PO-CH/NL/0110
PART C

Part . C.

**SECRET**

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Begins: 27/10/87.
Ends: 11/11/87.

PO -CH /NL/0110

PART C

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PART C

Chancellor's (Lawson) Papers:

THE WORLD FINANCIAL
MARKETS 1987 - 1988

Disposal Directions: 25 Years

[signature]
16/8/95.

SECRET

RD

MG NOON REPORT

FINANCIAL MARKETS

Tuesday 27 October 1987

| Opening | 10 AM | | NOON | Oil Price (10 AM) | |
|---|---|---|---|---|---|
| 74.0 | 74.0 | £ERI | 74.0 | | |
| 1.6865 | 1.6870 | $/£ | 1.6855 | Nov | $18.80 |
| 2.9944 | 2.9948 | DM/£ | 1.7760 | Dec | $18.89 |
| 1.7755 | 1.7752 | DM/$ | 2.9934 | Jan | $18.87 |
| 142.00 | 142.05 | Yen/$ | 142.15 | | |

| UK interbank £ | | | Eurodollars | |
|---|---|---|---|---|
| 9 1/2 | (-1/16) | 7 day | 7 | (-) |
| 9 1/2 | (+1/8) | 1 month | 7 1/16 | (-) |
| 9 3/8 | (+1/8) | 3 month | 7 5/8 | (-) |
| 9 1/2 | (-1/16) | 12 month | 8 | (+1/16) |

Figures in brackets show change since previous market close

MARKET COMMENT: In the foreign exchange market the dollar opened bearish. It eased in the Far East despite the Nikkei picking up. The markets here continue to be nervous of Central Bank intervention. Sterling eased overnight but remained steady during the early part of the morning. Following a rumour of an announcement about BP shares, sterling eased slightly (Nothing said). Sterling is now steady. The Japanese and Hong Kong equity markets closed up on yesterday. Nikkei closed 22835 +632 and the Hang Seng 2396 +154. The Dow Jones remained down at 1794 -156. The FTSE100 opened at 1684 and went higher reaching +47 as its high this morning and at 12.12 it was 1679 -5 its lowest point today.
The gilts market had some recovery after a lower opening. R McRobbie

MARKET INTERVENTION ($m) | OTHER COUNTRIES INTERVENTION ($m)

| | | |
|---|---|---|
| Overnight | +34$ | New York |
| Today so far | - | |
| Total | +34$ | |

GILTS

| | Latest market movements | Price change since previous close |
|---|---|---|
| Shorts | Better | -11/32 |
| Mediums | Easier | -14/32 |
| Longs | Better | -19/32 |
| Futures (Long Contracts) | | -33/32 (Vol:17292) |

Gilt Sales since market opening

-£6.4 million

All Index Linked

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

FROM: R N G BLOWER pp

DATE: 27 October 1987

NOTE FOR THE RECORD

cc: PPS
PS/FST
PS/EST
Sir P Middleton
Mr Cassell
Mr Monck
Mrs Lomax
Mr Moore
Mr Pertez
Mr Ilett
Mrs Brown

STOCK EXCHANGE STATISTICS

Mr Wilkinson from the Surveillance Department of the Stock Exchange rang me today. He said that on Wednesday, Thursday and Friday of last week a record level of bargains had been logged; 100,000 per day against 45,000 on a typical day but that value was £3 billion per day against a normal £2 billion. He said that this indicated that most bargains were for small investors and, indeed, customer business and market maker to market maker business had been split 60:40 rather than the normal 50:50.

2. Mr Wilkinson went on to say that their evidence was that the sellers on Wednesday and Thursday were institutions and the buyers private clients our bargain hunting.

3. Mr Wilkinson ended by saying he hoped that these statistics dispelled a few myths.

Bob Blower

R N G BLOWER

Prep

JOHN SMITH - INTERVIEW ON STOCK MARKETS COLLAPSE

Transcript from: BBC Radio 4, Today, 27 October 1987

INTERVIEWER: (BRIAN REDHEAD) The Chancellor of the Exchequer is under pressure, not least from the Labour Party, to make an early Commons statement on the slump and on the BP share issue and with me is the Shadow Chancellor, John Smith. Apart from the constitutional propriety of him talking to the Commons what can he possibly say that he hasn't said a hundred times since last Monday?

SMITH: Well he hasn't said very much since last Monday. In fact he rather broke his silence a bit when he spoke to the Stock Exchange. What I think is urgently needed is an appreciation not just in Britain but in America, West Germany and Japan, of the need for Governments to take action. Because at the heart of this matter is the belief that has been held by these Governments for a number of years since the dismantlement of the Bretton Woods agreemnt and organised intervention by Governments that you can leave it all to the markets. Well it's been left to the markets and the Governments have sat back with the result we're now in the most difficult situation we've been in for a very long very long time. And what we need now is Government action to secure two things. First of all a gradual reduction of the American trade and budget deficits and a coincidental reflation by the western European countries which would be a very intelligent way of not only tackling unemployment at home but tackling financial crises internationally.

INTERVIEWER: But was he not right the Chancellor to say two things, one to tell the Stock Market not to be so craven and two to tell President Regan to increase taxes?

SMITH: I don't think the fundamental problem is in the stock market. I don't believe that it's just simply a case of a correction, although corrections may have been needed. Or that it's a matter of electronic mechanisms getting ahead of us. It's more deep seated than that. It is because the markets round the world lost confidence in the capacity of the major industrial countries to organise their relationships with each other in an intelligent way, the so called G7 leading industrial countries in particular. And I think when Governments are starting to criticise the exchanges for their own faults I think that's a little bit unfair because they are reacting to the events which the Governments themselves have been responsible for.

INTERVIEWER: Well now BP, what is your advice, do you think they should go ahead - the underwriters after all have made a packet in the past if they suffer this time so what?

SMITH: There's certainly no equitable case for letting underwriters off. I mean they made £75 million underwriting British Gas and only a few days ago it was being pointed out that the Government wasa astute in having it underwritten. And if you let them off the hook now, as it looks as if it might be happening, then I think that will be a matter of very severe criticism indeed. But I think the Chancellor's got himself in between the devil and the deep blue sea. If he goes ahead with the offer, if he raises the money - which I think is the underlying Government reason for selling BP and everybody has known that from the beginning. On the other hand, if he pulls it - if he does that first one of course he won't get wider shareownership. And that 's his problem, that he's caught between the notion of wider share ownership and the notion of raising Government money.

INTERVIEWER: But the people who have alreadyapplied were simply demonstrating greed were they not, they were looking for something for nothing?

SMITH: Well I think perhaps if I may say so the very opposite in this case. Because some people are applying for shares at 330p when they're only worth 266 on the market. Although some of themunfortunately are still sending not only the applications but the cheques to go with them. And some unfeeling person in the Treasury, whom I'm sure must be wrong, said that the Government, even if they tore up the cheques, would sue them for the money. Now what has happened I think here is that a lot of people have been carried away by the Government hype. I mean it is slightly unusual to have Royal Marines sliding up and down the office buildings in London in order to demonstrate a share issue. And I think we saw £6 million spent in 1 month on a hype advertising campaign. Then a lot of people of course followed it up and they may even be thinking that they buy them at the prevailing price rather than at the 330p offer. So I think in those circumstances the Government ought to let these misguided people off the hook. Underwriters who know precisely what they're doing is another matter.

INTERVIEWER: But hasn't the Labour Party also been carried away by the hype? Are you not now talking about extending share ownership, aren't ~~prty?~~ you becoming a credit card party?

SMITH: No, ours will not become a credit card Party. Indeed I've been anxious to point out the economic difficulties that are caused by an excessive consumer credit boom. But we did long before the last election even talk about extending employee share ownership in particular. But what is wrong with this is the Government has created through the privatisation of public assets not only the sale well below the true balue but the notion that somehow it's a free for all that can only be winnmers. And that is what is happening, under attack and under siege at the momnent. It is quite clear there can be losers as well as winners and privatisation is not going to be the winner take all situation that the Government hoped it would be.

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pup

AB Ai H Ps Chancellor

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FRESH DEMAND FOR STATEMENT ON SHARES CRISIS

CHANCELLOR MR NIGEL LAWSON HAS COME UNDER RENEWED PRESSURE TO MAKE A COMMONS STATEMENT TODAY ON THE INTERNATIONAL SHARES CRISIS.

LABOUR LEADER NEIL KINNOCK ALSO WANTS HIM TO EXPLAIN THE GOVERNMENT'S VIEW ON INTEREST RATES AND THE BP FLOTATION.

THE FRESH OPPOSITION ATTACK CAME LAST NIGHT AS MR LAWSON SOUGHT TO BOLSTER CONFIDENCE IN FINANCIAL MARKETS.

BUT HIS DECISION TO SPEAK AT THE STOCK EXCHANGE CONFERENCE FOR INDUSTRY BEFORE ADDRESSING THE HOUSE INFURIATED LABOUR.

MR KINNOCK SAID THE CHANCELLOR HAD ''EVADED HIS RESPONSIBILITY'' AND HE HIT OUT AT GOVERNMENT ''INACTION OR COWARDICE''.

OTHER LABOUR MPS HAD EARLIER ACCUSED HIM OF ''TREATING THE COMMONS WITH CONTEMPT'' AND OF ''UNPRINCIPLED'' BEHAVIOUR.

MR LAWSON REAFFIRMED AT THE CITY CONFERENCE HIS FAITH IN FREE FINANCIAL MARKETS DESPITE THE MASSIVE DROP IN SHARE VALUES.

AND HE SAID HE FOUND IT HARD TO EXPLAIN ''WHY THE LONDON MARKET SHOULD BE FOLLOWING WALL STREET QUITE SO SLAVISHLY''. HE REFUSED TO BE DRAWN ON WHETHER THE £7 BILLION PRIVATISATION OF BP WOULD GO AHEAD AS PLANNED.

MAJOR FINANCIAL INSTITUTIONS IN LONDON AND NEW YORK HAVE APPEALED TO THE TREASURY TO POSTPONE THE SHARES ISSUE.

THEY STAND TO LOSE MORE THAN £1 BILLION, HAVING PLEDGED TO BUY UNSOLD SHARES.

THE OFFER PRICE OF 330P A SHARE WAS SET BEFORE THE CRASH.

BUT LAST NIGHT BP SHARES CLOSED AT 264P - 21P DOWN ON THE DAY AND 66P BELOW THE OFFER PRICE.

THE TREASURY WAS CONSIDERING THE PLEAS FOR A DELAY FROM THE INSTITUTIONS UNDERWRITING THE SELL-OFF - A MOVE THOUGHT UNLIKELY.

WOULD-BE INVESTORS WHO APPLIED FOR BP SHARES BEFORE THE CRASH ALSO STAND TO LOSE OUT.

THEY HAVE BEEN TOLD THAT THEY ARE BOUND TO BUY AT THE OFFER PRICE, ALTHOUGH IT IS HIGHTER THAN THE MARKET PRICE.

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TO DESKBY 270800Z FCO
TELNO 4074
OF 270518Z OCTOBER 87
INFO DESKBY 270800Z THE HAGUE, DESKBY 270630Z PEKING

THE HAGUE FOR PRIVATE SECRETARY TO SECRETARY OF STATE
FOLLOWING FOR HUM, HKD

MY TELNO 4070 AND TELECONS HUM/FORD AND CLIFT: HONG KONG STOCK AND FUTURES EXCHANGES

1. THE BANK OF CHINA AGREED DURING THE NIGHT TO COME IN ON THE PACKAGE ON A 1/3 SHARED BASIS WITH THE HONGKONG AND STANDARD CHARTERED BANKS. THE PROPOSAL WAS PUT TO EXCO THIS MORNING. SECRETARY FOR MONETARY AFFAIRS OUTLINED THE BACKGROUND AND THE ELEMENTS OF THE PACKAGE WHICH INVOLVES HKD1 BILLION PARTICIPATION OF THE BANKS AND HKD1 BILLION BY THE HKG. THE DIFFERENCE FROM THE PREVIOUS PACKAGE IS THAT ALL THE PARTICIPANTS WILL BE ON A PARI PASSU BASIS. THIS FACILITY WILL RANK BEHIND THE EXISTING HKD2 BILLION FACILITY AS FAR AS REPAYMENT IS CONCERNED. SMA PUT THE PROPOSED HKG TOTAL CONTRIBUTION OF HKD2 BILLION IN THE CONTEXT OF THE HKD8 1/2 BILLION ALREADY SPENT OVER THE PAST FOUR YEARS TO SUPPORT HONG KONG BANKS.

2. THE FINANCIAL SECRETARY AND I STRONGLY SUPPORTED THE PROPOSAL. I MADE THE RISKS CLEAR BUT SAID THAT GIVEN THE CRITICAL POSITION OF MARKETS THE GOVERNMENT MUST BE SEEN TO DO EVERYTHING IT COULD TODAY. I MENTIONED IN PARTICULAR THE GOVERNOR'S SUPPORT FOR THE PROPOSED ACTION AND SECRETARY OF STATE'S AGREEMENT.

3. MEMBERS UNANIMOUSLY EXPRESSED VERY STRONG SUPPORT FOR FORCEFUL GOVERNMENT ACTION. ALL UNOFFICIAL MEMBERS, LED BY SIR S Y CHUNG, SAID THAT THE PROPOSALS DID NOT GO FAR ENOUGH. THEY CALLED FOR FURTHER MEASURES, BOTH PRACTICAL AND PSYCHOLOGICAL, TO STEADY THE MARKET IN HONG KONG, AND SO FAR AS POSSIBLE, INFLUENCE OTHER WORLD MARKETS. THERE WAS STRONG OPPOSITION TO THE IDEA, WHICH I HAD OUTLINED IN MY REMARKS, THAT THE PROPOSED PACKAGE SHOULD BE THE LIMIT OF THE HKG'S COMMITMENT. MEMBERS BELIEVED THAT THE GOVERNMENT SHOULD BE SEEN TO BE READY TO SUPPORT THE MARKET IN THE FACE OF MUCH FURTHER DECLINES IN THE INDEX IF NECESSARY. PURVES (HONGKONG BANK) IN TAKING THIS LINE SAID THAT IF THE GOVERNMENT INDICATED

THAT THERE WAS SUCH A LIMIT, HE WOULD BE FORCED TO WITHDRAW FROM THE PACKAGE.

4. MEMBERS SUGGESTED THAT THE GOVERNMENT SHOULD TAKE TWO FURTHER MEASURES:

(A) COMMIT ITSELF TO AT LEAST A FURTHER HKD1 BILLION IN SUPPORT OF THE FUTURES GUARANTEE CORPORATION.

(B) INVEST FROM THE EXCHANGE FUND IN THE EQUITY MARKET IN ORDER TO PROVIDE PRACTICAL AND PSYCHOLOGICAL SUPPORT.

THEY ACCEPTED THIS WOULD NEED FURTHER CONSIDERATION AND THE AGREEMENT OF THE SECRETARY OF STATE. THEY HAVE APPROVAL TO THE PROPOSED PACKAGE ON THE UNDERSTANDING THAT I WOULD PUT THE FURTHER PROPOSALS TO YOU.

5. WHILST I ACCEPT THAT FURTHER INDICATIONS OF SUPPORT FROM GOVERNMENT WILL PROVIDE ADDITIONAL CREDIBILITY TO THE OVERALL PACKAGE, I AM CONSCIOUS OF THE FACT THAT THERE WILL BE NO POINT IN THROWING GOOD MONEY AFTER BAD. THUS I THINK WE SHALL NEED TO CONSIDER WHETHER OR NOT WE SHOULD PROVIDE ADDITIONAL SUPPORT AFTER WE HAVE SOME IDEA ON HOW MARKETS WORLD WIDE ARE NOW PERFORMING. SO FAR INDICATIONS ARE PROMISING. TOKYO HAS COMPLETED THE MORNING SESSION UP ON ITS OPENING. HERE IN HONG KONG AFTER AN HOUR'S TRADING THE HANG SENG INDEX HAS STABILISED. INITIALLY IT FELL BY OVER 100 POINTS BUT IT HAS SINCE RISEN STRONGLY AND IS NOW STANDING AT 2350, JUST OVER 100 POINTS ABOVE LAST NIGHT'S CLOSE AND THE HANG SENG FUTURES INDEX FOR OCTOBER HAS RISEN BY SOME 375 POINTS AND IS NOW STANDING AT THE SAME FIGURE AS THE PHYSICAL MARKET. IN ORDER THAT WE CAN RESPOND SWIFTLY IF IT SEEMS RIGHT TO DO SO, WE WOULD LIKE TO SEEK THE SECRETARY OF STATE'S APPROVAL UNDER SECTION 3(II) OF THE EXCHANGE FUND ORDINANCE FOR A PURCHASE OF BLUE CHIP EQUITIES (I.E. THE PRINCIPAL CONSTITUENTS OF THE HANG SENG INDEX) IN THE HONG KONG STOCK MARKET TO A VALUE OF UP TO HKD1 BILLION. WE WOULD NOT ANNOUNCE THE AMOUNT NOR NECESSARILY INVEST THE WHOLE FIGURE BUT I BELIEVE THE PSYCHOLOGICAL IMPACT OF ALLOWING IT TO BECOME KNOWN THAT THE EXCHANGE FUND WAS INVESTING IN THE STOCK MARKET WOULD BE MORE SIGNIFICANT THAN ANY ACTUAL PURCHASES. SIMILARLY KNOWLEDGE OF THE ADDITIONAL AVAILABILITY OF FUNDS TO THE GUARANTEE CORPORATION WOULD WE BELIEVE HAVE A SIGNIFICANT EFFECT ON CONFIDENCE. WE SEE IT AS UNLIKELY THAT IT WOULD NEED TO BE UTILISED, GIVEN THAT THE SUPPORT PACKAGE NOW IN PLACE COULD BE ADEQUATE TO COVER A FALL IN THE HANG SENG INDEX DOWN TO 1,000.

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6. GRATEFUL FOR THE NECESSARY AGREEMENT DESKBY 280100Z.

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cc PPS
PS/EST
Sir Peter Middleton
Mr Cassell
Mr Lomax
Mr Peretz or
Self.

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TO FLASH FCO
TELNO 4093
OF 271010Z OCTOBER 87

FOR HUM, HKD - PLEASE PASS TO GOVERNOR

27/10

REPORT ON THE STOCK/FUTURES MARKETS

STOCK MARKET

SHARES PRICES OPENED SHARPLY LOWER AS SELLING RESUMED AFTER YESTERDAY'S RECORD FALL. THE HANG SENG INDEX LOST 260 POINTS, OR ABOUT 12 PERCENT, TO 1980 IN THE FIRST FIFTEEN MINUTES OF TRADING. THE FALL WAS IN LINE WITH THE DECLINE OF HONG KONG SHARES TRADED IN LONDON. STRONG BUYING SUPPORT APPEARED AT THE 2000 LEVEL. SHARE PRICES REBOUNDED SHARPLY AT MIDDAY WITH THE HANG SENG INDEX ENDING THE MORNING SESSION AT 2332, UP 91 POINTS FROM YESTERDAY'S CLOSE. TRADING WAS ACTIVE WITH A TURNOVER OF DOLLARS 1.67 BILLION. SHARE PRICES REMAINED STRONG IN THE AFTERNOON AND THE MARKET CLOSED AT 2396, A RISE OF 155 POINTS COMPARED WITH THE PREVIOUS CLOSE. THE TOTAL TURNOVER WAS ABOUT DOLLARS 3.56 BILLION.

FUTURES MARKET

2. HANG SENG INDEX FUTURES ENDED HIGHER FOR THE MORNING SESSION WITH OCTOBER CONTRACTS LAST TRADED AT 2250 AGAINST YESTERDAY'S 1975 CLOSE ON A TURNOVER OF 1580 LOTS. NOVEMBER AND DECEMBER WERE SUSPENDED FOR THE MORNING AFTER OPENING AT LIMIT DOWN LEVELS OF 3042 AND 3095 RESPECTIVELY. 114 LOTS WERE TRADED IN NOVEMBER BUT THERE WAS NO TRADING IN DECEMBER. OCTOBER CONTRACTS CLOSED AT 2285 AT THE END OF THE AFTERNOON SESSION WITH A TOTAL TURNOVER OF ABOUT 3650 LOTS. THIS REPRESENTS A RISE OF 310 POINTS COMPARED WITH YESTERDAY'S CLOSE.

GENERAL

3. THE STOCK MARKET REBOUNDED TODAY IN THE LIGHT OF THE FOLLOWING DEVELOPMENTS -

(A) OUR ANNOUNCEMENT THIS MORNING THAT ANOTHER DOLLARS 2 BILLION WILL, IF NECESSARY, BE INJECTED INTO THE HONG KONG FUTURES GUARANTEE CORPORATION BY GOVERNMENT. THE HONG KONG BANK, STANDARD CHARTERED BANK AND THE BANK OF CHINA AND GOVERNMENT WILL DO ALL IT CAN TO RESTORE CONFIDENCE IN THE MARKET.

(B) THE HONG KONG ASSOCIATION OF BANKS ANNOUNCED A FURTHER REDUCTION OF ONE PERCENT IN INTEREST RATE ACROSS THE BOARD WITH EFFECT FROM TOMORROW.

(C) THE HONG KONG BANK ANNOUNCED THAT IT WAS TAKING ADVANTAGE OF THE TEMPORARY WAIVER OF THE TAKEOVER RULES TO BUY SUBSTANTIALLY INTO THE MARKET.

(D) THE THREE SITES PUT UP FOR GOVERNMENT LAND AUCTION YESTERDAY FETCHED REASONABLY GOOD PRICES, WELL IN EXCESS OF FORECAST PRICES, REFLECTING CONFIDENCE IN THE PROPERTY MARKET DESPITE THE DOWNTURN IN THE STOCK MARKET.

OTHER DEVELOPMENTS

4. SO FAR 45 MEMBERS OF THE HONG KONG FUTURES EXCHANGE HAVE BEEN SUSPENDED FROM OPERATION FOR FAILING TO MEET MARGIN CALLS ON OUTSTANDING HANG SENG INDEX CONTRACTS. IN THE BANKING SECTOR, THE BANKS ARE WEATHERING THE STORM. THERE ARE HOWEVER A FEW BANKS WHICH HAVE A SIGNIFICANT PORTFOLIO OF SHARE FINANCING LOANS. THESE HAVE BEEN CALLING MARGIN AND FOR THE MOST PART, THEIR CUSTOMERS ARE COMPLYING. SOME DEPOSIT TAKING COMPANIES ARE LESS COMFORTABLE. THE COMMISSIONER OF BANKING IS CLOSELY MONITORING THE SITUATION. THE BANKING COMMISSION HAS BEEN PARTICULARLY ENCOURAGING BANK LENDERS TO SUN HUNG KAI SECURITIES TO BE SUPPORTIVE, WITH A FAIR MEASURE OF SUCCESS. THE BROKER HAS BEEN ABLE TO SQUARE ITS BOOKS AT THE CLOSE OF BUSINESS TODAY. STRONG PRESSURE IS BEING APPLIED TO ONE BANK AND ONE DEPOSIT TAKER WHICH HAVE DEFAULTING FUTURES BROKERS SUBSIDIARIES. THERE HAVE BEEN SOME ANXIETIES ABOUT ASSURED SETTLEMENT OF STOCK EXCHANGE TRANSACTIONS AND SECRETARY FOR MONETARY AFFAIRS HAS BEEN IN DIALOGUE WITH BANKS, BROKERS AND THE STOCK EXCHANGE WITH THE AIM OF ACHIEVING MUTUALLY SATISFACTORY SOLUTIONS.

FORD

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TELNO 4099
OF 271150Z OCTOBER 87
INFO DESKBY 280100Z PEKING

FOLLOWING FOR HUM, HKD
MY TELNO 4074 : HONG KONG STOCK AND FUTURES EXCHANGES

WE HAVE BEEN GIVING FURTHER THOUGHT TO THE PRACTICAL ARRANGEMENTS. WHICH WE WOULD ADOPT IF YOU HAVE US THE AUTHORITY TO INVEST A PROPORTION OF THE EXCHANGE FUND IN EQUITIES. WE WOULD NEED A SYSTEM WHICH WOULD AVOID CRITICISMS ON THE ONE HAND THAT THE GOVERNMENT WAS MAKING INVIDIOUS CHOICES BETWEEN ONE COMMERCIAL STOCK AND ANOTHER AND ON THE OTHER THAT, BY BEING KNOWN TO BE IN THE MARKET, WE WOULD ENABLE HOLDERS OF SOME STOCKS WHICH MIGHT OTHERWISE BE DIFFICULT TO SELL TO OFFLOAD THEM.

2. THE MAIN SAFEGUARD WOULD LIKE IN AN ADAPTATION OF OUR EXISTING SYSTEM OF FUND MANAGERS. WE WOULD USE THIS TO APPOINT A SPECIAL TEAM WITH EXPERTISE IN EQUITY INVESTMENT IN THE LOCAL MARKET. (THIS WOULD NOT PRECLUDE INVESTMENT IN OTHER MARKETS WHERE HONG KONG STOCKS ARE QUOTED, E.G. LONDON.) THIS WOULD BE DONE IN CLOSE CONSULTATION WITH THE SECRETARY FOR MONETARY AFFAIRS.

3. WE ALREADY HAVE A SYSTEM, WITH GUIDELINES, FOR INVESTMENT OF PART OF THE EXCHANGE FUND IN EQUITIES. THIS WOULD BE ADAPTED TO ALLOW FOR INVESTMENT IN HONG KONG DOLLAR DENOMINATED EQUITIES. WE WOULD LIMIT OUR PURCHASES TO BLUE CHIPS WHICH ARE THE PRINCIPAL STOCKS IN THE HANG SENG INDEX. WE WOULD WISH TO ENSURE THAT THERE WAS NO CONCENTRATION IN ANY GROUP OF COMPANIES.

4. IN ORDER TO PREVENT PEOPLE TAKING ADVANTAGE BY OFFLOADING, THERE WOULD BE NO ANNOUNCEMENT OF GOVERNMENT PURCHASES OF EQUITIES AT THE TIME THEY TOOK PLACE (NOR ON DISPOSAL). SINCE WE SHOULD BE USING A FUND MANAGER, THE GOVERNMENT'S NAME WOULD NOT BE KNOWN TO OTHER INVESTORS.

5. PURCHASES WOULD BE MADE GRADUALLY IN SMALL PACKETS. OUR AIM WOULD BE TO MAKE JUDICIOUS TACTICAL USE OF A SMALL PROPORTION OF THE EXCHANGE FUND IN ORDER TO ADD UNDERLYING SUPPORT FOR THE MARKET. IT WOULD BE THE INTENTION TO ENSURE THAT KNOWLEDGE OF THE EXCHANGE FUND'S PRESENCE IN THE MARKET BECAME KNOWN IN MARKET CIRCLES IN THE MOST GENERAL TERMS. IN A MARKET SUCH AS HONG KONG THIS WOULD NOT BE DIFFICULT TO ACHIEVE.

6. WE HAVE A FURTHER POINT OF CLARIFICATION ON THE INTENDED STATUS OF THE PROPOSED ADDITIONAL TRANCHE OF HKD1 BN IN SUPPORT OF THE GUARANTEE CORPORATION. IT IS NOT (NOT) OUR INTENTION THAT THIS

SHOULD FORM PART OF A NEW PACKAGE WITH COMMERCIAL CONTRIBUTORS. IT CAN BE REGARDED AS A CONTINGENT ADDITION TO THE SECOND SUPPORT FACILITY, THE EFFECT OF WHICH WOULD BE TO INCREASE THE GOVERNMENT'S CONTRIBUTION FROM HKD1 BN TO HKD2 BN.

CORRECTION : PARA 2 LINE 1 SAFEGUARD WOULD LIE IN AN

FORD

YYYY

HMLNAN 1130

Ch.

FOREIGN AFFAIRS

The Foreign Secretary is likely to raise the following:

i) WEU in the Netherlands

ii) Schultz/Moscow

iii) Sri Lanka

iv) Hong Kong Futures Market (paper below).

NGT 28/10

HONG KONG

KELLY to CH (EX) 27/10

3882B

CONFIDENTIAL MARKET-SENSITIVE

C/see also transcript behind CR 27/10

FROM: C W KELLY

DATE: 27 October 1987

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Mr Cassell
Mrs Lomax
Mr Peretz o/r

Discuss with F. Cassell: Content with 4(i), but not 4(ii) N

HONG KONG

After much discussion, Hong Kong did manage to put a further package in place before their markets opened this morning. The details are slightly different from those described in my minute of yesterday. The Exchange Fund will provide a further HK$1 billion, as proposed. But the second HK$1 billion will now be split equally between the Bank of China, the Hong Kong and Shanghai Bank and Standard Chartered instead of being one-half; one-quarter; one-quarter. Certain private understandings have been reached with the Bank of China about their contribution.

2. On the last occasion, the Exchange Fund contribution was made on a last in, first out basis. This time all contributions will rank equally, and behind the existing facility as far as repayment is concerned.

3. The announcement of the package was well received. The involvement of the Bank of China was noted and welcomed. There has also been some fairly large-scale local support for the market. After a somewhat shaky start the Hang Seng index ended 154 points (7 per cent) up and the futures market also improved.

4. The participation of the two banks in the package was, however, conditional on the administration considering further support measures. EXCO are also pressing for further action, as a sign of strong government as much as anything. Specifically they have suggested:

i. A commitment of at least a further HK$1 billion in support of the futures guarantee corporation, this time solely from Exchange Fund resources. This is likely to be of psychological rather than real significance. Hong Kong think that the support package already in place should be sufficient to cover a further fall in the Hang Seng index of more than 50 per cent.

ii. Use of the Exchange Fund to buy Hong Kong equities. This is the revival of an earlier idea.

5. It is not yet clear whether it will be necessary to do either. It could prove to be academic if the present market really holds. But the latter would require the Foreign Secretary's approval and Hong Kong are seeking this now on a contingent basis up to a limit of HK$1 billion so that they can respond swiftly if circumstances seem to demand it.

6. Use of the Exchange Fund in this way raises a number of difficult questions. It could be the beginning of a slippery slope, setting an awkward precedent for future bouts of losses of confidence in Hong Kong for reasons more directly related to 1997. Nor can the approval of the Chinese necessarily be taken for granted, though Hong Kong appear to be feeling robust about this in the light of Bank of China support for what they have been doing so far.

7. But we have all along recognised the difficulty of trying to second guess Hong Kong from here. The FCO are disposed to agree to the request and, on the basis of our present knowledge, I do not think that I could justify pressing them to do otherwise.

8. The Bank of England are likely to take the same view, although they are waiting for Mr Loehnis to return from another meeting before confirming this.

9. I attach the latest pair of telegrams.

**C W KELLY**

encs

057036
MDHIAN 2843

cc. PPS
PS/PUS
Sir P. Middleton
Mr Cassell
Mr Kelly

pmp

CONFIDENTIAL
FM PEKING
TO IMMEDIATE FCO
TELNO 1839
OF 270748Z OCTOBER 1987
INFO IMMEDIATE HONG KONG

HONG KONG TELNO 4046 AND HONG KONG TELNO 170 TO PEKING (NOT COPIED TO FCO): HONG KONG STOCK AND FUTURES EXCHANGES: CHINESE REACTIONS

SUMMARY
1. WHATEVER THEIR PRIVATE FEELINGS, THE CHINESE AUTHORITIES HAVE PLAYED A STRAIGHT BAT IN PUBLIC ON THE TROUBLE OF THE HONG KONG FINANCIAL MARKET. IN SOCIAL CONTACTS, OFFICIALS RESPONSIBLE FOR GENERAL POLICY ON HONG KONG HAVE SO FAR BEEN LAID-BACK. THE CHINESE SEEM CAREFUL TO SAY AND DO NOTHING THAT MIGHT MAKE MATTERS WORSE.

DETAIL
2. THE CHINA DAILY OF 26 OCTOBER CARRIED A SHORT PIECE ON PAGE 2, ATTRIBUTED TO PRESS AGENCIES VIA XINHUA, ENTITLED ''HONG KONG FEARS BIG RUSH ON SELL''. THIS WAS A FACTUAL PIECE REPORTING, INTER ALIA, THE MEETINGS OF EXCO AND FINANCIAL LEADERS ON 25 OCTOBER, AND QUOTING BROKERS AND STOCK ANALYSTS AS PREDICTING THAT THE HANG SENG INDEX MIGHT FALL UP TO 1,000 POINTS ON 26 OCTOBER.

3. THE CHINA DAILY OF 27 OCTOBER CARRIES A FRONT PAGE PIECE, ATTRIBUTED TO THE SAME SOURCE, ENTITLED ''INVESTORS IN PANIC AS HONG KONG SHARES PLUNGE 33 PER CENT''. THIS IS ACCOMPANIED BY A LARGE PHOTOGRAPH OF TWO HONG KONG RESIDENTS PEERING ANXIOUSLY THROUGH A CLOSED GLASS DOOR INTO THE STOCK EXCHANGE. AGAIN, THE PIECE IS FACTUAL, REPORTING THE PERFORMANCE OF SHARE PRICES IN HONG KONG ON 26 OCTOBER AND QUOTING INTERVIEWEES DESCRIBING THE FINANCIAL LOSSES THEY HAVE SUSTAINED. IT GOES ON TO REPORT STOCK MARKET TRENDS IN THE UK, US, FRANCE, FRG, NETHERLANDS, AND SWITZERLAND.

4. DURING A PRES CONFERENCE AT THE PARTY CONGRESS ON 26 OCTOBER, A CHINESE SPOKESMAN SAID IN ANSWER TO A QUESTION THAT CHINA HAD NOTED AND UNDERSTOOD RECENT DEVELOPMENTS IN HONG KONG'S STOCK MARKET BUT WAS NOT UNDULY WORRIED ABOUT THE FATE OF MAINLAND INVESTMENTS IN THE TERRITORY.

