PO-CH/NL/0151
PART A

Part A.

SECRET

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Begins: ~~5/12/86~~ 2/1/87

Ends: ~~28/9/88~~ 8/7/88 (CONTINUED)

PO -CH /NL/0151

PART A

Chancellor's (Lawson) Papers:

CHANCELLOR'S PAPERS ON
THE MONEY MARKETS

Chancellor's Papers on
the Money Markets

Disposal Directions: 25 Years

30/8/95.

PO -CH /NL/0151
PART A

4316.23

CONFIDENTIAL

FROM: M G RICHARDSON

DATE: 2 January 1987

9/content?

CC 5/1

1. MR KELLY
2. CHANCELLOR

OK

cc: Economic Secretary o/r
Sir P Middleton
Mr Cassell
Mr Peretz
Mr Grice
Mr Culpin
Mr Ross Goobey

I agree. This is a purely precautionary move. There is no evidence as yet of bill rates becoming distorted. But it is right to err on the side of caution. In financial terms there is no cost in so doing - indeed there is a small gain since we will be lending at LIMEAN, which is above the Bank's dealing rate for bills.

S.1.

MONEY MARKET ASSISTANCE: NEW REPO WITH THE BANKS

Immediately after Christmas the Economic Secretary gave approval to the proposal in my minute of 23 December for a "foundation" gilt/export credit repo of 1% (roughly £1 billion) to run from 6 January until 9 March. Just over £1 billion has been taken up, but as foreshadowed in my earlier minute, the Bank now envisage the need for a second operation to begin next week.

2. I attach a copy of the Bank's note. They propose another 1% repo running until 23 February (a low coupon gilt falls for redemption on 24 February). This would bring the total facilities outstanding to 2%. The repo would probably begin on 15 January, but unexpectedly adverse exchequer swings might necessitate earlier action. The Bank are therefore seeking contingent authority to initiate the repo on or before 15 January, and to make an announcement on or before 9 January.

3. On Friday, the level of money market assistance was £13305m. The Bank expect it to increase as follows:-

£ billion

9 Jan	16 Jan	23 Jan	30 Jan
14.4	15.6	15.7	14.9
6 Feb	13 Feb	20 Feb	27 Feb
14.9	14.2	14.4	13.7

These figures are consistent with the forecast in the December Monthly Monetary Assessment.

4. The above projections are of course subject to a great deal of uncertainty. If anything, however, they suggest that £2 billion worth of repos outstanding could give a small cushion in the second half of February. The Bank recognise this, but emphasise the importance of erring on the side of caution in the area of money market management. They have also pointed to two factors that could make market management more difficult in the near future: the appearance of more bullish sentiment (which may make houses reluctant to sell their bills) and more advantageous terms for bank advances relative to bill finance.

5. At present the level of assistance is forecast to peak on 21 January at £16.1 billion. The Bank foresee a possible need for a third, very short, repo to tide the market over that period, and may come forward with a further proposal next week.

6. The earliest the Bank may wish to make an announcement would be 9.30 am on Wednesday 7 January. I should be grateful for your approval to the proposals in paragraph 2 above accordingly.

M G RICHARDSON

SECRET

MUFAX TO: MR. RICHARDSON, HMT

FROM: MR. W. A. ALLEN, BANK OF ENGLAND

(3 pages)

REPOS WITH THE BANKS

1 The repo which we announced last week and which will come into effect tomorrow will yield £1,067 million - ie roughly what we expected.

2 The prospective need for assistance during the period between now and the end of February, based on the Treasury Accountant's projections of Exchequer revenue and disbursements, is shown below (figures in £ millions). The figures in the first column assume no gilt sales; those in the second column assume that we sell roughly £1 billion gross of gilts this month and the same in February.

	Ignoring gross sales of gilts	Assuming gross sales of gilts as described in para 2
2 January (actual figure)	13,300	13,300
9 January	14,170	14,420
16 January	15,130	15,630
21 January (expected peak)	15,400	16,050
23 January	14,990	15,740
30 January	13,870	14,860
6 February	13,840	14,870
13 February	12,850	14,210
20 February	13,050	14,440
27 February	11,740	13,740

3 On this figuring tomorrow's repo should enable us to get to the end of this week without needing to hold more than £14 billion of bills, which is the maximum we think we can safely aim for without risking creating serious rate distortions and provoking "hard arbitrage" between the bill and interbank markets.

4 The need for assistance is forecast to increase by a further £1 billion or so next week, however, and we will therefore need to provide around £1 billion more in order to limit the scale of our bill holdings. On the figures as they stand, the best day for the repo to come into effect would be Thursday 15 January; it could unwind on Monday 23 February, when the need for assistance is expected to fall by some £700 million. We would announce this on Friday of this week (9 January).

5 The fragility of the arithmetic is illustrated by the experience of the last six working days, when the Exchequer swings (regardless of direction) have averaged £380 million a day, and on balance have added up to £290 million net against the market. Moreover as the money markets have become more optimistic about interest rate prospects over the last few days, interbank rates have fallen in relation to bill rates, and borrowing on acceptances has therefore become less attractive in relation to borrowing through advances. This may reduce the supply of new bills; and furthermore the houses may become less willing to sell bills to us. All this means that we may need to announce and bring into effect the next repo with the banks earlier than the figuring above suggests, so that we can use its opening date as a terminal date for bill repos with the houses later this week.

6 Against this background I would be grateful for authority to offer the banks repo facilities for up to 1% of their eligible liabilities (which should yield about £1 billion) for the period Thursday 15 January to Monday 23 February, to be announced on Friday 9 January. I should however also be grateful to have the discretion to bring forward the opening date of the repo and the

announcement date should developments during this week warrant it. The new repo would be on the same basis of terms (agreed with the CLSB) as the one we have already put in place.

3736/014

FROM: N J ILETT
DATE: 7 January 1987

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Evans
Mrs Lomax
Mr Peretz
Mr C W Kelly
Mr Neilson

Ch
Doesn't really answer question - but by implication no-one can think of circs when intervention might be appropriate
AA

THE FLOATING RATE NOTE MARKET

I am sorry not to have replied to Mr Allan's minute of 8 December (copies of the earlier correspondence attached).

2. I agree that we are most unlikely to want to intervene in the euromarkets. But we do need to monitor developments in these markets and to assess the knock-on effects of market problems. The perpetual FRN market episode at the beginning of December was particularly interesting because of the consequences for <u>future</u> capital base increases by UK banks (not, of course, as Dr McDonald seemed to think, for their present capital bases).

3. My concern in my minute of 5 December was essentially what struck me as the fragmented division of responsibility for matters relating to the euromarkets within the Bank. This is liable to make the monitoring and assessment of knock-on effects less efficient than it should be.

M.

N J ILETT

22/3069

— phoned David.

Ch

Cont'd.

SECRET

FROM: DAVID PERETZ
23 January 1987

CHANCELLOR

Ch
I will make sure Robert is kept in touch.
AA

cc Economic Secretary
Sir P Middleton
Mr Cassell
Mr Kelly
Mr Richardson
Mr Ross Goobey

2.30 LENDING

It is possible the Bank of England may want to do 2.30 lending this afternoon. I think the chances are rather less than 50:50, but they will not know for certain until after the 2 o'clock dealing round.

2. Today is the peak day of the year for market assistance (it will reach a total of about £16½ billion - £14.3 billion in bills). There is also a very large shortage in the money market today: around £1.2 billion.

3. Although inter-bank rates have if anything firmed slightly this morning, with the weaker exchange rate, bills rates have not, and the bill market seems to be reflecting some thoughts about potential falls in UK interest rates. This could make it difficult for the Bank of England to take out today's shortage at existing dealing rates.

4. They took out just over £500 million in an early round this morning and at midday, operating in all bands, and also by way of bill repos. - (leaving £700m to go at the 2 o'clock round).

5. We will have to wait until the 2 o'clock dealing round to see whether or not the Bank are able to take out the rest of the day's shortage at existing dealing rates. But if they are not able to do so they will have to take out the remainder of the shortage by late lending. The Bank would like to be in a position to announce immediately that they would be doing so by way of 2.30 lending, if at the time it still looked as if

the short term market needed that kind of message.

6. In the circumstances this would both be operationally sensible; and give the right signal to the market about our interest rate intentions - ie that we have no immediate intention of reducing rates. I see no reason to discourage the Bank from going ahead if they decide it is right to do so.

7. The lending would be until Monday week, and at 11¼% - a rate in line with the market (it lies about half way between current bill and inter-bank rates), and the (undisclosed) rate at which the Bank have recently lent to the market at 2.45.

8. There is a link with the possible gilt issue this afternoon, but it could go either way. If the gilt market were to go up as a result of 2.30 lending - which is quite possible - it might increase the case for going ahead, for which the Economic Secretary has already given contingent authority.

DLCP

D L C PERETZ

RA7.45

UNCLASSIFIED

pmp

FROM: A C S ALLAN

DATE: 17 February 1987

MR PERETZ

cc PS/Economic Secretary
Sir P Middleton
Mr Cassell
Mrs Lomax
Mr Kelly
Mr Ross Goobey

HENRY KAUFMAN ON FINANCIAL OPPORTUNITIES AND RESPONSIBILITIES

The Chancellor was grateful to you for sending him the Henry Kaufman talk. He wondered how the UK trends compared with those for the US discussed on pages 1 and 2?

ACSA

A C S ALLAN

Ms Lomax cc PPS
PS/EST
Sir P Middleton
Mr Cassell
Mr Kelly
Mr Ross Goobey

Interesting — as usual.

DWP 13/2

You understand. How do UK trends compare with those for the US discussed on pp 1 & 2?

Financial Opportunities and Responsibilities

by
Henry Kaufman

Salomon Brothers Inc

Bond Market Research

Financial Opportunities and Responsibilities

by
Henry Kaufman

I was delighted to accept Dean Palmer's invitation to speak to you today because you will be the people who, in the years to come, will have great opportunities and responsibilities in the financial markets. In your studies at this very fine school, and in your reading of the financial press, you have become aware of some of these opportunities. As the world financial markets have grown in size and complexity, Wall Street institutions have sought aggressively young, talented people who have the high levels of energy and ambition needed to master the vast array of activities that have come about recently as a result of securitization, innovation, deregulation, and the globalization of financial markets. Wall Street's need for people — and their response — prove again that economics does work. To attract talent, Wall Street institutions, in recognition of the meaningful value added that young people can bring to their businesses, have escalated compensation, both at the entry level and during the first several years of employment. And young people have responded to the promise of high-growth-oriented careers.

The recognition of the challenges and opportunities in the financial markets is evidenced by the fact that at many business schools, most students are specializing in finance. In fact, opportunities, compensation and the number of students seeking employment in financial institutions are all rising exponentially. There are limits, however, and whether such a dramatic spiraling will be followed by a plateauing or moderate gains or sharp contractions hinges, I believe, on how all of us — especially those of you who will rise to prominence — perceive both the opportunities and responsibilities.

The broad opportunities in the financial markets are exemplified by their growth. Consider the following:

- Credit market debt at the end of 1986 totaled $7.9 trillion, up from $3.1 trillion just ten years ago, a 9% annual increase.

- During this period, the value of equities rose from $1.0 trillion to $3.0 trillion, or 11.5% annually.

- In markets outside of the United States, outstanding publicly issued bonds denominated in 12 major currencies rose from $850 billion in 1975 to $4.1 trillion in 1986, or 17% per year.

- The U.S. dollar value of equities in these countries surged from $445 billion in 1975 to $3.1 trillion in 1986, or 21% annually.

- The aggregate daily worldwide trading volume in futures and options contracts on major exchanges soared from $81 billion in 1980 to $680 billion in the third quarter of last year.

- The market in interest rate swaps expanded to an estimated $300 billion in 1986, up from $200 billion in 1985 and only $3 billion in 1982.

However, it would be foolish to merely extrapolate these growth rates into the future. Financial and economic life is not that constant. Moreover, trends in the growth of overall markets tend to obscure important financial developments and structural changes within markets.

For example, debt in the U.S. since the early 1980s has been growing much more rapidly than nominal gross national product (GNP). This has not always been true. For a great part of the postwar period — from 1960 to 1980 — the rates of growth of debt and of GNP were nearly coincident. Credit market debt outstanding at the end of 1986 exceeded nominal GNP by a ratio of 2:1. A decade ago, it was 1.5:1. Even as inflation has abated, the very heavy dependence on debt has not really slowed down. While it is impossible to determine how high this ratio could go without endangering our financial system and our economy, this divergence cannot be ignored: It is a warning. The greater the divergence between the growth of debt and the economy, the less the economy will be able to tolerate swings in the business cycle.

Why?

The rapid expansion of corporate debt, in particular, is a problem that is bound to challenge your analytical skills and judgments when you are entrenched in your financial careers. In the past three years, alone, the book equity of nonfinancial corporations, which as you know consists of retained earnings and net new stock issuance, has contracted by $171 billion, reflecting massive retirement of equities; nonfinancial corporate debt, on the other hand, has increased by $525 billion. The result has been an aberrant deterioration in credit quality throughout this business expansion; this erosion is likely to continue in 1987.

One of your future tasks may be to unravel this new structure of corporate finance. The acceptance of lower corporate credit quality by the markets is a function of three factors: substantial credit availability; the absence thus far of a cyclical economic test; and the strong desire by investors to maintain income as interest rates have fallen. This is not to say that the high-yield corporate bond market — and therefore the economy — faces an immediate threat. As long as these conditions persist — and in all likelihood they will this year — this market will fare quite well. Some of the analytical and other justifications that support making commitments in these credits, however, are similar to those that were used to justify making loans to those now strangled by indebtedness, such as a number of developing countries, farmers and owners of some commercial properties.

All of us in finance — from analyst to chief financial officer to investor — play a vital role in balancing the debt leveraging process. At times, it is nearly impossible to withstand the pressure to leverage. There is the immediate reward of higher profits for borrowers, lenders and investors. Leveraging can help an entity garner market share, meet near-term growth objectives, and attract talented people. To curb the leveraging process may mean limiting these short-term goals and adhering to a longer-term strategy that will maintain the viability of an organization through both the up and down slopes of the cycles in the economy and financial markets. These are difficult goals to achieve. Few can effectively remain uncompromised, given the near-term-oriented financial environment in which we live today.

An interesting thought.

In the compromise, however, lies this danger: Excessive use of debt limits opportunities in periods of economic travail and perhaps even ends corporate life. It is a fact that sizable equity positions are essential for substantial risk taking, while large amounts of debt inhibit the search for opportunities. In a broader vein, when society is encumbered with huge debt levels, political and social change are a risk (possibly of an extreme magnitude) if a substantial economic contraction takes hold. The foundation of a real economic democracy is a substantial equity base.

Securitization — the process in which an asset is transferred from being nonmarketable to marketable — will also provide opportunities and challenges to you. While securitization is well under way, there is still a long way to go. In the United States, where securitization is most advanced, the value of securitized debt runs about $4.6 trillion out of total credit market debt of $7.9 trillion. Securitization in Japan and West Germany is only now getting under way, suggesting, of course, further opportunities for securitization.

The opportunities inherent in securitization are well-known. Wall Street institutions underwrite and trade securitized assets, resulting in an enlarged volume of financial transactions and a broader spectrum of profit opportunities. Through securitization, borrowers are likely to lower the cost of financing. To investors, securitization has increased the scope of investment alternatives not only in terms of maturity and quality, but also in the range of obligations denominated in different currencies.

What then are the potential problems that could result from securitization? First, note that there is a difference between *marketability* and *liquidity*. Marketability means selling an obligation at any price, while liquidity means selling an asset at close to par. This difference is often forgotten in the euphoric moments of bull markets and is recognized only when markets come under pressure. Securitization also encourages the belief that an investor's scrutiny of financial assets is not as critical as it was when the asset was nonmarketable and thus, by definition, "stuck" in the portfolio. The reasoning is that the assets, after all, can be sold, thus reducing the risk. This is, of course, a dangerous belief, which if held would mean that those who are the traditional guardians of credit would forgo some of their responsibilities. Marketability through securitization can only reduce the risk for some, but certainly not for the economy as a whole.

Securitization has also paved the way for the accelerated use of futures and options, which while often intended to limit risk, actually enlarge the balance sheet structure of institutions and enhance potential risk exposure. Today, options and futures are an integral part of financial activity. Undoubtedly, this increasing use of these instruments reflects, in many instances, efforts to limit risk; yet today, the opportunity to speculate through proxy instruments on thin margin is much greater than that in the 1920s. Moreover, the process of trying to limit risk in securities holdings through proxies causes total assets and liabilities to stay at high levels; heretofore, risk was limited by paring positions. There are also numerous market aberrations, both subtle and major, including differences in market depth, quality and political change that can, at times, undo what seem to be perfect arbitrages and hedges.

There are also other dimensions to the challenges posed by securitization. For example, until now, when a corporation's credit quality deteriorated, the open market closed its doors to these borrowers, and they were forced to return to the commercial banking system for accommodation. Now, assume for a moment that the credit markets become almost entirely securitized. Will commercial banks, which will then have become merchant banks *de facto*, open their loan facilities to the weakened credits in the open market? I suspect not, and thus, the real lender of last resort — the central bank — will be much more burdened periodically.

Securitization has several implications for financial officers, as well, and I suspect that a number of you will pursue that avenue. First, the matrix of financing opportunities will continually shift and broaden. This will require a deep knowledge of domestic and international markets. Second, in order for financial markets in the securities of your corporation to function just reasonably well, demands for improved income statement and balance sheet data will increase. Third, much more detailed disclosure of securitization will expose corporations to the potential of rapidly shifting values in liabilities and capital accounts — values that were perceived to be hidden or assumed to be constant in a credit market in which nonmarketable assets and liabilities dominated. In a securitized world, corporate credit quality deterioration cannot be concealed, because the market quickly marks down the value of the outstanding bonds and stocks.

a good thing

In addition, securitization, together with improvements in technology and information transmission, will continue to spur advances in monitoring portfolio performances. Indexes measuring the performance of the debt and equity markets will proliferate. In time, money managers may have sufficient pricing data to determine the value of their portfolios on a daily, or even intraday, basis. This development has already led to the rapid growth of passive portfolio management (that is, the indexing of portfolios to achieve a performance equal to that of the index). Assets committed to bond portfolios now stand at an estimated $50 billion, a fourfold increase since the start of 1986, but still only about 8% of the potential index universe, which we estimate to be $625 billion.

It would be a mistake, however, to conclude that the trend toward indexation will diminish market volatility. Quite the contrary. When a large portion of institutional funds becomes indexed, the decisions of the nonindexers will, by definition, have a powerful price impact at the margin. For Wall Street, at first, the movement toward indexation will enhance market activity; once the massive conversion is over, however, secondary market activity will slow appreciably. This slowdown reflects the fact that periodic adjustments in securities holdings in an indexed portfolio are bound to be small, compared with the large transactions that have to be made in the switch from an actively managed portfolio to an indexed one.

In addition to being involved in measuring portfolio performances, indexing portfolios and quickly analyzing of near-term events, financial analysts will move gradually toward the center of the decision-making process of financial institutions. Tomorrow's traders will have to be well-skilled in analytical tools to assess the opportunities and risks in rapidly changing markets in the U.S. and abroad. A decade from now, the Wall

Street security analysts will assume more sales and corporate finance responsibilities to improve the flow of information and to reduce costs. In this sense, the analyst will replace other people in these functions. Indeed, analysts' input will be essential to traders, who in order to function, will require analytical grounding; to some extent, the traders will take on more of the attributes of analysts.

In making judgments about the longer term, let me mention six caveats that I stated in my recent book, *Interest Rates, the Markets and the New Financial World*.

First, history shows that to project the future by merely extending the past is dangerous. In this century alone, each decade has differed sharply from the previous one. The decade of the 1910s was marked by World War I; the 1920s by speculation; the 1930s by worldwide depression; the 1940s by World War II; the 1950s by economic recovery and rehabilitation; the 1960s by a long economic expansion and the sowing of the seeds of inflation; the 1970s by oil shortages and double-digit inflation; and the 1980s, so far, by disinflation and deregulation.

Second, adherence to fashions of the moment in economic judgments is dangerous. This contributes to unsustainable business momentum, up or down.

Third, leadership — whether in business, finance, industry, culture, or civilization — has a definite life cycle, the duration of which varies. Consider the Roman Empire, ancient Greece and Spain, for examples. In the business world, IBM was an unknown when American railroads were the elite credit in the marketplace.

Fourth, finance is the handmaiden of economic growth, encouraging growth with new funds and disciplining those that have abused contractual relationships.

Fifth, the interdependence of nations will probably tend to increase with further rapid strides in science and technology.

Sixth, in a world marked by substantial gaps between rich and poor, between educated and illiterate, between countries with deep-seated ideological differences, and in which nuclear warfare is an ever-present danger, limits to economic growth based on past and present productive technology are not an acceptable solution. Nor is the shortsighted neglect of future economic potential.

All these caveats require that you, as future financial leaders, have not only a sense, but a thorough understanding, of economic and financial history. I find it discouraging that few business schools teach financial history. History is replete with both wisdom and foolishness. And indeed it would be foolish to believe that we have become only wise. In Santayana's words, "Those who cannot remember the past are condemned to repeat it." Historical knowledge is essential to making good judgments.

Opportunities and responsibilities for those of you who will be involved in the international financial arena are also changing and will become even more complex. U.S. financial institutions are bound to retreat from their dominance as long as we remain a debtor nation. The transfer of dollars abroad through our trade deficit will encourage the countries on the receiving end to enlarge their role in the deployment of these excess funds. Moreover, the higher savings rates in most major industrial nations, compared with that in the United States, will continue to give many foreign financial institutions superior growth rates. It should come as no surprise that today, worldwide, seven of the ten largest commercial banks and four of the six largest securities firms are Japanese. Foreign financial institutions will have a comparative growth advantage over U.S. institutions, because our financial markets are generally less regulated. Foreign institutions will thus have quicker access to U.S. markets than Americans will have to foreign markets.

Nevertheless, deregulation and the globalization of finance will intensify competition. Profit margins will be squeezed over time and institutions will be under pressure to control costs more closely, to seek new markets and trading opportunities, and to exercise the maximum permissible leverage in order to maintain a high level of profitability, while the financial transactions become even more intricate. As a result, the management of financial institutions, which will include in its ranks many of you here, will be scrutinized by investors, lenders and regulators. As always, managements will be judged on how they reconcile conflicting objectives, but the circumstances continue to grow more complex. To be sure, it is exciting to ponder this new financial world in which the volume of transactions is soaring, markets are linked internationally, and the matrix of arbitraging and hedging opportunities seems endless, especially as participants are able to trade around the clock. In this world, however, especially large institutions will require talented leadership to stay safely within the mainstream of the marketplace. This is because the mainstream of markets is a dynamic place and may well be perceived, incorrectly, to be focused on an esoteric and temporarily fashionable activity with the allure of large profits but hidden and incalculable risks.

You will, of course, help to shape the structure and direction of the financial markets by your actions and behavior. It is easy in the hurly-burly of today's markets to overlook our real role in finance. Financial institutions intermediate temporary funds and savings to provide liquidity and to attempt channeling funds to their most efficient and productive uses. All finance activities — from interest rate swaps, to buying call options and even to leveraged buyouts — must fall within the purview of this role.

We are entrusted with an extraordinary responsibility — other people's money. Financial institutions have huge liabilities, made up of the financial assets of households, businesses and governments, and usually only a small percentage of total footings is their own capital. Hence, we cannot escape public scrutiny. We are not independent of the world outside of finance. Otherwise, all would be pursuing occupations in financial markets and abandoning everything else. The fact is that no matter how ingenious we are or have been in financial markets, we did not invent the wheel, the computer or the electron microscope. We make critical judgments, however, that join money and credit with myriad economic activities. This is a singular and crucial responsibility. To carry it out successfully requires objectivity and a sense of the public trust.

If you do, your fortunes will flourish; you will gain great satisfaction from a career in finance; and you will have made a signficant contribution to the world's economic and financial well-being.

* * * * *

3887/012

SECRET

Pse thank

FROM: C W KELLY

DATE: 23 February 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Peretz o/r
Mr Culpin
Ms Goodman
Mr Richardson
Mr Ross Goobey

THE MARKETS

The reaction in the foreign exchange markets to the weekend meetings was cautious. There is some scepticism about whether the agreement means very much, but also wariness about taking the dollar down because of the possibility of central bank intervention. Activity has been fairly limited and no clear trend has developed. At the European close the dollar was more or less where it was on Friday night - DM 1.83 and yen 1.5360.

3. Sterling strengthened against both the DM and the dollar. This partly reflects continued bullishness about the economy generally (CBI surveys etc). But an important factor has also been greater certainty - encouraged by your radio interview - that a reduction in interest rates will not come until after the budget.

4. The money markets were also a bit calmer, for the same reason.

5. The Bank did not intervene in the foreign exchange market during the morning, partly because sterling was then fairly steady and the opportunity did not offer and partly out of concern that in the market's heightened state of awareness anything they did would be misinterpreted. But as the rates strengthened in the afternoon they bought $31 million.

6. The Italians bought $100 million. The French bought both dollars and DM, presumably feeling that with the pressure taken off the deutschemark they could now begin to restore their reserves. The Irish also picked up a few DM. As far as the Bank know, none of this was detected.

7. Gilts received less support from the exchange rate than might have been expected and traded within a fairly narrow range. But the Bank tapped out a further £150 million of the short IG this morning - probably more as a backwash of the equity market than as a result of anything in Paris.

CWK

C W KELLY

3887/031

SECRET

FROM: C W KELLY

DATE: 27 February 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr Peretz o/r
Mr Culpin
Mr Richardson
Mr Ross Goobey

C/ Chris Kelly needs a decision ASAP.

Discussed with Ch & said no (no need)

MARKETS : 2.30 LENDING

The money markets are not showing any great change this morning in their expectations about interest rates.

2. But the Bank are a little concerned about the possible outcome of the 1.00 pm Treasury bill tender. Last week's tender came out rather below the market, at 10.16 per cent. The new bills are currently trading at 10.13 per cent.

3. The Bank are not expecting any great change today. But the outcome will depend a bit upon the accident of who is bidding and how badly they need the bills. It is therefore possible that the outcome could be lower than that last week.

4. If so, they would like to signal their disapproval by 2.30 lending.

5. The lending would be done only for the signalling purpose. They are not at present anticipating enormous difficulty in clearing today's shortage, of £1550 million.

6. Can we give the Bank contingent authority to announce 2.30 lending if the Treasury bill tender does turn out significantly below last week's level? It would seem sensible to do so.

C W KELLY

SECRET

pup

FROM: F CASSELL
2 March 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Peretz
Mr Kelly
Mr Ross Goobey

Ch
OK?
AA

OK -

MARKETS: 2.30 LENDING

The markets are very strong today. Gilts are up to 1 point higher and inter-banks softer (down to 10 5/8 at 3 months). Rumours of a pre-Budget base rate cut of ½ per cent are again going the rounds.

10 3/4 on Friday close.

The Bank are pressing strongly for 2.30 lending today. There is a shortage of £800 million and the Bank's reactions will be very carefully watched by the markets.

Eddie George says that failure to reassert our position on rates today will encourage expectations of an imminent cut and, if we wished to avoid that, we would then have to take much stronger action later in the week.

I agree with this advice. I believe that you felt on Friday that 2.30 lending then might look heavy-handed (in the event, the need never arose). In today's buoyant market I do not think it would be seen that way. Rather, its absence could be interpreted as a sign that we were softening in our attitude.

If you agree, the lending would be announced at 2.15.

The Bank are also proposing to announce a new gilt today (maturing 2002). Mr Peretz is submitting to the Economic Secretary on this. The two announcements together should help to calm markets down.

F CASSELL

PA

FROM: P G F DAVIS
DATE: 4 MARCH 1987

MR REDLEY

LONDON COMMODITY MARKETS

David Smith of DTI rang me at lunchtime to-day to say that he had just heard from the Bank that the Governor was meeting commodity chairmen this afternoon (!) and wanted to issue a press notice saying that the Treasury and DTI fully supported what he was trying to do. Mr Smith and I agreed that we should refuse permission for that, partly on the grounds that neither the Chancellor nor Mr Channon had been consulted, and partly on tactical grounds. Mr Smith had explained to me that the Governor's initiative had the effect of supporting Saxon Tate and the LCE, that there had been a lot of politicking amongst the commodity markets recently, that the LME and some of the smaller markets with their own premises would oppose the Governor and that the LCE premises were unsuitable anyway as a home for the commodity exchanges, because while they could provide adequate trading floors there was insufficient space for these to be supported by the essential backrooms. Clearly, if there is to be guerrilla warfare, we do not want the Government arraigned in the press as the hidden aggressor. I suggested to Mr Smith, and he agreed, that he should give permission for the Governor to say (to the chairmen) only that he had kept the Treasury and DTI in touch and that what he was trying to do was in line with the general policy interests of this Government.

2. I then spoke to Peter Hall and afterwards Cathy Ryding - so that the Chancellor's office would know the story in case he saw a report of the meeting in to-morrow's press. I asked them to let me know if a note was required. So far I have heard nothing.

3. Separately, Mr Hall mentioned during my talk with him that he had now established that for the purposes of the FSA physicals markets must be kept completely separate from financials. !!

P G F DAVIS

SECRET

Pmp

FROM: F CASSELL
5 March 1987

Content!

CHANCELLOR

Ch
I have said
OK to Frank
AA

cc Economic Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Peretz
Mr Kelly
Mr Ross Goobey

MARKETS

Still bullish this morning. The one-month inter-bank is down $10^{13}/_{16}$, the three-month now down to 10¼. One clearer has indicated he is thinking of a ½ per cent cut.

I have reaffirmed to Eddie George your wish to hold rates until the Budget. He will discourage his caller - and has no doubt that he can do so. But the pressures for an early cut are building up.

There is a large money market shortage today (£1150 million). The Bank are not being offered bills. They have offered a REPO to the discount market going out to 2 April - a deliberately unattractive one. Only £17 million of this was taken up at the early morning round. The game of bluff will go on at the midday and the 2 pm rounds. The Bank's tactics will be to make it clear to the market that there will not be a REPO on more favourable terms. They hope that by 2.15 the discount houses will throw in the towel for today and take sufficient of the REPO (or offer bills) to reduce the shortage to a size that can be covered by late lending.

Failing that, 2.30 lending. I (and the Bank) would prefer to avoid that if we can, but in the circumstances need contingent authority. Are you content?

FC.

F CASSELL

ph1.33

UNCLASSIFIED

CHANCELLOR OF THE EXCHEQUER

FROM: A C S ALLAN
DATE: 6 MARCH 1987

CHANCELLOR

MARKETS MEETING AGENDA

Interest rates

Hold on till the Budget or move now? And if move now, by ½ per cent or 1 per cent? (You may want to precede this with some discussion of monetary conditions - the Governor's letter and the record of Peter's latest monthly meeting, both in folder).

New gilt

Is one appropriate/needed?

National Savings

Withdraw 32nd issue immediately? (Easier if rates are cut this week, otherwise possibly some difficult signals).

Funding

Prospects for next year - no more long gilts? I doubt whether you will get the Bank to sign up to this on Monday; you may need to offer to chair a separate meeting later.

Other points

i. Auctions. State of play/progress.

ii. LA credit worthiness. You said you might raise this with the Deputy Governor, but in fact Rachel's note in the folder points out there is a lot more to do via the usual channels before we need to press the Bank for a more high profile line.

AA

A C S ALLAN

I agree that we do not want the rate to go above 72.5, & we need to be especially careful about the DM/£ rate, which must stay well this side of 3 DM. BUT the tactics must be to intervene as ~~/substantially~~ as is necessary, without taking any ~~[illegible]~~ steps to ~~[illegible]~~ state visibility. THAT STAGE COMES LATER.

SECRET

From: Sir G.Littler
Date: 17 March 1987

CHANCELLOR

Re X & Y, do we want to go visible so soon? (But may be v diff to intervene heavily but invisibly in NY or Tokyo) AA

c.c. Sir P.Middleton
Sir T.Burns
Mr Cassell
Mr Peretz
Mr Kelly

MARKETS: IMMEDIATELY POST-BUDGET

We are meeting at 9 a.m. tomorrow morning, but I think we may need guidance in handling the foreign exchange markets before then. We saw some heavy buying of sterling in the Far East this morning. Markets are now very quiet - waiting. I see a strong possibility that the foreign reaction to the Budget could be very favourable, given a lower PSBR than is generally expected and what foreigners will see as a restrained yet politically helpful tax policy.

2. I have discussed this briefly with Sir P.Middleton and Sir T.Burns. We feel that some lift in the effective rate would be perfectly acceptable, say up to 72.5, but we would not want New York and Tokyo to carry the rate up too rapidly, before we have taken stock and acted on interest rates and seen the domestic market reactions.

3. If you share this feeling, we would need to be prepared to intervene in New York and Tokyo, perhaps quite substantially and
X | without trying to hide our action, with the aim of inducing those markets to stay within moderate limits. I would recommend that we authorise the Bank to deploy up to $500 million (given the scale of intervention we have faced earlier this month), while using the
Y | best available tactics to minimise the actual total in the event. NO!

9/3070G

S E C R E T

FROM: DAVID PERETZ
17 March 1987

CHANCELLOR - Do the [illegible] [illegible] annexes?

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Kelly
Mr Culpin
Mr Ross Goobey

MARKETS

I thought you might like a note as background for tomorrow morning's meeting. There will be quite a lot of business to get through in a fairly short time, particularly if as seems likely we decide we want to show our hand in an early round of bill dealings at 10 am.

2. The agenda is:-

(i) **How big a cut in base rates (½% or 1%)?** There is the usual combination of strategic and tactical considerations. There are also second order questions, to do with subsequent market operations: 2.30 lending, and intervention tactics. Annex A sets out the main issues. As things look today (before the Budget), we and the Bank are agreed we should try hard to stick at ½%, but we will have to reassess this in the light of the market reaction to the Budget.

