TREASURY

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PART A

CHANCELLORS SPEECHES
1988

FOR DISPOSAL ADVICE SEE INSIDE COVER

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CHANCELLOR'S SPEAKING NOTE FOR THE
INTERIM COMMITTEE, MORNING SESSION
THURSDAY, APRIL 14, 1988

A YEAR AGO AT THIS MEETING, THERE WAS SOME ANXIETY ABOUT THE PACE OF ECONOMIC ACTIVITY. IN THE EVENT, THIS PROVED UNFOUNDED AND GROWTH LAST YEAR TURNED OUT AT ABOUT 3 PER CENT.

IT NOW ALSO APPEARS THAT WE HAVE SHRUGGED OFF THE STOCK MARKET CRASH-- THE GREAT ECONOMIC NON-EVENT OF 1987. THIS IS MADE EVIDENT IN THE FORECASTS FOR THE US ECONOMY. FOLLOWING THE SHARE PRICE COLLAPSE, THE BLUE CHIP CONSENSUS FORECAST FOR GROWTH IN 1988 WAS REVISED DOWN FROM 2 3/4 PER CENT TO UNDER 2 PER CENT. IN RECENT MONTHS, THE FIGURES HAVE BEEN REVISED

UP AND THE LATEST FIGURE IS BACK TO THE PRE-CRASH LEVEL.

INDUSTRIALISED COUNTRIES' OUTPUT GROWTH, TAKEN AS A WHOLE, IS EXPECTED TO BE CLOSE TO 3 PER CENT AGAIN THIS YEAR, JUST A LITTLE BELOW THE AVERAGE FOR THE PAST 5 YEARS. AND THERE IS NO SIGN OF A RESURGENCE OF INFLATION. THAT TOO IS EXPECTED TO CONTINUE AT ABOUT 3 PER CENT.

SO, ALTHOUGH FAR FROM SPECTACULAR, THE ECONOMIC OUTLOOK FOR THE INDUSTRIALISED COUNTRIES AS A WHOLE IS NOT TOO BAD. WE MUST STILL DO ALL WE CAN TO STRENGTHEN THE SUPPLY PERFORMANCE IN OUR COUNTRIES AND TO CONTINUE WITH THE ANTI-INFLATIONARY POLICIES THAT HAVE SERVED US WELL IN RECENT YEARS. THE US STILL HAS SOME WAY TO GO IN REDUCING ITS BUDGET DEFICIT. AND WE MUST ALL

CONTINUE TO REJECT PROTECTIONISM. I APPRECIATE THE DETERMINED STANCE THE US ADMINISTRATION HAS SO FAR TAKEN, AND I TRUST WILL CONTINUE TO TAKE. INDEED, WE MUST ALL WORK TO REDUCE RATHER THAN INCREASE TRADE BARRIERS. LET US RESOLVE TO MAKE REAL PROGRESS AT THE MID-TERM REVIEW IN THE CURRENT GATT ROUND.

HOWEVER, WHILE PERFORMANCE IN AGGREGATE REMAINS SATISFACTORY, WE STILL LIVE WITH UNSUSTAINABLY LARGE CURRENT ACCOUNT IMBALANCES BETWEEN THE UNITED STATES, JAPAN AND GERMANY, ALTHOUGH WE HAVE BEGUN TO SEE SOME CORRECTION. LAST YEAR, DOMESTIC DEMAND GROWTH IN GERMANY, AND NOTABLY IN JAPAN, EXCEEDED THAT IN THE UNITED STATES. EVEN SO, THIS PATTERN NEEDS TO BE REPEATED FOR SEVERAL MORE YEARS.

ALTHOUGH FURTHER CORRECTION IS NECESSARY, IMBALANCES THAT BUILT UP OVER MANY YEARS CANNOT BE CORRECTED OVERNIGHT. NOR MUST WE BECOME TRAPPED INTO THE OUTMODED THINKING OF A WORLD OF EXCHANGE CONTROLS AND IMMOBILITY OF CAPITAL. THE PATTERN OF SAVINGS AND INVESTMENT OPPORTUNITIES INEVITABLY VARIES FROM COUNTRY TO COUNTRY. IN THESE CIRCUMSTANCES, SOME CURRENT ACCOUNT DEFICITS OR SURPLUSES MAY BE SUSTAINED A NUMBER OF YEARS.

