PO-CH/NL/0409

PART B

Part 1B.

SECRET

(Circulate under cover and notify REGISTRY of movement)

Begins: 27/1/88.
Ends: 19/2/88.

PO -CH /NL/0409
PART B

Chancellor's (Lawson) Papers:

THE RETAIL PRICE INDEX, RESERVES AND THE GOVERNMENTS ECONOMIC PROGRAMME OF 1988

DD's: 25 Years

9/1/96.

PO -CH /NL/0409
PART B

CABINET OFFICE PAPER

The following Cabinet Office papers have been taken off the file. If you require access to these papers please contact the Cabinet Office.

Reference	Date Of Paper
C(88)3	16/02/1988
CC(88) 6th	18/02/1988

psec.lb/mr.4 Lords

FROM: Assistant Parliamentary Clerk
DATE: 27 January 1988

01-270 5007

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Burr - IAE3
Mr Gieve - IDT
Mr Hibberd - EA1
Mr Mercer - EC2
Mr O'Donnell - EA2
Mr Dyer

FORTHCOMING TREASURY BUSINESS IN THE HOUSE OF LORDS

You may wish to be aware that the current forthcoming Treasury business in the Lords is as follows:

ORAL QUESTIONS

Tuesday 31 January Viscount of Oxfuird - To ask Her Majesty's Government whether the United Kingdom's share by volume of world trade in manufacturing industries is increasing or decreasing.

Government Spokesman: Lord Young of Graffham. EA2 Division in the lead.

Wednesday 8 February Lord Ezra - To ask as Her Majesty's Government whether they regard it as a matter for concern that, according to the recently published Social Trends survey, household savings as a percentage of disposable income was negative in 1986 and 1987.

Government Spokesman: To be confirmed. EA1 Division in the lead.

Monday 13 February Lord Jay - To ask Her Majesty's Government what is their estimate of the total of foreign-owned funds held in sterling which could be withdrawn on demand.

Government Spokesman: To be confirmed. EA2 Division in the lead.

Tuesday 14 February Lord Bruce of Donnington - To ask Her Majesty's Government whether they will report on the discussions at the European Community's Economic and Finance Council on the frauds referred to in the question asked by Lord Bruce of Donnington and answered by Lord Young of Graffham on 20 January 1988 (H.L. Deb. Cols. 206-207).

Government Spokesman: To be confirmed. EC2 Division in the lead.

TREASURY INTEREST QUESTIONS

ORAL

Monday 6 February Viscount of Oxfuird - To ask Her Majesty's Government whether they will give the latest available statistics on business start ups in 1988, and comparable figures for 1987.

Government Spokesman: To be confirmed. Dept of Employment in the lead

Mari Rogerson.

MARI ROGERSON

eog5.ay.28.1cr

SECRET

NOTE OF A MEETING IN ROOM 47/2 AT 3PM, WEDNESDAY 27 JANUARY

Those present:

Economic Secretary
Mr Scholar
Mr Peretz
Mr Grice
Mr Rich
Mrs Ryding
Mr Barnes

Mr Patterson)
Mr Wilson) DNS
Mr Ward)

Mr George)
Mr Allen) Bank of England
Mr Althaus)

Funding Arithmetic

1. Mr Peretz explained that the main change to the funding arithmetic since the last meeting at the end of November was a downward revision to the forecast PSBR of some £4 billion. Also, there had been intervention in December of around £2 billion. The gilt sales requirement for January to March was £3½ billion, and taking account of gilt sales already made or tied up, this left £1.3 billion still to be sold in February and March. There were many uncertainties, but the main one was the PSBR. At this time of year there was an average error on the PSBR forecast of £1½ billion and in all of the previous four years the forecast made at this time of year had proved over-pessimistic. It was possible that the PSBR surplus would be even bigger than forecast, but uncertainty on the LABR went the other way. A further uncertainty was the redemption of the index linked gilt due to occur on 30 March. The arithmetic assumed almost all of the redemption money would be paid this year, but it was possible that some could slip into next year. Given the current policy stance, it was unlikely that there would be significant intervention, and indeed even if there were, this would probably not be funded this year given the Chancellor's Mansion House speech. Next year's funding task looked almost non-existent given the forecast of a PSBR surplus and assuming that some intervention would be unwound. The situation would need to be monitored carefully towards the end of the financial year.

2. Mr George agreed with the points Mr Peretz had made.

National Savings

3. Mr Patterson explained that there had been high inflows into income bonds, since the turn of the year. The high rate of outflow experienced last autumn from fixed income certificates had also dried up. The increased contribution from National Savings to £2 billion for the financial year as a whole was primarily due to lower outflows rather than high inflows. Given the 1% competitive advantage since December when building society rates were reduced, sales generally had remained surprisingly low. He was however reluctant to advertise income bonds given recent pick-up in inflow. The forecast of a £2 billion contribution to funding for the year as a whole was likely to prove robust, providing there were no upheavals. However, the risks were up rather than down.

4. The Economic Secretary asked if rates on national savings should be reduced. Mr Patterson said that the most obvious candidate was the general extension rate (GER). It was agreed that the general position should be reassessed when more information on next year's funding task was available. But a reduction in GER from 1 March should be given serious consideration.

Gilt Edged Market

5. Mr George said that the mood in the gilts market had been generally good. Economic data had been encouraging and nervousness about overheating had waned. Also, the strength of the fiscal position had not generally been appreciated in the markets. There should be no difficulty in achieving the funding requirement for the year as a whole. The Bank's recommendation was a funding target for February of £1 billion including the second call on the auction. If markets proved very strong it might be sensible to take the insurance and fund rather more in February. It was agreed that the aim should be a full fund over the year as a whole, and that the funding target for February should be £1 billion.

Auction

6. Mr George said that the third in the series of experimental auctions had proved very interesting. The Bank would be taking the views of market makers the following day and the Bank hoped to be in a position to prepare a paper for the funding meeting in

February. We needed to be ready to announce future plans for auctions immediately post-Budget. The third auction had been a success in the sense that it had brought about an improvement in the market. Subject to the views of market makers, he would wish to continue with auctions, but perhaps two rather than three (maybe dropping the medium) and possibly less stock; to continue next year even if that required some buying in. The Bank's paper would be available in good time before the next funding meeting.

Cost of Funding

7. Mr Peretz explained that compared with the figures circulated in November, break even yields were slightly higher, but shorts and IGs remained better value than medium and long conventionals. The figures would be updated in line with the latest forecast. Table 3(b) showed that the proportion of shorts was 32% of total conventionals but this was slightly misleading in that it scored the convertible as a short. However, it was noted that with a few exceptions the conversion options were usually not taken, and Mr Grice noted that on our own internal interest rate forecast it would not be sensible to convert. Mr Peretz welcomed the fact that it had been possible to sell IGs recently, and hoped that a reasonable proportion of remaining sales this year could be IGs.

Money Market Outlook

8. Mr Allen said that money market assistance totalled just over £12 billion and was forecast to remain on a plateau until late March. There was no cash management need for a new repo, unless one was needed for interest rate reasons. The gap between bill rates and money market rates had now narrowed quite substantially and his own view was that the repo had helped narrow this gap.

Next Meeting

9. The Economic Secretary noted that the next funding meeting would be held on Wednesday 24 February.

Cathy Ryding

CATHY RYDING

Circulation: Those present
PPS -
Sir P Middleton
Sir T Burns
Sir G Littler
Professor B Griffiths - No 10

Contra, despite the dubious nature of (iii).
I am delighted for FTB to be President of the Polytechnic Teachers in Economics. How long is the term? —

FROM: SIR T BURNS
DATE: 28 JANUARY 1988

CHANCELLOR

cc Sir P Middleton

I have a number of invitations outstanding for which I would be grateful for your approval:

(i) The 5 pm Club: the invitation is for April.

(ii) A Layard Conference on "Barriers to European Growth" to be held in Germany in the second half of June. The Economic Secretary was originally asked but turned it down because of pressure of Parliamentary work. I am not very enthusiastic but if they have a good turn out it may be interesting.

(iii) Michael Tait who is now our Ambassador in the United Arab Emirates would like me to go to Abu Dhabi in the second half of March or early April to give a talk to various bankers/financiers. His suggested title is 'The British Renaissance'. If it can be fitted in between the Budget and Easter it could be interesting. He thinks he can fund the travel expenses. It would mean being away from Thursday to Sunday.

(iv) The Polytechnic Teachers in Economics have invited me to become President of the Association and speak at their conference in Plymouth in late March. This would be impossible if I accept Michael Tait's invitation. Otherwise there is something for giving them support - they tend to be less trouble than University Teachers of Economics! One possibility would be to suggest doing it the following year when hopefully the conference would be closer to London.

T BURNS

SECRET

From : D L C Peretz
Date : 28 January 1988

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

MARKETS: REACTION TO TRADE FIGURES

It does not look as if the market reaction to today's figures has helped much with our interest rate dilemma.

2. When the trade figures came out at 11.30 the exchange rate fell back a little, from just over DM 2.97 to, say, DM 2.96 3/4. The gilt market, which had by then risen about ½ a point on the day at the long-end, also temporarily fell back a little, but not for long. By the close gilts were just under a point up at the long-end on the day.

3. The main explanation for the strength of the gilt market is that it followed the similar rise in the US bond market, after US Q4 GNP figures: with the slower rise in consumer spending and increase in inventories both pointing to a better prospective US trade performance. Other factors may have been that our own December trade figures looked better on closer reading; and that the fact that the market scarcely fell when they came out suggested a fairly robust underlying tone to the market.

4. This rise in the gilt market has also been reflected in a fall in sterling short-term interest rates, with three month inter bank rate coming down 3/16% since close yesterday - to 8 5/8%.

5. None of this eases our dilemma on interest rates. The exchange rate is now just a little bit further away from DM 3.00, though as I write it has risen above DM 2.97. But short-term market interest rates are also lower, so that - in logic at least - a rise in the Bank's dealing rates would come as more of a surprise, and be more likely to trigger an upward movement in sterling.

6. We will take stock again in the morning with the Bank, in the light of press comment on the trade figures and the market reaction to that. If we decided we did want to move tomorrow, the Bank would press to do so at 10.00 am, since there is a large market shortage tomorrow which means there will be a 10.00 am dealing round. But as things look tonight neither we nor the Bank think a move tomorrow would be safe.

DLP

D L C PERETZ

ps2/49M

RESTRICTED

FROM: MISS M P WALLACE
DATE: 28 January 1988

MR P DAVIS

cc Mr Bottrill

DECEMBER TRADE FIGURES

The Chancellor was grateful for your minute of 26 January. He is content with your briefing, subject to the following amendments:

Defensive 4. - amend to read: "Deficit reflects significantly faster UK growth than in other major countries. This is unlikely to be permanent feature. Moreover, imports of materials and capital goods have been rising as industry increases investment."

Defensive 5. - insert after present Defensive 6, and amend answer to read: "No. See preceding answer."

MPW.

MOIRA WALLACE

SECRET

Ex Rets

From : D L C Peretz
Date : 28 January 1988

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

Thanks very much. Still less clear what to do!

MARKETS: REACTION TO TRADE FIGURES

It does not look as if the market reaction to today's figures has helped much with our interest rate dilemma.

2. When the trade figures came out at 11.30 the exchange rate fell back a little, from just over DM 2.97 to, say, DM $2.96^{3}/_{4}$. The gilt market, which had by then risen about ½ a point on the day at the long-end, also temporarily fell back a little, but not for long. By the close gilts were just under a point up at the long-end on the day.

3. The main explanation for the strength of the gilt market is that it followed the similar rise in the US bond market, after US Q4 GNP figures: with the slower rise in consumer spending and increase in inventories both pointing to a better prospective US trade performance. Other factors may have been that our own December trade figures looked better on closer reading; and that the fact that the market scarcely fell when they came out suggested a fairly robust underlying tone to the market.

4. This rise in the gilt market has also been reflected in a fall in sterling short-term interest rates, with three month inter bank rate coming down $^{3}/_{16}$% since close yesterday - to $8^{5}/_{8}$%.

21

5. None of this eases our dilemma on interest rates. The exchange rate is now just a little bit further away from DM 3.00, though as I write it has risen above DM 2.97. But short-term market interest rates are also lower, so that - in logic at least - a rise in the Bank's dealing rates would come as more of a surprise, and be more likely to trigger an upward movement in sterling.

6. We will take stock again in the morning with the Bank, in the light of press comment on the trade figures and the market reaction to that. If we decided we did want to move tomorrow, the Bank would press to do so at 10.00 am, since there is a large market shortage tomorrow which means there will be a 10.00 am dealing round. But as things look tonight neither we nor the Bank think a move tomorrow would be safe.

DLP

D L C PERETZ

ps2/52M

SECRET

FROM: MISS M P WALLACE
DATE: 29 January 1988

MR PERETZ

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Miss O'Mara
Mrs Ryding
Mr Cropper

MARKETS: REACTION TO TRADE FIGURES

The Chancellor has seen and was grateful for your minute of 28 January.

MOIRA WALLACE

35.3 JRF.3276.3

PMB

FROM: PAUL DAVIS

DATE: 29 January 1988

PS/ CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Paymaster General
Sir P Middleton
Sir G Littler
Sir T Burns
Mr Scholar
Mr Sedgwick
Mr Peretz
Mr Monck
Mr Bottrill
Mr Matthews
Miss O'Mara
Mr Pickford
Mr R I G Allen
Mr Bush
Mr Owen
Mr Patterson
Mr Tyrie

Mr Gray No 10
Miss Holt No 10

DECEMBER TRADE FIGURES

Much has been made in the press today (FT, Times, Independent, Guardian et al) that the 1987 current account deficit was the largest recorded since 1974. Whilst this is true on a nominal basis, as a proportion of GDP the 1987 deficit is far smaller than it was in the mid 1970s, as the table below shows.

	Current account £ billion	Current account as percentage of nominal GDP
1970	0.8	1.5
1971	1.1	1.9
1972	0.2	0.3
1973	- 1.0	- 1.4
1974	- 3.3	- 4.0
1975	- 1.6	- 1.5
1976	- 0.9	- 0.7
1977	- 0.1	- 0.1
1978	1.0	0.6
1979	- 0.7	- 0.3
1980	2.9	1.3
1981	6.3	2.5
1982	4.0	1.5
1983	3.3	1.1
1984	1.5	0.5
1985	2.9	0.8
1986	- 0.9	- 0.2
1987	- 2.7	- 0.7*

* Based on first three quarters GDP estimate.

PAUL DAVIS
EA2
35A/3

SECRET

FROM: MISS M O'MARA
DATE: 1 FEBRUARY 1988

Ch/ Content with briefing? / a number of changes passim, all presentational

ECONOMIC SECRETARY

cc Chancellor
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Peretz
Mr R I G Allen
Ms Goodman
Mr Polin

[We have commissioned note on EMCF swap for No 10]

MPOW 1/2

RESERVES IN JANUARY

I attach for your approval the draft press notice and accompanying briefing on the January reserves, prepared by Mr Polin.

2. We are publishing an underlying rise of $38 million. The market is expecting an underlying rise of around $500 million on average, although the range of expectations is quite wide. The lower figure may therefore come as a slight surprise to them, though perhaps less so after today's interest rate rise. However, you will recall that we would have published an underlying fall, had we not deliberately swapped out of the forward book to avoid provoking further debate on the profitability of our intervention. Market intervention in the month was in fact negligible.

3. The total reserves show a large fall of $1,233 million, partly reflecting the quarterly EMCF swap which accounts for $660 million and partly because we have taken advantage of our currently healthy position to prepay some of our more expensive public sector foreign currency debt. As we predicted last month, despite the withdrawal of any interest rate subsidy, new borrowing under the exchange cover scheme, although half the December figure, remained comparatively high in January at $93 million, as borrowers brought forward loans under the transitional arrangements agreed with the European Investment Bank. Borrowing under the scheme should be much lower in future months.

4. Table 2 shows other countries' spot market intervention. Operations were generally on a smaller scale than in December. The Japanese bought more than $1 billion dollars and the Canadians $1.2 billion. The US bought around $½ billion against deutschemarks and $¼ billion against yen. However, Spain, known to be a very heavy exchange market operator in both directions, bought over $2 billion. (Spanish interest rates are currently high and the market is expecting a fall.)

Mom

MISS M O'MARA

mjd 3/95m

UNCLASSIFIED

FROM: MISS M P WALLACE
DATE: 2 February 1988

SIR T BURNS

cc Sir P Middleton

The Chancellor has seen your minute of 28 January. He is content for you to accept these invitations - despite the dubious nature of the Abu Dhabi 'British Renaissance' trip.

2. The Chancellor is delighted that you are to be President of the Polytechnic Teachers in Economics. He has asked how long the tenure is.

MPW.

MOIRA WALLACE

42aG/NH/3744/12

BF 8/2 with X

FROM: MARTIN HURST

DATE: 2 February 1988

1. MR ILETT ✓ M. 2/ii

2. CHANCELLOR

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Monck
Mr Scholar
Mrs Lomax
Mr MacAuslan
Mr Courtney

Thanks. Latest figs show smaller difference between US & UK than might have been expected.

COMPANY GEARING

Mr Allan's minute of 26 January asked for figures showing debt/equity ratios for quoted companies as a whole in the UK and in the US, together with comments on the main causes of any differences.

2. It has not proved possible to obtain figures for all quoted companies in the UK and in the US or for any reasonable subset of quoted companies on a consistent definition. The Bank and the DTI were also unable to suggest any source. We have thus limited ourselves to figures for all industrial and commercial companies. Financial companies are excluded (as is conventional) because debt-equity ratios do not have the same significance for them, (since much of their debt is raised purely to finance the provision of loans to other sectors their measured gearing would be artifically high).

3. There are several different ways in which gearing can be measured. In particular both net and gross measures can be used for debt, and equity can be valued either using market value or on an historical cost basis. The figures in the table overleaf are for gross gearing using market valuation of equity. This measure is probably the clearest conceptual definition, and avoids the need to decide which assets should score as negative debt.

4. For comparison, net figures are shown in parentheses for the last two years and a BEQB table showing net gearing for the UK only on a net market value definition (also used in Hoare Govett's recent 'Quoted UK plc) is attached.

220/233/2

Debt/Equity Ratios (1)	1966-73	1974-79	1980	1981	1982	1983	1984	1985	1986
UK	0.67	1.38	1.13	1.23	1.03	0.87	0.74	0.72	0.62
(net)								(0.51)	(0.43)
US	0.54	0.96	0.77	0.92	0.87	0.78	0.90	0.83	0.78
(net)								(0.57)(2)	(0.50)

(Source OECD-'84, US Department of Commerce, CSO)

(1) Gross liabilities excluding equity and trade credit as a proportion of equity at market value.

(2) Net figures deduct holdings of liquid assets from debt.

5. Although comparisons of levels figures for gearing can be misleading, in part because different measures can lead to different relative results, it is clear that gearing in the UK has behaved in a different manner over time to that in the US. In particular while UK gearing fell between the late 1970s and the early 1980s and again post 1983, US gearing has been relatively steady. The rise in equity prices over the last few years will have tended to lower gearing in both countries but:

- The sharp falls in UK equity prices over 1973 and 1974 left the market valuation of equities at a very low level relative to historical trends, so some of the fall in UK gearing since then may represent a return to more normal levels. The falls in US share prices in the early 1970s were much less marked.

- The 1984 change in UK corporation tax considerably reduced the favourable tax position of debt relative to equity and may be responsible for some of the fall in gearing thereafter.

- The US market in commercial paper has been around for a long time, although the junk bond market is more recent. The growth of these instruments may have made marketable debt more attractive in the US than in the UK where junk bonds do not exist and commercial paper (which concept also includes euro and US paper) has only recently contributed significantly to corporate finance.

- The mid 1980s saw significant destruction of US equity. This occurred in two ways: first, leveraged buy outs, largely financed by junk bonds used debt finance to purchase the equity of target firms. This equity disappeared if the buy out was successful. Second, some firms then purchased their own equity as a defence to takeover bids. Different motives lie behind the current (post crash) purchases by firms of their own equity, which although partly defensive are attributable more to long term financing decisions and to a desire publicly to show firms' confidence in their future.

- A factor which, if relevant, would point in the other direction, viz a higher UK debt equity ratio, is the existence of pre-emption rights in the UK. These might discourage UK equity issuance relative to the US.

Martin Hurst

MARTIN HURST

BEQB September 1986

Table B
Gearing
Per cent

	Capital gearing(a)						
	Average 1970–79	1980	1981	1982	1983	1984	1985
Capital goods group	**23.7**	**20.6**	**18.5**	**18.7**	**15.1**	**16.2**	**18.4**
Building materials	22.0	15.1	16.7	18.1	18.0	17.5	19.3
Contracting and construction	24.5	18.3	11.6	9.7	11.4	12.9	13.1
Electricals	23.3	22.8	19.7	15.1	9.4	14.9	14.1
Electronics	10.3	5.6	−13.3	−14.1	−18.2	1.4	13.6
Mechanical engineering	21.2	17.2	15.6	17.3	13.6	12.0	7.3
Metals and metal forming	23.3	22.7	23.2	27.9	24.1	27.1	25.1
Motor components and distributors	34.6	32.8	35.9	37.1	30.5	25.6	32.9
Other industrial materials	25.2	24.1	27.7	30.6	29.9	27.1	27.5
Consumer group	**24.2**	**20.4**	**19.0**	**19.3**	**16.2**	**19.2**	**19.6**
Brewers and distillers	30.3	21.4	23.6	21.0	20.0	22.2	22.6
Food manufacturing	21.3	22.3	21.4	22.1	20.3	23.9	21.7
Food retailing	0.2	13.0	5.6	2.9	4.9	12.2	10.0
Health and household products	26.1	21.9	17.9	19.5	6.3	11.7	14.9
Leisure	31.9	23.8	22.1	27.3	26.6	23.7	21.9
Newspapers and publishing	14.1	12.6	14.4	14.7	11.9	7.9	34.5
Packaging and paper	35.5	26.9	27.5	27.5	24.7	20.9	18.6
Stores	11.1	8.1	7.2	9.9	5.9	4.5	12.1
Textiles	28.5	24.8	23.0	19.0	12.4	14.7	7.1
Tobacco	26.5	28.4	20.8	21.9	16.2	25.9	23.0
Other consumer goods	12.9	12.9	10.6	11.9	7.2	7.9	11.7
Other groups	**28.2**	**28.3**	**26.4**	**28.3**	**24.3**	**24.8**	**18.9**
Chemicals	25.9	30.1	29.3	29.9	24.3	22.8	22.3
Office equipment	32.1	18.5	18.9	23.5	24.6	23.4	12.2
Shipping and transport	31.8	32.8	30.8	34.3	25.9	25.5	18.7
Miscellaneous	27.4	26.0	22.2	24.2	23.5	26.0	17.9
All industrial groups	**24.6**	**21.6**	**20.1**	**21.2**	**17.8**	**20.2**	**20.2**
Oil companies	22.4	30.3	30.9	28.9	20.9	21.0	18.2
Industrials and oils	**24.3**	**23.6**	**22.8**	**23.2**	**18.6**	**20.4**	**19.7**
Number of companies analysed	*1,219*	*1,768*	*1,732*	*1,686*	*1,641*	*1,577*	*1,189*

Source: Datastream Limited.

(a) Total debt (less cash and equivalent) as a percentage of capital employed (historical cost, end-period measure).

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Mr Judd is becoming an exceeding time-consuming correspondent!

OXFAM

274 Banbury Road, Oxford OX2 7DZ
Telephone: (0865) 56777. Telex: 83610
Facsimile No. 57612

CH/EXCHEQUER
REC. 09 FEB 1988
ACTION Mr WALSH,
COPIES TO EST, Sir G. LITTLER, Mr H.P. EVANS, Mr MOUNTFIELD, Mr R.I.G. ALLEN, Ms LIFE, Mr HUDSON

FJ/VB

3rd February, 1988

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
11 Downing Street
London SW1

Dear Chancellor,

African Debt

Thank you for your letter of 24th December. I can understand your preference for using HMG's leverage on the other creditor countries to secure a multilateral, rather than a purely unilateral, agreement to ease Africa's debt burden. It occurs to me however that it might be possible to move forward in stages. If, for example, EEC Finance Ministers all agree to follow the initiative, this would be a strong platform from which to move forward, even if Japan and USA refuse at this time. As with HMG's cancellation of o.d.a. debts to least developed countries such action would provide an inspiring lead which, eventually, other governments might follow. Would you consider moving forward with your African debt plan as an EEC, rather than a G7, initiative?

I would also like to raise two points relating to public expenditure. The recently agreed UK contribution to the IMF's enhanced structural adjustment facility is, as I understand it, not to be a charge against the O.D.A. budget. But would I be right in saying that the £250 million you refer to in your letter - as pledged recently over three years to the World Bank efforts for low income, debt distressed countries - will all be funds drawn from the existing HMG aid budget? Will there be any additional Treasury financing, for example, to support the £120 million structural adjustment component?

Secondly, on budget questions, I return to your African debt initiative. Presumably this has been budgeted for in Treasury public expenditure estimates. If the plan fails to take off in 1988/9 because of G7 resistance, would you consider utilising the budgeted funds for other unilateral debt relief measures? For example, could the funds be used for a writing-off of a portion of export credit debt to least developed countries, or for a cancellation of o.d.a. debt to debt-distressed, though not least developed, countries, such as Zambia?

Finally I would be very interested to have your views on the US-Mexico debt initiative. Do you have any plans for a similar UK initiative?

continued/....

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Bank address _____

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To National Westminster Bank, 32 Cornmarket, Oxford (54–21–23) A/C no. 08550999 quoting our reference _____

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I promise not to keep up this correspondence interminably - you have more than enough pressures with which to contend - but it is frankly encouraging to have a Chancellor who has found the time to focus seriously on Third World issues. Incidentally, as the budget approaches whatever the joy amongst taxpayers at the prospect of any tax cuts (and, I hope, we're not guilty of hypocrisy about this!) we are on the one hand naturally concerned to see a strengthened overseas aid programme and on the other apprehensive about what cuts in tax will do to our own very important covenant related income - the income on which we build in the longer term with certainty. We are also concerned to protect the welcome new source of income created by your imaginative payroll deduction scheme.

With warmest regards.

Yours ever.

Frank Judd
Director

JM 5/2.

