Part A

# TREASURY

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FILE TITLE

PO - CH/GH/0189 Part_A

Visit Kuwaiti

Presentation of Economic Policy

FOR REGISTRATION USE ONLY

1981

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T.R.1.

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NOTE OF THE CONVERSATION BETWEEN THE CHANCELLOR OF THE EXCHEQUER AND THE KUWAITI FINANCE MINISTER AT NO.11 DOWNING STREET FROM 12 NOON TO 12.45 P.M. ON TUESDAY, 30 JUNE 1981

The Minister of Finance, Mr Abdul Latif Al Hamad, was accompanied by the Kuwaiti Ambassador to London, the Head of the Kuwaiti Investment Office and his Private Secretary. Mr Slater supported the Chancellor.

IMF Issues

2. After thanking the Chancellor for receiving him, Mr Hamad said, in reply to a question, that, while Kuwait would of course like to see the issue of the PLO's status resolved, they were more unhappy at the way in which the IMF's "rules had been twisted" in the handling of the issue. He did not think the present position unwelcome to the PLO, since it probably brought them more publicity than they would attract if their request was acceded to. The Chancellor said that the UK hoped that some compromise solution could be negotiated between the parties most immediately involved, the United States and the Arabs. Mr Hamad said Kuwait had hoped that other members would have played a more active and mediating role.

Energy Affiliate

3. Mr Hamad said Kuwait certainly supported the idea of an Energy Affiliate (EA). He believed, and had said, that it should be a new institution for the 1980's and 90's, not an extension to the institutions of the 1940's. If the intention was simply to raise more money for the IBRD, this could be achieved by changing the bank's gearing. He envisaged the EA as a new institution which would adopt an approach more aggresive than and different to that of the IBRD, under whose criteria, including that of absorbative capacity, meritorious projects, in for example Africa, were being declined support. As well as assisting countries with macro-energy problems, he envisaged an EA as providing support for projects meeting both energy and food needs,

/for example linked hydrofor example linked hydro-electric and irrigation projects. The Chancellor said that he thought an EA would be useful if it enabled more resources to be mobilised to tackle energy problems. He questioned, however, the need for or appropriateness of a new institution: hence his support for an affiliate. Mr Hamad said he shared the Chancellor's opposition to bureaucratic tendencies: he thought that by separating out the energy function, the IBRD's ability to undertake its other functions would be improved. He hoped that if an EA of the sort he favoured came to be established, it would be possible for it, as a new body, to cater more adequately for the interests of non-OECD lenders and borrowers in general. He thought that insufficient significance was attached to the fact that the credit worthiness of international financial institutions reflected the position of the borrower, as well as the lender. At the same time, he did not think that IFI's had taken sufficient account of the change which had taken place over recent years in the credit worthiness of certain countries, for example India, which now had a surplus on current account. He favoured giving 40 per cent of the votes of a new EA to the North, 40 per cent to the South and the balance of 20 per cent to the floating shares which would be given to the marginal lender of funds. He said he had seen Mr Clausen and made some of these points to him.

Investment Policy

4. In reply to a question from the Chancellor, Mr Hamad said that the character and behaviour of the institution and the need to promote growth in the third world were factors as important, if not more important, than prospective return in determining Kuwaiti investment decisions.

Prospects for the Oil Market

5. Mr Hamad thought that the present weakness in the market showed that it was market forces, not OPEC, that determined price. If the present glut continued it would affect the conduct of the next OPEC price-fixing meeting. He was concerned that the adverse effect which

/financing oil stocks

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financing oil stocks at the present high levels of interest rates would have on the balance sheets of multi-national companies, would cause managements to adopt more defensive views, causing the structure of the market to be weakened, as multi-nationals became more dependent on the spot market. He thought there would be little change in the market between now and the beginning of the next winter, after which it was, as always, difficult to say what would happen.

US Interest Rates

6. Mr Hamad said that the West Germans seemed to be upset by the high level of US interest rates. What was the UK's view? In reply, the Chancellor said that the UK shared the US Government's view about the need to sustain the fight against inflation. US inflation had been one of the most destabilising factors in the post-war world economy. Monetary policy, and within that interest rates, had a clear role to play. At the same time, however, the right balance between fiscal and monetary policy had to be struck. Against this background, the UK had expressed in a good neighbourly fashion its concern to the US Government about American interest rates. His 1981 Budget had enabled the UK Government to achieve a better balance between fiscal and monetary policy. It was his impression that domestic pressures, including from the powerful construction industry, would be as, if not more, effective than international pressure in encouraging the US administration to reduce interest rates. He hoped that interest rates would come down by achieving a better balance between fiscal and monetary policy, rather than relaxing the fight against inflation. Mr. Hamad said that while Kuwait as a surplus country with substantial dollar investments benefited from high dollar interest rates, wider considerations caused his government to share the concern felt by others at high US interest rates. While it was important to maintain the fight against inflation, it was also important to sustain demand in the world economy and middle income third world countries, which tended to have the greatest capacity for growth, were adversely affected by high interest rates.

International meetings

7. The Chancellor and Mr. Hamad agreed that the meeting of the

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Interim Committee at Libreville had been excessively costly and pretty ineffective. Mr. Hamad thought the interests of economy and efficiency would best be served by holding all such meetings in Washington. They agreed that more progress could be made at smaller and informal meetings than at the sort of meetings which presently characterised the IMF and IBRD. The present meeting was a splendid example!

R.I.T.

R.I. TOLKIEN
1 July 1981

Distribution

Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Sir Douglas Wass
Sir Kenneth Couzens
Mr. Hancock
Mrs. Hedley-Miller
Mr. Monck
Mr. Slater
Mr. McIntyre
Mr Lavelle
Mr Ridley

CHANCELLOR

cc Mr Slater

VISIT OF KUWAITI FINANCE MINISTER

You asked for additional material on oil producers' prices and output. You may find the table below helpful.

| | Price ($ per barrel) | | Current Output (million barrels per day) | Maximum Sustainable Output (for several months) |
|---|---|---|---|---|
| Saudi Arabia* | 32 | | 10.3 | 10.3 |
| Kuwait* | 35.50 | 70 bn | 1.5 | 2.75 |
| Iran | 37 | | 1.5 | 5.5 |
| Iraq | 36 | | 1.0 | 3.5 |
| Venezuela | 33 | | 2.0 | 2.4 |
| Nigeria | 40 | | 0.9 | 2.2 |
| Libya | 41 | | 1.0 | 2.1 |
| Algeria | 40 | | 0.6 | 1.1 |
| UK | 35(Forties) | 160-320 bn | 1.8 | 1.8 |
| Norway+ | 35.75(Ekofisk blend) | | 0.6 | ? |

*production includes share of Neutral zone

+price reduced by $4.25 this week

Proven reserves
Yrs of self-sufficiency
Tonnes p.a.

USA
USSR
OPEC total

Paul McIntyre

J P McINTYRE
30 June 1981

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CHANCELLOR

KUWAITI FINANCE MINISTER (MR. HAMAD)

.... A separate note is attached on oil reserves and production.

Points to make/likely to be made

(i) Oil market prospects - Kuwait a member of OPEC's Strategy Committee, which is examining oil pricing policy. Proposal is to link price to growth in west. Views?

North Sea oil: BNOC offer to cut prices by $4.25 a barrel still under negotiation; HMG does not fix prices; BNOC could not survive by cutting volumes; would have to cut prices to clear stocks; no deal with Saudis.

P.M. to Kuwait

- Views on OPEC surplus? In 1982? $100 B - '80

- Kuwaiti investment policy? $60 Bn £1 Bn in London

(ii) PLO - hope serious US/Arab negotiations will start soon;

(iii) Kuwaiti lending to IMF - encourage Kuwaiti lending; PLO status a problem? agree private capital flows also important

(iv) IBRD energy affiliate - Views? (Predecessor advised against affiliate).

My Oil Min

R.I.T.

R.I. TOLKIEN
30 June 1981

UK exports '80 - £600m (+ 11%)

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1. MR SLATER JF Slater 29/6
2. CHANCELLOR

Copies attached for:
Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Sir Kenneth Couzens
Mr Hancock
Mr Lavelle
Mr Mountfield
Mrs Hedley-Miller

Mr Ridley
Mr Cardona

cc Mr Atkinson
Mr Bonney
Mr Milligan

VISIT OF KUWAITI FINANCE MINISTER

You will be seeing the Kuwaiti Finance Minister, Mr Abdul Latif al Hamad, at 11 Downing Street tomorrow at 12 noon. Mr Slater will accompany you.

2. Mr Hamad became Finance Minister in March this year, replacing Abdul Rahman Al Atiqi. A short personality note is at Annex A.

3. You may like to make use of the following talking points:

(i) Oil Market Prospects

4. Kuwait is represented on OPEC's Long Term Strategy Committee, which was asked by the last OPEC conference in May to review its proposals for oil pricing policy. The original proposals, not published but widely reported in the press, would provide for steady increases in the price of oil, in line with real economic growth in the industrialised countries. You might ask what the Kuwaitis expect or wish to come out of the review and also how long they see the current weakness in the oil market persisting. A note on the oil market and Kuwait's oil policy is at Annex B.

5. Defensive: The Kuwaitis may be annoyed by cuts in North Sea prices. If this subject is raised, you can say that the BNOC offer to cut prices by $4.25 a barrel remains the subject of

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negotiations which may take some time to complete. These are commercial negotiations: HMG does not fix North Sea prices. The BNOC objective is to secure the full market price, no more and no less. BNOC, unlike other producers (eg Nigeria) has not been able to respond to current market pressures by reducing volume. As a trader buying oil for resale, the Corporation, faced by customers' refusal to buy and having no surplus storage capacity, would have to sell the oil on the spot market for low prices. [If necessary. It is true that the new offer price is roughly equivalent to a quality-adjusted Saudi price. But contrary to some press reports (eg Economist), there has, of course, been no deal with the Saudis to try to force other producers to cut their prices].

(ii) OPEC Surplus

6. The OPEC surplus was just over $100 billion last year. Some observers (eg Dr Zijlstra of the Dutch Central Bank) have been predicting the surplus will be eroded as quickly as after the first oil price shock. But our own estimates suggest it may persist at a fairly high level despite the weak oil market, only falling to perhaps $80-90 billion in 1982. Mr Hamad may have views.

(iii) Kuwait's Overseas Investments

7. Kuwait's net foreign assets at the end of last year are thought to have totalled over $60bn. A feature of their investment strategy has been substantial purchases of stakes in western industry, services, and real estate. (Background in the note on the Kuwait economy at Annex C). Mr Hamad might be asked if he expects investment policy to continue on the same lines.

8. In discussing deployment of Kuwait's surplus, IMF/IBRD issues may come up:

A. PLO

Line to take: Recognise strong feelings on both sides. We believe that a compromise will have to be reached by political negotiation between the US and the Arabs. We are

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worried at potential damage for IFIs of further procedural devices. That is why, at Executive Board meetings in mid-June, we supported US proposals for indefinite freezing of the status quo until a political solution can be found. We very much hope that serious US Arab negotiations will start as soon as possible.

B. KUWAIT LENDING TO THE IMF

Line to take: No need to raise specifically but helpful, en passant, to encourage Kuwaiti lending to the Fund.

