TREASURY

Part A

Part A

FILE NUMBER PO-CH/GH/0195

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Dinner With Regan

12/4/81

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1981				

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THIS FOLDER HAS BEEN REGISTERED ON THE REGISTRY SYSTEM

T.R.1.

LUNCH AT 11 DOWNING STREET ON SUNDAY 12TH APRIL AT 12.45 FOR 1.00 P.M.

Sir Geoffrey and Lady Howe - Chancellor of the Exchequer

Mr & Mrs Donald Regan - US Treasury Secretary

Mr Beryl Sprinkel - Private Secretary to Mr Regan

Mr & Mrs David Howell - Secretary of State for Energy.

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CHANCELLOR OF THE EXCHEQUER

cc Sir Kenneth Couzens
Mr Atkinson
Mr Mercer

LUNCHEON WITH US TREASURY SECRETARY, 12 APRIL 1981

Our Embassy provided, for Sunday's meetings, a note on President Reagan's economic programme and the outlook for the US economy. (Copy attached for ease of reference).

2. Mr Regan will want to hear from you about your own recent Budget. The G5 briefing is being submitted to you under a separate note.

3. For completeness, you may care to have the attached copies of the most recent monthly economic reports from France, Germany and Japan. These are long, but you would need only to read the first page or so of each.

4. I attach also a copy of Mr Sagami's letter of 29 December to Sir Kenneth Couzens, about the Japanese Budget, for which you asked, following the Finance Minister's reference to this in his recent response to your message to him about your Budget. The Japanese plan for 5.3% growth in 1981, which would be helpful so long as it was not secured mainly on the back of exports to the rest of us. Mr Sagami says - third paragraph of his letter - that export growth will slow down and imports will increase. But this remains to be seen.

5. The growth signals have however been disappointing : hence the lowering of the discount rate, and addition to public expenditure, referred to in the reporting telegram. (The more public expenditure in Japan the better, but they are fanatical about limiting public borrowing).

MHM

MRS M HEDLEY-MILLER
10 April 1981

Clerks

For G5 briefing pps
(BF 9/4)

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JW
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BRITISH EMBASSY
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Washington, D.C. 20008
Telephone: (202) 462-1340

30 March 1981

A J Wiggins Esq
Principal Private Secretary
 to the Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1P 3AG

Dear John,

NOTE ON THE US ECONOMY

David Hancock mentioned to John Anson that the Chancellor would welcome a note on the US economy prior to the next meeting of G-5, including an assessment of the economic prospects here. Such a note is enclosed, including what must be regarded as a speculative assessment of the prospects.

2. The note does not contain any reference to the remarks which Treasury Secretary Regan made before a House of Representatives Committee while the Prime Minister was here. Ken Couzens wrote to Beryl Sprinkel about this (copy attached). We have not seen any acknowledgement of this letter and we do not have any direct evidence that it was copied by Sprinkel to Regan (although others in the US Treasury, including Deputy Secretary McNamar, have seen it). Since the Chancellor did not choose to communicate directly with Secretary Regan about this, we have not pressed the point here. It is nonetheless reasonable to assume that the US Treasury will have briefed Regan accurately on these and other points relating to the UK economy before the G-5 meeting.

Yours ever,
Harry

H G Walsh

Encs:

c.c. D J S Hancock Esq
 H M Treasury

 A R H Bottrill Esq
 HM Treasury

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PRESIDENT REAGAN'S ECONOMIC PROGRAMME AND THE OUTLOOK FOR THE US ECONOMY

1. This note briefly describes President Reagan's economic programme, its chances of being implemented, and the outlook for the US economy and the Administration.

Programme for National Recovery

2. The programme for economic recovery announced on 18 February has four elements:

(i) A reduction of one-tenth in personal income tax rates each year for the next three years; and a reduction in the periods over which companies can write off different categories of capital expenditure for tax purposes;

(ii) a substantial reduction in the Federal expenditure leading to a balanced Federal budget by FY84;

(iii) a commitment to contain the growth of the Federal regulatory burden and eventually to reduce it;

(iv) a reduction in the rate of growth of the main monetary aggregates to one-half of 1980 levels by 1986.

The main budget figures are set out in Tables 1 and 2 attached. Statistics about monetary policy are contained in Table 3 while the Administration's economic assumptions are compared with outside forecasts in Table 4.

3. The primary objective of the tax cuts is to increase the incentive for individuals to work and save and for business to invest; of the expenditure cuts to reduce the budget deficit and (together with deregulation) limit the role of the Federal Government; and of monetary restriction to reduce the rate of inflation.

4. The extent to which the proposed tax reductions for individuals will produce significantly higher incentives in the way that has been claimed is however questionable for two reasons. First, some two-thirds of them are required simply to offset fiscal drag over the next three years. Second, some of them may be offset by tax increases at state and local level to finance increased state and local expenditure stemming from the fact that Federal assistance is proposed to be reduced. Accelerated depreciation allowances should however have the early effect assumed now that they, and their 1 January 1981 date of implementation, have been specified. It is known that some companies have held up investment decisions because of uncertainty about tax position.

Prospects for Implementation

5. As far as FY82 is concerned, the prospects for the implementation of most of the programme are good. On expenditure, influential Democrats such as Congressman Reuss believe that about three-quarters of the expenditure reductions will be passed in the House, and the signs

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are that the Senate might pass them all (or similar cuts of the same size). Deregulation is popular and the Administration will pursue this enthusiastically. Mr Volcker is determined, almost as a matter of personal pride, to contain monetary growth within the targets for M1A and M1B that have been reduced by ½% for 1981. The acceleration of depreciation allowances should be enacted pretty well as proposed. The prospect for an income tax reduction as proposed is less clear. But some reduction in personal taxation, perhaps basically similar to the proposed cut, should be enacted although Chairman Rostenkowski of the the House Ways and Means Committee (a Democrat) would wish to angle the benefit of reductions away from the better off.

6. In the longer term, the outlook for the programme is more difficult. A three-year personal tax reduction will probably not be passed this year. The prospects for personal tax reductions beyond 1982 would therefore seem to depend on the prospects for reducing the Budget deficit, which are almost certainly not as good as the Administration claims. The further reduction of public expenditure beyond 1982 is going to be very difficult. Defence, debt interest, and the social "safety net" programmes which the Administration have undertaken to protect, amount at present to about 70% of the Federal Budget. On the Administration's own figuring, if these programmes continue to be protected, the remaining Federal programmes will need to be cut by about one-quarter (in money terms) between 1981 and 1984. The Congressional Budget Office estimate that even this would not be enough if the Administration's assumptions about prices and interest rates are wrong: on different assumptions a further $29 billion in cuts would be required by 1984 in order to meet the Administration's target.

Prospects for the US Economy

7. During the course of 1981 the US economy will increasingly experience a fiscal squeeze, equivalent to some 1-1½% of GNP, resulting from the January 1981 increase in social security contributions, higher revenues from the oil windfall profits tax (following price decontrol) and income tax "bracket creep". In addition, the monetary base has remained almost unchanged for 4 months, and the effect of this will be working its way through. Industrial output already shows signs of slowing down. Without the President's programme, most commentators predict that the economy would be likely to stagnate or even experience a quarter or more of decline later in 1981. The programme incorporates a public expenditure reduction in FY82 of $49 billion, while budget receipts are estimated to be reduced by $57 billion in that year. Since the programme is only mildly expansionary, there seems little prospect of rapid economic growth before the end of calendar 1981. Neither are most of the main econometric forecasting services predicting a significant reduction in inflation. While they are also not predicting a significant reduction in interest rates by the end of the year, most commentators agree that the short-term outlook (at least to the autumn) is for some further decline in short-term rates.

8. Comparisons of the Administration's economic "assumptions" and the main econometric services' forecasts in Table 4 indicate

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that there remains a wide dispersion of views about the prospects for 1982 and beyond. These differences appear to relate to differing assumptions about the Fed's policies, to the uncertainty surrounding the economic impact of the tax changes, and to differing views about the role of expectations in stemming inflation. The greatest differences arise in the prediction of inflation. Merrill Lynch and the Administration both expect that inflationary expectations will be adjusted downward fairly rapidly as a result of the implementation of the programme. More conventional models give results that reflect a slower lowering of expectations which they link to past inflation rates.

9. The Administration have assumed that the main effects of monetary restraint will be on prices and not on output. The Administration have not published any estimates of what this implies for monetary velocity of circulation. But calculations are set out in Table 3 which show that a clash between monetary policy and the growth objective is clearly possible in 1982, given an unrealistic projected velocity of circulation for M1A and M1B by historical standards. The outlook therefore may be for high interest rates in FY82 if economic expansion resumes.