(ii) **A new gilt.** The Bank would like contingent authority to bring a new partly paid gilt tomorrow afternoon, to help manage the post-Budget market. The main question is whether this is sensible market management tactics, that will help ½% stick and avoid the risk of a sharp rise and subsequent sell off in the gilts market; or whether it would not be better to let long term interest rates take the strain for a period, if we are trying to resist too large a fall in short term rates. We also need to consider whether it is consistent with funding arithmetic. Annex B sets out the arguments, and the latest funding arithmetic.

(iii) **Gilt auctions.** We need to make a decision about the timing of the first auction; and about the one issue of substance still outstanding between us and the Bank of England: whether or not there should be some kind of commission paid in return for an underwriting commitment by the Gilt edged market makers. If you make an announcement on Monday, as you have provisionally decided, it should just be possible to hold the first auction on 15 April (if we want to go for that date) but the timing will be tight. (See Annex C for more details).

3. We will have to decide on (i) and (ii). It would be convenient to take (iii) tomorrow as well (and there is a link with (ii)), but not essential. If we run out of time we would need to arrange a separate discussion on auctions later in the week.

DLCP

D L C PERETZ

Copied to:

B/E
Governor
Deputy Governor
Mr George
Mr Loehnis
Mr Plenderleith

SECRET

ANNEX A

SHORT TERM INTEREST RATES

Assessment of Monetary Conditions

X1 Mr Grice's submission of 2 March reported our most recent assessment of monetary conditions. We have brought the summary table up-to-date, and a revised version is attached. This includes market rates as of this morning, information from the February provisional money figures (to be published on Thursday - about which you will have a separate minute from Mr Brook); and some other more recent information (notably the latest Halifax house price index).

2. The table also shows by way of comparison what the situation looked like on 23 May last year (just before base rates fell from 10½% to 10% on 27 May); and at the end of July, when we considered the possibility of a cut in rates to 9½% and decided against.

3. The messages from the **monetary aggregates** now looks not dissimilar from last summer. Twelve month growth rate of M0 is now only a little above its growth rate then; and the wider aggregates (as measured by PSL2) seem to be growing at about the same rate as during the summer. £M3 is affected by a turnround in the relative competitive position of the building societies between now and a year ago, and the growth of building society deposits at banks.

4. The **exchange rate** is still lower than it was last May, and substantially lower than either May or July after allowing for the movement in oil prices. **House prices** now seem to be growing at an annual rate of around 15%, compared with 10% in May and 12% in June - and there is some sign of acceleration.

5. To weigh in the balance the other way, fiscal policy as

measured by the PSBR is now tighter than we thought it was last summer; and interest rates abroad have fallen a little so that UK rates are relatively a little higher than they were.

6. While in the end it has to be a matter of judgement, none of this suggests that a cut in short term rates of more than ½% would be right - at least not unless and until there were a substantial further rise in the exchange rate. The risk of possibly bumpy markets in a pre-election period ahead reinforces the argument for caution.

Tactics

7. It may nevertheless not be easy, tactically. In advance of the Budget the short term money markets seemed to be pointing to a fall in base rates of rather more than ½%; and that was also probably the average expectation in the foreign exchange market. If strong market pressures emerge tomorrow we may be in the position of trying to limit the fall in interest rates and the rise in the exchange rate at the same time.

8. The situation is one that is perhaps more familiar the other way round, but the armoury of weapons we have and the arguments are the usual ones. We will have to assess how best to react in the light of market conditions tomorrow morning. You will want to consider the following:-

(i) There may well be a case for **showing our hand early** (ie at 10 am) and in as clear and decisive a way as possible.

(ii) We may need to be ready to use **2.30 lending** tomorrow afternoon, if necessary.

(iii) **Intervention.** It would seem sensible to be ready to bolster other action by continuing to do some fairly heavy creaming off, if necessary. After a time this might be noticed. (We are probably already in the position where the increase in the reserves to be published at the beginning of April is so far in excess of expectations that it could itself become a market factor, possibly leading to renewed upward pressure on the exchange rate/downward pressure on short term interest rates). We should discuss at what point we are prepared to do more open intervention - recognising that this could be something of a last throw.

(iv) You will want to consider the case for being ready to bring a gilt tomorrow afternoon, to complement other measures (see Annex B).

002/4549

Monetary developments since last month's report

	Latest outturns available at time of:			
	23 May 1986	31 July 1986	Feb report	17 Mar 1987
Monetary aggregates (12 month % growth)	(bking Apr)	(bking Jul)	(Cal Jan)	(Cal Feb)
M0 (sa)	3.2	3.0	5.1	4.1(4.0)+
£M3	16.7	18.4	17.6	18.9
PSL2	13.5	14.4	13.2	n/a
Bank lending	16.8	18.2	22.4	21.7
Bank & building society lending (est)	17.4	18.7	20.8	n/a
Interest rates (%)	23 May	31 Jul	27 Feb	17 Mar
3 month interbank	10.0	10.0	10.8	9.8
20 year gilt-edged	9.0	9.4	9.7	9.3
Yield gap	1.0	0.5	1.1	0.5
3 month overseas basket	6.7	6.5	6.3	6.3
3 month interbank/euro dollar differential	3.0	3.4	4.4	3.3
Real 3 month interbank	6.5	6.4	6.1	5.1
Equity dividend yield (all-share)	3.9	4.1	3.4	3.4
IG yields (1996) assuming 5% inflation	4.1	4.1	3.6	3.5
Exchange rate				
ERI	75.8	72.0	69.9	71.9
Oil adjusted reference index*	70.1	66.6	71.3	72.7
ERI/reference rate ratio	108.1	108.1	98.0	98.9
Asset prices				
FT-30 Index (% pa)	32.6	36.0	25.2	16.1
FT-30 Level (February peak: 1602)	1331	1272	1600	1576
Halifax house index (% pa)**	10.0	12.1	13.6	14.9

\+ latest four weeks (up to 11 March)

* indicates what ERI would be if exchange rate simply responded to oil prices in the ratio 1:4. In determining the reference rate the base taken is the Jan '83 - Nov '85 average for the ERI and oil price.

** figures are for April, June, January and February.

11/3070G

SECRET

ANNEX B

A NEW GILT

Depending on how the gilt market reacts to our moves tomorrow on short term interest rates, the Bank would like to be ready to announce a new gilt tomorrow afternoon - to come on sale from Friday.

Much too low - & why pd @ all?

2. The stock they have in mind is:-

(a) 2005 maturity, and FOTRA.

(b) £1 billion, £20 paid with the call placed in mid to late May.

(c) An 8½% coupon - which this morning would have given a 9.2% yield: but in the expectation that the yield would be 9% or less by the time the stock came on sale.

3. The Bank's argument on maturity is that it should be different from the 1997 just sold, and the 2002 and 2008 that preceded that; and that we would want to stay clear of short gilts for the time being, reserving that slot for the planned first auction. After 2005, the Bank's second choice would be something between 1997 and 2002.

Funding arithmetic

4. Our estimate of the funding position has been swinging around a little in the last few days. This reflects changes in estimates of the amount of funding likely to be done over the year as a whole by local authorities and nationalised industries, and in our estimates of monetary sector purchases of gilts - as we get the details of the February banking statistics. A few days ago it looked as if we were already overfunded for the year as a whole by £150 million; this was revised down to around £80 million, and that figure was then revised up to £170 million.

Further adjustments are still to come. These figures assume a PSBR of £3.3 billion (not the published £4.1 billion); and that we will publish a March reserves figure of just under $1 billion.

5. It can be argued, just, that a new partly paid gilt as above - bringing in £200 million this financial year - is consistent with this funding arithmetic. There may be further revisions to the arithmetic. We might want to do - and show - more intervention during the month. And other figures could change. If necessary the Bank could buy stock in towards the end of the month.

6. We cannot of course hope to be a 100% successful in our funding objective: final figures for several of the key variables will not be available until after the end of the financial year. We can only do our best (last financial year, as it turned out, we were in the end £420m underfunded).

7. On the other hand it can hardly be argued that the funding position either this year or next year <u>requires</u> a further new stock this year. And of course yields might fall further if we waited.

<u>Market management</u>

8. As I understand it the market management arguments <u>for</u> bringing a stock are:-

(i) That <u>if</u> the gilt market moves ahead strongly as a result of the Bank being seen to try to limit the fall in short term rates to only ½%, then not to have announced a new gilt could be unhelpful to the strategy of trying to limit the fall in short term rates.

(ii) If the gilts market charges ahead too far, it might well then fall back at some point. Better to try to smooth the process by selling stock into the rise, and being prepared to give some support if there is a fall.

9. The arguments for not bringing stock, apart from the funding position, are:-

(i) A number of commentators at present (mistakenly) think we are already well overfunded. Bringing a new gilt now could raise questions about the PSBR and funding position (including intervention) that we would rather not have to answer in the next few days (though we could if we had to).

(ii) A new stock, particularly one with only a £20 down payment, could risk stoking the gilts market up rather than calming it down.

(iii) If we do not need the funding now and we expect yields to fall, it would be cheaper to wait.

(iv) We have to take the strain somewhere. If we are in the business of trying to resist market pressure for a further fall in short term interest rates and a rise in the exchange rate, then we should be prepared to allow average interest rates to come down, by letting long term rates fall as far as the market takes them.

ANNEX C

GILT AUCTIONS

As you know the Bank have now more or less concluded their consultations with the market. There are two important issues left to settle before we can make an announcement.

Underwriting commitment/allotment commission

2. This is the one outstanding issue of substance where there is a difference between us and the Bank of England. You know our respective views; and have seen Mr George's letter of 13 March to Mr Cassell, and the attached record of the Bank's meeting with the Gilt edged market makers.

3. Whatever we decide on this, the Gilt edged market makers should welcome the fact that the auctions will be on a bid price rather than common price basis; and (if we agree) that they will be given a special facility for telephoning late bids to the Bank of England.

Timing and details of first auction

4. I think we are all agreed that the first experimental auction will be for a short gilt, with an amount of £1 billion.

5. That leaves the question of timing. There are two relevant considerations.

6. First, the funding position over the next few months. As we see things at present we will need to achieve gross gilt sales next year of around £10 billion - say £800-850 million a month. There are heavy redemptions in the early months of the year, totalling about £3 billion (of which only £700 million has so

far been bought in), so there is an argument for going for some front end loading of gilt edged sales. Against that, we already have tied up calls totalling £1¼ billion for April, and about £550 million for May.

7. All this seems to point to delaying the first auction until late May. If we were to hold it before Easter, we would want to make it an auction for a partly paid stock, with the call placed in late May or some time in June.

8. Second, we need to have an eye on the timetable of other events. After Easter we are into the Rolls Royce offer period (28 April-8 May). We also probably want to stay clear of the immediate aftermath of the local authority elections (7 May); and the major US Treasury auction in mid-May. So the first sensible date after Easter would be late May or early June.

9. Were it not for the complication of possible election dates, we would be recommending late May. An auction on 15 April for a partly paid stock is the other option.

10. If you want to go for 15 April, and to make an announcement on Monday, we will need to come back to you on the mechanics. Making an announcement in the evening in the House is always awkward, and it might be sensible to aim to have a Written PQ earlier in the day. The Bank will want to issue a notice giving further details a few days after the announcement.

11. Shortly after the first auction we would need to consider what dates to indicate for subsequent auctions during the year, so as to give the market forwarning.

19/3070G

FROM: DAVID PERETZ
19 March 1987

pup

MR ALLAN —

X vs queries interesting.

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mrs Lomax
Mr Grice
Mr Kelly
Mr Carr
Mr Ross Goobey

GROWTH OF UK FINANCIAL MARKETS

The Chancellor asked a little while ago (your minute of 17 February) how UK trends compare with those for the US summarised in a recent lecture ("Financial Opportunities and Responsibilities") by Henry Kaufman. I am sorry for the delay in replying. We have found it difficult to replicate Kaufman's US figures. But some of the UK figures are quite interesting.

(a) Credit market debt

- Kaufman's **US figures:** Grown to \$7,900bn in 1986 from \$3,100bn ten years earlier - an annual growth rate of 9%. This is a rise from 1.5 times US GNP to 2.0 times GNP in 1986.

- **UK figures:** (defined as debt (excluding equity) owed by the public, personal and company sectors: 1985 figures the latest available).

	Public sector	Personal sector	Companies	Total	£bn ratio to GNP
1975	63	41	51	155	1.46
1979	108	65	85	258	1.30
1985	189	203	161	553	1.55
% Annual growth rates					
1975-85	12	17	12	14	
1979-85	10	21	11	14	

So over the decade as a whole total UK credit market debt, as but has faster (nominal) annual % growth.

defined, has grown slower (and remains lower) than in the US as a proportion of GNP - though the ratio fell between 1975 and 1979 and has risen quite sharply since 1979.

(b) Value of Equities

- Kaufman's **US figures**: rose from $1,000bn in 1976 to $3,000bn in 1986 - an annual growth rate of 11.5%. This is a rise from 56% of GNP to 71% of GNP.

- **UK figures**:

	Value of Equities* (£bn)	GNP (£bn)	Equities as Percentage of GNP
1975	48	106	45
1979	76	198	38
1985	249	357	70
1986e	324	381	85

Growth Rates (average annual increase, per cent)

1975-85	17.9
1975-79	12.2
1979-85	21.9
1979-86e	23.0

* Excluding bank equities
e = estimate

(c) Futures and options contracts traded

- Kaufman states that the **worldwide average** daily figure for trades rose from $81bn in 1980 to $680bn in 1986Q3 representing an annual growth rate of around 40 per cent.

- For the **UK** LIFFE and the Stock Exchange have available figures only for the number of contracts traded. This total rose from 254,000 in 1980 to 12.3 millions in 1986, a 91 per cent a year growth rate. The UK figures cover only financial futures/options, and thus exclude commodity options.

(d) Interest rate swaps

- The sterling swap market is estimated to have grown from about £2bn in 1985 to £6bn in mid-1986. This rapidly growing market forms only a small part of the world market which Kaufman estimates to have increased from $200bn in 1985 to $300bn in 1986.

(e) The book equity of non-financial corporations

- Kaufman comments on the deterioration in **US** debt quality marked by a net $171bn contraction in the book value of equity of non-financial corporations over the last 3 years, and a $525bn increase in debt.

- Comparable **UK** figures are not available for the book value of equity; but non-financial corporate debt grew £40bn over the 1982-85 period, a figure rather similar to the US figure as a proportion of GNP.

DLCP

D L C PERETZ

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Secretary of State for Trade and Industry

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SECRET AND CMO

24 March 1987

The Rt Hon Viscount Whitelaw CH MC
Lord President of the Council
Privy Council Office
Whitehall
LONDON
SW1A 2AT

Dear Willie

FINANCIAL MARKETS (CLEARING ARRANGEMENTS) BILL

Thank you for your letter of 19 March in which you suggested that it would be premature to accept our bid for this Bill until it was clear what it would do. I am writing in advance of Thursday's Cabinet to provide more detail and explain why the Bill is urgent.

The problem arises from the existing arrangements of the Stock Exchange and several other exchanges for sustaining their markets if one of their members defaults. The position is complicated because a defaulting member will have a large number of sizeable contractual obligations to other members, the extent of which will depend partly on movements in the price of the investment to which the contract relates. These obligations will grow if the price moves in the "wrong" direction and it will therefore be necessary to liquidate the position of a defaulting member without delay. In many cases, these obligations are guaranteed by the clearing house, through which all contracts pass. As a precaution against default, a member is required to put up a proportion of the value of his contract (the margin) to the clearing house, which obviously needs an undisputed right to use this margin to fulfil the obligations which it has guaranteed.

These arrangements have operated satisfactorily for many years, but we now believe that they could be successfully challenged in the Courts under Insolvency legislation. Indeed a recent case has demonstrated to the Stock Exchange that they can no longer rely on existing procedures. Essentially it can be argued that the current procedures run counter to the normal provisions of the Insolvency Act. The statutory duties of a liquidator or administrator might

DW1CVS

999-1

well oblige him to reclaim the margin money, to share it between the generality of creditors, and to disavow loss making contracts while enforcing those which are profitable. This would only exacerbate the problems for other members of the exchange.

Thus there is a greater risk of challenge now that the Insolvency Act 1986 is in force, and because of the substantial changes now taking place in the City, particularly the increased participation of US businesses, familiar with a legislative system which expressly provides for default arrangements, and naturally more litigious.

Considerable work has already been done both to determine the problems which require legislation and to identify solutions. The Bill would disapply the provisions of the Insolvency Act in the case of a member of a relevant exchange. Instead it would enable the defaulting member's positions to be closed and enable his margin or other assets to be used for this purpose. Thereafter the normal insolvency procedures would apply, but without the possibility of upsetting these actions.

I need not stress that these exchanges make a major contribution to our balance of payments. We would not wish to see the achievements of the Financial Services Act threatened, nor to inhibit the development of links between our exchanges and those overseas. Yet if we were unable to deal satisfactorily with a major default on one of the exchanges there could be a serious effect on confidence. There is already some concern in the City about the legal standing of the present arrangements. It would be irresponsible of us to do nothing and find ourselves unprepared for a major default; yet further detailed consultation with City experts could arouse fears about the existing arrangements which could not be delayed without a promise of a firm place for the necessary Bill in the legislative programme.

I hope therefore that you can agree to the Bill being included in the 1987/8 legislative programme. I am copying this letter to the Prime Minister, other Cabinet colleagues and to Sir Robert Armstrong.

Yours,
Paul

PAUL CHANNON

DW1CVS

999-49

Inland Revenue

Policy Division
Somerset House

FROM: D G DRAPER
31 March 1987

1. MR CORLETT 31/3

2. ECONOMIC SECRETARY

Wd it, in principle, be possible to have a higher ADR rate of duty for ADRs dealt in in London? -

ADRs

1. You will wish to be aware that The Stock Exchange are examining the possibility of creating a market in ADRs in London. They have already sounded out the ADR banks and they will be approaching market makers shortly to see whether any of them would be prepared to act as market makers in ADRs.

2. As a quite separate matter The Stock Exchange are also making plans for their members to report deals in ADRs carried out through New York. The Stock Exchange expect this requirement to be imposed upon them by SIB.

---

cc Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Sir P Middleton
Mr Cassell
Mrs Lomax
Mr Ilett
Miss Sinclair
Mr Cropper
Mr Ross Goobey
Mr Isaac
Mr Corlett
Mr Beighton
Mr Spence
Mr Pipe
Mr Adderley
PS/IR
Mr Draper

3. Stock Exchange member firms have been free to buy ADRs for some time and as we discovered last year there has been a substantial arbitrage trade (both ways) between the ADR market in New York and the market for registered shares in London. Some dealers may well have taken positions in the ADR market but they have not hitherto acted as market makers as such and there has been no separate London market in ADRs. In promoting a market in ADRs The Stock Exchange say that they are trying to encourage member firms to recapture some of the business they have lost to New York. Although some American investors do buy UK registered shares direct The Stock Exchange are working on the basis that many American investors will only want shares in ADR form and that the best way of increasing London's share of the market in UK shares is to establish a rival ADR market in London.

4. The plan currently under consideration would not involve the release of depositary receipts in this country. Purchasers would have to obtain their ADRs in New York and it is envisaged moreover that settlement of trades would be through the Depositary Trust Company (DTC) in New York. Purchasers of ADRs in London would therefore require access to a DTC account facility - they could, however, obtain this through an American broker. Some large American institutions have their own accounts.

5. We were told last year that for United Kingdom institutional investors there were considerable disadvantages in holding investments in ADR form - dividends have to be taken in dollars, rights issues (on unsponsored ADRs) cannot be taken up and there are difficulties in exercising voting rights. A further obstacle was that as the market was not in London they could not trade in ADRs during normal working hours. The Stock Exchange proposals would remove this obstacle and the institutions will inevitably become more aware of ADRs if, as proposed, market makers show both ADR prices and registered share prices on their screens. Also to the extent that the development would lead to a deeper market in ADRs than in registered stock (for a number of leading companies there is already more trading in ADR form that in

registered form) this also could result in some loss of business from the market in registered stock and with it yield from stamp duties.

6. It was partly because this development was foreseen that the ADR tax was introduced. One of the factors, however, that was taken into account in fixing the rate at one and a half per cent was that there was at the time no market in London. In announcing the reduction from five per cent to one and a half per cent the Chancellor made it clear that if ADRs were used as a means of avoiding stamp duty by UK residents he would have to reconsider the rate of tax on conversions. We do not see any need to reconsider the rate at this stage but the development (if it goes ahead) will need to be watched. One advantage of the creation of an ADR market in London is that it might be easier to monitor purchases of ADRs by UK residents.

7. The Stock Exchange would clearly like to attract much of the ADR business currently done in New York back to London. This is understandable, but must create a genuine risk that UK investors will increasingly use ADRs as a means of avoiding stamp duty. We think it might be sensible to point out to The Stock Exchange that we remain concerned to ensure that the ADR charge is effective in protecting the revenue, and that we would be most concerned if it looked as if UK investors were making increasing use of a London ADR market. This might cause them to reconsider their plans.

8. The regular monthly meeting between the Treasury and The Stock Exchange is on 2 April, and the ADR market is on the agenda. It would be helpful to know if you agree officials should take the discouraging line suggested above.

DGD

D G DRAPER

32/3070D

pvp

SECRET

FROM: DAVID PERETZ
23 April 1987

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Kelly
Mr Ross Goobey

Ch
separate note on
end month reserves
below AA

MARKETS

I am attaching a few tables and charts that you might like to have by you for tomorrow morning's meeting with the Governor:-

(i) An up-to-date version of our standard table of the various indicators of monetary conditions. It shows also how things looked a month ago (when we last had a markets meeting); how they looked on 31 July last year (when we considered reducing base rates to 9½%, but decided against); and how they looked on 23 May last year (just before base rates fell from 10½% to 10%).

(ii) Charts showing movements in recent months in sterling and dollar short and long term interest rates.

(iii) A chart showing movements in the ERI in recent months.

(iv) A table of our weekly (market) intervention figures since the Louvre meeting.

Recent developments

2. The main developments since your last markets meeting, on

25 March, are:

- the continued weakness of the dollar, particularly against the yen, despite heavy and (sporadically) concerted intervention.

- The edging up of short and long term dollar interest rates (though there is no reason to believe a rise in the Fed's discount rate is imminent).

- The heavy intervention we have continued to undertake to keep sterling below 3.00DM. Especially at times when the dollar has strengthened somewhat, tending to bring the £ up with it against the DM.

Options and Issues

3. There are, I suppose, three options.

(a) To carry on as we have up to now (or at least try to do so).

(b) Cut interest rates (say by ½%).

(c) Uncap the exchange rate. (out of the question)

4. The issues are very largely tactical, and to some degree political.

5. We want to be cautious on interest rates given possible market risks ahead: opinion polls, dollar interest rates, etc. This is also an argument for stocking up the reserves. We also want to avoid any further rise in the exchange rate, particularly against the DM, largely on the grounds that it would tend to damage industrial confidence (particularly a rise above the psychologically important 3.00DM level), and represent something of a departure from the spirit of the Louvre Accord.

6. The main question is how long a policy of resisting upward

pressure by intervention alone will be tenable. There is plenty of history to suggest that intervention as sustained and heavy as we have undertaken in recent weeks (see attached table) ought to be taken as a signal that some other action is needed: either on interest rates or by letting the exchange rate move.

7. Assuming we continue with the present tactics for the time being, there are one or two subsidiary tactical issues we should discuss:-

(i) We have in recent days been resisting hard at 2.97DM, and the market has seen this. This has boxed us in a little, and we could give ourselves a little more room for manoeuvre, tactically, if we were prepared to see the rate rise temporarily above 2.97 (but short of 3.00DM) on occasion before intervening to push it back down again. Mr George is likely to raise this point. It is one with which I have some sympathy.

V dangerous indeed to do this.

(ii) There is the question of what reserves figure to publish for April (on 5 May). Mr Kelly is circulating a separate note on that.

below

D L C PERETZ

SECRET

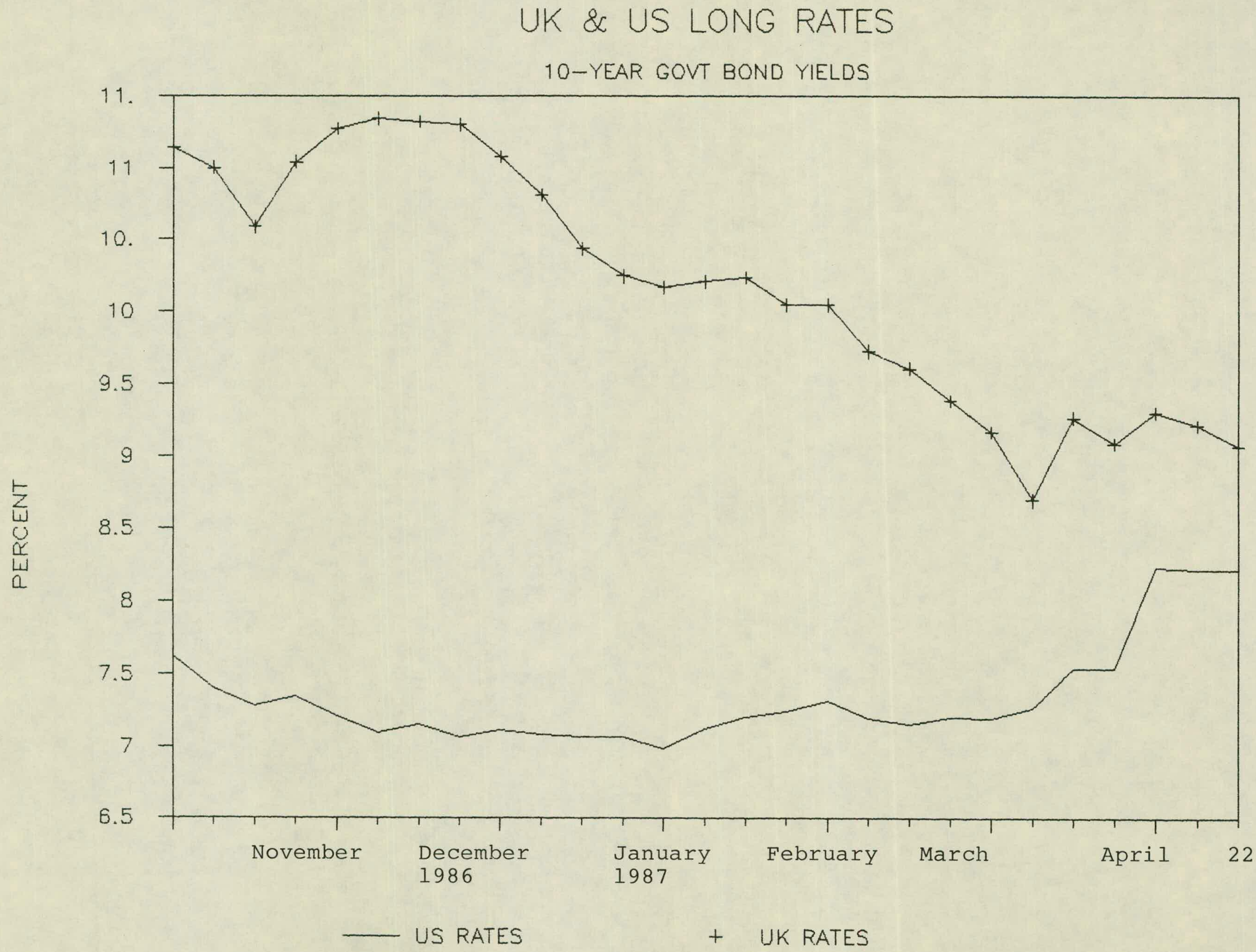
Monetary developments since last month's report

	Latest outturns available at time of:			
	23 May 1986	31 July 1986	March report	23 April 1987
Monetary aggregates (12 month % growth)	**(bking Apr)**	**(bking Jul)**	**(Cal Feb)**	**(Cal Mar)**
M0 (sa)	3.2	3.0	4.1	4.1(3.9)+
£M3	16.7	18.4	19.1	19.1
PSL2	13.5	14.4	13.3	13.5
Bank lending	16.8	18.2	21.7	20.7
Bank & building society lending (est)	17.4	18.7	20.0	n/a
Interest rates (%)	**23 May**	**31 Jul**	**26 March**	**23 April am**
3 month interbank	10.0	10.0	9.7	9.8
20 year gilt-edged	9.0	9.4	9.1	9.2
Yield gap	1.0	0.5	0.6	0.6
3 month overseas basket	6.7	6.5	6.1	6.3
3 month interbank/euro dollar differential	3.0	3.4	3.3	3.0
Real 3 month interbank	6.5	6.4	5.2	5.0
Equity dividend yield (all-share)	3.9	4.1	3.4	3.5
IG yields (1996) assuming 5% inflation	4.1	4.1	3.5	3.7
Exchange rate				
ERI	75.8	72.0	72.1	72.4
Oil adjusted reference index*	70.1	66.6	72.9	72.6
ERI/reference rate ratio	108.1	108.1	98.9	99.7
Asset prices				
FT-30 Index (% pa)	32.6	36.0	17.0	11.5
FT-30 Level (March peak: 1625)	1331	1272	1615	1555
Halifax house index (% pa)**	10.0	12.1	14.9	15.2

\+ latest four weeks (up to 15 April)

* indicates what ERI would be if exchange rate simply responded to oil prices in the ratio 1:4. In determining the reference rate the base taken is the Jan '83 - Nov '85 average for the ERI and oil price.

** figures are for April, June, February and March.


UK & US LONG RATES
10-YEAR GOVT BOND YIELDS
11.
11
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9.5
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PERCENT
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1986
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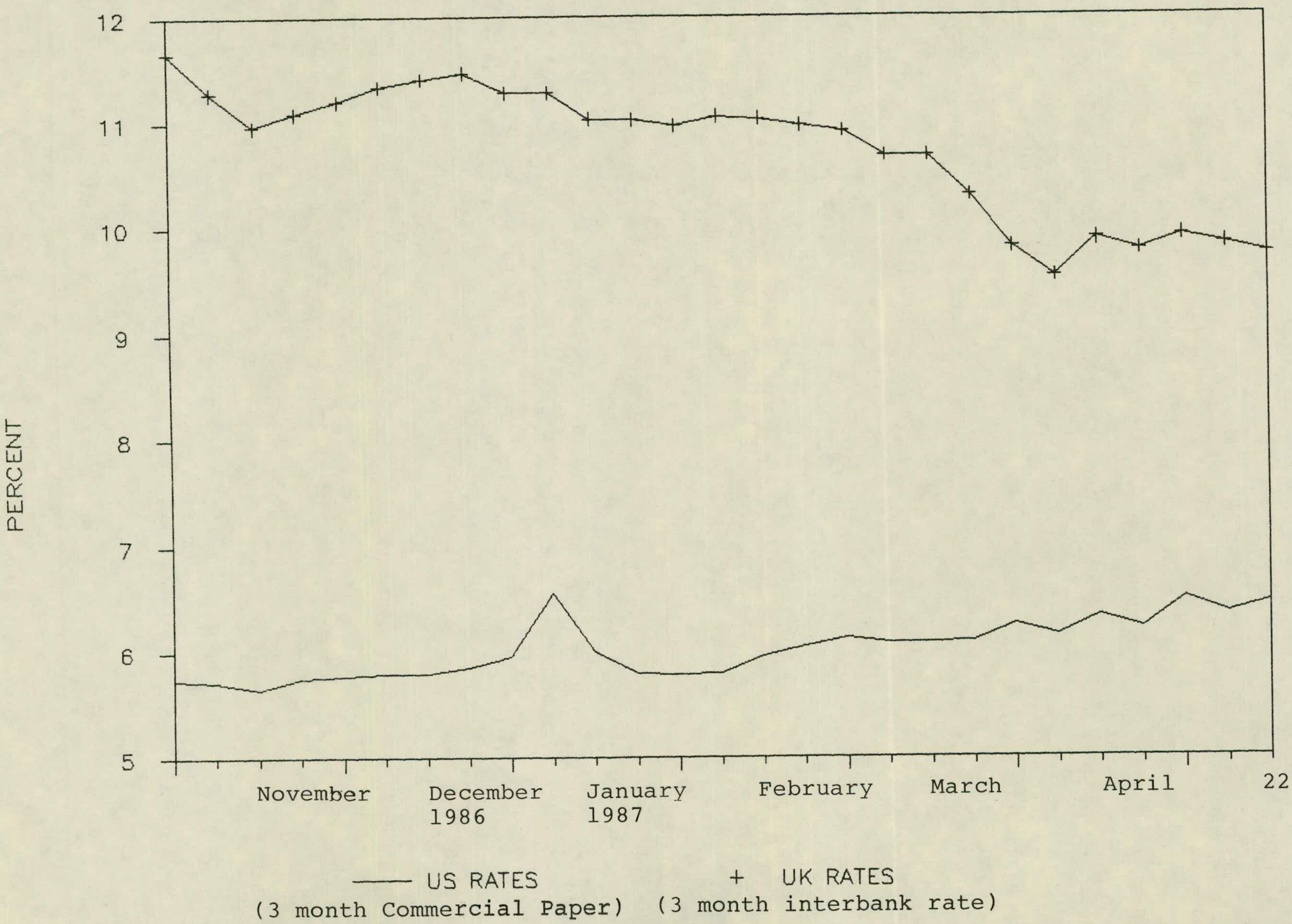
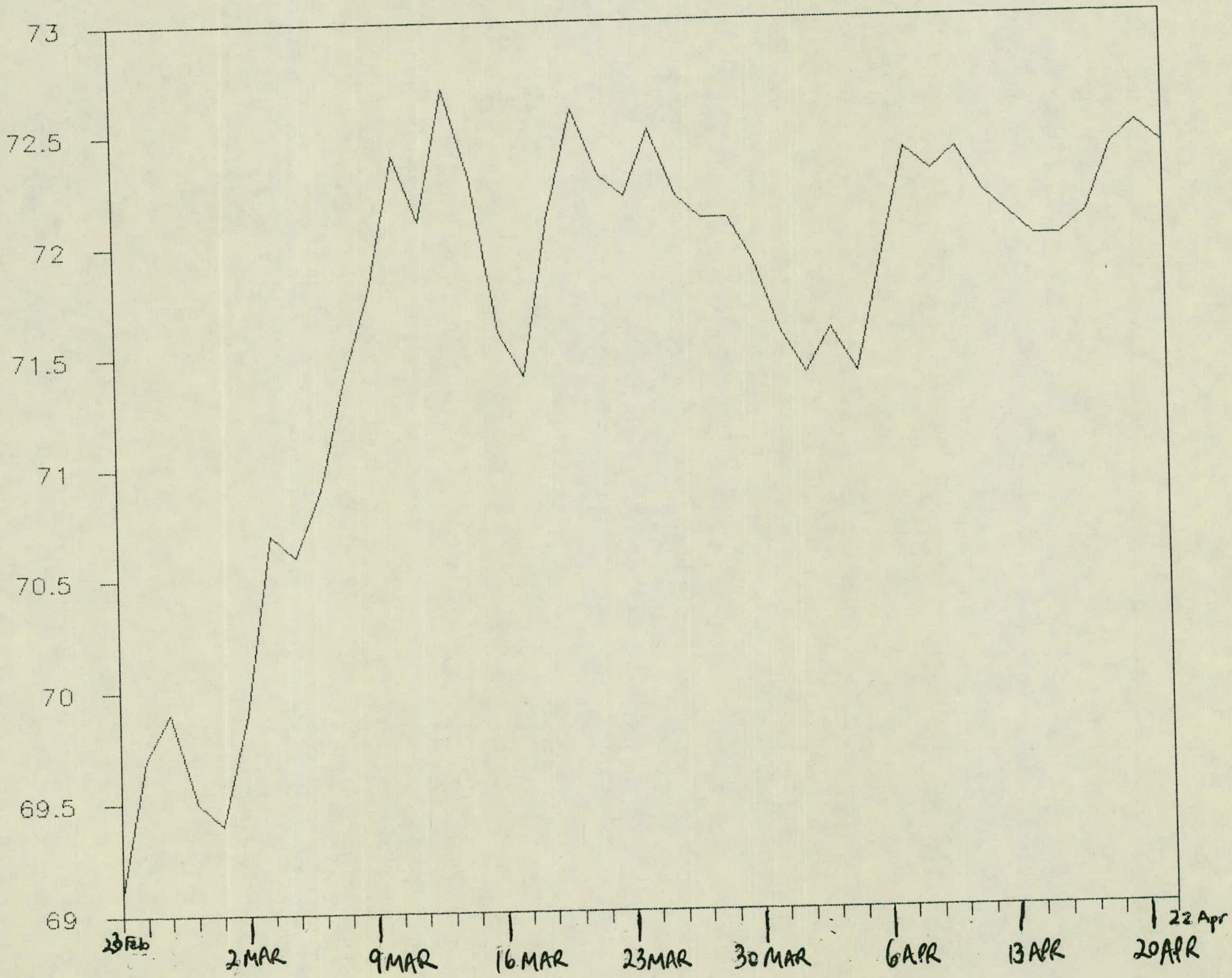
1987
February
March
April
22
US RATES
+ UK RATES

UK & US SHORT RATES



STERLING ERI (20 FEB. – 22 APR.)