Background: The Libreville Communique "endorsed the efforts currently under way to obtain for the Fund additional medium-term loans from several others [ie other than Saudi Arabia] member countries whose balance of payments is strong, as well as shorter-term financing from the monetary authorities of other members". The Fund has secured medium-term borrowing from Saudi Arabia of SDR 4 billion for this year and SDR 4 billion for next year, and a further SDR 1.1 billion from central banks of industrial countries (including SDR 150 million from UK but nothing from the US). This still leaves the IMF SDR 1-2 billion short of its borrowing targets for this year and next. Kuwait (and UAE) were approached by the Fund for a loan last October. A figure of SDR 2 billion was apparently canvassed. The Kuwaitis were unenthusiastic but did not rule out the possibility particularly of a short-term central bank loan. Since then little has been heard. The Kuwaitis may feel inhibited by the outstanding question of PLO observer status. Alternatively, or they may take the strictly commercial view that the capital markets represent a more attractive investment for their surplus. ?

C. IBRD ENERGY AFFILIATE

Line to take: We support increased energy lending by the IBRD and we are ready to take part in further discussions of ways of achieving this, including the idea of an Affiliate. What does Mr Hamad think?

Background: We would find the Affiliate a more attractive idea if we could be sure that OPEC surplus countries like

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Kuwait would put up significant amounts of new money. But this remains in doubt. Indeed, Kuwait's Oil Minister has told us that he advised Mr Hamad's predecessor against the Affiliate

9. Mr Hamad was a member of the Brandt Commission. You have already received briefing on the Brandt report for the NEDC meeting on 1 July.

10. A note by the FCO on the Kuwait political scene and UK/Kuwait relations is at Annex D.

Paul McIntyre

J P McINTYRE
29 June 1981

JT

A

ANNEX A

PERSONALITY NOTE

MR ABDUL LATIF YUSUF AL HAMAD

Kuwait Minister of Finance and Planning since March 1981.

Born 1936. Educated in Egypt. Read economics and political science at Harvard. Member of the Brandt Commission. Formerly Director-General of the Kuwait Fund for Arab Economic Development and Managing Director of the Kuwait Investment Company.

One of the most outstanding of the younger Kuwaitis. Is well thought of by international bankers and financial experts.

Married. Speaks excellent English.

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B

THE WORLD OIL MARKET

1. The current weakness of the oil market was reflected in the OPEC decision last month to freeze prices until the end of the year, leaving scope only for the Saudis, who have been charging the lowest prices in OPEC, to move up from $32 a barrel to $36. Spot prices have fallen below most producers' term prices, which were set following the OPEC conference in Bali last December. Downward pressures have been especially marked on high quality crudes including North Sea. African producers of similar crudes have also been under pressure but, so far at least, this has been reflected mainly in production cuts and they have not reduced official selling prices.

2. However, this weakness in the market has also to be seen in the context of recent exchange rate movements. The strengthening of the dollar, in which oil prices are fixed, has had the effect of increasing oil import bills. The effective dollar exchange rate has increased by about 14 per cent since 1 January.

3. Both supply and demand factors have been at work in weakening the oil market. The fall in demand following the sharp price increases in 1979-80 has been larger than expected, though we do not yet know how far it has been recession-induced (and so likely to be reversed in a recovery) and how far conservation and substitution of other fuels have been responsible. Non-communist world demand fell by around 3 million barrels a day (mbd) or 6 per cent last year compared with 1979. A further fall of over ½ mbd may occur this year. And despite some pick-up in economic growth, there may even be a further slight fall next year.

4. On the supply side, the Saudis have stepped up their production to more than 10 mbd, over 40 per cent of total OPEC production. In addition, non-OPEC supplies, mainly from Mexico and the North Sea, have been edging up. And the low level of activity in the Gulf war has permitted production in Iran and Iraq, now totalling over 2½ mbd, to exceed expectations.

5. The net result is a surplus in the market. Normally, companies would want to mop up this surplus during the summer months to

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replenish their stocks for the winter. But stocks are already high. And companies, many of whose revenues from products are not covering the cost of crude, are reluctant to buy at current prices. The decision by most OPEC countries (but not Saudi Arabia, Iraq, and Iran) to cut production seems unlikely to have much effect in firming up the market.

6. The Saudis have said that they have engineered the surplus to bring about price reunification within OPEC. Since Bali, OPEC term prices have ranged from the Saudis' $32 a barrel to the Libyans at $41. This is a much wider spread than would usually be justified by differences in the quality and location of crudes. The key questions are whether the Saudis will achieve their objective and, if so, at what level prices are unified.

7. Beyond unification of prices, the Saudi objective is to secure agreement within OPEC to a pricing policy which would provide for a steady increase in the real price of oil. Proposals on these lines were contained in the report of the OPEC Long Term Strategy Committee. The effect would be a steady rise in oil prices, in line with real economic growth in the industrialised countries. But it was agreed at the recent OPEC conference in Geneva that the proposals should be reviewed. The moderates may be looking for some softening of the proposals to take account of the fall in demand for oil or at least for some pause before they take effect. The hawks, on the other hand, may wish to press for more co-ordination of production policies so as to make future price increases sustainable - this is aimed particularly at the Saudis who have always insisted that production levels are for national governments to decide. The outcome of this review is hard to predict, but it seems unlikely to come up with proposals for anything less than the maintenance of oil prices in real terms. Thus any real decline in the course of this year and perhaps for part of next may prove to be a temporary lull.

Kuwait's Oil Policy

8. Oil production peaked at over 3 million barrels a day (mbd) in 1972. Since then, a slower depletion policy and, recently, cutbacks in response to the weakening of the oil market have reduced the target for annual output to 1.25 mbd (with an extra 0.25 mbd coming from the Neutral Zone shared with Saudi Arabia).

Kuwait's total production is therefore not much below that of the UK, though her reserves are much larger.

9. As a low absorber with large reserves, Kuwait might be expected to be firmly in the moderate camp within OPEC, sharing Saudi concern that too rapid an increase in oil prices may accelerate the switch to other fuels and so undermine the oil price in the longer term. However, in recent years, Kuwait has tended to occupy middle ground between the Saudis and the hawks on pricing policy. And her practice has been to charge as much as the market will bear for her own oil - until recently charging a $5.50 per barrel premium on some contract sales. The official price of her main crude is $35.50. If Kuwait prices were re-aligned, like North Sea prices, on the basis of the Saudi market ($32), this would mean a reduction of about $4 to $31.50. Kuwait's ability to maintain existing prices may be tested by September, when some important contracts - with BP, Shell and Gulf - come up for renewal.

10. A major theme of Kuwait's current policy is the move downstream - to refine more of her own crude at home and to go in for joint-venture petrochemical projects abroad.

C

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KUWAIT

Economy

Kuwait enjoys probably the highest GDP per capita in the world, $18, 332 in 1979. With oil reserves of 70 bn barrels sufficient, at current production, to last until the end of the next century, there has been no urgency about industrial diversification. The Kuwaiti need for infrastructure is now largely satisfied. Future investment will tend to be on the service sector and the maintenance of existing projects. Kuwait has concentrated on using gas associated with oil production instead of flaring it and claims to have achieved, at about 70%, the highest percentage usage of oil associated gas products in the Middle East.

Economic activity has slowed down over the past two years. With inflation running at 20% the Government has been curbing the rate of increase of its own expenditure.

Kuwait had a current account surplus of $14 bn in 1979, an estimated $14 bn in 1980 and a forecasted $15 bn in 1981. Accumulated foreign assets are thought to have totalled $60 bn at end-1980.

The UK exported £535 mn worth of goods to Kuwait in 1979 accounting for 10% of total imports, and maintaining third position behind Japan and the US. UK exports in 1980 rose to £596 mn (11% increase).

Overseas Investment Policy

Kuwait is the most aggressive, experienced and sophisticated of the OPEC investors, seeking quite openly to acquire substantial long-term investment in western industry, services and real estate.

Kuwait, through the Kuwait Investment Office (KIO), the London-based investment arm of the Ministry of Finance, has built up a substantial portfolio in the UK (estimates put the figure above £1 bn). One of its most publicised purchases was Hay's Wharf in which KIO acquired a controlling interest last year.

Through the vehicle of the Kuwait Foreign Trading Contracting and Investment Company (KFTCIC) and its aid agency the Kuwait Fund for Arab Economic Development (KFAED), Kuwait has invested in a number of projects in ldcs in addition to encouraging joint venture companies in the Arab world. Brazil and other industrialising Latin American countries have attracted Kuwaiti interest, particularly in the field of agriculture and mining projects with a strong export content.

Kuwait's portfolio investments in the US have recently attracted Press and Congressional comment. Concern has been expressed both at the size of Kuwait's investments in the US (put at $7 billion in one report, including holdings in many well-known US companies) and at indications that the Kuwaitis are asking their fund managers to adopt a more aggressive trading policy.

D

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ANNEX D

# I. KUWAIT : POLITICAL BACKGROUND

## Internal

1. Kuwait has a population of 1.3 million, of whom just under half are native Kuwaitis and 25% Palestinians. Kuwait has used its vast oil wealth to build up a widespread and well-functioning welfare system. This has gone some way to deflecting the complaints of the immigrant communities, some of whom have been there for two or three generations, that they do not enjoy the political privileges enjoyed by Kuwaiti citizens.

## National Assembly

2. The previous National Assembly was dissolved by the then Amir in 1976, but with a promise that it would be revived within five years. Elections were duly held on 23 February this year which were reasonably free although with a somewhat restricted franchise. Both the left-wing and Muslim fundamentalists did badly at the polls.

## Iran/Iraq War

3. While Kuwait's public statements have tended to show Arab solidarity with Iraq, Kuwait has tried to avoid antagonising either of its warring neighbours. There have been a few incidents with Iran, including air strikes on Kuwaiti border posts and the detention of a survey ship operating for the Kuwait Oil Company. Mediation efforts by the Non-Aligned Movement and the Islamic Conference have so far been unsuccessful in bringing the fighting to an end. There is little scope for the West to influence either side. Fighting continues along the front.

/Gulf

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Gulf Co-operation Council (GCC)

4. The Heads of State of the six members of the GCC (Kuwait, Saudi Arabai, Bahrain, Qater, UAE and Oman) held a Summit Conference in Abu Dhabi on 25/26 May and formally established the GCC. The stated aim of the Council is to develop co-operation in a variety of fields, including financial, economic and trade co-operation, although it is not yet clear how soon practical progress may be made. Although the underlying motive seems to be a concern for regional stability in the light of the Gulf war, defence co-operation is not listed among the GCC's aims.

## II UK/KUWAIT RELATIONS

5. From 1899 to 1961 Britain had a treaty relationship with Kuwait which gave the UK responsibility for Kuwait's defence and foreign relations. The Kuwait Liaison Team of 130 seconded UK servicemen helps train and advise the Kuwait armed forces. Our relations with Kuwait remain cordial but the Kuwaitis make clear they are not prepared to favour us in commercial matters simply for old times sake. In 1980 UK exports were £260m and imports from Kuwait were £655m. Kuwait provides about 10% of our oil import requirements.

