be an extreme example but currency fluctuations, although they can be reduced by holding a mix of currencies as reserves, have played a role in determining the value of reserves which was unknown in the 1960s. This new variability also generates large movements in the value of foreign trade, again with implications for changes in reserves. Finally, although there is disagreement on the whether the volume of speculation has increased or diminished with the introduction of floating rates, there has been a significant change in its nature over recent years. A large and increasing part of what are usually called 'speculative' currency movements are a result of international traders seeking to avoid losses from currency movements. Decisions to accelerate payment or seek extended credit in order to benefit from expected currency movements are now more widely

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1 See page 18.

considered and employed than in the past where movements in exchange rates were infrequent. By its nature, this type of speculation is extremely difficult to regulate.

Thus, like the sixties, the seventies present extreme difficulties to any attempt to isolate the effect of exchange controls on the reserves. The period 1972-1974 provides one of the few examples of significant relaxation of controls, but this period coincided with the floating of sterling and the collapse of the Smithsonian agreement. Movements in the exchange rate are similarly unhelpful, apart from being closely connected with movements in the reserves. Changes in the 1960's were infrequent and in the 1970s have been excessively frequent. On the other hand as is shown above (page 18), the introduction of controls over capital movement has often been made at times of pressure on reserves or the exchange rate.

This contradiction is more apparent than real. The majority of this report has been concerned with exchange controls which have been in force in the UK with little modification since the Second World War. In contrast, the exchange controls introduced at times of difficulty with the external account tend to be directed at speculative movements of money. At one time international capital movements were seen as an important equilibrating force in the international mechanism of payments, accordingly controls on capital movements were counter-productive. Rather it is .... "preferable to follow, wherever possible policies, aimed at attracting appropriate equilibrating movements of private capital through international co-ordination of interest rates or similar international action, or to offset undue movements of short-term capital through the use of international liquidity."[1] However, it is not easy to find any examples of countries which, at a time of balance of payments difficulties, adopted such policies. Under the regime of floating exchange rates short-term capital movements are viewed less favourably. Such capital movements are now commonly seen as contributing to exchange rates "overshooting", that is, the process of adjustment in any direction was being prolonged beyond the point at which the rate was correct. This would give rise to excessive and unnecessary currency movements.

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1 IMF's 14th Annual Report on Exchange Rates, page 28.

exchange controls of central concern in this report are not generally of the type directed at short term capital movements, the one small exception here is the controls on portfolio investment which affords limited scope for speculative transactions. The large changes in exchange rates and official reserves which can occur today as a result of short-term capital movements of a virtually uncontrollable type indicate that present controls, particularly on direct investment, play little part in moderating speculative currency movements.

Sources of funds

As noted above (page 23), one consequence of exchange controls in the UK is that practically all the funds for overseas investment come from either foreign currency borrowing or from overseas profits. Official figures indicate that in the 4 years from 1973 to 1976 inclusive[1], on average more than 75 per cent of net UK private investment overseas did not involve any cash flow, that is, it was funded from profits overseas, trade credit and so on. The remaining portion of net investment was more than covered by borrowing foreign currency from UK banks and other sources. While it would not be correct to assert that no use was made of funds from the UK at the official exchange rate, the figures above are net of disinvestment which prevents such an interpretation, it is clear that such funds can have played only a minor role. The official figures for net direct investment show a similar reliance on profit overseas as a source of funds.

Not all who wish to undertake investment overseas can avail themselves of overseas profits as a source of funds, to do so requires overseas subsidiaries which are making adequate profits. Thus organisations with a history of overseas activity and a well developed network of subsidiaries enjoy a clear advantage. Similarly, such organisations are more likely to have established financial subsidiaries in locations where conditions for the raising of finance are favourable. The operations of such enterprises could be to some extent independent of UK exchange controls, except that there remains a requirement that a proportion of profits (usually 2/3) be remitted to the UK parent company. Also the proportion of profits that are

1 CSO "Balance of Payments Statistics 1966-1976", page 61.

to be remitted is at the discretion of the authorities and in certain circumstances, for example, if the subsidiary is purely a vehicle for portfolio investment, remittance of all net profits may be required.

For enterprises without subsidaries operating and trading overseas, borrowing of foreign currency is the usual source of funds. The establishment of a subsidiary overseas to raise funds is not generally attractive, not only due to the technical problems directly associated with such an action but also the activities of such subsidiaries are subject to a number of exchange control requirements. The extensive use of funds borrowed at a fixed interest rate for investment has obvious shortcomings. Normal commercial prudence would suggest that investments funded in this manner would be undertaken only to a limited degree, where investors are allowed freedom of choice in investment finance there is usually considerable use of equity issues as a source of funds.

One aspect of the use of equity to finance overseas overseas investment merits further consideration. The case in which the issue is made to UK residents is unremarkable; the generated funds are converted at the appropriate rate and invested. However, if non-residents are the recipients of the issue the situation is more complex. A good example of such an issue would be the UK resident firm making a direct investment overseas by means of an exchange of shares. In the absence of exchange controls this method of effecting overseas investment has a number of attractions. Firstly the prospective investor is able to make the investment without any direct borrowing or immediate cash flow. Secondly, the foreign shareholder may prefer an exchange of shares to a direct cash purchase, for example, this may avoid a capital gains tax liability. Finally from the point of view of the UK economy, there is no immediate drain on foreign currency reserves. Admittedly when the foreign shareholder decides to cash his UK shares there will be a drain, but this is postponed (perhaps for a considerable time) whereas the benefits of the direct investment, which are described elsewhere, commence immediately.

The regulations which cover this type of operation are couched in order to achieve a symmetry between share exchanges and direct investment by other means. Specifically most direct investment is financed in such a way that foreign exchange reserves benefit, therefore if the investment is to be made by an exchange of shares, compensation to the reserves is required. This can be achieved in three ways. Firstly, the foreign currency securities could be sold and the resulting foreign exchange sold to a UK bank at the official rate; in most cases this would obviate the motive for acquisition. Secondly, investment currency to the value of the sterling securities at the time of exchange may be purchased and sold to a UK bank at the official rate, this is commonly known as "switch and surrender". Finally, foreign currency may be borrowed to the value of the sterling securities and sold to a UK bank at the official rate, this removes many of the advantages of equity financing. Thus where share exchanges are employed the option to "switch and surrender" is usually taken. This area provides a highly suitable place for relaxation of controls. On the one hand, mutually advantageous terms can be struck between the UK investor and the foreign shareholder; on the other hand, the drain on UK reserves is postponed whereas the benefits from the investment begin at once.

THE EFFECTS OF THE RELAXATION OF EXCHANGE CONTROLS

1. Introduction

In this section an attempt is made to provide estimates of the broad magnitude of the changes which would follow from the relaxation of exchange controls. As will become apparent, these estimates are subject to a wide margin of uncertainty and should be viewed with this qualification in mind. The complex nature of the interaction between investment flows and their determining factors, even in a domestic context, has been the subject of considerable research which has yielded only a limited number of conclusive results. In an international setting this is even more the case, even if the effects of exchange control are disregarded. Nevertheless the provision of some estimates is a worthwhile exercise even if they only indicate the dearth of work in this area. No attempt is made to directly relate specific relaxations of exchange controls to precise changes in investment flows. Given the imprecision of the exercise, such an attempt would be foolhardy. The wide ranging nature of exchange controls offers a great number of possibilities for partial relaxation and the measures which seem to be of most value are presented elsewhere in this report. The degree of analytical precision possible within the terms of this report, confine the problem to contrasting the present position with one of greatly reduced exchange restrictions. Such a position would be one in which exchange control on direct investment was removed and retained on portfolio investment only to the extent considered necessary to prevent excessive speculative transactions. It is not suggested that this represents a policy which sould be immediately brought forward, this would be a rash and unjustified proposal, but rather an examination of a 'limiting case' towards which some movement could be recommended. The remainder of this section deals firstly with direct investment and then with portfolio investment.

2. Direct investment

If an extensive relaxation of controls on direct investment were made, what would be the change in direct investment overseas by the UK? In order to answer this question it is necessary first to set a lower bound to the estimates. As described above (page 17), the most significant relaxation in recent years was applied from 1972 to 1974 in respect of investment in the EEC. It was suggested there that these changes altered investment in the EEC by approximately 20 per cent. This is probably below the figure required in this context for two reasons. Firstly, the revised regulations remained in force for only two years. It is unlikely that all investment which might arise had done so within this interval, in other words, behaviour had not completely adjusted to a position of long-run equilibrium. Secondly, the period 1972-74 commenced with the floating of sterling and concluded with the oil crisis. This does not seem an appropriate background for vigorous overseas investment, especially since the appearance of currency floating in 1972 was a break from recent historical precedent. Additionally, some 50 per cent of the value of investments would not be covered by the relaxation according to official estimates at the time. If we take a figure of 40 per cent, which in view of the above is likely to be below the true figure, this would give an increase in overseas investment in, for example, 1976 of £840 million.

The period immediately before the First World War provides a reference point which helps to set an upper limit to the volume of direct investment which would be undertaken in the absence of controls. The starting point is the relation between net foreign investment and gross capital formation. In the twenty years immediately before World War I, net foreign investment averaged £202 million per annum and gross capital formation in the UK averaged £302 million per annum. As suggested above (page 9), a large part of net foreign investment at this time fell into the category of portfolio investment. No exact figures are available for this period, or any period before the late 1950's, therefore, on the basis of the arguments above (page 9), it is assumed that 50 per cent of the total investment during this time was portfolio investment. That is, the ratio of net foreign direct investment to gross capital formation was 1 to 3. The change in importance of the public sector since that time should be mentioned. Total gross public expenditure in the period 1895-1914 averaged only 8 per cent of National Income, and of this only an insignificant part can be explicitly attributed to capital formation[1]. Accordingly the share of the public sector in capital formation during the 1895-1914 period is assumed to be negligible. Therefore a peak level of foreign direct investment of one third that of private gross domestic fixed capital formation is implied, in 1976 this would have corresponded to £4.4 billion. This represents a considerable overstatement of the present potential in the economy for direct investment overseas; the importance of the UK in the international economy has declined dramatically over the period in question.

The upper and lower limits to direct investment presented above suggest that the increase in direct investment overseas as a result of the removal of exchange control restrictions would be approximately £2 billion per annum in terms of 1976 values. It is evident from the preceding arguments that this figure is not a precise estimate, but on the other hand it represents the likely magnitude of any such increase in the long run. In the absence of any better estimate this figure will be used throughout the remainder of this section.

What would be the consequences for the balance of payments if controls were removed and this additional £2 billion of overseas investment began immediately? Admittedly controls are more likely to be removed over a period of time and the response of new investment would not be instantaneous but this extreme case is worth consideration. In 1976 values there would be existing investment, at £2.1 billion in 1976, and new investment to be financed. Control relaxation would enable existing investment to be financed from the UK, if so desired, in the same way as would new investment. However, UK industry has always made heavy reliance on undistributed income as a source of capital funds, between 1971 and 1976, it provided between one half and two thirds of capital funds[2], and it is to be expected that a substantial proportion of overseas investment would be financed directly or indirectly from overseas profits. Additionally, over the 1971-1976 period borrowing from banks contributed some 20 per cent of domestic capital funds. Therefore it is assumed that 50 per cent of this

1 Mitchell and Deane (op cit), page 397. 2 Economic Trends Annual Supplement 1977, page 142.

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total overseas investment of approximately £4 billion would be financed either from overseas borrowing or from retained profits overseas; this implies a maximum drain on official reserves of £2 billion a year initially.

This represents a considerable outflow of funds but, bearing in mind that it is very much a maximum estimate, not exorbitant. Between 1976 and 1977 the value of UK exports increased by nearly £7 billion at a time of slow growth in world trade. More importantly, so far only the immediate outgoings have been contemplated, as time elapsed the drain on reserves would be reduced. As overseas earnings from these investments built up an increasing proportion of investment would be financed from these sources. Given the reliance of industry on undistributed income as a source of capital funds, eventually about three quarters of total overseas investment would be financed in this way or from overseas borrowing. This would leave an annual outflow of about £1 billion which would be financed by sources in the UK and require currency from official reserves. Finally the invisible earnings from this increased investment should be included, as a first approximation, since private investment overseas is to double on the above arguments, it is assumed that interest, profit and dividends will double. In terms of 1976 values this implies an increase in IPD of £2 billion per annum to be counted as additions to reserves, this offsets the outflow noted immediately above.

To summarise, a widespread relaxation of exchange controls on direct investment is postulated to generate additional overseas investment of some £2 billion at 1976 prices. Initially there would be a drain on official reserves for almost the full amount of additional investment but after a few years the position would stabilise to one where the net additions to reserves would be £1 billion per annum (at 1976 values) greater than at present. This section has sought to demonstrate that the maintenance of a higher level of overseas investment is not only compatible with balance of payments equilibrium but would also be beneficial to the reserves. However the debate surrounding overseas investment is more wide ranging than the balance of payments and reserves, it is now appropriate to discuss some of the wider implications of such a situation.

3. Direct investment and the balance of trade

The effects of direct investment overseas on the balance of goods and services would affect both imports and exports. The establishment of an overseas subsidiary to supply a UK parent company with goods for input to the production process or for sale may increase UK imports to the extent that foreign suppliers might not be used in the absence of such a subsidiary. On the other hand, the subsidiary may merely replace existing foreign suppliers, possibly yielding additional advantages in price or security of supply. UK exports might benefit from the supply of capital goods to the subsidiary (probably in the initial years for the most part), the supply of goods for resale abroad or the supply of input items.

The only major study in the post-war period on UK direct investment overseas, conducted by Reddaway at the University of Cambridge, devoted considerable energy in valuing the significance of these trade effects. This study found the generation of imports by overseas investment to be of insignificant importance. This confirmed their impression that: "production of materials overseas for use by the parent group in the UK is an extremely minor objective of their overseas investment, considered as a whole."[1]

The addition to exports from overseas investment was of a quantifiable if not substantial, magnitude. The period over which the study ran, namely 1955-1964, may make some of its conclusions less valid today. For example, Reddaway points out that sales of capital equipment to certain major countries are inhibitted by tariffs, since that time there have been considerable reductions in tariff barriers. On the other hand the methodology of the study makes any compensating adjustments impracticable even if they were considered to be desirable.

Taking the results of the study[2] and applying them directly to the example in this report, at 1976 prices the increase in volume of direct investment of £2 billion arrived at above would lead to an initial increase of UK

1 W.B. Reddaway "UK Direct Investment Overseas", page 78. 2 Op cit, page 124.

exports of £180 million. This would help to reduce the initial drain on UK reserves to some degree. Thereafter the continuing effects on exports would amount to only £30 million per annum at 1976 values.

Although increased exports are generally considered to be advantageous to the UK, the orders of magnitude of these flows are not such as to make them a major factor in assessing the desirability of UK overseas investment.

4. Overseas investment and domestic investment

Compared with many of our international competitors the rate of capital formation within the UK has been disturbingly low for many years. Direct investment overseas is sometimes visualised as being a contributing factor to this situation, in that it is compared with investment in machinery, plant and buildings in the UK. Hence this 'export of capital' is reducing manufacturing and employment potential at home. Clearly certain types of overseas investment could not take place in the UK, for example investment in extractive industrial capacity for raw materials which do not exist in the UK. Additionally it is incorrect to make direct comparisons between the value of overseas investment and, for example, the value of gross domestic fixed capital formation. Overseas investment includes not only fixed productive assets but also stock building, stock appreciation, and other transactions of a financial nature such as additions to or repayments of working capital, other loans and trade credit and transactions in securities. On the other hand overseas investment is expressed net of disinvestment. Leaving aside such conceptual confusions, to what extent do firms invest overseas to the detriment of capital formation in the UK?

Once again considering the peak years of overseas investment before the First World War, it is true that from about 1875 foreign and domestic investment tended to move in opposite directions.[1] In recent years this tendency is less pronounced or absent, this could be due to a number of factors for example, the earlier flows included considerable portfolio investment, a category of investment now subject to heavy restriction. Even

1 Deane and Cole (op cit), page 267.

if a relaxation of controls meant the reappearance of this earlier pattern, that of domestic and foreign investment moving in opposite directions, the conclusion that controls are preventing the export of capital is not immediate. As has been pointed out elsewhere: "the virtual disappearance of opportunities for foreign investment in the 1930's and after does not seem to have released any funds for domestic investment."[1] The availability of funds for investment is partly determined by the investment opportunities which present themselves, thus it is hardly surprising that foreign investment should seem most attractive when investment in the UK is low. Naturally, this works both ways, the UK lags behind other major industrialised countries in its response to world economic cycles and is less affected by downturns in these cycles. Thus when conditions overseas are unattractive the UK may benefit from increased investment. It is not plausible that in the absence of the permission to invest overseas all available funds would then be deployed in capital investment in the UK. If there are no investment possibilities which offer an adequate return either the capital funds will not be sought, by bank borrowing or capital issues, or funds which do accumulate, for example, profits in excess of dividends, would be held as financial investments until such time as investment conditions improve.

Nor is it justifiable to argue that overseas investment reduces the funds available for domestic investment to an extent which prevents such investment taking place. There is no evidence that a shortage of funds has had a limiting influence on investment in the UK. On the contrary it has been found:

"The companies in our sample were virtually unanimous in saying that (in our ten-year period) shortage of finance had not forced upon them a choice between expansion at home and capital expenditure overseas: either undistributed profits and depreciation gave enough funds for all products which were considered desirable on 'market' grounds, or the company was able to raise finance by issuing shares or debentures, either in the UK or abroad".[2] Finally even if the most extreme assumptions are made as to the use of the UK capital market as a source of funds for overseas investment,

1 Deane and Cole (op cit), page 267. 2 Reddaway (op cit), page 93.

that is, some £2 billion in 1976 prices was to be so raised, this would represent only 12 per cent of all capital funds of industrial and commercial companies in 1976.

In summary, there is no evidence which indicates that overseas investment has displaced domestic investment in the past or that it would do so in the future. On the contrary, it could be argued that at times when the UK does not provide suitable opportunities then foreign investment will enable the generation of funds which could be directed towards the UK when conditions improve.

5. Portfolio investment overseas

Portfolio investment has been of diminishing importance in the twentieth century, both the volume of investment and the earnings from that investment have been falling, particularly since the Second World War. This is largely a consequence of the way in which exchange controls apply to transactions of this nature, although the long term downward trend of the UK's importance in the international economy has doubtless played some part. That such investment should have received little encouragement is perhaps unremarkable, portfolio investment in the view of many has an aura of speculative and unproductive transactions. But portfolio holdings have been of great value to the UK in the past, both as a source of invisible earnings and, on one notable occasion at the beginning of the Second World War, as a source of foreign currency at a time of great exigency. The value of portfolio investment was appreciated by the Bland Committee which recommended thus: "The committee, in the belief that obstructions to both the inflow and outflow of portfolio investments are likely to undermine earnings of invisible income, recommends that the Government should consider policies aimed at eliminating or reducing such obstructions."[1]

A drawback of portfolio investment, which is not present for direct investment, is that it may provide a vehicle for speculative movements of funds. This is probably of less importance now than in the 60's, as noted above, movements of funds in the course of legitimate trading operations

1 Bland (op cit) page 172.

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are now managed to a much greater extent to avoid exchange losses or benefit from exchange rate movements. Compared with this, portfolio investments are unlikely to provide a major source of speculative funds.

The reaction of portfolio investment to any partial or even total relaxation of exchange controls, is extremely difficult to predict. To provide any sound estimates, while not impossible, would require a depth of analysis outside the scope of this report, the presentation of figures without such a basis would be speculation, in the other sense. This does not prevent the recommendation of some relaxation for portfolio investment, not only the historical precedent of its large contribution to the balance of payment is relevant, but also the opportunity it would give to UK financial institutions to expand their activities on an international basis. The invisible earnings of the city could not fail to be enhanced by such a step. On such a basis a policy of gradual relaxation could be envisaged, this might have a different impact on institutional investors or investment trusts compared with the general investor.

