TREASURY

SECRET
(Circulate under cover and
notify REGISTRY of movement)

FILE BEGINS 1/9/87 ENDS 14/9/87

PO -CH /NL/0010
PART N

MISCELLANEOUS PAPERS

PO -CH /NL/0010
PART N

FOR DISPOSAL ADVICE SEE INSIDE COVER

DISPOSAL DIRECTIONS	SIGNATURE	DATE
DESTROY AFTER 25YEARS		7/1/94
PRESERVE		

TION USE ONLY

REFER TO	DATE	REFER TO	DATE
PA(14/9/87) PAR	7/1/94		

CLOSED
CONTINUED ON:-
PART P

FOR RECORDS SECTION USE ONLY

CONFIDENTIAL

CHIEF SECRETARY

FROM: B H POTTER

Date: 1 September 1987

cc:
Chancellor
Financial Secretary
Sir Peter Middleton
Mr F E R Butler
Mr Anson
Mr Cassell
Mrs Lomax
Miss Noble
Mr L Watts
Mr Perfect

a
seems sensible + helpful.

AH

REPORT OF WORKING GROUP ON LOCAL AUTHORITY FINANCIAL PRUDENCE

The Working Group on Local Authority Financial Prudence was set up to examine the use of creative accounting devices by local authorities and to review measures being developed to encourage prudent financial behaviour. This second part of the remit was, in effect, an invitation to try and develop a prudential regime for local authorities. We now have the Group's full report.

2. The Group has made good progress on the nature and scale of creative accounting devices. Annex A (attached) summarises the Group's conclusions and lists the main devices. The main points are:-

i) though the two principal devices used - advance leasing and deferred purchase are now blocked - other mechanisms, particularly sale and leaseback and capitalisation of housing repairs are still being used to finance extra spending;

ii) there is tenative evidence however that the flow of creative deals has decreased in recent months;

iii) an aggregate net "gain" to LAs (assets acquired less spending recorded) will continue till 1989-90; thereafter, the burden on LAs will increase as past creative financing has to be paid for.

3. The Group has developed a much clearer understanding of the prognosis. Extensive use of creative accounting devices is confined to about 20 authorities - mostly those that are or have been rate-capped. And the most severe financial problems caused by creative financing of the gaps between actual expenditure and the rate-capped limit, are concentrated in London and one or two other inner-city authorities. Dealing with their acute financial problems will become a pressing policy issue over the next year or two - one authority, Haringey, may not get through this year. But there are tentative indications that following the election, some authorities such as Camden are taking a more realistic attitude to their financial problems.

4. By contrast, the Group has made very little progress on developing a prudential regime. Prudential ratios - in particular a ratio of local authority debt to income - were conceived as the information on an authority's underlying financial position that would trigger certain responses from Government, auditors and lenders. But it remains uncertain whether the ratios are empirically capable of serving this function. Hence in our view, it is doubtful whether the full prudential regime itself can be made effective. The Audit Commission is undertaking further work and will report in October. DOE, recognising the pivotal role of the ratios in the prudential regime, will be reluctant to give them up.

5. But, despite the uncertainty on the regime itself, some good policy proposals have emerged from the Group's work. A summary of policy proposals being pursued, rejected or taken forward in other contexts is at Annex B and C. Two initiatives have emerged as particularly important.

i) The "stop" power for the Auditor would act on the flow of creative accounting by challenging or stopping individual deals. It would allow the Auditor, on the basis of information supplied by the Treasurer, to stop a particular financial transaction before it happened, rather than comment retrospectively. You have already written to Mr Ridley (3 August) agreeing to this power to prevent illegal action and to the necessary strengthening of the Treasurer's role (14 August). The Group's further proposal is that the Auditor's stop power might be extended to cover imprudent action. We support the principle though, as Lord Whitelaw has pointed out (letter of 23 July), there could be legal difficulties in assessing imprudence.

ii) The overseer power is designed to deal with the authorities in financial difficulties (as a result of past creative accounting). It is common ground between DOE and ourselves that the overseer would be advisory and would help construct and monitor a recovery plan; would need access to supporting additional revenue finance through a right to disapply rate limitation; and could only be successful where the LA co-operated. DOE see the overseer as Government appointed. We see advantages in the Government distancing itself from the painful recovery measures necessary and leaving the initiative with the local authority perhaps using private consultants. DOE also envisage that the PWLB might restructure LA debt. We are far from convinced that such a restructuring role would be appropriate for the PWLB in its present form.

Next steps

6. It is unclear whether the Working Group will continue (though the Monitoring Sub-Group will keep the information on creative accounting devices and individual LA finances up to date). As the covering letter to the report indicates, DOE now envisage that the two main policy proposals - enhanced "stop" power and the overseer proposal - should be considered collectively by Ministers. The intention is that this would take place in September/October, inter alia so that the "stop power" could be included in the Local Government Bill.

7. The overseer proposal is not necessarily dependant on the av[illegible]lability of such ratios (particularly under the Treasury model) and hence can be considered by Ministers as a free-standing policy proposal. But the "stop" power has closer links with the idea of a prudential regime. It would therefore be highly desirable to reach a conclusion on whether the prudential ratios can serve as a satisfactory trigger device. We will be pressing DOE officials to reach a view in time for the Ministerial discussions on these policy proposals.

8. Finally, we will be doing more work on what role Government lending - and the PWLB in particular - can or should play. Introducing tiered PWLB rates looks far less promising than it did initially. They are not feasible without robust prudential ratios, to provide a legally defensible basis for identifying uncreditworthy authorities; they cannot provide answers to the short term problems; and it is far from clear that it is worth making major, disruptive changes to the PWLB to deal with the special problems of a handful of authorities. We are looking therefore more specifically at how the role of Government lending fits into the various overseer options.

Barry H. Potter

B H POTTER

Nature and Scale of Creative Accounting

The table attached summarises the main schemes. The main points are as follows.

i) A useful distinction can be drawn between creative accounting (manipulating the accounts mainly to raise block grant entitlement) and creative financing (borrowing by another name). Much of the former problem is expected to be resolved under the new PLG grant regime and new capital control systems. But the desire to spend now and pay later through creative financing will remain for some authorities.

ii) In quantitative terms, the important devices have been advance finance leasing and deferred/advance purchase. Both are now controlled; but there is a hangover of £lb of assets that may be acquired over the next 10 years under advance leasing and up to £1.8b of deferred purchase still to be paid for over the next ten years. Sale and leaseback and capitalisation of housing repairs are the main devices now in use; neither is yet controlled. Interest rate swaps and parallel loans have recently become more significant, though in at least one authority, the Auditor has expressed concern about their use.

iii) The net gain to a LA from using a creative device can be measured as the value of assets acquired less the spending recorded for control purposes. On reasonable assumptions, the aggregate net gain to LAs will decline rapidly each year between now and 1989-90 and then become negative as the past use of such devices has to be paid for.

iv) The stock of creative accounting deals is relatively large, particularly in proportionate terms for certain authorities. But there is a tentative impression that the flow of creative deals may now be slowing down: in part this reflects new realism by some authorities, in part a more cautious attitude to such deals on the part of lenders.

CREATIVE ACCOUNTING DEVICES

U[illegible] of Special Funds:	minor; irrelevant after 1990 under PLG grant regime;
Capitalisation:	mainly housing repairs; major; associated benefit to LA of extra housing subsidy blocked; but capitalisation still used for RFA advantages; can be combined with sale/leaseback;
Use of Superannuation Funds:	minor; not resolved; further work underway on links with LA companies;
Changed Sinking Rate Fund:	minor; little scope for increased use;
Deferred/Advance Purchase:	major: banned under Local Government Act 1987: but up to £1.8b deferred payments still to be paid for over next few years;
Sale/Leaseback:	major: no legislative action taken but Ridley's PQ answer in February seems to have discouraged lenders; some evidence of falling-off; no action taken;
Sale of Mortages:	minor: no longer in operation;
Advance Leasing:	major: controlled when leasing became prescribed expenditure: but up to £1b assets still to be acquired over the next few years;

S[illegible]ffied Housing:	will be banned under new Local Government Bill;
Interest Rate Swaps:	medium: premium payment by bank up front; no action taken; but Haringey auditor has questioned;
Parallel Loans:	minor: no action; DOE may challenge legality.

ANNEX B

D[illegible]elopment of A Prudential Regime

1. In the past, the response to creative accounting has been to control or prohibit each of the devices concerned. The concept underlying the prudential regime is to break from this piecemeal approach and shift to a comprehensive regime that focuses on the individual LA's finances. It is based on the idea of a graduated response to a deteriorating financial position in the LA - by lenders, by Government and by the authority itself.

2. To work it needs accurate, up to date and legally tight information on the authority's financial position; it needs a mechanism for bringing that information to light timeously; and it requires appropriate policy responses. The Group's work has been on the basis that the information on the underlying financial position would be calibrated by the use of prudential ratios (in particular a ratio of local authority debt to income). A stronger role for the local authority Treasurer would provide for information on proposed financial transactions to be revealed. And the policy response could cover action by the Auditor to stop imprudent financial transactions and a higher rate for borrowing from the PWLB. Once a further threshold had been exceeded, PWLB lending could cease; and an overseer might be appointed to advise on a recovery programme.

3. Useful, but limited, progress has been made on many elements of the regime. But on the prudential ratios - the key information to trigger certain policy responses - the position remains unclear. Preliminary work shows a broad correspondence between adverse ratios and authorities known to have funding gaps: but the relationship is imprecise (with some prudent authorities having moderately high ratios) and varies between classes of authority, because of their different service functions. The Audit Commission has drawn attention to the possible legal difficulties in setting different trigger levels for different types of authority.

4. The Audit Commission is carrying out the work to develop the ratios and expect to give a further report in October. It remains uncertain whether the prudential ratios are likely to be satisfactory indicators of the degree of financial imprudence and hence whether the prudential regime, as envisaged by the Group, can be made effective.

ANNEX C

C[illegible]ATIVE ACCOUNTING "SOLUTIONS"

New Definitions of Borrowing:	"... a LA may not incur liability to make payments in future other than by ..." : for use in new Capital Control Regime; approach looks promising
Prudential Ratios:	further work nececessary; only broadly right on empirical basis; different for different classes; questionable whether they will be sufficiently robust, in empirical and legal terms, to provide a satisfactory trigger;
Stop power:	Ministers have approved for illegal action: will go into Local Government Bill; still to consider for imprudent action; practical legal difficulty, in establishing what constitutes imprudent behaviour;
Role of Treasurer:	Ministers have agreed: to be included in Local Government Finance Bill;
Payment of Exchequer Grant:	rejected as applied to mandatory block grant; would be draconian and could quickly precipitate financial collapse;
Good Practice Certificate:	[to be developed by Audit Commission as part of good financial management; not to be considered as part of prudential regime;]

Overseer: DOE and Treasury models to Ministers in September; early legislation planned;

PWLB: low key at this stage; link to prudential ratios; reconsider when ratios work is further advanced;

Commissioners: contingency legislation to be updated.

ps2/1R

SECRET AND PERSONAL

PWP

CHANCELLOR OF THE EXCHEQUER

FROM: CATHY RYDING
DATE: 1 September 1987

MR P DAVIS

cc Chief Secretary
Economic Secretary
Financial Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr Sedgwick
Mr Peretz
Mr Bottrill
Mr Kelly
Miss O'Mara
Mr Culpin
Mr Barrell
Mr Own

Mr Norgrove - No.10

JULY TRADE FIGURES

The Chancellor has seen your minute to the Financial Secretary of 27 August.

2. The Chancellor had the following comments on the draft press briefing:

Positive 1: add "(July figures itself second highest ever.)"

Defensive 6, final sentence: redraft to read "As growth overseas picks up, UK exports will benefit."

Defensive 9, first and second sentence: redraft to read "Non-oil exports so far this year slightly higher than FSBR forecast, and latest CBI survey show export orders still buoyant."

Defensive 12: redraft as follows "Necessary fall occurred in 1986. Period of stability in exchange rate now desirable - sentiment endorsed by CBI."

Defensive 15: redraft as follows "No problem. Current deficit negligible so far in 1987. FSBR forecast of current account deficit for 1987 as a whole only ½ per cent of GDP, following cumulative current account surplus of almost £20 billion between 1979 and 1986. With net overseas assets worth around £114 billion by end 1986, overall external position unprecedentedly strong."

CR

CATHY RYDING

SECRET AND PERSONAL
UNTIL 11.30 am TUESDAY 1 SEPTEMBER
THEN CONFIDENTIAL

27/8.

FROM: PAUL DAVIS
DATE: 27 AUGUST 1987

1. **MR BOTTRILL**
2. **FINANCIAL SECRETARY**

cc: See attached list

* I have made a number of important changes to the defensive briefing. NL. PS Also posting ①.

JULY TRADE FIGURES

The July trade figures will be published at 11.30 am on Tuesday 1 September. They will show a deficit on visible trade of £910 million. Combined with an unchanged CSO projection of the monthly invisibles surplus of £600 million, they give a projected current account deficit of £310 million in July compared to a revised deficit of £140 million in June. In the three months to July the current account was in deficit by £946 million compared to a surplus of £547 million in the previous three months. In the year so far, the current deficit has been £369 million.

2. Small adjustments to the April, May, June and July current account figures have been made to take account of unprocessed documents resulting from the strike by Customs computer staff at Southend. In the July figures only exports have been adjusted, with the effect of reducing the current account deficit by £47 million. No allowance has been made for any reduction in exports and imports in May and June as a result of industrial action by Customs staff at ports - or rebound in July when the action ended. There is no available evidence of such effects although the possibility of them suggests the need for additional caution in interpreting the monthly figures.

Main points

3. Current Account

£ million

	1986 Year	Q3	Q4	1987 Q1	Q2	May	June	July
Manufactures	-5491	-1741	-1826	- 736	-1860	-900	-512	-625
Oil	4056	621	785	1164	1033	365	245	284
Other goods	-7028	-1771	-1684	-1563	-1534	-561	-473	-569
Total visibles	-8463	-2891	-2725	-1135	-2361	-1096	-740	-910
Invisibles	7483	1973	1795	1637	1800*	600*	600*	600*
Current balance	- 980	- 918	- 930	502	- 561	-496*	-140*	- 310*

* projection

[illegible]. The value of exports rose by about £0.4 billion between June and July (almost entirely due to increased exports to the USA) and imports rose by about £0.5 billion; hence the visible deficit in July was about £0.2 billion ~~less~~ more than in June. In the three months to July the visible deficit was £1.5 billion larger than in the previous three months reflecting a £1.3 billion deterioration in the non-oil balance and a £0.3 billion fall in the oil surplus. Over the same period the manufacturing trade deficit widened by around £1.3 billion - to £2.0 billion - a little greater than the quarterly deficits in the second half of last year.

5. The invisibles balance for the first quarter has been revised by £144 million in the light of the Pink Book and other new information. The CSO has made no revisions to its projections for the second quarter, for which the first estimates will be published on 17 September, a fortnight later than the previous timetable.

6. **Exports**

	percentage change			
	July on June	**3 mths to July on previous 3 mths**	**3 mths to July on same period year earlier**	**1986 on 1985**
Total value	6	-2½	10	-6½
Total value excl. oil and erratics	5	0	10	2½
Total volume	6½	-4½	3	3½
Total volume excl. oil and erratics	6	-1½	6	2½
Manufactures volume (excl.erratics, OTS basis)	6½	-1½	4½	1
Fuels volume (OTS)	9	-17	-9	2
Basic materials volume (OTS)	-8	-14	8½	10½
Food, drink and tobacco volume (OTS)	11	½	5½	8½

7. Export volumes, excluding oil and erratics, rose by 6 per cent in July. Exports of manufactures rose sharply from the relatively

low levels of May and June. There was a rise in food, drink, and tobacco exports of 11 per cent. Fuel exports rose by 9 per cent reflecting the completion of annual maintenance of North Sea installations in June and higher prices.

8. The erratic quarterly path of exports with a sharp rise at the end of last year then some easing in the early months of this year make it difficult to assess the underlying trend. The latest figures are consistent with some modest renewed growth of non-oil exports and in the seven months to July they were 2 per cent higher than in the second half of last year and 8½ per cent higher than a year ago.

9. <u>Imports</u>

percentage change

	July on June	**3 mths to July on previous 3 mths**	**3 mths to July on same period year earlier**	**1986 on 1985**
Total value	7½	5½	13	1
Total value excl. oil and erratics	8½	6½	13	7
Total volume	6	6	8	6½
Total volume excl. oil and erratics	7	8	10	6
Manufactures volume (excl.erratics, OTS basis)	7½	10	11	5½
Fuels volume (OTS)	6½	-3½	-9	8½
Basic materials volume (OTS)	-3½	-2½	13	6½
Food, drink and tobacco volume (OTS)	8½	4	1	8

10. Import <u>volumes</u>, excluding oil and erratics, rose by 7 per cent in July, virtually offsetting the equally sharp fall in June. Imports of manufactures, fuels and food, drink and tobacco rose. Within manufactures all categories rose with the strongest rises coming in intermediate and capital goods. Imports of fuels increased reflecting increased imports of products.

[illegible]1. The quarterly path for imports, like that for exports, has been erratic recently with a sharp rise in the latter half of last year followed by a large fall in early-1987. The latest figures are again consistent with a renewed upward trend in imports with non-oil volume in the seven months to July now 9 per cent higher than a year ago.

Geographical area

12. The value of exports to the US recovered somewhat in July but in the three months ending July was 17 per cent lower than in the previous three months. Exports to the EC fell by 1 per cent and exports to oil exporters also by 1 per cent. Exports to Japan rose by 29 per cent in July and in the three months to July were 15 per cent higher than in the previous three months.

Trade prices

	percentage change			
	Import prices (OTS)		**Export prices (OTS)**	
	July on June	**3 mths to July on previous 3 mths**	**July on June**	**3 mths to July on previous 3 mths**
Manufactures (excl.erratics)	½	-1½	½	½
Food, drink, tobacco	0	-1½	0	-½
Basic materials	½	0	0	+½
Fuel	0	-2	0	-½
Total (BOP basis)	1½	-2	0	½
Total less oil(BoP basis)	1½	-2	0	½

13. In the three months to July the total terms of trade and the non-oil terms of trade as measured by unit value indices both improved by 2½ per cent compared to the previous three months. The favourable trend over the past few months reflects rises in the oil price and the exchange rate, only partly offset by rises in commodity prices in SDR terms. (NB: the published series are unit value indices, which can present a misleading picture over a period of time due to their use of 1980 weights.)

Comparison with Treasury forecasts

14. In 1987 so far non-oil import volumes have been around 8 per cent higher than in the same period a year ago, very similar to the published FSBR forecast for 1987 as a whole but rather higher than the summer forecast which gave some weight to the low figures for early 1987. The volume of non-oil exports so far this year has been some 8½ per cent higher than a year ago somewhat higher than both the FSBR and summer internal forecasts for the year as a whole. The current deficit of £0.4 billion so far this year is rather better than expected at the time of the FSBR but slightly worse than the summer forecast.

Market expectations

15. The market expectation is for a current account deficit of £200 million in July. The July figures are a little worse than expected by the City, but should not be received too badly.

Press briefing

16. I would be grateful for clearance of the attached press briefing.

PAUL DAVIS
EA2

SECRET AND PERSONAL
UNTIL 11.30 am TUESDAY 1 SEPTEMBER
THEN UNCLASSIFIED

DRAFT BRIEFING FOR IDT

Positive

1. Export volumes (excluding oil and erratics) in three months to July 6 per cent higher than a year earlier - stronger growth than in most other developed countries. (July figure itself shows highest ever.)

2. CBI Survey for July shows export order books still buoyant.

3. Terms of trade (both including and excluding oil) in three months to July improved by 2½ per cent over previous quarter.

Defensive

1. Current account deteriorated by £170 million in July as a result imports growing faster than exports since June. Monthly figures erratic but deficit of £310 million in June leaves only modest current account deficit of £369 million so far in 1987. Deficit only to be expected when UK growth running above long-term trend and rest of world growth below trend.

2. Current deficit widening. Current deficit of £369 million for year so far lower than £1848 million deficit in second half of 1986. Out-turn so far this year better than £2½ billion deficit expected at Budget time.

3. Current account deficit in 1986 worse than thought previously. Pink Book estimate of 1986 current account deficit £980 million, up £860 million from previous estimate. Current account balance of large flows, hence small revisions can cause large changes in balance.

4. Strong domestic demand growth sucking in imports: Intermediate goods and semi-manufactures continue to make a large contribution to rise in imports, reflecting expansion of UK industrial output.

[illegible]. Trend in imports upwards: Recent figures very erratic. Imports volumes (excluding oil and erratics) so far this year still below level in second half of last year.

6. Imports rising faster than exports [In three months to July on a year earlier, import volumes (excluding oil and erratics) up 10 per cent, compared with 6 per cent rise for exports. On previous three months import volumes up 8 per cent while exports down 1½ per cent.] Not surprising given that UK economy is growing faster than most other major economies. As growth overseas picks up, UK exports ~~[illegible]~~ will benefit. ~~Gains in competitiveness since end 1985 should help to restrain import growth and boost exports.~~

7. Capacity constraint threatens current account performance. [Phillips and Drew forecast 2 July 1987 stated export boom unlikely to last as competitiveness declines and imports likely to increase since industry facing capacity constraint. Reported by Philip Stevens, Financial Times 6 July.] Always expected imports to rise as economy grows strongly. ~~Evidence of capacity constraints not conclusive.~~ Industrialists report capacity utilisation relatively little changed over past year. ~~and still below 1973.~~ CBI in latest survey state "there is no evidence of widespread bottlenecks due to fixed capacity over the next twelve months".

8. Exports no longer growing. In three months to July export volumes (excluding oil and erratics) 6 per cent higher than same period a year ago. Volume of manufactures exports 4½ per cent up over same period.

9. FSBR forecast for growth in exports in 1987 too optimistic: ~~Exports forecast to grow in 1987 as world trade rises and benefits of improved competitiveness continue to come through.~~ latest CBI survey show export orders still buoyant. Export volumes (excluding oil and erratics) 6 per cent higher in three months to July than a year ago.

10. FSBR forecast of £2½ billion current account deficit in 1987 too optimistic: Out-turn so far this year better than expected. Current account of balance of payments shows only small deficit in year so far.

Non-oil exports so far this year slightly higher than FSBR forecast; and [illegible]1. Non-oil tradeable sector unable to respond owing to erosion of manufacturing base. [FT report on car components industry 30 June indicates many suppliers have disappeared although there is now some optimism following sterling's depreciation. Optimistic outlook corroborated in Commons Trade and Industry select committee report on UK motor components industry]. Manufacturing industry doing very well - output up 4½ per cent comparing latest three months with a year earlier. CBI surveys consistently optimistic. Volume of manufacturing exports (excluding erratics) 4½ per cent higher in three months to July than a year earlier.

12. Fall in exchange rate needed - sterling's recent strength threatens competitiveness: ~~Non-oil visible trade responding to 1986 exchange rate adjustment.~~ Necessary fall occurred in 1986. Period of stability in exchange rate non desirable. — sentiment ~~Vital that pay settlements kept under control if existing gains in competitiveness to be maintained and~~ endorsed by CBI.

13. Invisibles revised down in 1987 Q1 - implications for Q2? Revision to 1987 Q1 invisibles figures made in light of Pink Book and other new information. Estimates for 1987 Q2 to be published on 17 September.

14. Invisibles revisions delayed: New procedure should contribute to improved quality of quarterly invisibles estimates and reduce the need at least for short-term revisions.

15. UK's external position precarious: No problem. (Current deficit ~~modest~~ negligible) so far in 1987. FSBR forecast of current account deficit for 1987 ~~only~~ as a ½ per cent of GDP, while only following cumulative current account surplus of almost £20 billion between 1979 and 1986. With net overseas assets worth around £114 billion by end 1986, overall external position ~~in any case~~ unprecedentedly strong.

TRADE FIGURES FOR MAY 1987

Advance circulation

Chancellor
Chief Secretary
Economic Secretary
Financial Secretary

Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr Sedgwick

Mr Peretz
Mr Kelly
Miss O'Mara

Mr Culpin
Mr Barrell
Mr Owen

Mr Norgrove - No.10

Circulation after 11.30 am on Wednesday 2 September

Paymaster General
Mr Monck
Mr Matthews
Mr Patterson
Mr Tyrie
Miss Roche - No.10

3

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 4887
GTN 215)
(Switchboard) 01-215 7877

C/ I sent this to the FST to clear
CR 27/8

Mr A Allan
Principal Private Secretary
Chancellor of the Exchequer
H M Treasury
Parliament Street
LONDON
SW1 3AG

26 August 1987

I am attaching a copy of the draft Press Notice on the Current Account of the United Kingdom Balance of Payments in July. The draft was agreed earlier today at the usual interdepartmental meeting.

Publication is set for Tuesday 1 September at 11.30 am and I should be grateful if you would arrange for the Notice to be cleared by 10.00 am Friday 28 August and to inform me accordingly.

A copy of this letter and draft Press Notice is being sent to Sir Peter Middleton and Mr Davis, H M Treasury.

Yours sincerely

W. E. Boyd.

W E BOYD

CH/EXCHEQUER
REC. 27 AUG 1987
ACTION MR BOTTRILL
COPIES TO FST

27/8

ADVICE TO FST PLEASE

REVISED DRAFT

Copy No. 3.(21)

THE CURRENT ACCOUNT OF THE UNITED KINGDOM BALANCE OF PAYMENTS

JULY 1987

The current account for July, seasonally adjusted, was estimated to have been in deficit by £310 million compared with a deficit of £140 million in June. In July, exports - seasonally adjusted on a balance of payments basis - were valued at £6776 million and imports at £7686 million so that trade in goods was in deficit by £910 million.

The balance on invisibles is projected to be in surplus by £600 million, a large surplus on the transactions of the private sector and public corporations being partly offset by a deficit on Government transactions

MAY TO JULY 1987

In the three months ended July, the current account showed a deficit of £0.9 billion compared with a surplus of £0.5 billion in the previous three months. There was a deficit on visible trade of £2.7 billion in the latest three months compared with a deficit of £1.1 billion in the three months ended April. The surplus on invisibles in the latest three months is projected at £1.8 billion.

CURRENT ACCOUNT

TABLE 1

£ million, Seasonally adjusted

	Current Balance	Visible Trade			Invisibles Balance[b]
		Balance	Exports fob	Imports fob	
1985	+ 2919	-2178	78111	80289	+ 5097
1986	- 980	-8463	72843	81306	+ 7483
1986 Q2	+ 135	-1608	17786	19393	+ 1742
Q3	- 918	-2891	17553	20444	+ 1973
Q4	- 930	-2725	19340	22065	+ 1795
1987 Q1	+ 502	-1135	19637	20772	+ 1637
Q2	- 561a	-2361	19381	21742	+ 1800a
1987 Feb	+ 314	- 202	6973	7174	+ 546
March	+ 129	- 417	6429	6846	+ 546
April	+ 74a	- 526	6610	7136	+ 600 a
May	- 496a	-1096	6372	7467	+ 600 a
June	- 140a	- 740	6399	7139	+ 600 a
July	- 310a	- 910	6776	7686	+ 600 a
Feb-Apr 1987	+ 548a	-1144	20012	21156	+ 1629 a
May-July 1987	- 945a	-2745	19547	22292	+ 1800 a
Jan-July 1987	- 369a	-4406	45794	50200	+ 4037 a

a Invisibles for April to July 1987 are projections.

b Monthly figures are one third of the appropriate calendar quarter's estimate or projection. Information relating to credits and debits can be found in Table 3.

VISIBLE TRADE IN JULY

There was a deficit on visible trade in July of £910 million compared with a deficit of £740 million in June. At £284 million, the surplus on oil was £39 million more than in June. The deficit on non-oil trade increased by £209 million.

At £6776 million, exports in July were £377 million (6 per cent) higher than in June. Exports of oil increased by £45 million betweeen the two months and exports of the erratic items increased by £72 million. Excluding oil and the erratic items, exports increased by 5 per cent between June and July.

Total imports were valued at £7686 million in July, which was £547 million (7 1/2 per cent) higher than in June. Imports of oil were little changed from the June level as were imports of the erratic items. Excluding oil and the erratic items, imports grew by 8 1/2 per cent between June and July.

RECENT TRENDS

Visible balance

In the three months ended July, there was a deficit on visible trade of £2.7 billion - a surplus on trade in oil of £0.9 billion offset by a deficit on non-oil trade of £3.6 billion. Between the three months ended April and the latest three months, the deficit on visible trade increased by £1.6 billion - the surplus on oil fell by £0.3 billion while the deficit on non-oil trade increased by £1.3 billion

Exports

Exports amounted to £19.5 billion in the three months ended July, £0.5 billion (2 1/2 per cent) less than in the previous three months. Exports of oil fell by £0.4 billion, accounting for most of the overall fall. Exports of the erratic items were little changed. Excluding oil and the erratic items exports were virtually unchanged between the three months ended April and the latest three months.

By volume, exports fell by 4 1/2 per cent between the three months ended April and the latest three months although they were still 3 per cent higher than in the same period last year. Excluding oil and the erratic items, export volume fell by 1 1/2 per cent in the latest three months and was 6 per cent higher than a year ago. The underlying level of non-oil export volume remains close to the high level reached at the end of last year.

Imports

Total imports were valued at £22.3 billion in the latest three months, £1.1 billion (5 1/2 per cent) higher than in the previous three months. Imports of oil fell by £0.1 billion over the three months while imports of the erratic items were little changed. Excluding oil and the erratic items, imports grew by 6 1/2 per cent between the three months ended April and the latest three months.

Total import volume in the latest three months was 6 per cent higher than in the previous three months and 8 per cent higher than in the same period last year. Excluding oil and the erratic items, import volume rose by 8 per cent in the latest three months to stand 10 per cent up on a year ago. The underlying level of non-oil import volume now appears to have been increasing in recent months.

?

Terms of trade and unit values

The terms of trade index rose by around 2 1/2 per cent between the three months ended April and the three months ended July with the export unit value index increasing by 1/2 per cent and the import unit value index falling by 2 per cent. Compared with the same three months of last year, the export unit value index is up by 5 1/2 per cent and the import unit value index is up by 4 1/2 per cent. As a result the terms of trade index is now about 1/2 per cent higher than a year ago.

Export unit values for fuels fell by 1/2 per cent between the three months ended April and the latest three months while the unit value index for non-oil exports increased by 1/2 per cent. Within the total for non-oil exports, most sectors showed little change in unit values. Rises of 2 per cent in the unit values of cars and of intermediate goods accounted for most of the overall change.

Import unit values for fuels fell by 2 per cent in the latest three months as did those for the total of non-oil goods. Import unit values for finished manufactures fell by 2 1/2 over the latest three months.

Analysis by area

Exports to the developed countries fell by 4 per cent between the three months ended April and the latest three months, largely reflecting a 15 per cent fall in deliveries to North America (although these picked up sharply between June and July). Exports to the European Community countries fell by 1 per cent in the latest three months while exports to the other developed countries rose by 5 per cent. Deliveries to the developing countries increased by 2 1/2 per cent between the three months ended April and the latest three months.

Imports from the developed countries increased by 6 per cent over the latest three months with arrivals from the European Community countries up 8 per cent, arrivals from North America up 4 per cent and imports from the other developed countries growing by 13 per cent - the latter mainly reflecting higher imports from Japan. Imports from the developing countries increased by 9 1/2 per cent between the two three month periods.

NOTES TO EDITORS

1 **INVISIBLES**

"REVISIONS

1. The figures for visible trade and for invisibles for periods up to and including 1986 have been revised in line with the annual estimates published in the CSO Pink Book on 21 August.

INVISIBLES

2. The figures for invisibles in the first quarter of 1987 are consistent with the annual estimates published in the CSO Pink Book on 21 August.

3. Preliminary estimates for the second quarter of 1987, replacing the projection included in tables 1 and 2,will be published in a CSO press notice on the balance of payments accounts on 17 September. The timing of the latter is about a fortnight later than the comparable press notices for previous quarters. This delay follows a review of the timetable for preparing quarterly balance of payments statistics, which concluded that more time should be allowed to prepare the preliminary estimates to improve their quality and to reduce the likelihood of revisions within relatively short periods. The revised timetable will ensure a fuller response to a number of quarterly surveys and increase the chances that figures for key large firms are included. These changes mean that now the projection will not normally be revised in the monthly press notice until after the publication of the quarterly estimates. (This modifies the procedures described in the note in Economic Trends for December 1986.)

4. The invisibles balance projection for July repeats the figure for the months of the second quarter. This figure will be reassessed in the next monthly press notice (in respect of August and due on 24 September) in the light of the preliminary estimates for the second quarter (to be published on 17 September) and other developments.

5. Estimates of invisibles are based on a variety of sources,available on a quarterly, annual or periodical basis, usually derived from sample inquiries of those engaging in the various transactions. In some parts of the account the information available is incomplete and subject to significant errors of estimation.Monthly figures of the invisibles balance are quarterly estimates and projections,expressed at a monthly rate.For recent months the figures are projections - rounded to the nearest £100m to emphasise their approximate nature - which are superceded by figures from the quarterly balance of payments which in the past were published in early March, June, September and December, but will appear in future around the middle of these months.

ADJUSTMENT FOR UNPROCESSED DOCUMENTS

6 Following an investigation by Customs and Excise into the effects of industrial action on the processing of import and export entries the figures for April to July have been adjusted to take account of unprocessed documents attributable to those months. These adjustments have been made to the Balance of Payments based figures (tables 1 to 7 and 16), but not to the OTS figures (tables 8 to 15). The amounts involved are as follows:

Adjustment for unprocessed documents

	April	May	June	July	£ million
Exports	+32	+57	+72	+47	
Imports	+64	+23	+35	-	

AREA (tables 11 and 15)

7 ~~5~~ Low value consignments ie items of an individual values less than £475, are not analysed by country and are therefore excluded from the area data in tables 11 and 15. In addition the method of seasonal adjystment leads to further differences between the sum of areas and figures for total trade.

MONTHLY REVIEW OF EXTERNAL TRADE STATISTICS

8 ~~6~~ The Monthly Review supplements the information contained in this Press Notice. It gives longer historical runs of data and contains charts, tables on the UK Balance of Payments, UK exports and imports on an Overseas Trade Statistics basis, and certain international comparisons.

The Monthly Review is available from the Department of Trade and Industry at the address given below for an annual subscription of £38 which includes the annual supplement. Individual copies are priced at £3, (£6 for the annual supplement).

STANDARD NOTES

9 There is a set of standard notes that describe the basis on which the figures in this Press Notice are compiled including the differences between the Balance of Payments (BOP) and the Overseas Trade Statistics (OTS) figures. Copies can be obtained from the address below.

Enquiries about the Standard Notes, and the Monthly Review, should be addressed to S2A, Room 255, Department of Trade and Industry, 1 Victoria Street, London SW1H 0ET, Telephone: 01-215 4895.

INDEX OF TABLES

A BALANCE OF PAYMENTS BASIS

	TABLE	PAGE
Current account	1	1
Current balance, visible trade and invisibles	2	6
Invisibles	3	6
Export and import unit value and volume index numbers	4	7
Value and volume of exports and imports excluding the more erratic items	5	7
Trade in oil	6	8
Trade in Goods other than oil	7	9

B OVERSEAS TRADE STATISTICS

	TABLE	PAGE
Exports by commodity	8	10
Exports by commodity: volume indices	9	10
Exports by commodity: unit value indices	10	11
Exports by area	11	11
Imports by commodity	12	12
Imports by commodity: volume indices	13	12
Imports by commodity: unit value indices	14	13
Imports by area	15	13

C QUARTERLY BALANCE OF PAYMENTS DATA

	TABLE	PAGE
Commodity analysis of visible trade	16	14

Table 2

CURRENT BALANCE, VISIBLE TRADE AND INVISIBLES
(Balance of Payments basis)

£ million seasonally adjusted

		Current Balance	Visible Trade					Invisible Balance[b]
			Exports fob	Imports fob	Visible Balance	of which Oil	Non-Oil	
1985		+ 2919	78111	80289	- 2178	+ 8104	- 10282	+ 5097
1986		- 980	72843	81306	- 8463	+ 4056	- 12519	+ 7483
1986	Q2	+ 135	17786	19393	- 1608	+ 765	- 2372	+ 1742
	Q3	- 918	17553	20444	- 2891	+ 621	- 3512	+ 1973
	Q4	- 930	19340	22065	- 2725	+ 785	- 3510	+ 1795
1987	Q1	+ 502	19637	20772	- 1135	+ 1164	- 2300	+ 1637
	Q2	- 561 a	19381	21742	- 2361	+ 1033	- 3395	+ 1800a
1986	Nov	- 462	6569	7630	- 1061	+ 329	- 1390	+ 599
	Dec	- 313	6477	7388	- 911	+ 256	- 1167	+ 598
1987	Jan	+ 28	6235	6752	- 517	+ 383	- 900	+ 545
	Feb	+ 344	6973	7174	- 202	+ 328	- 529	+ 546
	March	+ 129	6429	6846	- 417	+ 454	- 870	+ 546
	Apr	+ 74 a	6610	7136	- 526	+ 423	- 949	+ 600 a
	May	- 496 a	6372	7467	- 1096	+ 365	- 1461	+ 600 a
	June	- 140 a	6399	7139	- 740	+ 245	- 985	+ 600 a
	July	- 310 a	6776	7686	- 910	+ 284	- 1194	+ 600 a
May-July 1986		- 154	17707	19679	- 1973	+ 685	- 2658	+ 1819
Feb-Apr 1987		+ 548 a	20012	21156	- 1144	+ 1204	- 2349	+ 1692a
May-July 1987		- 945 a	19547	22292	- 2745	+ 895	- 3639	+ 1800 a
% Change								
Latest 3 months								
- on previous 3 months			- 2½	+ 5½				
- Same 3 months one year ago			+ 10	+ 13				

a Invisibles for April to July 1987 are projections.

b Monthly figures are one third of the appropriate calendar quarter's estimate or projection.