OVER THE PAST YEAR, WE HAVE SEEN A FURTHER STRENGTHENING OF POLICY COOPERATION BETWEEN THE INDUSTRIALISED COUNTRIES, AND EFFORTS TO CHANGE THE BALANCE BETWEEN DOMESTIC DEMAND AND EXPORTS HAVE STARTED TO PAY OFF. THE DECISIVE ACTION BY THE AUTHORITIES AFTER OCTOBER 19 PLAYED A CRUCIAL PART IN DEFUSING THE POTENTIALLY

DAMAGING CONSEQUENCES OF THE STOCK MARKET COLLAPSE. AND CLOSE INTERNATIONAL COOPERATION HAS HELPED TO STABILISE THE DOLLAR FOLLOWING ITS EARLIER NECESSARY FALL. WE HAVE HAD A WELCOME REDUCTION OF EXCHANGE RATE INSTABILITY, AND IN THIS CONTEXT THE G7 REAFFIRMED AT THEIR MEETING YESTERDAY THEIR AGREEMENT OF LAST DECEMBER.

WE MUST CONTINUE TO BUILD ON THIS EXPERIENCE. I REMAIN DEEPLY SCEPTICAL ABOUT DETAILED PLANS TO FINE TUNE FISCAL POLICIES BETWEEN COUNTRIES; OR TO COMPUTE DETAILED PATTERNS OF EXCHANGE RATES THAT WILL BE CONSISTENT WITH PARTICULAR OBJECTIVES FOR CURRENT ACCOUNT BALANCES. BUT, AS I ARGUED A YEAR AGO, THE OBJECTIVE OF GREATER EXCHANGE RATE STABILITY SHOULD BE GIVEN AN EXPLICIT ROLE IN INTERNATIONAL COOPERATION

AND CAN BE AN IMPORTANT DISCIPLINE TO ENCOURAGE COMPATIBLE POLICIES.

IN THE WAKE OF THE DECLINE OF THE DOLLAR FOLLOWING THE STOCK MARKET CRASH, SOME ARGUED THAT THE LOUVRE AGREEMENT WAS A MISTAKE. FOR MY PART, I SHARE THE VIEWS EXPRESSED BY PAUL VOLCKER IN GENEVA LAST NOVEMBER.

"THE ARGUMENT OF SOME SEEMS TO BE THAT THE AGREEMENT SACRIFICED APPROPRIATE INTERNAL ECONOMIC MANAGEMENT TO THE REQUIREMENTS OF A STABLE EXCHANGE RATE. THAT SEEMS TO ME A MIS-READING OF BOTH THE NATURE OF THE UNDERSTANDING AND, MORE BROADLY, THE NEED TO ACCORD THE REQUIREMENTS OF EXCHANGE RATE STABILITY MORE PROMINENCE IN ECONOMIC POLICY MAKING."

CLEARLY, IF A CONFLICT BETWEEN OBJECTIVES FOR INFLATION AND EXCHANGE RATES EMERGES PRIORITY MUST BE GIVEN TO INFLATION--BUT, IN PRACTICE, THIS DILEMMA OCCURS ONLY INFREQUENTLY.

IN GIVING GREATER PROMINENCE TO EXCHANGE RATE STABILITY, GOVERNMENTS CAN GIVE MARKETS AN IMPORTANT LEAD. GOVERNMENTS ARE NOT ALL POWERFUL; BUT NEITHER ARE THEY IMPOTENT. THEY INFLUENCE SOME OF THE MOST IMPORTANT FACTORS DETERMINING EXCHANGE RATES - BUDGET DEFICITS AND INTEREST RATES, AND MARKETS GIVE WEIGHT TO WHAT THEY INTERPRET AS THE AUTHORITIES PREFERENCES.