FROM: J D PORTES
Date: 5 February

1. MR MCINTYRE

2. MISS WALLACE (APS/CHANCELLOR)

cc PS/Chief Secretary
Miss Peirson

RPI ERROR: LOSERS

You told us that Mrs Elizabeth Peacock MP has asked why some pensioner couples with one order book would receive only £8 compensation whereas others with two books would receive £16.

2. The vast bulk of compensation payments will be made this month. Claimants in most of the groups to be compensated will receive £8 for each benefit order book they possess. It was essential, in order that the payments should be made as quickly and cheaply as possible, to pay on the basis of order books.

3. Because of the operation of the benefit rounding rules, a pensioner couple has suffered the same loss of basic pension as a single pensioner (about £8). But pensioner couples have an order book each, and it was decided that there was no alternative to overcompensating them. They will therefore get a total of £16 compared to their loss of £8. There are about 2 million such couples, giving a total overcompensation of £16m to this group.

4. However there are some couples in receipt of pension who have only one order book. We think this must be the problem Mrs Peacock has identified. These are generally couples where the man has retired, but the wife is under 60 (i.e. not retired) and not earning. The man will then get a dependency addition to his pension, which is equal to the value of the married woman's pension. Such a couple will receive exactly the same amount of total pension as a pensioner couple. They will, however, only have one order book and will hence only receive £8 in compensation. They will not be 'losers' - as explained above, it is the pensioner couples with two order books who are being overcompensated.

5. In fact, the great majority (over 90 per cent) of pensioners with combined order books will not lose.

6. There are, however, some disabled pensioners who will genuinely lose as a result of having combined order books. These are primarily those who are in receipt of the higher rate of attendance allowance combined with a pension, invalidity benefit, or widow's benefit. There are about 175,000 such claimants and they will each suffer a net loss of about £5. The number of people undercompensated in this way is about 2 per cent of the pensioner population.

7. Later this year payments will be made to new beneficiaries (those who start claiming after February and will also lose from the error) and to the small number of very high losers (mostly people on high rates of industrial injuries benefit, war pensioners and the like). You should be aware that, in order to keep administrative costs within reasonable bounds, it may not be feasible to compensate fully every single claimant among the high losers.

8. And of course, all claimants on income support and unemployment benefit will lose (which is where the money to overcompensate the married couples above comes from).

9. This note has been cleared with DHSS, who are taking a firm line on not compensating those who have lost because they have combined order books (see attached Hansard).

J D PORTES

total number of D and C operations performed in England and Wales in each of the last 25 years for which figures are available.

Mrs. Currie: I shall let my hon. Friend have such information as is available without incurring disproportionate costs as soon as possible.

AIDS

Mr. Corbett: To ask the Secretary of State for Social Services whether the special trust fund for HIV positive carriers to be run by the Haemophilia Society has yet been established; and when he expects the first applications for financial assistance to be invited.

Mr. Newton: Following close collaboration officials and officers of the Haemophilia Society, measures necessary to establish the special trust fund are nearing completion. The Haemophilia Society is already giving financial help on an interim basis to urgent cases to need. Applications for financial help from other haemophiliacs infected with HIV and their dependants are being accepted so that payments can be made as quickly as possible.

Health Statistics

Mr. Corbyn: To ask the Secretary of State for Social Services (1) if he will list by London health authority the total available patient beds for each year since 1979;

(2) if he will list by district health authority *(a)* the establishment figure of medical laboratory scientific officers for each year since 1979, *(b)* the number in post for each year since 1979, and *(c)* the number who have left the National Health Service in the last year;

(3) if he will list by district health authority, the number of people on waiting lists for urgent and non-urgent operations for December of each year since 1982.

Mr. Newton: I shall let the hon. Member have such information as is available centrally without incurring disproportionate costs as soon as possible.

Benefits (Adjustment)

Mr. Fearn: To ask the Secretary of State for Social Services if he has any plans to review the system of flat rate compensation payment available to benefit claimants or as a result of the miscalculation of the retail prices index; and if he will make a statement.

Mr. Scott: We have no plans to review the system of ex gratia payments we are making as a result of the error in the calculation of the RPI. We are making these payments, although we have no legal requirement to do so, to more than 12 million beneficiaries. The exercise is designed to combine as far as possible fairness with speed of payment.

Mr. Fearn: To ask the Secretary of State for Social Services if he has any plans to review the position of benefit claimants in receipt of more than one benefit for which a flat rate compensation payment is available after the miscalculation of the retail prices index who have received only one payment because they have a combined order book.

Mr. Scott: We have no plans to do so. Having two benefits combined on one order book does not automatically mean that the claimant has suffered twice from the error in the retail prices index. The ex-gratia special payments fully compensate the great majority of people who have combined order books for two benefits, including the least well-off pensioners with supplementary pensions. Less than 10 per cent. of people with combined books will be undercompensated for the retail prices index error because of the method of payment.

Child Care and Family Services

Miss Widdecombe: To ask the Secretary of State for Social Services when he will be issuing a consultation paper on his proposals concerning standards for day care and residential holidays for children aged between five and 16 years referred to in the White Paper "The Law on Child Care and Family Services".

Mr. Newton: The Department, jointly with the Department of Education and Science and the Department of the Environment, has today issued a consultation paper "Day Care and Residential Holidays for Children over Five". It is being sent to local authorities including non-metropolitan district councils in England; voluntary bodies active in the child care, disabled, mental handicap, educational, sporting and recreational fields; and organisations representing medical, nursing and social work interests.

The Government have decided that a full registration system which would apply to all activities provided for children aged between five and 16 would be inappropriate and impractical. It is primarily the responsibility of parents to satisfy themselves about the adequacy of the arrangements to which they entrust their children. Whilst we recognise that children need to be protected from harm, we believe that out-of-school or holiday play schemes need a lower level of control than residential holidays where children are away from their parents for some time. The Government are seeking views on two options: the introduction of a limited registration scheme (for which legislation would be necessary). This would be operated by local authorities and apply to residential holidays for groups of children for up to 27 days; or the establishment of voluntary codes of practice to be drawn up by private or voluntary organisations. These would cover day care and residential activities.

Similar consultation exercises are being carried out by my right hon. Friend the Secretary of State for Wales and my right hon. and learned Friend the Secretary of State for Scotland.

Geriatric Patients

Mr. Meale: To ask the Secretary of State for Social Services if he will list the numbers of geriatric patients in the Central Nottingham health authority area for each year from 1979-1987 inclusive.

Mrs. Currie *[holding answer 15 January 1988]:* The information requested is given in the table.

Number of geriatric patients treated in National Health Service hospitals in the Central Nottingham Health Authority[1] for each year from 1979 to 1986 (latest available).

Year	In-patient discharges and deaths	Out-patient attendances	Regular day patients
1979	2,381	1,686	4,903
1980	2,448	2,056	5,823
1981	2,458	1,878	5,723

90/G.jfw.4561.007

SECRET

FROM: J W GRICE

DATE: 5 February 1988

1. SIR PETER MIDDLETON

2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Sir T Burns
Sir G Littler
Mr Monck
Mr Lankester
Mr Scholar
Mr H P Evans
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr R I G Allen
Mr Bottrill
Mr Hibberd
Miss O'Mara
Mr Riley
Mr Pike
Mrs Ryding
Mr Cropper
Mr Tyrie
Mr Call
Mr George - B/E
Prof Griffiths No 10
Mr Cassell - Washington
File: MAMC Fl

MONTHLY MONETARY ASSESSMENT: JANUARY 1988

This note records the main points made at Sir Peter Middleton's regular meeting assessing monetary conditions on 3 February. Attached is the usual Monthly Assessment.

Sir Peter Middleton's Meeting

2. Opening the discussion, Mr Scholar noted that the Assessment had been made before the rise in base rates on 1 February. At that time the exchange rate and market interest rates were below their level at the last monthly meeting (22 December), and the Assessment suggested that monetary conditions had loosened over the previous month. Monday's base rate rise had changed some of that. The three-month inter-bank rate was now a shade above its pre-Christmas

level and the yield curve had flattened somewhat. But the effective exchange rate index was still a point below its 22 December level. The DM/sterling rate was unchanged but the dollar had strengthened.

3. The money figures contained no great surprises:

(i) the January 12 month growth rate for M0 was around 4½ per cent. But given the sharp fall in M0 in the first quarter of 1987, the rate would probably rise to the top of or even a little over the 2-6 per cent target range in February and March;

(ii) M3 continued to grow rapidly but with no signs of a trend acceleration. By contrast, M4's growth rate - though still lower than that of M3 - seemed to be trending up a little;

(iii) bank lending in December was very high (an increase of 2.6 per cent). There were a number of explanations - notably the effective closure of the Stock Exchange as a source of new corporate finance, dollar-sterling bill arbitrage and probably some round-tripping - described in more detail in the Assessment.

4. Overall, the impression was that we were back to the monetary conditions of a month ago. This raised the question of whether further tightening was appropriate, though that could be difficult to achieve with international interest rates tending to fall.

5. Mr George shared the view that monetary conditions were similar to those when the last meeting was held. We had then felt that conditions were loose. Underlying credit growth, discounting special factors, still seemed to be very strong. Narrow money was also growing at a brisk rate.

6. Sir Terence Burns thought that demand remained buoyant. There were some indications of localised weakening but no convincing evidence of a dramatic slowdown in domestic demand. There was, if anything, more danger of a fall in external demand. The Treasury Forecast was for slower demand growth in 1988 but the uncertainties were obviously substantial.

7. Other points were made in discussion:

(a) in the aftermath of the Stock Market fall, companies were likely to continue both to borrow heavily from banks and to draw down their liquidity. There was a prospect of some months of high credit growth with subdued monetary growth. But such a slowing in broad monetary aggregates would not itself be comforting; the reduction in actual money would be matched by a reduction in that willingly held;

(b) indicators of house price inflation (chart XVII of the Assessment) were moving disparately. But the underlying picture was clearly one of rapid and probably accelerating house price increases;

(c) total bank plus building society lending had been growing steadily at an annual rate of around 19-20% for 18 months, and, while not accelerating, growth at that rate gave increasing cause for concern the longer it continued.

8. Summing up, Sir Peter Middleton said the meeting was agreed that monetary conditions were certainly not too tight and perhaps still looking loose. The implication would be to take advantage of any further opportunities to raise interest rates, if or when they arose, as well as keeping fiscal policy tight.

JWG

J W GRICE

Ex Rels

CONFIDENTIAL

From: Sir G.Littler
Date: 8 February 1988

CHANCELLOR

c.c. Economic Secretary
Sir P.Middleton
Mr Scholar
Mr Peretz
Miss O'Mara

FRENCH IDEAS ON E.M.S.

I had quite a useful talk on 5 February in Paris with Trichet. For immediate purposes:

- although your bilateral with Balladur tomorrow should concentrate on Community financing, you will want to give a bilateral response to Balladur's EMS proposals;
- if there is discussion of these EMS proposals over lunch, following Balladur's brief presentation of them, you may want one or two remarks to offer;
- subject to any reactions from you I should like to ask David Peretz to carry out a little study, in a limited circle including B/E and Treasury only, of (1) ways of promoting official - especially reserves - use of private ecu, and (2) possible roles for a Community financial institution falling well short of a 'central bank'.

2. At Annex A is a summary of the Balladur proposals, with a few elaborations drawn mainly from my talk with Trichet.

3. At Annex B are notes for use in giving a bilateral response to Balladur, and at Annex C a speaking note for a response over lunch - assuming that the main point there will be procedural.

(Geoffrey Littler)

CONFIDENTIAL ANNEX A

THE BALLADUR PROPOSALS

The proposals (English translation attached) are for early action in four areas and for study in a fifth. A summary follows.

1. Same exchange rate discipline for all

The point is stressed that with freedom of capital movement for all the differences of exchange rate regimes will represent a particular 'unfairness' of discipline between member states.

2. Same freedom of capital movements for all

The proposal (already being pursued) is here made without reservation or pre-condition.

3. Same economic and financial obligations for all

There are two parts to this, both addressed primarily to the Federal Republic:

(a) Economic: stronger economies should be prepared/forced to adjust in the same way as weaker ones; otherwise there is not only unfair distribution of the burdens of adjustment - the stronger economy may, as now, drag the others into deteriorating competitiveness vis-a-vis third countries;

(b) Financial: the burden of intervention, and the risks of exchange losses on it, are unfairly loaded on to the weakest currencies - to correct this we should explore: diversification of reserves; official use of ecu; new rules for ecu swaps; symmetry of intervention rules.

4. Same stance towards non-Community currencies by all

The proposals acknowledge progress via the G7 but ask for unspecified extra and stronger action (Trichet was unclear what might be involved here, except that he felt that Germany had not behaved well last autumn).

5. Longer-range Institutional Developments

The proposal here is for a study of both the modalities of developing a single currency for the Community and the scope for moving towards a central bank for the Community.

Commentary

Part of the motive for these proposals being made now is domestic French politics: the European concept has sex appeal in that context and Balladur is seizing the high ground (which could for example be particularly effective against Barre).

But the part to which Trichet attached most importance is that which could help to 'rectify the imbalance' between France and Germany, or the Banque de France and the Bundesbank. In my talk with him he was intensely concerned over the conduct of German economic policy and the damage he sees flowing from the German refusal to take measures to expand their internal demand. By comparison, he sees improvements in the balance between weak and strong currencies in intervention as secondary, although still very valuable.

On the single currency and central bank concepts, Trichet was at pains to stress that this is for the longer term, but he sees the achievement of a true single market as something which

will increase both the desirability of and the pressures for moves in these directions and wants to see study set in hand.

On procedure in the Community generally, Balladur is likely to ask for studies by the Monetary Committee and Committee of Central Bank Governors with a view to some preliminary report by the June ECOFIN - very anxious to get this far during the German Presidency. He knows this will not be easy and will accept that any report by then is likely to be only very preliminary.

0414S

TRANSLATION

Minister of State
Minister for the Economy, Finance
and Privatisation

RTF
29/1/88

Mr Nigel Lawson
Chancellor of the Exchequer
Great George Street
London SW1

Paris, 8 January 1988

Dear Nigel

The events experienced by the world since the end of October, the turbulence on the foreign exchanges and in the stock markets and the consequent public anxiety about the possibility of maintaining balanced growth make it our duty to consider every means that will enable Europe to avoid the worst repercussions of this worldwide crisis.

The Finance Ministers of the seven main industrialised countries have, indeed, implemented a co-operative strategy to correct the serious imbalances affecting the world economy. They reaffirmed their commitment to the stability of the dollar in their joint declaration of 23 December 1987, which includes an implicit undertaking by the central banks to work towards this by whatever means are appropriate.

I hope (undoubtedly like you yourself) that as a result the markets will settle down and recover their stability and public sentiment will be reassured. However, this does not release us from the responsibility to use this respite to strengthen the economic and monetary organisation of Europe of the Twelve. We have to remember that at least half the trade of each of the countries concerned is with members of the European Community. Stable exchange rates within this area are thus a matter of priority.

This is why I believe that the time has come for a fresh move to strengthen the European Monetary System. This is the purpose of the enclosed memorandum. I hope that it can be jointly discussed at an early date.

Yours sincerely

(Signed)
Edouard BALLADUR

0902P

TRANSLATION

EUROPEAN MONETARY INTEGRATION

We had an important meeting in Nyborg last September. We made some substantial improvements to the exchange rate mechanism, adjusting the features of the mechanism for very short-term financing and, in particular, extending this mechanism to the financing of interventions within the margins. Secondly, we took the fundamental decision of giving the official ECU the status of a fully-fledged currency as an acceptable medium for the settlement of debts in relations between central banks. Finally, we agreed to step up the pace of coordination of our economic and monetary policies.

These decisions bore fruit as early as October, when the international monetary and financial disturbances put the European Monetary System to the test. Our earlier decisions enabled the system to stand up well. Intra-marginal interventions were financed jointly by the central banks. The coordination of monetary policy decisions resulted in our bringing about concerted interest rate movements on three occasions. We were thus able to eliminate the tensions which had appeared in the EMS.

However, we have not yet taken all the necessary measures for strengthening Europe's monetary organisation. The exchange rate mechanism still has a number of serious defects. If we do not manage to improve it, we could seriously jeopardise the European monetary system and Europe in general. I believe that it is essential to make improvements to the EMS as it stands today, while at the same time considering the subsequent stages of monetary integration in Europe.

I - THE NEED FOR FURTHER PROGRESS

In view of the violence of the external shocks, flowing from international disturbances which have been particularly serious over the past few months, and the continuing large economic and monetary imbalances between member states, to show complacency at the progress made in Nyborg could be to put at risk what has been achieved for the system so far.

1 - There are deficiencies and gaps in the way the European Monetary System operates.

What are they?

Firstly, because of the asymmetrical nature of the system, the same constraints are not imposed on all the participants. The burden of adjustment and, to a lesser extent since Nyborg, the cost of financing interventions is borne by the countries whose currencies are least in demand.

The different credit mechanisms provisionally enable interventions to be financed by a temporary sharing of the cost among several central banks, although in the end it is the central bank whose currency is at the bottom of the margin which bears the cost. However, the currency at the bottom of the margin is not necessarily "responsible" for the tensions.

As for the discipline imposed by the exchange rate mechanism, the effect may be favourable when it acts as a constraint on economic or monetary policies which are not sufficiently rigorous. It leads to abnormalities when the effect is to exempt countries whose policies are too restrictive from making the necessary adjustment efforts. Thus, the fact that some countries have over a number of years been accumulating current account surpluses amounting to between 2 and 3% of GNP represents a serious anomaly.

This is one of the reasons why European currencies are at present tending to appreciate against the dollar and the currencies linked to it. This trend is against the basic interests of Europe and the European economies. We therefore need to devise a new system which eliminates this disadvantage.

Secondly, the currencies of the main European countries do not yet have the same exchange rate system. At the present time, one group of countries has accepted the discipline of the narrow margin mechanism, namely, the Federal Republic of Germany, France, the Netherlands, the BLEU, Denmark and also Ireland. One of the principal countries of the EEC, Italy, has a wider fluctuation margin. The United Kingdom, Spain, Portugal and Greece are not yet subject to any exchange rate discipline.

This situation is prejudicial to Europe's internal economic coherence and to the balanced working of the exchange rate mechanism.

Up to now the European Monetary System has managed to tolerate such weaknesses. The new situation which will be created by the liberalisation of capital movements and the creation of the large internal market will no longer allow such a diversity of situations. The implications of these changes are such that it will not be possible to maintain the status quo. The creation of a large financial area is in the interest of Europe. The only way to help build it and give it a lasting structure is to press ahead rapidly with European monetary integration.

II - WHAT NEEDS TO BE ACHIEVED

In order to create a solid foundation for the next stage, further improvements should be made to the operation of the system, in the direction already taken by the recent Basle and Nyborg Accords. In particular, a better distribution of the burden which the system imposes on the different economies and a strengthening of the system's cohesion vis-à-vis the outside world are needed.

To this end, the following policies and proposals could be considered:

1 - Creation, within short a time as possible, of the conditions for bringing the European currencies under the same exchange rate discipline.

Two points need to be made here:

a) It would be natural if the same exchange rate discipline were applied to the currencies of those countries whose economic development is comparable to that of the countries participating in the exchange rate mechanism. The United Kingdom and Italy, which are among the seven largest industrial countries, clearly belong to this category and thus have a special responsibility with regard to the EMS.

b) The way for these countries to join the exchange rate mechanism will be made easier by the improvements which can be made to the mechanism at the present time. Of course, joining the mechanism only makes sense if the same fluctuation margin is applied to all currencies.

2 - Early liberalisation of capital movements in the Community as a whole.

The aim of liberalising capital movements is to improve the competitiveness of the European economy as a whole and to prevent inadequate policies from hiding behind artificial barriers. It is in the common interest to achieve this and so active steps should be taken to this end.

3 - Lessening the asymmetry in the system.

a) Steps must be taken to prevent a single country having de facto responsibility for determining the economic and monetary policy objectives of the system as a whole. To this end, overall economic and monetary objectives should be set jointly by the countries that are observing exchange rate discipline. Exchange rate discipline is not compatible with complete autonomy of national economic policies. To achieve these common objectives, there must be close coordination of economic and monetary policies. The coordinated interest rate movements of recent days provide an example of the kind of coordination that is essential. No country must be automatically excused from adjusting its policy as soon as it diverges from the objectives set jointly, whether the policy is over-expansionary or over-restrictive.

b) Gradual steps should also be taken to prevent a major non-Community currency or a single national currency being used in practice as an intervention and reserve currency for the system as a whole.

The diversification of central bank reserve assets is a desirable goal. Of course, it should always be pursued in the system's interests and it should be the natural consequence of interventions aimed at reinforcing the stability of the system. Likewise, the ECU should become a normal reserve asset within the system. To this end, the mechanism of swap operations with the EMCF should be reviewed.

Finally, it is not desirable that, whatever improvements are made to the joint credit mechanisms, the burden of financing interventions should systematically fall on the central bank of the country whose currency is least in demand. This anomaly would be obvious where the country whose currency underwent the largest appreciation diverged most from the previously defined objectives. A precise obligation must therefore be imposed on the currency which tends to diverge abnormally, whether in the upward of downward direction.

4 - Strengthening of the cohesion of the European monetary system vis-à-vis the outside world.

The way in which the exchange rate mechanism operated during the period of market stability which followed last February's international agreements showed the importance of having an orderly framework of exchange rate relations with the main non-Community currencies, whether it be the dollar or the yen. The existence of such a framework clearly depends on partners' willingness to cooperate. Nevertheless, experience proves that, when this is absent, there is a greater need than ever for Europe to speak and act in concert. Europe's monetary competitiveness is a matter of fundamental importance and common concern, which must be given close attention. To protect it requires collective measures. More regular and more systematic consultation procedures must be introduced.

III - THE LONG-TERM DEVELOPMENT OF A SINGLE-CURRENCY AREA

In 1992 Europe will become a fully integrated economic area. The degree of interdependence of each of the EEC Member States, particularly of those whose currency is part of the exchange-rate mechanism, is already very high. Logic dictates that a single-currency area should therefore be established, ie an area within which a single currency would be legal tender in every country and in which there would be a common central institution and "federal" banks in each country.

As you know, various proposals have been made regarding the creation of a European Central Bank. These proposals raise a number of problems. We should list the questions that arise and consider the following points, in particular:

- are there technical prerequisites for the implementation of the single-currency zone?

- would there be arrangements for gradual participation for those countries which were unable to progress at the same speed as the others?

- if the policy were to move towards a single currency, should this be defined in terms of a basket of currencies?

- would one currency circulate within the European area, or several?

- should a single Central Bank be established immediately?

- what should be its functions?

- how would its relations with the Community's political authorities and the national monetary authorities be governed?

*

* *

All in all, we must improve the present system in four areas in order to achieve:

- the same exchange rate discipline for everyone;

- the same freedom of capital movements in all the Member States;

- the same obligations for every country as regards adjusting their economic policies, irrespective of whether their economies are excessively expansionary or restrictive;

- the same stance by all European countries towards non-Community currencies.

At the same time, we must also consider the institutional aspects of European monetary integration. It would be desirable if consideration of this subject could get under way within the next few months.

Translating Services HO-5
PAH, SM
19.1.88

CONFIDENTIAL ANNEX B

U.K. RESPONSE TO THE BALLADUR PROPOSALS

First a quick run over the five areas:

- **1. Same exchange rate discipline for all.**
  Nothing to add to our known position.
- **2. Same freedom of capital movements for all.**
  Welcomes French support on this (which has been crucial in getting the prospect of Community agreement). Might add incidentally that you are aware of French worries about possible cross-frontier tax problems in this context - hope that proposed Monetary Committee study will identify any real problems and dispose of others.
- **3. Same economic and financial obligations for all.**
  This interests us most - see below.
- **4. Same stance towards non-Community currencies by all.**
  Agree in general - importance of holding G7 solidarity as best way forward. Not clear what else we can do.
- **5. Longer-range Institutional Developments.**
  Very dubious about pursuing at this stage the concepts of a future single currency or a future central bank for the Community. This revives the idea of full economic and monetary union. Our view is that we should get a single market first - which may itself create pressures towards greater formal and institutional harmony - and that to try now to plan fuller union would be premature. There are meanwhile some areas in which we and French might be able to find common ground for practical progress: we should concentrate attention on those.

Revert to area of 'symmetry' - much sympathy with French worries about the German position and the dominance of the Bundesbank in the whole EMS system. Distinguish - as Balladur does - between general economic policies and greater symmetry in intervention.

Economic symmetry

Not sure whether we are wholly at one over this. Can see some argument for allowing a degree of presumption in favour of strong, successfully anti-inflationary economies. In the old argument between 'convergence to the average' and 'convergence to the best', we have some sympathy with the latter.

But as regards current German position, we do share worries about the lack of dynamism in the German economy and the risk that their domestic demand will be weaker than they could and should be able to support:

- the array of subsidies and rigidities in their industries (including agriculture) and corporate structures and markets is deplorable: we should go on attacking this;
- their monetary policy must be ready to serve the common interest of exchange rate stability and not be driven only by domestic considerations (their performance on inflation, absolutely and relatively, warrants their taking slight risks of erring on the generous side);
- would welcome accelerated tax and other changes which might contribute to a more dynamic performance;
- but reluctant to press simply for fiscal stimulus of demand.

Intervention Symmetry

We seem to have a good deal of common ground here:

- diversification of official reserves: recognise the German worry about becoming a second reserve currency (know the problems from our old sterling area period), but think they exaggerate the risks; we believe that a more widespread practice of official cross-holdings could improve options available to authorities;
- encouragement of ecu reserves: we are not interested at present in formalities of linking official and private ecu; what does attract us is the idea of developing use of private ecu in official reserves - a Communautaire move; one which would almost certainly deepen and widen the private ecu market; and use of ecu in intervention could help the sharing of financial costs a little;
- review of swap facility: would be glad to pursue at technical level - our idea would be to fit the formal arrangements into a system making use of private ecu;
- symmetry of intervention obligations: an interesting idea, which could perhaps be enhanced if private ecu or ecu valuation were brought in to the process - again needs more technical study.

Finally, these ideas all raise questions about the need to amend the existing EMS Agreement between central banks. One element for which we tried in Nyborg, but seem not to have achieved, was the presumption that central banks (specifically the Bundesbank) could not unreasonably block transactions desired by others - e.g. Bundesbank seeking to block our dealing in ecu!