The Administration

10. Unquestionably the most important person involved in economic policy below the President so far has been Mr David Stockman, Director of Management and Budget. Without his drive and detailed knowledge of public expenditure programmes, the Reagan programme could not have been put together in such a short space of time and vital impetus would have been lost. The Treasury team have generally performed distinctly less well. Secretary Regan has not yet managed to imprint his views on economic policy and is hampered because two of his Under Secretaries, Mr Beryl Sprinkel (a monetarist) and Mr Norman Ture (a supply-sider), firmly hold disparate views. Beneath the surface, there are signs of disagreement between Mr Sprinkel and Mr Volcker both on monetary techniques and on policy. Mr McNamar, the Treasury Deputy Secretary replacing Mr Carswell, has however played a more effective role in policy areas than was originally thought likely. Chairman of the Council of Economic Advisers Weidenbaum, although he was appointed late, appears to be acting as a mediator between the extremists of different doctrines. In specifying the Administration's scenario, it was reportedly he who played a key role in reaching a compromise.

11. The Administration has not yet focussed its attention on international economic policy to the same extent as on the domestic economy. An assessment of their approach will not be possible until international economic policy has been reviewed by the Cabinet Council on Economic Policy, which will take at least a couple of months. But from the few clues available, it will probably be directed towards protecting US national interests within a free market context. The US dollar will be allowed to float free, and the Administration will take a restrictive view of multilateral foreign aid and will seek to direct bilateral aid so as to secure political objectives.

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TABLE I SUMMARY OF PROPOSED CHANGES IN FEDERAL OUTLAYS FY82[a] ($m)

	Sub-total (items over $1000m)	Total
Office of the President	-	602
Department of Agriculture	-	4,628
- Food stamps	2,304	-
- child nutrition	1,243	-
Department of Commerce	-	664
Department of Defence(b)	-	1,298
Department of Education	-	1,656
Department of Energy	-	3,682
Department of Health and Human Services	-	7,424
- Health grant consolidation	2,315	-
- Social security minimum benefits	1,000	-
- social security student benefits	1,000	-
Department of Housing and Urban Develo- ment	-	1,065
Department of Justice	-	121
Department of Labour	-	6,406
- Public service employ.progs.	3,454	-
- Trade adjustment unempl.benefits	1,150	-
Department of State	-	224
Department of Transportation	-	1,723
Department of Treasury	-	4,513
- payment of outstanding business tax liabilities	3,493	-
Environmental Protection Agency	-	426
NASA	-	469
Veterans Admin	-	691
Other independent Agencies	-	2,740
TOTAL ON-BUDGET SAVINGS	-	40,310(d)
Federal Financing Bank		4,722
Rural electrification and telephone	1,152	-
Farmers Home Administration	1,698	-
Student loan marketing Association	1,423	-
TOTAL SAVINGS	-	45,032(c)

(a) Reductions from the January 1981 budget proposed by President Reagan or 10 March 1981.

(b) Defence makes a contribution to savings although overall its outlays are increased.

(c) $13.4 bn of this total reflects reductions in Federal grants to State and Local Governments.

(d) These savings together with $8.2 bn of savings that were also included in President Carter's January budget, sum to the $48.6 bn on-budget savings proposed by President Reagan for FY82 (see Table 1).

UKTSD
26 March 1981

TABLE 2: PRESIDENT REAGAN'S FEDERAL BUDGET TOTALS 1980-1986 ($bn)

		Actual 1980	FY81	FY82	FY83	FY84	FY85	FY86
Revenue:	Current services basis	520	608.8	701.6	806.2	915.5	1032.0	1157.9
	Contribution of:							
	- Income tax reductions	-	-6.4	-44.9	-81.4	-118.1	-141.5	-162.4
	- Depreciation reform	-	-2.5	-9.7	-18.6	-30.0	-44.2	-59.2
	March 1981 Revised Budget	520	600.3	650.3	709.1	770.7	849.9	940.2
	Revenue as a %age of GNP	20.3	21.1	20.4	19.7	19.3	19.3	19.5
Outlays:	Current policy base[(a)]	579.6	657.8	729.1	792.1	849.0	911.0	972.8
	Contribution of:							
	- identified outlay savings (see Table 1)	-	-6.4	-48.6	-67.2	-81.2	-92.8	-102.7
	- additional savings yet to be proposed	-	-	-	-29.8	-44.2	-43.7	-42.7
	March 1981 target ceiling	579.6	655.2	695.3	732.1	770.2	844.0	912.0
	Outlays as a %age of GNP	22.6	23.0	21.8	20.3	19.3	19.2	19.0
Budget Balance:	March 1981	-59.6	-54.9	-45.0	-22.8	0.5	5.8	28.2

Source: Budget revisions for fiscal year 1982, Tables 1, 2, 5 and 7. 10th March 1981

(a) The current policy base estimated by the Reagan Administration is the level of outlays with no changes to current programmes or service levels, using current economic assumptions. However, defence purchases and foreign aid are included in the base in the ammounts in the Carter Administration budget, of January 1981

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TABLE 3: MONETARY POLICY

A. Monetary growth (%)

Fourth quarter to fourth quarter	M1-A[a]	M1-B[a]	M2	M3	Bank credit
1978	7.4(7.9)	8.2(8.0)	8.4	11.3	13.3
1979	5.0(6.7)	7.7(6.8)	9.0	9.8	12.3
1980	5.0(6.3)	7.3(6.7)	9.8	9.9	7.9
1981 target	n.a. (3 to 5½)	n.a. (3½ to 6)	6.0 to 9.0 -	6½ to 9½ -	6 to 9 -

B. Nominal GNP growth (%)

	Year to Q4/1981
Federal Reserve Board (25.12.81)	9-12
Administration (10.3.81)	11.0
Wharton Econometrics (4.3.81)	13.5

C. Implied velocity growth (% p.a.)

Fourth quarter to fourth quarter	M1-A[a]	M1-B[a]	M2	M3	Bank credit
1960-79 - ave.	3.3	3.1	-0.1	-0.8	-0.4
- range	-0.3 to5.8	-0.3 to 5.8	-3.5 to 4.6	-4.6 to 5.0	-2.2 to 2.5
1980	4.3(3.0)	2.1(2.6)	-0.3	-0.4	1.5
1981[b]	n.a.(6.5)	n.a.(6.0)	3.3	2.8	3.3
1982[c]	n.a.(8.7)	n.a.(8.3)	5.4	4.9	5.4

(a) Numbers in parenthesis are adjusted for the estimated impact of shifting to ATS and NOW accounts from other assets, and should give a better indication of the underlying trend of monetary expansion.

(b) Uses the Administration assumptions of an 11% growth in nominal GNP and the mid-point of the Federal Reserve Board's target range.

(c) Uses the Administration's assumption of a 13.3% growth in nominal GNP for the year to the fourth quarter of 1982 and the mid-point of the Federal Reserve Board's (FRB) target range for 1981. If the FRB were to reduce the target range for 1982 the implied velocity growth would be correspondingly higher.

UKTSD
26 March 1981

TABLE 4 Selected Major Economic Indicators

	1980*	1981	1982	1983
Real Gross National Product, 1972 dollars (percent change)				
Administration	- 0.1	1.1	4.2	5.0
Chase	- 0.1	1.2	3.5	3.9
DRI	- 0.1	1.3	2.9	3.0
Merrill Lynch	- 0.1	0.6	4.9	6.0
Wharton	- 0.1	2.2	2.4	3.1
GNP Deflator (percent change)				
Administration	9.0	9.9	8.3	7.0
Chase	9.0	11.4	9.7	8.4
DRI	9.0	10.0	9.7	8.6
Merrill Lynch	9.0	9.5	7.1	6.0
Wharton	9.0	11.9	10.6	9.1
Unemployment Rate (percent)				
Administration	7.2	7.8	7.2	6.6
Chase	7.2	7.8	7.5	6.5
DRI	7.2	7.5	7.3	7.8
Merrill Lynch	7.2	7.8	7.3	5.8
Wharton	7.2	7.5	7.7	7.7
91 day Treasury Bill Rate (percent)				
Administration	11.4	11.1	8.9	7.8
Chase	11.4	13.2	11.2	10.6
DRI	11.4	13.0	13.8	12.2
Merrill Lynch	11.4	11.2	7.2	6.6
Wharton	11.4	14.0	15.0	13.0
Money Supply -M1-B (percent change fourth quarter on fourth quarter)				
Administration	NA	NA	NA	NA
Chase (yr.on yr.)	6.4	7.9	8.3	8.2
DRI	7.3	7.3	6.4	5.8
Merrill Lynch	7.3	8.3	7.2	9.2
Wharton	7.3	6.9	7.0	7.0

NA = Not Available
* = Actual

The forecasts are those reported by:

i. Chase Econometrics, February 1981
ii. Data Resources Inc., February 25 1981
iii. Merrill Lynch Economics, February 19 1981
iv. Wharton Econometric Forecasting Associates, March 4 1981

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Sir Kenneth Couzens KCB
Second Permanent Secretary
Overseas Finance

3 March 1981

PERSONAL

Mr Beryl Sprinkel
Under Secretary Designate,
Monetary Affairs
US Treasury
15th Street NW
WASHINGTON DC 20020

Dear Beryl

You may have heard that what Secretary Regan said to a Congressional Committee about Mrs Thatcher's economic policy on 27 February probably received more publicity in the UK than it did in the United States. It was reported prominently in the Financial Times and the Times, and on the radio.