WHILE INTEREST RATES ARE THE MOST IMPORTANT INSTRUMENT FOR INFLUENCING EXCHANGE RATES, INTERVENTION ALSO HAS A ROLE TO PLAY IN HELPING GOVERNMENTS TO COUNTERACT POTENTIALLY DAMAGING SHORT-TERM MOVEMENTS IN EXCHANGE RATES. THIS IS ESPECIALLY TRUE IF INTERVENTION IS COORDINATED BETWEEN COUNTRIES. LARGE-SCALE INTERVENTION SHOULD NOT BECOME A WAY OF LIFE, BUT CONTROLLED INTERVENTION IS A USEFUL INSTRUMENT OF POLICY.

ALL THIS CLEARLY HAS CONSIDERABLE RELEVANCE TO THE SUCCESSFUL FUNCTIONING OF THE INTERNATIONAL MONETARY SYSTEM. I SET OUT MY OWN IDEAS ON THIS AT THE ANNUAL MEETINGS LAST SEPTEMBER. I AM GLAD THAT THE G7 YESTERDAY AGREED TO CONSIDER WAYS OF FURTHER IMPROVING THE INTERNATIONAL MONETARY SYSTEM.

FINALLY, TURNING TO THE UK ECONOMY, ECONOMIC PERFORMANCE CONTINUES TO CONFOUND THE FORECASTERS. OUT OF SOME 20 INDEPENDENT FORECASTS, ALL UNDER-ESTIMATED LAST YEAR'S 4-1/2 PER CENT GROWTH; ALL BUT ONE UNDERESTIMATED THE LARGE FALL OF UNEMPLOYMENT; INFLATION REMAINED BELOW THE LEVEL PREDICTED BY ALL BUT THREE OF THESE FORECASTERS; AND DESPITE THE FASTER GROWTH THE CURRENT ACCOUNT POSITION WAS BETTER THAN EXPECTED.

IT IS NOW WIDELY RECOGNISED THAT WE HAVE SEEN A TRANSFORMATION IN THE PERFORMANCE OF THE BRITISH ECONOMY. IN MY BUDGET LAST MONTH I ANNOUNCED A RADICAL REFORM OF THE TAX SYSTEM, WITH A TOP RATE OF INCOME TAX OF ONLY 40 PER CENT, AND A BUDGET SURPLUS. PRUDENT FINANCIAL POLICIES HAVE

GIVEN BUSINESS AND INDUSTRY THE CONFIDENCE TO EXPAND, WHILE SUPPLY SIDE REFORMS HAVE PROGRESSIVELY REMOVED THE BARRIERS TO ENTERPRISE. WHILE MUCH REMAINS TO BE DONE, IT MAY BE OF SOME INTEREST THAT [redacted] OUR SUCCESS HAS BEEN ACHIEVED BY PURSUING THE POLICIES THAT HAVE BEEN REPEATEDLY ENDORSED BY THIS COMMITTEE.

SPEAKING COPY

CHANCELLOR'S SPEAKING NOTE FOR THE INTERIM COMMITTEE MORNING SESSION, SUNDAY, SEPTEMBER 27, 1987

WHEN WE DISCUSSED THE PROSPECTS FOR THE WORLD ECONOMY IN APRIL, THERE WERE WIDESPREAD FEARS ABOUT THE WEAKENING IN GROWTH THAT WAS THEN APPARENT. I SAID THAT I BELIEVED THAT THIS WEAKNESS OWED MUCH TO THE DIFFICULTY OF ADJUSTING TO THE TWIN SHOCKS OF THE SHARP FALLS IN BOTH OIL AND OTHER COMMODITY PRICES AND--IN PARTICULAR--IN THE DOLLAR.

THIS IMPLIED THAT THE WEAKNESS IN GROWTH WOULD BE TEMPORARY. I AM PLEASED TO SEE THAT THIS IS BEING BORNE OUT. IN EACH OF THE TWO LARGEST ECONOMIES, THE UNITED STATES AND JAPAN, GROWTH HAS QUICKENED. AND THE PROSPECT IS FOR A CONTINUED STEADY GROWTH OF OUTPUT IN THE INDUSTRIALISED COUNTRIES AS A WHOLE.

THIS EXPERIENCE DEMONSTRATES ONCE AGAIN THE NEED TO KEEP IN PERSPECTIVE SMALL FLUCTUATIONS IN GROWTH RATES. THESE ARE BOUND TO OCCUR. WHAT MATTERS IS THAT SENSIBLE

MEDIUM-TERM POLICIES ARE PURSUED THAT ENCOURAGE THE CONTINUATION OF STEADY GROWTH.