Not a central bank, but:

It might be worth trying on Balladur - after reiterating our great reluctance to start talking about a central bank - the idea that some Community home might be found for a range of transactions which should not impinge on national policies. For example:

- a clearing system for private ecu transactions in the private ecu market (currently BIS);
- similarly clearing of official reserves transactions in private ecu;
- running the present (or an amended) EMCF swap system;
- offering BIS-type facilities for deposits by central banks in ecu, perhaps also in Community currencies generally, or even in counterpart dollars;
- conducting Community loan operations (currently done by the Commission).

Conclusion

Our preference would be to explore some of these ideas in a quiet way, at least until we are clearer about the substance of them and their practicability. [We are proposing further study in London, in the Treasury and Bank, and would be happy to keep particularly close to the French as we and they make progress in developing any promising lines].

CONFIDENTIAL ANNEX C

U.K. RESPONSE TO THE BALLADUR PROPOSALS

Speaking Note for Lunch

[NOTE: It would be as well to avoid speaking too early - and in particular to try to wait until Germany and/or Netherlands have commented]

I have some sympathy with those who have recalled the view many of us expressed at the end of our Nyborg meeting - that we ought now to have a period of consolidation, rather than at once seek further areas of progress. What we achieved at Nyborg, and only after prolonged discussions, was a better framework of cooperation in use of relative interest rates as well as in the modalities of intervention. It has been working in practice - even under the trying world market conditions of recent months.

I am also very sceptical about the value of studying now the concepts of a single currency and a single central bank. These take us again into the question of full economic and monetary union. I think it is premature. Our main task for the next few years is to build the single market in other respects, and I would prefer to focus on that.

However I do see some areas in which further improvements in the system could be explored, especially perhaps in developing the use of private ecu for some official reserves and intervention transactions.

Agree that officials and central bankers should look into these matters - but let us avoid raising over-ambitious fresh targets and target-dates.

Ex Rel

CONFIDENTIAL

From: Sir G.Littler
Date: 8 February 1988

CHANCELLOR

c.c. Economic Secretary
Sir P.Middleton
Mr Scholar
Mr Peretz
Miss O'Mara

FRENCH IDEAS ON E.M.S.

I had quite a useful talk on 5 February in Paris with Trichet. For immediate purposes:

- although your bilateral with Balladur tomorrow should concentrate on Community financing, you will want to give a bilateral response to Balladur's EMS proposals;
- if there is discussion of these EMS proposals over lunch, following Balladur's brief presentation of them, you may want one or two remarks to offer;
- subject to any reactions from you I should like to ask David Peretz to carry out a little study, in a limited circle including B/E and Treasury only, of (1) ways of promoting official - especially reserves - use of private ecu, and (2) possible roles for a Community financial institution falling well short of a 'central bank'.

2. At Annex A is a summary of the Balladur proposals, with a few elaborations drawn mainly from my talk with Trichet.

3. At Annex B are notes for use in giving a bilateral response to Balladur, and at Annex C a speaking note for a response over lunch - assuming that the main point there will be procedural.

(Geoffrey Littler)

25

THE BALLADUR PROPOSALS

The proposals (English translation attached) are for early action in four areas and for study in a fifth. A summary follows.

1. Same exchange rate discipline for all

The point is stressed that with freedom of capital movement for all the differences of exchange rate regimes will represent a particular 'unfairness' of discipline between member states.

2. Same freedom of capital movements for all

The proposal (already being pursued) is here made without reservation or pre-condition.

3. Same economic and financial obligations for all

There are two parts to this, both addressed primarily to the Federal Republic:

(a) Economic: stronger economies should be prepared/forced to adjust in the same way as weaker ones; otherwise there is not only unfair distribution of the burdens of adjustment - the stronger economy may, as now, drag the others into deteriorating competitiveness vis-a-vis third countries;

(b) Financial: the burden of intervention, and the risks of exchange losses on it, are unfairly loaded on to the weakest currencies - to correct this we should explore: diversification of reserves; official use of ecu; new rules for ecu swaps; symmetry of intervention rules.

4. Same stance towards non-Community currencies by all

The proposals acknowledge progress via the G7 but ask for unspecified extra and stronger action (Trichet was unclear what might be involved here, except that he felt that Germany had not behaved well last autumn).

5. Longer-range Institutional Developments

The proposal here is for a study of both the modalities of developing a single currency for the Community and the scope for moving towards a central bank for the Community.

Commentary

Part of the motive for these proposals being made now is domestic French politics: the European concept has sex appeal in that context and Balladur is seizing the high ground (which could for example be particularly effective against Barre).

But the part to which Trichet attached most importance is that which could help to 'rectify the imbalance' between France and Germany, or the Banque de France and the Bundesbank. In my talk with him he was intensely concerned over the conduct of German economic policy and the damage he sees flowing from the German refusal to take measures to expand their internal demand. By comparison, he sees improvements in the balance between weak and strong currencies in intervention as secondary, although still very valuable.

On the single currency and central bank concepts, Trichet was at pains to stress that this is for the longer term, but he sees the achievement of a true single market as something which

will increase both the desirability of and the pressures for moves in these directions and wants to see study set in hand.

On procedure in the Community generally, Balladur is likely to ask for studies by the Monetary Committee and Committee of Central Bank Governors with a view to some preliminary report by the June ECOFIN - very anxious to get this far during the German Presidency. He knows this will not be easy and will accept that any report by then is likely to be only very preliminary.

0414S

TRANSLATION

Minister of State
Minister for the Economy, Finance
and Privatisation

Mr Nigel Lawson
Chancellor of the Exchequer
Great George Street
London SW1

Paris, 8 January 1988

Dear Nigel

The events experienced by the world since the end of October, the turbulence on the foreign exchanges and in the stock markets and the consequent public anxiety about the possibility of maintaining balanced growth make it our duty to consider every means that will enable Europe to avoid the worst repercussions of this worldwide crisis.

The Finance Ministers of the seven main industrialised countries have, indeed, implemented a co-operative strategy to correct the serious imbalances affecting the world economy. They reaffirmed their commitment to the stability of the dollar in their joint declaration of 23 December 1987, which includes an implicit undertaking by the central banks to work towards this by whatever means are appropriate.

I hope (undoubtedly like you yourself) that as a result the markets will settle down and recover their stability and public sentiment will be reassured. However, this does not release us from the responsibility to use this respite to strengthen the economic and monetary organisation of Europe of the Twelve. We have to remember that at least half the trade of each of the countries concerned is with members of the European Community. Stable exchange rates within this area are thus a matter of priority.

This is why I believe that the time has come for a fresh move to strengthen the European Monetary System. This is the purpose of the enclosed memorandum. I hope that it can be jointly discussed at an early date.

Yours sincerely

(Signed)
Edouard BALLADUR

0902P

TRANSLATION

EUROPEAN MONETARY INTEGRATION

We had an important meeting in Nyborg last September. We made some substantial improvements to the exchange rate mechanism, adjusting the features of the mechanism for very short-term financing and, in particular, extending this mechanism to the financing of interventions within the margins. Secondly, we took the fundamental decision of giving the official ECU the status of a fully-fledged currency as an acceptable medium for the settlement of debts in relations between central banks. Finally, we agreed to step up the pace of coordination of our economic and monetary policies.

These decisions bore fruit as early as October, when the international monetary and financial disturbances put the European Monetary System to the test. Our earlier decisions enabled the system to stand up well. Intra-marginal interventions were financed jointly by the central banks. The coordination of monetary policy decisions resulted in our bringing about concerted interest rate movements on three occasions. We were thus able to eliminate the tensions which had appeared in the EMS.

However, we have not yet taken all the necessary measures for strengthening Europe's monetary organisation. The exchange rate mechanism still has a number of serious defects. If we do not manage to improve it, we could seriously jeopardise the European monetary system and Europe in general. I believe that it is essential to make improvements to the EMS as it stands today, while at the same time considering the subsequent stages of monetary integration in Europe.

I - THE NEED FOR FURTHER PROGRESS

In view of the violence of the external shocks, flowing from international disturbances which have been particularly serious over the past few months, and the continuing large economic and monetary imbalances between member states, to show complacency at the progress made in Nyborg could be to put at risk what has been achieved for the system so far.

1 - There are deficiencies and gaps in the way the European Monetary System operates.

What are they?

Firstly, because of the asymmetrical nature of the system, the same constraints are not imposed on all the participants. The burden of adjustment and, to a lesser extent since Nyborg, the cost of financing interventions is borne by the countries whose currencies are least in demand.

The different credit mechanisms provisionally enable interventions to be financed by a temporary sharing of the cost among several central banks, although in the end it is the central bank whose currency is at the bottom of the margin which bears the cost. However, the currency at the bottom of the margin is not necessarily "responsible" for the tensions.

As for the discipline imposed by the exchange rate mechanism, the effect may be favourable when it acts as a constraint on economic or monetary policies which are not sufficiently rigorous. It leads to abnormalities when the effect is to exempt countries whose policies are too restrictive from making the necessary adjustment efforts. Thus, the fact that some countries have over a number of years been accumulating current account surpluses amounting to between 2 and 3% of GNP represents a serious anomaly.

This is one of the reasons why European currencies are at present tending to appreciate against the dollar and the currencies linked to it. This trend is against the basic interests of Europe and the European economies. We therefore need to devise a new system which eliminates this disadvantage.

Secondly, the currencies of the main European countries do not yet have the same exchange rate system. At the present time, one group of countries has accepted the discipline of the narrow margin mechanism, namely, the Federal Republic of Germany, France, the Netherlands, the BLEU, Denmark and also Ireland. One of the principal countries of the EEC, Italy, has a wider fluctuation margin. The United Kingdom, Spain, Portugal and Greece are not yet subject to any exchange rate discipline.

This situation is prejudicial to Europe's internal economic coherence and to the balanced working of the exchange rate mechanism.

Up to now the European Monetary System has managed to tolerate such weaknesses. The new situation which will be created by the liberalisation of capital movements and the creation of the large internal market will no longer allow such a diversity of situations. The implications of these changes are such that it will not be possible to maintain the status quo. The creation of a large financial area is in the interest of Europe. The only way to help build it and give it a lasting structure is to press ahead rapidly with European monetary integration.

II - WHAT NEEDS TO BE ACHIEVED

In order to create a solid foundation for the next stage, further improvements should be made to the operation of the system, in the direction already taken by the recent Basle and Nyborg Accords. In particular, a better distribution of the burden which the system imposes on the different economies and a strengthening of the system's cohesion vis-à-vis the outside world are needed.

To this end, the following policies and proposals could be considered:

1 - Creation, within short a time as possible, of the conditions for bringing the European currencies under the same exchange rate discipline.

Two points need to be made here:

a) It would be natural if the same exchange rate discipline were applied to the currencies of those countries whose economic development is comparable to that of the countries participating in the exchange rate mechanism. The United Kingdom and Italy, which are among the seven largest industrial countries, clearly belong to this category and thus have a special responsibility with regard to the EMS.

b) The way for these countries to join the exchange rate mechanism will be made easier by the improvements which can be made to the mechanism at the present time. Of course, joining the mechanism only makes sense if the same fluctuation margin is applied to all currencies.

2 - Early liberalisation of capital movements in the Community as a whole.

The aim of liberalising capital movements is to improve the competitiveness of the European economy as a whole and to prevent inadequate policies from hiding behind artificial barriers. It is in the common interest to achieve this and so active steps should be taken to this end.

3 - Lessening the asymmetry in the system.

a) Steps must be taken to prevent a single country having de facto responsibility for determining the economic and monetary policy objectives of the system as a whole. To this end, overall economic and monetary objectives should be set jointly by the countries that are observing exchange rate discipline. Exchange rate discipline is not compatible with complete autonomy of national economic policies. To achieve these common objectives, there must be close coordination of economic and monetary policies. The coordinated interest rate movements of recent days provide an example of the kind of coordination that is essential. No country must be automatically excused from adjusting its policy as soon as it diverges from the objectives set jointly, whether the policy is over-expansionary or over-restrictive.

b) Gradual steps should also be taken to prevent a major non-Community currency or a single national currency being used in practice as an intervention and reserve currency for the system as a whole.

The diversification of central bank reserve assets is a desirable goal. Of course, it should always be pursued in the system's interests and it should be the natural consequence of interventions aimed at reinforcing the stability of the system. Likewise, the ECU should become a normal reserve asset within the system. To this end, the mechanism of swap operations with the EMCF should be reviewed.

Finally, it is not desirable that, whatever improvements are made to the joint credit mechanisms, the burden of financing interventions should systematically fall on the central bank of the country whose currency is least in demand. This anomaly would be obvious where the country whose currency underwent the largest appreciation diverged most from the previously defined objectives. A precise obligation must therefore be imposed on the currency which tends to diverge abnormally, whether in the upward of downward direction.

4 - Strengthening of the cohesion of the European monetary system vis-à-vis the outside world.

The way in which the exchange rate mechanism operated during the period of market stability which followed last February's international agreements showed the importance of having an orderly framework of exchange rate relations with the main non-Community currencies, whether it be the dollar or the yen. The existence of such a framework clearly depends on partners' willingness to cooperate. Nevertheless, experience proves that, when this is absent, there is a greater need than ever for Europe to speak and act in concert. Europe's monetary competitiveness is a matter of fundamental importance and common concern, which must be given close attention. To protect it requires collective measures. More regular and more systematic consultation procedures must be introduced.

III - THE LONG-TERM DEVELOPMENT OF A SINGLE-CURRENCY AREA

In 1992 Europe will become a fully integrated economic area. The degree of interdependence of each of the EEC Member States, particularly of those whose currency is part of the exchange-rate mechanism, is already very high. Logic dictates that a single-currency area should therefore be established, ie an area within which a single currency would be legal tender in every country and in which there would be a common central institution and "federal" banks in each country.

As you know, various proposals have been made regarding the creation of a European Central Bank. These proposals raise a number of problems. We should list the questions that arise and consider the following points, in particular:

- are there technical prerequisites for the implementation of the single-currency zone?

- would there be arrangements for gradual participation for those countries which were unable to progress at the same speed as the others?

- if the policy were to move towards a single currency, should this be defined in terms of a basket of currencies?

- would one currency circulate within the European area, or several?

- should a single Central Bank be established immediately?

- what should be its functions?

- how would its relations with the Community's political authorities and the national monetary authorities be governed?

*

* *

All in all, we must improve the present system in four areas in order to achieve:

- the same exchange rate discipline for everyone;

- the same freedom of capital movements in all the Member States;

- the same obligations for every country as regards adjusting their economic policies, irrespective of whether their economies are excessively expansionary or restrictive;

- the same stance by all European countries towards non-Community currencies.

At the same time, we must also consider the institutional aspects of European monetary integration. It would be desirable if consideration of this subject could get under way within the next few months.

Translating Services HO-5
PAH, SM
19.1.88

CONFIDENTIAL ANNEX B

U.K. RESPONSE TO THE BALLADUR PROPOSALS

First a quick run over the five areas:

- **1. Same exchange rate discipline for all.**
  Nothing to add to our known position.
- **2. Same freedom of capital movements for all.**
  Welcomes French support on this (which has been crucial in getting the prospect of Community agreement). Might add incidentally that you are aware of French worries about possible cross-frontier tax problems in this context - hope that proposed Monetary Committee study will identify any real problems and dispose of others.
- **3. Same economic and financial obligations for all.**
  This interests us most - see below.
- **4. Same stance towards non-Community currencies by all.**
  Agree in general - importance of holding G7 solidarity as best way forward. Not clear what else we can do.
- **5. Longer-range Institutional Developments.**
  Very dubious about pursuing at this stage the concepts of a future single currency or a future central bank for the Community. This revives the idea of full economic and monetary union. Our view is that we should get a single market first - which may itself create pressures towards greater formal and institutional harmony - and that to try now to plan fuller union would be premature. There are meanwhile some areas in which we and French might be able to find common ground for practical progress: we should concentrate attention on those.

Revert to area of 'symmetry' - much sympathy with French worries about the German position and the dominance of the Bundesbank in the whole EMS system. Distinguish - as Balladur does - between general economic policies and greater symmetry in intervention.

Economic symmetry

Not sure whether we are wholly at one over this. Can see some argument for allowing a degree of presumption in favour of strong, successfully anti-inflationary economies. In the old argument between 'convergence to the average' and 'convergence to the best', we have some sympathy with the latter.

But as regards current German position, we do share worries about the lack of dynamism in the German economy and the risk that their domestic demand will be weaker than they could and should be able to support:

- the array of subsidies and rigidities in their industries (including agriculture) and corporate structures and markets is deplorable: we should go on attacking this;
- their monetary policy must be ready to serve the common interest of exchange rate stability and not be driven only by domestic considerations (their performance on inflation, absolutely and relatively, warrants their taking slight risks of erring on the generous side);
- would welcome accelerated tax and other changes which might contribute to a more dynamic performance;
- but reluctant to press simply for fiscal stimulus of demand.

Intervention Symmetry

We seem to have a good deal of common ground here:

- diversification of official reserves: recognise the German worry about becoming a second reserve currency (know the problems from our old sterling area period), but think they exaggerate the risks; we believe that a more widespread practice of official cross-holdings could improve options available to authorities;
- encouragement of ecu reserves: we are not interested at present in formalities of linking official and private ecu; what does attract us is the idea of developing use of private ecu in official reserves - a Communautaire move; one which would almost certainly deepen and widen the private ecu market; and use of ecu in intervention could help the sharing of financial costs a little;
- review of swap facility: would be glad to pursue at technical level - our idea would be to fit the formal arrangements into a system making use of private ecu;
- symmetry of intervention obligations: an interesting idea, which could perhaps be enhanced if private ecu or ecu valuation were brought in to the process - again needs more technical study.

Finally, these ideas all raise questions about the need to amend the existing EMS Agreement between central banks. One element for which we tried in Nyborg, but seem not to have achieved, was the presumption that central banks (specifically the Bundesbank) could not unreasonably block transactions desired by others - e.g. Bundesbank seeking to block our dealing in ecu!

Not a central bank, but:

It might be worth trying on Balladur - after reiterating our great reluctance to start talking about a central bank - the idea that some Community home might be found for a range of transactions which should not impinge on national policies. For example:

- a clearing system for private ecu transactions in the private ecu market (currently BIS);
- similarly clearing of official reserves transactions in private ecu;
- running the present (or an amended) EMCF swap system;
- offering BIS-type facilities for deposits by central banks in ecu, perhaps also in Community currencies generally, or even in counterpart dollars;
- conducting Community loan operations (currently done by the Commission).

Conclusion

Our preference would be to explore some of these ideas in a quiet way, at least until we are clearer about the substance of them and their practicability. [We are proposing further study in London, in the Treasury and Bank, and would be happy to keep particularly close to the French as we and they make progress in developing any promising lines].

CONFIDENTIAL ANNEX C

U.K. RESPONSE TO THE BALLADUR PROPOSALS

Speaking Note for Lunch

[NOTE: It would be as well to avoid speaking too early - and in particular to try to wait until Germany and/or Netherlands have commented]

I have some sympathy with those who have recalled the view many of us expressed at the end of our Nyborg meeting - that we ought now to have a period of consolidation, rather than at once seek further areas of progress. What we achieved at Nyborg, and only after prolonged discussions, was a better framework of cooperation in use of relative interest rates as well as in the modalities of intervention. It has been working in practice - even under the trying world market conditions of recent months.

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However I do see some areas in which further improvements in the system could be explored, especially perhaps in developing the use of private ecu for some official reserves and intervention transactions.

Agree that officials and central bankers should look into these matters - but let us avoid raising over-ambitious fresh targets and target-dates.

pmp

FROM: MOIRA WALLACE
DATE: 8 February 1988

MR GRICE

cc Sir P Middleton
Mr Peretz

MONTHLY MONETARY ASSESSMENT: JANUARY 1988

The Chancellor has seen and noted your minute of 5 February.

MOIRA WALLACE

70/2(B)

FROM: **PETER PATTERSON**
DATE: 9 February 1988

1. **MR PICKFORD** — Seen and approved in draft.
2. **CHANCELLOR**

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir T Burns
Mr Odling-Smee
Mr Sedgwick
Mr R I G Allen
Mr Bottrill
Mr Hibberd
Mr Owen
Miss Simpson
Mr Tyrie
HE/014

a
This was for last Order PQs, now overtaken since Qu1 withdrawn.

UK COMPETITIVENESS

Bryan Gould has recently claimed that British industry is less competitive now than in 1978, and that it has also suffered a sharp loss of competitiveness over the last year (letter to Sunday Times, 31 January - see attached).

2. The "half-dozen indices which are used to measure competitiveness" are probably those in table F3 of the DTI's "Monthly Review of Overseas Trade Statistics". The figures below are taken from the January issue. (In all cases, apart from the relative profitability series, an increase indicates a loss of competitiveness).

UK competitiveness in manufactures
(1980=100)

	Relative export prices	Import price competitiveness	Relative producer prices	IMF indices of relative unit labour costs		Relative export profitability	Sterling Effective Exchange Rate Index (1975=100)
				Actual	Normalised		
1978	84.5	86.0	81.7	67.9	72.2	106.5	81.5
1979	90.4	93.0	89.4	80.7	83.3	102.5	87.3
1984	87.6	92.0	87.7	84.4	93.6	107.8	78.8
1985	89.7	91.8	90.0	85.6	95.0	109.7	78.2
1986	87.4	91.4	87.9	80.4	90.0	111.1	72.8
1987							72.6
1986Q4	83.2*	88.7	83.4	74.2	85.6	112.2	68.3
1987Q1	86.3*	88.7	85.8	76.2	88.4	112.0	69.9
Q2	90.7*	92.2	89.9	80.0	93.3	111.0	72.8
Q3	(90½)≠	92.7	(90)≠	(80)≠	(93½)≠	110.5	72.7
Q4							74.9

* Estimate
≠ Approximate estimate based on later IMF figures

3. The bald figures show that Mr Gould's statements are correct as far as price or cost competitiveness is concerned:

(a) all six measures show UK industry to be less competitive now than in 1978, and

(b) there has been a deterioration in UK competitiveness since the end of 1986.

However these comparisons make no allowance for improvements in non-price aspects of competitiveness.

Competitiveness since 1978

4. Since 1978, cumulative inflation in the UK has been considerably higher than in a weighted average of 15 or so competitor countries, by as much as 50 per cent on some indices. Over the same period sterling's effective exchange rate has depreciated by only about 10 per cent.

5. However, the choice of 1978 rather than 1979 as a starting point favours Mr Gould's comparison because the sterling exchange rate rose steadily from 1978Q2. Compared to 1979, latest estimates of four of the indices show little change in cost/price competitiveness.

6. However overall competitiveness obviously cannot be measured solely by statistics on price and cost competitiveness. It is clear that supply side improvements in industry have considerably advanced the UK's non-price competitiveness since the 1970s, with better performance on delivery dates, reliability and quality of product. This is evidenced not only by industry's improved productivity and profitability, and by the CBI's reports from industry. More tellingly, it is also clear from the performance of our manufacturing exporters since 1981 who have broadly maintained their share of total world trade in manufactures, following decades of decline.

Competitiveness over the past year

7. Mr Gould is correct to assert that cost/price competitiveness has deteriorated over the past year, a reflection of the 10 per cent rise in sterling's effective exchange rate since late 1986. But this only partly offsets the gains in competitiveness which occurred through 1986 as the exchange rate fell following the oil price fall. Cost competitiveness therefore remains some 6-7 per cent more favourable than on average in 1984 and 1985.

8. As the Autumn Statement points out, UK unit labour costs have been rising more slowly than the average in other major industrial countries. However this statement relates

to growth in unit labour costs, measured in domestic currencies, between 1986 and 1987, and not through 1987.

9. The indices of price competitiveness tell a slightly less favourable story than the cost indices because profit margins have been adjusted to absorb some of the productivity gains. The IMF's index of relative normalised unit labour costs attempts to take account of the effects of the activity cycle on labour costs. This also gives a less favourable result since part of recent productivity gains are cyclical. However, we have very strong doubts about the IMF's methodology for constructing this series and do not give it much weight.

Line to take

10. If this is raised at Treasury First Order questions on Thursday, we suggest the following line to take:

> Non-price competitiveness just as important as price competitiveness. Improvement in export performance since 1979 (eg halt in decline of UK manufacturers' share of world export markets) reflects supply-side improvements.

Peter Patterson

P L PATTERSON

31 JANUARY 1988

SUNDAY TIMES

Britain lags far behind, Labour cries

YOU SUGGESTED (Editorial, last week) that British industries are increasingly competitive – a claim constantly made by ministers and endorsed by the prime minister in her Panorama interview.

Yet each one of the half-dozen indices which are used to measure competitiveness shows that British industry is less competitive today than it was in 1978. Indeed, the two most widely used indices – relative export prices for manufactures and relative unit labour costs – show a sharp loss of competitiveness over the last year, and also demonstrate that at no point during the Thatcher years has British industry been as competitive as in 1978.

The insouciance with which false claims are repeatedly made by ministers – the claim that the tax burden has been reduced is another example – and the carelessness with which they are repeated lead to the depressing conclusion that we live under a regime where government propaganda is all too likely to prevail over the facts.

Bryan Gould MP
Opposition Spokesperson on
Trade & Industry

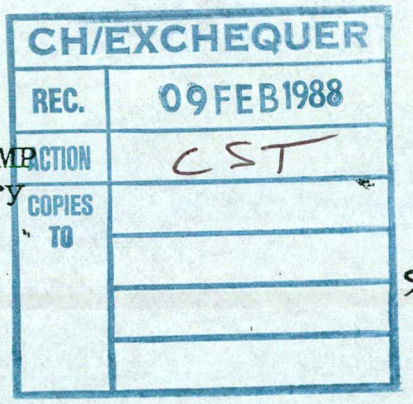
RESTRICTED

BE 10/2 prop

SECRETARY OF STATE FOR SCOTLAND

SCOTTISH OFFICE

WHITEHALL, LONDON SW1A 2AU



9/2

The Rt Hon Kenneth Clarke QC MP
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H 0ET

9 February 1988

Dear Kenneth,

PUBLICISING GOVERNMENT GRANTS

Thank you for your letter of 30 December outlining your proposal to gain more publicity for the larger offers of financial assistance to industry. In general I welcome this idea.

The present arrangements for the very low key publication of our larger offers have, indeed, prevented us from taking sufficient credit for the way in which we are helping industry in the regions. The recent launch of the Enterprise Initiative provides us with an excellent opportunity to reconsider our policy on these matters and to start publicising regional selective assistance cases except when that would be contrary to the public interest or would harm the commercial interests of the firm concerned. Publicity will help also to allay fears that the new measures which we have introduced imply a cut in the assistance available to industry in the regions.