31/3070D

SECRET

Market intervention (spot and forward) 23 Feb-22 Apr

$million

Week beginning		Cumulative
23 Feb	+223	+223
2 Mar	+1209	+1432
9 Mar	+1182	+2614
16 Mar	+666	+3280
23 Mar	+1159	+4439
30 Mar	+45	+4484
6 Apr	+1404	+5888
Daily		
13 Apr	+8	+5896
14 Apr	+73	+5969
15 Apr	+53	+6022
16 Apr	+83	+6105
21 Apr	+69	+6174
22 Apr	+728	+6902
23 Apr	+478	+7380

Note Cumulative off-market intervention
23 Feb-23 April: -1133

c/ The promised letter from Dr Latsis. Copy to Bank / Rachel?

CR 27/4

JOHN S. LATSIS (LONDON) LIMITED

PETROLA HOUSE, 4 CURZON PLACE, LONDON, W1Y 7AA

TELEPHONE 01 - 629 8802
TELEX 8954561
CABLES LATSCO, LONDON W1

Send, with appropriate covering letter for me, to Dep-Gov. N.

27 April, 1987

Dear Chancellor,

It was a pleasure to see you last Friday and I have appreciated the opportunity you gave me to announce to you the family's decision to establish in London a wholesale banking operation in the traditional commercial and private banking services. I am particularly grateful, too, for giving me some of your valuable time because I do seek your advice.

At the end of our meeting you asked me to write to you giving personal details on the members of the family and on the manner in which we intend to proceed. I shall try to do both as briefly as possible.

The Latsis family business activities are divided into five main categories:

Energy and Transportation Group	Construction Group
Shipping, oil trading, oil refining.	Infrastructure, petrochemical, buildings.
Engineering Group	**Real Estate Group**
Engineering and consulting in 22 countries.	Office buildings, residential and development projects.

Banking and Financial Services

Banque de Depots, Geneva. Banque de Depots, Luxemburg.

The Group has maintained a shipping office in London since 1956.

Latsis family business interests, are closely held, usually 100%, and are controlled by an executive committee headed by Mr John S. Latsis. My father started in commodity trading and shipping before the war. Activities were interrupted during his active war service. Large-scale commodity trading activities were resumed after the war in parallel with shipping during the 50's and 60's. Since the early 60's oil trading and subsequently refining became major activities. Engineering and construction were added as central activities from the mid 70's. The Banque de Depots was acquired in April 1980 reflecting the family's growing interest in banking and financial services.

Mr John S. Latsis was born in 1910 and is a Greek national. After finishing the local Commercial School he immediately set up his own commodity trading business. He has been the driving force behind many innovative business ventures and continues to be active.

I am the only son of John S. Latsis, born in 1946, and I am a Greek national as well. I hold B.Sc., M.Sc., Ph.D. degrees from the London School of Economics. After successive teaching positions at Harvard University and Boston University, I entered the family business in 1978. I am responsible for all financial matters of the Group, heading the Geneva operations and also controlling our banking activities both in Geneva and in Luxemburg.

The other members of the Group's executive committee are: Mrs Henriette Latsis, a Greek national; Mrs Dorothy Latsis, a British national; Mrs Anne Marie Louise Latsis, a Swiss national; and Miss Marguerite Latsis, also a Swiss national.

Pursuant to the family's decision to set up an independent wholesale banking operation in London, a capital of £100,000,000 has been accordingly reserved. Such capital is considered appropriate for a banking operation of the type we propose, especially in view of the wide range of activities envisaged.

After the acquisition of Banque de Depots and its successful operation both in a wide range of banking services and in specialised fields -- the family's decision to further develop independent banking activities in other financial centres followed. Hence, our presence more recently in Luxemburg. Plans for further expansion in Paris, Monaco and in New York are well under way, too. Consequently, the necessity at this stage of a serious presence in the United Kingdom, and in particular in London, as a global financial centre, could not have been overlooked. Indeed, the firm intention of the family is that the proposed British banking entity will be the leading institution in our international banking and financial services network.

The shareholders will be exclusively family members and U.K Trusts whose beneficiaries will also be family members and/or their issue. Suitable freehold premises have been acquired recently at 6 Lothbury, E.C.2., which the Royal Bank of Canada is expected to vacate by mid-June.

I have engaged Lazard Brothers & Co. Limited as advisors in connection with establishing the proposed bank. Confidential financial information of the Group has been released to Lazard's for the exclusive use of the Bank of England. It is my understanding that Lazard's have already made a first contact with the Bank of England, and I am scheduled to meet those responsible for authorisation early next month.

Of the two broad options open to us, namely, acquisition of another banking institution or direct application to the Bank of England for recognition -- I have a preference for the latter. We consider the acquisition of an already existing banking concern, merely as a means of obtaining a licence, to be both an unnecessary and artificial exercise. In our case, all the conditions for successfully initiating a viable banking operation are certainly present.

An acquisition would almost inevitably involve an entity containing certain unwanted characteristics, including personnel and policies not necessarily consistent with our objectives -- probably leading, in turn, to a difficult period of adaptation which would be bound to cause organisational and human problems not only in the short term.

During this period of preparation I have made various contacts with appropriate persons from banking circles in the City discussing our plans and establishing in principle a tentative structure for the board and senior management of the proposed new institution. I feel that if recognition is not forthcoming in the near term, it would be difficult for us to maintain the impressive momentum presently achieved -- including the interest of suitable persons to join our long term effort.

Depending on the expected delay for obtaining recognition from the Bank of England, other less desirable options, as the acquisition of a banking institution or a licenced deposit taker, may of course have to be considered by the family.

I, therefore, welcomed the privilege of seeing you last week seeking your advice before determining our final course of action. This project falls under my personal responsibility, I am committed to it -- and I am, therefore, at your disposal for any additional information, references or other action as necessary.

Fully aware too, of the heavy demands on your time, especially in the months ahead, may I add that I wouldn't have imposed upon you unless I were convinced that our proposed investment in this country will prove to be consistent with the best interests of the British economy.

Yours sincerely,

Spiro J. Latsis

The Rt. Hon. Nigel Lawson MP
Chancellor of the Exchequer
LONDON

S E C R E T

FROM: F CASSELL
30 April 1987

CHANCELLOR

We have discussed exp. x. ..

cc Economic Secretary
Sir P Middleton
Sir G Littler or
Sir T Burns
Mr Peretz
Mr Kelly
Mr Culpin
Mr Ross Goobey

MARKETS

Since we spoke this afternoon the £/DM rate has eased back to around $2.98. Which is helpful, but still not comfortable. The market is still very volatile.

The Bank are in close touch with the Fed and will instruct them to buy whatever is necessary to keep the rate under DM3. They will obviously have to judge how to implement this instruction in the light of developments.

European markets are closed tomorrow. This could provide an opportunity for getting the rate lower early in the day. But the trade figures to be published at 11.30 are not helpful in this context. And it is recognised that the main objective is to get the rate down at the close.

Latest agency reports from Washington suggest that the Japanese are preparing to lower their interest rates. The Reagan/Nakasone talks could therefore, over the weekend, lead to a strengthening of sentiment in the dollar. This could pose problems for us on Monday, when the London markets are closed and sterling could be carried up with the dollar in overseas centres.

Intervention tactics for that day will need to be considered tomorrow. Eddie George, however, has asked me to suggest to you that it might be helpful if over the weekend you could find an opportunity to make a statement that we would not wish to see sterling any higher. Perhaps something along the following lines:

> The recent turmoil in the exchange markets has been sparked by short-term considerations of one sort or another. The Government recognises industrialists' concern about the level of sterling. I can assure them that we are not going to allow these transitory influences to damage industry's confidence. We do not wish to see the pound rise any further.

I doubt [illegible] whether you'll want to do this

X

A statement of this sort might be helpful in holding down sterling on Monday.

A markets meeting would then plainly be needed on Tuesday. The Bank think that this might best be in the middle of the morning, when there has been time to see how markets have opened after the weekend. (The technical position on Tuesday is unlikely to be one in which a 10 am dealing round is needed.)

Will [illegible]

F CASSELL

cc Mr George, Bank of England

SECRET

BANK OF ENGLAND
LONDON EC2R 8AH

THE DEPUTY GOVERNOR

1 May 1987

CH/EXCHEQUER
REC. 01 MAY 1987 ✓ 1/5
ACTION MR PERETZ
COPIES TO EST CST
SIR P MIDDLETON
SIR T BURNS
MR CASSELL
MR C KELLY
MR ROSS GOOBEY

The Rt Hon N Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1P 3AG

Ch
Rather a good letter
AA

Dear Chancellor

The monetary data for March again did not convey any very clear message: narrow money remained well behaved but broad money and credit growth remained uncomfortably strong, though inflated - notably in the case of £M3 - by seasonal underfunding. The non-monetary indicators suggest that demand is very strong (notwithstanding the apparent pause in the growth of consumer spending); that output has responded to the strength of demand; and that the prospects for continued growth in demand are good. Recent pay settlements have been modestly encouraging, although the growth rate of average earnings has not fallen back. A consequence of the strength of output growth has been that the growth rate of unit labour costs has fallen. House prices, however, seem to have accelerated and equity prices have remained buoyant.

Our judgment of the evidence on the domestic economy is that the reductions in interest rates and injections of liquidity through the foreign exchange market that have already taken place, together with the tax cuts made in the Budget, should be amply sufficient to sustain demand in the coming months; and indeed that we have begun to run some risk of re-emergence of more general inflationary pressures. Against this background we think the domestic arguments are against any further fall in interest rates in present circumstances.

At the same time we share your concern about upward pressure on the exchange rate, and the damage that this - if it were allowed to go very far - could do to business attitudes at a critical juncture by encouraging industry to take advantage of its present favourable competitive position through higher margins rather than increased volumes and capacity. The massive external inflows which have continued unabated since Tuesday's reduction in interest rates, therefore, present us with a serious dilemma.

There is little doubt that these inflows are in part associated with the prospects for an election, and to this extent they may well be reversible. But it is also possible that they reflect a more fundamental re-rating of the UK's prospects and may therefore persist over a longer period.

Until the political situation is clarified we are not likely to know much more about the character of the present exchange pressure. In the meantime, it would seem prudent in our policy response to try to take the pressure where it would do least damage if there had to be a reversal in, say, a couple of months or so. In the first instance, this would point to continuing to intervene on a large scale, but we recognise that there are limits to how long we can go on in this way and limits anyway to how effective it can be. Despite the heaviest intervention so far we were driven perilously close to DM3.00 yesterday, and if, as now seems more likely, there is a substantive outcome from the Nakasone-Reagan talks, which stabilised the dollar at least for a time, that could drag us up further on the DM cross rate. At some stage, therefore, and this could be reached quite soon, we may again be faced with the choice of complementing intervention either with a further reduction in interest rates or letting the exchange rate go through DM3.00.

There are clear risks in either of these options. It may be, however, that the risks of letting the exchange rate rise are more immediate than those involved in taking more of the strain on interest rates. Business sentiment could be affected straightaway and be very difficult to restore if the exchange pressure did indeed reverse after an election, whereas the damage to inflationary expectations resulting from lower interest rates and the liquidity effect of intervention might - with the exchange rate remaining firm - take somewhat longer to come through. That would point to the next step at least being a further easing of interest rates. This approach does depend upon the possibility that the exchange pressure is short term. If it proved to be more fundamental, then I believe we would need to re-consider our stance, since in those circumstances taking the strain on interest rates would be to repeat the mistakes of 1977

but look [illegible] where [illegible] now!

I believe that it would be useful to meet soon after the holiday to review the position then. In the meantime we will continue to intervene to the extent necessary to prevent the DM cross rate from breaching 3.00, and you may wish to consider whether a public statement to the effect that, at a time of international currency turbulence, we were not prepared to see short-run (political) factors, which were making sterling relatively attractive, damage industrial convidence which could have more lasting effects upon the economy. A statement along these lines over the weekend might protect us in some degree against possible international pressures on Monday when our market will be closed.

Yours sincerely

George Blunden

5/3070E

SECRET

FROM: DAVID PERETZ
1 May 1987

MR ALLAN

cc PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Kelly
Mr Ross Goobey

MARKETS: 9 O'CLOCK MEETING, 5 MAY

The Deputy Governor's monthly letter about interest rates, which is due to arrive later this afternoon should act as useful background for this meeting. So too should our monthly monetary assessment, submitted under Mr Grice's minute of 30 April.

2. The separate minute from Mr Grice of 30 April under the heading "Monthly Monetary Assessment: April 1987: Discussion of Tactics" discusses the options.

3. You and others may also like to have the attached table showing the exchange market intervention we have carried out, to date, since the Louvre Accord.

Ch
CST will have to leave at 9.30 to attend PM's meeting on mergers policy
AWK
1/5

DLCP

D L C PERETZ

SECRET

31/3070D

SECRET

Market intervention (spot and forward) 23 Feb-1 May

$million

Week beginning		Cumulative
23 Feb	+223	+223
2 Mar	+1209	+1432
9 Mar	+1182	+2614
16 Mar	+666	+3280
23 Mar	+1159	+4439
30 Mar	+45	+4484
6 Apr	+1404	+5888
13 Apr	+217	+6105
20 Apr	+2196	+8301

Daily

27 Apr	+248		+8549
28 Apr	+935		+9484
29 Apr	+382	+3069	+9866
30 Apr	+1013		+10879
1 May	+501		+11380

Note Cumulative off-market intervention 23 Feb-1 May: -1246

How much $, & how much DM?

5 May	+152	+11532
6 May	+533	+12065
7 May	+16	+12081
8 May (noon)	+1790	+13871

19/3070E

Nigel
Just thanks
please

1. ~~Alex~~
2. markets folder

SECRET

FROM: DAVID PERETZ
8 May 1987

CHANCELLOR

Thanks. The tone of this will be extremely alarmist; but we will – as agreed – [illegible] take stock [illegible] on [illegible]

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Sir G Littler
Mr Cassell o/r
Mr Kelly
Mr Ross Goobey

MARKETS

As you will have seen from the evening market report, short term market interest rates did not soften further this afternoon. The gilt market fell a little (around 3/8 at the long end) after this afternoon's tap was announced. IGs rose a little (around ½ point) presumably because the tap was not an IG and the Bank sold about £140m of IGs during the day - selling out of the 2011 and 2024 tranchettes that have been on the books for some time.

2. In the foreign exchange market the Bank's final intervention score for the day (up to the close in London) was $2.9 billion, of which $½bn was after your meeting this afternoon, with about £100m sold at 4.00pm to try to get the closing rate moving downwards. I suppose you could count the operation as a success in the sense that the £/DM rate did not rise even though the $ was strengthening at the time.

3. But I would not put much store by that. The dealers report that things have reached the point where as soon as they begin to sell, and dislodge the £/DM rate even fractionally, new buyers immediately appear. It is the well known story of what happens once you are seen to be defending a specific rate: no one, at present at least, is thinking of taking profits on sterling - so long as we stay this side of DM 3.00.

4. Assuming things look much the same on Monday morning the Bank will, as agreed, do what is necessary to hold the rate in

the Far East; and try the tactic of a substantial selling as soon as the London Market opens. We may then need to take stock. But as was said at this afternoon's meeting, we are reaching the point where intervention is increasingly ineffective - and in danger of becoming counter-productive.

5. There is one other technical complication I should mention. Today's intervention will lead to a substantial money market surplus on Tuesday, and it is not yet obvious how we are going to deal with that. The Bank are thinking about it. They will no doubt find a way to cope (ie to sterilise the effect on MO), though it could complicate any interest rate signalling we want to do next week. But it is another - albeit rather minor - illustration of the complications caused by intervention on the present scale.

DLCP

D L C PERETZ

24/3070E

Nigel - just thanks to Derek.

SECRET

FROM: DAVID PERETZ
11 May 1987

CHANCELLOR

A satisfactory day, assisted by our tactics, which turned out as I had expected.

cc Chief Secretary
Economic Secretary
Sir P Middleton o/r
Sir T Burns
Sir G Littler o/r
Mr F E R Butler
Mr Cassell o/r
Mr Kelly
Ms Goodman
Mr Ross Goobey

MARKETS

It has been a rather up and down day in the foreign exchange market, but for the time being at least the pressure seems to be off. It could of course re-emerge at almost any time, but now that the election announcement has been made there is no obvious event in the near future to trigger a further bout of sterling buying.

2. It is a considerable relief not to have to face the kind of interest rate/exchange rate choices we were contemplating, on a contingency basis, on Friday. The Bank's intervention tactics on Friday night and today may well have helped, though I would not want to argue that too strongly. What seems to have happened is that, for once, the election announcement was fully discounted in advance, and that when it came it prompted some modest profit taking.

3. As you will know from the evening report, the total intervention score for the day, including intervention on Friday evening in New York, was around \$1.3bn. Over \$400m of this was in the Far East this morning, where sterling started very strong and rose temporarily above DM3.00 in Australia. This held the rate to just under DM3.00 by the London opening, at which point the Bank came in as strong sellers, and managed to get it down for a while to perhaps 2.99½. It then rose at various points

during the day, not so much on sterling buying as on the coat-tails of a strengthening dollar, and the Bank had to intervene on various occasions to hold the line. Then when the election was announced at 2 o'clock, the Bank immediately sold £100m to stop the rate rising, and if possible to get it to move down a little - which in practice they managed to do. The fact that sterling did not rise on the announcement seems to have led to some reasonably wide-spread profit taking, and this evening the cross rate is down to DM2.97¾, the lowest it has been since 1 May.

4. In the domestic markets gilts have fallen back a little this afternoon, with the exchange rate. Short term interest rates have been pretty steady all day, with the three month rate around 8¾.

5. There is a money market surplus tomorrow (the results of Friday's intervention) so the Bank will not have to show their hand in bill market dealings. (They plan to deal with the shortage by a combination of selling Treasury Bills and two or three day forward sterling/dollar swaps).

DLCP

D L C PERETZ

8/3070F

SECRET

FROM: DAVID PERETZ
15 May 1987

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Kelly
Mr Grice
Mr Culpin

MARKETS MEETING: 18 MAY

The position looks a good deal easier today, at the end of the week, than it did on Monday morning. A number of developments have helped:-

(i) In the event the election announcement proved an occasion for profit taking on sterling, rather than for a further large inflow of funds.

(ii) The US dollar has been weaker, following yesterday's trade figures, for once falling against the DM as well as Yen. (The dollar has risen again just a little with the latest ¼% rise in US prime rates).

(iii) The Governor's Mais lecture, and the BEQB assessment, have helped get the message across that we do not want to see any further rise in sterling: that the asymmetry in our views about sterling is now the other way round from immediately after Louvre.

(iv) The gilts market has fallen back a little at the end of the week, partly as the market comes to terms with the likely extra demands we will have to make on it to sterilise the intervention we have been doing.

2. So unless anything startling happens over the weekend, we

will not be under any pressure to make immediate decisions on Monday morning. It might, nevertheless, be worth having some further discussion of what we would do if we were faced with a further bout of strong upwards pressure on sterling. The point of discussing this is not that it is the most likely scenario; but that if it did happen we could find that even massive intervention may not hold the line for long, and that we might have to make decisions very quickly.

3. It might also be worth having a word about what it would be useful for you to say on the exchange rate. I think you have it in mind to include a passage in your CBI speech on 19 May.

4. I am not sure that my visit to the Bundesbank this week has brought any great new insights, though a number of interesting points came up which we will be recording separately. It is clear that the Germans at present are facing a very similar policy dilemma to our own, with a tension between a concern (on behalf of industry) not to let the DM rise too far or fast (the dollar rate is their main concern), and their reading of domestic credit conditions (with central bank money overshooting). The Bundesbank Council is split down the middle, with this week's reduction in their key repo rate indicating that those who pay regard to the external dimension have the upper hand for the time being. I guess they will continue to do so while the Germany economy continues to look so sluggish.

5. Those I spoke to seemed pretty doubtful about the value of large scale sustained intervention (and they raised their eyebrows a little at what we have been up to). If the DM does come under upward pressure my guess is that they would come in; but that they would fairly quickly accept a mixture of slightly lower interest rates, and a modest rise in the DM. I suppose that would not necessarily be against our interests, even if it marked a small departure from the spirit of Paris.

6. I attach a couple of background tables, on monetary conditions and our recent intervention.

DLCP

D L C PERETZ

Monetary developments since last month's report

Latest outturns available at time of:

	Oct 1986	March report	April report	
Monetary aggregates (12 month % growth)	(Cal Oct)	(Cal Feb)	(Cal March)	(cal April)
M0 (sa)	4.9	4.1	4.1	4.8
£M3	18.5	19.0	19.0	20.4
PSL2	15.0	13.3	13.5	N/A
Bank lending	19.4	21.7	20.7	21.0
Bank & building society lending (est)	19.5	20.0	19.4	N/A
Interest rates (%)	23 Oct	26 March	30 April	14 May
3 month interbank	11.4	9.7	9.3	8.6
20 year gilt-edged	10.6	9.1	8.8	8.8
Yield gap	0.8	0.6	0.5	-0.2
3 month overseas basket	6.2	6.1	6.3	6.4
3 month interbank/euro dollar differential	5.4	3.3	2.3	1.5
Real 3 month interbank	8.0	5.2	5.1	4.4
Equity dividend yield (all-share)	4.2	3.5	3.3	3.2
IG yields (1996) assuming 5% inflation	4.2	3.5	3.7	3.5
Exchange rate				+10%
ERI	67.5	72.1	73.2	73.7
Oil adjusted reference index*	69.9	72.9	72.8	73.2
ERI/reference rate ratio	96.6	98.9	100.5	100.7
Asset prices				
FT-A Index (% pa)	19.4	26.8	25.4	38.5
FT-A Level (March peak: 1027)	782	1019	1024	1080
Halifax house index (% pa)**	12.8	14.9	15.2	14.5

* indicates what ERI would be if exchange rate simply responded to oil prices in the ratio 1:4. In determining the reference rate the base taken is the Jan '83 - Nov '85 average for the ERI and oil price.

** figures are for September, February and March.

\+ April outturn

31/3070D

SECRET

Market intervention (spot and forward) 23 Feb-1 May

$million

Week beginning		**Cumulative**
23 Feb	+223	+223
2 Mar	+1209	+1432
9 Mar	+1182	+2614
16 Mar	+666	+3280
23 Mar	+1159	+4439
30 Mar	+45	+4484
6 Apr	+1404	+5888
13 Apr	+217	+6105
21 Apr	+2196	+8301
27 Apr	+3079	+11380
5 May	+3664	+15044

Daily

11 May	+1302	+16346
12 May	+1	+16347
13 May	+87	+16434
14 May	+614	+17048
15 May	+78	+17126

Note Cumulative off-market intervention
23 Feb-1 May: -1485

PERSONAL

BANK OF ENGLAND
LONDON EC2R 8AH

THE DEPUTY GOVERNOR

27 May 1987

Ch
A letter back saying most grateful?
AA

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London
SW1P 3AG

Yes pse.

Dear Nigel

LATSIS GROUP

Following my letter of 1 May I thought you would be interested to hear that Dr Spiro Latsis did call on the Bank with his advisers from Lazards to discuss the plans of his family's group of companies to set up a banking presence in London.

The plans Dr Latsis outlined for a start-up presence in London are unfortunately by no means easily acceptable, although we have not rejected them immediately. We have asked Dr Latsis to produce a detailed business plan for us to consider the proposition further and will try to formulate an acceptable solution.

Good now do!

Regrettably I do not think that Dr Latsis has been well advised by Lazards. It is most unfortunate that we have been approached with a concrete proposal only late in the day and after some expense has already been incurred. Had we been involved more fully at an earlier stage in planning, the chance of obtaining an authorisation within the desired time frame would have been considerably greater.

Yours sincerely

George

PERSONAL

Papers please.

BANK OF ENGLAND
LONDON EC2R 8AH

THE DEPUTY GOVERNOR

1 May 1987

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London
SW1P 3AG

Assume the new Banking Act gets Royal Assent this session, when does it come into force? N.

Dear Nigel

Thank you for sending me a copy of the letter you received from Dr John Latsis.

Dr Latsis is calling on the Bank next week and it is useful to have advance warning of his concerns. Which of the routes of acquisition or start-up is quickest or most acceptable is difficult to say without firm propositions. There may however be a misunderstanding behind Dr Latsis' letter. Our files suggest that, in earlier contacts, the family had formed the impression that the process of acquiring a new authorisation could take two or three years. This may be a result of confusion about the requirements of the present Banking Act, under which recognised status can indeed take two or three years to achieve; but authorisation to take deposits can be gained much more quickly. We thought we had corrected that misapprehension through Lazards, but have perhaps failed to do so. When the new Banking Act comes into force, the distinction between authorisation and recognition will as you know disappear.

We will of course need to look very carefully at any proposition and enquire into the background of the shareholders. That cannot be done overnight, and we may not be able to move on either front quite as fast as Dr Latsis would wish. But we shall of course be as constructive as possible.

Yours sincerely

George

29/3062

Pup

SECRET

FROM: DAVID PERETZ
12 June 1987

PRINCIPAL PRIVATE SECRETARY

cc PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Kelly
Mr Richardson
Ms Goodman

Thanks. N.

MARKETS

It may be useful to record what happened in the financial markets overnight, and where things stand this morning. As you know the foreign exchange and gilts market remained open in London for most of the night.

2. In the **foreign exchange market** there was an initial surge in the £ after the ITN exit poll at 10.00 last night. From a closing rate yesterday afternoon of DM2.9811 and $1.6617, it rose to a little over DM2.99 and around $1.66¾. It then fell back on profit taking (initially connected with the BBC poll which suggested a small majority). That was the pattern through the night. The Bank did not need to intervene to hold the rate: though at one point their dealers did contact a few banks making it clear they might be interested in selling £s if the rate rose much further. This may have helped and indeed could have led to the (inaccurate but not unhelpful) TV report that the Bank were intervening to hold the rate.

3. The Bank dealers report fairly heavy turnover last night up to about 3.00am, with some large corporate orders for sterling being covered by profit taking from professionals. The business was mainly in London, not Tokyo. This morning so far the market is firm but not especially active, with the rate opening at DM2.9838 and $1.6640.

4. The **gilts market** was also fairly active with good turnover into the early hours. Initially the market rose - at the long end by up to 1¾ points - with the 8% 02/06 tap trading at a little over £31 at one point (compared with, £29 26/32 at yesterday afternoon). But by this morning some of the gain was lost. The Bank report some Japanese buying (but nothing spectacular) and some domestic profit taking. IGs are sharply (1½ points or so) down. The Government broker sold £150m of the tap at £30 3/8 first thing this morning, but has not been bid for more at a higher price. That leaves £550m on the Bank's book though it is of course still possible they will sell out later in the day.

5. The **equity market** opened strongly this morning, with the FT 100 index starting 44 points up (at 2294), but then fell back a little. up 19 @ 10.40

6. No signs as yet of any pressures in the **money markets,** with short term interest rates scarcely changed from yesterday. 3 month interbank is 8 5/8% (8 11/16% yesterday); 1 month interbank 8 13/16% (unchanged from yesterday).

DLCP

D L C PERETZ

37/3062

SECRET

FROM: DAVID PERETZ
15 June 1987

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Culpin
Mr Kelly
Mr Grice

MARKET MEETING: 16 JUNE

The purpose of this meeting is to take stock, now that the election is over. We will presumably want to discuss our attitude to short term interest rate changes, and intervention tactics and strategy.

2. Markets have in fact been fairly subdued since the election. The gilts market fell back quite sharply today, and now stands around the same level as a week ago (with long yields around 8.9%). Short term interest rates have edged up just a little, with three month interbank rate now 1/16% higher than just before the election. And the exchange rate has stayed in a DM2.98/2.99 band without any substantial intervention by the Bank of England - though this may be because the market expects the Bank to come in at around DM2.99½. (In fact since the election announcement on 11 May there has only been one day - 14 May - when substantial intervention (more than $100m) was required to keep sterling below DM3.00.) So there is no immediate market pressure for lower short term interest rates.

3. As to our assessment of underlying monetary conditions, in fact very little has changed since the assessment submitted with Mr Grice's minute of 29 May; or indeed since the last more substantive assessment contained in Mr Grice's minute of 30 April. We then concluded that it was difficult on domestic grounds to argue for any further reduction in interest rates; and that if upwards pressure on the exchange rate were to persist there would be a policy dilemma (between external and internal factors) that would need very careful consideration.

4. I attach an up-to-date version of our summary table assessing the various indicators of monetary conditions.

B Woodall
p.p. D L C PERETZ

•4555/022

SECRET

Monetary developments since last month's report

Monetary aggregates (12 month % growth)	Dec 1986 (Cal Nov)	May report (Cal Apr)	June report Cal May)
M0 (sa)	5.3	4.8	4.4
M3	18.6	20.5	18.9 +
M4	-	14.6	n/a
M5	15.1	14.1	n/a
Bank lending	20.8	21.0	21.7
Bank & building society lending (est)	20.1	19.9	n/a

Latest outturns available at time of: Dec 1986, May report, June report.

Interest rates (%)	30 Dec	28 May	15 June
3 month interbank	11.3	8.9	8.8
20 year gilt-edged (par yield)	10.3	9.0	8.9
Yield gap	0.9	-0.1	-0.1
3 month overseas basket	6.3	6.4	6.4
3 month interbank/euro dollar differential	5.0	1.6	1.7
Real 3 month interbank	7.2	4.8	5.0
Equity dividend yield (all-share)	4.1	3.2	3.1
IG yields (1996) assuming 5% inflation	4.1	3.7	3.7

Exchange rate			
ERI	69.0	72.5	72.9
Oil adjusted reference index*	72.4	73.1	73.1
ERI/reference rate ratio	95.3	99.2	99.7

Asset prices			
FT-SE Index (% pa)	18.4	32.8	44.8
FT-SE Level (June peak: 2290)	1673	2157	2308
Halifax house index (% pa)**	13.1	14.5	14.7

---

* indicates what ERI would be if exchange rate simply responded to oil prices in the ratio 1:4. In determining the reference rate the base taken is the Jan '83 - Nov '85 average for the ERI and oil price.

** figures are for November, April and May.

+ provisional "provisional" figure

4319.7

CONFIDENTIAL

FROM: M G RICHARDSON

DATE: 16 June 1987

1. MR KELLY

2. CHANCELLOR

C/ minute to issue?

I strongly endorse the recommendation that you should write as proposed.

16.6.