5. AT A SUPPER PARTY GIVEN BY MISS BAILES ON 26 OCTOBER FOR REGULAR CONTACTS IN THE MFA HONG KONG AND MACAO AFFAIRS OFFICE, INCLUDING

057036
MDHIAN 2843

WANG JIAJI AND LIN ZHIYING, EMBASSY PARTICIPANTS TOOK THE OPPORTUNITY TO BRING THE CHINESE SIDE UP TO DATE ON THE DAY'S DEVELOPMENTS AND THE MAIN LINES OF THE INITIAL RESCUE PACKAGE DESCRIBED IN TURS. IT WAS CLEAR FROM THE MFA OFFICIALS' COMMENTS THAT NONE OF THEM WAS WELL INFORMED ON THE MATTER, BUT EQUALLY THAT THEY HAD NOT (SO FAR) THOUGH IT DESERVING OF ANY PARTICULAR CONCERN.

COMMENT.

6. IF THE CHINESE ARE CONCERNED ABOUT THE IMPACT OF CURRENT EVENTS ON CHINA'S INVESTMENTS IN HONG KONG, OR THE IMPLICATIONS FOR HONG KONG'S LONGER-TERM STABILITY, THEY ARE BEING CAREFUL NOT TO SHOW IT IN ANY WAY WHICH MIGHT AGGRAVATE MATTERS. NOR HAVE THEY SAID ANYTHING IN PUBLIC YET ABOUT FURTHER ACTION WHICH COULD INVOLVE CHINESE BANKS. THEY PERHAPS CALCULATE THAT, FOR THE TIME BEING, THEIR SHORT AND LONG TERM INTERESTS ARE BEST SERVED BY NOT DOING ANYTHING THAT MIGHT BE CONTRUED AS INTERFERENCE AND/OR MIGHT FURTHER DESTABILISE THE MARKET.

EVANS

YYYY

DISTRIBUTION 27

MAIN 24

| | |
|---|---|
| LIMITED | PS/LORD GLENARTHUR |
| HD/HKD | PS/PUS |
| HD/ECONOMIC ADVSRS | MR MCLAREN |
| PS | MR GILLMORE |

ADDITIONAL 3

| | |
|---|---|
| A LOEHNIS B OF ENG | GOVERNOR HONG KONG |
| MRS GR LOMAX TRSY | |

NNNN

Un- Checked A, B, C, Peretz, Kelly

ChlEX 12/2

GERHARD STALTENBERG - INTERVIEW ON $ PROBLEMS

Transcript from: ITV CHANNEL 4, 7-8PM News, 28 October 1987

PRESENTER: ... our business affairs correspondent, Nicholas Owen, asked Herr Staltenberg whether the slide in the value of the $ wasn't evidence that the Louvre Accorde is now in tatters?

STALTENBERG: No, we have re-affirmed the Louvre Accorde in the last few days. I have been in touch with my colleagues of major industrial countries, central banks are co-operating. There has been some intervention today. If necessary there can be stronger co-ordinated international intervention. We all think that's very important to avoid a further fall of the $.

INTERVIEWER: (Nicholas Owen) Do you think in view of what's happening in the stock markets and to the $ that there is a real danger now of recession?

STALTENBERG: I don't think it for the situation as I see it. But on the other hand we must do what we can do and there are limitations of course to avoid a stronger fall in the stock market. At least in New York and Tokyo it was a kind of adjustment after too strong speculative upward movement but it had an international effect on all countries and what we need most are political decisions in the United States. Strong efforts and agreements to make substantial cuts in the budget deficit. The urgency of getting agreement between the administration and the Congress about cutting the budget deficit is much more obvious than in the last months and I hope the strong efforts will lead to a quick result.

INTERVIEWER: Do you think there's a need for a new economic summit, for the leaders of the industrialised nations to get together again to agree new accordes?

STALTENBERG: Not for the time being. We are in very close contact, as I say it, and I think we can get this actual co-operation we need by these contacts.

INTERVIEWER: Therer have been calls both in America and Britain and ;other places for you here in Germany to stimulate your economy, to reflate it, particularly by cutting interest rates - are you prepared to do so?

STALTENBERG: We had some months of very slow growth , it was a consequence of the very strong devaluation of the Deutchmark, necessary adjustment, the last figures are good, promising. We make a very strong tax reform with tax cuts and interest rates of course are very low when you compare them with other industrial countries. But we have to look at these issues again of course after the last experiences.

INTERVIEWER: Are you saying there will be more cuts in interst rates in Germany?

STALTENBERG: I just say we have to look into the issues again. No announcement of any decisions.

INTERVIEWER: But will there be announcements of some sort do you expect in the next few days?

STALTENBERG: I don't want to give any announcement very early. We will reconsider the whole situation.

INTERVIEWER: Are you in favour of loosening up your economy, of reflating your economy?

STALTENBERG: Oh we reflate our economy. We take, we accept, by strong tax cuts a higher deficit. So this is very important. We decided this some time ago.

INTERVIEWER: Obviously in this country there is a great fear about inflation in view of what happened many many years ago but isn't that fear now rather overdone?

STALTENBERG: I don't think that it is overdone. Price stability has a price, a high priority for very good reasons. Our monetary aggregages are expanding very fast.

INTERVIEWER: Does that mean the money supply?

STALTENBERG: The money supply especially though there is no restrictive policy at all.

INTERVIEWER: You said in a speech the other day that criticism isn't a one way street. Presumably you have the United States in mind?

STALTENBERG: That's a simple truth. No, we haveimproved our co-operation really between Finance Ministers and central bankers of major industrial countries especially since the Paris meeting in February. And my advice to my colleagues is in a very nervous time to use all means of personal and private exchange butsome interviews, as we have seen in the last 2 weeks, were misleading for a nervous public.

INTERVIEWER: Do you think this whole situation can be resolved therefore with talks between the two sides, is it really possible to get things back on an even keel as we would say?

STALTENBERG: Well I still believe when I look to the basic economic figures of all our industrial countries, with some differnentials, there is no reason for a very dramatic downturn on the stock market.

INTERVIEWER: But everything hinges on something being done, some steps being taken in the United States?

STALTENBERG: It's the most important political decision we need.

INTERVIEWER: And we need it fast?

STALTENBERG: I hope so it will be fast. But we are not the decision makers, we can give good a dvice.

INTERVIEWER: But you can take some decisions of your own here in Bonne can't you?

STALTENBERG: Oh yes, we are just on the way, it's 3 weeks ago that we decided on the structure of tax reform and further tax cuts so we will implement legislation now.

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LIBID: 9 9 9 9 9 1/16

| INTERBANK | EURO-DOLLAR | GILT |
| --- | --- | --- |
| | | E +9 |
| 9 1/8 −1/8 | 7 1/16 – | B +25 |
| ~~8~~9 1/16 −1/8 | 7 ?/~~8~~16 – | B +28 |
| 9 1/16 −1/16 | 7 3/4 – | FTR +23 |
| 9 1/8 −1/16 | 8 1/8 – | VOL: 10470 |

pup

SECRET

## MG NOON REPORT

FINANCIAL MARKETS — Wednesday 28 October 1987

| | Opening | 10 AM | | | NOON | | Oil Price (10 AM) | |
|---|---|---|---|---|---|---|---|---|
| 74.5 | 74.2 | 74.3 | 74.6 | £ERI | 74.3 | | | |
| 1.7290 | 1.7010 | 1.7040 | 1.7245 | $/£ | 1.7125 | 1.7195 | Nov | $18.90 |
| 2.9920 | 2.9972 | 2.9965 | 299-15 | DM/£ | 2.9960 | | Dec | $18.97 |
| 1.7305 | 1.7620 | 1.7585 | 173-47 | DM/$ | 1.7495 | 1.7353 | Jan | $18.95 |
| 137.45 | 140.30 | 139.92 | 137.85 | Yen/$ | 138.90 | 138.4 | | |

| | UK interbank £ | | | | Eurodollars | |
|---|---|---|---|---|---|---|
| 9 1/8 (-1/8) | 9 1/4 | (-1/4) | 7 day | 7 1/16 – | 7 1/8 | (+1/8) |
| 9 1/16 (-1/8) | 9 1/4 | (-3/16) | 1 month | 7 3/16 – | 7 1/4 | (+3/16) |
| 9 1/16 -1/16 | 9 1/8 | (-5/16) | 3 month | 7 3/4 – | 7 7/8 | (+1/4) |
| 9 1/8 (-1/16) | 9 1/8 | (-3/8) | 12 month | 8 1/8 – | 8 1/8 | (+3/16) |

Figures in brackets show change since previous market close

MARKET COMMENT In New York last night the dollar came under pressure as markets tested Central Bank support. The FED intervened and as a result, the dollar steadied. It again came under renewed pressure in the Far East after an article in the NY Times saying US is breaking the Louvre accord. The BOJ provided support as the dollar fell. It continued to fall this morning despite earlier concerted intervention organised by the Bundesbank, and briefly reached a high of 1.7655DM. Between 11am and noon the dollar saw a renewed bout of selling and fell to a low of DM1.745. Sterling has firmed to a new 5 1/2 year high level against the dollar. Pressure eased as Central Banks confirmed intervention.
The Japanese and Hong Kong equity markets closed down on yesterday. Nikkei 22578 -257 and Hang Seng 2370.16 -25.6. The Dow Jones closed up +52.5 at 1846.5. The FTSE100 opened at 1679.7 -23.6 and is now at 1618.2 -85, falling sharply as the dollar devalued.
The gilts market opened and has continued strongly on the US Bond, on sterling and equity weakness.

R J McRobbie

MARKET INTERVENTION ($m)

| | | |
|---|---|---|
| Overnight | +22$ | New York |
| Today so far | +46$ agst DM | |
| | +625$ | |
| Total | +647$ | |
| | +46$ agst DM | |

OTHER COUNTRIES INTERVENTION ($m)

Germany: +150$ — Denmark: +25$
France: +30$ — Holland: +32$(For)
Belgium: +6$
Italy: +24$
United States: +80$(27.10)
Switzerland: +50$
Japan: +240$

GILTS

| | Latest market movements | Price change since previous close |
|---|---|---|
| Shorts | Easier | +15/32 |
| Mediums | Better | +33/32 |
| Longs | Easier | +42/32 |
| Futures (Long Contracts) | | +44/32 (Vol:17564) |

Gilt Sales since market opening

£0 million

-2.7 (all IL)

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

SECRET

Still firmer, but below the best

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| 9 1/4 | (-3/16) | 1 month | 7 1/4 | (+3/16) |
| 9 1/8 | (-5/16) | 3 month | 7 7/8 | (+1/4) |
| 9 1/8 | (-3/8) | 12 month | 8 1/8 | (+3/16) |

Figures in brackets show change since previous market close

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R J McRobbie

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|---|---|---|
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| Belgium: | +6$ | | |
| Italy: | +24$ | | |
| United States: | +80$(27.10) | | |
| Switzerland: | +50$ | | |
| Japan: | +240$ | | |

**GILTS**

| | Latest market movements | Price change since previous close |
|---|---|---|
| Shorts | Easier | +15/32 |
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| Longs | Easier | +42/32 |
| Futures (Long Contracts) | | +44/32 (Vol:17564) |

Gilt Sales since market opening: £0 million

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

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063577
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CONFIDENTIAL
FM PARIS
TO DESKBY 290900Z FCO
TELNO 1058
OF 281811Z OCTOBER 87

PRIVATISATIONS

SUMMARY
MATRA TO BE POSTPONED FURTHER. UNOFFICIAL APPROACH FROM BALLADUR'S CABINET ADVOCATES PRUDENCE IN BP FLOTATION.

DETAIL
AS REPORTED (TELECON JAY/ALLEN), MESSIER, THE PRIVATISATION EXPERT IN BALLADUR'S CABINET, MADE CONTACT TO-DAY ON INSTRUCTIONS FROM DE CROISSET, DIRECTEUR DU CABINET, TO SAY THAT THE TRESOR HAD DETECTED THE FIRST SIGNS OF PANIC ON THE BOURSE TO-DAY, AND WOULD BE SIGNALLING TO THE MARKETS THIS EVENING A POSTPONEMENT OF THE MATRA FLOTATION BEYOND THAT WHICH THE MARKET WAS EXPECTING. MESSIER SAID THAT IN THESE CIRCUMSTANCES THE TRESOR HOPED THAT WE MIGHT DECIDE TO DELAY THE FLOTATION OF B.P. THEY FELT THAT INSTITUTIONS WERE UNDER GREAT PRESSURE, AND WERE APPREHENSIVE ABOUT MEASURES WHICH WOULD INCREASE IT. MESSIER STRESSED THAT BALLADUR WAS WELL AWARE THAT IT WOULD BE INAPPROPRIATE FOR HIM TO TAKE A FORMAL VIEW ON THE BP FLOTATION, BUT THAT HIS STAFF THOUGHT IT IMPORTANT TO PUT THE CASE FOR PRUDENCE.

COMMENT
AN ~~D~~ ODD APPROACH, WHICH ONE CAN TAKE AT FACE LEVEL. BUT IT IS UNLIKELY TO HAVE BEEN MADE WITHOUT BALLADUR'S KNOWLEDGE. IT MAY WELL BE, OF COURSE, THAT HAVING DECIDED ON A FURTHER POSTPONEMENT OF MATRA IN THE LIGHT OF DEVELOPMENTS ON THE MARKETS HERE, BALLADUR WILL BE ANXIOUS TO AVOID UNFAVOURABLE COMPARISONS, ALL THE MORE LIKELY GIVEN THE CURRENT HIGH POLITICAL PROFILE OF THE PRIVATISATION PROGRAMME, WITH A DECISION ACROSS THE CHANNEL TO GO AHEAD WITH B.P.

2. FCO PLEASE ADVANCE TO PS/CHANCELLOR, EVANS, BENT, TREASURY, PS/GOVERNOR, KIRBY, BANK OF ENGLAND.

WESTON

YYYY

SENT 29 OCT 1987

CREDIT SUISSE FIRST BOSTON
LIMITED
2A GREAT TITCHFIELD STREET LONDON W1P 7AA

JOHN M. HENNESSY
CHAIRMAN AND CHIEF EXECUTIVE

Cl
Best bit is right @ the end!
AA

PS Rake – read with much interest, and in part agree.
NL

28th October 1987

Mr. Nigel Lawson,
Chancellor of the Exechequer,
H.M. Treasury,
Parliament Street,
London.
SW1P 3AG.

Dear Chancellor,

I have written the attached article for the European edition of the Wall Street Journal for publication today. I believe it is absolutely essential G-7 do something, as noted therein, and hope you agree.

Best regards.

Jack

Jack Hennessy
Chairman
Credit Suisse First Boston Ltd

Enc.

**LONDON** - The search is on for the villains responsible for the world stock markets crash. Yuppie greed, computers out of control, the Fed, the Japanese investor, the budget and trade deficits, and Reaganomics have been singled out thus far, with more likely to come in the search for the perpetrators of "Wallgate". This form of American pastime is normally not too harmful. This time it could be fatal--if this crisis is not used as the opportunity to attack fundamentals and begin to restore the balance in the structure of the world economy.

We have seen only the surface events of the crash thus far. The second round effects will begin shortly and be more lasting and much greater than predicted. The excesses, invisible in growing economies and markets, will become plainly clear - including but not limited to, large unsellable positions deriving from the inability to unwind arbitrage positions, counterparty insolvencies on swaps, individuals and financial institutions unable to meet margin calls and other commitments: bridge financings and new issues seizing up. These threaten to unleash a deflationary chain reaction and will impact in any case on the real economy.

This is not a situation amenable to a quick fix, but it does require immediate action. Providing liquidity, as is being done, will give the patient a transfusion. Action on the budget, when and if it happens, could stabilise the patient if agreement comes quickly. The executive branch seems finally ready. The U.S. Congress must avoid the temptation to drag this out. The stakes are too high. The present system of the U.S. financing its entire external debt through the private market, automatically, is over. The music has stopped and partial funding of the debt in other currencies is desirable, as well as necessary. Further attacking the trade and debt imbalances can no longer be postponed because the markets are suffering not only from a speculative excess but a crisis of confidence. This stems from a general accumulation of problems and what appears to be a breakdown of cooperation among the Group of Seven nations of the U.S., France, Britain, West Germany, Japan, Italy and Canada.

In sum, this situation is not self-correcting. The magnitude of this event should convince the major industrial nations to stop pursuing purely national goals and to agree to a new set of short and long term actions which will herald a return to a more stable economic order and which has eluded the world since the end of the Bretton Woods system on August 15th, 1971. If this seems unduly alarmist, let me explain. A large part of the original stock selling wave was by foreigners, who now control the fate of the dollar and the U.S. stock and bond markets. The Louvre and Plaza accords on monetary and exchange rate cooperation gave the markets a false sense of security. When the underlying disagreement on policy occurred, publicly two weeks ago, the confidence was shaken. It will be hard to restore.

To achieve a restoration of confidence a number of long-cherished ideas and practices at home and abroad must be changed. Foremost, the imcompatible policies being pursued by most, if not all industrial nations have to end. Each is trying to run its domestic economy -- monetary and fiscal policy -- to produce an exportable surplus. This is seen by exchange markets, by the press and by politicians as "virtuous behaviour". If a meeting were held today of all the world's finance ministers, and a request made for all to stand up who were willing or actually trying to run a trade deficit in the next 2 or 3 years no one, except a few LDCs (and only a few of them) would stand up. If all nations behave as saints, the result is a deflationary hell -- reminiscent of the 1930s when competitive devaluations were pursued to achieve a larger share of shrinking world trade.

This is where the world is heading today. It is why the current situation is not solely America's responsibility. Everyone has benefited and enjoyed it. This is no longer sustainable. The market has recognised this. The governments have not yet. Europe and Japan have the opportunity to play the major economic role that their success and world position merits. Unfortunately, if they do not step up and assume the major burden, the options are much less appealling. These are:

- **Deflating**

  America has had a trade surplus only during recent domestic recessions. This option is unsatisfactory, as it leads to world recession. This time the U.S. will not be able to pull the rest of the world out as it did by expanding first its domestic economy in 1982 and 1983.

- **Inflating**

  Since foreigners would hold dollar debt, the U.S. can inflate and repay in devalued dollars. That is what most nations have done in similar circumstances. This would not be acceptable to Americans, who remember only too well the "misery index" of 1979, when unemployment and inflation added more than 20 per cent. Yet many foreigners fear the possibility.

- **Erecting fortress America**

  The U.S., together with Canada and perhaps Mexico, form, in effect, a North American common market, whis is self-sufficient in food, energy, raw materials, mining and labour. Closing U.S. borders would result in the short run in a high level of U.S. economic well being inside the walls. This option looks like the most attractive and is perhaps the most likely outcome, but involves a lot of foreign pain and would be in the longer run a disaster, economically and for western security interests.

In the face of these unacceptable alternatives there is only one solution - a set of collective actions by the seven leading industrial nations. Not all the steps are obvious, but at least some of the following must happen quickly to restore confidence in the financial system.

- **A Group of Seven Meeting**

  An immediate meeting of G-7 finance ministers and central banks must be convened, who would agree formally to something similar to the following. They would need to provide system liquidity as required. Apparently this has occurred but there should be an actual G-7 commitment. They should commit to keep international and cross-border capital markets open and functioning. For example, no more unilateral imposition of withholding taxes, as West Germany did in the days before the crash. The temptation will be to re-regulate flows not institutions and practices. This would be wrong.

. **A new Louvre agreement**

Isolated action on the dollar exchange rate and the U.S. budget could be counter-productive and hence are extremely delicate in the current environment. A small devaluation to restore credibility - coupled with other suggested actions - is probably desirable as it would achieve a level of dollar which is credible - that is one where massive intervention does not have to take place. The market finds the existing exchange levels unbelievable as intervention has been running at an annualised rate of close to $150 billion and has the undesirable effect of flooding the intervening countries with liquidity and forcing them to tighten money out of fear of future inflation. There must be major appreciation of the currency of Taiwan, South Korea and a number of other newly industrialising countries. Longer term, a monetary system which requires enormous intervention must be replaced by a more permanent one.

. **Fiscal repairs**

Agreement on a major reduction of the 1988/89 U.S. budget deficit is required, but not by itself. This must be coupled to a formal agreement to an equal or greater expansion in the rest of the world. The delicacy of any tax increase in the face of the enormous deflationary forces, which have just been unleashed, must be evident to all. At this point the wisest course would seem to be to reach executive/congressional agreement for across-the-board cuts in spending, and if needed increase in taxes (even perhaps a U.S. VAT) with timing discretion given while the impact of the crisis is measured and the size of the expansionary fiscal policies of other nations agreed.

. **Action on Third World debt**

A major commitment to increase the World Bank's capital to help get the heavily indebted countries growing. Forty per cent. of U.S. exports used to go to less-developed countries and too high a proportion of Third World exports still go to the U.S. This cannot continue and the other G-7 members must make a commitment to take more.

During the crises that occurred from 1971 to 1973 in the international monetary system, the U.S. Treasury Secretary at the time, George Schultz, used to tell his staff: "Get your plan ready for the next one." It was only in such crisis moments that nations can be made to agree to what's good for all of them. A new but different Bretton Woods agreement must be worked out. An immediate target date should bring about bi-lateral preparation, and U.S. cooperation could be increased by setting the date beyond the November 1988 election.

The post-World War II order did not just happen. It grew out of the leadership of a few, remarkable individuals, who had the stature, knowledge and collective experience during the 15 years from 1929 to 1944 to come up with a practical plan. Now, as then - leadership will make the difference. There is available at least one person acceptable to both U.S. political parties and to foreign governments to chair preparations for such a meeting, Paul Volcker. Lord Keynes from the U.K. and Harry Dexter White from the U.S. Treasury played such roles in 1944.

J.M. Hennessy, Chairman of Credit Suisse First Boston, was the U.S. Treasury Assistant Secretary for Policy between 1972 and 1974, during which period Bretton Woods foundered.

Ref.



TABLE I

UNITED KINGDOM

INDEX OF SECURITY PRICES

(1926 = 100)

| Year and Month | Index | Year and Month | Index | Year and Month | Index |
|---|---|---|---|---|---|
| 1925 | | 1928 | | 1931 | |
| January . | 96 | January . | 120 | January . | 84 |
| February . | 94 | February . | 119 | February . | 82 |
| March . | 94 | March . | 123 | March . | 84 |
| April . . | 94 | April . . | 125 | April . . | 82 |
| May . . | 93 | May . . | 129 | May . . | 70 |
| June . . | 93 | June . . | 125 | June . . | 72 |
| July . . | 90 | July . . | 121 | July . . | 75 |
| August . | 94 | August . | 122 | August . | 72 |
| September . | 95 | September . | 125 | September . | 68 |
| October . | 98 | October . | 128 | October . | 76 |
| November . | 101 | November . | 125 | November . | 80 |
| December . | 99 | December . | 121 | December . | 71 |
| 1926 | | 1929 | | 1932 | |
| January . | 101 | January . | 130 | January . | 72 |
| February . | 100 | February . | 129 | February . | 70 |
| March . | 99 | March . | 125 | March . | 75 |
| April . . | 97 | April . . | 125 | April . . | 73 |
| May . . | 99 | May . . | 126 | May . . | 67 |
| June . . | 100 | June . . | 123 | June . . | 64 |
| July . . | 99 | July . . | 121 | July . . | 73 |
| August . | 100 | August . | 124 | August . | 75 |
| September . | 101 | September . | 126 | September . | 79 |
| October . | 101 | October . | 118 | October . | 79 |
| November . | 102 | November . | 106 | November . | 80 |
| December . | 101 | December . | 106 | December . | 80 |
| 1927 | | 1930 | | 1933 | |
| January . | 105 | January . | 108 | January . | 83 |
| February . | 104 | February . | 104 | February . | 84 |
| March . | 104 | March . | 101 | March . | 80 |
| April . . | 104 | April . . | 105 | April . . | 81 |
| May . . | 107 | May . . | 104 | May . . | 84 |
| June . . | 107 | June . . | 98 | June . . | 88 |
| July . . | 107 | July . . | 98 | July . . | 94 |
| August . | 108 | August . | 93 | August . | 93 |
| September . | 110 | September . | 96 | September . | 96 |
| October . | 114 | October . | 90 | October . | 100 |
| November . | 114 | November . | 92 | November . | 100 |
| December . | 114 | December . | 87 | December . | 99 |

The above index relates to the price of 92 ordinary industrial shares, the prices being taken on the 15th of each month. The index is based upon that of the *London and Cambridge Economic Service*, but the series has been recalculated from the original 1924 base for purposes of comparison with the American index.

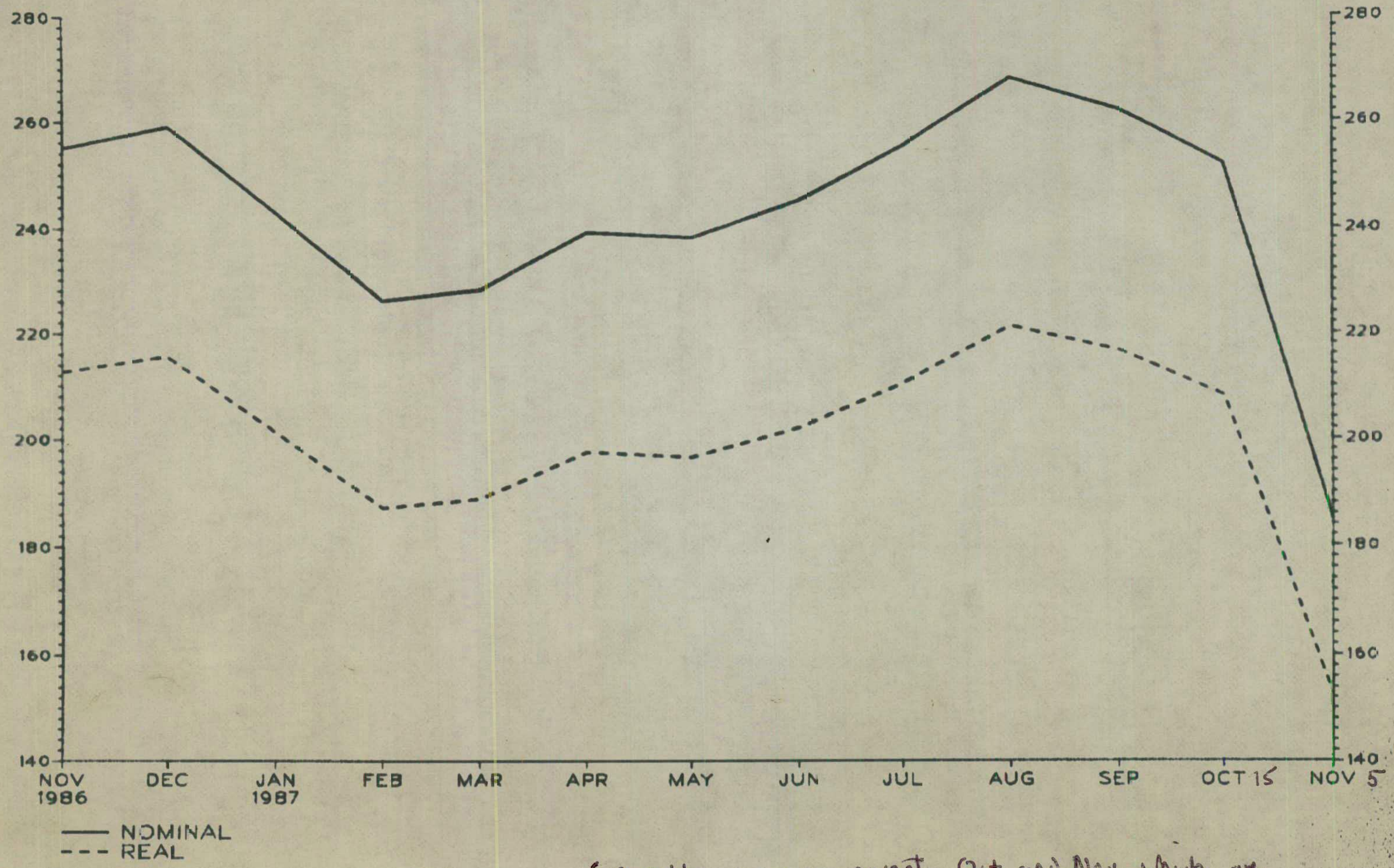
28/10/87.

puf

28/10/87.

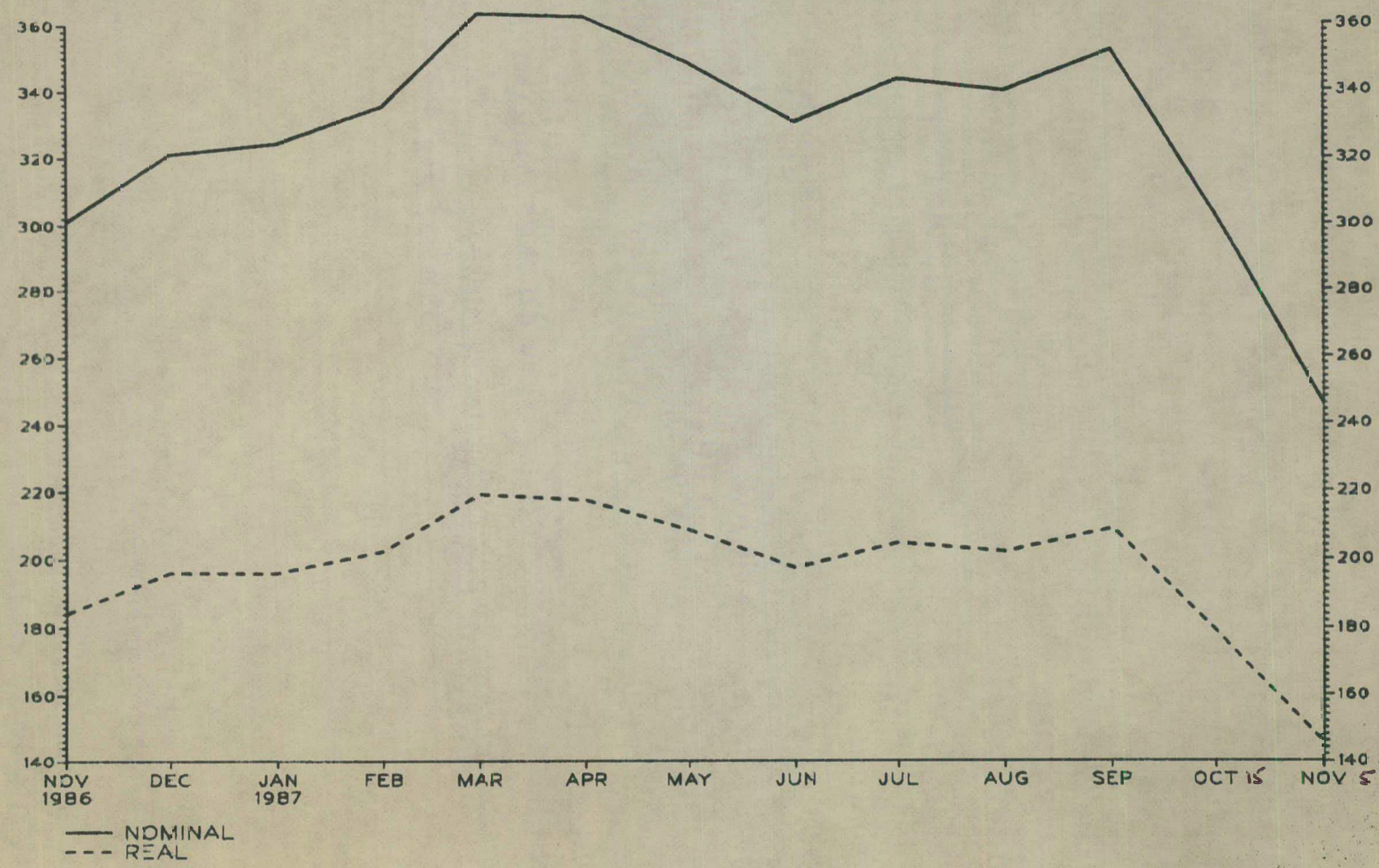
| | Germany (Commerzbank) | France (CAC General) |
| --- | --- | --- |
| 5 Nov 1986 | 1999·2 | 376·3 |
| 5 Nov 1987 | 1396·6 | 297·1 |
| Change 1986 to 1987 | -30%. | -21% |
| Change since 15 Oct 1987 | -27%. | -23.5% |

## GERMAN SHARE PRICES



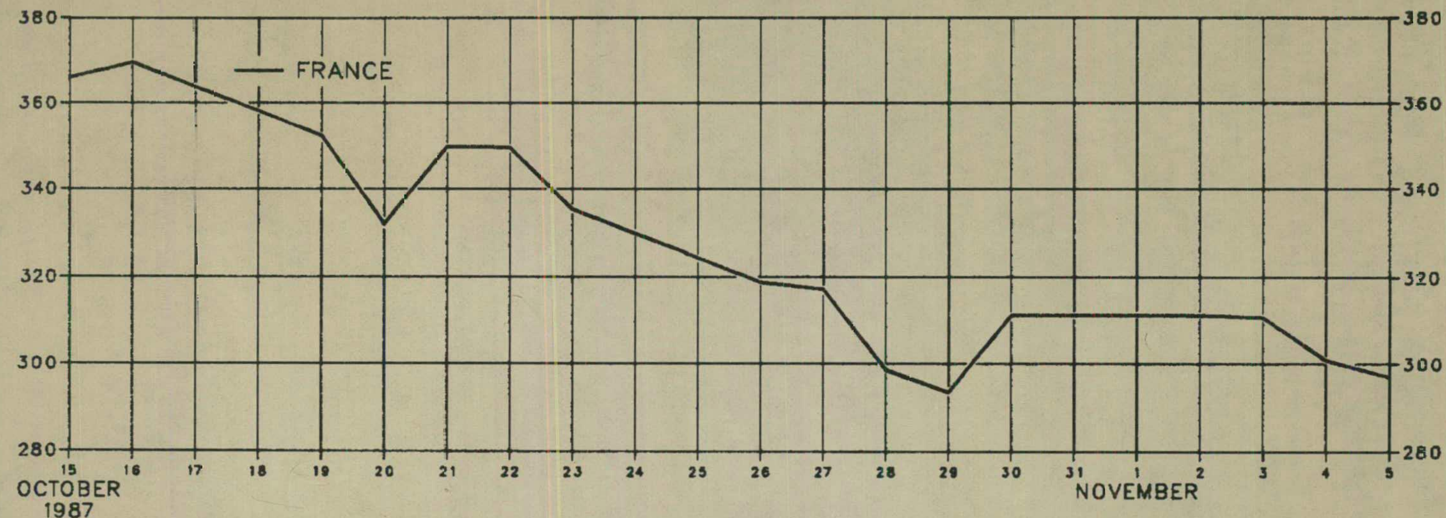

(Monthly averages, except Oct and Nov, which are daily figures).