Action could be taken to reduce the dollar premium on investment currency. The size of the pool could be increased by, for example, allowing a proportion of the returns to portfolio investment to be treated as investment currency thus ensuring their reinvestment. Any or all of these measures would reduce the level of the dollar premium and enable an increase in overall portfolio investment. Special treatment could be extended to investment trusts. The degree of cover (at present 15 per cent) which they must maintain on foreign currency portfolio could be reduced, they could be allowed to use some or all of their profits for reinvestment at the official rate and so on.

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CONTROLS IN A POLITICAL CONTEXT

1. EEC commitments

On joining the EEC on January 1, 1973 the UK government committed itself to a programme of increasing relaxation of exchange controls on transactions between residents of the UK and those of other EEC countries. There was an obligation on the UK to liberalise inter-EEC movements of capital within the first five years of membership but, in the event, little liberalisation took place. The original timetable for liberalisation was:-

By the end of 1972 - substantial liberalisation of direct capital investments in the EEC by UK enterprises, complete liberalisation of capital investment in the UK by EEC residents, and removal of restrictions on the movement of personal capital associated with the freedom of movement of workers.

By the end of 1974 - the removal of all remaining restrictions on direct investment in the EEC by UK businesses.

By mid 1975 - the removal of restrictions on the movement of personal capital to EEC countries.

By the end of 1977 - the removal of restrictions on portfolio investments in property and securities, etc., in the EEC by any residents of the UK.

Although it is obvious that this timetable is considerably out of date it is useful in so far as it indicates the direction in which the UK exchange control authorities are committed to move and should, therefore, give an indication of the priorities. Also as noted above (page 25), the UK is not the only member of the EEC which maintains control on capital movements, significant restrictions exist in France and Italy.

The improved economic situation in the UK at the end of 1977 led to considerable pressure from certain directions that further liberalisation should be put into immediate effect, but the country still has a large volume of medium-term debts which will fall due for repayment in the coming years. The Chancellor said at the time that the first aim should be to use the proceeds of North Sea oil for investment at home rather than allow it to go abroad, although some increase in overseas investment might have a role to play. This indicated a reluctance to liberalise to any greater degree than was forced upon the government by other EEC members. In fact some minor liberalisations, the most significant being the abolition of the 25 per cent surrender requirement, were made at the beginning of 1978.

Could the UK maintain controls on capital movements to other parts of the world but remove them for movements to the EEC? In the case of direct investment it is probable that controls could be maintained, assuming that controls on portfolio investment to all areas were still in operation. Once portfolio investments in the EEC became free of control it is unlikely that any form of geographical discrimination would be practicable. Holders of sterling would be able to transfer funds through the EEC to any destination. To a certain extent this would be a repetition of a situation which occurred during the operation of the Sterling Area. At that time transactions through the 'security dollar gap' or 'the Kuwait gap'[1] caused a loss of sterling to the area. The authorities were able to restrict these transactions but under modern conditions would not be able to prevent export of sterling via, say, Germany. This view receives some confirmation from events at the beginning of this year. The removal of the 25 per cent surrender requirement referred to above applied worldwide and not only to the EEC. This was widely reported as being a consequence of the relaxation being 'too difficult to police if limited to Europe.'[2]

2. <u>The timing of relaxation</u>

It has been argued elsewhere in this report that the contribution to the UK of its overseas investment, which has been great in the past, is presently diminishing. International pressures for control relaxation are probable

1 See B. Tew "International Monetary Cooperation 1945-70", page 198. 2 Economist December 24, 1977.

over the next few years, in line with other major countries. One of the most widely feared consequences of relaxing exchange controls is that a massive outflow of funds from the UK would rapidly develop, the longer exchange controls are maintained the more difficult it becomes to make exact predictions about the results of their removal and thus to assess the size of this danger. It is certain that no responsible government would attempt to dismantle them wholesale overnight, a policy of gradual relaxation would be adopted.

Evidently, the best time for such a policy to commence is at a time when the balance of payments is not a cause for extreme concern and when overseas confidence in the UK is good. Any dangers of large speculative outflows or extreme increases in direct investment would be at a minimum at such a time. The UK is presently in a sounder position, both with respect to the balance of payments and its standing in the international community, than it has been for many years. On this basis policy moves to reduce exchange controls could well be implemented.

SUMMARY AND CONCLUSIONS

This report shows that since the Second World War the UK has, by its own historical standards, undertaken overseas investment at only a very modest level. The invisible earnings from overseas investment have shown limited growth, in comparison with the earnings of other invisibles. Inward foreign investment in the UK, encouraged by exchange controls, has led to the situation where the earnings from our overseas investments only slightly exceed the payments necessary to foreign investors, and this surplus is falling. On present trends this source of invisible earnings will soon be negligible and then become an outflow. Within the sub-divisions of investment, portfolio investment (once the major earner in this category) is now yielding insignificant returns to the UK, and most recently payments overseas on portfolio investments have begun to exceed UK earnings in this category. Portfolio investment has been hit particularly hard by exchange controls, it has shown no signs of growth since the Second World War and has been recently replaced by disinvestment, even before allowing for inflows of similar foreign funds.

The claimed benefits of exchange controls to the reserves ignore these long term effects on the balance of payments. The short term effects are beneficial, the regulations ensure that the majority of overseas investment is financed in such a way that there is no drain on the reserves. But the restricting effect on investment is such that the earnings of UK investments are growing more slowly than the payments to foreign investors, eventually this must lead to a net drain on reserves as the payments begin to exceed the earnings.

This study also provides some estimates of the effect of relaxing controls. These estimates show that although there would be a drain on the reserves initially, earnings from increased investment would soon make the new level of investment self-financing, leaving a final position where invisible earnings from investment would continue to make a positive contribution to the balance of payments. In addition, no evidence is found that this increase in overseas investment would be at the expense of domestic capital formation.

There are not only direct economic arguments in favour of relaxation of exchange controls. The UK has made commitments to the EEC to remove restrictions on capital movements within the community. Invisible earnings not directly associated with investment, for example by the City would benefit and some increases in exports are predicted.

It is argued that the sole adverse effect of removing controls, that is on the reserves, could be moderated by gradual relaxation. More importantly, it is impossible to maintain indefinitely a situation where both outward investment is restricted and earnings from investment make a positive contribution to the balance of payments. Finally, it is noted that the UK is in a strong position to begin some liberalisation of controls at this time; the balance of payments is a less binding constraint than for some years and the economy is in better health in the view of the international community.

On this basis, action to begin to remove exchange controls is to be recommended. Those wishing to make direct investments should be given greater access to funds at the official exchange rate and much greater freedom in their choice of financing methods for overseas investment. Specifically, controls which presently inhibit the use of share exchanges in direct investment should be reviewed since investment by this method has advantages not only for the individuals concerned but also reduces the immediate drain on reserves. Steps should be taken to reduce the drains on the investment currency pool, and preferably to increase it in size. Institutional portfolio investors could be given more latitude in the conduct of their operations.

EF2CS

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PS/FINANCIAL SECRETARY

EF(2)CS
14 JUN 1979

cc to: PS/Chancellor of the Exchequer
PS/Chief Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir Douglas Wass
Mr Barratt
Mr Dixon
Mr Hancock
Mrs Hedley-Miller
Mr Middleton
Mr Unwin
Mr Cropper
Mr Ridley
Mr Drane
Mr Ilett
Mr McIntyre
Mr D A Dawkins (B/E)
Mr C Benjamin (DCI)
Mr G Lanchin (DOT)
Mr G E Fitchew (UKRep Brusse

EXCHANGE CONTROL AND THE BUDGET DEBATE

1. You have told us that, for lack of time yesterday evening, the Financial Secretary was unable to include in his winding-up speech the passage on exchange control relaxations (as shortened and finally approved). Since speaking with you, I have heard that the Trade Secretary's office have told the Chancellor's office that Mr Nott would probably be glad to include something on exchange control when he opens the resumed debate on Monday 18 June. If he can fit it in, it seems to us that it would be good if Mr Nott were to speak at least about the case for concentrating initially on outward direct investment and on the evidence against the TUC thesis that overseas investment supplants investment in the UK. Mr Nott himsel might also like to say a word about the restoration to UK merchants of sterling finance for third country trade; and a word about our EEC position could also be useful, subject to Mr Fitchew's advice in the light of any reaction from the Commission to the Chancellor's letter to Mr Jenkins of 11 June.

2. As I understand, the alternative to something being said, at least about outwar direct investment, by Mr Nott on 18 June would be to wait until the Second Reading o the Finance Bill on 27 June, when the Financial Secretary might be able to include an exchange control passage if he speaks. I suppose an earlier occasion might aris if between now and then there is any hostile comment in the House which needs a quick answer.

3. If Mr Nott will be dealing with the subject next Monday, I do not think it woul be appropriate to ask him to get on the record the point to which we have attached importance in relation to private property abroad, namely, the reasons why the sale

/proceeds...

DRAFT LETTER FROM: PS/FINANCIAL SECRETARY
TO: PS/SECRETARY OF STATE FOR TRADE

EXCHANGE CONTROL AND THE BUDGET DEBATE

1. As you know, the Financial Secretary did not have time when winding-up yesterday evening to say something, as he had planned to do, about the exchange control relaxations announced by the Chancellor on 12 June. I understand that your Secretary of State might welcome the chance to say something on the subject when he opens next Monday 18 June. The Financial Secretary now proposes to cover exchange control in his speech to the London Chamber of Commerce, where he is lunching tomorrow, but he thinks it would be useful if Mr Nott could find time to say something in the House about the justification for the measures taken on outward direct investment and on the finance of third country trade. On the former subject, Treasury Ministers would like to get on record as widely as possible some of the evidence against the view advanced by the TUC and others that overseas investment supplants investment at home.

2. It may be helpful if I enclose the attached copies of what the Financial Secretary hoped to say yesterday about these two topics. He intends to use some or all of this material, suitably modified, in his speech tomorrow; and I will let you have a text of what he proposes to say as soon as possible. It may also be advantageous for Mr Nott to say something briefly about our EEC position. I shall be in touch with you again on this point as soon as possible: the wording already prepared may need modification in the light of further news from Brussels.

proceeds of existing properties are no longer eligible for the investment currency premium. I hope that this can be dealt with soon by an arranged PQ for written answer, perhaps next Thursday 21 June, if not before. I have asked Mr Ilett to submit a draft for this purpose.

4. If the Financial Secretary agrees, you might write to Mr Nott's Private Secretary on the lines of the attached draft, enclosing a copy of the Financial Secretary's passages on outward direct investment - from "we are concentrating on. to "...to impose a decision on the investing firm.", and on third country trade. Mr Hancock's amendments to the text you sent me yesterday have already been includ I should like to suggest another one in the fifth line of the paragraph on page 6, on raw materials, to take care of the point that investments in coal production certainly can take place in the UK: after "example" amend to read "in the developr of most raw materials crucial to our interests."

C H W HODGES
14 June 1979

P.S. While this note was being typed I have heard that the Financial Secretary is now proposing to speak on exchange control at the London Chamber of Commerce lunch tomorrow, to which he has just been invited. Mr Nott will need to know what the Financial Secretary will have said. I have altered the draft letter to cover this point.

CONFIDENTIAL

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EXC/34/04 (9)

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cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Couzens (O.R)
Mr. Barratt
Mr. Hancock
Mr. Hodges

CHANCELLOR OF THE EXCHEQUER

EXCHANGE CONTROL

The Private Secretary to the Secretary of State for Trade telephoned me to say that following a conversation Mr. Nott had last night with the Chief Secretary he was more than ever convinced that further relaxations of Exchange Control should be urgently announced. Mr. Nott thought that the markets had reacted very much as expected to the Budget, and that Sterling would further strengthen when the Trade Figures were announced early next week [this must surely be debateable!]. He therefore hopes very much that you will announce further relaxations in your wind-up speech on Monday night.

MAH.

M.A. HALL
15th June, 1979

1. Mr Barnell
2 Mr Ilett o.r.
JPM
19.6.79.

Exc/54/04 (G) EF, CY Mr Ilett. 14

CONFIDENTIAL

Ref

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out for Sec

PS/SECRETARY OF STATE EF(CS)

22 JUN 1979

cc PS/Secretary
Mr Burgh Dep Sec
Mr Gray Dep Sec
Mr Liesner Dep Se
Mr Dworkin EcS5
Mr Meadway CRE1/1
Mr Chapman G2
Mr Lane G4
Mr Coates EcS5D
Mr Preston G1
Mr Gaffin Inf

SECRETARY OF STATE'S BUDGET SPEECH MONDAY 18 JUNE

X I attach notes covering all the topics which we discussed with the Secretary of State the other evening. Of course, there is enough here for a two-hour speech rather than the 20 minutes which Mr Nott wanted to devote to Departmental business out of his proposed total of 30 minutes or so. But much of the background can easily be dropped; attacking the previous S-P concentration on import penetration sits rather uneasily with our intention to seek a GATT safeguard code, supporting the MFA etc; and in any case the Secretary of State wanted a quarry, not a speech.

2 I also attach a copy of the Financial Statement and Budget Report 1979-80; the note on the latest WEP; and the PQs etc referred to in the section on competition policy. You will doubtless dig out (or ask me for) copies of the last press notice and brief on the February/April trade figures, the note on the Cambridge School by Mr Liesner and others which have been submitted recently.

3 You know that you are likely to receive a letter from PS/FST asking Mr Nott to make some remarks about the exchange control relaxations. I had told the Treasury that Mr Nott had intended to say something on this subject anyway. We will not know until, probably, later this afternoon what Mr Lawson said at lunch with the London Chamber of Commerce and therefore what remains to be said on Monday. Unfortunately the draft speech which I received from the Treasury yesterday does not appear to correspond to that referred to in a submission made to the FST and there seems to be little point in sending it to you; the Treasury may in any case offer a precise text. But in case not, I attach some notes on key points. The subject would fit in well between the MTNs and competition policy. ?

4 The Treasury may ask Mr Nott to say a word or two about EEC consultations on the relaxations. My advice would be to keep off this unless we are given UKRep-approved words. We are not expert in this area of EEC business though we were concerned when the relaxations were being considered that the proposals for using sterling for merchanting did not infringe the non-discrimination provisions of the Rome Treaty. no need

5 When we talked to the Secretary of State the other evening I was not very happy about arguing that the RPI was not an indicator of "inflation" and setting in apposition the projected rise in the RPI and the rise in disposable income. The

Opposition, of course, have seized upon the 4 per cent increase and are shouting that it is inflationary. Perhaps, given the extent of the field which the Secretary of State wants to cover, it would be better to concentrate on the budget strategy elements incentives and competition rather than get involved in what "inflation" really means. In any case, the Government's own main forecast of GDP is for a 1 per cent fall over the next year.

6 I understand the Secretary of State has separately asked Mr Lane for material on price rises held back.

G LANCHIN
G
V/404 215-5534
15 June 1979

Attachments

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A OPENING REMARKS

1 This budget is a first step towards reversing Britain's post-war decline. We do not have to be a third-rate nation dwindling in both relative affluence and influence. Central to our future living standards and political role is our economic performance. But Government can only do so much to improve this. It can preserve financial discipline and with it a stable currency both internally and externally. And it can recreate an environment where work, risk and excellence are better rewarded than indifference, caution and mediocrity.

2 In the light of this I emphasise:

i) Public expenditure remains too large a proportion of GDP. It uses a substantial part of our resources notably of highly qualified workers. High public expenditure means high taxation especially of incomes. Personal income tax is widely regarded as being too high and a disincentive.

ii) Recent money supply figures show that the monetary side of our affairs was not under control. On unchanged policies the PSBR would have been around £10bn in 1979/80 implying persistently high interest rates damaging industry, house buyers and so on; Or accelerating monetary growth with dire results for sterling, the rate of inflation and business confidence. We have constantly warned effective monetary control requires a complementary fiscal policy not one always pulling in the opposite direction. Restoring control of the money supply would have required tough action by whoever was in office. If public expenditure had not been cut the net weight of tax would have had to rise.

B THE GOVERNMENT'S STRATEGY AND TRADE

International Background

1 Since the short sharp recession of 1974/75, growth in world economic activity and trade has been slower, and inflation and unemployment generally higher, than in the previous period of 15 years or so. In the decade or so to 1974, the OECD economies grew on average at around 5 per cent a year. World trade in manufactures grew considerably faster; about 10 per cent or so in volume terms. Since 1976, growth in the OECD area has been relatively sluggish at annual rates around 3½ per cent.

2 In 1978 growth in the industrial countries was again rather less than 4 per cent. A substantial slow-down in the US in 1979 and the first half of 1980 is in prospect. Overall growth seems almost bound to slacken this year, and even more so next.

3 World trade growth in manufactures in 1978 was particularly sluggish: only 3 per cent (weighted by the pattern of our trade). This year and next it may pick up a bit as smaller more open countries grow a little faster, say around 5-6 per cent in 1979 and 1980, but still far less than the 60's and early 70's.

4 An important reason for unpromising international environment is the rise in oil prices - already about 30 per cent higher than six months ago. Of course we now have North Sea oil which we did not in 1973. We are increasingly protected from the direct trade effects of higher oil prices. But oil price increases spur inflation everywhere and depress our overseas markets and with exports of goods and services accounting for 30 per cent of our GDP a sluggish world market is bound to hold back growth at home. Overall, rising oil prices will harm us, if less than other countries.

Recent UK Trade Figures and Prospects

5 In 1978 we had a small surplus on current account, helped by the increasing contribution of North Sea oil and a significant improvement in the terms of trade, originating in particular from

weak commodity prices. Exports of manufactures grew in volume at about the same rate as world trade. But imports rose by 13½ per cent, reflecting in part a strong rise in domestic demand which British industry failed to meet.

6 The figures for the first 4 months of this year are very difficult to interpret, owing to distortions resulting from industrial action. But they do indicate a less favourable performance although the most recent survey of short-term export prospects suggests recovery in volume in the second half of the year more than offsetting a fall in the first half.

7 Our invisibles surplus fell in 1978, reflecting increased transfers, notably payments to the EEC. Some further decline is expected this year although, within the total, the surplus on services may begin to rise again. We are rightly greatly concerned about the failure of our manufacturers to compete effectively at home and abroad. We must not allow this to make us forget the continuing importance of the services sector to the balance of payments.

C TRADE POLICY

General

1 The Government's policy is clear. We will see that dumping is vigorously dealt with. With our EEC partners we will seek defences against massive and sudden surges of imports. For example, we support the MFA. But we totally reject generalised import controls.

2 There is no denying how rapidly imports of manufactures have grown in recent years. Certainly the real problem behind disappointments in trade is the lack of industrial efficiency. But leaving aside our international commitments adopting general import controls can only reduce the stimulus of overseas competition. Would reduce not improve industrial efficiency.

3 We are more dependent on exports than any other major industrialised country. UK : 30% GDP; FRG : about 26%; France : 20%; Japan : 14%.

4 A strong export performance is the key to higher growth, less unemployment, and weightier wage packets. British industries that are fully competitive in world markets should be able to do particularly well in their domestic markets.

5 As already said, responsive when there are genuine problems but little sympathy with those who find disaster in import penetration figures in every sub-sector. In the open trading system vital to our overall interests and in a world of rapidly changing technology, we all need to specialise and adapt.

6 Answer to the problems essentially in creating incentives and releasing resources. Confident that budget incentives will encourage the entrepreneurial flair and foster the higher efficiency vital to our trade performance.

MTNs

7 Our attitude to the GATT negotiations consistent with this.

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8 MTN package a considerable achievement in recent unfavourable world economic climate. We hope it will be fully and accurately implemented as soon as possible in developed world, and that many developing countries will, on reflection, be able to associate themselves with it. Important step away from threat of spreading protectionism.

9 Negotiations on safeguards code continuing. HMG will play an active and constructive part in them through the EEC. Major objective is agreement on the selective safeguard, which would enable disruption to be minimized when safeguard action is unavoidable to protect against sudden surges of imports. Prepared to discuss with others constraints and conditions, but selective safeguard must be usable when appropriate. Negotiations will be difficult and may not succeed, but HMG believe EEC should do utmost to ensure that they do.

C(1) EXCHANGE CONTROL RELAXATIONS

1 All part of same strategy as on trade: to have as open a régime as possible.

2 Concentrating initially on direct investment. Controls impose costs and distortions. Shortage of capital is not hindering investment in the UK but profitable opportunity.