Table 3

INVISIBLES

£ million seasonally adjusted

		All Sectors						Private Sector and Public Corporations[d]		
					of which					
		Credits	Debits	Balance	Services	Interest Profits Dividends	Transfers	Credits	Debits	Balance
1984		77061	71203	+ 5858	+ 3481	+ 4216	- 1839	71761	62373	+ 9388
1985		79784	74687	+ 5097	+ 5381	+ 2992	- 3276	75134	64724	+10410
1986		76202	68719	+ 7483	+ 4990	+ 4686	- 2193	71094	59111	+11983
1985	Q1	21694	20605	+ 1089	+ 1132	+ 908	- 951	20449	17911	+ 2538
	Q2	20159	18644	+ 1515	+ 1470	+ 748	- 703	19117	16427	+ 2690
	Q3	19351	17615	+ 1736	+ 1500	+ 1118	- 882	18129	14953	+ 3176
	Q4	18580	17823	+ 757	+ 1279	+ 218	- 740	17439	15433	+ 2006
1986	Q1	18916	16943	+ 1973	+ 1255	+ 791	- 73	17562	14918	+ 2644
	Q2	18452	16710	+ 1742	+ 1178	+ 1117	- 553	17140	14308	+ 2832
	Q3	19246	17273	+ 1973	+ 1242	+ 1506	- 775	17958	14669	+ 3289
	Q4	19588	17793	+ 1795	+ 1315	+ 1272	- 792	18434	15216	+ 3218
1987	Q1	19601	17964	+ 1637	+ 1243	+ 1177	- 733	17949	14885	+ 3064

d ie excluding general Government transactions and all transfers.

SECRET and personal
until release of press notice on E1SEP 87 at 11.30 a.m.

EXPORT AND IMPORT UNIT VALUE AND VOLUME INDEX NUMBERS

(Balance of Payments basis)

Table 4

Indices 1980 = 100

	Unit Value (Not seasonally adjusted)			Volume (seasonally adjusted)	
	Exports	Imports	Terms of Trade[e]	Exports	Imports
1985	143.5	145.2	98.8	118.7	126.0
1986	136.6	134.0	101.9	123.1	134.2
1986 Q2	134.8	131.6	102.5	121.9	129.1
Q3	134.3	130.1	103.2	122.6	139.0
Q4	138.1	136.8	100.9	130.5	144.0
1987 Q1	140.7	140.0	100.5	130.0	133.2
Q2	141.2	136.2	103.7	126.3	140.7
1986 Nov	138.1	136.7	101.0	132.8	147.9
Dec	138.7	138.3	100.2	131.6	143.9
1987 Jan	140.4	140.1	100.2	124.6	131.4
Feb	140.8	140.3	100.4	138.4	138.0
March	141.0	139.8	100.8	126.9	130.2
Apr	141.0	137.2	102.8	131.4	138.6
May	140.9	135.7	103.8	123.9	144.3
June	141.6	135.7	104.4	123.5	139.1
July	141.7	137.5	103.1	131.3	147.6
May-July 1986	134.2	130.2	103.1	122.6	133.1
Feb-Apr 1987	140.9	139.1	101.3	132.2	135.6
May-July 1987	141.4	136.3	103.8	126.2	143.7
% Change					
Latest 3 months on					
- previous 3 months	+ ½	- 2	+ 2½	- 4½	+ 6
- same 3 months one year ago	+ 5½	+ 4½	+ ½	+ 3	+ 8

[e] Export unit value index as a percentage of the import unit value index.

VALUE AND VOLUME OF EXPORTS AND IMPORTS EXCLUDING THE MORE ERRATIC ITEMS[f]

(Balance of Payments basis)

Table 5

seasonally adjusted

	Value £ million fob		Volume Index 1980 = 100	
	Exports	Imports	Exports	Imports
1985	73819	76749	123.1	133.7
1986	67459	77657	126.0	142.5
1986 Q2	16238	18455	123.0	136.8
Q3	16367	19561	126.5	147.7
Q4	17759	21146	133.0	153.8
1987 Q1	18125	19833	132.9	141.8
Q2	17961	20681	129.4	149.0
1986 Nov	5997	7305	134.9	157.7
Dec	5936	7112	133.9	154.3
1987 Jan	5765	6489	128.3	140.8
Feb	6449	6884	141.2	147.4
March	5910	6461	129.3	137.2
Apr	6144	6753	135.0	146.3
May	5899	7139	127.0	153.3
June	5918	6790	126.2	147.3
July	6224	7330	133.8	156.7
May-July 1986	16347	18843	124.9	141.8
Feb-Apr 1987	18503	20097	135.2	143.6
May-July 1987	18041	21258	129.0	152.4
% Change				
Latest 3 month on				
- previous 3 months	- 2½	+ 6	- 4½	+ 6
- same 3 months one year ago	+ 10	+ 13	+ 3½	+ 7½

[f] These are defined as ships, North Sea installations, aircraft, precious stones, and silver.

SECRET and personal
until release of press notice on -1 SEP 87 at 11.30 a.m.

TRADE IN OIL[g]

(Balance of Payments basis)

seasonally adjusted

	Balance of Trade in oil	Exports of Oil					Imports of Oil				
		Total	Crude Oil [SITC (REV 2) 333.0]			Rest of Division 33	Total	Crude Oil [SITC (REV 2) 333.0]			Rest of Division 33
	£ million fob	£ million fob	£ million fob	million tonnes	Avg value per tonne £ fob	£ million fob	£ million fob	£ million fob	million tonnes	Avg value per tonne £ fob	£ million fob
1985	+ 8104	16134	13006	79.6	163.4	3128	8029	4234	26.9	157.6	3796
1986	+ 4056	8221	6294	82.1	76.7	1927	4165	2324	32.6	71.2	1841
1986 Q2	+ 765	1783	1211	18.6	65.1	572	1018	550	7.7	71.7	469
Q3	+ 621	1529	1120	19.7	57.0	408	908	435	8.7	50.1	473
Q4	+ 785	1886	1533	21.6	71.0	353	1101	617	9.6	64.5	484
1987 Q1	+ 1164	2225	1824	21.9	83.4	401	1061	624	7.9	79.3	437
Q2	+ 1033	2076	1658	19.8	83.6	417	1042	658	8.3	79.3	384
1986 Nov	+ 329	632	528	7.5	70.6	104	303	178	2.8	62.8	126
Dec	+ 256	625	494	7.0	71.0	132	370	239	3.6	66.8	131
1987 Jan	+ 383	731	600	7.4	81.2	131	348	209	2.8	75.2	139
Feb	+ 328	752	600	7.1	84.3	151	424	241	3.0	81.3	183
Mar	+ 454	743	624	7.4	84.6	119	289	173	2.1	81.7	116
Apr	+ 423	832	679	8.0	84.9	153	409	269	3.4	79.2	139
May	+ 365	629	516	6.4	81.3	113	264	127	1.6	77.5	137
June	+ 245	615	464	5.5	84.5	151	370	261	3.3	80.2	108
July	+ 284	660	496	5.8	85.1	163	375	217	2.7	82.1	158
May-Jul 1986	+ 685	1666	1151	18.7	61.7	516	982	535	8.9	60.1	447
Feb-Apr 1987	+ 1204	2326	1903	22.5	84.6	423	1122	684	8.5	80.6	438
May-Jun 1987	+ 895	1903	1476	17.7	83.5	427	1009	606	7.6	80.3	403
% Change Latest 3 months on											
- previous 3 months		- 18	- 22	- 21	- 1½	+ 1	- 10	- 11	- 11	- ½	- 8
- same 3 months one year ago		+ 14	+ 28	- 5½	+ 35	- 17	+ 3	+ 13	- 15	+ 34	- 10

---

[g] Trade in petroleum and petroleum products. These figures differ from those published by the Department of Energy which are on a time of shipment basis (see paragraph 8 of the standard notes).

SECRET and personal
until release of press notice on 1 SEP 87 at 11.30 am

TRADE IN GOODS OTHER THAN OIL
(Balance of Payments basis)

	Total								Excluding Erratics[f]			
	Value, £ million, fob (seasonally adjusted)			Unit value index 1980 = 100 (not seasonally adjusted)			Volume index 1980 = 100 (seasonally adjusted)		Value, £ million fob (seasonally adjusted)		Volume index 1980 = 100 (seasonally adjusted)	
	Balance of non oil trade	Exports	Imports	Exports	Imports	Terms of Trade[e]	Exports	Imports	Exports	Imports	Exports	Imports
1985	- 10282	61977	72259	141.8	141.8	100.0	110.6	133.0	57685	68719	114.9	142.8
1986	- 12519	64621	77141	145.1	141.5	102.6	115.2	140.5	59238	73491	117.7	150.9
1986 Q2	- 2372	16003	18375	144.2	139.1	103.7	114.7	135.4	14455	17437	115.1	145.0
Q3	- 3512	16024	19536	145.3	140.3	103.5	114.7	143.7	14839	18653	118.5	154.4
Q4	- 3510	17454	20964	148.1	146.3	101.3	123.1	149.4	15873	20045	125.3	161.4
1987 Q1	- 2300	17411	19711	149.7	148.0	101.1	121.8	139.7	15899	18772	124.4	150.4
Q2	- 3395	17305	20700	150.3	143.5	104.7	119.5	149.0	15885	19639	122.4	159.6
1986 Nov	- 1390	5937	7327	148.1	146.3	101.3	125.5	156.4	5365	7002	127.3	168.9
Dec	- 1167	5852	7018	148.6	147.6	100.7	124.6	149.7	5311	6743	126.5	162.6
1987 Jan	- 900	5504	6404	149.5	148.4	100.7	115.4	137.1	5034	6141	118.7	148.7
Feb	- 529	6221	6750	149.5	148.0	101.0	131.6	142.7	5697	6460	134.2	154.3
Mar	- 870	5686	6557	150.1	147.6	101.7	118.5	139.1	5168	6172	120.5	148.3
Apr	- 949	5778	6727	150.0	144.7	103.7	120.5	144.3	5312	6344	123.6	153.8
May	- 1461	5743	7204	150.2	143.0	105.0	118.5	156.0	5270	6875	121.6	167.9
June	- 985	5784	6769	150.6	142.7	105.6	119.3	146.5	5303	6420	122.1	156.9
July	- 1194	6117	7311	150.5	144.8	103.9	126.9	155.9	5564	6954	129.3	167.5
May-July 1986	- 2658	16040	18698	144.2	138.8	104.0	115.2	138.3	14681	17861	117.0	149.1
Feb-April 1987	- 2349	17686	20035	149.9	146.8	102.1	123.5	142.1	16177	18975	126.1	152.1
May-July 1987	- 3639	17644	21283	150.4	143.5	104.8	121.6	152.8	16138	20249	124.3	164.1
% Change												
Latest 3 months on												
- previous 3 months		-	+ 6	+ ½	- 2	+ 2½	- 1½	+ 7½	-	+ 6½	- 1½	+ 8
- same 3 months one year ago		+ 10	+14	+ 4½	+ 3½	+ 1	+ 5½	+10	+ 10	+13	+ 6	+ 10

---

[f] These are defined as ships, North Sea installations, aircraft, precious stones, and silver.

[e] Export unit value index as a percentage of the import unit value index.

SECRET and personal until release of press notice on -1 SEP 87. at 11.30 a.m.

EXPORTS BY COMMODITY
(Overseas Trade Statistics basis)

Table 8

£ million, fob, seasonally adjusted

	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Manufactures excluding erratics[h]								
						Total	Semi-manufactures excluding precious stones & silver(PS)			Finished manufactures excluding ships, North Sea installations and aircraft (SNA)				
							Total	Chemicals	Other	Total	Passenger Motor Cars	Other Consumer	Intermediate	Capital
SITC (REV 2)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
1985	78392	4971	2128	16795	52506	48473	18458	9412	9046	30015	1343	5257	13475	9940
1986	73009	5478	2046	8683	54595	49697	18758	9692	9066	30939	1362	5712	13682	10183
1986 Q2	17832	1284	443	1922	13644	12214	4607	2394	2213	7607	340	1391	3353	2523
Q3	17632	1394	542	1614	13582	12506	4800	2470	2330	7706	362	1470	3353	2523
Q4	19347	1571	561	1970	14570	13139	4924	2539	2386	8215	361	1534	3407	2467
1987 Q1	19637	1372	624	2309	14642	13287	4880	2507	2374	8407	459	1660	3579	2740
Q2	19316	1347	543	2158	14614	13260	4880	2498	2381	8380	488	1653	3542	2745
1987 May	6342	459	164	657	4821	4378	1623	835	787	2755	156	534	1165	900
June	6351	443	188	636	4872	4420	1655	828	827	2764	150	527	1178	909
July	6785	500	170	697	5212	4667	1747	867	879	2920	192	602	1183	943
Feb-Apr 87	20022	1363	600	2413	14948	13556	4974	2580	2394	8581	480	1738	3602	2761
May-Jul 87	19478	1401	521	1991	14905	13464	5025	2531	2494	8439	498	1663	3526	2752
Percentage change	- 2½	+ 3	- 13	- 17	- ½	- ½	+ 1	- 2	+ 4	- 1½	+ 3½	- 4½	- 2	- ½

[h] These are defined as ships, North Sea installations (together comprising SITC (REV 2) 793), aircraft (792) precious stones (667), and silver (681.1).

[j] Based on the United Nations Broad Economic Categories end-use classification.

EXPORTS BY COMMODITY: VOLUME INDICES
(Overseas Trade Statistics basis)

Table 9

INDICES 1980 = 100, seasonally adjusted

	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Manufactures excluding erratics[h]								
						Total	Semi-manufactures excluding precious stones & silver(PS)			Finished manufactures excluding ships, North Sea installations and aircraft (SNA)				
							Total	Chemicals	Other	Total	Passenger Motor Cars	Other Consumer	Intermediate	Capital
SITC (REV 2)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
Weights	1000	69	31	136	735	658	252	112	141	406	18	71	170	147
1985	119.3	119.2	106.1	171.7	110.8	115.7	118.9	133.3	107.5	113.6	99.4	111.6	121.2	107.6
1986	123.6	129.6	117.1	175.5	114.0	116.9	121.9	139.4	108.1	113.8	93.2	117.5	120.4	106.9
1986 Q2	122.1	120	102	170	115	116	120	138	106	113	95	116	119	107
Q3	124.4	134	126	174	113	118	125	143	111	113	97	122	120	102
Q4	130.5	146	129	179	120	123	127	146	112	120	91	123	126	105
1987 Q1	130.2	129	145	183	119	122	126	143	112	120	114	133	126	115
Q2	125.7	124	120	171	118	121	125	140	113	118	120	133	120	114
1987 May	123.4	128	109	160	116	119	125	142	111	116	114	126	118	112
June	123.0	121	124	149	118	121	127	136	119	117	109	125	116	111
July	132.2	135	114	162	127	129	134	146	125	126	141	144	120	120
Feb-Apr 87	131.9	128	134	188	122	125	128	147	113	122	120	142	122	114
May-Jul 87	126.2	128	116	157	120	123	129	141	119	119	121	132	118	114
Percentage change	- 4½	+ ½	- 14	- 17	- 1	- 1½	+ ½	- 4	+ 5	- 2	+ 1	- 7	- 2½	+ ½

[h] These are defined as ships, North Sea installations (together comprising SITC (REV 2) 793), aircraft (792) precious stones (667), and silver (681.1).

[j] Based on the United Nations Broad Economic Categories end-use classification.

SECRET and personal
until release of press notice on -1 SEP 87 at 11.30 a.m.

Table 10

EXPORTS BY COMMODITY: UNIT VALUE INDICES
(Overseas Trade Statistics basis)

INDICES 1980 = 100 not seasonally adjusted

	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Manufactures excluding erratics[h]								
						Total	Semi-manufactures excluding precious stones & silver(PS)			Finished manufactures excluding ships, North Sea installations and aircraft (SNA)				
							Total	Chemicals	Other	Total	Passenger Motor Cars	Other Consumer	Intermediate	Capital
SITC (REV 2)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
Weights	1000	69	31	136	735	658	252	112	141	406	18	71	170	147
1985	143.4	134	140	155	143	142	135	139	132	147	162	147	150	141
1986	136.5	140	123	81	147	148	138	141	135	154	182	157	157	146
1986 Q2	134.7	141	124	74	146	147	138	142	134	153	179	156	156	145
Q3	134.2	140	120	62	148	148	137	140	135	155	186	156	159	146
Q4	138.0	142	121	72	151	150	139	141	138	157	198	161	160	148
1987 Q1	140.5	141	122	82	152	153	141	144	139	160	201	164	163	150
Q2	141.0	140	123	81	153	154	141	145	137	162	204	163	168	150
1987 May	140.8	139	123	80	153	154	141	145	137	163	207	163	169	149
June	141.5	140	124	82	153	154	141	146	138	162	203	163	169	150
July	141.5	140	125	83	153	154	141	145	139	162	206	164	167	150
Feb-Apr 87	140.8	141	123	82	153	153	141	145	138	161	201	164	165	150
May-Jul 87	141.3	140	124	82	153	154	141	145	138	162	205	163	168	150
Percentage change	+ ½	- ½	+ ½	- ½	+ ½	+ ½	-	+ ½	- ½	+ 1	+ 2	- ½	+ 2	-

[h] These are defined as ships, North Sea installations (together comprising SITC (REV 2) 793), aircraft (792) precious stones (667), and silver (681.1).

[j] Based on the United Nations Broad Economic Categories end-use classification.

Table 11

EXPORTS BY AREA
(Overseas Trade Statistics basis)

£ million, fob, seasonally adjusted

	Total[K]	Developed Countries						Developing Countries			Centrally planned economies
		Total	European Community	Rest of W Europe	North America Total	USA	Other	Total	Oil exporting countries	Other	
1985	78392	62787	38226	7438	13332	11519	3791	13876	5952	7924	1587
1986	73009	57709	35004	6963	12128	10380	3614	13139	5495	7644	1721
1986 Q2	17832	13799	8328	1710	2880	2494	881	3451	1551	1900	446
Q3	17632	13944	8498	1709	2829	2432	909	3215	1317	1897	368
Q4	19347	15474	9545	1799	3225	2717	905	3254	1238	2016	470
1987 Q1	19637	15715	9330	1747	3676	3153	962	3401	1313	2088	437
Q2	19316	15515	9789	1903	2886	2407	937	3445	1306	2139	337
1987 May	6342	5090	3225	651	894	725	321	1179	459	719	117
June	6351	5079	3210	613	949	800	308	1123	416	707	91
July	6785	5398	3223	607	1203	1026	366	1201	416	785	124
Feb-Apr 87	20022	16206	9762	1907	3589	3072	947	3418	1304	2114	428
May-Jul 87	19478	15567	9658	1870	3045	2551	994	3503	1292	2212	332
Percentage change	- 2½	- 4	- 1	- 2	- 15	- 17	+ 5	+ 2½	- 1	+ 4½	- 23

[K] See paragraph ~~8~~ 7 of Notes to Editors.

SECRET and personal
until release of press notice on -1 SEP 87 at 11.30 a.m.

IMPORTS BY COMMODITY

(Overseas Trade Statistics basis)

Table 12

£ million cif seasonally adjusted

						Manufactures excluding erratics[h]								
							Semi-manufactures excluding precious stones & silver(PS)			Finished manufactures excluding ships, North Sea installations and aircraft (SNA)				
	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Total	Total	Chemicals	Other	Total	Passenger Motor Cars	Other Consumer	Intermediate	Capital
SITC (REV 2)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
1985	85027	9337	5388	10664	58312	54934	19611	6901	12710	35322	4165	8884	11623	10649
1986	86066	10067	4988	6294	62833	59472	20713	7346	13367	38759	4809	10177	12706	11067
1986 Q2	20467	2419	1211	1522	14914	14087	5024	1795	3229	9063	1136	2412	2979	2537
Q3	21836	2564	1190	1502	16041	15199	5207	1831	3376	9992	1279	2653	3268	2792
Q4	23269	2632	1376	1541	17146	16303	5472	1922	3549	10832	1279	2838	3597	3118
1987 Q1	21819	2473	1386	1468	16148	15248	5377	1943	3434	9871	1054	2576	3289	2952
Q2	22819	2450	1411	1465	17176	16183	5686	2024	3662	10497	1196	2785	3549	2967
1987 May	7826	899	469	393	5957	5676	2003	700	1303	3674	414	951	1253	1056
June	7511	783	460	520	5658	5317	1856	669	1186	3461	416	964	1131	950
July	8127	855	453	546	6058	5772	1934	687	1247	3838	468	959	1307	1104
Feb-Apr 87	22180	2447	1410	1551	16430	15408	5494	1972	3522	9913	1044	2659	3343	2867
May-Jul 87	23464	2537	1382	1459	17673	16765	5792	2056	3736	10973	1298	2874	3691	3110
Percentage change	+ 6	+ 3½	- 2	- 6	+ 7½	+ 9	+ 5½	+ 4½	+ 6	+ 11	+ 24	+ 8	+ 10	+ 8½

[h] These are defined as ships, North Sea installations (together comprising SITC (REV 2) 793), aircraft (792) precious stones (667), and silver (681.1).

[j] Based on the United Nations Broad Economic Categories end-use classification.

IMPORTS BY COMMODITY: VOLUME INDICES

(Overseas Trade Statistics basis)

Table 13

INDICES 1980 = 100 seasonally adjusted

						Manufactures excluding erratics[h]								
							Semi-manufactures excluding precious stones & silver(PS)			Finished manufactures excluding ships, North Sea installations and aircraft (SNA)				
	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Total	Total	Chemicals	Other	Total	Passenger Motor Cars	Other Consumer	Intermediate	Capital
SITC (REV 2)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
Weights	1000	124	81	138	626	543	217	63	154	326	42	94	96	94
1985	124.6	114.4	102.2	86.2	140.7	154.4	143.9	176.1	130.6	161.4	127.9	139.5	172.8	187.1
1986	132.8	123.5	108.7	93.4	148.2	163.0	152.0	188.0	137.2	170.4	131.6	158.3	187.0	183.1
1986 Q2	127.1	120	105	85	143	157	149	187	134	162	125	154	181	169
Q3	138.1	126	106	112	153	168	155	191	140	176	142	165	193	185
Q4	142.4	125	119	106	158	174	157	192	142	186	133	170	205	205
1987 Q1	130.9	120	122	91	146	161	152	191	136	166	103	156	185	187
Q2	137.8	120	122	90	158	173	163	205	146	179	121	172	203	192
1987 May	141.8	133	121	72	164	182	172	216	154	189	122	178	215	205
June	136.1	114	120	97	156	171	160	203	143	178	128	178	196	184
July	146.4	124	116	103	166	184	166	208	148	196	143	179	222	214
Feb-Apr 87	132.7	119	122	94	149	162	156	196	140	167	103	161	188	181
May-Jul 87	141.4	124	119	91	162	179	166	209	148	188	131	178	211	201
Percentage change	+ 6½	+ 4	- 2½	- 3½	+ 9	+ 10	+ 6	+ 6½	+ 6	+ 13	+ 27	+ 10	+ 12	+ 11

[h] These are defined as ships, North Sea installations (together comprising SITC (REV 2) 793), aircraft (792) precious tones (667), and silver (681.1).

[j] Based on the United Nations Broad Economic Categories end-use classification.

SECRET and personal
until release of press notice on 1 SEP 87 at 11.30 a.m.

Table 14

IMPORTS BY COMMODITY: UNIT VALUE INDICES
(Overseas Trade Statistics basis)

INDICES 1980 = 100 not seasonally adjusted

	Total	Food beverages and tobacco	Basic Materials	Fuels	Total Manufactures	Manufactures excluding erratics[h]								
						Total	Semi-manufactures excluding precious stones & silver(PS)			Finished manufactures excluding ships, North Sea installations and aircraft (SNA)				
							Total	Chemicals	Other	Total	Passenger Motor Cars	Other Consumer	Intermediate	Capital
SITC (REV 2)	0-9	0+1	2+4	3	5-8	5-8 less SNAPS	5+6 less PS	5	6 less PS	7+8 less SNA	j	j	j	j
Weights	1000	124	81	138	626	543	217	63	154	326	42	94	96	94
1985	143.1	137	130	172	141	141	133	139	130	146	152	147	155	134
1986	132.5	136	113	97	143	144	133	141	130	152	170	148	158	141
1986 Q2	130.1	135	113	96	140	142	131	139	128	148	169	144	153	139
Q3	129.1	136	111	78	142	144	132	139	130	152	168	147	159	141
Q4	135.1	139	115	84	149	150	137	145	133	159	178	155	167	147
1987 Q1	137.9	138	117	94	151	152	138	147	135	162	189	155	167	151
Q2	134.8	136	117	93	147	149	137	145	133	157	183	149	164	148
1987 May	134.4	135	116	92	147	149	137	144	134	157	185	147	164	147
June	134.3	136	117	94	146	148	137	145	133	156	181	147	164	147
July	135.2	136	117	94	147	149	138	146	134	157	183	150	163	146
Feb-Apr 87	137.2	137	117	95	150	152	138	147	134	161	186	154	166	151
May-Jul 87	134.6	135	117	93	147	149	137	145	134	157	183	148	164	146
Percentage change	- 2	- 1½	-	- 2	- 2	- 1½	- ½	- 1	-	- 2½	- 1½	- 4	- 1	- 3

[h] These are defined as ships, North Sea installations (together comprising SITC (REV 2) 793), aircraft (792) precious stones (667), and silver (681.1).

[j] Based on the United Nations Bread Economic Categories end-use classification.

IMPORTS BY AREA

Table 15

(Overseas Trade Statistics basis)

£ million cif seasonally adjusted

	Total[K]	Developed Countries						Developing Countries			Centrally planned economies
		Total	European Community	Rest of W Europe	North America Total	USA	Other	Total	Oil exporting countries	Other	
1985	85027	71665	41474	12102	11709	9926	6379	11327	2815	8512	1893
1986	86066	73285	44506	11864	10054	8468	6861	10514	1877	8637	1856
1986 Q2	20467	17360	10566	2729	2420	2030	1645	2540	460	2080	466
Q3	21036	18569	11426	2896	2512	2138	1735	2670	408	2262	456
Q4	23269	19705	11950	3151	2771	2331	1833	2928	511	2418	511
1987 Q1	21819	18625	11411	3060	2435	2025	1720	2540	462	2078	482
Q2	22819	19602	12100	3202	2616	2223	1684	2683	432	2251	497
1987 May	7826	6696	4265	1036	845	722	550	936	158	778	157
June	7511	6453	3923	1059	853	715	617	917	139	778	159
July	8127	6944	4250	1107	946	791	641	906	139	767	181
Feb-Apr 87	22180	18933	11522	3260	2546	2128	1605	2517	431	2086	513
May-Jul 87	23464	20093	12439	3202	2644	2228	1809	2758	436	2323	497
Percentage change	+ 6	+ 6	+ 8	- 2	+ 4	+ 4½	+ 13	+ 9½	+ 1	+ 11	- 3

K See paragraph ~~8~~ 7 Notes to Editors.

SECRET and personal
until release of press notice on 21 SEP 87 at 11.30 a.m.

UKBAAJ

Table 16

COMMODITY ANALYSIS OF VISIBLE TRADE
(Balance of Payments basis)

£ million, seasonally adjuste

SITC (R2)	Food Beverages and Tobacco 0 + 1			Basic Materials 2 + 4			Fuels 3		
	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance
1985	4932	8522	- 3591	2144	4795	- 2651	16795	10233	+ 6562
1986	5439	9230	- 3792	2058	4416	- 2359	8683	5994	+ 2690
1985 Q3	1260	2126	- 866	532	1173	- 641	3576	2134	+ 1442
Q4	1194	2083	- 889	504	1070	- 566	3862	2237	+ 1625
1986 Q1	1219	2247	- 1027	504	1092	- 588	3177	1641	+ 1536
Q2	1271	2213	- 942	445	1076	- 631	1922	1426	+ 496
Q3	1383	2356	- 973	545	1025	- 480	1614	1393	+ 221
Q4	1565	2415	- 849	564	1223	- 659	1970	1533	+ 438
1987 Q1	1354	2285	- 931	629	1232	- 603	2308	1413	+ 895
Q2	1344	2269	- 925	553	1175	- 622	2146	1414	+ 733

SITC (R2)	Semi-Manufactures 5 + 6			Finished Manufactures 7 + 8			Total Manufactures 5 - 8		
	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance	Exports fob	Imports fob	Visible Balance
1985	20051	19949	+ 102	32221	35324	- 3103	52271	55273	- 3002
1986	20946	21524	- 578	33540	38453	- 4913	54486	59977	- 5491
1985 Q3	4865	5125	- 260	7962	8379	- 417	12827	13504	- 678
Q4	4952	4900	+ 53	8096	8645	- 549	13048	13545	- 497
1986 Q1	4851	5294	- 443	7925	8751	- 825	12777	14045	- 1269
Q2	5221	5179	+ 42	8395	9092	- 697	13615	14271	- 656
Q3	5290	5339	- 49	8230	9922	- 1692	13520	15261	- 1741
Q4	5585	5712	- 127	8990	10688	- 1698	14575	16400	- 1826
1987 Q1	5474	5652	- 178	9190	9748	- 558	14664	15400	- 736
Q2	5520	5836	- 316	9166	10711	- 1544	14686	16547	- 1860

Monthly data at this level of detail are published in the Monthly Review of External Trade Statistics.

SECRET and personal
until release of press notice on -1 SEP 87 at 11.30 a.m.

SECRET AND PERSONAL until release of press notice at 11.30 am on 1 September 1987 and thereafter unclassified

To: MINISTER FOR TRADE

Copy No. (3) 28

From: Peter Stibbard
US/S2
V/260 Ext. 4871

25 August 1987

OVERSEAS TRADE FIGURES FOR JULY 1987

THE CURRENT ACCOUNT

In July, exports are valued at £6.8 billion* and imports at £7.7 billion so that visible trade, seasonally adjusted on a balance of payments basis, show a deficit of £0.9 billion compared with a deficit of £0.7 billion in June.

The Central Statistical Office project a surplus on invisibles of £0.6 billion for July so that the current account is provisionally estimated to have been in deficit by £0.3 billion compared with a deficit of £0.1 billion in June.

TABLE 1: CURRENT BALANCE, VISIBLE TRADE AND INVISIBLES
(Table 2 of Press Notice)

Seasonally adjusted
Balance of Payments
Basis
£ million

	Current Account Balance	Visible Trade Balances			Invisibles Balance
		Total	Oil	Non-oil	
1985	+2919	-2178	+8104	-10282	+5097
1986	- 980	-8463	+4056	-12519	+7483
1987 Feb-Apr	+ 613A	-1144	+1204	- 2349	+1757
May-July	- 945A	-2745	+ 895	- 3639	+1800A
1987 May	- 496A	-1096	+ 365	- 1461	+ 600A
June	- 140A	- 740	+ 245	- 985	+ 600A
July	- 310A	- 910	+ 284	- 1194	+ 600A

A = Projection

*** The export figures in this note differ slightly to those shown in Mr Boyd's note of 20 August because we have now included two late items reported to us by Customs since then.**

SECRET AND PERSONAL until release of press notice at 11.30 am on 1 September 1987 and thereafter unclassified

In the three months ended July, there was a deficit on visible trade of £2.7 billion - a surplus on trade in oil of £0.9 billion offset by a deficit on non-oil trade of £3.6 billion. Between the three months ended April and the latest three months, the visible trade balance deteriorated by £1.6 billion - the surplus on oil fell by £0.3 billion while the deficit on non-oil trade increased by £1.3 billion.

EXPORTS

The value of exports in July was £377 million (6 per cent) higher than in June. Exports of oil increased by £45 million between the two months and exports of the erratic items increased by £72 million. Excluding oil and the erratic items, exports increased by 5 per cent between June and July.

In the three months ended July, total export volume was 4½ per cent lower than in the previous three months although still 3 per cent higher than in the same period last year. Excluding oil and the erratic items, export volume fell by 1½ per cent between the three months ended April and the latest three months and stands 6 per cent up on a year ago. It is too early to say whether there has been any change from last month's assessment, which was that non-oil exports have settled at a level a little below the high totals reached at the end of last year.

TABLE 2: EXPORTS BY VALUE AND VOLUME (Tables 1, 4 and 7 of Press Notice)

Bop Basis, Seasonally Adjusted

	VALUE (£m)		VOLUME (1980 = 100)	
	Total	Total Less Oil and erratics	Total	Total less Oil and erratics
1985	78111	57685	118.7	114.9
1986	72843	59238	123.1	117.7
1987 Feb-Apr	20012	16177	132.2	126.1
May-July	19547	16138	126.2	124.3
1987 May	6372	5270	123.9	121.6
June	6399	5303	123.5	122.1
July	6776	5564	131.3	129.3

By value, exports fell by 2½ per cent between the three months ended April and the latest three months. Exports to the developed countries fell by 4 per cent between the two periods largely reflecting a 15 per cent fall in deliveries to North America (although these picked up sharply in July). Exports to the European Community countries fell by 1 per cent in the latest three months while exports to the other developed countries rose by 5 per cent. Deliveries to the developing countries increased by 2½ per cent between the three months ended April and the latest three months.

IMPORTS

The value of imports in July was £547 million (7½ per cent) higher than in June. Imports of oil were little changed from the June level as were imports of the erratic items. Excluding oil and the erratic items, imports grew by 8½ per cent between June and July - with finished manufactures showing the strongest rise.

In the three months ended July, total import volume was 6 per cent higher than in the previous three months and 8 per cent higher than in the same period last year. Excluding oil and the erratic items, import volume rose by 8 per cent in the latest three months to stand 10 per cent up on a year ago. The underlying level of non-oil import volume now appears to have been increasing in recent months, possibly reaching a level higher than that at the end of 1986.

TABLE 3: IMPORTS BY VALUE AND VOLUME (Tables 1, 4 and 7 of Press Notice)

Bop Basis, Seasonally Adjusted

	VALUE (£m)		VOLUME (1980 = 100)	
	Total	Total less oil and erratics	Total	Total less oil and erratics
1985	80289	68719	126.0	142.8
1986	81306	73491	134.2	150.9
1987 Feb-Apr	21156	18975	135.6	152.1
May-July	22292	20249	143.7	164.1
1987 May	7467	6875	144.3	167.9
June	7139	6420	139.1	156.9
July	7686	6954	147.6	167.5

SECRET AND PERSONAL until release of press notice at 11.30 am on 1 September 1987 and thereafter unclassified

By value, imports rose by 5½ per cent between the three months ended April and the latest three months. Imports from the developed countries increased by 6 per cent over the latest three months with arrivals from the European Community countries up 8 per cent, up 4 per cent from North America and by 13 per cent from the other developed countries. Imports from the developing countries increased by 9½ per cent between the two three month periods.

TRADE IN MANUFACTURES

Figures showing trade in manufactures on a balance of payments basis will be published in the September edition of the Monthly Review of External Trade Statistics, following the release of the press notice. On present estimates they show a deficit in the three months ended July of £2.0 billion compared with a deficit of £0.8 billion in the previous three months. The deficit on trade in manufactures in the first seven months of this year stands at £3.2 billion compared with a deficit of £2.2 billion in the first seven months of 1986.

TABLE 4: TRADE IN MANUFACTURES (SITC 5-8) (Table 16 of Press Notice, quarterly data only)

£ million
Seasonally Adjusted
Balance of Payments Basis

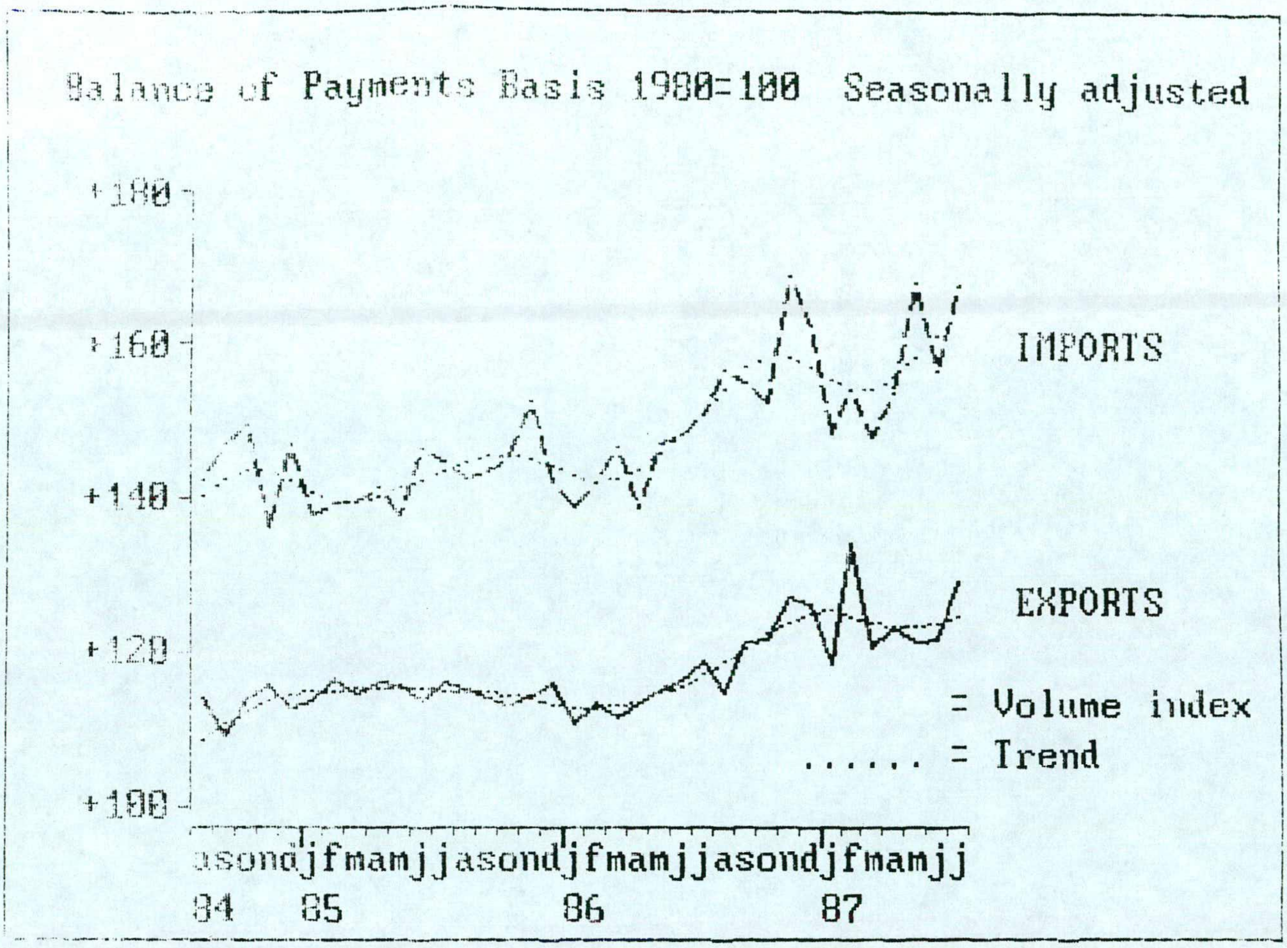
	Exports	Imports	Balance
1985	52271	55273	-3002
1986	54486	59977	-5491
1987 Feb-Apr	14957	15722	- 765
May-July	14977	17013	-2036
1987 May	4855	5755	- 900
June	4919	5430	- 512
July	5203	5828	- 625

PUBLICATION

The press notice containing the July figures is scheduled for release at 11.30 am on Tuesday 1 September. An announcement about the release date for the August figures will be made at th same time. Our provisional schedule is for publication of the August figures on Thursday 24 September, which would bring the trade figures back to the timetable originally announced for 1987 before the industrial action at Customs and Excise occurred.