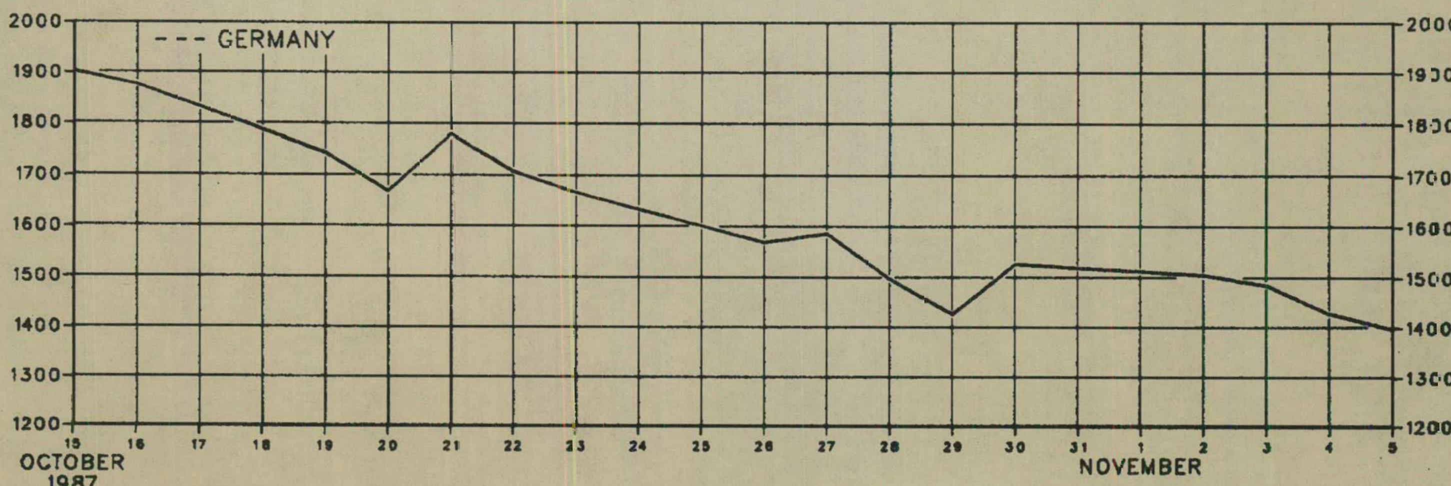
## FRENCH SHARE PRICES




(monthly averages, except Oct and Nov, which are daily averages)

# STOCK MARKET PRICES : FRANCE AND GERMANY




CHARTS.FRACH1

MR 1/29

STOCK MARKETS

**FTSE 100**

(NB all figures are closing indices)

| | | |
|---|---|---|
| Start of 1986 | 2 Jan 1986 | 1420 |
| 1986 low | 14 Jan 1986 | 1370 |
| First time through 1600 | 12 March 1986 | 1624 |
| March peak | 3 April 1986 | 1718 |
| Year ago | 5 Nov 1986 | 1644 |
| Start of 1987 | 2 Jan 1986 | 1681 |
| First time through 2000 | 4 March 1987 | 2003 |
| 1987 peak | 16 July 1987 | 2443 |
| Pre-storm | 15 Oct 1987 | 2302 |
| Last night's close | 4 Nov 1987 | 1604 |

4.15PM 6/11 1611

(BP 78½)

| Last Night's Close | % Change | Latest |
|---|---|---|
| - on a year ago | - 2½% | -2½ |
| - on 1987 high | - 34% | |
| - on 15 October | - 30% | |

## WALL STREET

| | | |
|---|---|---|
| Two years ago | 5 Nov 1985 | 1397 |
| Start of 1986 | 2 Jan 1986 | 1538 |
| One year ago | 5 Nov 1986 | 1899 |
| Start of 1987 | 2 Jan 1987 | 1927 |
| 1987 Peak | 25 Aug 1987 | 2722 |
| One month ago | 5 Oct 1987 | 2640 |
| Pre-storm | 15 Oct 1987 | 2355 |
| Low since storm | 19 Oct 1987 | 1738 |
| Last night's close | 5 Nov 1987 | 1945 |

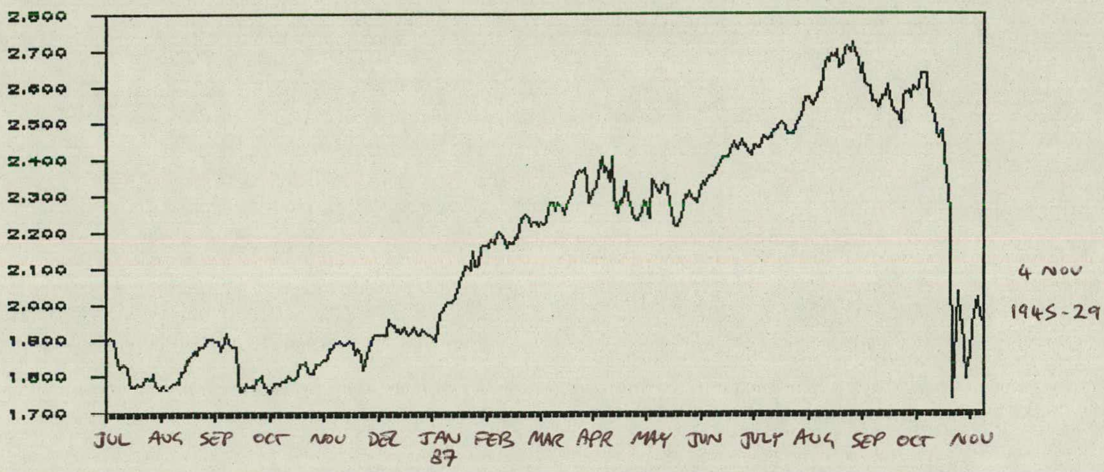
| | % change |
|---|---|
| Last night's close | |
| - on 1987 high | - 29% |
| - on 15 Oct | - 17% |
| Recent low (19 Oct) | |
| - on 1987 high | - 36% |
| - on 15 Oct | - 26% |

Tokyo

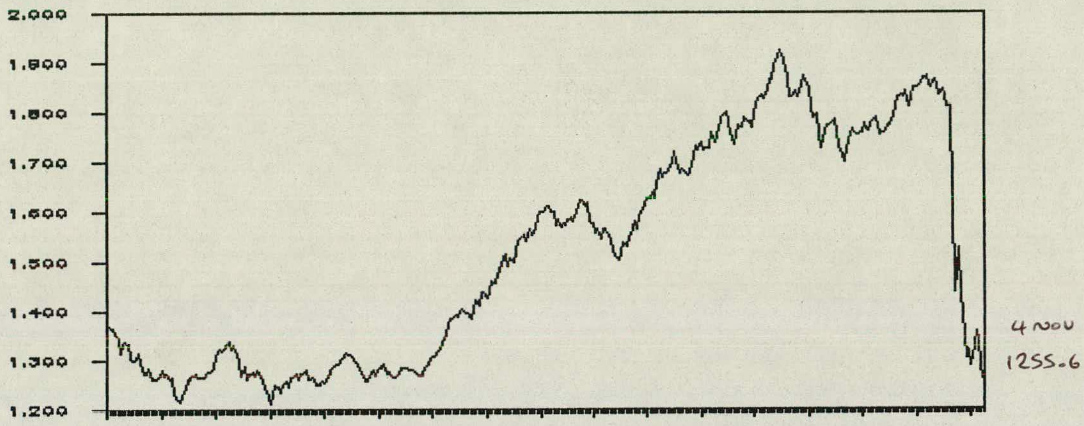
Last night's close

- on 1987 low +22%
- on 1987 high -15%
- on 15 October -14%

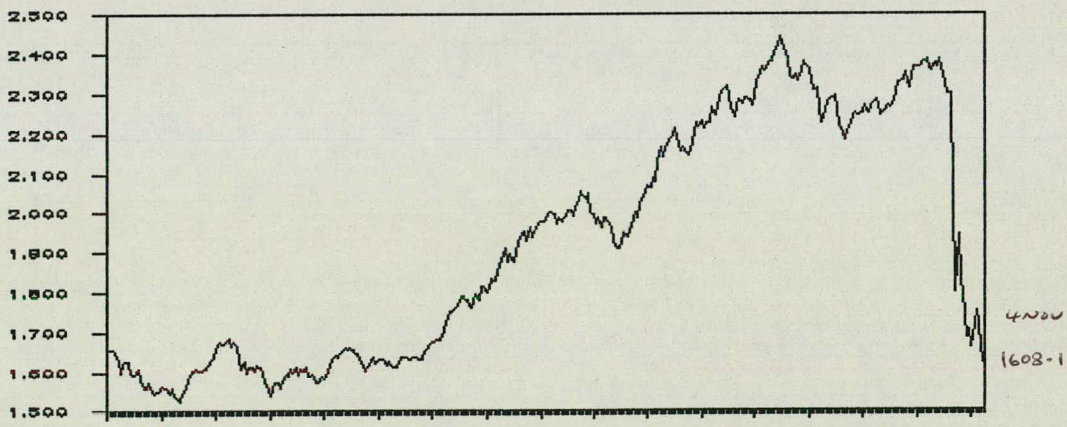
## Dow Jones Industrial Average



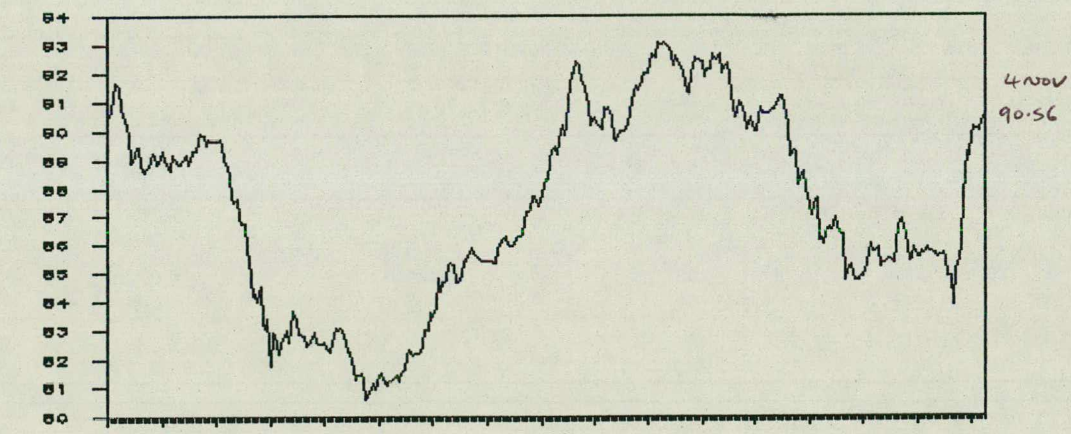

## FT Ordinary Index




## FTSE 100




## Gilt Index



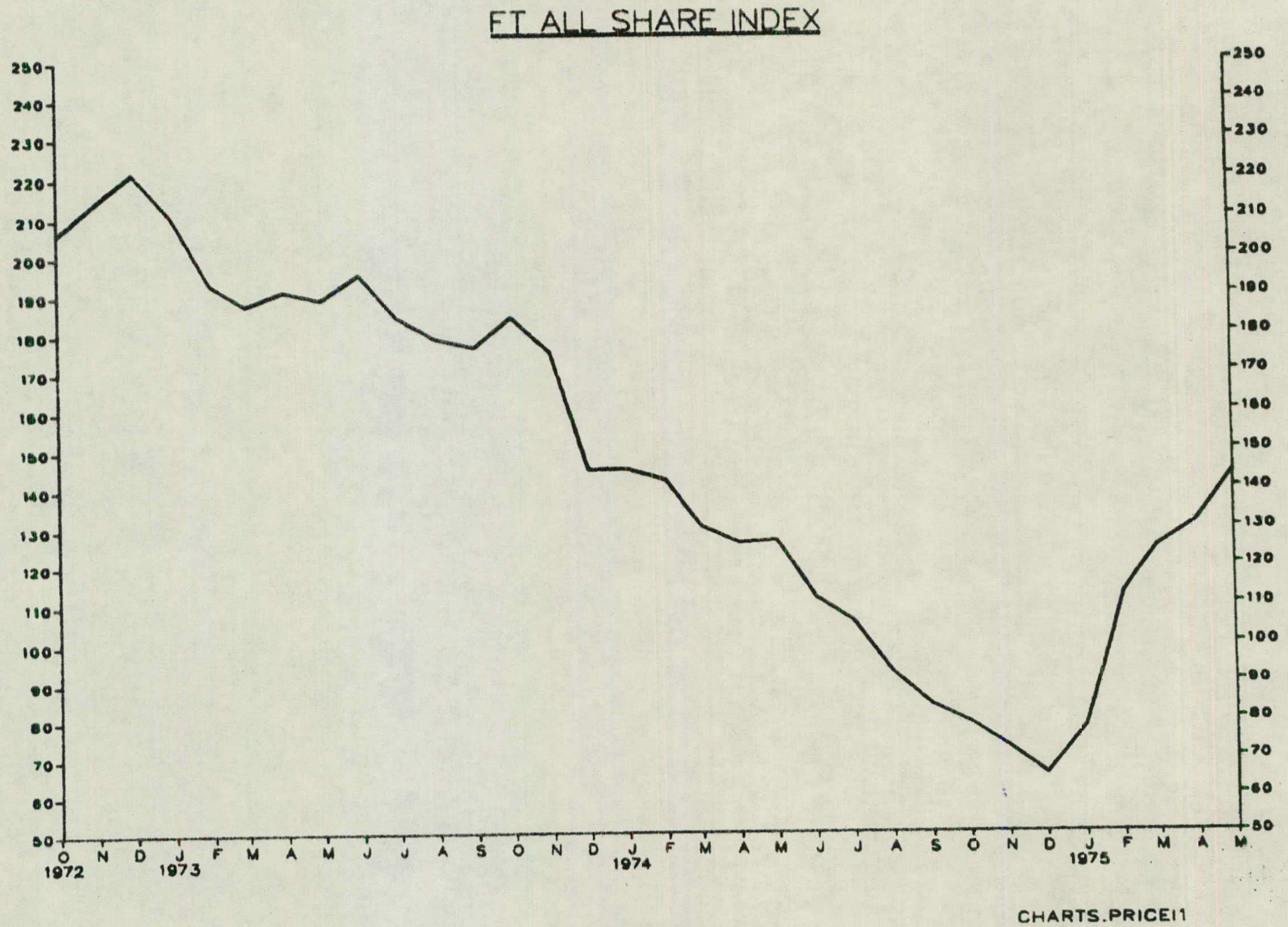

GRAPHS

## 1974 share price fall

| | High | Low | % change |
|---|---|---|---|
| Highs and lows | | | |
| - in 1974 | 145.0 (Jan 1974) | 61.92 (13 Dec 74) | - 57.3 |
| - through out | 224.61 (~~February~~ Nov 1972) | 61.92 | - 72.4 |

See also graph attached

1974


FT ALL SHARE INDEX
250
240
230
220
210
200
190
180
170
160
150
140
130
120
110
100
90
80
70
60
50
O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M
1972
1973
1974
1975
CHARTS.PRICE11

RA3.20

# PRIVATISATION ISSUES

**(Fully paid prices except where indicated)**

| | Issue Date | Issue Price | Peak Price | Thursday close (15/10) | 1pm today (5/11) | % change on issue price |
|---|---|---|---|---|---|---|
| Jaguar | August 1984 | 165 | 626 | 578 | 278 | +68 |
| BT | November 1984 | 130 | 336 | 261 | 218 | +68 |
| British Gas | December 1986 | 135 | 200 | 168 | 135 | - |
| British Airways | February 1987 | 125 | 235 | 219 | 130 | +4 |
| Rolls Royce | May 1987 | 170 | 240 | 206 | 125 | -26 |
| BAA (*) | July 1987 | 100 | 152 | 151 | 102 | +2 |

(* partly paid, fixed price offer)

101454
MDLOAN 2308

UNCLASSIFIED CORRECTED VERSION 3 NOV 87
FM FCO
TO PRIORITY ABIDJAN
TELNO GUIDANCE 091
OF 301700Z OCTOBER 87
AND TO PRIORITY BIS NEW YORK, WASHINGTON, TOKYO, JOHANNESBURG
AND TO PRIORITY HONG KONG, SINGAPORE, STOCKHOLM, OSLO, VIENNA
AND TO PRIORITY RIYADH, KUWAIT, NEW DELHI, OTTAWA, CANBERRA
AND TO PRIORITY UKDEL OECD, PRETORIA, EC POSTS, BERNE, HELSINKI
AND TO PRIORITY JEDDA, BANDAR SERI BEGAWAN, BOGOTA, BRASILIA
AND TO PRIORITY CAIRO, CARACAS, LAGOS, LIMA
AND TO PRIORITY MEXICO CITY, MONTEVIDEO, QUITO, UKMIS GENEVA
AND TO PRIORITY UKMIS NEW YORK, STRASBOURG, UKMIS VIENNA
AND TO PRIORITY ISLAMABAD, TEL AVIV, WELLINGTON
AND TO SAVING ABU DHABI, ACCRA, ADDIS ABABA, ALGIERS, AMMAN
AND TO SAVING ANKARA, ASUNCION, BAGHDAD, BAHRAIN, BANGKOK
AND TO SAVING BANJUL, BELGRADE, BRIDGETOWN, BUCHAREST
AND TO SAVING BUDAPEST, BISBA, COLOMBO, DHAKA, DAKAR, DAMASCUS
AND TO SAVING DAR ES SALAAM, DUBAI, FREETOWN, GABORONE
AND TO SAVING GEORGETOWN, GUATEMALA CITY, HARARE, HAVANA
AND TO SAVING JAKARTA, KAMPALA, KATHMANDU, KHARTOUM, KINGSTON
AND TO SAVING KINSHASA, LA PAZ, LIBREVILLE, LILONGWE
AND TO SAVING LUANDA, LUSAKA, MANILA, MAPUTO, MASERU, MBABANE
AND TO SAVING MOGADISHU, MONROVIA, MOSCOW, MUSCAT, NAIROBI
AND TO SAVING NICOSIA, PANAMA CITY, PEKING, PORT LOUIS
AND TO SAVING PRAGUE, PORT MORESBY, PORT OF SPAIN, PORT STANLEY
AND TO SAVING RABAT, RANGOON, SANA'A, SAN JOSE, SANTIAGO, SEOUL
AND TO SAVING SOFIA, SUVA, TEGUCIGALPA, KUALA LUMPUR, TUNIS
AND TO SAVING VALLETTA, VICTORIA, YAOUNDE, WARSAW, UKDEL CSCE
AND TO SAVING UKDEL MBFR

INTERNATIONAL FINANCIAL SITUATION

1. PRESS AND TELEVISION HAVE PROVIDED SATURATION COVERAGE OF THE WORLDWIDE FALL IN STOCK MARKET PRICES OVER THE PAST FORTNIGHT. THERE HAS BEEN WIDESPREAD SPECULATION ABOUT THE EFFECT ON EXCHANGE RATES, INTEREST RATES, GROWTH PROSPECTS, FUTURE COOPERATION BETWEEN THE MAJOR INDUSTRIALISED COUNTRIES (THE G7) AND SO ON.

2. THIS GUIDANCE GIVES POSTS A LINE TO TAKE ON THE MORE OBVIOUS QUESTIONS. POSTS SHOULD BEAR IN MIND THE ESSENTIAL DIFFERENCES

BETWEEN PRIVATE SECTOR ACTIVITY ON THE FINANCIAL AND EQUITY MARKETS, AND PUBLIC POLICY DIRECTED AT MAINTAINING SOUND MACROECONOMIC POLICIES. IT IS NOT OUR JOB (AND WOULD BE VERY FOOLISH) TO OFFER VIEWS ON HOW FAR THE STOCK MARKETS WILL FALL, OR WHEN A RECOVERY WILL TAKE PLACE. IT IS OUR JOB TO TRY TO CONVINCE OUR CONTACTS THAT MOST OF THE ECONOMIC POLICIES THAT INDUSTRIALISED COUNTRIES ARE PURSUING ARE SOUND, AND THAT WHERE THERE ARE PROBLEMS (SEE QUESTIONS 8-12 BELOW) THESE ARE BEING ADDRESSED.

3. THE BP SHARE OFFER HAS GONE AHEAD, AGAINST A BACKGROUND OF A STRONGER BP PRICE. THE CHANCELLOR WILL PRESENT HIS AUTUMN STATEMENT ON 3 NOVEMBER. THIS COVERS PUBLIC EXPENDITURE DECISIONS AND THE TREASURY'S LATEST ASSESSMENT OF PROSPECTS FOR THE UK AND WORLD ECONOMIES, TAKING INTO ACCOUNT AS FAR AS POSSIBLE THE LIKELY EFFECTS OF RECENT FALLS IN THE STOCK MARKETS. WE SHALL SEND YOU THE SALIENT POINTS TELEGRAPHICALLY OR BY BAG.

LINE TO TAKE

4. Q: WHY HAVE STOCK MARKET PRICES FALLEN?
A: NO SIMPLE ANSWER. US TRADE FIGURES AND US-GERMAN DISAGREEMENTS OVER ECONOMIC POLICY OFTEN CITED AS TRIGGER FOR DECLINE. BUT CAUSES GO DEEPER. OVER PAST FIVE YEARS, SHARE PRICES IN LONDON AND FRANKFURT HAVE DOUBLED IN REAL TERMS (IE DISCOUNTING INFLATION), TREBLED IN NEW YORK AND PARIS, AND QUADRUPLED IN TOKYO. SOME OF THIS GROWTH JUSTIFIED BY IMPROVED ECONOMIC PROSPECTS. BUT GROWING GAP WITH RETURN ON BONDS. NEITHER UNEXPECTED NOR UNPRECEDENTED THAT SOONER OR LATER SHARE PRICES WOULD CORRECT THEMSELVES. WHAT WAS NOT FORESEEN WAS SIZE AND SPEED OF THAT CORRECTION.

5. Q: WHY WASN'T IT FORESEEN?

A: IN GENERAL, NOT POSSIBLE TO FORECAST STOCK PRICES RELIABLY. MARKETS OFTEN OVERSHOOT. LOOK AT MOVEMENTS OF DOLLAR IN RECENT YEARS. MODERN TECHNOLOGY MAY HAVE SPEEDED UP CORRECTION, BUT EQUALLY TRUE THAT THIS IS FIRST MAJOR CORRECTION SINCE NEW TWENTY FOUR HOUR GLOBAL MARKETS CAME INTO BEING.

6. Q: SHOULDN'T THE MARKETS BE REGULATED MORE CLOSELY?

A: PURPOSE OF REGULATION IS NOT TO FIX PRICES IF LEVELS UNSUSTAINABLE. EQUITY INVESTMENT BY DEFINITION A RISK BUSINESS.

7. Q: BUT GOVERNMENTS MUST TAKE THEIR SHARE OF RESPONSIBILITY FOR NOT FOLLOWING SENSIBLE ECONOMIC POLICIES.

A: MORE COOPERATION IN RECENT YEARS BETWEEN MAJOR ECONOMIES THAN AT ANY TIME IN PAST. REGULAR MEETINGS OF FINANCE MINISTERS AND CENTRAL BANK GOVERNORS. WE ALL ACCEPT THAT OUR NATIONAL ECONOMIC POLICIES AFFECT OUR PARTNERS, AND THE WORLD ECONOMY MORE GENERALLY. REFLECTED IN MANY WAYS: AGREEMENT AT 1986 TOKYO SUMMIT ON NEED FOR COMPATIBILITY OF NATIONAL ECONOMIC OBJECTIVES, STRENGTHENING OF MULTILATERAL SURVEILLANCE AND USE OF AGREED INDICATORS TO THAT END. EXCHANGE RATE COOPERATION CULMINATING IN LOUVRE AGREEMENT OF FEBRUARY THIS YEAR, AND ITS REAFFIRMATION SINCE THEN. ALWAYS ROOM FOR IMPROVEMENT, AND CHANCELLOR ADVOCATED A MORE PERMANENT REGIME OF MANAGED FLOATING AT FUND/WORLD BANK ANNUAL MEETINGS ONE MONTH AGO, WITH AIM OF UNDERPINNING PRESENT POLICIES BY COLLECTIVE ANTI-INFLATIONARY STANCE. BUT ACHIEVEMENTS ARE REAL: FIVE YEARS OF SUSTAINED GROWTH WITH LOW INFLATION.

8. Q: BUT DESPITE ALL THIS, NOT ALL GOVERNMENTS HAVE PLAYED THEIR PART. LARGE US FISCAL AND CURRENT ACCOUNT DEFICITS, GERMAN AND JAPANESE SURPLUSES.

A: WE HAVE OFTEN CRITICISED WHEREVER NECESSARY THESE COUNTRIES' RELUCTANCE TO TAKE THE DOMESTIC ACTION, REQUIRED TO SUSTAIN MORE STABLE EXCHANGE RATES. BUT FACT IS THAT THESE IMBALANCES BUILT UP OVER SEVERAL YEARS, AS A RESULT OF POLICIES FOLLOWED IN EARLY EIGHTIES. CANNOT BE REVERSED OVERNIGHT. WHAT MATTERS IS MARKET PERCEPTION THAT EFFECTIVE AND SUSTAINED ACTION BEING TAKEN, YEAR ON YEAR, TO REDUCE THEM (THEIR COMPLETE ELIMINATION IS UNNECESSARY, SINCE WE DO NOT LIVE IN A WORLD WHERE EVERY COUNTRY'S IMPORTS AND EXPORTS ARE OBLIGED TO BALANCE).

9. Q: PROGRESS IN REDUCING IMBALANCES TOO SLOW.

A: LARGE FALL ALREADY IN US FISCAL DEFICIT, DOWN FROM 221 BILLION DOLLARS IN FY 1986 TO 148 BILLION DOLLARS IN FY 1987. FURTHER PROGRESS CERTAINLY NEEDED, AND PRESIDENT REAGAN AND CONGRESSIONAL LEADERS NOW ENGAGED IN SEEKING 23 BILLION DOLLAR CUTS FOR FY 1988. VITAL THESE CUTS IMPLEMENTED. INDEED, LARGER CUTS DESIRABLE. MUST ALSO ACHIEVE CUTS IN FY 1989 AND BEYOND. (THE PRIME MINISTER TOLD THE COMMONS YESTERDAY THAT 'MEASURES

WHICH BOTH IN SCALE AND CONTENT GO BEYOND WHAT HAS PREVIOUSLY BEEN ENVISAGED WOULD DO MORE THAN ANYTHING ELSE TO BRING BACK CONFIDENCE').

10. Q: IMPOSSIBLE UNLESS ADMINISTRATION AGREES TO TAX INCREASES, SINCE CUTTING FEDERAL SPENDING SEEMINGLY SO INTRACTABLE.

A: WE HOPE ADMINISTRATION WILL TAKE WHATEVER ACTION IS NECESSARY. RAISING TAXES WOULD DEMONSTRATE RESOLVE.

11. Q: US BELIEVE FRG NOT DOING ENOUGH.

A: MAJOR TAX REDUCTIONS SCHEDULED FOR JANUARY 1988 WILL STIMULATE GERMAN ECONOMY, HELP TO REORIENT ECONOMY SOMEWHAT AWAY FROM EXPORTS. BUT IMMEDIATE NEED IS FLEXIBLE MONETARY POLICY, INCLUDING INTEREST RATE REDUCTIONS, SINCE FRG INFLATION MINIMAL AND NO SERIOUS RISK OF IT ESCALATING NOW THAT STOCK MARKET FALL HAS LOWERED PROSPECTS FOR WORLD ECONOMIC GROWTH AND INFLATION.

12. Q. FINANCIAL MARKETS' INSTABILITY SHOW LOUVRE ACCORD DISCREDITED?

A: ON THE CONTRARY. RECENT DEVELOPMENTS DEMONSTRATE BOTH THE NEED FOR AND DESIRABILITY OF GREATER EXCHANGE RATE STABILITY. REINFORCING NOT ABANDONING, LOUVRE ACCORD WILL HELP TO REASSURE MARKETS.

13. Q: G7 MEETING TO RESTORE CONFIDENCE?

A: MINISTERS AND OFFICIALS IN REGULAR CONTACT. POLICY COORDINATION AND ACTION DO NOT AUTOMATICALLY REQUIRE MEETINGS. COUNTERPRODUCTIVE TO HOLD MEETING WITHOUT LIKELIHOOD OF SUCCESSFUL OUTCOME.

14. Q: IMPACT OF SHARE PRICE FALL ON WORLD ECONOMIC GROWTH?

A: TOO SOON TO SAY HOW MUCH. IN SECOND HALF OF 1986 AVERAGE REAL GNP GROWTH WAS JUST BELOW 2.5 PER CENT. SOME SIGNS OF STRENGTHENING IN FIRST HALF OF 1987, AND UK GROWTH EXPECTED TO BE AROUND 4 PER CENT THIS YEAR. BOUND TO BE SOME REDUCTION ALL ROUND AFTER RECENT EVENTS. OTHER THINGS BEING EQUAL, STOCK MARKET FALL WILL AFFECT BUSINESS CONFIDENCE, RAISE COST OF EQUITY FINANCE, REDUCE CONSUMPTION, AND SO AFFECT INVESTMENT INTENTIONS. EXPORT MARKETS MAY ALSO BE LESS BUOYANT.

15. Q: WORRYING.

A: YES, BUT OTHER SIDE OF PICTURE IS LOWER INFLATION BROUGHT ABOUT BY REDUCED DEMAND, LOWER COMMODITY PRICES, AND LOWER INTEREST RATES. LESSON OF 1929 IS THAT GOVERNMENTS DO NOT HELP RECOVERY BY TAKING DELIBERATE ACTION TO COMPRESS DEMAND FURTHER, OR TO PROTECT THEIR INDUSTRIES AND SO DEPRESS WORLD TRADE. SO RECENT CUTS IN INTEREST RATES WELCOME. NOW EVEN MORE IMPORTANT THAN BEFORE TO RESIST ALL TRADE PROTECTIONISM (THERE ARE WELCOME SIGNS THAT THE US CONGRESS IS NOW MORE CONSCIOUS OF THE DANGERS) AND PROMOTE LIBERALISATION IN THE GATT NEGOTIATIONS. ABOVE ALL, SURPLUS COUNTRIES LIKE GERMANY AND JAPAN MUST ACT TO EXPAND THEIR DOMESTIC DEMAND AND TAKE IN MORE IMPORTS. RECENT SHOCKS SHOULD STRENGTHEN POLITICAL WILL TO FOLLOW THIS PATH.

16. Q: DEVELOPING COUNTRIES WILL SUFFER.

A: AGAIN, TWO SIDES TO QUESTION. CERTAINLY ANY FALL IN COMMODITY PRICES - AFTER THE SLIGHT RECOVERY FROM LAST YEAR'S ALL-TIME LOW - WOULD DAMAGE PRODUCERS' EXPORTS AND RISK FURTHER COMPRESSION BY THEM OF IMPORTS, WITH ADVERSE EFFECT ON INDUSTRIALISED COUNTRIES' TRADE. BUT DEVELOPING COUNTRY DEBTORS WILL SEE THEIR DEBT SERVICING BURDEN DECLINE BECAUSE OF THE FALL IN INTEREST RATES THAT HAS OCCURRED.

17. Q: THEY NEED COMPENSATION FOR COMMODITY PRICE FALLS, MORE RESOURCES FROM GOVERNMENTS, INTERNATIONAL FINANCIAL INSTITUTIONS AND BANKS, AND DEBT RELIEF.

A: SHOULD NOT UNDERESTIMATE PROGRESS IN PAST YEAR IN DEVELOPING DEBT STRATEGY. COMPENSATORY FINANCE: IMF'S COMPENSATORY FINANCING FACILITY (CFF) AND EC'S STABEX ALREADY EXIST, CFF CURRENTLY UNDER REVIEW IN FUND, AND IMPORTANT NEW US PROPOSALS TO WIDEN ITS MEMBERS' ACCESS TO COMPENSATORY FINANCING FOR UNEXPECTED DEVELOPMENTS LIKE FALLS IN COMMODITY PRICES, EXPORT VOLUMES, NATURAL DISASTERS AND POSSIBLY HIGHER INTEREST RATES.

MORE RESOURCES: NEGOTIATIONS ON A NEW WORLD BANK GENERAL CAPITAL INCREASE UNDER WAY, MAY CONCLUDE AS EARLY AS DECEMBER. ALSO NEGOTIATIONS FOR A SUBSTANTIAL ENLARGEMENT OF THE IMF'S STRUCTURAL ADJUSTMENT FACILITY (ACCESS LIMITED TO POOREST COUNTRIES).

DEBT RELIEF: CHANCELLOR'S PARIS CLUB INITIATIVE STILL ON TABLE, AND WE CONTINUE TO BELIEVE THAT THE POOREST AND MOST INDEBTED COUNTRIES, ESPECIALLY THOSE IN SUB-SAHARAN AFRICA, SHOULD BE GIVEN INTEREST RATE CONCESSIONS ON BILATERAL DEBTS. FUND AND WORLD BANK IN DIFFERENT SITUATION: FOR GOOD REASONS THEY DO NOT RESCHEDULE OR PROVIDE DEBT RELIEF (THOUGH MUCH OF THEIR LENDING TO THE POORER COUNTRIES IS IN PRACTICE ON CONCESSIONAL TERMS), BUT THERE MAY BE WAYS OF ALLEVIATING SOME OF THE PROBLEMS CAUSED FOR DEVELOPING COUNTRIES BY SMOOTHING OUT AWKWARDLY HIGH REPAYMENT OBLIGATIONS IN ANY GIVEN YEAR.