The only reservation I have is that we need to balance carefully our wish for publicity and the applicant's desire to withhold an announcement until his project is sufficiently advanced to protect his market position in relation to his competitors. The only change therefore that I would suggest to your proposals is that publicity should follow a company's acceptance of an offer of assistance, rather than at offer stage since it could be counterproductive to publicise an offer that is then rejected or that relates to a project which then does not proceed. We should consider the timing of our publicity in relation to this.

I am copying this letter to recipients of yours.

Yours ever,

Malcolm

MALCOLM RIFKIND

RESTRICTED

EML039F3

3978/11

mp.

FROM: P J CROPPER
DATE: 9 February 1988

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Forman MP
Mr Tyrie
Mr Call

SMALL BUSINESS COMMITTEE

The Conservative backbench Small Business Committee called on the Chancellor on 21 January. **Present:**

Graham Bright MP **Bill Cash MP**
David Shaw MP **- Hustler, Peat Marwick**
John Townend MP
Henry Bellingham MP **Nigel Forman MP**

Graham Bright spoke to the Committee's budget submission (attached).

David Shaw put the case for tax exemption on the first £100,000 of a company's profits.

Henry Bellingham suggested that the BES was being abused, and favoured an individual holding limit of £5,000. The average BES scheme was too big, and absorbed an unreasonable proportion of available resources. He also favoured a Loan Guarantee Scheme limit in excess of £75,000.

David Shaw favoured BES relief for the entrepreneur himself.

John Townend would exempt shares in private companies from IHT. Decision making had drained away to the South East of England. It was essential that proprietors in other parts of the UK should be allowed to continue running their companies. He would be very happy to see CGT go altogether.

PJC

P J CROPPER

mjd 3/115m

UNCLASSIFIED

FROM: MISS M P WALLACE
DATE: 9 February 1988

MR PORTES

cc PS/Chief Secretary
Miss Peirson
Mr McIntyre

RPI ERROR: LOSERS

The Chancellor has seen and was grateful for your minute of 5 February.

MOIRA WALLACE

10/2/88.

SECRET

TABLE 1 - RESERVE TRANSACTIONS FOR JANUARY 1988

$ million

		Spot	Forward
1.	End December levels	44326	5854
2.	Transactions in January		
(i)	Market	-7	
(ii)	Swaps	-1504	+ 1504
(iii)	Maturities	+ 1764	-1764
(iv)	Other Bank customers	-169	-
(v)	Government		
	(a) departments' expenditure	-103	-237
	(b) public sector debt interest	-82	-
	(c) HMG debt interest	-57	-
(vi)	Interest on the reserves	+ 196	-
TOTAL INTERVENTION		**+ 38**	**-497**
(vii)	Public sector borrowing under ECS		
	(a) borrowing	+ 93	
	(b) repayment	-538	
	net	-445	
(viii)	Repayments of HMG assigned debt	-166	
(ix)	EMCF valuation change	-660	+ 660
CHANGE IN THE RESERVES		**-1233**	**+ 163**
3.	End January levels	43093	6017

TABLE 2 - OTHER COUNTRIES' SPOT MARKET INTERVENTION+

January 1988

($ million equivalent)

	Dollars	OTHER CURRENCIES (including EMS)
Ireland	-	-191 DM
Belgium	+ 129 + 13 agst. DM	+ 479 DM + 4 Swfr
France	+ 610 + 30 agst. DM	+3513 DM
Italy	+ 366 + 30 agst. DM	+ 795 DM + 85 ECU
Netherlands	+ 133(Forward)	-
Germany	+ 415 + 50 agst. Yen	-
Denmark	+ 282	+ 250 DM
Spain	+ 2078	-93 DM
Sweden	-	+ 111 DM
Norway	-	-
Switzerland	+ 163	-
Japan	+ 1060	-
Canada	+ 1217 + 18 agst. Yen + 37 agst. DM	+ 32 Yen + 91 DM
US	+ 235 agst. Yen + 480 agst. DM	-
Greece	-14	-
Austria	+ 10 agst. DM	-
Portugal	+ 39	-

+ On a done date basis. UK figures in previous table are on a dealing month basis.

psec.lb/mr.4 Lords

FROM: Assistant Parliamentary Clerk
DATE: 10 February 1988

01-270 5007

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PS/Customs & Excise
Mr Bonney - IAE1
Mr Gieve - IDT
Mr Hibberd - EA1
Mr Mercer - EC2
Mr Dyer

FORTHCOMING TREASURY BUSINESS IN THE HOUSE OF LORDS

You may wish to be aware that the current forthcoming Treasury business in the Lords is as follows:

ORAL QUESTIONS

Tuesday 14 February Lord Bruce of Donnington - To ask Her Majesty's Government whether they will report on the discussions at the European Community's Economic and Finance Council on the frauds referred to in the question asked by Lord Bruce of Donnington and answered by Lord Young of Graffham on 20 January 1988 (H.L. Deb. Cols. 206-207).

Government Spokesman: Lord Young of Graffham. EC2 Division in the lead.

Thursday 16 February Lord Campbell of Croy - To ask Her Majesty's Government by how much productivity has increased in manufacturing industry in the United Kingdom since 1979.

Government Spokesman: Lord Brabazon of Tara. EA1 Division in the lead.

Wednesday 1 March Baroness Lockwood - To ask Her Majesty's Government why university halls of residence are classified as non-domestic for purposes of Value Added Tax.

Government Spokesman: Lord Strathclyde. Customs and Excise in the lead.

TREASURY INTEREST QUESTIONS

ORAL

Thursday 2 March Lord Jay - To ask Her Majesty's Government what action they are taking to prevent large scale fraud in the distribution of export subsidies by the commission of the European Communities under the Common Agricultural Policy.

Government Spokesman: To be confirmed. Ministry of Agriculture Fisheries and Food in the lead.

Mari Rogerson

MARI ROGERSON

SECRET

MG EVENING REPORT

FOREIGN EXCHANGE MARKETS

Wednesday 10 February 1988

Previous close		Today opening 8.30am	Today close 4.00pm	%change $/currency since Plaza	since Paris	since 16 October 1987
73.9	£ERI	74.0	74.4	-9.3	7.7	1.1
1.7430	$/£	1.7515	1.7625	28.3	15.3	5.9
2.9701	DM/£	2.9691	2.9772	-23.7	6.7	-0.7
1.4391	ECU/£	1.4383	1.4392			
95.2	$ERI	-	94.8	-32.1	-8.8	-5.4
1.7040	DM/$	1.6952	1.6892	68.2	8.1	6.6
129.25	Yen/$	129.05	128.75	85.3	19.3	11.0

Feb $16.60 Mar $16.85 Apr $16.67 Spot Brent Feb $16.15 Mar $16.40 Apr $16.40

UK RESERVE TRANSACTIONS ($million)

(a)

Today	This month so far	Total since 1 Apr 87
8	35	28259
-19	-2	-7330
-11	**33**	**20929**

(a) Spot and forward transactions on a done date basis.

(b) Spot transactions only on a value date basis, as in published figures.

	Estimated end-month position *
Market intervention	29
Off-market transactions	-3
TOTAL	**26**
Net borrowing	-220
Valuation changes	0
TOTAL CHANGE IN RESERVES	**-194**

* On conventional assumption of no further market intervention.

OTHER COUNTRIES MARKET INTERVENTION ($million equivalent)

Belgium	-	Germany	-	Italy	-
Denmark	-	Holland	-	Japan	-
France	-	Ireland	-	US	-

MARKET COMMENT

The dollar eased slightly overnight in New York and in the Far East in very quiet and cautious markets.Markets now await US trade data out on Friday.Japanese holiday tomorrow.In London the dollar continued to ease as the markets took the view that US monetary policy was easing.

Sterling began quietly today and on the sidelines but it saw considerable commercial demand this afternoon mainly from the middle east.It has gained 0.5 on the index,2 cents on the dollar and nearly 3/4 pfennig on the Mark since last nights closes.Worries about the "industrial relations climate" seem to have eased helped by the Chancellorial comments on interest rates made yesterday.

Rates at 5.35PM: $1.7628 DM2.9779 DM/$1.6893 Y/$128.90

I C Polin

HONG KONG	Previous	Today	Change
Hong Kong dollar	7.8055	7.805	0.0005
Hang Seng Index	2223.04	2233.47	10.43
3 month interbank rate	3%	3%	UNCHANGED

NAME: I.C.Polin
TEL NO: 270-5558

SECRET

pse can I have papers for last funding meeting?

M.

Ch/ The answer is overfunding of 4.1

Thanks. Since the PSBR [illegible] for FES/HMA is [illegible] same order – [illegible] agree that this [illegible] this FY? M.

12/2

BF to M

16/2

SECRET

MONEY MARKETS — **Wednesday 10th February**

INTEREST RATES

	£ Interbank		Eurodollar	
	Today	Change	Today	Change
7 days	8 1/8	0	6 1/2	-1/8
1 mth	8 25/32	-3/32	6 5/8	-1/16
3 mth	9 9/32	-3/32	6 11/16	-1/16
12 mth	9 11/16	-1/16	7 1/16	-1/16

BILLS

	Today	Change
3 Month Treasury Bills	8 7/8 - 8 13/16	-1/16

BANK MONEY MARKET OPERATIONS

	Purchases/Sales £ m	Rates	Discount Rate on Eligible Bank Bills
Band 1 (0-14 days)			8 7/16 - 5/16
Band 2 (15-31 days)			8 11/16 - 9/16
Band 3 (32-63 days)	22	8 7/8	8 15/16 - 7/8
Band 4 (64-91 days)	221	8 7/8	8 15/16 - 29/32
TOTAL BILLS	243		
Repurchase			
Lending	30		
TOTAL OPERATIONS	273	against shortage	£ 350 m

US RATES

	3 month CDs	10 yr Tsy Bond	20 yr Tsy Bond
Today/Change	6.55 -0.09	8.14 -0.04	8.40 -0.02

STOCK MARKET

	FT Ind-Ord	FTSE	Gilt index
Today/Change	1364 8	1719 12	88.61 0.26

MARKET COMMENT

GILTS opened easier, with stocks being offered at overnight list prices. Trading was quiet in the morning, and prices recovered losses. There was some late buying, and at the close shorts and mediums were 1/8 up, longs 3/8.

INDEX-LINKED also opened easier, and the slight demand caused the authorities to change the price of the two tranchettes. They finished 1/4 better at close.

EQUITIES had a mixed opening, but prices advanced on hearing of Wall Street's improved opening.

NAME: S Farey
TEL NO: 270 5560

SECRET

GILT-EDGED MARKET — **Wednesday 10th February**

Transactions basis, cash values (£m); sales + purchases -

ISSUE DEPARTMENT: MARKET TRANSACTIONS

	Today	February
Gross sales shorts		13.8
Gross sales mediums		
Gross sales longs and undated		13.0
Gross sales index-linked	39.5	177.1
Part paid calls		0.4
Buying in non-next maturities	-10.4	-116.1
CRND: Market transactions		-18.6
TOTAL 'GROSS' SALES	29.1	69.6
Buying in of next maturities		
Redemptions	-0.8	-31.2
TOTAL TRANSACTIONS WITH MARKET	28.3	38.4

			Future calls	500
Sales required to meet	February	target of	£ 1000 m	431

PRICES/YIELDS OF GILT-EDGED STOCKS

	Yesterday's close: Par yield (per cent)	Change from yesterday's close: Price (£/32)	Change from yesterday's close: Yield (%)
Shorts	9.429	5	-0.05
Mediums	9.665	4	-0.02
Longs	9.504	13	-0.05

REPRESENTATIVE STOCKS

	Price (£/32): Today	Price (£/32): Change	Yield (per cent): Today	Yield (per cent): Change
8% Treasury 1992	95 5	3	9.42	-0.03
8 3/4% Treasury 1997 'C'	44 26	4	9.59	-0.02
11 3/4% Treasury 2003/07	117 4	13	9.75	-0.04
2% Index-Linked 2006	108 4	10	3.95	-0.02
3% Treasury Loan, 1992	83 26	2	7.43	-0.02
8% Treasury Convertible 1990	99 14	4	8.25	-0.06

GILT FUTURES

		Open	Close	Volume
Long Contract	March	118.22	119.06	26691
Medium Contract	March	94.28	95.00	399

NAME: S Farey
TEL NO: 270 5560

EC

10/2/88.

CONFIDENTIAL

Note for the Record

ECOFIN LUNCH: 9 FEBRUARY 1988

The usual informal lunch was held in the margins of the February ECOFIN meeting, from 1 p.m. to 2-30 p.m. Stoltenberg presided. The Chancellor attended for the UK. I attended as Chairman of the Monetary Committee.

Future ECOFIN agendas

2. Stoltenberg said that the idea of bringing the April date for ECOFIN forward from 18 April had not prospered. He therefore proposed that the March ECOFIN agenda should include preparation for the April Meetings in Washington. He would ask the Monetary Committee to prepare a draft Presidency speech in the light of the discussion, which should be circulated at the beginning of April. This was agreed. Ruding, while not dissenting, thought it could be useful for Community Ministers to meet in Washington the day before the Interim Committee [transparently an attempt to make a G7 gathering more difficult!]. After negative mutters from several Ministers Stoltenberg said he thought it unnecessary, but we could see nearer the time!

3. At other points during the lunch discussion, Stoltenberg proposed or accepted the following arrangements, all of which were taken as agreed:

- the April ECOFIN would return to the dossier on capital liberalisation, with further reports from the Monetary Committee and the Committee of Central Bank Governors, and a report from the Council Working Group;

- the May informal ECOFIN would focus on tax harmonisation and also be able to look at particular political points from the capital liberalisation dossier;

- the aim should be to reach conclusions at the June ECOFIN on the whole capital liberalisation dossier;

- the June ECOFIN would also receive reports from the two Committees on the 'Balladur proposals' (see below).

Balladur Proposals

4. Balladur briefly recalled that he had written in January to his Community colleagues raising two categories of questions on further strengthening of the EMS: first, some measures which he thought necessary or desirable for 'perfectionnement' of the working of the system; secondly, the idea of a central bank for the Community, on which he insisted that he had no preconceptions but simply felt that some exploratory thinking would be sensible. He proposed that the Monetary Committee and the Committee of Central Bank Governors be invited to study his proposals with a view to reports for an ECOFIN discussion in June.

5. Eyskens thought the proposals were timely and sensible. Capital liberalisation implied the need for a stronger EMS if the Community's progress was to be coherent. He therefore totally supported the suggested studies and ECOFIN discussion.

6. De La Hesa (Spain) found the proposals interesting in the context of Spain's internal debate over joining the EMS. He was worried about the pace of growth in Europe, which had an important bearing on Spain's grave unemployment problems. The asymmetry of the EMS as it functioned at present was an impediment to progress. He was particularly troubled over the apparent unfairness of an arrangement which Spain had incidentally helped by purchases of some 15 billion of dollars during 1987, but in which the economic benefit to Spain was weak. He therefore supported the proposals.

7. Amato said he supported the proposals basically because successful capital liberalisation needed the kind of economic and financial backing they were seeking.

8. The Chancellor welcomed the proposals, while noting that the second category raised very long-range questions. The Nyborg agreements could not be the last word on strengthening the EMS and it was right to look for further improvements. On sterling, he could only repeat that it would join the ERM but he could not say when; meanwhile it had been 'travelling alongside' for over a year and he intended this to continue. Balladur's first category of ideas was certainly worth studying. The single currency idea could involve some intriguing possibilities, not mutually exclusive, such as: allowing all Community currencies to become legal tender throughout the Community; encouraging much greater use of the ecu (which he would support); and an independent single currency (surely premature). He was well content with the procedure suggested by Balladur.

9. Delors said these ideas must be seen in the context of the prospective single market. He recalled that there were some 300 Directives to be adopted to that end - but they still left other questions unanswered, many of them revolutionary in nature. There should be no thought of pre-conditions, but Balladur had raised important issues on which progress would be helpful. He hoped that a realistic programme of work could be maintained.

10. Cadilhe made a plea for Lisbon to be the site of the Community Central Bank whenever it came into being.

11. Ruding thought some elements of the Balladur proposals were interesting. But he was conscious of three major areas now under discussion: capital liberalisation; tax harmonisation; and strengthening the EMS. He wanted priority to be given to the first, which must be completed as soon as possible. He would give next priority to the second, because of the worries expressed by many colleagues. He thought the third must be considered in the light of the substantial progress already made under that heading. Above all, he urged avoidance of any pre-conditions for different moves, since they could only result in everything being blocked.

12. Stoltenberg picked up remarks by Delors on the programme of work in relation to the single market. Capital liberalisation must now have priority - he hoped to complete decisions by June. He looked forward to an important discussion of tax harmonisation in May, when the informal ECOFIN would also provide an opportunity to look at some political aspects of capital liberalisation. The idea of linkages between different problems should not be given excessive emphasis, and pre-conditions should be avoided. Nyborg had reached good decisions on the EMS, ones which had been tested and found to have worked. Against this background, he thanked Balladur for his proposals and agreed that the Monetary Committee and Committee of Central Bank Goverors should be invited to study them, with a view to some discussion at the June ECOFIN.

13. Balladur expressed his thanks and said he was entirely at one with the President and others in not wanting to be too ambitious.

Greek Economy

14. The Chairman of the Monetary Committee briefly reported on the recent Committee review of the Greek economy - which had given rise to considerable worry, especially at the deterioration of the position of public finances: far from being reduced as had been intended, the PSBR was expanding troublesomely. He said he had followed the usual practice of sending fuller comments to the Greek Finance Minister on a private basis, copied only to the President of ECOFIN and the President of the Commission.

15. Roumeliotis gave a more favourable account of progress, but accepted that the PSBR development was a major concern, which he intended to tackle as vigorously as possible. Stoltenberg concluded that the Commission and the Monetary Committee should continue their monitoring.

World Bank Capital

16. Ruding made available the attached note, but only after the lunch. He urged agreement on a change in the IBRD standard of value, from dollar to SDR, analogous with what had been done in the IMF. There was general agreement among other Ministers that this was sensible, but with the qualification that the U.S. were known to be opposed and they should not be pressed to a point which could endanger the priority need to secure ratification of the general increase in IBRD capital. It was agreed that the Executive Directors in the IBRD representing Community countries should seek to copperate, as was indeed happening.

Stoltenberg's Visit to Washington

17. Stoltenberg explained that he had visited Washington for talks with the IMF and IBRD about the prospective annual meetings in Berlin. But he had also seen Baker, Greenspan and others from the U.S. authorities. He had come away with the encouraging

impression that Baker and Greenspan were now positively interested in maintaining exchange rate stability - and their actions in recent intervention were consistent with this. He thought they had been influenced by the October events, which had not helped prospects for U.S. activity, and the fear that a further exchange rate fall could do similar damage. He could not go so far as to say that exchange rate stability had become a major priority for the U.S. authorities - if they saw a serious threat of recession they might well ignore the exchange rate in their policy reaction. But the climate was certainly better than it had been.

18. He went on to draw attention to the acute problem of certain NICs and their enormous trade and current account surpluses. Some might think this mainly an American problem, but Europe had a huge interest in resolving it and should collaborate in seeking to influence these countries, in particular demanding that they open their own markets.

19. The Chancellor drew attention to the major difference between Hong Kong and Singapore, which had the most open markets in the world, and South Korea and Taiwan, which were very heavily restricted markets and enjoyed much larger trade surpluses.

20. Delors agreed with the Chancellor. In Taiwan and South Korea there was the double problem of trade restrictions and unsatisfactory exchange rates - both must be tackled. He said that the Commission was conscious of the problems and considering how they might be tackled.

(Geoffrey Littler)
10 February 1988

Copies to:

Mr Alex Allan
Sir P.Middleton
Mr Lankester
Mr Scholar
Mr Peretz
Miss O'Mara

Mr Bostock (UKREP)
Mr Loehnis (B/E)

Subject: World Bank standard of value.

The Netherlands proposes the following text for paragraph 32 of the draft report of the Executive Directors to the Board of Governors on the General Capital Increase of the World Bank:

quote
The Directors note that the decision on the standard of value of Bank capital which was taken on October 14, 1986, has made the Bank's headroom vulnerable to the effects of currency fluctuations and contributed substantially to the decline in headroom in the course of 1987. While the proposed increase in capital will provide the necessary headroom, there is no assurance that this problem will not recur towards the end of the period which the GCI is intended to cover, and in subsequent capital increases. Therefore, Directors agreed to establish a Committee of the Board to investigate alternative approaches for the present standard of value. Within three months after the resolution on the general capital increase is adopted by the Board of Governors, the Committee will present its findings to the Executive Board for decision.
unquote

The Netherlands would not be opposed if, upon the establishment of a new standard of value, the Committee of the Board wishes to consider a transitional arrangement to suspend temporarily the maintenance of value payments for those countries that would be subject to these payments under the new arrangements. Moreover, those countries that have or will have used the present repurchase arrangement for national currency subscription (the former so called Philippines formula transaction) will not incur any maintenance of value obligations on portions paid in this manner.

53/2/LPD/3752/003

FROM: P D P BARNES
DATE: 11 February 1988

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Sir T Burns
Mr Odling-Smee
Mr Sedgwick
Mr R I G Allen
Mr Pickford
Mr Bottrill
Mr Hibberd
Mr Owen
Miss Simpson
Mr Tyrie

UK COMPETITIVENESS

The Economic Secretary has seen Mr Patterson's submission to the Chancellor of 9 February.

2. The Economic Secretary thinks that the line we should take in response to Mr Gould is that 'the proof of the pudding is in the eating'. He thinks we should cite the rise in export volumes since 1979 and over the last 12 months, and the end of the long downward trend in the UK share of world manufacturing trade.

P D P BARNES
Private Secretary

I Andrew
(I'm not minded to shoot
A — was for PQ what
was withdrawn)

2 pup

PRELIMINARY DRAFT

2/15/88

AN OVERVIEW OF KEY EXCHANGE-RATE REGIMES

Thomas D. Willett

Claremont Graduate School

and

Claremont McKenna College

Paper to be presented at the Cato Institute's Sixth Annual Monetary Conference "Dollars, Deficits, and Trade: The Changing World Economy," Washington, D.C., February 25-26, 1988.

We have now had roughly a decade and a half of experience with the widespread use of flexible exchange rates among the major industrial countries. We have learned a great deal from this experience but disputes about exchange rate policies and calls for international monetary reform are as frequent and heated as ever. The ranges of views about flexible exchange rates has narrowed somewhat. They have clearly not have been as disasterous as was feared by many critics who foresaw a repeat of the disasters of the 1930s. Neither, however, have they proven to be a complete solution to international monetary issues, eliminating the need for international monetary cooperation and generating international monetary stability as some of the strongest supporters had hoped.

While supporters can plausibly argue that floating rates helped the world economy survive severe strains few can be happy with the absolute level of performance of our international monetary arrangements over the past decade. Thus continuing interest in evaluating alternative exchange rate policies and regimes and considering proposals for reform is quite understandable.

Developments in Exchange Rate Analysis

While there has been only modest narrowing in the range of views held by international monetary experts about preferred

exchange rate arrangements, there has been considerable improvement of our understanding of how exchange rate issues should be analyzed. I should hasten to make clear that the previous statement is meant in the broad sense of the conceptual framework(s) in which exchange rate issues can be analyzed most fruitfully. On the other hand, at the level of more specific questions, such as how are exchange rates determined or what are optimal coordination strategies, our advances in theoretical and exchange research have often left us feeling less rather than more sure that we know the answers. As theoretical models of exchange rate determination and exchange rate dynamic have proliferated, we have gained a much better appreciation of the complexities of the issues involved in discussing equilibrium levels and time paths of exchange ranges, but with little comparable gain in our ability to empirically implement such analysis.

A number of models initially appeared to fit important aspects of the data well but in each case more systematic testing failed to confirm their robustness. Indeed one can argue that one of the major messages of the recent exchange rate literature, with its emphasis on the role of expectations and news and delineation of numerous channels of influence on exchange rates is that we should not expect to be able to give very precise empirical implementation to exchange rate models. We can still argue that there were many good reasons, having largely to do with U.S. economic policies why the dollar fell

substantially in the late 1970s and then soared in the early 1980s but that we can say much less about the short run dynamics of exchange rate behavior.[1]

Perhaps the major analytical lesson that we have learned is the severe danger of analyzing exchange rate issues in isolation. It is now much better understood that the effects of exchange rate changes on major economic variables such as price levels, the volume of international trade, and domestic employment will often depend crucially on the causes of the changes.[2] This applies not only to the quantitative magnitudes of the effects but also to their direction in terms of whether they tend to have a stabilizing or destabilizing influence. As a result of this recognition, debates over such issues as the inflationary effects of fixed versus flexible exchange rates today can rest on much firmer foundations than was true in earlier periods.[3] Modern analysis also makes us wary of sweeping generalizations about the effects of fixed versus flexible rates. As is emphasized in the literature on optimum currency areas and optimal stabilization policy in open economies, evaluations of the effects of alternative exchange rate regimes can vary substantially depending upon the assumptions made about the patterns of economic shocks, structure of the economy, and the weights given to different policy objectives.[4]

Such analysis also highlights another consideration, which will be the central focus of this paper. One cannot

productively analyze the performance of an exchange rate regime independent of its interrelationships with national monetary and fiscal policies. A paper written fifteen or twenty years ago with a title such as "An Overview of Key Exchange Rate Regimes" would have probably focused primarily on the various forms exchange rates arrangements might take, from the extremes of genuinely fixed and freely floating rates through various intermediate forms such as the adjustable peg, wider bands, crawling pegs and managed floating.[5] Today that list would be expanded to include proposals for reference rates, target zones and indicator systems, and alternative intervention strategies for managed floating.[6] These are issues of non-trivial importance. However they are not, in my judgment the most important types of issues for those concerned with how we can best reduce international monetary instability.

Analysis of alternative exchange rate regimes must include careful attention to the interrelationships with national economic policies which are envisioned. The same set of exchange rate arrangements may work well or poorly depending on the behavior of other economic policies. It is now widely recognized for example, that fixed exchange rates are just not workable among countries which insist upon maintaining highly divergent domestic monetary and fiscal policies. Arguments for fixed exchange rates are often made on the (frequently implicit) assumption that they will be accompanied by internationally coordinated national macroeconomic policies.