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## Visits

6. The Lord Privy Seal visited Kuwait from 6-8 February. The Duke of Kent, as Vice-Chairman of the BOTB, paid a visit in the same month. Mr Nott, however, did not include Kuwait in his Gulf tour; the Kuwaitis, close to the Gulf war, might have been sensitive to a visit by a senior Western Defence Minister.

7. The Prime Minister will visit Kuwait and Bahrain on 25-27 September on her way to the Commonwealth Heads of Government meeting in Australia. The Kuwaiti and Bahraini Governments have agreed to the dates, but the visit has not yet been officially announced.

23 June 1981

pwp

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1. MR SLATER JHSlater 1/7
2. CHANCELLOR OF THE EXCHEQUER

cc CST
FST
MST (C)
MST (L)
Sir Douglas Wass
Sir Kenneth Couzens
Mr Hancock
Mr Lavelle
Mr Peretz
Mr McIntyre

VISIT OF PROFESSOR HORWOOD

A further point which may arise in your conversation with Professor Horwood this afternoon, particularly since the main purpose of his visit to London is to hold talks with financiers, is the recent attempt by the South Africans to borrow sterling on the London capital market.

2. In April we learnt that an official South African body had approached various City institutions with the aim of floating a long-term "bull-dog" sterling bond in London. They appear to have made it clear that their purpose was to obtain an "official" UK seal of approval by this form of public issue. We believe that the response from the banks was discouraging, and nothing further has been heard.

<u>Line to take</u>

3. If Professor Horwood raises this subject, you should point out that since the abolition of exchange controls the London capital market is open to all comers, subject to queueing arrangements operated by the Bank of England. Nevertheless, it is, of course, up to the City institutions themselves to decide who they will lend to, and since this is still a developing market it is not surprising that they should be cautious when new borrowers approach them.

Sarah Walker

S P B WALKER
1 July 1981

IC

Covering
CONFIDENTIAL

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1. [MR SLATER] away / Agreed. P. McIntyre 30/6.

2. CHANCELLOR OF THE EXCHEQUER

cc CST
FST
MST (C)
MST (L)
Sir D Wass
Sir K Couzens
Mr Hancock
Mr Lavelle
Mr McIntyre

VISIT OF SOUTH AFRICAN FINANCE MINISTER

Professor the Hon O P F Horwood MP, the South African Minister of Finance, will call on you at 3.30pm on Wednesday 1 July. Mr McIntyre will accompany you. Professor (no longer Senator, since the abolition of the South African Senate) Horwood is in London for his annual discussions with financiers. He will also be calling on Mr Biffen on Thursday afternoon.

2. I attach a short note by the Bank of England on the South African economy, and a political brief by the FCO.

Economy

3. South African interest rates have been rising, the most recent occasion being last week when the Reserve Bank's discount rate rose from 9.5% to 10.5%. This reflects a tightening of monetary policy designed to bring down inflation, currently running at an annual rate of 15%. The South African authorities have had considerable difficulty in controlling the money supply, which grew in the first quarter of 1981 at an equivalent annual rate of 60%. They have also taken steps to limit the growth of credit, by asking the major commercial banks to apply self-restraint. The major difficulty attached to the new stronger anti-inflation policy is that it threatens the growth of the economy at a time when cyclical factors are tending to slow it down. Continuing strong growth is important to South Africa in order to contain unemployment among blacks and improve their living standards. In spite of strong growth in recent years (8% in real terms in 1980) unemployment among young black males is 42%.

CONFIDENTIAL

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Points to make

4. You may wish to make use of the following points:-

- What effect will the additional emphasis on anti-inflation policies have on short-term prospects for growth in the South African economy?

- What are the prospects for the gold price and what effect will this have on the South African balance of payments?

/The average gold price in 1980 was $614 per oz; it was $429.50 yesterday. South African government revenues and exports are highly dependent on gold. It has been estimated that if the gold price averages $500 per oz in 1981, there could be a balance of payments deficit of R2.2bn (about £1.29bn)7.

- /If the subject of Namibia is raised7 HMG were disappointed at the failure of the Geneva conference. We hope a solution acceptable to all sides can soon be found.

- You are glad to see that UK trade with South Africa continues to prosper and expand.
/The value of UK exports to South Africa grew by 39.6% in 1980, to just over £1bn. The value of South African exports to the UK grew by 41.8% to just over £750m7.

Sarah Walker

S P B WALKER
30 JUNE 1981

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SOUTH AFRICA

## Domestic

Reflecting the largest rise in real private consumption expenditure (8.5%) since the war as a result of higher wages and tax cuts, real GDP grew by 7.9% during 1980 (cf 3.8% in 1979). The high level of economic activity in all sectors of the economy began to exert pressure on prices (consumer prices are rising at an annual rate of 15.15%) which, together with an explosive expansion of the money supply (M2 increased by 27% in 1980 largely as a result of high gold sales proceeds; and at an annualised rate of 46% in Q1 1981 - mainly reflecting "re-intermediation" of credit following the abolition of credit ceilings in August) have led to more restrictive monetary management in 1981 and higher interest rates. Reflecting this policy stance, bank rate has been raised in three stages from 7% to 10½% since February 1981. Liquidity has been absorbed by encouraging foreign trade to be financed in Rand, while the budgetary surplus has been frozen on deposit with the Reserve Bank.

## External

A doubling of the price of gold (which represented 50% of the value of the Republic's exports in 1980) was mainly responsible for a current account surplus of US$3.6 bn, equivalent to 4½% of GDP, in 1980 despite a 14% growth in import volume. The capital account was characterised by large outflows attributable mainly to the switching of trade finance from foreign to (cheaper) domestic sources. The current account is expected to swing into substantial but sustainable deficit in 1981 reflecting the effects of the world recession on South Africa's export markets and the fall in the price of gold. Foreign exchange reserves at end-May 1981 were R653 mn (US$790 mn equivalent to 2½ weeks' 1980 imports); reserves including gold (12.3 mn ozs) stood at £5,063 mn (US$6,075 mn or 3½ months' 1980 imports). Although the Rand appreciated by 10.5% on a trade-weighted basis during 1980 and by 14.5% since the managed float was introduced in January 1979, it depreciated by 2.8% during Q1 1981 and has continued to decline.

Oil

South Africa relies on oil for only 25% of her total energy requirements (mainly for civilian and military transport). There is no indigenous oil, and supplies have to come mainly through spot market purchases. Development of the SASOL oil-from-coal plants is expected to reduce dependence on imported oil to less than 15% of total energy requirements by 1984. Underground stocks of oil have been built up to the equivalent of perhaps two to three years' consumption.

UK trade

In 1980, UK exports to South Africa totalled approximately £1,000 mn representing a market share of 12.1% and consisting mainly of chemicals, machinery and equipment, aircraft and vehicles. The UK was the third largest supplier after the USA (13.6%) and West Germany (12.9%). Imports from South Africa were valued at about £756 mn, an increase of 40% by value on 1979 as much of the diamond export trade was switched back to London from Switzerland.

UK investment in South Africa is currently valued at some £4 bn, about 50% of total foreign investment and 10% of UK investment abroad. The disinvestment by UK companies from South Africa in the late 1970s now appears to have ceased, although British Steel Corporation has agreed to sell its South African interests to South African buyers to meet financial needs in the UK. The Reserve Bank has agreed exceptionally to allow £12 mn of these proceeds to be repatriated at the commercial rate, thus avoiding the discount (currently about 25%) forfeitable through the financial Rand market - the usual route for disinvestment proceeds.

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## Political Background

### General Election 29 April

The governing National Party (NP) won 131 seats (a loss of 7), the liberal Progressive Federal Party (PFP) won 26 (a gain of 9) and the moderate New Republic Party (NRP) 8 (a loss of 1). The extreme right-wing HNP won no seats but quadrupled its share of the poll to about 14%, rendering several previously safe NP seats marginal. This result is clearly mixed for Prime Minister P W Botha: while he can now claim to have his own mandate and he still has a huge majority in Parliament, he has lost support within the Afrikaner community to the far right. The PFP will now be much more effective in opposition and has strengthened its electoral position, especially in English speaking areas.

### Prospects for Reform

2. Mr Botha has declared that he will now press on with his programme of limited reforms to apartheid to eliminate what he calls 'unnecessary and hurtful discrimination'. There is, however, no suggestion of altering the basics of 'grand apartheid'; in particular the Government is committed to bringing all the tribal homelands to 'independence' and it still refuses to consider any form of power sharing with the black community in central government.

3. The advisory 'President's Council', which came into effect on 1.1.81 and whose brief is to examine constitutional alternatives for the future of South Africa, will make its first recommendations later this year. It is expected to include the suggestion that the coloured (mixed-race) population be included in Parliament, though on a separate voters' roll. How P W Botha responds will depend on the degree of opposition from his own (right-wing) party caucus, and on how willing Natinonal Party MPs with newly marginal seats are to risk losing more support to the right.

South Africa - Internal Disturbances

4. Industrial unrest has grown over recent months as the black trades unions have become more effective. There have in particular been a number of strikes in the car industry in the Cape.

5. There are periodic guerilla attacks on South African soil usually claimed by the banned African National Congress (ANC). Most recently there were several incidents surrounding the celebrations for the 20th Anniversary of the Republic.

NAMIBIA

UN Security Council Debate

6. On 30 April, after a 10-day debate in the Security Council, UK, France and US vetoed 4 draft resolutions which sought to impose comprehensive economic sanctions against South Africa, because of its intransigence in the Namibia negotiations following the break-down of Geneva conference in January. The Africa Group are likely to re-introduce the vetoed resolutions in the General Assembly under the Uniting for Peace procedure after the Organisation of African Unity (OAU) summit.

Recent Developments in the Negotiations

7. The Foreign Ministers of the Five western Governments (US, UK, FRG, France and Canada) met in Rome to discuss Namibia on 3 May. They issued a joint communique which reaffirmed the Five's commitment to work for a negotiated settlement in accordance with Security Council Resolution 435 of September 1978 and instructed officials to develop proposals, including constitutional arrangements to increase the confidence of the parties and enhance the prospects of achieving a settlement. The US will explore further with the South Africans what minimum requirements they would need to commit themselves formally to implementation of a settlement leading to the independence of Namibia.

South African Attitude

8. After agreeing in principle to a Namibian settlement on the basis of the Five's proposals in 1978, South Africa has raised numerous objections. At the Geneva conference in January they stated that it would be premature to implement a Namibia settlement. It appears that the South African Government have not yet decided whether to risk a SWAPO government in Windhoek. Namibia was not an issue in the recent South African elections and it is unlikely that the result will have much effect on the Namibia negotiations.

JH

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E.6

CHANCELLOR

AN ECONOMIC INITIATIVE

I have had an interesting reaction from John Hoskyns to the proposals for the linkage of NIS reductions with the pay outturns. I showed to him the guts of the argument which I had set out in my recent minute to you, and the attached letter suggests a helpful ploy for preparing the ground for the future, which would require some collusion with the CBI.