BUT INDUSTRIALISED COUNTRIES' MAIN RESPONSIBILITIES ARE TO MAINTAIN STEADY GROWTH, TO REDUCE THE IMBALANCES WHICH JEOPARDISE IT, AND TO OPEN UP THEIR MARKETS TO DEVELOPING COUNTRY EXPORTS.

HOWE

YYYY

<u>DISTRIBUTION</u> ~~76~~ 530

<u>MAIN</u> 1

FCO/WHITEHALL (PALACE)

<u>ADDITIONAL</u> 1

GUIDANCE

<u>SAVING</u> 74

| | |
|---|---|
| ABU DHABI | LUSAKA |
| ACCRA | MANILA |
| ADDIS ABABA | MAPUTO |
| ALGIERS | MASERU |
| AMMAN | MBABANE |
| ANKARA | MOGADISHU |
| ASUNCION | MONROVIA |
| BAGHDAD | MOSCOW |
| BAHRAIN | MUSCAT |
| BANGKOK | NAIROBI |

BANJUL
BELGRADE
BRIDGETOWN
BUCHAREST
BUDAPEST
BISBA
COLOMBO
DHAKA
DAKAR
DAMASCUS
DAR ES SALAAM
DUBAI
FREETOWN
GABORONE
GEORGETOWN
GUATEMALA CITY
HARARE
HAVANA
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KAMPALA
KATHMANDU
KHARTOUM
KINGSTON
KINSHASA
LA PAZ
LIBREVILLE
LILONGWE
LUANDA
NICOSIA
PANAMA CITY
PEKING
PORT LOUIS
PRAGUE
PORT MORESBY
PORT OF SPAIN
PORT STANLEY
RABAT
RANGOON
SANA'A
SAN JOSE
SANTIAGO
SEOUL
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TEGUCIGALPA
KUALA LUMPUR
TUNIS
VALLETTA
VICTORIA
YAOUNDE
WARSAW
UKDEL CSCE
UKDEL MBFR

OCMIAN 4636

NNNN

MG NOON REPORT

FINANCIAL MARKETS — Friday 30 October 1987

| Opening | 10 AM | | NOON | Oil Price (10 AM) | |
|---|---|---|---|---|---|
| 74.5 | 74.4 | £ERI | 74.5 | | |
| 1.7140 | 1.7135 | $/£ | 1.7135 | Nov | $18.75 |
| 2.9844 | 2.9798 | DM/£ | 2.9806 | Dec | $18.85 |
| 1.7400 | 1.7390 | DM/$ | 1.7395 | Jan | $18.82 |
| 138.65 | 138.85 | Yen/$ | 138.95 | | |

| UK interbank £ | | | Eurodollars | |
|---|---|---|---|---|
| 9 3/8 | (-3/16) | 7 day | 6 3/4 | (-1/16) |
| 9 1/4 | (+3/16) | 1 month | 7 1/16 | (-) |
| 9 1/4 | (+5/32) | 3 month | 7 5/8 | (-) |
| 9 1/4 | (+1/8) | 12 month | 8 1/16 | (-1/16) |

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange market the dollar firmed slightly in New York on profit taking but eased again in the Far East on bearish sentiment. It has remained relatively steady in a calm market.Sterling opened easier on last nights close but continued steady. German 3 month Euromark rates have eased from yesterday's London closing level of 4 5/16% to this morning opening level of 4% following Bundesbank signal to their markets today of lower interest rates.EMS pressures dominate market attention today.

The Japanese, Hong Kong and US euqity markets closed up. The Nikkei at 22765 +731, the Hang Seng at 2240.13 +35.6 and the Dow Jones at 1938.33 +91.5. The FTSE100 opened at 1745.6 up 63.6, it is now at 1764.1 up 82.1.

The gilts market opened easier, improved on foreign buying but fell back as equities rallied.

R McRobbie

MARKET INTERVENTION ($m)

Overnight -

Today so far -

Total -

OTHER COUNTRIES INTERVENTION ($m)

JAPAN +901$

CANADA +13$ agst DM (last night)

GILTS

| | Latest market movements | Price change since previous close |
|---|---|---|
| Shorts | Steady | -3/32 |
| Mediums | Easier | -7/32 |
| Longs | Easier | -20/32 |
| Futures (Long Contracts) | | -27/32 (Vol:17000) |

Gilt Sales since market opening

-£0.3 million

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

SECRET

THE STOCK EXCHANGE

cc. Mr Hudson } useful
PS/FST } speech material

RL 2/11

30 October 1987
85/87

RECORD LEVELS OF TRADING IN UK EQUITIES LAST WEEK

In the five trading days of last week, October 19-23, while Stock Exchanges elsewhere in the World closed, shortened their hours or suspended dealing in major stocks, the International Stock Exchange remained open, enabling a record level of trading in UK equities to take place. Contrary to a widely held view, most of this trading was by customers and more UK shares were purchased than sold.

More than 100,000 bargains with a value of £3 billion were traded daily on Wednesday, Thursday and Friday. The normal daily average is 45,000 bargains, with a value of £2 billion. These figures demonstrate that trading volume was high despite a falling market.

Many commentators have claimed that the majority of deals were intra market maker, but in fact customer business accounted for between 85 - 90% of all bargains, a similar proportion to that of a normal trading day. Moreover, in terms of value traded, customer business represented 60% of total turnover - substantially higher than the normal 50/50 split with intra market maker activity.

Sales accounted for only 20% of customer bargains, with a large average bargain size of £50,000, indicating that pressure to sell came mainly from institutional clients. Despite the FTSE index showing a downward trend, 80% of customer bargains were purchases with an average value of £12,000. It is clear from these figures that private clients continued to show confidence in the market.

For further information: Anne Coleman, Chief Press Officer; Teresa Hodges, Gill Ackers, Press Officers;
Telephone: 01-588 2355; Fax 01-256 8972
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NEWS RELEASE NEWS RELEASE NEWS RELEASE NEWS RELEASE NEWS RELEASE NEWS RELEASE

PERSONAL

PWP

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

2 November 1987

Denys H Henderson Esq
Chairman
Imperial Chemical Industries PLC
Imperial Chemical House
Millbank
LONDON SW1P 3JF

Dear Denys

Many thanks for your letter of 27 October, and your kind words.

I entirely agree that it is vital that the fall in the stock market should not be allowed to throw the British economy off course, after all the progress that has been made in recent years. In particular, the new spirit of confidence that has been so evident this year must not be squandered.

My aim over the next few weeks is therefore to keep the economy on an even keel, and to do my best to ensure that the co-operation between the Finance Ministers of the leading countries continues, which is, I am sure, the best way of minimising the risks to the world economy.

Finally, my congratulations on your excellent third quarter results, which, as you say, should be of considerable value in reminding the market of the underlying health of the British economy.

Yrs sincerely
Nigel

NIGEL LAWSON

9/Ack/NPA?

# Sheppards

Julie 10/11

NP/imdi

4th November 1987.

Nigel Lawson, Esq.,
Chancellor of the Exchequer,
H.M. Treasury,
Parliament St.,
LONDON

Dear Mr Lawson,

I would like to congratulate you on preserving the principle of underwriting responsibility for BP, while limiting the market implosion that might have taken place without the 'safety net'.

The Bank of England may now have to take up most of the newly issued stock, and an offer for sale will probably once again be required. To solve this problem, I suggest another Treasury innovation : a gilt convertible into equity.

Currently, convertible bonds are attractive to fund managers, offering the downside risk of fixed interest descriptions while giving the upside potential of equities. BP's share price is certain to be higher in five years time than it is today. Therefore, a gilt convertible into BP at intervals over the next five years should carry a lower coupon than a conventional gilt, thus saving H.M. Government money, while perhaps still selling BP at 330p or better. This innovative instrument might also avoid the necessity and expense of a new issue.

Thank you for your interest.

Yours faithfully,

Nigel Purchase

N. Purchase

ECONOMIST

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BAII

FROM: SIR T BURNS
DATE: 6 NOVEMBER 1987

CHANCELLOR

cc Sir P Middleton
Sir G Littler
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr S Davies

THE UK AND A US RECESSION

You asked for my views on the consequence for the UK of a US recession, and possible policy responses.

**The Consequence for the UK of a US Recession**

2. The forecast for the US underlying the Industry Act Forecast published in the Autumn Statement was for growth in GDP of around 1-1½ per cent next year.

3. Although the direct weight of the US in UK exports is not particularly large (about 15 per cent of UK manufactured exports go to the US compared with some 45 per cent that go to EC countries) a US recession would have widespread effects. A slow-down in the US would cause a reduction not only in our exports in that market, but also in our exports elsewhere, as other countries were affected by the slow-down in the US. In the absence of any other disturbances a 2 per cent lower rate of growth in the US next year might reduce world trade and UK exports by a little over 1 per cent in total. In turn this could reduce UK GDP growth by up to ½ per cent, if there was no policy response in the UK.

4. On its own this would not be unduly alarming because we begin from a position of strong demand in both export and domestic markets. Before the fall of equity prices we were inclined to think that we might have been underestimating the strength of demand. Even a ½ per cent reduction from the Autumn Statement

forecast would leave non-oil GDP growth at or a little above 2½ per cent - not far short of productive potential growth. There would be a distinct risk that unemployment might be starting to rise again in the latter part of 1988, but not at a particularly alarming rate.

5. At the same time, there would be benefits to the UK inflation rate from the impact of lower world activity on world commodity prices. The effect on world commodity prices cannot be estimated with any confidence; but for each 10 per cent drop in industrial materials prices UK inflation might be cut by ¼ per cent by the end of 1988. This reduction in inflation would tend to raise UK domestic demand, giving a partial offset to the loss of output caused by lower exports.

6. The dollar is currently some 6 per cent or so lower against sterling than assumed in the Autumn Statement forecast, and could clearly weaken further. The effect of this on UK competitiveness could marginally reduce UK growth next year. At the same time, sterling's strength against the dollar helps with the inflation outlook: the latest exchange rate could be worth a further ¼ per cent off UK inflation at the end of 1988.

7. Lower UK growth will, of course, imply a higher PSBR next year than we would have otherwise have expected. But the change is not such as to cause concern given the fiscal prospects as they currently stand: ½ per cent or so less growth next year would probably add under £1 billion to the PSBR in 1988-89. There would also be some deterioration in the current account; but the deterioration would be relatively small - perhaps under £½ billion if world commodity prices fell by 10 per cent.

**The Policy Response**

8. It is possible to argue that little in the way of a policy response is called for as nominal GDP is projected in the Industry Act Forecast to overshoot the MTFS ranges this year and next (and with a rather larger overshooting suggested by the October

internal forecast). A case can be made for taking the opportunity to get back on track to meet our objectives for reducing growth in money GDP over the medium term.

9. On the other hand there is clearly a risk that the combination of the direct effects of the share price fall, plus a recession in the US, could give such a blow to confidence that there is a substantial impact on world and UK output. The figures given above are necessarily only very rough orders of magnitude. The dangers arise when shocks in the US are transmitted to other countries through shocks to confidence and policy responses.

10. So far we have responded by adjusting interest rates as we have adopted the view that monetary conditions have clearly tightened. There may be scope for further falls although if the Germans do not reduce their interest rates any further we may begin to put some downward pressure on the £/DM rate. There is some room for a lower £/DM rate within our present framework but this may allow no more than a further ½ to 1 per cent off the interest rate differential. Such an easing of domestic monetary conditions would provide some offset to the lower world activity on UK output while the inflationary consequences should be tolerable.

11. Given the prospects for public finances there seems to be plenty of scope to allow the automatic stabilisers to operate. But at this stage I would not want to be thinking in terms of a further easing of fiscal policy. It is a clumsy weapon to deal with short-term shocks; any support for output would take time to become visible and even longer to reverse; and the impact on the current account could bring a risk of a break in confidence in sterling.

## Conclusions

12. On balance this suggests that we can go some way to mitigate the effects of a recession on the UK. But we cannot isolate ourselves entirely. The more we try to offset lower external

demand by more domestic demand the bigger are likely to be the adverse current account effects unless commodity prices fall sharply. There is some scope for lower interest rates which could be reversed if conditions change. And there is scope for the automatic stabilisers to play their part. But we cannot hope to fine tune such disturbances. The important principle is that we should continue to try to maintain the correct medium-term framework. There may be an argument for restating the NEDO pledge - that the MTFS is just as much a guarantee against inadequate demand as it is against excessive demand - but it is important that we do not give the impression of being able to deliver this on a year by year basis.

T BURNS

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From the Parliamentary Under Secretary of State
for Corporate and Consumer Affairs

The Hon Francis Maude MP

ECONOMIC SECRETARY
REC'D - 9 NOV 1987
Mr Ilett (Advice Please)
PS/Chancellor
Sir P. Middleton
Mr Cassell
Mrs Lomax
Miss Noble
Mr Neilson

Peter Lilley Esq MP
Economic Secretary to
The Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

N.B. Important. No statement unless major.

6 November 1987

Dear Peter

**FINANCIAL MARKETS BILL**

Our officials have been considering the text of a possible statement that we might need to make about the proposed Financial Markets Bill if events in the financial markets were to cause the failure of a major player to meet his obligations. As you may know, in summer the Law Officers agreed that it would be possible to give the Bill retrospective effect provided that an announcement was made to this effect on the day of such a default. I am not at this stage saying that we would wish to make such an announcement. But I think we should make preparations now so that we are ready to move quickly if an announcement were agreed to be necessary.

... The text of the draft enclosed has been agreed with The Stock Exchange and the International Commodities Clearing House, but no one is committed to a decision to use it. It might well need to be modified in the light of the specific case which led us to make the announcement.

We would not of course make the statement without first securing the Chancellor's agreement and that of the Governor of the Bank of England, so that we can assess the effect it is likely to have on confidence. I would also propose to consult The Stock Exchange and the ICCH.

The Bill is designed to put on a secure legal footing the ability of the relevant financial market authorities to handle a member's default. If the legislation is to be retrospective, the normal approach would be to make an immediate announcement of the intention to legislate with effect from the time of the

J05CHO

announcement. On this basis, we would need to make the statement as soon as the market authorities alerted us to the need to make it. Only after it had been made would they be able to take action secure in the knowledge that it would be safeguarded under the Bill.

The alternative approach would be to leave it to the authorities to take action without the safeguard afforded by a statement. But if a legal challenge to their actions were subsequently made it would be very difficult to justify legislating with retrospective effect when no announcement had been made in advance of the actions concerned.

There are attractions in a very short Statement, but I understand that the Law Officers would expect the Statement to set out the retrospective effects of the Bill with reasonable precision. Both The Stock Exchange and ICCH share that view on the grounds that they need it to be clear enough to rely upon.

The draft Statement indicates that no person will be able to claim damages from the authorities for any loss he suffers if the authorities act in good faith - and this immunity will apply retrospectively. Various other regulators under the Financial Services Act enjoy a similar immunity and I believe it is necessary to extend it to cover the actions of authorities under the Bill so that they can act with confidence to protect the market.

I repeat that I am not now seeking to prejudge whether we should issue a statement if a specific problem were to occur - much will depend on the circumstances at the time. But if we did want to issue it, we would need to have a basic text ready, which we could modify quickly in the light of those circumstances.

I am copying this letter to Lord Mackay (to whom we are writing separately on the question of immunity), Patrick Mayhew, The Governor and Sir Robert Armstrong.

**FRANCIS MAUDE**

DRAFT PARLIAMENTARY STATEMENT

With permission, Mr Speaker, I would like to make a statement about the Government's intention to introduce legislation as soon as Parliamentary time is available, designed primarily to modify certain aspects of insolvency law. The legislation will clarify the legal position of financial market authorities when managing the effects of a default by one of their members. Market authorities have always had to act quickly to ensure that a default does not affect the market as a whole but some doubts of a technical nature have been expressed about their precise legal position.

Mr rt hon friend the Secretary of State therefore decided some time ago to introduce legislation during the current Session of Parliament to remove this uncertainty. The legislation will establish beyond doubt that market authorities can take appropriate action to minimise the impact on other members and on the market as a whole. [In view of current events, I thought that I should inform the House today of the Government's intentions.]

In the event of a default by a member there must be clear procedures to cope with the default which are certain in law. If the authorities cannot act quickly, there may be a risk of other members in turn defaulting, with serious consequences for the integrity of the market and for the customers and creditors of all the members. Past experience shows the crucial importance of speedy action by the appropriate authorities to prevent this.

This action may include closing the defaulting member's poisitons. Where the market operates a system of margin payments, the authorities will use any margin in their hands to meet any deficit arising from this process. In some circumstances the defaulter may have used margin provided to him by one of his customers to fund the payment of a net margin call from the authorities arising partly from a deficit on a position relating to another customer. The authorities will not be able to prevent this, but the legislation will limit the adverse effect upon the first customer.

In other markets where there is no margin system different action may have to be taken in pursuit of the same objectives.

For example, The Stock Exchange undertakes to ensure the settlement of certain bargains in equities which have been entered for settlement within the TALISMAN system. To do this it will need to exercise the charge which it has over the defaulter's assets in the TALISMAN system. For other unsettled bargains made on or after DATE, The Stock Exchange has introduced new rules. These rules will apply to bargains where the defaulting member acted as a principal. The Stock Exchange may set a hammer price at which those bargains are to be closed. Such bargains may then be closed and the profits and losses stemming from closure at the hammer price would be netted off.

The proposed legislation will ensure that actions taken in good faith to cope with a default or impending default cannot be challenged or set aside under insolvency law. If the defaulting member becomes subject to insolvency procedures, a modified insolvency regime will apply.

No person will be able to claim damages from the authorities for any loss suffered as a result of action taken in good faith.

[By preventing financial difficulties spreading from the defaulter to other members, the actions of the authorities will indirectly protect those members' creditors. That will clearly benefit the bulk of investors using the market. The rights of investors who have done business with the defaulter will be affected. But in practice those rights would bring them little benefit if the integrity of the market is undermined.]

The Bill will provide that appropriate actions taken on or after today's date will be subject to the provisions of the Bill. These actions will therefore be immune from challenge.

Mr Speaker, I am sure that the House will agree that uncertainty in the law is in no-one's interest. The market authorities must be able to act decisively in the interest of the generality of investors and creditors. A further statement on the details of the legislation will be made in due course.

pmp

# W E E K E N D   W O R L D

Sunday, 8th November 1987

LAWSON AND THE CRASH

A SLUMP ON THE WAY?

LIVE STUDIO INTERVIEW WITH:

THE RIGHT HON. NIGEL LAWSON M.P.
CHANCELLOR OF THE EXCHEQUER

MATTHEW PARRIS

Good afternoon. For a third week the world's news has been dominated by the convulsions in the stock markets and the currency exchanges. Since the Crash of '87 the focus has now shifted to political action to prevent the crisis spiralling out of control. In Washington and in Basle this week, crucial talks are continuing. On Weekend World today, I shall be talking at length to the Chancellor of the Exchequer, Nigel Lawson, about the action needed to stabilise the world economy, and the prospects for us all if such action fails. Also in the studio is Mr Michael Osborne, a leading City economist, and we shall be going live to Washington and to Germany for reports on the economic crisis and the political action needed to resolve it.
But first, the latest news headlines from ITN and Fiona Armstrong.

ITN NEWS HEADLINES

MATTHEW PARRIS

Hello again. For the Chancellor of the Exchequer the past week has been one in which he's played an increasingly prominent role in the continuing crisis. It began on Tuesday when he addressed the House of Commons on the future of the domestic economy. The next day he enlarged his scope.
On Wednesday evening Nigel Lawson, the Chancellor of the Exchequer, addressed the City's most eminent financiers in his annual speech at the Mansion House. They'd suffered assault and battery from the Crash of '87 over the previous two and a half weeks, and they feared the worst was yet to come.
But, boldly the Chancellor put forward a crisis plan to prevent the market crash turning into a deep world recession. First, he called for a deep cut in the American budget deficit - the difference between the US government's spending , and its income. This deficit is the root of the market's concern.

NIGEL LAWSON

CHANCELLOR OF THE EXCHEQUER

But the need for the United States budget deficit to continue to fall significantly remains crucial, and this I believe should go beyond the 23 billion dollars to which the President is committed under the new Gramm-Rudman Act. And preferably with at least some increase in some form of taxation as part of that package. And this is essential not simply because reduction of the United States's budget deficit is necessary in economic terms, but also because this has now become the touchstone of whether the United States has the political will to make hard choices and to do what needs to be done.

MATTHEW PARRIS

The other part of the Lawson plan, is that America's major trading partners would act. They would cut their interest rates to maintain the pace of world growth as American growth slackened. But this would only happen after the United States had fulfilled its part of the bargain with an agreement to cut the budget deficit.

NIGEL LAWSON

And if such an agreement is soon reached between the administration and the Congress then I believe the other major nations of the world would agree to making it part of a wider, international accord, involving, among other things, a reduction of interest rates.

MATTHEW PARRIS

The Lawson plan was launched at a crucial moment. On Tuesday he had addressed the House of Commons with a glowingly optimistic

MATTHEW PARRIS (contd)

forecast for the British economy. But on Wednesday, rumours that Reagan and Congress were making no progress in talks over the budget deficit, sent shares, and the dollar, sliding. To try to stem the falls, Nigel Lawson had to cut interest rates, but to no avail. On Thursday the markets drove the dollar down again. Mrs Thatcher weighed in too, she wrote to President Reagan urging swifter action to cut the budget deficit. But then, sensationally, James Baker, the US Treasury's Secretary told the world America was more interested in averting any recession at home, than stopping the dollar's slide. Immediately the dollar fell yet further. And on Friday the Republicans proposed a 75 billion dollar two year cut in the deficit, but with no deals certain. It's not clear yet whether the events of the past week have made the implementation of Nigel Lawson's strategy to resolve the crisis more or less easy to achieve. But there's little doubt that if it could be implemented the effects of the crash could be contained. If Reagan and Congress got their heads together and cut the budget deficit, then confidence would return to the foreign investors who lend to the United States, the dollar would probably stabilise. And international agreement on lower interest rates, the second string to Mr Lawson's bow, would boost spending and investment. Recession in America, would then be at least partically offset. But the question of implementation of the practical obstacles to be overcome, remains a big one.

ROGER BOOTLE
ECONOMIC ADVISOR, LLOYDS MERCHANT BANK

The Lawson plan is spot on, I think, with regard to what has to be done to save the world from recession, it's really a question of whether it's practical. In the US there's a major difficulty clearly in bringing the Congress and the President together to a satisfactory agreement about reducing the budget

ROGER BOOTLE (contd)

deficit with the President being adamant that he's not going to raise taxes, although he's to some extent moderated on that recently, and not cut defence spending. Meanwhile Congress being reluctant to cut non-defence spending. In Germany, on the other hand, the authorities there are reluctant for domestic reasons to cut interest rates and to expand fiscally, because they're worried about their monetary growth and they're still concerned about their inflation rate, so the Lawson plan absolutely right in economics, it's a question of whether politically it's practical.

MATTHEW PARRIS

But if the Lawson plan fails, the world economy could spiral down into a real recession. Foreign investors would lose even more confidence in the dollar, and sell billions of dollars of US Goverment Bonds and shares. Central banks who have been valiantly trying to support the dollar recently, would then be swamped by the amount of dollars being off-loaded onto the market. To prevent a complete free-for-all the Federal Reserve, America's central bank, would have to raise interest rates to persuade foreign investors to go on investing in America. Then other countries might be forced to raise their interest rates as well. And high interest rates would lead to a collapse in spending and investment around the world. A deep world recession would then be inevitable.

ALAN BUDD
PROFESSOR OF ECONOMICS, LONDON BUSINESS SCHOOL

We know that these difficulties about US policy are making markets very,very nervous and this could go on and we know that this could spread into further falls in share prices, for example, worries about the dollar and so on, which could then drive the world into a serious recession, and far from having

ALAN BUDD (contd)

any growth in the world economy next year at all, we could actually have world output falling. And although the British economy is strong and has been growing very strongly, it can't escape the consequences of a world recession on that scale. And we would start to see its finances getting into trouble, we'd start to see the public sector borrowing requirement starting to rise, and we'd also possibly start seeing unemployment rising.

MATTHEW PARRIS

So, can the Lawson plan be made to work? In our Washington studio we have Scott Pardee, Vice Chairman of a leading Japanese investment bank in New York, and Jeffrey Birnbaum, Wall Street Journal journalist who's been covering the deficit negotiations. Mr Birnbaum does it look as though, at least as far as Wall Street, the Wall Street Journal and what your readers think is concerned, does it look as though the offer that the Republicans have made is going to be accepted by the Democrats?

JEFFREY BIRNBAUM
CONGRESSIONAL CORRESPONDENT, 'WALL STREET JOURNAL'

No, I would say that it is just another offer in a long series of offers that are likely to be made this week and perhaps even into next week, the so-called Michael Plan put forward by the House Republican leader that's the one you're talking about, is considered by some of his even his Republican colleagues to be something of a throw-away plan, we're likely to see other plans however, that come along to bring the two sides closer together.

MATTHEW PARRIS

What's the problem on the Democratic side with the idea of

MATTHEW PARRIS (contd)

spending cuts?

JEFFREY BIRNBAUM

Well, in effect the Democrats believe that the crisis on Wall Street should not create a crisis on Main Street and they believe that they are the ones who have to protect the people who benefit from the Government Programmes that are targets for cuts from deeper than necessary cuts - they don't believe that a financial crisis should hurt the people who are most susceptible to, who are already hurting, basically, and in contrast the Democrats of course want to raise taxes significantly, something President Reagan continues to resist.

MATTHEW PARRIS

Well, I was going to ask you about that, if the Democrats won't accept spending cuts, could the Republicans be persuaded to accept tax increases?

JEFFREY BIRNBAUM

It's not as simple as that, the Republicans already have accepted the notion of raising taxes. President Reagan in starting these talks acknowledged that a tax increase was necessary. The question is how much and what kind. Again the democrats are insisting that well-to-do high income people bear the burden of whatever tax increase comes, President Reagan is resistant to tampering with tax rates which is a code word for also hitting the rich people. There's also the question of size of tax increase. The Democrats want at least half of the minimum 23 - 24 billion dollar package to be to come from taxes, President Reagan and the Republicans are more interested in making that closer to one third of the package.

MATTHEW PARRIS

Well, now, looking at all this how big a cut in the deficit do you think it is realistic for us to expect?

JEFFREY BIRNBAUM

At this point I would say that a 24 billion dollar package enough to avert the 23 billion dollar automatic Gramm-Rudman cut is what's expected, and I must say that I do expect such an agreement, perhaps this week, but certainly next week, whether it goes much beyond that 24 billion dollars is a matter of domestic politics and perhaps some questionable budget savings.

MATTHEW PARRIS

You see, that 24 billion is very much less than our own Chancellor Mr Lawson and our Prime Minister have been calling for. May I ask you what has been the reaction in Washington to those calls from Britain?

JEFFREY BIRNBAUM

Speaking privately some of the negotiators in Congress are somewhat resentful of the strong remarks by Mr Lawson, they've been, they indicate that in some ways those comments have been counter-productive because it's somewhat easy for someone from Europe to complain about the United States, it may be good politics they say, and they say that in fact Mr Lawson's comments are somewhat exaggerated and therefore don't have an impact, the impact of more even handed complaint coming from someone who - coming outside of the context of politics, or so they tell me.

MATTHEW PARRIS

Thank you Mr Birnbaum, now if I could turn Mr Pardee, Mr Pardee

MATTHEW PARRIS (contd)

you're the Vice Chairman of a leading Japanese Investment Bank in New York, what will the reaction of those whom you advise in Japan for instance, and the reaction of the markets be to a cut of the 23,24 billion dollar order that we're talking about? Will they be satisfied?

SCOTT PARDEE
VICE CHAIRMAN, YAMAICHI INTERNATIONAL INC.

Yes, I think there will be some disappointment because the, we already know about the 23 billion dollars, we've gone through this agreement process before, it's just a question of how it's going to be sliced between taxes and spending, so I think the markets are looking for something much larger, like double, the 23 billion dollars they're talking about. And it's not just the number itself, it's the process that's bothering the markets. We seem to have a loss of leadership by the administration as well as by the Congress, and dealing with really the biggest problem the United States has at this point.

MATTHEW PARRIS

So Mr Pardee, the markets are looking for something like double what's being offered, but what if they don't get it, what if they have to accept the 24 billion is there any other way, besides a cut in the deficit that those whom you advise could be reassured? What would happen?

SCOTT PARDEE

Well the main, the main reassurance would have to be a re-affirmation by the United States's Treasury, that the Treasury of the US Administration is going to support the dollar. I think the talking down of the dollar has done as much damage as the continuing debate over over fiscal policy.

MATTHEW PARRIS

How would they give that affirmation, would that mean interest rate rises?

SCOTT PARDEE

No, not necessarily. Just a re-affirmation I think that they, if they walked away it seems from the Louvre Agreement and this is part of the reason why the Chancellor of the Exchequer and other leaders abroad are beginning to put pressure on the Administration to sort out the problems we have here at home.

MATTHEW PARRIS

Thank you. Thank you very much gentlemen, both of you. Now let's go over to Bonn where we have, yes, yes we do Count Otto von Lambsdorff, who is the Economic Spokesman for the FDP, the minority partner in Germany's ruling coalition. Count Lambsdorff you've heard what they're saying in Washington, you've listened to this little interview. What is your reaction to that?

COUNT OTTO VON LAMBSDORFF
ECONOMIC SPOKESMAN, FREE DEMOCRATIC PARTY

Well, I think that to start with this remark, the remarks which Chancellor Lawson made were not at all exaggerated, I think they are appropriate and they are necessary. I would like to add two things to the speech, to the remarks which he has made. First, I do not believe that anything meaningful in the course of the budget deficit of the United States is going to happen before the next Presidential election. We have waited for this now for eighteen months under the Louvre Accord nothing has happened, nothing is going to happen. 23 billion cuts is nothing which the market would, the markets would regard as a credible signal of the United States's Administration to close the gap, I am pessimistic. Secondly, one other remark, I would strongly

COUNT OTTO VON LAMBSDORFF (contd)

recommend all of us to ask the United States now to refrain from protectionist trade legislation, because that indeed would lead us into a very difficult economic situation would-wide.

MATTHEW PARRIS

I take it Count, from what you say that Germany is not satisfied with the reaction that Washington has shown so far to this crisis?

COUNT OTTO VON LAMBSDORFF

No we certainly aren't.

MATTHEW PARRIS

Now today the heads of the world's central banks are meeting in Basle, do you think that the Germans might be able to be persuaded if the Americans are not, as you see it, co-operating that the Germans might be able to be persuaded at that meeting to play more of a part in maintaining the dollar? In maintaining interest rates?

COUNT OTTO VON LAMBSDORFF

Yes well what we have done is we have the Bundesbank has cut interest rates, not a very big cut, but they did only couple of days ago, but there is a mis-interpretation or mis-understanding, interest rates are made by the markets and they are not made by central bank decisions only, the discount rate for instance does not lead the interest rate markets any more, and that is true for the last ten or 15 years, certainly in the Federal Republic. We have decided on tax cuts, significant tax cuts, between 1986 and 1990, we are going to have a tax cut,

COUNT OTTO VON LAMBSDORFF

net tax cut of 50 billion Deutschmark, I would like to see these tax cuts coming up earlier, the Government says we can't do it for legislative reasons, I think it would be helpful and necessary to have earlier and perhaps even more far reaching tax cuts.

MATTHEW PARRIS

Count Lambsdorff, our Chancellor of the Exchequer has said that if the Americans do cut their budget deficit sufficiently, then the rest of the world will be able to lower its interest rates. Can he speak for the Germans in saying that?

COUNT OTTO VON LAMBSDORFF

I would suggest to the German government if something really does come out of Washington, once again Mr Birnbaum I'm sorry to say it I don't believe it, I don't expect it,but if something does come out of Washington I would strongly suggest to the German government to undertake a new effort in international economic co-operation and to deliver.

MATTHEW PARRIS

Are you confident that they will?

COUNT OTTO VON LAMBSDORFF

I think, I think there's a great readiness, that there's a broad discussion in this country what we could do and I hope they would.

MATTHEW PARRIS

Right,thank you Count Lambsdorff, it does appear from what you've said that the problem at the moment lies in Washington,

MATTHEW PARRIS (contd)

now I would like to move back to our London studio where I have with me Mr Michael Osborne, one of the City's leading economists, Mr Osborne, if the attitudes that we've seen just now in Washington and Bonn don't shift, if they stay much as they have been for the next few weeks, how are the markets going to react?

MICHAEL OSBORNE
CHIEF ECONOMIST, KLEINWORT GRIEVSON

Well, I think you're going to see far more of what we've already had. You saw last week the collapse of the dollar after the collapse of the stock markets, there are obvious implications for the American economy of that fall which given that the economy is now probably moving into recession will simply compound the situation and make the recession that much worse.

MATTHEW PARRIS

Now if the American economy goes into that much worse a recession, what will the impact on the world economy and on the British economy be?

MICHAEL OSBORNE

Well there are two effects here, firstly will be the direct effect on the growth rate of world trade, we're going to find it much more difficult to export as will everybody else. Secondly, will be the indirect effects via the further falls in stock markets. If Wall Street continues to fall we're going to continue to fall whatever might be said over here.

MATTHEW PARRIS

How would that affect British companies?

MICHAEL OSBORNE

Well, certainly they would be affected because of their exposure on the export front, we have to export to survive. Secondly, of course, a lot of UK companies are exposed to the United States because of the links they have over there with their subsidiary companies and so forth, and a fair chunk of the profits which are re-patriated to UK quoted companies, come from the United States, and that explains a lot of the very sharp fall in our market in relation to expectations perhaps at the moment about the economy.

MATTHEW PARRIS

In the circumstances of that harder landing, will it be possible in Britain do you think, to maintain the sort of growth rates that the Chancellor was talking about last week?