The mechanisms by which such policy coordination might come about needs to be carefully spelled out and analyzed.

More generally in analyzing alternative exchange rate regimes, we need to carefully distinguish among several distinctly different types of analysis. One is how alternative exchange rate arrangements may be expected to operate under different patterns of economic policies and shocks. A second important aspect of analysis should then focus on the likely patterns of policies and how these may in turn be influenced by the exchange rate regime and policy understandings which go with it. Here political economy analysis becomes crucially important for analyzing both the likely course of unconstrained national policies and how alternative exchange regimes are likely to influence the course of these policies.[7]

Conflicting Traditions in the Analysis of International Monetary Reform

There have been two strong and conflicting traditions in the literature on alternative exchange rate systems and international monetary reform. One views the major objective of exchange rate and international monetary arrangements to interfere as little as possible with national macroeconomic policy making. The other views the international monetary system as a much needed source of discipline over otherwise unconstrained national policy making.[8] These views differ of

course on whether they see national economic policy making as taking place more in line with the public interest view, typically assumed for example by Keynesians or the perverse political pressures view held by many public choice analysts and hard money advocates.[9]

The public interest view of the operation of the political process, combined with the (Keynesian) theory of economic policy a applied to open economics generally leads to optimally managed flexibility as the preferred exchange rate regime (for countries large enough to make an independent currency viable),[10] although the content of optimal management strategies is highly model specific. Those concerned with using the international monetary system to provide discipline over national macroeconomic policies have in turn generally favored a gold standard or some other form of fixed exchange rate system.

Unfortunately the writers in these two traditions have tended to pay relatively little attention to each others' analysis. Compared with the volume of international monetary writings in these two traditions, there has been relatively little analysis presented from the perspective of an intersection of these views which sees a need for institutional reforms to discipline the domestic policy making process, but questions whether international rules are the best way to attempt to impose such discipline.[11] (Different dimensions of the meaning of the best way will be discussed later.)

Conceptually we may distinguish among several different types and/or levels of political analysis needed to "close" the analysis of alternative international monetary regimes. One of course involves considering whether or not domestic political pressures tend to generate non-economically optimal economic policies from the perspective of a closed economy.[12] A second, quite unrealistic in my opinion, but quite commonly adopted (often implicitly) in international monetary literature, assumes political problems only at the international level with self interested national governments' tending to engage in suboptimal (from a global perspective) levels of internationally cooperative actions.

Where political problems are assumed at both the national and international levels, the analysis can become quite complex. In my judgment this is an area which deserves much greater attention. Depending upon the issue in question and the nature of the political forces assumed to be at work, "biases" at the national and international levels may be either additive or offsetting. Judgments on this issue may also differ depending upon the criterion for judgment adopted. For example, it is frequently argued that nationalist concerns will tend to lead to an underprovision of short run exchange rate stability. On the other hand recent analysis of political business cycles and other incentives for time inconsistency problems can generate pressures for self interested national governments to seek arrangements for short run exchange rate

fixity which would increase the incentives for unconstrained national macroeconomic policies to follow strategies with an inflationary bias.[14] One of the lessons which we certainly should have learned is that greater short run exchange rate fixity by itself is not a sure contributor to greater longer run stability.

Political analysis can interact with economic analysis both on issues of feasibility and enforcement. From one perspective, discussions of what is currently politically feasible may be used to narrow the range of policy options to be seriously considered in the short term. From another, analysis of political realities can be crucial to discussions of the need for possible institutional reforms to change the operation of, and/or constrain the outcomes from, the political process. Complementary to such analyses are considerations of the likely operation, i.e., enforceability and workability, of institutional reforms if adopted and of the political feasibility of adopting such institutional reforms in the first place. Unfortunately there seems likely to often be a tradeoff between the latter two considerations, i.e., the more binding a reform is likely to be, the more difficult it will be to reach agreement on its adoption. Thus, for example, our historical experience suggests that it is much easier to get agreement among governments for fixing their exchange rates in the short run than it is to negotiate the constraints on national

macroeconomic policies which would be necessary to make these exchange rates sustainable over the longer run.

There is an urgent need for analysis of all of these types and levels of political analysis. No one of them is the sole correct level of analysis. What is important, however, is that analysits be clear on what type of analysis they are presenting. There is more than enough grounds for disagreements over particular political analysis, just as there is with economic analysis, without further adding to the scope for controversy by failing to make clear the specific type of analysis and political-economic interrelationships being considered.

This is a difficulty which has frequently occurred with proposals for various exchange rate and monetary policy rules. Some have clearly been motivated primarily by concerns about optimal policy strategies, while others have been more concerned with the promotion of discipline and/or rules of the game to limit the use of beggar thy neighbor policies. Often however, the motivation for particular proposals has not been made sufficiently clear.

Rationales for Alternative Exchange Rate Regimes: Optimal Discretion, Policy Rules and Constraint Systems

Let us consider some of the major possible rationales or objectives for exchange rate regimes. From the standpoint of

public interest (or ideal political process) decision making, the question would be one of facilitating optimal discretionary policy responses. From a traditional Keynesian optimal policy perspective, the content of such policy strategies would include official intervention to offset destabilizing speculation and internationally coordinated monetary, fiscal, and intervention policies to optimally offset other economic and financial shocks.

With imperfect information, case by case discretion would move toward, and in the limit, be replaced with policy rules which determine policies on the basis of estimates of or views about the average pattern of disturbances.[15] These rules might become quite complicated, focusing on a large number of indicators as in some of the current indicator proposals. Combined with imperfectly internationally oriented national decision makers, a case emerges for forums for discussion and enforcement of internationally coordinated discretionary policies or policy rules. In the absence of willingness of national governments to cede such authority to an international body, rules limiting the range of permissible national policy actions and/or requiring particular policy actions under specified conditions become an attractive strategy.

Commonly proposed examples of such international rules or guidelines of a negative type are limits on the cumulative amount of and/or circumstances of official intervention in the foreign exchange market, e.g., prohibitions on aggressive as

opposed to leaning against the wind intervention.[16] Requirements to intervene if exchange rates move outside of an internationally agreed target zone are an example of a frequently proposed positive rule.[17] With a still lower level of international cooperation, such rules might be given a presumptive role as a basis for marshalling moral suasion.

While a great deal more analysis of this issue is needed, I would conjecture that when imperfections in the operation of domestic political processes are systematically introduced the case for focusing on exchange rates as the basis for policy rules is likely to be substantially reduced. Conceptually the discipline argument for institutional reforms presents more of a case for the imposition of constraints on policy outcomes rather than for policy rules per se.[17] In other than new classical economic models, the particular form of a policy rule adopted will typically have a substantial influence on the performance of the economy (and this can occur in some new classical models as well). Ideally one would like a constraint system to allow economically optimal policy outcomes while limiting the scope for deviation from this outcome due to political pressures. Unfortunately much of the literature fails to make a clear distinction between the case for optimal policy rules from the standpoint of the traditional theory of economic policy and the case for national and/or international constraint systems to offset political biases and/or beggar thy neighbor policies.

The Difficulties of Converting Optimal Policy Rules to Sensible Constraint Systems

With a particular dominant type of disturbance, we may be able to achieve both objectives with a particular policy rule. For example, if international currency substitution and portfolio shifts were the only major sources of disturbance than Ronald McKinnon's proposal of fixed exchange with non-sterilized intervention determining the domestic money supply would be an optimal (or at least quite reasonable) policy rule.[18] However, a domestic monetarist like Milton Friedman sees a quite different pattern of disturbance than does an international or global monetarist like McKinnon.[19] Thus Friedman prefers a fixed national money supply rule for the major industrial countries combined with flexible exchange rats among them. Likewise gold standard advocates and Keynesians assume still different perponderant patterns of disturbances.[20] It is certainly difficult and likely inappropriate to try to obtain fundamental institutional reforms whose desireability is highly dependent upon the answers to questions which are open to considerable controversy among mainstream economists. On this view one should seek to reach agreement on constraint systems which seem reasonable albeit non-optimal to a substantial proportion of experts. Taking such a constitutional perspective also suggests the desireability of simplicity and enforeceability in the design of institutional

reforms.[21] The combination of these considerations presents a strong case for domestically rather than internationally focused constraint systems.

On the basis of simplicity and easy technical enforceability the pure form of McKinnon's fixed rate proposal is quite attractive. As he himself describes it, his proposal presents the basic attractive features of the gold standard rules of the game while doing away with the need to depend on the vagarities of the gold market. But converted from a policy rule to a constraint system this attraction quickly disappears. How do we allow a loose version of this approach? Systematic partial sterilization would make little economic sense and would make even less as a political rule. Mandatory nonsterilized intervention at the limits of some target zone for exchange rates would be more attractive as a constraint system. However as with gold based systems, such a regime would still be subject to the problems of making reasonable estimates of initial equilibrium rates and of the disequilibrating effects on domestic money growth which would result from changes in equilibrium real exchange rates. Recent empirical studies on purchasing power parity and exchange rate behavior suggest that this is a possibility which must be taken very seriously.[22]

Looking at the behavior of exchange rates along with that of many other variables makes considerable sense in the formulation of discretionary monetary policy, including

discretionary behavior within a broader constraint system. The design of a sensible mechanical relationship between the exchange rate and domestic monetary policy is a quite different question. For example, consider the dollar in 1985. It was high but falling. Did this indicate a stronger case for monetary ease or tightness?

The case becomes even more difficult in looking at the relationship between the exchange rate and fiscal policy. While proposals for target zones for exchange rates were initially put forth largely to deal with perceived problems of destabilizing or insufficiently stabilizing speculation, in his recent writings, John Williamson has stressed the potential role of target zones in promoting fiscal discipline.[23] A set of mechanical rules for adjusting fiscal policy in response to exchange rate movements could certainly be devised, but it seems unlikely that one would find a rule which produced desirable behavior under a plausible range of circumstances. Still more difficult perhaps would be trying to sell such a rule for fiscal discipline to national legislatures. As a presumptive guideline there could be some value to such an approach but my reading of the situation is that much stronger forms of reform are required for us to be able to reasonably expect a substantial sustained reduction in international monetary instability. This issue of fiscally produced instability would remain a problem even under the adoption of a

full scale fixed exchange based set of rules for monetary policy à la McKinnon.

The Case for Domestically Versus Internationally Based Constraint Systems

Concern with the technical feasibility of assuring consistency among policies complements optimal policy and simplicity arguments for domestically based constraint systems. The latter may be expressed relatively straight forwardedly in terms in limits of the size of (possibly full employment) budget deficits and rates of monetary growth. Money growth rules could specify a range on the permissible average rate of growth of some monetary variable or allow for deviations from a target range for average rates of inflation or nominal income to force adjustment in the growth rates of a monetary variable.[24] With a constraint system approach, this type of feedback system need not give rise to the type of dynamic instability likely to occur from a tight short term linkage between price and money growth variables.

Such a domestic constraint system would allow exchange rates to move consistently with underlying economic conditions. Exchange rate variability would not be eliminated but it would be reasonable to expect that much of the plunge of the dollar in the late 1970s and surge in the first half of the 1980s would have been avoided because variability in U.S. monetary

and fiscal policies would have been reduced. Residual concerns about possible excessive short term exchange rate variability due to destabilizing speculation could still be addressed through official intervention, perhaps even geared to a soft system of target zones. Considerable analysis of the details of both the domestic constraint systems and the exchange market provisions would be needed in order to formulate the best specific for such a system, but their essential characteristic would be that exchange market provisions would be secondary to the domestic monetary and fiscal policy constraints.

The fundamental alternative is the set of proposals under which exchange market developments drive domestic monetary and fiscal policy. Historical experience suggests that with support from the United States an international agreement placing considerable limits on short term exchange rate variability would be much easier to achieve than would the type of domestic constraint system described above. It seems doubtful, however, that effective agreement would be reached on the types of rules for domestic monetary and fiscal policy which would be necessary to make the system of short term exchange rate fixity consistent with longer term stability. There is considerable question whether one could overcome the technical difficulties involved in designing the quantitative specification of policy rules which would avoid dynamic instability and/or persistent payments disequilibrium and the forcing of changes in monetary and fiscal policy which would

have serious destabilizing effects on the domestic economies.[25] Nor would these seem to be the types of reforms which would be likely to generate substantial political support.

A Summing Up: Our Fundamental Choices in a Politicized World

While there are many fascinating details of alternative sets of exchange rate arrangements which deserve attention, at the most fundamental level we have a choice among four types of exchange rate and international monetary regimes in a world in which biases in the operation of political pressures play a major role in the determination of unconstrained domestic macroeconomic policies.

We may have either of two variants of disciplined or constrained systems, one focused on exchange rates and the other domestically oriented. We may likewise have two types of regimes with relatively unconstrained domestic monetary and fiscal policy. These unconstrained variants may have either pegged or flexible rates in the short run, but historical experience suggests that both would produce considerable global economic instability over the long run. In a world of political economic policies, the case for fundamental institutional reforms to help promote long run economic and financial stability, including exchange rate stability, is strong.

In my judgement for the major industrial countries we should look for greater exchange rate stability primarily as a consequence of, rather than as a means to, greater domestic financial stability. Conceptually domestic monetary and fiscal policies can be geared to the exchange rate regime, but on grounds both of best promoting macroeconomic stablity if followed and of the political likelihood that consistent policies actually would be followed, the weight of historical experience suggests to me that exchange rate regimes should be designed in light of domestic financial considerations rather than vice versa. If this view is correct, then the most fundamental issues concerning the design of exchange rate regimes are strongly dependent upon the analysis of domestic monetary and fiscal policy and institutions.

Adoption of floating exchange rates was not the cause of the acceleration of world wide inflation in the 1970s as some have argued. Since national monetary and fiscal policies were not systematically linked in practice to obligations to maintain pegged rates, little systematic discipline was imposed and the major pressures in the U.S. which generated the acceleration of inflation (associated with the financing of the Vietnam War) were initiated under pegged rates.[26] While it is a debatable issue, on balance it seems likely that floating rates have generated more discipline on average than have pegged rates unaccompanied by specific linkages to national macroeconomic policies.

What seems clear, however, is that even if on balance floating rates promoted more rather than less discipline, this was still woefully inadequate. Floating rates in and of themselves are not sufficient to provide adequate financial discipline. Further institutional reform to place explicit limits on the range of permissible discretionary variations in national monetary and fiscal policies is urgently needed. While such reforms would likely conflict with the short run political advantages of many powerful officials, and hence will be difficult to achieve, it would be in the long run interests of countries adopting such reforms. By reducing the export of instability such reforms would also be desirable from the standpoint of a country's trading partners.

While ultimately such reforms would be national decisions and the specifics could well vary from one country to another, it would be desirable to approach such reform efforts within a cooperative international framework rather than exclusively as matters of unilateral national actions.

I have argued that for the major industrial countries such reforms should be focused primarily on domestic rather than exchange rate criteria. There are two major caveats to this proposition. One is that as is stressed in the theory of optimum currency areas, for smaller countries it may be more economically desirable to peg to a relatively stable larger country or to join to others with other small countries to form a currency area.

A second is that in the dynamic of establishing a political and economic climate within which the adoption of more fundamental institutional reforms would become feasible, it is possible that exchange rates-linked understandings could sometimes prove useful. The latter type of argument should be approached with considerable caution. The experiences with the European Economic Community have found the linkages from economic reform to political integeration to be much weaker than many advocates had hoped. There is also always a danger that such evolutoinary strategies will succumb to the promises of quick political fixes which fail to produce longer run stability while diverting attention from more fundamental issues. Still the avoidance of economic warfare after the breakdown of pegged rates in the 1970s is an important example that there can be some truths to such evolutionary arguments. The failure of the most recent experiences of the European Monetary System to be obvious failures, albeit that "success" has depended on the widespread use of capital controls, suggests that efforts at exchange rate related evolutionary strategies deserve further attention.

Except for small countries, however, such strategies should be seen as complements to, rather than as substitutes for, concerns with directly establishing limits over the range of discretion for national monetary and fiscal policies. It is the behavior of the latter which determines the feasibility of alternative exchange rate regimes.

ENDNOTES

[1]I should like to emphasize that I am not arguing that theoretical and empirical research on exchange rate dynamics and speculative behavior is a waste of time, but rather that we should not expect highly accurate short term forecasts or strong consensus on equilibrium levels of rates to emerge from this process. For recent analysis and references to the literature on exchange rate modelling and forecasting, see, for example, Arndt, Sweeney, and Willett (1985); Bhandari (1987); Bhandari and Putnam (1983); Bigman and Taya (1983); Bilson and Marston (1984); and Jones and Kenen (1985).

[2]See, for example, Arndt, Sweeney, and Willett (1985) and Willett (1982).

[3]See, for example, Corden (1977); Crockett and Goldstein (1976), Darby, et al. (1983), and Willett and Wolf (1983).

[4]See, for example, the analysis and references in Arndt, Sweeney, and Willett (1985), Buiter and Marston (1985), Kenen and Jones (1985), and Willett (1985).

[5]See, for example, Halm (1970).

[6]See, for example, Frankel and Goldstein (1986), Kenen (1987), and Williamson (1986), and (1987).

[7]For examples and references to the literature which takes political economy approaches to domestic and international monetary relations, see Cohen (1977), Lombra and Witte (1982), and Willett (1983) and (1988).

[8]For discussions and references to the literature on the discipline debate see Willett and Mullen (1982).

[9]On these different views see Buchanan and Wagner (1977) and the papers by Willett and Banaian in Willett (1988).

[10]See, for example, Tower and Willett (1976).

[11]Of course Milton Friedman has long advocated such an approach with his emphasis on domestic monetary rules. For recent analysis along these lines, see Genberg and Swoboda (1987), Gutowski (1978) and (1979), and Willett (1987).

[12]For analysis and references to the literature on this question see Willett (1988).

[13]A number of examples of such analysis may be found in Buiter and Marston (1985).

[14]See Rogoff (1985), Vaubel (1986), and Willett and Mullen (1982).

[15]See, for example, Tower and Willett (1976).

[16]For examples of discussions of these issues during the Committee of Twenty Negotiations over international monetary reform during the 1970s see de Vries (1985); Willett (1977); and Williamson (1977).

[17]Of course the ideal institutional reform would be one which removes the biases in the decision making process in the first place. For the purposes of this paper I shall assume that the scope for much first best reforms is quite limited.

[18]See, for example, McKinnon (1984) and (1985), and Willett (1985).

[19]While some initial empirical research did support McKinnon's view on the importance of international currency substitution for the United States, these findings did not hold up strongly in the light of subsequent research. For recent critical surveys of this empirical literature see Willett, et al., (1987).

[20]See, for example, Mayer and Willett (1988).

[21]Such a perspective refers to the analysis of fundamental rules of the game. They need not be formally embedded in constitutional provisions. For recent examples of analysis taking such a perspective see Dorn and Schwartz (1987).

[22]See, for example, the analysis and references in Arndt, Sweeney, and Willett (1985), Darbey, et al. (1983).

[23]See, for example, Williamson (1986) and (1987) and for critical analysis see Branson (1986); Cooper (1986); Fischer (1986); Frenkel (1987); and Frenkel and Goldstein (1986).

[24]For discussion and references to the literature on the alternative possible forms and targets of such constraint systems see Dorn and Schwartz (1987).

[25]See, however, Edison, et al. (1987).

[26]See, for example, Barro (1982) and Calleo ( ) for statements that the breakdown of pegged rates and gold convertibility played an important role in reducing discipline in the United States. For empirical work reaching the opposite conclusion see Briggs, et al. (1988) and Darby, et al. (1983).

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Paper to be presented at the Cato Institute's Sixth Annual Monetary Conference

Draft

February 1988

Toward An International Commodity Standard?

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Determination of the basis for a national currency is one of the foremost attributes of national sovereignty. At irregular intervals over the past half century countries have been urged to link their currencies by more or less rigid formulae to a variety of commodity baskets, with contents varying from one (gold) to several dozen commodities, and even beyond to an index of prices of goods and services, with varying intermediate combinations. Usually the stated aim is to assure stability of the real value of money or, what is not the same, to reduce uncertainty in the real value of money. These objectives are typically assumed to be sufficient unto themselves, but sometimes they are justified as reducing uncertainty for business and household decisions that involve allocation of resources over time, and thereby contributing to national well-being.

This paper will discuss the desirability of basing an international monetary system - encompassing the formal rules and conventional practices governing payments among residents of different nations - on a basket of

commodities. To anticipate the conclusion, it finds that such a move, while technically workable (though difficult) would not have much to recommend it, and it offers an alternative suggestion for improving the international monetary system: a common currency among the industrialized democracies, with a common, jointly agreed monetary policy, which might well be targetted on some measure of price stability.

But as background it will be helpful first to review briefly the various suggestions that have been made over the years to tie a given national currency to commodities - to tie money to the real economy so as to "anchor" the price level in some way.

National Commodity-based Monetary Systems

Commodity Money. The most straight-forward way to link a national currency to the real side of the economy is to have a commodity *be* the currency, or, closely related, to require the money-issuing authority buy and sell the currency for the commodity at a fixed price (perhaps with a seigniorage charge between a buying and a selling price), as was done under the metallic standards - usually based on gold or silver, occasionally copper - of bygone times. But unless the commodity in question is an unusual one, representative of the whole collection of goods and services in which producers and consumers have an interest, this procedure will lead both to flucuations over time in the growth of the money supply and to fluctuations in the general price level measured in terms of currency and of the monetized commodity. This is simply a manifestation of changes in the commodity terms of trade, for any commodity in terms of others, that will occur in any economy undergoing continual changes in technology and in the level and composition of final demand. If P is an index of money prices of a broad and relevant

collection of goods and services, P_G is the money price of the monetary commodity (e.g. dollars per ounce of silver), and T is an index of the terms of trade between the monetized commodity and the other goods and services, then

$$P = P_G \times T \qquad (1)$$

A commodity standard fixes P_G by law or convention. But that is not sufficient to assure the stability of P, the widely accepted objective, so long as T is not also fixed. But T will vary in response to variations in the relative supply and demand for the monetized commodity relative to other goods and services. If P_G is fixed, P will vary with T. Moreover, not only will P be variable, but it will also be unpredictable except insofar as future movements in T can be predicted with confidence. More will be said below about the stability and the predictability of P under the historical gold standard.

Commodity-convertible Money. The foregoing problem can be mitigated by enlarging contents of the monetized commodity basket. Alfred Marshall (1926) suggested a century ago that a basket comprising fixed weights of gold and silver, with the price between them free to vary, would offer a more stable monetary medium (measured in T or P) than would gold or silver alone. Edgeworth dubbed it a symmetallic standard, to differentiate from a bimetallic standard, based on gold and silver at a fixed price, which ran the risk, under Gresham's Law, of evolving into a mono-metallic standard, as one or the other became more valuable as a commodity than as money. (Isaac Newton had undervalued newly reminted silver coins relative to gold in 1717, and thus inadvertantly put Britain on the gold standard as silver was exported; a similar development occurred in the United States in 1834, when legislation

designed to correct an undervaluation of gold in terms of silver overdid it by altering the mint ratio from 16:1 to 15:1, and full-bodied silver ceased to circulate as money.)

A logical extension of Marshall's symmetallism would be to enlarge the basket of commodities, fixed in quantities, in which money is defined and against which it is issued. Such a proposal was put forward by Benjamin Graham (1937) in the 1930s.[*]

[*] The next few paragraphs draw heavily on Cooper (1982), pp. 38-43.

Graham proposed that the dollar be defined in terms of a fixed-weight basket of 23 commodities, and that the Federal Reserve issue notes against warehouse receipts for the basket thus defined. He selected his commodities on the strength both of their economic importance and their storability, and they included the standard list of such commodities, varying from coal to wood pulp. Graham was motivated in large measure by anti-depression considerations; the idea was first advanced in 1933. He felt that support for commodity prices in times of economic slack would help stabilize overall economic activity. By the same token, sale of the commodity basket (demonetization) would limit inflationary pressure in booms, both by supplying commodities out of stocks and by contracting the money supply. His scheme in effect would provide perfectly elastic demand for the commodities (taken as a group - their individual relative prices were free to vary) in the monetary unit in times of depressed economic activity, and perfectly elastic supply (so long as physical stocks lasted) in times of boom.

Graham envisioned that his scheme should supplement the then-existing monetary system. His unrelated namesake Frank D. Graham (1942) carried the

proposal further. He would have included a much longer (but unspecified) list of commodities in his basket, and he would have required all future money growth to be based solely on purchases of warehouse receipts for these commodities, in the stipulated proportion. This proposal would have tied money growth directly to production of the monetized commodities, in this respect much like a metallic gold standard but with an enlarged basket.

Stabilizing the price level of a basket of storable commodities will stabilize the general price level only if the terms of trade between the monetized commodities and other goods and services is unchanging over time, an improbable event. Broadening the basket from a single commodity may help, but the problem in equation (1) remains: fixing P_G will not in general stabilize P. For instance, over the period 1947-1986 the price index for crude materials - which includes all the items in Graham's list plus some - increased by 177 percent. Prices of finished manufactured goods rose by 291 percent over the same period of time, and prices of services in the consumer price index rose by 684 percent. Reducing the price increase of crude materials to zero would not have avoided inflation in a broader index.

Apart from this problem and from the fact that real resources are tied up in the warehoused monetary commodities - proponents have placed the annual costs at 3-4 percent of the outstanding value - it is unclear why there has not been more enthusiasm for commodity-reserve proposals. While they could not stabilize the general price level, they might make its movements more predictable, insofar as prices of finished goods and services have a reasonably stable relationship to commodity prices, about which more will be said below. Yet these proposals have found little interest beyond intellectuals. I suspect that conservatives really want gold, for reasons of

history and sentiment, whereas non-conservatives prefer managed fiat money.* Also, the schemes are too complicated to appeal to a wider public.

> * It is of interest, though, that F.A. Hayek (1943) viewed commodity money favorably.
>
> Keynes and Friedman both opposed it. Keynes, though highly supportive of stabilization schemes for individual commodities, opposed a commodity reserve currency on the grounds that it would have the same disadvantages as a gold standard in failing to persuade organized labor that they should keep their demands for money wages in line with the increase in efficiency wages (that is, productivity). He considered the risk of excessive money wage demands as one of the major obstacles to maintenance of a full employment economy. See his 1943 letter to Benjamin Graham, reprinted as an appendix to B. Graham in Yeager (1962), pp. 215-17.
>
> Milton Friedman (1953) also opposed a commodity-reserve currency on the grounds that a full commodity-reserve currency, lacking the mystique and historical legitimacy of gold, would in time become financially burdensome because of the real costs associated with it. This in turn would lead in effect to discretionary policy, which he also opposed. It is therefore dominated both by a gold standard, with its mystique, and by a properly managed fiat money, which Friedman favors.