3 All the available evidence against the view that exporting capital means exporting jobs. Investment in most key raw materials has to be made abroad. In marketing, distribution promotes British exports/employment. Some markets can only be penetrated by setting up inside the barriers. If we are not there our competitors will be. The NEDC Sector Working Parties [which the previous Administration believed so valuable] widely felt without overseas investment markets would be lost.

4 The Government intends to restore the use of sterling by UK merchants to finance third-country trade as soon as details can be worked out. Already referred to contribution of our service industries.

D COUNTER-INFLATION

1 Budget's strategic aims to begin to increase 'citizen's' choice as a consumer and incentive as a worker.

2 Present addition to prices inescapable, but is once-for-all. Prices affected will be about half of consumers' expenditure: not the most essential items that weigh heaviest in the budgets of the least well-off. In a purely statistical sense this will increase the 12-month rate of inflation until next Summer. Crucial for the future course of inflation and employment that wage bargainers take account not only of the effect of the tax measures on the RPI [+4%] but also of the extra money they will have in their pockets as a result of tax cuts. It is the real disposable income that matters. The RPI does not measure people's purchasing power.

3 The prospect for improvement in real personal disposable income (RPDI) per head over the next year is much less favourable than in 1978. Last year's growth rate for RPDI per head [6%] was unsustainable: only achieved by first holding wages down, then losing control. High pay increases coincided with lagging lower price increases.

4 High pay far outstripping productivity eventually feeds into higher prices. Even with last year's strong growth, RPDI per head was only 4% above its level in 1974 when the previous Government came into office. The increase between 1970 and 1974 on the other hand was 17%. [1970-1973 16½%].

5 Tax changes far from the major influence on prices. Government inherited an accelerating rate of inflation. At retail level inflation was already back in double figures. Wholesale Price Indices showed worse in the pipeline: factory-gate prices have been rising at 1-1½% a month all this year. Many price increases left poised over the economy pending the Election: posts, coal, electricity, bread.

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6 Price Commission - one thing that has not influenced inflation. Confirmed by Mr Hattersley in reply to Mrs Oppenheim in Oral Answer, 20 November 1978 (Hansard Cols 904-905 attached). Uncertainty Commission created in pricing and investment decisions - major burden on industrial management and confidence. Limited effect of interventions: deferred rather than prevented price increases: deferment often no more than 3 months. Result of deferment often a larger price increase later: as Commission itself acknowledged in the case of electricity (see press notice of 15 March 1979 attached).

7 The best price control is competition (Mr Hattersley said the same when in Government: Standing Committee B, Second Reading Price Commission Bill, 10 May 1977, attached). Previous administration's uneasiness with Price Commission shown by their Manifesto commitment (page 8) 'to combine its functions with those of the Monopolies and Mergers Commission.' Important urgently to strengthen competition, remove debilitating effect of Price Commission Act.

8 Competition Bill

i New, speedy procedures. DGFT will have new powers to initiate inquiries into firms in private and public sectors suspected of anti-competitive practices. Will refer to MMC or take certain action himself. If MMC finds practice against public interest, necessary action possible.

ii Accept that where competition is weak there may be legitimate concern over prices. Both in public and private sectors DGFT will be empowered, on direction, to examine significant price questions of public concern. If he finds weakness or limitation of competition, or anti-competitive practices, refer the matter under his general powers to MMC which can take appropriate remedial action.

iii Wider review of policy and institutions for encouraging competition.

9 Least of all should Government seek to reduce industry's profitability. Chancellor mentioned sharp drop in recent years. Industrial and commercial companies real rate of return (excluding North Sea oil) 4½% in 1977. Appears to have been about the same in 1978. Well below other countries. Around 12% in early 1960s. (Manufactures 3½% 1977; about same 1978; around 10% early 1960s). Agree with previous administration that 'the downward trend in profitability must be reversed' (Cmnd 6507, paragraph 32, June 1976). No soundly based economic recovery possible otherwise.

10 Much discussion of the Budget's effect on pay bargaining. Leader of Opposition (12 June) asked if union negotiators can claim less than the increase in the RPI, regardless of tax changes. Seemed to imply that they need double recompense for higher VAT - once in income tax and again in an increase in gross pay.

11 Some firms can afford bigger pay increases than others. Trade Unions implored previous administration to 'trust us' to bargain responsibly within what employers can afford. Present Government has given them the freedom they asked for: it carries a great responsibility. Another theme of the Budget was the need to ensure that those involved in collective bargaining understand the consequences of their actions. Total money available will rise in the range indicated by Chancellor: 7 - 11%. Unions have overwhelming power, by insisting on more than employers can afford, to destroy their members' livelihood: important to their members and the nation that they use it wisely.

EF2 c s

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15 JUN 1979

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1. MR HANCOCK

2. FINANCIAL SECRETARY

cc Principal Private Secretary
PS/Chief Secretary
PS/Minister of State (Commons)
PS/Minister of State (Lords)
Mr Couzens
Mr Barratt
Mr Dyer
Mr Dawkins - B of E

EXCHANGE CONTROL: PROPERTY

I attach a draft arranged PQ and answer which incorporates the relevant points from the speech the Financial Secretary had intended to make on Wednesday. This will put on record Ministers' decision not to allow the premium on property sales.

Draft Question

To ask Mr Chancellor of the Exchequer, whether UK residents who have in the past bought private property abroad, will still be allowed the benefit of the investment currency premium on the sale of that property.

Draft Reply

As my Rt Hon Friend announced in his Budget Statement on 12 June, UK residents may now, with permission, use official exchange up to a limit of £100,000 per calendar year for private property purposes. In consequence, the sale proceeds of existing properties ~~can~~ will no longer be eligible for the investment currency premium; and it will no longer be possible to allow emigrants from the UK who have previously bought a property through the premium to reverse the transaction once they have emigrated. [The Bank of England has issued a notice to banks and others which, inter alia, explains how applications now in the pipeline will be handled.]

N.J. Ilett.

N J ILETT
15 June 1979

EXC/34/04 (9) EF2/CS pq.

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FINANCIAL SECRETARY TO THE TREASURY

MR HANCOCK

cc Principal Private Secretary
PS/Chief Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir K Cousins
Mr Barratt
Mr Ilett
Mr Dyer
Mr Dawkins B of E

EXCHANGE CONTROL: PROPERTY

This is to confirm that the Financial Secretary has seen Mr Ilett's submission of 15 June and approved the draft arranged PQ with only one minor change. In line 4 of the draft reply the word "can" shoul now read "will".

Arrangements will therefore be made for the question and answer to appear in Hansard as soon as possible.

A. O'FLYNN
18 June 1979

CONFIDENTIAL

84/04

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EF(2)CS
20 JUL 1979

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr. Barratt
Mr. Hodges

MR. HANCOCK

EXCHANGE CONTROL

The Chancellor has seen my minute of 15th June. He has commented that his own instinctive inclinations would be the same as Mr. Nott's; but that he discussed Exchange Control with Sir Kenneth Couzens last week and was advised to think in terms of a much longer timescale (12-18 months) for further relaxations. The issues are obviously too complex to be resolved by tonight; in any case, the Chancellor would regard this as much too early for second thoughts. But he would like early consideration to be given to the next steps and their timing.

(M. A. HALL)
18th June, 1979

Mr. Dawkins, Bank

Mr. Gill

Mr. Allan

Mr. Naughton

Mr. McIntyre ~~EFCS pa - relaxations~~.

Mr. Ilett EFCS ~~3pm~~

pa - general. ~~19/6~~.

Mr. Russell

Mrs. Lomax.

EXC/34/04 (9)

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cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Couzens (O.R)
Mr. Barratt
Mr. Hancock
Mr. Hodges

CHANCELLOR OF THE EXCHEQUER

EXCHANGE CONTROL

The Private Secretary to the Secretary of State for Trade telephoned me to say that following a conversation Mr. Nott had last night with the Chief Secretary he was more than ever convinced that further relaxations of Exchange Contro should be urgently announced. Mr. Nott thought that the markets had reacted very much as expected to the Budget, and that Sterling would further strengthen when the Trade Figures were announced early next week [this must surely be debateable!]. He therefore hopes very much that you will announce further relaxations in your wind-up speech on Monday night.

MAH.

M.A. HALL
15th June, 1979

EXC/84/04/(9)

CONFIDENTIAL

Y4/C4
CC 97/20/01

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CHIEF SECRETARY TO THE TREASURY

MR HANCOCK

CC Chancellor of the Exchequer
Financial Secretary
Sir D Wass
Sir Kenneth Couzens
Mr Barratt
Mr Jordan Moss
Mrs Hedley-Miller
Mr Unwin
Mr Lovell
Mr Ashford
Mr Ilett
Mr McIntyre
Mr Ramell
Mr Fitchew UKREP Brussels

JUL 1979

CHIEF SECRETARY'S MEETING WITH VICE PRESIDENT ORTOLI, 18 JUNE

The Chief Secretary saw M Ortoli on 18 June as recommended in Mr McIntyre's brief of 15 June.

... 2. I attach Mr Fitchew's record of the meeting, and draw attention to the fact that the conversation covered reactions to the Budget and the UK position on EMS Interest Rate Rebates in addition to Exchange Control.

A C PIRIE
20th June 1979

CONFIDENTIAL

84/04

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cc: Mr. Hancock
Mr. Prescott
Mr. Ilett
Mr. Maughan
Mr. Allan
Mr. G.M. Gill
Mr. Mortimer (DOT)

Mr Gill
Mr Bain

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

EFICS

25 June 1979

Dear Emmanuel

Thank you for your letter of 22 May about export competitiveness. I am sorry that I have not replied earlier.

I am much concerned that our exporting industries should remain competitive. But I am not convinced that this can be done by trying to manipulate the exchange rate. The rate is primarily determined by market forces and the scope for the Government to influence it is strictly limited. It is in any case by no means clear that a depreciation of the nominal exchange rate would bring with it lasting gains in competitiveness: the feed-through from higher import prices to higher wage claims seems only too swift. Rather, we must restore competitiveness by working to reduce the growth of our own unit costs and by improving non-price competitiveness.

I sympathise with your view that we must transfer some of our oil wealth from current to capital account. As you will have seen, I announced in my budget speech some significant relaxations of exchange control. These are intended to be the first step in a progressive dismantling of the controls.

GEOFFREY HOWE

Sir Emmanuel Kaye, CBE

27 JUN 1979

FINANCIAL SECRETARY

cc Principal Private Secreta
PS/Chief Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir D Wass
Sir K Couzens (o.r.)
Mr Barratt
Mr Bridgeman
Mr Middleton
Mr Unwin
Mr Gill
Mr Hodges (o.r.)
Mrs Lomax
Mr Allan
Mr Ilett
Mr McIntyre
Mr Spencer
Mr Ridley
Mr Dawkins)
Mr Walker) B of E
Mr Sangster)

EXCHANGE CONTROL

The Chancellor of the Exchequer has asked us to give early consideration to the ne steps in the process of relaxing exchange control and their timing. (Mr Hall's minute of 18 June refers.) He said that his instinctive inclinations were the sa those of Mr Nott who urged him to announce urgently further relaxations of exchang control in view of the strength of sterling since the Budget.

2. In this minute I attempt the following by way of reply:-

(i) A description of our planned programme of work and the time scale that we have up to now envisaged as being administratively feasible and consistent with the policy of a gradual step-by-step relaxation which you and the Chancellor approved.

(ii) A discussion of the arguments for and against accelerating that programme in response to the current strength of sterling.

(iii) A description of what a July package might consist of if it were thought desirable.

3. I hope that I have set out the considerations sufficiently fully to enable you to consider the matter and let the Chancellor have your advice on his return next week. There are many different ways of looking at the problem and I cannot claim to have done justice to every point of view that is held within the Treasury and the Bank. For that reason you might find it helpful to discuss this minute with some of those chiefly concerned before you advise the Chancellor.

Current programme of work

4. As a result of our discussions with you before the Budget, we have in hand the preparation of a submission which discusses the options for the first move in a programme of the gradual relaxation of controls over portfolio investment. Our working assumption has been that Ministers will wish to be able to announce such a package of relaxations to greet Parliament on its return from the Summer Recess in October; but that it would not be thought prudent to relax controls over portfolio entirely in one step. (In the past 2 weeks the latter assumption has been called in question and I say more about that below.) The technical problems of devising a first step in a gradual programme are considerable and we need more time to produce a paper which is sufficiently well thought out to be a proper basis for discussion with Ministers. We have promised you that we will let you have such a paper by the end of July at the latest and, unless there is now a change of plan, that will be possible. To indicate the scope of the submission, I attach as Annex A to this minute a list of the options that have so far been identified and whose merits are being considered in the paper now being drafted.

5. Various combinations of the listed options are possible - other combinations would not make sense. The scale of the package will obviously depend on a judgement about the outlook for the balance of payments, the exchange rate and other Government policies at the time of the introduction of the package.

6. It would seem appropriate that an unlimited ration of official exchange for outward direct investment worldwide should be allowed at the same time as the first major step in the relaxation of controls over portfolio investment. This would give the Commission one of the things that they wanted, namely complete freedom of capital movements for direct investment within the Community. And there are other relaxations not strictly related to portfolio (and therefore not listed in Annex A) which it would be possible to add to such a package consistently with the assumption of gradual relaxation.

Case for accleration

7. Sterling is at the moment remarkably strong. None of us were surprised that the Budget drove the rate up - particularly after it was decided to include a 2% increase in the MLR. Even if the exchange control relaxations had been announced on their own independently, we would not have expected the announcement effect to have exercised a downward pressure on sterling immediately. It will take a little time before firms making outward investment decisions can fully assess the implications of the relaxations for their plans. The outflows resulting from the package announced in the Budget can be expected to begin to occur during the coming months. But they may, of course, be quite modest if sterling remains strong.

8. Much more remarkable is the way in which the foreign exchange markets have shrugged off the trade figures which are, by any reckoning, very disappointing. The current account appears to have been in substantial deficit so far this year and there is a backlog of unrecorded imports still to come. It is hard to see how the present strength of sterling can be attributed to a detailed examination by overseas investors of the domestic UK economy, even allowing for the present high interest rates. International factors must be playing an important role. To quote a recent edition of "International Insider": "While on fundamentals even its best friend would not deny that sterling was over-valued, the markets do not trade on fundamentals, and neither do the holders of oil surpluses."

9. But we have been through periods of eccentric strength of sterling before. Sooner or later it is quite possible that some event will precipitate a change in the market's attitude so that more weight will be given to the prospects for UK inflation, growth and current account. Possibly this change will occur before the autumn. It might be precipitated by further bad trade figures, or by a run of seriously worrying figures for the money supply. But we would, at present, think this unlikely. Such little local difficulties seem at present more likely to be drowned by the effects of the oil crisis and the troubles of the dollar. But that does not mean that nothing will ever happen to cause the market to change its priorities and to start to give close attention to the unsatisfactory performance of the domestic UK economy. It seems at present more likely that such a turn-round, if it happened, would be caused by some dramatic event in the field of labour relations during the autumn or winter - perhaps a disruptive strike or an inflationary wage settlement in a key sector.

10. The case for an acceleration of the programme of exchange control relaxations can be considered from (at least) two contrasting points of view:-

(i) as a contribution to the Government's macro-economic policies; or

(ii) as a way of making hay while the sun shines.

These are discussed below.

Acceleration as a contribution to macro-economic policy

11. The Chancellor has, in his Budget, given a very high priority to getting down the rate of inflation by tight monetary and fiscal policies. The means chosen to achieve tight monetary conditions will cause a short sharp increase in the RPI. In view of this general policy, the level of the exchange rate has considerable significance. In the first place, the most powerful transmission mechanism from tight monetary conditions to the rate of inflation is, in an open economy like that of the United Kingdom, likely to lie via a high exchange rate. Second, a high exchange rate is the only factor in the immediate economic prospect that will tend to offset the many causes of an acceleration of the rate of growth of prices. Third, the chances of making significant progress in combatting inflation depend in the short run on making an impact on inflationary expectations. The exchange rate offers one of the principal means of doing this. Operators in financial markets are clearly influenced by the Government's declared monetary policy; this is one reason why the rate responded so strongly to the Budget package. But there is little evidence that the labour market is similarly impressed by monetary targets. Even so, monetary policy may also have an indirect effect on labour market expectations through its effect on the exchange rate and the actual price level. Allowing the exchange rate to float upwards may therefore be the best way of ensuring in the short run that monetary targets have an effect on the price level. In the longer run such a policy, followed at this critical stage in the new Government's period of office, might yield additional benefits in changing labour market attitudes so that tighter monetary policies would in future have a swifter and more direct effect on inflation than has previously been the case so that a given inflation objective could be achieved with less loss of output.

12. Considered from these points of view a high exchange rate for sterling is positively helpful to the Government's basic economic policy. Bringing forward the programme of exchange control relaxation in order to get the exchange rate down would, on this analysis, be a harmful and not a helpful move.

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13. The practical significance of these arguments cannot be quantified and must depend for their evaluation on a broad judgment by Ministers. But the effects of a high exchange rate, as predicted by the Treasury model, can be illustrated by reference to the FSBR forecast. This was based on a fall in the effective rate for sterling from 67 in the second quarter of 1979 to under 65 at the end of this year and 62 in the middle of 1980. The forecast of an increase in the RPI of 13½% from the third quarter of 1979 to the third quarter of 1980 takes account of this fairly moderate fall in the exchange rate.

14. If the exchange rate were to fall more sharply - say by an additional 5%, taking it to around 62 by the end of this year and 59 by the middle of 1980 - we would expect this to add about a further 1% to retail prices by the third quarter of 1980. The longer-term effect would be much bigger as higher import costs gradually fed through to higher domestic costs through price/earnings interactions and other relationships.

15. If by contrast the effective rate were to stay at its present level of about 68 then retail prices might be about 1 - 1½ below the level forecast in the FSBR in the third quarter of 1980. Again, the long-term effect would be expected to be larger than this.

16. So much for the benefits of a high exchange rate. The counter-argument is that the costs in the short term to competitiveness, the current account, output and employment of a rate as high as 68 would be too great. How severe and how long lasting these effects would be would depend critically on how quickly wage settlements were adjusted to reflect lower import prices and the increased competitive pressure on firms in the private sector. According to the relationships in the Treasury model, if the exchange rate stayed at 68, then the current account in 1980 would show a deficit of about £½ billion instead of the very small surplus in the latest forecast and the year on year fall in GDP would be increased from about 1% to about 2%. If wages did not respond quickly to the lower prices, then the effects in subsequent years could be much larger.

17. A case can be made for the accelerated relaxation of exchange control as a way of reducing the effect of the monetary squeeze on the profitability of that part of our economy that produces goods and services that enter into international trade - the "tradable goods sector". The argument runs as follows.

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If exchange control relaxations did produce a fall in the exchange rate, the consequence would be to raise the price level and to raise interest rates. The fall in the exchange rate would tend to expand output and the rise in interest rates to reduce it. The net effect might be expansionary at least in the short term. But, even if it were not, there would be a switch in profitability between firms making non-tradables to firms making tradables. Such a switch should eventually benefit the current account of the balance of payments.

18. This would be a desirable result. At present the current account appears to be in deficit. If, as the Chancellor said in the Budget Speech, we are to use the opportunity of North Sea oil to build up our net overseas assets so as to yield an income when North Sea oil declines, it will be necessary to run a surplus on current account. Any action we can take that would convert the present deficit to a surplus would therefore be consistent with the Chancellor general policies as stated.

19. To decide whether accelerating our programme of exchange control relaxation would help or hinder the Government's general economic policies thus depends on:-

(i) a judgment about the probable effects of extra relaxations on the exchange rate:

(ii) a judgment about the likelihood of a change of market sentiment this autumn or winter that would produce a sharp drop in the rate independently of any exchange control relaxation; and

(iii) a judgment about the relative importance of the counter-inflation arguments in paragraph 11 - 15 and the short-term current account and output arguments in paragraphs 16 - 18.