CR 16/6

OK as proposed

cc: Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Scholar
Mr Peretz
Mrs Lomax
Ms Sinclair
Mr Ilett
Mr Neilson
Mr Plenderleith B/E
Mr Hyett T Sol

GILT EDGED SETTLEMENT AND THE INSOLVENCY ACT

The Secretary of State for Trade and Industry has written to colleagues proposing that a Financial Markets (Clearing Arrangements) Bill should be included in next year's legislative programme (his minute to the Prime Minister of 15 June). The Bill could also provide a legislative vehicle for solving a problem that insolvency - and the Insolvency Act in particular - may cause for the Central Gilts Office (CGO) settlements system, and thus the liquidity of the gilt-edged market.

2. At QL this morning Lord Whitelaw concluded that the proposal should be considered by Cabinet on Thursday. This minute recommends that you write as soon as possible supporting the Bill's inclusion in the programme, and the incorporation of a solution to the gilts problem.

The Case for the Bill

3. Effective clearance systems are necessary for the smooth functioning of financial markets. They play a critical role in ensuring that transactions are matched and settled without delay and with a minimum of risk. Lord Young proposes legislating to overcome a conflict between the Insolvency Act and the

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arrangements made by clearance systems (eg LIFFE, Stock Exchange) to handle insolvency. If these arrangements were used they could be successfully challenged by other creditors. DTI are concerned that, if this possibility became generally known, it would undermine confidence in the clearance systems. Indeed, as Lord Young points out some US businesses have already expressed concern that the UK legislation, unlike that in the US, does not provide explicit protection for clearance systems. The DTI's proposed solution is to amend the Insolvency Act to provide, in effect, a degree of preferential treatment for the clearance systems. If an exchange member defaulted, an official would be appointed whose task would be to close the member's positions on the exchange as rapidly as possible. To do this it would be necessary to use some of the defaulter's assets, which under existing insolvency legislation ought to be shared between all the defaulter's creditors.

4. DTI are convinced that a legislative solution is the only one available. Market operators are already concerned at the absence of legislative cover, and a successful court challenge to those arrangements in a future case could seriously damage confidence. Given the importance for the London market as a whole of maintaining confidence in the clearance systems, FIM think the Bill can be justified. The Financial Secretary has already supported the Bill at QL on a number of occasions; so the draft letter attached would simply confirm our position.

The Gilts Problem

5. The gilts difficulty arises from settlement banks' concern about the validity of their floating charge over clients' stock held in CGO accounts. The assured payments system is a central feature of the new settlement arrangements in the gilt-edged market post-"Big Bang". It provides the main participants in the market with an assurance that, in settling their trades and without any limit on the value of the deals involved, movements of stock will automatically and simultaneously be matched by movements of cash (or irrevocable instructions for the movement of cash) in the opposite direction. To support this unlimited commitment, the

settlement banks (who are responsible for making the "assured payments") have relied principally on a floating charge over their clients' (market makers, money brokers, etc) stock held within the settlement system for security for any net cash payment due. It is the guarantee of annual payments of unlimited size that makes the gilts settlement system unique in the UK.

6. The settlement banks have, however, been concerned that they may not be able to enforce their charge, or may be able to do so only after unacceptable delay, in the event of, say, a market maker's insolvency. These concerns have been sharpened by the provisions in the Insolvency Act for the appointment of Administrators, which could threaten further the enforceability of the charge. Until it is possible to give a clear demonstration that these concerns are not justified, the settlements banks are likely to become increasingly uneasy about the present arrangements and to be reluctant to accept the widening of CGO membership which, on other grounds, we would like to promote.

7. Initially this left us in something of a quandary. On the one hand we could not be confident that the prospect of continuing uncertainty over the CGO system was a strong enough justification for primary legislation, against the inevitably strong competition for Parliamentary time. On the other, the banks' anxieties could only be fully set at rest by statutory legislation to give the floating charge comprehensive protection against outside challenge. But the Financial Markets (Clearing Arrangements) Bill provides a convenient opportunity for clarifying the position of the CGO banks' floating charge. In paragraph 8 of his minute Lord Young refers briefly to the CGO problem, and suggests that this could be resolved in the Bill.

8. We recommend that you write before Cabinet supporting the inclusion of the Bill in the legislative programme, and explaining in a little more detail the nature of the gilts difficulty. I attach a draft accordingly.

9. This minute and the attached draft have been agreed with FIM and the Bank.

M G Richardson

M G RICHARDSON

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~~DRAFT~~ MINUTE FROM CHANCELLOR TO PRIME MINISTER

FINANCIAL MARKETS (CLEARING ARRANGEMENTS) BILL

I have seen ~~the Secretary of State for Trade and Industry's~~ David Young's minute to you of 15 June.

2. I very much hope that the Financial Markets (Clearing Arrangements) Bill can be included in the 1987-88 legislative programme for the reasons be rehearses. ~~We have additional cause - shared by the Bank of England - for supporting the Bill:~~ In particular, as paragraph 8 of ~~the Secretary of State's~~ his minute suggests, the Bill will be a useful vehicle for dealing with the problems connected with the enforceability of the floating charge in the gilts settlement system - not least ~~that~~ those caused by the Insolvency Act. ~~Eradication of the problem~~ This is important for the liquidity of the gilt-edged market, an essential factor in our debt management operations which have been running at £10-15 billion gross sales per annum.

3. ~~It may be helpful if I elucidate~~ the difficulty which the Bill would deal with~~. It concerns the~~ Central Gilts Office assured payments system, which is a central feature of the new settlement arrangements in the gilt-edged market post "Big Bang". In essence this system provides the main participants in the market with an assurance that movements of stock will automatically and simultaneously be matched by movements of cash in the opposite direction.

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To support this unlimited commitment, the settlement banks (who are responsible for making the "assured payments") have relied principally on a floating charge over their clients' stock. The value of these holdings provides security for any net cash payment due.

4. The settlement banks have, however, been concerned that in the event of, say, a market maker's insolvency, they may not be able to enforce their charge, or may be able to do so only after unacceptable delay. These concerns have been sharpened by the provisions in the Insolvency Act for the appointment of Administrators, which could threaten further the enforceability of the charge. Until these concerns are allayed, the settlement banks are likely to become increasingly uneasy about the present arrangements and to be reluctant to accept the widening of CGO membership which we would like to promote.

5. The only solution ~~we~~ The Treasury and Bank of England have identified is legislation that will clarify and reinforce the security provided by the floating charge in the context of the CGO, if possible to the extent of giving it formal precedence over any competing charge. My officials are consulting with the Bank and their legal advisers to ~~i dentify~~ seek how this can most simply be effected.

6. I am copying this minute to all Cabinet colleagues and to Sir Robert Armstrong.

1521/020

FROM: M J NEILSON

DATE: 19 June 1987

This can be a sensitive subject. You might want to use this opportunity to back the Bank people on this side. RL. 22/6.

1. ~~MRS LOMAX~~

2. ECONOMIC SECRETARY

cc: PPS
PS/CST
PS/FST
Sir P Middleton
Sir G Littler
Mr Cassell
Mr H Evans
Mr Peretz
Mr C Kelly
Mr Ilett
Mr Perfect
Mr Tarkowski

Rt X, the queue is an anachronism (together with supporting legislation) [illegible] [illegible]. But [illegible] can't [illegible] for [illegible] it is now convenient for [illegible] booking dates for privatisation issues. But rather just the privatisation [illegible] we want to keep one in the armoury [illegible].

BANK GUIDELINES ON CAPITAL MARKET ISSUES

The Bank want to make some changes to their guidelines for capital market issues, covering both the equity queue and the arrangements for debt issues. They propose issuing consolidated guidelines, a draft of which is attached. We see no major problems with what they are proposing, subject to one point on which we do not expect the Bank to cause difficulty. The Bank normally clear with us market notices with a significant policy content, which in this case relates to foreign firms involvement in the UK market.

2. The Bank has traditionally operated a queuing system in both the equity and bond markets. Their formal powers to do so are provided by the 1958 Control of Borrowing Order, and are, strictly speaking, limited to giving <u>timing</u> consent for new issues, in order to maintain orderly markets. But, as is clear from the guidelines, the Bank also rely on their informal authority to impose requirements in other respects, such as on issue structure and lead management. The main changes they now propose are on lead management. !

The main proposals

3. There are two main proposals:

(i) The Bank want to drop the current requirement that, when a sterling issue is lead managed by a foreign-owned firm, it must be co-led by a British firm. This requirement was originally put in place temporarily, after the abolition of Exchange Controls, to give UK firms a chance to establish themselves in the domestic market. This has become increasingly untenable, particularly since traditional operators in the UK market, like Phillips & Drew, have been taken over by foreign firms, but have still been allowed to lead-manage sterling issues on their own. We agree with the Bank that it is now time that this out-of-date restriction be abolished. Foreign lead managers will still, of course, be subject to the reciprocity requirement described below.

This is a less sensitive issue for British firms than it was: what they care about is lead management, rather than the junior rôle.
RL.

(ii) The Bank also maintains a reciprocity requirement, under which foreign firms may only lead manage sterling issues if UK firms can do the same in their home country. The Bank's reciprocity requirement is based on the de facto position, and not just on the theoretical de jure position. The Bank now want to allow German and Dutch banks to lead manage sterling issues, since they are now broadly satisfied that British firms can lead issues in their markets. They also propose trying to persuade the French to abandon the remaining barriers in their markets, on EuroFranc lead management, using progress with Germany and the Netherlands as an argument for the French to make a move. If the Bank think that the Dutch and Germans now fulfil this requirement we have no reason to contest this.

Technical modifications

4. With one exception the remaining changes to the guidelines that the Bank propose making would simply codify existing practice. This covers incorporating vendor placings and bought deals formally within the queue, allowing foreign firms to lead manage their own issues without need for reciprocity, and an increase on the limit per issue on bulldog issues to £200m. (On the last, the World Bank was the first borrower to take advantage of the Bank's

decision to increase this limit from £100m to £200m. This decision was based on the judgement that the case for a limit - the risk of crowding out corporate borrowers from the market - has been substantially reduced, as the market shows an ever increasing capacity to absorb issues).

5. The one proposal with which we do take issue is that the embargo on zero coupon, deep discount and indexed-linked issues by public sector borrowers (including local authorities, nationalised industries, and foreign sovereign bodies) should be lifted. LG and PE strongly oppose lifting this embargo for local authorities and nationalised industries, respectively, because it would allow them to push their repayments of borrowing further into the future and thus to borrow more for current expenditure. The Bank's guidelines are not the ideal way of controlling such borrowing, but for the time being they are all that is available.

6. We have no specific policy reasons to oppose lifting the embargo on sovereign bodies issuing these instruments. But any announcement of a partial lifting of the embargo might draw attention to the treatment of local authorities and nationalised industries, and prompt them to complain. The Bank themselves would not favour lifting the embargo for sovereigns alone, so we would advise against any change in the current coverage of the embargo.

Procedure

7. The Bank would like to issue the consolidated guidelines (attached) as soon as possible. There is one potential presentational issue here. We have an outstanding remit from Ministers to look at the future of the equity queue, and of the legislation which underlies it (the 1958 Control of Borrowing Order, many times amended, and the 1946 Borrowing (Control and Guarantees) Act . We have had a paper ready since before the Election, but this is not an immediate priority, so we shall be submitting it when more urgent matters have been dealt with. But the question does arise whether the Bank should be issuing revised consolidated guidelines before, rather than after, Ministers have considered policy in this area. In practice we do not think this would be a problem. We shall not be proposing major changes

to current arrangements. If Ministers do decide on substantial changes to the statutory position this would require primary legislation, which could not be expected for some time, since it would be outside the scope of a Finance Bill. Any announcement would therefore be likely to take place sufficiently long after the Bank issue the attached guidelines that it would not look odd.

8. Though we do not have major problems with the Bank's proposals, these are fairly sensitive issues, and you may wish to hold a meeting with representatives of the Bank to go over the ground, before giving your clearance for them to go ahead with publishing their guidelines, suitably amended on deep discount etc instruments.

Short term corporate bonds

9. You may be interested in one other possible market development, relating to short term corporate bonds. A special regime for corporate borrowers in this market was set up in 1985, but there have up to now been no issues. We understand from the Bank that there is a good chance that Commercial Union will announce soon a financing package which includes up to £100m in short term corporate bonds. If this does go ahead, and no final decisions have been taken, it would represent a significant development, and we shall be watching closely in case it signals a general increase in interest in this form of instrument.

M J NEILSON

CAPITAL MARKET ISSUES IN STERLING

1 This guidance notice brings together the Bank of England's current guidelines on capital market issues in sterling. It describes the basic framework currently operated by the Bank, and incorporates certain changes introduced in the light of recent discussions with market participants. Three main aspects are covered in the notice - timing consent, lead management, and the structure of issues.

2 The Bank wants to be able to monitor activity in the sterling capital market in order to promote the development of the market on an efficient and orderly basis. To that end the Bank would wish to be consulted in advance on any features of sterling issues which are new or have implications for the development of the market. Such consultation should be directed to the Bank's Gilt-Edged Division: the point of contact is the Senior Manager (Sterling Capital Markets) or his staff (telephone numbers: and).

I TIMING CONSENT

The statutory requirement

3 New issues in sterling for amounts of £3 mn or above require timing consent from the Bank of England before the issue is made; this is a statutory requirement, under the Control of Borrowing Order 1958 (as subsequently amended). The purpose of timing consent is to enable the Bank to monitor the flow of new issues. Routine requests for timing consent should be directed to the Government Broker in the Bank's Gilt-Edged Division (telephone numbers: and).

The new issues queue

4 As part of the process of timing consent, the Bank operates a new isues queue whose basic purpose is to encourage the maximum continuing flow of issues by seeking to maintain orderly conditions in the new issues market. Reflecting this purpose, the Bank seeks to operate the queuing arrangements flexibly and to adapt them from time to time in response to market developments. In operating the queue the Bank's guiding principle is to try to avoid inadvertent clashes between large competing issues, while seeking wherever possible to meet the timing requested by an issuer. In the Bank's experience, a queuing system operated on this basis can be of benefit to issuers, especially in the case of larger issues.

The operation of the queue

5 In operating the queue, the Bank follows essentially the <u>same approach</u> for all types of sterling issue - equities (whether offers for sale, rights issues or placings) and bonds (including floating rate notes), whether sold into the domestic market or internationally.

6 For all these issues, issuers may <u>book a date in advance</u> up to a reasonable period ahead, and the Bank will wherever possible approve the timing requested; this may result in more than one issue coming to market on the same day. In particular circumstances, however, the Bank may wish to suggest an alternative timing - for example, if there is already a large issue booked on or close to the date requested, or if a concentration of large or similar issues in a short period seems likely to be a source of market disturbance; in these circumstances the Bank will always endeavour to find an issuer an alternative date as close as possible to the timing requested.

7 For <u>offers for sale</u>, the Bank will normally try to find a date when the issue can be brought without another offer on the same day. Where this proves difficult, the Bank would expect to consult the issuing houses concerned about the possibility of sharing a date for their offers.

8 Issuers who have not booked a date in advance may approach the Bank at any time to bring an issue <u>at short notice</u>, and the Bank will treat such issues in essentially the same way as normal bookings. Thus the Bank will wherever possible approve the timing requested, but if there is an unacceptable clash with issues already booked in that period the Bank may need to suggest an alternative timing.

9 Over the past year <u>vendor placings</u> have come increasingly to have a market impact similar to other forms of issue. The Bank has therefore tended to bring such placings into the queuing arrangements described above and proposes to continue to treat vendor placings on this basis in future.

10 In the new market structure some issues may be brought to market in the form of "<u>bought deals</u>". Since such issues are likely in practice to begin distribution as soon as they are bought, their market impact is likely to be similar to that of conventional underwritten issues. The Bank therefore proposes to treat the two on the same basis.

11 <u>Bulldog issues</u> by foreign sovereign and parastatal borrowers have at times in the past been a potential source of market congestion, reflecting the tendency of such borrowers to want to concentrate their issues on periods of particular market strength. The Bank has accordingly needed at times to space out such issues in order to avoid undue bunching, and will continue to do so to the extent necessary to avoid market congestion. For bulldog borrowers who have a firm intention to bring an issue, but are awaiting a place in the queue, the Bank maintains a 'waiting list'. Names are added to the waiting list on a first-come, first-served basis, and places in the queue are offered by taking names from the top of the waiting list and working down. Borrowers on the waiting list who twice decline the offer of a place in the queue are removed from the list.

12 The Bank will keep all the arrangements outlined above under review and will be ready to respond to views from market participants on ways they might be adopted as the market develops.

II LEAD MANAGEMENT

13 In order to promote the orderly development of the sterling capital market and to ensure that the Bank can adequately monitor activity in the market, it remains the Bank's wish that capital market issues in sterling, including those carrying a sterling option, should be managed and organised in the UK, though they may, of course, freely be sold abroad. To that end, the Bank would wish lead-management arrangements to follow the guidelines set out in paragraph 15 below. These essentially require lead-managers to satisfy the Bank that they meet two tests - capacity to lead-manage and reciprocity.

14 Hitherto the Bank's guidelines have included the provision that, where sterling issues are lead-managed by foreign-owned firms, it would expect such issues to be co-lead-managed by a UK-owned firm. Since the sterling capital market was re-opened to foreign borrowers with the ending of exchange control in 1979, there has been a substantial expansion of new issue activity, in which UK-owned firms have played a major part. In the light of this progress, the Bank has agreed with market participants that the requirement for a UK-owned co-lead-manager can now lapse.

15 Accordingly, the Bank's lead-management guidelines are as follows:

(i) The Bank will continue to wish all capital market issues in sterling, including those carrying a sterling option, to be lead-managed by a UK-based firm with the capacity in the UK to act as an issuing house.

(ii) Foreign-owned firms with such a capacity will be eligible to lead-manage sterling issues if in the Bank's view there are reciprocal opportunities in their domestic capital markets for equivalent UK-owned firms.

(iii) Foreign-owned firms may lead-manage their own issues; the reciprocity test will not be applied in such cases.

Firms who do not meet the guidelines for lead-management are able to participate freely in sterling issues in a co-management position (but not as a co-lead-manager).

III STRUCTURE OF STERLING ISSUES

16 The Bank is keen to facilitate innovation in the types of instruments issued in the sterling capital market. As indicated above, to enable it to monitor developments the Bank would wish to be consulted in advance on features of sterling issues which are new or have implications for the development of the market; but the Bank would not expect to object to new features unless they seem likely to be a source of market disturbance.

17 In response to enquiries from the market the Bank has from time to time given guidance about the structure of sterling issues, as follows:

Size of issues

18 There is no limitation on the size of equity or debt issues by corporate issuers. But to ensure a reasonable balance among different types of issue coming to the market, the Bank has hitherto set a limit of £100 mn per issue on issues by foreign sovereign or parastatal borrowers, applicable equally to issues in either the bulldog or the sterling eurobond markets. Now that some of these issues are beginning to come to maturity, the Bank has reviewed the scope for increasing the ceiling and has concluded that it would be appropriate to increase it to £200 mn per issue. The Bank will continue to expect there to be a reasonable interval between successive issues by a single sovereign or parastatal borrower.

Maturity

19 The Bank would not wish bond or FRN issues to have an initial maturity of less than 5 years, but there is no upper limit on maturity. Debt issues of less than five years can be made under specific guidelines which are set out in two guidance notices: Short-term Corporate Bonds, for issues of 1-5 years' maturity (notice issued on 19 March 1985), and Sterling Commercial Paper, for 7-364 days' maturity (notice issued on 29 April 1986).

Deep discount, zero coupon and index-linked stocks
[To be raised with HMT]

20 Subject to the normal requirement for timing consent under paragraphs 3-4 above, both UK and foreign companies may issue deep discount (including zero coupon) and index-linked stocks. Hitherto approval has not been forthcoming for such issues by local authorities or by foreign sovereign or parastatal borrowers, but from now on there would be no objection to issues of this type by such borrowers.

---

21 The Bank's Gilt-Edged Division stands ready to respond to any questions on this notice and to give guidance on other matters which may arise in relation to capital market issues in sterling.

Bank of England
[Date]

1318/016

CONFIDENTIAL UNDER SECTION 19 OF THE 1979 BANKING ACT

FROM: MRS R LOMAX

DATE: 22 JUNE 1987

CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Mr Cassell
Miss Noble
Mr Board

Thanks. X is absurd: since Clydesdale is not independent, due to [illegible] by one of the big 4, there can be no ~~[illegible]~~ diminution of competition. It is purely for Lloyds + TSB. I trust that if GB does recommend a reference, LY will overrule him. N.

MIDLAND

In view of the weekend press comment, you might like to know where things now stand.

2. Kit MacMahon is still trying to sell off the Clydesdale. The deal with TSB seemed to go completely cold during the course of last week - because of difficulty in agreeing a price, and worries about a possible reference to the MMC. But last thing on Friday night, Brian Quinn rang to report that Sir John Read had been in to the Bank, in a very positive mood - keen to go ahead, dispute over terms manageable, just have to live with the uncertainty about an MMC reference and so on. The Chairman of TSB Scotland is coming down for further discussions this week.

3. The Bank have not yet heard Kit MacMahon's side of the story - though no doubt that will emerge during the course of the day. However, they do know that he has been to see X Sir Gordon Borrie for confidential guidance and has been told that there is some presumption that there would be a reference.

4. Meanwhile, the National Australian Bank is still an alternative buyer for Clydesdale. They have also been in to see Brian Quinn, who says they are "quite keen" but not fully in the picture about the competition: they too are bringing people over for further talks this week.

5. Kit MacMahon has also consulted Gordon Borrie about the Australians and has been advised, without committment of course, that this is unlikely to lead to a reference, since there are no obvious competition issues. Whether the Bank would be happy with the Australians is another matter: the supervisors do not know much about this particular institution, and are distinctly chilly towards Australians in general, on the basis of their other behaviour in London. (I think the Federal Govt owns some of it)

!

6. For obvious reasons, Kit MacMahon is anxious to strike a deal with one or other party as soon as possible. The Bank do not rule out an announcement this week.

Not before Thursday's board meeting.

RL

RACHEL LOMAX

1318/31

CONFIDENTIAL UNDER SECTION 19 OF THE 1979 BANKING ACT

Thanks: I disagree with X (on the cross) but v. much agree with Y. N.

FROM: MRS R LOMAX
DATE: 24 JUNE 1987

PRINCIPAL PRIVATE SECRETARY

cc PS/Economic Secretary
Sir P Middleton
Mr Cassell
Miss Noble
Mr Board

MIDLAND

Your minute of 22 June records the Chancellor's scepticism about the case for an MMC reference were TSB to acquire the Clydesdale.

X Arguably, there is a good case on competition grounds for distinguishing between the Scottish and English retail banking markets: Section 69(3) of the Fair Trading Act 1973 allows an MMC reference to be framed in terms of "the supply of goods and services in a specified part of the United Kingdom". We do not have the precise figures, but we are fairly certain that TSB and Clydesdale together would account for more than 25% of Scottish retail banking business. [Scotland has its own cheque clearing system of which Clydesdale is a member. The Bank says, as a very quick and rough guide, that in Scottish retail banking the Bank of Scotland and the Royal Bank of Scotland are each about twice as big as Clydesdale, which in turn is about twice as big as TSB Scotland.] The fact that Clydesdale is now owned by one of the big 4 is not obviously relevant: in Scottish terms, its sale to TSB will have a significant effect on the balance of the market.

Y I find Sir Gordon Borris snap reaction to the Australians a little surprising, and somewhat disturbing, in view of the Banking Bill discussions about a national interest power. The Government's position was that foreign approaches to our major banks or one of the high street banks, would almost certainly be referred to the MMC on public interest grounds. Some of the same Scottish issues that surfaced in the Hong Kong Shanghai/Royal Bank case would crop up again - though arguably not to quite the same extent, since Clydesdale is already English controlled.

We may know more tomorrow, after the TSB Board meeting.

RL.

RACHEL LOMAX

Permanent Secretary
H M TREASURY

Chancellor,

Midland

I don't think this quite conveys the right impression. The Dep. Gov's view - with which I agree - is that the Australians would be unacceptable on reciprocity grounds. The Scottish dimension is an additional concern. So he is pressing Midland either to sell off some better assets eg T Cook or go for a rights issue. The problem with Clydesdale was that it seemed to be a poor buy for TSB.

PEM 26/6.

1318/35

CONFIDENTIAL UNDER SECTION 19 OF 1979 BANKING ACT

FROM: MRS R LOMAX
DATE: 26 JUNE 1987

CHANCELLOR

a
For lunch.
AA

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Miss Noble
Mr Board

MIDLAND

The TSB Board yesterday decided against the Clydesdale purchase, on perfectly understandable strategic grounds. They were not convinced that consolidating TSB's position in Scotland and Northern Ireland is the right way forward.

And they did not think it represented value for money

The Australians are still in play. There is to be a further meeting with Midland on Monday and they hope to come to a decision in the early part of next week. Purely on prudential grounds the supervisors have been impressed. NAB is the largest Australian bank, predominantly retail, conservative and very well provisioned. But the Bank have warned them of the risk of an adverse political reaction north of the border. In a good climate, there might (just) be a welcome for a proposal to liberate Clydesdale from English control and set up a separate autonomous subsidiary with Scottish management: after the election result however, there must be a good chance that it would be seized on as a way of embarrassing the Government. In that atmosphere, the attention may focus not only on the MMC, but also on the reciprocity provisions in the Banking Act. While the latter do not come into force until October, the Financial Services Act reciprocity provisions are already in force.

On the other hand, if the deal with the Australians falls through, Midland are still left with a big problem.

RL

2

RACHEL LOMAX

From : D L C Peretz
Date : 17 July 1987

CHANCELLOR

Thanks. We must clearly hold the line on interest rates & reassess in the light of the market's response to the trade figures. N

cc EST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell o/r
Mr C W Kelly
Mr Culpin

MARKETS

As you know the £ came under further upward pressure today, with a surge around midday when the rate reached a little over DM 2.99½. Including intervention last night in New York and this morning in the Far East, we have taken in $762m today - of which around $250m was in DM. This follows yesterday's take of $428m (of which 267 was in DM).

2. The main factor has been the oil price, with spot Brent above $20½. The $ has also risen, first against the Yen, and then against the DM, putting further pressure on the £/DM cross rate. This $ strength (or rather Yen and DM weakness) may also owe something to the oil price.

3. At one stage Eddie George thought he might need to ask you to hold a markets meeting today. His underlying concern is - as I think we all accept - that if anything monetary conditions are laxer than we would want; and that the process of resisting a rise in the exchange rate, particularly if that reflects a lasting rise in oil prices which would itself add to inflationary pressures, risks making them laxer still. He agrees however that it would be much better to wait if we can to take stock after Wednesday's trade figures (there might be a convenient opportunity before or after the meeting fixed for Wednesday to discuss funding policy).

4. As to how things go early next week, something will depend on how the market reacts to Monday's money figures (on which there is a separate submission). The record lending figures, combined with

the sharp rise in retail sales in June, is likely to be the main message for the market. This might ease our immediate problems on the exchange rate front. But there is of course the possibility that it will actually increase upward pressure on sterling : the market may think we will be more reluctant to reduce interest rates.

DLCP

D L C PERETZ

paperpse (BF?)

91/G.LD.4508.031

FROM: T PIKE

DATE: 11 January 1988

1. MR ~~GRICE~~ PERETZ
2. PS/CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr ~~Peretz~~ Grice o.r.
Miss O'Mara
Mrs Ryding
Ms Goodman

ARTICLE IN WALL STREET JOURNAL: DOLLAR'S SEASONAL TRADING PATTERN

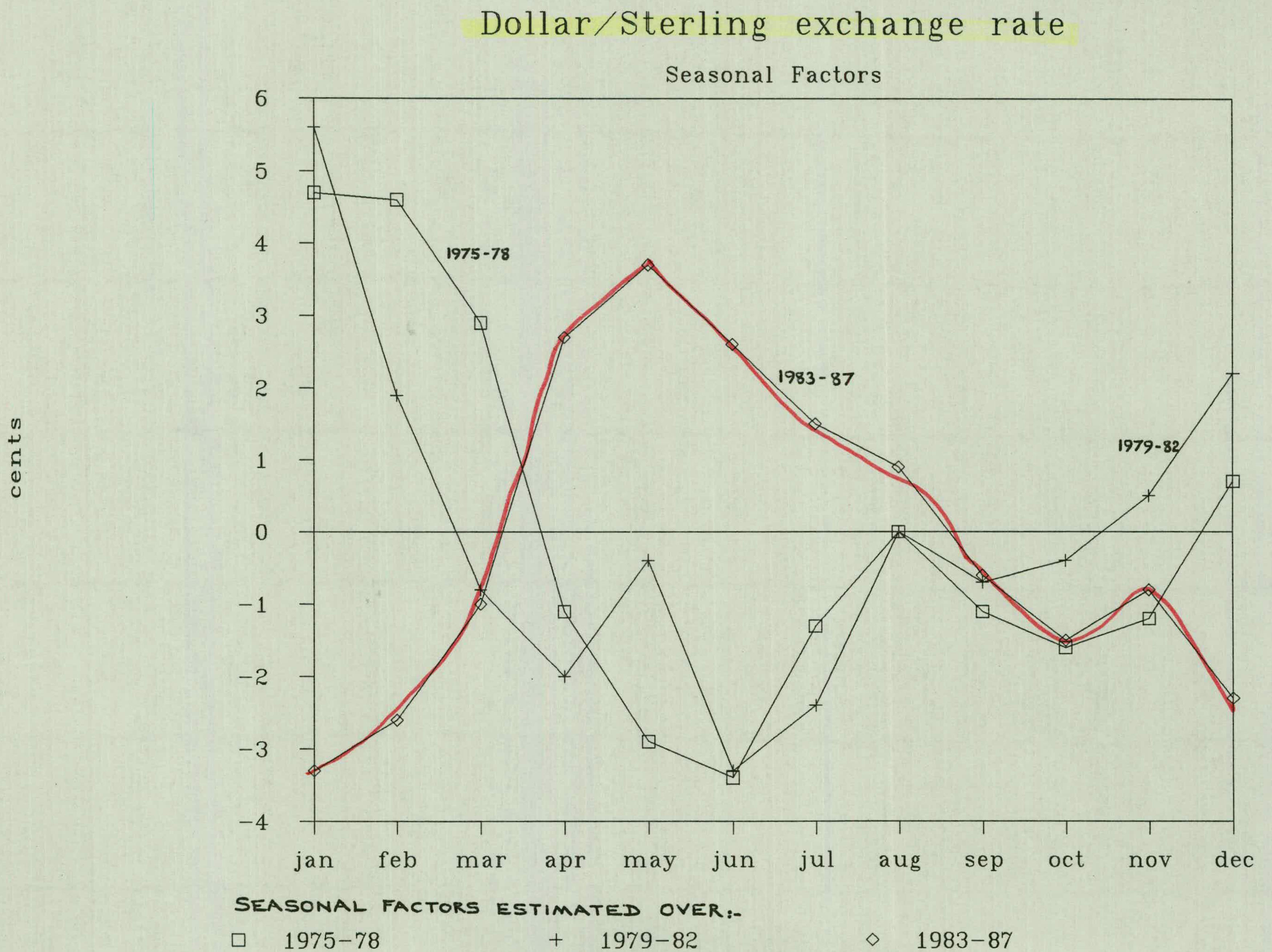
The Chancellor asked if the statistics on UK interest and exchange rate seasonality shown in Ms Goodman's note of 22 December could be converted into chart form. These are attached together with a chart of the seasonality of the D-Mark/Sterling exchange rate, which was not covered in Ms Goodman's note.

2. The main conclusion from the table and charts is that, while in each sub-period there is often a significant seasonal pattern (as measured by the F statistics shown in the table of Ms Goodman's note), the seasonal pattern is moving over time. This is most striking for the dollar/sterling exchange rate, see chart 1, which exhibits a significant seasonal pattern in each sub-period, although the seasonal pattern has virtually reversed itself since 1982. The D-Mark/Sterling exchange rate is highly seasonal in the latest sub-period (1983-87), see chart 2, but the seasonal pattern likewise has been moving over time.