2. The only transcript I have so far received comes from the British Broadcasting Corporation. If this transcript (attached) is correct, I am afraid that the Committee heard one or two mistakes of fact. Since, as has been repeatedly said during Mrs Thatcher's visit to the United States, the main thrust of the economic policies of our two governments is so similar, it would be a pity if either side misunderstood what the other was doing or trying to do, or were misinformed about the environment in which the attempt was being made. So I hope you will forgive me if, with the Chancellor's agreement, I send you one or two corrections.

3. First, the proportion of the working population in Britain which, on the widest possible stretch of the term, could be regarded as working for government is 30%, not 60%. This includes everybody working for any kind of local authority and the employees of all state-owned industries and of the National Health Service. The great majority of them are not working for the Government, though they are in the public sector.

4. Secondly, Mrs Thatcher's Government reduced the top rate of tax on earned income from 83% to 60% and on investment income from 98% to 75%. They did this in their first budget a few weeks after taking office. They also raised substantially the levels of income at which these maximum rates were reached.

5. Thirdly, they did not try to control the foreign exchange markets. The reverse is true. They completely abolished all exchange controls after 40 years in the autumn of 1979 and they have permitted the exchange rate to be determined strictly by market forces. They did not join the exchange rate arrangements of the European Monetary System. So it is hard to say that "their efforts to control the foreign exchange markets were unsuccessful". As believers in market forces, they didn't make any.

6. Fourthly, "they ruined their export trade" is a bit of an over-statement. British exports had to be achieved in a harsher environment. But the volume of British exports rose 1.75% in 1980 over 1979 and their dollar value increased by 27½%. For comparison, the value increase of Japanese exports in the same period was 25% and of US exports 22½%. And value is what pays the import bill and looks after the current account.

7. Fifthly, the story about the high pay increases (so-called Clegg increases, after the Committee which recommended them) in the public services in 1979 needs correction. Mrs Thatcher decided she must honour the pledge of the preceding Government on these increases, though she would certainly say they were excessive and damaging, especially in 1980. It is incorrect to say that the workers who received these "catching up" increases were not highly unionised. They were in fact all completely unionised and negotiated on a national basis.

8. As you know, everyone in Government in Britain greatly hopes that the programme of your Government will succeed. It is in the interests of the whole Western world that it should and Mrs Thatcher has already applauded the principles on which that programme is constructed. We all recognise that in our parallel efforts we are coping with disadvantages you do not have: a higher rate of inflation to begin with; a much bigger public sector, with several major nationalised industries; much more unionisation, especially in the public sector; a much weaker economy at a lower level of productivity; and the need to make a start with the programme at the onset of a major oil price increase and recession instead of after the worst had passed.

9. So there are good structural reasons why the struggle ought to be easier for you than it is for us. But it is unhelpful, and also unrealistic to suggest that we have failed because of policy mistakes whereas you won't because you won't make any. Our Government does not accept that it has failed, as you will have gathered from Mrs Thatcher. We have after all reduced our rate of inflation faster in 1980 than any other major country. Anyway, as our Chancellor remarked, Finance Ministers have to stick together. They don't have many other friends when the going gets rough!

10. We much look forward to seeing Secretary Regan and yourself in London on 12 April - if not sooner.

My best regards. Yours sincerely

Ken Couzens

K E COUZENS

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DONALD REGAN'S CRITICISM OF MRS THATCHER'S ECONOMIC POLICY

Transcript from BBC Radio 4, Today, 27 February 1981

PROGRAMME PRESENTER: .... He was giving evidence to a Congressional Committee and was asked what mistakes the British Government had made in the economic sphere. Well he took a deep breath because he had an awful lot to say about this:

REGAN: ...... nonetheless, when Mrs Thatcher and her Party came into power practically 60% of the population in Gt Britain in one form or another was working for the Government. Luckily we don't have that in this country. And at the same time Mrs Thatcher was faced with a rate of inflation that was even greater than we have today. She also admits that the tax cuts that she proposed were not nearly as great as perhaps they should have been. You will recall that in the so called unearned income area her suggestion was from 93% down to about 80%, and in the earned area from 83% to 63%. But having done that they then raised the value added tax, VAT, there wasn't that much incentive therefore in her tax cuts in order to get her economy really started again. One other feature that happened at that time; they tried to control the foreign exchange markets. Their efforts were not successful. As a result, what happened brought the £ really up in value. So high in fact that they ruined their export trade. Therefore the programme that she had designed did not produce the stimulative effect that she wanted. Now right after that there were a large number of workers who were not highly unionised, who had not had pay increases to the equivalent of what some of the highly unionised areas of the country had. She gave pay increases in the neighbourhood of 22 to 28% within the first year of being in Government. This had to have an explosive inflationary effect. Now contrast that with what we're trying to do. What we're trying to do here is to give incentive tax cuts right across the board and to bring down, over a 3 year period, unearned income to the 50% range. At the time we're doing this this has a great impact on our capital/gains situation, it gives greater incentive to save, to invest. We are also really deeply into budget cuts. And the Budget cuts are going to really get federal spending, fiscal responsibility if you will, where we want it. Accompanying that we have monetary reform. Now in England they did not get the M3 under control. M3 over there continued to grow at a rate of 12 to 15%. Our money is going to stay under control. The deficits that we're projecting for '82 and '83 will be financed more out of private savings than out of printing of money or monetising our debts. We think that our programme is much more sensible, much more comprehensive, and with a greater degree of chance of success than the British experience.

SAVING TELEGRAM

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FROM PARIS

UNCLASSIFIED

FRAME ECONOMIC

Mrs Loveday
France File

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TO FCO SAVING TEL NO 48 OF 3 APRIL 1981 AND INFO SAVING TO BONN, DUBLIN, BRUSSELS, THE HAGUE, COPENHAGEN, ATHENS, ROME, LUXEMBOURG, UKREP BRUSSELS, MADRID, WASHINGTON, LISBON, TOKYO, UKDEL OECD, UKDEL STRASBOURG, CONSULATES GENERAL FRANCE

FRANCE: ECONOMIC REPORT FOR MARCH 1981

SUMMARY

1. The latest economic indicators have once more brought little comfort to the Government as it approaches the Presidential election. In February, unemployment, seasonally adjusted, rose a further 2.8% to 1,606,000; prices rose 0.9% bringing the year on year rise to 12.7%; a seasonally adjusted trade deficit of F3.7 billion brought the deficit for the first two months of 1981 to almost F10 billion and the industrial production index plummeted to an index figure of 124, the lowest for 3½ years. Ministry of Employment returns showed, however, that the purchasing power of French hourly paid workers and those in receipt of the minimum monthly wage was maintained in 1980; and the final budget returns for 1980 showed that the Government had succeeded in keeping within its forecast deficit for the first time since 1975.

2. Further price liberalisation measures, mainly affecting fresh foodstuffs, were announced on 11 March; the Government also announced further support for the French machine tool industry.

DETAIL

MACHINE TOOL INDUSTRY

3. At their weekly meeting on 11 March, the Council of Ministers approved a programme designed to support and redevelop the French machine tools sector. No details were given about the financial aspects of the programme. However, the Government have already made available F1 billion in loans for the purchase of industrial robots and approximately F100 million for electronically controlled machine tools.

PRICES

4. The retail price index rose 0.9% in February compared with 1.2% in January and 0.9% in December. This brought the year on year rise to 12.7%.

5. Further price liberalisation measures were announced on 11 March and implemented later in the month. These affected retailers' profit margins on sales of fruit, vegetables, meat and dairy produce. The measures represent a further stage in the Government's price liberalisation programme announced in 1978. Energy products, certain transport charges and pharmaceutical products remain subject to Government control despite hopes

/expressed

expressed earlier by President Giscard that the liberalisation programme would be completed before the end of his first period in office. Following the announcement of the latest measures, M Monory, the Minister of the Economy, repeated the Government's view that price liberalisation had not had a significant impact on the retail price index in France. He forecast that retail prices would rise by 11.5% in 1981 compared with 13.6% in 1980.

WAGES

6. According to figures published by the French Ministry of Employment, hourly wage rates rose by 3.1% in the December quarter of 1980 compared with 3.4% in the previous quarter. The annual increase in hourly wage rates was however 15.4% in 1980 compared with 13.7% in 1979. After taking into account reductions in the working week the purchasing power of hourly paid workers rose 1.5% in 1980 compared with 0.8% in 1979.