Making hay while the sun shines

20. A different approach would be to discount the importance of exchange control relaxation as a contribution to macro-economic policy and see it instead as a contribution to the Government's long-term policies for improving the supply side of the economy. On this view, dismantling controls has short-term risks and long-term benefits and should be done while sterling is strong. The exceptional present strength of sterling gives one an opportunity which may not occur again. We should therefore make hay while

the sun shines. (In assessing this case, of course, allowance must be made for the lag between the announcement of new relaxations and the consequential outflows. The sun needs to be shining when the outflows occur, not just when the announcement is made.)

21. An immediate practical problem is that we are not yet ready to propose a substantive first step in the dismantling of controls over outward portfolio investment which Ministers have said should be the next major step. Whereas in the field of outward direct investment methods of relaxing controls gradually were easy to find, in the field of portfolio investment devising the first step in a gradual relaxation is a difficult task. We do not therefore think that it is realistic to suppose that a balanced and coherent package of gradual relaxations could be announced before the Summer Recess. This does not, of course, mean that there should be no new announcements - and the options are discussed in the next section.

Options for a July package

22. The most attractive move, if it were decided to accelerate the programme, might seem to be the abolition of controls over portfolio investment. But that would be a risky step for reasons explained in the note at Annex B. In any case, we do not think we could do it in July. There are numerous technical problems that would have to be resolved before the relevant exchange control notices could be drafted. These include:-

(i) whether it would continue to be necessary to require foreign currency securities to be left in deposit;

(ii) whether the liberalisation should apply to the banks and what the consequences of that might be;

(iii) what the rules should be for the retention of the proceeds of any sales of foreign currency securities;

(iv) the treatment of savings accounts in foreign currencies.

These matters could be studied in time to enable Ministers to consider a plan for the virtual abolition of portfolio controls as an alternative to a gradual decontrol package on the lines of Annex A for announcement in October or

November. But it is just not realistic to suppose that decisions could be taken on all the relevant points before Parliament rises at the end of July.

23. A second possibility would be to extend the third country trade relaxation to banks. But we could not recommend that either. It would be a particularly open-ended relaxation - if sentiment towards sterling changed the outflow could be very large.

24. Other possibilities with comments are listed in Annex C. The most attractive options in that list are:-

(i) The retentions item in paragraph 5 - a central estimate of the resulting outflow might be of the order of £$\frac{1}{4}$ billion.

(ii) Permission to repay outstanding foreign currency borrowing to finance existing portfolio investment - either outstanding for 2 years at the date of announcement (paragraph 6) or outstanding for 2 years at the time of repayment (paragraph 7). A central estimate of the outflow in the first year might also be of the order of £$\frac{1}{4}$ billion.

25. In combination, these relaxations would be about half the size of the package announced in the Budget. The Treasury model would give results of the following order of magnitude:-

(i) the exchange rate about $1\frac{1}{2}$% lower than otherwise by the first quarter of 1980;

(ii) the current account improved by about £$\frac{1}{4}$ billion in 1980;

(iii) GDP about $\frac{1}{8}$% higher by mid-1980:

(iv) the RPI about $\frac{1}{2}$% higher by the third quarter of 1980.

26. We might annoy the Commission if we announced a major new package which did not include the Community bonds proposal which Monsieur Ortoli favours - see paragraph 8 of Annex C. Ministers might therefore think that it would be tactful to add it. To avoid accusations of discrimination by the Americans, it might be thought prudent to go further and extend the concession to certain other international institutions like IBRD. In either case, extra outflow would not be large.

27. None of these three candidates is of particularly high priority. The retentions rule has not caused serious representations. In October Ministers might want to deal with borrowing to finance portfolio in a different way from the options in Annex C. The Community and IBRD bond proposal would really only be a gesture to keep the Commission sweet. If market sentiment changed in the autumn, the fact that a substantial package had been implemented in July might restrict the scope for further moves; whereas, if no substantial relaxation were made in July, we would hope that it would be possible to announce a significant first step in the dismantling of portfolio controls even if sterling were a good deal less strong than it is today.

28. There are a number of consequentials to the Budget package that should or could be implemented in July. The scheme for allowing UK resident merchants to use sterling to finance third country trade is nearly ready and the implementing exchange control notice will be issued to banks early in July. EF2 division will be putting to you over the weeks ahead a number of minor changes, essentially of a tidying up nature, which could also be announced before the Summer Recess. Examples are the controls over diamonds; the use of gold for industrial purposes; the delegation to the commercial banks of some controls over both inward and outward direct investment; the simplification of import payment procedures including advance payment for imports; and freedom to switch securities in restricted deposit. None of these (apart from third country trade already decided) would be likely to have any substantial effect on the balance of payments and the exchange rate - but they would show that the Government were intent on a gradual programme of relaxation.

<u>Summary of conclusions</u>

29. (i) It is not practicable to announce the first step in a planned and gradual relaxation of portfolio controls before the Summer Recess. Nor could portfolio controls be virtually abolished in July. But a choice between these options could certainly be made in October. (See paragraphs 21 - 22)

(ii) If Ministers wanted to announce a substantial package in July, then the options in Annex C for retentions, outstanding borrowing for portfolio and Community and IBRD bonds should be considered. (See paragraphs 24 - 27)

(iii) Whether (ii) would tend to help or hinder the Government's macro-economic policies is highly debatable. (See paragraph 19)

(iv) We shall be putting a number of minor proposals for announcement in July to you in the near future. (See paragraph 28)

D.H.

D J S HANCOCK
27 June 1979

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p.a.

FINANCIAL SECRETARY

c Principal Private Secretary	Mr Hancock
PS/Chief Secretary	Mr Middleton
PS/Minister of State (C)	Mr Unwin
PS/Minister of State (L)	Mr Gill
Sir Douglas Wass	Mr Hodges
Sir L Airey	Mrs Lomax
Sir K Couzens	Mr Butt
Mr Byatt	Mr St Clair
Mr F Jones Mr Littler	Mr Davies
Mr Barratt	Mr Ridley
Mr Bridgeman	

EXCHANGE CONTROL

1. The Industrial Policy Group of the Treasury has been invited to comment on Mr Hancock's submission to you of 27 June, which is to be discussed at a meeting on Monday. This note reflects the views of Mr Jones and Mr Byatt as well as myself.

2. We think the arguments for trying to make the exchange rate lower than it otherwise would be are stronger than set out in paragraphs 16 and 17, though we do not disagree with what is said there. Manufacturing industry is likely to be caught in a severe squeeze between the downward pressure of monetary policy and the upward pressure of costs. While the need (as brought out in the Budget speech) is for higher profits, the prospect is for lower ones Given the monetary and fiscal constraints, there are few things the Government can do to ease the pressures. Influencing the exchange rate through relaxation of exchange control is one of them. Ideally we would like to use the North Sea revenue to create a stronger industrial base in this country - but we have not found a reliable means of achieving that; permitting external investment at least means the accumulation of assets rather than allowing the revenue to bring about further deindustrialisation, which is a consequence of upward pressure on the exchange rate.

3. This applies particularly to portfolio investment. In the case of direct investment, there is the insoluble controversy over whether any significant part of it is in substitution for fixed investment which might have taken place in the UK: the industrial viewpoint (in favour of relaxation) has never been unequivocally accepted by us.

/4. The

4. The argument in the submission is, however, substantially about timing. Here there is the question of what is practicable, which is not for the IP Group to comment on. Obviously it is bette to have a good package later than a botched one quickly. But there is the further argument for waiting that we do not necessarily want to move too quickly to industry's rescue. The way industrialists are talking about pay does not suggest that they are yet seeing their financial position as the constraint which will cause the rate of pay settlements to decelerate sharply. The Budget cannot succeed unless this is perceived.

5. In short, there is probably not a great deal as between July and October so far as the Industrial Policy Group is concerned. But on general grounds we would want to see the biggest practicable packages for portfolio investment this year. And there is probably something in the argument for making hay while the sun shines.

Reg.

P V DIXON

29 June 1979

Exc/84/04 CONFIDENTIAL (H)

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FINANCIAL SECRETARY

2. EFCS pa JPM 5.7.79.

Copies attached for:

Chancellor of the Exchequer
Chief Secretary
Minister of State - Commons
Minister of State - Lords

Copied to:

Sir D Wass
Sir L Airey
Sir F Atkinson
Sir K Couzens
Mr Barratt
Mr Byatt
Mr F Jones
Mr Littler
Mr Bridgeman
Mr Dixon
Mr Unwin
Mr Gill
Mrs Lomax
Mr Scholar
Mr Allan
Mr Ilett
Mr McIntyre ✓ Mr Cardona

Mr McMahon)
Mr Dawkins) B of E
Mr Walker)
Mr Sangster)

Mr Fitchew - UKREP (Personal)

JULY PACKAGE OF EXCHANGE CONTROL RELAXATIONS

Following the meeting in your room yesterday, we have, as you requested, prepared two notes for the Chancellor's consideration as follows:-

(i) a submission on a possible package of exchange control relaxations that could be announced before the Recess; and

(ii) a brief summary of the principal economic arguments relevant to proposals for relaxing controls over overseas portfolio investment.

These are attached.

D.H.

D J S HANCOCK
3 July 1979

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A JULY PACKAGE OF EXCHANGE CONTROL RELAXATIONS

The Chancellor of the Exchequer asked us to consider the next steps in the process of relaxing exchange controls and their timing in view of the strength of sterling since the Budget. (Mr Hall's minute of 18 June refers) He said that his instinctive inclinations were the same as those of Mr Nott who had urged him to announce further relaxations in his winding up speech in the Budget Debate.

2. The economic arguments for accelerating the programme of exchange control relaxation are complex and debatable. They are discussed in the separate note attached. In brief, our view is that, in the medium term, relaxation would probably cause the real exchange rate to be lower (ie competitiveness to be greater) than otherwise, thus benefitting that part of the economy subject to international competition. This effect would tend to be accompanied by a rise in domestic real interest rates. In the short run the effect of relaxations on the nominal exchange rate is difficult to predict - the impact effect of a new announcement could actually be to send the rate up. In this connection Ministers may wish to recall that Mr Nott, who suggested to the Chancellor that the relaxation programme should be accelerated, did not argue his case on competitiveness grounds but said that the effects on the exchange rate were hard to predict and might in the short term actually be perverse. (His letter to the Chancellor of 25 May refers.)

3. Whatever view Ministers take of the macro-economic arguments, the present strength of sterling has created anxieties about competitiveness and stimulated pressures for an acceleration of the programme for dismantling controls to which the Government is committed. The outlook for sterling over the period ahead, during which the consequential outflows will begin to affect the balance of payments, is unlikely to get any better if we wait. There are therefore good grounds for bringing forward the next substantial step in the process of dismantling our controls from October, as planned up till now, to July before Parliament goes into recess. We are not able at the moment to devise a scheme for the virtual abolition of control over portfolio - which is not nearly as simple a task as might at first sight appear - and in any case it is questionable whether it would be wise to move that far as early as July.

4. Following discussions between the Treasury and the Bank and with the Financial Secretary, we have now defined a package to meet the following criteria:

(i) It can be implemented before the Recess provided that decisions are taken quickly (see further on the timetable below).

(ii) It constitutes a very substantial second step in a phased programme of dismantling our exchange controls.

(iii) It will leave us with an exchange control regime that could, without any serious embarrassment to the Government or administrative disadvantage, remain in place for a substantial period of time just in case confidence in sterling turned down in the autumn and it were decided to postpone the third step in the relaxation programme until the outlook became more settled. (N.B. This is a precaution, not an intention.)

5. The package in summary is as follows and is discussed more fully below:-

(i) Official exchange for all securities denominated in EEC currencies.

(ii) Permission to use official exchange to invest in the bonds of international organisations of which the United Kingdom is a member, including those issued by Community institutions.

(iii) Repayment with official exchange of all the foreign currency borrowing taken out for portfolio investment two years or more before the date of announcement.

(iv) Unlimited official exchange for outward direct investment.

(i), (ii) and (iv) would include ability to repay both new and outstanding foreign currency borrowing for these purposes with official exchange at will. This is the natural consequence of allowing <u>unlimited</u> official exchange for these categories of new investment.

<u>Timetable considerations</u>

6. The announced date for the Recess of Parliament is Friday 27 July; but there is hope that the last day will in fact be Wednesday 25 July. This is three weeks from tomorrow. From an administrative point of view it is

not necessary to make the announcement while Parliament is sitting; but Parliament would expect to be informed about a structural change of this sort.

7. The Bank of England strongly advise against leaving a substantial gap between the announcement of the decision and the circulation of exchange control notices to the banks and authorised depositories. The precedent of third country trade is misleading. In that case there was no strong pressure by merchants to take decisions to borrow in sterling. But any change affecting the investment currency market is likely to affect investment decisions immediately and it would cause great inconvenience to those concerned if they could not find out precisely what they were and were not allowed to do. This means that the exchange control notices must be printed and ready for distribution on Wednesday 25 July.

8. It takes two weeks to print the notices in sufficient quantities. The Bank are now preparing drafts on the assumption that the package defined above will be approved. The texts will need to be finalized to be sent to the printer on Wednesday week, 11 July. At least 24 hours would be needed to make any substantial change in the drafts so that the last day for any addition to the package or substantial alteration in the definition of the components is Monday 9 July.

9. Subsequently any of the four component parts of the package defined in paragraph 5 above could be dropped at some cost in nugatory printing.

Effects on the balance of payments

10. Some remarks about the size of the outflows likely to result from the various options based on information available today are included in the following notes. A more detailed note will follow in a day or two's time.

Selection of the next step on portfolio

11. This submission has been prepared in haste and our detailed examination of the options curtailed. The conclusion we have rather hurriedly reached is that the choice of options to meet the criteria explained in paragraph 4 boils down essentially to that between:-

(i) some form of ration scheme; and

(ii) permitting unlimited access to official exchange for defined categories of securities.

A ration would be cumbersome and difficult to administer in an equitable way. To avoid undue administrative cost, it would almost certainly have to be available only to the institutions and not to individuals at all. For these reasons the Financial Secretary has indicated a strong preference for the approach in (ii), and the two options discussed in the next few paragraphs follow that approach.

Unlimited official exchange for purchase of foreign currency securities denominated in EEC currencies.

12. The currency in which a security is denominated provides an unambiguous means of identification on which a selective scheme can therefore be based. If that principle of selection is adopted, the obvious starting point is the EEC in view of our Treaty obligations. We could not go as far as to meet our Treaty obligations in full at this stage because that would mean allowing unlimited official exchange for the purchase of any foreign currency security which is dealt in on a stock exchange in the Community. Dollar securities would then be included, and we would be effectively moving to liberalisation world-wide. The proposal therefore is to limit our first step to securities denominated in EEC currencies, excluding unit and investment trusts (on the grounds that they are an obvious route to Wall Street). This approach involves a distortion of investors' choice by favouring certain investment rather than others but that is the price that must be paid for a selective scheme, and we hope that the discrimination will not last for long. The Commission will be pleased. The Americans by contrast are likely to be disappointed - they welcomed the removal in the Budget package of most of the discriminatory elements in our controls and would regret the adoption by this Government of the principle of discrimination. But the Chancellor could write to Mr Blumenthal before the announcement to explain that the relaxation was intended as a temporary measure consistent with our step-by-step approach and that our objective remained complete liberalisation.

13. It is difficult to predict the size of the outflows that would be likely to result from this relaxation. As a proportion of total UK holdings of foreign currency securities, those denominated in EEC currencies are rather small. The capital markets in the other member states are rather narrow. So long as confidence in sterling remained reasonably firm, therefore, the

consequential outflows are unlikely to be large. The Bank are examining this point and we may be able to be more specific in the further note promised in paragraph 10.

14. This option and the one discussed in the next few paragraphs raise the question whether existing holdings of the relevant securities should continue to attract the premium. We recommend that they should not do so. The arguments are set out in the Annex.

Unlimited official exchange for purchase of bonds issued by international organisations of which the UK is a member.

15. The identification of classes of security by type of borrower is another way of devising a selective relaxation. This option would please M. Ortoli, who wanted us to include liberalisation for bonds issued by Community institutions in the Budget package; but it would have the added advantage of avoiding discrimination in favour of the Community. (It follows a precedent established by the Danes.) In addition to the Community institutions it would benefit the World Bank and various regional development banks such as the Asian Development Bank. The Government could therefore take some credit for the change in discussions both at home and abroad about our relations with the developing countries; this might have some modest value in counteracting the disappointment caused by cutbacks in our aid programme.

16. There are outstanding about £4 billion of quoted securities issued by the Community institutions and about £4 billion issued by the other organisations. However, there is little evidence of UK interest in these bonds. Most of them are firmly held so that the quantity available for investment by UK residents at any one time is not large. This relaxation is therefore unlikely to cause large outflows.

Official exchange for repayment of foreign currency borrowing.

17. The effect on capital outflows of these first steps in the relaxation of portfolio controls would be likely to be substantially increased if they were combined with permission to repay at any time with official exchange borrowing which had been outstanding for 2 years or more at the date of the announcement. Except to the extent that existing borrowers were limited by gearing considerations from further borrowing, this would not encourage new borrowing and would not result in much new outward portfolio investment. On its own, therefore, it would be difficult to present as a natural next step in

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the planned programme of relaxations foreshadowed in the Budget Speech; but, in conjunction with a move on EEC currency securities, it would look like part of a balanced package. Many owners of foreign currency securities are believed to dislike borrowing and therefore to be likely to take advantage at an early stage of a facility that permits them to repay outstanding borrowing with official exchange. The consequent outflow, possibly of the order of £$\frac{1}{4}$ billion assuming continued firm confidence in sterling, would not be unwelcome.

Unlimited Official Exchange for Outward Direct Investment

18. This item is the removal of all restrictions on access to official exchange for outward direct investment with the following consequences:-

(i) all future outward direct investment could be financed without limit with official exchange;

(ii) all foreign currency borrowing taken from now on could be repaid at will; and

(iii) all foreign currency borrowing taken in the past could now be repaid at will (instead of over 5 years as in the Budget package).

(i) and (ii) above are unlikely to add much to the outflows likely to follow the 12 June measures, which a central estimate put at £700 million annually. (iii) could in theory cause more substantial outflows, but in practice it is likely that the bulk of borrowing which has been outstanding for some time would have been eligible for repayment under earlier rules, had the borrower so wished. The additional outflow is very difficult to predice, but would be unlikely to be more than about £500 million (once and for all) and could be much less. A central estimate might be £$\frac{1}{4}$ billion.

19. The greater part of the restrictions on outward direct investment were dropped in the Budget package and it was envisaged that the removal of the rest would form part of the next substantial step in the autumn. To drop the rest as soon after the Budget as 25 July could seem a little odd. But Ministers could explain that the strengh of sterling permitted them to bring forward the time at which it was possible to complete the dismantling of controls over the financing of outward direct investment.

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20. The Commission would be pleased by this move - it would mean that we were establishing freedom of capital movements in the Community so far as direct investment was concerned.

The Effect on the Premium

21. The effective premium in the investment currency market was as high as 56% in August last year and it was still almost 50% as recently as February. Partly as a result of the Conservative Party's declared commitment to exchange control relaxations, the premium fell steeply before the election to the 20-25% area. Following the Chancellor's statement in the Budget Speech that we intended a progressive dismantling of the controls, it has fallen further to below 10% on 3 July. It is likely that, if further relaxations were announced this month, the premium would fall again, perhaps almost to zero.

22. One of the effects would be that holders of securities bought with the premium would suffer a sizeable loss in their portfolio values, and though no criticism seems to have been made on that score so far, there might be some after the announcement of further relaxations. The Government's defence would be that the premium reflected supply and demand in the investment currency market, in which there had been no government intervention, and that a fall in the premium was an inevitable result of the liberalisation measures which were in the long-term interests of investors.

Conclusions

23. We should like Ministerial authority as soon as possible for the drafting and printing of exchange control notices to implement the package defined in paragraph 5 above and described in this paper - including the point about the premium on existing holdings made in paragraph 14 and the Annex. Approval would be on the understanding that any of the four separate component parts of that package could be dropped at any time before 25 July. After about Monday of next week, 9 July, it would not be possible to alter the components of the package and have the exchange control notices ready on time. Particularly in view of current pressures on public expenditure, we should obviously prefer not to incur the costs of printing notices for options which Ministers had no serious intention of implementing.