T. Pike

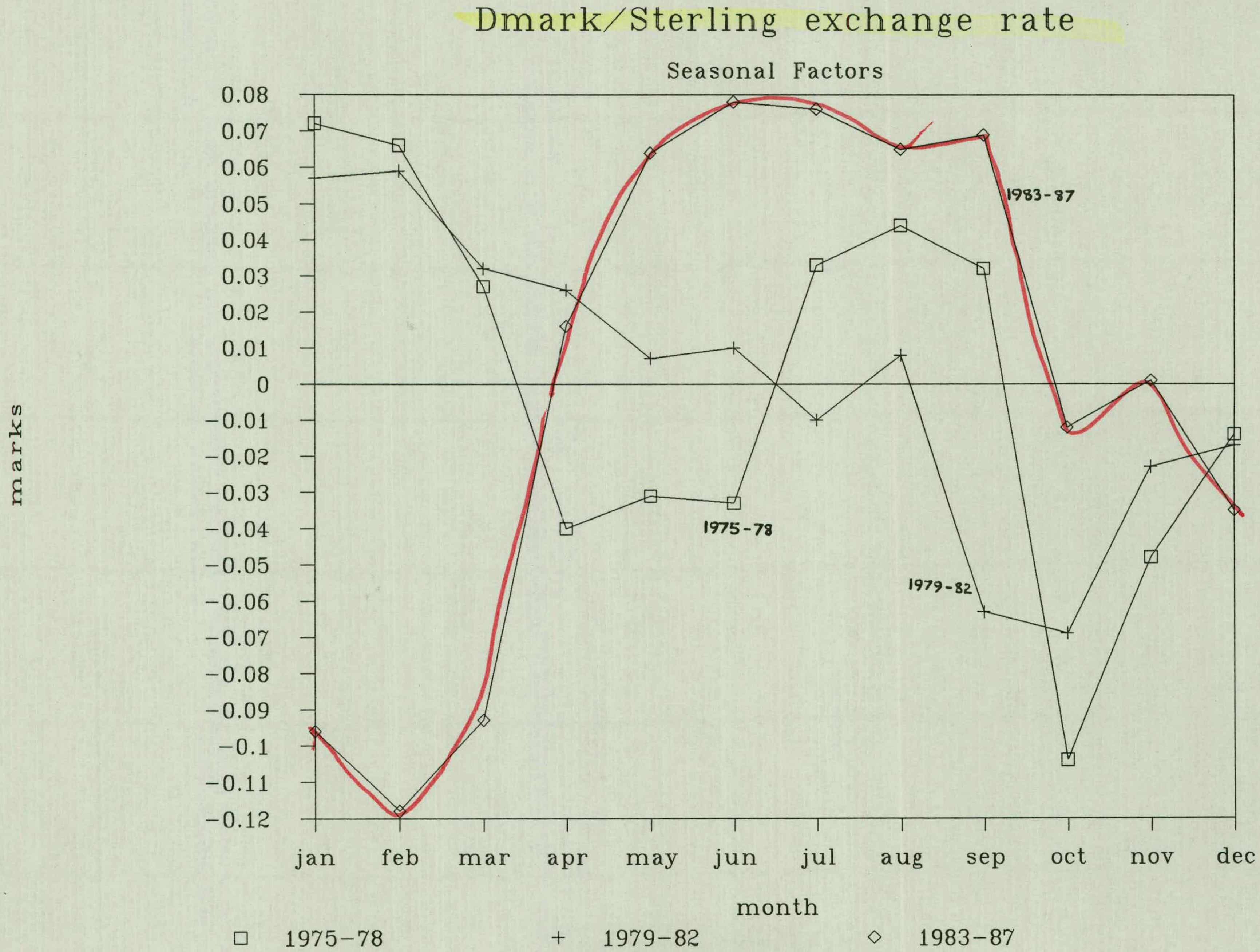
T PIKE

CHART 1



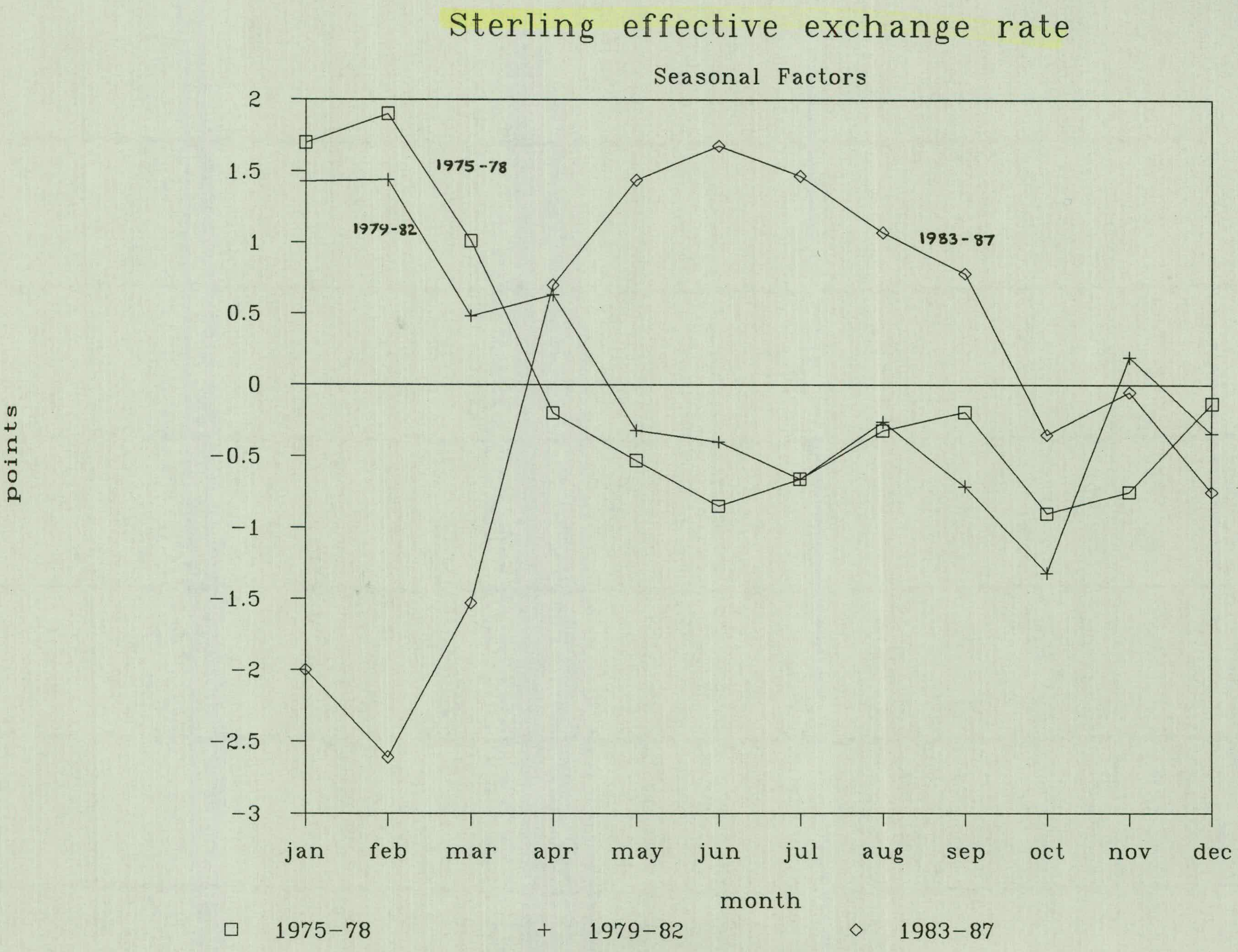
NOTE: A positive seasonal factor indicates that the exchange rate is boosted by seasonal influences.

CHART 2



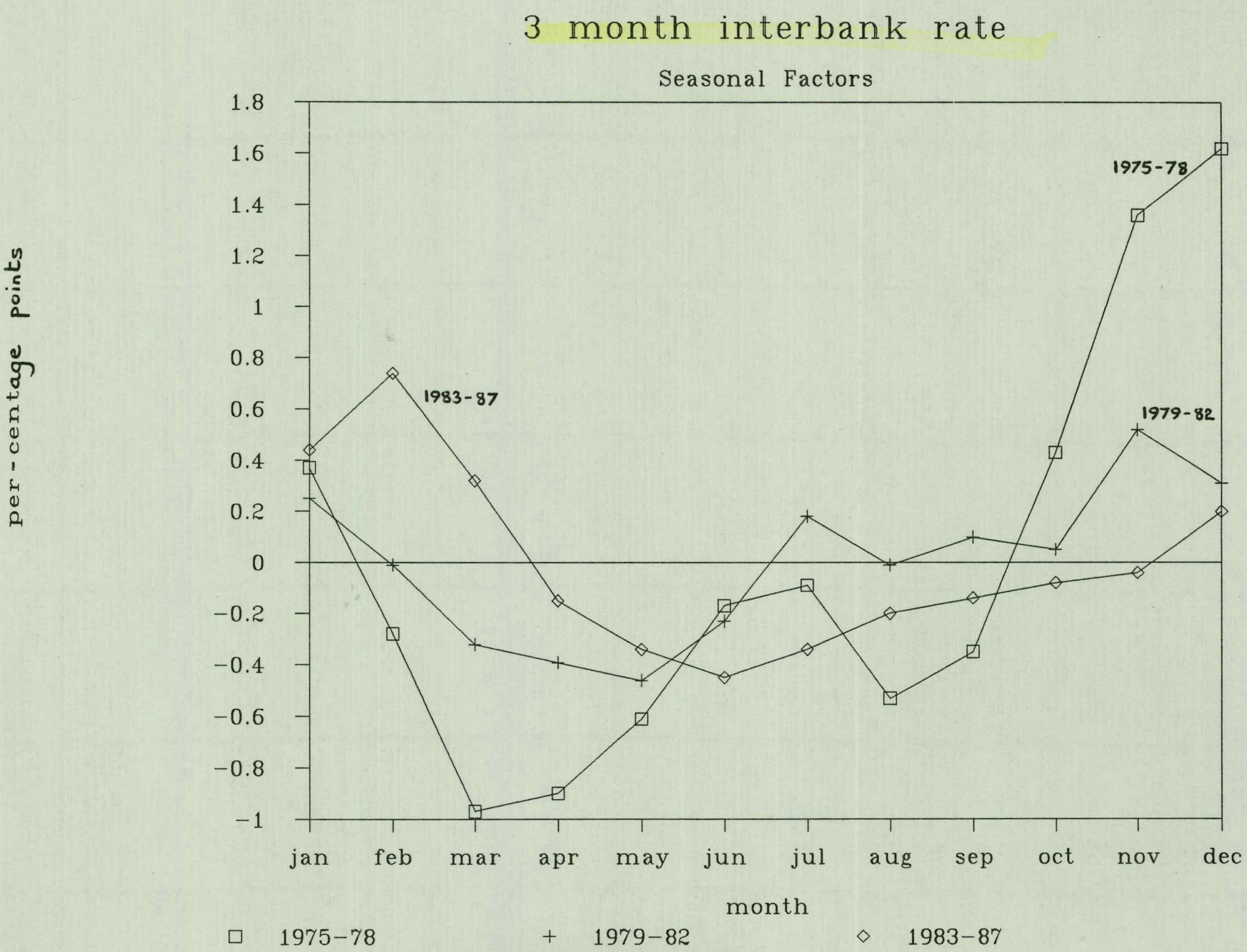
Dmark/Sterling exchange rate
Seasonal Factors
0.08
0.07
0.06
0.05
0.04
0.03
0.02
0.01
0
−0.01
−0.02
−0.03
−0.04
−0.05
−0.06
−0.07
−0.08
−0.09
−0.1
−0.11
−0.12
marks
jan feb mar apr may jun jul aug sep oct nov dec
month
1983-87
1975-78
1979-82
□ 1975−78
+ 1979−82
◇ 1983−87

CHART 3



Sterling effective exchange rate
Seasonal Factors
points
2
1.5
1
0.5
0
-0.5
-1
-1.5
-2
-2.5
-3
jan
feb
mar
apr
may
jun
jul
aug
sep
oct
nov
dec
month
1975-78
1979-82
1983-87
□ 1975-78
+ 1979-82
◇ 1983-87

CHART 4


3 month interbank rate
Seasonal Factors
1.8
1.6
1.4
1.2
1
0.8
0.6
0.4
0.2
0
-0.2
-0.4
-0.6
-0.8
-1
per-centage points
1975-78
1983-87
1979-82
jan
feb
mar
apr
may
jun
jul
aug
sep
oct
nov
dec
month
□ 1975-78
+ 1979-82
◇ 1983-87

G42a/CD/3737/021

CONFIDENTIAL

FROM: N J ILETT
DATE: 16 May 1988

PRINCIPAL PRIVATE SECRETARY

cc: PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr H Evans
Mrs Lomax o/r
Mr R I G Allen (IDT)
Miss Noble
Mr Neilson o/r

Thanks. Contd.

US RESPONSE TO THE STOCK MARKET CRASH : PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS

I attach Washington Telegram 1261, which warns that the President's Working Group on Financial Markets will be publishing its Report this afternoon, local time. (This version of the telegram omits 2 paragraphs - the full telegram is on its way from Washington.)

2. The Working Group covers the Treasury, FED, Securities and Exchange Commission and Commodity Futures Trading Commission. As an attempt to co-ordinate views and get sectoral interests to work together, the Working Party has obviously (and predictably) come close to a total failure. In terms of the main perceived weaknesses thrown up by the Crash, there is no agreement on bringing derivative markets into line with cash markets in respect of margin, on better co-ordination between regulators, or on clearing and settlement procedures; and virtually nothing on contingency planning.

3. The one positive recommendation is that in extreme circumstances, defined as a movement of 250 points in a single day on the Dow, the equity and futures markets should be closed for one hour. A further fall of 400 would close the markets for two hours. The thinness of the reasoning behind this recommendation leads pretty quickly to the conclusion that, as the telegram says, the Working Group felt that they had to

agree on something for public consumption.

4. The circuit breaker recommendation would have some implications for the UK because business could be switched here once the circuit had broken in the US. So we could be pressed to introduce similar rules here to make the US arrangements more watertight. On another view, we could sit back and watch the business come to London. That said, the size of the market movements the Working Group has specified would make such occasions very rare indeed - further evidence that the Working Party can only agree on points which are unlikely to matter.

5. I suggest that, if asked, the Press Office should say that we shall be studying the Report and reactions in the USA to it, and decline to comment on the possible relevance of the circuit breaker recommendation for the UK. I have asked the Bank to do the same, and I understand that the DTI are taking the same line.

N.I.

N J ILETT

cc immediate
Mr Willett DTI
Mr Pride DTI

CONFIDENTIAL

1. I bett

ADVANCE COPY

015726
MDADAN 6319

SENT 16 MAY 1988

CONFIDENTIAL
FM WASHINGTON
TO DESKBY 160800Z FCO
TELNO 1261
OF 152230Z MAY 88

REPORT OF PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS
SUMMARY
1. THE REPORT OF PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS HAS NOW BEEN BROUGHT FORWARD TO MONDAY MAY 16. THE GROUP WILL RECORD DISAGREEMENTS BETWEEN THE REGULATORY AGENCIES ON THE NEED FOR ENHANCED MARGIN REQUIREMENTS, BUT WILL RECOMMEND THE INTRODUCTION OF A CIRCUIT BREAKER TO CLOSE THE MARKETS IN THE EVENT OF A VERY SHARP MOVEMENT. THERE WILL BE NO RECOMMENDATION FOR ANY CHANGE IN THE REGULATORY STRUCTURE.
DETAIL
2. THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS WILL PRESENT ITS REPORT TO THE PRESIDENT AT 3:00 PM (LOCAL TIME) ON MONDAY 16 MAY. IT WILL BE FORMALLY PUBLISHED, WITH A PRESS CONFERENCE, ABOUT AN HOUR LATER. THIS PUBLICATION TIME IS ABOUT TWO DAYS EARLIER THAN WAS ORIGINALLY EXPECTED. THE NEW PUBLICATION TIME IS STILL VERY SENSITIVE, SO PLEASE PROTECT.
3. THE MEMBERS OF THE WORKING GROUP ARE GOULD (TREASURY), RUDER (SEC), GREENSPAN (FED) AND GRAMM (CFTC). WE HAVE NOT YET SEEN A COPY OF THE REPORT, BUT TREASURY CONTACTS HAVE GIVEN US AN OUTLINE OF ITS CONTENTS. THESE ALSO REMAIN SENSITIVE UNTIL PUBLICATION.
4. THE REPORT WILL SAY THAT IT HAS SOUGHT, FIRST, TO ADDRESS THE ISSUES THAT AFFECT THE SYSTEMIC RISKS REVEALED BY THE OCTOBER CRASH - SPECIFICALLY: MARGIN REQUIREMENTS' THE NEED FOR CIRCUIT BREAKERS AT TIMES OF INTENSE PRICE'VOLATILITY, AND THE IMPLICATIONS OF HAVING SEP THE SEC BELIEVE THAT
THE POSITION FOR THE FUTURES MARKETS SHOULD BE BROUGHT INTO LINE WITH THAT FOR EQUITIES. THE CFTC, HOWEVER, REFUSES TO AGREE AND

1987).
13. THERE IS SOME PRESSURE IN CONGRESS FOR LEGISLATION TO IMPROVE COORDINATION - MANIFESTED BY SENATOR PROXMIRE'S BILL. THE BRADY REPORT NOMINATED THE FED AS AN OVERALL REGULATOR, WHICH PUT MANY LEGISLATORS IN AN AWKWARD POSITION, SINCE THEY APPROVED OF THE OBJECTIVE, BUT WOULD THEMSELVES (BECAUSE OF JEALOUSIES ARISING FROM THE DIFFERING JURISDICTIONS OF DIFFERENT COMMITTEES) BE UNABLE TO IMPLEMENT THE RECOMMENDATIONS. THE REPORT WILL LET THEM OFF THAT HOOK BY FAILING TO RECOMMEND ANY CHANGES IN THE REGULATORY STRUCTURE. THIS PROVIDES AN EASY TARGET FOR CRITICISM. THE CRITICISM WILL BE ALL THE GREATER SINCE THE REPORT DEMONSTRATES THE FAILURE OF THE PRESENT REGULATORY AGENCIES, WHEN WORKING TOGETHER, TO AGREE.
14. THE PROSPECTS FOR LEGISLATION STILL LOOK FAIRLY REMOTE, BUT THIS REPORT IS LIKELY TO REVIVE INTEREST IN PROPOSALS LIKE THAT OF SENATOR PROXMIRE.
15. THE ADVANCE IN TIMING, WHICH WAS MADE NECESSARY BY TREASURY SECRETARY BAKER'S ABSENCE FOR MOST OF THE COMING WEEK, WILL CAUSE CONSIDERABLE IRRITATION TO CONGRESSMAN MARKEY - CHAIRMAN OF THE TELECOMMUNICATIONS AND FINANCE SUB-COMMITTEE OF THE HOUSE ENERGY AND COMMERCE COMMITTEE. HE HAS SCHEDULED A HEARING ON THE REPORT FOR THURSDAY MAY 19 IN THE EXPECTATION THAT HIS HEARING WOULD BE THE FIRST MAJOR COMMENT ON THE REPORT. HE WILL NOT LIKE THE FACT THAT HIS HEARING WILL BE UPSTAGED BY TWO DAYS OF COMMENT IN THE PERIOD BETWEEN PUBLICATION AND HIS HEARING.
16. FCO PLEASE ADVANCE TO SCHOLAR AND MRS LOMAX (TREASURY) AND TO GREEN (BANK).

ACLAND

YYYY

DISTRIBUTION 6

ADVANCE 6

HD/NAD
HD/ERD
MR SCHOLAR TRSY
MRS LOMAX TRSY
MR GREEN BANK OF ENGLAND
RESIDENT CLERK

NNNN

SO THE WORKING GROUP HAS FAILED TO COME UP WITH ANY RECOMMENDATION.

6. THE REPORT WILL IDENTIFY TWO ELEMENTS IN THE ASSESSMENT OF THE APPROPRIATE LEVEL OF MARGIN REQUIREMENTS: THE FIRST IS PRUDENTIAL, THE SECOND IS THE NEED TO RESTRAIN MARKET VOLATILITY. THE CURRENT MARGIN LEVELS WILL BE ENDORSED BY THE GROUP AS SUFFICIENT TO MEET PRUDENTIAL REQUIREMENTS. THE SEC ARGUE THAT THE MARGIN ON FUTURES SHOULD BE HIGHER THAN AT PRESENT, ON THE GROUNDS THAT THE PRESENT LOW LEVEL ENCOURAGES SPECULATION AND VOLATILITY. THE REST OF THE GROUP DO NOT AGREE SO ONCE AGAIN THEY WILL FAIL TO REACH AN AGREED RECOMMENDATION.

7. THE GROUP WILL RECOMMEND THE INTRODUCTION OF A CIRCUIT BREAKER. THEY WILL SAY THAT WHEN THE EQUITY MARKETS SHOW A MOVEMENT OF 250 POINTS IN A SINGLE DAY ON THE DOW INDEX, THE MARKETS (FUTURES AS WELL AS EQUITIES) SHOULD BE CLOSED FOR AN HOUR. AN EQUIVALENT FALL IN THE FUTURES MARKETS WILL ALSO TRIGGER THE CLOSURE OF EQUITIES AND FUTURES MARKETS. AFTER THE HOUR, THE MARKETS WILL RE-OPEN. IF THE DOW THEN SHOWS A FURTHER FALL OF 400, THE MARKETS WILL THEN CLOSE FOR TWO HOURS.

8. THE JUSTIFICATION WILL BE THAT MARKET MOVEMENTS OF THIS SIZE DISRUPT THE TRADING MECHANISMS OF THE MARKETS. THE GROUP WILL SAY THAT, AS DESCRIBED IN THE BRADY REPORT, TRADERS CANNOT TELL WHAT PRICE LEVELS ARE, MARGIN REQUIREMENTS CANNOT BE DETERMINED, THERE IS UNCERTAINTY AMONGST CREDITORS ABOUT THE TRUE EXPOSURE OF MARKET PARTICIPANTS, THERE IS UNPREDICTABLE AND SPORADIC ACCESS TO MARKETS FOR INVESTORS AND A CLEAR DANGER TO THE SYSTEM. A BREAK IS NECESSARY TO CALM THINGS DOWN.

9. THE GROUP ALSO FAIL TO REACH ANY FIRM RECOMMENDATIONS ON CLEARING AND SETTLEMENT PROCEDURES. THERE IS NO IMMEDIATE PROSPECT OF A SINGLE CLEARING SYSTEM AS RECOMMENDED BY BRADY. SO THE REPORT WILL ANNOUNCE A SERIES OF STUDIES DESIGNED TO FIND WAYS OF ACHIEVING THE ADVANTAGES OF A SINGLE SYSTEM. THIS WILL

11. THERE WILL BE NO RECOMMENDATION FOR ANY CONTINGENCY PLANNING - BEYOND THE COOPERATION DESCRIBED ABOVE.

COMMENT

12. THE REPORT WILL CREATE CONSIDERABLE CONTROVERSY IN CONGRESS, SINCE IT REVEALS DEEP DISAGREEMENT BETWEEN THE DIFFERENT REGULATORY AGENCIES ON THE QUESTION OF MARGIN REQUIREMENTS, AND FAILS TO ADOPT ANY SPECIFIC PROPOSALS TO ENHANCE COORDINATION BETWEEN THE AGENCIES. INDEED, IT IS LIKELY THAT MANY OF THE GROUP MEMBERS ONLY AGREED TO THE CIRCUIT BREAKER IN ORDER TO ENSURE THAT THE REPORT HAD AT LEAST ONE POSITIVE RECOMMENDATION. IT IS PROBABLE THAT, HAD THE MECHANISM BEEN IN PLACE THROUGHOUT THIS CENTURY, IT WOULD ONLY HAVE BEEN TRIGGERED TWICE (1929 AND

3632/9

CONFIDENTIAL

I shd be grateful if Economics cd let me have a note on Congdon's track record on inflation predictions. NL.

FROM: P J CROPPER
DATE: 18 May 1988

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Tyrie
Mr Call

IEA

Some three weeks ago the IEA planned a small seminar to discuss Tim Congdon's views on credit growth, money supply, interest and exchange rates. It took place this afternoon with Congdon, Minford, Flemming, Paul Bareau, the IEA team and a few others.

2. Congdon and Minford baited each other. Congdon judged that the latest cut in the base rate was completely misguided, that the peak of the Lawson boom would occur before very long, and that twenty months after the peak the rate of inflation would go up to 2½ x its present level - which has been the case, on average, twenty months after the last five cyclical peaks. The aftermath of the boom will be a difficult time.

3. Minford roared with laughter, saying in effect that there was not a cloud on the horizon. John Flemming held the ring, with a good deal of economist's stock in trade. I kept very quiet.

4. What particularly struck me was their attempt to explain what had been happening by reference to rather narrow domestic parameters. People seem to forget that the sterling exchange rate boom of 1981-82 reflected foreigners' enthusiasm for the revolution in public finance under the new Conservative administration; the dollar boom of 1983-84 reflected initial

enthusiasm for President Reagan; now we are seeing enthusiasm for a Government with a good majority and five years to run, in a world where political uncertainty seems to have gripped the USA, France and Germany simultaneously. In short, it is all a question of hot money. So how could we avoid cutting base rates? I should think we will see base rate at six per cent before have finished. After all, that is what it was under Mr Healey at one time in 1977.

PJC

P J CROPPER

Behaviour of inflation at and after previous cyclical peaks

Year of peak	Cyclical peak: Date	Cyclical peak: Inflation rate, %	Subsequent inflation high: Date	Subsequent inflation high: Inflation rate, %	Number of months from peak to inflation high	Increase % in inflation from peak to inflation high
1960	3rd pt 1960	1.4	May 1962	5.7	21	4.3
1964	May 1964	3.0	Apr 1965	5.6	11	2.6
1969	May 1969	5.3	Aug 1971	10.3	27	5.0
1973	May 173	9.5	Aug 1975	26.9	27	17.4
1979	May 1979	10.3	May 1980	21.9	12	11.6

Source: *Monthly Digest of Statistics*

The average length of time between the cyclical peak and the date of the subsequent inflation high is 19.6 months. The average increase in inflation betwen the peak and the subsequent inflation high is 8.2%. The rate of inflation at the cyclical inflation high is, on average, 2.6 times the rate of infation at the previous peak in activity.

ps2/100M

UNCLASSIFIED

Bf ~~4/6~~ ~~7/6.~~ ~~8/7~~ pup

FROM: MISS M P WALLACE
DATE: 25 May 1988

MR PATTERSON - EB

cc PS/Sir T Burns
Mr Price

CONGDON ON INFLATION

The Chancellor has asked for a note on Tim Congdon's record of inflation predictions. I believe that someone has done some research on this before. Can you - or copy recipients - dig out what was done before, and get it updated if necessary?

MPW.

MOIRA WALLACE

dti

the department for Enterprise

CH/EXCHEQUER
REC. 27 MAY 1988 27/5
ACTION MR ILETT *
COPIES TO PS/FST, PS/EST
Sir P. MIDDLETON
MR SCHOLAR
MRS LOMAX
MR NEILSON

CONFIDENTIAL

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

Department of Trade and Industry
1-19 Victoria Street
London SW1H 0ET
Switchboard 01-215 7877
Telex 8811074/5 DTHQ G
Fax 01-222 2629

The Rt Hon Nigel Lawson MP
House of Commons
LONDON
SW1A OAA

Ch/ I have skimmed this. You certainly need do no more than glance at the Executive Summary. (My impression is that, despite the bulk of the document, substantiation of its conclusions is a bit thin. But we await advice from FIM). 27/5

* with copy of Report

Direct line 215 5422
Our ref DW3AHC
Your ref
Date 26 May 1988

Dear Nigel,

REPORT ON THE STOCK MARKET FALL

As you may know, towards the end of last year I asked officials to review the major studies being carried out around the world of the implications of the Stock Market Fall of last October, and to draw out any implications for UK markets and market mechanisms. The aim was to produce a report identifying what responses might be appropriate by the various UK regulators and market authorities, and to enable us to satisfy ourselves that no inappropriate measures were likely to be taken.

The work has been carried out with participation by Treasury officials. The Bank have also been closely associated and the Securities and Investments Board, The Stock Exchange, LIFFE, the International Commodities Clearing House and a number of users have all been consulted. Of course many of the issues examined are the responsibility of the various regulatory and market authorities; the report is therefore understandably cast as noting what the authorities are doing in the light of the market fall and inviting them to consider the other recommended actions in their area.

The main conclusion is encouraging: that our systems stood up well in the circumstances of last October. The report is sceptical about many of the recommendations in the American reports, particularly those advocating wider use of circuit breakers or proposals to limit certain kinds of computer trading. It does, however, identify a number of areas where technical improvements could and probably should be made to improve dealing and settlement arrangements. What is said in

the Enterprise initiative

CONFIDENTIAL

the report on these reflects discussions with the authorities concerned and should be broadly acceptable.

If you are content I propose to write to the organisations concerned, sending them the report in confidence, (omitting the sensitive passages) and inviting them to take note of any of the recommendations relevant to them.

I understand that officials, particularly in the Bank, have reservations about wider publication on the basis that parts of it, particularly Part V, might indicate a degree of contingency planning that could lead to moral hazard. I have to say I do not share this view: Part V seems to me a blandly-phrased statement of the obvious - that regulators should collaborate, particularly in difficult market conditions.

It is public knowledge that the Department is considering the implications of the market fall, in consultation with the relevant market authorities, and we are bound to be asked about our conclusions. It would in my judgement be better to present these conclusions at our own initiative, as part of a considered document, rather than risking the accusation that we have suppressed our findings. I will therefore ask my officials to discuss with yours the preparation of a suitably abridged version for publication.

I am copying this to the Prime Minister and to the Governor.

Yrs
David

NH8/69Jo

CONFIDENTIAL

BF ~~8/6~~
JMGT
9/6

(I take it that the full report was enclosed with these minutes?!)

FROM: J M G TAYLOR
DATE: 1 June 1988

PS/FINANCIAL SECRETARY

cc PS/Economic Secretary

REPORT ON THE STOCK MARKET FALL

... I attach a copy of this report (Lord Young's letter of 26 May, already copied to you, covered this). The Chancellor would be grateful for any observations which the Financial Secretary and the Economic Secretary might have.

J M G TAYLOR

SECRET

From : D L C Peretz
Date : 1 June 1988

PPS

cc Sir P Middleton
Sir G Littler
Miss O'Mara
Mr Pike
Mr Cropper

MARKETS MEETING : 2 JUNE

The Chancellor and others attending tomorrow's markets meeting might like the attached up to date summary table of monetary conditions.

2. By way of comparison it shows the position six months ago, one month ago, and on the day before we last moved interest rates (down) : 17 May.

DLCP

D L C PERETZ

90/G.jfw.4555/061

SECRET

Monetary developments since last month's report

Latest outturns available at time of:

	Nov Report	Apr Report	May	
Monetary aggregates (12 month % growth)	(Oct)	(Mar)	(Apr)	
M0 (sa)	5.6	5.8	6.2	(6.2)+
M3	22.4	20.9	19.3	
M4	15.8	16.8	15.9	
M5	15.2	16.6	15.6	
Bank lending	22.9	25.2	26.8	
Bank & building society lending	19.3	20.8	21.8	
Interest rates (%)	**30 Nov**	**4 May**	**16 May**	**1 June**
3 month interbank	8.9	8.4	8.1	8.0
20 year gilt-edged (par yield)	9.3	9.3	9.2	9.3
Yield gap	-0.4	-0.9	-1.1	-1.3
UK real 3 month interbank	4.9	4.3	n/a	n/a
Equity dividend yield (all-share)	4.7	4.2	4.3	4.2
IG yield (2001) assuming 5% inflation	3.9	3.8	3.7	3.8
3 month UK interest differential with:				
Germany	5.2	5.0	4.5	4.5
US	1.0	1.2	0.7	0.3
World basket	2.2	2.1	1.7	1.5
Exchange rate				
Yen/£	242	233	236	228
$/£	1.83	1.86	1.89	1.82
DM/£	3.00	3.13	3.19	3.15
ERI	76.4	77.9	79.2	77.3
Oil adjusted ERI*	105.5	109.3	110.3	108.3
Asset prices				
FT-A Index (% pa)	-1.4	-11.1	-16.2	-15.6 (est)
FT-A Level (July peak: 1239)	796	95	917	934 (est)
Halifax house index (% pa)**	16.2	20.3	n/a	22.0

\+ May

* The oil adjusted ERI shows whether the joint effect of oil price and exchange rate changes has been counter-inflationary or otherwise, relative to the base period Jan 1983-Nov 1985, on the assumption that the inflationary effect of a 4 per cent rise in oil prices is exactly offset by a 1 per cent rise in the exchange rate.

** figures are for November, April and May

SECRET

MG NOON REPORT

FINANCIAL MARKETS Friday 3 June 1988

Previous Close	Opening	10 AM		NOON	Oil Price (11 AM)
76.5	76.5	76.3	£ERI	76.2	
1.8000	1.8035	1.8017	$/£	1.7985	Jun $16.45
3.1108	3.1078	3.1034	DM/£	3.1019	Jul $16.70
1.7282	1.7232	1.7225	DM/$	1.7247	Aug $16.85
126.50	126.10	125.60	Yen/$	125.97	

UK interbank £			Eurodollars	
7 1/8	(-)	7 day	7 3/8	(-)
8 5/16	(+3/16)	1 month	7 1/2	(-)
8 15/16	(+1/4)	3 month	7 5/8	(-)
9 23/32	(+7/32)	12 month	8 1/4	(-)

Figures in brackets show change since previous market close

MARKET COMMENT Sterling remains focus of market attention although US unemployment data due out at 1.30PM today could refocus attention on the dollar.Sterling steadied in New York but rose in the Far East on an easier dollar.Today it has seen good two way business with sellers slightly out-numbering buyers but the market is not yet decided which way to push the currency and is still looking for another 1/2% rise in base rates.Market expects the US unemployment rate to be unchanged at 5.4% and non farm payrolls +222,000 (from +174,000 last month).The US and Japanese equity markets closed lower with Hong Kong closing higher. The Dow closed at 2054.5 -11.6,the Nikkei closed 28822 -48,and the Hang Seng closed 2568.4 +12.7.The Gilt market opened steady but has drifted sterling.

Ian Polin

MARKET INTERVENTION ($m)

OTHER COUNTRIES INTERVENTION ($m)

Overnight	-
Today so far	-
Total	-

GILTS

	Latest market movements	Price change since previous close	Gilt Sales since market opening
Shorts	Better	+2/32	-£7.2 million Conventionals (mainly longs).
Mediums	Better	0	
Longs	Better	-3/32	
Futures (Long Contracts)		-1/32 (VOL:8499)	

NAME: I.C.Polin,MG1 Division
TEL NOS: 270 5556/5560

SECRET

BF with advice at 15/6

BANK OF ENGLAND
LONDON EC2R 8AH

THE DEPUTY GOVERNOR

7 June 1988

CHEQUER 8/6
08 JUN 1988
Mr ILETT
PS/EST PS/EST
SIR P MIDDLETON
Mr SCHOLAR
MRS LOMAX
Mr NEILSON

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
London
SW1H 0ET

Dear Lord Young

REPORT ON THE STOCK MARKET FALL

In the absence of the Governor abroad on business, I am writing to thank you for sending us a copy of your letter of 26 May, addressed to the Chancellor, together with the accompanying report by your officials. This reply was seen in draft by the Governor before he left, and he fully supports all that is said in it.