P J STIBBARD

VOLUME INDICES EXCLUDING OIL AND THE ERRATIC ITEMS



SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE ON 1.9.87

CIRCULATION LIST

Copy No 1 Minister for Trade
2 Prime Minister
3 Chancellor of the Exchequer
4 Secretary of State for Trade and Industry
5 Chancellor of the Duchy of Lancaster
6 Sir Robert Armstrong (Cabinet Office)
7 Sir Brian Hayes (Dept of Trade and Industry)
8 Sir Peter Middleton (H M Treasury)
9 Govenor of the Bank of England
10 Chairman of the Board of H M Customs and Excise
11 Mr J Hibbert (CSO)
12 Mr Finlinson (H M Customs and Excise)
13 Mr B Buckingham (CSO)
14 Mr Davies (H M Treasury)
15 Mr Barrell (H M Treasury)
16 Mr P Sedgwick (H M Treasury)
17 Mr D Owen (H M Treasury)
18 Mr A McIntyre (CSO)
19 Dr P Rice (Dept of Energy)
20 Mr Bottrill (H M Treasury)
21 Mr H H Liesner)
22 Mr P J Stibbard)
23 Mr W E Boyd)
24 Mr E J Wright) Dept of Trade and
25 Mr A R Hewer) Industry
26 Miss C Siddell)
27 Miss H Chapman)
28 Mr D Packer)

SECRET AND PERSONAL until release of press notice at 11.30 am on 1 September 1987 and thereafter unclassified

To Minister for Trade Copy No .3..(28)

From W E Boyd
S2A
V/206 Ext. 4887

20 August 1987

OVERSEAS TRADE FIGURES FOR JULY: EXPORTS

1 The value of exports in July, seasonally adjusted on a balance of payments basis, is estimated at £6.7 billion, £0.3 billion (5 per cent) higher than in June. Exports of oil and the erratic items together increased by £0.1 billion. Excluding oil and the erratic items exports grew by 4½ per cent between June and July. This largely reflects a sharp improvement in the level of exports to North America which had fallen in the second quarter of the year.

2 In the three months ended July, total export volume was 5 per cent lower than in the previous three months but 2½ per cent higher than a year earlier. Excluding oil and the erratic items export volume fell by 1½ per cent between the three months ended April and the latest three months but was 6 per cent up on a year earlier. The underlying level of non-oil export volume has improved a little in recent months.

3 Recent export figures are shown in the attached table; charts plotting the main aggregates are also attached. Import figures for July are not yet available. A note describing imports and the current account will be circulated on Tuesday 25 August and the press notice is scheduled for release on Tuesday 1 September.

pp

W E BOYD

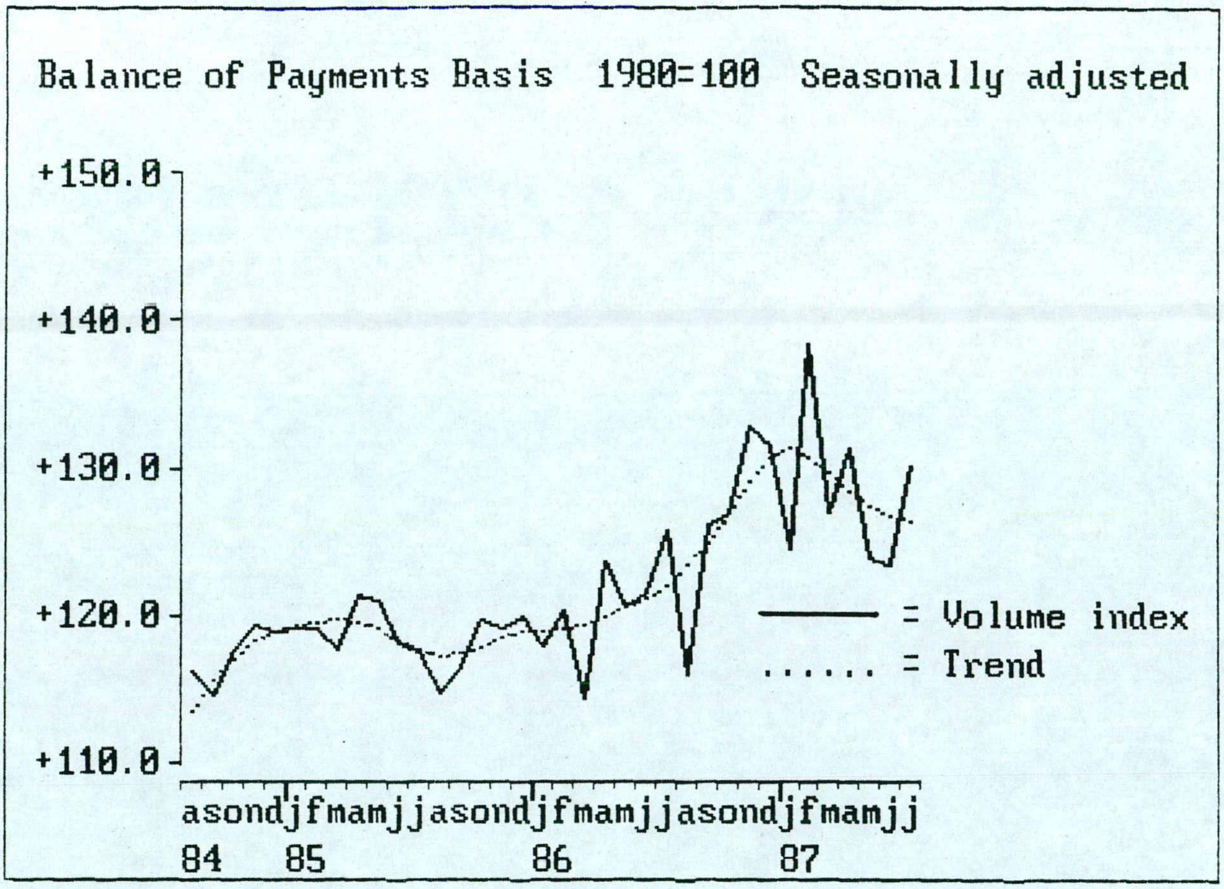
SECRET and PERSONAL until release of press notice
on - 1 SEP 87 at 11.30am and thereafter unclassified

Copy No...(   )

EXPORTS
(Balance of payments basis: seasonally adjusted)

		---TOTAL TRADE---		EXCLUDING --OIL & ERRATICS--	
		VALUE £m	VOLUME (1980=100)	VALUE £m	VOLUME (1980=100)
1986	Q2	17786	121.9	14455	115.1
	Q3	17553	122.6	14839	118.5
	Q4	19340	130.5	15873	125.3
1987	Q1	19637	130.0	15899	124.4
	Q2	19381	126.3	15885	122.4
1987	FEB	6973	138.4	5697	134.2
	MAR	6429	126.9	5168	120.5
	APR	6610	131.4	5312	123.6
	MAY	6372	123.9	5270	121.6
	JUN	6399	123.5	5303	122.1
	JUL	6704	130.2	5541	128.8

TOTAL EXPORTS

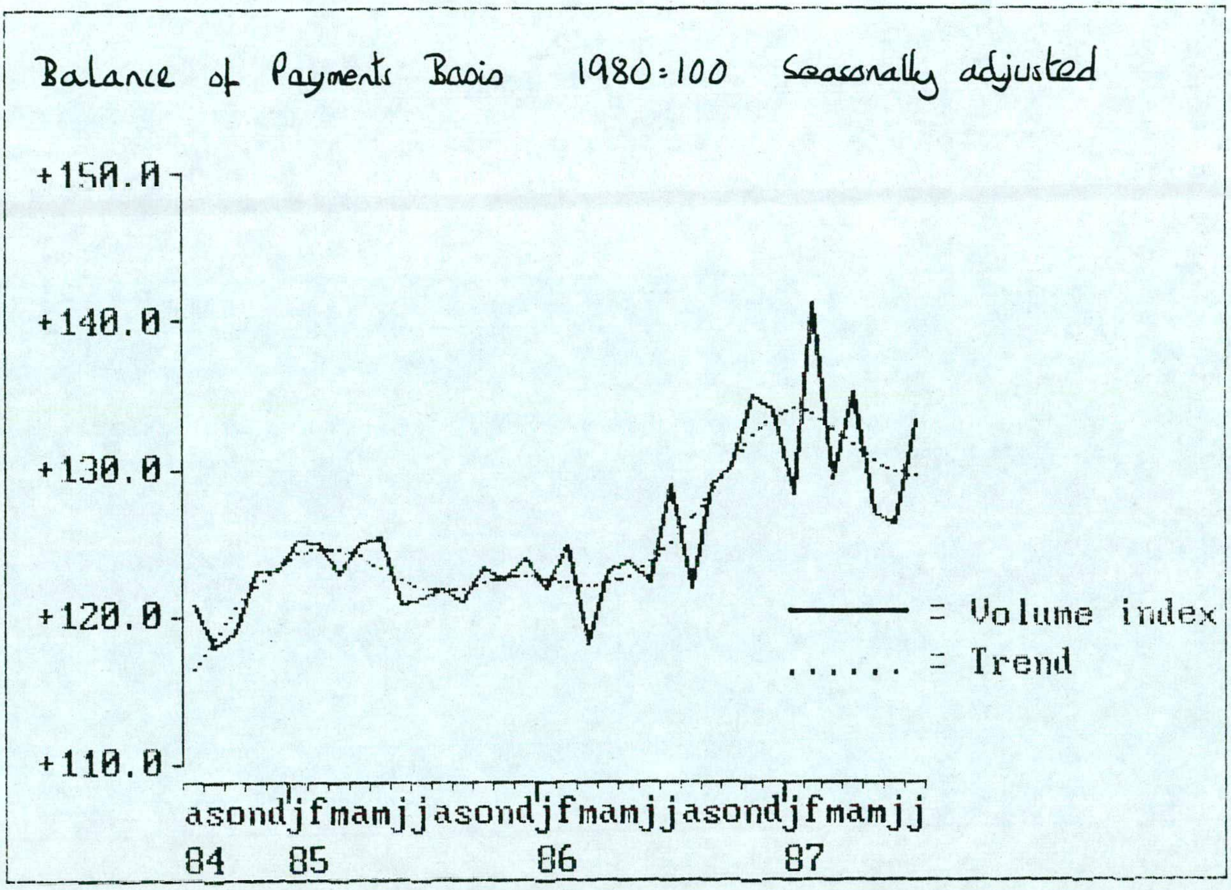


Balance of Payments Basis 1980=100 Seasonally adjusted

SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE ON 1.9.87

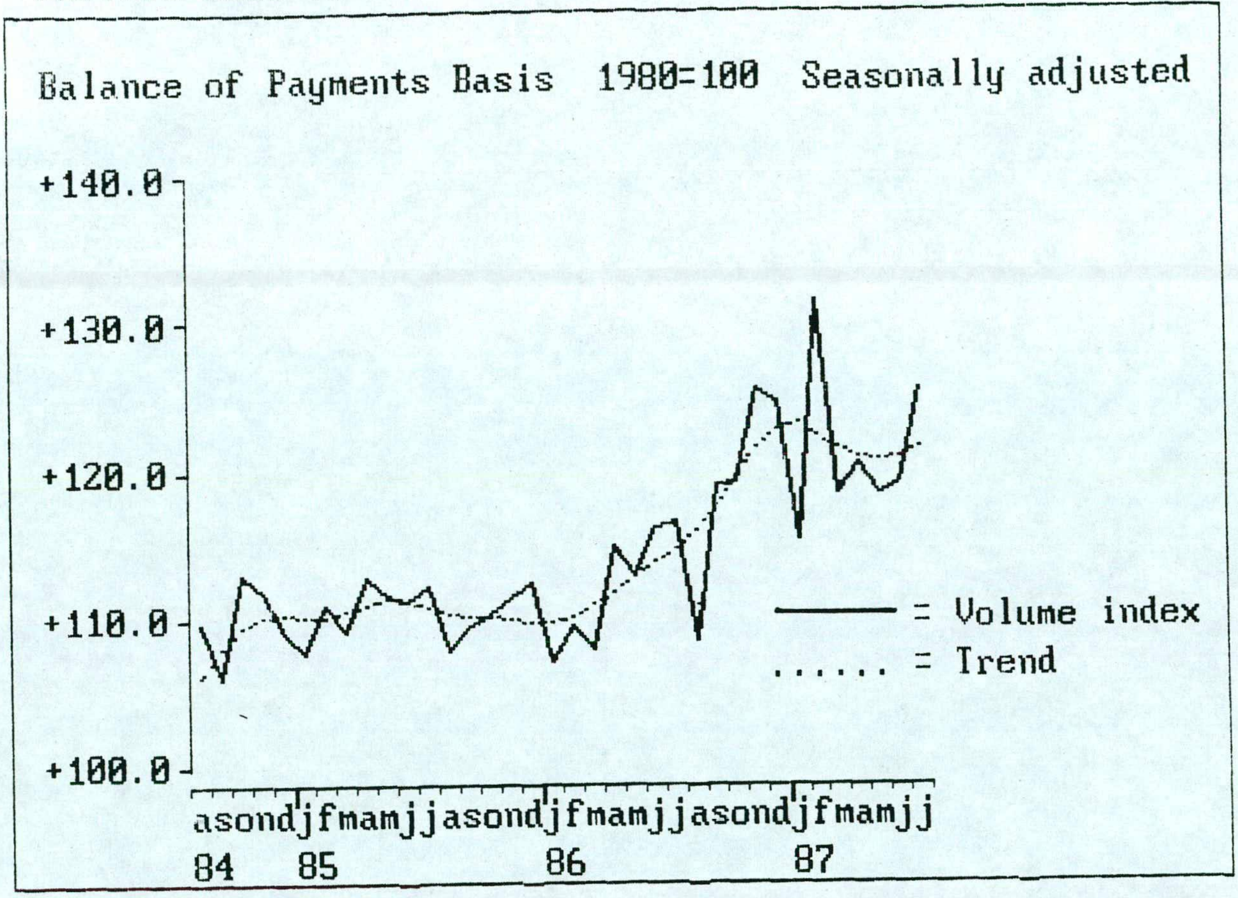
SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE ON 1.9.87

EXPORTS LESS ERRATICS



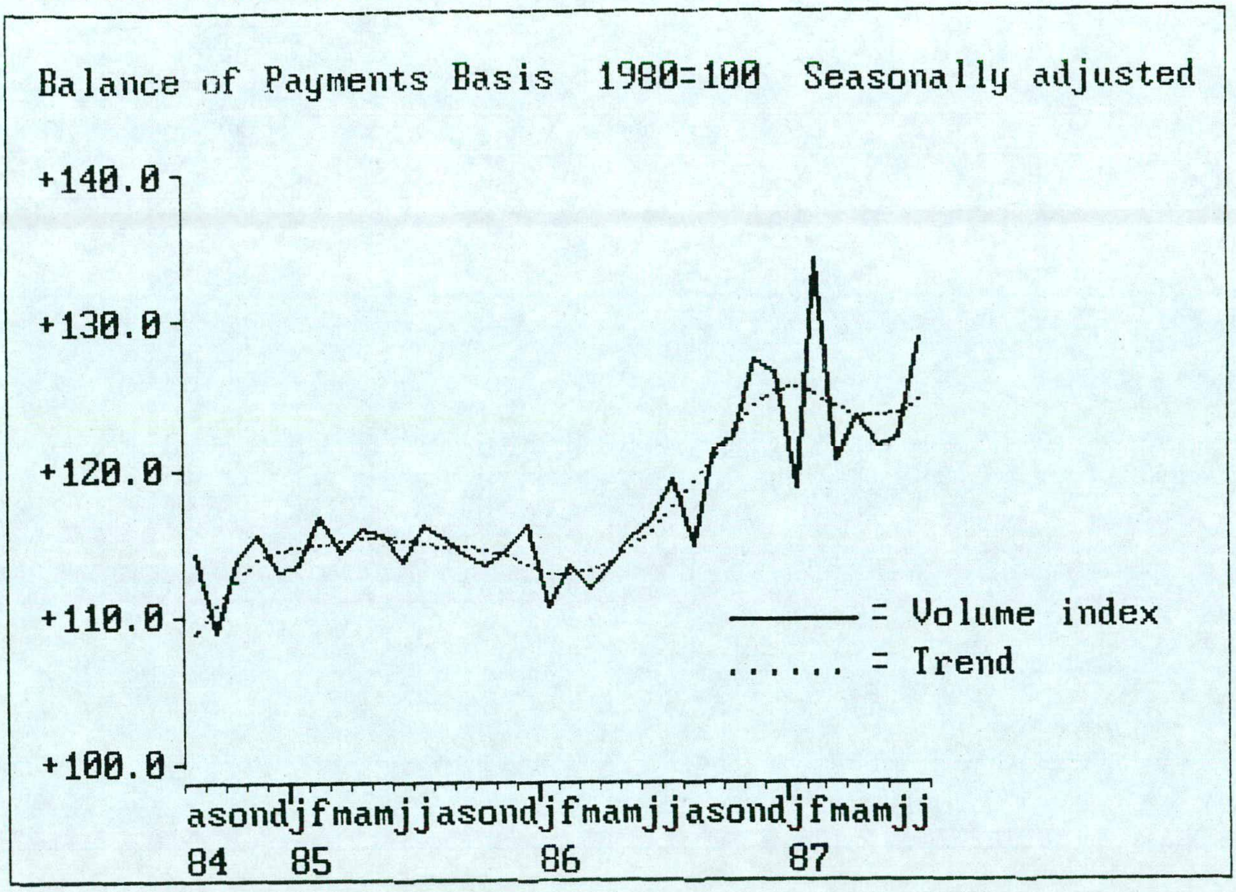
= Ships, North Sea Rigs, Aircraft, Precious Stones & Silver

EXPORTS LESS OIL



SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE ON 1.9.87

EXPORTS LESS OIL AND ERRATICS



SECRET AND PERSONAL UNTIL RELEASE OF PRESS NOTICE ON 1.9.87

CIRCULATION LIST

Copy No 1	Minister for Trade	
2	Prime Minister	
3	Chancellor of the Exchequer	
4	Secretary of State for Trade and Industry	
5	Chancellor of the Duchy of Lancaster	
6	Sir Robert Armstrong (Cabinet Office)	
7	Sir Brian Hayes (Dept of Trade and Industry)	
8	Sir Peter Middleton (H M Treasury)	
9	Govenor of the Bank of England	
10	Chairman of the Board of H M Customs and Excise	
11	Mr J Hibbert (CSO)	
12	Mr Finlinson (H M Customs and Excise)	
13	Mr B Buckingham (CSO)	
14	Mr Davies (H M Treasury)	
15	Mr Barrell (H M Treasury)	
16	Mr P Sedgwick (H M Treasury)	
17	Mr D Owen (H M Treasury)	
18	Mr A McIntyre (CSO)	
19	Dr P Rice (Dept of Energy)	
20	Mr Bottrill (H M Treasury)	
21	Mr H H Liesner	Dept of Trade and Industry
22	Mr P J Stibbard	
23	Mr W E Boyd	
24	Mr E J Wright	
25	Mr A R Hewer	
26	Miss C Siddell	
27	Miss H Chapman	
28	Mr D Packer	

CHANCELLOR'S OFFICE
Room 12/2

DTI Press Notice

Department of Trade and Industry
1 Victoria Street SW1H 0ET
Press Office: 01-215 4474/5060/5064
Out of hours: 01-215 7877

np

Number: 87/497

Date: 1 September 1987

OPERATIONAL NOTE - PUBLICATION OF MONTHLY OVERSEAS TRADE FIGURES

The overseas trade figures for August 1987 are scheduled for release at 11.30 am on Thursday 24 September 1987.

Information on release dates of the figures for later months will be announced at the same time.

Publication of the figures has been delayed as a result of industrial action at HM Customs and Excise Computer Centre at Shoeburyness. This action has now ended.

ENDS

[illegible]ANCELLOR OF THE EXCHEQUER'S DIARY

Wednesday 2 September

9.00 am No.11: Ministers and Advisers

Post Prayers 1. Mr Tyrie
2. Mr Call.

11.00 am Mr Battishill and Mr Scholar (Tax strategy)

2.00 pm No.11: Caroline Roberts

4.30 pm No.11: Godfrey Chandler

[depart for Stoney Stanton]

Chancellor
Mrs Lawson

PS/Chief Secretary
PS/Financial Secretary (2)
PS/Paymaster General
PS/Economic Secretary

Sir P Middleton
Sir T Burns
Sir G Littler
Mr Butler
Mr Cassell
Mr Scholar
Miss O'Mara
Mr Culpin
Mr Pickford
Mr Porteous
Mr Dyer
Mrs Hatter

Mr Cropper
Mr Tyrie McCall
Miss D Gable

Enquiry Room (2)
Security Guards (2)
Chancellor's Messengers

Mr Allan
Mr Taylor
Mr A Hudson
Mrs Ryding
Mr Fray
Mr A Lyons
Mr J Williams
Miss J Camp
Mrs Spragg

Mr A Woolley (No 11)
Mr J Beattie
PS/Inland Revenue
PS/Customs & Excise
Miss C Roberts
Mr C Fountain (No.10)
Mr N Forman MP
Mr M Lennox-Boyd MP
Inspector Pearce (weekly only)
Miss G C Evans (Tuesday only)

CHANCELLOR OF THE EXCHEQUER'S DIARY

Thursday 3 September to Tuesday 15 September 1987

Thursday 3 September

1.00 pm	Lunch - Robert Fleming Holdings, EC2 + Mr Allan
6.30 - 8.00 pm	Reception: John Stokes MP Clive and Stokes International Terrace, HOC

Friday 4 September

1.00 pm	Lunch: Lord Bruce-Gardyne Connaught Hotel, Carlos Place, Mayfair

Saturday 5 September

	Advice Centres
9.30 - 10.30 am	Lutterworth
11.00 am - 12.30 pm	Braunstone

Sunday 6 September

Monday 7 September

11.00 am	No.11: Musoko Twane, Zambian Prime Minister
3.00 pm	HMT: FST + others (BP Sale Employee Priority

Tuesday 8 September

10.30 am	St James's Palace: Lord Airlie (CROWN ESTATE COMMISSION STRATEGY) [NB. Chancellor to be driven to Ambassadors Court
5.15 pm	No.10: E(LF) (HOUSING)

Wednesday 9 September

10.00 am	Annual Forum for Companies with Employee Share Schemes, (SPEAK) IOD Pall Mall
12.30 pm	HMT: CST + others (REVISIONS TO MTFS ASSUMPTIONS)
6.30 pm	No.11: Mr Tyrie (PARTY CONFERENCE)

Thursday 10 September

9.00 am	No.10: PM + others
10.30 am	Cabinet
	Post Cabient E(EP) (TEACHERS PAY)

Friday 11 September

10.00 am	No.11: Mr Carmichael (RENTED HOUSING)	
2.10 pm	Depart No.11)	
2.55 pm	Depart Northolt)	
5.00 pm	Arrive Beldringe Airport)	Informal ECOFIN
7.00 pm	Reception Hotel 'Hesselet', Nyborg)	
7.30 pm	Dinner)	

Saturday 12 September - Sunday 13 September

ECOFIN

Monday 14 September

Chequers: PM's Meeting (ELECTRICITY PRIVATISATION)

Tuesday 15 September

10.30 am	Open Keynes Conference NEDO Offices + Reform Club

CONFIDENTIAL

FROM: M C BETENSON

DATE: 3 September 1987

1. MR ~~INSTONE~~ Seen in draft

2. CHIEF SECRETARY

cc Chancellor
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Hawtin or
Miss Peirson
Mr Turnbull
Mr Gibson
Mrs Holmans
Mr Parkinson
Mr Perfect
Miss Streater
Miss Haskins
Mr Cropper
Mr Call

Ch
See some comments on draft White Paper
AA

I agree strongly with both your 2 pts. 1st of these, [illegible] timing, we should [illegible] N.R. [illegible] to welcome, tho' [illegible] we are [illegible] [illegible] ~~[illegible]~~ [illegible] J.

BETENSON
TO
CST
3/9

HOUSING POLICY: E(LF) MEETING, 8 SEPTEMBER

Mr Ridley has circulated two papers (E(LF)(87)37 and 38) for discussion at this meeting. I attach briefing notes on both papers.

2. E(LF)(87)37 attaches a further draft of a Housing White Paper and seeks colleagues' agreement to publication in the second half of September, subject to amendments which may be suggested in correspondence.

3. E(LF)(87)38 reports on general progress on outstanding housing policy issues and seeks agreement to an initial tranche of 5 to 10 Housing Action Trust (HAT) designations and agreement in principle to a rolling programme of designations. The paper includes Treasury arguments against agreeing now to a rolling programme. But the report, and an attached detailed paper on the evaluation of HATs, otherwise records agreement with Mr Ridley on the development of the HATs initiative.

Recommendation

4. Subject to agreement on a number of detailed amendments which could be proposed in correspondence, I do not think it is essential to continue to oppose publication of a White Paper (although there is no particular Treasury interest in publication now). The draft as it stands is relatively bland and would not commit the Government to more than E(LF) has already agreed. I attach a copy

of the draft (top copy only) with the amendments we think should be made noted [illegible] manuscript. There is no need to raise any of these at the meeting but the briefing note highlights some issues should you be challenged on the need for detailed amendments.

5. On HATs, an initial tranche of 5 designations could be funded within your Survey fallback of additions of (£m) 20, 50, 70. The upper end (10 initial designations) of the range suggested by Mr Ridley might require more provision, depending on the characteristics of HAT areas chosen and the rate of build-up of spending. You willtherefore need to oppose any suggestion that a specific number of designations within the 5 to 10 range should be agreed now and insist on the formulation, which Mr Ridley's paper itself sets out, that the number of HATs in an initial tranche must be subject to Survey decisions.

6. You will also need to press Treasury arguments against a rolling programme of HATs on the ground that evaluation of initial designations is vital to ensure value for money and good targeting before further HATs are set up. This is essentially a delaying tactic and we are unlikely to be able to stave-off pressure for more designations until much more than a limited progress report is available. But agreement in principle now to a rolling programme would greatly stregthen Mr Ridley's position in pressing for early expansion of the initiative and substantially larger PES provision.

Mark Betenson

M C BETENSON

3462/020

CONFIDENTIAL

E(LF)(87)37 BRIEF

E(LF)(87)37 - DRAFT WHITE PAPER ON PROPOSALS FOR HOUSING LEGISLATION

Aim

Accept White Paper can be published in broadly present form but insist that publication awaits agreement on amendments to be proposed in correspondence.

Points to make

1. Still do not regard White Paper as essential. Present draft necessarily relatively bland, given continuing need to refine details. So difficult to claim it performs vital public information role - later detailed consultative papers could do that.

2. Since case for publication debatable must not proceed unless emphasis and drafting right. So publication must be subject to agreement on amendments in correspondence - delay should be accepted if necessary.

3. [If pressed on amendments needed]. Do not wish to take Committee's time on detailed amendments now, but eg:

   i. Cannot accept contention of paragraph 5.6 that involvement of private sector simply adds to total resources available for housing. Must take Survey decisions on public provision in light of needs to be met - if private sector is meeting more of these, demand for public expenditure should be reduced.

   ii. Cannot accept suggestion in paragraph 1.19 that subsidies to public sector landlords should to some extent match mortgage interest relief to owner occupiers. Subsidy should ensure availability of housing at rents tenants can afford, not seek to balance incentives designed to encourage home ownership.

Summary

Present draft more acceptable than earlier versions. Does not commit Government to any particular approach to reform of financial regime for local authority housing (on which DOE revising substantially earlier proposals, for later collective discussion and inclusion in Bill for future session). No commitment is given to size of HATs initiative or to methods of valuing transfers of housing (on which further detailed work still being undertaken). Draft also makes clear that constraints will be placed on housing benefit subsidy for deregulated rents and that Government will take powers to restrict payment of benefit if necessary.

E(LF)(87)38 - HOUSING POLICY: PROGRESS REPORT ON OUTSTANDING ISSUES

Aim

Accept detailed work on most remaining issues can be taken forward in correspondence (with reform of local authority housing accounts reserved for collective discussion when revised DOE proposals available).

2. Accept detailed paper (attached as appendix to main paper) on selection and assessment of Housing Action Trusts (HATs) provides workable initial analysis of policy, with further refinement to be taken forward in context of detailed work on selecting individual HATs.

3. Reject agreement in principle now to rolling programme of HAT designations. Mr Ridley should bring any proposals for expansion beyond initial HAT tranche to Committee in light of evaluation of first HATs. Accept initial tranche could be between 5 and 10 HATs (NB: 5 to 10 in total - <u>not 5 to 10 a year</u>) but must be subject to Survey decisions on resources and no commitment to a specific number at E(LF).

E(LF)(87)38
BRIEF

Fallback

Accept full evaluation of initial HATs may not be possible before further designations if momentum of programme to be sustained. But must have collective opportunity to consider expansion in light of as detailed a progress report as Mr Ridley can make at the time he wishes to bring forward proposals.

Points to make

1. Welcome opportunity HATs give of displacing local authority provision. But policy will be contentious so vital it should be seen as successful and cost effective. Must have as much evaluation as possible to highlight, and allow to correct, initial difficulties before second tranche of designations.

2. No need to decide on rolling programme now. 5 to 10 initial designations represents substantial start for wholly novel policy. This will give HATs significant momentum; must concentrate on work in relation to this tranche of

designations - large task in itself.

3. Wrong to take a view on HATs expansion until results from first HATs show how far extended programme can be financed through reduced provision for local authorities and income from receipts. Rolling programme would place growing pressure on limited public expenditure resources unless substantial offsetting savings generated, and cannot yet quantify properly extent of risk.

Summary

Paper states work on course for introduction of legislation in November. Mentions work on outstanding details continuing. Discussions between DOE and Treasury Officials planned shortly on detailed housing association consultation paper and on transfer terms for local authority and New Town housing. Paper agreed with Treasury but highlights remaining dispute on whether to agree in principle to rolling programme of HATs. Paper argues that Mr Ridley's PES bid would be sufficient for initial tranche of 5 to 10 HATs (paragraph 9vi). This represents late drafting change not agreed with us. Earlier versions of paper correctly stated that bid was consistent with 5 to 10 designations a year over the Survey period. If rolling programme is rejected, and only initial 5 to 10 HATs agreed, at least half of Mr Ridley's bid would not need to be met.

p.108

SECRET

FROM: **J P MCINTYRE**
DATE: **4 September 1987**

CHIEF SECRETARY

cc **Chancellor**
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Scholar
Miss Peirson
Mr Turnbull
Mr Gibson
Mr Scotter
Mr Tyrie

CST

Pretty damning comm-Viable in Annex B — in particular X. Another approach to savings would be to make the benefit less for all children after the first, or even progressively less as the number of children increases. There is a clear logic to this, & I believe it is normal practice in some countries. NL

CHILD BENEFIT

As you know, we had hoped that your discussion with Mr Moore at next Wednesday's bilateral would be based on an agreed paper by officials setting out the options. This will not now be possible.

2. The reason is that Mr Moore wants the paper to include options for taxing CB. As you instructed earlier this week, we have told DHSS officials that tax cannot be on the agenda. They have said there cannot then be an agreed paper.

3. You might want to consider having a private word with Mr Moore in advance of the bilateral to explain your position on the tax question. This might avoid difficulty on the point at the meeting.

4. At the meeting itself, you may want to offer Mr Moore a paper on options, covering means testing and reductions in the rate. I attach a draft of such a paper for you to consider. It would require further work by officials, particularly on administrative problems, before you got into detailed discussion with Mr Moore at a later meeting.

5. It would be helpful to know whether you would like to be in a position to offer Mr Moore a paper on these lines next week and whether there are any changes you would want made to it.

J P MCINTYRE

CHILD BENEFIT

The Chief Secretary has proposed in the 1987 Survey that substantial savings should be made in public expenditure on Child Benefit (CB).

2. This paper examines some ways of achieving major savings, namely means testing and adjustments to the rate of CB.

Background

3. The cost of CB has risen from £2$^3/_4$ billion in 1979-80 to £4½ billion this year, representing about 10 per cent of the social security budget. It is paid to 7 million families, in respect of 12 million children. The current rate is £7.25 per week; this will continue in 1988-89.

4. The chart at Annex A shows the distribution of expenditure on CB by income group. Inter alia, it shows that nearly £2 billion (around 40 percent) goes to households with incomes over £13,000 (gross) a year. This is an inevitable consequence of paying a universal benefit, given a broadly even distribution of family sizes across income groups.

5. A selection of recent government statements on CB is at Annex B. Most of these statements pledge maintenance of CB as a universal tax-free benefit. The June 1987 Conservative manifesto was less specific:

> "Child Benefit will continue to be paid as now, and direct to the mother."

But other statements made at election time repeated the earlier, more detailed commitment.

MEANS TESTING: OPTIONS

6. There are two broad options:

(a) Benefit cut-off ie complete withdrawal of benefit if income exceeds a certain amount.

(b) Benefit taper ie reduction in benefit by a percentage of the amount by which income exceeds a given threshold.

A variation of either option would be to adjust the starting-point for withdrawal according to the number of children in the family.

7. There are of course many possible starting points for withdrawal under either option. To illustrate the effects we have assessed the following:

Option 1: Benefit cut-off above average earnings, taken here as £165 a week (net), the average for a one earner couple on male average earnings.

Option 2: Benefit taper of 50 percent above average earnings.

Option 3: Benefit cut off at £250 per week (net), roughly 1½ times average earnings.

Option 4: Benefit taper of 50 per cent above £250 (net)

Option 5: Benefit cut-off at £165 plus £20 a week net for each of the second and subsequent children.

Option 6: Benefit cut-off at £250 plus £20 a week net for each of the second and subsequent children.

8. In assessing these options, there are a number of considerations:

(a) Public expenditure savings

(b) Number of families affected

(c) Effect on incentives

(d) Administration

Public Expenditure savings

9. These are estimated at:

	Savings (£bn)
Option 1	2.6
Option 2	2.3
Option 3	1.1
Option 4	0.95
Option 5	2.2
Option 6	0.9

Number of families affected and distribution of losses

10. The number of families affected and their average weekly loss would be:

	No. of families	Av. weekly loss (£)
Option 1	3.9	12.85
2	3.9	11.40
3	1.7	12.95
4	1.7	11.00
5	3.5	12.10
6	1.4	12.15

11. As a proportion of CB recipients, about 55 per cent would be affected by Options 1 and 2. About 24 per cent would be affected by Options 3 and 4. Options 5 and 6 would reduce these proportions a little. The table at Annex C set out the detailed distribution of losses.

12. With complete withdrawal (options 1, 3, 5, and 6), the size of loss depends entirely on numbers of children. The minimum loss is £7.25 a week and the maximum modelled loss is £36.25 a week, although families with more than five children could lose more. Over 80 per cent of losses are in one and two child families. With withdrawal above average income (option 1), about 1.6 million families would lose £7.25 a week and 1.8 million would lose £14.50 a week. If withdrawal started at £250 a week (option 3) 0.6 million families would lose £7.25 and 0.8 million would lose £14.50. Average loss with total withdrawal is about £12.90 a week.

13. With 50 per cent taper (Options 2 and 4), the size of loss depends upon level of net income as well as on numbers of children. Losses are greater at a given income, the greater the number of children. Losses can range from a few pence up to the modelled maximum of £36.25. Most families above the income limit lose the whole of their CB entitlement (up to 3.6 million with withdrawal at average income). The remainder of those with net incomes above the starting point for withdrawal lose some of their entitlement. This moderates the numbers of very large losses and brings some losses down below £5 a week. If withdrawal started at £250 a week, 1½ million families lose over £5 a week and the average loss would be about £11 a week.

14. Stepped withdrawal (options 5 and 6) reduces the number of losses amongst families with two or more children, by comparison with the complete withdrawal of options 1 and 3. With withdrawal starting at average income for a one child family, but £20 per child higher for the second and subsequent children, the number of two child families losing their benefit falls to 1.5 million (compared with 1.8 million in option 1). The number of 3 child or larger families losing their benefit is reduced by an even greater proportion (eg the number of 4 child families losing is roughly halved). A similar pattern emerges with stepped withdrawal around a £250 a week starting point. The number of losses amongst two child families is cut by about a quarter to 0.6 million.