24. A draft minute for the Chancellor to send to the Prime Minister and the other colleagues centrally concerned is being prepared on the assumption

that approval will be given. It would be advisable to let the Prime Minister have it before the weekend so that she will see it at the same time as the brief for her meeting with the CBI on Monday 9 July.

25. We should like authority to consult the Commission in confidence - following the precedent of the Budget package. It would be tactful to give them 2 weeks notice, which means asking UKREP to make the first approach sometim next week.

26. Once the July package is out of the way, a paper will be written on the arguments for and against extending to banks permission to use sterling for third country trade. There are other options for a third package in October that could also be considered at the appropriate time.

27. We are preparing a number of submissions on minor suggestions for simplifying the exchange control regime; but work on these will now have to give place to work on the July package. None of them are sufficiently dramatic to make it important to announce them while Parliament is sitting - a Press Notice could be issued when each decision is taken.

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ANNEX

SHOULD EXISTING HOLDINGS OF EEC CURRENCY SECURITIES ETC GET THE PREMIUM?

1. Paragraph 14 of the paper refers to the question whether to allow existing holdings of EEC currency securities and bonds issued by international organisations (ie. those bought with investment currency before 25 July) to be sold with benefit of the premium. This Annex explains the arguments.

2. The case for allowing the premium is:-

(i) Investors who have paid the premium will be upset if we deprive them of it.

(ii) An indirect form of refinancing will still be possible ie. holders of securities not being liberalised will be able to sell for the premium and buy the securities in the liberalised categories with official exchange (assuming they are reasonable substitutes.) Thus all refinancing could only be stopped by abolishing the investment currency market. It is unfair to pick on those who happen to be holding the categories being liberalised.

(iii) The announcement of the package may well flatten the premium, taking away most or all of the potential windfall gain and reducing the risk of a large associated outflow. Why not let market forces take away the premium and keep our hands clean? (The premium is below 7% this morning.)

3. The case for removing premiumworthy status is:-

(i) We did that to property owners in the Budget package. Different treatment for shareholders would make our position on property harder to defend.

(ii) We could be criticised for allowing windfall gains.

(iii) If we allowed the premium, Authorised Depositaries would have to distinguish between holdings bought before the announcement and afterwards. The possibility of premium fiddles would be increased.

(iv) We are allowing unlimited official exchange for these securities not a ration. ie. total demand for them can be met with official exchange. With a ration, this need not have been so, and continued access to the investment currency market may have been necessary.

4. On balance we think it would be better to remove premiumworthy status from existing holdings of the securities to be liberalised. The Bank agree with this conclusion. The treatment of property is a clear precedent and, since the Government is clearly intent on abolishing the premium market, the holders of premiumworthy securities know that they are going to lose the premium sooner or later anyway. Indeed, it has already dropped from 50% to below 10% in the course of this year.

RELAXING CONTROLS ON OVERSEAS PORTFOLIO INVESTMENT : A SUMMARY OF SOME OF THE ECONOMIC ARGUMENTS

1. The short run consequences of relaxing exchange controls depend critically on the underlying strength of demand for sterling at the time. If sterling is in heavy demand, for whatever reason, limitations on its sale are unlikely to distort economic behaviour, so that offering investors increased opportunities to acquire foreign assets may have little immediate impact on the foreign exchange market. Indeed, in the very short run, a major relaxation of controls may be taken as a gesture of confidence in the future of sterling by the authorities, so demand may actually be increased. So it is by no means inconceivable that the impact effect of a new exchange control package would be to increase the upward pressure on the exchange rate, and to exert some downward pressure on UK interest rates. In the view of the Bank's chief dealer, a perverse response of this sort is a distinct possibility under present circumstances. On the other hand, if sterling were to weaken suddenly, relaxing controls could put strong additional downward pressure on the exchange rate and help to push interest rates even higher.

2. In the somewhat longer run, however, relaxing controls on portfolio investment should produce a significant outflow of capital. The persistence of a sizeable dollar premium over a long run of years including this year when sterling has been in heavy demand and when relaxation of controls has been widely expected - is convincing evidence of an unsatisfied demand for foreign securities. This might be satisfied by a largely once-for-all outflow of capital, as investors adjusted their portfolios: but there might also be a small continuing outflow financed from new savings.

3. With a floating exchange rate and a given monetary target, the most obvious result of this outflow would be downward pressure on the exchange rate and upward pressure on domestic interest rates. There might be other effects as UK investors ran down their holdings of gilts, bank deposits, equities and other financial assets to finance the purchase of foreign securities. For example, domestic equity prices would be likely to fall, and partly as a result, there could be an increase in the demand for bank lending. Relaxations which led

to the loss of the dollar premium would inflict a capital loss on existing portfolios, and this might lead to a somewhat higher level of savings as investors tried to rebuild their wealth.

4. In the medium term, the effect of relaxing controls should be to lower the exchange rate in real and nominal[*] terms - unless the present quite exceptional strength of sterling persists for longer than we think likely. In the short run, an outflow of portfolio capital can be financed by an inflow of short term funds; and the exchange rate will fall and interest rates rise to improve the rate on sterling assets by enough to bring this about. But in the longer term, an outflow of capital must be offset by a current account surplus. Indeed, it is only by running a current account surplus that the UK can increase its net holdings of foreign assets. To produce these results, the real exchange rate must fall. A rise in domestic real interest rates is likely to be an important element in preventing short run gains in competitiveness from being completel eroded by higher domestic inflation.

5. These changes in real interest rates and competitiveness would have important implications for the real profitability of different sectors of British industry. Output and employment in the traded goods sectors of the economy (which broadly correspond to manufacturing industry) would be favoured at the expense of activity in those sectors less open to foreign competition or more sensitive to interest rates. These effects would provide some very incomplete, but probably significant, counter poise to the adverse effects of North Sea oil on the competitiveness of UK manufacturing industry - effects which may have lasting consequences which will not be easily reversed when the oil runs out. To this extent, there is a strong medium term macro-economic case for relaxing exchange controls.

6. The case for immediate, major relaxation as a way of depressing the exchange rate in the short run (even if it succeeds) is less clear cut. On general grounds we would welcome the relief to industrial profitability that a lower exchange rate would bring. But the recent strength of sterling is, at least in part, the result

[*] In theory, relaxing controls would reduce the real exchange rate even if the nominal exchange rate were fixed: but the adjustment would be much lengthier and would result from lower domestic prices rather than a lower exchange rate.

of the government's current monetary policies. As the quickest means by which a tight monetary policy can be expected to influence the price level is through the exchange rate a high nominal rate is an integral part of the current strategy. Moreover, the direct effects on prices will be an offset to the impact effect of the increases in indirect taxes in the Budget. A sharp squeeze on industrial profitability may be the only means of stiffening the resolve of employers in the face of wage claims: it may therefore be the almost inevitable consequence of trying to reduce inflation through monetary restraint. On this reasoning, using a relaxation of exchange controls as a way of deliberately depressing the exchange rate is to risk weakening the thrust of counter inflationary policy.

7. On the other hand, the present level of the exchange rate may be taken as evidence that monetary policy has become undesirably tight. In this case, a relaxation of controls, by reducing the demand for money relative to the supply, would offer one way of somewhat easing the squeeze without repudiating the monetary target.

8. Looked at very simply, it can be argued - as regards both the medium and the short term - that the combination of tight monetary policies, North Sea oil and the remaining battery of exchange controls places a disproportionate share of the burden of reducing inflation on the traded goods industries. A further major relaxation of controls would not protect manufacturing from the hard realities of life, but it would remove an unnecessary and self-imposed impediment to maintaining UK competitiveness.

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CHANCELLOR OF THE EXCHEQUER

I told him — nothing, of this to Wass, at [illegible] only

cc Chief Secretary
Financial Secretary
Minister of State - Commons
Minister of State - Lords
Sir D Wass
Sir L Airey
Sir F Atkinson
Sir K Couzens
Mr Barratt
Mr Byatt
Mr F Jones
Mr Littler
Mr Bridgeman
Mr Dixon
Mr Unwin
Mr Gill
Mrs Lomax
Mr Scholar
Mr Allan
Mr Ilett
Mr McIntyre
Mr Cardona
Mr Ridley
Mr McMahon) B of E
Mr Dawkins)
Mr Walker)
Mr Sangster)
Mr Fitchew - UKREP (Persona

Chancellor

If you approve you will want

(a) to minute the PM (para 28)

(b) authorise exploratory discussion with EEC (para 29)

(c) settle the issue in para 26. Agree with FST

[illegible]

To be announced on July 19, [illegible]

(d) Write Blumenthal

JULY PACKAGE OF EXCHANGE CONTROL RELAXATIONS

I am sending forward for your consideration two documents which we have already discussed with the Financial Secretary who will, I understand, be minuting you separately:-

(i) a submission on a possible package of exchange control relaxations that could be announced before the Recess; and

(ii) a brief summary of the principal economic arguments relevant to proposals for relaxing controls over overseas portfolio investment.

2. For the benefit of the Financial Secreaty and others who saw an earlier version of the submission, I should explain that the main changes in the submission, resulting from further discussions today, are:-

CONFIDENTIAL

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FINANCIAL SECRETARY TO THE TREASURY

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir L Airey
Sir F Atkinson
Sir K Couzens
Mr Barratt
Mr Byatt
Mr F Jones
Mr Littler
Mr Bridgeman
Mr Dixon
Mr Unwin
Mr Gill
Mrs Lomax
Mr Scholar
Mr Allan
Mr Ilett
Mr McIntyre
Mr Cardona
Mr McMahon)
Mr Dawkins) B of E
Mr Walker)
Mr Sangster)
Mr Fitchew - UKREP

JULY PACKAGE OF EXCHANGE CONTROL RELAXATIONS

I attach the suggested stage two package of exchange control measures to be taken this month. It has been worked up hurriedly, but I do not believe it is any worse for that. It is basically the first major step in the portfolio field coupled with the completion of dismantling in the direct investment field. It has a strong 'European' flavour, but is unlikely, in the circumstances, to present difficulties with the US government.

As you will see from paragraph 26, assuming you agree to this package, three particular decisions need to be taken.

As to the first, my inclination would be to ask the Bank to take immediate further soundings of the investment trusts in the hope that the EEC relaxation can be total, but I fear that those soundings will suggest otherwise.

As to the second, I believe the right answer to be 'no'. Given the derisory size of the premium, I do not envisage any serious difficulty arising from this.

FINANCIAL SECRETARY TO THE TREASURY

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As to the third, I would strongly favour one year, particularly if EEC investment and unit trusts are to be excluded from the liberalisation.

As to timing, you will see from paragraph 8 that, given a limited pr of the new exchange control notices, it would be perfectly possible to announce the package at Treasury questions on 19 July provided the decision is made shortly.

Finally, I would emphasise that the short term consequences of announcing this package might well be a further strengthening of the exchange rate. This seems to me inevitable, and no cause for hesitation. But it might affect the way in which the package is presented.

PCS

NIGEL LAWSON

4 July 1979

84/04 140

PS/CST PS/FST PS/MST(C) PS/MST(R) Sir D Wass Sir L Airey Mr Lovell Mr Hancock Mr Hodges Mr Ilett Mr Ridley

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

5 July 1979

EF2cd

Dear Jasper

I am writing to acknowledge your letter of 5th July, and confirm that it was with my prior approval that the Governor recommended to the Court of Directors that a reduction be made in the rate of call for Special Deposits from banks (other than those in Northern Ireland) and from deposit-taking finance houses from the equivalent of 2 per cent of eligible liabilities to ½ per cent, with effect from the 11th July 1979; and that the rate of call be restored to 1 per cent with effect from the 3rd August 1979 and to 2 per cent with effect from the 13th August 1979.

Yours

Geoffrey

(GEOFFREY HOWE)

Sir Jasper Hollom, KBE
Deputy Governor,
Bank of England

73/7

cc Chief Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Sir Kenneth Couzens
Mr. Barratt
Mr. Byatt
Mr. F. Jones
Mr. Littler
Mr. Bridgeman
Mr. Dixon
Mr. Hancock
Mr. Unwin
Mr. Gill
Mrs. Lomax
Mr. Scholar
Mr. Allan
Mr. Ilett
Mr. McIntyre
Mr. Cardona

Mr. McMahon)
Mr. Dawkins) Bank of
Mr. Walker) England
Mr. Sangster)

Mr. Fitchew - UKREP

PA 26

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EF(2)CS
10 JUL 1979

FINANCIAL SECRETARY

JULY PACKAGE OF EXCHANGE CONTROL RELAXATIONS

The Chancellor has seen your minute of 4 July, together with Mr. Hancock's of the same date.

2. The Chancellor agrees that the package in the annex to Mr. Hancock's minute should be announced in Treasury Questions of 19 July if at all possible. He has already given the Prime Minister an outline of this package; he would now be grateful for a draft minute giving her a fuller picture.

3. The Chancellor is content that confidential discussion with the European Commission should proceed. He would also like to give Mr. Blumenthal a preview of the package.

4. On the three issues in paragraph 26 which require decision, he agrees with you.

MAH.

M.A. HALL
5 July 1979

CONFIDENTIAL

5 JUL 1979

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FINANCIAL SECRETARY

cc Sir Douglas Wass
Sir Kenneth Couzens
Mr Barratt
Mr Dixon
Mr Unwin
Mr Gill
Mr Ilett
Mr McIntyre

Mr Dawkins - B of E

JULY PACKAGE OF EXCHANGE CONTROL RELAXATIONS

I refer to Mr Hall's minute of today's date responding to yours of yesterday.

2. Attached is a draft minute for the Chancellor to send to the Prime Minister. You will see that I have kept to the broad lines of the package and not gone into detail.

3. It would, I suggest, be desirable for the Chancellor to send this minute tomorrow so that the Prime Minister reads it at the same time as her briefing for her meeting with the CBI on Monday.

D.H.

D J S HANCOCK
5 July 1979

PPS

FST is entirely content with Mr Hancock's draft note for the Chancellor to send the PM.

PCD 6.7.79

EXC/34/04 (H)

CONFIDENTIAL

V9/7

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~~DRAFT~~ MINUTE FOR THE CHANCELLOR OF THE EXCHEQUER TO SEND TO THE PRIME MINISTER

COPIES TO

Secretary of State for Foreign and Commonwealth Affairs
Secretary of State for Industry
Secretary of State for Trade
Governor of the Bank of England
Sir John Hunt

EXCHANGE CONTROLS

I refer to my minute of 23 May in which I described the proposals for exchange control relaxation that were subsequently announced in the Budget Speech.

2. Since the Budget ~~sterling has been remarkably strong. This~~ partly reflects the effect on confidence of the Government's determination to squeeze inflation out of our economy by firm monetary discipline and strict control over public expenditure. ~~But~~ it also ~~results from~~ the high level of sterling interest rates, which are necessary to maintain monetary control, ~~and~~ our favourable position as an oil producer at a time of rising oil prices. The effective rate for sterling today is [redacted] over ~~70~~ 70.5, an increase of 4 per cent since the Budget. ~~This sharp appreciation has caused~~ increasing anxieties about the effect on competitiveness - ~~and no doubt~~ the CBI will raise this matter ~~with you~~ when ~~you~~ see them ~~next Monday.~~

Please check with Mr. Gill

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3. At the time of the Budget I had planned to announce a second package of exchange control relaxations in October. I still regard ~~consider to be~~ valid the arguments for making relaxations one step at a time which I explained in my minute of 23 May. But the recent strong upward pressure of demand for sterling does enable me to bring forward the October package. I therefore plan to make a new announcement on 19 July.

4. Exchange control notices are now being prepared to implement the following relaxations:-

(i) Unlimited official exchange for all securities denominated in EEC currencies.

(ii) Unlimited official exchange for investment in the bonds of international organisations of which the United Kingdom is a member, including those issued by Community institutions.

(iii) Permission to repay with official exchange all foreign currency borrowing taken out for portfolio investment one year or more before the date of the announcement.

(iv) Unlimited official exchange for outward direct investment.

5. Items (i) - (iii) constitute, in combination, a substantial first step in the relaxation of our controls over portfolio investment.

It would not be possible in July to abolish controls on portfolio - a good deal more work will have to be done on the technical consequence of such a move before we are in a position to implement it. In any case, as I said earlier, I believe that the arguments for proceeding one step at a time remain valid.

6. The choice of securities denominated in EEC currencies as the first main block of securities which UK investors will be free to buy with official exchange will clearly please the Commission. The Americans on the other hand will be disappointed. Mr Blumenthal expressed his satisfaction with the fact that my Budget package removed most of the elements in our controls which discriminated in favour of the Community. But I propose to write to him before the announcement and assure him that it is our intention to move steadily towards complete freedom for UK residents to invest in securities denominated in any currency, including the dollar.

7. The international organisation bond proposal will also ~~please~~ the Commission - Mr Ortoli hoped that I would be able to include such a relaxation for the bonds of Community institutions in the Budget package. ~~Giving him what he wanted so much earlier than he had reason to expect could help to gain his goodwill in the context of our negotiations about the Community budget.~~ The relaxation will also apply to the bonds issued by other international organisations including those that help the developing countries such as the World Bank. We shall therefore be able to take some credit for this change in discussions both at home and abroad about our relations with the developing countries; and this might have some modest value in counteracting the disappointment caused by cut-backs in our aid programme.

8. Many institutions do not like being obliged to borrow foreign currency to buy securities without paying the premium and will welcome the opportunity to repay with official exchange borrowing outstanding for a year or more. Taking this step now should also reduce the size of the outflow that will result from the abolition of controls over portfolio when we are able to do that.

9. The fourth constituent of the package is to give unlimited official exchange for outward direct investment - ie to increase the £5 million ration included in the Budget package to permission to use official exchange for direct investment at will. It might seem a bit soon to change policy within a few weeks of the Budget. But given the strength of sterling I do not think anyone will be very surprised and I will be able to explain that the continued ~~and increasing~~ strength of sterling permitted me to bring forward the time at which it was possible to complete the dismantling of controls over the financing of outward direct investment. The TUC reaction to the Budget package has been rather muted and this further step is unlikely to make much difference to their attitude. The CBI will obviously be very pleased.

10. I ~~hope that~~ you will agree that it is appropriate to accelerate our planned programme for the dismantling of exchange controls ~~in the way proposed above~~. I ~~must stress that~~ we ~~should not assume~~ that the announcement will reduce pressure on sterling in the short term. Indeed, ~~I think we must accept~~ that the immediate effect could conceivably be to drive the rate up still further because this reaffirmation of the Government's intentions may make sterling seem an even more attractive currency to hold. But in the longer term we would expect the relaxations to result in capital outflows and to cause the

exchange rate to be lower than would otherwise be the case. Perhaps even more important, dismantling these controls will improve the functioning of the markets and give investors greater freedom of choice. The combination of these new relaxations with those already announced in the Budget will constitute a very big step in the direction we all want to go.

10. I am sending copies of this minute to the Secretaries of State for Foreign and Commonwealth Affairs, Industry and Trade, to the Governor of the Bank of England and to Sir John Hunt.

G - H

CONFIDENTIAL

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CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr Barratt
Mr Dixon
Mr Unwin
Mr Gill
Mr McIntyre

JULY PACKAGE OF EXCHANGE CONTROL RELAXATIONS

In paragraph 10 of the submission attached to my minute of 4 July I promised a more detailed note on the balance of payments effects of the July package. This is now attached.

D.H.

D J S HANCOCK
5 July 1979

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JULY PACKAGE OF EXCHANGE CONTROL RELAXATIONS : POSSIBLE OUTFLOWS

It is difficult to predict the scale of any capital outflows which may follow the new liberalisation measures. How far investors will wish to use the additional access to official exchange depends critically in the short run on the strength of sterling. This means that little weight can be attached to the estimates given below for each element of the package. If sterling stays strong, the initial effect would probably be very small. With this caveat, it seems that the total effect over a year or so might be about £1 billion. If EEC unit and investment trusts are included the projection is even more difficult, but their inclusion could increase the possible outflow to nearer £1½ billion.