THAT IS WHAT WE ARE SEEING. INDUSTRIAL COUNTRIES ARE NOW IN THE FIFTH YEAR OF EXPANSION. THERE IS LITTLE SIGN OF CAPACITY CONSTRAINTS AND NO REASON WHY THE UPSWING CANNOT BE SUSTAINED.

THIS HAS BEEN POSSIBLE BECAUSE OF OUR SUCCESS IN THE BATTLE AGAINST INFLATION. IT IS VITAL THAT THERE IS NO RETREAT FROM WHAT WE HAVE ACHIEVED OVER THE PAST SIX YEARS. IN 1980 THE AVERAGE INFLATION RATE OF THE INDUSTRIAL COUNTRIES WAS ALMOST 12 PER CENT. IT THEN FELL CONTINUOUSLY TO A LOW OF JUST UNDER 2½ PER CENT IN 1986. THIS YEAR HAS SEEN A SMALL UPTURN. BUT THAT WAS ENTIRELY PREDICTABLE. THE PATTERN OF OIL PRICE MOVEMENTS PRODUCED AN ADVENTITIOUS DROP IN INFLATION LAST YEAR, AND A VIRTUAL GUARANTEE THAT THIS YEAR'S RATE WOULD BE SLIGHTLY HIGHER.

BUT THE UNDERLYING SITUATION IS SATISFACTORY. MONETARY DISCIPLINE REMAINS IN PLACE. GROWTH IN UNIT LABOUR COSTS IN THE INDUSTRIAL COUNTRIES HAS BEEN CONSISTENTLY LOW. AND ALTHOUGH WE HAVE SEEN SOME RISE IN COMMODITY PRICES--OFTEN A USEFUL INDICATOR OF INFLATIONARY PRESSURES--THAT HAS BEEN FROM THE EXTREMELY LOW BASE REACHED LAST YEAR. THERE IS NO SIGN OF A RETURN TO THE FALSE LEVELS OF THE INFLATIONARY SEVENTIES.

THE CURRENT ACCOUNT IMBALANCES BETWEEN THE THREE MAJOR ECONOMIES ARE LESS SATISFACTORY. BUT IT IS EASY TO OVERSTATE THE PROBLEM.

THERE IS NO IRON LAW THAT DICTATES THAT THE CURRENT ACCOUNTS OF THE MAJOR INDUSTRIAL COUNTRIES SHOULD ALWAYS BE IN BALANCE. WE HAVE AN INTEGRATED WORLD ECONOMY AND WE ENCOURAGE THE FREE FLOW OF CAPITAL AND GOODS. INVESTMENT OPPORTUNITIES AND SAVINGS PROPENSITIES INEVITABLY DIFFER FROM COUNTRY TO COUNTRY AND IT IS NATURAL FOR THIS TO PRODUCE SUBSTANTIAL, AND OFTEN SUSTAINED, CAPITAL ACCOUNT FLOWS. THESE FLOWS ARE BOUND

TO HAVE THEIR COUNTERPARTS IN CURRENT ACCOUNT SURPLUSES AND DEFICITS.

BUT ALTHOUGH THERE MAY BE UNDERSTANDABLE REASONS WHY THERE SHOULD BE SUBSTANTIAL FLOWS OF CAPITAL IN ONE DIRECTION FOR SEVERAL YEARS, THERE ARE CLEARLY LIMITS TO THE ACCUMULATED EXTERNAL LIABILITIES OR ASSETS THAT CAN BE SUSTAINED WITHOUT CREATING MAJOR ANXIETIES FOR CAPITAL MARKETS. THAT IS WHY WE NEED TO CONTINUE TO MAKE PROGRESS IN REDUCING THE EXISTING IMBALANCES — AND, NEEDLESS TO SAY, WE NEED TO DO IT WITHOUT ANY RECOURSE TO PROTECTION

BUT IT WOULD ~~IT WOULD, HOWEVER,~~ BE A MISTAKE TO ATTEMPT TO FINE TUNE POLICY TO MEET PRECISE CURRENT ACCOUNT OBJECTIVES. FOR ONE THING, THE BASIC DATA ARE TOO INACCURATE, AS THE IMPORTANT NEW IMF STUDY ON THE WORLD CURRENT ACCOUNT DISCREPANCY HAS SHOWN. I BELIEVE THE FUND STAFF SHOULD NOW TRY AND ALLOCATE THE DISCREPANCY, HOWEVER ROUGHLY, TO INDIVIDUAL COUNTRIES.