MICHAEL OSBORNE

I think one has to accept that two and a half per cent is at the top end of the range, if we do get further falls in the American stock market, further falls here, obviously we will get offsetting reductions in interest rates, but they're only offsetting, they won't completely offset, and the problem is the UK market is now looking for a much slower growth rate next year than two and a half per cent, that's why we've fallen.

MATTHEW PARRIS

Could it go so far as to stop economic growth for a while in this country?

MICHAEL OSBORNE

From where we stand at the moment that does not look likely, particularly because of what the Chancellor has said he will

MICHAEL OSBORNE

do and indeed what he has already done, everybody welcomes that, but if the Americans continue to fail to cut the federal deficit, continue to leave it to the Exchange rate, that must be a possibility, it's no good being the top of the league if the game's going out of business.

MATTHEW PARRIS

Again it seems that the Americans are the problem at the moment. Thank you very much indeed Mr Osborne. Plainly, a number of experts retain considerable scepticism about the prospects of economic stability being near to hand. In a moment I'll be talking to Nigel Lawson, the Chancellor of the Exchequer, but first, we'll take a break, stay with us.

MATTHEW PARRIS

Chancellor, you've made it clear that an international lack of confidence about the determination of the Americans to solve their budget deficit problems, lies at the heart of recent stock market crash, and recent continuing worries. Are you confident that the Americans are going to solve those problems?

NIGEL LAWSON MP
CHANCELLOR OF THE EXCHEQUER

I think that there is a very good chance, and certainly I know that Jim Baker, my opposite number, the American Treasury Secretary is trying very hard to do so. It's complicated in their system because it's not something that the administration alone can secure, it has to have the agreement of the Congress and the Congress has a democratic majority, opposition party majority, so it's difficult. But a lot of the agreement has already been reached, they are now both agreed that there have to be cuts in the deficit and they have both agreed now effectively that tax increases as well as spending cuts, have to play their part and so what they're now arguing about and discussing is precisely what the makeup of the package should be, how big it will be in the first year, and also something which hasn't been mentioned in the programme so far, which is also very important, how big in the second year.

MATTHEW PARRIS

So many of the reports that we're receiving suggest that the 24 billion is about as much as they're going to be able to agree. We don't get from the reports we're receiving from Washington any sort of confidence that they're going to get, be able to go beyond that 24 billion. You seem to.

NIGEL LAWSON MP

I hope they will, I think that that is desirable, I think that is right in economic terms, and I think it will reassure the markets and bring confidence back to the markets which is so badly lacking. But we shall have to see what they can come up with, it would certainly be desirable that it would be significantly greater than 23 billion.

MATTHEW PARRIS

Hope is one thing Chancellor, but how confident are you, your Autumn statement for instance seems to me to depend upon the Americans going very much further than that 24 billion, are you confident?

NIGEL LAWSON MP

Well not really. I've been working very hard to try and help promote a satisfactory international package, not merely spelling out what I believe it should contain, but also I've been in constant contact with my opposite numbers overseas, particularly in the United States and Germany which in many ways are the two key players here. But, of course, I'm also concerned to see that whatever happens the British economy is alright, and we have now a very, very strong position, a strong position economically, a strong position politically, and can, I think, weather any storm, after all if I may just point out we weathered the coal strike successfully, we weathered the collapse in the oil price successfully, we've weathered during my time as Chancellor, there was extraordinary girations in the dollar.

MATTHEW PARRIS

I hope we'll come to the question of economy in...

NIGEL LAWSON MP

...so I believe that we can successfuly react to this whatever happens, but obviously if we can get a satisfactory international package that would be infinitely better.

MATTHEW PARRIS

If, Chancellor, if, so much seems to depend upon it, it's, and I must put this to you, it's taken the worst crash in Wall Street's history to produce some sort of movement towards a 24 billion dollar cut, everybody agrees that much more is needed, it's not enough for a Chancellor to say that we hope that this will happen, how confident can you honestly feel?

NIGEL LAWSON MP

It's not true that the Americans have done nothing. And it's not true that we have done nothing internationally until now, we discussed all this, the problem of American deficit at the Plaza Agreement in September 1985, the Finance Ministers of the major nations, and again at the Louvre Agreement in February of this year. And partly as a result of that, the Americans did in the year which has just ended cut their budget deficit by over 70 billion dollars, a cut of one third from what it was already. So it's not true that they've done nothing until now, they have done a great deal. The problem is that more needs to be done, particularly since other countries are beginning to get sceptical about whether it's sensible for them to go on financing the deficit and indeed about the, the worry about the Americans political capacity to deal with the problem, and so more needs to be done, and I have been doing everything that I can to try and help this and of course, as you know, the Prime Minister has written personally to President Reagan about this.

MATTHEW PARRIS

Chancellor, we all agree that more needs to be done, the question is how much is going to be done. Now we look over at what people are saying in the United States, Martin Fitzwalter, the President's spokesman, says that agreement was not imminent, Beyl Sprinkel who's the President's Chief Economic Adviser, says that tax increases are highly unlikely, Thomas Foley the Democrat Leader in the House, says that talks were unlikely to result in more than a 23 or 24 billion dollar reduction in the

MATTHEW PARRIS (contd)

deficit. All these in the last couple of days, if they're so pessimistic, how can you feel confident?

NIGEL LAWSON MP

I believe and I obviously have no control over what is happening there, this is a matter which the American administration and the United States Congress have to agree together.
But I believe that before the deadline of the 20th November, and the sooner the better as far as I'm concerned.
But I believe before the deadline of the 20th November they will come up with an agreed package which will contain tax increases as well as deficit, as well as expenditure cuts to deal with the deficit, and it'll be a substantially bigger I believe for the second year than it will be for the first year, whether the overall size and composition of the package is sufficient, sufficient in its own right and sufficient to restore confidence in the markets immediately, we shall have to see, but I believe that they're going to come up with something, I'm sure of that.

MATTHEW PARRIS

Chancellor it's fine to be confident about agreement by the 20th on the 24 billion dollar package, everyobdy is confident about that, it's about the size and scope of what you say and others say has to follow, that there is so much uncertainity. Now it can't be the case that you're simply depending for your medium term financial strategy, for the prospects that you've set out for Britain in your Autumn statement, that you're simply depending on the hope that something better will occur.

NIGEL LAWSON MP

Well no, you're quite right, and as I indicated a moment ago I am already in the process of making plans to insure that whatever happens so far as the United States is concerned, the British economy will be alright. And we do start in an exceptionally strong position and we can see that we are alright.

MATTHEW PARRIS

Now, right now bankers are meeting, heads of the central banks are meeting in Basle.
What sort of agreement do you expect that they'll be able to reach there, for instance to carry on supporting the dollar until there are clearer signs coming from the United States.

NIGEL LAWSON MP

I don't think that much is going to come out, or is expected to come out of that agreement between the central bankers.
Any substantive agreement is going to have be an agreement reached between the finance ministers and central bankers of the seven major countries meeting together, so called G7, group of seven meeting. And that I believe will take place just as soon as the Americans have sorted out their budget deficit reduction package.

MATTHEW PARRIS

What is the Basle meeting about today then, what does it add up to?

NIGEL LAWSON MP

The Basle meeting is a routine meeting, they have these meetings pretty well every month. Obviously they will be discussing the, privately, they will be discussing the current situation.
But it, I don't think that anything, any decisions are going to come out of that. Decisions will have to wait first of all for a meeting of the finance ministers, and that will in turn, will have to be after the Americans have resolved their current negotiations between the administration and the Congress.

MATTHEW PARRIS

Is there any limit to the scale and the size and continuation of central bank intervention in order to maintain the dollar, or will patience with the United States run out?

NIGEL LAWSON MP

You cannot sustain the dollar by intervention alone. You need to have, first the various countries pursuing the right economic policies which that intervention then is supporting, is going with the grain of the economy or the market. And secondly you have to have a readiness to use interest rate differentials between the various countries in order to sustain it. But I believe that there is a clear desire among all the countries concerned, to have, as we have for most of the time since February, far greater than the market ever thought possible, a degree of stability in the exchange rates. But of course, in the light of recent events, it is now all the more important of course that America commits herself very fully to that, and in deeds as well as words.

MATTHEW PARRIS

Well I'll come on in a moment if I may to the other countries concerned, but let's take Britain. Very recently you've pushed interest rates down, do you think that you may have too, and that you will be able to do that again if it proves necessary.

NIGEL LAWSON MP

Well certainly if it proves necessary I shall do it.

MATTHEW PARRIS

So do you think that, at least in the next week or so, that that sort of pressure is going to be put on you. What if the markets jump for instance, if there is a sudden loss of confidence in the dollar, how will you react?

NIGEL LAWSON MP

I'm not going to say now how I'm going to react. I have to take everything into account, but certainly I think recent events have shown that I am prepared to react and react quickly if it is necessary to do so to keep the British economy going ahead well as

NIGEL LAWSON MP (contd)

it is, and the two and a half percent growth which I've forecast for the next year, 1988, it's obviously huge margin of error bearing in mind the uncertainties of the present situation. But it is a forecast which is meant to take into account what has happened in the stock markets already and the likely effect of that.

MATTHEW PARRIS

You've done your best Chancellor, but being brutally honest are you, and other economic leaders in the Western world not now reduced to standing on the sidelines hoping that the Americans will do the right thing, urging them to do the right thing, but lacking any real power to persuade them to act further?

NIGEL LAWSON MP

No it's not like that at all. Obviously each country is sovereign. But the Americans are not the, although they're the most powerful nation in the Western world, and therefore the most powerful economically, the rest of the world is much more important taken together. If you take the Japanese economy which is a very strong economy and going ahead well at the present time, and if you take the European economies, including the British economy, we're not just corks bobbing helplessly on the surface of the ocean, nothing like it. We can, I think see that we get through this difficult patch with some, obviously reduction in the rate of growth but nothing alarming, but it would be very much better if we can get an international agreement and the Americans obviously have a crucially important role to play there.

MATTHEW PARRIS

Chancellor, a difficult question and I realise that it is, but with the markets in the very nervous state that they are now in, can a British Chancellor do anything more than talk up the economic chances, would he dare to say if he were seriously worried?

NIGEL LAWSON MP

Yes I think than he can do a great deal more than just talk up, he can make sure, he can take measures which make sure that he keeps his own house in order.
And that's what I've done and that's what I shall continue to do.

MATTHEW PARRIS

Would you say if you felt an underlying lack of confidence, if you thought that there was a real danger that things were going to slide into sharp recession, would it be the right thing for a Chancellor to say?

NIGEL LAWSON MP

I don't know whether it would be the right thing or the wrong thing. But I can tell you that I have been speaking frankly, I have been speaking frankly to the British people, and indeed some people were saying that my speech at the Mansion House last week was if anything too frank, but I felt it was right to give an account of why I thought this particular collapse in the markets had happened, what the problem was and how we should set about putting things right.

MATTHEW PARRIS

Let's return now to the prospects for Britain which you spoke about in the House in your Autumn statement. You painted a fairly rosy picture of the prospects for Britain. You said that prediction was a hazardous business, but you also said that no economic blizzard, however strong, could blow us seriously off course.
Are you sure?

NIGEL LAWSON MP

Yes I certainly believe that to be so. If you look at the performance of the British economy in recent years, it has been quite remarkably strong, I mean stronger than we've ever known before in this country.

NIGEL LAWSON MP

Whether you look at the continuous rate of growth year after year, whether you look at inflation staying low, whether you look at manufacturing productivity grown faster than other country in the world and the fact that we've been able to do this despite, for example, the oil price collapsing, we never would have thought, Everybody thought our whole economy depended on that. It has the strength.

MATTHEW PARRIS

I'll give you the strength of the British economy for the purposes of this argument, it may be fairly widely accepted that the British economy starts in a much stronger position than many others. But if there is a major sharp world recession, what would the impacts on Britain be.

NIGEL LAWSON MP

Our task, and by our I mean not merely my task but also the task of all the, my opposite numbers in the major nations of the world. Our task is to avoid a major recession, the only complaint I have about the interviews and so on which I've watched with interest before you came to talk to me, was that a number of people seemed to be drifting from warning about the dangers of world recession to talking as almost as if it were upon us. It's not. We can avert it and we will avert it, one of the most important things we have to do, which I believe again we can and will do, is what Otto Lambsdorff was saying, avoiding a lurch into protectionismn, and there the President Reagan has been very, very strong. He has made it absolutely clear that he is not prepared to endorse any protectionist legislation that Congress may promote and I sincerely hope in present circumstances it will desist from promoting it.

MATTHEW PARRIS:

I must bring you, Chancellor, back to my question to which you replied that your task was to try to avoid a major world recession. Of course it is, but doesn't the public deserve more? If I had the Secretary of State for Defence with me and we were talking about Britain's military preparedness, and he said that his task was to avoid war and that if world statesmen behaved coolly and sensibly and with level heads, there would be no war, that wouldn't be enough: I would want to know about his state of preparedness should the worst happen. You must have been thinking about the possibility of a major world recession.

NIGEL LAWSON, MP:

Yes I think the analogy is a rather good one if I may say so. I mean that is precisely what our defence policy is, it is to deter a world war because we know what a terrible thing a world war would be and nobody's denying that it would be the most appalling thing, and therefore our policy is entirely one of deterrence. Now in much the same way, obviously a world recession is nothing like as bad as a world war, but our policy is to avert a world slump, and I'm confident that having learnt from the lessons of what happened following 1929, having the degree of international cooperation that we do have now, and the economies fundamentally in a sound position - most of them, most of the world's economies, that we can avert a recession.

MATTHEW PARRIS:

Of course it's accepted, Chancellor, that our policy is to try to avert a world recession and of course we all hope that you do, but at the Mansion House you said that the British economy could escape the effects of a world slump. Can that be true?

NIGEL LAWSON, MP:

Oh yes, it can certainly, it can't escape all the effects of a serious world recession and indeed I have already demonstrated this by the fact in the sense that I've revised down my forecast of the likely rate of growth in the coming year. But what we can ensure is that although we are, of course, not unaffected, the effects are not major.

MATTHEW PARRIS:

Your scaling down, though, in your autumn statement was not for the effects of a major world recession, it was for the effects of a rather softer and more managed landing. How much further would you have to scale down that 2½% growth forecast for a major world recession?

NIGEL LAWSON, MP:

I don't know, that's a hypothetical question. As I say, I beleive firmly that we can avert a major world recession. If there were to be one, we would certainly be able to ensure that the British economy went on growing and that we were not, in ourselves, involved in the slump as we were in the 1930's. That I'm confident about.

MATTHEW PARRIS:

Chancellor, of course it's a hypothetical question, Chancellors deal in hypothetical questions, your scenario for the soft landing in your autumn statement was a hypothetical scenario. I'm asking you to look at another hypothesis, the hypothesis that the landing is harder than was predicted and asking you to accept, as I sense that you do, that in the case of a serious world recession, 2½% would be optimistic and we would have to come right down from that. Is that right?

NIGEL LAWSON, MP:

Well I've indicated as you rightly reminded the viewers that I said when I produced my forecast, that forecasting is a hazardous business, particularly at the present time. But you know even the 2½% which I forecast is better than it seems because that's 3% for the rest of the economy other than North Sea oil because North Sea oil is now we're declining our production and North Sea oil is declining. So that the rest of the economy, which is where most of the people are employed, would on my forecast be going ahead at 3%. Now if, in fact, it goes ahead a little bit less than that, that's not something to be worried about.

MATTHEW PARRIS:

Not a little bit less, Chancellor, people are worried about a serious world recession and there you go again going back to the soft landing scenario and I'm not challenging your 2½% growth forecast there, I'm asking you to revise it downwards for the possibility of a more serious world recession. You would have to.

NIGEL LAWSON, MP:

No I think obviously I will have to make a new forecast which I will do in February, and on the basis of that I shall decide my budget judgement in the spring. But at the present time the forecast I have given is the best forecast I can give, and as I say I think what is important is that a serious world recession can be averted, and must be averted, and I believe will be averted.

MATTHEW PARRIS:

Chancellor, you gave one forecast for one scenario; the scenario in which we do succeed in averting a serious world recession. Alan Budd at the London Business School has produced for us a forecast in which he looked at the possibility of a more serious world recession and its effects on the British economy. He looked at a halving of growth rates, he looked at rising unemployment, and he said that that was an optimistic view because that didn't take into account the collapse in confidence that there might be, there would be, amongst businessmen in the event of a serious recession. Would you take issue with Alan Budd?

NIGEL LAWSON, MP:

I'd take issue with him in the sense that I don't think that's going to happen. Obviously if you're asking me to agree that a serious world recession is a bad thing and that people do find the going tougher, well of course that's so. But it's my job to avoid it.

MATTHEW PARRIS:

Chancellor, you said we could weather any storm.

NIGEL LAWSON, MP:

Yes I believe we can, certainly we can.

MATTHEW PARRIS:

So whatever happens in a serious world recession, British growth will continue. You can't see any prospect....

NIGEL LAWSON, MP:

It won't continue at the same rate, but it will certianly continue.

MATTHEW PARRIS:

And you don't, for instance, see any possibility of us having to accept rising unemployment again, having to accept a standstill in our growth rate?

NIGEL LAWSON, MP:

I don't know what you mean by a standstill in our growth rate, if you mean no growth rate. I don't think that's going to happen. I don't think that's going to happen at all, we can ensure that we go on growing. The British economy really is in a very strong position, British industry has never in my lifetime been more efficient and more competative; confidence is strong and our unit labour costs are rising less than those of our major competitors and I see us going through this, weathering this storm as, as I said we did the coal strike, which went on for a year and many people thought the economy couldn't stand that, many people thought it couldn't stand the collapse of the oil price and in fact we withstood that without any harm and we are in a stronger position now even than we were then.

MATTHEW PARRIS:

But nobody's suggesting, Chancellor, that we won't weather the storm in the sense that the economy will entirely collapse, they're simply looking at what sort of problems, what sort of turbulence we might encounter during that storm. We know it would be less, the growth rate, than $2\frac{1}{2}$%, you've said you don't believe that it could be less than zero, well could it come down to 1% for instance?

NIGEL LAWSON, MP:

I don't think there's any point in bandying figures about.

MATTHEW PARRIS:

Why not, you bandied the $2\frac{1}{2}\%$ about?

NIGEL LAWSON, MP:

Yes, because I'm obliged to make my best forecast twice a year and I do that, I make a forecast in the autumn which I've done, which is the best forecast I could make and it was a very optimistic one in the circumstances, although there was some slow down in growth there. I will also do a second forecast which will be at the time of the budget, I don't make inpromptu forecasts in between the two, Mr. Parris.

MATTHEW PARRIS:

Don't you think, Chancellor, that the British people do deserve to know a little of your thinking about the possibilities of how things might go if the soft landing scenario, which you envisaged in your autumn statement, doesn't occur. Don't we deserve to hear a little more?

NIGEL LAWSON, MP:

I think what the British people have a right to expect is that I will take whatever measures are necessary to make sure the British economy is secure, and the British economy is affected as little as possible by any difficulties that there are outside, and that is precisely what I shall do.

MATTHEW PARRIS:

Well let's now look at the measures that you might be obliged to take, and I would like to stay for a little while on the possibility of a hard landing for the world's economy, and a look again at Alan Budd's figures. Alan Budd suggested that it wouldn't just be for real jobs in the economy, the real economy, that we would have to look again, it would also be for the Government's borrowing figures that the difference between what the Government spends and what it gets in revenue in the even of a serious world recession might have

MATTHEW PARRIS (cont'd)

to rise, that deficit would come under serious strain. How would you react to that? You see apart from the extra billion or so that Alan Budd predicted might need to be spent over the target, there would also be quite possibly the need to buy back all those BP shares and that's another 1½ billion, so already we're 2½ billion over the target. Do you let us go over the target like that?

NIGEL LAWSON, MP:

Well it's interesting that you quote that figure 2½ billion, that's a purely speculative figure, but let's just fasten on that for a moment. The borrowing requirement now looks like turning out at a billion for this year, quite astonishingly low. What I had budgeted for, and what I had obviously considered was economically ok, otherwise I would not have budgeted for at the beginning of this financial year, was 4 billion, so even if you add the 2½ billion, and I don't think it is right to do so, but even if you were to add the 2½ billion to the billion which I've projected the autumn forecast, that brings you up to 3½ billion which is still within the 4 billion deficit which I ~~we~~ set at the time of the budget. So the whole thing is containable, completely containable, because we have got the public finances in such a sound position, and that is of course in stark contrast with the position in the United States where their problem is precisely because they have not got their public finances in a sound position.

MATTHEW PARRIS:

I perhaps didn't make myself clear, Chancellor, Alan Budd was talking about 2½ billion above the 4 billion target, so that takes us to 6½.

NIGEL LAWSON, MP:

Oh well if he was talking about that then I would disagree with him.

MATTHEW PARRIS:

You see I spoke last week to John Redwood, one of your colleagues, a member of Parliament who was until quite recently the head of the Prime Ministers policy unit. John Redwood thought that in the event of a serious recession, and in the even of serious and sustained pressure on the borrowing requirement that it would be quite right for a Chancellor to allow borrowing to rise to 5, 6 or 7 billion pounds. Would you disagree with him?

NIGEL LAWSON, MP:

I would not want to see public sector borrowing requirements at that level. We have secured the position that we have as a result of prudent public finance, getting the borrowing requirement down, many people said at the time if you get the borrowing requirement down it'll have a depressing effect on economic growth; quite the reverse, as the public sector borrowing requirement has come down , as the budget deficit has steadily become less, so we have been growing faster now this year than any other major nation in the world, and so I would not wish to reverse course there, But as I say, I don't believe that we are going to have this major world depression that you talk about, and it is absolutely vital that we avoid it, just as I don't believe - to use your parallel - that we're going to have the world war which you were talking about.

MATTHEW PARRIS:

Well, say that you do refuse to change course and you do stick to the 3½ billion that you spoke of a while ago, you wouldn't then have room for tax cuts in a serious world recession.

NIGEL LAWSON, MP:

I've no idea what the scope will be at the time of the budget in the spring, I will have to as I indicated a moment ago anyhow, make a new forecast then, and on the basis of that forecast decide what the scope is, if any, of a reduction in taxation and what would be the appropriate public sector borrowing requirement, have to decide that at the time in the light of the world conditions and the British economy. What I am confident

NIGEL LAWSON, MP, (Cont'd)

of is that I can produce a budget which will ensure, as my previous budgets after all have done, that the British economy continues soundly to go ahead.

MATTHEW PARRIS:

Would you drop tax cuts, Chancellor, to keep borrowng at this level?

NIGEL LAWSON, MP:

All I will say to you is this, because I can't anticipate my budget, but what I'll say to you is this, that one of the reasons why I think the Prime Minister and I do have the authority to tell the Americans that they really do need, as the Americans themselves accept, that they do need to cut their budget deficit if necessary putting up taxes, is because we came into office in 1979 as a party committed to lowering taxation. We inherited a huge budget deficit and we took steps to reduce that budget deficit ourselves which included, at the time, increasing taxation, notably in Geoffrey Howe's 1981 budget.

MATTHEW PARRIS:

So you'd do it again if necessary?

NIGEL LAWSON, MP:

So at that time we were prepared to practice and not just preaching. I don't believe this is likely to be necessary, but what I can assure you and everybody who may be watching this programme, is that whatever is necessary to do, to keep the British economy sound, that I will do.

MATTHEW PARRIS:

And if putting taxes up again to keep borrowing down did prove to be necessary, though you hope and believe it won't, then you'd do it?

NIGEL LAWSON, MP:

Yes, but I don't believe it will be because we've got our public finances in such a sound position. We've got our public sector borrowing requrement now down to a level which I think only on three occasions since the early 1950's has it been as low as that.

MATTHEW PARRIS:

Chancellor, I asked you just a moment ago whether you would be prepared to put taxes up if it was necessary to stick to your borrowing requirement, your reply started with two words 'Yes, but' and you then went on to say that you didn't believe that it would happen, but I take it that if it did happen you would.

NIGEL LAWSON, MP:

I will do, as I say, whatever is necessary whether it is on the monetary front; that means interest rates, or whether it's on the fiscal front; that involves taxation, to keep the British economy sound and secure. But I think it is highly unlikely, highly unlikely, that that would involve any increase in taxation. But I would do whatever is right and whatever is necessary.

MATTHEW PARRIS:

Might that include sacrificing further falls in unemployment as well?

NIGEL LAWSON, MP:

No, on the contrary, it is because we have pursued the policies that we have that unemployment has now been falling, falling faster than any other major country in the world, and I believe it will continue to fall over the coming year. Not perhaps as much, not perhaps as much as it has over the past year but I believe it is likely to continue to fall.

MATTHEW PARRIS:

One of your predecessors, Mr. Callaghan, compared the office to the progress of a duck across a pond; he said that one

MATTHEW PARRIS, (CONT'D)

appeared to be buoyant and gliding across the surface, on the surface, but underneath one was paddling like hell. Is that how you feel now?

NIGEL LAWSON, MP:

No I don't think it is. I think that the state of the British economy has improved tremendously since Mr. Callaghan, Lord Callaghan as he now is, was Chancellor of the Exchequer. And of course it's a job which involves hard work, you have to keep your eye on a lot of balls at the same time but no I think that we are fortunate that if this sort of storm, this international blizzard, had to come it has come at a time when the British nation is economically strong and politically strong. And that will see us through.

MATTHEW PARRIS:

Chancellor, thank you very much indeed.

FTSE -48
DJ -50
HS -15

SECRET

MG NOON REPORT

FINANCIAL MARKETS

Monday 9 November 1987

| Opening | 10 AM | | NOON | | Oil Price (10 AM) | |
|---|---|---|---|---|---|---|
| 75.5 | 75.4 | £ERI | 75.4 | | | |
| 1.7850 | 1.7825 | $/£ | 1.7820 | 1.7935 | Nov | $17.70 |
| 2.9831 | 2.9803 | DM/£ | 2.9804 | 2.9800 | Dec | $17.80 |
| 1.6712 | 1.6720 | DM/$ | 1.6725 | | Jan | $17.90 |
| 134.85 | 134.90 | Yen/$ | 134.95 | | | |

| UK interbank £ | | | Eurodollars | |
|---|---|---|---|---|
| 9 3/8 | (-3/16) | 7 day | 6 5/8 | (-) |
| 8 15/16 | (-3/32) | 1 month | 6 3/4 | (-) |
| 8 5/8 | (-1/4) | 3 month | 7 1/4 | (-) |
| 8 3/4 | (-3/16) | 12 month | 7 3/4 | (-) |

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange market the dollar eased in New York on doubts as to whether Washington will be able to settle its problems on the Budget deficit.
The dollar opened here slightly down on Fridays close but has firmed slightly this morning. Sterling opened down on Fridays close close and has eased this morning on selling from Middle East sources, and on market acceptance of recent UK interest rate cuts.
The US and Japanese equity markets closed down with the Hong Kong market closing up. Dow Jones 1959 -26, Nikkei 22418 -218, Hang Seng 2139 +25.
The FTSE100 opened at 1585 -36 and is now at 1576 -45.
The gilts market has continued firm this morning and the Bank has supplied stock.

R McRobbie

MARKET INTERVENTION ($m)

Overnight -

Today so far -

Total -

OTHER COUNTRIES INTERVENTION ($m)

Japan +225$
United States +70$ agst DM (6.11.87)

GILTS

| | Latest market movements | Price change since previous close |
|---|---|---|
| Shorts | Steady | +25/32 |
| Mediums | Better | +41/32 |
| Longs | Better | +31/32 |
| Futures (Long Contracts) | | +50/32 (Vol:14447) |

Gilt Sales since market opening

+£83.0 million of which +57.0 was Index Linked

NAME: Miss R J McRobbie, MG1 Division

57

From: R B SAUNDERS
Date: 9 November 1987

MR GRICE) separate copies
MR ILETT)

cc PPS
PS/Economic Secretary
Sir T Burns
Mr Cassell
Mrs Lomax o/r
Mr Peretz

**MARKET FACTS**

Sir Peter Middleton would be grateful for some statistical information covering the following points:

(i) what have been the levels of turnover in the equity and gilts markets since 15 October? How do these compare with typical levels pre- and post-Big Bang? Do we know how far these are transactions between market-makers and how far with institutions? In other words, to what extent could it be said that the stock market fall is the result of traders marking down their prices rather than real selling pressure from institutions;

(ii) how do present market levels compare with those in the past? How does the fall since 15 October compare with that on other exchanges over the same period? And how do they compare with their levels a year ago?

(iii) how is market liquidity, both overall and individual institutions? How has overall liquidity been affected by intervention over the last year or so?

SAUNDERS 10/11

2. Could you please agree a division of labour. I imagine questions (i) and (ii) are for FIM and (iii) for MG. Could I ask for replies by close of play **tomorrow, Tuesday 10 November.**

RBS

**R B SAUNDERS**
Private Secretary

CH/EXCHEQUER
REC. 10 NOV 1987
ACTION Mrs Lomax
COPIES TO CST EST
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr R I G Allen
Miss O'Mara
Mr A Hudson
Mr Cropper.

10 DOWNING STREET

LONDON SW1A 2AA

*From the Private Secretary*

9 November 1987

Dear Alex,

**MARKETS**

Lord Stevens, Chairman of United Newspapers and MIM Britannia Limited, called to see the Prime Minister this morning. Some of the discussion concerned the markets, and Lord Stevens made a strong attack on the performance of the Stock Exchange over the past few weeks. The markets had been thin and it had often proved extremely difficult to deal. The market capitalisation of MIM had been moved on occasion by tens of millions of pounds on the basis of a selling order of a few tens of thousands of pounds. Market makers had widened their spreads and at one stage one major broker had tried for an agreement under which market makers would widen their spreads to 10 per cent. Lord Stevens also said that broker had sent MIM no statement since February this year. It was difficult to see how they could know what their profits were when they had not reconciled their dealings with customers. At one point he had told MIM's dealers to turn off their Stock Exchange screens. Wall Street in contrast had coped with record volumes.

!?

I am sure the Prime Minister will want to return to this subject in the next few days, and she may well feel inclined to discuss it in her Guildhall speech on Monday. I should be grateful for your urgent comments. Among other things, it would be helpful to have an analysis of turnover in London and New York over the past few weeks in relation to movements in the stock indices, and how turnover has compared with more normal times. Lord Stevens also argued that UK institutional investors are short of liquidity, and it would be useful if this could also be covered.

I am copying this letter to Tim Walker (Department of Trade and Industry).

Yours,

David.

David Norgrove

Alex Allan, Esq.,
H.M. Treasury.

LORD STEVENS

4556/020

CONFIDENTIAL

FROM: J W GRICE

DATE: 10 November 1987

SIR PETER MIDDLETON

cc PPS
PS/Economic Secretary
Sir T Burns
Mr Cassell
Mrs Lomax
Mr Peretz
Mr Ilett (o/r)
Mr Pike
Mr Neilson
Ms Bronk

Ch
No response yet on other point

GRICE 10/11

**MARKET LIQUIDITY**

Mr Saunders' minute of 9 November asks for information from MG about the level of market liquidity, both overall and for individual institutions, and the effect of intervention over the last year. The attached note is in response.

2. The main points are as follows:

a) intervention has added to private sector liquidity. In the 12 months to September 1987, the effect was to add some £6 billion to liquidity with a further £4 million in October. But this was offset by other public sector transactions; in particular by the heavy public debt sales to the private and overseas sectors well in excess of the PSBR. In the year to September public sector transactions overall reduced private liquidity by about £3½ billion. October's largely unfunded intervention will probably have changed this to a flat position (First Guess figures arrive today) but not to a major positive contribution (see Table 2);

b) private sector liquidity as a whole has been rising faster than money incomes but much more slowly than total financial wealth. So the liquid asset proportion of the private sector portfolio has been dropping to very low levels. In this sense, it has been "illiquid" even though the absolute amount of liquidity has been rising rapidly. The fall in equity prices will, as a matter of arithmetic, have raised the liquid assets proportion though it must still be well below levels typical of the 1970s and early 1980s. Moreover, it may well be below where the private sector would wish it to be in the aftermath of the equity fall;

c) for some time the proportion of the portfolios of the pension funds, life assurance companies and investment trusts held in liquid assets has been at probably minimum operational levels. As with the private sector as a whole, rapid growth in their liquid assets reflected only the fast growth of their portfolios overall. The fall in equity prices will have raised their liquidity ratios but probably by less than the shift in their liquidity preferences. On plausible assumptions, their current liquidity ratios are below levels typical of earlier bear markets;

d) unit trusts look to have higher liquidity ratios. But their liquid assets are not large in relation to possible outflows. Market rumours that unit trusts have been heavy sellers of equities could be well-founded if managers have responded to or anticipated sizeable withdrawals.

JWG

J W GRICE

## MARKET LIQUIDITY

This note is in three sections:

(a) it examines how overall liquidity has behaved since October 1986 and the counterparts to the increase; in particular the contribution of intervention;

(b) it considers the liquidity measures in relation to macroeconomic variables such as income and wealth;

(c) it looks at the liquidity positon of the main institutions which invest in equities.

### a. Overall Liquidity and its Counterparts

2. The following table shows the annual growth rates of the three main measures of private sector liquidity over the last year:

**Table 1: Measures of Liquidity**

Percentage change over a year earlier

| | | M3 | M4 | M5 |
|---|---|---|---|---|
| 1986 | Oct | 18.5 | 15.8 | 15.1 |
| | Nov | 18.6 | 15.6 | 15.1 |
| | Dec | 18.1 | 15.2 | 14.4 |
| 1987 | Jan | 17.6 | 13.9 | 13.3 |
| | Feb | 19.0 | 13.9 | 13.3 |
| | Mar | 19.0 | 13.9 | 13.4 |
| | Apr | 20.4 | 14.5 | 14.0 |
| | May | 18.8 | 13.6 | 13.4 |
| | Jun | 19.1 | 13.8 | 13.5 |
| | Jul | 20.8 | 14.8 | 14.3 |
| | Aug | 22.0 | 15.5 | 14.9 |
| | Sep | 19.5 | 14.9 | 14.3 |
| | Oct * | 22.2 | n/a | n/a |

3. M3 has been growing faster than the other two measures of liquidity. This probably reflects no more than changes in the relative attractiveness of banks and building societies and, in

* First guess, subject to wide margin of error

present circumstances the wider measures M4 and M5 are probably more reliable. Even so, growing at rates of around 14-16 per cent, liquidity is expanding at about twice the growth rate of money GDP.