15. Stepped withdrawal could also be combined with a 50 per cent taper and corresponding reductions in the number of families losing would follow.

Incentives

16. The total withdrawal options would have a damaging effect on incentives. Earning an extra £1 a week could lead to the loss of £7.25 for each child. Thus in Option 1 a two child couple with a net income including CB of £163.50 a week (£149 excluding CB) who did an hour's overtime (at say £3 an hour) would see their net income fall to £151 because of their loss of CB. They would have to earn an extra £22 a week even to bring their net income back up to its previous level. A family with five children would have to earn an extra £56 a week even to get back to the same level of net income. This would clearly be a disincentive to working extra hours, or taking a better job which took net income above the starting point for withdrawal.

17. The disincentive effect of a tapered withdrawal would be less. With a 50 per cent taper, the 0.8 million or so families who did not lose all their CB would see their marginal tax rate rise from 36 per cent to 68 per cent if they were basic rate taxpayers and below the upper earnings limit for NIC. There would be a disincentive to working extra hours or taking better paid jobs, as only part of the extra earnings would feed through to net pay. Married women working part-time below the LEL who are not currently subject to any tax would become subject to a 50 per cent effective tax rate.

Administration

18. The following is based on an initial assessment by DHSS officials.

19. To extend means testing on the scale envisaged under these options would have significant administrative implications. Options 1 and 3 would be simplest to administer because they involve complete withdrawal above a certain income. However, it would be essential under all three options to devise a simple means test given the number of people involved. The most cost-

effective approach would be to rely on claimants' own declaration of income, backed up by a check in sample cases. Considerable further work would need to be done in DHSS on the mechanics of means testing in particular whether the test should be for six months, as in family credit, or for longer periods. DHSS officials have given a preliminary indication that over 2,500 extra staff would be required to administer means testing. These extra staff might cost roughly £30 million a year. However, a full assessment has not yet been carried out. Without this, it is not possible to say whether, for example, administering CB on this basis would be disproportionately expensive compared with other benefits.

20. It would be possible to require claimants to produce the P60s they receive from employers. This form does not show unearned income or the existence of capital. By the time it reaches many employees it is long out of date as a reflection of current circumstances.

21. An alternative would be to require claimants to declare income over a recent period on a yearly claim form - with suitable penalties in the background - and examine a sample of claims to curtail fraud and abuse. This policing could be on any scale thought to be necessary: with requests for P60s, checks with Inland Revenue, local interviews and, possibly, simple enquiry letters to employers.// DHSS officials believe that the changes
22. required to the child benefit computer would take not less than 18 months to implement.

REDUCTION IN CB RATE

23. This would enable all families to continue to receive CB. But a sharp reduction in the rate would be needed to achieve major public expenditure savings. An alternative would be to continue the full rate for the first child and to cut the rate for subsequent children. The four options below illustrate what might be done:

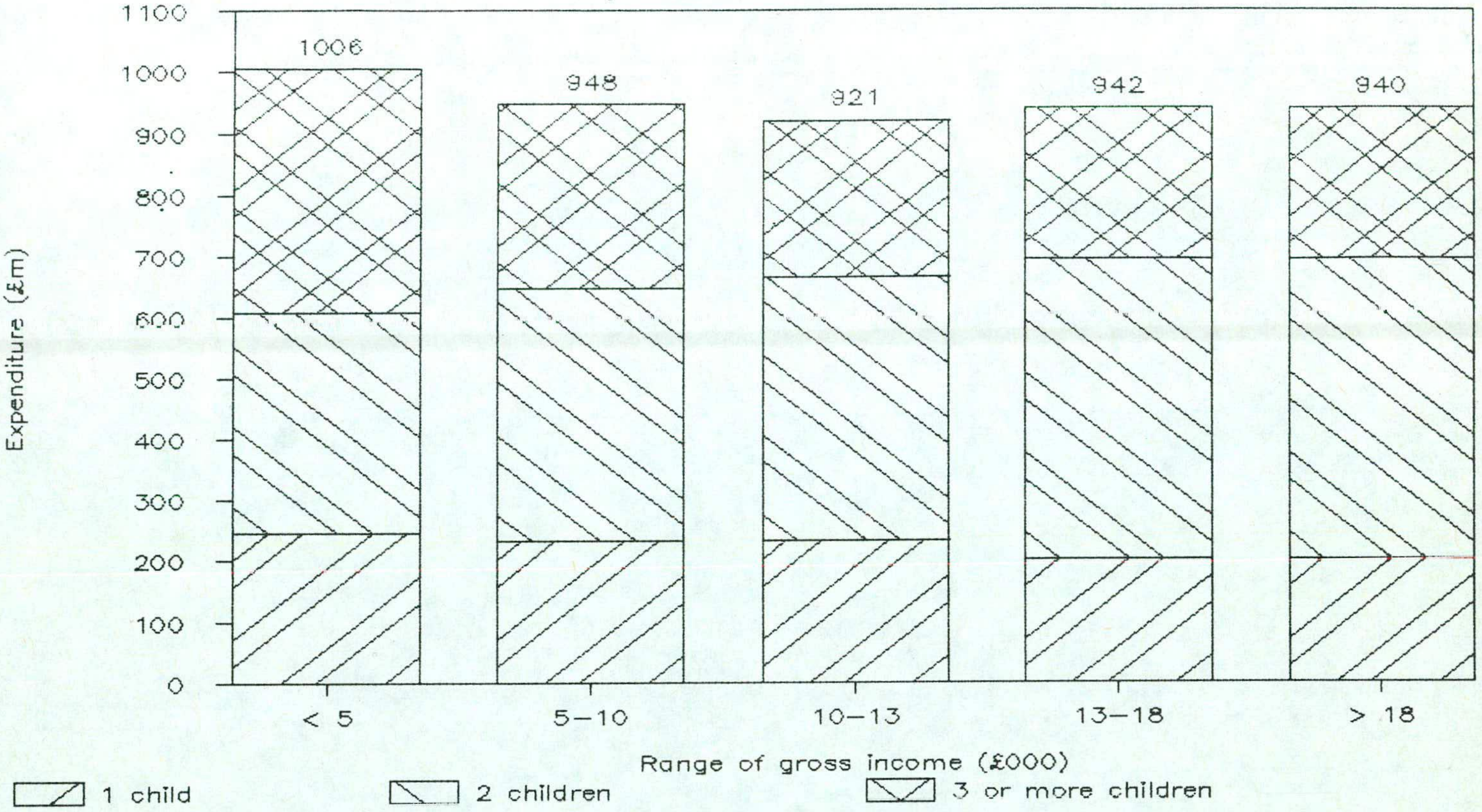
		savings (£bn)
Option A:	halve rate for first child	1.3
Option B:	halve rate for second and subsequent children	1.0
Option C:	reduce rate for all children by 25%	1.1
Option D:	full rate for first child and half rate for subsequent children	1.0

24. The administrative implications of these options have not yet been explored with DHSS.

Annex A

Figure 1: Distribution of child benefit in 1987–88

by no. of children and income quintile



Annex B

CHILD BENEFIT - PUBLIC COMMITMENTS

The following quotations are examples of recent public commitments on child benefit. They reflect the stance established in the Green and White Papers on the reform of social security:

> "Everyone with a family will continue to receive child benefit. The standard rate is £7 per week per child. It partly compensates for the removal of the child allowance. .... The right hon Gentlemen is trying to give the impression that child benefit is not going to every family. He is wrong."
>
> Source: Prime Minister's reply to a question from Dr Owen. Official Record, 20 June 1985, Vol 81 Col 432-433.

> "We'll review child benefit each year as we always have, but I can't tell you what the outcome of that will be. But I can tell you that child benefit will continue as a non-means-tested universal payment, paid to the mother and tax-free. There ought to be no question about that".
>
> "What pressure for /child benefit/ to wither away?"
>
> Source: Minister of State for Social security (Mr John Major) in a pre-election interview with Richard Berthoud. "Poverty", pp 8, Spring 1987, No 66.

> "Child benefit will continue to be paid as now, and direct to the mother".
>
> Source: "The Next Moves : The Conservative Party Manifesto 1987" pp 33.

X|

> "Child benefit will continue as a universal tax-free and non-means-tested benefit".
>
> Source: General Election Briefing - Conservative Research Department, 22 May 1987.

> "There are no plans to reduce the scope of child benefit. All families will continue to get child benefit and it will be paid to the mother....".
>
> Source: Minister of State for Social Security (Mr Scott). Official Record, 14 July 1987, Vol 119, Col 464.

SECRET

ANNEX C

Distribution of reductions in child benefit by size of loss

Thousands of families (average loss £ per week)

	Lose under £5 a week	Lose £5-£10 a week	Lose £10-£15 a week	Lose £15-£20 a week	Lose £20-£25 a week	Lose £25-£30 a week	Lose over £30 a week	Total number of losers
Option 1	-	1580 (7.25)	1800 (14.50)	-	450 (21.75)	95 (29.00)	15 (36.25)	3935 (12.85)
Option 2	300 (2.45)	1610 (7.23)	1590 (14.25)	50 (17.68)	320 (21.76)	60 (28.90)	7 (35.18)	3935 (11.40)
Option 3	-	645 (7.25)	790 (14.50)	-	195 (21.75)	45 (29.00)	4 (36.25)	1675 (12.95)
Option 4	185 (2.33)	670 (7.25)	650 (14.30)	15 (17.51)	125 (21.75)	25 (28.90)	2 (35.25)	1675 (11.00)
Option 5	-	1580 (7.25)	1545 (14.50)	-	310 (21.75)	50 (29.00)	4 (36.25)	3490 (12.10)
Option 6	-	650 (7.25)	630 (14.50)	-	125 (21.75)	25 (29.00)	2 (36.25)	1420 (12.15)

Numbers of families rounded to nearest 5000
except in over £30 column.

[illegible]

20/2920

CONFIDENTIAL

FROM: S KELLY
DATE: 4 September 1987

1. MR BURR TJBurr 4/9
2. CHIEF SECRETARY

cc Chancellor
Paymaster General
Mr F E R Butler
Mr Anson
Mr Gilmore
Mr Hawtin
Mr Turnbull
Mr Potter
Mr Perfect
Mr Cropper
Mr Tyrie

CHARGES FOR SCHOOL ACTIVITIES

Mr Baker's minute of 19 August to the Prime Minister covers a revised draft consultation paper on charges for school activities. We recommend that you can be content with the revised draft subject to the drafting changes set out in the annex, which have been agreed with DES officials. A draft letter to Mr Baker is attached.

2. An earlier version of the draft was considered by E(EP) on 21 July. You made three points then following up your letter of 20 July to Mr Baker: about the general approach, the detailed treatment of educational "extras" in the draft, and the proposed regime for GM schools.

General approach

3. E(LF) on 26 February concluded that a power should be introduced to enable schools to charge for certain extra-curricular activities. It invited Mr Baker to consider further whether it would be possible to define those activities for which charges could be levied or alternatively to define

those for which they could not. The draft proposes definitions both of what can be charged for and what cannot. You pointed out on the earlier version that, as well as being contrary to the E(LF) remit, this approach was unnecessary and risked creating a new grey area of activities which appeared in neither list.

4. Mr Baker's minute is almost exclusively addressed to this point. He concludes, with the support of the Attorney General, that there is no alternative to some form of belt and braces legislation. His arguments are not entirely convincing. He rules out your preferred option of a detailed definition in the Bill of activities for which no charges could be madeon the grounds that it would provide a field day for those who wanted to find loopholes. But that is to say no more than that the definition would need to be carefully drafted. It is a counsel of despair to abandon the attempt before it has even been started. We recommended in briefing for E(EP), however, that you need not press the point beyond your letter of 20 July if Mr Baker continued to oppose it. We do not recommend that you should press it now, especially since Mr Baker has enlisted the Attorney's support.

Educational extras

5. The objective of legislating on charges is to clarify the law in order expressly to legitimate existing charging practices. Contrary to that objective, the earlier version of the consultation paper clearly envisaged restrictions on charging compared to current practice in some areas, most importantly instrumental music tuition. Although Mr Baker claims to have taken account of your comments on the point in your 20 July letter, the revised version is in fact little better than the original. We recommend that you should put to him the attached further redraft of the offending sections (principally paragraphs 14-18) of the paper. That redraft has been agreed with DES officials. It represents the best we judge we shallbe able

to achieve. Crucially, it gives us all we want on individual music tuition by proposing an express power to charge for such tuition.

GM schools

6. The original draft proposed that GM schools should be required to seek Mr Baker's express approval to their charging policies. You argued that this was unnecessarily worrying. Mr Baker has now accepted your point that there is no need to treat GM schools any differently from maintained schools.

Stephen Kelly

S KELLY

20/2929

CONFIDENTIAL

DRAFT LETTER FOR THE CHIEF SECRETARY TO SEND TO THE RT.HON KENNETH BAKER MP, SECRETARY OF STATE FOR EDUCATION AND SCIENCE

CHARGES FOR SCHOOL ACTIVITIES

I have now seen a copy of the revised draft consultation document attached to your minute of 19 August to the Prime Minister. I welcome the fact that you no longer propose to require GM schools to seek your express approval to their charging policies.

I am content, in the light of the Attorney General's advice, not to press my concern about your proposal to define in legislation both what activities can be charged for and what cannot. Your revisions at restricting paragraphs 15 and 16 of the drafts do not, however, meet my concern in my 20 July letter about not restricting existing charging practices by by LEAs. On individual music tuition, the draft persists in confusing the essentially separate issues of charging and contracting out. There seems to me no alternative to an express power to charge for such tuition, however it is provided. Suggested amendments to this section of the draft, agreed between our officials, are at annex.

Copies go to the Prime Minister, other members of E(EP), John Moore, Tom King, Patrick Mayhew, and to Sir Robert Armstrong.

[JM]

20/2920

CONFIDENTIAL

ANNEX

CHARGES FOR SCHOOL ACTIVITIES

Paragraph 9(b): add at end, "except in the case of individual music tuition (see paragraph 15)".

Paragraph 13: delete last two sentences

Paragraphs 14-18: redraft as follows:

"14. Such a list, and the statutory exclusions suggested in paragraph 9, would be consistent with the principle of free provision, and with what the Secretary of State understands to be authorities' current practice. **He would, however, welcome views on the extent to which the list does indeed reflect both present practices and those which LEAs have in recent months felt obliged to abandon because of uncertainty over vires.**

15. The Secretary of State would also welcome views on a number of specific areas. To allow charges to be made for individual instrumental music tuition would require specific proviso set out in 9(b) above. It would be necessary to define this carefully so as to allow charges to be made for what is essentially optional private tuition, while not allowing charges for studies which are necessary to contribute to collective class or school activity such as an orchestra. How might such a definition be constructed? The alternative of ruling out all charges for LEA music staff, as for other LEA teachers, would only allow charges to be made by private music teachers operating on school premises (as in 13(a)). **Would this lead to reductions in provision, create further anomalies, and encourage a fragmentation of provision so that school-based instrumental and other work could not feed into collective musical activitiy across an authority?**

16. There is the possibility of uncertainty about the definition of "adequate" materials and equipment which would be free under 9(d). There must be a practical limit to the obligation of authorities to provide equipment and materials. For example, if a pupil chose to learn the tuba, should an instrument be purchased for that pupil by the LEA? Current practice in this and related areas varies. **Is the formulation used in paragraph 9(d) consistent with a reasonable limit, or would it cause authorities further problems?**

17. There is also the separate issue of materials for craft and home economics lessons. Charges for some, at least, of these materials would be ruled out under 9(d). The Government intends that current practice should be allowed to continue broadly unchanged. But it is difficult to distinguish between essential materials for cookery, and, for example, science. It would, however, remain open to schools to charge parents for any finished product from such lessons if they wished to purchase it (as most probably would). **Would this be enough to ensure that present practice continued or should some more explicit exception be made?**

18. Finally, there is the question of whether there should be different treatment of trips which contribute to external examination courses. Schools and parents have less control over such activities. Some authorities now try to make free provision for field trips required for examinations, but it is difficult to distinguish in practice between those visits which may be necessary for an examination course and those which are merely desirable. The list in paragraph 13 would allow charges for any trips whether or not they were linked to an examination course, and this reflects current practice in many authorities. **Is there a practical alternative which would avoid placing too great a burden on LEAs?**

CONFIDENTIAL

RD

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

My ref:

Your ref:

CHIEF SECRETARY
REC. -7 SEP 1987
TO Mr Instone
cx Mr Butler
Mr Anson Mr Gilmore
Mr Hawtin Mr Turnbull
Mr A M White Mr Cropper
Mr Call.

The Rt Hon Peter Walker MBE MP
Welsh Office
Gwydyr House
Whitehall
LONDON
SW1

4 September 1987

Dear Secretary of State,

TENANTS' RIGHT TO TRANSFER

At E(LF)15th on 14 July, I was invited to consider further, in consultation with the Secretaries of State for Wales and Scotland and the Chief Secretary, Treasury the precise arrangements for preserving tenants' right to buy (RTB) when they exercise their right to transfer to a new landlord. It was also decided at that meeting to leave open the possibility of transfer by tenants of flats and maisonettes even if a majority in their block wished to remain council tenants. I now seek colleagues' agreement to how I propose to proceed on these matters.

On RTB, I think it right that transferring tenants should, wherever possible, continue to have a right to buy at a discount. I would prefer that right if possible to be statutory, rather than a less certain contractual right. The policy that we have developed in the context of other transfers to independent landlords, and on the basis of which we legislated in section 8 of the Housing and Planning Act 986, has been to preserve the RTB statutorily. The only reason in the present case to allow a tenant to surrender his right contractually would be if it made it practicable for a new landlord to take him on and so made the difference between his being able, and not being able, to transfer.

But in principle there is no reason why a tenant's possession of a statutory RTB sould deter a landlord from taking him on. This is because, in almost all cases, given currently foreseeable market conditions, the price which the landlord would receive for a RTB sale would, even after discount, exceed the transfer price he paid based on market value subject to tenancy. I conclude that we should preserve transferring tenants' RTB stautorily, rather than contractually.

I was invited to consider also whether the RTB should apply on transfer to a charitable housing association. This could be justified on the argument that public, and not charitable, funds had originally been used to provide their dwellings; and that there was thus no logical reason for them to lose their RTB. But charitable associations might nevertheless see sales at a discount as incompatible with their charitable objectives.

We need to balance the interests of these tenants against the fact that preservation of their RTB would be contentious, especially in the Lords. Not dissimilar legislative proposals in 1983 to bring publicly-financed housing of charitable associations within the RTB provoked major opposition. And preservation of the RTB might reduce the stock of potential landlords by discouraging some charitable associations from taking part. I believe that we should nevertheless seek to preserve the RTB for those transferring to charitable housing associations, while accepting that to do so may be controversial.

Similar arguments apply, but less controversially, to transfers to housing associations which have never previously received public support, another category of landlord excluded from the main RTB. I propose that tenants transferring to such associations should also have their right statutorily preserved. The arguments for a third category of general exemptions from the RTB, however - co-operative housing associations - are rather different, depending less on the original means of providing the dwelling than on the communal nature of the tenure itself. I propose that we should retain this exemption from the RTB for tenants transferring under their new right.

On flats, my proposal that the transfer of a block should require a majority vote of the tenants, and that the local authority would be granted a long lease on any flat whose tenant did not wish to transfer, was agreed. A note on the basis on which I have put the drafting of Instructions to Counsel in hand is annexed.

This leaves the question of arrangements to allow tenants in a minority who wish to transfer to do so. We shall have to decide what we want to do along these lines before finalising the drafting of the Bill: I do not believe that secondary legislation could bear the weight of deciding both the circumstances in which local authorities might be required to grant leases on individual flats, and the terms on which they would be required to do so.

One possibility raised in discussion at E(LF) was requiring the local authority to set up a management company for any block where tenants wished to transfer and to sell long leases to the new minority landlord. I have considered this proposal, but do not favour it. So elaborate an arrangement would be expensive and difficult for authorities and offer poor value-for-money when small numbers (or individual tenants) were involved. If the authority retained an influence over the management company commensurate with their holding in it, the arrangement would leave them in de facto control of the management of the block. Arrangements to exclude or curtail their influence over the management of the block would be difficult to justify on financial management grounds. In either case, the arrangement would be likely to be unattractive to prospective landlords.

A preferable option would be to empower each tenant individually to invite a new landlord to buy a leasehold interest from the local authority in respect of his flat. This could begin the process of takeover. And it would face the council with a leaseholder experienced and articulate enough to exert a powerful influence on management and maintenance practices in the block. The more leases an intermediate landlord of this kind had, the more influential the position it would be in. This would go some way towards the effect that colleagues had in mind in suggesting a management company without the extreme complication of providing for the control and conduct of the company as an intermediary between the council and the new landlord. It would also come closer to the truly individual right which we would ideally wish to achieve.

Although such an arrangement would be clearly preferable to the management company route, it must be doubtful, however, whether many individual tenants, or small minority groups, would be able to attract landlords who would be prepared to take on the very exposed position of a minority intermediate landlord. And many landlords will not in any event want to participate unless they have effective control of common parts and common services. I propose to ask officials to work up the preferred option further, but I intend to consider again whether to go ahead when we have better information, from talking to potential landlords, about what its true practice usefuness would be. I will consult colleagues again at that stage on whether or not to proceed: in the meantime, this will leave Parliamentary Counsel free to press on with drafting more central parts of this and the other housing policies for the Bill.

I shall shortly be consulting you, Malcolm Rifkind and John MacGregor further on terms of transfer under the tenant's right to transfer; and on the action I propose to stimulate interest among both tenants and landlords. Meanwhile, I should be grateful to know by 11 September if colleagues are content for me to proceed in relation to flats and to the RTB as I propose in this letter, which I am copying to the Prime Minister, other members of E(LF) and Sir Robert Armstrong.

Yours sincerely

Deborah Lamb

pp NICHOLAS RIDLEY
(approved by the Secretary of State
in draft & signed in his absence)

CONFIDENTIAL

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

7 September 1987

Dear Tom,

OPTING OUT OF ILEA: CONSULTATION DOCUMENT

The Prime Minister has seen your Secretary of State's minute of 20 August to which was attached a draft consultation paper about organisation of education in inner London.

The Prime Minister had a number of comments, as listed in the note attached. She is otherwise content, subject to the views of colleagues.

I am copying this letter to the Private Secretaries to members of E(LF) and E(EP), Michael Saunders (Law Officers' Department) and Trevor Woolley (Cabinet Office).

Yours,

David.

(D.R. NORGROVE)

CH/EXCHEQUER
REC. 08 SEP 1987 ✓
ACTION CST
COPIES TO

Tom Jeffery, Esq.,
Department of Education and Science.

CONFIDENTIAL

THE ORGANISATION OF EDUCATION IN INNER LONDON

Paragraph 8
The Prime Minister would prefer not to say that it would be open to inner London boroughs to apply to assume responsibilities for education later than April 1990, and has asked that the last sentence of paragraph 8 should be deleted.

Paragraph 15
The requirement on the opting-out boroughs (line 9) that they must 'first' consider applicants from ILEA central staff apparently goes further than Mr. Baker's paper to E(EP) (of 23 July). That proposed only to 'require the boroughs to consider ILEA applications before making an appointment'. The word 'first' is ambiguous and seems badly chosen.

Paragraph 19
There is no reference here to protecting the movable assets of schools in boroughs likely to opt out, a subject that concerned E(EP).

Paragraph 22
E(EP) were also concerned that the counter obstruction legislation should deal with staff as well as other contracts. It may be worth making it clear in the consultation document that it will.

Paragraph 27
It seems right that the exemption from rate-capping should apply only where education expenditure is not above the level inherited from ILEA. Otherwise, a borough could opt out in the knowledge that it could raise education spending even higher without being rate-capped.

The Prime Minister agrees with the Chief Secretary (letter of 2 September) that it would be useful in the consultation paper to confirm that payments for detriment will be made where ILEA central staff take up posts in the boroughs at a lower salary level and also to refer to redundancy compensation for staff later made redundant by the ILEA itself.

A. Allen
12/2 pwd

cc: PPS
Re
RJ

NI5692 5 HHH 223

LABOUR READY FOR BATTLE ON POLL TAX

LABOUR'S FIRST MAJOR OFFENSIVE AGAINST THE GOVERNMENT SINCE THE PARTY'S JUNE ELECTION DEFEAT WILL BE A NATIONAL CAMPAIGN TO FIGHT PLANS FOR A NEW POLL TAX.

PARTY OFFICIALS TOOK THE DECISION AT A PRIVATE MEETING YESTERDAY AS LABOUR PREPARED FOR ITS CONFERENCE AT BRIGHTON LATER THIS MONTH.

AND ALTHOUGH THE CONFERENCE WILL CONDUCT AN INQUEST ON THE ELECTION CAMPAIGN, OFFICIALS ARE DETERMINED THAT DELEGATES SHOULD BE LOOKING TO THE FUTURE, RATHER THAN DIGGING UP THE PAST AND LOOKING FOR SCAPEGOATS.

A RADICAL APPRAISAL OF LABOUR'S POLICIES, WHICH WILL INVESTIGATE HOW THE PARTY CAN REGAIN THE VOTES OF WOMEN AND THE YOUNG IN PARTICULAR, WILL BEGIN AT NEXT MONDAY'S MEETING OF THE PARTY'S POWERFUL HOME POLICY COMMITTEE.

ITS CHAIRMAN, MR TOM SAWYER, WHO IS DEPUTY GENERAL SECRETARY OF THE NATIONAL UNION OF PUBLIC EMPLOYEES, IS EXPECTED TO PRODUCE A PAPER SETTING OUT WAYS OF IMPROVING LABOUR'S APPEAL TO THOSE SECTIONS OF THE ELECTORATE, PARTICULARLY THE SKILLED WORKING CLASS WHICH HAVE ABANDONED THEM AT THE LAST TWO ELECTIONS.

HIS UNION WILL FOLLOW THIS UP BY LEADING THE WAY AT THE CONFERENCE WITH CALLS FOR A REVIEW OF LABOUR'S POLICIES. HE WILL TELL DELEGATES THE NEXT GENERAL ELECTION MUST START IMMEDIATELY - AND NOT FOUR WEEKS BEFORE THE NEXT POLLING DATE.

--

090909 SEP 87

CONFIDENTIAL

FROM: M GIBSON
DATE: 7 September 1987

CHIEF SECRETARY

cc Chancellor
Mr F E R Butler
Mr Anson
Miss Peirson
Mr Turnbull
Mr McIntyre
Mr Gieve
Mr Tyrie

INCOME SUPPORT COMPENSATION FOR 20 PER CENT RATES CONTRIBUTION

I attach a paper agreed with DHSS officials which sets out the arguments between us and DHSS on this bid, agreed in principle before the Election, but with the exact figures depending on the measures identified to avoid windfall gains.

2. We think the E(LF) minutes provide enough ammunition for you to argue that the DHSS proposals are not adequate. Even if you eventually concede that no further measures are possible to remove more non-householders, you can argue that DHSS should bring forward alternative savings measures. The bottom line is that their proposals save only £40 million from a total cost now revised upwards to £420 million. So the net cost of this concession is now £380 million, compared with £300 million announced before the Election, based on the rough assumption that about £70 million might be saved from excluding all non-householders from the total cost of £380 million then identified.

3. Mr Moore is unlikely to have read this paper before the bilateral in view of his absence abroad. But DHSS officials know that you are receiving it and of course the £380 million bid is on the agenda table.

M. Gibson.

M GIBSON

a274

PAPER BY TREASURY AND DHSS

COMPENSATION IN INCOME SUPPORT FOR 20% CONTRIBUTION TO RATES

The Government's decision

Before the Election, the Secretary of State for Social Services confirmed that from April 1988 everyone who is liable to pay domestic rates will make a minimum contribution of 20% to their rates bill. He also announced that when the rates for income support are set in the autumn, they would include the average amount that householders who are income support claimants would have to meet as their minimum contribution. The details were to be determined when the benefit rates were set. The cost was quoted as about £300 million in 1988-89.

2. This announcement reflected a prior decision in E(LF) that income related benefits should be increased to put all recipients facing the new rates contribution in a position to meet the best estimate of their average liability in 1988-89. E(LF) agreed, however, that it was essential to prevent windfall gains to non-householders so far as possible, and that mechanisms to achieve this should be vigorously explored. It was also agreed that how the addition to benefits after 1988-89 should be rolled forward should be left open. It was recognised that the decision would put an additional heavy burden on public expenditure for 1988-89 and subsequent years, and E(LF) agreed that it was essential to minimise any further increase in the Government's spending plans during the Survey later in the year.

Costs

3. The cost of compensating all recipients of income related benefits by £1.30 was estimated for E(LF) as £380 million in 1988-89, of which £352 million would count as public expenditure. About £70 million of the £380 million total cost represented windfall gains to non-householders who face no rate payments. The Secretary of State for Social Services said that he was prepared to adopt any reasonable steps to reduce windfall gains, up to the full £70 million if that proved possible. The savings arising from the possible measures to prevent windfall gains, primarily non-dependent deductions, were estimated at £50 million.

a274

4. The costs were calculated on the same basis as the Technical Annex to the 1985 Social Security White Paper. This was mainly based mainly on 1983-84 data and it was recognised that the costs would change when a full recosting of the new benefit structure took place using later data. The table attached shows the latest estimate of gross and net costs after allowing for the DHSS proposals for the recovery of windfall gains.

<u>The DHSS proposals</u>

5. To discharge E(LF)'s remit regarding windfall gains, DHSS officials have proposed:

a. no compensation for 16-17 year olds, on the basis that nearly all this group are non-householders (1986 data: 147,000 non-householders, 10,000 householders).

b. an increase in the deductions from rate rebates for non-dependants. An unified deduction of £3.00 for 1988 is proposed; this implies an increase, compared to updated Technical Annex rates, of £1.55 for those on Income Support (compared to a straightforward addition of £1.30) and a reduction of £0.20 for those receiving other benefits or training or in work.

c. no compensation to be included for non-householders at the point of change in 1988.

The DHSS measures will prevent windfall gains to about half of the 1 million non-householders and claw back 55 per cent of the associated expenditure. They reduce the costs of the compensation, on a recosted basis, from £419 million to £381 million (by £38 million).

6. DHSS officials believe that it is not possible at this late stage to make structural changes to the new schemes without seriously endangering the transition in April 1988 and removing some of the much prized simplifications. Other measures, such as

a reduction of £1.30 in the benefit of people identified as non-householders at the point of change, would rapidly produce circumstances in which two people in identical circumstances would receive different amounts of benefit and would encourage unnecessary movements on and off benefit to take advantage of the more favourable treatment to new claimants.

7. DHSS officials conclude that there are no further measures available which would both contribute to the remit to prevent windfall gains as far as possible and be defensible as consistent with the public commitment on compensation.

Treasury position

8. Treasury officials do not accept that these proposals fulfil the E(LF) remit. They have suggested that:-

(a) windfall gains and their costs could be reduced further by giving no compensation to any single 18-24 year olds, of whom 75% (457,000) are non-householders and only 150,000 householders;

(b) further savings could be achieved by increasing non-dependant deductions for those in work. They note that the DHSS proposal has removed the differential in deductions between those in work and those on benefit. They do not consider that a deduction of £3 (or £11 for the combined deduction from rate and rent rebates proposed for 1988) is adequate for those in work, bearing in mind the level of in-work earnings and the extent to which the non-dependant's housing costs will otherwise be met by the State.

DHSS position

9. DHSS officials reject the Treasury proposals. They consider that:

a. the exclusion of all single 18-26 year olds from compensation cannot be defended in view of the repeated

Ministerial commitments to compensate householders. It would mean that some 150,000 householders would not receive any help towards their minimum rate contribution - at a time when their benefit rate was being cut by around £5 a week and the extra help with water rates being withdrawn;

b. the Treasury suggestion of increasing non-dependent deductions for people not receiving income support does not contribute to the E(LF) remit on windfall gains. The DHSS proposal for changes in non-dependent deductions is designed specifically to claw back the value of the 20% rates compensation (and a little more) from a recognisable category of claimants for whom it would represent a windfall gain and to do so in a way which can be presented as a simplification. Even this targetted measure adversely affects those non-dependents who are neither in receipt of income support nor in work. DHSS officials consider that further changes in non-dependant deductions intended to reduce the cost of housing benefits should be considered separately.

Next Steps

10. DHSS and Treasury officials are agreed that the next step should be for the Secretary of State for Social Services to write to the Chief Secretary with his proposals to meet the E(LF) remit.

a274

COMPENSATION FOR 20% RATES COMPENSATIO

Cost estimates on "recosted" basis

	Total	PE
	£m	£m
Compensations to all	419	391
Reductions in cost from		
proposed increase in NDDs	25	0
exclusion of 16-17 year olds from protection	11	2
removal of transitional protection from non-householders	2	2
Cost of compensation after reductions	381	378

SECRET

BANK OF ENGLAND
LONDON EC2R 8AH

E.A.J. GEORGE
EXECUTIVE DIRECTOR

Mon policy

7 September 1987

Copies sent 7/9

cc Sir T Burns
Mr Cassell
Mr Peretz
Mr Odling-Smee
Mr Lavelle
Mr Grice
Mr Pike
Mr Sedgwick
Mr M Richardson
Mrs Lomax
Mr Kelly
Professor Griffiths (No 10)

Sir Peter Middleton KCB
H M Treasury
Parliament Street
London
SW1P 3AG

Dear Peter,

I enclose our regular monthly note on interest rates over the next few weeks for our meeting on Thursday afternoon.

Yours ever,

Eddie

B.L.

9/10.87

33/7-9

0963A

SECRET

7.9.87

£ millions

INTEREST RATES OVER THE NEXT FEW WEEKS

1 The undisclosed interest rate band remains at 9-11%. The discount rate at which we buy bills in all maturity bands up to 3 months was raised by 1%, to 9 7/8%, on 6 August and base rates were raised immediately afterwards to 10%.

Market conditions

2 Nervousness in domestic markets increased following the rise in interest rates. The markets were surprised by the timing: although it signalled continuing official commitment to sound financial policies, which should have been encouraging for the longer term, it also implied that policy might be tightened further in the short term if current indicators failed to improve. In fact, despite a number of mildly reassuring statistics published subsequently, concern about possible overheating generally increased - particularly after the announcement of the July money figures. There was, however, a distinct change of mood at the beginning of September, with greater confidence that a further tightening of policy was not imminent and might even be avoided. But there has been no real depth to the markets in this period, and sentiment remains brittle with an increasingly wary eye on interest rate developments abroad.

3 On the foreign exchanges, sterling required support in early August, but has gained ground over the period as a whole, particularly in the last 10 days or so. The firmness of the oil price on Gulf tensions and the level of sterling interest rates have been generally supportive factors; but some lumpy sales of sterling to pay for US acquisitions have at times been a restraining influence - and could remain so. In effective terms sterling showed a modest appreciation, gaining a little on cross rates and more substantially against the doller, the weakness of which has been the main feature of the period and which has not been arrested by last week's rise in US interest rates.

	27 July	28 August	7 September
Interbank rates %			
1 month	8 15/16	9 7/8	9 3/4
3 months	9 13/32	10 11/16	10 7/32
12 months	10 1/32	10 15/16	10 5/8
Bond yields (FT indices) %			
5 years	9.62	10.51	10.33
25 years	9.66	9.99	9.87
Exchange rates			
ERI	72.5	72.5	73.3
£/$	1.5985	1.6335	1.6595
£/DM	2.9650	2.9575	2.9760
$/DM	1.8540	1.8135	1.7940

Monetary conditions

4 The growth of the monetary aggregates in July was as shown below (figures seasonally adjusted).

Percentage growth in

	1986		1987		June	July	July
	Q3	Q4	Q1	Q2	monthly increase	monthly increase	12 month increase
M0*	1.6	2.4	-1.0	1.1	0.2	1.2	5.4
M3	4.4	1.6	6.8	5.1	1.0	2.3	20.8
NIB M1	8.8	-4.6	2.1	7.1	3.8	-0.3	12.6
M1	7.7	-0.3	7.7	7.1	2.6	0.9	22.9
M2	4.3	1.9	1.3	4.0			
M4	2.8	2.0	4.1	4.1	1.3	1.8	14.8
M5	2.9	1.9	3.9	4.2	1.3	1.8	14.4

*Weekly average

5 M0 increased by 1.2% in the month. An erratic rise in bankers' balances (growing from below their operational target to somewhat above) account entirely for the rise in the twelve month growth rate in M0 between June and July. The twelve month growth rate of notes and coin remained around 4 1/2%.

6 The main feature of the month was the rapid growth of M3, associated with a record increase in bank lending - see below. M4 and M5 grew more slowly. Total building society deposits included within M4 rose by only 0.9% and the societies continued to build up bank deposits. The composition of the increase in M3 was again affected by changes in suspense and transit items, which help explain the erratic path of nib M1 over the last two months. Most of the July inflow into M3 was concentrated in wholesale deposits, especially time deposits and CDs.

7 Among the counterparts to broad money growth the PSBR showed a small underfund, with overseas residents again buying large amounts of gilts. The main area of interest, as in June, however is the rapid growth in bank lending to the private sector.

8 Sterling bank lending to the private sector rose by a massive 4860 in July (following 3930 in June). Although it is difficult to trace the precise mechanism it seems likely that the recent surge in lending is in part to be explained as a switch into sterling borrowing from foreign currency borrowing. In the first five months of the year, before the election, total private sector bank borrowing (£ and currency) averaged some £4.5 bn a month, compared with an average of £3.2 bn a month during 1986. Much of the faster growth of borrowing prior to the election was in currency - currency borrowing averaged £2.2 bn a month in the first five months compared with an average of £690 mn a month in 1986; £ borrowing on the other hand averaged £2.3 bn a month over the first five months, a little less than the £2.5 bn a month on average in 1986. In June and July after the election currency borrowing actually fell by some £750 mn a month, whereas borrowing in £ rose by £4400 mn a month, the combined net total of £3650 a month representing a fall of some 20% from the rate in earlier months.