2. I should also mention that I have a discussion about the initiative with Rob Shepherd, who in turn had been talking about it independently to Chris Patten. He reports a distinct reservation on Jim's side, whose precise nature is not easy to discern. I think one part of his reservation may relate simply to a feeling that the time is not ripe for such an initiative, and that it would need very careful preparation with the CBI and others. In expressing that feeling, I think that he is doing no more than I would now do. Another more prosaic reason may be simply that he is due to go on holiday in a few days, and would not want another idea to be developed - if it is to be worked up with full Ministerial commitment - in his absence. Finally, of course, he will no doubt see that this proposal could to some extent be run as an alternative to the expenditure proposals which he has put forward, since it is not unreasonable to defend the initiative as a good way of getting down unemployment by acting directly on its causes.

AM

ADAM RIDLEY
30 July 1981

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# 10 DOWNING STREET

28 July 1981

Adam Ridley Esq
Special Adviser
HM Treasury
Parliament Street
LONDON SW1

Dear Adam,

I have now talked to Alan, David and Andrew Duguid here about your plan to link NIS reductions to pay outturns. Here are our reactions.

1. It has possible upside, no downside. It may be impossible for such a scheme to have a real effect on pay demands and settlements; but it certainly can't make them worse. And at the least, it does put each individual union (especially the big public sector unions) into a quite awkward position. For example, it could wrong-foot the miners quite badly right at the outset.

2. The main objection from both the Prime Minister and Geoffrey may be that we are sliding into the "norms" business. But the MTFS itself implies a norm which would be consistent with minimal unemployment and a particular monetary stance. And indeed, we have been more successful than we might have supposed in getting the 6% norm to stick in the public services. I remember colleagues saying, when the 6% was originally mooted, that it was just laughable to think that we could get away with anything much under 10% or 12%. So we oughtn't to be frightened of norms.

3. As regards tactics, it seems to us very important to get Len Murray well and truly impaled on the hook of "NIS as a key factor in unemployment". The steps might go as follows:

   (a) Get agreement that the idea is possible and contains no downside. This requires a meeting between the Prime Minister and Geoffrey (probably including Jim, but I think he's away on holiday next week) on Monday or Tuesday - as soon as the Treasury have agreed that the idea has merit (though that may be a forlorn hope I suppose!).

   (b) Warn Terry Beckett that we would like him to press the Chancellor at NEDDY on reductions in NIS as the main contribution to recovery and increased employment without inflation. (It may be necessary to take Beckett into our confidence.)

   (c) At NEDDY itself, Terry should encourage Murray (TUC is already on record about the NIS I think) to walk into the trap of a dual pitch at Geoffrey on NIS reduction. Geoffrey points to the great difficulties of finding the money, but promises to think about it.

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(d) At the end of August, at a suitable opportunity, Geoffrey on return from holiday announces, not a scheme or a norm, but simply that he will undertake to reduce NIS in the Budget according to some formula depending on the pay outturns by that date. This then shows a positive initiative which sets the cat among the pigeons at TUC etc.

4. This timetable would also of course give officials more time to think the scheme through and perhaps add a few useful twists. We think the scheme is a Budget matter and should not be discussed in Cabinet, otherwise it will leak. Murray and the TUC would then see it coming, smell and rat and start working out how to reject it without losing credibility. The public would see reports of the CBI and TUC talking with one voice on NIS at NEDDY; and the CBI rapturously greeting the Chancellor's proposals at the end of August.

Yours ever
John

JOHN HOSKYNS

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E.6

CHANCELLOR

cc Chief Secretary

AN ECONOMIC INITIATIVE

When we were discussing various ideas for reducing unemployment at No 11 Downing Street the other day, you may recollect that I raised the possibility of what one might call the Chris Patten initiative, namely an offer by the Government to reduce the National Insurance Surcharge if, and to the extent that, earnings increases fell below some benchmark figure. I think the time has now come to consider this possibility very seriously indeed, with a view to its being launched in the near future. The following note sets out my reasoning.

General considerations

2. Although I remain an optimist about the economic recovery, I think that the Treasury's position at the moment is a difficult one, in which this "NIS initiative" would help in a variety of ways. Seen as an economic measure, it is something positive which offers hope, which goes a long way to meeting many of the colleagues' anxieties about pay and about helping industry. For the CBI it would combine the attractions of helping their pay initiative and meeting one of their prime requests for assistance to industry. Seen ideologically, it is a proposal which should attract support across a fairly wide spectrum within the Party, possibly all the way across the spectrum. It could, I think, be launched before the holidays get under way - at a time which would be extremely important from the point of view of the Government's general standing in the country. It is a very serious initiative, which would be treated as such by the newspapers without any risk of being effectively damned as a gimmick. I do not see how it could be very seriously attacked by the opposition, and I would have thought the Social Democrats would have no option but to say that it was an imaginative gesture which merited their and the Liberal Party's support. Seen as an economic proposal, it also has an almost unique combination of

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advantages/ in relation to any alternative, some of which are alluded to briefly below.

The scheme in outline

3. The kind of scheme I am envisaging would be childishly simple, and needs scarcely more words to describe it at this point than Chris used in his original article. The Government's offer might take one or other of the following forms:

(i) For every percentage point by which average earnings increase below, say, 7% by next March, the Government will reduce the NIS by an equivalent percentage point in the following June.

(ii) Alternatively, if it is easier to offer it on the average level of settlements - which means one must allow something for drift - one might formulate the offer on the basis of every percentage point by which the average level of settlements falls below, say, 5% .

Careful investigation would be needed to find the precise gearing which is appropriate to the proposal, to arbitrate between the relative merits of earnings increases or settlements, to assess at what date one would want to make a measurement and at what date one would want to put the NIS cut into force, to see whether a straight one-for-one relationship is appropriate and so on. But all this is, I think, secondary to the principle at this stage /I think that something in the region of one-for-one would make good sense, and would almost certainly have immense advantages of presentation over any other possible formula./

4. I have not seen any simulation carried out on the Treasury model or any other which has examined/what the consequences of such a scheme would be. But I am pretty sure that it would be as near self-financing as makes no difference within a financial year, at the very least; and that it could even bring a net return. I should add in parentheses that the simulation results which we have seen - for example when I raised the related issue of a possible NIS cut after the Budget - suggest that the measure is not self-financing because model builders assume, quite properly, that the NIS leaks all over the place, particularly into wages.

I return to this point in a moment.

Advantages of the scheme

4. (a) Most tax cuts and wage increases do not create big PSBR/ offsets because of the problem of leakages of one kind or another, particularly into pay and prices, with the obvious concomitant that the proportion of the initial sum of money so devoted which goes into real output is small. If we assume, as I think is reasonable, that launching the scheme as a major political gesture would do nothing to increase pay - since it is a "payment by results" scheme - then the assistance will be firmly directed in the first instance into the pockets of industry. If it goes there, it will have favourable results whatever they do with it. If everything is handed on in lower prices, that will be a favourable effect on inflationary expectations, competitiveness, interest rates and the demand for British goods. Even if it all goes into profits, that will have a good effect on confidence and, in due course, investment, and there will be many other secondary advantages arising through the strengthening of balance sheets and share values. No one could foresee very precisely what the particular use of such a cut might be, but I think we can take it that it would make an NIS cut a very feasible option for the Government to consider in almost any budgetary circumstances.

(b) That is not all. Unless one is an extreme pessimist, the introduction of such a scheme would be almost certain to have some downward effect on wages as well. The benefits of that do not need further spelling out.

(c) If one announced such an initiative at this stage, it would perhaps be the nearest thing to the "message of hope" for industry which so many are calling for. It would, after all, be a gesture which meant something to nearly every employer in the land however small.

(d) It could be presented - in total honesty - as a major response to the unemployment problem, as I was arguing the other day. It should begin to exercise its influence (if it has any at all) in the very near future, which could have a favourable impact on employment opportunities by the autumn or early winter.

(e) There is no need for the scheme to be kept a broad brush one for all age groups. It could be modified in the spirit of Alan Walters' proposals, for example with a bias towards eliminating the NIS on the young.

(f) It would give the imminent wage round a clear focus without implying a norm or constituting anything resembling an incomes policy. The parallels with Denis Healey's manoeuvres a few years ago will be obvious; but that was an occasion on which the device in question was a thing used as an adjunct to an incomes policy, with its separate apparatus of price controls etc etc. I think that the scheme as presently envisaged would not be open to any sustained or serious criticism on these grounds. There would be no implications of uniformity about it, and the precise figure chosen for the benchmark would, though highly significant economically, be seen to have no binding quality on individual wage settlements. The logic of the whole scheme would be simply "the lower the better".

(g) If the scheme was launched in the near future, it would in all probability have a very favourable impact on the financial markets and expectations at a most difficult time. There might therefore be secondary advantages from the point of view of monetary control and funding the PSBR.

(h) It would put the TUC in a most interesting position. Like Peter Shore, they are bound to go on asking for the NIS to be cut. If you put forward the scheme, you will be for once not negating their proposal, but riding the punch and turning it back on them in a not unconstructive way. In a sense the message will be "of course it is difficult for either of us to take independent initiatives to cut labour costs; but we can both do so together without getting involved in elaborate bi- or tripartite arrangements about which all of us might have reservations".

<u>A related initiative for the nationalised industries</u>

5. The development of the nationalised industries' investment review suggests to me strongly that one could consider at least the possibility of putting forward a related initiative which

applies to them at roughly the same time. The current Investment and Financing Review (IFR) has shown very clearly that the industries have cut their prices but not their costs, as the forecasts on which they build up their corporate plans have been revised downwards in the light of their slow realisation of the degree of recession which one must anticipate in the economy. The result is that their EFL requests for next year and the years after are of the order of £2-3 bn higher. Faced with this grave threat to the Government's financial objectives, the Treasury is in a difficult position. The only thing it can control and use to offset such demands is the annual investment total for each corporation. To do so however would be to commit just the "error" everybody complains of, namely to cut capital investment in order to accommodate current expenditure. However these awkward enlarged EFL demands may have arisen, the only way out of the present dilemma is to get the industries to perform better on their costs. The obvious way to do so is, rather as with BR, to make approval of the investment they so desperately need - at least at the margin - contingent on clear and bankable agreements between management and unions about improved costs. I don't think the NI unions mind very much about the general NIS argument for the economy as a whole, but they certainly mind a great deal about being modernised. I have discussed this idea briefly with the Chief Secretary, but only in the last 48 hours which has given him little opportunity to react to it even if he thinks there is something in it!

Timetable

6. If there is any merit in pursuing this proposal whatever, by far the most attractive occasion for launching it would be at the NEDC on 5 August. However I increasingly ask myself whether it might not be equally important to, at the very least, lower it on the table at as early an occasion as this Thursday's Cabinet. I think you will need a major constructive and unforeseen initiative if the meeting is to go well.

AR.

P.S. This recommendation is not the result of a collusive initiative between CPL & myself!

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FINANCIAL SECRETARY TO THE TREASURY

J.H.

This, + PC, + yr. minute are all > or < correct. I must hv. mtgs arranged with Messrs. Pym + Parkinson, to agree the case for all this: on the basis of a standard note, from Stirling notes which I shd have now. 2 or 3 points will have to be omitted. These shd precede any minute to + discussion with PM. Discuss exact contact with me.

CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Mr Ridley
Mr Cropper

PRESENTATION OF ECONOMIC POLICY

One important area which we did not (and could not) touch on at yesterday's full meeting on how to get our economic message across was the role of Conservative Central Office. I think it would be appropriate for you to speak to the Party Chairman directly about this because I am not really in a position to elicit full information. The worries are:-

i) A number of shadowy committees have been set up by Alan Howarth reporting to an over-all 'Liaison Committee' on which Mr Pym, the Chairman and others sit. One of these committees is designed to put a certain economic message across to 'opinion formers'. What the others do I am unable to learn. Clearly, this is an area where matters could go badly wrong and where we have legitimate concern. Cecil Parkinson might be asked to tell Alan Howarth to prepare a note on them.

ii) Some of the most embarrassing mis-statements of economic policy - more or less coded - have been circulated through the Central Office machine. At present economic speeches prepared by CRD officers for ministers are not even seen by the head of the economic section (who is reliable in these matters). Whatever you decide about your colleagues showing you (or us) economic speeches circulated through their departments, I think that we must be careful to prevent the misuse of the Party circulation system and Research Department resources too. Perhaps this too might be a point worth making in the talk with Mr Parkinson.

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iii) I think that we should insist on seeing the text of Party Political Broadcasts, as a general rule, on any economic matters before they go out. Also a point for the Chairman to agree.

iv) One result of the drying up of the Government Information Service and the virtual ending of PMG Notes is that the Party itself - through the medium of CRD - is worse informed on economic matters, in spite of the liaison between Special Advisers and Lynda Rouse. Clearly this question is highly sensitive and must rest with decisions by you, the Prime Minister and others about what is to be done about either activating or circumventing the official information system. If circumvention is the chosen course, for whatever reason, there might be a possibility of regular economic briefing (over and above the regular CRD Briefing Notes on whatever subject Alan Howarth sees fit) being issued through the Party to Ministers and Party stalwarts alike but written by us.

v) One brighter note: I understand that CRD will be issuing regular 'good news' bulletins based on information obtained through the Department of Industry. I am monitoring this.

RH

ROBIN HARRIS
27 October 1981

PUP 38

I've drawn on this to make up your table

[signature]

FINANCIAL SECRETARY TO THE TREASURY

CHANCELLOR

cc Mr Ridley
Mr Cropper

CENSURE DEBATE: COST OF ALTERNATIVES

From most modest to most extravagant:

1. Blue Chips ('Changing Gear') want extra spending of £4-5 billion over 2 years <u>and</u> £2 billion for cutting NIS. They add that taxes <u>might</u> need to be raised. Most modestly assessed as in the first year an extra £4 billion borrowing (NB J Watson - one of signatures - said he was <u>against</u> increasing tax to pay for it on Week-End World on 25 October)

2. Gilmour: measures proposed in Blackpool on 14 October would have gross cost of £5 billion - but unlike 'Chips' does not recognise that there could be pressure on interest rates, which he wants to reduce: he never denied on Week-end World (25 October) that the money would be found by "printing" - ie abandoning money targets.

3. Heath and Rippon avoid figures.

4. i) TUC 'Plan for Growth: The Economic Alternative' (February 1981) proposed measures ($\frac{2}{3}$ higher spending $\frac{1}{3}$ NIC and NIS reductions) of gross cost £$6\frac{1}{4}$ billion. Also lower interest and exchange rates.

But ii) TUC 'Reconstruction of Britain' (20 August 1981) proposes a £24 billion programme of public sector <u>capital investment</u> alone rising from £3 billion in 1982-83 to £7 billion in 1986-87. No figure for effect on borrowing.

5. <u>Labour Plans</u>:

i) Foot Speech (Cardiff): 4 July 1981 (and very similar Shore on 15 January 1981 Supply Day) - estimated <u>by Treasury</u> as costing up to about £6$\frac{1}{4}$ billion in full year (lower taxes, higher public investment).

ii) 27 July Censure Debate: Foot's earlier proposals broadly re-stated by him were alleged by Dr Owen to lead to an £18 billion to £22 billion PSBR. Shore intervened to say the programme "has not been costed" (Hansard, 27 July 1981 Col. 859)

iii) 'The Socialist Alternative': NEC Document commended by Healey and Benn to Labour Conference is not costed either.

RH

ROBIN HARRIS
28 October 1981

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A.5 speeches

CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir A Rawlinson
Sir K Couzens
Mr Ryrie
Mr Burns
Mr Kemp
Mr Norgrove
Mr Cropper
Mr Harris

CENSURE DEBATE

I attach some notes on economic arguments you might want to deploy, and a modest expansion of the idea Ian Stewart and I suggested earlier of casting aspersions on Labour's motives for holding the debate.

2. Mr Kerr and Mr Harris have, I believe, pursued separately the question of a DE brief for defence against the accusation that job support schemes were used to manage down the latest unemployment figures.

3. There has not been time to locate all the quotations one might like. If you want any particular ones, there should be an opportunity to dig some out tomorrow morning.

J Anderson

AR ADAM RIDLEY
27 October 1981

POSSIBLE FOOT/HEALEY ARGUMENTS

The following propositions may be advanced by Messrs Foot and Healey - and, possibly, others. Possible responses are suggested in note form.

1. Criticism: "HMG's policies are directly and very largely (or solely) responsible for the recession"

A. The recession and its scale can be attributed very largely, if not wholly, to the 1978-80 wage explosion; the increase of oil prices in 1979; and the unprecedented upward movement in the pound. None of these was due to Government policies or actions.

- The wage explosion was doubly Labour's fault: the rebound from its own failed incomes policy; and the Clegg (and related) awards for almost all public sector workers. /One wonders whether Labour planned to renege on Clegg after the election./

- The OPEC price increases had the effect according to OECD of knocking about 5½% off what GNP would otherwise have been by 1981 second half in the OECD area, and the UK was in no way immune from this (see Economic Outlook July 1980 p.122 and attached extract). No way open to us or any other Government to sidestep that vast recessionary blow - particularly as economy was at its cyclical peak anyway in 1979 and unlikely to have expanded at that rate had there been no oil crisis.

- The upward movement of the exchange rate was irresistible - even with exchange controls removed, which alone could help to relieve the pressure. No empirical evidence it was due to tight money or high interest rates. No economists or econometricians forecast the increase before the event, or can explain it afterwards, particularly not in terms of our monetary policy and interest rates.

NB Worth noting that under Labour GDP fell by 3% 1973-75 when exchange rate was depreciating fast:

UK Effective Rate

| | |
|---|---|
| 1973 | 123.6 |
| 1974 | 141.4 |
| 1975 | 100.0 |
| 1976 | 85.6 |

Recession in manufacturing would inevitably have been greater if it had risen as in 1979-80.

Questions

If party opposite think present Government responsible for this recession, do they accept responsibility for 1974-76?

Does Mr Foot remember his Daily Mirror article (24 July 1974) as Secretary of State for Employment,

"I am not prepared to sit in this place and preside over mass unemployment."?

Or is that why he decided to move sideways to preside over the Council?

Does Mr Healey not recall the earlier references to economic hurricanes and blizzards which he claimed had blown Labour off course in 1974 onwards?

2. Possible Healey policy criticisms/proposals

Devalue (and join EMS); cut NIS; expand PSBR.

Comment: Very difficult to take such proposals seriously.

Exchange Rate RHG must remember well enough how in 1977 he failed totally to stop exchange rate rising and had, before the end of the year, to "uncap" the rate despite having cut MLR from 14 to 5½% and spending many billions of pounds in fruitless intervention. All that in far easier circumstances than 1979-81, with no petro-£, oil price crisis etc. One also remembers the previous Government's refusal to join EMS in 1978-79, and RHG's

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**Table 35**
**Simulated effects on OECD area of real oil price increase since end-1978**[a]

| | 1979 | 1980 | 1981 | 1979 I | 1979 II | 1980 I | 1980 II | 1981 I | 1981 II |
|---|---|---|---|---|---|---|---|---|---|
| Increments to volume growth rates (s.a.a.r.): | | | | | | | | | |
| Disposable income | –1.2 | –3.2 | –1.0 | –0.9 | –3.0 | –4.0 | –1.9 | –0.7 | –0.4 |
| Private consumption | –0.7 | –2.4 | –1.3 | –0.5 | –1.8 | –2.9 | –2.1 | –1.2 | –0.8 |
| Total domestic demand | –1.0 | –3.4 | –1.9 | –0.7 | –2.5 | –4.0 | –3.2 | –1.8 | –0.7 |
| Imports[b c] | –1.4 | –4.5 | –2.7 | –1.0 | –3.6 | –5.1 | –4.4 | –2.6 | –1.1 |
| Exports[b c] | –0.9 | –2.2 | –1.0 | –0.6 | –2.2 | –2.4 | –1.9 | –0.8 | –0.4 |
| GNP | –0.9 | –3.0 | –1.5 | –0.6 | –2.3 | –3.4 | –2.7 | –1.5 | –0.5 |
| Cumulative effect on: | | | | | | | | | |
| GNP | –0.9 | –3.8 | –5.4 | –0.3 | –1.4 | –3.1 | –4.5 | –5.3 | –5.5 |
| Savings ratio | –0.5 | –1.4 | –1.1 | –0.2 | –0.8 | –1.4 | –1.4 | –1.2 | –1.0 |
| Increments to growth rates (s.a.a.r.): | | | | | | | | | |
| Consumer prices | 1.6 | 5.0 | 3.6 | 1.3 | 4.0 | 5.8 | 4.6 | 3.6 | 3.0 |
| Export prices[b] | 3.0 | 5.4 | 3.1 | 3.0 | 6.0 | 5.9 | 4.0 | 3.0 | 2.5 |
| Import prices[b] | 6.9 | 12.2 | 2.6 | 6.1 | 15.9 | 15.1 | 3.9 | 2.7 | 1.4 |
| GNP deflator[b] | 0.9 | 3.7 | 3.8 | 0.7 | 2.1 | 3.9 | 4.7 | 3.7 | 3.2 |
| Increment to foreign balance relative to baseline[b] ($ billion, s.a.a.r.) | –39.1 | –93.4 | –61.5 | –15.1 | –63.1 | –101.8 | –85.0 | –70.7 | –52.4 |

a) These results are sensitive to the assumed import growth rate of OPEC. In the baseline forecast underlying this simulation, it has been assumed that OPEC import volumes would have grown at 5 per cent per annum in the absence of the oil price rise. However, OPEC import volume growth was weak through 1979, despite the oil price rise, in part because of an important import cutback by Iran, and this special factor is allowed for in the simulation figures. The simulated increments to the foreign balance would have been considerably less throughout the period, had "more normal" OPEC spending on imports occurred.
b) National accounts basis; trade includes services; prices are implicit deflators.
c) Includes OECD area intra-trade.

the latest oil "shock" became clear during the last twelve months. In part, this was due to the behaviour of households, who allowed spending to run ahead of income.

The "second oil crisis" has already manifested itself in the inflation and current account statistics. The latest information indicates that consumer prices in the OECD area may now be growing at an annual rate of 15 per cent. As noted above, it would now seem that final energy prices are reacting both faster and to a greater extent than previously[11]. Given the still moderate response of wages in a number of countries on this occasion, it seems that a large part of the price acceleration can be directly attributed to the rise in oil and other energy prices.