UNEMPLOYMENT

7. Unemployment, on a seasonally adjusted basis, rose a further 2.8% in February to 1,606,000. This brought the increase over a 12 month period to 15.5%. On an unadjusted basis the total rose 0.8% in February to 1,667,700. The number of vacancies on offer, seasonally adjusted, rose by 1% to 77,900.

INDUSTRIAL PRODUCTION

8. The industrial production index, seasonally adjusted and excluding building, fell to 124 in January, its lowest level for 3½ years. The sharp drop is partly accounted for however by distortions in the returns for electrical capital goods and followed an unexpectedly sharp increase from an index figure of 128 in November to 133 in December. The three month moving average from November to January fell by two points to 128.

9. The latest Bank of France survey of industrial opinion shows that production in February held generally steady and that industrialists are reasonably optimistic about short term prospects. The National Statistical Institute (INSEE) also looks forward to slightly more stable production levels in the coming months although it notes that there were no signs of anticipated upturns in either domestic or external demand. Both the Bank of France and INSEE note that, although many French companies are moderately optimistic about likely future trends in production, they are not yet disposed to recruit additional workers.

10. Motor vehicle production in France declined a further 21.7% in February and both major French producers announced further temporary lay offs. Exports fell by 18.9% in February and domestic demand fell by 17.6%.

FOREIGN TRADE AND THE BALANCE OF PAYMENTS

11. France had a seasonally adjusted visible trade deficit of F3.7 billion in February compared with a deficit of F5.9 billion in January. Imports totalled F49.7 billion and exports F46 billion. Trade in capital goods in February showed a surplus of F1 billion and trade in agricultural produce showed a surplus of F1.8 billion. The deficit on energy, however, was F11.4 billion.

/ENERGY

12. Prices of controlled oil products were raised a further 5 centimes per litre in March. This increase reflects only the rise in the dollar against the franc since the last increases announced in early February and does not reflect any increase in the dollar price paid for crude oil imports into France. The French refining industry has stated that the latest increase was hopelessly inadequate and has argued that a 30 centime per litre increase would have been more appropriate. The industry is now said to be losing approximately F1 billion per month because of the Government's pricing policy.

1980 BUDGET

13. The final budget deficit in 1980 was F30.3 billion compared with a forecast deficit of F31.2 billion. This is the first time since 1975 that the deficit outturn has not exceeded the Government's initial forecast. According to the Communiqué issued by the Council of Ministers following their weekly meeting on 4 March, the improved returns are attributed to reduced Government expenditure. The deficit itself was financed entirely by medium and longterm loans totalling F31 billion.

OFFICIAL RESERVES, CAPITAL MOVEMENTS AND EXCHANGE RATES

14. French reserves of gold and foreign currency fell slightly in March, and by 26 March had dropped to F369.544 billion compared with F372 billion in late February.

15. The franc lost its position as strongest currency in EMS to the Deutschemark in mid March but, in line with other European currencies, recovered ground against the dollar after substantial losses in February.

16. After rising steadily over a six week period, French share prices levelled off during the middle of March and rose only slightly towards the end of the month. Trading levels on the Paris Bourse were normal for the time of year.

16. The main French commercial banks reduced their base lending rates to 12.75% on 8/9 March having raised these to 13% from 12.25% at the end of February. Overnight rates in the money market also eased in early March before rising again to average 11¾% during the second half of the month. At the end of March they resumed their upward movement reaching an eight month high of 12 1/8% on 1 April.

FRANCE VALUES IN PARIS DURING MARCH

	6/3	13/3	20/3	27/3
US $	5.00	4.99	4.91	4.95
100 SF	258.10	257.60	259.78	258.59
100 DM	235.42	235.82	235.88	235.69
£	11.06	11.07	11.08	11.13

HIBBERT

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FRENCH ECONOMIC INDICATORS

(seasonally adjusted, except as noted)

		1980	1981
1.	GDP growth	1.5%	1.6 - 2.2% (Govt forecast)
2.	Industrial production index	133 (December)	124 (January)
3.	Total unemployed	1,514,900 (December)	1,606,000 (February)
4.	Exports	F39.2 billion (February)	F46.0 billion (February)
5.	Imports	F43.5 billion (February)	F49.7 billion (February)
6.	Trade balance	- F60 billion (1980)	- F3.7 billion (February)
7.	Balance on current account	- F31 billion (1980)	
8.	Exchange rate against $ (last working day of the month)	F4.15 (February)	F4.95 (March)
9.	Official reserves	F217 billion (as at 25 January 1980)	F369.544 billion (as at 26 March 1981)
10.	Growth in money supply	11% (official target) 9.1% (Jan-Nov 1980)	
11.	Rise in retail prices	13.6%	0.9% (February) 12.7% (February year on year) 11.5% (Govt forecast)
12.	Rise in hourly wage rates	15.4%	

FRANCE ECONOMIC
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THIS TELEGRAM
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TO FCO TELNO 13 SAVING OF 24 MARCH 1981. Info all EC Posts, UKDel OECD, UKMis Geneva, all Consulates-General in the Federal Republic, Washington, Tokyo.

FEDERAL GERMAN ECONOMY

General

1. The economic indicators give mixed signals. Industrial demand, especially for exports, picked up in January. Production figures are delayed as the index is being rebased, but indications are that the weakening trend continued. Unemployment in February was virtually unchanged from the January level. Consumer price inflation dropped to 5.5 per cent from 5.8 per cent in January. But there was again a large current account deficit, with the visible trade balance also well in the red.

2. The Bundesbank, insisting it has no alternative, has continued its tight money policy to attract capital from abroad and keep tabs on inflation. The SPD in particular see this as detrimental to/the domestic economic outlook. The Bundesbank say it is much less damaging than wage rises. Some economic institutes have issued gloomy growth forecasts for 1981: Essen and Berlin believe a recession of around 1 per cent likely, Kiel predicts -2 per cent. The Confederation of German Industries (BDI) believes the downward trend will continue far into the year, flattening at the end. It puts the blame on destocking.

3. The weakness of the DM over the past few months has improved German competitiveness and hence the outlook for exports, although its more recent revival will push up German export prices again. There was some disappointment that the cooler economic atmosphere was reflected in the International Trade Fairs in Munich in the West and Leipzig in the East. There are fears that the current level of interest rates will depress investment activity which will concentrate even more than hitherto on rationalisation and replacement. But there are signs that the Bundesbank's policies are having the desired effect: the DM is back at the top

of EMS and the foreign exchange reserves rose sharply in the 1 two weeks of March. With interest rate differentials narrowed, especially with the US, overseas investors are again showing an interest in the Federal Republic. Market interest rates are now dropping gradually. Lambsdorff went out of his way in Washington to praise the Reagan Administration's economic policy.

4. Internally, however, the outlook for private consumption has deteriorated and construction demand has fallen further into the doldrums. The Federal Government's budgetary policy has been upset by high defence equipment expenditure and the level of unemployment. Its projected new borrowing requirement for 1981 will, despite the Finance Minister's words to the contrary, certainly exceed the DM 27 mrd (probably by about DM 3 mrd) provided for in the draft budget which is still at the committee stage.

5. Continuing pressure from the unions and parts of the SPD for stimulatory programmes is still resisted in the government. But the Federal Minister of Labour has pressed for more assistance for the unemployed to the annoyance of the Finance Ministry (Matthöfer wants to tax unemployment benefits). Calls continue to be heard from all sides for the unblocking of important public sector capital spending programmes, especially for nuclear power stations and telecommunications projects. This would release considerable sums and have an important multiplier effect. There is also pressure to decontrol rents or improve certain tax write offs in order to stimulate private house building.

6. It is likely that the current wages round will end in settlements around or below the inflation rate, despite continuing industrial action by the engineering union, IG Metall, in support of their 8 per cent claim. Meanwhile the Trade Union Federation's (DGB) Extraordinary Congress has reaffirmed its moderate Basic Policy.

7. Crude oil imports in January/February 1981 fell by 20.8 per cent compared with the first two months of 1980, but the bill for them increased by DM 1 mrd, with Britain the FRG's second (third in February alone) supplier after Saudia Arabia.

8. Oil helped to swell the British share of the FRG import market in 1980 to 6.7 per cent compared with 5.9 per cent in 1979. 6.5 per cent of German exports went to Britain (6.7 per cent in
/1980 1979; the figure for Q4/ was 6 per cent; this was not the German share of the British market as reported in saving telegram no 9).