You refer to concerns which Bank officials have expressed about publishing the report, and comment that the passages on collaboration between regulators amount to no more than bland statements of the obvious. We accept that this is a fair description of those particular passages, as they are now worded. Nevertheless the very act of making public the series of official conclusions set out in Chapter 6 would give an impression of a checklist of actions to be taken and arrangements to be brought into play in a crisis by the appropriate regulators which would give journalists and others a standing invitation continually to enquire about their nature or progress.

I will give two illustrations of what we have in mind. One is the passage calling for improvements in the arrangements between banks and their dealer customers, where we consider that such arrangements actually stood the test of October 1987 very well in London and where, although there were no doubt lessons learnt by individual banks and securities dealers, as well as by regulators, the conclusion that these need particular improvement gives a misleading and slightly alarmist impression of the reality. This would of course be less worrying in a report given limited circulation than in one given wide publication. Another example is in the drawing of attention to the fact that the Stock Exchange is considering a central margining system for equities. This is certainly an interesting and potentially important proposal which we would expect your officials to report to you. But it seems premature for it to be highlighted in a published report, when it is at an early stage of internal consideration in the Stock Exchange and may in the event possibly not be pursued, if a comparison of its costs and benefits shows it to be inferior to other methods of reducing counterparty risk.

Hence our preference would still be that you should not publish the report. We do not sense any great pressure from the media for publication; and the likelihood of this arising is surely receding the further away we move from October 1987. It would be sufficient in our view for you to circulate the report to those bodies which your officials have consulted and who would anyway include the people principally interested in its conclusions. That course would also have the advantage that some, perhaps all, of the excisions from the report which would be necessary in a wider publication need not not be made; and to that extent the report could be less anodyne.

We recognise, of course, that it is for you to judge whether to publish a report which you commissioned from your officials. If you go ahead, we assume that it will be presented on that basis rather than as the joint product of your own Department and, among others, the Bank.

I am copying this letter to the Chancellor of the Exchequer and the Prime Minister.

Yours sincerely

George Blunden

1144/026/CR/42a/G

FROM: M J NEILSON

DATE: 9 June 1988

1. MRS ~~LOMAX~~ Agreed in draft

2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Monck
Mr Scholar
Mr Peretz
Mr Ilett - or
Miss Noble
Miss O'Mara or
Mr Sharples - o/a
Mr Cropper
Mr Call

Ch/ content with this draft? OK

10/6

REPORT ON THE STOCK MARKET FALL

With his letter of 26 May Lord Young has sent you a copy of a paper prepared by his officials on the Stock Market Fall. He proposes circulating it to the regulators involved in its preparation, and preparing an abridged version for publication.

2. The Deputy Governor has now recorded the Bank's views. He is very much against publication, but has no objections to the paper being circulated to the regulatory bodies (who have, incidentally, already seen it in draft).

3. The DTI paper is not an impressive document. It is primarily a catalogue of the conclusions of other reports, and the actions being taken by the regulatory bodies. As Lord Young explains in his letter the general message is that the London markets stood up well to the crash. But there is little in the paper to suggest that the DTI have taken an independent view of London's performance; they have relied almost entirely upon data from the Stock Exchange, and upon Stock Exchange analysis of that data.

4. As an internal document it is harmless. The regulatory bodies have already seen it in draft, so it would do little harm to send it to them. But we share the Bank's view that neither the paper nor a summary of it should be published. We can see no pressure from the outside world for such a document (indeed even in the

US the crash is no longer a hot issue). The paper is little more than a rubber stamp of other peoples views, and, as such, may well be seen as something of a whitewash. It is also a pretty scrappy piece of work.

5. But publication would not be disastrous, and we tend to support the Bank's line, which is to advise Lord Young not to publish, but to make clear that it is his decision, and to insist that, if published, the Treasury should in no way be associated with it.

6. If Lord Young insists on putting something on the public record, there are other options. He could follow the precedent of last year's Takeover Panel Review - which was incidentally much more controversial - by publishing only a short list of conclusions. But even this seems unnecessary.

7. Though the paper as a whole is a poor one, there are only a few specific points that we would object to. The Deputy Governor has already picked up the two most important. Some of the others are:

- What little is said in the paper about speculation is contradictory. In paragraph 3.17 they say that "we do not believe the level of speculation in the UK is excessive" in paragraph 4.16 they say "it is an open question whether the current level of speculation is excessive"! The analysis of the role of speculation in paragraph 3.17 is a good illustration of the paper's weakness in assessing arguments in making judgements.

- In paragraph 4.41 tax factors are cited as inhibiting index arbitrage. This is something that could be quoted against us in the future, and should be dropped.

- Little thought appears to have been given to the paper's impact in the US. The main example of this is the material on circuit breakers; on page 4 of the Executive Summary, DTI imply that the imposition of circuit breakers in the US would provide an opportunity for UK markets to steal business. This is the sort of comment that may provoke US regulators to press us to fall in with their plans for circuit breakers.

8. But there is no need to make these points in your reply - we can pick them up if Lord Young insists on publication. (You should also note paragraph 2.11 which covers the BP offer, the wording of which strikes us as acceptable).

9. I attach a draft letter for you to send Lord Young.

M J NEILSON

1144/028/CR/42a/G

DRAFT LETTER

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry

REPORT ON THE STOCK MARKET FALL

Thank you for your letter of 26 May enclosing a report by your officials on the Stock Market Fall. I have also seen the Deputy Governor's letter of 7 June, and agree with all the points he makes.

There is clearly no reason why you should not send a copy of the report to the regulatory bodies, particularly since I understand they have seen the paper in draft already.

But I see no case for publication, either of this paper, or of an abridged version. There is little pressure for publication, and, frankly, the paper adds very little to the conclusions of earlier reports eg. by the Stock Exchange. If published, I fear it will be seen as a somewhat feeble and very belated response to October's events.

That said, it is for you to decide on publication. If you do decide to go ahead I trust it will be made clear that this is a report by your officials and not in any way a joint product with the Treasury.

I am copying this letter to the Prime Minister and the Governor.

N LAWSON

mjd 3/167m

cc- CST, FST, EST
Sir P Middleton, Sir T Burns
Sir G Littler, Mr Monck
Mr Scholar, Mr Peretz
Mr Neilson, Mrs Lomax
Mr Ilett, Miss Noble
Miss O'Mara
Mr Sharples, Mr Cooper
Mr Call

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

13 June 1988

The Rt Hon Lord Young of Graffham
Secretary of State for Trade and Industry
1-19 Victoria Street
London SW1

MP

Dear David

REPORT ON THE STOCK MARKET FALL

Thank you for your letter of 26 May enclosing a report by your officials on the Stock Market Fall. I have also seen the Deputy Governor's letter of 7 June, and agree with all the points he makes.

There is clearly no reason why you should not send a copy of the report to the regulatory bodies, particularly since I understand they have seen the paper in draft already.

But I see no case for publication, either of this paper, or of an abridged version. There is little pressure for publication, and, frankly, the paper adds very little to the conclusions of earlier reports eg. by the Stock Exchange. If published, I fear it will be seen as a somewhat feeble and very belated response to October's events.

That said, it is for you to decide on publication. If you do decide to go ahead I trust it will be made clear that this is a report by your officials and not in any way a joint product with the Treasury.

I am copying this letter to the Prime Minister and the Governor.

Yours
Nigel

NIGEL LAWSON

G42a/CD/3737/049

FROM: M J NEILSON
DATE: 13 June 1988

CHANCELLOR

cc: Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Monck
Mr Scholar
Mrs Lomax
Mr Moore
Mr Peretz
Mrs Brown
Mr Gieve
Miss O'Mara
Miss Noble
Mr Ilett o/r
Mr Sharples o/a
Mr Cropper
Mr Call

Thanks.

STOCK EXCHANGE QUALITY OF MARKETS QUARTERLY

not now (aeroplane reading?)

The latest edition of the Stock Exchange Quality of Markets Quarterly, (copy attached - top only) which is due to be published on June 15, includes interesting articles on the retail equity market, market performance since the crash, and post-crash issues (including circuit breakers). This note summarises the main points.

Private investors and services

2. This article set out the results of a survey of 129 Stock Exchange member firms' private client business, and summarises some of the conclusions of the Treasury/Stock Exchange survey of share ownership, with which you are familar. The main points are:

- Minimum commissions show no signs of falling. They are currently around £20, compared to an average of £12.50 immediately after Big Bang. But commissions have been at this level for some time now.

- Member firms are showing increasing signs of planning to expand their private client business, but the article implies that most firms will concentrate on relatively high net worth clients, targeting by either pricing policy or by restricting who they will deal with.

- Firms are beginning to specialise in offering either full advisory, discretionary or execution only services.

- There is an interesting summary of emerging market structure, covering recent initiatives such as Barclayshare's nominee scheme, and the expansion of Nat West's execution only dealing service.

- The article includes projections about future levels of activity in the retail market, and concludes that there might be an increase of around 50% in transactions by private clients in the medium term. This figure may well get some publicity, but is based on a number of random assumptions about the extent to which different categories of investor will increase their activity, and is therefore highly unreliable.

3. The general picture given by the article is that firms are slowly beginning to see the opportunities in the retail market, but that they are initially focussing on the more sophisticated investor. This message is mildly encouraging, but gives no indication of whether the service provided to the less sophisticated investor is likely to improve.

Market quality since the crash

4. The general message is that market quality has improved since the crash, but is still some way from pre-crash levels:

- Volatility has dampened down very quickly since October/ November, as measured by the number of days in which large price movements occurred. In the year up to the Crash daily movements of 1% occurred on average six times per month; since December such movements have occurred between seven and eight times a month. (There were 15 such movements in November).

- Spreads have not returned to pre-crash levels. For alpha stocks, for example, the average pre-crash spread was 1.2%, rising to 3.4% in October, and is now just under 2%.

- Post-crash, more of the business is being done by institutions than by retail investors (though this is based exclusively on an analysis of bargain size). Retail investors are however still doing more buying than selling.

5. The article rather obscures the fact that turnover in the domestic equity market is still more than 20% down on pre-crash levels; they do this by saying that, taking the Stock Exchange's four markets together, the amount of money passing though the Exchange is little changed. This is because turnover in gilts is normally 2-3 time larger than in equities, so a small increase in gilts turnover has offset a large fall in equity turnover. Commissions on gilts are much lower than on equities, so aggregate commission income is much reduced from pre-crash levels.

Capacity issues and circuit breakers

6. This article looks at the main problems in the UK equity market during the crash, and assesses whether circuit breakers would help deal with those problems in future. Predictably, the Stock Exchange reject circuit breakers, (for reasons with which we would tend to agree), but they put forward no alternative solutions. The main points made in the article are:

- A key problem in October was that the market had insufficient capacity to deal with the high volumes. London coped at least as well as any other market. (The increase in <u>transactions</u> processed was greater in London than in New York, though share volumes were higher in New York). The Stock Exchange rightly say that a balance must be drawn between controlling costs in normal trading conditions and maintaining capacity sufficient for unusually high volumes.

- The fact that many orders could not be placed, and therefore could not be reflected in the market price, meant that the market price was not a reliable indicator. This added to uncertainty in the market.

- Circuit breakers were looked at as a solution for the market capacity problem, and rejected because the Stock Exchange consider delay in executing orders to be better than suspending transactions altogether, and because they have not identified workable arrangements for orderly re-opening. Having rejected circuit breakers for the time being they stress that they remain open minded on the issue.

- Technological developments and increasing links between markets mean that future price adjustments are likely to be rapid, like in October.

Apart from circuit breakers, the other proposals for coping with market capacity problems are pretty lame. They argue that the small order execution system (SAEF) one to come in towards the end of this year will help market capacity, but the argument is unconvincing because SAEF will be suspended in fast markets, which is exactly when capacity problems occur. Their other proposals will help ensure that market makers fulfill their obligations (eg by answering their telephones) but do nothing to deal with undercapacity.

MJN

M J NEILSON

NH6/3M

UNCLASSIFIED

BF ~~22/6~~

FROM: MISS M P WALLACE ~~24/6~~

DATE: 15 June 1988

MR NEILSON

4502

cc Financial Secretary ~~28/6~~
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Monck
Mr Scholar
Mrs Lomax
Mr Moore
Mr Peretz
Mrs Brown
Mr Gieve
Miss O'Mara
Miss Noble
Mr Ilett
Mr Sharples
Mr Cropper
Mr Call

~~pse chase gently.~~

~~15/7~~

MGGa

Early Next week

→ Sarah

Goodo. BF ~~4/7~~ ~~7/7~~ ~~9/7~~ ~~13/7~~

STOCK EXCHANGE QUALITY OF MARKETS QUARTERLY

The Chancellor was grateful for your minute of 13 June. He has commented that, although the present time - only eight months after black Monday, with equity turnover low, and costs high - is not a time when one would expect a great initiative to exploit the mass retail market, he would nonetheless be grateful for a note explaining why this has happened in the US (e.g. the Merrill Lynch retail market operation) but not here. I should be grateful if you could provide this.

mpw.

MOIRA WALLACE

91/G 4509/039/cc

FROM: MS V F BRONK

DATE: 16 June 1988

Interesting background reading. DLP 16/6

1. MR PERETZ
2. PRINCIPAL PRIVATE SECRETARY

2ND FLOOR

cc PS/EST
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Odling-Smee
Mr Sedgewick
Mrs Lomax
Miss O'Mara (o/r)
Mr Mowl
Mr Grice
Mr Ilett
Mr Pike
Mrs Ryding
Mr Williams (o/a)
Mr Hurst
Mr Neilson
Mr Courtney
Mr P S Hall
File MAMC L4

INSTITUTIONAL INVESTMENT

This minute discusses institutional investment behaviour since the equity crash. For the life companies and pension funds - by far the biggest block - provisional (but unpublished) DTI estimates are available for 1988Q1. For unit and investment trusts, data extends only to 1987Q4. Table 1, attached, shows the size of these funds at market values and their portfolio proportions by broad asset type. Table 2 shows their new investments.

Fourth Quarter of 1987

2. The main points to be drawn from the figures are as follows:

(i) all of the institution's portfolios fell sharply in value, as would be expected given the equity price collapse. Market values fell on average by around 20 per cent. But the portfolios of life companies fell in value by rather less, reflecting their higher exposure to fixed interest securities, whilst unit and investment trusts dropped by more because of their higher exposure to UK and overseas equities;

(ii) despite these reductions, the value of institutional investments remained well above the level at the end of 1986. At the end of 1987, the combined portfolios of the four sets of institutions was £426 billion, some 6 per cent higher than a year before;

(iii) Table 2 shows that new investment patterns were generally similar across the institutions. All four sets made heavy net sales of overseas securities but matched them by heavy purchases of UK company securities. This may reflect a feeling that UK equities were cheap after the correction, but it is more likely to be because of underwriting commitments previously entered into;

(iv) liquidity behaviour, however, was more disparate. Unit and investment trusts increased their cash and short term assets by over £1 billion, raising their liquidity proportions to historically high levels of about 10 per cent and 7 per cent respectively (compared with averages of 5 per cent and 2 per cent since 1979). Pension funds also accumulated over £2¾ billion in cash and short-term assets, but their liquidity proportion rose less dramatically, to about 5 per cent from an average of under 4 per cent since 1979. By contrast, life assurance companies barely increased their holdings of short-term assets at all, and their liquidity proportion rose (due to revaluation effects) to only just over the 1979-87 average of about 3 per cent.

First Quarter of 1988

3. From the provisional data for the pension funds and life companies, the following observations can be made:

(a) the combined market values of their portfolios rose by about £12½ billion. This partly reflects new net inflows of around £4 billion but is also due to the gently firmer trend in equity prices. Nevertheless, the combined portfolio value remains about 17 per cent below that at the end of 1987Q3, before the equity price correction;

(b) the divergent movement in liquidity behaviour in 1988Q4 continued. Pension funds accumulated £1¼ billion of short-term assets (after £2¾ billion in Q4) increasing their liquidity proportion again, to about 5¾ per cent. By contrast, life assurance companies ran down liquid assets, allowing the liquidity proportion to fall back under 3 per cent;

(c) the investment pattern in UK company securities was also different. Life companies bought a further £1 billion of company securities, rebuilding their portfolio proportion a little to about 49 per cent. But pension funds, sold an estimated £½ billion, reducing their portfolio proportion to about 55 per cent.

(d) both sets of institutions continued to sell overseas securities in 1988Q1, but much more modestly than in 1987Q4. Life assurance companies sold £0.4 billion compared with £0.7 billion in 1987Q4, reducing their portfolio proportion to less than 9 per cent. Pension funds sold about £0.1 billion after selling £2.5 billion in 1987Q4, and their portfolio proportion fell to less than 13 per cent.

(e) a very striking feature was resumed purchases of gilts. Pension funds bought £1.4 billion, restoring their portfolio proportion to the level at the end of 1986, of about 15 per cent. Life companies purchased £1.2 billion taking their portfolio proportion to about 21 per cent, above that at the end of 1986. By contrast, in 1987 as a whole, pension funds were net sellers of gilts by around £2 billion. Life companies purchased nearly £1 billion but this was almost entirely accounted for by indexed stock.

<u>Implications</u>

4. These figures have a number of implications for the interpretation of recent monetary conditions. Perhaps the most important relate to the broad money numbers and the exchange rate.

5. Some, though not all, of the institutions short term assets are included in M4. The following table shows recent changes in institutions' liquidity - their "net short term assets" -,the financial institutions' contribution to M4 and the changes in M4 itself.

Changes £ billion

	M4	OFI Holdings of M4	Institutions Net Short Term Assets	
			Total	o/w Bank deposits
1987Q1	9.2	4.0	3.0	2.8
Q2	10.8	1.2	1.2	1.7
Q3	11.6	2.4	1.2	0.1
Q4	11.2	2.3	4.0	3.6
1988Q1	10.7	1.9	1.1*	n/a

* Life companies and pension funds only

It is clear that there was an increase in institutional liquidity preference in 1987Q4: - the institutions raised liquidity by £4 billion despite the greatly reduced size of their portfolios. But this did not appear to raise monetary growth in the economy overall. Neither M4 in total nor the financial institutions component of it grew abnormally rapidly. The reasons for this include:

(i) an offsetting fall in sterling liquidity within the OFI sector, in particular a decrease of £¾ billion in securities dealers' sterling bank deposits;

and (ii) a rise within institutions total liquidity of foreign currency liquidity, in particular a rise of £½ billion in unit trusts' foreign currency bank deposits.

6. The marked change in institutions attitudes to overseas securities will have made a substantial difference to the pattern

of the balance of payments. The following table shows the net transactions of the main institutions in overseas securities during the 1980's.

Net Transactions in Overseas Assets **£ million**

	Pension Funds	Life Companies	Investment Trusts	Unit Trusts	Total
1981	1793	801	246	290	3130
1982	3120	1242	707	233	5302
1983	1613	1366	311	730	4020
1984	449	612	- 273	272	1060
1985	2682	1195	11	1173	5061
1986	2675	1025	110	2430	6240
1987Q1	1551	528	- 48	557	2588
Q2	313	314	- 171	- 62	394
Q3	39	133	- 47	620	745
Q4	- 2543	- 715	- 881	- 1110	- 5249
1988Q1	- 99	- 353	n/a	n/a	n/a

Until 1987 there were more or less continuous portfolio investment outflows as the institutions built up their overseas asset proportions after the abolition of exchange controls. Outflows were particularly heavy in 1987Q1. Not all of these transactions will have resulted in sales of sterling since many will have been on a covered basis. But a proportion, probably the majority, will have done so, exerting a depressing influence on sterling. In the second and third quarters of 1987 however, outflows were much more moderate and this was followed in the fourth quarter by very heavy inflows of some £5¼ billion. It is natural to suppose that this turnaround was responsible for much of the relative underlying strength of the pound over the last 15 months. Data for 1988Q1 is not complete but the life company and pension fund data suggests that there were further small inflows.

Vyvian Bronk

MS V F BRONK

TABLE 1 - INSTITUTIONAL INVESTMENTS: ESTIMATED LEVELS & PROPORTIONS

PENSION FUNDS	Cash & Short Term Assets excl Short	Cash & Short Term Assets incl Gilts	Gilts	o/w IGs	Company Securities	O'seas Securities	Property	Other	TOTAL
Level £ billion:									
end 1979	2.2	2.7	9.1	0.0	18.9	2.0	6.2	2.3	40.9
end 1980	2.1	2.3	11.5	0.0	25.0	4.4	8.2	2.8	54.0
end 1981	2.2	2.5	12.5	1.4	28.9	6.4	9.7	3.7	63.4
end 1982	2.6	3.0	18.2	2.3	37.7	10.3	10.5	4.8	84.2
end 1983	4.1	4.9	22.6	3.0	50.6	16.2	11.3	6.3	111.0
end 1984	5.1	6.2	24.5	3.8	66.0	18.7	12.4	7.6	134.4
end 1985	5.2	5.9	27.2	4.4	80.6	22.9	12.9	7.6	156.4
end 1986	6.8	7.4	29.2	5.8	100.1	32.2	13.9	8.3	190.5
Q1 1987*	8.1	8.8	31.4	6.3	120.4	38.0	13.9	8.3	220.1
Q2 1987*	7.8	8.5	30.3	5.2	140.1	40.0	13.7	8.3	240.3
Q3 1987*	8.0	8.5	27.8	4.9	152.3	42.5	13.8	8.5	253.0
Q4 1987*	10.7	11.3	28.9	5.5	111.1	26.2	14.1	8.2	199.2
Q1 1988*@	12.0	12.8	31.3	6.0	114.1	26.5	14.3	8.2	206.3
As % of Assets:									
end 1979	5.5	6.5	22.4	0.0	46.4	5.0	15.1	5.7	100.0
end 1980	3.8	4.3	21.3	0.0	46.3	8.2	15.2	5.2	100.0
end 1981	3.5	3.9	19.7	2.2	45.6	10.1	15.2	5.9	100.0
end 1982	3.1	3.5	21.7	2.7	44.7	12.2	12.5	5.7	100.0
end 1983	3.7	4.4	20.4	2.7	45.6	14.6	10.1	5.7	100.0
end 1984	3.8	4.6	18.2	2.8	49.1	13.9	9.2	5.7	100.0
end 1985	3.3	3.8	17.4	2.8	51.5	14.7	8.3	4.8	100.0
end 1986	3.6	3.9	15.3	3.0	52.5	16.9	7.3	4.3	100.0
Q1 1987*	3.7	4.0	14.3	2.8	54.7	17.3	6.3	3.8	100.0
Q2 1987*	3.2	3.5	12.6	2.2	58.3	16.7	5.7	3.5	100.0
Q3 1987*	3.1	3.4	11.0	1.9	60.2	16.8	5.5	3.4	100.0
Q4 1987*	5.4	5.6	14.5	2.8	55.8	13.1	7.1	4.1	100.0
Q1 1988*@	5.8	6.2	15.2	2.9	55.3	12.8	6.9	4.0	100.0

LIFE ASSURANCE COMPANIES	Cash & Short Term Assets excl Short	Cash & Short Term Assets incl Gilts	Gilts	o/w IGs	Company Securities	O'seas Securities	Property	Other	TOTAL
Level £ billion:									
end 1979	1.5	2.0	11.3	0.0	13.8	1.3	10.3	4.4	42.7
end 1980	1.6	2.1	14.6	0.0	18.0	2.2	12.4	5.0	53.7
end 1981	2.2	2.8	15.2	0.4	20.5	3.3	14.5	5.3	61.0
end 1982	2.5	3.7	22.8	1.0	27.1	5.8	16.0	5.5	79.8
end 1983	2.8	4.4	25.8	1.4	35.1	8.9	17.2	6.1	95.8
end 1984	3.0	4.9	27.6	1.7	45.1	12.0	18.7	6.4	112.8
end 1985	2.8	4.3	30.5	2.3	55.3	14.1	20.2	7.3	130.1
end 1986	3.5	5.2	31.4	2.2	74.5	18.5	22.0	8.6	158.6
Q1 1987*	4.0	5.9	34.8	2.7	90.4	21.4	22.1	8.7	181.4
Q2 1987*	4.6	6.4	34.2	2.7	103.9	22.6	22.4	9.0	196.7
Q3 1987*	5.2	6.9	32.7	3.0	112.9	24.2	22.3	9.3	206.6
Q4 1987*	5.3	7.3	34.3	3.1	82.7	15.4	22.8	9.7	170.1
Q1 1988*@	5.1		36.3		86.3	15.2	22.8	9.7	175.4
As % of Assets:									
end 1979	3.5	4.7	26.6	0.0	32.4	3.0	24.2	10.4	100.0
end 1980	3.0	4.0	27.2	0.0	33.5	4.1	23.0	9.2	100.0
end 1981	3.6	4.5	25.0	0.7	33.6	5.5	23.8	8.7	100.0
end 1982	3.2	4.6	28.6	1.2	34.0	7.3	20.1	6.9	100.0
end 1983	2.9	4.6	26.9	1.5	36.7	9.3	17.9	6.3	100.0
end 1984	2.6	4.4	24.5	1.5	40.0	10.6	16.6	5.7	100.0
end 1985	2.2	3.3	23.4	1.8	42.5	10.8	15.5	5.6	100.0
end 1986	2.2	3.3	19.8	1.4	47.0	11.6	13.9	5.5	100.0
Q1 1987*	2.2	3.3	19.2	1.5	49.8	11.8	12.2	4.8	100.0
Q2 1987*	2.3	3.3	17.4	1.4	52.8	11.5	11.4	4.6	100.0
Q3 1987*	2.5	3.4	15.8	1.4	54.6	11.7	10.8	4.5	100.0
Q4 1987*	3.1	4.3	20.2	1.8	48.6	9.0	13.4	5.7	100.0
Q1 1988*@	2.9		20.7		49.2	8.7	13.0	5.5	100.0

* Estimated market values   @ Based on early estimates of transactions

TABLE 1 (continued)

UNIT TRUSTS

	Cash & Short Term Assets excl Short	Cash & Short Term Assets incl Gilts	Gilts	Company Securities	O'seas Securities	Property	Other	TOTAL
Level £ billion:								
end 1979	0.2	0.2	0.1	2.8	0.7		0.0	3.8
end 1980	0.2	0.2	0.1	3.4	1.1		0.0	4.8
end 1981	0.3	0.3	0.2	3.7	1.5		0.0	5.6
end 1982	0.3	0.4	0.3	4.6	2.3		0.1	7.7
end 1983	0.6	0.6	0.4	6.2	4.2		0.1	11.4
end 1984	0.9	1.0	0.6	8.2	5.2		0.1	14.9
end 1985	1.1	1.2	0.5	11.7	6.4		0.0	19.7
end 1986	1.4	1.4	0.5	17.5	12.4		0.1	31.9
Q1 1987*	2.6	2.6	0.6	21.7	14.5		0.1	39.5
Q2 1987*	3.3	3.4	0.6	25.6	15.1		0.1	44.8
Q3 1987*	3.4	3.4	0.5	29.0	16.7		0.1	49.7
Q4 1987*	3.9	3.9	0.7	21.4	10.2		0.2	36.3
As % of total assets:								
end 1979	5.5	5.7	1.4	74.4	18.3		0.4	100.0
end 1980	3.7	3.9	1.5	71.2	23.0		0.6	100.0
end 1981	4.5	4.8	3.1	65.3	26.5		0.5	100.0
end 1982	4.5	5.3	4.2	60.2	30.1		0.9	100.0
end 1983	5.0	5.5	3.6	54.1	36.6		0.6	100.0
end 1984	6.1	6.8	3.8	55.0	34.6		0.5	100.0
end 1985	5.6	5.9	2.6	59.0	32.5		0.2	100.0
end 1986	4.4	4.5	1.7	54.8	38.8		0.3	100.0
Q1 1987*	6.6	6.7	1.5	54.9	36.8		0.2	100.0
Q2 1987*	7.5	7.6	1.3	57.2	33.7		0.3	100.0
Q3 1987*	6.8	6.8	1.0	58.3	33.6		0.3	100.0
Q4 1987*	10.6	10.6	1.9	59.0	28.1		0.5	100.0
INVESTMENT TRUSTS								
Level £ billion:								
end 1979	0.2	0.3	0.3	4.3	2.2	0.0	0.1	7.2
end 1980	0.2	0.3	0.3	4.8	3.2	0.0	0.1	8.6
end 1981	0.3	0.3	0.2	4.9	3.7	0.0	0.1	9.2
end 1982	0.2	0.3	0.2	4.8	4.9	0.0	0.1	10.3
end 1983	0.2	0.2	0.3	5.6	7.3	0.0	0.1	13.5
end 1984	0.4	0.5	0.3	6.7	8.1	0.0	0.1	15.7
end 1985	0.4	0.5	0.5	8.6	8.7	0.1	0.3	18.5
end 1986	0.4	0.5	0.3	9.5	10.5	0.0	0.1	20.9
Q1 1987*	0.3	0.4	0.6	11.7	11.8	0.0	0.1	24.5
Q2 1987*	0.5	0.6	0.7	13.3	12.1	0.0	0.1	26.8
Q3 1987*	0.8	0.9	0.4	14.4	12.8	0.1	0.1	28.6
Q4 1987*	1.5	1.7	0.8	10.4	7.8	0.1	0.1	20.7
As % of total assets:								
end 1979	2.8	4.1	4.4	60.4	31.2	0.2	1.0	100.0
end 1980	2.7	3.4	3.1	56.0	36.8	0.2	1.2	100.0
end 1981	3.1	3.6	2.0	53.2	40.7	0.3	0.8	100.0
end 1982	2.4	3.0	1.9	46.8	47.5	0.3	1.0	100.0
end 1983	1.1	1.8	2.3	41.5	53.8	0.3	1.0	100.0
end 1984	2.6	3.4	2.0	42.5	51.9	0.2	0.9	100.0
end 1985	2.0	2.8	2.5	46.4	47.4	0.3	1.4	100.0
end 1986	2.1	2.5	1.5	45.5	50.2	0.2	0.5	100.0
Q1 1987*	1.2	1.6	2.5	47.7	47.9	0.2	0.5	100.0
Q2 1987*	1.9	2.2	2.5	49.8	45.2	0.2	0.5	100.0
Q3 1987*	2.9	3.2	1.5	50.2	44.8	0.2	0.4	100.0
Q4 1987*	7.3	8.3	3.8	50.3	37.7	0.3	0.7	100.0

* Estimated market values

91/G 4497/008/cc

TABLE 2

TRANSACTIONS IN ASSETS

£ million

	TOTAL INVESTMENTS	NET CASH AND SHORT-TERM ASSETS	GILTS	UK COMPANY SECURITIES	OVERSEAS SECURITIES	PROPERTY	OTHER
PENSION FUNDS							
1987 Q3	2174	150	- 822	2485	39	134	188
1987 Q4	2318	2779	106	2035	- 2543	246	- 305
1988 Q1 DTI Early Estimate	2284	1229	1395	- 418	- 99	186	- 9
LIFE ASSURANCE COMPANIES							
1987 Q3	3308	569	503	1767	133	- 33	369
1987 Q4	2649	65	431	2006	- 715	481	381
1988 Q1 DTI Early Estimate	1677	- 200	1194	1036	- 353	N/A	N/A
UNIT TRUSTS							
1987 Q3	2121	41	- 58	1504	612	0	22
1987 Q4	358	466	158	810	- 1096	0	20
INVESTMENT TRUSTS							
1987 Q3	193	329	- 211	116	- 47	3	3
1987 Q4	253	676	336	98	- 886	14	15

fst/lbs-jun88 CONFIDENTIAL

FROM: J S HIBBERD
DATE: 24 JUNE 1988

CHANCELLOR OF THE EXCHEQUER

cc : Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Sir G Littler
Mr Anson
Dame A Mueller
Mr Scholar
Mr Odling-Smee
Mr Sedgwick
Mr S J Davies
Mr Gieve
Mr C Mowl
Mr Pickford
Mr Hudson
Mr Patterson

Please minute

LBS JUNE ECONOMIC OUTLOOK

The June issue of the LBS Economic Outlook will be released over the weekend. It is embargoed until midnight on Sunday, but a summary will appear before then in the Sunday Times.

The Outlook

2. The LBS forecast is compared with the Treasury June internal forecast in Table 1. The main features of the LBS outlook are:

- **UK GDP growth** (output measure) of 3.4 per cent in 1988.

- **RPI inflation** at 4.8 per cent in 1988Q4.

- **Current account deficit** of £5 billion in 1988 compared to £1.7 billion in 1987.

- A negative **PSBR** (or a PSDR) of £6 billion in 1988-89.

- **World trade growth (manufactures)** of about 5 per cent in 1988 compared to 3½ per cent in 1987.

The forecast in detail

TABLE 1

(percentage changes on year earlier)	LBS June Forecast			Treasury June Internal Forecast		
	1987	1988	1989	1987	1988	1989
Gross domestic product (output measure)	4.8	3.4	2.4	5	4	3
Consumers' expenditure	5.2	4.6	3.1	5	6	4
Total fixed investment	3.5	8.3	3.6	4	10½	3
General government consumption	1.2	0.4	0.9	½	0	½
Change in stockbuilding (% contribution to GDP)	0.1	0.1	-0.1	0	0	0
Exports of goods and services	5.7	2.6	5.1	5½	2	5½
Import of goods and services	7.6	7.3	5.2	7½	9	6
Manufacturing output	5.4	4.5	3.6	5½	5	3
World trade in manufactures	3.3	5.5	5.3	6	10	5
Retail prices (Q4)	4.1	4.8	4.3	4	5	5½
Current account (£billion)	-1.7	-5.0	-4.9	-1½	-9½	-10
PSBR (£billion, financial years).	-3.5	-5.9	-4.3	-3½	-7½	- 7½

3. **Consumer spending** is forecast to grow by 4½ per cent in 1988, closely in line with the forecast increase in real personal disposable income. The **personal sector saving ratio** stabilises at an average 5½ per cent for 1988 as a whole, the same as in 1987. (It actually rises through 1988). The LBS investment forecast reflects the same optimism revealed by the June DTI Investment Intentions Survey and recent CBI Surveys. **Private non-housing fixed investment** is forecast to rise by 8½ per cent in 1988, after 7 per cent in 1987. **Total investment** is also projected to rise by 8½ per cent compared with 3½ per cent in 1987. **Stockbuilding** adds little to demand in 1988, and stock-output ratios continue to decline. The LBS expect domestic demand to rise slightly faster in 1988 (4½ per cent) than in 1987 (4¼ per cent).