9 The retail banks' recent figures for lending to the personal sector reflect their increasing share of mortgage lending at the expense of the building societies. "Other" CLSB personal lending moderated in July, after an unusually rapid increase in June.

10 The monthly growth rate of broad money is expected to fall back over the next three months with M4 growing by 1.3% in August and around 0.5% for September and October. With the exception of August, when inflows are boosted by a return of funds from the BAA issue, building society inflows are assumed to be modest. As societies are also predicted to continue building up bank deposits, the forecast is for somewhat higher growth in M3 than M4. The twelve month growth rate of broad money accelerates in August (to 15.4% for M4 and 22.2% for M3) but falls back, thereafter (14.4% for M4 and 20.2% for M3 by end-October).

11 Building society lending is forecast to remain subdued as bank lending grows at an underlying monthly rate of around £3 bn. This lending is partly offset particularly in September and October by overfunding, reflecting PSBR surpluses, and by negative NNDLs.

12 M0 is forecast to grow by 0.6% in each of the next three months taking its twelve month growth rate of 5.6% by end-October.

13 The latest economic data indicate that output growth remains strong, with domestic producers continuing to respond well to buoyant demand. Output is now 4% higher than a year ago with non-oil output 4 1/4% higher. Apart from resumed growth in consumer spending, the latest estimate for investment to QII suggests that a recovery in industrial investment has recently intensified. The latest trade figures were disappointing on the imports side, though some comfort might be drawn from their recent composition with more growth in semi-manufacturers and capital goods than in finished consumer goods.

14 Although the retail price index fell a little in July, its twelve month growth rate edged up to 4.4% as there was a larger fall in July last year. Manufacturers' input prices rose by a further 1.1% in July, partly reflecting increases in petroleum product prices, following the large increase in June. World commodity prices generally are rising faster than we had earlier expected. Despite the increases in input prices, manufacturers' output prices changed little in July and the twelve month growth rate remained at 3.6%. The increase in underlying annual earnings was 7 3/4% in June, the same as in the previous two months. At present this is being offset by productivity gains so that ULC are subdued; but there must be some concern about future labour costs when output growth moderates.

15 The Halifax house price index grew by 14.6% in the year to August, a modest increase in the 14.3% recorded in June and July and above the rate prevailing at the end of last year. There are indications that the rate of house price inflation in London and the South East may have eased.

Conclusion

16 As usual the evidence on monetary conditions overall is mixed. The jury is still out on overheating. The direct evidence on inflation does not point unambiguously to an underlying upturn. And although the latest monetary and credit

data were discomforting, there are grounds for believing that their message is not as worrying as appears at first sight. All that said, the risks seem asymmetrical. There is little reason to suppose that over the next year or two underlying inflation will decline from the 4-5% level of the past three or four years; but we would be less confident that it could not end up above 5%.

17 On this view the rise in interest rates last month was certainly needed. And our present judgment would be that there is still a better case for higher rather than for lower rates. We accept nevertheless that the evidence is not decisive, and would not argue at this stage for a further initiative to tighten policy.

18 The markets do not at present seem disposed to test us in either direction. But if downward pressure on interest rates were to emerge (eg in the context of renewed upward pressure on the sterling/DM exchange rate) we would be disposed to lean heavily against it; whereas if pressure emerged in the opposite direction (eg in the wake of the clutch of economic and monetary statistics to be published next week) we would be disposed to acquiesce rather more readily. Neither of these contingencies seems particularly likely, however, in which case we can afford to wait for further evidence on how monetary conditions develop.

Bank of England
September 1987

4373/007

CC: PPS, CST, PMG, EST
Sir P. Middleton
Mr. Cassell
Mr. Monck
Mr. Moore
Mr. Scholar
Mrs. Lomax
Mr. Cropper
Mr. R. Blower
Mr. Tyrie
Mr. Prescott IR
PS/IR.

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Philip S Baxendale Esq
Job Ownership Ltd
9 Poland Street
LONDON
W1V 3DG

7 September 1987

Dear Mr Baxendale

Thank you for your letter of 28 August. I agree with what you say but would be happy to see Senator Rockefeller if he were to come over to London.

With best wishes

Yours sincerely

Norman Lamont

NORMAN LAMONT

C

to see

Rc 9/9

1 Alex
2 C

FROM: J ODLING-SMEE
DATE: 8 September 1987

MR CULPIN

cc Sir T Burns

CONVERSATION WITH SAMUEL BRITTAN

1. Samuel Brittan called me with some questions about Penelope Rowlatt's working paper on the inflation process. He was unable to get hold of her. He is thinking of writing a piece for his economic viewpoint either this week or next.

2. His main interest is in Table 3 which summarises the contributions to domestic inflation in various periods since 1969 after substituting out for lagged domestic inflation. His two main questions related to what was assumed about the exchange rate and the impact of competitors' prices on domestic prices. I explained that the exchange rate was assumed to move to the extent of half of deviations between world and domestic price movements, and that a different assumption would produce different numbers in the world price inflation and foreign exchange market rows of the table. On competitors' prices, I said that there was probably a misprint in paragraph 90 which mentions the long-run coefficient on competitors prices: it looks to me as though it should refer to the short-run coefficient. I told him that he could see from page 24 that the long-run coefficient was 0.38, and I pointed out that domestic prices were also influenced by the prices of imported inputs.

3. In the course of his comments he made clear that he rather agreed with two of Penelope Rowlatt's conclusions, namely that the turning points in domestic inflation are mainly attributable to changes in the real cost of primary commodities, and that one of the main influences on UK inflation has been the effects of world prices of finished goods. I emphasised how dependent these and all the conclusions were on the precise model and the way in which the inflationary process has been partitioned. I am sure he understands this, but he is likely to oversimplify when presenting the results.

S.M. South
pp. **J ODLING-SMEE**

117/1

SECRET AND PERSONAL

CH/EXCHEQUER 9/9
REC. 09 SEP 1987
ACTION PS/CST
COPIES TO
Sir P. Middleton
Mr F.E.R. Butler
Mr Monck
Mr Turnbull

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

8 September 1987

pmp

Dear Mr Allan.

PUBLIC EXPENDITURE

The Chancellor this afternoon briefly outlined to the Prime Minister the prospects for changes to the planning total over the planning period which were likely to result from this year's Public Expenditure Survey.

There was also a brief discussion of individual programmes. The Chancellor explained in particular that the Scottish Secretary was fiercely resisting any suggestion of a reduction in Scottish expenditure, even though on a crude calculation, Scotland was over-provided by as much as £1 billion and even an adjustment to take account of relative population changes would imply a substantial reduction. The Prime Minister said that there was bound to be a limit to the number of difficult decisions which could be forced through in any year and, if it was a choice between a reduction in Scottish expenditure and closure of Ravenscraig, her preference would be for the latter. However, it would be right to continue to press for a reduction in Scottish expenditure at this stage of the Survey and the aim should be, as last year, to secure an outcome below the level implied by strict operation of the formula.

The Prime Minister accepted that a full scale reassessment of the formula would be unlikely to be worth pursuing, both because knowledge of it would leak and because of the time it would take.

I should add that the discussion of the position in Scotland was a hurried one. In view of the sensitivities both on Scottish expenditure and on Ravenscraig, I should be glad to be kept in close touch with developments so that the Prime Minister can be consulted as necessary.

Yours sincerely

pp. D R NORGROVE

A. C. S. Allan, Esq.
H. M. Treasury

SECRET AND PERSONAL

CONFIDENTIAL

Papers P 50

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

My ref:

Your ref:

The Rt Hon Nigel Lawson MP
HM Treasury
Parliament Street
LONDON
SW1

9 September 1987

CH/EXCHEQUER 12/9
REC. 09 SEP 1987
ACTION CST
COPIES TO

Dear Nigel

DUAL RUNNING: RATES AND THE COMMUNITY CHARGE

Thank you for your letter of 11 August 1987.

The format of the community charge demand (both during and after the transitional period) will need careful thought and, obviously, the proper approach to indicating the level of central government funding requires close attention. We do not need to resolve this at this stage. Officials will anyway need to do more work before we reach conclusions. I am, however, concerned that we do not lose the opportunity, which the new financing arrangements will provide, to use the charge demand to enhance accountability by presenting a simple, clear message about spending and charges. We will therefore have to balance the requirements of clarity and comprehensibility against those of completeness. We should also bear in mind that there will be the opportunity, as now, to require the provision of supporting information to accompany the actual charge demand.

I am copying ths letter to members of E(LF) and to Sir Robert Armstrong.

Yours ever
Nicholas

NICHOLAS RIDLEY

SECRET

From : D L C Peretz
Date : 9 September 1987

CHANCELLOR

Ch
Full brief will be with you by lunchtime tomorrow. This is EMS bit, incorporating comments on how Geoff got on.

cc PS/EST
Sir P Middleton
Sir G Littler o/r
Mr Cassell
Mr Lavelle
Mr H P Evans
Mr C W Kelly
Miss Barber
Ms Goodman

INFORMAL ECOFIN : STRENGTHENING THE EMS AND LIBERALISATION OF CAPITAL MOVEMENTS

There are three papers on the table for this discussion.

A3 - Delors' paper "Complete Liberalisation of Capital Movements and Strengthening the EMS".

A1 - Paper by the Chairman of the Monetary Committee on "Strengthening the EMS".

A2 - Report by the Committee of Central Bank Governors on "Strengthening the EMS".

We ~~do not yet~~ now received and substituted for draft. ~~have a final version of the second paper. This will be available for the meeting. Meanwhile Miss Barber is forwarding the latest draft;~~ and the final versions of the other two papers. attached

2. I have had a telephone report from Sir G Littler in Paris of his discussion yesterday with Trichet on EMS issues. He suggests you should try to have a word with Balladur (who is travelling to Nyborg via Germany) early on, to check again on the various points you and he discussed in Paris. Sir G Littler's report, which is incorporated in the briefing below (see paragraphs 7-16), suggests there are several issues where you might be able to propose a way forward that would attract French support.

Objectives

3. Our aim is to keep up the pressure on other countries to dismantle their exchange controls; and to try to secure progress on the various sensible proposals to improve the functioning of the ERM.

Further Liberalisation of Capital Movements

4. Although in the past papers tabled for informal ECOFINs by the Commission have received little mention in discussion, Sir G Littler suggests that on this occasion you might usefully make a few remarks on the Delors paper. I am therefore attaching (Annex A) a speaking note, together with a background note, on that paper.

5. The speaking note contains the main points to make on exchange controls. In particular you might urge the Commission to make rapid progress in proposing their new directive; and note that it surely makes sense to review the future of the 1972 directive at the same time. On the latter point you should note that the Monetary Committee report (end of paragraph 14) records the majority of members as being of the view (which of course we support) that the 1972 directive is no longer necessary.

6. One point to watch on the link between liberalisation and strengthening the EMS. If too firm a link is established some will argue that they cannot liberalise until greater progress is made in improving the working of the EMS (including in particular increased support facilities). Paragraph 1 of the Monetary Committee report has the degree of linkage about right : the EMS needs strengthening in particular because :-

> "capital flows are becoming larger and more volatile, and because exchange controls, which are in any event losing their effectiveness, are being dismantled".

Strengthening the EMS

7. The Central Bank Governors and Monetary Committee Reports cover quite a lot of ground. Some changes are easy to agree to, and in some cases already in operation, eg :-

- more regular monitoring by Monetary Committee and Central Bank Governors of interest rate and exchange rate developments, and indicators of underlying economic performance;
- greater attention to interest rate differentials, as well as intervention, in maintaining ERM limits;
- a desire that future realignments should, where possible, be small enough to avoid a change in market rates - thereby improving chances that speculators will lose money.

If so who loses

The following paragraphs concentrate on the particular issues most likely to come up in discussion : much the same list as you discussed with Balladur in Paris in July.

8. There is one general **procedural point.** The various reports suggest that some matters are within the "competence" of central bank governors and the governors say they have "agreed" some changes, and not others. For us and the French, at least, that cannot (constitutionally) be the case. Even if the form a change takes - eg on access to the VSTF for intramarginal intervention - is a change in the central bankers' agreement, we would want to insist that it was discussed and agreed by Ministers in ECOFIN (presumably in due course at a formal ECOFIN).

9. **Intramarginal intervention.** Paragraph 34 of the draft central bank governors' report, sets out what was "agreed" at Basle on access to the VSTF for intramarginal intervention. This represents as far as the Bundesbank are prepared to go. The issue was discussed at a Bundesbank Council meeting and some Council

members objected even to this. Trichet told Sir G Littler that Balladur feels strongly that we should go further :-

- either there should be a limit, as proposed (2 times the "debtor quotas" : see Annex B for list), but that within that limit there should be automatic access to the VSTF
- or access should be by agreement, on the basis and with the presumptions as proposed, but without limit

Sir G Littler indicated we could support the second proposition without difficulty. Whether either will be acceptable to the Germans is another matter.

Ditto the first, but 2nd better.

10. **Cross holdings of currencies.** Neither the Monetary Committee report (para 8) nor the central bank governors' report (para 35) take this very far. This reflects extreme Bundesbank reluctance to diversify their reserve holdings. The texts simply note that cross holdings are possible and do occur, notwithstanding the rule that they should not exceed working balances without agreement. You could perhaps air a proposition on the following lines (which Sir G Littler tried on Trichet, who indicated Balladur would support) :

- complete freedom for countries who want to increase their holdings of other Community currencies to do so (by agreement), but with no obligation.
- a presumption that central banks will agree to other central banks holding their currencies unless there are clear reasons to object.
- a presumption that over time the major Community central banks [ie the Bundesbank] will diversify their reserve holdings among the major currencies [possibly the SDR currencies, but ie not the Drachma, etc].

diff: doesn't include lira

11. You may want to discuss with Balladur whether it might be better tactics vis-a-vis the Bundesbank to pursue this, especially

the third tiret, in the G5/G7 rather than in the EMS context. Certainly in the Louvre accord context there would appear to be some good practical reasons for diversifying reserve holdings - eg to make co-ordinated intervention easier. ? ✓

12. **Extension/settlement of VSTF drawings.** It looks as if the improvements "agreed" by the Governors (paragraphs 33 and 37 of their report) will be accepted without much discussion. They did not feature in the Littler/Trichet bilateral.

13. **Ecu.** It is unclear what if anything Balladur will want to raise on this. The Governors' report, final version, is (rightly) pretty negative about French/Italian technical proposals for introducing a link between the private and official ecu circuits. It may be that the French do not particularly want to pursue this further for the time being.

14. **Realignment procedures.** You can expect French support if you make your proposal that to avoid scenes at future realignments there should be advance agreement that these will always be expressed as symmetrical movements about the ecu of the revaluing and principal devaluing currency.

15. It seems best (and Trichet agreed) to avoid going in to the agri-monetary consequences of this. They will be affected by the July Agriculture Council decision that green devaluations should in future follow automatically from EMS realignments over a staged period, instead of as at present being the subject of subsequent negotiation (this is referred to in para 11 of the Monetary Committee report). This change will inevitably make future realignment conferences more difficult. In particular, for the Germans (assuming they are at the top of the band) it will have the effect of forcing agricultural prices down every time they revalue, making them more reluctant to agree to do so. By contrast, depreciating countries such as the French might receive some temporary advantage for their farmers, though the effects are not wholly symmetrical.

Chit!

16. **Margins.** This is probably a subject for trilateral discussion (on which the French would have to start the ball rolling) with the French and Germans rather than in the meeting itself. It came up in the Littler/Trichet discussion. The French are toying with the idea of widening the ERM margins to 3 or 3½%, and adopting a 2/2¼% inner band, à la Louvre. This might be a way of losing the Italian 6% band : would it help us to join? Obviously we have to avoid any suggestion that we are negotiating. But it is an interesting, and sensible, idea in its own right, whether or not we join. (The Italian position, incidentally, is that they will not reconsider the 6% band until they have got through abolishing exchange controls).

[illegible] will Ruding

DLCP

D L C PERETZ

MONETARY COMMITTEE
OF THE EUROPEAN COMMUNITIES

STRENGTHENING THE EMS

- Report by the Chairman of the Monetary Committee to the
Informal Meeting of the Finance Ministers
at Nyborg on 12 September 1987 -

At the conclusion of last January's Realignment Meeting Ministers requested the Monetary Committee to examine measures to strengthen the operating mechanisms of the EMS, and in responding to this request the Committee has examined a wide range of proposals.

Experience in the recent past and in particular the disturbed conditions in the markets at the end of 1986 revealed the need to strengthen the EMS. This need is all the more pressing because capital flows are becoming larger and more volatile, and because exchange controls, which are in any event loosing their effectiveness, are being dismantled. In these circumstances it is above all necessary to make better use of all the instruments as they are at present, but there is also room for improving some of them.

Interim reports were made to Ministers in April and in June of this year. The present report, which, like them, has been drawn up on the personal responsibility of the Chairman, presents the full results of the Committee's work.

I. STRENGTHENING THE EMS: ECONOMIC POLICY

1. Convergence

Last June the European Council confirmed the importance of a strengthening of the EMS for the completion of the internal market which will be a source of stronger, non-inflationary economic growth. In recent years there has been an increasing degree of convergence in the data relating to fundamental economic factors in the Member States. The position is however not yet fully satisfactory in all respects and in all countries. Public sector deficits and current account balances remain worrying in some cases. Continuous efforts are necessary to preserve the degree of convergence which has been achieved, and to make it more complete.

2. Mutual surveillance

The Monetary Committee is of the view that cooperation within the EMS has to be extended beyond the short-term aspects of policy, in a surveillance process which is expected to reveal in particular:

- inconsistencies of policies within individual EMS countries;
- inconsistencies between EMS countries;
- any danger of the emergence of unsustainable positions;
- incompatible approaches to major third currencies.

Surveillance of this type can be made more effective by the use of macroeconomic indicators and projections. It is considered that in such a process the objectives can be attained which at one stage it was suggested should be pursued through a single indicator of convergence. In July of this year the Committee conducted its first examination on the basis of a set of macroeconomic indicators projected to 1990. The aim is to achieve greater consistency of economic policies within the EMS and in the wider international field. This is to become an established procedure and the Committee will carry out surveillance of this type on a regular basis, probably twice a year.

3. Closer cooperation in the field of monetary policy

Recent experience, and in particular that of late 1986, has shown that close cooperation in the field of monetary policy is an essential component of the EMS. In order to improve convergence and strengthen the EMS, in view of the new demands put upon it, it is necessary to raise cooperation to a new level, while respecting the distribution of institutional competences within each country. For this purpose a variety of instruments are available and they should be used in a flexible and comprehensive manner.

- Monetary authorities must stand ready to defend the stability of the parity grid by ensuring that interest rate differentials between EMS countries are appropriate, and to this end there must be a willingness to make timely changes in national rates.

- The flexible use of the permitted fluctuation margins can, under certain conditions, help to deter speculation.

- Intra-marginal intervention has a recognized role within the system which is discussed further in point 7.

- Official and semi-official statements on the exchange rate situation may exacerbate tensions and should be avoided as far as possible.

There is an understanding that realignments should in future be infrequent and as small as possible, especially in order to ensure that speculation is not rewarding. This understanding and the appropriate use of the instruments mentioned above constitute the core of a stronger management of the system.

Alongside the Committee of Governors, the Monetary Committee examines the latest exchange and interest rate developments at each monthly meeting and considers what conclusions can be drawn.

4. Coordination of policies towards USA and Japan

The Louvre agreement, as reaffirmed in Washington in April, was an important step forward in international cooperation on exchange rates and improves the environment for the EMS. The markets, which were initially sceptical, have subsequently shown signs of accepting that there has been a change in the conditions in which they operate. This changed perception has been due to the determination with which the parties to the agreement have cooperated in the short-term management of the system. However, an essential feature of the new approach to exchange rates is the commitment to appropriate economic policy measures, and some of the necessary steps have not yet been fully implemented, particularly in the USA and Japan.

II. STRENGTHENING THE EMS: TECHNICAL EXCHANGE RATE ISSUES

This is an area of responsibility which also concerns the Committee of Central Bank Governors very closely. The discussions in the Monetary Committee, and much experience, have shown that there is scope for improving the functioning of the EMS within the present structure of the system. Members have moreover stressed the need for caution before proceeding to the introduction or extension of automatic obligations.

5. Divergence indicator

The divergence indicator has lost some of its significance as a result of the widespread use of intra-marginal intervention. Although some technical imperfections have been identified in the present method of calculating the indicator, a set of simulations conducted with the aid of Commission staff has shown that the elimination of these imperfections would not greatly improve its effectiveness. The divergence indicator is regarded by the Committee as a useful but not as a privileged source of information about the situation in the exchange rate mechanism. The Monetary Committee will continue to use the divergence indicator in its internal examination of exchange and interest rates and will endeavour to make that use more effective.

6. Intra-marginal intervention

Intra-marginal intervention has played an important role in the past, although this was not anticipated in the EMS Agreement. It can be useful, particularly in the event of external shocks, but it can cause problems if conducted on a substantial scale and in a rigid way. It should not be seen as an alternative to the adjustment of policies when that is necessary, and it should not be seen as a substitute for the use of other instruments; large and persistent intra-marginal intervention raises the question as to whether other instruments, in particular interest rates, have been used in an adequate and timely fashion. It is a key feature of the EMS that intra-marginal intervention in member states' currencies is a matter for consultation since the central bank issuing the intervention currency has an interest in the techniques and in the amounts used.

At present there is no right of access to the very short term financing (VSTF) arrangements to cover intra-marginal intervention. In special cases it can be so used by mutual agreement. Such access should in future be possible within certain limits and unless the central bank whose currency is being used shows that there are reasons justifying a refusal. However, such an extension of present arrangements must not entail a relaxation of the disciplinary effect of the EMS.

7. Cross-holdings of EMS currencies in member countries' reserves

Cross-holdings of EMS currencies and holdings of private ECUs in reserves would be seen by some members as a sign of increased solidarity. On the other hand other members emphasized that not all EMS currencies can be used with equal ease in the markets, and that this issue has implications for attitudes to the development of the international monetary system. The Committee noted that the present EMS Agreement allows the holding of working balances in partner currencies, while larger holdings require the consent of partner central banks.

The Committee will discuss further whether, and, if so, in what conditions the cross-holding of member states' currencies could have a constructive and stabilizing effect on the development of the EMS and of the international monetary system.

8. The financing available for compulsory intervention

The discussion on this subject showed that there is a consensus in favour of some extension of the time limit for initial settlement under the VSTF and for some raising of the ceiling for automatic renewal under that facility.

As regards the settlement of debts incurred under the VSTF in official ECU, this can be effected as of right to the extent of 50% of the amount due, although 100% of the amount may be settled in this way by agreement. Some members consider that this formal limit is inconsistent with the central role envisaged for the ECU in the system, but it is to be borne in mind that any higher formal limit would mean extending an obligation. Nevertheless, given the satisfactory experience so far with official ECU mechanisms, which has not given rise to excessive debtor or creditor positions in ECU, there is now a willingness to go beyond this limit in practice and to review the formal obligations at a later stage.

9. The use of the ECU

Since provision has been made in all member countries for the free use of the private ECU, the Committee has again taken up certain questions related to the use of the private ECU as a reserve and intervention currency; these matters will be discussed further in the Committee.

10. Realignment procedure

The Monetary Committee is of the view that there is no such thing as a technical realignment. Experience has shown that even small general changes of central rates can raise issues of political importance. No technical changes need to be made to the present procedure, but it is desirable to de-dramatize realignments as far as possible. The usual practice should be for the decision to be prepared by the Monetary Committee, and given the approval of Ministers by telephone, whenever possible.

11. Special regimes

The countries of the Community have several different statuses as regards monetary integration:

- . Members of ERM having special arrangements (wider margin, double exchange market);
- . EMS Members not participating in the ERM;
- . countries outside EMS.

It is desirable that all make the efforts necessary to the extent that conditions allow. This is however basically a matter for decision by the countries concerned. The dismantling of present special regimes and the creation of uniform conditions in the ERM would strengthen the EMS, but at this stage there may be more pressing steps such as the recent liberalization of capital movements in Italy which also are in the interests of the system.

III. FULL FREEDOM OF CAPITAL MOVEMENTS

The Monetary Committee has always pressed for a more complete implementation of the freedom for capital movements which is laid down in the Rome Treaty. It therefore welcomes the Commission's announced intention of presenting in the near future a draft of a new Directive which would lead to full capital liberalization. Substantial progress has been made over the last two years and it is a matter of great satisfaction that the Community authorities have been able to abrogate the safeguard clauses which applied to France and Italy. Moreover, independently of the many changes made to exchange control legislation, the growing internationalization of capital markets has been reflected in a large increase in the volume of capital flows, and controls have become less effective. In its recent discussions the Monetary Committee concentrated on the monetary implications of capital liberalization, and has not dealt with other aspects such as the fiscal issues.

12. Relationship between capital liberalization and the EMS

Capital liberalization is changing the environment within which the EMS must be managed and there will in particular be much less room for independent monetary policies within the system.

These developments have many implications. On the one hand the greater need to adjust economic policies will help to make the system secure on a lasting basis. Moreover, the commitment to full liberalization will be seen by the markets as a sign that the EMS authorities are confident in the strength of the system. On the other hand the move to complete freedom of capital movements is as such not without risk. Member countries do not all start from the same position, particularly as regards the degree of development of their financial systems. However, the Committee is convinced that the stability of exchange rates can be maintained in the new situation provided that cooperation within the system is intensified, and provided that appropriate transitional arrangements can be made for specific cases.

13. Safeguard clause

It should be recalled that the Rome Treaty itself includes a number of safeguard clauses and in particular Article 73 relating to disturbances to capital markets, and Articles 108 and 109 relating to balance of payments problems.

Several members of the Committee are however of the opinion that these clauses do not cover the specific problems which can arise from capital liberalization, and that the procedures involved are too inflexible. They therefore argue that the new draft Directive should include a specific safeguard clause for dealing with financial disturbances arising for purely monetary reasons when the fundamental economic situation is sound.

Other members view the question rather differently and consider that monetary movements are always closely linked to the soundness of the fundamental situation and to the credibility of the authorities' policies. These members generally consider that the existing safeguard clauses are sufficient, although some of them would prefer to have available an escape clause relating exclusively to capital inflows which threaten stability-oriented monetary policy.

This question requires further discussion; if agreement is to emerge, it must be clear that the clause will apply

. only for short periods of time,
. exclusively to transactions not yet liberalized,
. only in exceptional circumstances,
. by a Community procedure.

There was also discussion of the future role of the 1972 Directive on regulating international capital flows and neutralizing their undesirable effects on domestic liquidity. Many members are of the opinion that in the fundamentally different conditions of today this Directive is no longer necessary and should be abrogated.

14. Medium term credit facilities

The Committee has reviewed the Community's medium term credit mechanisms. In its view the Community Loan Mechanism is the normal instrument, and Medium Term Financial Assistance should be retained only as a saftey net. Many members argued that the scope of the Community Loan Mechanism should be extended so as to make it available to countries in which the fundamental economic situation is sound and which introduce a substantial programme of capital liberalization; the extension would thus be subject to specific conditionality. It is felt by some members that this extension might be needed to deal with the substantial adjustment of private portfolios which may follow liberalization. Moreover, several members argued for raising the limits applying to medium term Community credit.

However, other members consider that no change is desirable in the size or conditions of access to these facilities. They doubt whether substantial additional intervention will be necessary as a result of liberalization, if appropriate policies are followed, although it may be necessary to change policy mixes.

15. Supervisory problems

The complete liberalization of capital movements is only one element in the financial integration of the Community. The freedom to provide financial services across national boundaries within the Community is also potentially a source of great benefit and it is to be hoped that there will be rapid and simultaneous advance on both these fronts. The Banking Advisory Committee is at present discussing a full programme to achieve the liberalization of financial services, including new draft Directives which will be presented to the Council. The Committee has taken note of the Commission's view that the full liberalization of capital movements is not conditional on the implementation of any element of the freedom to provide financial services.

IV. CONCLUSIONS

The most important conclusions which can be drawn from the Committee's work as a whole are as follows.

1. Particularly in view of the increasing mobility of capital and the progressive liberalization of capital movements, a strengthening of the EMS is desirable.

2. The basis for this strengthening must be a further improvement of the fundamental economic factors. This requires above all a reinforcement of efforts to bring about a progressive convergence of economic and financial policies and still closer cooperation in the field of monetary policy. To this end periodic monitoring should take place in the competent committees, supported by the use of macroeconomic indicators, account being taken of relationships with the important international currencies, particularly the US dollar and the Yen.

3. Further progress is also desirable in cooperation within the EMS exchange rate mechanism. One-way speculative capital movements can and should be countered in future by a flexible use of available instruments and policies. In this connection, there is a consensus in favour of granting access to the VSTF for some financing of intra-marginal intervention, as indicated above. Further, the financing available under this facility could be somewhat extended in time and amount. These changes would only be acceptable if the necessary balance is preserved between adjustment and financing within the EMS.

   In the view of the Committee there is also room for progress in the field of the acceptability of the ECU.

4. Further, the special regimes which still exist (wider margins, non-participation in the exchange rate mechanism, double exchange market) should be permanently subject to review to decide whether circumstances justify their continuation.

5. The creation of the single domestic market in the Community requires a liberalization of capital movements. This liberalization process will increase the credibility of European cooperation in the field of monetary policy. In the view of the Committee, the stability of the EMS can continue to be assured even while capital movements are further liberalized, in so far as cooperation within the system is intensified in the ways described above and appropriate transitional arrangements are made in specific cases.

3886B/024

(transitional arrangements for newer states for another few ...

S'bg – strong

no general safeguard clause over & above one in a mkt ....

Article 73 enough [Delors: no]

ANNEX A

NOTE BY PRESIDENT DELORS : THE COMPLETE LIBERALISATION OF CAPITAL MOVEMENTS AND STRENGTHENING THE EMS

Treaty + internal mkt

Liberalisation of financial services

<u>Speaking notes</u>

[illegible]

(i) Very much welcome thrust of President Delors' paper and careful thought in it. Particularly glad to see recognition that capital liberalisation need not wait on prudential harmonisation, still less on ~~fiscal~~ tax harmonisation.

(ii) Now await concrete proposal from Commission for draft directive. Hope we will see this sooner rather than later. Important to make rapid progress if we are not to lose the momentum of President Delors' initiative.

[illegible]

(iii) Must make sense to review future of 1972 Directive at the same time. Note view of ~~majority) of~~ many members of the Monetary Committee that this directive is no longer necessary and should be abrogated. Would add that in my view it is also unworkable, ~~and undesirable~~. Should agree to abrogate it immediately and incorporate anything in it of value in the new capital movements directive.

[illegible]

[(iv) Point made in the paper about the danger of "competitive laxity" in prudential supervision well taken. However, also danger ~~See little sign of that at present. But may be case that some countries are better than others at getting the mix between regulation and market freedom right. This is entirely healthy. Also risk the other way,~~ that some member states will hold on to restrictive practices which are rationalised in prudential terms but are really of a protective nature. Important question for the future is how we can maintain a correct supervisory balance and, in a Community context, adapt supervisory arrangements to keep up with events.]

Note

(v) ~~Take seriously~~ some colleagues' concerns about implication of freedom of capital movements for tax evasion. Have to say that in the UK's case have not found that this problem was made worse by abolition of exchange controls in 1979. In any event as much a question of national reporting arrangements and better coordination between the tax authorities as tax differences. ~~Proposals to harmonise rates of tax on interest, or systems of withholding such tax at source, would not be acceptable to the UK.~~

Background

This is a long and rather diffuse paper. In part it covers the same ground as the reports from the Chairmen of the Monetary Committee and Central Bank Governors. In part it goes rather wider. Past Commission papers of this kind have attracted relatively little attention in discussion, partly because of their relatively unfocussed nature. On this occasion it may be desirable to take it a little more seriously. It sketches out a number of ideas about progress towards the internal market, not all of which we would welcome. It might therefore be helpful to set down a few markers now.

Capital liberalisation

2. The next concrete step towards capital liberalisation will be the presentation by the Commission of a new draft directive. Delors' note promises that this will be coming forward "shortly". It would do no harm to encourage him to make it sooner rather than later.

3. The general approach to be taken in the directive has been exhaustively discussed in ECOFIN and in the Monetary Committee. There is little point in going over the same ground in detail again in advance of receiving a specific proposition from the Commission.

?

[illegible] ~~was~~ a [illegible] control reg!

4. But it is worth noting that the Delors note confirms that, consistently with the line taken by the Commission in earlier discussions, there are a number of points where we might find the Commission's proposals when they come less than satisfactory.

5. In particular, they continue to take the view that it is necessary to retain the 1972 Directive. Indeed they want to increase its scope to make it more symmetrical between inflows and outflows and to provide in certain circumstances for concerted implementation of exchange controls against third countries. This is despite the view of the ~~majority~~ many of the Monetary Committee (see the end of paragraph ~~14~~ 13 of Tietmeyer's report) that the directive is unecessary, to which we would add unworkable and undesirable. We do, of course, have a special interest in this because the repeal of the Exchange Control Act puts us technically in breach of the Directive as it currently stands. It could therefore be quite important to us to get agreement that the directive should be abrogated and any part of it which remains of value incorporated into the new capital movements directive. If it is left to be dealt with separately, which is no doubt what the Commission would prefer, we may find it difficult to get agreement on abrogation rather than simply leaving it as it is. Other member states do not feel as strongly about it as we do.

6. There are three other points of lesser importance:

i. The Commission continue to see the need for an additional safeguard clause allowing temporary derogation from the capital liberalisation obligation to deal with financial disturbance arising for monetary reasons. This would be on top of those that already exist in Article 73 of the Treaty to deal with disturbances in capital markets and Articles 108 and 109 relating to balance of payments problems. In our view a new clause would be both presentationally undesirable and unnecessary. The existing procedures are sufficient. A number of other member states feel the same way (see paragraph 14 of Tietmeyer's report). But if others really feel the need to have a new procedure of this kind,

? emphasis safeguards

we could probably go along with it, subject to it being of a very restrictive nature, available only in exceptional circumstances and for short periods of time and subject to an appropriate Community monitoring procedure.

[illegible] - a [illegible] cons

ii. The Commission want to beef up the Community's medium-term credit mechanisms (the Community Loan Mechanism and Medium-Term Financial Assistance), increasing the amount available and making them available not just for balance of payments purposes but also as assistance/bribe to a member state trying to move towards further liberalisation of capital movements. We have not yet been persuaded of the need to extend the scope of the facilities in this way, nor to add to the amount. There are also a number of technical aspects of the Commission's proposal (which they are likely to make shortly in the form of a draft regulation) which could cause us difficulty.

G10 members sh go the whole way

iii. Transitional arrangements. The Commission are clear that some kind of transitional arrangements to full capital liberalisation will be necessary for some of the weaker countries. There is no real problem for us here. It is possible to make a case against arrangements of this kind. But something will clearly be politically necessary for countries like Spain and Greece. We will want to keep them as limited in scope and time as practically possible.

Prudential supervision

7. There are a number of propositions in Delors' general remarks about prudential supervision with which we might take issue if we were so minded. There is, for example, a suggestion in the fourth paragraph of the introduction that the Community should "manage change", which might be Eurospeak for increasing Commission power in areas where we and others would prefer them to keep out.

8. The concern about "competition in laxity" is a familiar theme. The thought is that differences in the nature or rigour of supervision could create competitive inequality, which could

in turn distort the movement of capital and/or create systematic risk or reduce investor protection by encouraging a rush to the bottom.

Japanese ?

9. [In reality there is no evidence that this is happening. It is possible of course, that some countries may be better than others at getting the mix between regulation and market freedom right. Hence London's success. But that is entirely healthy.] The opposite risk is that some member states will hold on to restrictions alleged to be required for prudential reasons whose real motive is protection of domestic markets.

10. There is no great need to pick this up. The important point is that there is now general recognition, including from the Commisson, that the full liberalisation of capital movements is not conditional on prior moves towards prudential harmonisation. The more interesting question is how we can all continue to get the right balance between regulation and freedom of markets and adapt supervision in an EC context at the speed which is necessary to keep up with market developments.

Fiscal question

11. There is also acceptance, though in some cases given more grudgingly, that capital liberalisation need not wait on fiscal harmonisation. We see discussion of this as being of very low priority indeed compared with other barriers to capital movements.

12. A number of countries (Denmark, Ireland France) remain concerned about the implications of capital liberalisation for tax evasion. The Danes in particular are worried about the possibility of large numbers of Danish citizens opening deposit accounts in the Germany where interest is paid gross and income tax rates lower than in Denmark. (Under the Danish system income tax on bank interest is calculated by the banks even for higher rate taxpayers, withheld at source and paid direct to the tax authorities). But this is a problem which has as much to do with reporting arrangements and coordination between national tax authorities as with tax differences, and we are sceptical about how much worse capital liberalisation will make it anyway

given the opportunities for evasion which already exist through, eg, Switzerland and the Caymans. The Danes recognise that they will have to find some way of facing up to it.

13. This section of the paper also makes reference to the Commission's "proposals" for the harmonisation of corporate taxation. As far as the we are aware, no such proposals have yet been made. We are likely to experience considerable difficulty with them when they are.

Strengthening the EMS

14. The remainder of the paper is covered in the main brief. To the extent that the Commission note raises a number of possibilities not covered by the other papers (eg the idea that Member States could create reserves of private ecus by depositing national currencies with the EMCF), they are unlikely to be raised in discussion or, if they are, will receive short shrift from the Germans. If they are to be taken any further, they will need to be discussed first by the Monetary Committee and Central Bank Governors.

ANNEX B

"Debtor Quotas" under the EMS short term support mechanism

	mecu
Belgium	580
Denmark	360
Germany	1740
Greece	150
Spain	725
France	1740
Ireland	100
Italy	1160
Holland	580
Portugal	145
UK	1740

(with effect from January 1986)

EMS + CAPITAL MOVEMENTS
A

INFORMAL ECOFIN 11-13 SEPTEMBER 1987 ANNEX A

EMS AND CAPITAL MOVEMENTS

Attached are:

(1) the ~~draft~~ final version report from the chairman of the Monetary Committee;

(2) the report from the Committee of Central Bank Governors;

(3) a Commission paper circulated by the Presidency - "The complete liberalisation of capital movements and strengthening the EMS".