The current balances of the OECD economies moved from a surplus of about $10 billion in 1978 to a deficit of about $35 billion in 1979. Nearly all of this swing of around $45 billion can be attributed to transactions with OPEC. The OECD deficit in 1980 is expected to move to around $80 billion, representing a further deterioration of around $45 billion; although payments for OPEC oil are expected to be about $90 billion higher than in 1979, exports to OPEC may be about $50 billion higher.

The demand deflationary (or output-reducing) effects of the oil price rises are now beginning to be seen. In order to gain some idea of their size, simulations of all the oil price rises since January 1979 to date have been carried out using the OECD Secretariat's model of the world economy, INTERLINK. Results are presented in Table 35. The simulated effects are shown as increments to baseline growth rates or levels, i.e. those which would have occurred in the absence of the real rise in oil prices. The most important technical assumptions which underlie this simulation are:

*i)* the oil price is assumed to remain unchanged in real terms after mid-1980 (see footnote to Table 31);
*ii)* monetary policy is assumed to accomodate changes in nominal GNP without affecting real interest rates, whilst the flow of OPEC revenues into the OECD banking system, which could affect interest rates, is not modelled;
*iii)* non-wage public expenditure is assumed fixed in nominal terms but government wage expenditures, tax receipts and transfers change endogenously;
*iv)* whilst increases in the price of imported oil are shifted forward into domestic demand deflators within one half-year, domestically-produced energy prices rise in sympathy but with a lag of up to three years;
*v)* wages respond to higher consumer prices, usually over a period of about two years;
*vi)* OPEC import volumes adjust to incremental export receipts over more than two years, but are subject to "speed limits" which constrain their average growth to about 20 per cent;

11. See the Wages, Costs and Prices section for details of the movement of the energy component of the CPI in the periods 1973-1975 and 1978-1980.

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Table 35
**Simulated effects on OECD area of real oil price increase since end-1978[a]**

| | 1979 | 1980 | 1981 | 1979 I | 1979 II | 1980 I | 1980 II | 1981 I | 1981 II |
|---|---|---|---|---|---|---|---|---|---|
| Increments to volume growth rates (s.a.a.r.): | | | | | | | | | |
| Disposable income | –1.2 | –3.2 | –1.0 | –0.9 | –3.0 | –4.0 | –1.9 | –0.7 | –0.4 |
| Private consumption | –0.7 | –2.4 | –1.3 | –0.5 | –1.8 | –2.9 | –2.1 | –1.2 | –0.8 |
| Total domestic demand | –1.0 | –3.4 | –1.9 | –0.7 | –2.5 | –4.0 | –3.2 | –1.8 | –0.7 |
| Imports[b c] | –1.4 | –4.5 | –2.7 | –1.0 | –3.6 | –5.1 | –4.4 | –2.6 | –1.1 |
| Exports[b c] | –0.9 | –2.2 | –1.0 | –0.6 | –2.2 | –2.4 | –1.9 | –0.8 | –0.4 |
| GNP | –0.9 | –3.0 | –1.5 | –0.6 | –2.3 | –3.4 | –2.7 | –1.5 | –0.5 |
| Cumulative effect on: | | | | | | | | | |
| GNP | –0.9 | –3.8 | –5.4 | –0.3 | –1.4 | –3.1 | –4.5 | –5.3 | –5.5 |
| Savings ratio | –0.5 | –1.4 | –1.1 | –0.2 | –0.8 | –1.4 | –1.4 | –1.2 | –1.0 |
| Increments to growth rates (s.a.a.r.): | | | | | | | | | |
| Consumer prices | 1.6 | 5.0 | 3.6 | 1.3 | 4.0 | 5.8 | 4.6 | 3.6 | 3.0 |
| Export prices[b] | 3.0 | 5.4 | 3.1 | 3.0 | 6.0 | 5.9 | 4.0 | 3.0 | 2.5 |
| Import prices[b] | 6.9 | 12.2 | 2.6 | 6.1 | 15.9 | 15.1 | 3.9 | 2.7 | 1.4 |
| GNP deflator[b] | 0.9 | 3.7 | 3.8 | 0.7 | 2.1 | 3.9 | 4.7 | 3.7 | 3.2 |
| Increment to foreign balance relative to baseline[b] ($ billion, s.a.a.r.) | –39.1 | –93.4 | –61.5 | –15.1 | –63.1 | –101.8 | –85.0 | –70.7 | –52.4 |

*a)* These results are sensitive to the assumed import growth rate of OPEC. In the baseline forecast underlying this simulation, it has been assumed that OPEC import volumes would have grown at 5 per cent per annum in the absence of the oil price rise. However, OPEC import volume growth was weak through 1979, despite the oil price rise, in part because of an important import cutback by Iran, and this special factor is allowed for in the simulation figures. The simulated increments to the foreign balance would have been considerably less throughout the period, had "more normal" OPEC spending on imports occurred.
*b)* National accounts basis; trade includes services; prices are implicit deflators.
*c)* Includes OECD area intra-trade.

the latest oil "shock" became clear during the last twelve months. In part, this was due to the behaviour of households, who allowed spending to run ahead of income.

The "second oil crisis" has already manifested itself in the inflation and current account statistics. The latest information indicates that consumer prices in the OECD area may now be growing at an annual rate of 15 per cent. As noted above, it would now seem that final energy prices are reacting both faster and to a greater extent than previously[11]. Given the still moderate response of wages in a number of countries on this occasion, it seems that a large part of the price acceleration can be directly attributed to the rise in oil and other energy prices.

The current balances of the OECD economies moved from a surplus of about $10 billion in 1978 to a deficit of about $35 billion in 1979. Nearly all of this swing of around $45 billion can be attributed to transactions with OPEC. The OECD deficit in 1980 is expected to move to around $80 billion, representing a further deterioration of around $45 billion; although payments for OPEC oil are expected to be about $90 billion higher than in 1979, exports to OPEC may be about $50 billion higher.

The demand deflationary (or output-reducing) effects of the oil price rises are now beginning to be seen. In order to gain some idea of their size, simulations of all the oil price rises since January 1979 to date have been carried out using the OECD Secretariat's model of the world economy, INTERLINK. Results are presented in Table 35. The simulated effects are shown as increments to baseline growth rates or levels, i.e. those which would have occurred in the absence of the real rise in oil prices. The most important technical assumptions which underlie this simulation are:

*i)* the oil price is assumed to remain unchanged in real terms after mid-1980 (see footnote to Table 31);

*ii)* monetary policy is assumed to accomodate changes in nominal GNP without affecting real interest rates, whilst the flow of OPEC revenues into the OECD banking system, which could affect interest rates, is not modelled;

*iii)* non-wage public expenditure is assumed fixed in nominal terms but government wage expenditures, tax receipts and transfers change endogenously;

*iv)* whilst increases in the price of imported oil are shifted forward into domestic demand deflators within one half-year, domestically-produced energy prices rise in sympathy but with a lag of up to three years;

*v)* wages respond to higher consumer prices, usually over a period of about two years;

*vi)* OPEC import volumes adjust to incremental export receipts over more than two years, but are subject to "speed limits" which constrain their average growth to about 20 per cent;

11. See the Wages, Costs and Prices section for details of the movement of the energy component of the CPI in the periods 1973-1975 and 1978-1980.

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# Special measures are proving cost-effective says Employment Secretary

Because they are labour intensive, special employment and training measures introduced by the Government to make an immediate impact on unemployment are proving to be cost-effective, Employment Secretary Mr Albert Booth explained to careers specialists at the conference in Exeter last month.

"An equivalent expenditure on general reflationary measures would have much less impact on unemployment," said Mr Booth. "It is estimated that the cost of an extra job through general reflation is about ten times—approximately £13,000—the cost of a job or training opportunity provided through special programmes."

The programmes were of course not a substitute for reflation but a supplement to policies designed to achieve faster growth and improved industrial performance, Mr Booth declared. Nor were the places provided on programmes for young people meant as a substitute for employment, but a positive alternative to unemployment.

***Focus on jobs and young people at Exeter careers conference***

tion for all young people seeking work. The need for such preparation was underlined by the fact that "in a tight labour market it was the 40 per cent or so who left school with minimal or non-existent qualifications and experience whose chances of employment were least promising."

### Joint study group

Last month, a joint Government and MSC study group was announced to look into ways of extending and improving the arrangements for vocational preparation of young people. This will contribute to the Government's White Paper, proposed next year, surveying the whole field of education and training policies for the 16–18 age group and putting forward proposals for offering them some

## More careers advice for brighter pupils

Some schools had not allowed the Careers Service to play its full part in advising more able youngsters in the past, Mr Albert Booth, the Employment Secretary, told the annual conference of the Institute of Careers Officers.

"I believe this is changing," said Mr Booth. "We must certainly get away from the idea that because a youngster is heading for higher education he or she does not need careers advice."

### Interest stimulated

Careers officers from all over the country were told that manufacturing industry must be enabled to attract the brightest people into careers. Young people who were capable of getting good qualifications at universities or polytechnics must have their interest in industrial careers stimulated while they were still at school, said Mr Booth.

He stressed that this was not merely a matter of ensuring that they considered industrial careers when they had finished their education. It was vital to ensure that the education system itself produced the well-qualified people needed at the top.

If bright children could see the interest and challenge of careers in industry, they might be motivated to choose suitable subjects at school and in their higher

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10 DOWNING STREET

*From the Private Secretary*

27 October 1980

CALL BY M. THORN

I enclose a copy of the record of the Prime Minister's discussion earlier today with M. Gaston Thorn.

I am sending copies of this letter and its enclosure to John Wiggins (H.M. Treasury), Kate Timms (Ministry of Agriculture, Fisheries and Food), Stuart Hampson (Department of Trade), Ian Ellison (Department of Industry) and David Wright (Cabinet Office).

M. O'D. B. ALEXANDER

8t 28/10.

CH/EXCHEQUER
REC. 28 OCT 1980
~~ACTION~~ CST
FST
COPIES TO
SIR D. WASS.
SIR K. COUZENS.
MR RYRIE.
MR HANCOCK.
MR BARRATT.
MRS HEDLEY-MILLER.
MR MOUNTFIELD
MR LOVELL
MR ASHFORD.
MR SLATER
MR ROBERTS

R. M. J. Lyne, Esq.,
Foreign and Commonwealth Office.

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F.S. [illegible] + [illegible] is right: + we shd say so - tho' it looks [illegible] as tho' this wish is [illegible]

RECORD OF A CONVERSATION BETWEEN THE PRIME MINISTER AND THE PRIME MINISTER OF LUXEMBOURG, M. GASTON THORN, AT 10 DOWNING STREET ON MONDAY 27 OCTOBER 1980 AT 1215 HOURS

Present:

| | |
|---|---|
| Prime Minister | M. Thorn |
| Mr. M. Alexander | M. Kasel |

I passed this point to Mr Alexander at No 10 who said the PM was already aware of it. JW 29/10

* * * * * * * * * *

Commission Portfolios

The Prime Minister asked about the prospects for the allocation of portfolios within the new Commission. M. Thorn said that he had been informed by the Foreign and Commonwealth Secretary about the Prime Minister's wishes. The difficulty for him was that the majority of Commissioners wanted to stay put and to keep their present portfolios. The position of the French Government was not untypical: President Giscard had told him that he would have preferred to change both his Commissioners but since he wished to hang on to the portfolios he would probably end up by keeping both M. Ortoli and M. Cheysson in post. This meant that M. Thorn had very little flexibility. Effectively the only portfolios which he seemed likely to have at his disposal would be Transport, Personnel, Social Affairs, Competition and Energy. It had been proposed that Agriculture and Fish might be separated, but M. Gundelach would not agree to this. M. Davignon would like to absorb the Energy portfolio. Although Industry and Energy would make a good pairing, M. Davignon perhaps had enough responsibilities already. (The Prime Minister made it clear that this was her view also). Generally, it would be sensible to cut down the number of Commissioners, particularly given the prospect of Greek, Spanish and Portuguese appointments. The Prime Minister agreed.