4. The private sector can hold liquid assets as the result either of transactions of the public sector or transactions with financial institutions - banks and building societies - which are themselves private sector bodies. It is therefore possible to see how public and private sector transactions have contributed to the overall increase in liquidity. Table 2, facing, shows the cumulative increase in M5 monthly over the year to September 1987. Several points emerge:

(a) although intervention over the last year has been heavy, which itself would have acted to increase private sector liquidity, this has been largely offset by other public sector transactions. In particular, sales of public sector debt have been substantial. In the earlier part of the year, these were both to the private sector and to the overseas sector. In the current financial year, they have been mainly to the overseas sector. The consequence of this is that the net public sector contribution to liquidity over the last twelve months has been negative though relatively small. This is not purely accidental. The full fund rule is based on M3 rather than M5. But it has kept the public sector contribution close to zero on either measure;

(b) bank and building society lending - some £53½ billion in the year to September - more than explains the total increase in liquidity over the same period - £38½ billion. Some of the excess has gone into increased foreign currency deposits; residents have sold some of their sterling liquidity in return for increased foreign currency deposits. A further £7 billion has been absorbed by non-deposit liabilities - private sector assets held with the banks or building societies but not in liquid deposit form.

5. October's experience will make some difference to these numbers. Full figures are not yet available but intervention totalled nearly

4556/018



## Table 2: Sources of the Increase in Private Sector Liquidity over the Last Year

### M5 CUMULATIVE INCREASE FROM SEPTEMBER 1986 TO:-

£ billion

| | 1986 Dec | 1987 Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep |
|---|---|---|---|---|---|---|---|---|---|---|
| Public Sector Transactions | | | | | | | | | | |
| PSBR | -1.6 | -5.3 | -5.7 | -2.5 | -0.6 | -0.8 | -1.4 | -1.8 | -1.1 | -0.9 |
| Public sector debt sales:- | | | | | | | | | | |
| to private sector (-) | -2.1 | -3.3 | -3.2 | -3.1 | -3.6 | -4.1 | -4.1 | -3.3 | -3.0 | -2.9 |
| to overseas (-) | -0.9 | -0.6 | -0.9 | -1.7 | -2.3 | -2.3 | -3.7 | -4.8 | -5.4 | -6.0 |
| Intervention | -0.3 | -0.2 | -0.1 | 1.2 | 3.0 | 5.9 | 5.7 | 6.0 | 5.7 | 6.0 |
| Other public sector transactions | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 | 0.3 | 0.3 | 0.3 | 0.4 | 0.3 |
| **Total Public Sector Contribution** | -4.6 | -9.1 | -9.5 | -5.7 | -3.1 | -1.0 | -3.2 | -3.7 | -3.4 | -3.5 |
| Private Sector Transactions | | | | | | | | | | |
| Bank and building society lending | 14.8 | 17.7 | 21.3 | 25.8 | 28.7 | 32.5 | 38.7 | 44.5 | 46.9 | 53.5 |
| Bank and building society non-deposit liabilities(-) | -1.6 | -0.1 | -0.6 | -2.8 | -3.5 | -5.0 | -5.6 | -4.1 | -4.8 | -7.2 |
| Overseas net sterling bank deposits (-) | 0.1 | -1.4 | -1.3 | -1.1 | -1.7 | -3.5 | -2.4 | -2.8 | -2.5 | -2.3 |
| Other private sector transactions | -1.9 | -1.0 | -1.1 | -0.6 | -1.2 | 0.2 | -0.1 | -1.3 | -0.9 | -2.1 |
| **Total Private Sector Contribution** | 11.4 | 15.2 | 18.2 | 21.4 | 22.3 | 24.2 | 30.6 | 36.4 | 38.7 | 41.9 |
| **Total Increase in Private Sector Liquidity (M5)** | 6.8 | 6.1 | 8.7 | 15.7 | 19.2 | 23.2 | 27.4 | 32.7 | 35.3 | 38.4 |

£ billion over the month whilst gilt sales to all sectors were around £1½ billion. This will tend to increase the public sector contribution to private liquidity. But the basic story - that public sector transactions have not been a major source of increased liquidity over a period of time - is unlikely to be much affected.

## b. Private Sector Liquidity in Relation to Income and Wealth

6. On any of the main measures, private liquidity has been rising faster than income throughout the 1980's. One consequence has been that the ratio of liquid assets to income has risen to record levels; the inverse - velocity of circulation has fallen to low levels.

**Table 3: Private Sector Liquidity and Income**

£ billion

| | | M5 | Money GDP | Liquidity Ratio (%) |
|---|---|---|---|---|
| 1979 | | 109.0 | 197.4 | 55.2 |
| 1980 | | 123.4 | 230.6 | 53.6 |
| 1981 | | 141.3 | 254.1 | 55.6 |
| 1982 | | 158.8 | 277.5 | 57.2 |
| 1983 | | 181.0 | 301.5 | 60.0 |
| 1984 | | 203.4 | 322.7 | 63.0 |
| 1985 | | 229.9 | 354.3 | 64.9 |
| 1986 | Q1 | 250.1 | 370.4 | 67.5 |
| | Q2 | 260.2 | 374.0 | 69.6 |
| | Q3 | 267.9 | 381.2 | 70.3 |
| | Q4 | 276.3 | 390.0 | 70.8 |
| 1987 | Q1 | 285.0 | 396.4 | 71.9 |
| | Q2 | 296.5 | 404.4 | 73.3 |
| | Q3 | 307.6 | n/a | |

7. On the other hand, the total financial wealth of the private sector has increased even more quickly than liquidity. Consequently the proportion of the private sector portfolio held in liquid asset form has fallen steadily.

## Table 4: Private Sector Liquidity and Financial Wealth

£ billion

| | M5 | Private Financial Wealth | Percentage of Portfolio held in Liquid Assets |
|---|---|---|---|
| 1979 | 109.0 | 253.0 | 43.1 |
| 1980 | 123.4 | 287.6 | 42.9 |
| 1981 | 141.3 | 339.8 | 41.6 |
| 1982 | 158.8 | 406.4 | 39.1 |
| 1983 | 181.0 | 494.7 | 36.6 |
| 1984 | 203.4 | 579.2 | 35.1 |
| 1985 | 229.9 | 658.2 | 34.9 |
| 1986 Q1 | 250.1 | 758.9 | 33.0 |
| Q2 | 260.2 | 777.2 | 33.5 |
| Q3 | 267.9 | 798.1 | 33.6 |
| Q4 | 276.3 | 845.2 | 32.7 |
| 1987 Q1 | 285.0 | 927.5 | 30.7 |
| Q2 | 296.5 | n/a | |
| Q3 | 307.6 | n/a | |

8. There is no reason to suppose that the private sector has been unhappy to see the liquid assets proportion of its portfolio fall. The main reason for the increase in financial wealth has been the rising trend of equity prices up to the late summer of this year. Whilst this experience continued, it would be natural for the private sector to allow its liquidity proportion to decline. But the low liquidity proportion does mean that the private sector would be in no position to offset any fall in equity prices - due to extraneous factors - by aggressively buying further equities even at lower prices.

9. Moreover, after the fall in equity prices which has now occurred, with the possibility at least of further falls to come, it would be surprising if the liquidity preference of the private sector had not itself increased. The decline in equity prices will itself have decreased total financial wealth so that as a matter of arithmetic there will have been some rise in the liquidity ratio. Given the relative importance of equities in total wealth and the extent of the fall in prices, the liquidity ratio may now have risen to about 34 per cent. Even so, it would be below the levels which Table 4 shows to have been customary until recent years. It is therefore quite possible that the private sector will want to re-

build its liquidity still further in coming months, though lower short term interest rates may work in the opposite by making holding liquidity less attractive than it would otherwise be.

## c. Institutional Liquidity

10. The preceding discussion has been about liquidity in the economy as a whole. The present section considers the liquidity of the four main groups of institutional investors: life companies, pension funds, investment trusts and unit trusts. Their relative importance can be seen from their total asset positions at the end of March 1987.

**Table 5: Assets of Institutional Investors**

| | £ billion End-March 1987 |
|---|---|
| Pension Funds | 219.4 |
| Life Assurance Funds | 177.7 |
| Unit Trusts | 38.8 |
| Investment Trusts | 24.6 |
| (Memo item) | |
| Private Financial Wealth | 927.5 |

11. There is an important difference between unit trusts and the other institutions, which should be noted. Unit trust managers can invest only to the extent that their units are purchased by final investors. So if investors sell units then managers are in turn forced sellers of investments such as equities. By contrast, the liabilities of pension funds and life companies are largely fixed in the short term and are independent of market conditions. So whilst managers of these funds may wish to sell equities as a result of market circumstances they will never be forced sellers as unit trust managers may be.

12. Table 6 below shows the liquidity positions of the pension funds and life assurance companies. Data exists to the end of the second quarter in the case of the former and to the end of the third quarter for the latter.

## Table 6: Liquidity of the Pension Funds and Life Companies

| | Pension Funds | | | Life Assurance Companies | | |
|---|---|---|---|---|---|---|
| | Cash and Short Term Assets (£bn) | Total Assets (£bn) | Liquidity Percentage | Cash and Short Term Assets (£bn) | Total Assets (£bn) | Liquidity Percentage |
| 1979 | 2.2 | 40.9 | 5.5 | 1.5 | 42.7 | 3.5 |
| 1980 | 2.1 | 54.0 | 3.8 | 1.6 | 53.7 | 3.0 |
| 1981 | 2.2 | 63.5 | 3.5 | 2.2 | 63.7 | 3.6 |
| 1982 | 2.6 | 84.3 | 3.1 | 2.5 | 79.8 | 3.2 |
| 1983 | 4.1 | 111.0 | 3.7 | 2.8 | 95.8 | 2.9 |
| 1984 | 5.7 | 133.3 | 4.3 | 3.0 | 112.8 | 2.6 |
| 1985 | 5.8 | 157.4 | 3.7 | 3.2 | 129.8 | 2.5 |
| 1986 | 8.0 | 189.8 | 4.2 | 3.8 | 154.9 | 2.5 |
| 1987 Q1 | 9.3 | 219.4 | 4.2 | 4.4 | 177.7 | 2.5 |
| Q2 | 9.1 | 240.3 | 3.8 | 5.1 | 193.1 | 2.6 |
| Q3 | n/a | n/a | n/a | 5.7 | 201.9 | 2.8 |
| Nov 9* | 10.3 | 186.0 | 5.5 | 6.6 | 158.0 | 4.2 |

**Percentage Change over Previous Year**

| | Pension Funds: Cash and Short Term Assets | Pension Funds: Total Assets | Life Assurance Companies: Cash and Short Term Assets | Life Assurance Companies: Total Assets |
|---|---|---|---|---|
| 1980 | -8.7 | 32.0 | 7.7 | 25.8 |
| 1981 | 7.9 | 17.6 | 34.0 | 18.6 |
| 1982 | 18.5 | 32.8 | 17.7 | 25.3 |
| 1983 | 54.7 | 31.7 | 8.2 | 20.1 |
| 1984 | 40.6 | 20.1 | 7.6 | 17.7 |
| 1985 | 0.9 | 18.1 | 7.9 | 15.1 |
| 1986 | 39.4 | 20.6 | 19.8 | 19.3 |
| 1987 Q1 | 33.3 | 20.8 | 12.8 | 20.3 |
| Q2 | 38.1 | 30.5 | 56.2 | 28.7 |
| Q3 | n/a | n/a | 115.5 | 38.7 |

* Assuming no transactions since last data period and all net inflows since the end of the third quarter held in cash.

13. As a proportion of their portfolios, the liquid assets of both pension funds and, more particularly, life companies have been maintained at low levels in recent years. To all intents and purposes both sets of institutions must be considered to have been fully invested as at the middle of the year, with cash balances near the minimum required for portfolio management purposes. As in the case of the private sector as a whole, the subsequent fall in equity values will itself have acted to raise the liquidity proportion. In addition, it seems reasonable to assume that most if not all net inflows since the end of the third quarter have been held in

[illegible]h. But against that, it is not very likely that either sets of institutions have gained appreciable liquidity from net equity sales. Whilst any one investor can increase his liquidity by selling equities, that is not possible for the financial system as a whole and these institutions are large in relation to the market in total. Table 6 projects the liquidity proportions of the two sets of institutions as at 9 November on these assumptions. The liquidity ratio of the pension funds may have risen to about 5½ per cent and that of life companies to about 4¼ per cent. Whilst these ratios would be higher than the levels of recent experience, they would be no higher than prevailed in 1980 and well below levels typical of the aftermath of previous bear markets in the late 1960's and mid-1970's.

14. Table 7 shows the asset and liquidity positions of the investment and unit trusts. Reliable data exists only up to the second quarter of 1987.

**Table 7: Liquidity Position of Investment and Unit Trusts**

| | Investment Trusts | | | Unit Trusts | | |
|---|---|---|---|---|---|---|
| | Cash and Short Term Assets (£bn) | Total Assets (£bn) | Liquidity Percentage | Cash and Short Term Assets (£bn) | Total Assets (£bn) | Liquidity Percentage |
| 1979 | 0.2 | 7.2 | 2.8 | 0.2 | 3.8 | 5.5 |
| 1980 | 0.2 | 8.6 | 2.7 | 0.2 | 4.8 | 3.7 |
| 1981 | 0.3 | 9.2 | 3.1 | 0.3 | 5.6 | 4.5 |
| 1982 | 0.3 | 10.3 | 2.4 | 0.3 | 7.7 | 4.5 |
| 1982 | 0.2 | 13.5 | 1.1 | 0.6 | 11.4 | 5.0 |
| 1984 | 0.4 | 15.7 | 2.6 | 0.9 | 14.9 | 6.1 |
| 1985 | 0.4 | 18.5 | 2.0 | 1.1 | 19.7 | 5.6 |
| 1986 | 0.4 | 10.9 | 2.1 | 1.4 | 31.9 | 4.4 |
| 1987 Q1 | 0.3 | 24.6 | 1.1 | 2.4 | 39.2 | 6.1 |
| Q2 | 0.6 | 26.8 | 2.1 | 3.2 | 44.6 | 7.1 |

15. Broadly, the liquidity percentage of the investment trusts has been similar to that of the life companies and pension funds. No doubt it has risen somewhat after the equity markets decline but not by as much as the trust managers would like. At first sight, the unit trusts appear to be more comfortably placed. Their liquidity proportion has risen in 1987 to more than three times that of the

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investment trusts. But this needs to be seen in the context of heavy net inflows in recent months - some £6 billion in the nine months to the end of September. Managers may have had difficulty placing this volume of new money into the market quickly so that some was temporarily left on deposit. Following the sharp fall in equities, it seems possible that there could be equally heavy net outflows. Such outflows would be large relative to unit trusts' holdings of liquid assets. Trust managers are rumoured to have been heavy sellers of equities in recent days. This would make sense either if some trusts were forced sellers because of outflows or if managers were selling in advance of anticipated outflows.

4148/34

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FROM: M NEILSON
DATE: 10 NOVEMBER 1987

PS/SIR P MIDDLETON

cc: PPS
PS/FST
PS/EST
PS/Sir T Burns
Sir G Littler
Mr Cassell
Mrs Lomax
Mr Peretz
Mr Scholar
Mr Grice
Mr Ilett (or)

Ch
Some interesting stuff here
AA

**MARKET FACTS**

below

In your minute of 9 November you asked for some statistical information on recent developments in the equity and gilt markets. Mr Grice is dealing separately with item (iii) on market liquidity, and this note covers item (i) Turnover, and item (ii) Historical and International Comparisons.

**(i) Turnover**

**Equity Market**

2. Charts 1 and 2 attached show turnover both between market makers and by customers on a daily basis since 15 October. Chart 3 gives average equity market turnover on a monthly basis since the Big Bang. The main points to note are:

- average daily turnover in the six months to September 1987 was around £2 billion, split approximately 50:50 between intra-market transactions and customer business;
- since 15 October average market turnover has also averaged about £2 billion, but with 60 per cent of this business done by customers. With share prices having fallen by 30 per cent over this period, the fact that turnover has not fallen in value terms implies that the numbers of shares traded has increased markedly over the last month;

(stated high, but falling away more recently)

- average daily turnover in the week beginning 19 October reached record levels, of around £3 billion per day. Customer business accounted for 60 per cent of turnover.

3. There is little in this data to substantiate the argument that the stock market fall is a result of traders marking down their prices rather than real selling pressure from institutions. The problem is of course that even daily data can mask the mechanisms by which market movements take place. It is perfectly possible that at critical points during the day, market makers might be leading the market down. The Stock Exchange are themselves now collecting hourly data during the critical period, in an attempt to analyse the mechanisms. This work should be available in a fortnight or so. In the meantime, anecdotal evidence from the Stock Exchange suggests that market makers are acting in the way jobbers did pre-Big Bang, by marking down share prices early in the day to protect themselves against customer led price falls.

4. The information we have received from the Stock Exchange on average spreads since the Stock Market's falls took place are revealing. These spreads are one objective indication of the degree of liquidity in the market. Spreads appear to have widened substantially since 15 October, for all types of equity, as the table below indicates. This is of course another means of self protection for the market maker. (The figures quoted are simply a snapshot on 20 October, and may not give a completely reliable picture)

?

| | **Average September 1987** | **20 October 1987** |
|---|---|---|
| Alpha stock | 0.70% | 1.37% |
| Beta stock | 1.58% | 2.04% |
| Gamma stock | 2.68% | 3.65% |

**The Gilt Market**

5. Though the gilts market has not performed at all like the equity market in recent weeks, turnover has increased substantially. In the first year since Big Bang, turnover in the gilts market averaged £4-5 billion per day. Roughly half of this was between market makers and half with customers. Since mid-October, turnover has been running at around £6-8 billion per day. The Bank say that the split between intra-market and customer business has remained around 50:50.

**(ii) Historical and international comparisons**

but 1929 peak much higher in US.

6. Charts 4 and 5 show UK and US indices on an annual basis since 1900. It is notable that the 1929 crash was considerably more severe in the US than in the UK, but that the 1974 crash, while more pronounced than 1929 in the UK, was relatively minor in the US. By way of illustration, UK share prices fell by 72½% from peak to trough 1972-74 while US prices fell by 48½%. Similar figures (but only available peak year to trough year) for the 1929 crash are a 78% fall in the US compared to 40½% in the UK. So far in 1987, though London has fallen substantially further -32% than New York - 18.6% - since 15 October, their falls since the 1987 high have been broadly comparable, at 36% and 30% respectively.

7. Table 1 shows changes in international equity indices as of close 9 November 1987 on a year earlier, the 1987 highs, and 15 October 1987. The UK performance does not seem exceptional by any of the measures, most striking is the relative buoyancy of the Japanese indices, by almost any measure the most chronically overvalued and out of touch with fundamentals.

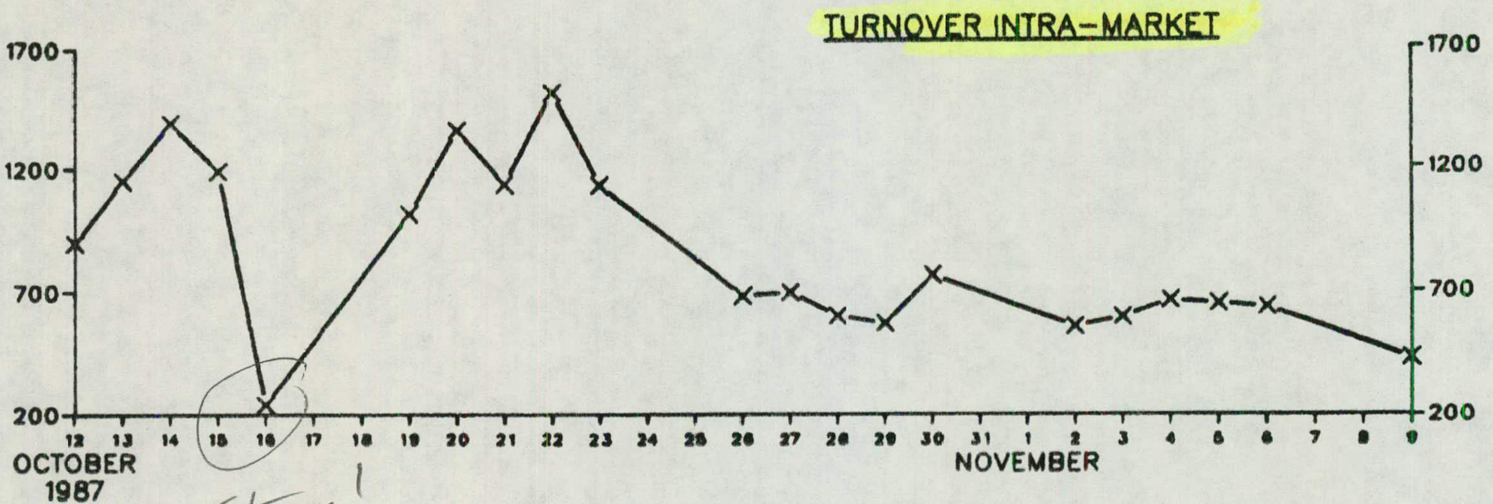
8. We have also looked at rates of return on equities measured in terms of profit (earnings) &/or dividends as a measure of how overvalued the equity market was before recent falls. The two measures give conflicting signals when comparing 1974 with recent falls.

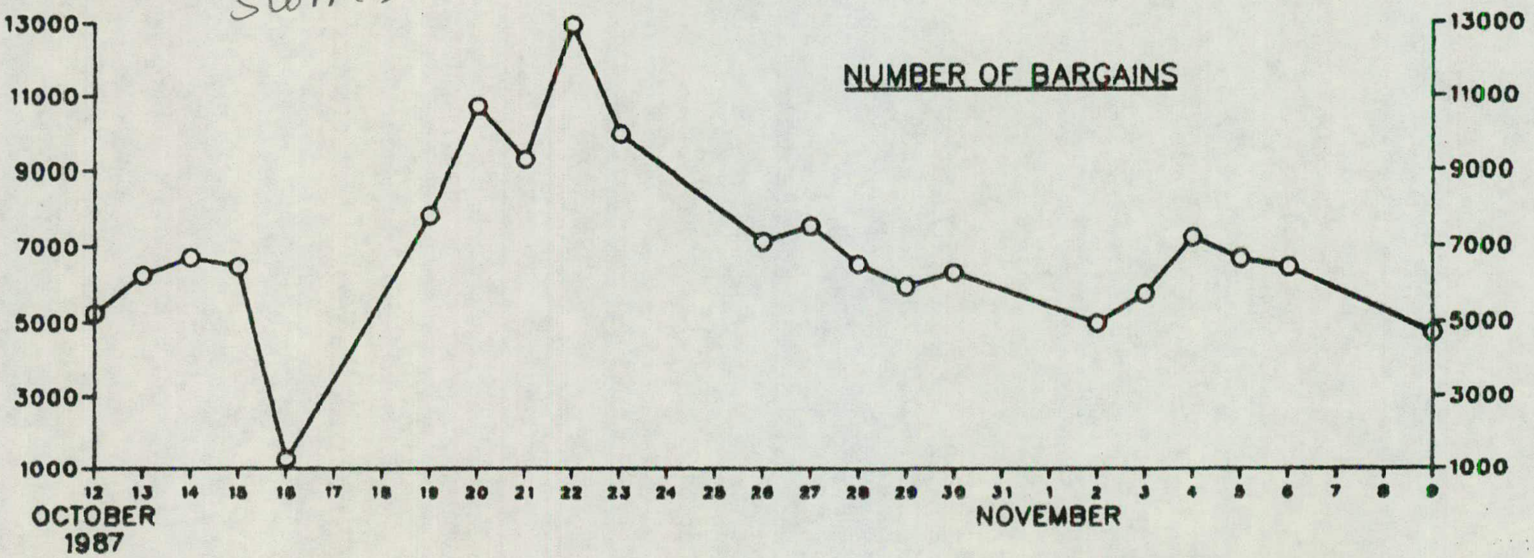
Chart 6 shows dividend and earnings yields for the UK since 1963 and Chart 7 since October 15. These charts indicate that while dividend yields in 1987 were below those prior to the 1974 crash earnings yields were still above the lowest levels of the 1970s at around the average for the six years prior to 1974.

M NEILSON

CHART 1

# UK LISTED EQUITIES

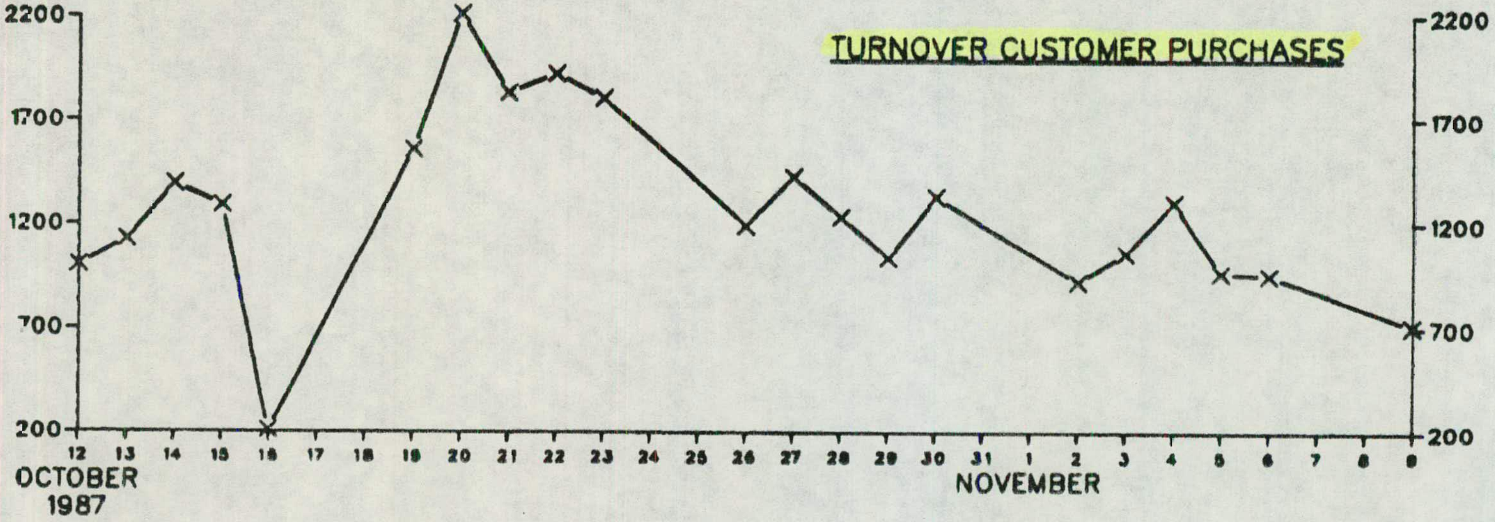


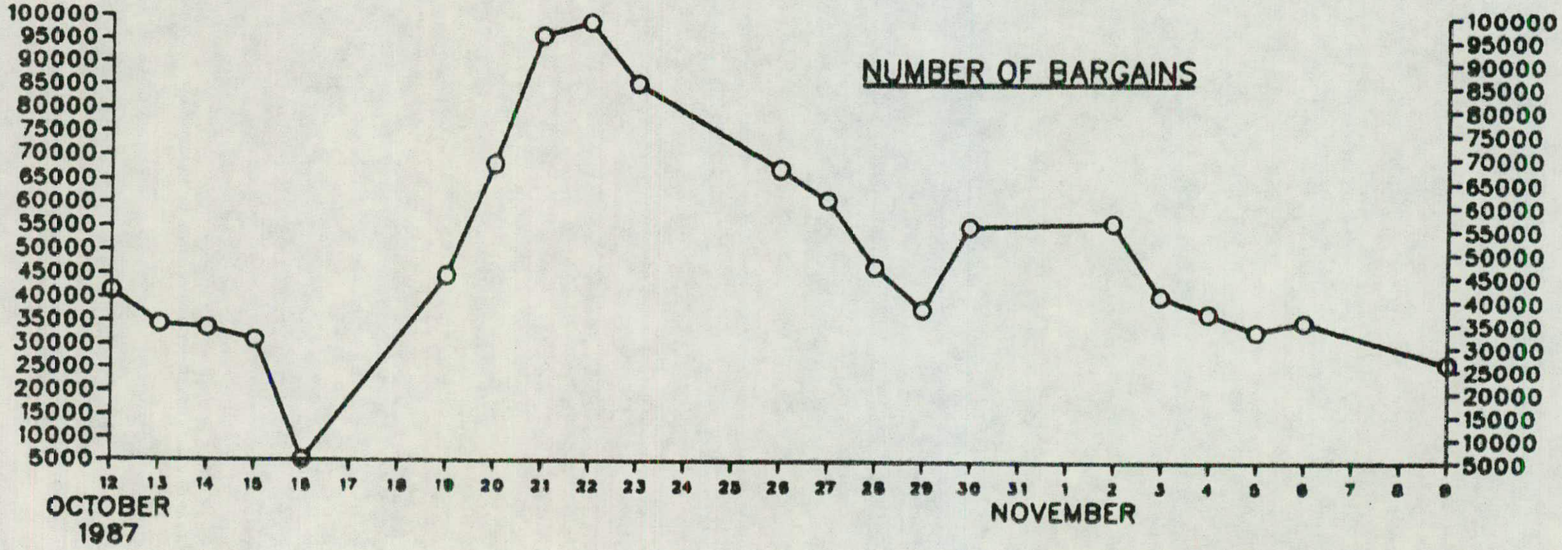




CHARTS.CAPITALS

CHART 2

# UK LISTED EQUITIES




CHARTS.CAPITALS

CHART 3.