The Tabular Standard. In the mid-1960s Albert Hart, Nicholas Kaldor and Jan Tinbergen revived the idea of commodity reserve currency in an explicitly international context, and their proposal will be taken up below. But before doing so, it is worth mentioning the logical extension of the commodity-money idea in the context of a national currency to the entire basket of goods and services which is deemed to be the relevant price level for purposes of stabilization. This is known as the "tabular" standard and was described by W. Stanley Jevons in 1975, advocated by Irving Fisher in 1920, and revived by Robert Hall in 1982. Fisher, writing during the gold standard period, proposed that the definition of the dollar in terms of gold should be indexed to the cost of living. In this way not only contracts written in nominal terms but currency itself in effect would be indexed so as to stabilize their [illegible], except during the intervals between adjustments. If,

for instance, the cost-of-living index fell, the number of grains of gold that defined the dollar as a unit of account would be reduced by a corresponding amount. For purposes of settling debts, the real value of the dollar would be preserved, since more gold would be required to settle a given dollar debt. The reverse adjustment would take place if the relevant price index rose. In terms of equation (1), P_G would be adjusted exactly to compensate for movements in T, thus stabilizing P over time.

This scheme amounts to the full indexation of all contracts, including gold convertible paper money, against changes in the value of gold, with gold remaining the formal basis of the dollar. Fisher would also have adjusted the gold money supply in parallel with adjustments in the gold value of the dollar. If the price level fell, for instance, the dollar price of gold would be raised, and gold would flow into the Treasury (against the issuance of gold certificates) from private holdings, from abroad, and eventually from new production. The reverse would occur if the price level rose. Fisher would have reinforced this natural influence by issuing new gold certificates against the capital gains on existing Treasury stocks of gold, or by retiring gold certificates in the event of rising prices.

Robert Hall (1982) has revived the idea of a tabular standard (without endorsing it), but he suggests substituting for gold a fixed-weight basket of four commodities (ammonium nitrate, copper, aluminum, and plywood, ANCAP for short) whose index tracked well the U.S. consumer price index over thirty years. The dollar would be defined in terms of the ANCAP basket, and the basket would be legal tender in settlement of debts. Bank notes could be issued freely, fully redeemable in ANCAPs. When the consumer price index rose, the dollar would be redefined to contain more ANCAPs. In this way,

dollar contracts with deferred payment would involve repayment that was constant in terms of purchasing power, as measured by the consumer price index. Unlike Fisher or the Grahams, Hall would not require or even permit the government to engage in purchases or sales of the commodities comprising ANCAP. It would simply define the dollar in terms of ANCAP and endow them with the attribute of legal tender, so that debts could be settled in ANCAP or paper claims on them. Private arbitrage, which would involve some physical storage of the commodities in the ANCAP basket, would ensure that a paper dollar or dollar demand account remained equal in value to the current ANCAP definition of the dollar.

Price-level Target. Storage costs could be avoided by dropping the intermediary commodities (gold in Fisher's proposal, the ANCAP basket in Hall's) and simply gearing monetary action to a target price level. If the price level rose above the target, the monetary authorities would take steps to reduce some definition of the money supply (relative to trend), or to raise interest rates; and the reverse if the price level fell below its target. The action could be governed by formula. Since this approach would not involve the direct purchase and sale of commodities, however, the linkage between changes in monetary policy and prices would be an indirect one, mediated not only by the real economy but also by the responsiveness of the public to, say, additions or subtractions from some measure of the money supply. How close and how reliable is the linkage between money and prices is a deeply controversial question. It has been known for years, moreover, that when there are response lags in the system, maintaining steadiness in one variable (the price level) by controlling another variable (the money supply, or short-term interest rates) in the face of diverse and not directly observable shocks is not an easy task, and indeed if improperly formulated even well-intended

policy actions may lead to less rather than greater stability (Phillips, 1954).

Furthermore, if the response lags themselves are unknown and variable, simple formula-based control will be sub-optimal, and might even be destabilizing. This observation points to discretionary control of monetary policy, aimed at a well-defined target such as stability in some measure of the price level. This conclusion presupposes, of course, that the complex and not fully articulated "feeling" of the monetary authorities in a variety of circumstances will yield superior results to a formula-based response. This presupposition is and will continue to be a source of continuing controversy, involving as it does a comparison of discretionary responses that will always, ex post, be sub-optimal except by sheer good luck, with a formula-based response which can always, ex post, be made optimal with sufficient imagination. But of course that is not the relevant comparison for comparing regimes with respect to future disturbances and responses.

If a price level is to be targetted, a *specific* measure of the price level must be chosen. What should it be? The consumer price index is the obvious choice, but that involves certain problems when considered in the context of an international monetary system, taken up below. Moreover, in an open economy the consumer price index contains imported items, and thus may be strongly and directly influenced by prices of imported goods, a problem that is less acute for value-added deflators.* The appropriate choice requires careful

* But not entirely absent insofar as some domestically produced goods are in close competition with foreign-produced goods.

consideration of exactly what ultimate objectives are to be served by price level stability.

Even the notion of price level stability, on any particular measure, requires more careful specification if it is to be targetted. Do we mean by stability *constancy* over time, i.e. an expectation of return to a particular level? Or do we mean that it should not change from where it is now, i.e. a zero expected rate of change? These are not the same, and they have quite different implications for policy if the price level is altered by some unforeseen event, or unexpectedly altered by a foreseen event. Should by-gones be by-gones, or should the price level be forced back to its earlier level? Finally, when we talk about the desirability of stability in the price level, that may really represent a loose way of expressing a desire for predictability in the price level. Most of the costs that economists have been able to attribute to price level "instability" arise from unpredictable movement rather than from predictable movement. Again, a more precise statment of ultimate objectives is required to sort out these various possibilities.

Once this necessity is acknowledged, and active manipulation of monetary policy is countenanced, whether by formula or discretion, the question naturally arises whether stability of some measure of the price level is or should be the sole economic objective of society and, if not, whether monetary policy should be directed solely toward that objective, rather than, say, to reducing unemployment, to increasing home ownership, or to fostering investment in plant and equipment.*

* For a proposal for formula-based use of monetary policy to pursue a combination of price stability and employment stability, see Hall (1986).

Since stability of the price level is manifestly not society's only economic objective, what is the case for directing monetary policy solely toward that objective? It must rest on one or another of several possible assumptions:

1. Price stability is a necessary condition for the attainment of other objectives, so there is no real conflict or "trade-off" among objectives.[*]

   [*] See, for example, the recent statement by Alan Greenspan in December 18, 1987, testimony before several subcommittees of the House Committee on Banking, Finance, and Urban Affairs: "The mandate for economic policy in the United States and elsewhere should be to maintain the maximum growth in real income and output that is feasible over the long run. A necessary condition for accomplishing that important objective is a stable price level, the responsibility for which has traditionally been assigned in large part to the central bank, in our case to the Federal Reserve."

2. Monetary actions cannot influence any of the other objectives. This view, often adopted in the formal theorizing of professional economists, is clearly erroneous in the short run, and is unlikely to be true in the long run, for any given definition of money (Tobin and Buiter, 1976).

3. Monetary actions have a comparative advantage in influencing the price level, and other instruments are better suited to the pursuit of other objectives. This proposition has some validity, but runs up against Brainard's (1967) observation that in an uncertain world optimal policy formulation would require that all objectives influence the choice of all policy instruments.

4. While monetary actions might usefully help to attain other objectives, attempts to use them for this purpose, and disagreements over which

objectives should be emphasized, are likely to reflect inconstancy of purpose and lead to instability in real activity and in the price level, or even neglect of the latter objective. This observation, while possibly valid, takes the economist out of his role as economic analyst and prescriber of economically optimal policies, and into the realm of political and social analysis. That is fair enough, but consistency requires that a similar perspective be taken on other proposed policy regimes as well, and on the political prospects for their continuation in proposed form under the impact of serious disturbances and social strains.

An International Commodity-based Monetary System

The world has over 160 distinct national monies. The collection of national choices concerning the basis for these monies determines the character of the international monetary regime, which may but need not involve formal, explicit undertakings by national authorities with regard to their monetary relationships with other countries, and may but need not involve formal multilateral agreement on the main features of the international monetary regime. Some observations on the relationship between national monetary bases and the international regime are in order.

First, if two or more countries choose the same national standard, linked to the same basket of goods and services (e.g. gold), by so doing they also fix the exchange rate between their national monies, which to that extent determines the international standard as well. A special case involves the choice by one country to peg its currency to the currency of another country. It thereby indirectly chooses the same standard as the other country, whatever it be.

Second, if two or more countries choose different standards, i.e. a different basket, as bases for their currencies, then all but inevitably the exchange rate between those currencies will have to be altered from time to time, if not continuously. In particular, this is true even if the countries choose on the same principle, such as stabilizing the national consumer price index. A corollary is that if a country chooses to peg its currency to that of another country, it will not, in general, stabilize its national price level, except by coincidence. The reason has to do with the presence of non-tradable goods and services, combined with the proposition that over time there is likely to be an upward drift in the price of (mostly non-tradable) services (P_N) with respect to the price of (generally tradable) goods (P_T), and that this drift will occur at a rate that will differ from country to country, with the difference depending largely on the difference in per capita income as well as growth rates.

The secular rise in P_N/P_T arises in part from a slower growth in productivity in services than in tradable goods, and in part because we have much greater difficulty in measuring productivity growth in services than in goods, leading to a tendency to overstate price increases in services. Indeed, for a number of services the national statistical authorities identify outputs with inputs (e.g. an hour of a doctor's time), so that by assumption there can be no increase in measured productivity. Under these circumstances, the secular upward drift in P_N/P_T will be a positive function of the national growth in productivity, and this in turn will be especially rapid in low-income, rapidly growing countries, such as Japan in the 1950s or South Korea in the 1980s.

When we speak of a national price level, we usually mean a weighted average of P_N and P_T, in which the weights must be adjusted from time to time, generally giving more weight over time, at least for high income countries, to the service component of consumption. If $P = a(t)P_N + (a - 1)P_T$ is targetted for constancy in each of two countries that differ in per capita income, that will require a secular decline in P_T in both countries, but more sharply in the poor than in the rich country. That in turn will require a secular appreciation of the currency of the poor country, provided tradable goods in the two countries are in close competition. Alternatively, if the exchange rate is fixed between the two currencies, P will increase more rapidly in the poor but growing country than in the rich one, and that indeed conforms with general experience.*

* During the 1950s, when the Japanese currency was fixed at ¥360 per U.S. dollar, the consumer price index in Japan grew at 4.1 percent per annum, compared with 2.1 percent in the United States, even while Japanese tradable goods were becoming more competitive relative to American goods.

This general phenomenon has been emphasized by Balassa (1964) and shows up in a different way in Kravis et al (1982), who show that real purchasing power countries is far higher than is suggested by per capita income converted at official exchange rates.

The alteration in exchange rates need not take place continuously, but failure to do so will generate a transitory misallocation of resources, toward tradable goods in the low-income, growing countries, and away from tradable goods in the high-income countries. Moreover, discrete changes in exchange rates, or the prospect of them, provoke substantial international movements of speculative capital, unless prevented by exchange controls. So these characteristics also affect the international monetary regime, pushing it toward floating exchange rates, or at least toward managed flexibility, whether by formula or not. The general point is that national consumer price

levels and exchange rates cannot both be stabilized over time; one or the other must sooner or later be given up. The strains become less severe, however, as the ratio of tradables to non-tradables in national output grows (a function of trade barriers and transport and communication costs) and as the dispersion among nations in per capita income declines.

If nations choose to target their exchange rates instead, to fix their currencies to other currencies, that will anchor individual currencies, but it will not anchor the international monetary system as a whole. That can be accomplished in one of two ways:

1. a collective agreement to some common target, such as the price of tradables (e P_T, where e is each country's exchange rate, fixed to a numeraire currency), or some average of national consumer price indices, or some other common basket.

2. an implicit agreement that the country whose currency is used by others as an anchor will target some basket of goods and services. If the basket is its consumer price index, and if P_N/P_T rises over time, the money price of tradables will fall both in the anchor country and in all countries whose currencies are tied to it; the consumer price index will also fall in those where the upward drift of P_N/P_T is slower than in the anchor country.

International Monetary Standards as Proposed

There has been much less systematic discussion of the international monetary standard than of national standards. Historically, the international

standard has simply been the resultant of national standards. There have, however, been several exceptions to this generalization.

The Genoa Conference of 1922. The Genoa conference was called after the First World War to deal explicitly with the international standard, and concretely to address the shortage of monetary gold that would emerge as countries resumed - as it was taken for granted they would - convertibility of their currencies into gold. Exchange rates among currencies were floating at the time, but that was assumed to be an unsatisfactory and therefore a temporary condition. The problem was that national price levels had greatly increased since 1914, and could not be supported by the available gold; yet to require monetary contraction sufficient to restore convertibility was recognized to require a substantial and prolonged depression in economic activity.

The proposed solution was to economize on monetary gold in two ways: 1) to call in gold from circulation, to be held by central banks (this was largely an accomplished fact outside the United States); and 2) to encourage central banks to hold in their reserves "bills of exchange" on foreign financial centers in partial substitution for gold reserves. Thus a multiple reserve currency system was formally sanctioned, along with exchange rates fixed by gold convertibility. Under a simple monetarist model, the world price level could then ultimately be determined by the world's monetary gold stock, plus the willingness of central banks to hold in their reserves financial claims in other currencies. Without specifying the latter component quantitatively, however, the price level would strictly be indeterminant. But at the time the problem was assumed to be that central banks would hold too little foreign exchange reserves, not too much, and that the gold holdings of

the countries whose currencies were held, combined with a commitment to gold convertibility, would limit the expansion of foreign exchange holdings - and thus also of domestic currencies and the price level.

The significance of the Genoa Conference lies mainly in its attempt to view the international monetary system as a whole.

Bretton Woods. British and American authorities negotiated a plan for the international monetary system during the Second World War, whose purpose was to foster trade and growth and avoid a repetition of the economic disasters of the interwar period. The regime that emerged was structurally similar to the regime envisaged at Genoa: fixed exchange rates determined by a gold parity for each currency, convertibility into gold or into a currency that was convertible into gold (the U.S. dollar), and the holding of foreign exchange as international reserves. There were two important additions: the regimen of the system was not to prevent the pursuit of national employment policies; and if the combination of commitments and policies became irreconcilable, a country could, with international permission, change the parity of its currency, i.e. devalue or revalue against gold and other currencies.

In practice, after some postwar adjustments, major currencies rarely changed their parities; and the U.S. dollar came to play a much greater role in reserves than had originally been envisioned. Gold provided a de jure anchor for the system, except for a somewhat mysterious provision for a "uniform change in par values," i.e. a change in the price of gold. In fact, the system relied for its anchor on the prudence of U.S. economic policies, disciplined as necessary by conversion of dollars into gold.

The world economy grew much more rapidly in the 1950s and 1960s than anyone dared anticipate in the late 1940s, and the demand for reserves grew with it. They were supplied in part from the large U.S. gold stock, but in larger part by a build up of dollar balances. This development led to the dilemma posed by Triffin (1960): if dollar balances continued to grow, the gold-convertibility of the dollar would cease to be credible; if they did not, the growth in world trade might be constrained by insufficient internationally acceptable monetary medium.

The dilemma was resolved in 1968 by the decision to create a new international fiat money, the SDR - now defined as a fixed weight basket of the five leading currencies - to be created by the International Monetary Fund at not less than five year intervals with the aim "to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such manner as will promote the attainment of [IMF] purposes and will avoid economic stagnation and deflation as well as excess demand and inflation in the world" (IMF Article XVIII(1a)). In 1976 it was agreed that IMF members should strive to make the SDR "the principal reserve asset in the international monetary system" (IMF Article XXII). In principle, the SDR could be issued to satisfy the secular growth for international reserves, subject to the general guideline of avoiding both inflation and economic stagnation. Thus was introduced a fully discretionary monetary system at the international level, which in fact mirrored the practice at the national level in virtually all countries, with the exceptions of Liberia and Panama (which use U.S. dollars), the CFA franc zones of west and equatorial Africa, and a few British colonies which still use fully backed currency boards for local issue. In fact, there have been only two decisions to allocate SDRs over a twenty year period, totalling 21 billion, or $29 billion at current exchange

rates, a sum that accounts for less than 5 percent of existing official foreign exchange reserves, and even less if officially-held gold is included in reserves.

In short, neither national monetary systems nor the international monetary system is anchored to the world of goods and services, except by the prudence of monetary authorities. In addition the international monetary system at present is extremely permissive with regard to exchange rates, requiring only that nations notify the IMF of their exchange arrangements and that these conform with the objectives of fostering "orderly economic growth with reasonable price stability" and of promoting economic and financial stability. Member nations are enjoined to "avoid manipulating exchange rates or the international system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members" (IMF Article VIII(1)), and cannot introduce discriminatory exchange rate practices.

An International Commodity Reserve Currency. When discussion of the Triffin dilemma was in full swing, Albert Hart, Nicholas Kaldor, and Jan Tinbergen (1964) proposed that it be resolved by creation of an international commodity reserve currency (ICRC), an international version of the Graham proposal. The proposal was updated in a post-SDR context by Hart (1976). Hart suggests that the goods in question should be both standardized and storable, and offers an illustrative list (reproduced in Table 1) of 31 commodities which might make up the basket. He suggests that annual storage and turnover costs on the commodities selected should not exceed 5 percent, and he would leave some operational flexibility for the final list of goods to be included in the ICRC, and their weights, which would be necessary if the

Table 1

Standarized and Storable
Commodities for Possible Inclusion in an
International Commodity-Reserve Currency

Wheat	Pork bellies, frozen	Cotton
Maize	Orange juice, frozen	Wool
Rice	Butter	Jute
Soybeans	Lard	Hard fibers
Oats	Milk, dried	Silk
Linseed		Rubber
Peanuts	Copper	
Sugar	Lead	Plywood
Coffee	Zinc	Lumber
Tea	Tin	Woodpulp
Cocoa	Silver	Newsprint

Source: Hart(1976), p. 6

initial accumulation period is to have a fixed time period, for example five years.

The IMF would purchase the basket of commoditites, aiming at an amount equal to, say, 25 percent of world trade in these commodities, issuing SDRs in exchange.*

* A 1966 proposal in the *Oxford Economic Papers* suggests 75 percent of world trade in the listed commodities. No explanation is given for the lower figure suggested in 1976.

The SDRs so issued would be the principal source of new international reserves. Increases in monetary gold and in foreign exchange reserves would not be allowed once the scheme was in full swing, although Hart would permit the IMF to engage in open market operations in SDRs to provide some monetary flexibility beyond purchases of the commodity basket.

The commodity basket would be bought or sold as a unit, by telegraphic instruction to the different markets and storage areas in which the various goods were physically held around the world. The IMF would have a 10 percent buy-sell spread on its purchases and sales of the basket, to cover costs and to gain a bit of seigniorage. The gross costs of managing the scheme would involve storage costs plus interest plus the costs of turnover, since some of the commodities deteriorate physically over time and would have to be changed occasionally. Annual storage costs for most of the commodities Hart reckons at 1 percent or less of their value, although for wheat and maize it approaches 6-7 percent. It is noteworthy that the interest costs, from a social point of view, might be negligible if the stocks are acquired mainly in times of economic slack, when the future opportunity cost of producing now is low, a point that Hart fails to mention. He does note that net social costs

would be lower than gross cost to the extent that the existence of public storage of these commodities permits some reduction in private stocks, and to the extent that his scheme headed off various proposals for export-restricting commodity schemes that were under discussion at UNCTAD in the mid-1970s.

Hart makes the interesting suggestion that the IMF might occasionally substitute future contracts for physical holdings of individual commodities in the basket, thereby releasing those commodities into the market under conditions of an emergency.

Under this conception of an international currency, individual nations would be free to set national monetary standards as they chose, and to allow their currencies to float against one another and against the SDR. But individual countries would be permitted to peg their currencies to the SDR, and in all likelihood many would do so, just as many peg their currencies to some other currency, or to a basket of currencies, today.

In sum, this proposal involves an international unit of account and the creation of an international money which is anchored in a basket of economically significant commodities. The unit of account would over time maintain a stable value in those commodities through purchase or sales of the basket, within a margin of plus or minus 5 percent. The omission of oil and coal from the basket is noteworthy - they were both included in Graham's list in 1937. Moreover, this scheme obviously would not stabilize a more general price level if there is secular drift between the average prices of the ICRC commodities and other prices. The problem of a secular increase in prices of services, as we measure them, has already been discussed.

The question whether there is secular drift in the prices of primary products relative to the price of manufactured goods has long been debated. The view of David Ricardo, revived in the 1970s by the Club of Rome, is that the price of manufactured goods must decline secularly relative to the price of primary products in a world of growing population and income, due to the increase in rents on agricultural land and resources in limited supply. Under these circumstances, stabilizing the value of the monetary unit in terms of primary products would result in a secular decline in the price of manufactured goods, although that would perhaps be offset in whole or in part by the rise in the measured price of services.

In the early 1950s, Raul Prebisch took the opposite view, widely held in many developing countries, that there is a secular rise in the price of manufactured goods relative to that of primary products. If the monetary unit is stabilized in terms of the prices of primary products, and the Prebisch view is correct, the ICRC scheme will generate secular inflation. In fact, the historical evidence is ambiguous on very long-term movements in the ratio of primary product to manufactured prices (Spraos, 1980). But there do seem to be swings in one direction or the other for periods of a decade or longer, such as took place under the gold standard, but less pronounced than for gold alone.

The International Monetary Systems in Practice

The Gold Standard. The pre-World War I gold standard does not fall into the category of carefully worked out international monetary systems. It was a historical consequence of national choices, strongly influenced by the political, military, and economic successes of Britain, plus the historical accident of Britain's being on the gold standard. It was, moreover, a period

of great economic tension and considerable instability both in prices and in output (Cooper, 1982).

An idealized version of the gold standard was, to be sure, a self-correcting mechanism that could both stabilize the world price level and generate the right amount of international liquidity. For a single country with an insufficient monetary base to support its desired activities, the national price level would fall, a trade surplus would develop, gold would flow into the country from the rest of the world, and this process would continue until price level equality was restored with sufficient additions to gold money to support the higher desired economic activity. This was a mechanism described by David Hume clearly and concisely in 1752.

For the world monetary system, inadequate gold would lead to a decline in the world price level, thus increasing the real value of money and satisfying the need for money in that way. But a longer term adjustment would also be set in motion. With gold more valuable in real terms, gold production could be expected to increase, and the total supply of money in physical terms would thus be augmented. This process would assure long-run stability of the price level provided technological improvements in ore extraction and new discoveries could be assumed to offset exactly the gradual exhaustion of known gold supplies and thwart the emergence of Ricardian rents, which otherwise would require a trend decline in the general level of prices measured in gold money so long as the economy was growing.

Unhappily this idealized version was not readily observable in reality. The lags in the adjustment process were so long that large swings in prices could be observed as a result of periodic surpluses or shortages of gold relative to commodities. Table 2 records the changes in wholesale prices that

Table 2

Wholesale Price Changes Under the Gold Standard

Years	United States	United Kingdom	Germany	France
		(percent change)		
1816-1849	-45	-41	-29	-33
1849-1873	67	51	70	30
1873-1896	-53	-45	-40	-45
1896-1913	56	39	45	45

Source: Cooper (1982), p. 9.

occurred during a century under the gold standard, roughly parallel movements in all four countries listed, by amounts between 30 and 70 percent. This is certainly not a record of stability.

It is conceivable that, despite these long swells, economic agents expected an eventual return to a "normal" price level. Certainly a striking feature of the 19th century is that there were long periods of price decline as well as long periods of inflation.

If the relevant public expected the long-term price level to be stable, long-term interest rates should be *negatively* correlated with the price level, high levels giving rise to expectations of a subsequent fall in prices, which should lower nominal long-term interest rates; and vice versa for a lower-than-normal price level. In fact, long-term nominal interest rates were *positively* correlated with prices, rising as the price level rose, falling as it fell: a phenomenon dubbed the Gibson Paradox by Keynes (1930), and a puzzle to analysts already in the 1920s.

The movements in long-term interest rates are more easily interpreted by assuming that the relevant public expected the contemporary price level to remain unchanged regardless of where it is relative to past levels, perhaps adjusted slightly for recent changes. That is, if prices have fallen recently, the public expected them to fall a bit more, and then remain unchanged.

But if this was their expectation - and it fits best the relationship between the price level and long-term interest rates - they were constantly fooled. We now know that, at least for a twenty year holding period (this was the maturity of many bonds), ex post real interest rates varied much more

sharply than did nominal interest rates, and both series were positively correlated with the price level. This is not a record of intertemporal constancy in contract values.

It is conceivable too that despite long-term swells in prices, and apparently erroneous expectations about the real value of long-term contracts, short-term predictability was quite high, despite the high variability both of short-term prices and of short-term interest rates. Lawrence Summers (1983) has shown, however, that short-term nominal interest rates did not in fact adjust well to compensate for short-term fluctuations in the price level. More recently, Meltzer (1986) has shown that quarterly prediction errors, on a simple forecasting model relying only on past data of each series, were much higher in the gold standard era both for prices and for real output than they were in the period 1950-1980. Table 3 records the forecast errors for quarterly forecasts of U.S. GNP and prices for each of six monetary periods as characterized by Meltzer (he distinguishes between a gold standard with and without a Federal Reserve System, and he separates the period of fixed long-term interest rates during the 1940s; he does not exclude the two world wars). A comparison of the first two rows with the last two rows shows a *dramatic* improvement in quarterly predictability on moving from the gold standard to either the managed monetary system under Bretton Woods or the period of fluctuating exchange rates since the early 1970s. The forecast errors decline relative to price and output variability as well as in absolute terms, and they decline sharply on expectations with respect to level and rate change of the variables as well as with respect to general background noise (Meltzer, pp. 141-44). It is likely, furthermore, that an extension of Meltzer's analysis through 1981-87 would show, by these standards, a marked superiority of the Bretton Woods system over the full period of fluctuating exchange

Table 3

Variance of Quarterly Forecast Errors[a]

	U.S. Nominal GNP	U.S. Price Level	U.S. Real GNP
Gold Standard			
1890(1)-1914(4)	2.98	.25	2.83
1915(1)-1931(3)	1.80	.60	1.41
No clear standard			
1931(4)-1941(4)	5.64	.24	4.02
1942(1)-1951(1)	.67	.60	.78
Bretton Woods, 1951(2)-1971(3)	.13	.02	.11
Fluctuating rates, 1971(4)-1980(4)	.13	.02	.14

a. x1000

Note: Quarterly forecasts are made using a Kalman filter with respect to expected level and expected rate of change on past data for each series.