CAP

The Prime Minister said that it was essential to find a different way of financing the Community's agricultural surpluses.

/ It was

It was ridiculous to go on producing surpluses on the present scale, the more so since they had the effect of undermining the economies of agricultural producers elsewhere. The re-structuring of the CAP would, of course, be extremely difficult. It was therefore essential to stick to the 1% VAT ceiling. M. Thorn said that he agreed and knew that President Giscard was also determined to stick to the 1% VAT ceiling. It was essential to secure reforms in the near future. There was an enormous potential, e.g. in France, for increased agricultural production. If these increases were to occur before reform had been secured, it would become impossible to secure changes. It was symptomatic of the present difficulties that the Commission appeared to be about to propose agricultural price increases of 17% for next year. The Prime Minister said that no such proposal would get past the British Government. She would not even be prepared to accept price increases at half this level. M. Thorn said that he had hoped the Prime Minister might accept something between 6% and 8%. Luxembourg could live with increases of that order.

Community Budget

M. Thorn said that he hoped the main work on restructuring the Community Budget could be done during the U.K. Presidency. The Prime Minister said that she thought it would take longer. M. Thorn said that he envisaged that the Commission would put forward its proposals in July next year. It would, however, be necessary to do a great deal of preparatory work during the Dutch Presidency. He hoped to arrange a number of bilateral talks between the Presidency and members of the Community in the period March to June. His objective would be to ensure that whatever proposals were put forward by the Commission would be on lines that were at least broadly acceptable to the Community as a whole. He recognised that some of these informal contacts would have to take place before the French Election, but he saw no difficulty in that. Most of the work would have to be done by the next Commission since the papers under preparation by the present Commission seemed to be almost exclusively analytical.

/ The Prime Minister

The Prime Minister commented that most members of the Community would probably refuse to show their hand before the Commission had tabled its proposals. M. Thorn said this was certainly true as far as the French were concerned.

European Council

M. Thorn asked how the Prime Minister envisaged the agenda for the European Council meeting at Luxembourg in December. President Giscard had made it clear that he thought it would be inappropriate to discuss most of the major Community problems, e.g. unemployment, energy, the CAP and restructuring. He wanted a primarily political agenda. In M. Thorn's view this would be inappropriate and would not be understood by public opinion. The Prime Minister said that she agreed. It would be essential to have a general debate on economic issues. The problems of the CAP and on Budget restructuring could not be ignored. Nor could the problems being experienced by industry and trade, e.g. petrochemicals, cars, steel and the Multi-Fibre Arrangement. Mr. Jenkins should be encouraged to give a wide-ranging report which dealt with future problems as well as with the achievements of his Commission. There was no need to look for decisions. But the problems had to be identified and general directions laid down. M. Thorn said he fully agreed. He hoped that the Prime Minister would be prepared to argue for an agenda along the lines she had described. The Prime Minister added that if there was to be a discussion of this kind, particularly if there was to be a review of problems in the industry/trade area, she would see considerable advantage in having M. Davignon present.

Commenting more generally on European Council meetings, the Prime Minister said that she continued to think that three Summits a year was excessive. If there were only two a year, fewer decisions would be appealed upwards and more substance given to the work of the other meetings of Councils of Ministers. M. Thorn said that it would be difficult to reverse the present trend.

/ Middle East

Middle East

The Prime Minister asked M. Thorn for his assessment of the present situation in the Middle East. M. Thorn said that he did not think the United States could, on their own, find a solution to the Arab/Israel dispute. There was a role for Europe. However, Europe's policy should be neither anti-American nor "for the glory of Europe". Europe had in recent months played a necessary role in exerting pressure on Mr. Begin. We should continue to pursue a pragmatic approach analysing the problems and keeping in the closest touch with the United States as we went along. The Arabs were already aware of Europe's new willingness to assume a measure of responsibility for the problems of the area and welcomed this. The Prime Minister said she warmly agreed about the need to avoid drifting apart from the United States.

The Prime Minister asked M. Thorn for his impressions of Yasser Arafat. M. Thorn said he was not at all sure what to make of Arafat. He was certainly an able man and aware of all the aspects of the situation. He had been anxious in his meetings with M. Thorn to appear reasonable and flexible. Nevertheless he was also extremely ambitious and anxious to be a head of state. He had told M. Thorn that he would be content initially to have a 'handkerchief of territory' provided it was with full sovereignty. This had left M. Thorn with the impression that whatever he was given he would try to expand. He did not exclude confederation with Jordan as a final outcome but would insist on having sovereignty in the first instance. In response to a question from the Prime Minister, M. Thorn said that he did not think that Arafat was particularly close to Moscow. Certainly he claimed that he was not a Communist and never would be. He received the larger part of his financial backing from the Arabs. His link with the Communists stemmed from the fact that he had initially received the strongest and most unconditional support from Syria which was, of course, closely linked with Moscow.

The discussion ended at 1300.

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pps pc
(in Ortoli briefing folder)
Thanks
Phil

FINANCIAL SECRETARY TO THE TREASURY

CHANCELLOR

cc Sir D Wass
Sir K Couzens
Mr Hancock
Mrs Hedley-Miller
Mr Ashford

COMMISSIONER PORTFOLIOS

I have seen Mr Hancock's minute of 24 October, commenting on latest developments in relation to the allocation of Commission portfolios in advance of your meeting with Mr Thorn this morning.

If Mr Richard were to be given the aid portfolio, he would not be on our side. This alone is surely a powerful reason for not giving him it.

NL.

NIGEL LAWSON
27 October 1980

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CHANCELLOR OF THE EXCHEQUER

PSE PRODUCE

1 page summary

(see my notes)

of points for

ORTOLI.

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CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir D Wass
Sir K Couzens (or)
Mrs Hedley-Miller
Mr Ashford

MEETING WITH MR THORN: COMMISSIONER PORTFOLIOS

There have been some developments over the question of European Commission portfolios which you should know of before you see Mr Thorn on Monday morning. As you will have noticed, the UK nominations of Mr Tugendhat and Mr Richard have been announced. It is agreed that our first objective should be to secure for Mr Tugendhat (who will become the UK Vice-President) the portfolio for the Community Budget. The Prime Minister will be seeking to persuade Mr Thorn that Mr Tugendhat be given, under the President of the Commission, proper coordinating authority within the Commission on all matters with budgetary implications (including, although she may not say so, the budget re-structuring exercise).

2. You will recall that we had identified three possible portfolios for our second Commissioner: development, industry and competition. Both you and the Financial Secretary expressed a preference for competition or failing that industry and felt that development should have third place.

3. However, Mr Richard has expressed a preference for development. As a former Ambassador in New York, he is of course well qualified to deal with this subject. He may have a wider motive. He sees his role as being primarily to keep the Labour Party interested in Community membership; and from that point of view the development portfolio would be quite a suitable base.

4. Partly for this reason, and partly because we do not believe we would have any very serious difficulty in securing the competition portfolio if we made an all out effort to get it, the Prime Minister has been briefed to mention all three of the portfolios as possibilities to Mr Thorn without expressing a preference between them at this stage.

D.H.

24 October 1980

D J S HANCOCK

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COVERING CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir K Couzens
Mr Hancock
Mrs Hedley-Miller
Mr Ashford
Mr Edwards

VISIT OF PRESIDENT - ELECT THORN AND COMMISSIONER ORTOLI

Mr Thorn, the President-elect of the European Commission, is calling on you at 10.15 a.m. on Monday, 27 October. He will subsequently be seeing Lord Carrington and having lunch with the Prime Minister. He will be accompanied by M. Dondelinger, the Luxembourg Permanent Representative to the EC, M Kasel, a Luxembourg official, and M Hastert, the Luxembourg ambassador in London. Sir Michael Butler and Mr Hancock will also be present.

2. Following a conversation that you had with him in Washington, M Ortoli is coming to see you at 4 p.m. on Tuesday, 28 October. We do not yet know who will be accompanying him, but Sir Kenneth Couzens will be attending on the UK side.

3. Mr Ortoli has specifically asked to talk about the EMS and budget restructuring. Mr Thorn will also wish to discuss the budget review, since it is the main task awaiting the new Commission when they take office.

4. I attach briefing on both topics. The brief on restructuring consists of a copy of the brief prepared for the use of all UK Ministers in their talks with M. Thorn, together with a note of a few points which might come particularly appropriately from you. All the points are suitable for use with both visitors.

5. The full brief on the EMS is designed for your conversation with M. Ortoli. M. Thorn will not be expecting a lengthy exchange of views on this subject, and in his case you will wish to draw selectively on the points in the brief, as appropriate.

J A Thomson

J A THOMSON
24 October 1980

THE EMS

M. Ortoli is unlikely to raise technical issues requiring detailed background information. The following brief is therefore in the form of speaking notes.

2. It is not at all easy to discuss the exchange rate aspects of the EMS from a medium term perspective. It is hard to look into the future where exchange rates are concerned.

1 3. The exchange rate mechanism has certainly had a successful start. It has perhaps been surprisingly stable, given the differentials in inflation rates. The relative weakness of the Deutschmark, which had been expected to be so strong as to be potentially disruptive, and which did cause problems early on when it climbed quickly from low down to top position, has no doubt helped. Thirteen months without any major realignment is an achievement : much better than the snake in its final year.

4. The divergence indicator system has not played nearly as prominent a role as had been foreseen when we were working out the exchange rate mechanism. But in the period ahead the UK would be inclined to leave the arrangements as they are. There are no
2 clear pointers to improvements. But of course we are ready to discuss ideas for change if there are strong views to the contrary.

5. So far as concerns sterling and the exchange rate mechanism,
3 we cannot escape the conclusion that we have been right to stand aside. If sterling had been in the margins scheme it might perhaps have behaved differently. But probably not. An appreciation of some 20% compared with the average of the other EMS currencies reflects very strong upward pressure indeed, which could probably not have been avoided. While the Government is wrestling with the control of the monetary aggregates, the idea of massive intervention is disquieting. Success in this area 5

What does he think? 4

is of interest to the Community as a whole, not just for the UK. The alternative of constant realignments would be equally disquieting for all. We are not looking for delay in joining the arrangement. But we still cannot see when the time will be ripe. (6)

Does he?