4. The LBS note that Customs 88 may have led to some under-recording of exports in 1988Q1. Exports may have been further

depressed by ferry disputes. Consequently, they partly discount the poor recorded performance in early 1988. They point to the strong recovery in exports in March and April, and expect UK exporters to maintain their share in world markets from now on. **Exports of goods and services** are expected to rise by about 2½ per cent in 1988 which, given the outturn in January-April, implies strong growth through the rest of this year. This export forecast is perhaps a little optimistic. They seem to have under-estimated world trade growth through 1987 and early 1988 and may, as a result, have overestimated the strength of underlying export performance in recent months.

5. **Imports of goods and services** are expected to rise by a little under 7½ per cent in 1988, marginally slower than in 1987. The **current account deficit** is projected to widen to £5 billion in 1988. This too looks optimistic, since the deficit in the first four months of 1988 has already reached £3½ billion.

6. The year-on-year growth of the **output measure of GDP** slows to 3½ per cent in 1988. Growth also slows through the year so that, by 1988Q4, GDP is about 2 per cent higher than a year earlier. **Manufacturing** output rises 4½ per cent in calendar 1988. The LBS see further strong growth in **employment** in 1988. However, given the slowdown in economic activity, growth in **manufacturing labour productivity** slows to 4¼ per cent in 1988 (after over 6½ per cent growth last year). **Whole economy productivity** rises 1¼ per cent in 1988, after a 3 per cent increase in 1987. The LBS forecast a further fall in UK adult unemployment to an average of 2.42 million in 1988, compared to 2.88 million in 1987.

7. **Whole economy average** earnings growth is expected to average 8¼ per cent in 1988 compared to 7 per cent in 1987. Manufacturing average earnings rise at about 8 per cent in 1988. But, with slower productivity growth, manufactures unit labour costs rise by 3¾ per cent, after only 1¼ per cent growth last year. **Producer price inflation** is likely to average about 4½ per cent. **RPI inflation** is expected to rise to 4.8 per cent by end-1988.

Economic Viewpoint — wrote you already.

8. In his last "Economic Viewpoint" before his move to Barclays Bank, Alan Budd looks back to the controversies over exchange rate policy in 1977 and compares this year's arguments over the merits of trying to hold sterling close to 3DM. In 1977 the LBS had argued

forcefully against the policy - eventually abandoned in November of that year - of intervening and cutting interest rates to offset upward pressure on sterling. Alan Budd argues that after sterling had fallen sharply in 1976 the authorities needed to let sterling rise if they were to get the benefit to inflation of subsequent tightening in policy.

9. Budd argues that he more recent episode was quite different. Sterling had fallen in 1986, as in 1976, but this time as an appropriate - and non-inflationary - reaction to the fall in world oil prices rather than as a result of lax policy. Nevertheless Alan Budd argues that if the government seriously intends to cut inflation below the 4-5 per cent range it needs to tighten policy; and this would probably involve a temporary rise in the exchange rate. He suggests that "in retrospect, it may have been an error for the authorities to have held on to the DM3 rate for as long as they did since it provided a misleading signal about the government's policy." He concludes, however, that "we can provide grudging support as long as we believe that the background policies are consistent with lower inflation and a general move to greater exchange rate stability".

Line to take on forecast

Positive

LBS see another year of strong growth in 1988 with continued low inflation. Balance of domestic demand expected to shift in favour of increased business investment. Unemployment continuing to fall.

Defensive

Large balance of payments deficit, economy overheating, too much consumer spending.

LBS outlook for balance of payments still only 1¼ per cent of GDP. Consumer spending expected to slow down in LBS forecast, and investment to pick up strongly. No widespread signs of overheating.

Jim Hibberd

J S HIBBERD

73/2570

FROM: MRS R LOMAX

DATE: 24 June 1988

PRINCIPAL PRIVATE SECRETARY

cc. PS/EST
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Ilett
Mr Gieve
Mr Neilson

MANDARIN LEMON: DTI REPORT ON STOCK MARKET CRASH

We spoke briefly about the attached story in this week's Economist, which alleges that the Treasury and the Bank of England have suppressed DTI's report on last October's stockmarket crash either because it is embarrassing, or because it is bad. In fact Lord Young (who has been in Hong Kong this week) has not yet decided whether to publish the report; and of course the Chancellor's recent letter said explicitly that the decision was for him. That apart, the report is pretty well informed.

2. What seems to have happened is that the publication of the Stock Exchange Quality of Markets report last week inspired Ian Carson (of the Economist?) to ask what had happened to the DTI's report. He was interviewed on a Channel 4 midday programme last Friday, and said that DTI report's had alarming implications, and was therefore being suppressed by the Treasury. No-one else seems to have picked it up, but someone at the Economist talked to the Bank press office: hence the second part of the Economist story.

3. I understand our press office had some questions this morning, and we have suggested that they take a very non-committal line: we do not know if DTI are going to publish a report or not, and anyhow that is a matter for them. To go any further would only whip up interest, and create the demand for the report's publication which was so signally missing a week ago.

RL.

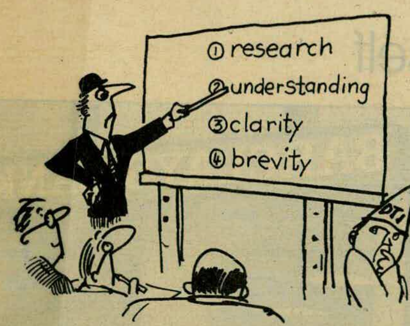
RACHEL LOMAX

ECONOMIST 24/6/88

Mandarin lemon

ALONG with the Barlow Clowes scandal, Britain's Department of Trade and Industry (DTI) has another reason to feel that its pride as a regulator of the City of London's securities business has been battered of late.

The Treasury and the Bank of England are sitting on a 300-page report by the DTI on last October's stockmarket crash. The report says there was a lack of contingency planning for a crisis in London's markets. A drying-up of liquidity; the collapse of a major securities firm; the knock-on effect of disasters in foreign markets: all these are mentioned by the DTI as eventualities for which London was under-prepared at the time of the crash. Any crisis would have been made worse, the report suggests, by the conflicting activities of London's various regulatory bodies. Some DTI officials claim the report is being kept under wraps because these conclusions are embarrassing to the City's regulators.



The wraps may be on for other reasons, more embarrassing to the DTI. The Bank and the Treasury feel that the report is badly written, is feeble in its analysis and suggests that the DTI has not understood many of the complexities of the way securities markets work. For instance, it is obvious that if investment bankers are to be shielded from moral hazard, the Bank of England must keep secret any plans to act as a lender of last resort for securities firms.

The Bank maintains that it had contingency plans at the time of the crash, and that they worked well. A close relationship with the International (née London) Stock Exchange kept it aware of the daily capital positions of stockmarket firms. So the Bank knew which firms were in danger, and played a part in corrective action by arranging lines of credit from parents or banks. The Bank claims that its contingency arrangements are in even better shape now than they were at the time of the crash: it has begun to consult with the Securities and Investments Board and its self-regulatory organisations about how to cope with any future crisis.

The Bank's increasing desire to influence securities regulation—reflected in the move of one of its directors, Mr David Walker, to be chairman of the SIB—is based partly on its fear that any systemic problem in securities markets could infect the whole banking system. So the DTI may have had a point.

cm/min/bdp Covering CONFIDENTIAL

Tony P pl

FROM: COLIN MOWL
DATE: 27 June 1988

PS/CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Sedgwick
Mrs Lomax
Miss Noble
Mr Ritchie
Mr Calder - IR

SUMMER FORECAST: TREATMENT OF BANKS' DEBT PROVISIONS

Further to the reports on the summer economic forecast I attach, for the record, a note by Mr Ritchie setting out the treatment of banks' debt provisioning in the corporation tax forecast.

Colin Mowl

COLIN MOWL

CORPORATION TAX FORECAST - EFFECTS OF BANK'S DEBT PROVISIONS

This note sets out the estimates of the effects of banks' provisioning for bad debt used in constructing the forecast of corporation tax (CT) receipts, and describes the assumptions on which these estimates are based.

2. The estimates of banks' provisions and the effects on CT accruals and receipts are shown below:-

BANKS' PROVISIONING AND EFFECTS ON CT

£ million

	1986	**1987**	**1988**	
Provisions	720	2300	660	
Effects on CT Accruals	-330	-610	-230	
	1987-88	**1988-89**	**1989-90**	**1990-91**
Effect on CT Receipts	- 270	-590	-300	-20

The estimates of provisions to be allowed as deductions against taxable income for 1986 and 1987 are based on Inland Revenue's latest information about the provisions sought by banks, adjusted downwards slightly to allow for negotiations with tax inspectors. Cumulative provisions up to and including 1987 are being negotiated with reference to the Bank of England matrix. The relationships between provisions, accruals and receipts take account of tax exhaustion, carrying of losses forward and back, and the payment lags for the banks concerned.

3. For 1988, the estimates assume additional provisioning by the banks in aggregate equivalent to 5 per cent of debt exposure. It is assumed that this will come about as a result of those banks which have not as yet made significant provisions for bad debt deciding to do so. No further increase in debt provisioning is assumed for last year's pace setters. It is anyway unlikely under present operating rules that any increases in provisioning above the levels provided for by the Bank of England's matrix would be allowed as deductions for tax relief.

2.1.7.

SECRET

FROM: MISS M E PEIRSON

DATE: 1 July 1988

CHANCELLOR

Thanks.

cc Chief Secretary
Mr Anson
Sir T Burns
Mr Phillips
Mr Sedgwick
Mr Turnbull
Mr MacAuslan
Mr McIntyre o/r
Mr Mowl
Mr Macpherson
Mr R Watts

TREASURY ECONOMIC FORECAST: PUBLIC FINANCES: SOCIAL SECURITY

1. You wondered how the figures in table IV (c) of Mr Mowl's report of 24 June, of £0.8bn in 1988-89 rising to £1.8bn in 1990-91, for the forecast of social security overspend due to "more realistic underlying growth", compare with ST's views; and what the latest thinking is about the factors behind the underlying growth.

2. We in ST were consulted about the forecast. The underlying growth, as far as it can be estimated, has been around 3-3½% per annum in the last few years, rising to 4% in 1987-88; and the PSF forecast assumes a slow decline (3% in 1988-89 and 2½% per annum in the next two years), compared with the very sharp decline implicit in DHSS's PEWP plans (¾% in 1988-89 and 1¼-1½% in the next two years). The difference for 1988-89 onwards gives the figures in table IV (c).

3. There are various reasons for assuming a rather lower underlying growth rate in the future than in the past, as Mr Mowl's forecast does:-

i) The social security reforms: In particular, the replacement of "single payments" (which boosted growth in supplementary benefit) by discretionary loans from the social fund. The early short term forecasts coming out of DHSS for the current year suggest considerable dampening, but we in ST and PSF are rather sceptical (there are still no outturn data even for the first months).

ii) Lower unemployment, though that may not have much effect since it is easier to create than to destroy a benefit culture.

iii) An eventual slow down in the spread of the benefit culture.

4. The underlying growth rate could fall more sharply than in the PSF forecast, but in the past we have always tended to underestimate it. In any case, I certainly would not want to endorse anything like the growth rates implicit in the PEWP.

5. As regards the factors behind the underlying growth rate, these have changed to some extent recently, though they still include some familiar items:-

a) Ever-increasing take-up of disability benefits. The recent surge may partly be a response to availability for work testing, which appears to be pushing people off the unemployment register and onto invalidity benefit.

b) Real increases in local authority and private rents, affecting housing benefit. (Unlike the upratings, rent increases are not taken out of the forecast before arriving at the underlying growth).

c) Rapid growth in the numbers of single parent claimants of income support and housing benefit.

d) Increases in social security payments to the elderly in private residential care.

e) Increases in house prices, affecting payments to the unemployed etc to meet their mortgage interest.

MEP

MISS M E PEIRSON

RESTRICTED

FROM: P JEFFERSON SMITH

DATE: 8 JULY 1988

Board Room
H M Customs and Excise
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22 Upper Ground
London SE1 9PJ
Telephone: 01-620 1313

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Lankester
Mr Byatt
Mr Scholar
Mr Culpin
Mr R I G Allen
Mr Riley
Mr Gilhooly
Mr Cropper
Mr Painter IR
Mr McGivern IR
Mr Bostock (UKREP)
Mr Walton (UKREP)

CHANCELLOR OF THE EXCHEQUER

Many thanks. A good paper. I have made a [illegible] minor amendments, mainly cosmetic. I have taken account of pts in para 5 of this note. We can defer settling 3(a) + 3(b) [illegible] time; but I agree @ present with para [illegible]

THE MARKET-BASED APPROACH TO 1992

At the informal ECOFIN in May you agreed to circulate a paper setting out our market-based alternative to the Commission's proposals. Officials in the Treasury and here in Customs have produced the attached draft which represents an agreed approach. The draft also reflects, in part, comments from UKREP.

2. If you approve the draft I would propose circulating it via EQ(O) to interested Departments at official level to allow for comment prior to despatch to Brussels. The Greek Presidency have mentioned that fiscal approximation could be on the agenda for ECOFIN's informal September meeting (they are not sure), with the EPC and High Level Group reports as an input. Progress on these issues is not, however, a Greek priority.

Internal distribution: CPS, Mr Nash, Mr Wilmott, Mr Fryett, Mr Allen, Mr Kent, Mr Knox, Mr Oxenford

3. UKREP has suggested, and we agree, that the paper would best be sent to the Presidency for circulation to other delegations (as suggested in the High Level Group Chairman's report) rather than be submitted to EPC (as envisaged at Travemunde). If tax approximation does feature on the September agenda, the choices appear to be between:

(a) oral presentation at the meeting with the promise of the paper very soon thereafter, with a remit to the High Level Group to consider it; or

(b) as in (a) but with circulation shortly before the meeting.

4. In practice there is probably little to choose between them; on balance we would recommend (b), in the hope that this would encourage your opposite numbers to agree to set in train a proper study of practicable steps towards reductions in the costs of intra-Community trade.

5. On the content of the paper, there are a few points to note:

(a) generally, UKREP would advise a shorter paper with less emphasis on the fundamental differences of philosophy between the Commission (and other pro-harmonisers) and ourselves. We and the Treasury however feel that it is important to expose the differences and bring out our philosophy on market forces, deregulation etc very clearly;

(b) paragraph 5 cites the relevant Treaty provisions and seems to us factually correct. But we may need to look at it again in the light of the Law Officers' advice;

(c) in paragraph 17 (last sentence), we have included a reference to abolition of duty free allowances on travel between Member States. It is a wholly logical consequence of the market-based approach, but will cause a frisson in the departments concerned with airport or transport costs. The sentence is not essential to the paper, and we would appreciate guidance on whether to float the point at this stage.

Mrs E Dibbens

pp P JEFFERSON SMITH

TAXATION IN THE SINGLE MARKET: A MARKET-BASED APPROACH

Introduction

1. The Commission have put forward proposals for approximation of indirect taxes in the context of completing the Single Market in 1992. This paper sets out how the Community's objectives might be achieved by ~~utilising~~ harnessing market forces.

The present system

2. The system currently in use in the Community for indirect taxes on trade between Member States is based on the Destination Principle: ie exports are relieved of tax, imports are charged at the tax rates of the importing country. Exporters to any market thus face the same tax rate as that market's domestic suppliers. There is no distortion of competition between foreign and domestic suppliers.

3. In order to implement this system and ensure that tax revenue accrues in the country where the goods are consumed, appropriate fiscal controls are required. These include also restrictions on the quantities of tax-paid (as well as tax-free) goods which individuals can bring from one Member State to another. The level of controls applied, and whether they are applied at the frontier or inland, differs considerably between Member States. Controls also exist for many other purposes - for example to prevent drug or arms smuggling, to protect public or animal health, or to operate licensing or quota arrangements.

4. The present system imposes costs on those who trade or travel between Member States. In this context it is important to note that inland controls impose costs just as frontier controls do. The Commission's recent study on the "Economics of 1992" - the Cecchini Report - suggests that the cost of all border controls currently amounts to 8-9 bn ECU: 1.7-1.9% of the value of intra-EC

trade, or 0.25% of Community GDP. The UK's experience is that only about a quarter to a half of these costs (about 0.1% of GDP) are associated with fiscal controls. Furthermore, border costs vary substantially between Member States: the Cecchini figures suggest that they may vary by more than 5 times, with the lowest costs around half the average.

The Single Market

5. Article 8A of the Treaty of Rome provides that the internal market should be established by the end of 1992; and defines the internal market as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty". Article 99 of the Treaty provides that the Council will adopt harmonisation measures for indirect tax "to the extent that such harmonisation is necessary to ensure the establishment and functioning of the internal market within the time laid down in Article 8A". The Treaty thus leaves to the Council a considerable measure of discretion as to the fiscal implications of the creation of the single market.

6. According to the Brussels European Council of March 1985, the purpose of creating a Single Market is to create a more favourable environment for stimulating enterprise, competition and trade. In the words of the Padoa-Schioppa report, the intention is to improve the efficiency of resource allocation in the Community. Businesses should be able to compete in all Member States on an equal footing. In practice creation of the Single Market means:

- reducing to a minimum the costs and other impediments to trade arising from different national regimes and measures;

- making markets more competitive, by deregulation and the elimination of unnecessary restrictions and constraints on production and consumption.

7. The UK is fully committed to the completion of the Single Market, which will improve economic efficiency within the Community. The recent history of the UK economy demonstrates the benefits which result from deregulation, from freeing markets and from dismantling barriers and controls. It is by releasing, not constraining, market forces that soundly-based economic growth will be achieved. The desirability of this approach is now widely accepted by the major industrial countries, and Community policies must be seen in this wider context.

8. The more competitive economy which will result from completing the Single Market will tend to mean closer alignment of prices of particular goods and services, both between and within Member States. But the pattern of relative prices and the allocation of resources will be determined by the market through the competitive process. It is this process which will enhance economic efficiency in the European economy.

9. Similarly, the more competitive economy will tend to mean closer alignment of tax rates. But it no more follows that the Community needs to dictate tax rates centrally than that it needs to dictate prices. The UK believes that tax rates should reflect local conditions and social priorities. (In this context it is notable that neither the Treaty of Rome nor the Single European Act abolish national systems of tax collection). Market forces will bring about not only a sufficient degree of harmonisation, but also a better quality of harmonisation than would be the case if it were imposed at Community level.

The Commission's proposals

10. The Commission propose a centralised system of indirect tax approximation, covering both VAT and excise duties, with tax rates or bands set in Brussels. The proposals are presented as contributing to completion of the Single Market, but in certain

important respects are quite contrary to the philosphy underlying it. Although the Commission's 1985 White Paper recognised the potential role of market forces*, the approach is essentially dirigiste rather than market-based, so involving undesirable costs and rigidities. Such an approach is unlikely to ensure that tax rates adequately reflect evolving market conditions and preferences.

11. The Cecchini Report did not separately identify the costs associated with present fiscal controls, and nor did it consider the costs of the Commission's proposals. A proper comparison is impossible at this stage, not least because more detail is required from the Commission on the administrative details of their proposals, especially the VAT clearing house and the linked bonded warehouse scheme. But despite a lack of information, the grounds for believing that the cost of the proposed arrangements would be less than could be achieved by simplifying the present system are flimsy.

12. A satisfactory clearing house system, satisfying the criteria set out by the EPC, has yet to be devised. But because of its inherent complexity, and inevitable concerns about the revenue at risk, the associated costs are likely to be substantial. The linked bonded warehouse scheme for excises would also impose costs, and would even appear to impose restrictions of the passage of goods between Member States which do not exist at present. As regards the present system, the UK believes that average cost savings of around 50% could be achieved if the costs of frontier barriers were reduced to those of the "cheapest" Member States; in some cases the reduction could be over 80%. In view of this it is

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* Paragraph 186: "Market forces will themselves create pressures to achieve a degree of tax approximation."

far from clear that the costs of the Commission's proposal would be less than could be achieved under the present system.*

13. The Commission's proposals are wide-ranging and of potentially great significance. They have implications - in many cases substantial implications - for a range of important national policy areas, including economic, social, health, fiscal and budgetary, transport, environment, energy. For some Member States the tax approximation proposals involve large and relatively sudden changes with potentially unwelcome consequences (many of which the "Cecchini Report" did not take into account). When the benefits and disadvantages of the proposals are considered, the overall balance will differ for each Member State, but certainly in some (if not in many) it is likely to be unfavourable.

14. Even more fundamentally, the arrangements implicit in the Commission's approach are unlikely to be consistent with the objective of greater competition. Inevitably indirect tax rates would be set in a way which took insufficient and belated account of market forces. Any structure which requires unanimous agreement to alter tax bands or structures is unlikely to be sufficiently responsive to the needs of change. Rates would be brought closer together than they are under the current system, but probably at levels which take insufficient account of social priorities in Member States and conditions in world and Community markets. The potential benefits of greater harmonisation would be outweighed by significant costs.

A market-based approach

15. The UK Government believes there is another way of meeting the Community's objective. The aim would be to provide increased scope for market forces to influence indirect taxes, thereby moving towards a greater degree of harmonisation. This approach

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* As the EPC Opinion of 30 June put it: "there clearly exists a further considerable potential for saving, independently of tax harmonisation."

recognises that continued reliance on a system based on the Destination Principle permits free and fair competition in national markets. It allows Member States freedom to set indirect tax rates according to national circumstances and social priorities. At the same time it recognises that competitive pressure will in fact lead to greater harmonisation. The main elements of the market-based approach are set out below.

16. The first element is a substantial reduction in frontier controls on intra-Community trade, to the minimum consistent with maintaining the Destination Principle. Measures which should be considered include: deferred VAT accounting for imports (the recently withdrawn draft 14th VAT Directive); greater moves towards controls based on internal, audit-type procedures; greater use of information technology; and substantial modification of the Community Transit system. The initial goal would be to reduce controls between all Member States to no more than the level currently in operation ~~in~~ within Benelux, with active consideration being given to schemes which could reduce these controls still further. The UK is already moving in this direction by preparing two new schemes for faster clearance at frontiers and the greater use of periodic submission of VAT and statistical data.*

17. The second major element is the enhancement of market forces in the context of individual travel between Member States. Restrictions on the quantity of goods which individuals can take (tax-paid) from one Member State to another should be substantially and progressively relaxed, with the ultimate aim that they should be completely eliminated. The initial steps need not be large, but by the end of 1992 they should be sufficient to

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* Attention will need to be focussed on the abolition of MCAs, reduction in statistical requirements (or other means of obtaining trade statistics that do not require administrative procedures at frontiers), common animal and plant health standards (at level of best practice), and quota and licensing arrangements. It is also essential that progress is made on common information technology systems which could be used, for example to eliminate the documentary requirements of the Community Transit system.

ensure an important role for market forces - ~~ie~~ in the shape of cross-border shopping - in areas where tax rates are ~~particularly different.~~ far apart. In these circumstances duty free allowances would ultimately be abolished.

18. These reductions in trading costs and increases in travellers' allowances would increase the competitive pressure on Member States when setting indirect tax rates. Countries with high tax rates would tend to lose revenue as its nationals shopped in other Member States, and would face greater competition from overseas' producers; and conversely for low tax rates. Governments would have to choose a pattern of indirect tax rates which strikes a balance between these competitive pressures and national preferences.

19. This market-based approach would be very much in keeping with the microeconomic policies increasingly being pursued in the major industrial countries, with the focus on deregulation and competition. It provides a much better guarantee than the Commission's proposals that indirect tax rates and structures will suit the circumstances of 1992 and beyond, rather than those of 1988. The pressures on tax rates would in general be downwards, providing an essential antidote to the inbuilt pressures for increased public expenditure and taxation. In contrast, the Commission's proposals would mean additional regulation and a diminished role for the market; there would be no countervailing downward pressure on tax rates.

20. The market-based approach does not mean an immediate abandonment of the principle that goods bear the indirect taxes in force in the country where they are sold or resold. Any sudden change from this principle to a free-for-all would have large and potential damaging implications for many Member States. Furthermore, the UK recognises that frontier barriers cannot be removed in one go; a gradual approach will be needed.

21. It will be essential in the immediate future to maintain existing levels of preventive controls, for example against drugs and firearms smuggling, (consistent with Article 36 of the Treaty of Rome and the Declaration on Articles 13-19 of the Single European Act). In addition, substantial development of common intelligence systems and electronic exchange of information between Member States will be necessary. It will require considerable resources and effort to develop systems which over time can reduce or entirely remove the need for national preventive controls. The UK is prepared to devote sufficient resources and effort to ensuring that systems are developed successfully.

Alcohol and tobacco

22. Allowing market forces completely unfettered sway would be unacceptable in certain areas. Because of the serious social and health risks of excessive consumption of alcohol and tobacco, allowing greater (and ultimately unrestricted) access to cheap supplies of these products would be a retrograde step; at the moment there are very marked divergencies between Member States' taxation of these products. The EPC Report recognised that harmonisation would cause great difficulties and thus recommended caution. Furthermore, any harmonisation should not force individual Member States to adopt significantly lower tax rates than they would ideally wish to impose for social and health reasons. Accordingly the UK considers it essential <u>either</u> that there should be continuing (but perhaps slightly relaxed) restrictions in this area, <u>or</u> that high minimum duty rates should be set.

23. These continuing requirements mean it will be necessary to retain systems for verification and checking of goods passing between Member States. However, efforts to simply the formalities to which freight movement and travellers are subject should result in significantly lower costs.

Conclusion

24. This paper has outlined a market-based approach to taxation, in keeping with both the philosophy underlying the Single Market and the wider international climate of deregulation and competition. The key feature of this approach is that market forces would affect decisions by governments as well as the private sector of the European economy, ensuring flexibility of taxes in the face of changing circumstances. The UK Government considers that the Commission's centralised approach is not acceptable as a means of setting indirect taxes for the Community in a competitive world economy.

25. The alternative approach is necessarily more limited than the Commission's proposals. However, it takes a realistic view of the Community's current state of development and what it is reasonable to expect can be achieved by the end of 1992. It is also intended to avoid major difficulties and adjustment costs. It is designed to provide a relatively smooth ~~migration~~ path to progressive further reduction of controls (especially through the increasing use of information technology) with the ultimate aim of removing frontier formalities. It is intended to develop in parallel with the increasing integration of the Single Market through providing increasing scope for market forces to influence tax rates rather than attempting to apply a rigid, centrally-dictated structure of indirect taxation, which is premature, unnecessary and probably inappropriate. There should now be a concerted effort by all Member States and the Commission to devise a programme of action which will produce tangible results by the end of 1992.

sw76

FROM: MR S W MATTHEWS

DATE: 8 July 1988

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Byatt
Mr Lankester
Mr Scholar
Mr Evans
Mr Odling-Smee
Mr Sedgwick
Mr Dolphin
Mr Hood
Mr Savage o/r
Mr C Allen o/r

INFLATION RISKS IN THE WORLD ECONOMY: COMPARISON WITH PREVIOUS PERIODS OF DOLLAR WEAKNESS

In our report on the latest WEP exercise (attached to my submission to you of 10 June), we forecast that the strengthening of activity and sharp rises in non-oil commodity prices since mid-1987 could produce a modest rise in consumer price inflation in the major industrial countries, with the average rate in the G7 rising from about 3 per cent now to nearly 4 per cent in a year's time.

2. There are risks that world inflation could go higher and we thought that it would be worth comparing present circumstances with the two episodes in the 1970s, when inflation rose sharply, 1973-74 and 1979-80, to see how far there are parallels. The attached note, drafted with considerable assistance from Messrs Dolphin and Allen, cannot claim to be a definitive study but it suggests some interesting conclusions:

a) as in 1987, large scale intervention was used to try to prevent dollar depreciation in the periods 1970-72 and 1977-78;

b) in the first episode in the early 1970s, this intervention contributed to a significant loosening of monetary policy; in 1977-78 intervention and the Born Summit agreements on fiscal policy produced some relaxation of macroeconomic policy, but this was less marked than in the first episode; financial innovation and deregulation make it hard to assess world monetary conditions today, but intervention to support the dollar appears to have produced some easing;

c) the expansion in world economic activity was very strong in 1972-73, but slightly less so in 1977-78 (although probably still faster than the growth of potential); while growth has picked up since mid-1987 it has not so far been as fast as in the cyclical upswings that preceded the 1973-74 and 1979-80 inflationary episodes;

d) commodity prices have started to grow strongly over the past year, but there are some important differences from the earlier episodes:

- oil prices have not increased and for the moment OPEC is in a state of disarray.

- non-oil commodity prices have risen from exceptionally low levels in real terms and have barely reached their previous peak.

3. Our conclusion is therefore that, while there are similarities with the 1970-74 and 1977-79 episodes, there are also important differences, so that only a modest rise in the average rate of inflation in the major countries is in prospect - assuming, of course, that they stand by their commitment to sound macroeconomic policies.

SM.

S W MATTHEWS

DOLLAR WEAKNESS AND WORLD INFLATION

1. In the 1970s there were two periods in which consumer price inflation rose sharply, 1973-74 and 1979-80. In both instances this was preceded by a period of dollar weakness and a commodity price boom. The more recent weakness of the dollar in 1985-87 has now also been followed by sharp rises in commodity prices, but inflation so far has remained low. This note presents a short statistical analysis of the two earlier episodes and considers briefly how far the circumstances then are replicated today.

1970-1974

2. During the breakdown of the Bretton Woods exchange rate system the dollar was under almost continuous downward pressure, partly because of the cumulative loss in international competitiveness by the US during the 1960s and partly because US domestic demand was tending to grow faster than GNP. Between 1970 and 1973 the dollar's nominal effective exchange rate fell by about 20 per cent (see Chart 1), despite large scale intervention to support it, which led to sharp increases in the foreign exchange reserves of other industrial countries, particularly in the period prior to the Smithsonian Agreement.

Table 1: Industrial countries' reserves (SDRs)

		Percentage change over year to:			
		1970Q4	1971Q4	1972Q4	1973Q4
Total		52	69	21	-2
of which:	US	-33	-43	26	-8
	Other	73	80	20	-1

3. Large-scale intervention to protect the dollar appears to have been asymmetrically sterilised, leading to increases in the average growth rate of money supply in the major countries in 1970-71 (see Chart 2). US monetary growth was largely unaffected

by the intervention. In other countries, increases in liquidity resulting from purchasing dollars appear not to have been fully sterilised, and monetary growth picked up sharply.

Table 2: G5 broad money growth

		Percentage change over year to:			
		1970Q4	1971Q4	1972Q4	1973Q4
Total		10	18	16	10
of which:	US	7	14	13	7
	Other	15	24	20	14

4. Nominal interest rates in each of the major industrial countries fell during 1970 and 1971. For the major five in aggregate, real interest rates fell by 4 percentage points in the space of less than one year (Chart 3), contributing to the pick up in monetary growth. The stance of fiscal policy remained broadly unchanged.

5. The pace of activity stepped up in 1971 and 1972 as first private consumption and then investment in the major industrial countries began to grow more rapidly (Chart 4). By the end of 1972 the major five economies were growing at over 6 per cent a year. Industrial production was particularly buoyant (Chart 5).

6. Non-oil commodity prices began to respond to the pick up in activity during 1972 and by the middle of 1973 both food and industrial materials' prices were rising rapidly (Chart 6), with poor harvests also playing a role in the case of food. Oil prices also began to rise during 1973, but the large OPEC price rise did not occur until the beginning of 1974.

7. Consumer price inflation in the major industrial countries began to pick up as a result of domestic demand pressures and the rises in non-oil commodity prices (Chart 8). Even before the increase in oil prices, the average inflation rate in the major five had risen from less than 5 per cent in the year to 1972Q4 to

nearly 10 per cent in the year to 1973Q4. The oil price rise, and further rises in other commodity prices in early 1984 pushed the average rate of inflation to a peak of 13 per cent later that year.

1977-1979

8. The major industrial countries experienced a sharp recovery in 1976 from the recession of 1974-75. In most countries output growth slowed in 1977, but growth continued to be strong in the US, led by domestic demand. As a result the US current account deteriorated and the dollar began to weaken again. As the full scale of the deterioration became apparent the dollar fell by about 15 per cent (see Chart 1). Intervention to resist its fall was on a less massive scale than in the early 1970s, but still produced substantial rises in foreign exchange reserves outside the US.

Table 3: Industrial countries' reserves (SDRs)

	Percentage change over year to:		
	1977Q4	1978Q4	1979Q4
Total	28	20	7
of which: US	16	-13	10
Other	30	22	7

9. Unlike in the earlier period, however, there was little pick up in aggregate money supply growth rates in 1977 and 1978 (Chart 2) although money supply growth accelerated quite sharply in some countries, notably Germany. Short-term interest rates fell a little in Japan and Germany, but rose (somewhat belatedly) in the US in 1978. Average interest rates in the major five remained low in real terms (Chart 3).

10. US growth continued to be strong in 1978 and activity picked up elsewhere, particularly in Europe (partly in response to the Bonn Summit measures). For a time inflation, though remaining high on average, did not accelerate. Although commodity prices

started to rise quite strongly, it was only in the middle of 1979, when oil prices began to rise sharply, that consumer price inflation began to accelerate.

1985-1988

11. The scale of the rise in the dollar over the period 1980-84 was remarkable in view of its trend in the 1970s (Chart 1). Not surprisingly the fall in the dollar's exchange rate during 1985-87 was far more substantial than in the two earlier periods. This depreciation was managed with some skill through the co-operative efforts of the G5. When the dollar threatened to "undershoot" in 1987 significant intervention was made in support of the dollar. The growth in foreign exchange reserves consequent on this intervention appears to have been in a similar scale to 1977.