Official exchange for all securities denominated in EEC currencies

2. It is estimated that at end-1977 UK holdings of EEC currency securities were about £500 million, which was only about 7% of the estimated total stock of UK portfolio investment overseas. From the date of the announcement, those holdings bought with premium currency (probably over half) will no longer be premiumworthy there will therefore be no incentive to refinance those holdings by buying official exchange. However, in spite of relatively high UK interest rates, investors who have borrowed foreign currency to buy these securities may choose to repay their loans and refinance their holdings with official exchange. If all borrowers did this, the total outflow might be about £200 million.

3. Beyond that, investors may wish to buy additional EEC currency securities (i) to make up for the capital loss to their portfolios from losing the premium on those securities and (ii) to make up for the losses to their entire portfolios arising from the large fall in the premium this year, from nearly 50% in February to less than 10% now. But the volatility of the premium has led some institutions to consider it as a quite separate, even embarrassing element in their portfolios. Whether they will see any need to rebuild their portfolios to compensate for the loss of the premium is therefore in doubt. And because it has varied so much, it is in any case hard to say what level of premium would be a good indicator of pent-up demand. If it were, say, 25%, we might expect the effect of (i) to be abo £75 million and of (ii) up to £2 billion. But the narrowness of the capital marke in other Member States will be a major constraint if unit and investment trusts ar excluded. Moreover, investors may hold off if they expect the government to make further relaxations of exchange controls which will open up more attractive opportunities, especially Wall Street. So an outflow of anything approaching

£2 billion is highly unlikely; that is more reasonably an estimate of the effect of complete removal of the controls on portfolio.

4. We might assume that, at the very outside, investors may wish to double their present holdings of these securities over the next few months or a year: that would produce an outflow of about £500 million. Together with refinancing of borrowing (paragraph 2), the maximum outflow would be about £700 million. A central estimate might therefore be about £300 million. If unit and investment trusts were included the picture would be quite different. Some of these institutions would provide a ready and attractive route to Wall Street and could absorb large quantities of UK funds. It would not be unreasonable to double the central estimate to £600 million if they were included.

Official exchange for quoted bonds issued by international organisations of which the UK is a member

5. The total volume of such bonds outstanding is around £8 billion, about equally divided between bonds issued by Community institutions (EEC, EIB, ECSC and Euratom) and those issued by other organisations, eg the World Bank.

6. In general, these bonds are fixed interest securities and are unlikely to excite very much interest among UK investors. An indication of this has been the low take-up of a new facility introduced in January 1978 to enable loans taken out to buy bonds issued by Community institutions to be repaid with official exchange. Authorisations for such borrowing have totalled less than £100 million over the 18 months the scheme has been running and less than £50 million has actually been taken out. It is therefore doubtful if investors will wish to buy very many of these bonds in order to rebuild their portfolios, as envisaged in paragraph 3 above.

7. There is also not much of a market in these bonds: most are firmly held by large institutions. Any significant additional demand would be self-regulating, in that bond prices would soon be driven up.

8. The evidence from the existing facility for EEC institutions is not very clear, but it suggests that the outflow arising from this relaxation should be rather small: at most, perhaps £100 million a year. A Central Estimate might be £50 million.

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O[illegible]icial exchange for repayment of foreign currency borrowing

9. The maximum outflow for a change applying to borrowing outstanding for one year or more at the date of the announcement will be about £1.2 billion. In view of high relative interest rates in the UK and given that some of this borrowing will have financed purchases of EEC currency securities or bonds issued by international organisations (subsumed in estimates above) a central estimate of the additional outflow might be £500 million.

Unlimited official exchange for outward direct investment

10. This relaxation will have the following effects:-

i. all future outward direct investment could be financed without limit with official exchange;

ii. all foreign currency borrowing taken from now on could be repaid at will; and

iii. all foreign currency borrowing taken in the past could now be repaid at will (instead of over 5 years as in the Budget package).

i. and ii. above are unlikely to add much to the outflows likely to follow the 12 June measures. iii. could in theory cause more substantial outflows, but in practice it is likely that the bulk of borrowing which has been outstanding for some time would have been eligible for repayment under earlier rules, had the borrower so wished. The additional outflow is very difficult to predict, but would be unlikely to be more than about £500 million (once and for all) and could be much less. A central estimate might be £$\frac{1}{4}$ billion.

Summary

11. This gives the totals in paragraph 1 as follows:-

		£m
(i)	EEC securities	300 - 600
(ii)	bonds	50
(iii)	foreign currency borrowing	500
(iv)	direct investment	250
		1,100 - 1,400

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PRINCIPAL PRIVATE SECRETARY

cc PS/Financial S
Sir Douglas W
~~Sir Kenneth C~~
Mr Barratt
Mr Dixon
Mr Unwin
Mr Gill
~~Mr McIntyre~~
Mr Ret
EF

JULY PACKAGE OF EXCHANGE CONTROL RELAXATIONS

I should like to apologise for an omission on the paper dated 5 July on this subject. Could the sente "A central estimate might be £50 million" be added to the end of paragraph 8 on page 2.

MRS M L BROWN
PS/D J S HANCOCK
6 July 1979

Exc/54/04 (4)

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FINANCIAL SECRETARY TO THE TREASURY

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir K Couzens
Mr Jordan-Moss
Mr Hancock
Mr Hodges
Mr Ridley

JULY PACKAGE OF EXCHANGE CONTROL RELAXATIONS

No doubt you will have seen the Governor's letter of 6 July commenting on my minute of 4 July.

As you know, I am very doubtful of the argument in his paragraph 1, against taking soundings of our domestic institutions to discover the extent of their resentment to any liberalisation for EEC currency securities issued by investment Trusts and similar institutions outside the Scheduled Territories. However, in the light of his analysis of the effect of such a move (his paragraph 2), and the evident strong Bank feeling on this, it might be wisest to succumb: we are, after all, considering (I hope) an arrangment which will last only a few months, maybe until October.

On the scope of the next step in relaxing exchange controls, I have been reflecting on the effect on the UK equity and gilts markets of providing access to the very large US market. In view of the undoubted attractions of US investment, particularly for the institutions, I suggest that it might be prudent to ensure that we have (a) sold the BP shares and (b) funded as much as possible of this year's PSBR before liberalising investment in US securities. This would not be possible if we go the whole hog this month: it would be if we left non-EEC portfolio liberalisation until October.

NL.

NIGEL LAWSON
9 July 1979

Exc/54/04 (H)

CONFIDENTIAL

Mr Hodges 16/vii

Sir D Wass
Sir K Couzens
Mr Barratt
Mr Hancock
Mr Dixon
Mr Unwin
Mr Gill
Mr Ilett
Mr McIntyre

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

PRIME MINISTER

EXCHANGE CONTROLS

11/VII 1979

I refer to my minute of 23rd May in which I ~~described the~~ proposals for exchange control relaxation that were subsequentl announced in the Budget Speech.

2. The strength of sterling since the Budget partly reflects the effect on confidence of the Government's determination to squeeze inflation out of our economy by firm monetary disciplir and strict control over public expenditure. It may also owe something to the high level of sterling interest rates, which are necessary to maintain monetary control. But it is mainly due to our favourable position as an oil producer at a time of rising oil prices. The effective rate for sterling today is over 70.5, an increase of some 4 per cent since the Budget. We spoke last night about the extent to which this is causing anxiety about the effect on competitiveness; the CBI will raise this matter when we see them latertoday.

3. At the time of the Budget I had planned to announce a second package of exchange control relaxations in October. As I mentioned last night, I still regard as valid the arguments (which I explained in my minute of 23rd May) for making relaxations one step at a time. But the recent strong upward pressure of demand for sterling does enable me to bring forward the October package. I therefore plan to make a new announceme on 19th July.

/4. Exchange

92/7

4. Exchange control notices are now being prepared to implement the following relaxations:-

(i) Unlimited official exchange for all securities denominated in EEC currencies.

(ii) Unlimited official exchange for investment in the bonds of international organisations of which the United Kingdom is a member, including those issued by Community institutions.

(iii) Permission to repay with official exchange all foreign currency borrowing taken out for portfolio investment one year or more before the date of the announcement.

(iv) Unlimited official exchange for outward direct investment.

5. Items (i)-(iii) constitute, in combination, a substantial first step in the relaxation of our controls over portfolio investment. It would not be possible in July to abolish controls on portfolio - a good deal more work will have to be done on the technical consequences of such a move before we are in a position to implement it. In any case, as I said earlier, I believe that the arguments for proceeding one step at a time remain valid.

6. The choice of securities denominated in EEC currencies as the first main block of securities which UK investors will be free to buy with official exchange will clearly please the Commission. The Americans on the other hand will be disappoint Mr. Blumenthal expressed his satisfaction with the fact that my Budget package removed most of the elements in our controls which discriminated in favour of the Community. But I propose to write to him before the announcement and assure him that it is our intention to move steadily towards complete freedom for

/UK residents

UK residents to invest in securities denominated in any currency including the dollar.

7. The international organisation bond proposal will also meet a point raised by the Commission - Mr. Ortoli hoped that I would be able to include such a relaxation for the bonds of Community institutions in the Budget package. The relaxation will also apply to the bonds issued by other international organisations including those that help the developing countrie such as the World Bank. We shall therefore be able to take some credit for this change in discussions both at home and abroad about our relations with the developing countries; and this might have some modest value in counteracting the disappointment caused by cut-backs in our aid programme.

8. Many institutions do not like being obliged to borrow foreign currency to buy securities without paying the premium and will welcome the opportunity to repay with official exchang borrowing outstanding for a year or more. Taking this step now should also reduce the size of the outflow that will result frc the abolition of the remaining controls over portfolio when we are able to do that.

9. The fourth constituent of the package is to give unlimited official exchange for outward direct investment - i.e. to increase the £5 million ration included in the Budget package to permission to use official exchange for direct investment at will. It might seem a bit soon to change policy within a few weeks of the Budget. But given the strength of sterling I do not think anyone will be very surprised and I will be able to explain that the continued strength of sterling permitted me to bring forward the time at which it was possible to complete the dismantling of controls over the financing of outward direct investment. The TUC reaction to the Budget package has been rather muted and this further step is unlikely to make much difference to their attitude. The CBI will obviously be very pleased.

/10. I know

CHANCELLOR OF THE EXCHEQUER

10. I know you agree that it is appropriate to accelerate our planned programme for the dismantling of exchange controls along these lines. Although the ~~removal~~ rumour of this relaxation is said to have had some downward effect on Friday, we cannot be sure that the announcement will reduce pressure on sterling in the short term. Indeed, it is still possible that the immediate effect could be to drive the rate up because this reaffirmation of the Government's intentions may make sterling seem an even more attractive currency to hold. But in the longer term we would expect the relaxations to result in capital outflows and to cause the exchange rate to be lower than would otherwise be the case. Perhaps even more important, dismantling these controls will improve the functioning of the markets and give investors greater freedom of choice. The combination of these new relaxations with those already announced in the Budget will constitute a very big step in the direction we all want to go.

11. I am sending copies of this minute to the Secretaries of State for Foreign and Commonwealth Affairs, Industry and Trade, to the Governor of the Bank of England and to Sir John Hunt.

G.H.

(G.H.)

9 July, 1979

CONFIDENTIAL

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EXC/84/04 (H)

C 32

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CHANCELLOR OF THE EXCHEQUER

cc Mr Hancock
Mr Hodges
Mr McIntyre
Mr Dyer
Mr Dawkins B/E

JULY PACKAGE OF EXCHANGE CONTROL RELAXATIONS: ANNOUNCEMENT

I have been looking a little more closely at your suggestion that you might announce the exchange control relaxation in answer to an oral queston on Thursday 19 July. As you know, there is no practical reason why the package cannot be ready in time for that day; but, on reflection, I think a statement might be more satisfactory than an oral answer.

My main concern is that in answering an oral question it would scarcely be possible to do much more than mention the fact that you are making the first step to relax portfolio control, and you certainly could not go into the sort of detail the House might reasonably expect. A fuller explanation would need, I guess, at least 10 minutes and is hardly the sort of thing you would want to undertake at Question Time if only because members who plan to ask questions further down the list would probably be irritated.

This suggests that the best bet is either to make a statement after Business Questions that day or else, if this can be done, to answer Jonathan Aitken's question on precisely this subject (No 34) by prior arrangement directly after Prime Ministers' Questions. The former method has the advantage of postponing the announcement until the investment currency markets are more or less closed for the day, while the latter would give the heavy dailies more time for substantive comment.

I should be grateful for your reactions to this rescheduling of the announcement timetable. If you agree, we will need to write to Norman St John Stevas.

NIGEL LAWSON
10 July 1979

Chancellor

The FST's advice assumes that announcement on the 17th was not technically possible. The 18th is out because of the No. 10 Seminar.

The 17th is technically possible according to the Bank, but distinctly unattractive because of the Royal Garden Party at 4pm.

I think we should aim to persuade the Leader of the House that the 19th is best, notwithstanding the usual embargo on Thursday statements (apart from Business).

10/7.

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10 DOWNING STREET

Sent 10/7
M Hodges
PS/CST
PS/FST
PS/MST(C)
PS/MST(L)

From the Private Secretary

10 July 1979

M Barratt
M Jordan

Dear Martin.

EXCHANGE CONTROLS

This is to confirm that the Prime Minister is content with the Chancellor of the Exchequer's proposals for the further dismantling of exchange controls, as set out in his undated minute which we received yesterday.

I am sending copies of this letter to Paul Lever (FCO), Andrew Duguid (Department of Industry), Tom Harris (Department of Trade), John Beverly (Bank of England) and Martin Vile (Cabinet Office).

Yours ever,

Tim Lankester.

M.A. Hall, Esq.,
HM Treasury.

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C
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1. MR HANCOCK DH 10/7.
2. CHANCELLOR OF THE EXCHEQUER

cc for: Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Sir Kenneth Couzens
Mr Barratt
Mr Jordan-Moss
Mr Littler
Mrs Hedley-Miller
Mr Unwin
Mr Cardona
Mr Ridley

cc to: Mr Michell
Mr Ashford
Mr Ilett
Mr McIntyre
Mr Dawkins (B/E)
Mr Fitchew (UKRep)

CHANCELLOR'S DINNER WITH M. ORTOLI ON 11 JULY:
EXCHANGE CONTROL RELAXATIONS

1. When approving the "stage two" package of exchange control relaxations for announcement next week, the Chancellor agreed that confidential discussion with the European Commission should proceed. While contact has been made in Brussels, the dinner with M. Ortoli on 11 July gives the Chancellor an opportunity to explain the Government's decisions to him personally.

2. M. Ortoli will now be aware of the changes to be made, and can be expected both to welcome them and to confirm that there is no need for a further meeting with Commission officials like the full discussion we had here on 5 June. The Chancellor could outline the measures and say that a note of them would be transmitted through UKRep, Brussels. It is not yet clear whether another formal letter would have to be sent to the President of the Commission or whether they would see a need to take any action regarding their current Article 108 decision.

Line to take

3. The Chancellor could explain that the strength of sterling had enabled him to accelerate the progressive dismantling of exchange controls announced in his Budget Statement on 12 June. Parliament would be informed next week of the further steps to be taken. These provide for:

(a) unlimited official exchange for outward direct investment anywhere in the world; and

(b) a major relaxation of controls over outward portfolio investment, so

/as...

as to allow unlimited official exchange for all securities denominated in EEC currencies and for investment in the bonds of international organisations of which the United Kingdom is a member, including those issued by Community institutions, and also repayment with official exchange of all foreign currency borrowing taken out for portfolio investment one year or more earlier

4. A note of the changes would be sent to the Commission this week through the UK Representation in Brussels, as would a copy of the Treasury Press Notice to be issued when the announcement was made. While confident of, and grateful for, the Commission's discretion in these sensitive matters, any advance leaks could of course be unsettling for the markets.

5. The emphasis in this package is on the portfolio side, embracing the relaxatic for Community bonds which M. Ortoli had hoped could be made in last month's Budget. Securities denominated in EEC currencies have been chosen as the first main sector for portfolio liberalisation although the intention is to move steadily, as circumstances permit, towards freedom for UK residents to invest in securities denominated in any currency. The package as a whole thus takes us far towards meeting in full our obligations under the Capital Movements Directives.

6. If M. Ortoli should express unease that the pound's strength and the growing importance of North Sea oil makes it difficult for the Commission to continue authorising our remaining restrictions, the Chancellor could reassure him that he remains determined to carry through a progressive dismantling of exchange controls as speedily as conditions permit.

7. We shall put up a further note if we hear anything more of interest from Brussels before tomorrow evening.

C H W HODGES
10 July 1979

CONFIDENTIAL
EXC/34/04 (4)

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PRINCIPAL PRIVATE SECRETARY

cc PS/Financial Secretary
Mr Hancock
Mr McIntyre
Mr Dyer
Mr Dawkins (B/E)
Mr Willetts (B/E)

ANNOUNCEMENT OF EXCHANGE CONTROL RELAXATIONS
(Financial Secretary's minute of 10 July)

On the Chancellor's suggestion of announcing the July package in the normal course of answering oral questions (i.e. probably before 3pm), I have checked with the Bank of England on the importance of not making the announcement before the Stock Exchange closes at 3.30pm. The Bank consider it essential to have it after 3.30pm if the authorities are not to incur blame for serious confusion over dealings in a wide range of securities. It would also be helpful, though less important, for the announcement to be as near as possible to the time (4-4.30pm) when the investment currency dealers normally pack up for the day.

Chancellor

In confirmation of my ms. note

C H W HODGES
11 July 1979

CONFIDENTIAL

164 C – very sensible suggestion; and the diary permits it. 36

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr Barratt
Mr Jordan-Moss
Mrs Hedley-Miller
Mr Hodges

Mr McMahon) B of E
Mr Dawkins)

Mr Ryrie - UKTSD

US REACTIONS TO EXCHANGE CONTROL PACKAGE

We are preparing, at your request, a letter for you to send to Mr Blumenthal to give him advance warning of the exchange control package and to explain why it includes the provision of unlimited official exchange for securities denominated in EEC currencies. Among the points that could be made are:-

(i) The relaxation is intended as a temporary measure consistent with our step by step approach and that our objective remained complete liberalisation of portfolio investment worldwide.

(ii) The Government hoped that it would not be long before this objective could be achieved.

(iii) Denomination in a currency is an unambiguous way of identifying a class of securities and is therefore a sound administrative basis for a partial relaxation of controls.

(iv) The package also includes unlimited official exchange for direct investment worldwide - thus in the field of direct investment there would be no discrimination whatever.

2. We have been considering with Sir K Couzens and Mr Ryrie how to handle the delivery of the letter so as to ensure the most sympathetic possible reception. The United States Ambassador in London, Mr Brewster, has taken a particular interest in exchange controls and urged you to remove the discriminatory elements in the regime that you inherited when you took office. We should therefore like to suggest that you invite him to call on you before lunch on the day of the announcement, namely next Wednesday 18 July, so that you could hand over the letter for him to arrange delivery to Mr Blumenthal.

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This would give you an opportunity to assure Mr Brewster personally that the Government was quite sincere in its hopes that the discrimination against dollar securities would be short lived.

3. If you accepted this suggestion, Mr Ryrie would try to secure an appointment to see Mr Soloman of the US Treasury later the same day (our time) to give him a copy of the letter also and to make the same points orally.

4. Alternatively, if you preferred not to see the Ambassador, or if such a meeting could not be arranged, Mr Ryrie would try to seek an interview with Mr Blumenthal himself to deliver the letter in Washington. We could not, of course, be sure that Mr Blumenthal would be available; and if he was not, Mr Ryrie would endeavour to see Mr Soloman instead. The fact that he had attempted to see Mr Blumenthal personally would, no doubt, help to convince the American authorities of our concern that the Government's intentions be correctly understood.

5. We should be glad to have your agreement to the procedure suggested in paragraphs 2 - 3 above - and failing that to the alternative in paragraph 4.

D.H.