A1

TO ALL MEMBERS OF THE MONETARY COMMITTEE

THERE FOLLOWS THE FINAL VERSION OF THE REPORT ON STRENGTHENING THE EMS WHICH THE CHAIRMAN WILL PRESENT TO MINISTERS AT NYBORG. MEMBERS ARE REQUESTED TO PROVIDE THEIR MINISTERS WITH THIS TEXT FOR THE INFORMAL MEETING.

A. KEES
COMEU B

STRENGTHENING THE EMS

- REPORT BY THE CHAIRMAN OF THE MONETARY COMMITTEE TO THE INFORMAL MEETING OF THE FINANCE MINISTERS AT NYBORG ON 12 SEPTEMBER 1987 -

AT THE CONCLUSION OF LAST JANUARY'S REALIGNMENT MEETING MINISTERS REQUESTED THE MONETARY COMMITTEE TO EXAMINE MEASURES TO STRENGTHEN THE OPERATING MECHANISMS OF THE EMS, AND IN RESPONDING TO THIS REQUEST THE COMMITTEE HAS EXAMINED A WIDE RANGE OF PROPOSALS.

EXPERIENCE IN THE RECENT PAST AND IN PARTICULAR THE DISTURBED CONDITIONS IN THE MARKETS AT THE END OF 1986 REVEALED THE NEED TO STRENGTHEN THE EMS. THIS NEED IS ALL THE MORE PRESSING BECAUSE CAPITAL FLOWS ARE ECOMING LARGER AND MORE VOLATILE, AND BECAUSE EXCHANGE CONTROLS, WHICH ARE IN ANY EVENT LOOSING THEIR EFFECTIVENESS, ARE BEING DISMANTLED. IN THESE CIRCUMSTANCES IT IS ABOVE ALL NECESSARY TO MAKE BETTER USE OF ALL THE INSTRUMENTS AS THEY ARE AT PRESENT, BUT THERE IS ALSO ROOM FOR IMPROVING SOME OF THEM.

INTERIM REPORTS WERE MADE TO MINISTERS IN APRIL AND IN JUNE OF THIS YEAR. THE PRESENT REPORT, WHICH, LIKE THEM, HAS BEEN DRAWM UP ON THE PERSONAL RESPONSIBILITY OF THE CHAIRMAN, PRESENTS THE FULL RESULTS OF THE COMMITTEE'S WORK.

I. STRENGTHENING THE EMS: ECONOMIC POLICY

1. CONVERGENCE

LAST JUNE THE EUROPEAN COUNCIL CONFIRMED THE IMPORTANCE OF A STRENGTHENING OF THE EMS FOR THE COMPLETION OF THE INTERNAL MARKET WHICH WILL BE A SOURCE OF STRONGER, NON-INFLATIONARY ECONOMIC GROWTN. IN RECENT YEARS THERE HAS BEEN AN INCREASING DEGREE OF CONVERGENCE IN THE DATA RELATING TO FUNDAMENTAL ECONOMIC FACTORS IN THE MEMBER STATES. THE POSITION IS HOWEVER NOT YET FULLY SATISFACTORY IN ALL RESPECTS AND IN ALL COUNTRIES. PUBLIC SECTOR DEFICITS AND CURRENT ACCOUNT BALANCES REMAIN WORRYING IN SOME CASES. CONTINUOUS EFFORTS ARE NECESSARY TO PRESERVE THE DEGREE OF CONVERGENCE WHICH HAS BEEN ACHIEVED, AND TO MAKE IT MORE COMPLETE.

2. MUTUAL SURVEILLANCE

THE MONETARY COMMITTEE IS OF THE VIEW THAT COOPERATION WITHIN THE EMS HAS TO BE EXTENDED BEYOND THE SHORT-TERM ASPECTS OF POLICY, IN A SURVEILLANCE PROCESS WHICH IS EXPECTED TO REVEAL IN PARTICULAR:

- INCONSISTENCIES OF POLICIES WITHIN INDIVIDUAL EMS COUNTRIES.,
- INCONSISTENCIES BETWEEN EMS COUNTRIES.,
- ANY DANGER OF THE EMERGENCE OF UNSUSTAINABLE POSITIONS.,
- INCOMPATIBLE APPROACHES TO MAJOR THIRD CURREMCIES.

SURVEILLANCE OF THIS TYPE CAN BE MADE MORE EFFECTIVE BY THE USE OF MACROECONOMIC INDICATORS AND PROJECTIONS. IT IS CONSIDERED THAT IN SUCH A PROCESS THE OBJECTIVES CAN BE ATTAINED WHICH AT ONE STAGE IT WAS SUGGESTED SHOULD BE PURSUED THROUGH A SINGLE INDICATOR OF CONVERGENCE. IN JULY OF THIS YEAR THE COMMITTEE CONDUCTED ITS FIRST EXAMINATION ON THE BASIS OF A SET OF MACROECONOMIC INDICATORS PROJECTED TO 1990. THE AIM IS TO ACHIEVE GREATER CONSISTENCY OF ECONOMIC POLICIES WITHIN THE EMS AND IN THE WIDER INTERNATIONAL FIELD. THIS IS TO BECOME AN ESTABLISHED PROCEDURE AND THE COMMITTEE WILL CARRY OUT SURVEILLANCE OF THIS TYPE ON A REGULAR BASIS, PROBABLY TWICE A YEAR.

- 3 -

3. CLOSER COOPERATION IN THE FIELD OF MONETARY POLICY

RECENT EXPERIENCE, AND IN PARTICULAR THAT OF LATE 1986, HAS SHOWN THAT CLOSE COOPERATION IN THE FIELD OF MONETARY POLICY IS AN ESSENTIAL COMPONENT OF THE EMS. IN ORDER TO IMPROVE CONVERGENCE AND STRENGTHEN THE EMS, IN VIEW OF THE NEW DEMANDS PUT UPON IT, COOPERATION WILL HAVE TO BE RAISED TO A NEW LEVEL, WHILE RESPECTING THE DISTRIBUTION OF INSTITUTIONAL COMPETENCES WITHIN EACH COUNTRY. FOR THIS PURPOSE A VARIETY OF INSTRUMENTS ARE AVAILABLE AND THEY SHOULD BE USED IN A FLEXIBLE AND COMPREHENSIVE MANNER.

- MONETARY AUTHORITIES MUST STAND READY TO DEFEND THE STABILITY OF THE PARITY GRID BY ENSURING THAT INTEREST RATE DIFFERENTIALS BETWEEN EMS COUNTRIES ARE APPROPRIATE, AND TO THIS END THERE MUST BE A WILLINGNESS TO MAKE TIMELY CHANGES IN NATIONAL RATES.

- THE FLEXIBLE USE OF THE PERMITTED FLUCTUATION MARGINS CAN, UNDER CERTAIN CONDITIONS, HELP TO DETER SPECULATION.

- INTRA-MARGINAL INTERVENTION HAS A RECOGNIZED ROLE WITHIN THE SYSTEM WHICH IS DISCUSSED FURTHER IN POINT 7.

(shut up ministers!) - OFFICIAL AND SEMI-OFFICIAL STATEMENTS ON THE EXCHANGE RATE SITUATION MAY EXACERBATE TENSIONS AND SHOULD BE AVOIDED AS FAR AS POSSIBLE.

THERE IS AN UNDERSTANDING THAT REALIGNMENTS SHOULD IN FUTURE BE INFREQUENT AND AS SMALL AS POSSIBLE, ESPECIALLY IN ORDER TO ENSURE THAT SPECULATION IS NOT REWARDING. THIS UNDERSTANDING AND THE APPROPRIATE USE OF THE INSTRUMENTS MENTIONED ABOVE CONSTITUTE THE CORE OF A STRONGER MANAGEMENT OF THE SYSTEM.

- 4 -

ALONGSIDE THE COMMITTEE OF GOVERNORS, THE MONETARY COMMITTEE EXAMINES THE LATEST EXCHANGE AND INTEREST RATE DEVELOPMENTS AT EACH MONTHLY MEETING AND CONSIDERS WHAT CONCLUSIONS CAN BE DRAWN.

4. COORDINATION OF POLICIES TOWARDS USA AND JAPAN

TNE LOUVRE AGREEMENT, AS REAFFIRMED IN WASHINGTON IN APRIL, WAS AN IMPORTANT STEP FORWARD IN INTERNATIONAL COOPERATION ON EXCHANGE RATES AND IMPROVES THE ENVIRONMENT FOR THE EMS. THE MARKETS, WHICH WERE INITIALLY SCEPTICAL, HAVE SUBSEQUENTLY SHOWN SIGNS OF ACCEPTING THAT THERE HAS BEEN A CHANGE IN THE CONDITIONS IN WHICH THEY OPERATE. THIS CHANGED PERCEPTION HAS BEEN DUE TO THE DETERMINATION WITH WHICH THE PARTIES TO THE AGREEMENT HAVE COOPERATED IN THE SHORT-TERM MANAGEMENT OF THE SYSTEM. HOWEVER, AN ESSENTIAL FEATURE OF THE NEW APPROACH TO EXCHANGE RATES IS THE COMMITMENT TO APPROPRIATE ECONOMIC POLICY MEASURES, AND SOME OF THE NECESSARY STEPS HAVE NOT YET BEEN FULLY IMPLEMENTED, PARTICULARLY IN THE USA AND JAPAN.

What about Germany?

II. STREMGTHENING THE EMS: TECHNICAL EXCHANGE RATE ISSUES

THIS IS AN AREA OF RESPONSIBILITY WHICH ALSO CONCERNS THE COMMITTEE OF CENTRAL BANK GOVERNORS VERY CLOSELY. THE DISCUSSIONS IN THE MONETARY COMMITTEE, AND MUCH EXPERIENCE, HAVE SHOWN THAT THERE IS SCOPE FOR IMPROVING THE FUNCTIONING OF THE EMS WITHIN THE PRESENT STRUCTURE OF THE SYSTEM. MEMBERS HAVE MOREOVER STRESSED THE NEED FOR CAUTION BEFORE PROCEDING TO TNE INTRODUCTION OR EXTENSION OF AUTOMATIC OBLIGATIONS.

5. DIVERGENCE INDICATOR

THE DIVERGENCE INDICATOR HAS LOST SOME OF ITS SIGNIFICANCE AS A RESULT OF THE WIDESPREAD USE OF INTRA-MARGINAL INTERVENTION. ALTHOUGH SOME TECHNICAL IMPERFECTION?/? HAVE BEEN IDENTIFIED IN THE PRESENT METHOD OF CALCULATING THE INDICATOR, A SET O?/? SIMULATIONS CONDUCTED WITH THE AID OP COMMISSION STAFF HAS SHOWN THAT THE ELIMINATION OF THESE IMPERFECTIONS WOULD NOT GREATLY IMPROVE ITS EFFECTIVENESS. THE DIVERGENCE INDICATOR IS REGARDED BY THE COMMITTEE AS A USEFUL BUT NOT AS A PRIVILEGED SOURCE OF INFORMATION ABOUT THE SITUATION IN THE EXCHANGE RATE MECHANISM. THE MONETARY COMMITTEE WILL CONTINUE TO USE THE DIVERGENCE INDICATOR IN ITS INTERNAL EXAMINATION OF EXCHANGE AND INTEREST RATES, AND WILL ENDEAVOUR TO MAKE THAT USE MORE EFFECTIVE.

6. INTRA-MARGINAL INTERVENTION

INTRA-MARGINAL INTERVENTION HAS PLAYED AN IMPORTANT ROLE IN THE PAST, ALTHOUGH THIS WAS NOT ANTICIPATED IN THE EMS AGREEMENT. IT CAN BE USEFUL, PARTICULARLY IN THE EVENT OF EXTERNAL SHOCKS, BUT IT CAN CAUSE PROBLEMS IF CONDUCTED ON A SUBSTANTIAL SCALE AND IN A RIGID WAY. IT SHOULD NOT BE SEEN AS AN ALTERNATIVE TO THE ADJUSTMENT OF POLICIES WHEN THAT IS NECESSARY, AND IT SHOULD NOT BE SEEN AS A SUBSTITUTE FOR THE USE OF OTHER INSTRUMENTS. LARGE AND PERSISTENT INTRA-MARGINAL INTERVENTION RAISES THE QUESTION AS TO WHETHER OTHER INSTRUMENTS, IN PARTICULAR INTEREST RATES, HAVE BEEN USED IN AN ADEQUATE AND TIMELY FASHION. IT IS A KEY FEATURE OF THE EMS THAT INTRA-MARGINAL INTERVENTION IN MEMBER STATES' CURRENCIES IS A MATTER FOR CONSULTATION SINCE THE CENTRAL BANK ISSUING THE INTERVENTION CURRENCY HAS AN INTEREST IN THE TECHNIQUES AND IN THE AMOUNTS USED.

See corrigendum!

AT PRESENT THERE IS NO RIGHT OF ACCESS TO THE VERY SHORT TERM FINANCING (VSTF) ARRANGEMENTS TO COVER INTRA-MARGINAL INTERVENTION. IN SPECIAL CASES IT CAN BE SO USED BY MUTUAL AGREEMENT. SUCH ACCESS SHOULD IN FUTURE BE POSSIBLE within certain limits and UNLESS THE CENTRAL BANK WHOSE CURRENCY IS BEING USED SHOWS THAT THERE ARE REASONS JUSTIFYING A REFUSAL. HOWEVER, SUCH AN EXTENSION OF PRESENT ARRANGEMENTS MUST NOT ENTAIL A RELAXATION OF THE DISCIPLINARY EFFECT OF THE EMS.

7. CROSS-HOLDINGS OF EMS CURRENCIES IN MEMBER COUNTRIES' RESERVES

CROSS-NOLDINGS OF EMS CURRENCIES AND HOLDINGS OF PRIVATE ECUS IN RESERVES WOULD BE SEEN BY SOME MEMBERS AS A SIGN OF INCREASED SOLIDARITY. ON THE OTHER HAND, OTHER MEMBERS EMPHASIZED THAT NOT ALL EMS CURRENCIES CAN BE USED WITH EQUAL EASE IN THE MARKETS, AND THAT THIS ISSUE HAS IMPLICATIONS FOR ATTITUDES TO THE DEVELOPMENT OF THE INTERNATIONAL MONETARY SYSTEM. THE COMMITTEE NOTED THAT THE PRESENT EMS AGREEMENT ALLOWS THE HOLDING OF WORKING BALANCES IN PARTNER CURRENCIES, WHILE LARGER HOLDINGS REQUIRE THE CONSENT OF PARTNER CENTRAL BANKS.

THE COMMITTEE WILL DISCUSS FURTHER WHETHER, AND, IF SO, IN WHAT CONDITIONS THE CROSS-HOLDING OF MEMBER STATES' CURRENCIES COULD HAVE A CONSTRUCTIVE AND STABILIZING EFFECT ON THE DEVELOPMENT OF THE EMS AND OF THE INTERNATIONAL MONETARY SYSTEM.

8. THE FINANCING AVAILABLE FOR COMPULSORY INTERVENTION

THE DISCUSSION ON THIS SUBJECT SHOWED THAT THERE IS A CONSENSUS IN FAVOUR OF SOME EXTENSION OF THE TIME LIMIT FOR INITIAL SETTLEMENT UNDER THE VSTF AND FOR SOME RAISING OF THE CEILING FOR AUTOMATIC RENEWAL UNDER THAT FACILITY.

AS REGARDS THE SETTLEMENT OF DEBTS INCURRED UNDER THE VSTF IN OFFICIAL ECU, THIS CAN BE EFFECTED AS OF RIGHT TO THE EXTENT OF 50 0/0 OF THE AMOUNT DUE, ALTHOUGH 100 0/0 OF THE AMOUNT MAY BE SETTLED IN THIS WAY BY AGREEMENT. SOME MEMBERS CONSIDER THAT THIS FORMAL LIMIT IS INCONSISTENT WITH THE CENTRAL ROLE ENVISAGED FOR THE ECU IN THE SYSTEM, BUT IT IS TO BE BORNE IN MIND THAT ANY HIGHER FORMAL LIMIT WOULD MEAN EXTENDING AN OBLIGATION. NEVERTHELESS, GIVEN THE SATISFACTORY EXPERIENCE SO FAR WITH OFFICIAL ECU MECHANISMS, WHICH HAS NOT GIVEN RISE TO EXCESSIVE DEBTOR OR CREDITOR POSITIONS IN ECU, THERE IS NOW A WILLINGNESS TO GO BEYOND THIS LIMIT IN PRACTICE AND TO REVIEW THE FORMAL OBLIGATIONS AT A LATER STAGE.

9. THE USE OF THE ECU

SINCE PROVISION HAS BEEN MADE IN ALL MEMBER COUNTRIES FOR THE FREE USE OF THE PRIVATE ECU, THE COMMITTEE HAS AGAIN TAKEN UP CERTAIN QUESTIONS RELATED TO ITS USE AS A RESERVE AND INTERVENTION CURRENCY.. THESE MATTERS WILL BE DISCUSSED FURTHER IN THE COMMITTEE.

10. REALIGNMENT PROCEDURE

THE MONETARY COMMITTEE IS OF THE VIEW THAT THERE IS NO SUCH THING AS A TECHNICAL REALIGNMENT. EXPERIENCE HAS SHOWN THAT EVEN SMALL GENERAL CHANGES OF CENTRAL RATES CAN RAISE ISSUES OF POLITICAL IMPORTANCE. NO TECHNICAL CHANGES NEED TO BE MADE TO THE PRESENT PROCEDURE, BUT IT IS DESIRABLE TO DE-DRAMATIZE REALIGNMENTS AS FAR AS POSSIBLE. THE USUAL PRACTICE SHOULD BE FOR THE DECISION TO BE PREPARED BY THE MONETARY COMMITTEE, AND GIVEN THE APPROVAL OF MINISTERS, BY TELEPHONE WHENEVER POSSIBLE.

ok for
Madrid
[illegible]
(principles)

11. SPECIAL REGIMES

THE COUNTRIES OF THE COMMUNITY HAVE SEVERAL DIFFERENT STATUSES AS REGARDS MONETARY INTEGRATION:

- MEMBERS OF THE ERM HAVING SPECIAL ARRANGEMENTS (WIDER MARGIN, DOUBLE EXCHANGE MARKET).,
- EMS MEMBERS NOT PARTICIPATING IN THE ERM.,
- COUNTRIES OUTSIDE THE EMS.

IT IS DESIRABLE THAT, TO THE EXTENT THAT CONDITIONS ALLOW, ALL MAKE THE EFFORTS NECESSARY TO JOIN THE ERM. THIS IS HOWEVER BASICALLY A MATTER FOR DECISION BY THE COUNTRIES CONCERNED. THE DISMANTLING OF PRESENT SPECIAL REGIMES AND THE CREATION OF UNIFORM CONDITIONS IN THE ERM WOULD STRENGTHEN THE EMS, BUT AT THIS STAGE THERE MAY BE MORE PRESSING STEPS SUCH AS THE RECENT LIBERALIZATION OF CAPITAL MOVEMENTS IN ITALY, WHICH ALSO ARE IN THE INTERESTS OF THE SYSTEM.

III. FULL FREEDOM OF CAPITAL MOVEMENTS

THE MONETARY COMMITTEE HAS ALWAYS PRESSED FOR A MORE COMPLETE IMPLEMENTATION OF THE FREEDOM FOR CAPITAL MOVEMENTS WHICH IS LAID DOWN IN THE ROME TREATY. IT THEREFORE WELCOMES THE COMMISSION'S ANNOUNCED INTENTION OF PRESENTING IN THE NEAR FUTURE A DRAFT OF A NEW DIRECTIVE WHICH WOULD LEAD TO FULL CAPITAL LIBERALIZATION. GREAT PROGRESS HAS BEEN MADE OVER THE LAST TWO YEARS AND IT IS A MATTER OF GREAT SATISFACTION THAT THE COMMUNITY AUTHORITIES HAVE BEEN ABLE TO ABROGATE THE SAFEGUARD CLAUSES WHICH APPLIED TO FRANCE AND ITALY. MOREOVER, INDEPENDENTLY OF THE MANY CHANGES MADE TO EXCHANGE CONTROL LEGISLATIOM, THE GROWING INTERNATIONALIZATION OF CAPITAL MARKETS HAS BEEN REFLECTED IN A LARGE INCREASE IN THE VOLUME OF CAPITAL FLOWS, AND CONTROLS HAVE BECOME LESS EFFECTIVE. IN ITS RECENT DISCUSSIONS THE MONETARY COMMITTEE CONCENTRATED ON THE MONETARY IMPLICATIONS OF CAPITAL LIBERALIZATION, AND HAS NOT DEALT WITH OTHER ASPECTS SUCH AS THE FISCAL ISSUES.

12. RELATIONSHIP BETWEEN CAPITAL LIBERALIZATION AND THE EMS

CAPITAL LIBERALIZATION IS CHANGING THE ENVIRONMENT WITHIN WHICH THE EMS MUST BE MANAGED AND THERE WILL IN PARTICULAR BE MUCH LESS ROOM FOR INDEPENDENT MONETARY POLICIES WITHIN THE SYSTEM.

THESE DEVELOPMENTS HAVE MANY IMPLICATIONS. ON THE ONE HAND THE GREATER NEED TO ADJUST ECONOMIC POLICIES WILL HELP TO MAKE THE SYSTEM SECURE ON A LASTING BASIS. MOREOVER, THE COMMITMENT TO FULL LIBERALIZATION WILL BE SEEN BY THE MARKETS AS A SIGN THAT THE EMS AUTHORITIES ARE CONFIDENT IN THE STRENGTH OF THE SYSTEM. ON THE OTHER HAND THE MOVE TO COMPLETE FREEDOM OF CAPITAL MOVEMENTS IS AS SUCH NOT WITHOUT RISK. MEMBER COUNTRIES DO NOT ALL START FROM THE SAME POSITION, PARTICULARLY AS REGARDS THE DEGREE OF DEVELOPMENT OF THEIR FINANCIAL SYSTEMS. HOWEVER, THE COMMITTEE IS CONVINCED THAT THE STABILITY OF EXCHANGE RATES CAN BE MAINTAINED IN THE NEW SITUATION PROVIDED THAT COOPERATION WITHIN THE SYSTEM CAN BE INTENSIFIED, AND PROVIDED THAT APPROPRIATE TRANSITIONAL ARRANGEMENTS CAN BE MADE FOR SPECIFIC CASES.

13. SAFEGUARD CLAUSE

IT SHOULD BE RECALLED THAT THE ROME TREATY ITSELF INCLUDES A NUMBER OF SAPEGUARD CLAUSES AND IN PARTICULAR ARTICLE 73 RELATING TO DISTURBANCES TO CAPITAL MARKETS, AND ARTICLES 108 AND 109 RELATIMG TO BALANCE OF PAYMENTS PROBLEMS.

SEVERAL MEMBERS OF THE COMMITTEE ARE HOWEVER OF THE OPINION THAT THESE CLAUSES DO NOT COVER THE SPECIFIC PROBLEMS WHICH MAY ARISE FROM CAPITAL LIBERALIZATION, AND THAT THE PROCEDURES INVOLVED ARE TOO INFLEXIBLE. THEY THEREFORE ARGUE THAT THE NEW DRAFT DIRECTIVE SHOULD INCLUDE A SPECIFIC SAFEGUARD CLAUSE FOR DEALING WITH FINANCIAL DISTURBANCES ARISING FOR PURELY MONETARY REASONS IN SITUATIONS WHERE THE FUNDAMENTAL ECONOMIC SITUATION IS SOUND.

OTHER MEMBERS VIEW THE QUESTION RATHER DIFFERENTLY AND CONSIDER THAT MONETARY MOVEMENTS ARE ALWAYS CLOSELY LINKED TO THE SOUNDNESS OF THE FUNDAMENTAL SITUATION AND TO THE CREDIBILITY OF AUTHORITIES' POLICIES. THESE MEMBERS GENERALLY

CONSIDER THAT THE EXISTING SAFEGUARD CLAUSES ARE SUFFICIENT, ALTHOUGH SOME OF THEM WOULD PREFER TO HAVE AVAILABLE AN ESCAPE CLAUSE RELATING EXCLUSIVELY TO CAPITAL INFLOWS WHICH THREATEN STABILITY-ORIENTED MONETARY POLICY. !!

THIS QUESTION REQUIRES FURTHER DISCUSSION., IF AGREEMENT IS TO EMERGE, IT MUST BE CLEAR THAT THE CLAUSE WILL APPLY

. ONLY FOR SHORT PERIODS OF TIME,
. EXCLUSIVELY TO TRANSACTIONS NOT YET LIBERALIZED,
. ONLY IN EXCEPTIONAL CIRCUMSTANCES,
. BY A COMMUNITY PROCEDURE.

THERE WAS ALSO DISCUSSION OF THE FUTURE ROLE OF THE 1972 DIRECTIVE ON REGULATING INTERNATIONAL CAPITAL FLOWS AND NEUTRALIZING THEIR UNDESIRABLE EFFECTS ON DOMESTIC LIQUIDITY. MANY MEMBERS ARE OF THE OPINION THAT IN THE FUNDAMENTALLY DIFFERENT CONDITIONS OF TODAY THIS DIRECTIVE IS NO LONGER NECESSARY AND SHOULD BE ABROGATED.

14. MEDIUM TERM CREDIT FACILITIES

THE COMMITTEE HAS REVIEWED THE COMMUNITY'S MEDIUM TERM CREDIT MECHANISMS. IN ITS VIEW THE COMMUNITY LOAN MECHANISM IS THE NORMAL INSTRUMENT, AND MEDIUM TERM FINANCIAL ASSISTANCE SHOULD BE RETAINED ONLY AS A SAFTEY NET. MANY MEMBERS ARGUED THAT THE SCOPE OF THE COMMUNITY LOAN MECHANISM SHOULD BE EXTENDED SO AS TO MAKE IT AVAILABLE TO COUNTRIES IN WHICH THE FUNDAMENTAL ECONOMIC SITUATION IS SOUND AND WHICH INTRODUCE A SUBSTANTIAL PROGRAMME OF CAPITAL LIBERALIZATION., THE EXTENSION WOULD THUS BE SUBJECT TO SPECIFIC CONDITIONALITY. IT IS FELT BY SOME MEMBERS THAT THIS EXTENSION MIGHT BE NEEDED TO DEAL WITH

THE SUBSTANTIAL ADJUSTMENT OF PRIVATE PORTFOLIOS WHICH MAY FOLLOW LIBERALIZATION. MOREOVER, SEVERAL MEMBERS ARGUED FOR RAISING THE LIMITS APPLYING TO MEDIUM TERM COMMUNITY CREDIT.

HOWEVER, OTHER MEMBERS CONSIDER THAT NO CHANGE IS DESIRABLE IN THE SIZE OR COMDITIONS OF ACCESS TO THESE FACILITIES. THEY DOUBT WHETHER SUBSTANTIAL ADDITIONAL INTERVENTION WILL BE NECESSARY AS A RESULT OF LIBERALIZATION, IF APPROPRIATE POLICIES ARE FOLLOWED, ALTHOUGH IT MAY BE NECESSARY TO CHANGE POLICY MIXES.

15. SUPERVISORY PROBLEMS

THE COMPLETE LIBERALIZATION OF CAPITAL MOVEMENTS IS ONLY ONE ELEMENT IN THE FINANCIAL INTEGRATION OF THE COMMUNITY. THE FREEDOM TO PROVIDE FINANCIAL SERVICES ACROSS NATIONAL BOUNDARIES WITHIN THE COMMUNITY IS ALSO POTENTIALLY A SOURCE OF GREAT BENEFIT AND IT IS TO BE HOPED THAT THERE WILL BE RAPID AND SIMULTANEOUS ADVANCE ON BOTH THESE FRONTS. THE BANKING ADVISORY COMMITTEE IS AT PRESENT DISCUSSING A FULL PROGRAMME TO ACHIEVE THE LIBERALIZATION OF FINANCIAL SERVICES, INCLUDING NEW DRAFT DIRECTIVES WHICH WILL BE PRESENTED TO THE COUNCIL. THE COMMITTEE HAS TAKEN NOTE OF THE COMMISSION'S VIEW THAT THE FULL LIBERALIZATION OF CAPITAL MOVEMENTS IS NOT CONDITIONAL ON THE IMPLEMENTATION OF ANY ELEMENT OF THE FREEDOM TO PROVIDE FINANCIAL SERVICES.

IV. CONCLUSIONS

THE MOST IMPORTANT CONCLUSIONS WHICH CAN BE DRAWN FROM THE COMMITTEE'S WORK AS A WHOLE ARE AS FOLLOWS.

1. PARTICULARLY IN VIEW OF THE INCREASING MOBILITY OF CAPITAL AND THE PROGRESSIVE LIBERALIZATION OF CAPITAL MOVEMENTS, A STRENGTHENING OF THE EMS IS DESIRABLE.

2. THE BASIS FOR THIS STRENGTHENING MUST BE A FURTHER IMPROVEMENT OF THE FUNDAMENTAL ECONOMIC FACTORS. THIS REQUIRES ABOVE ALL A REINFORCEMENT OF EFFORTS TO BRING ABOUT A PROGRESSIVE CONVERGENCE OF ECONOMIC AND FINANCIAL POLICIES AND STILL CLOSER COOPERATION IN THE FIELD OF MONETARY POLICY. TO THIS END PERIODIC MONITORING SHOULD TAKE PLACE IN THE COMPETENT COMMITTEES, SUPPORTED BY THE USE OF MACROECONOMIC INDICATORS, ACCOUNT BEING TAKEN OF RELATIONSHIPS WITH THE IMPORTANT INTERNATIONAL CURRENCIES, PARTICULARLY THE US DOLLAR AND THE YEN.

3. FURTHER PROGRESS IS ALSO DESIRABLE IN COOPERATION WITHIN THE EMS EXCHANGE RATE MECHANISM. ONE-WAY SPECULATIVE CAPITAL MOVEMENTS CAN AND SHOULD BE COUNTERED IN FUTURE BY A FLEXIBLE USE OF AVAILABLE INSTRUMENTS AND POLICIES. IN THIS CONNECTION, THERE IS A CONSENSUS IN FAVOUR OF GRANTING ACCESS TO THE VSTF FOR SOME FINANCING OF INTRAMARGINAL INTERVENTION, AS INDICATED ABOVE. FURTHER, THE FINANCING AVAILABLE UNDER THIS FACILITY COULD BE SOMEWHAT EXTENDED IN TIME AND AMOUNT. THESE CHANGES WOULD ONLY BE ACCEPTABLE IF THE NECESSARY BALANCE IS PRESERVED BETWEEN ADJUSTMENT AND FINANCING WITHIN THE EMS.

IN THE VIEW OF THE COMMITTEE THERE IS ALSO ROOM FOR PROGRESS IN THE FIELD OF THE ACCEPTABILITY OF THE ECU.

4. FURTHER, THE SPECIAL REGIMES WHICH STILL EXIST (WIDER MARGINS, NON-PARTICIPATION IN THE EXCHANGE RATE MECHANISM, DOUBLE EXCHANGE MARKET) SHOULD BE PERMANENTLY SUBJECT TO REVIEW TO DECIDE WHETHER CIRCUMSTANCES JUSTIFY THEIR CONTINUATION.

5. THE CREATION OF THE SINGLE DOMESTIC MARKET IN THE COMMUNITY REQUIRES A LIBERALIZATION OF CAPITAL MOVEMENTS. THIS LIBERALIZATION PROCESS WILL INCREASE THE CREDIBILITY OF EUROPEAN COOPERATION IN THE FIELD OF MONETARY POLICY. IN THE VIEW OF THE COMMITTEE, THE STABILITY OF THE EMS CAN CONTINUE TO BE ASSURED EVEN WHILE CAPITAL MOVEMENTS ARE FURTHER LIBERALIZED, IN SO FAR AS COOPERATION WITHIN THE SYSTEM IS INTENSIFIED IN THE WAYS DESCRIBED ABOVE AND APPROPRIATE TRANSITIONAL ARRANGEMENTS ARE MADE IN SPECIFIC CASES.

NNNN

9413704 HMTLDN G
21877 COMEU B
End of message

Corrigendum

C.C. Mr Peretz
Mr Kelly

TO ALL MEMBERS OF THE MONETARY COMMITTEE

CHAIRMAN'S REPORT TO MINISTERS ON STRENGTHENING THE EMS

CORRIGENDUM

IN POINT 6 (''INTRA MARGINAL INTERVENTION'') THE THIRD SENTENCE OF THE SECOND PARAGRAPH SHOULD READ

''SUCH ACCESS SHOULD IN FUTURE BE POSSIBLE WITHIN CERTAIN LIMITS AND UNLESS THE CENTRAL BANK WHOSE CURRENCY IS BEING USED SHOWS THAT THERE ARE REASONS JUSTIFYING A REFUSAL.''

A.KEES
COMEU B

cc PPS
Miss Barber

9413704 HMTLDN G
21877 COMEU B
End of message

ANNEX A2

A2

Committee of Governors of the
Central Banks of the Member States
of the European Economic Community

Basle, 8th September 1987

Please find attached the final text of the report by the Committee of EEC Central Bank Governors on the strengthening of the EMS. As it was agreed at the meeting of the Committee, the Governors are invited to pass a copy of this document on to their own Minister of Finance.

The Chairman of the Committee will formally hand a copy of the report to the Chairman of the informal meeting of the ECOFIN Council in Nyborg. The French and German translations will be sent shortly and will also be available in clean copies in Nyborg.

Kind regards.

G. Morelli

Attachment

Committee of Governors of the
Central Banks of the Member States
of the European Economic Community

8th September 1987

REPORT BY THE COMMITTEE OF GOVERNORS ON THE STRENGTHENING OF THE EMS

1. In the Communiqué issued on the occasion of the realignment of 12th January 1987 the Ministers of Finance of the EEC countries asked the Committee of Governors and the Monetary Committee to examine measures to strengthen the operating mechanisms of the European Monetary System (EMS). Pursuant to that request, preparatory work for the Committee of Governors was conducted by the Committee's expert groups and the Alternates. Two oral interim reports on this work have been presented by the Chairman of the Committee of Governors to the Council of Ministers of Finance, respectively on 4th April and 15th June 1987. The Governors' final report, which focuses primarily on the matters within their competence, is presented below.

2. The Report is divided into two parts. Part I reviews the experience with the EMS and analyses the major changes in the economic environment that are likely to influence the working of the system. Part II summarises the main conclusions of the analysis and discusses ways and means to strengthen the EMS mechanisms and improve their functioning.

I. THE ECONOMIC ENVIRONMENT AND THE FUNCTIONING OF THE EMS MECHANISMS

A. Changes in the economic environment

3. Over the years, the EMS has performed satisfactorily, despite pronounced instability in the world economy. The Governors are convinced that the system has contributed to the achievement of a considerable degree of exchange rate stability based on greater economic convergence by fostering discipline in monetary and fiscal policies and preventing undue delays in policy adjustments. It is nonetheless their belief that the performance of the EMS benefited from a number of factors and circumstances whose influence on the system may now be changing.

4. Since the inception of the system the EMS countries have given priority to reducing inflation. In many cases exchange rate changes have

not fully accommodated inflation differentials, and higher inflation countries have maintained appropriate interest rate differentials. This has had a stabilising effect on exchange rate expectations and helped to reduce speculation against weak currencies. A remarkable reduction of inflation rates has indeed been achieved, but inflation differentials have not been eliminated and there has been less convergence in budgetary and other policies that have a bearing on exchange rate cohesion. As long as convergence remains incomplete, central rate realignments will continue to be necessary from time to time and there is a danger that interest rate policy will be excessively constrained by external considerations especially if realignment decisions are unduly delayed.

5. The EMS exchange rate arrangement has been affected by the large movements in the dollar exchange rate, both because the Deutsche Mark is a preferred substitute for the US currency in international portfolios and because dollar swings influence the competitiveness of EMS countries differently. Downward pressure on the US currency has generally been associated with upward pressure on the Deutsche Mark within the EMS. As long as large payments imbalances between the major countries persist and the policies being pursued do not appear fully consistent with their correction, the international environment will continue to be a potential source of destabilising pressure within the EMS; this pressure will be reinforced by remaining differences in the performance and policies of the EMS countries.

6. Increasing integration of financial markets, sophistication of market operators and mobility of international capital are likely to accentuate EMS tensions stemming from the internal and external factors indicated above. The Community countries that had maintained capital restrictions have been gradually removing them, in line with the objective of completing the internal market by 1992. In practice, the dismantling of capital controls can have conflicting effects on exchange rate stability. On the one hand, it not only fosters more efficient resource allocation and macro-economic policy convergence but also reinforces external discipline, with a potentially stabilising influence on exchange rate expectations; on the other, it increases the risk of markets amplifying the exchange rate repercussions of external disturbances or perceived policy divergences of a temporary nature.

7. With fixed but adjustable exchange rates and increased capital mobility resulting from progressive integration of financial markets and

the abolition of remaining restrictions, national monetary policies will be exposed to strains so long as individual countries' economic and financial policies and performances leave room for departures from internal and external balance whose effects spill over to other countries. This implies that all partners should pursue in a closely co-ordinated manner policies that foster stability of domestic prices and costs and external balance as a basis for lasting exchange rate stability: in particular, countries should agree that central banks would be committed to giving priority to the objective of price stability in the conduct of monetary policy.