/ NEW

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New Orders

9. Provisional figures for January show a marked increase in demand, with new orders for industrial goods rising in real terms by 4 per cent. Orders from abroad rose particularly sharply by 6.5 per cent real following the 7 per cent real increase in December, up till when they had been weak in 1980. Domestic orders however, remained at a low level increasing by only 1 per cent. The two month comparison, December/January against October/November, also reflects the recovery in overseas demand: it rose 10.5 per cent with a 1.5 per cent increase in orders overall, but with domestic orders actually falling by 2 per cent, due mainly to the effect of exceptionally large orders in October 1980. Demand in both the capital and comsumer goods sectors was up by 3.5 per cent. Orders for basic and producer goods fell by 1.5 per cent. But compared to the corresponding period a year earlier, demand is still weak. Overall orders are down in real terms by 4.5 per cent, with domestic orders having fallen 7.5 per cent and orders from abroad 2.5 per cent. Consumer goods have suffered most (-8.5 per cent), followed by basic and producer goods (-6.5 per cent) and capital goods (- 1.5 per cent).

New Orders (seasonally adjusted)

1976 = 100

	Total		Domestic		Foreign	
	Value	Volume[1]	Value	Volume	Value	Volume
1980 January	126	112	126	111	127	115
October	121	105	123	106	120	102
November	118	102	118	101	119	103
December	120	103	118	101	126	110
1981 January*	125	107	120	102	133	117

* = provisional
1 = in 1976 prices

Construction

10. Official output figures for the construction industry at the start of the year are not yet available. However, according to the IFO survey, wintry weather in January continued adversely to affect construction activity. 91 per cent of firms polled complained of disruptions due to the weather, almost as many as in January 1979, when the catastrophic weather almost brought the industry to a standstill. As a result, capacity utilisation in January fell a further four percentage points to 54 per cent, compared to 64 per cent a year earlier. The length of order books at 2.8 months, was half a month below the corresponding figure for January 1980. Prices were at a standstill in January and the outlook is for continuing stagnation.

11. An analysis published by the HWWA in Hamburg suggests further decline in construction activity throughout 1981, with new construction projects suffering particularly heavily, while renovation and modernisation programmes will remain fairly lively. Overall investment is expected to fall by 5 per cent in real terms over the previous year.

/PRIVATE

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Private Consumption

12. High expectations for the start of the year were not fulfilled. Provisional figures for January suggest a 2.5 per cent fall in turnover in real terms compared to January 1980, when, however, consumption reached an unexpectedly high level. The fall in turnover from December to January was not as steep as the long-term average for this period, ~~however.~~ Scepticism within the trade attained a similar level to 1974 and stocks are still generally regarded as being too large. The annual rate of increase in retail prices fell from 4.9 per cent in January to 4.8 per cent in February, though expectations for the coming months suggest renewed acceleration.

13. A study by the DIW in Berlin maintains that private consumption in 1981 will at best stagnate in real terms, thus failing to provide any stimulus to the economy. Uncertainty regarding the whole economic climate, characterised by high unemployment and interest rates, will increase the tendency to save rather than consume. While the depression in the motor vehicle industry is expected to have bottomed out, savings will occur in other sectors such as foreign travel. The Hamburg HWWA Institute also expect stagnation in consumer spending (with no change in the savings ratio) although, due to the recession, it should increase as a percentage of GNP.

Prices

14. The increase in the cost of living of private households in West Germany in February fell to 5.5 per cent at an annual rate, after 5.8 per cent in January, the first fall since last October. Prices rose by 0.7 per cent over the previous month. Food prices remained 5.2 per cent up on a year earlier, rising by only 0.6 per cent over the preceding month having jumped in January by 2.1 per cent on/month-on-month basis. Other indicators available for February show further falls in the rates of increase of industrial producer prices and retail prices. Industrial producer prices moderated to 6.7 per cent at a year-on-year rate after 6.8 per cent in January, while retail price increases dropped from 4.9 per cent to 4.8 per cent.

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15. The alteration of the base year for foreign trade price indices from 1970=100 to 1976=100 made the figures for January 1981 more favourable. The annual rate of increase in import prices, although rising 3.2 per cent over December, stood at 11.5 per cent after 14.8 per cent for the year 1980. Export prices were rising at an annual rate of 4.3 per cent in the first month of 1981 after 6.4 per cent in 1980, and were up 1 per cent on December 1980. Terms of Trade figures for January are not yet available, though the general worsening is expected to continue with import prices still outpacing export prices.

/PRICES

Prices

1976=100

	Cost of living	Industrial producer prices	Agricultural producer prices	Export prices	Import prices
1980 January	113.7	113.5	100.7	112.9	121.2
February	114.9	114.5	100.6	113.7	122.8
December	119.3	120.0	103.0*	116.6	130.9
1981 January	120.3	121.2	102.2*	117.8	135.1
February	121.2	122.2			

* = Provisional

Labour Affairs

16. The employment situation held steadier in February than expected, mainly because of the mild weather. The forecast is that unemployment will rise again gradually.
Detailed comparative figures are:-

	End Feb 1981	End Jan 1981	End Feb 1980
a. Unadjusted total	1,299,919(5.6%)	1,308,565(5.6%)	992,520(4.3%)
b. Adjusted	1,071,000	1,039,000	813,000
c. Short-time working	373,648	401,508	101,600
d. Unfilled vacancies	239,282	228,108	312,600
e. Total men in a.	724,281	729,353	526,532
f. Total women in a.	575,638	579,212	465,988

17. The construction industry has reached a moderate nationwide wage settlement of 4 per cent despite inflation of 5.5 per cent. But the industry is suffering proportionately more deeply than others from the recession and the settlement reflects the outlook of IG Bau Steine und Erden. There are one or two complaints being voiced by regional officers particularly in those areas, like Baden Württemberg, which are less affected by the recession.

18. This settlement will certainly influence the crucial negotiations in the engineering industry which are still being pursued with deepening difficulties and wider warning strikes. But some movement has taken place. The employers have moved to 4 per cent from their long-held 2.5 per cent opening offer and IG Metall have let it be known that a 5.5 per cent offer would be acceptable.

/19

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19. The important Extraordinary Congress of the Trade Union Federation (DGB) took place from 12-14 March but produced no controversy and the draft revised Basic Policy of the movement was agreed without division. It should ensure the maintenance of a reasonable moderate and sensible trade union outlook.

Balance of Payments

20. In January the deficit on current account increased to DM 5.0 mrd, after DM 0.7 mrd in December and DM 2.4 mrd in January 1980, by far the largest deficit since July last year. Seasonally adjusted, the deficit was also well above the average level for the final quarter of 1980. The visible trade surplus of DM 1.0 mrd in in December turned into a deficit of DM 0.9 mrd in January,(which turned into a small surplus after seasonal adjustmemt) with exports falling nominally by 2.5 per cent on an annual basis, while imports rose by 2 per cent. The effect on import prices of the weak DM played a role here. Seasonally adjusted, both imports and exports rose considerably, having fallen slightly in December.

21. As usual for January, the invisibles account reverted to a deficit (DM 1.3 mrd) after a surplus in December of DM 0.5 mrd. Expenditure on capital account rose by DM 1.6 mrd over the previous month, while income remained practically constant. Transfer payments (DM 2.1 mrd) were slightly lower than in December.

22. On long-term capital account there were sizeable inflows of capital from abroad (DM 1.8 mrd), due mainly to public sector borrowing. Banks also imported long-term capital to the value of DM 0.8 mrd, and called back DM 0.2 mrd of credit granted abroad. These moves were in accordance with the banks' "Gentlemens Agreement" to grant no long term credit overseas until after end March. In the direct investment sector there were the customary outflows (January: DM 0.4 mrd). On short term capital account there were renewed inflows of capital in January (DM 2.3 mrd), after outflows of DM 3.1 mrd in December and DM1.3 mrd a year earlier. The net external assets of the Bundesbank in the first month of 1981 fell by DM 0.8 mrd, but they recovered in March.

Monetary

23. The strong monetary expansion of recent months continued unabated in January. Although M3 fell slightly in nominal terms, the seasonally adjusted rise (DM 6.9 mrd) was similar to the rise in December and well above the figure for January 1980 (DM2.1 mrd). In the last six months M3 has increased at a seasonally adjusted annual rate of 8.5 per cent;at the end of January it was 7 per cent up on a year ago. (M2: + 9.5 per cent; M1 + 6 per cent).

24. The normal seasonal fall in bank credit to the private sector was unusually low in January (DM - 4.1 mrd) compared to a reduction of DM 10.4 mrd a year earlier. Seasonally adjusted, private sector credit has continued to accelerate, with both long-term and short-term credit in strong demand. Over the last six months private sector credit has risen at a seasonally adjusted annual rate of 11.5 per cent.

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25. The public sector exercised little influence on monetary development in January, with new credit (DM 1.3 mrd) being practically cancelled out by a DM 1.2 mrd reduction in money owing to the banks. Domestic non-banks' external transactions in January resulted in a small inflow of capital; the net external assets of the banks and the Bundesbank rose by DM 0.2 mrd, having fallen by DM 5.1 mrd in December.