D J S HANCOCK
12 July 1979

CONFIDENTIAL

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1. MR HANCOCK

2. PRINCIPAL PRIVATE SECRETARY

copies for:
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State (Commons)
PS/Minister of State (Lords)
Sir Douglas Wass
Sir Kenneth Couzens
Mr Barrattt
Mr Unwin
Mr P G Davies
Mr Ridley
Mr Ilett
Mr McIntyre

ANNOUNCEMENT OF EXCHANGE CONTROL RELAXATIONS

The draft reply submitted yesterday by Miss O'Mara to the letter from the Chancellor of the Duchy's office about major policy announcements before the Summer Recess mentioned that there are arguments for making the exchange control statement (as a Written Answer) on 18 July instead of announcing on 19 July as originally envisaged and that the Treasury would be writing separately with specific proposals.

2. On the assumption that the Chancellor of the Exchequer confirms his approval of using a Written Answer on 18 July, the further letter might be on the lines of the attached draft.

C H W HODGES
12 July 1979

P.S. I have just heard from Mr Hall that the Chancellor has agreed to a Written Answer on 18 July.

Revised draft substituted.

D.H.

12/7.

CONFIDENTIAL

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~~DRAFT~~ PRIVATE SECRETARY LETTER TO

Private Secretary,
Chancellor of the Duchy of Lancaster
Privy Council Office
Whitehall SW1A 2AT

cc PS/Paymaster General
PS/Cabinet Secretary

GOVERNMENT POLICY ANNOUNCEMENT: EXCHANGE CONTROL

Following ~~our~~ my reply to your letter of 10 July, I can now say that the Chancellor proposes to announce the further exchange control relaxations in the form of a Written Answer to an arranged PQ on Wednesday 18 July.

2. Now that the package has been agreed, the Chancellor wishes to announce it as soon as practicable. The Written Answer procedure will enable us to control the timing of the announcement so that it occurs after the Stock Exchange has closed for the day but well before the next morning's papers go to press.

3. At least one of the Oral PQ's likely to be reached on 19 July is relevant and the proposed procedure will give Members the opportuni to digest the announcement before they put Supplementary Questions to the Chancellor.

4. The Chancellor therefore hopes that the Leader of the House will see no difficulty in this proposal.

5. I am copying this letter to Richard Prescott and Martin Vile.

SECRET

EXC/34/047/(4) 168 12 38

For Information:

Financial Secretary
Sir Douglas Wass
Mr Jordan-Moss
Mr Barratt
Mrs Hedley-Miller
Mr Hancock
Mr Middleton
Mr Hodges 13/vii
Mr Michell

Mr Fitchew - UKTSD

PRINCIPAL PRIVATE SECRETARY

CHANCELLOR'S DINNER WITH M. ORTOLI 11 JULY 1979

I attach a record of this dinner. There are two consequential points.

On the formula about the interest rate subsidy we will submit further advice following a meeting tomorrow with Sir Donald Maitland.
On exchange controls, we did not go into detail about the relaxations with M. Ortoli, but I believe arrangements for consultation with the Commission are already in hand.

KEC.

K E COUZENS
12 July 1979

enc

SECRET

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CHANCELLOR'S DINNER WITH M. ORTOLI 11 JULY 1979

The Chancellor dined with M. Ortoli and M. Pierre de Boissieu (Ortoli's Chef du Cabinet) and myself at M. Ortoli's invitation. Mos of the discussion, which lasted more than 4 hours, was of a rather philosophical and historical kind which M. Ortoli obviously enjoys. M. Ortoli regarded this as mainly an occasion to get to know the Chancellor.

2. He did however raise three matters on Community business:

i. the UK position on EMS interest rate subsidies;

ii. exchange control relaxations;

iii. the UK position on the EMS.

3. On interest rate subsidies M. Ortoli sought to persuade us to accept a simple statement that the question whether, and if so how fa the UK would receive interest rate subsidies on joining the EMS would be considered by the Council when we joined. He said that our latest formula which stipulated for the application to us of the criteria in the November EPC report, was unacceptable to France and Holland. He tried to persuade us that the 8 other members would go ahead on their own through an inter-governmental agreement outside Community machine if we did not facilitate general agreement. Of course he preferred t avoid that. As an alternative to his formula about consideration afr in the event of our joining, he suggested the addition to the draft minute of a statement that in the view of the UK Government the EPC report should be a guide for deciding on our entitlement to interest rate subsidies if we joined the EMS.

4. The Chancellor said he could see no reason why it should not be accepted that the same criteria should be applied in deciding our entitlement as had been applied to Italy and Ireland. The UK had mad a determined effort to settle this matter. We were not blocking the relevant regulation, but merely asking for a record in the minutes of

the Finance Council. The Government had made clear its intention, while acting as a committed member of the Community, to fight Britai corner. It would not be consistent with that to give critics the chance to say they had abandoned the British interest on this point. We did not regard it as a major matter, but that argument cut both w

5. M. Ortoli urged that we could always make it a condition of our entry to the EMS that interest rate subsidies should be conceded us and that our 8 partners would look absurd if they refused such a concession at that point. We said it could equally be argued that a UK Government ready to enter the EMS would look ridiculous if it mad its decision critically dependent on this relatively minor matter.

6. It was left that there would be further exploration about the possibility of a suitable formula. Our impression was that there wa a fair chance of getting a formula which referred to parallel treatm with Italy and Ireland, though without a specific reference to the EPC report. I undertook to let the Chancellor have a note about wha would or would not be acceptable.

7. On <u>exchange control</u> M. Ortoli's main point was that if we did decide to undertake further relaxations, we should give the Commissi an opportunity to carry out their formal scrutiny of what we intende so as to avoid any procedural difficulty. The Commission for their part did not wish to press us in any way and M. Ortoli was obviously at pains to wrap up his procedural request as politely as possible. We confirmed that there was the possibility of some further exchange control relaxation, that we were fully conscious of the need to cons the Commission, but that we were sure that on this occasion the cont of the proposals would please our European partners since they were slanted in their direction.

8. On <u>EMS</u> M. Ortoli's main point was that we should keep in clos touch with him about our thinking and should participate fully in the review of the divergence indicator. He was not pressing us for any early decision and understood why an immediate decision would not be

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appropriate. But he was anxious to see the UK in the EMS, both in order to round off the system and in order to give it greater weight in discussions with the United States. He freely admitted that there was a real chance that the EMS would not succeed. 1980 would be a critical year. He could see a possibility that the EMS would be kept alive in name only without real content. For example, that could happen if there were frequent changes of parity.

9. M. Ortoli said that developments so far raised precisely the problems that had been foreseen through the 1978 negotiations - the key role of Germany and the pursuit of domestic policy inconsistent with the smooth maintenance of the exchange rate links. There was a[l] the question of policy in relation to the dollar. The Chancellor confirmed that we would participate fully in the review of the divergence indicator. He also explained some of the special factors in our present situation which made it difficult for us to reach a conclusion on membership of the EMS at the moment. He had introduce[d] a Budget of a structural kind and applied a new firmer monetary framework to the economy. We had yet to see the full working out of this on our exchange rate position. One of the ways in which moneta[ry] discipline worked was through the exchange rate. We were also adjusting our thinking to the fact that we now had a petro-currency. North Sea oil meant that while we suffered the inflationary effects [of] the OPEC oil price increases we did not as an economy lose resources in the same way as some of our partners. One way in which the maintenance of our resource balance operated was through the exchange rate. Finally, we were progressively dismantling exchange controls [of] 40 years standing. All these factors meant that our exchange rate position was unusually uncertain, at least for the present.

10. M. Ortoli did not embark on any discussion of our budgetary position except to say that he thought Mrs Thatcher had scored a majo[r] achievement at Strasbourg. She had presented the UK budgetary positi[on] in a simpler and more direct way by stressing the inequity of the present position which others had been obliged, as a matter of common sense to recognise. There was plenty of room for argument about how much relief we should get and by what method; and for example whether the situation would be changed if there were a further great increase

in oil prices. However, there was acceptance of the need for action and he argued that what had happened at Strasbourg made it less necessary for us to press our point on EMS interest rate subsidies. In accordance with the briefing, we did not attempt to press M. Ortol on the budgetary question.

11. On more general economic matters, M. Ortoli repeatedly referred approvingly to what the Chancellor had done in the Budget and to the structural character of the changes in it. He distinguished this Budget sharply from the ordinary conjunctural type of Budget. He stressed however the importance of the reaction of British entreprene both in fighting their corner on wage claims and in showing greater readiness to accept the risks of investment. He and M. de Boissieu l gloomy things to say about the French economy. There was great uncertainty about where to look for markets and for profits. The implication was that investment and expansion might flag.

H M Treasury
12 July 1979

CONFIDENTIAL

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L B/CSI
B/FST
PS/MST(C)
PS/MST(L)
Sir D Wass
Sir K Couzens
Mr Barratt
Mr Unwin
Mr Hancock
Mr Pagden
Mr Ritz
Mr Ilett
Mr ~~McIntyre~~
Mr Hodges

39

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

Mr ~~Ramsell~~
Mr ~~West~~

12th July 1979

Dear John,

GOVERNMENT POLICY ANNOUNCEMENT : EXCHANGE CONTROL

Following my reply to your letter of 10th July, I can now say that the Chancellor proposes to announce the further exchange control relaxations in the form of a Written Answer to an arranged PQ on Wednesday, 18th July.

Now that the package has been agreed, the Chancellor wishes to announce it as soon as practicable. The Written Answer procedure will enable us to control the timing of the announcement so that it occurs after the Stock Exchange has closed for the day but well before the next morning's papers go to press.

At least one of the Oral PQs likely to be reached on 19th July is relevant and the proposed procedure will give Members the opportunity to digest the announcement before they put Supplementary Questions to the Chancellor.

The Chancellor therefore hopes that the Leader of the House will see no difficulty in this proposal.

I am copying this letter to Richard Prescott and Martin Vile.

Yours ever,

(M.A. HALL)

J. Stevens, Esq.,
Private Secretary to
The Chancellor of the Duchy of Lancaster

CONFIDENTIAL

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Chancellor
American content.
We may want to ... the Americans on a Wednesday morning.

1. MR HANCOCK DH 13/7.

2. CHANCELLOR OF THE EXCHEQUER

cc for:

Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr Barratt
Mr Jordan-Moss
Mr Hedley-Miller
Mr Unwin
Mr McMahon (B/E)
Mr Ryrie (UKTSD)

cc to:

Mr Michell
Mr Ilett
Mr McIntyre
Mr Bayne (FCO/FRD)
Mr Dawkins (B/E)
Mr Fitchew (UKREP)

US REACTIONS TO EXCHANGE CONTROL PACKAGE

LETTER TO MR BLUMENTHAL

The Americans are sensitive about discrimination in exchange controls and they protested about this feature in some of the changes we made in the EEC context at the end of 1977. The US Ambassador raised the point, in anticipation of further changes, when he met the Chancellor on 17 May last and, on 13 June, Mr Blumenthal expressed his satisfac- that the Budget relaxations were non-discriminatory. Since the pack- age to be announced in a Written Answer on 18 July discriminates in favour of securities denominated in EEC currencies, the Chancellor has decided to send an explanatory letter in advance to Mr Blumenthal, which it has been suggested he might hand to Mr Brewster before lunch on 18 July, with a copy being delivered in Washington later that day by Mr Ryrie. A draft is attached.

Paul McIntyre

for C H W HODGES

13 July 1979

Mr McIntyre to see
Mr Ramsell
Thank you
JPM
17/7

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GR 450
CONFIDENTIAL
DESKBY 160630Z
FM FCO 131830Z JULY 79
TO IMMEDIATE UKREPBRUSSELS
TELEGRAM NUMBER 696 OF 13 JULY
EXCHANGE CONTROL RELAXATIONS
FOLLOWING FOR FITCHEW FROM MCINTYRE
BELOW IS TEXT OF LETTER FROM CHANCELLOR TO ORTOLI

BEGINS

1. WE WE DINED TOGETHER ON 11 JULY, WE TOUCHED BRIEFLY ON THE QUESTION OF OUR EXCHANGE CONTROLS. AS YOU KNOW, I AM ANNOUNCING TO PARLIAMENT ON 18 JULY THE NEXT STEPS IN THE PROGRESSIVE DISMANTLING OF THESE CONTROLS. I AM WRITING TO YOU NOW, IN ADVANCE OF THE ANNOUNCEMENT AND IN CONFIDENCE, TO LET YOU KNOW WHAT THESE NEXT STEPS ARE AND WHY THEY ARE BEING TAKEN NOW, SO SOON AFTER THE MEASURES I ANNOUNCED IN MY BUDGET SPEECH.

2. AT THE TIME OF THE BUDGET, I DID NOT EXPECT TO MAKE FURTHER RELAXATIONS OF THE CONTROLS UNTIL PARLIAMENT RETURNED IN THE AUTUMN HOWEVER, THE CONTINUING STRENGTH OF STERLING SINCE THE BUDGET HAS ENABLED ME TO BRING FORWARD THE NEXT STAGE IN THE RELAXATIONS. I SHOULD EXPLAIN THAT I DO NOT REGARD RELAXING THE CONTROLS AS A MEAN OF GETTING DOWN THE EXCHANGE RATE. I BELIEVE THAT THE ARGUMENTS FOR RELAXING THE CONTROLS STAND ON THEIR OWN MERITS. BUT STERLING'S STRENGTH HAS GIVEN ME AN OPPORTUNITY TO PRESS AHEAD.

3. THE MEASURES, EACH TAKING EFFECT ON 19 JULY, ARE AS FOLOWS:-

(I) OFFICIAL EXCHANGE WILL BE AVAILABLE WITHOUT LIMIT FOR OUTWARD DIRECT INVESTMENT. FOREIGN CURRENCY BORROWING TAKEN AT ANY TIME TO FINANCE SUCH INVESTMENT WILL BE ELIGIBLE FOR REPAYMENT WITH OFFICIAL EXCHANGE.

(II) FOR OUTWARD PORTFOLIO INVESTMENT, OFFICIAL EXCHANGE WILL BE AVAILABLE FOR INVESTMENT IN SECURITIES DENOMINATED AND PAYABLE SOLELY IN THE CURRENCIES OF OTHER EEC COUNTRIES AND IN THE BONDS OF INTERNATIONAL ORGANISATIONS OF WHICH THE UNITED KINGDOM IS A MEMBER INCLUDING THOSE ISSUED BY THE COMMUNITY INSTITUTIONS. IN ADDITION FOREIGN CURRENCY BORROWIN TAKEN TO FINANCE OUTWARD PORTFOLIO INVESTMENT UP TO ONE YEAR AGO WILLBE REPAYABLE WITH OFFICIAL EXCHANGE.

/MY

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MY OFFICIALS WILL SEND THE COMMISSION A COPY OF THE PRESS NOTICE TO BE ISSUED BY THE TREASURY ON 18 JULY, WHICH WILL CONTAIN A SOMEWHAT FULLER STATEMENT OF THE CHANGES.

4. I THINK YOU WILL AGREE THAT TAKEN TOGETHER, THESE MEASURES REPRESENT A SIGNIFICANT SECOND STEP IN THE RELAXATION OF OUR CONTROLS AND TOWARDS MEETING IN FULL OUR OBLIGATIONS UNDER THE CAPITAL MOVEMENTS DIRECTIVES. THE LIBERALISATION OF OUTWARD DIRECT INVESTMENT DOES OF COURSE ENCOMPASS FREEDOM OF CAPITAL MOVEMENTS FOR THIS PURPOSE WITHIN THE COMMUNITY, WHICH I KNOW YOU WERE ANXIOUS TO SEE US ACHIEVE. YOU WILL ALSO SEE THAT THE FIRST MAJOR STEPS ON THE PORTFOLIO SIDE ARE VERY MUCH ORIENTED TOWARDS OUR TRANSACTIONS WITH OTHER MEMBER STATES.

5. YOU WILL APPRECIATE THAT I AM NOT ABLE TO SAY WHEN THE NEXT STAGE OF OUR PROGRAMME OF RELAXATIONS WILL BE, BUT I CAN ASSURE YOU THAT I REMAIN DETERMINED TO MEET OUR TREATY OBLIGATION IN FULL AS SOON AS POSSIBLE.

6. AT THIS STAGE, TO MAKE FURTHER IMMEDIATE RELAXATIONS BEYOND THOSE I AM ANNOUNCING WOULD IN MY JUDGMENT INVOLVE A SERIOUS THREAT OF DIFFICULTIES AS REGARDS THE UNITED KINGDOM'S BALANCE OF PAYMENTS THE GOVERNMENT OF THE UNITED KINGDOM CONSIDER THAT THE PROTECTIVE MEASURES WHICH WILL REMAIN AFTER THE RELAXATIONS TO BE ANNOUNCED ON W18TH JULY ARE JUSTIFIED FOR THE TIME BEING BY THE TERMS OF ARTICLE 108 OF THE TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY AND BY THE BALANCE OF PAYMENTS CHAPTER OF THAT TREATY AS A WHOLE, AND THEREFORE TRUST THAT THE COMMISSION WILL CONTINUE THE AUTHORISATION OF THOSE MEASURES UNDER THE TERMS OF ARTICLE 108(3).

7. THE ANNOUNCEMENT ON 18 JULY WILL BE IN THE FORM OF A WRITTEN ANSWER TO A PARLIAMENTARY QUESTION, GIVEN AT 1715 HRS BRUSSELS TIME PERHAPS I MAY ADD THAT, WHILE CONFIDENT OF AND GRATEFUL FOR THE COMMISSION'S DISCRETION IN THESE SENSITIVE MATTERS, ANY ADVANCE LEAKS COULD BE UNSETTLING FOR THE MARKETS.

ENDS
CARRINGTON

FILES
EID (I)
MR FRETWELL
MR BUTLER

COPIES TO
MR RAMMELL H M TREASURY
MR HODGES H M TREASURY

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

177 42

E1

Seen 3/7

From the Secretary of State

CONFIDENTIAL

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London, SW1

Mr Hodges
CST
FST
MST(C)
MST(L)
Sir D Wass
Sir K Couzens
Sir L Airey
Sir A Rawlinson
Sir F Atkinson
Mr Littler

13 July 1979

Mr Jordan-Moss
Mr Dixon
Mrs Hedley-Miller
Mr Hancock
Mr Ridley

Dear Geoffrey.

I am very glad to see that the Prime Minister has endorsed the proposal set out in your minute of 9 July for an early next stage in the relaxat of exchange controls. I was particularly pleased to see the use of official exchange is now to be unlimited for both outward direct investment and for the purchase of all securities denominated in EEC countries.

I would myself have liked to have seen included in the package a complet relaxation of control over the use of sterling for the finance of third country trade. I realise this raises rather fundamental questions about the role of sterling as an international currency, but these questions will have to be tackled sooner or later if, controls are eventually to be abolished completely, as I believe and urge they should.

As you know, I fully support our present economic strategy which will generate very considerable pressures on employers, not least to settle pay at reasonable levels. A high exchange rate is an essential part of our present policy and in this sense the strength of sterling is of direct benefit in what we are trying to do. And yet industry is extremely worried by the levels to which sterling has been increasing, especially in the past few weeks. An increasing number of representatio are making it clear the large amount of trade which we stand to lose,

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From the Secretary of State

well before the various gains through lower prices and costs work through. Hence my preference for what would be an even stronger package.

I am seized to write in particular having heard what members of my British Overseas Trade Advisory Council had to say on Thursday last. Of course I know how sentiment can swing and gloom reinforce itself at such a meeting, but the account of difficulties traders are now faced with was real enough and was supported by what struck me as a most sober assessment from the representative of the European Trade Committee of the British Overseas Trade Board, which deals with around half our manufactured export and import trade, and with our invisible trade as well. They took a clear view on the abolition of all restrictions on the use of sterling in third country trade.

In view of the fact that the discussion and preparation of a stronger package could well preclude an announcement next week, if not by the recess, I am perfectly content not to press for its extension now. However, I do urge that contingency work should be put in hand at the earliest opportunity for further possible relaxation in the autumn, assuming of course that sterling remains strong. I should like to press most strongly for this work to include whatever discussion is necessary of the various difficulties that stand in the way of a complete relaxation of the use of sterling in third country trade.

I am copying this to the Prime Minister, the Foreign Secretary, the Secretary of State for Industry, the Governer of the Bank of England and Sir John Hunt.