8. It is recalled that, as recorded in the conclusions of the Presidency of the European Council in December 1978, the purpose of the EMS is to establish a greater measure of monetary stability in the Community and the EMS should be seen as a fundamental component of a comprehensive strategy aimed at lasting growth with stability, a progressive return to full employment, the harmonisation of living standards and the lessening of regional disparities in the Community. Moreover, the Single European Act specifically aims at reducing such disparities, with a view to strengthening the economic and social cohesion of the Community. In the absence of a strengthening of the economic and social cohesion of the Community, the completion of the internal market and the full liberalisation of capital movements may exacerbate these disparities. Therefore, consistent monetary policies, exchange rate stability and, indeed, overall progress towards monetary and financial integration must not be seen as ends in themselves, but rather as part of a process that, allied to direct Community action, will facilitate the reduction in regional disparities in the Community.

B. The functioning of the EMS mechanisms

Exchange rate management

9. When strains have developed within the system, they have initially been met by intramarginal interventions, sometimes very large, by the central bank whose currency was under downward pressure. Intramarginal interventions have been effective in avoiding destabilising expectations and more generally in providing relief and gaining time to decide on more comprehensive responses when pressures persisted. Experience has nonetheless shown that if a given intramarginal exchange rate is defended for too long and the market becomes aware of the scale of intervention, speculation may be reinforced. Moreover, on occasion market perception of an

inclination by the authorities to rely primarily on interventions may have fuelled speculative pressure.

10. Interest rate policies have also proved helpful in reducing exchange rate tensions when the changes in rates were made quickly and on an appropriate scale. Experience shows that it was the central bank of the weak currency that generally had to raise its interest rates and widen differentials. However, central banks' ability to adjust interest rates to meet incipient market pressures has sometimes been constrained by domestic policy considerations. In certain instances market pressures have been heightened by delays in the implementation of supporting domestic policy measures. Although the initial reaction to strains in the system has normally come from the central bank of the weak currency, when the pressure has proved too strong and the weak currency has been allowed to fall to its lower limit, the strong currency central bank has had to intervene and accept the effect on its money market conditions of the inflow of foreign exchange.

Realignments

11. Realignments have generally been carried out smoothly. In some cases they were nonetheless decided on under heavy pressure after being widely anticipated by the markets; the possibility of deciding upon a new set of central rates has sometimes tended to be linked to member states' domestic political calendars. Moreover, changes in central rates sometimes resulted in significant adjustments in market rates, thereby encouraging the belief that speculative activity prior to a realignment would be profitable.

Interventions

12. Under current EMS rules, interventions at the margins are compulsory, and can be financed without limits by drawing on the very short-term financing facility (VSTF). Intramarginal interventions are basically unregulated except that: (i) those in EMS currencies require prior agreement by the issuing central bank; (ii) those in dollars are to be avoided when bound to accentuate dollar trends or conflict with the aims of simultaneous dollar interventions by other EMS central banks. These rules have been applied flexibly and the concertation procedures have in general made it possible to overcome emerging conflicts.

[illegible]

[illegible] sa

(politikai

[illegible] [illegible])

13. Most of the interventions within the system have been intramarginal, and chiefly in dollars and Deutsche Mark. In some instances, when use of the main currencies appeared inappropriate, resort was made to intervention in the private ECU market.

14. In certain circumstances co-ordinated intramarginal interventions may be effective in forestalling market pressures. However, such interventions can, in some cases, result in an accumulation of EEC currencies in official reserves. Such holdings would need to be fully liquid and usable for intervention in conformity with the existing rules. However, some countries are reluctant to allow the accumulation of their currency as a reserve asset.

BAD

Credit mechanisms

15. The Governors agree that the present VSTF arrangements have neither been abused nor caused major difficulties for debtor countries. Nonetheless, the period for repayment under the rules has expired on occasion before capital flows were reversed and debtor positions could be unwound through reflows in the currencies of the creditor countries. Repayment obligations were met in these circumstances by market borrowing, which has so far been easily available. This problem, however, is likely to become more serious as larger capital movements can now be expected. Moreover, since financial market conditions may change, it is important that the financing facilities provide adequate resources for the management of the system in periods of tension.

16. The VSTF was conceived at a time when most interventions were expected to be at the margins. Since then, intramarginal interventions have become standard practice and now far exceed compulsory interventions. Some Governors therefore consider that the fact that recourse to the VSTF for intramarginal interventions is dependent on the consent of the two central banks involved may have deprived the system of a powerful deterrent against speculative attacks. Indeed the few instances of use of the VSTF for such interventions occurred only in 1979. Easier access to VSTF for intramarginal intervention would also represent an encouragement for countries not participating in the exchange rate mechanism to join it. Other Governors, by contrast, consider that speculation could actually be encouraged by a perception that the system's financing constraints had been eased. It was pointed out moreover that the central banks with stronger currencies liberally and flexibly accepted the use of their currencies for

!!!

Germ wr prep t jn ERM/EMS!

intervention in the past. These central banks might have reason to reconsider their attitude if the financing of intramarginal interventions were to compromise the stance of their monetary policy. !!

17. Short-term monetary support has not been used since 1974. This has not been due to shortcomings in the mechanism, but rather to the reluctance of EEC countries to finance balance-of-payments disequilibria with official credit when market financing was easily available. Moreover, when recourse to official credit mechanisms was made, countries showed a preference for medium-term instruments, such as the Community loan mechanism, in view of the nature of balance-of-payments imbalances and the time needed to correct them.

The role of the ECU

18. On the whole little use has been made of official ECUs in settlements and no large net ECU positions have built up since debtor countries have tended to repurchase their ECUs promptly. This tendency has undoubtedly been strengthened by the switch from official discount rates to market rates for the remuneration of ECU positions. The usability of the official ECU has been improved by the mobilisation mechanism introduced in July 1985. This allows central banks to obtain dollars or Community currencies against ECUs, for a limited time, subject only to the requirement of a need for intervention currencies.

19. The development of the private ECU market has been followed closely by the Committee of Governors on the basis of periodic reviews by their experts. The Governors welcome the fact that with the recent abolition of specific restrictions on the use of the private ECU in Germany and Spain the ECU is now essentially on the same footing as any other foreign currency in all EEC countries. The remaining restrictions on use of the ECU are side effects of the foreign exchange controls still in force in some countries.

Non- or incomplete participation in the exchange rate mechanism

20. The EMS was intended to encompass all the EEC countries; at present only eight of them participate in the exchange rate mechanism. In general, non-participation has not caused major difficulties, though the movements of sterling have from time to time put pressure on the Irish pound, owing to Ireland's close trade links with the United Kingdom.

However the inclusion of the pound sterling and the Greek drachma in the ECU basket means that changes in their exchange rates affect the market value and yield of the ECU. Such changes, and movements of the lira outside the narrow band of the exchange rate mechanism, can to an extent distort the divergence indicator and alter the value of claims and liabilities in the VSTF; they can also affect the private ECU market. The basic problem with non-participation, however, is that it casts doubt on the future of European monetary integration.

21. Italy's retention of wider fluctuation margins has not caused significant problems for other EMS countries or for the system as a whole, in part because less than full use has been made of its broader band, which has served principally to provide operational flexibility and to avoid large changes in market rates on the occasion of realignments. However the reduction in inflation differentials has weakened the reasons for maintaining wider margins, but it is understood that Italy is giving priority to the dismantling of its long-standing foreign exchange controls.

22. For many years, the BLEU has maintained a two-tier exchange market as a way to stabilise official exchange rates for commercial transactions while achieving and maintaining full freedom for capital transactions. This arrangement has allowed the authorities to avoid the introduction of restrictions at times of crisis. Moreover, the spread between the rates in the two markets has generally been less than 1 per cent. Nevertheless, the participation of the BLEU in a fully derestricted Community-wide capital market would logically entail the adoption of a unified exchange rate system.

II. <u>POLICIES TO STRENGTHEN THE EMS</u>

<u>Main conclusions of the analysis</u>

23. Persistence of international payments disequilibria coupled with the remaining disparities in economic fundamentals and increased capital mobility between EMS countries could result in destabilising capital flows. In such circumstances it would prove more difficult to preserve exchange rate stability within the EMS, especially if monetary policies are not adapted more promptly and co-ordinated more closely when temporary pressures develop in foreign exchange markets. Some member countries with highly open economies fear the adverse impact on economic growth of raising

[illegible]

domestic interest rates to stem capital outflows. Conversely, the countries that have defeated inflation and whose currencies are tending to appreciate fear lest the huge capital inflows that could occur in periods of tension should cause them to lose control of their monetary aggregates. There is, therefore, the risk that temporary pressures will lead to realignments that economic fundamentals do not justify and that would otherwise have been avoidable. This would impair the credibility of the EMS and compromise its positive role in promoting the downward convergence of inflation rates.

If temp: limit; if fundamentals realign

NB

24. The Governors agree that the risk of exchange rate stability being adversely affected by increased mobility of capital and the elimination of exchange controls should be avoided. To this end the anti-inflationary stance of economic policies and the present flexibility of the system should be preserved. Moreover, to help achieve these goals, they consider that various policy steps are in order. Some of these steps require action by national governments, while the central banks are competent to act on others related more specifically to the management and operating mechanisms of the EMS.

V badly drafted!

A. Issues requiring action by national governments

?

25. The stability of the EMS and the possibility of further progress in the construction of an integrated monetary area in Europe depend primarily on the convergence of economic fundamentals. Indeed, since monetary policy on its own cannot ensure the convergence required to achieve stable exchange rates, the full support of fiscal and other policies is required. Further convergence would help to stabilise exchange markets and strengthen private operators' perception that exchange rates will remain stable.

26. It is also desirable for all the EEC countries to accept the discipline of the exchange rate mechanism on an equal footing (see paragraphs 20-22). The Governors stress that progress towards this objective should be made sooner rather than later, as an important step towards full monetary integration in Europe.

27. Realignment policy can also enhance EMS stability by minimising the potential gains from position-taking in expectation of a realignment. In the first place, markets should be led not to expect large exchange rate movements in the wake of a realignment. Secondly, any impression that the authorities are prepared to yield to market pressures through realignments should be avoided. Accordingly, realignments should be infrequent and changes in central rates should be kept small so as, whenever possible, to

May be incompatible

ns –

* all written
interpretation as if
made of junk per
a single reader.
But [illegible] to a
brain [illegible] world.

avoid changes in market rates. This implies, however, that further progress should be made in the convergence of economic fundamentals. There is also a need to make realignments less predictable, notably by early recognition of fundamental disequilibria and, when these develop, by a prompt decision to realign before the markets see this as inevitable. Finally, everything possible should be done to dispel the impression that realignments are somehow linked to domestic political events. Dissens !

B. Action by Central Banks

The role of monetary policies

28. In a medium-term perspective, monetary policies should be geared to narrowing the remaining inflation differentials and making national inflation rates converge on price stability. In the short run, this approach should continue to be implemented in a flexible way. Departures from the desired path of monetary growth should, however, be temporary so as not to allow serious or extended divergence from a policy course that is consistent with domestic price stability and convergence; otherwise, expectations would be generated in the market that the emergence of fundamental causes of tensions will be tolerated. Accordingly, short-term policy adjustments should be made in full consideration of the causes of exchange market strains and the final objectives of price stability and convergence within the system. *

29. Increased financial innovation and liberalisation of capital movements in those countries which have not already taken this action will not only have implications for interest and exchange rate policies, but also for monetary policy instruments and intermediate targets. The foreseeable increase in residents' holdings of foreign liquid assets will make it more difficult to analyse monetary and credit aggregates. The scope for circumventing controls will be greatly increased, thereby strengthening the case for the use of indirect monetary tools based on interest rates. The abolition of exchange restrictions will improve the allocation of resources and reduce the cost of financial intermediation, but careful consideration must also be given to the differences in the supervisory, regulatory and fiscal arrangements governing financial markets with a view to eliminating distortions that might have a bearing on financial stability. [illegible]

[illegible]?

Exchange rate management - a strengthened monitoring procedure

30. The Governors agree that in the new environment there is scope for a more active and flexible use of all the instruments available to central banks for meeting short-term exchange rate pressures and for better co-ordination of such action among the central banks participating in the EMS. Full and concerted use of all the instruments for defending EMS stability will be all the more necessary to cope with any financial shocks that originate outside the system and affect the participating currencies differently. While recognising that intramarginal interventions will continue to play an important role, the Governors are considering allowing fuller use of the exchange rate fluctuation band with the aim of enhancing the perception of exchange risk among market participants. They also believe that interest rates should be adjusted more promptly when incipient pressures arise, thereby helping to check speculation by raising the cost of open foreign exchange positions. Moreover the Governors intend to seek ways of strengthening central bank co-operation on interventions and related policies, regarding not only EMS currencies but, when appropriate, third currencies and ECUs.

31. To promote more effective use of the instruments available for maintaining exchange rate cohesion within the EMS, the Governors have agreed to strengthen, within the Committee of Governors, the procedure for joint monitoring of economic developments and policies with the aim of arriving at common assessments of prevailing circumstances and appropriate policy responses. This new procedure will build on existing arrangements for mutual exchange of information and monitoring, but it will entail two significant innovations. First, to ensure that potential strains are identified as early as possible, monitoring will focus more specifically and systematically on simultaneous consideration of intervention, exchange rate, and interest rate policies. Secondly, the Governors will use the findings of the monitoring exercise to discuss appropriate policy responses, including the use of interventions and their co-ordination.

EMS mechanisms

32. The Governors emphasise that it is essential to avoid any easing of discipline or change in the balance between adjustment and financing of balance-of-payments disequilibria. In the light of their operational experience with the EMS mechanisms and the changes in the environment, the

Governors have agreed that a number of modifications would be useful and desirable.

(a) Very short-term financing

33. The duration of such financing (which is unlimited in amount) will be extended by one month, taking the maximum duration from two and a half to three and a half months. Initial financing operations will still be automatically renewable for three months at the request of the debtor country, but the ceiling on automatic renewal, at present equivalent to the country's debtor quota in the short-term monetary support mechanism, will be raised to 200 per cent. of this quota.

34. The Governors have agreed that automatic VSTF financing of intramarginal interventions should not be introduced. They point out that such financing of intramarginal interventions through the EMCF is already possible if the central banks directly involved concur. They accept a presumption that intramarginal intervention agreed to by the central bank issuing the intervention currency will qualify for financing via the EMCF on the following conditions: !

- the cumulative amount of such financing does not exceed the double of the debtor quota of the debtor central bank in the short-term monetary support mechanism;
- the debtor central bank is also prepared to use its existing holdings of the currency to be sold for intervention in amounts to be agreed;
- repayments shall be made in accordance with the rules specified in Article 16.1 of the EMS Agreement. The creditor central bank reserves the right to request payment in its own currency if this appears necessary in the light of its own monetary conditions, taking into account the reserve position of the debtor central bank.

35. Larger cross-holdings of EMS currencies in participating central banks' reserves can be expected to develop as a natural consequence of increased integration and monetary convergence in the EMS. Although substantial accumulations of assets in EMS currencies do not appear desirable, ?? holdings of larger working balances in these currencies, subject to prior agreement by the issuing central banks, could in certain circumstances help to improve the working of the system. The Governors believe that current

?

arrangements in this regard do not constitute an obstacle to such enhanced holdings of partners' currencies.

(b) Short-term monetary support

36. The Governors consider that the short-term monetary support mechanism does not need to be modified.

(c) Matters relating to the ECU

37. On the basis of the positive experience with official ECU mechanisms, the Governors have agreed to accept settlement in ECUs of outstanding claims in the VSTF in excess of their central bank's obligation and up to 100 per cent. as long as this does not result in an unbalanced composition of reserves and no excessive debtor and credit positions in ECUs emerge since these would in time endanger the ECU's credibility. After two years of experience, the formal rules relating to the official ECU will be subject to review.

38. As regards the further development of the ECU, the Governors reaffirm their belief that the private ECU market should continue to develop in response to market forces. The Governors welcome the lifting of restrictions on the use of the private ECU in Germany and Spain and are confident that the remaining restrictions on the use of the private ECU will be removed as part of the liberalisation of capital movements under way in the Community.

39. The Governors have examined other ways to broaden the usability of the ECU. In particular, they have considered various proposals to introduce a link between the private and official ECU circuits. They have reached the conclusion that these proposals would be feasible and that they would neither raise major technical or legal problems nor have major monetary or exchange rate implications under present circumstances. Although their practical consequences in the short term would appear to be limited, their implementation would nonetheless raise issues relating to the long-term evolution of the ECU and the involvement of the monetary authorities in the functioning of the private ECU market, issues which the Committee of Governors will keep under review.

ANNEX A3

A3

COMMISSION
OF THE
EUROPEAN COMMUNITIES

The President

Brussels, 30 July 1987

Confidential

The Complete Liberalisation of Capital Movements and Strengthening the EMS

I. Introduction

The Community has set itself the goal of completing the internal market in which goods, persons, services and capital will move freely by 1992. In May 1986 the Council adopted a communication from the Commission which presented a programme for the liberalisation of capital movements in the Community. The first stage of that programme resulted in the enactment of a Directive in November 1986 which came into force in February 1987. Already some of the Member States concerned have gone further than required by this Directive, and a number of Member States have removed all restrictions on capital movements. The complete freedom of capital movements should be possible among a majority of Member States, before the 1992 target date.

The final stage of the liberalisation of capital movements will take place against a background of a rapidly changing international financial system. The volume, volatility and velocity of financial transactions has increased enormously over the last few years despite the disappointing performance of the world economy. Financial transactions have become increasingly disassociated from the real economy; and at the same time there have been unprecedently large external imbalances between countries and huge swings in real exchange rates. There has been an increase in systemic volatility and fragility. Furthermore, financial and technological innovation, as well as some significant policy changes have led to a globalisation of financial markets, with the result that the number of cross-border and cross-currency transactions is increasing at least as fast as financial activity within any one country. More attention should be given to the potential risks associated with this situation.

The final stage of the liberalisation of capital movements within the Community, which is only one element in the process of creating an integrated financial market, will not add significantly to the risks which are associated with these overall developments, but it should not be undertaken without using the opportunity to minimise those risks.

The strategy should neither be to resist inevitable changes nor to opt for wholesale deregulation; instead it is necessary to manage change. Further liberalisation of capital movements will in most cases reinforce the dynamic process through which the financial systems in the Member States will fuse together; but uncontrolled, this process could lead to a gradual drift towards a lowering of prudential standards, through a competition in laxity. Those nations with the most stringent regulation and supervision would be under pressure from their financial institutions, whose costs must partly reflect these rules, to relax controls. To achieve a balance with the interest of the users of financial services, the Commission has proposed a comprehensive

Provisional address: Rue de la Loi 200, B-1049 Brussels — Telephone 235 11 11 — Telegraphic address: "COMEUR Brussels"
Telex: "COMEU B 21877"

programme which will ensure a sufficient degree of harmonisation of regulation of financial services so that all Community countries can have confidence in each other's systems. The needs of the internal market and the EMS require that these risks are treated at a Community as well as a world level.

Special transition measures will have to be made for the minority of members whose financial systems do not allow them to proceed as quickly as the others with capital liberalisation. The arrangements would include a binding time-table; and in some cases there could be Community assistance. The Commission has already announced its plan to broaden the scope of the Community instruments which provide medium-term balance of payments assistance. In the past these instruments have been activated to assist members which have introduced or tightened exchange controls at a time of a balance of payments crisis. It is now proposed that their use could be extended, with the appropriate conditionality, to support a Member State which is moving towards further liberalisation of capital movements, despite a difficult external position.

Further liberalisation of capital movements has far-reaching implications for the EMS, which must in any case be strengthened in the light of recent experiences and of developments in the international system. On the one hand increased capital mobility will reinforce the external constraint which already exists on exchange and interest rate management for all Member States. On the other hand it increases the potential for destabilising capital flows and market volatility. To ensure that increased exchange rate instability does not undermine the progress towards the ultimate objectives of monetary stability and the achievement of a unified market that has already been made, it is necessary to increase the co-ordination of monetary policy through a strengthened EMS.

II. Scope of the next stage

The next stage of liberalisation of capital movements will also be the final stage. Innovation has already eroded the barriers between markets to such an extent that it is not possible to make any differentiation between transactions to be liberalised in the next stage. It will also involve more than the removal of exchange controls. Restrictions and distortions which prevent the effective exercise of the liberty to transfer capital, must also be removed, in conformity both with recent rulings of the Court of Justice and with Article 67 of the Treaty, which states that the Member States shall progressively abolish between themselves all restrictions on the movement of capital belonging to persons resident in Member States.

It is this formulation which will form the basis of the Directive that the Commission intends to present shortly to the Council. The proposed new Directive will contain a specific safeguard clause which will permit the reimposition of exchange controls, on a temporary basis and under Community supervision, for monetary transactions if the national authorities consider that their policies are threatened by sharp disturbances.

W:

The purpose of the final stage of liberalisation of capital movements is to ensure that residents in liberalising Member States are effectively and fully entitled to benefit from the opportunities offered in the financial markets in other Member States.

In practice, as the removal of restrictions will be made "erga omnes", they will also be entitled to benefit from the opportunities offered by all other financial markets. This however will not be a provision in the proposed new Community texts. The 1972 Directive on regulating international capital flows and neutralising their undesirable effects on domestic liquidity, which ensures that Member States possess the necessary instruments for activating the safeguard clause referred to above should be modified to enlarge the scope of the instruments and make their use more symetric. It could also be modified to provide a further legal basis for the co-ordination of external policy to allow for a concerted implementation of protective and/or monetary policy instruments in order to regulate short-term capital movements to or from third countries.

at odds with
Monet Cttee &
CB Govs view
that "controls
ineffective"
✓

II.1 **Prudential supervision**

Given the high level of prudential supervision that is present in all Member States, further harmonisation is not a precondition for the full liberalisation of capital movements. Increased capital mobility will not endanger their financial systems, it will however increase the need for a minimum degree of harmonisation to ensure both the conditions for fair competition between financial intermediaries and the protection of investors and savers.

A fully integrated Community-wide financial area will involve the free movement of financial services as well as the complete liberation of capital movements. The legislative proposals in the White Paper on the internal market lay out the Commission's views on what will provide the necessary basis for the liberation of financial services. The approach followed is to identify the minimum harmonization of essential prudential and supervisory standards required to underpin the mutual recognition of standards and thus the principle of home country control. It should be emphasised that minimum harmonisation does not mean harmonisation at a minimum level. The Community must offer a high level of protection which also takes into account the general need to adapt Member States' legislation governing banking and securities markets to the changing environment; and consider the interests of the European financial services industry in the global market-place.

Depositors and investors will continue to be protected by their own national regulatory and supervisory systems for the financial transactions that they make in their country of residence. Liberalisation of capital movements will however give them an extra degree of choice and should as a rule give greater freedom of access to the financial services offered in other Community countries or indeed the rest of the world. In exercising this choice, they naturally put themselves under the prudential regime of that other country.

II.2 Fiscal questions

In some Member States the domestic financial system is extensively used for the purposes of control and collection of taxes, especially those on investment income and capital gains. Although it should be noted that those states which have already fully liberalised have satisfactorily coped with fiscal problems, and that it is not the absence or presence of exchange controls which determines the amount of fiscal evasion, the Community cannot be indifferent to this concern. For the case of dividend income the Commission's proposals for the harmonisation of corporate taxation include harmonisation of corporate tax systems on a partial imputation model and a provision for a common level of withholding tax. For the case of interest income from deposit accounts and bonds, for which a common withholding tax is unlikely to be acceptable, the solution lies in an enhanced coordination between national authorities, based in part on the 1977 Directive concerning mutual assistance between national authorities over direct taxation, which allows for information to be exchanged where fraud is suspected.

As well as ensuring that the full liberalisation of capital movements does not lead to an increase in fiscal evasion, it is also necessary to ensure that provisions in national fiscal regimes do not constitute a disincentive to capital movements. There are a number of schemes in various Member States which by discriminating in favour of domestic securities effectively impede the free movement of capital. These will have to be progressively removed.

PEPs ?!

III. Strengthening the EMS

To reap the full benefits of an integrated financial area which include : a more efficient allocation of financial resources; lower costs and wider choice for individual and business consumers of financial services; deeper and broader markets; and a more dynamic European financial industry which should be better able to compete world-wide, will also require continued monetary stability through a strengthened EMS.

The international situation, which combines substantial overshooting and extreme volatility of exchange rates and massive payments imbalances, clearly demonstrates the inconveniences of combining increased capital mobility with a lack of monetary order. Experience has shown that floating exchange rates do not allow different countries to pursue their national policies independently. There are no techniques that allow countries both to insulate themselves from the rest of the world and to capture the gains that are potentially available from increased trade and higher levels of interdependence. Nor is it sufficient that individual countries independently pursue stability oriented policies. Certainly that is necessary, but international stability also requires co-operation and co-ordination, as is now generally accepted. Indeed a great deal of progress has been made, especially since the Tokyo summit of May 1986.

The international monetary system is in some important respects, tending towards a direction which the Community already took in 1979 with the setting up of the EMS. Further liberalisation of capital movements however reinforces the need to strengthen the EMS. By allowing increased mobility of short-term and monetary assets, the final phase increases the potential for destabilising speculative flows which could jeopardise the achievements that have been made with regard to price and exchange rate stability.

The System must be strengthened in such a way as to minimise the possibilities that such flows will in practice materialise, and to ensure that their potentially harmful effects can be attenuated as much as possible.

A balanced approach, relying on both tighter policy co-ordination and strengthening the system's mechanisms will be necessary for three principal reasons. First, it is accepted at a theoretical level that if a group of countries have both fixed exchange rates and completely free capital movements between themselves, there would be no scope for separate national monetary policies. As the EMS is not a fixed rate system, some flexibility at each of the points of the triangle composed of : mobility of capital movements, exchange rate stability and unity of monetary policy, is vital. Second, policy co-ordination, although a key ingredient to overall success, cannot in itself eliminate the possibility of destabilising capital flows triggered by non-policy or external shocks. Finally it is essential to complement increased capital mobility and the progressive creation of a unified financial market by strengthening the system's mechanisms in such a way as to ensure a reasonable degree of symmetry.

III.1 Policy co-ordination and indicators

Macro-economic indicators can help to strengthen policy co-ordination both through making the surveillance process more concrete, and by providing a detailed and quantified view on the consistency of objectives. They can also facilitate the attainment of a pattern of policy mixes between each country which are mutually compatible and consistent with the overall aims of growth and stability through providing a background for the necessary decisions on which instruments are to be used, when, and by whom, as well as on the relative weight to be given to the various instruments.

Progress in this area is being made at both an international and Community level. At the Venice summit it was agreed that each of the G-7 countries should develop medium term objectives and projections that are mutually consistent; and that performance indicators should be used to verify that there are no significant deviations from the intended policy course. Within the Community, an indicator-based process is under consideration. The Monetary Committee has recently had a discussion on the basis of a paper submitted by the Commission. The indicators developed within the EMS need not be the same as those developed at the international level although both sets should of course be consistent and complementary.

The Community's battery of indicators should take into account the special circumstances of the EMS. As well as considering the sustainability of current account positions, they must give weight to the objective of exchange rate stability. Also they must be geared to the need to establish as far as possible a common view of the position of the EMS vis-à-vis the exterior. This does not yet imply defining a target zone or reference range for the ECU vis-à-vis the dollar and yen, which would not be realistic or significant in the absence of an agreement with the monetary authorities competent for those two currencies. But as external shocks have the capacity to cause tensions both directly and indirectly, the System cannot be indifferent to them. The Community's procedure should also take into account any decisions made in the context of G-7 surveillance, and should check their consistency with EMS requirements.

The potential effects of the Community surveillance procedures are dampened by the lack of full participation of all currences within the exchange rate mechanism of the EMS. Any mutual consistency exercice is clearly affected by the degree of commitment to the existing pattern of exchange rates.

III.2 Shorter-term Monitoring

Increased capital mobility and the further integration of financial markets will enhance the need for an effective early-warning system to detect disturbances and tensions in the System. As the distinctions between domestic and external markets are reduced, shocks of both a policy and a non-policy nature have more and more direct repercussions between Member States, making it necessary to take a joint view of developments and to establish as far as possible a common line of action.

Given the exchange rate constraints of the System, this joint view should concentrate on the following areas:-

- the fluctuation of exchange rates within the bands, as a more co-operative approach to the use of these margins could both discourage speculation and could help prevent realignments;

- interest rate differentials, which should play a key role in maintaining the stability of the parity grid in the short-term;

- intramarginal interventions, which can at times be a useful additional instrument together with interest and exchange rate policy.

The internal management of the System can only take place against a background of an agreed appreciation of the external situation, which will also have to concentrate on: the exchange rate of the ECU vis-à-vis the major international currencies, interest rate differentials, and the appropriateness of intervention.

Given their respective competences and the differences in Member States over the body which bears the primary responsibility for the various decisions that have to be made and implemented, it is normal that both the Monetary Committee and the Committee of Central Bank Governors should regularly devote attention to these topics.

III.3 Mechanisms and Institutions

The System's mechanisms are continuously evolving in response to changing internal circumstances, and to developments in the world economy. At times modifications of texts as well as practices is also necessary. It is also appropriate to ask whether there should not be some evolution in the institutional arrangements. At this stage these considerations concern: the practice of intervention and its financing; the ECU; and the European Monetary Co-operation Fund.

a) Intervention

As increased capital mobility will increase the potential for destablising capital flows triggered by financial rather than by fundamental shocks, larger interventions may at times be necessary. It should be emphasised that this does not at all mean that the occasions on which intervention is an efficient or desireable policy instrument will increase; if anything, the contrary may be the case because increased co-operation will ensure a better coherence of fundamentals. The necessary magnitudes, when intervention is called for, may however be larger. Also in a strengthened system, based on a higher level of co-ordination, there is an increased justification for some common financing.

At the fluctuation limits intervention is automatic, potentially unlimited, and the financing arrangements are predetermined using the Very Short Term Financing Facility (VSTF). Some strengthening of the VSTF is however appropriate. As experience has shown that capital reflows can take some time, the duration of the credit should be extended and the ceiling increased for the amount which can be automatically renewed.

Intramarginal interventions also have a role to play within the System. The total size of interventions will in many cases be smaller if intervention is undertaken early rather than if currencies are allowed to reach their bilateral limits. The weaker currency loses less reserves, and the stronger has to support a smaller potential disruption to its domestic money market. Intramarginal intervention can also spread the monetary consequences of intervention if it is undertaken in ECU rather than an individual currency. As the gains are flowing to the whole system, there seems to be little reason why the procedures should not be better co-ordinated. Also the resulting interventions could, at least in some cases, be financed by Community mechanisms, especially in cases where the decisions had been made in the context of the joint monitoring of the shorter term tensions in the System, which could have taken into account the divergence indicator.

b) The ECU

The System loses an element of symmetry because the ECU is not at its centre as was initially envisaged. The official ECU is at the moment subject to an acceptability limit of 50 percent. This should be raised to 100 percent. Also its use is limited by the mechanism used for its creation. This mechanism could be improved both by increasing the duration of the swap periods - i.e increasing it from 3 months to for example a year - and by making the swap system permanent.

The status of the private ECU can also be improved. Links between the private and the official ECU should be tightened. It should be possible to use the mobilisation mechanism to obtain private ECU as well as dollars or Community currencies. Especially if it was agreed in the context of the regular monitoring procedure that intramarginal intervention in ECU would be in the interests of the System, there should not be this discrimination against the ECU.

As with the use of any monetary instrument, the decision to intervene in ECU should be based on an overall view, but an improved divergence indicator could provide a useful additional element in the decision-making process. This indicator, which was intended to add a further element of symmetry to the system, has not been used mainly because of the extent of unilateral unco-ordinated intervention, which biases its signals. If intramarginal intervention was to become more co-operative and co-ordinated, the technical problems with the indicator could be rectified and its threshold lowered.

c) The EMCF

Although it could be possible to obtain private ECU for intervention through the mobilisation of official ECU, it would be more simple to create them through a deposit of Community currencies with the EMCF, as was envisaged in the Annex to the Conclusions of the European Council held in Bremen in July 1978. It was there suggested that member state currencies would be transferred in an amount of a comparable order of magnitude to the transfers of gold and dollars. The ECU created against Community currences could be made indistinguishable from private ECU, and could be used for intervention. They would not impede in any way on the existing official ECU circuit.

Under present conditions, interventions in private ECU only have small monetary effects in the countries of the basket currencies; i.e their monetary consequences do not differ very much from intramarginal interventions in EMS currencies. If ECU created through the EMCF were used for intervention purposes, there would be wider monetary consequences. This however is already the case when national central banks are involved on both sides of the transaction as in the case of intervention at the margins. The difference with an ECU intervention would be that it would spread the monetary consequences more broadly.

It should also be asked whether the shorter-term monitoring process, which should be at the base of a better co-ordination, should not take place within the framework of the EMCF. Article 2 of the Regulation establishing the Fund states that it shall promote the proper functioning of the margins of fluctuation of the Community currencies against each other, and interventions in them on the exchange markets.

psl/19A

SECRET

FROM: A C S ALLAN
DATE: 3 September 1987

SIR G LITTLER

BILATERAL WITH THE CHANCELLOR: 3 SEPTEMBER

This is to record the main points raised at your bilateral with the Chancellor this afternoon.

Foreign Exchange Market intervention

2. The Chancellor said that he felt that the next time there was any concerted action to prop up the dollar, we should be part of it; you said this was already in hand. The Chancellor also noted that it was clear that the markets had now calmed down, and had absorbed and accepted the 1 per cent increase in interest rates. Given that sterling was relatively strong against both the dollar and deutschemark, it now seemed sensible to aim to do some creaming off of reserves.

BILATERAL WITH SIR G 3/9

Arrangements for informal ECOFIN

3. You reported that Balladur was now going to Denmark via Bonn, and this had displaced any possibility of a trilateral soon after arrival in Denmark on Friday. The Chancellor said he would want to have both a bilateral with Balladur and a trilateral with Stoltenberg over the course of the weekend. You agreed to fix this up.

EC Budget

4. You reported that Mr Edwards was putting together the appropriate figures for you to give Trichet at your meeting next week. These were based on Commission estimates, and were effectively unassailable. The objectives were to make sure the French understood the figures, and to demonstrate to them that they had common cause with us and the Germans in fighting off the Commission's extravagant proposals.

Sub-Saharan African debt

5. You reported that at the Monetary Committee it had become clear that the Camdessus proposals on the SAF would not work: the US would not accept them, and the Japanese and Germans were also raising difficulties. You thought this opened a way for us to secure agreement with the French that we should go for an interest subsidy, both on IMF debts and on Government debts. The Chancellor said that even if we failed to make progress in getting other countries to agree, he would still want to keep his proposals running: we gained much credit from them; and if we were pressed on why we did not go it alone, we could very reasonably point out that that would lose us any leverage over other countries.

EMS

6. The Chancellor said he had been interested in the recent piece by Credit Suisse First Boston, but had been surprised by the suggestion that Balladur favoured Community negotiations with the US and Japan. You said you throught the French were playing up to the Commission, by stressing the importance of a co-ordinated EC position and a greater role for the ECU. The Chancellor thought this was a foolish tactic: it was easy to get Commission plaudits, but this would only heighten Bundesbank opposition.

7. You reported that at the Monetary Committee, you had made some progress on intra-marginal intervention: there were few problems over the availability of finance, but the Germans objected in principle to allowing any country a right to intervene within the margins. However, Tietmeyer was ready to accept a presumption in favour of intra-marginal intervention, with the onus on the other country to object, though the Bundesbank had reserved their position. There had been no discussion about cross-currency holdings, where the Bundesbank position was totally rigid, or on wider margins. There was some agreement that new procedures for realignments were needed, but scepticism about how far new rules

would work in practice. The Chancellor commented that the proposals on re-alignments were not just designed to avoid unseemly wrangles: they also had substantive implications for the agri-money costs.

8. The Chancellor said he thought an agreed paper with the French would be helpful. This was not something we would table, but he saw some advantages in getting agreement on a non-paper: that would help with forms of words, and would avoid misunderstandings. The same applied to Sub-Saharan African debt.

Tax approximation

9. You said that it was now clear that Lord Cockfield would not attend the informal ECOFIN; and Delors had agreed that tax approximation should not be on the agenda. You had been assured personally by the Danes that they wished to keep the agenda to the two main items. Tietmeyer did not know Stoltenberg's exact position, but knew he wanted to discuss the procedures for considering the proposals. The Chancellor asked you to find out how Lord Cockfield planned to take this forward: was he, for example, planning to present his proposals to the October ECOFIN? That would cause some difficulties for the Chancellor, since the IOD Annual Taxation Dinner was that evening. So it would help if the ECOFIN could start in the morning, though it was possible the Chancellor might wish not to go at all and to send the Paymaster General instead.

G10

10. The Chancellor noted that the objectors seemed to have been whittled down to one; Sweden. He thought it was important to make sure the Swedes knew they would be identified and isolated.

IMF Annual Meetings

11. You noted that there was a threat that the Brazilians and Argentinians would adopt a joint position, which could cause difficulties; but it did not seem likely that they would be able to persuade the Mexicans to join them, and that eased the problems. The Chancellor asked me to ring Mr Lankaster to find out if Baker had any plans for new initiatives (and I have subsequently done so).

ACSA

A C S ALLAN

PH1/52

SECRET

CHANCELLOR OF THE EXCHEQUER

FROM: A C S ALLAN
DATE: 5 AUGUST 1987

SIR G LITTLER

cc PS/Economic Secretary
Sir P Middleton
Mr Cassell
Mr Peretz
Mr Kelly

TALKS WITH BALLADUR: EMS

This note records the discussions on the EMS.

2. The <u>Chancellor</u> started by saying that our position on joining the EMS was well known. He was not able to say any more at present. But there could be changes in the system which both the UK and France would like to see, and which could make it easier for us to join.

3. <u>Balladur</u> said that he had spoken to Pohl, and he, Larosiere and Stoltenberg would all be meeting before Copenhagen. One particular objective was to persuade the Germans to hold other currencies in their reserves. The Germans maintained that as soon as they held francs they would be forced to hold drachmas as well, and would inevitably suffer large exchange losses. On intra-marginal intervention, the German position was perhaps less firm. Balladur thought the problems would be greatly eased if sterling were to join. He asked what proposals the UK had.