26. Monetary capital formation, which had weakened towards the end of last year, strengthened in the first month of 1981, with an increase of DM 3.0 mrd in long-term capital placed with the banks, compared to DM 2.4 mrd a year earlier.

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Federal Republic of Germany: Main economic statistics

asonally adjusted	Q4 1979	Q3 1980	Q4 1980	% change on prev. quarter	% change on prev. year
		DM mrd			
1. Expenditure on the GNP (current prices)					
a) Gross National Product	362.0	378.7	379.3	+ 0.2	+ 4.8
b) Private consumption	195.9	207.1	209.6	+ 1.2	+ 7.0
c) Government consumption	71.2	77.4	77.1	- 0.4	+ 8.3
d) Fixed capital formation	85.1	90.8	90.0	- 0.9	+ 5.8
e) Exports of goods & services	98.8	106.7	105.8	- 0.8	+ 7.1
f) Imports of goods & services	98.7	107.2	107.5	+ 0.3	+ 8.9
g) Net exports	0.1	- 0.5	- 1.6		
2. Expenditure on the GNP (constant prices)					
a) Gross National Product	223.6	224.0	222.4	- 0.7	- 0.5
b) Private consumption	122.4	124.5	124.5	+ 0.0	+ 1.7
c) Government consumption	38.3	39.4	39.0	- 1.0	+ 1.8
d) Fixed capital formation	54.0	54.4	53.3	- 2.0	- 1.3
e) Exports of goods & services	65.1	67.4	66.2	- 1.8	- 1.7
f) Imports of goods & services	62.8	64.5	63.2	- 2.0	+ 0.6
g) Net exports	2.3	2.9	3.0		
3. Income of households					
a) Gross wages & salaries	166.8	175.2	177.7	+ 1.4	+ 6.5
b) Disposable income	228.5	240.9	244.2	+ 1.4	+ 6.9
c) Savings as a % of b)	14.2	14.0	14.2		
4. Productivity					
a) In the economy as a whole					
i) GNP per working person (1970 prices)	137.0	136.7	136.1	- 0.4	- 0.7
ii) wage and salary costs per production unit	161.6	169.9	173.0	+ 1.8	+ 7.1
		1970=100		month	year
b) In industry	Nov 79	Oct 80	Nov 80		
i) output per employed person	144	140	138	- 1.4	- 4.2
ii) wage and salary costs per production unit	155	168	173	+ 3.0	+ 11.6
5. Industrial production	Dec 79	Nov 80	Dec 80		
a) Total	125	120	118	- 1.7	- 5.6
b) Manufacturing industry	125	120	118	- 1.7	- 5.6
c) Construction	117	101	97	- 4.0	- 17.1
6. New orders (1976=100)	Jan 80	Dec 80	Jan 81		
a) Total	126	120	125	+ 4.2	- 0.8
b) Domestic	126	118	120	+ 1.7	- 4.8
c) Foreign	127	126	133	+ 5.6	+ 4.7

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Unadjusted	Feb 80	Jan 81	Feb 81	% change on prev Month	Year
		in 1000's			
7. Unemployment					
a) i) unemployed	992.5	1 308.6	1 299.9	- 0.7	+ 31.0
ii) as a % of the working population	4.3	5.6	5.6		
b) Short-time workers	101.6	401.5	373.6	- 6.9	+267.9
c) Vacancies	312.6	228.1	239.3	+ 4.9	- 23.5
		1976=100			
8. Prices					
a) Cost of living of all private households	114.9	120.3	121.2	+ 0.7	+ 5.5
b) Producer prices of industrial products	114.5	121.2	122.2	+ 0.8	+ 6.7
	Jan 80	Dec 80	Jan 81		
c) Export prices	112.9	116.6	117.8	+ 1.0	+ 4.3
d) Import prices	121.2	130.9	135.1	+ 3.2	+ 11.5
		DM mrd			
9. Balance of payments					
a) Visible trade					
i) exports	28.0	30.3	27.3		
ii) imports	27.6	29.3	28.2		
iii) balance	+ 0.3	+ 1.0	- 0.9		
b) Supplementary trade items	+ 0.6	+ 0.1	- 0.7		
c) Services	- 1.0	+ 0.5	- 1.3		
d) Transfers	- 2.5	- 2.3	- 2.1		
e) Current account	- 2.4	- 0.7	- 5.0		
10. Net foreign reserves	89.9	77.8	78.5		

Seasonally adjusted				Total in DM mrd at the end of:
11. Money stock				
M1	- 2.1	- 2.1	+ 1.0	Jan 81: 247.0
M2	+ 3.9	+ 0.6	+ 7.5	Jan 81: 424.2
M3	+ 2.1	+ 6.8	+ 6.9	Jan 81: 718.9
Unadjusted				
12. Monetary capital formation	+ 2.4	+ 13.5	+ 3.0	Jan 81: 813.8

13. Bank rates: Since 2.5.80 Discount rate: 7.5%
Since 3.3.81 Special Lombard rate: 12%

Sources: Federal Statistical Office, Wiesbaden; Deutsche Bundesbank, Frankfurt
Discrepancies in the totals are due to rounding

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Mr Meyer

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Mrs Kealy
Japan Desk

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BY BAG

FROM TOKYO

TELNO 5 SAVING [CULL]

DATED 20 MARCH 1981

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Addressed to FCO Telegram No 5 Saving of 20 March 1981

Repeated for information Saving to Paris, Bonn, Rome, Washington, Brussels, The Hague, Dublin, UKREP Brussels, UKMIS Geneva, UKDEL OECD, Ottawa, Canberra, Peking, Seoul, Jakarta, Singapore, Manila, Kuala Lumpur, Governor Hong Kong, BTC Hong Kong, Osaka.

JAPAN: MONTHLY ECONOMIC REPORT: FEBRUARY 1981

Summary

1. Industrial production and shipments rose again in January, although by less than forecast, and the upward trend in inventories was reversed. MITI forecasts are for further progress in industrial production in February but in March a partial reversal is expected.

2. The rate of inflation remained on a downward trend: wholesale prices fell once more despite a weakening in the yen and some increase in oil prices, and the year-on-year rate of increase dropped to 3.9%. Seasonal factors caused a further rise in consumer prices, but the underlying downward trend of the year-on-year rate of increase continued.

3. The year-on-year rate of growth of the money supply continued to decline gradually, mainly because of the sluggishness of domestic demand.

4. On 17 March the Bank of Japan announced a reduction in the official discount rate of 1% to 6¼%, and a reduction in banks' reserve requirements. The window guidance restrictions regulating the level of bank lending was also effectively removed. The Government announced a package of measures, including an acceleration of public works expenditure, designed to stimulate the economy, and a further package aimed at a continuation of the reduction of the rate of inflation.

5. The current account of the balance of payments was again in approximate balance in January but purchases by non-residents of Japanese securities led to a record inflow of long-term capital. There was also a large inflow of short-term capital; as a result the overall surplus for the month was $2.7 billion.

6. The yen was broadly stable between mid-February and mid-March. On 20 March it was about ¥209 to the dollar.

Key Indicators

	Latest Month (January)	% Change Over Previous Month	Year Earlier
Industrial Production (SA)	145.1	0.8	3.6
Wholesale Prices (FEBRUARY)	132.1	- 0.2	3.9
Tokyo Consumer Prices (FEBRUARY)	142.8	0.4	6.8

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Key Indicators (Cont'd)

	JANUARY $M	DECEMBER $M
Exports (SA)	12,239	11,909
Imports (SA)	10,930	10,664
Trade Balance (SA)	1,309	1,245
*Current Balance	- 97	35
Long Term Capital	1,545	- 217
*Overall Balance	2,734	- 743
Official Discount Rate	6¼% (from 7¼% on 18 March 1981)	
Foreign Exchange Reserves	26,685 (end February)	26,502 (end January)

* Taking seasonally adjusted trade figures.

Internal Developments

7. The provisional index of industrial production, seasonally adjusted, was 0.8% higher in January than the December figure which was revised upwards. This was a smaller increase than had been forecast by MITI. Nevertheless industrial production in the three months ended January was 2.1% higher than in the previous three months, an annual rate of increase of nearly 9%. The MITI forecast for February is for a further increase of 1.4%, an upward revision of the original forecast, but in March a decline of 0.9% is expected.

8. Ex-factory shipments rose much more sharply in January, by 2.1%, and the volume of shipments in November-January was 2.2% higher than in August-October.

9. At the same time the index of producers' inventories of finished goods fell by 1.4%, and the inventories to shipments ratio by 2.7%; some progress appears to have been made in inventory adjustment, but the inventories to shipments ratio in January was still 10.8% higher than in January 1980.

10. The value of private domestic orders for machinery, seasonally adjusted, was nearly 40% lower in January than in December, when orders were exceptionally high because of a bunching of demand from the power industry. The value of orders in the three months ended January was 7% higher than in the previous months.