(7) 6. Looking further ahead, the interesting development are likely to be on the development of the ECU and the European Monetary Fund (EMF). These two are interlinked. The discussion of the Informal Meeting of Finance Ministers in Luxembourg recently suggested that most member Governments do not want to go ahead too fast on the EMF. This is understandable. One version could have the characteristics of a central bank for the Community, with responsibilities for exchange market intervention which would in turn impinge significantly on domestic monetary policy. This raises very far reaching constitutional issues indeed. A rather different approach might set up an EMF broadly on the lines of the IMF. This too would have a bearing on the development of the ECU, which would be provided as the form of credit, and would therefore also raise important questions as to where the powers of decision-making would lie. We would have to consider carefully whether an EMF on these lines posed too much of a threat to the IMF itself. These matters are complex. They are being studied by the Monetary Committee and Central Bank Governors, but they have not yet been placed before Finance Ministers. We would be very happy to hear how M. Ortoli envisages developments in the future. But HMG has as yet no firm position.

Questions

(A)

or

(B)

N.B.

Meanwhile

(8) 7. Perhaps it is realistic to suppose that the big decisions will have to continue to be avoided for a while longer. If so this probably means that the present system for issuing ECUs, which is against the deposit of 20% of reserves on a 3 month renewable swap basis, would have to be continued when it expires in March (ie two years after the EMS entered into force).

8. But this need not mean standstill, and the UK would be sorry if the work in this area were not pursued. The UK is certainly playing its full part in the present discussions in the Monetary Committee. One practical way of moving forward may be to foster ECU denomination of loan issues. The Commission is keen on this. It may need patience, and there should not be repeated experiments if the issues are not well received in the markets. But with patience and care it should pave the way for one of the more important possible developments of the ECU in the medium-term, which would be as part of a multiple reserve asset system. We will study all this with great care and interest.

9

Defensive Points (if raised)

9. I do not believe that the inclusion of sterling in the ECU basket, while the UK does not participate in the exchange rate mechanism, has significantly affected the way the EMS operates. There may have been some small technical problems with the divergence indicator, but I think that these could be easily resolved if the other member states so wished. Meanwhile the present arrangement has the advantage of keeping the door open for UK membership of the exchange rate mechanism at any time.

10. I do not believe that our absence from the exchange rate mechanism has any important effect on the establishment of the EMF. In the numerous technical studies which have been undertaken on the EMF I know of no problem that could be related to the absence of one member state from the exchange rate arrangements.

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COMMUNITY BUDGET RESTRUCTURING

Points to Make

1. You are grateful for the part that M. Thorn personally has played in securing a speedy passage for the regulations giving effect to the 30 May agreement. The UK particularly appreciates his success in persuading the European Parliament not to press for conciliation, which would have held up the implementation of the agreement in a way which would have been politically most awkward for the UK.

2. As M. Thorn will appreciate, the UK's net contribution to the Community Budget is a very sensitive subject in Britain. It is inconceivable that any UK Government could have contemplated making a net contribution of the size of that which, in the absence of the agreement, would have faced Britain in this and subsequent years. Even after the agreement, the UK remains the second largest net contributor: a position so out of keeping with our relative prosperity that it is doubtful if it is politically tolerable as more than a stepping-stone to a more equitable state of affairs.

3. A reduction in the share of national income pre-empted by Government and tight control of public borrowing are central to the Government's policy for reducing inflation and revitalizing the UK economy. This strategy involves painful cuts in public services. It is highly damaging to the Community's popular image in the UK if opponents of Britain's membership can plausibly suggest that these cuts could have been less severe but for the UK's continuing net contribution to the Community Budget.

4. That is why it is particularly important for the British Government that the review provided for in the 30 May agreement should put the UK's financial relations with the rest of the Community permanently on a footing which the majority of reasonable Britons would regard as fair and equitable. Without such an outcome, Community membership

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will remain a running sore in British politics, to the detriment of the UK and her partners alike.

5. But the risk of disaffection on the part of the British electorate is only one of the risks that the Community runs if it fails to put its house in order. The CAP may collapse under the weight of the surpluses it generates. Without adequate re-structuring, the additional strain of enlargement might prove too much for the Community's creaking budgetary arrangements.

6. The UK is an anxious as anyone to find a genuinely communautaire solution to these problems, which are problems for the Community, not just for Britain. We would much prefer it if our problem could be solved without resort to ad hoc measures of the sort agreed for 1980 and 1981. We are ready to discuss constructively any ideas that others may put forward, provided that they do not involve an increase in the 1% VAT ceiling. But it is essential that the unacceptable situation that the 30 May agreement staved off should not be allowed to recur.

7. The risk which faces the Community, and the incoming Commission, is not an easy one. But we believe and hope that everyone in the Community now recognises how vital it is. Britain will do all it can to help to carry it to a successful conclusion. We would welcome any ideas that M. Thorn may have.

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VISIT OF M THORN: 27 OCTOBER

BRIEF 2B: RESTRUCTURING OF COMMUNITY BUDGET
POINTS TO MAKE

1. Commitment to review major turning point in Community development. Valuable opportunity to set house in order. Make full use.

2. Cannot be shirked. Triple challenge of:
   (a) 1% VAT ceiling;
   (b) enlargement;
   (c) commitment to avoid unacceptable situation.

3. UK preliminary thought. Approach open minded. Exploratory stage.

4. Must keep to timetable i.e. Commission paper by June; aim at solution by end 1981. Otherwise likely dislocation of Community business. Commission proposals in good time.

5. UK committed to finding Community solutions to Community problem.

6. Fundamental problem: rapid growth/dominance of CAP; stunted growth of other policies. Former must be controlled to make room for latter within 1% ceiling. Must also ensure pattern prevents recurrence of unacceptable situation.

7. Must find solution within 1% ceiling. Raising unacceptable to number of Member States but would also make problem worse. If breached no effective constraint on CAP spending; cost of enlargement; UK net contribution larger.

8. Important that decisions affecting 1981 budget (especially price-fixing) should not prejudice finding of long-term solution.

Agriculture

9. Commission proposals on Agriculture will set tone and scope. Important they are widely framed. No use shutting off options before Member States have had chance to discuss.

10. Must cut cost of CAP and reduce surpluses. They undermine Community finances and political support for Community.

11. Do not question principles and objectives of CAP, but structural

/surpluses

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surpluses and problems must be tackled to prevent collapse of CAP.

12. Broad objectives of reform should be:

(a) elimination of structural surpluses, especially milk;

(b) reduction in CAP's share of budget;

(c) progress towards market clearing prices;

(d) preservation of healthy agricultural industry.

13. Believe central element must be policy of severe price restraint. Prepared to consider combining it with direct aids to help those hardest hit. Freeze

14. Recognise restraint itself unlikely to be sufficient. Ready to consider how it can be supplemented. Already Council commitment in principle to super levy for milk. For cereals price support must relate to volume of production. For beef, intervention should be reduced. Quantitative restrictions appropriate for other commodities eg. Mediterranean products.

15. Opposed to across-the-board extension of basic co-responsibility levy principle. Avoids tackling central problem.

16. Strongly support reduction of CAP's share of budget as medium term objective. Finance Ministers should consider urgently in relation to 1981. Syncronisation of price-fixing and budget procedures might help.

17. <u>1981 Price fixing</u>: must not prejudice restructuring. Rumours of 8-10% totally unacceptable. Hope Commission proposals will be set at realistically low level. Surplus products should be treated more severely.

18. <u>A New Stresa Conference</u>: (if raised). Not averse to such an approach. Need to be carefully prepared. CAP reform only one part of restructuring. Conference would presumably need to cover all aspects?

<u>Non-Agricultural</u>

19. If CAP cut, scope for <u>expansion of RDF/Social Fund</u> and possibly <u>new policies</u>. UK approach <u>positive</u>. Outstanding proposals: coal,

/structural

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Structural measures for transport, fisheries.
New policies: urban/industrial decay; energy.

20. These policies cannot solve problem by itself. Massive budget expansion would be needed.

21. Role in preventing unacceptable situation only effective if preponderantly beneficial to States likely to find themselves in this situation.

21. Revenue side: changes should be considered. May not be possible to avoid unacceptable situation by action on expenditure alone.

22. No doubt Commission will consider French/German idea of ceiling on net benefits/contributions.

/ESSENTIAL FACTS

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ESSENTIAL FACTS

1. UK preliminary work: papers produced by Departments cover most of the ground. No firm conclusions but clear that if unacceptable situation to be avoided, combination of measures will be needed. Important at this stage not to rule out possibilities.

2. Commission preliminary work: present Commission is to produce line by line examination of budget, detailed papers on CAP and on other major spending policies. Will prepare groundwork but leave new Commission to come forward with proposals. Useful to sow in M Thorn's mind idea of retaining wide range of proposals.

3. Timetable: present deadline set in para 7 of 30 May Council Agreement (i.e. Council will attempt to solve problem by structural changes but if this not possible proposals along lines of 1980/81 solution will be put forward to cover 1982). German public position is still that review must be complete by end 1981 though Schmidt earlier indicated privately that he thought early 1982 more realistic. Our interests best served by sticking to letter of 30 May Agreement (i.e. initially in favour of end 1981 deadline).

4. 1% VAT ceiling: French and Germans support UK view on maintenance of ceiling. Raising would make problems more difficult since it would open sluice gate for more agricultural spending.

5. CAP Reform
This is a useful opportunity to outline our preliminary thinking and impress on M Thorn the importance of the Commission initiating a wide ranging debate on CAP reform presenting a series of options to the Council rather than putting forward a single recipe. It will also be important to convince M Thorn that the Commission proposals for 1981/82 agricultural prices must not prejudice the restructuring exercise. (There have already been rumours that Gundelach is contemplating increases of 8-10%). We need to disabuse M Thorn of the idea that we could accept increases of this dimension.

6. When he saw the Secretary of State early this year, M Thorn suggested that one possible way for the Community to deal with CAP reform might be the convening of a new Stresa Conference. This was the conference held in July 1958 as required by Article 43 of the Treaty to draw up the detailed rules and regulations of the Common Agricultural Policy. We have no over-riding objection to the idea of a conference, but it is not clear what it would achieve particularly as restructuring goes wider than CAP reform. It is not yet clear whether M Thorn will still wish to pursue this idea.

7. Non-Agricultural: various proposals in existence. UK proposals for Community policy to encourage indigenous production of coal - others have blocked because benefits UK disproportionately but this is precisely kind of policy we must have if unacceptable situation to be avoided. Moreover their argument is based on "juste retour" for each Community policy - contrary to their

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position in the budget negotiation. Other proposals on the table : structural measures in fisheries/transport infrastructure. Neither would bring significant benefit to UK in present form but both offer potential . New policy areas: urban/industrial decay, energy. Considerable potential. Would be useful to sound out whether M Thorn has any particular suggestions/preferences.

8. <u>Enlargement</u>: likely to bring further problems in that acceding States will have significant call on funds which at present benefit UK (RDF/Social Fund). If Commission follow line taken over Greece's share of RDF, UK could become net contributor to both these.

9. <u>Revenue side</u>: possibility of change should not be ruled out. Likely to prove <u>difficult to avoid</u> unacceptable situation without some means of bringing level of gross contributions into line with GNP share.

10. <u>Ceiling on net benefits:</u> French/German idea has not been filled out yet. This could be important as negotiation develops because promising area for UK if idea of override mechanism gained ground. However , we must be careful not to get into lead in proposing this: will be seen clearly as dictated by self-interest with risk of isolating us in negotiation. At present most we should do is to encourage Commission to look further into French/German idea.

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IRENE RIPLEY

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