Fig 2.1

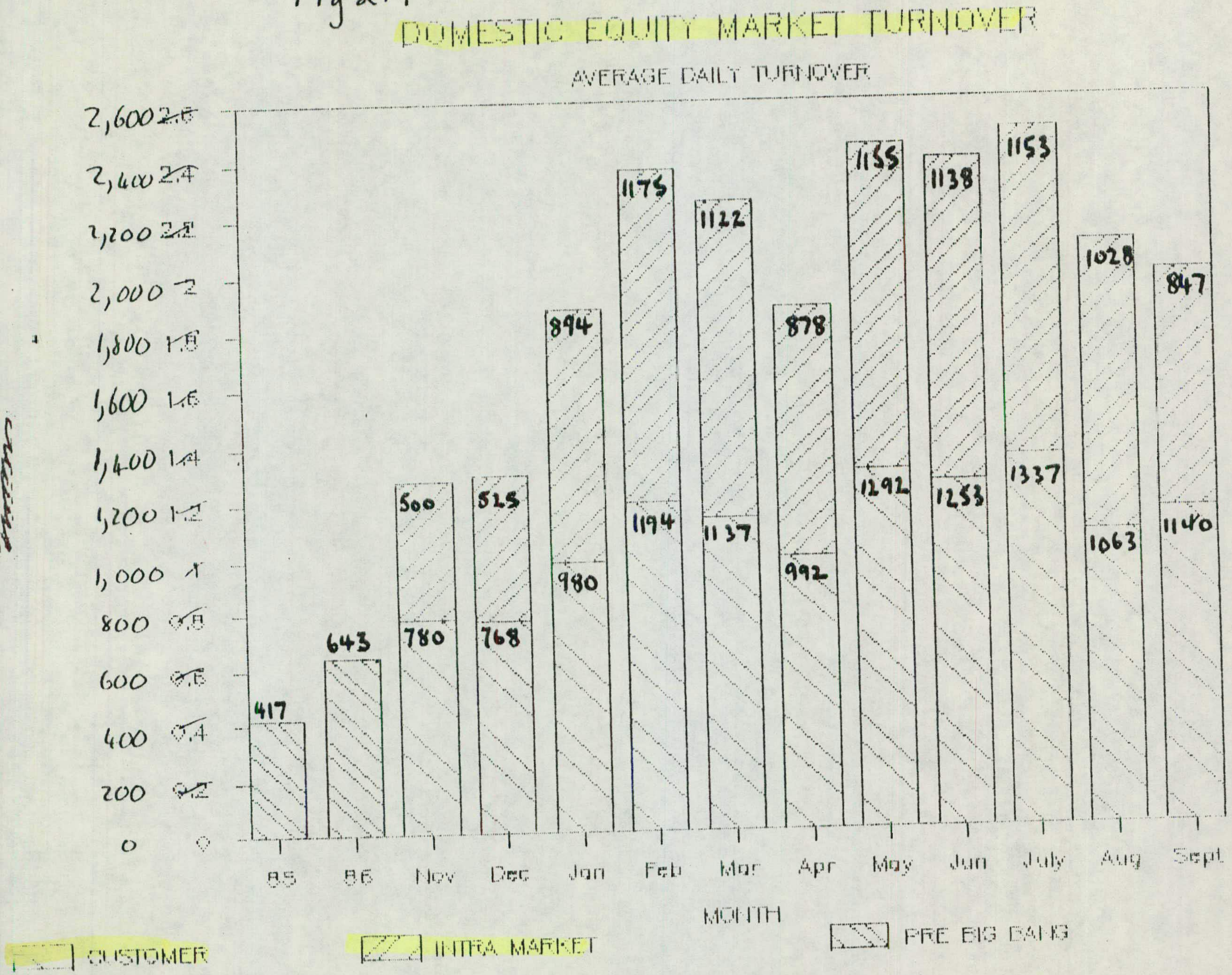


chart 4

**Chart UK. 15 Share prices and interest rates, 1900–83**

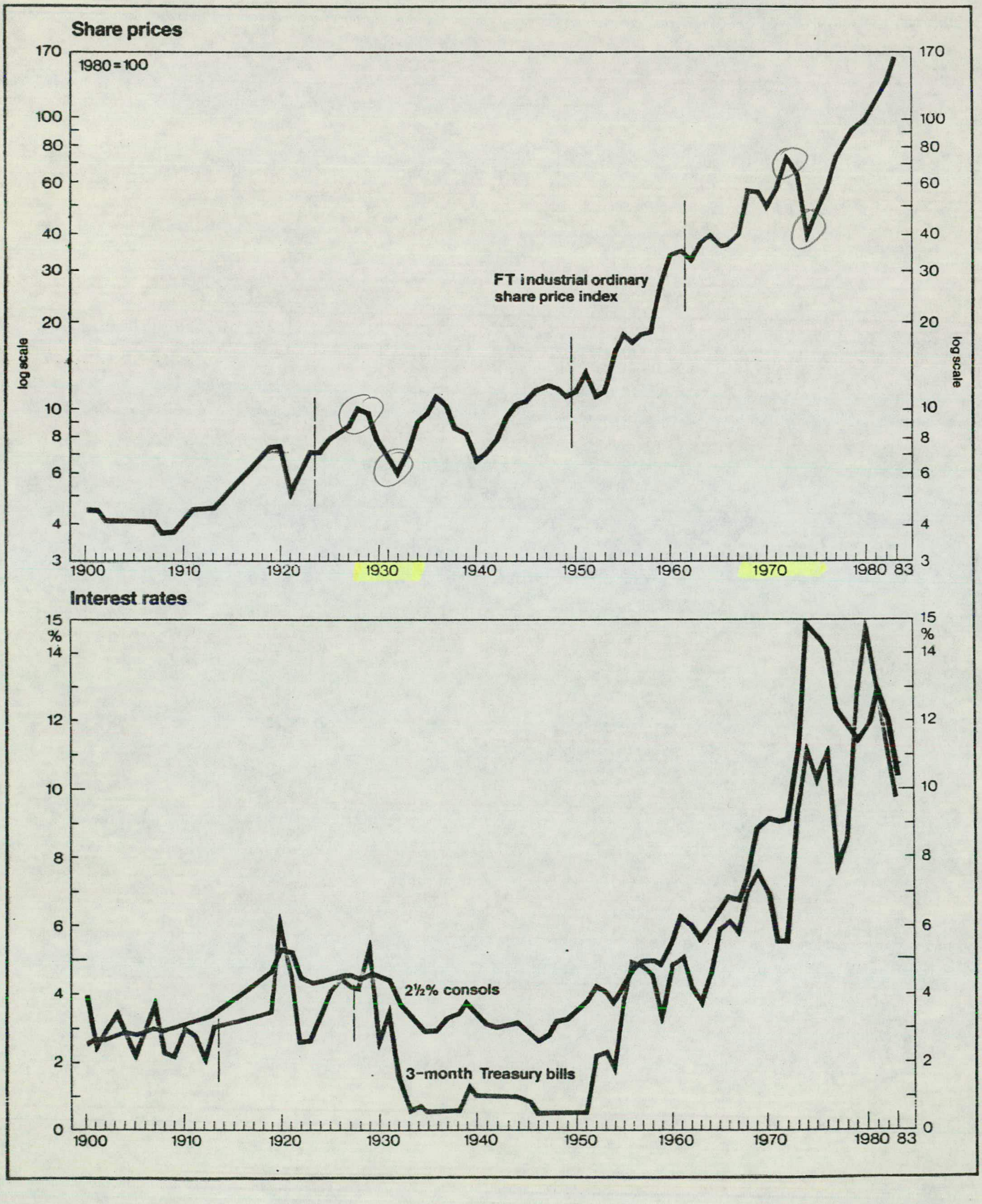


Chart S

## Chart US.15 Share prices and interest rates, 1900–83

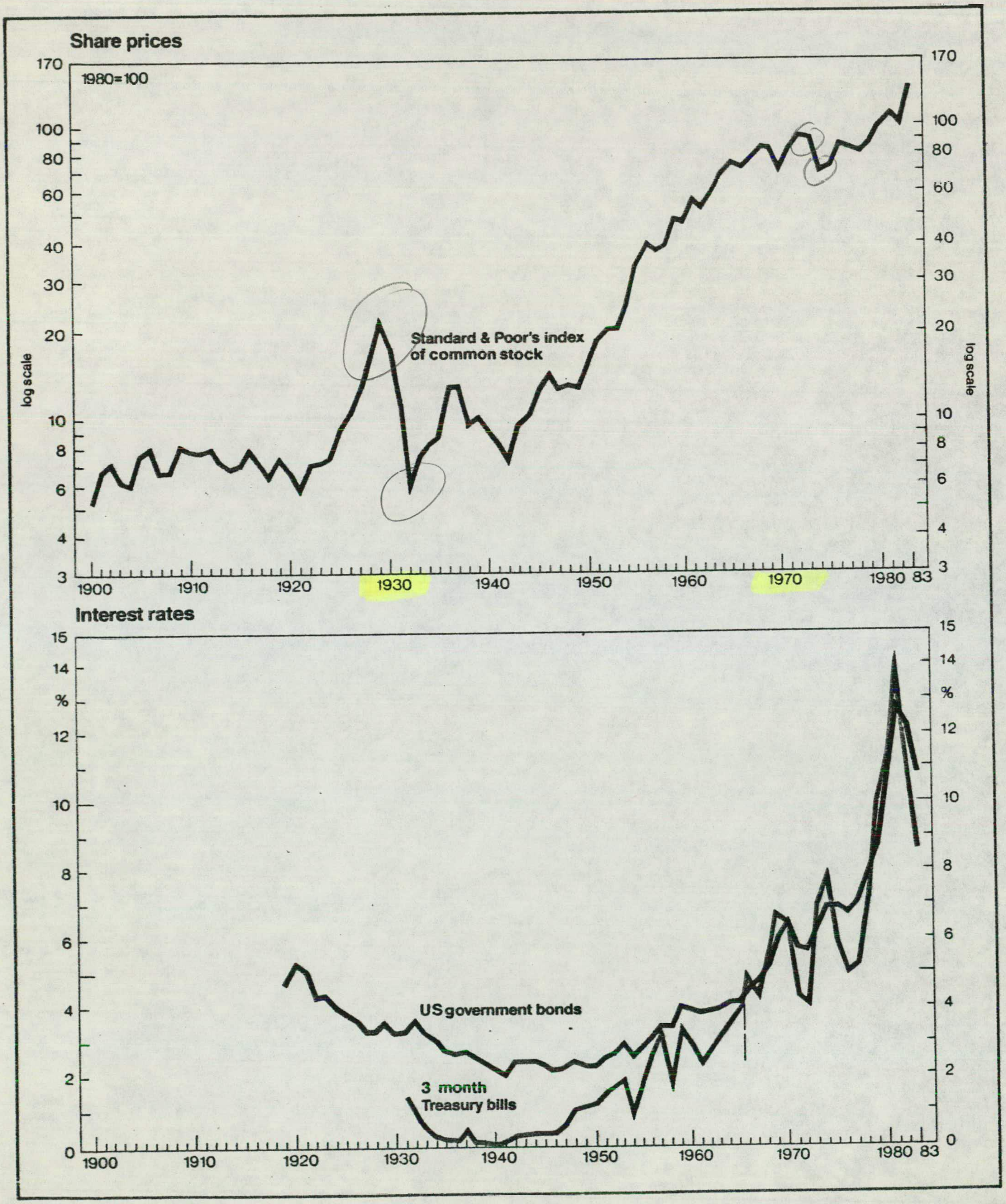


TABLE 1

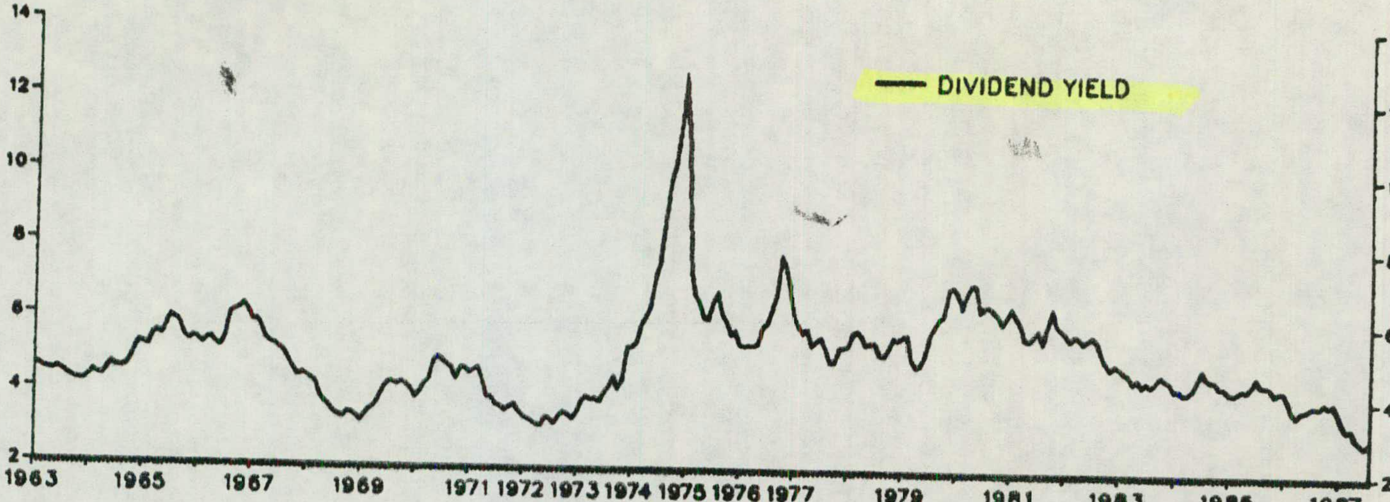
Stock Market Indices Close 9/11/87

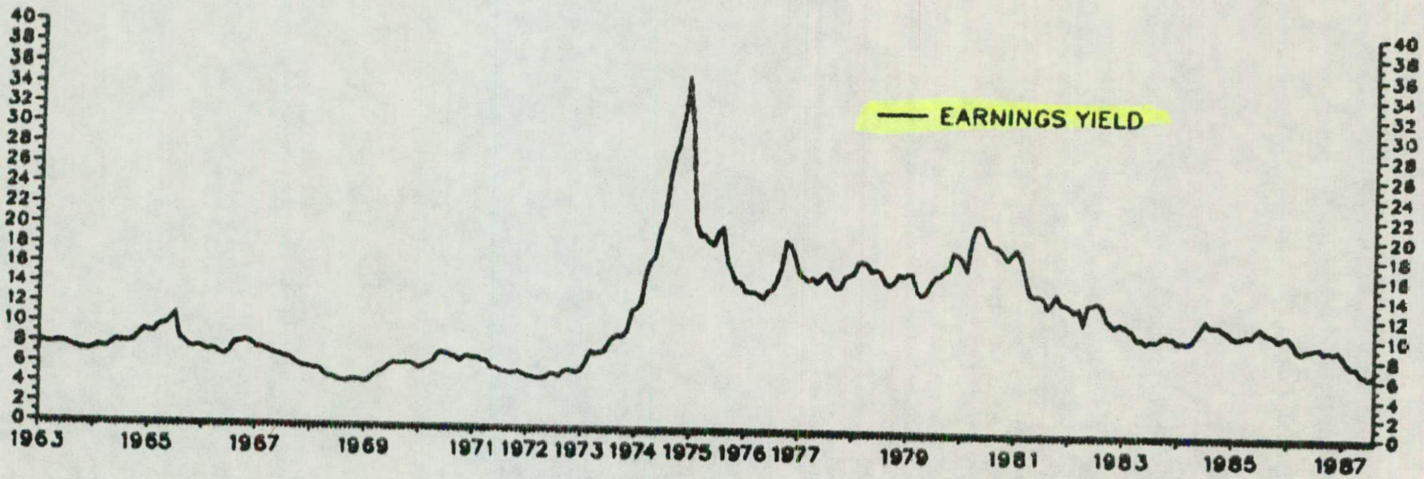
% change on

| Index | a) year earlier | b) 1987 high | (date of high) | c) 15 October 1987 |
|---|---|---|---|---|
| FTSE | - 5.5 | - 35.9 | (16 July) | -32.0 |
| Dow Jones | - 0.7 | - 30.2 | (25 August) | -18.6 |
| Nikki Dow | +36.9 | - 15.9 | (14 October) | - 9.8 |
| Cac generale (France) | -22.9 | - 36.5 | (26 March) | -20.2 |
| Commerz bank (Germany) | -34.8 | - 36.1 | (17 August) | -30.8 |
| Hang Seng (Hong Kong) | - 3.5 | - 45.8 | (1 October) | -42.1 |
| All 100 (Australia) | -10.8 | - 45.7 | (21 September) | -41.7 |
| MS Capital International (World) * | +11.3 | - 19.4 | (27 August) | -17.5 |

* Close 6/11/87

# FT ACTUARIES 500 SHARE INDEX 10th APRIL=10

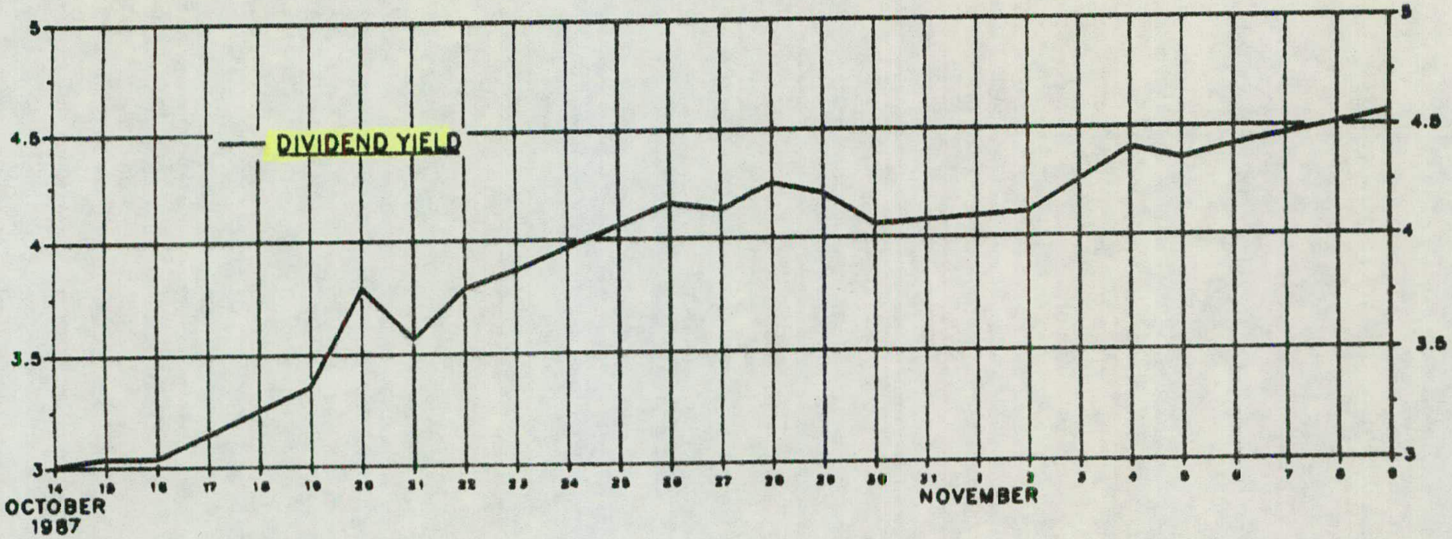


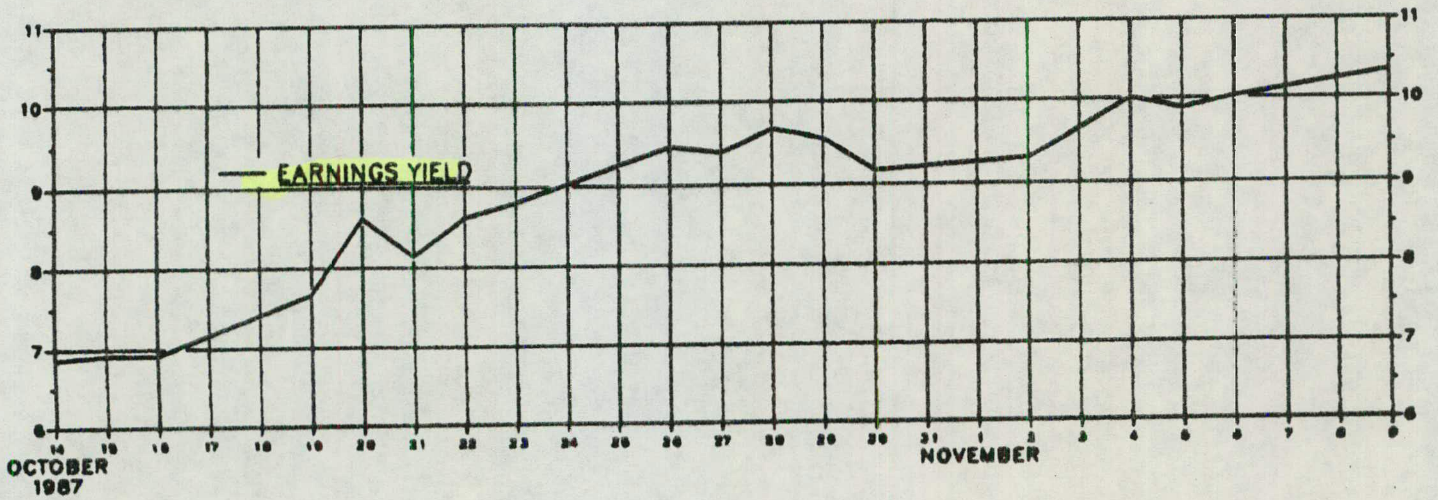




CHARTS.FT1

CHART 6

# FT ACTUARIES 500 SHARE INDEX




CHARTS.FT2

CHART 7

Schroders
J. Henry Schroder Wagg & Co. Limited
120 Cheapside, London EC2V 6DS

GEG/cjd

A. Allan, Esq.,
HM Treasury,
Parliament Street,
LONDON,
SW1P 3AG.

10th November, 1987

Dear Alex,

I thought you might be amused to see the last paragraph on page 9 of the enclosed US circular!

Kind regards.

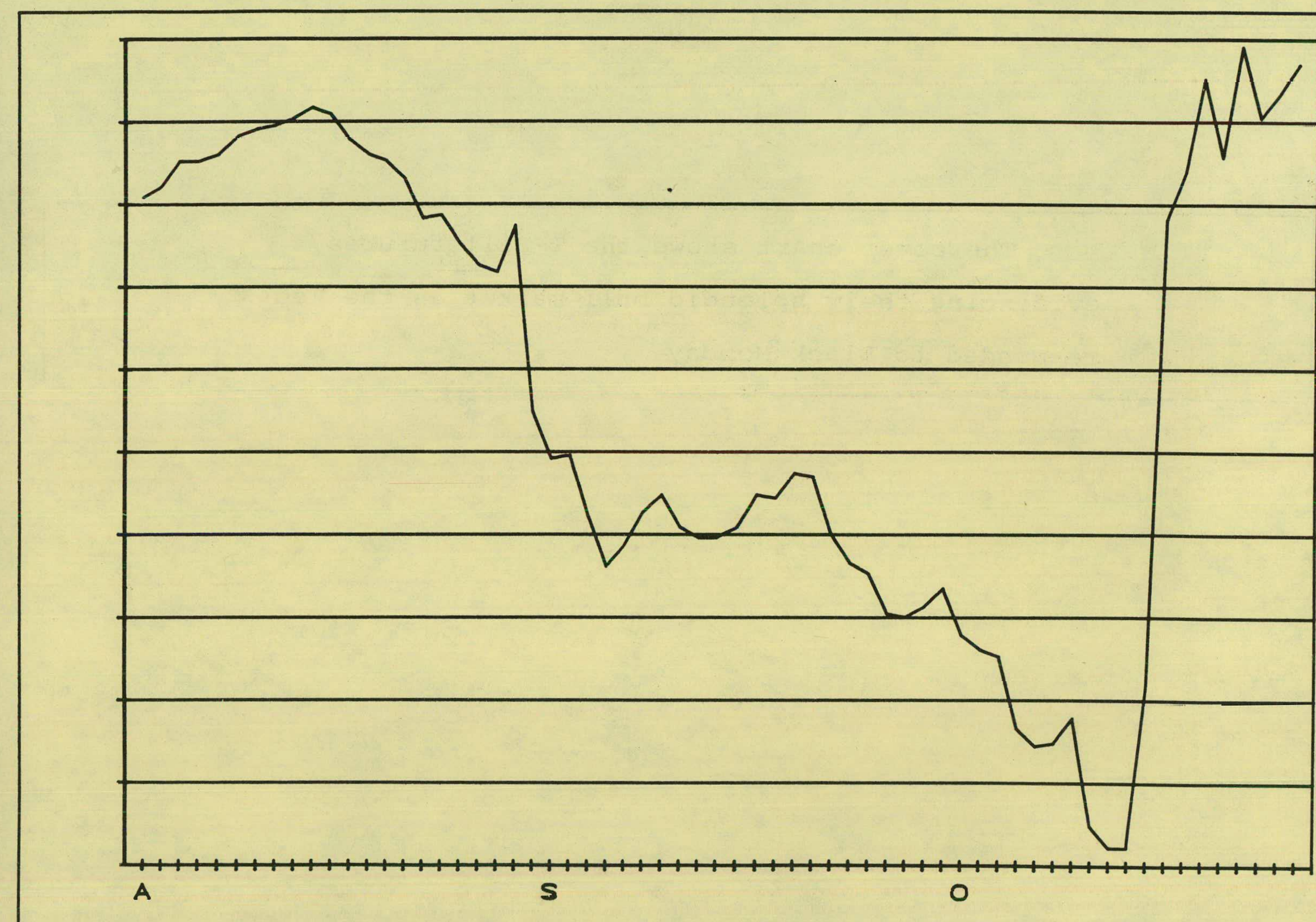
Yours sincerely,

Gerry

G. E. Grimstone

WERTHEIM
SCHRODER

# PORTFOLIO STRATEGY LETTER




**VOLUME I NO. 12**
**NOVEMBER 2, 1987**

**DONALD COXE**
**KATHLEEN HAYKAL**

| RECOMMENDED ASSET ALLOCATION | | | CHANGE FOR WEEK |
|---|---|---|---|
| EQUITY COMPONENT: | 56% | | |
| DOMESTIC STOCKS | | 32% | 0% |
| FOREIGN STOCKS | | 4% | 0% |
| CASH | | 20% | 0% |
| DEBT COMPONENT: | 44% | | |
| BONDS (DURATION 8-9 YEARS) | | 22% | -12% |
| 5 YEAR TREASURIES | | 22% | 12% |
| CASH | | 0% | 0% |

The cover chart shows the T-Bill futures, evidencing their splendid bull market as the Fed responded to Black Monday.






Getting the Dow back to 2,000 is certainly a happy feeling.

Keeping it there, or spawning a new bull market will take more than a frightened Fed.

While policymakers navigate the tricky shoals of trade, currency, and recession risks, the easy money in five-year Treasuries is appealing.

Although stocks now trade at levels that make them extremely attractive in a longer-term sense, we do not yet see that the domestic and international political fundamentals are yet in place to make stocks more attractive than medium-term bonds.

A debtor nation virtually devoid of net personal savings must make itself attractive to those abroad deploying their own savings.

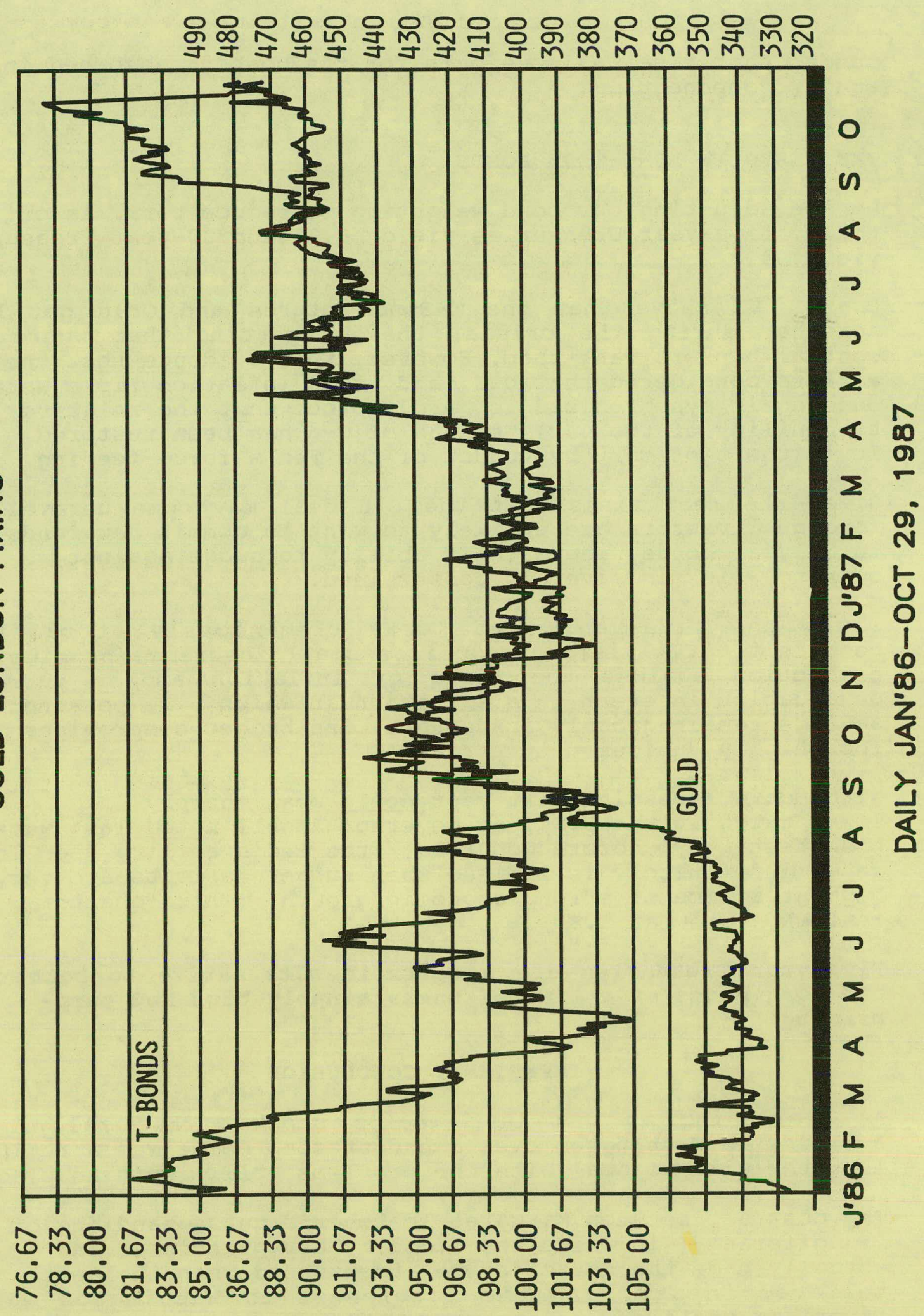
At some point, the U.S. will have made the readjustments to make its stocks attractive to foreigners. By then, it will also have started to generate domestic savings and it will have begun to reduce its dependency on foreign capital.

In the meantime, the probability remains that we will, under the impact of some bad piece of news, retest the panic lows, triggering the crisis in retail investors' confidence which the suddenness of this selloff failed to engender. That bullish sentiment could soar so rapidly in the Market Vane survey after Black Monday is worrisome.

Grizzly bears live, on average, longer than two months.

CHART VI

T-BOND FUTURES (INVERTED) VS GOLD LONDON FIXING




DAILY JAN'86–OCT 29, 1987



Dow 1993.53
T-Bonds 87-12

**THE BASE-BUILDING BEGINS: REALIGN BONDS**

**Last week's recovery in the stock market was reassuring evidence that the Apocalyptic visions of some widely-quoted commentators and pundits are off the mark.**

**We remain of the view that the stock market will have to undergo a period of base-building before a new bull market begins, and therefore only recommend a restructuring of the bond component of the model portfolio at this time.**

**THE CAUSES OF THE CRASH**

The crash came when the investing world concluded that the safety net underpinning the world economy and world financial markets was coming apart.

The strands of that safety net are:

1. The handshake agreement between the central bankers of the G-6 countries to support their own major banks participating in the Euromarket: that agreement led to the full bailouts of the Continental Illinois, one British and one Danish bank in the five years since it was made. Since it is a purely voluntary arrangement and lacks legislative or treaty backing, it is subject to ongoing reappraisal of its reliability in the minute-by-minute changes in the TED Spread (the difference in yield between T-Bills and Eurodollars).

2. The G-5 and G-6 Agreements on the exchange rate of the dollar and on the coordination of basic economic policies among the leading trading nations. Being also purely voluntary agreements, lacking legislative or treaty backing, they are also subject to ongoing reappraisal in world currency, commodity, bond and stock markets.

The other parties to G-6 (and most investors in their home countries) looked to gradual improvement in the U.S. trade and fiscal deficits, and a continuation of American commitment to free trade. The American pledges to those goals came from Paul Volcker, James Baker, and Ronald Reagan, all of whom enjoyed vast respect abroad.

First, Mr. Volcker left his job, to be replaced by someone of strong credentials, but lacking the experience, the mystique, and the sheer physical presence of the magisterial Volcker.

Second, Ronald Reagan suffered a gradual decline in prestige, culminating in the shocking (to foreigners) defeat on the Bork nomination, stark evidence of impotence at a time when strength was needed on both the trade and fiscal fronts in face of an aroused Congress led by strong liberals.

Finally, James Baker, who had built a remarkable string of international successes based on his ability to deliver on his promises and on his avoidance of shooting from the lip, lost his credibility because of , first, the Bork defeat, which showed that his Administration was no longer in control of the national agenda, and, second, his public display of petulance at alleged Germanic uncooperativeness on interest rates.

Since foreign governments and foreign investors were supplying about $3 billion each week to keep the U.S. stock and bond markets functioning and the U.S. consumers' spending spree intact, the removal from actual or apparent power of all three of the U.S. international dealmakers made foreigners anxious.

As they were reconsidering their exposure to the U.S. market, the release of yet another set of terrible trade numbers was the catalyst for a violent reaction, which culminated in the catastrophe of Black Monday.

**PANIC**

In financial and political terms, every action doesn't necessarily produce an equal and opposite reaction. But Black Monday shocked the world, and central bankers and politicians responded. The Fed abandoned, at least temporarily, its exchange-rate targeting on the dollar, pouring liquidity into the system at a rate not seen since May 1984, (when the Continental Illinois went down). Republicans and Democrats assured a panicked populace that they would abandon partisanship to defuse the crisis.

Although, in the longer run what is needed is the political determination to get America to live within its means, the call in a liquidity crisis is the classic call of the college student: "Send money."

As Charts I and II show, the Fed had considerable room to maneuver in October because of its long-sustained tight money policy this year. Chart III shows that the long period of restraint had already made a recession in 1988 a reasonable bet.

If the markets were really worried about inflation in August and September, by late October they were frightened about outright deflation. Charts IV and V show the CRB Futures Index and Gold. The earlier rises in those inflation indicators were aborted last week.

That shift in fear-focusing naturally meant a huge rally in bonds. Given our Model Portfolio's heavy emphasis on



bonds, that rise was some balm for the bombing absorbed in the equity component.

**THE RISKS IN LONG-TERM BONDS**

We are adjusting our bond weighting to reduce term. As of today, five-year Treasuries yield 8.3% and 30-year Treasuries yield 9%.

Chart VI shows that the T-Bond Futures and Gold got back together during the crisis, thereby putting them where the central bankers want them. However, this evidence that the markets considered that U.S. and world inflation risks were once again synchronized is hardly proof that the relative tranquility of the early months of G-6 has been restored. It is the temporary byproduct of the Fed's force-feeding.

Given the real risks that the G-6 deal may come unravelled, foreign investors are unlikely to want to commit new funds to 30-year bonds, where their ability to hedge against currency risk is severely constrained.

Thus, the five-year area looks tremendously attractive, because the .7% yield giveup is a small insurance premium for protection against the risks of inflation and/or currency devaluation inherent in a situation in which U.S. personal savings remain grossly inadequate, and budget compromises look highly dubious.

Although a recession next year <u>could</u> mean sharply lower rates in the U.S., as Governor Angell noted last week in his testimony before Congress, the Fed's ability to lower rates indefinitely is limited when budget deficits are very high at a time of strong economic growth. (Third-quarter real GNP grew at 3.8%).

**Five-year Treasuries are a splendid alternative to both cash and long bonds at a time of unsustainably high Fed pump-priming.**

**INVESTMENT CONCLUSION**

As heartening as was last week's stock market rally, the acrimony in Washington over a budget compromise was a reminder that the will to deal with the problems still isn't in place.

The contrast between Margaret Thatcher's gutsy handling of the BP offering,( in which she stood by her principles and actually made the market prove its manhood when it least believed in it), and the feebleness in Washington was a revealing testimony to the remarkable comeback in Britain under the redoubtable Thatcher.