11. The Bank of Japan's February quarterly survey, covering 524 major companies, shows that businesses expect a marked slowdown in the growth of fixed capital formation in fiscal year 1981. However, the predictive record of the survey has in the past been patchy, and it is too early to say whether the continued growth of private fixed capital formation, which forms an important element in the official outlook for the economy for fiscal 1981, is at risk.

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12. The seasonally adjusted index of the value of retail sales fell by 0.6% in January, and was 3% lower than in January 1980. However, the seasonally adjusted index of department store sales rose 3.4% to a level 7.4% higher than a year earlier. New car registrations (excluding mini cars) were 8% lower in February than a year earlier. There is still no clear sign of a recovery in the rate of growth of private consumption.

13. The rate of unemployment, seasonally adjusted, fell to 2.06% in January from the revised December figure of 2.17%, and the number of unemployed fell to 1.17 million from the revised figure of 1.23 million. The ratio of job openings to job seekers remained stable at approximately 0.72. The number of workers in regular employment registered a further marginal decline. The labour market appears on balance to have stabilised after showing some weakness in the last few months of 1980.

14. The wholesale price index fell by 0.2% in February, and the year-on-year rate of increase dropped dramatically from 6.7% in January to 3.9% in February. Continued declines in the wholesale prices of domestically produced goods in February were to some extent offset by higher oil prices and a slightly weaker yen.

15. The Tokyo consumer price index rose again in February, by 0.4%, and the year-on-year rate of increase remained at 6.8%. The weather remained unfavourable, causing higher prices for seasonal goods, but the underlying trend in the rate of inflation at the consumer level is still downwards.

Gross National Expenditure

16. Gross National Expenditure in the December quarter, at constant 1975 prices and seasonally adjusted, was 0.5% higher than in the September quarter. The basis of the calculation of GNE at constant prices has been changed from 1970 to 1975 prices. There are material differences between the growth rates for recent quarters shown by the figures on the two bases. Percentage changes in GNE in the four quarters of 1980 compared in each case with the preceding quarter, seasonally adjusted, have been as follows:-

Quarter	1	2	3	4
1970 prices	1.8	0.8	1.5	0.6
1975 prices	1.4	0.4	1.3	0.5

17. The most striking differences in the figures for a particular component of GNE are in those for the surplus of the nation (exports less imports of goods and services on a national income basis) as follows:-

Quarter	1	2	3	4
1970 prices	31.1	4.0	18.8	4.7
1975 prices	102.6	5.4	46.7	6.4

Thus the 1975 based figures show that growth in the Japanese economy in 1980 was slower than indicated by the 1970 based figures and even more dependent on the external sector than the previous figures had indicated.

/18.

18. In the December quarter, however, domestic demand did show some increase. Private consumption expenditure continued to grow, although at a very modest pace, private fixed capital formation was also an expansionary force, although to a lesser extent than in the previous quarter. However, private investment in dwellings continued to fall and inventory accumulation was again lower. By far the most important single expansionary force, in accordance with Government policy, was public sector fixed capital formation, but its effect was largely offset by public sector inventory liquidation. The surplus of the nation contributed about 60% of the growth in GNE in the December quarter.

Monetary Developments

19. Interest rates fell and conditions in the money market eased in advance of the discount rate cut of 1% which became effective on 18 March. Consistent with the need to boost the flagging domestic economy, formal window guidance has been removed for the April-July Quarter.

20. In January the growth of the money supply (M2 + CDs) continued its downward path, showing a year-on-year rise of only 7.4%, compared with 7.8% in December. This slower rate of growth is attributed generally to the sluggishness of domestic demand. Also in January, the average interest rate on bank loans fell by a further 0.132% to 8.142%. The picture of loan demand is mixed: while the economy wallows, bank lendings are rising with quite strong demand from business for financing equipment investment, excess inventories and production cut-backs. This is perhaps an indication of the tightening liquidity position of the corporate sector.

21. In February, while there was a net issue of bank notes higher than in the corresponding month of last year, the value of bank notes in circulation was only 2.6% higher than a year earlier - a clear reflection of the depressed state of consumer demand. There was an outflow of Treasury funds in February compared with a small inflow in the same month last year, largely because interest payments on Government debt and expenditure on public works were considerably higher. The net result was that there was a small shortage of funds in the money market, but with the banks' reserve requirements falling by a larger margin, the banks repaid a portion of their Bank of Japan credit.

22. In the short-term money markets, interest rates generally continued to fall, if only modestly, during February as a cut in the official discount rate became clearly more imminent. Thus the call-loan rate (unconditional median) fell from 8.875% to 8.625% and the bill discount rate (over two months) fell from 8.75-8.875% to 8.375-8.5%. By contrast, in the gensaki (bond repurchase) market the three-month rate hardened from 8.32% to a peak of 8.507% just before the month-end before slipping back to 8.461%. In the last part of the month the gensaki rate was in the unusual position of standing above the three-month bill discount rate. The cause of this perverse movement was an apparently weak supply of surplus corporate funds to the gensaki market. The CD rate (over 150 days) also declined modestly during the month from 8.46% to 8.33%.

23. In March all money market rates continued their fall both before and after the discount rate cut. On 18 March, the call loan, bill discount and gensaki rates all stood at around 7.5%.

24. In the bond market yields had been on a steadily declining trend for more than two months when they reached a 6-month low in early February as dealers built up their inventories prior to the expected discount rate cut. Thereafter, however, yields hardened somewhat as a /result

result of a slackening demand from non-residents and as securities companies held off because their funding costs in the gensaki market were rising. Thus from around 9.4% early in the month, the yield of a representative 6.1% Government bond rose to 9.53% at month-end. The yield then fell further in March to stand at 9.21% on the 8th. An interesting feature of the bond market is that the differential between high and low coupon Government bonds has widened: demand from non-residents, who go for the lower coupons for maturity yield, has slackened, so yields have risen; whereas domestic banks, looking for high current yields to boost their depressed earnings, have pushed up the price of high coupon bonds.

25. From February the samurai bond market for public offerings reopened after some weeks' closure because of unattractive terms. There were two issues in February, totalling ¥35 billion, by Sweden and the Inter-American Development Bank; two issues are due for March, for Venezuela and the Asian Development Bank, totalling also ¥35 billion; and two issues a month, totalling ¥40 billion a month, are lined up for April and May, and several potential borrowers are known to be in the queue thereafter. In addition the foreign yen bond market for private placements reopened in February after being dormant since October 1979 with an issue of ¥10 billion by the Council of Europe, and one other issue has taken place subsequently.

26. The discount rate cut of 1% takes the rate down to 6.25%. The cut was called for in the current relatively depressed demand conditions and was permitted by the progress made on inflation, by the improvement in the balance of payments and by the stability of the exchange rate. It was accompanied by a reduction in the banks' reserve requirements to take effect from 1 April, which takes them back to the levels prevailing up to February last year and releases about ¥650 billion on to the money markets. This, together with a period of seasonal surplus in the corporate sector, should serve to ease money market conditions further over the next two months.

27. Deposit rates fixed by the authorities have also been reduced, with, as an example, the one-year rate in both the postal savings system and the banks falling by 0.75%. The banks' short-term prime lending rate is also likely to fall by 0.75%. The Government bond issue yield, currently around 8.2%, will probably be cut from next month, since secondary market yields in the high coupon bonds have now fallen below the subscription yield.

28. As a final substantial measure of relaxation the Bank of Japan have announced that for the first time since October-December 1978 they will be setting no formal celing on bank lending for the April-June quarter. However, banks are being asked to submit their lending plans for the coming quarter to the Bank of Japan who will coordinate them if necessary to avoid an excessive increase in credit outstanding. It is also expected that from next quarter there will be some relaxation of the guidelines on the banks' foreign lending, both in yen and foreign currencies.

The Balance of Payments

29. The current account in January, seasonally adjusted, was again in approximate balance. Exports were 2.8% higher than in December and imports rose 2.5%, but the slight increase in the trade surplus was offset by a slightly larger increase in net invisible payments. The current account was also in approximate equilibrium in the three months ended January, compared with a small deficit of $0.4 billion in the previous three months.

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30 The dollar value of exports, seasonally adjusted, was 6.8% higher in November-January than in the previous three months, an annual rate of growth of 30%. On a year-on-year basis in January exports of iron and steel and chemicals fell, but above average increases were shown by automobiles, which accounted for over 25% of the value of total exports, heavy electrical machinery, including power generation equipment, tape recorders, television sets, ships and motorcycles.

31. The dollar value of imports, seasonally adjusted, was 6.1% higher in November-January than in August-October. The value of most imports, on a yen basis, was lower in January 1981 than in January 1980. Even the value of imports of mineral fuels, which accounts for a little over half the value of total imports, was slightly lower.