Source: Meltzer (1986), p. 141.

rates, although of course we could not be sure that the difference was attributable to the change in international monetary arrangements.

In sum, the historical gold standard did not perform very well - indeed it was a source of consternation and controversy to those who lived through it - except with respect to fixing exchange rates among currencies.

The Present Non-standard. The present mixed arrangement of fixed and fluctuating exchange rates also does not reflect a considered collective judgment on what the international monetary system should be. Rather, present arrangements are a jumble reflecting national choices and evasion of choices. They are not "anchored" in anything, neither a commodity basket nor even (except for the United States) the prudence of U.S. macroeconomic policy. This lack of an anchor is a source of uneasiness. Neither national price levels nor the SDR-denominated price level are determined in the "logic" of the arrangements, although of course they are determinant at every moment of time. The lack of a clear anchor may suggest that there is no foundation for long-term expectations about the price level - although, as we have seen, such expectations were not very accurate, ex ante, under the historical gold standard either.

There are two further problems with present international monetary arrangements. The first concerns unsettled expectations about the future value of real exchange rates among major currencies, over the horizon of one to five years that is appropriate for investment and production decisions. It is noteworthy that while under the gold standard prices moved substantially, the price indexes in different countries moved roughly in parallel with one another, suggesting that there may not have been significant variations in

national competitiveness arising from the monetary side of national economies, although this is an aspect of the gold standard that deserves to be more closely explored.

Most businessmen, especially in manufacturing, if they are to be subjected to economic disturbances, place a high value on their competitors being subjected to the same disturbances, so they are not put at a competitive disadvantage. The problem with present arrangements involving flexible exchange rates is that it provides no such assurance in industries operating in a world market. On the contrary, for reasons remote from a firm's activity, often originating in the arcane world of finance, the firm can suddenly find itself facing much stiffer competition (or much less, but that is rarely a cause of concern) as the result of the movement of an exchange rate.

This uneven source of uncertainty will have several consequences adverse to the efficient allocation of resources. The first is that businessmen, at the national level, will attempt to blunt the source of supposedly unequal competition by urging an increase in trade barriers of various kinds. This response was manifest in the United States in 1983-86, it will slow import liberalization in Japan in the late 1980s, and I expect it to become more pronounced in Europe as trade surpluses decline there.

Second, investment will be reduced in the tradable sector as a result of the greater uncertainty arising from fluctuations in real exchange rates - an uncertainty of a more compelling type for investors than uncertainty about the general price level over the period of their investments. The latter influences profitability, but the likelihood that unanticipated changes in the price level will cause bankruptcy is much lower than the likelihood that

unanticipated changes in the exchange rate will cause bankruptcy. It is perhaps not a complete coincidence that investment rates in manufacturing have dropped sharply in all major industrial countries since the advent of flexible exchange rates, although there are other explanatory factors as well, most notably the two oil price increases and the associated sharp recessions in economic activity.

Third, firms will adjust their investment behavior to hedge against the offending uncertainty. Since they cannot hedge their future commitments to production through financial markets, they will do so by investing abroad, across currency zones, even if that means giving up some of the advantages of cost and scale associated with exporting from their home bases or some other lowest cost location. One possible consequence, since some of this diversification takes place through takeovers and buyouts, is a greater world concentration in certain industries, leading to a reduction in worldwide competition.

So on all these counts a regime which reduces real exchange rate uncertainty without corresponding increases in costs elsewhere would represent an improvement over present arrangements.

A further point should be mentioned. Under present arrangements the most important official international reserve continues to be the U.S. dollar, despite a general commitment to make the SDR the principal reserve asset. The dollar is supplemented by holdings of other currencies, most notably the German mark and the Japanese yen. In practice, dollars are likely to provide most of the growth in reserves over the next decade, although the share held in other currencies may grow somewhat. Reserves are necessary, and are thought to be necessary, because the exchange rates of almost all countries

are either fixed to something, or are subject to managed floating. We have a mixed and permissive system rather than a floating rate system. Moreover, as many countries have now discovered, access to the international capital market is not assured at all times, especially when a country is seen to be in some external economic difficulty, i.e. just when it needs foreign funds most badly. So monetary authorities feel they need owned reserves, and they will want those reserves to grow, on average, over time.

Sometimes countries acquire reserves as the lesser of evils, as a result of exchange market intervention to keep their currencies from appreciating too rapidly or too far. But once acquired the higher level of reserves sets a new expectation; while some decline may be tolerated and even welcome, a decline toward the former level more often than not provokes restrictive action to halt the drop. A rachet is thus introduced into implicit reserve targets.

Over the coming decades the relative importance of the United States in the world economy is likely to decline - not because the U.S. economy is performing badly, but because others are performing well. Europe and Japan are also likely to experience relative declines as well, and for the same reasons: low population growth rates and productivity that advances only as rapidly as new technology permits. Other countries have more rapid population growth, and they can continue to introduce existing technology from abroad. Of course, poor economic policies or political turmoil may retard their growth, but on balance the share of gross world product is likely to decline over time.

The combination of reduced relative economic importance with increasing use of its currency as an international reserve will sooner or later put serious strains on U.S. monetary policy. In a certain sense, it implies more

external "discipline" on the United States. But this discipline will not necessarily conduce toward greater economic or monetary stability, so as to provide a firm anchor for the system. Rather, the Federal Reserve will find itself more frequently having to respond to international financial pressures, whether they are rational in the larger scheme of things or not, and these may sometimes cause less rather than more stability in monetary affairs. Yet the proper role of a monetary system, national or international, is to provide a stable expectational environment for the wealth-producing sectors of the economy, and for the public generally.

An International Fiat Money

The exceptional importance of real exchange rate uncertainty suggest that a system should be introduced that can reduce it. Several proposals to accomplish this objective have been made, ranging from target exchange rate zones which would limit exchange rate movements around a calculated equilibrium real exchange rate (Williamson, 1985) to close coordination of monetary policy among the three largest countries with a view both to stabilizing their exchange rates and controlling their collective monetary growth (McKinnon, 1984).

But to eliminate exchange rate uncertainty definitively - and sharply reduce real exchange rate uncertainty - requires a single currency. For the international monetary system this could be effectively achieved, with much greater prospect of negotiability, by introducing the single currency first to the large industrialized democracies of Europe, North America, and Japan, rather than a global currency. A single money requires a single monetary policy. The constitution of the new International Central Bank (ICB), as we may call it, could be modelled on the Federal Reserve System, with changes

appropriate to the circumstance that participants would be nations rather than regions within a nation. Representatives of national central banks, whether or not under control of sitting governments, could make up the Board of Governors, with votes weighted by the relative size of national economies. Or finance ministries could be directly represented. Or there could be nationally selected independent appointees, with the number of appointees apportioned by economic size. Whatever its exact constitution, the key point is that decisions on monetary policy would be a collective one; no single government could determine the outcome.

The ICB's powers would be similar to those of central banks today, with a discount window for distress lending and open market operations to influence the monetary base. Governments would share the seigniorage resulting from the issue of central bank money. But no government could finance budget deficits at the ICB beyond its share of the seigniorage; it would have to go to the financial market for that.

Other democratic countries could formally join the system, and of course any non-member could chose to fix its exchange rate vis-a-vis the international kroner*, which would permit many of the advantages of fixed exchange rates without the formal commitments.

* It does not matter what the new currency is called. In view of the widespread use around the world of the U.S. dollar, "dollar" would be a natural designation, but that might be politically offensive to some. So it could be called the thaler, or the kroner, or the franc. *The Economist* (January , 1988) has suggested the "phoenix".

What principles should guide the actions of the ICB? It would face much the same choices that nations face today, although of course it could not fix the exchange rate, because there would be no plausible currency to which to

fix it. The discussion above on various national standards becomes relevant, including the various disadvantages of a commodity-based standard. Nonetheless the ICB needs some guidelines. It could be, as Keynes (1930, p. 391) suggested, a tabular standard based on an index of wholesale prices of 62 internationally traded commodities, with an implied secular inflation in consumer prices, which Keynes recognized and welcomed. Or it could be a target based on a weighted average of the consumer price indices in the participating countries, with its implied secular decline in commodity prices. Or it could be a defined price level such as this but modified in response to movements in unemployment away from some target level, as Hall (1986) has suggested. Or it could even fail to agree on a sharply defined target and muddle through as the Federal Reserve does now. That would not be intellectually satisfying, but Meltzer's findings suggest that we could be much worse off under many alternatives.

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PRELIMINARY

The International Monetary System: Developments and Prospects

by

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Paper presented at Cato Institute's
Sixth Annual Monetary Conference
Dollars, Deficits, and Trade:
The Changing World Economy

Washington, D.C.
February 25-26, 1988

* The views expressed are the authors' alone and do not necessarily represent the view of the International Monetary Fund.

I. Introduction

1. This paper addresses several central issues raised by recent developments in the world economy and considers their implications for the design and functioning of the international monetary system. We do not make any proposals. Our purpose instead is to identify factors that merit attention in any serious examination of the system.

2. First, some background. Over the past two-and-a-half years, the international economic landscape in the industrial world has been dominated by the following key developments.

To begin with, there have been unprecedented current account imbalances for the three largest economies. Last year, the United States recorded a current account deficit of $160 billion, while Japan and the Federal Republic of Germany registered surpluses of $85 billion and $43 billion, respectively. A primary objective of policy has been to reduce these external imbalances while still maintaining satisfactory growth of the world economy. The contribution that fiscal policy should make to reducing absorption relative to output in the United States, and to increasing it in surplus countries, has become an integral--and often a contentious--element in the policy dialogue. Suffice to say that the adjustment of fiscal positions has proven to be a difficult process, with firm evidence of a narrowing of earlier divergencies apparent only within the last year or so.

Heavy official intervention in exchange markets (especially during 1987) and episodes of coordinated adjustments in interest rates--both

undertaken in an effort to foster more stability in key-currency exchange rates--have been a second prominent feature of the landscape. These, in combination with the monetary response to the global stock market crash of last October 19 and plans for a liberalization of capital controls in the European Monetary System (EMS) by 1992--have once again put the spotlight on an old question: how successful can monetary policy be when it is asked to wear two hats, one for internal and the other for external balance?

Another distinguishing characteristic of the last two-and-a-half years has been the sizable decline in both the nominal and real value of the U.S. dollar. By now, all of the 1980-85 real appreciation of the dollar (on an effective basis) has been reversed. The central question has been: do you think the dollar decline has gone far enough? On a number of occasions (e.g., Louvre, February 22, 1987; the September 1987 meetings of the Interim Committee; and the G-7 statement of December 22, 1987), officials have supplied their own answer--by offering a concerted view on the consistency of the existing pattern of exchange rates with "fundamentals." Moreover, strong interest continues to be expressed in some reform proposals--including a system of target zones--that hinge on knowledge of equilibrium exchange rates.

Last but not least, the period since the Plaza Agreement has witnessed a strengthening of international economic policy coordination among the major countries. Coordination agreements have featured both country-specific policy commitments and official pronouncements on the

pattern of exchange rates, but have not specified rules, anchors, or a center-country for the exchange rate system. Debate continues on whether the present coordination process is merely an intermediate stage on the way to a more far-reaching rule-based reform of the system, or is instead a durable, workable compromise between what some regard as the excesses of decentralized floating and the straitjacket of fixed rates.

3. So much for the landscape. How does it relate to prospects for the international monetary system? We would say "quite a lot." Indeed, much of the controversy over reform of the system can be traced back to different views about the capabilities and limitations of more managed exchange rates regimes to deal with just the sort of policy problems outlined above. In our view, four central issues merit particular attention in the current climate:

First, can the exchange rate regime do much to help discipline fiscal policy;

Second, what are the extent and costs of reduced monetary independence under greater fixity of exchange rates;

Third, how can the equilibrium exchange rate best be determined; and

Fourth, does a well-functioning international monetary system require a clearly defined set of rules, an acknowledged leader, and an explicit anchor?

We examine each of these issues in turn.

II. Fiscal Policy and the Exchange Rate Regime

1. The proposition that the commitment to defend the parity provides economic agents with increased discipline to avoid inflationary policies is one of the oldest and most durable arguments for fixed rates. Yet close scrutiny of the typical focus of the discipline hypothesis suggests that it could be akin to Hamlet without the Prince of Denmark. In what follows, we elaborate on this point.

2. The traditional province of the discipline hypothesis is monetary policy. Under the well-known Mundell-Fleming model, monetary policy is completely ineffective for a small country with fixed exchange rates in a world of high capital mobility. This is merely one application of the dictum that policymakers who seek to achieve simultaneously fixed rates, open capital markets, and an independent monetary policy will be frustrated. The best they can do is to achieve any two of the three objectives. Thus, once the choice is made for fixed rates and open capital markets, monetary policy is effectively disciplined. The exchange rate could be devalued to give monetary policy a longer leash, but this is ruled out by the assumption that devaluation would bring with it heavy political costs. 1/

More recently, the domain of the discipline argument has been extended to wage policy. The basic idea here is that if exchange rate adjustments don't completely offset inflation differentials, then the resultant real appreciation for high inflation countries will deter

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1/ The issue of whether the consequences of a more expansionary monetary policy will be as visible under a fixed rate as under flexible rates is discussed in Frenkel and Goldstein [1987].

exports, real output, and employment--thereby acting as a disincentive to excessive wage settlements. 1/ An interesting and unresolved question is how long it will take to convince workers of the downward slope of the labor-demand schedule, especially if wage developments are dominated by insiders with jobs rather than by outsiders without them.

3. Surprisingly enough, disciplinary effects on fiscal policy have been relatively neglected--and this despite the role often attributed to lax fiscal policy (particularly in the United States) in both the breakdown of Bretton Woods and the large--many would say "excessive"--real appreciation of the dollar during the 1980-85 period.

4. It is therefore worth asking if and how alternative exchange rate regimes might influence fiscal policy.

First, consider fixed rates. With high capital mobility, a fiscal expansion will yield an incipient positive interest rate differential, a capital inflow, and a balance of payments surplus--not a deficit. Hence, exchange rate fixity helps to finance--and by no means disciplines--irresponsible fiscal policy. As suggested in the recent literature on "speculative attacks," 2/ only if and when the markets expect fiscal deficits to be monetized will they force the authorities to choose between fiscal policy adjustment and devaluation. The better the reputation of the monetary authorities, the longer in coming will be the discipline of markets. In this connection, it is worth observing

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1/ See Giavazzi and Giovannini [1988].

2/ See Flood and Garber, and Krugman for models of such speculative attacks.

that whereas the EMS has produced significant convergence of monetary policy, convergence of fiscal policies has not taken place. 1/

Second, consider the outcome under target zones. Suppose the zones are to be defended by monetary policy. In that case, a fiscal expansion that puts appreciating pressure on the exchange rate will produce a loosening of monetary policy to keep the rate from leaving the zone. Again, the exchange rate regime will have exacerbated--not disciplined--the basic cause of the problem. Only if the threatened departure of the exchange rate from the zone initiates a review of the whole range of policies and if that (multilateral) review tilts the balance of power in the domestic debate toward fiscal responsibility, will target zones discipline fiscal policy. This missing link between exchange rate movements and fiscal policy under target zones is being increasingly recognized. Note that whereas first-generation target zone proposals spoke mainly of monetary policy, second-generation proposals have added a specific rule to rein in fiscal policy; contrast Williamson [1985] with Miller and Williamson [1987].

What about floating rates? With high capital mobility, one would again expect fiscal expansion to prompt appreciation of the real exchange rate. Pressures for reversal are then likely to come from the beleaguered traded goods sector, as it looks for ways to turn around its decline in competitiveness. The trouble here is that there is also the protectionist alternative to fiscal discipline, which, if adopted, would again follow one inappropriate policy with another.

1/ See Holtham et al [1987].

The recent U.S. experience is suggestive of the difficulties associated with forging a dominant constituency for fiscal reform, and of the perseverance necessary to combat measures for quick-fix protectionist alternatives.

Finally, consider the influences operating on fiscal policy in a regime of managed floating with international economic policy coordination. One immediate advantage is that the potential for a perverse monetary policy response is reduced since specific fiscal policy commitments can be specified directly as part of a negotiated policy package. That is, one avoids the intermediate link between the exchange rate signal and the policy response. But this regime too is not without pitfalls. For one thing, the kind of specific, quantitative policy commitments that lend themselves to reliable monitoring may be perceived as intruding too much on national sovereignty. For another, there is no explicit mechanism for sharing the fiscal adjustment across participants. Also, there is the problem of implementation of fiscal policy agreements when the responsibility for implementation lies with different branches of government in different countries. 1/

5. The bottom line of all this is that if proposals for modification or reform of the exchange rate system are truly to lead to more disciplined macroeconomic policies, more attention has to be given to how the exchange rate regime will impact on fiscal policy behavior. To some observers, like Robert Solomon [1986], the answer is that fiscal reform must precede reform of the exchange rate system. To

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1/ See Feldstein [1987].

others, the answer may be that better fiscal discipline requires mechanisms outside of the exchange rate system, such as Gramm-Rudman legislation. And to still others, the answer may be that the multilateral give-and-take encouraged by policy coordination or a system of target zones is a necessary, if not sufficient, tool for achieving greater fiscal responsibility. One thing is clear: it will be hard to know how to shape the evolution of the exchange rate system without knowing beforehand how to better discipline fiscal policy.

III. Monetary Policy Independence

1. As suggested earlier, a strong message from the theoretical literature is that a more fixed exchange rate regime requires keeping more of an "eye" on the exchange rate in the conduct of domestic monetary policy. What is much more controversial is what such a reduced independence of monetary policy would cost.

2. Concern about reduced monetary independence is often strongest in countries with either relatively low or relatively high inflation rates. In the former, there is a worry about repetition of the latter days of Bretton Woods when disequilibrium exchange rates, heavy exchange market intervention, and massive capital flows combined to wrestle control of the money supply away from the authorities. In their view, a similar occurrence would jeopardize both their price-stability objectives and their hard-won anti-inflationary reputations. For the high inflation countries, there is a concern that less monetary independence could handicap the battle against the cyclical component

of high unemployment. In addition, high-inflation countries often suffer from weak fiscal systems with relatively heavy reliance on the inflation tax. 1/ In this regard, they worry that a lower inflation rate will reduce their revenue from seignorage, run up against tax evasion in seeking to compensate for it by raising other taxes, and hence, complicate what are already difficult fiscal problems.

3. More generally, there is a concern that greater stability of exchange rates would be purchased at the cost of both greater instability of other prices in the economy--including interest rates and prices of nontraded goods, and of a diminished capacity to use monetary policy to pursue other objectives of policy. For example, a large hike in interest rates taken to protect a weak currency could disrupt stock market prices. Similarly, a firm commitment to defend a given exchange rate pattern might limit the freedom of maneuver of monetary authorities in combating a weakness of certain financial institutions.

4. Some would say that exchange market intervention offers a solution to the "two-hat" problem by introducing an additional policy instrument to handle the exchange rate. Note that this line of argument should refer exclusively to sterilized intervention since non-sterilized intervention is best regarded as monetary policy by another name. Yet the available empirical evidence on sterilized intervention is not very encouraging to those who favor highly managed rates. In brief, the Jurgensen Report [1983] concluded that sterilized intervention

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1/ See Frenkel [1975] and Dornbusch [1988].

is not likely to have a powerful effect on the level of the exchange rate over the medium to long run. Thus, while intervention may be helpful in smoothing short-run volatility and in providing the market with a "signal" about the future course of policies, 1/ it is not by itself likely to deliver monetary policy from having to serve two masters.

5. Another possible way out of the box would be controls on international capital flows. This is indeed the route sometimes taken in the past by some members of the EMS, as evidenced by the widening of interest differentials (adjusted for differences in tax treatment) between onshore and offshore financial instruments (denominated in the same currency) during periods of exchange rate crisis. 2/ No one asserts that capital controls are costless. The argument instead is that such controls are less costly to the real side of the economy than alternative policy options. In fact, Tobin's [1980] "sand-in-the-wheels" proposal for an international round-tripping tax on all capital flows employs just this rationale.

In our view, the case for capital controls is a weak one, on at least five counts.

First, the benefits from liberalization of capital controls appear to be substantial, including higher real returns to savers, smaller spreads between borrowing and lending rates, a lower cost of capital to firms, better hedging possibilities against a variety of risks, and a more efficient allocation of investment. 3/

1/ See Mussa [1981].
2/ See Giavazzi and Giovannini [1988].
3/ See Folkerts-Landau and Mathieson [1988].

Second, capital controls themselves induce changes in financial structure and rent-seeking activities that make it difficult to subsequently reverse them; yet the longer they stay in place, the more serious the distortions associated with them.

Third, there is no effective way to separate a priori productive from nonproductive capital flows. Also, the costs of an inappropriate classification could be large. In this connection, if some speculators are deterred from seeing through the "J-curve," exchange market stability could be adversely affected--a result directly opposite to the original rationale for controls.

Fourth, since controls are seldom negotiated on a multilateral basis, they can poison the atmosphere for advances in coordination and cooperation in other areas; in particular, controls on capital flows are run counter to the development of an outward-looking policy strategy.

Fifth, round-tripping taxes are neither practical nor desirable. To work, such taxes need to be applied universally; yet an incentive always exists for some country not to impose the tax and thereby to capture much of other countries' business, i.e., their effectiveness will be diminished by "regulatory arbitrage." 1/ Also, they would require a country that wishes to attract a capital inflow to raise interest rates even more, to offset the effect of the tax, thereby possibly increasing the variability of interest rates.

1/ See Levich [1987].

6. Yet another tack would be to assign fiscal policy to internal balance so that monetary policy can concentrate more on the exchange rate. Such an argument, however, faces two immediate problems. One is that fiscal policy is considerably less flexible than monetary policy in almost all industrial countries; contrast, for example, the frequency of meetings of the FOMC with the frequency of budget submissions to Congress. The other problem is that fiscal policy is not oriented to short-run stabilization goals in most industrial countries; it is instead guided by other considerations (e.g., reducing the share of government in GDP, reducing the burden of taxation, etc.) that often become objectives in themselves. For these reasons, it is hard to think of fiscal policy as a close substitute for monetary policy.

7. Thus far, we have outlined some of the costs and trade-offs that might be associated with less independent monetary policy. There is, however, another side of the issue that sees both the loss and consequences of monetary independence under greater exchange rate fixity as much less serious. Advocates of this position make the following points:

First, the independence of monetary policy disappears once the exchange rate is transformed from a policy instrument to a policy target. Experience suggests that few countries are able to treat the exchange rate with "benign neglect" once it moves by a large amount.

Second, increased independence of monetary policy is not synonymous with increased effectiveness. The true constraint on the latter is not the exchange rate regime but instead the openness of national economies, particularly high international capital mobility. With floating rates, exchange rates respond rapidly to perceived changes in monetary policy; nominal wages and prices adjust rapidly to changes in exchange rates; and the invariance of real wages to exchange rate changes--guaranteed over the long run by the homogeneity postulate--limits the effects of monetary policy on real output and employment. In the end, the real choice is between accepting reasonable constraints beforehand or having them imposed at higher cost later by markets. 1/

Third, the inflexibility of fiscal policy is an asset--not a liability--in a world of inflation-prone authorities. Growth and price stability will be best served when fiscal policy is put on a steady, medium-term course. If there is an unusual situation that is widely recognized as calling for a shorter-term adjustment of fiscal policy, it can be accomplished (witness recent temporary departures from the medium-term path of fiscal consolidation in Japan and in the Federal Republic of Germany).

8. To sum up, the real issue is not whether monetary policy is capable of restoring more stability to exchange rates. Surely it can. It is instead what one has to give up in terms of other objectives to get it. To some observers, that shadow price is too high and they would therefore prefer to live with a "natural" degree of exchange rate stability--

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1/ See Duisenberg [1988].

much in the way that one accepts a "natural" rate of unemployment. To others, the exchange rate regime cannot take away what is no longer there in any case, namely, the ability of monetary policy to influence real output and employment in the long run under conditions of high capital mobility. Again, the view that prevails in the end will have a lot to do with the structure of any modification or reform of the exchange rate system.

IV. Identifying Equilibrium Exchange Rates

1. As highlighted in our earlier snapshot of key developments in the world economy, the 1980s have been marked by large swings in major currency exchange rates. One popular position has been that these currency swings have been subject to large and persistent misalignments, where by "misalignment" one means a departure of the actual (real) exchange rate from its equilibrium level. One implication of this view is that the exchange rate is too important a relative price to be left entirely to the market and therefore that officials should guide the market by supplying it with their own concerted view of the equilibrium rate. An opposing position is that the very concept of an equilibrium exchange rate different from the market rate is so riddled with conceptual and empirical problems as to render it operationally vacuous. 2/

2. The case that the equilibrium exchange rate may differ from the rate generated by the free operation of the marketplace rests on a number of arguments:

1/ For an elaboration of these considerations, see Frenkel and Mussa [1981] and Frenkel [1983].

2/ See Haberler [1987].

One is that the equilibrium rate should reflect the sustainability of policies. 1/ For example, if the market exchange rate reflects an unsustainable budget deficit, then this rate may not be considered as an equilibrium even though it clears demand and supply in the market.

A second rationale for rejecting the market rate as an equilibrium rate is that it may imply undesirable values for certain objectives of policy, such as unemployment, growth, or the degree of restriction in goods and capital markets. Nurkse [1954], for example, defined the equilibrium rate as the rate that would produce equilibrium in the balance of payments, without wholesale unemployment, undue restrictions on trade, or special incentives to incoming or outcoming capital.

The existence of market imperfections represents another possible reason for eschewing the market's verdict, this time on second-best considerations. Specifically, the existence of imperfect labor mobility is sometimes put forward as a reason for concluding that the market rate is too "noisy," 2/ and that exchange rate stability shares certain "public good" attributes. 3/

The recent literature on "speculative bubbles" can also be seen as antagonistic to the market-rate-is-the-right-rate position by demonstrating that models of profitable destabilizing speculation can exist.