CHART IV

# CRB FUTURES INDEX

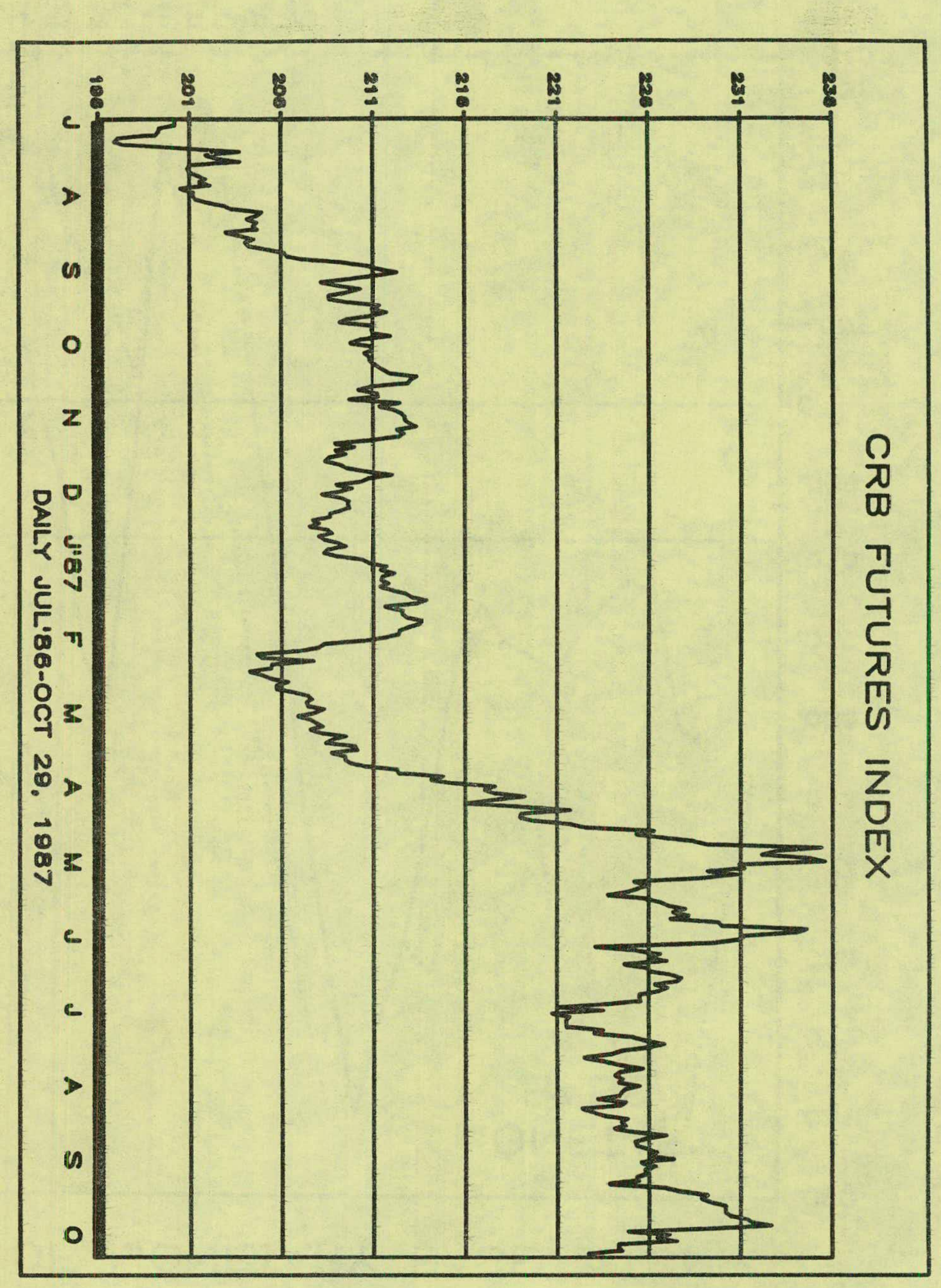



CHART V

# GOLD PRICES (LONDON FIXING)

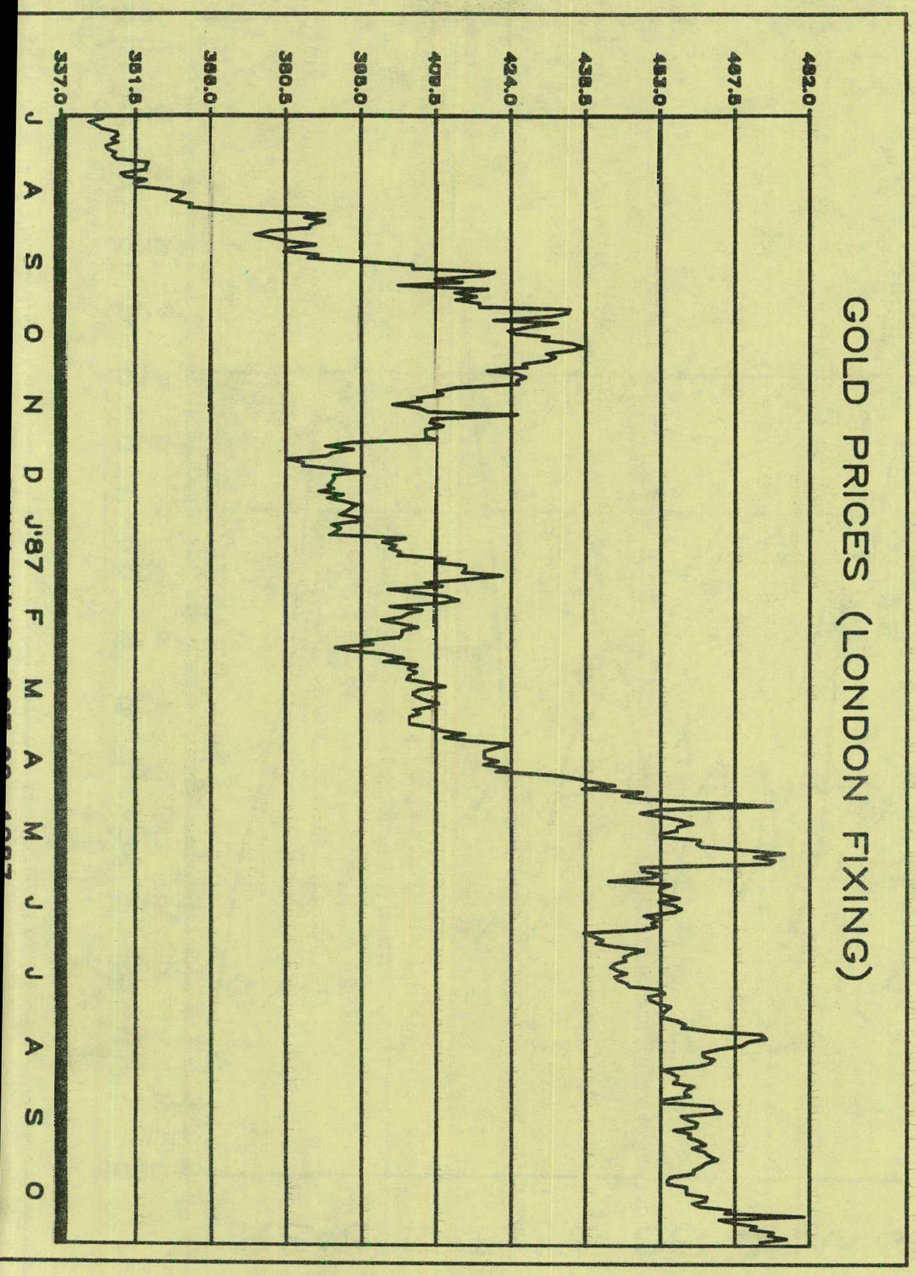



CHART I

# ANNUALIZED 3 MONTH % RATE OF CHANGE IN TOTAL ADJUSTED FEDERAL RESERVE CREDIT

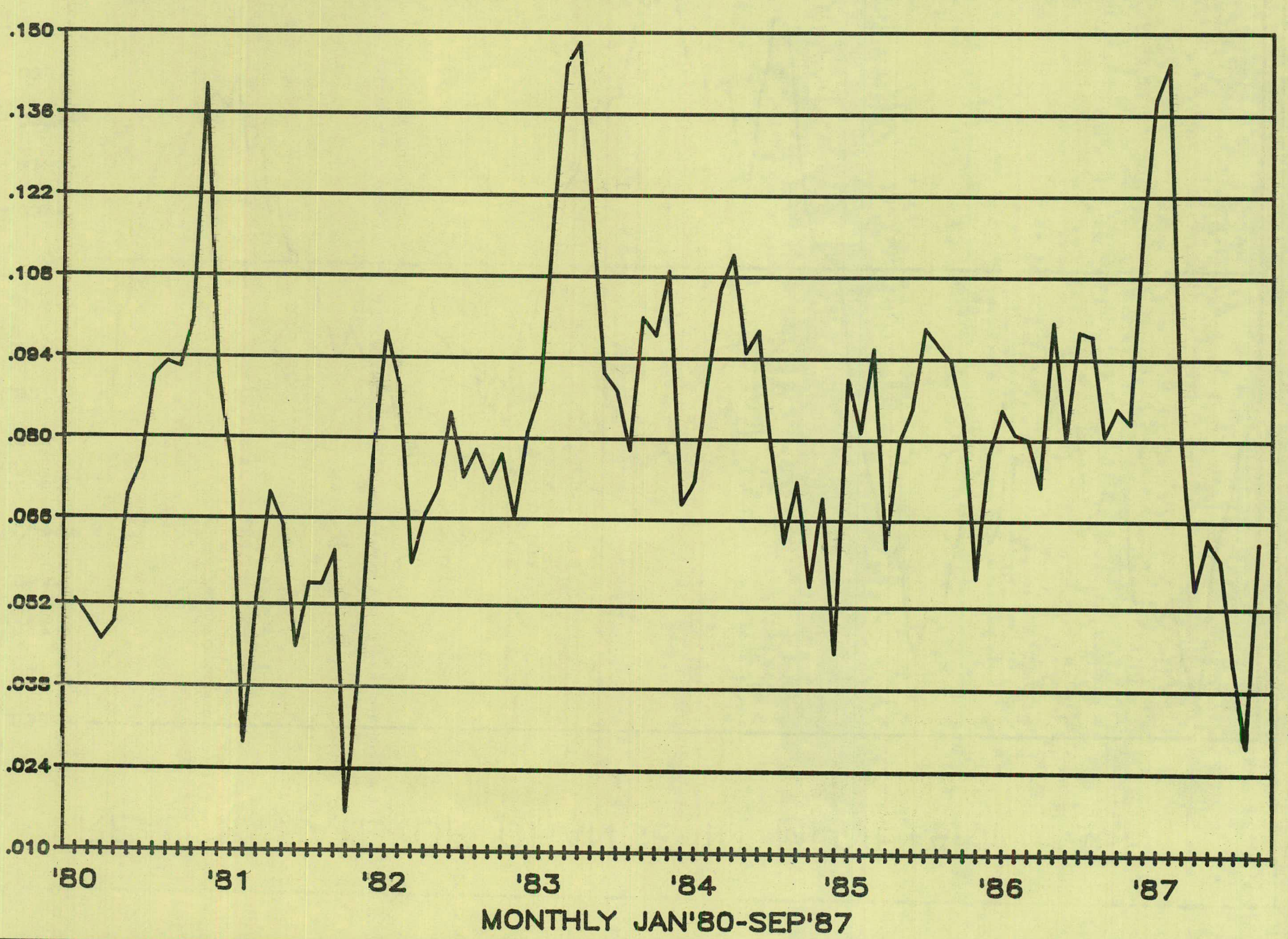
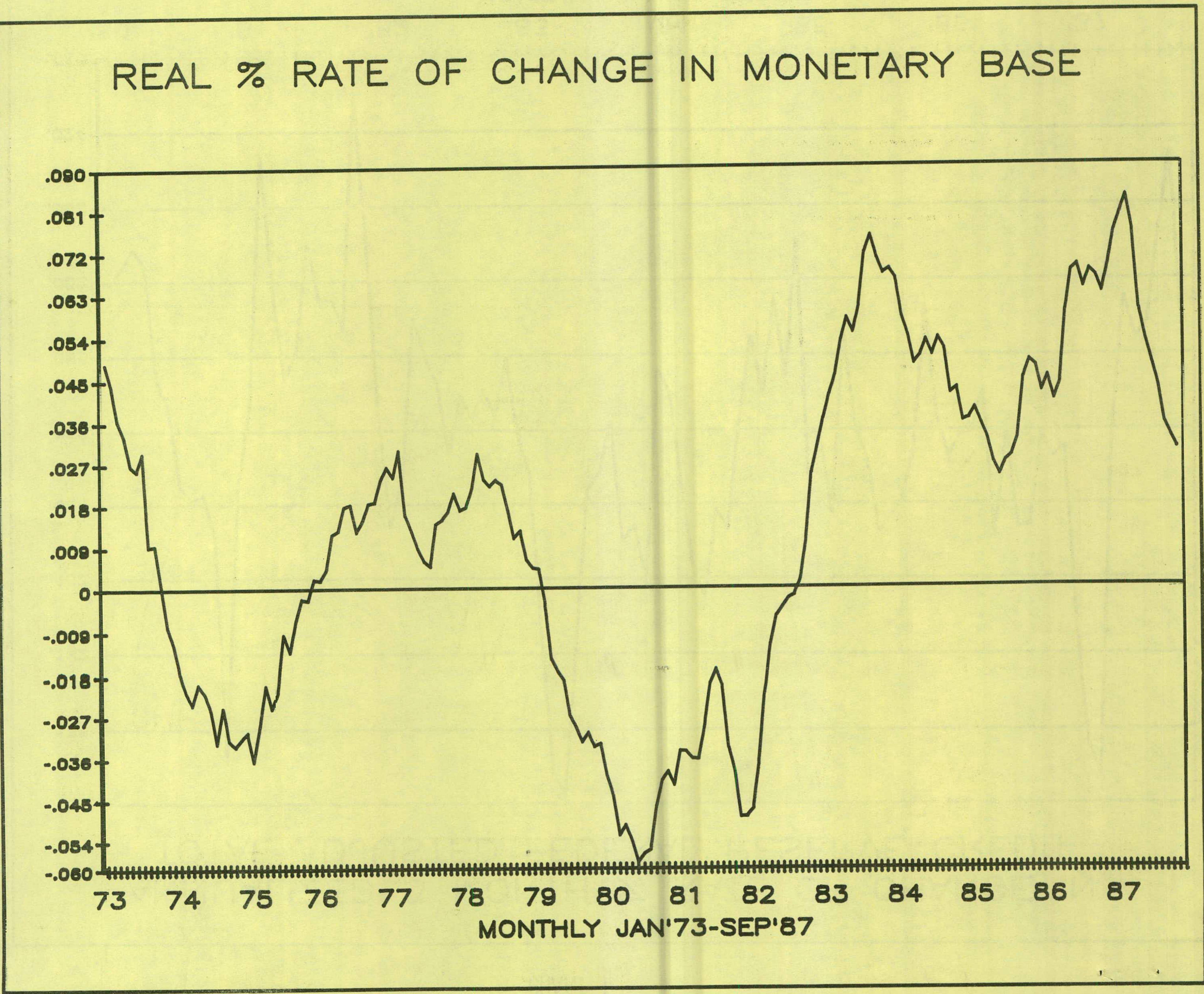


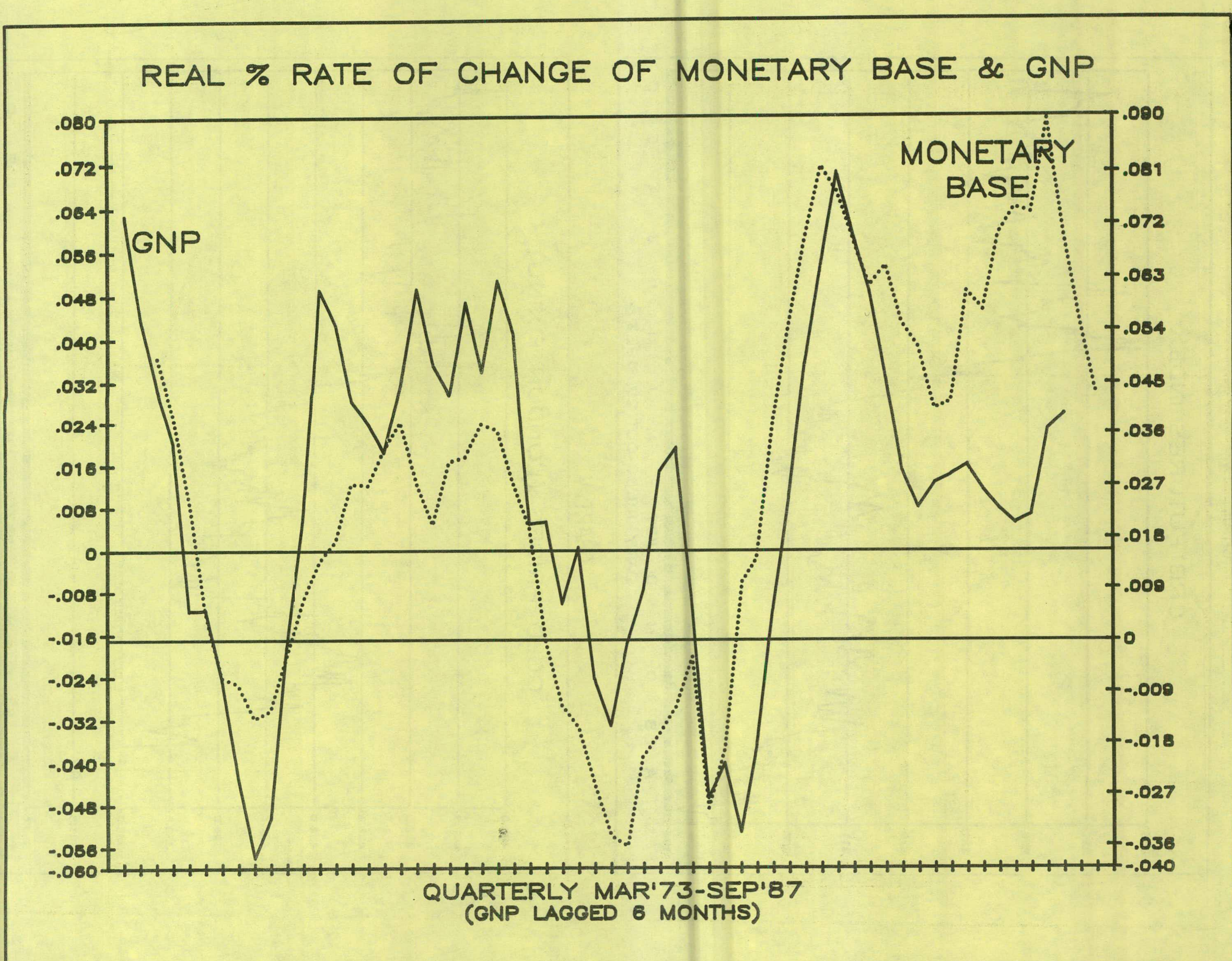
CHART II




WERTHEIM SCHRODER & CO. Incorporated

-6-

CHART III




WERTHEIM SCHRODER & CO. Incorporated

-7-

ps3/25T

**CONFIDENTIAL**

pup

FROM: J M G TAYLOR
DATE: 10 November 1987

PS/ECONOMIC SECRETARY

cc Sir P Middleton
Mr Cassell
Mr Ilett
Mrs Lomax
Miss Noble
Mr Neilson

**FINANCIAL MARKETS BILL**

The Chancellor has seen Mr Maude's letter of 6 November to the Economic Secretary.

2. He wishes to stress the importance of linking any statement to the failure of a major player. Unless the player is unequivocally major, there should be no statement.

J M G TAYLOR

1318/25

SECRET

~~Please return to ACSA in due course~~

The first five paras seem definitely so: I have made a few other suggestions in the interests of greater accuracy.

FROM: MRS R LOMAX
DATE: 11 November 1987

SIR P MIDDLETON

cc: PPS
PS/Economic Secretary
Sir T Burns
Mr Cassell
Mr Peretz
Mr Grice
Mr Kelly
Mr Ilett
Mr Neilson

Pmy

**MARKETS: NOTE FOR NO 10**

No 10 clearly want a note on the performance of the London market in recent weeks, as background to the Prime Ministers Guildhall speech next Monday. The attached joint effort by FIM and MG attempts to meet this need. You may want to supplement it by some of the charts circulated earlier by Mike Neilson.

2. I am not sure whether it covers all the points mentioned in Mr Saunders' minute and David Norgrove's letter. Rather it takes the form of a commentary on a version of recent events which has gained considerable popular currency, and to which the Prime Minister has clearly been exposed, not least via her conversation with Lord Stevens. I have also incorporated early results of a careful analysis of recent events by the Bank and the Stock Exchange some of which was summarised in Mike Neilson's factual note.

3. The second half of the note draws heavily on the minute by Joe Grice which you have also already seen, and the final section, on the monetary policy response, is pure MG. On underfunding, David Peretz has asked me to point out that the last paragraph simply gives the first estimate figure (M3 basis) for October, which shows a substantial £1.9 billion injection of liquidity that month. As you will have seen from Joe Grice's earlier note, you can get different figures depending on the time period and basis of calculation chosen - although, as it happens, our current estimate of the position over the financial year 1987-88 to end-October is one of net underfunding of around £4 billion on both an M3 and M5 basis.

RL

RACHEL LOMAX

MARKETS

A popular, but largely anecdotal, version of recent events in the equity market paints an unflattering picture of the way London's new market structure has behaved under pressure. It is said, for example, that much of the initial heavy selling came from market makers rather than institutional investors; and that inexperienced market makers have panicked in marking down prices. ~~The institutions' failure to provide buying support in these circumstances is explained by their relative "illiquidity".~~

2. In more detail, the story goes as follows. The equity market makers went into the week beginning 19 October with a large amount of stock on their books. When the slide began, they both marked prices down sharply and unloaded stock in an attempt to shorten their positions, giving a further twist to the downward price spiral. Subsequently they have tried to stay short of stock, and have resorted to a number of strategems to achieve this - from not answering the 'phone to quoting extremely unappealing prices.

3. This sort of behaviour has an obvious commercial logic for traders who make money out of taking positions; but, even where it is not in conflict with their obligation to make two way prices at all times, it implies that market makers failed to act as a stabilising force when the market was falling, and may even have been positively destabilising.

4. The sharpness of the correction in equity prices in London is also explained by the "fact" that the long term investing institutions were allegedly so short of cash by early October, and so heavily invested in UK equities (even before the BP underwriting stick), that they were unable to offer support to the market by buying in stock as prices fell.

5. The rest of this note looks at some preliminary evidence on market performance over recent weeks and briefly describes

the action the authorities have taken to underpin the liquidity of the market. It is worth noting at the outset that liquidity is - somewhat confusingly - used in at least three different senses. It is used to describe those characteristics of the equity market which determine the ease with which equities can be bought and sold. It is used to describe the position of particular financial institutions, including market makers: their holdings of easily realisable capital-certain assets, cash, short-term gilts etc, and their access to credit facilities. And it is used to refer to the quantity of money or money-like assets in the system as a whole.

## ~~The new market structure~~

How the market performed

6. ~~The Bank and the Stock Exchange are still sifting through the detailed evidence on the performance of the equity market over the past few weeks, and any conclusions at this stage must be extremely tentative. For what it is worth, however, their impression is that the new market structure has performed~~ relatively well, in extreme circumstances. ~~This view is supported by the following facts:-~~

~~The~~ Some relevant facts about how the new UK market structure reacted to the sharp fall in Wall Street are as follows.

(a) ~~it is not true that early selling pressure came mainly from the market makers.~~ On October 19 and 20 - the days which saw the most extreme price movements - Stock Exchange figures show a very substantial imbalance between **customer** sellers and buyers. The's ~~which quite~~ clearly reflected **some** very large institutional sales. On those crucial days the market makers **took on** stock and performed a stabilising function; ~~whether or not they meant to;~~ they were certainly not the main source of early selling pressure;

(b) in the **week beginning October 19**, there was a record level of trading in UK equities, with the proportion of customer business about normal, in terms of bargains, and substantially <u>above</u> normal in terms of value trading;

(c) sales accounted for only 20% of customer bargains, with average bargain size on some days of as much as £50,000, indicating that customer selling pressure was coming mainly from institutional (as opposed to private) clients;

(d) in **subsequent weeks** market makers have succeeded in shortening their books; but that has included periods when they have been able to sell into rallies;

(e) over the whole period **since 15 October** average market turnover has averaged about £2 billion, split 60:40 between customers and intra market transactions. This compares with average daily turnover in the six months to September 1987 of £2 billion, with a roughly 50:50 customer/market split. So, in terms of the <u>number</u> of bargains, turnover has actually increased.

7. The bear market has of course affected behaviour in the market. ~~None of this is to say that the UK market has proved as liquid under the past few weeks as it was during the bull market of the previous months. Anecdotal evidence from the Stock Exchange suggests that~~ Market makers ~~are~~ seem to have been acting much as jobbers did pre-Big Bang, marking down share prices early in the day to protect themselves against customer-led price falls. Relative to September the ability to deal in size has been reduced, and spreads have widened ~~significantly, as the following snapshot data illustrate~~.

| <u>**Average spreads**</u> | <u>**Average September**</u> | <u>**20 October**</u> | <u>**4 November**</u> |
|---|---|---|---|
| Alpha stock | 0.70% | 1.37% | 2.08 |
| Beta stock | 1.58% | 2.04% | 3.28 |
| Gamma stock | 2.68% | 3.65% | 3.58 |

8. ~~But this does not mean that the market makers are not doing their jobs.~~ ~~They~~ Market makers cannot however be expected to act as a short term

shock absorber, with the commitment of capital that implies, without some widening in spreads. Nor is it reasonable to expect them to act as "buyers of last resort" over a prolonged period. Their job is to enable investors to deal, not to influence prices over the longer term.

9. There are also Someways involved grounds ~~for arguing that~~ the London market has performed well relative to New York, even though in general prices ~~seem to~~ have fallen a little more ~~sharply~~ here than in New York (and~~, particularly,~~ Tokyo) since mid October. For example:-

And much more than the

a in ~~contrast to~~ New York, where trading hours were shortened and dealing in 90 stocks was suspended, Stock Exchange hours have been maintained, and trading in all stocks has continued uninterrupted and at a high level;

b price volatility has been about the same in London as in Tokyo, and about half that in New York. ~~(The Bank have calculated that the standard deviation of % weekly changes in the relevant market indices between 5 October and 2 November was 10 in London, compared with 8 in Tokyo and 18 in New York.)~~

Why did London fall sharply

We need to do further analysis before we can draw conclusions about why the market reacted as it did to the fall in Wall Street.

10. The ~~relative~~ sharpness of the market correction in London ~~raises interesting questions.~~ Part of the explanation may lie in the absence of factors which, in different ways, have helped to support the New York and Tokyo markets.(a) In the US, companies have responded to the market collapse by buying back their own shares. ~~- something which, while not impossible for UK companies, is scarcely practical at~~ cannot do this at short notice (since it involves seeking the Courts' consent, as well as shareholders' approval).(b) In Japan the long term investing institutions have provided buying support, prompted by the Ministry of Finance, ~~[and aided by portfolios which are said (somewhat surprisingly) to be significantly more liquid than those of their UK counterparts]~~

what

(b) We also lack the large private investor prepared to take a chance when the market has fallen.

~~11. In any event it is worth asking why UK long term investing institutions have not provided more buying support in recent~~

Levels cf. 12 months ago
London
Tokyo
NY

~~weeks; and in particular whether there is any truth in the claim that they are short of liquidity.~~

**Behaviour of institutional investors**

12. At first sight, the idea that UK institutions are illiquid is hard to reconcile with the very rapid growth in their liquid assets over the past couple of years. Figures are available for pension funds and unit trusts up to end-June; and provisional estimates for Life Assurance companies up to end-September. Pension funds alone held over £9 billion of cash and short term assets by the middle of 1987, an increase of nearly 40% on a year earlier. And at the end of September Life Assurance companies held around £5¾ billion in cash and short term assets - more than double their level of liquidity a year earlier. The absolute liquidity of unit trusts was also at a high level in mid-1987 - at £3.2 billion nearly three times the level at the end of 1985.

13. However the picture looks rather different when liquidity is related to the size of total portfolios. The following table gives information about the liquidity position over time of the pension funds and life assurance companies - by far the two largest groups of institutional investors.

**Cash and short term assets as a percentage of total assets**

| | Pension Funds | Life Assurance Companies |
|---|---|---|
| **1971-1980** | | |
| Average | 6.2 | 3.4 |
| Highest | 15.9 (1974) | 5.8 (1974) |
| Lowest | 2.0 (1971) | 1.0 (1971) |
| **1981-1986** | | |
| Average | 3.8 | 2.9 |
| Highest | 4.3 (1984) | 3.6 (1981) |
| Lowest | 3.1 (1982) | 2.5 (1986) |
| **Latest** | 3.8 (1987 Q2) | 2.8 (1987 Q3*) |

* Provisional estimate

14. Soaring equity prices have inflated the size of the total portfolios managed by these institutions and relative to these totals institutional liquid assets look if anything to be rather low. Pension fund liquidity in particular has been much lower throughout the 1980s than was the norm in the 1970s and indeed some would claim that to all intents and purposes the institutions have been pretty fully invested over the last few years. Apart from the liquidity position, pension funds, for example, had about 60 per cent of total assets invested in company securities in mid-1987, compared with around 45% in the early 1980s. On balance, therefore, there is some support for the view that the institutions had relatively little scope for increasing their equity holdings. On the other hand, liquidity ratios have for short periods been below those which prevailed immediately before the share price falls, so it would not have been ~~absolutely~~ impossible for them to make ~~limited~~ further purchases had they wanted to.

15. But it is easy to understand why they might not have wanted to buy. Institutional investors will have shared the general perception that the market had finally peaked, and revised their views about the prudent allocation of their assets, shifting their preferences away from equities towards cash and, to a lesser extent, gilts. While individual investors can liquidate their holdings of stock, large institutions can only do so at the risk of precipitating a sharp fall in prices. In these circumstances, it is not surprising to find institutions complaining of illiquidity - both in the sense that they find themselves holding less cash than they would like, and dealing in a market that cannot easily accommodate their transactions at given prices.

16. For completeness it is worth mentioning the liquidity of one other group of institutions, the banks. There have been no signs of illiquidity in the banking system or of particular banks. But one of the lessons of the 1929 crash is that it is important to prevent the fall in equity prices being permitted to endanger the banking system. The authorities stand ready to act as lender of last resort to any bank with liquidity (as opposed to solvency) problems. This was the assurance that Federal Reserve Chairman Greenspan felt it necessary to repeat publicly on "black Monday". The Bank of England's readiness to discharge this function is well known and has not been called into question.

**Liquidity of the System**

17. The liquidity of the economy as a whole is, of course, a matter of monetary policy, although the position of individual groups of institutions forms part of the picture.

18. The story for the private sector as a whole is somewhat similar to that for the financial institutions. In absolute terms, as is clear from the rate of growth of broad money, liquidity has been expanding rapidly for a long period, with no sign of any slow down. Broad liquidity has risen as a proportion of money GDP - from under 54% in 1980 to over 73% in June 1987. However total private sector wealth has been growing even faster, and liquid assets as a proportion of the total fell from 43% in 1980 to 35% in 1985 to under 31% earlier this year.

19. The ratio will have risen in recent weeks as a result of the fall in the value of equity holdings. But it seems highly likely that the private sector's desire to hold liquid assets (assuming unchanged interest rates) will have risen even more sharply.

20. In this situation there are two kinds of action the authorities can take, and have taken.

i) Direct action to supply liquidity to the system. Largely as a result of exchange market intervention,

SECRET
UNTIL
19/11/87

the government borrowing requirement was "underfunded" on the M3 definition in October by an estimated £1.9 billion. That is a measure of the extent to which the Government added liquidity to the system in October. The Chancellor made it clear in his Mansion House speech that October's intervention would be funded as and when appropriate; but that it would not be appropriate in current circumstances to extract liquidity by selling gilts on a major scale.

ii) Action on interest rates. Given the scale of the shift in liquidity preference, action here is likely to be much more significant than direct action to delay funding. Reducing interest rates and allowing gilt prices to rise (the latter will be helped by action under (i)) reduces the demand for liquid assets and gilts, thereby providing indirect support for the equity market. In the circumstances interest rates can be cut without risk to future inflation, provided the authorities stand ready to raise interest rates again as and when confidence return, and liquidity preference falls back again.

C13/28/mjd

UNCLASSIFIED

pmg

FROM: **MRS JULIE THORPE**
DATE: **11 November 1987**

**PS/FINANCIAL SECRETARY**

**LETTER FROM SHEPPARDS**

The Chancellor has received the attached letter from Mr N Purchase at Sheppards.

2. The Chancellor has asked if the Financial Secretary would please deal with this.

Julie Thorpe.

**MRS JULIE THORPE**
Diary Secretary

Sheppards

NP/imdi

4th November 1987.

Nigel Lawson, Esq.,
Chancellor of the Exchequer,
H.M. Treasury,
Parliament St.,
LONDON

Dear Mr Lawson,

I would like to congratulate you on preserving the principle of underwriting responsibility for BP, while limiting the market implosion that might have taken place without the 'safety net'.

The Bank of England may now have to take up most of the newly issued stock, and an offer for sale will probably once again be required. To solve this problem, I suggest another Treasury innovation : a gilt convertible into equity.

Currently, convertible bonds are attractive to fund managers, offering the downside risk of fixed interest descriptions while giving the upside potential of equities. BP's share price is certain to be higher in five years time than it is today. Therefore, a gilt convertible into BP at intervals over the next five years should carry a lower coupon than a conventional gilt, thus saving H.M. Government money, while perhaps still selling BP at 330p or better. This innovative instrument might also avoid the necessity and expense of a new issue.

Thank you for your interest.

Yours faithfully,

Nigel Purchase

N. Purchase

ECONOMIST

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FROM: P D P BARNES
DATE: 11 November 1987

MR ILETT

cc PS/Chancellor
Sir P Middleton
Mr Cassell
Mrs Lomax
Miss Noble
Mr Neilson

FINANCIAL MARKETS BILL

You were kindly providing advice on Mr Maude's letter of 6 November. The Economic Secretary has seen the Chancellor's comments of 10 November.

2. The Economic Secretary has the following intial comments:-

(i) He agrees with the Chancellor and presumes there will be no statement unless the Stock Exchange compensation fund is likely to prove inadequate.

(ii) The Economic Secretary thinks the statement itself opaque in the extreme, as it does not reveal or define the problem being resolved.

(iii) The last sentence of the statement implies that legislation is not ready. The Economic Secretary thinks that this does not easily square with the opening sentence.

(iv) The Economic Secretary thinks that in practice any statement would need a section covering the response to the particular crash which made it necessary.

(v) The statement at present does not make explicit that the legislation would be backdated.

PB

P D P BARNES
Private Secretary