32. The seasonally adjusted dollar value of export letters of credit received in February was 9.9% higher than in January and 7.6% higher in December-February than in the previous three months. Neither the trend of the past few months nor the behaviour of this leading indicator suggest slower growth in Japanese exports in the immediate future.

33. The deficit on invisibles, including transfers, in January was rather higher than in December, and the deficit in the three months ended January, at $3.7 billion, was $0.7 billion higher than in the previous three months. The most important single factor contributing to the increased January deficit was a deterioration of $125 million in net investment income.

34. There was a large inflow of long term capital in January, following a small outflow in December. The whole of the turnround was accounted for by increased purchases by non-residents of Japanese securities. The net inflow of long term capital in the three months ended January was $1.4 billion, compared with $0.9 billion in the previous three months. Taking seasonally adjusted trade figures, the basic balance showed a surplus of $1.4 billion in January compared with a small deficit in December. The surplus on basic balance in November-January was $1.0 billion, a little higher than in the previous three months. There was also a large inflow of short-term capital in January and, after taking account of errors and omissions, the overall balance showed a surplus of $2.7 billion, a record figure for one month, compared with a deficit of $0.7 billion in December. The overall surplus in the three months ended January was $3.5 billion, compared with $0.6 billion in the previous three months.

35. The foreign exchange reserves rose by $0.2 billion in February to $26.7 billion. The yen was broadly steady between mid-February and mid-March against the dollar, and the Bank of Japan stayed out of the market. On 20 March the rate was about ¥209 to the dollar.

Policy Measures and Prospects

36. As the rate of inflation continues to fall the preoccupation of the authorities is increasingly with maintaining the growth of activity in the economy. To this end the authorities announced a package of measures on 17 March. The Bank of Japan reduced the official discount rate by 1% to 6¼%, effective 18 March. At the same time banks' reserve requirements have been reduced with effect from 1 April to the levels prevailing up to February 1980, and window guidance for the June quarter has been effectively relaxed completely, leaving the banks free to increase their lending as they think fit.

37. At the same time, the Government announced one package of measures to stimulate the economy, and a further package with the objective of

/achieving

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achieving a continued reduction of the rate of inflation.

38. The principal expansionary measure announced was a planned acceleration of public works expenditure in the first half of fiscal 1981 with the aim that at least 70% of the budget for the full year should be contracted for in the first half. The normal contract rate for the first half of a fiscal year is about 66% but deferment of expenditure in the first half of fiscal year 1980 reduced the contract rate to 59% so that expenditure in the second half of the current fiscal year has been exceptionally high. Thus the planned acceleration in the first half of fiscal 1981 may not do much more than maintain this high rate of expenditure.

39. Other measures announced were aimed at some of the softer areas in the economy, small businesses, housebuilding, and plant exporters, and consisted mainly of easier and cheaper access to finance. Reference was also made to the proposed amendments to the Export Insurance Law, which will inter alia improve the amount of preshipment cover available.

40. The measures designed to reduce the rate of inflation were mainly cosmetic, but particular reference was made to the stabilisation and in some cases reduction of public utility prices and to the improvement of the supply of vegetables and livestock products.

41. It is hard to see what further action the authorities can take if, despite these measures, the performance of the economy remains unsatisfactory, so long as the main objective of fiscal policy continues to be the reduction of the budget deficit. There are signs of slowdown in a number of areas of the economy, but the most significant uncertainty is over the behaviour of consumers. An upturn in private consumption expenditure is a principal element in the growth forecast for fiscal 1981. Both an increase in real income, resulting from a higher rise in wages following the spring negotiations combined with a lower rate of increase in consumer prices, and a decline in the savings ratio, are expected to contribute to this upturn. It may be that signs of these developments will appear after the spring round of wage increases, but so far consumers do not seem to be behaving in the appropriate fashion.

CORTAZZI

FINANCIAL
ERD
FED

THIS TELEGRAM
WAS NOT
ADVANCED

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S T A T I S T I C S

Latest Month JANUARY - except where stated
All statistics seasonally adjusted, except where stated
R - Revised

	Latest Month	Previous Month	% change over Previous Month	% change over Year ago (NSA)
Industrial Production	145.1	144.0R	0.8	3.6
Shipments	139.8	136.9R	2.1	2.0
Inventories of Finished Goods	113.3	114.9R	- 1.4	7.8
Inventories to Shipments Ratio	87.5	89.9R	- 2.7	10.8
Wages and Salaries				6.2
Job Openings/Job Seekers	0.72	0.72R		
Number of Unemployed	1.17M	1.23RM	- 4.9	
Number of Unemployed (NSA)	1.23M	1.18 M		8.8
Rate of Unemployment (NSA)	2.2	2.1		
Rate of Unemployment	2.06	2.17R		
Department Store Sales	152.5	147.5	3.4	7.4
Index of Retail Sales	129.9	130.7R	- 0.6	- 3.0
Wholesale Price Index (NSA) FEB	132.1	132.3	- 0.2	3.9
Consumer Price Index (NSA) (all nation)	141.3	139.6	1.2	7.4
Consumer Price Index (NSA) (Tokyo) FEBRUARY	142.8	142.2R	0.4	6.8
Average Interest Rate on Bank Loans	8.142	8.274		
Bank of Japan Notes in Circulation (NSA) FEBRUARY				2.6
Money Supply M2 + CD (NSA)				7.4
Stock Exchange Index (First Section) FEBRUARY	505.9	505.7		
No of Business Failures (Tokyo Shoko) FEBRUARY	1,327	1,313	1.1	4.0
Housing Starts (Private) (1,000 SQ M) NSA	5,723	8,229		- 22.1
Public Works Disbursements (Billion Yen) NSA FEBRUARY	340.3	173.3		11.8
Private Domestic Orders for Machinery (Less ships) (Billion Yen)	539.4	894.1	- 39.7	0.4

/TRADE

	Latest Month	Previous Month	% change over Previous Month	% change over Year Ago (NSA)
	$M	$M		
Trade Balance SA	1,309	1,245		
NSA	- 1,473	2,388		
Invisible Balance (NSA)	- 1,406	- 1,210		
Current Account (SA)	- 97	35		
Long Term Capital (NSA)	1,545	- 217		
Short Term Capital and Errors and Ommissions (NSA)	1,286	- 561		
Overall Balance NSA	- 48	400		
SA	2,734	- 743		
Total Imports (IMF basis, NSA)	10,657	11,664		15.9
(" " , SA)	10,930	10,665	2.5	
Japanese Imports from UK (Customs Clearance Basis, NSA CIF)	237	258		72.2
Japanese Imports from the EEC (CC, NSA)	759	799		28.4
Japanese Imports from the USA (CC, NSA)	2,087	2,259		14.6
Total Exports (IMF basis, NSA)	9,184	14,052		33.8
(" " , SA)	12,239	11,902	2.8	
Japanese Exports to UK (CC, NSA)	299	382		50.5
Japanese Exports to the EEC (CC, NSA)	1,295	1,808		43.6
Japanese Exports to the USA (CC, NSA)	2,334	3,135		16.7
Export Letters of Credit FEBRUARY	8,979	8,169	9.9	11.5
Foreign Exchange Reserves (Japanese definition) at end FEBRUARY	26,685	26,502		
Ratio of Imported Raw Materials held by Producers to Consumption DECEMBER	109.7	114.8	- 4.4	9.7
Export Prices (Yen basis, NSA)	102.9	103.2		- 1.0
Import Prices (Yen basis, NSA)	150.4	151.4		8.3
Trade Terms	82.7	78.8R		
Export Volume (NSA)	119.5	194.2		- 1.9
Import Volume (NSA)	120.0	131.2		0.5

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SIR KENNETH COUZENS

cc Mr Barratt
Mr Hancock o/r
Mr Atkinson

STAFFING AND EFFICIENCY OF INTERNATIONAL ORGANISATIONS

If the Chancellor decided to speak about this to Mr Regan - paragraph 16 of your note of 8 April - he might wish to make the following points :

a. during travels have seen something of international organisations. Not altogether happy about staffing and efficiency, particularly at a time when we're all trying to be stringent with government departments and agencies at home.

b. no doubt we all try to contain expenditure by "foot dragging" when the budgets of all the agencies are considered each year.

c. is there anything else we could do? More concerned with the UN agencies than the Washington organisations, where the US made great efforts recently, but where the sympathies of other countries were not wholly engaged. These institutions are not particularly bloated, and both cover their current costs.

d. in the UN, it might be best to concentrate our fire. UNESCO? ILO?

e. have to remember that our foreign Offices will have strong views!

f. would Mr Regan perhaps like to reflect on this? ~~and revert to it on a future occasion?~~

Would he support us & get the State Department to do so if we were able to persuade our Foreign Office to have a go at UNESCO/ILO?

MHM.

MRS M HEDLEY-MILLER
10 April 1981

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IRENE RIPLEY

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