TALK WITH BALLADUR
/EMS

4. The <u>Chancellor</u> said he thought at this stage it was for the French to put forward proposals, but he would be very happy to provide support. He thought there were five areas where the EMS could be improved, some already proposed by the French.

   i. He strongly supported the French position on cross holdings of currencies; even though this would cause us some difficulties, he thought it made great sense. The problem was with the Bundesbank's self-imposed rule.

ii. More tactical flexibility in intervention would be a great help, and he would welcome the extension of the VSTFF to intra-marginal intervention.

iii. The dreadful scenes in January had convinced him that we needed better mechanisms for realignments. In practice, most realignments involved a demandeur and the Germans. He thought that the simplest solution would be for the demandeur and the Germans to agree on the extent of the relative movement in their currencies, and then to move symmetrically about the ecu. All the other currencies would be able to slot in anywhere in between.

iv. He thought slightly wider margins would help, though this was perhaps less important. There might be scope for achieving a compromise with the Italians whereby, for example, everyone's margin was set at 3%.

v. Finally, he felt that it was essential to make rapid progress on abolishing exchange controls. While some countries retained exchange controls, this gave the impression that it was impossible to live in the EMS without them.

5. Balladur was clearly interested in this package. He thought a system for realignments which involved less drama would be very desirable; but he noted that the Germans would be difficult to persuade: they would want to retain a lever over where other countries fixed their rates within the band. He also thought that the Chancellor's emphasis on exchange controls was over-done: all that the French had left was a "dernier petit bastion". Businesses were already completely free, and all that remained were minor

CHANCELLOR OF THE EXCHEQUER

controls on individuals, which could not realistically affect the UK much. The Chancellor commented that France had nonetheless refrained from taking the final step, and the fact that they had the mechanisms still in place gave rise to fears in some quarters that in the event of exchange rate difficulties they would reimpose controls.

6. It was agreed that you and Trichet should discuss further the scope for a joint package to be put to the informal ECOFIN in September. In conclusion, the Chancellor emphasised that he was not saying that if his five point plan was agreed, the UK would then join the EMS: that was a matter for separate decsion.

ACSA

A C S ALLAN

RP

CHANCELLOR OF THE EXCHEQUER

C

Q3 Invisibles

The CSO haven't reached an agreed view yet & are reluctant to say anything until they do. They will have to agree a figure by this Friday in time for the imports note. I'll let you know the figure as soon as we hear anything

CR 16/9.

Thanks

CONFIDENTIAL

SECRETARY OF STATE FOR EDUCATION AND SCIENCE

CH/EXCHEQUER
REC. 10 SEP 1987 ✓10/9
ACTION CST
COPIES TO

Papers Pse

4

PRIME MINISTER

OPTING OUT OF ILEA: CONSULTATION DOCUMENT

I am grateful for the comments recorded in the attachment to your Private Secretary's letter of 7 September, and for the comments from John Major and Nicholas Ridley (their letters of 2 and 7 September respectively). Tony Newton, in his letter of 25 August, also raised some points which are relevant to the consultation paper on ILEA.

We have amended the text in the light of your comments and those of other colleagues, and I attach a copy of the revised version, which I propose to issue this Friday, 11 September. Changes from the previous version are sidelined in the text. It may be helpful if I explain the reasons for the form taken by some of these.

You asked me to delete the second sentence of paragraph 8, which explained that it would be open to inner London boroughs to apply to assume responsibilities for education from a date later than April 1990. I share your wish to ensure that as many boroughs as possible take advantage of opting out at the earliest opportunity, and I am therefore content to remove the sentence. My paper to E(LF) in July (E(LF)(87)20) however made it clear that I envisaged that there could be subsequent tranches of applications to opt out, and there was I think no dissent from that suggestion. I believe that some Labour authorities may not wish to take the plunge at this stage, but might very well choose to do so once they saw that opting out had become a reality. Furthermore, some of our Conservative colleagues, at present in opposition on borough Councils, will hope to gain control in May 1990, and will certainly wish then to have the opportunity to bring their boroughs out also.

There is no doubt that, whether we make it clear in the text or not, we shall be asked whether April 1990 is the only date on which opting out will be possible. Subject to your views, I think that our line must continue to be that the legislation will not preclude applications to opt out at a later date.

I recognise the concern which E(EP) felt on the question of counter obstruction in relation both to moveable assets and to staff contracts. It is however not clear what action we could sensibly announce at this stage in relation to either category. My officials are continuing to give urgent attention to this question, but it would be premature to make a specific statement of our intention. I hope therefore that colleagues will accept that the sentence added to paragraph 23 is a sufficient marker for the purpose of the consultation paper.

Nick Ridley shared my view that in the absence of agreement about arrangements to support redundancy and detriment compensation to ILEA staff it would be preferable to remain silent on this point. You however agreed with John Major that it would be useful to confirm that existing compensation would be available. There is of course at present no provision for compensation for detriment. I recognise the value in providing reassurance to ILEA staff. It is however difficult to go far in this direction when we are as yet unable to answer questions about whether there will be any specific assistance and if so where the money will come from. The sentence added to paragraph 16 is as far as I believe we should go at present; in particular, it avoids any reference to detriment. It has been agreed at official level with the Treasury.

John Major raised again the question of the role of the Education Assets Board (EAB) during opting out. In the interest of issuing the consultation paper this week I am prepared, as he requests, to drop the reference to this which was contained in paragraph 21 of the previous draft. However, at a stage when we cannot foresee how many boroughs will in the event opt out, and the consequent scale of operation necessary to smooth the process, it seems to me undesirable to deprive ourselves from the outset of any possible recourse to a body which we are setting up specifically to assist with the kind of transactions that will arise. I have asked my officials to pursue this question in more detail with the Treasury.

John Major also picked up Tony Newton's point about generating resources from disposal of surplus assets. I shall be commenting further on this in the paper which I am preparing for E(EP) on the scope for manpower controls on ILEA.

I am copying this minute to other members of E(LF) and E(EP), to Patrick Mayhew and to Sir Robert Armstrong.

T.D. Jeffery

p.p. KB
(Approved by the Secretary of State
and signed in his absence)

10 September 1987

Department of Education and Science

CONSULTATION PAPER

THE ORGANISATION OF EDUCATION IN INNER LONDON

Introduction

1. The Government wants the education service to become more responsive to the requirements of parents and employers. Some of the Government's principal educational initiatives bear directly on this objective - the delegation of financial responsibility to schools, more open enrolment, the establishment of grant-maintained schools and of City Technology Colleges are all particularly relevant. The influence of parents on the governing bodies of schools, and the powers of governors, are being enhanced by the Education (No 2) Act 1986. In higher education, the Government's proposal to re-establish the polytechnic and certain colleges as corporate bodies has as one of its main objectives the freeing of these institutions so that they can respond more rapidly to changing requirements.

2. The Government believes that in inner London special considerations apply which make it necessary to go still further towards ensuring responsiveness to local needs. The special circumstances of London have long been recognised. It has been argued that educational provision in the metropolitan area should be managed as a whole, with the resources to make available a wide range of provision to pupils and students who frequently travel across borough boundaries to receive education. But the logic of that argument leads in the direction of very large local education authorities (LEAs) which inevitably find it difficult to keep in touch with and match the requirements and aspirations of different areas. So far as outer London is concerned, this problem was resolved in 1965, when the outer London boroughs became the LEAs for their areas. They have now been carrying out education functions for nearly a quarter of a century.

3. The position in inner London was long held to be different. It was argued that inner London's education had been planned and organised on a unitary basis since the 19th century and that individual inner London boroughs would be among the smallest LEAs in the country. Against this, there was severe criticism of the Inner London Education Authority (ILEA) on the grounds of its educational performance despite levels of expenditure far in excess of those of any other LEA in the country. The Local Government Act 1985 provided for the retention of a unitary authority. But the new ILEA has shown little sign that it is ready to tackle the root causes of its educational and financial problems.

4. The Government believes that the time has come to allow inner London boroughs the opportunity to demonstrate that they could provide an efficient education service within their areas. The forthcoming Education Bill will accordingly contain provisions designed to enable these boroughs to apply to become the LEAs for their areas. ILEA will continue to be the local education authority for the areas of those boroughs who do not choose to take advantage of this opportunity. The Government will of course continue to press ILEA to take the action necessary to improve its educational and financial performance.

5. This paper sets out the Government's proposals for the organisation of education in inner London. The comments of all interested parties are invited.

BROAD OUTLINE OF THE LEGISLATIVE PROPOSALS

Timing

6. Boroughs would be invited to apply to assume education functions from 1 April 1990. This will mean that transfer of responsibility would coincide with the proposed introduction of the community charge and the Unified Business Rate. The legislation would not allow boroughs which become LEAs to opt back into ILEA.

Procedures For Opting Out

7. The legislation would provide that -

(i) Inner London boroughs and the City of London would be able to apply to the Secretary of State to assume the education functions in relation to their area subject to a resolution to that effect by the full Council passed by a simple majority. It would be open to one or more boroughs to make a joint application proposing a joint education authority or joint education committee for their combined area.

(ii) The applications should be submitted by not later than 28 February 1989 and should be published and made available to the public.

(iii) It would be open to any interested party, including other local authorities, to submit objections to the application. These objections should be submitted to the Secretary of State within a period of one month after the receipt of the borough's application, and should be copied to the borough concerned.

(iv) The Secretary of State should, after consideration of the applications and any objections, be able to make provision by means of a statutory Order subject to the affirmative resolution procedure of both Houses of Parliament for the transfer of the functions of local education authority for its area to a borough (or boroughs - see (i) above) or the City of London from the ILEA. Such transfers would have effect from 1 April 1990. The Orders would provide for the establishment within the authorities concerned of "shadow" LEAs for an interim period - probably from 1 September 1989 - in which they would be able to make the necessary preparations for the transfer, including the transfer of staff, assets and liabilities.

(v) The Secretary of State would provide by statutory Order - subject to the negative resolution procedure of both Houses of Parliament - for the transfer from ILEA to the new LEAs of land, buildings and related assets and liabilities (see paragraphs 17-20 below).

(vi) ILEA would be placed under a duty to supply any information required by the Secretary of State or by the boroughs with respect to their application, to cooperate with the boroughs in the transitional period and to obtain the Secretary of State's consent before undertaking certain transactions.

(vii) Sections 18 and 19 and Schedule 9 of the Local Government Act 1985 would be amended so that the period of office of ILEA members for opted out boroughs would terminate on 31 March 1990, the Inner London Education Area would be redefined to exclude those boroughs, and the number of members of ILEA would be adjusted accordingly. Section 22 of the Act, which empowers the Secretary of State to review ILEA by 31 March 1991, would be repealed.

8. The timetable set out above is designed to lead to a transfer of responsibility for education in April 1990.

Provision of Services

9. In considering an application from an inner London borough, the Secretary of State would require a detailed explanation of the way in which the borough would propose to fulfil its statutory duties if it became an LEA. The Secretary of State would need to be satisfied that the borough would be able to provide appropriate education for all its pupils and students,

including those with special educational needs, and that it would be able to provide inspectorial and other support services to meet its statutory duties and to maintain educational provision of a high standard. Boroughs would also need to show that they expect to make effective provision for the youth service, including appropriate support of voluntary organisations, and for a careers service. In some cases - perhaps particularly that of the careers service - authorities may wish to combine their own provision with co-operative arrangements with other LEAs. Where inner London boroughs would expect to inherit institutions of London-wide or regional significance, particularly in the case of further education or adult education, the Secretary of State would expect a commitment on the part of the borough to maintain such provision. He is mindful of the good record which LEAs - including small authorities - have in this respect.

10. As soon as possible after Royal Assent, guidance would be provided by Circular on the information which would be required from an inner London borough to support an application. This is likely to include -

- projected numbers of pupils and students, taking account of the flows of pupils and students in and out of the borough, set against the institutions available and their capacity;
- the property which the borough proposes to inherit for this purpose (see paragraph 18 below);
- policy on the organisation of nursery, primary, secondary and further education, including detailed proposals for the future of institutions offering provision of regional or national significance;
- policy on the school curriculum, including the borough's plans to secure effective arrangements for the progressive implementation of the national curriculum;

- the borough's approach to arrangements in hand in its schools and colleges under the education support grant, in-service training grant, and other specific grant schemes;

- policy on special educational needs, and the way in which the borough would propose to implement this - including arrangements for access to the services of educational psychologists - with projected numbers set against the institutional framework envisaged;

- the organisation proposed for the adult education service, the careers service, the youth service, the school health service, the education welfare service;

- the structure envisaged for the local inspectorate;

- the administrative organisation proposed;

- the recruitment procedure for the education department's central services;

- proposals for the establishment of an education committee in accordance with the provisions of schedule I to the Education Act 1944;

- information about the borough's overall financial situation.

11. Under existing legislation parents are entitled to seek places for their children in schools outside the LEA in which they reside, and students may similarly apply to colleges outside their area. These provisions will naturally apply in the case of any inner London borough which becomes an LEA. The arrangements for recoupment between LEAs will apply in London as elsewhere in respect of pupils and students attending schools and colleges outside their home LEA.

The City of London

12. Like the other inner London authorities, the City of London would be eligible to apply to become the LEA for its area. The Secretary of State assumes that if the City chose to take advantage of this opportunity it would wish to make joint arrangements with another LEA; for example a neighbouring LEA might provide most services on its behalf. The Secretary of State will be prepared to enter into separate consultation with the City as necessary.

Staffing

13. The Secretary of State will also provide by Order for the block transfer to the new LEAs of the teaching staff linked to particular institutions in the boroughs concerned. This would mean that these staff would carry over their existing pay and conditions of employment. In the same way terms and conditions currently in force for lecturers in institutions of non-advanced further education would carry over to the new employers. Teachers not clearly linked to a particular institution, such as advisory and supply teachers or peripatetic teachers, would in general remain employed by ILEA, although it may be appropriate to provide for block transfer terms for those teachers the majority of whose work is at institutions in one of the new LEAs.

14. Certain categories of non-teaching staff, such as laboratory technicians and school secretaries, are clearly linked to particular institutions. It would be appropriate to provide block transfer terms for these staff. In other cases, such as school meals staff, it may be appropriate for the new LEAs to recruit directly to fill their staffing recruitments. There may be further cases, for example some youth service workers, where it might be appropriate to provide for the transfer of groups of staff in designated services, as happened in some cases at the time of the abolition of the Greater

London Council. The Government envisages that detailed consultation will be needed before precise boundaries can be drawn in the case of non-teaching staff.

15. It would not be appropriate to provide for block transfer terms for most of ILEA's central staff (administrators, inspectors and other groups of professionals such as educational psychologists). The boroughs would therefore for the most part recruit directly for these posts, enabling them to decide from the outset the size and structure of this part of their work force. The Government however believes that it would be right to require the boroughs, when making appointments within this category, to consider applications from ILEA staff before making an appointment. The boroughs would not be compelled to appoint such applicants in preference to those from elsewhere but this process should assist the reduction in ILEA's staffing which will be required as a consequence of a reduction in the scale of the authority's operation.

16. Under the Local Government Act 1985 the London Metropolitan Government Staff Commission was set up to safeguard the interests of staff who would otherwise be made redundant by the abolition of the GLC and metropolitan counties. The Government's proposals to permit the transfer of education responsibilities will not lead to major staffing upheavals, but there will inevitably be issues arising which could best be dealt with by a similar Commission. The Commission might, for example, advise on the interfaces between block transfer, group transfer and individual recruitment by the opting out boroughs. Such a Commission would ensure that proper consideration was given to the interests of all the staff affected. Existing terms for compensation would remain in force for staff made redundant as a consequence of the proposals in this paper.

Transfer of assets

17. The Government believes that the arrangements for transfer of land and buildings, together with the equipment located on or in them and associated rights or liabilities including related debt charges, should reflect where possible those that worked successfully in the case of the abolition of the GLC and the Metropolitan County Councils. The guiding principles for the transfer procedure should be continuity in the operation of educational establishments, clarity about where the title to property lies, and neutrality with regard to third parties' rights or obligations in respect of the property transferred.

18. The basic rule in identifying the property to be transferred would be that all the ILEA property within the boundary of the opting out borough should transfer when that borough became an LEA. In putting forward its application for this purpose the borough would have a duty to provide a complete list of the property which it believed it should inherit, making use as necessary of powers to be included within the legislation which would require ILEA to make available any necessary information. There would however be exceptions to this basic rule, as follows -

(i) Land or buildings which the new LEA did not propose to inherit would remain the property of ILEA.

(ii) The Secretary of State would determine the ownership of any institution falling within the boundary of an opting out borough, but which was the subject of a request by ILEA - within the period of one month allowed for objections to the application (see paragraph 7(iii) above) - that it should not transfer to the borough.

(iii) Where a borough could show that an ILEA establishment located outside inner London had provided regularly for a significant number of pupils or students resident in the borough, it would be open to it to argue that it should inherit that establishment in order to maintain a comprehensive service for its residents. This situation (like that described in (ii) above) could apply in the case of eg certain residential special schools. Determination of such cases would be a matter for the Secretary of State.

(iv) In the case of an institution mainly based in an opting out borough but having some of its facilities located outside that borough, including for example cases where playing fields in one borough serve a school in another or in more than one borough, the following procedure would apply -

- The guidance to potential applicants (paragraph 10 above) would invite them to attempt to agree a solution with their neighbours in putting forward their application.

- In the absence of agreement, the Secretary of State would in general be guided by the principle that institutions should remain as an entity, and that they should transfer to the predominant owner, using the location of the largest area of floor space as an initial criterion, but taking account also as appropriate of the intensity of use of each site (measured by pupil or student numbers). The latter criterion might be particularly appropriate in determining the ownership of playing fields. The Secretary of State would however have the power not to leave an institution with the predominant owner, if an overriding case had been made out by another authority for an exception to be made.

- It would be open to the loser in any dispute to negotiate user rights in property located within its own boundaries or to which institutions located in its boundaries had traditionally had access. The relevant property Order might require the owner to make available such rights.

19. Fittings, furniture and equipment in both educational institutions and other premises would transfer with the property in or on which they were located.

20. ILEA would be required to vacate the relevant premises by 31 March 1990.

Protecting the Interests of Opting Out Boroughs

21. The Government wishes to ensure that inner London boroughs taking on education responsibilities should inherit without serious encumbrance the assets which they need for effective operation. The Secretary of State accordingly announced in the House of Commons on 22 July 1987 that the forthcoming legislation would require ILEA to obtain his consent in advance to the following actions:

- any disposal of land or interests in land, including buildings, used or held or obtained for or in connection with the authority's education functions;

- any contract for a consideration having a value in excess of £15,000.

The requirement in relation to contracts does not apply in the case of the inner London polytechnics, which are subject to a regime being applied in the case of all the polytechnics and colleges which are to be re-established as freestanding corporate bodies.

22. In discussion with ILEA the Department of Education and Science has agreed arrangements for applying this regime which are designed to facilitate the effective day-to-day operations of the authority, while allowing the boroughs with a legitimate interest in particular transactions an opportunity to make their views known. The Government's aim is to protect the interests of boroughs proposing to opt out and in operating these arrangements it will assess the possible need to take further measures should new circumstances arise.

Other Government Policy Initiatives

23. The arrangements described in this paper will not affect the ability of schools' governing bodies to apply to the Secretary of State for grant-maintained status. Boroughs assuming education responsibilities in April 1990 will, like other LEAs, need to consider a scheme of financial delegation for the schools and further education institutions they will inherit. The Secretary of State will be prepared to receive representations from the boroughs on the question of the timetable to which they should be required to work.

Financial Arrangements

24. From April 1990, a new system of local government finance will be brought into operation. Instead of raising business rates to finance spending in their own areas, every rating authority in England will levy a uniform business rate, the product of which will be distributed among authorities across the country according to their adult populations. In addition to a share of the national business rate, authorities will receive grant from the Exchequer so as to compensate for different levels of need and to contribute a fixed sum per person towards a standard level of services. The difference

between this income and the expenditure of authorities in the area will be financed from the community charge together with domestic rates during the period 1990 to 1994.

25. Under this system, all inner London residents will benefit from central Government grant and a standard share of the national business rate in respect of education and other services. Local authorities in inner London will finance their total spending, after taking account of this income, from the community charge. ILEA will continue under these new arrangements to issue a precept for budgeted spending to boroughs which remain within it. They will meet this precept from the sources of income described above, including the community charge. Boroughs which choose to remain in ILEA should not therefore be adversely affected, under these arrangements, as a result of the decisions of other boroughs to opt out, providing ILEA makes commensurate savings in its ~~overheads~~ costs.

26. Under the new system, overspending on services will feed directly into the community charge. At ILEA's present levels of spending that would impose a considerable burden on community charge-payers in inner London. The Government is determined to use its power to limit rates and precepts to relieve the burden on inner London rate-payers over the next two years. It plans to phase in the charge over four years from 1990 so as to moderate the necessary changes in local spending and taxation. The new system of local authority finance will include powers to limit precepts and community charges. The Government believes, however, that it would be unfair in the early years of the new arrangements if those boroughs which opt out of ILEA were to be designated under such powers simply on account of the cost of services inherited from ILEA where they were actively seeking to reduce expenditure. Its scheme for community charge limitation will take account of this.

27. If a borough is able to offer education more efficiently and effectively than does the remaining ILEA, it can pass the whole saving direct to its community charge payers. The Secretary of State is aware that several boroughs have announced their determination to provide a high quality education service at a realistic level of expenditure. He believes that the Government's proposals open the prospect of progress towards that objective.

Consultation

28. Comments are invited on the proposals set out in this document. They should be sent by 16 October to -

Mr P Cohen
Department of Education and Science
Room 3/54
Elizabeth House
York Road
London
SE1 7PH

002/2989

CONFIDENTIAL

FROM: **CHIEF SECRETARY**
DATE: **10 September 1987**

CHANCELLOR

PRESCRIPTION CHARGES

... I attach the minute by Ms Boys which you requested.

2 I agree we should look at a comprehensive prescription charges package. But removing prescription charge exemptions for children to yield £60m should be set against our larger options on Child Benefit which could yield £500m.

X 3 I would prefer to pursue Child Benefit.

John M.

JOHN MAJOR

Thanks. I agree with X. The prescription charges option is clearly v. much a 2nd best.

NL

s91

From: **Ms P A Boys**
Date: **9 September 1987**

1 **Chief Secretary**
2 Chancellor

cc: Sir P Middleton
Mr F E R Butler
Mr Anson
Miss Peirson
Mr Cropper
Mr Tyrie
Mr Sturges

PRESCRIPTION CHARGES

The Chancellor has asked for a note on the scope for a significant reduction in the age to which children are entitled to free prescriptions (Mr Allan's minute of 7 September).

At present, children up to the age of 16 are exempt from prescription charges. The savings from removing exemptions, except for those on income support, for the present categories of those who are exempt are:

Children:	£60 million
Pregnant and nursing mothers and medically exempt	£30 million, rising to £35 million by 1990-91
Pensioners	£180 million, rising to £190 million by 1990-91.

A case could certainly be argued that it is up to the age of 8 when children are most prone to illness, particularly infectious childhood diseases before they build up immunity; and that exemption from prescription charges should be limited to that period. But if one assumes that 0-8 year olds are twice as prone to illness (and thus likely to receive free prescriptions) as 9-16 year olds, the saving from limiting exemptions to all 0-8 year olds is reduced to £20 million. This estimate does not take account the larger number in the 0-8 year old group, resulting from a recovery in the birth rate in this decade.

s91

A £20 million saving would be better than nothing. We are, however, hoping to secure a much larger sum through a complete restructuring of prescription charges - perhaps by removing exemptions except from those on income support and **reducing** the present prescription charge from £2.40 to £2. This would save £250 million. Alternatively, a lower charge (say £1) might be introduced for those from whom the present exemption is lifted. If we can get Mr Moore to agree to consider possibilities on these lines, we could bear in mind the possibility of keeping exemptions for all 0-8 year olds, as a concession to be deployed if necessary.

Penelope Boys

P A BOYS

SECRET

FROM: J P MCINTYRE
DATE: 11 September 1987

CHIEF SECRETARY

PS/ Mr [illegible] and Paul:
Which date
[illegible]

cc Chancellor
Mr F E R Butler
Mr Anson
Miss Peirson
Mr Scholar
Mr Turnbull
Mr Gieve
Mr Gibson
Mr Tyrie

SOCIAL SECURITY: TIMETABLE FOR BENEFITS UP-RATING

Following Wednesday's bilateral, we have been examining with DHSS officials the scope for delaying the announcement of Income Support and Housing Benefit rates beyond the late September/early October period which Mr Moore claimed was essential.

2. We have persuaded DHSS officials that there is some scope for delay until mid-October, but no longer. This at least means that the announcement can be after the Party Conference. They are putting further advice to their Ministers over the weekend and we expect Mr Moore or Mr Scott to write to you early next week. They emphasise that their Ministers might not wish to delay until the last possible moment, but they are aware of the difficulties with an early announcement.

3. I attach at Annex A the timetable which DHSS put to us yesterday pointing to a late September/early October announcement and at Annex B a timetable which looks feasible to us on the basis of our discussions with them today.

4. There are three constraints:

a. the period needed for consultation with Local Authorities on Housing Benefit;

b. the time needed to get the various Orders through Parliament;

c. the time DHSS need to convert their existing Supplementary Benefit cases to Income Support before the reforms are implemented next April.

Each of these is considered in detail below.

Consultation with Local Authorities

5. DHSS do not have a written opinion from Counsel. But their report of what Counsel advised in conference is:

> "he could not give any assurance that we would be safe from legal challenge if we allowed 2 weeks for Authorities to respond and 1 further week for the Secretary of State to consider their comments: but that the risk of successful challenge would be high if we tried to allow less time for either leg of this process."

6. Counsel added that the risk of challenge could be reduced by informing authorities well in advance of the limited time for consultation. The full text of the DHSS note of the conference is at Annex C.

7. We understand from LG that they are not aware of any consultation period with LAs on other matters of less than 3 weeks; the period is often longer. In our own area, we know that the Authorities were content with 2 weeks to consider the draft Order on the implementation costs of the new HB regime (but this excludes the week Counsel has said is advisable for DHSS to consider the LAs' reaction).

8. There is a provision in the Social Security Act 1986 - section 61(8) - which allows the Secretary of State not to consult if "it appears to him that by reason of the urgency of the matter it is inexpedient to do so; or the organisations have agreed that consultations should not be undertaken." But Counsel has told

DHSS that they do not have sufficient justification to claim urgency, and we must assume that the LAs would not agree to forgo consultations.

9. The DHSS timetable allows nearly 5 weeks for the consultation process, including 1 week for the Secretary of State to consider the LAs' reactions. Their officials now accept that this could be compressed to 3 weeks, bearing in mind that the Authorities have already seen a draft of the HB Order and that the only new information they will get is the rates. But they say that their Ministers will have to take a view on whether they are prepared to do this against the slightly higher risk of legal challenge. Timetable B assumes they will accept this risk and go down to 3 weeks.

Parliamentary approval

10. DHSS have allowed just over 3 weeks from the Orders being laid to their coming into effect. This is to give the Joint Committee on Statutory Instruments, which normally meets weekly, two opportunities to consider them (should they wish) and allows time for a debate in both Houses.

11. We have persuaded DHSS officials that this period could be reduced by a week and still allow the Committee two bites at the cherry. We pressed them on why we could not assume that the Committee would deal with the matter in one session. The answer is that there will be some 16 different Orders, some of them complex, and that the Committee has in the past raised questions on DHSS Orders which have required them to be taken again the following week. DHSS' firm view is that it would not be safe to rely on the Committee completing its deliberations in one session. If we accept that, there is no further scope for reducing the time needed for Parliamentary approval beyond that shown in Timetable B.

Conversion to Income Support

12. DHSS remain adamant that the conversion exercise must commence in the week beginning 23 November if it is to be

completed on schedule by April. Their summary of the operational constraints is at Annex D.

13. The main points are:

a. A 23 November start allows 19 weeks for completion compared with 21 for a normal uprating ie DHSS say they are already allowing less time than usual for what is a more complicated exercise,

b. There are actually 20 weeks between 23 November and the start-date for Income Support of 11 April, but DHSS are assuming that one week will be lost to holidays in this period, because Easter falls on 3 April, just before the start-date.

c. DHSS claim there is no scope for employing additional machinery or staff to accelerate the process. Some overtime is already assumed, and they doubt whether staff could be persuaded to do significantly more.

d. In the DHSS view, a week's delay beyond 23 November would ~~remit~~ result in 250,000 cases not being converted on time. Apart from the embarrassment this would cause, the emergency arrangements needed to deal with these people would themselves be heavily staff intensive.

Assessment

15. We expect a letter from one of the DHSS ministers early next week which we hope will propose release of the HB/IS rates on 16 October, 2 weeks later than Mr Moore was suggesting at the bilateral. This would enable Cabinet to take the issue on 15 October, if necessary. However, assuming we do not reach agreement with Mr Moore on the new rates, there would probably have to be some prior discussion whether in Star Chamber or some other *ad hoc* Ministerial group. We will need to consider how to arrange this, given the Party Conference in the previous week.

16. It is doubtful whether we could wring any more out of this time table to delay the announcement much longer.

Announcement of other Benefits

17. Next week's letter from DHSS is also likely to propose that pensions and other benefits be announced soon after Parliament returns on 21 October. Thursday 22 October is the date they have pencilled in. For operational reasons, they will say that anything later than 2 November is ruled out.

18. The difficulties this poses for the Survey timetable were discussed in my minute of 4 August. We will let you have further advice when we see the DHSS proposals.

Jpm

J P MCINTYRE

ANNEX A

TIMETABLE

As soon as possible	Letter to Local Authority Associations advising on consultation timetable (Counsel says as much forwarning as possible required in view of short consultation period)
w/c 28th September	HB rates to Local Authority Associations for comment. (Tantamount to announcement of rates for income-related benefits.)
7th October	September RPI available.
9th October	September RPI published. (speculation from now on about uprating)
w/c 19th October	Secretary of State considers Local Authority Associations comments on rates (Counsel advises one week minimum)
21st or 22nd October	Social Security Bill published.
w/c 26th October	Uprating announcement (including final rates for income-related benefits and not uprating child benefit).
Friday, 30th October (latest)	Draft regulations laid.
w/c 2nd November	Latest week to start retirement pension issue at new rates without additional work and operational problems.
Tuesday, 3rd November (and/or Tues. 9th November)	JCSI. These are very substantial sets of regulations and joint committee might not be prepared to take them in one go at short notice.
9th or 10th November	Second reading Social Security Bill
w/c 9th November (and/or 16th November)	Three sets of income-related regulations (possibly associated with uprating regulations) to be debated in both Houses. Full day debate may be needed.

w/c 16th November	Committee stage Social Security Bill begins.
w/c 23rd November	Income support conversion exercise starts. Regulations must be made by then.

Annex B

September

asap	Letter to LAs warning of consultation timetable

October

6	Party Conference begins
9	September RPI announced
15	Cabinet considers new benefit rates
16	New benefit rates announced. Consultation with LAs on Housing Benefit begins.
21	Parliament returns
30-6 Nov	Secretary of State begins considering LA's comments on Housing Benefit

November

6	Regulations laid and sent to Jt C'tee on Statutory Instruments.
10 (and maybe 17)	Regulations considered by Jt C'tee
16-20	Debates on regulations in both Houses. Regulations made.
23	Income Support conversion exercise begins.

ANNEX C

NOTE OF CONFERENCE
CONFIDENTIAL

Part II of the Social Security Act 1986 (Benefit Rates)

Note of conference held at 2 Garden Court, Temple on 4 September, 1987

Counsel sought an explanation as to why the Income Support Regulations have to be laid almost immediately after the Benefit Regulations are announced. He was informed that a minimum of 19 weeks is required to enable the Adjudication Officers to be in a position to administer the Regulations. It is anticipated that the rates of benefit will be announced on or about the 27 October and the Regulations must be laid by 29 November, 1987. It was felt that the Ministers would be unlikely to announce the figures before Parliament resits on 21 October.

Counsel advised that the Department could not avoid consultation before the Income Support Regulations are laid before Parliament. Such an action would place the Department in an impossible position and inevitably give rise to challenge.

Counsel advised that the urgency provisions set out in Section 61(8) are designed for situations where there are new events, not where, such as here, it has been known for some time what the problem would be but for collateral reasons there has been insufficient time. The normal procedures make matters difficult for the Department but do not provide a justification to use the bypass procedures.

Counsel advised that the Department must find a means of consulting in advance and advised that letters should be sent to local authorities as soon as possible informing them of the Department's difficulties and advising them of the time limits available for consultation. Counsel's view was that the greater the information that could be passed onto the local authorities the less chance of successful challenge through thr Courts. Clearly it would be preferable if Ministers could be persuaded to release the figures in advance of announcement so that the consultation period could be extended.

Counsel advised that he could not give any assurance that we would be safe from legal challenge if we allowed 2 weeks for Authorities to respond and 1 further week for the Secretary of State to consider their comments: but that the risk of successful challenge would be high if we tried to allow less time for either leg of this process. We could, however, reduce the risk of challenge by informing Authorities well in advance of the relevant dates of the limited time to be allowed.

ANNEX D

Operational Constraints

Background

1. We usually allow 21 weeks to carry out a normal supplementary benefit uprating. Even within this allowance, a certain number of offices will fail to complete the process by the due date - 27 this year and 176 the year before. A start date of 23 November allows only 19 weeks to carry out a much more complicated exercise.

Practical Constraints

2. Income support order books are produced by an old fashioned process, using manually operated machines. We have only 776 of these machines nationally, with no possibility of acquiring more in time. On a 19 week timetable, assuming the machines are used continuously during normal working and overtime hours, the conversion exercise will require the machines to be used to within 10 books a day of their maximum capacity. One week's slippage would require running the machines at maximum capacity, with no allowance for breakdowns. More than one week's delay would require more books than the machines could produce in the time available.

Staffing

3. It is already too late to recruit and train extra staff for conversion. The 19 week timetable assumes we will use our full allocation of staff, including overtime. It is highly unlikely that staff could be persuaded to work significantly more overtime than assumed in these plans; even if they did, attempting to work with continuous overtime is counter-productive. There is already little slack to allow for any other increases in work (such as a severe winter, or an upsurge in demand to get claims in before the new system comes into effect). It would anyway be difficult to persuade staff to make an extra effort if management was clearly not allowing adequate time for what was described as its top priority job.

Consequences of Overrun

4. A weeks delay in starting would mean that some 250,000 cases had not been converted by the due date; the people concerned would have to be paid some "safe" rate on an emergency basis. The emergency arrangements themselves are staff intensive, so that additional weeks of delay would start to compound the problems exponentially at the end. More than two weeks delay in starting would effectively put the start back till after the Christmas and New Year holidays, resulting in large numbers of people dependent on stop gap arrangements in virtually all of our offices.

5301/8/ldn

PMP 18/9

This text not to be issued: AEF/IF are amending
[illegible] (I have suggested [illegible] small amendments).

FROM: AMANDA HIGGINS

DATE: 14 September 1987

1. **MR MOUNTFIELD**
2. **PS/CHANCELLOR**

cc
PS/Chief Secretary
PS/Economic Secretary
Sir G Littler
Mrs Case
Mr Walsh
Ms Life
Mr Carpinter
Mr Pitcairn

AFDB/WARBURG DEBT REFINANCING PROPOSAL FOR ZAIRE

Babacar Ndiaye, President of the African Development Bank wrote to the Chancellor in August enclosing a further copy of the above proposal and asking to meet the Chancellor in Washington at the Annual Meetings to discuss the proposal. I have delayed submitting a reply until now so that we could discuss the proposal with Warburgs and the UK Executive Director to the AFDB.

Although the same doubts as those mentioned in Mr Pitcairn's submission of 10 August remain, another possible advantage to the scheme emerged in discussions with Warburgs. This scheme, or a modified version of it, might be able to help the United States over its budgetary problems. Such a proposal would be worth further consideration if we are unable to get other creditors to accept the Chancellor's proposal to cut interest rates.

I recommend that the Chancellor sends Ndiaye a short reply, saying that he finds the scheme interesting, that several aspects of it cause concern, but that he will consider it further. As the Chancellor's schedule for Washington is already very tight he might prefer to decline Ndiaye's invitation to meet but suggest that he sees Sir G Littler instead and I attach a draft reply on those lines. Ndiaye is likely to lobby the Chancellor in the margins of the meeting and a line to take will be included in the Chancellor's debt brief.

Amanda Higgins

AMANDA HIGGINS

I agree. I had long talks with Warburgs and with the UK Exec. Director (Sutherland).

5301/9/ldn

DRAFT LETTER FROM THE CHANCELLOR TO BABACAR NDIAYE PRESIDENT OF AFRICAN DEVELOPMENT BANK.

Thank you for your letter enclosing your very interesting proposal for refinancing Zaire's external debt. I have delayed replying until now so that my officials could discuss your proposal with Warburgs and the United Kingdom's Executive Director to the African Development Bank.

I am grateful to you for bringing me in so fully on your proposal[,] which is another approach to the problem I tried to attack in my speech to the Development Committee in April. We share the objective that the interest rate for the poorest and most heavily indebted countries in Sub-Saharan Africa should be set at a level that is affordable, and that at the same time avoids adding to the existing stock of debt by capitalising unpaid interest.

However, several aspects of your scheme give me cause for concern. The first is the lack of any formal IMF-style conditionality and the resulting lack of leverage that creditors would have. The second is the inclusion of both commercial bank and government debt in your proposal; this would not acknowledge creditors' separate roles and risks disrupting the current burden sharing arrangements.

Although, on balance I prefer my own scheme which directly [attacks] addresses things that governments themselves can do, I will certainly consider your scheme further. I would have liked to discuss it with you at the Annual Meetings, but unfortunately my schedule is too tight to permit a meeting of sufficient length to explore the details of your proposal. May I suggest [that,] instead [that you discuss the proposal] [a meeting] with Sir Geoffrey Littler[,] who will be with me in Washington,[?] [might be constructive.]