Yours ever
John

JOHN NOTT

EXC/84/100 (H)

CONFIDENTIAL

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cc PS/Chief Secretary
PS/Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr. Barratt
Mr. Hancock
Mr. Ilett
Mr. McIntyre
Mr. Dyer
Mr. Dawkins

Chancellor

I suggest an addition at the end; and a possible alternative sentence at the beginning if you prefer to avoid mention of the strength of the £.

13/7

PRINCIPAL PRIVATE SECRETARY

EXCHANGE CONTROL : PQ AND WRITTEN ANSWER FOR 18TH JULY

I attach a draft Question and a Written Answer which has been agreed with the Bank of England.

If the terms of the Question are approved, the Parliamentary Clerk would be glad to know before he meets a Member* at 11.30 a.m. on Monday 16th July.

p.p. (C.H.W. HODGES)
15th July, 1979

EXC/54/04 (H) 180

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EXCHANGE CONTROL RELAXATIONS

DRAFT PQ AND WRITTEN ANSWER FOR WEDNESDAY 18TH JULY 1979

(Answer to be handed in at the House of Commons at " 15 p.m. on 18

Q. To ask the Chancellof the Exchequer, whether he has any plans for the further relaxation of exchange controls.

A. Yes. Sterling has continued strong since the initial relaxation announced in my Budget Statement on 12th June. This enables me to make further progress now in dismantling exchange control. I have decided to allow complete freedom of choice in the financing of outward direct investment, and to take three significant steps towards liberalising outward portfolio investment.

With effect from tomorrow, 19th July, official exchange will be available without limit for all outward direct investments: and foreign currency borrowing taken at any time to finance such investments will be eligible for repayment with official exchange. As regards portfolio investment, also with effect from tomorrow, official exchange will be available for investment by UK residents in most securities denominated and payable solely in the currencies of other EEC countries and in foreign currency securities issued by international organisations of which the United Kingdom is a member, including those issued by European Community institutions and the World Bank. One of the consequence will be that the sale proceeds of existing and new holding of such securities, however acquired, will no longer be eligible for sale in the investment currency market. Thirdly, foreign currency borrowing taken by UK residents to finance outward portfolio investment and which has been outstanding at least one year as of tomorrow will be repayable with official exchange. As in the case of last month's measures, I have discussed these changes with the Commission of the European Communities. ~~Full details are in notices being issued by the Bank of England,~~

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EXC/34/04 (H)

cc PS/Chief Secretary
PS/Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr. Barratt
Mr. Hancock
Mr. Ilett
Mr. McIntyre
Mr. Dyer
Mr. Dawkins

PRINCIPAL PRIVATE SECRETARY 16.7.79.

EXCHANGE CONTROL : PQ AND WRITTEN ANSWER FOR 18TH JULY

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If the terms of the Question are approved, the Parliamentary Clerk would be glad to know before he meets a Member*
at 11.30 a.m. on Monday 16th July.

pp (H.W. HODGES)
15th July, 1979

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EXC/84/04 (H)

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EXCHANGE CONTROL RELAXATIONS

DRAFT PQ AND WRITTEN ANSWER FOR WEDNESDAY 18TH JULY 1979

(Answer to be handed in at the House of Commons at 4.15 p.m. on 18

Q. To ask the Chancellof the Exchequer, whether he has any plans for the further relaxation of exchange controls.

A. Yes. ~~Sterling has continued strong since the initial relaxation announced~~ In my Budget Statement ~~on 12th June~~ ~~This enables me to make further progress now in~~ dismantling ~~of~~ exchange control. I have decided to allow complete freedom of choice in the financing of outward direct investment, and to take three significant steps towards liberalising outward portfolio investment.

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Chancellor, KC thinks this minute goes a bit too far. In the light of X, and not a telephone call to No 10 from me suffice? MAW 16/7

P/

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State - Commons
Minister of State - Lords
Sir Douglas Wass
Sir Kenneth Couzens
Mr Barratt
Mr Unwin
Mr P G Davies
Mr Gill
Mr Hodges
Mrs Lomax
Mr Ilett
Mr McIntyre

Mr Ridley
Mr Dawkins - B of E
Mr Sangster - B of E

Phone cm BVR

TRADE FIGURES AND THE EXCHANGE CONTROL PACKAGE

I understand that the Prime Minister has asked whether it would be wise to go ahead with the announcement of the next package of exchange control relaxations on Wednesday given the disappointing trade figures announced this afternoon.

X 2. In fact sterling has strengthened since the announcement and not weakened. The effective rate at the close was 71.3 compared with 71.07 at the opening this morning. Just before the announcement the dollar rate was $2.23¾. It rose to a peak of $2.2440 and then fell back slightly to $2.2415 at the close. Since the close the rate has moved up a bit again.

3. I attach a draft minute for you to send to the Prime Minister which is intended to underline the point that our approach has all along been based on an appreciation that the outlook for sterling was very uncertain and that, even if the exchange rate had fallen somewhat following the announcement of the trade figures, this would not have been a very strong argument for postponing the exchange control package.

D.H.

D J S HANCOCK
16 July 1979

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DRAFT MINUTE FOR THE CHANCELLOR TO SEND TO THE PRIME MINISTER

COPIES TO
Secretary of State for Foreign and Commonwealth Affairs
Secretary of State for Industry
Secretary of State for Trade
Governor of theBank of England
Sir John Hunt

EXCHANGE CONTROL PACKAGE AND THE TRADE FIGURES

I refer to my minute of 9 July proposing a new package of exchange control relaxations and to your Private Secretary's reply dated 10 July.

2. I have been considering whether we should postpone the announcement in view of the disappointing trade figures put out this afternoon. Present plans are that the exchange control package will be announced by an arranged Written Answer at about 4.15 p.m. on Wednesday 18 July.

3. In fact sterling has strengthened since the announcement of the trade figures. The effective rate at the close in London tonight is 71.3 compared with 71.07 at the opening. Just before the announcemen the dollar rate was $2.23\frac{3}{4}$. It rose to a peak of 2.2440 and then settled back slightly to 2.2415 at the close. After the close, the rate tended upwards again.

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4. Sterling was in any case very strong before the announcement. Its recent strength has, in fact, exceeded all expectations, not only in Government departments but more widely in the City. Although I recognise the advantages of a strong rate for the pound, I do not think that some easing back would be a bad thing. It would bring relief to those sectors of industry which have been especially hard hit by the recent surge in our exchange rate.

5. My recommendation to bring forward stage 2 of our planned relaxation programme from October to July was influenced by the way in which the foreign exchange markets had shrugged off the announcement of the trade figures for January to May which was made on 19 June. The new information in the latest announcement makes the position look distinctly worse but it appears that once again the market has not reacted badly. Nonetheless we must recognise that the outlook for sterling is uncertain, not only because of the current account position but also because of the recent trend of bank lending. These uncertainties underline the wisdom of our gradual approach to exchange control relaxation.

6. However, it is difficult to see what advantage would be gained by postponing the announcement of the package that has now been agreed. The expectation has been aroused that the Government intends to press on with its programme of dismantling exchange controls as fast as circumstances permit; and we have been under pressure to add quickly to the Budget package. Wednesday's announcement will be a substantial additional step. But it has also been designed to provide a viable interim system of control that could be allowed to endure for an appreciable time just in case things went wrong between now and the autumn and we decided that it would be prudent to postpone the third step in the process of relaxation until 19

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7. I will review the matter again tomorrow when the market has had time to make a more considered assessment of the implications of the trade figures. But, unless there were to be a sudden and dramatic change for the worse, then I think it would be right to go ahead as planned.

8. I am sending copies of this minute to the Secretaries of State for Foreign and Commonwealth Affairs, Industry and Trade, to the Governor of the Bank of England and to Sir John Hunt.

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Chancellor, we maybe want to consider putting a comment in after all, depending on tomorrow [illegible] [illegible] [illegible] to [illegible] [illegible] to [illegible].

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CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir K Couzens
Mr Barratt
Mr Unwin
Mr P G Davies
Mr Gill
Mr Hodges
Mrs Lomax
Mr Ilett
Mr McIntyre
Mr Ridley
Mr Cardona
Mr Dawkins B/E
Mr Sangster B/E

TRADE FIGURES AND THE EXCHANGE CONTROL PACKAGE

I strongly agree with Mr Hancock's note of earlier today. We should go ahead as planned. I should be happy to discuss if you wish.

NL

NIGEL LAWSON
16 July 1979

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CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
PS/Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr Barratt
Mr Hancock
Mr Ilett
Mr McIntyre
Mr Towers
Mr Ridley
Mr G K Willetts (B/E)

EXCHANGE CONTROL: SUPPLEMENTARY PQs ON 19 JULY

In replying yesterday afternoon to a Supplementary Question from the Rt. Hon. Terence Higgins MP (O.R.col.1973), you said you would have to look at the detailed points raised by him but it would be your intention to proceed towards the removal of unnecessary administrative obstacles as quickly as possible.

2. Mr Higgins asked:

(a) whether it would still be necessary for travel agents and others issuing foreign currency to individuals to mark their passports;

(b) whether it was still proposed that those buying shares in Europe would have to leave them with a recognised depository (sic).

3. On (a), no change has been made in the present requirement for passport marking by authorised bodies issuing foreign currency facilities to residents of the Scheduled Territories for travel abroad. This is because we still have limits, increased last month, on the amounts issuable per journey without special Bank of England permission, and we need to be able to monitor them through spot checks. These are carried out by Customs Officers who find passport marking an important aid to doing the job without causing too much delay at points of departure. Marking the passport also shows that the issuing agent has provided a copy of our Notice to Travellers, which contains a formal notification under Section 1(2) of the Exchange Control Act 1947 of the conditions on which foreign currency for travel is permitted.

4. We cannot prudently dispense with limits on travel allowances and some arrangements for policing them so long as we have significant restrictions on outward portfolio investment since otherwise it would be too easy to evade the latter by

/exporting...

exporting foreign currency. We reviewed the marking of passports at one of my regular meetings with Customs and the Bank last week; and it was concluded that it could not yet be discontinued, for the reasons given above.

5. On Mr Higgins' second question (b), the new rules do provide for what we are calling the "liberalised securities" to be in the custody of an Authorised Depositary, who accepts responsibility for the observance of the terms of exchange control permissions and requirements. This is a well-tried mechanism for ensuring that purchases and sales are made in accordance with our current rules: in particula so long as some foreign currency securities are not liberalised, we need to ensure against leakage by their being procured outside the rules with the sale proceeds of liberalised securities.

6. If you accept these recommendations, a letter to Mr Higgins will be drafted accordingly.

C H W HODGES

20 July 1979

Mr - Hodges

See >

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available? Will my right hon. Friend confirm that the taxation of short-term unemployment benefits would provide a considerable incentive to take up jobs where they were available?

Mr. Biffen: Yes.

Mr. Dubs: How many extra civil servants will be needed to bring that about?

Mr. Biffen: Extra staff costs in relation to taxing short-term benefits for the unemployed would be relatively modest, but it is true that the wider scale scheme would involve quite substantial increases in staff. That is precisely why an examination is now being undertaken, so that a proper and up-to-date evaluation can be made.

Mr. Cockeram: Does my right hon. Friend accept that when social security and unemployment benefits are raised in line with inflation that produces distortions with those whose wages are not rising in line with inflation, and that when those distortions are magnified by the failure to tax the former but to tax the latter that produces the encouragement to stay out of work?

Mr. Biffen: I very much accept that point, and it underlines the necessity for the review.

Money Supply

7. **Mr. Richard Wainwright** asked the Chancellor of the Exchequer what is his estimate of the current rate of growth of the M3 money supply.

Sir Geoffrey Howe: In the eight months to mid-June, sterling M3 grew at an annual rate of 13·3 per cent.

Mr. Wainwright: In view of the disappointingly slow progress towards the target of money supply that he announced in the Budget, will the Chancellor explain whether he is now abandoning a policy that could not reach accomplishment without killing off large sections of British industry?

Sir G. Howe: The hon. Gentleman totally misunderstands the position. In respect of money supply growth, the Government inherited a situation that was badly off course, and getting more so. When we came into office the money supply growth rate was well above the top limit of the 8 to 12 per cent. range set by the previous Government, and the action taken in the Budget, including the increase in minimum lending rate, cannot be expected to have had an effect on that yet.

Mr. Denzil Davies: Does the Chancellor agree with the statement last night by one of the senior managing directors of the Union Discount Company, that to bring the money supply back within the targets interest rates will have to go higher before the end of the year?

Sir G. Howe: I should not like to accept that proposition. What I have no doubt about is that to overcome the explosive rate of growth of the money supply that we inherited it has been necessary for the Government to introduce firm monetary policies, including an increase in minimum lending rate, and it remains necessary for us to adhere to that. I hope that it will not be necessary to go beyond that. I cannot emphasise too strongly that these measures are an inevitable response to that part of the inheritance that we received.

Exchange control

8. **Mr. David Price** asked the Chancellor of the Exchequer in view of the strength of the £ sterling, what further steps he intends to take to reduce exchange controls.

Sir Geoffrey Howe: I refer my hon. Friend to the answer I gave to my hon. Friend the Member for Ruislip-Northwood (Mr. Wilkinson) on 18 July.

Mr. Price: Following my right hon. and learned Friend's written answer yesterday, what is the extent of the remaining exchange control restrictions, and what economic or, indeed, national purpose do they serve?

Sir G. Howe: As my hon. Friend appreciates, we have made two substantial reductions in the scope of exchange control. The substantial part that remains concerns arrangements for the control of portfolio investment outside investments denominated in EEC currencies. The apparatus of which they represent a part has been with us for about 40 years, and we are proceeding to its progressive dismantlement at which I judge to be the right pace in the circumstances.

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Mr. Healey: Will the right hon. and learned Gentleman comment on a point in the original question, namely, the implication that the relaxation of exchange control that he has just announced will reduce the strength of the pound sterling? How does he reconcile such a view, if he holds it, with what his right hon. Friend the Financial Secretary said a moment ago, that there was nothing that the Government could do that would influence the sterling exchange rate?

Sir G. Howe: As the right hon. Gentleman appreciates, the sterling exchange rate is substantially set by market judgments. The case for reduction in exchange control stands in its own right and is justified for that purpose. The fact that sterling now stands high provides circumstances in which it becomes possible to make those changes.

Mr. Higgins: If the Chancellor is anxious to reduce unnecessary bureaucracy and waste of resources, will he say whether it will still be necessary for travel agents and others issuing foreign currency to individuals to mark their passports? Secondly, is it still proposed that those buying shares in Europe will have to leave them with a recognised depository?

Sir G. Howe: At present, the basic arrangements for applications under the existing exchange control regime remain in force. I shall have to look at the detailed points raised by my right hon. Friend, but it would be our intention to proceed towards the removal of unnecessary administrative obstacles as quickly as possible.

Mr. Robert Sheldon: Why is the Chancellor so pleased with the high level of sterling, bearing in mind the statements by prominent industrialists about the harm that it is doing to manufacturing industry? In view of the right hon. and learned Gentleman's addiction to market economics, does he agree that the higher the cost of our exports the fewer we sell, and that the cheaper the cost of our imports the more we buy, to the detriment of our manufacturing industry? Why does he not instruct the Bank of England to intervene sensibly in the market?

Sir G. Howe: The movement of the exchange value of the pound sterling has effects on both factors to which the right hon. Gentleman referred, but experience under successive Governments has shown that attempts to predetermine or determine the proper exchange value for the pound sterling are difficult to achieve, even if it is right to try to do so.

Value Added Tax

9. **Mr. Cryer** asked the Chancellor of the Exchequer what representations have been made against the increase in value added tax.

Mr. Peter Rees: Over 400 representations, covering a wide range of subjects, have been received since the Budget.

Mr. Cryer: When the Minister receives representations from his Cabinet and Ministerial colleagues and other hard-hearted and prosperous-looking Tories about taxing the unemployed and those on social security benefits, will he remember that VAT hits those on lower incomes much harder than it does the rich people who put the Tory Party into office? Will he accept that the swingeing increases in VAT help to underline the OECD report, published today, which suggests that this country is heading quickly towards recession and increasing inflation? Surely the VAT increases will accelerate that trend?

Mr. Rees: On the hon. Gentleman's first point, I remind him of what his right hon. Friend the Member for Heywood and Royton (Mr. Barnett) said at an earlier stage, namely, that VAT is nothing like as regressive as was at first thought.

Mr. Cryer: I do not agree with that.

Mr. Adley: Is my hon. and learned Friend aware that when the previous Conservative Government left office the flat rate of VAT was 10 per cent. and it is now 15 per cent., so the intervening five years of Socialist Government correspond with the 5 per cent. increase? We are having to pay 1 per cent. VAT per annum for Socialism. Is he further aware that most people are confident that five years from now the Government will have added a reduction in VAT to the reductions already made in direct taxation?

Mr. Rees: I note my hon. Friend's optimistic prognostications.

Mr. Heffer: Has the hon. and learned Gentleman had his attention drawn to the speech by Sir Maurice Laing and

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FINANCIAL SECRETARY TO THE TREASURY

MR HANCOCK

24/07

Chancellor
Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir K Couzens
Mr Barratt
Mr Bridgeman
Mr Dixon
Mr Middleton
Mr Unwin
Mr P G Davies
Mr Gill
Mr Hodges
Mrs Lomax
~~Mr~~ Ilett
Mr McIntyre
Mr Ridley
Mr Cropper
Mr Cardona
Mr Dawkins) B/E
Mr Sangster)

EXCHANGE CONTROL

The Financial Secretary would be grateful for a factual note summaris in tabular form, the existing exchange control regimes in other EEC countries and in Japan and the USA. I suggest that you aim to have this ready for his return from leave on 13 August.

PCD

P C DIGGLE
23 July 1979

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cc Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr. Barratt
Mr. Hancock

MR. HODGES

EXCHANGE CONTROL: SUPPLEMENTARY PQs ON 19 JULY

The Chancellor has seen your submission of 20 July. He has commented that he is profoundly sceptical about the whole of the argumentation in reply to (a). His view is that the marking of passports is extremely spasmodic, and there is no possible means of enforcing surrender of foreign currency not used for legitimate purposes on travel abroad; furthermore, credit cards make an obvious breach in the limits allowed without special Bank of England permission.

2. He goes on to ask how many of Bank of England staff have so far been shed from the Foreign Exchange Department, and whether such staff have been redeployed or simply left the Bank's complement and not been replaced?

3. The Chancellor has also asked for some factual information about arrangements for promulgating the most recent package of exchange control relaxations. He has asked how many copies of exchange control notices were issues, to whom, and at what cost? He has also asked what the notices add to information contained in his reply to the Arranged PQ and attendant Press Notices?

4. The Chancellor is content with your suggested response to Mr. Higgins' (b).

MAH

M. A. HALL
24 July 1979

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JUL 1979

CHANCELLOR OF THE EXCHEQUER

cc: Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr. Barratt
Mr. Jordan-Moss
Mr. Littler
Mr. Dixon
Mrs. Hedley Miller
Mr. Gill
Mr. Hodges
Mr. Ilett
~~Mr. McIntyre~~ Mr Cassell
Mr. Ridley
Mr. Hanc

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

24 July, 1979

Dear John

Thank you for your letter of 13th July about the relaxation of exchange controls.

As you recognise, the business involved in putting together a larger package would have delayed implementation of measures announced on 18th July. I have already set work in hand on preparing a third step in the dismantling of the controls which, if sterling remains strong, I would hope to take in the autumn; and this work will include studying further the question of extending sterling facilities for third-country trade to the banks, on which I have noted the views recently expressed to you by your British Overseas Trade Advisory Council.

As you say, this proposal raises rather fundamental questions about the role of sterling as an international currency. This is one of the points that my officials are now examining. I have asked them to keep the FCO and the Departments of Trade and Industry in touch with their work.

I am sending copies of this letter to the Prime Minister, the Foreign and Commonwealth Secretary, the Secretary of State for Industry, the Governor of the Bank of England and Sir John Hunt.

Geoffrey

(GEOFFREY HOWE)

The Rt. Hon. John Nott, M.P.

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