Table 4: Industrial countries' reserves (SDRs)

		Percentage change over year to:	
	1985Q4	1986Q4	1987Q4
Total	1	9	28
of which: US	20	5	-20
Other	-1	10	35

12. As the monetary aggregates in most countries can no longer be regarded as reliable guides to monetary conditions in individual countries, we should perhaps focus in the current case on (real) interest rates as indicators of world-wide monetary conditions. The fall in nominal and real short-term rates (Chart 3) suggests that there was some easing of policy in 1987. Rises in US interest rates in March/April and German rates in June 1988 have only partly reversed this. Nevertheless, the loosening of monetary policy appears to have been much less than in 1970-73 and real interest rates are significantly higher than in 1977-79.

13. The pick up in the growth rate of the major industrial countries since mid-1987 differs in some respects from the previous episodes considered, in that it followed a comparatively

mild hesitation in the pace of growth rather than a recession and also followed substantial falls in oil and other commodity prices in 1985-86. Exports, investment and industrial activity have been particularly buoyant (Charts 4 and 5). Fiscal expansion does not appear to have played a significant role, but (as already noted) there has been some easing of monetary policy.

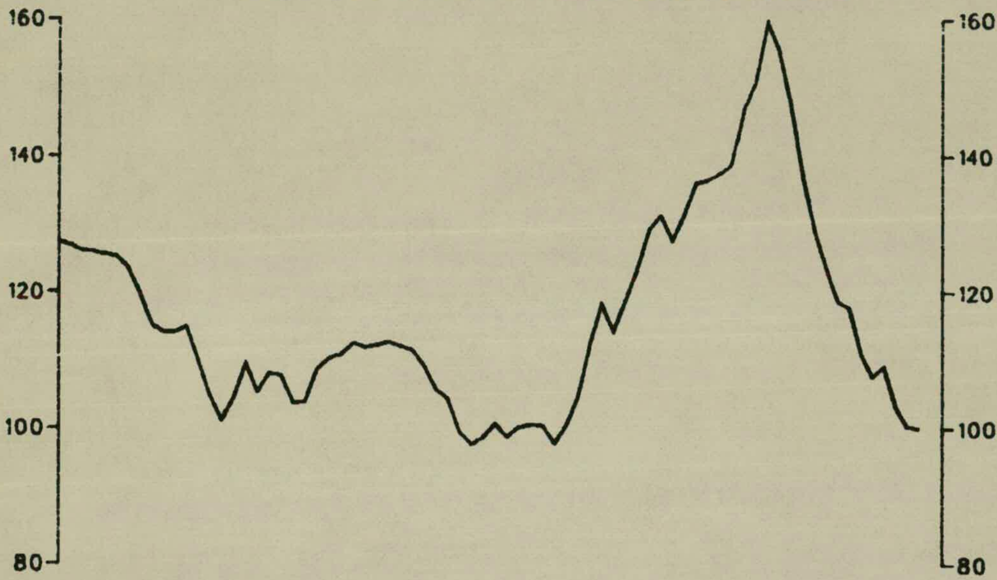
14. The strengthening of industrial activity has led to a recovery in the prices of industrial materials. But they have so far barely recovered to their 1984 peak (Chart 7). Food prices remained weak until fears about drought in the US pushed up prices of certain commodities (Chart 6). Oil prices have been largely unaffected by the strengthening of activity. Overall, therefore the behaviour of commodity prices to date points to only a modest pick up in inflation.

15. While, there has been no pick up in consumer price inflation in industrialised countries to date (Chart 8), the evidence of the two earlier periods suggests that there are inflationary risks. Nevertheless, the greater commitment among the major countries now to sound macro-economic policies and the current disarray of OPEC point to only a limited rise in consumer price inflation, unless activity proves significantly stronger than we currently expect.

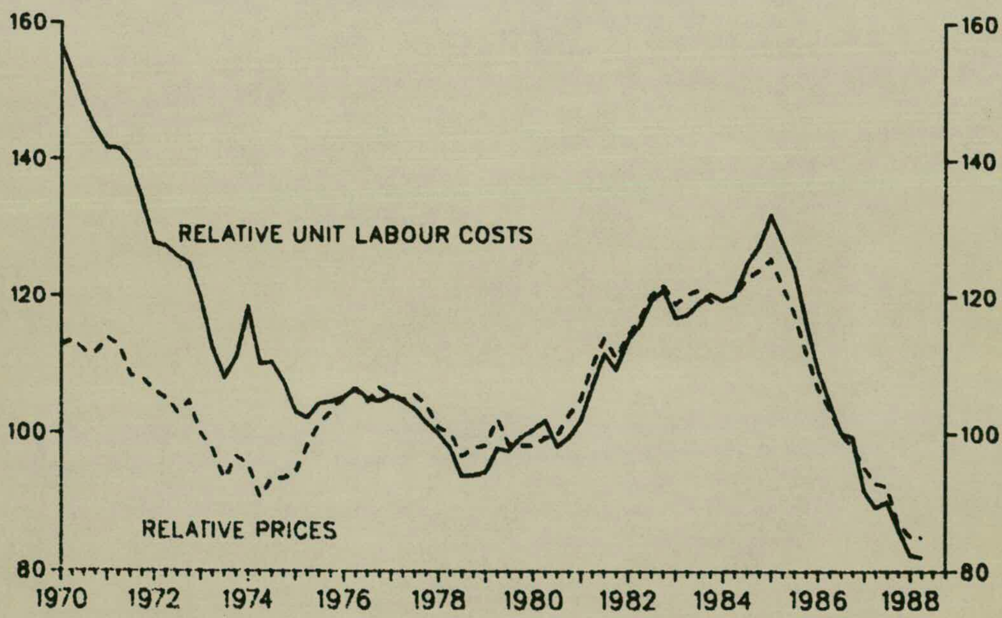
CHART 1 : US DOLLAR EXCHANGE RATE

1980 = 100

NOMINAL EFFECTIVE EXCHANGE RATE

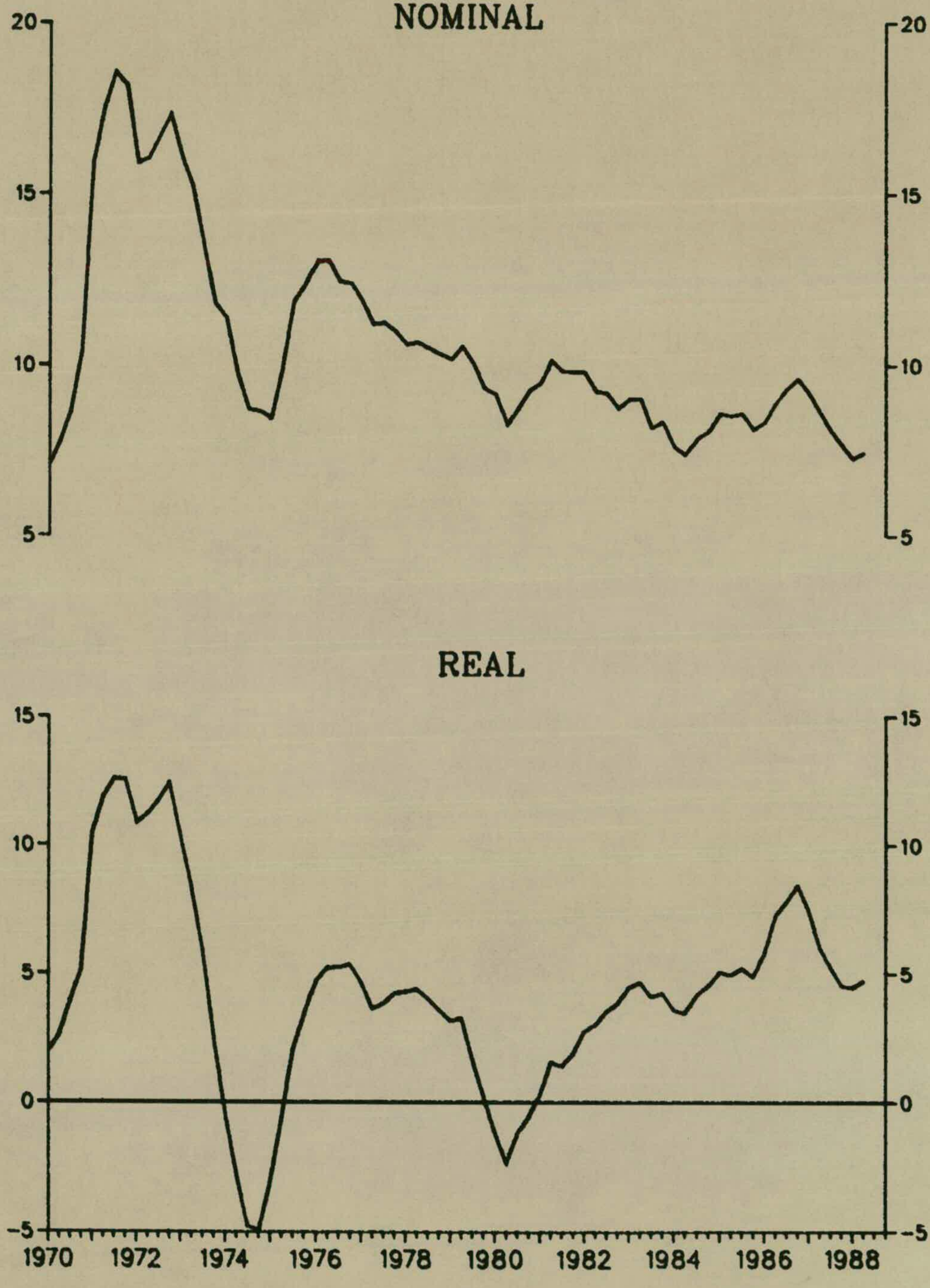


REAL EFFECTIVE EXCHANGE RATE



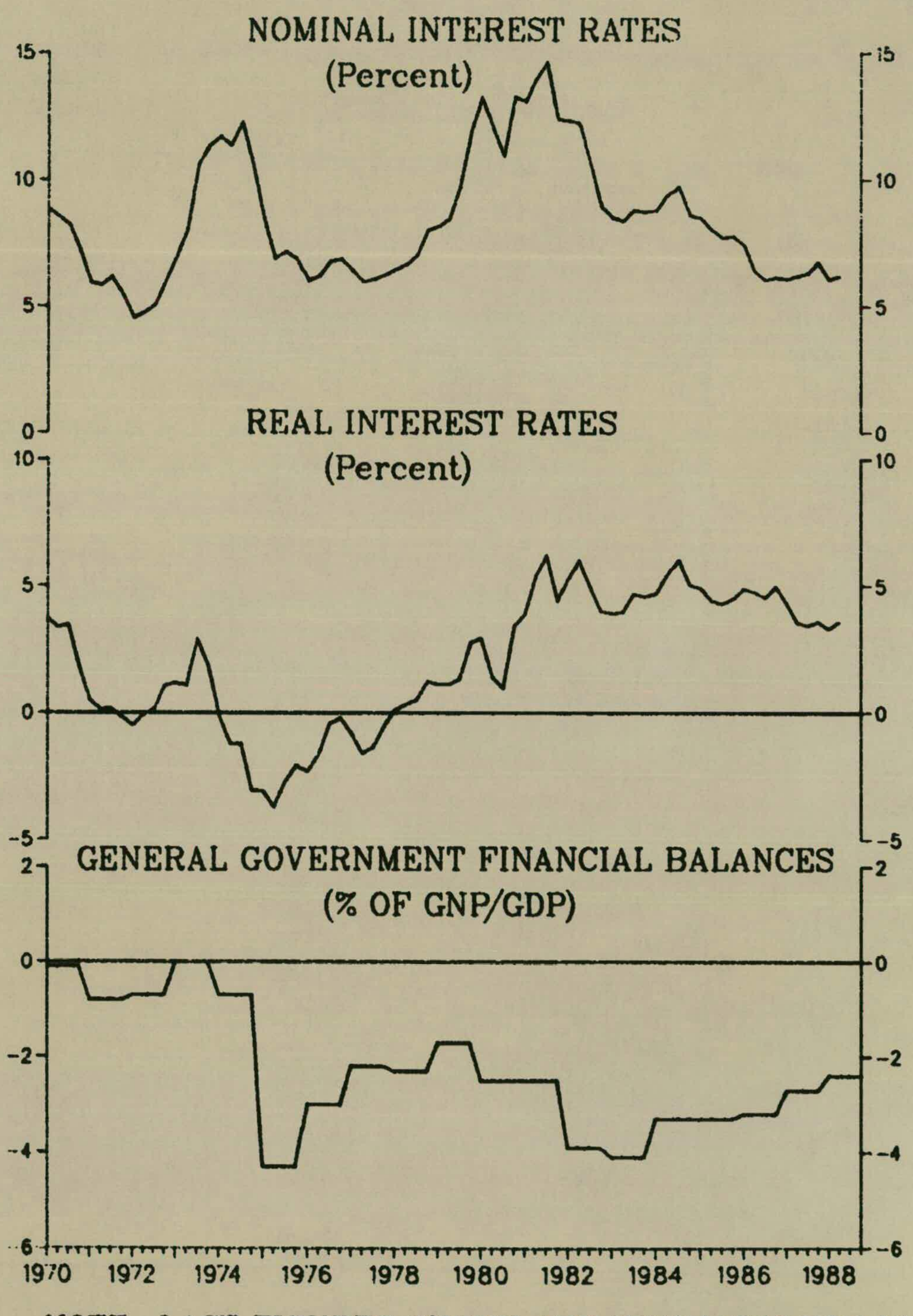
NOTE : LAST FIGURES SHOWN ARE ESTIMATES FOR 1988Q2

CHART 2 : G5 MONETARY GROWTH



NOTE LAST FIGURES SHOWN ARE ESTIMATES FOR 1988Q2

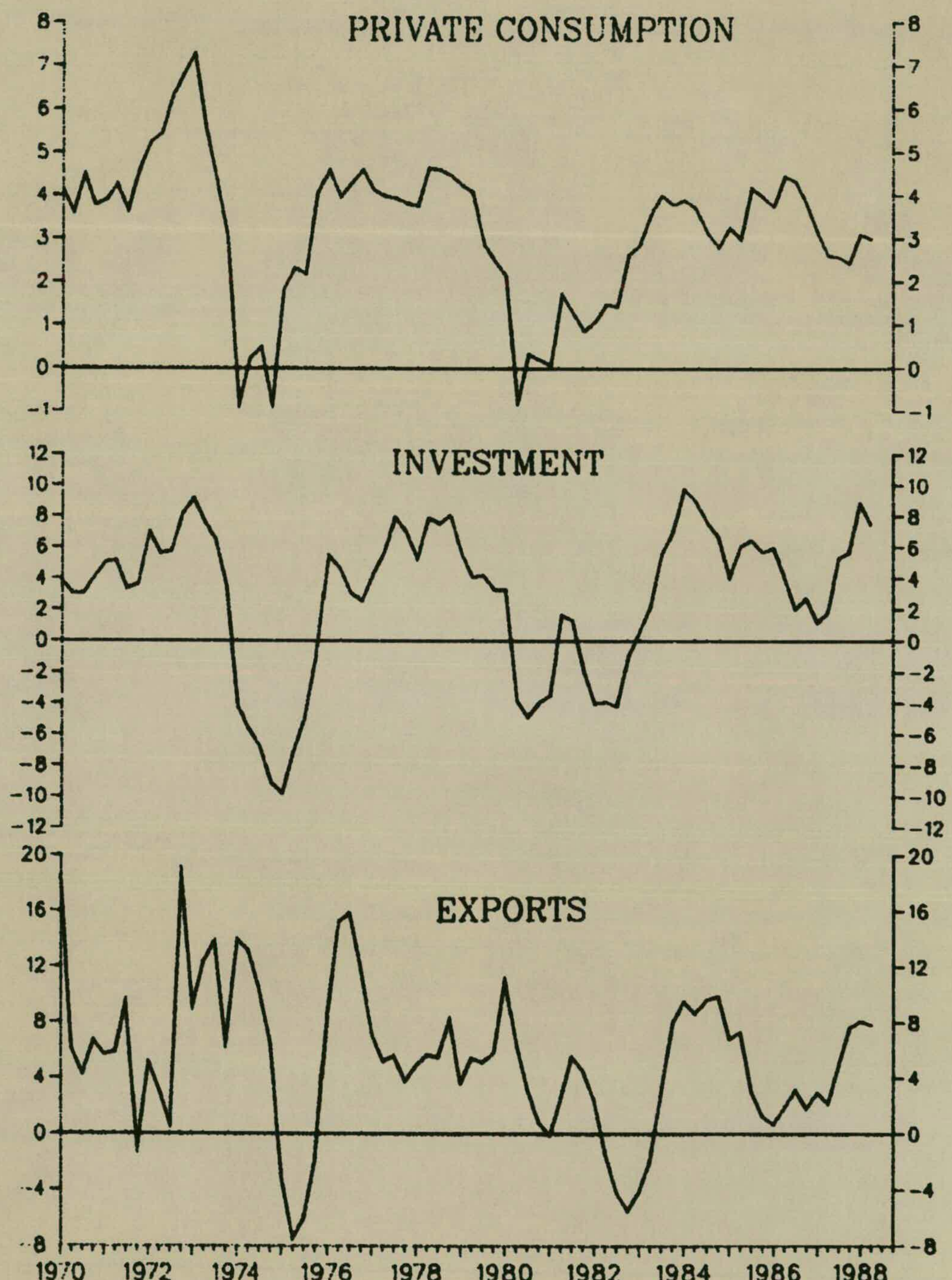
CHART 3 : POLICY INDICATORS



NOTE : LAST FIGURES SHOWN ARE ESTIMATES FOR 1988Q2

CHART 4 : G5 EXPENDITURE GROWTH

PERCENTAGE CHANGE OVER YEAR EARLIER

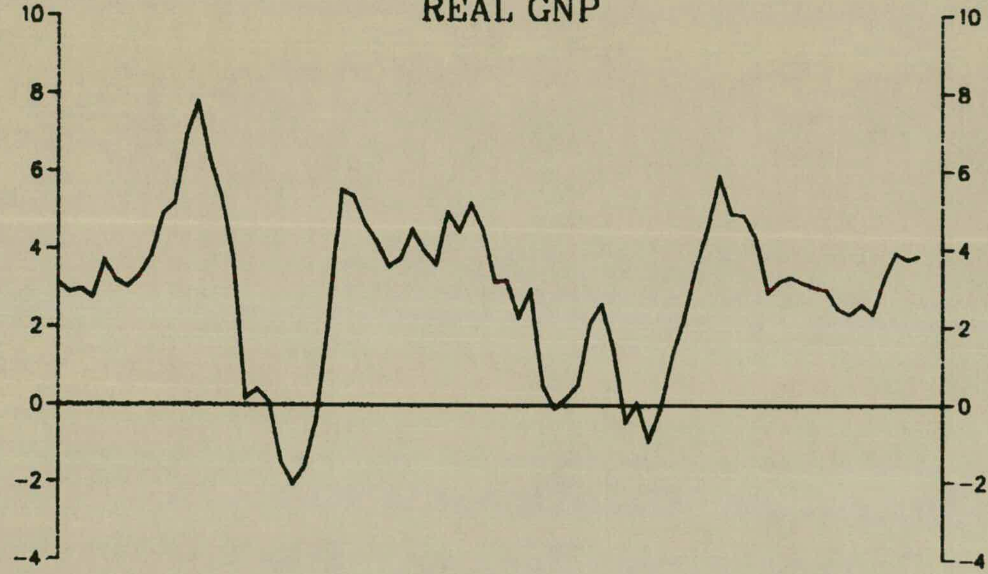


NOTE : LAST FIGURES SHOWN ARE ESTIMATES FOR 1988Q2

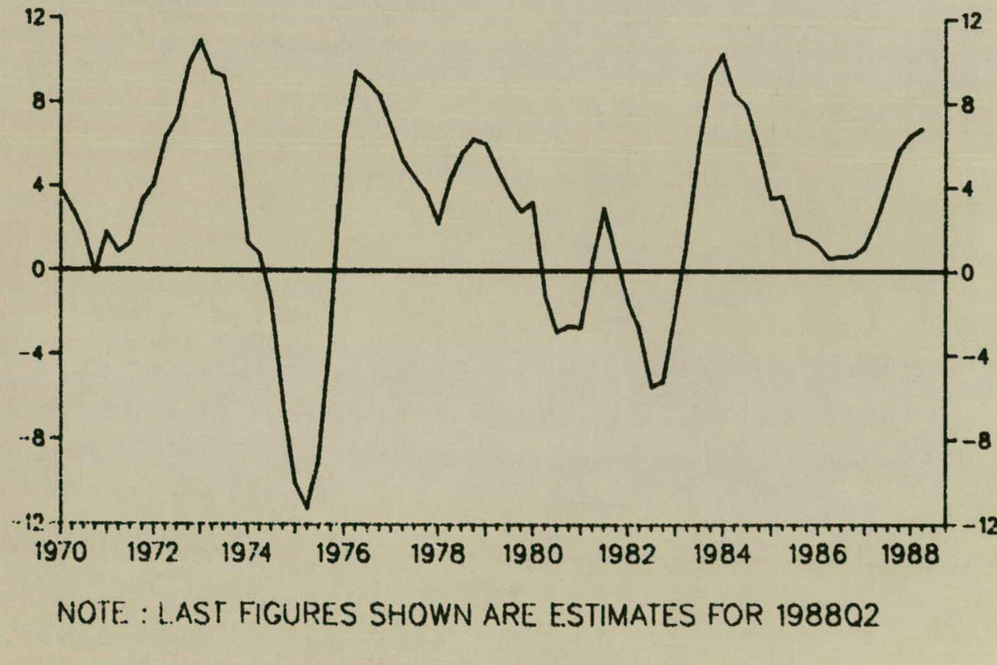
CHART 5 : G5 PRODUCTION GROWTH

PERCENTAGE CHANGE OVER YEAR EARLIER

REAL GNP



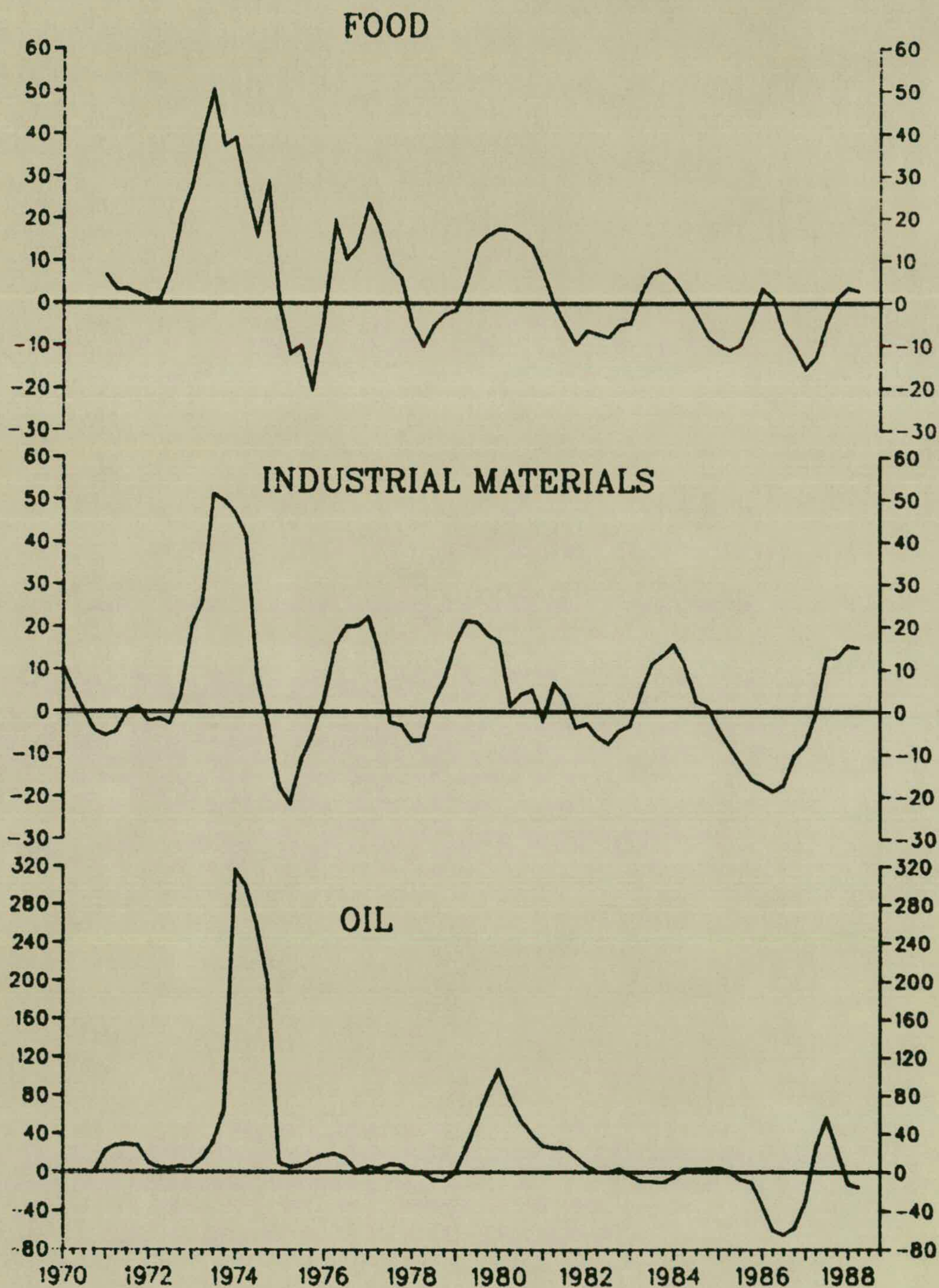
INDUSTRIAL PRODUCTION



NOTE : LAST FIGURES SHOWN ARE ESTIMATES FOR 1988Q2

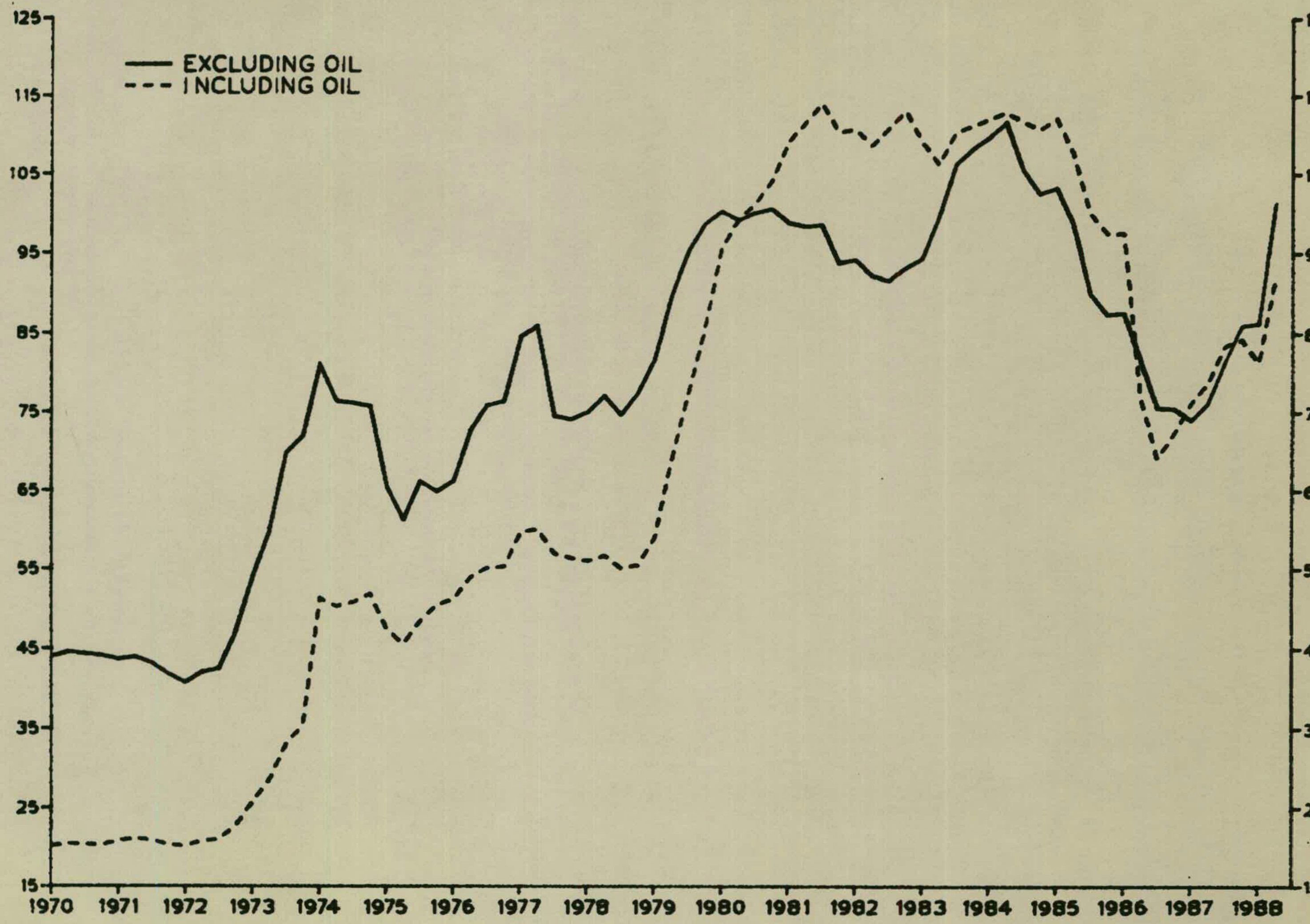
CHART 6 : COMMODITY PRICES (SDRs)

PERCENTAGE CHANGE OVER YEAR EARLIER



NOTE : LAST FIGURES ARE ESTIMATES FOR 1988Q2

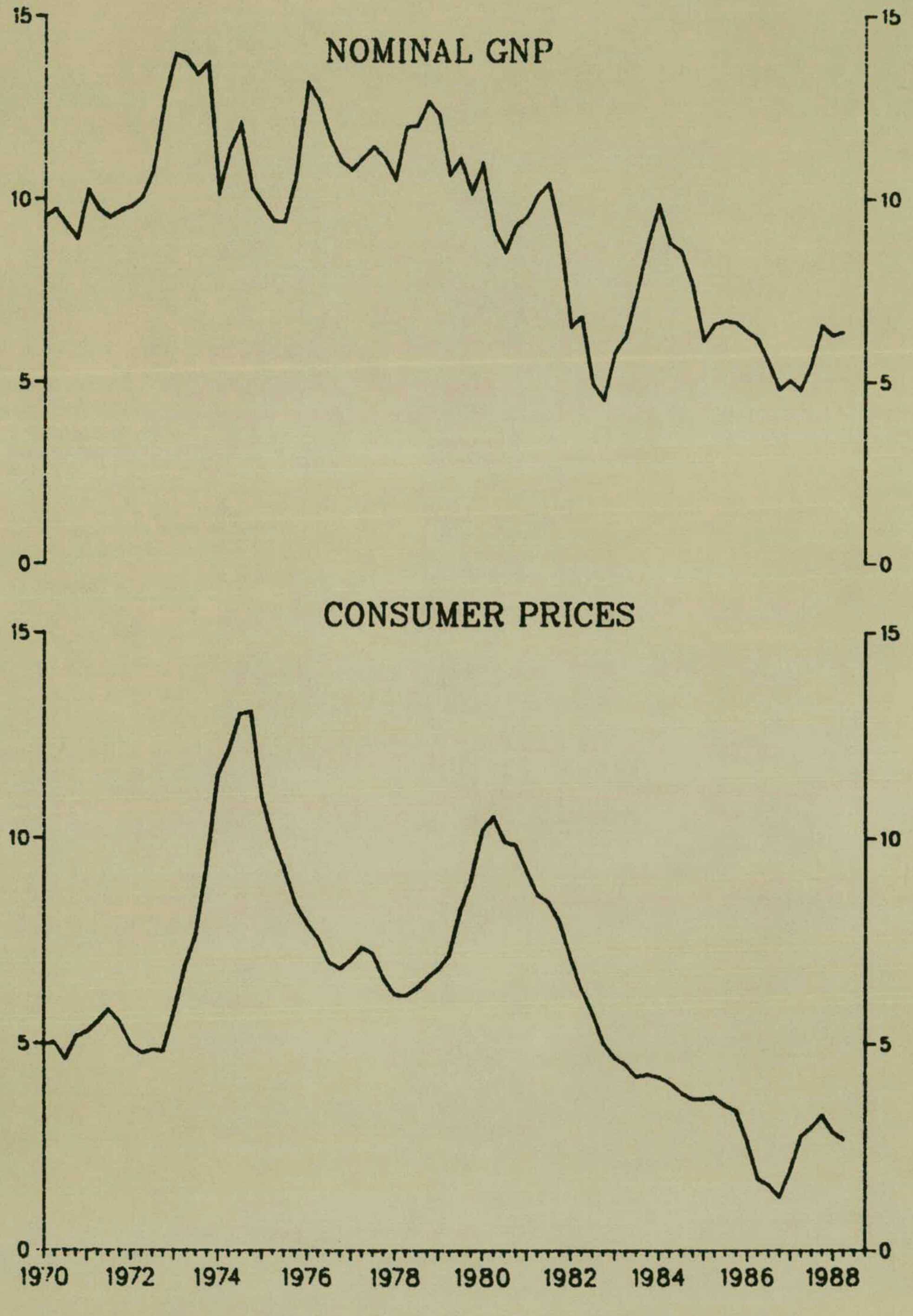
CHART 7 : COMMODITY PRICE LEVELS - 1980 = 100



NOTE : LAST FIGURES SHOWN ARE ESTIMATES FOR 1988Q2

CHART 8 : G5 INFLATION INDICATORS

PERCENTAGE CHANGE OVER YEAR EARLIER



NOTE : LAST FIGURES SHOWN ARE ESTIMATES FOR 1988Q2