1/ See Frenkel [1987].

2/ For an empirical attempt to judge whether actual exchange rates are too noisy in terms of departures from fundamentals generated by a monetary model of exchange rate determination, see West [1987].

3/ See Cooper [1976].

On the empirical side, there is likewise by now a large body of empirical work which suggests that there have been periods over the past 15 years when the market's evaluation of the equilibrium rate was considerably different from the sustainable rate (Krugman [1986]), or when it was difficult ex post to explain actual rate movements in terms of "fundamentals" (Buiter and Miller [1987]).

Finally, even if one did want to look to the market for the equilibrium rate, opponents of floating rates point out the market rate is distorted by a variety of official interventions that render it a far cry from a "clean float." Since there are many ways to skin a cat and since it is hard to envisage a prohibition on all such interventions, the market rate is, in their view, of limited use.

3. Still, it takes an estimate to beat an estimate. That is, if the market's view is rejected, then authorities need to supply their own estimate of the equilibrium rate. What then are the leading approaches? 1/

Perhaps the most long-lived is the purchasing-power-parity (PPP) approach. This can be expected to generate reasonable estimates if one can identify an equilibrium base period and if all shocks between the base and current periods are monetary in origin. But when there are real shocks, one normally wants a departure from PPP. Trend inter-country differences in labor productivity (not just in tradables relative to

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1/ See Frenkel and Goldstein [1987] for a more comprehensive discussion of alternative methods for estimating the equilibrium exchange rate.

nontradables a la Balassa [1964] but in tradables as well); 1/ permanent changes in the terms of trade; and shifts from net creditor to net debtor positions--are just some of the real factors that call for a change in real exchange rates. In this sense, it can be hazardous to assume that the equilibrium exchange rate is constant over time.

A second option is to resort to structural models of exchange rate determination to produce estimates of the exchange rate consistent with "fundamentals." The fly in the ointment here, aside from measurement problems for some of the right-hand side variables, is that these models--be they of the monetary or portfolio balance variety--have been shown to possess poor out-of-sample forecasting properties. 2/ But why then should markets trust them as reliable indicators of equilibrium rates?

Yet a third way to go is to use an econometric trade model to solve for the level of the exchange rate that--given anticipated real output and inflation paths over the next 18 months or so, and given any relative price effects still "in the pipe"--will produce a current account equal to "normal capital flows." This is often referred to as the underlying balance approach. The main sticking point with this approach, aside from the wide range of estimates of trade

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1/ See Marston [1987] for an empirical analysis of trend differences in labor productivity in tradables as between the United States and Japan, and for evidence on the drawbacks of measures of competitiveness that rely on broad price indices such as the CPI. On the broader issues concerning the limitations of the PPP approach, see Frenkel and Mussa [1980] and Frenkel [1981].

2/ See Meese and Rogoff [1984, 1985].

elasticities, 1/ is the need to estimate "normal capital flows." Given the instability of perceived investment opportunities across countries and over time, it is hard to say if, for example, the United States should be regarded as a net capital exporter or a net capital importer, and if the latter, whether normal inflows are $10 billion or $100 billion.

4. All of this suggests--at least to us--that estimates of equilibrium exchange rates could be subject to rather substantial margins of error, and that official estimates of equilibrium rates should be allowed to change over time in response to changes in real economic conditions. Those who favor a modification or reform of the exchange rate system therefore need to ponder two questions: (i) are official estimates of the equilibrium exchange rate likely to be better on average than the market's estimate, and (ii) would a moving official estimate of the equilibrium exchange rate with a relatively wide band be helpful as an anchor for medium-term expectations about exchange rates? If both these questions can be answered in the affirmative, then the recent evolution of the system toward more "management" and more "fixity" of exchange rates is likely to continue. If not, then strong reliance on the market to determine the right exchange rate, like democracy, may be the worst system--except for all the others.

1/ See Goldstein and Khan [1985] for a survey of trade elasticities.

V. Leaders, Rules and Anchors

1. The strengthening of international economic policy coordination that began in earnest at the Plaza in September 1985 represents, as noted above, a move in the direction of more cooperative management of the system. Yet some might describe present arrangements as a "non-system" because relative to, say, Bretton Woods or the EMS, there is a less formal structure, with no specific operating rules, no acknowledged leader, and no explicit anchor. It is therefore of interest to consider whether such factors are likely to influence the effectiveness of an exchange rate system.

2. A convenient way of characterizing the Bretton Woods system is as an "implicit contract" between the leading country, or hegemon, and the satellite countries. The leader accepts the obligation to conduct its macroeconomic policies in a prudent, stable way--perhaps best summarized by a steady, low rate of inflation. This obligation is also reinforced by the leader's commitment to peg some nominal price--in this case, the price of gold. Since there are only N-1 separate exchange rates among N countries, the leader is passive about his exchange rate. The satellite countries commit to peg their exchange rates within agreed margins to the leader. As a reaction to the competitive depreciations of the 1930s, all exchange rate adjustments were placed under international supervision and were to be undertaken under conditions of "fundamental disequilibrium." As a consequence of their exchange rate obligations, the satellites forego independence in their monetary policies but receive the assurance that they have hitched their wagons

to an engine that will stay on the tracks. Under this implicit contract, both sides can be said to be "disciplined" by their obligations and both share any efficiency gains associated with moving closer to an international money.

With the benefit of hindsight, it is apparent that such implicit contracts can come under strain from a number of directions (in addition to Triffin's [1960] well-known "confidence problem"). One such strain is a breakdown of discipline by the leader such that the satellites come to see it as exporting inflation rather than stability. The satellites are then likely to sever their links with the leader and to seek stability through other mechanisms, including money-supply targeting and regional exchange rate arrangements with a more stable leader. A second strain is a change in underlying conditions that calls for a change in the real exchange rate between the leader and some of the satellites to restore external balance. If that equilibrating change in the real exchange rate is blocked by too much rigidity of nominal exchange rates (in surplus satellite countries), then the leader is apt to abandon his commitment to be passive about the exchange rate.

3. The European Monetary System (EMS) like Bretton Woods, places exchange rate adjustments under common supervision. It also has clear rules about the intervention obligations of members. While there is no formal leader, many observers regard the Federal Republic of Germany (and its Bundesbank) as the de facto or acknowledged leader. 1/ In

1/ See Giavazzi and Giovannini [1986].

this sense, it might be regarded as a system with informal hegemony. The implicit contract is similar in many ways to that under Bretton Woods. Germany follows macroeconomic policies that "export" price stability and anti-inflationary credibility to the others. It is noteworthy that while there have been 11 realignments within the EMS, none of them has resulted in a revaluation relative to the deutsche mark, thus leaving Germany's reputation as an exporter of stability intact. Other EMS members are often described as "tying their hands" on domestic monetary policy. 1/ Exchange rate realignments may not always provide full compensation for past inflation differentials. In this way, the resulting real appreciation for high inflation countries can act as a disincentive to inflation, while low inflation countries receive a gain in competitiveness that provides some compensation for their export of anti-inflationary credibility. Monetary policy in Germany is typically regarded as the anchor.

4. While there clearly have been periods when large countries have exerted a stabilizing influence on the system, it would, in our view, be erroneous to conclude that hegemony is a necessary characteristic of a well-functioning international monetary system. For one thing, Eichengreen's [1987] careful study of alleged hegemonic systems, including the gold standard, reveals that the amount of coordination needed for smooth functioning was substantial. A case in point is the coordinated action of last Fall in the EMS when Germany and the Netherlands lowered their interest rates, while France raised its rate.

1/ See Giavazzi and Pagano [1985].

Second, the appearance of hegemony can sometimes result as much from common objectives as from asymmetries in economic size or reputation among countries. Again, the EMS serves as a fascinating laboratory. In the early 1980s, disinflation was the top priority in virtually all EMS countries. Since Germany had the best reputation for price stability, there was a commonality of interests in trying to converge to the German inflation rate. Now, however, some observers (e.g., Dornbusch [1988]) argue that given both the progress already made on the inflation front and the high unemployment rates prevailing in some EMS (and potential EMS) countries, it is time to give greater weight to objectives other than inflation. To some, such a decision would inevitably result in a more symmetric EMS. Indeed, these observers (e.g., Holtham et al [1987]) view the proposals on the EMS put forward to the EC Monetary Committee last Fall by Minister Balladur of France as prefacing such a development of the EMS.

5. The system of floating rates that replaced Bretton Woods in 1973 could be said to have its own implicit contract. This contract suggested that each country should adopt sound and stable macroeconomic policies at the national level, with the expectation that stability of exchange markets would emerge as a useful by-product. In the event, some major countries did not adopt sound and stable policies at the national level, spillovers or externalities associated with these poor policies were significant (including protectionist pressures), and exchange rates displayed considerable volatility. In this decentralized system, there was no acknowledged leader. National

macroeconomic policies served as anchors. The fact that intervention practices were sometimes different and uncoordinated led some (McKinnon [1985]) to argue that an upward rise was imparted to the world money supply.

6. The perceived inadequacies of the decentralized floating rate system were, not surprisingly, the impetus for the move to stronger international economic policy coordination. The rationale behind the coordination process--and we think it can only be regarded as an evolving process--is that you need a mechanism to internalize the externalities of policy actions by the larger countries. Specifically, multilateral surveillance is employed to see that the international spillovers--both good and bad--of each country's policies--including the feedback of these spillovers to the country itself--are taken into account in the final, multilateral policy bargain. In some cases, countries may also be able to use "peer pressure" to help them take policy actions that are unpopular domestically but which are beneficial to them in the long run. 1/

Although successive coordination agreements share several common elements (policy commitments, a concerted view on exchange rate developments, and pledges for closer cooperation on exchange market intervention), there are no explicit rules that apply across agreements. This flexibility carries both advantages and disadvantages. On the one hand, the agreements can cover a broad range of policies (including structural as well as macroeconomic policies), they can be

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1/ See Haberler [1987] for a different view on peer pressure.

quite country-specific and quantitative, and they can be custom-tailored to the most pressing problems of the day. On the other hand, without rules there are higher negotiation and recontracting costs.

Countries' monetary and fiscal policies serve as anchors in this system. Recently, however, U.S. Treasury Secretary Baker and U.K. Chancellor Lawson suggested the possible use of a commodity-price basket indicator as an early warning signal of future aggregate price developments. This might provide some assurance that stabilization of exchange markets does not come at the expense of either global inflation or deflation.

Another recent and noteworthy innovation in the coordination exercise is the consideration of aggregate indicators for the G-7 countries as a group. Their rationale is straightforward: even when members of the coordination group reach agreements that are viewed as mutually beneficial, care still needs to be taken to ensure that such policy packages have satisfactory implications for those not at the table. This is particularly relevant in the case of the G-7 countries since the spillover effects of their policies on the rest of the world are known to be large. Aggregate indicators, covering such variables such as G-7 growth rates are simply a vehicle for getting a better handle on these spillovers. In this connection, it is well to remember that there is a debt problem as well as a problem of improving the functioning of the international monetary system, and measures introduced to alleviate one will inevitably affect the other.

SECRET

pap

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

15 February 1988

Dear Alex,

VALUATION OF THE RESERVES

The Prime Minister was most grateful for the material provided with your letters of 9 February, concerning the revaluation of the EMCF swap, and 10 February, concerning the valuation of dollar reserves in the UK and Germany.

16/2

CH/EXCHEQUER
REC. 15FEB1988
ACTION
COPY TO

EST, Su P Middleton
Su G Littler
Su T Burns
Mr Scholar
Mr Peretz
Miss O'Mara

Yours,
Paul

PAUL GRAY

Alex Allan, Esq.,
H M Treasury

Mr Grice
Ms Goodman
Mr Cropper

SECRET

SECRET

16/2/88.

NOTE

The circulation of this memorandum has been restricted. Recipients are accordingly asked to ensure that the confidentiality of its contents and the need to know principle are strictly observed. It should not be sent outside the Private Office.

SECRET

ANNEX 1

	1980	1981	1982	1983	1984	1985	1986	1987	1988(1)
World GNP,(2) in major 7 economies (per cent change)	1	1½	-½	3	5	3	2½	3	2½
UK GDP,(2) (per cent change)	-2½	-1	1½	3½	2½	3½	3	4¼	3
Domestic demand,(2) (per cent change)	-3	-1½	2	4½	3	3	4	4	4
Retail prices Q4 (per cent change) on a year earlier	15½	12	6	5	5	5½	3½	4	4
Interest rates (average 3-month interbank)	16½	14	12½	10	10	12	11	9½	9½(3)
Unemployment (UK, per cent of working population excluding school leavers)	5½	8½	10	11	11	11½	11½	10½	9
Sterling Index	96	95	90½	83	78½	78	73	72½	74(3)

(1) Provisional pre-Budget figures.

(2) At constant prices.

(3) February 12.

ANNEX 2: DIRECT EFFECTS OF TAX CHANGES

A. Direct Taxes: Indexation

The RPI increased in the year to December 1987 by 3.7 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and other thresholds would be:

Personal allowances	1987-88	1988-89
Single and wife's earned income allowance	2,425	2,515
Married allowance	3,795	3,945
Bands, eg:		
29% rate	0-17,900	0-18,600
60% rate	over 41,200	over 42,800

The total revenue costs of indexation of income tax (included in the forecast) are £840 million in 1988-89 and £1,370 million in 1989-90.

B. Indirect Taxes: Indexation

The effects of 3.7 per cent revalorisation of the excise duties (including VAT effects) are as follows:

VAT inclusive price change		Yield in 1987-88 £m	RPI impact % points
Beer	0.8p/pint	60	0.04
Wine	3.1p/75cl light wine	20	0.02
Spirits	20.1p/bottle	25	0.03
Tobacco	3.4p/20 king size	100	0.09
Petrol	3.7p/gallon	195	0.07
Derv	3.2p/gallon	50	neg.
VED	£3.7/car	100	0.03
Overall effect, including minor duties (included in forecast)		550	0.28

C. Ready Reckoners: Illustrative Tax Changes

	£ million 1988-89	1989-90
INCOME TAX		
Allowances and Thresholds		
1% above indexation on all statutory allowances	185	240
1% above indexation on all statutory allowances and thresholds	215	295
Rates		
Change in basic rate of 1p	1,250	1,600
Change all higher rates by 1p	85	165
CORPORATION TAX		
Change in main rate of 1 percentage point	360	560
Change in small companies' rate of 1 percentage point	25	45
VALUE ADDED TAX		
Change in VAT rate of 1 percentage point[1]	940	1,310

[1] A 1% change in the VAT rate would change the RPI by 0.5%

ANNEX 3: PUBLIC FINANCES AND THE TAX BURDEN

Taxation, Expenditure and Borrowing

Since the Government first took office, total taxes and NICs have risen by over 4 percentage points of GDP, though the ratio has fallen from its peak in 1981-82. This has enabled us to secure a substantial reduction in public borrowing.

Table 1

Overall Taxation, Expenditure and Borrowing
(percentage of GDP at market prices)

	Non-North Sea Taxes plus NICs (as per cent of non-North Sea GDP)	Total Taxes plus NICs	General Government Expenditure (excluding privatisation proceeds)	PSBR
1978-79	34.1	33.8	43.2	5.3
1979-80	35.2	35.1	43.4	4.8
1980-81	36.1	36.3	46.0	5.4
1981-82	38.7	39.4	46.5	3.3
1982-83	38.2	38.9	46.8	3.1
1983-84	37.8	38.5	45.9	3.2
1984-85	37.8	39.1	46.2	3.1
1985-86	37.0	38.5	44.5	1.6
1986-87	37.4	37.9	43.9	0.9

Personal Taxation

2. Despite reductions in income tax, total personal taxes (direct and indirect, including employees' NICs and domestic rates) in 1987-88 are about £24 billion higher in real terms (ie 1987-88 prices) than they were in 1978-79. For income tax and national insurance contributions the following table shows how the proportion of gross pay they represent rose up to 1981-82, particularly for the low paid:

Table 2

Income Tax and NICs as a % of Gross Earnings*

	½ average earnings	average earnings	2 average earnings
1978-79	16.0	27.8	31.4
1981-82	20.8	29.3	32.2
1982-83	20.8	29.8	32.3
1983-84	20.1	29.6	31.7
1984-85	19.3	29.2	31.5
1985-86	18.9	29.0	31.5
1986-87	18.9	28.5	30.9
1987-88 (estimate)	18.9	27.4	29.7
1988-89 (indexation)	19.3	27.6	30.0

*Adult male earnings (all occupations). Married couple, wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.

3. These figures reflect the rise in the standard employees' NIC rate from 6½% to 9%. The lower rates introduced in the 1985 Finance Act do not affect the cases shown. So far as income tax is concerned, personal allowances have increased by about 22% in real terms since 1978-79, slightly less than earnings. The basic rate has been reduced from 33p to 27p, but the 25p reduced rate band has been abolished.

4. As the table shows, indexation of allowances in the Budget would lead to a slight rise in the proportion of incomes taken in tax and NICs. This is because earnings are assumed to rise by more than the increase in tax thresholds, which is indexed to changes in prices.

Business Taxation

5. Following the sharp rise in corporation tax receipts over the past two years, total taxes paid by businesses (outside the North Sea) are now higher as a percentage of GDP than in 1978-79. Within this total, the major change has been a fall in employers' NICs and NIS as a percentage of GDP, offset by increases in corporation tax, business rates and 'other' taxes as the following table shows:

Table 3

Taxes paid by Businesses £bn in 1987 88 prices

(figures in brackets are % of GDP)

	Corporation Tax[1]	Taxes on self employment incomes	Employers' NICs and NIS	Rates	Other[2]	Total
1978-79	7.7	2.6	12.6	5.1	4.0	32.1
	(2.2)	(0.7)	(3.6)	(1.4)	(1.1)	(9.1)
1987-88 (estimate)	15.2	3.3	11.3	7.2	5.9	43.0
	(3.6)	(0.8)	(2.7)	(1.7)	(1.4)	(10.1)

[1]Excludes North Sea, but includes ACT

[2]VED, car tax, road fuel duty, duty on rebated oils, capital taxes

psec.lb/mr.4 Lords

FROM: Assistant Parliamentary Clerk
DATE: 17 February 1988

01-270 5007

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PS/Customs & Excise
Mr Bonney - IAE1
Mr Gieve - IDT
Mr Dyer

FORTHCOMING TREASURY BUSINESS IN THE HOUSE OF LORDS

You may wish to be aware that the current forthcoming Treasury business in the Lords is as follows:

ORAL QUESTIONS

Wednesday 1 March Baroness Lockwood - To ask Her Majesty's Government why university halls of residence are classified as non-domestic for purposes of Value Added Tax.

Government Spokesman: Lord Strathclyde. Customs and Excise in the lead.

TREASURY INTEREST QUESTIONS

ORAL

Thursday 2 March Lord Jay - To ask Her Majesty's Government what action they are taking to prevent large scale fraud in the distribution of export subsidies by the commission of the European Communities under the Common Agricultural Policy.

Government Spokesman: Baroness Trumpington. Ministry of Agriculture Fisheries and Food in the lead.

Mari Rogerson

MARI ROGERSON

FROM: MRS D LESTER
DATE: 17 FEBRUARY 1988

1. MR EVANS
2. PS/CHANCELLOR

cc: PS/EST
Sir G Littler
Mr Mountfield
Mr Walsh
Mr R I G Allen
Ms Life
Mr Hudson
Mr May
Miss Higgins

LETTER TO THE CHANCELLOR FROM FRANK JUDD OF OXFAM

Frank Judd, Director of Oxfam, wrote to the Chancellor on 3 February about African debt.

He has written previously on 19 October and 24 December 1987 (copies of correspondence attached for top copy only) and received substantive replies from the Chancellor. I understand that the Chancellor wishes to send a short response on this occasion. I attach a draft reply which has been agreed with AEF.

Debbie Lester

MRS D LESTER
IF1

Retype final

DRAFT REPLY TO FRANK JUDD, DIRECTOR OF OXFAM

Thank you for your further letter of 9 February about African debt. Let me respond briefly to the points you raise.

We have made a great deal of progress over the past year in easing the problems of the poorest countries in Africa. But, as I said in my earlier letters, we need a general agreement by Paris Club creditors in order to implement my proposal to reduce interest rates on rescheduled debt. We will continue to take every opportunity to try to convince all Paris Club creditors of the need to reduce interest rates. If there is agreement, the cost will be met from the Reserve in 1988-89.

Amendment telephoned by Mrs Lester. AF 17/12

The UK's contribution, ~~by way of subsidy, to~~ to the subsidy in the the Enhanced Structural Adjustment Facility is likely to be bigger than that of any other country. As I explained in my written answer to Bowen Wells MP of 14 December (copy attached), additional funds for the ESAF will be made available to the ODA to cover the costs of the increased contribution. The cost of our original offer was already included in the aid budget, which is set to rise in real terms, as was the cost of the £250 million for World Bank co-financing.

In my speeches in Washington in April I expect to set out my views ~~on the Mexican and other debt initiatives~~. on recent developments on the debt front.

NIGEL LAWSON

Payroll Giving

94. **Mr. Colvin:** To ask the Chancellor of the Exchequer what has been the value to the arts of the Government's payroll giving scheme since it was introduced.

Mr. Brooke: I regret that this information is not available.

International Monetary Fund

Mr. Wells: To ask the Chancellor of the Exchequer whether he will make a statement on the United Kingdom's contribution to the enhanced structural adjustment facility of the International Monetary Fund.

Mr. Lawson: At the annual meeting of Commonwealth Finance Ministers in September, I announced that the United Kingdom would make a contribution to the interest subsidy associated with the proposed enhanced structural adjustment facility (ESAF) of the International Monetary Fund, which is designed to support structural adjustment programmes in low-income countries. Since then I have reviewed the United Kingdom's contribution to the enlarged SAF, decisions on which should be completed by the end of this month. The United Kingdom executive director to the IMF has now been authorised to increase Her Majesty's Government's earlier offer to an interest subisidy sufficient, at present interest and exchange rates, to subsidise lending rising to 1 billion SDRs (the equivalent of £750 million). This is more than double our earlier offer.

The facility will complement the United Kingdom's own initiative for measures to relieve the burdens of bilateral debt servicing of these countries, which I announced last spring in Washington and which we are continuing to press. There is increasing international recognition of the need to relieve the debt burdens of the poorest African countries, provided they are pursuing sustained programmes of economic reform.

Additional funds will be made available to the overseas aid programme to cover the costs of this increased contribution. The additional costs in 1988-89 will be charged to the reserve and will therefore not add to the total of planned public expenditure.

The prospect of this additional contribution has been warmly welcomed by the IMF managing director and is being made on the basis that appropriate contributions will be made by other major countries and that differentially favourable access will be given to those in greatest need, especially the low-income heavily-indebted countries of sub-Saharan Africa.

Employment

Mr. Adley: To ask the Chancellor of the Exchequer what estimate he has made of the effect of the recent fall of share prices on the level of employment; and if he will make a statement.

Mr. Major: The forecast published in the Autumn Statement took account of the fall in world stock markets. While this inevitably made the prospect more uncertain, growth of 2½ per cent. (3 per cent. for the non-oil economy) was forecast, holding out the prospect of further falls in unemployment.

Mortgage Interest Tax Relief

Mr. Shersby: To ask the Chancellor of the Exchequer if he will make an estimate of the number of people buying homes in the United Kingdom with the benefit of mortgage tax relief over the latest period for which figures are available.

Mr. Norman Lamont: It is estimated that about 8·4 million tax units are benefiting from mortgage interest relief in 1987-88.

Capital Gains Tax

Dr. Marek: To ask the Chancellor of the Exchequer what has been the cost to the Exchequer for the last year of capital gains tax relief where compulsory purchase has been involved; and how many cases there have been.

Mr. Norman Lamont: About £3 million on the basis of receipts in 1986-87. Information is not held centrally on which to base an estimate of the number of cases involved.

Value Added Tax

Mr. Teddy Taylor: To ask the Chancellor of the Exchequer what discussions he has had with the Electricity Council and British Gas about the implications for their industries and consumers of the proceedings on the levying of value added tax, initiated in the European Court of Justice on 15 September; and if he will make a statement.

Mr. Lilley: The European Court of Justice is not expected to issue its judgment until some time in the new year. The judgment's detailed implications, if any, for individual industries will need to be assessed when the judgment is issued. The Government have not yet held discussions with the Electricity Council or British Gas.

Job Creation

Mr. Wray: To ask the Chancellor of the Exchequer pursuant to his reply of 9 December, how many of the jobs created between 1983 *(a)* in manufacturing industry and *(b)* in the services sector were in Scotland; and if he will make a statement.

Mr. Major: Estimates of self-employment by industry are not available for Scotland. The table sets out the figures for employees in employment in manufacturing and in services, along with estimates of total employees in employment, total self-employment in Scotland, and total employment.

108/G/GBH/150/24

SECRET

FROM: MISS M O'MARA

DATE: 19 FEBRUARY 1988

CHANCELLOR OF THE EXCHEQUER

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Scholar
Mr Peretz
Mr R I G Allen
Ms Goodman

Ch

Better to publish something like - $28m?

AA

FEBRUARY RESERVES FIGURE

We have to decide what underlying change we want to show when February's reserves figure is published. (The last dealing day for value this month is Thursday 25 February.)

2. Yesterday's evening report showed an underlying fall of $28 million, on the assumption of no further market intervention during the month. However, the picture is complicated by MOD's rolling programme of forward purchases. If we wish to offset the impact of this on the forward book, we should need to show an underlying fall of $200-225 million for February. (We shall ensure the evening report makes the consequences of MOD forward purchase clearer in future months.)

3. The Bank's slight preference is to show a "true" figure for February. They point out that the market believes the authorities were giving sterling some support earlier in the month, although in fact we were not. Thus an underlying fall of around $200 million would come as no surprise. The gilts market would also probably welcome an underlying fall but given the current position on funding in 1987-88, this is not a point to which we would attach much importance.

4. You have been concerned not to publish an underlying fall in recent months in case this stirred up discussion about the profitability of our intervention. We last engaged in substantial market intervention in the first half of December, when the £/DM cross rate came under pressure. Sterling then stood around $1.80. The rate in February has been around $1.75, so to the extent commentators were to believe we had been unwinding in February some of the market intervention we undertook in December, they would conclude we had done so at a profit.

5. Would you be content to publish an underlying fall of around $200 million this month?

MOM

MISS M O'MARA