NOR ARE THE INACCURACIES IN THE BASIC DATA THE ONLY PROBLEM. CURRENT ACCOUNT PROJECTIONS SUFFER FROM VERY

WIDE MARGINS OF ERROR; AND IT IS ALMOST IMPOSSIBLE TO JUDGE IN ADVANCE THE STRENGTH OF COMPLEMENTARY CAPITAL FLOWS.

THE PRESENT COMBINATION OF DEFICITS AND SURPLUSES HAS EMERGED OVER SEVERAL YEARS IN WHICH THE GROWTH OF DOMESTIC DEMAND IN GERMANY AND JAPAN WAS CONSISTENTLY BELOW THE GROWTH OF OUTPUT, WHILE IN THE UNITED STATES IT WAS CONSISTENTLY ABOVE. THE PROCESS OF UNWINDING THE IMBALANCES REQUIRES A REVERSAL OF THE DIFFERENCES BETWEEN DOMESTIC DEMAND AND OUTPUT IN THOSE COUNTRIES. THIS IS BOUND TO TAKE TIME TO COMPLETE, BUT — AND THIS IS IMPORTANT — IT HAS NOW BEGUN.

IT WOULD BE A SERIOUS MISTAKE TO SEEK A SHORT CUT BY A FURTHER DOLLAR DEPRECIATION. IT WAS UNDOUBTEDLY NECESSARY TO CORRECT THE HUGE MISALIGNMENT OF THE DOLLAR IN 1985. BUT THERE IS NO CASE FOR GOING TO THE OPPOSITE EXTREME OF AN ARTIFICALLY LOW DOLLAR. THE BENEFITS TO THE CURRENT ACCOUNT WOULD BE SMALL COMPARED TO THE DAMAGE TO US INFLATION AND THE DISLOCATION TO THE WORLD ECONOMY.

THE MAIN LESSON FROM RECENT YEARS IS THAT WE SHOULD AVOID EXCHANGE RATE MISALIGNMENTS, NOT ENCOURAGE THEM.

THAT IS WHY WE REAFFIRMED THE LOUVRE AGREEMENT AT THE MEETING OF THE GROUP OF SEVEN YESTERDAY.

FINALLY, MR. CHAIRMAN, YOU HAVE ASKED US TO COVER SDR ALLOCATIONS AND ACCESS LIMITS IN THIS MORNING'S DISCUSSION. ON SDR ALLOCATIONS, I CAN BE VERY BRIEF. I SEE NO EVIDENCE WHATEVER OF AN OVERALL SHORTAGE OF LIQUIDITY IN THE WORLD. THE ENORMOUS GROWTH IN INTERNATIONAL CAPITAL MARKETS HAS GREATLY REDUCED THE CASE FOR SDRs THAT WAS MADE OUT IN THE 1970s. SO I SEE NO NEED TO CONSIDER SDR ALLOCATIONS NOW.

WE SHALL BE DISCUSSING THE REVIEW OF QUOTAS THIS AFTERNOON. THIS [illegible] SEEMS TO ME CLEAR THAT THERE IS NO NEED TO TAKE ANY URGENT DECISIONS ON THAT [illegible]. BUT IT IS IMPORTANT IN THE MEANTIME THAT WE SHOULD RETAIN ENLARGED ACCESS, AT PRESENT LEVELS.

MR. CHAIRMAN, THE KEY TO LONG-TERM GROWTH IS THE SUPPLY PERFORMANCE OF OUR ECONOMIES. EXPERIENCE ALL AROUND THE WORLD HAS SHOWN HOW THIS CAN BE HELPED BY DEREGULATION, BY PRIVATISATION, BY INCREASING COMPETITION, AND BY ~~MAINTAINING~~ FACILITATING THE FREE FLOW OF GOODS, SERVICES AND OF CAPITAL. THESE SUPPLY-SIDE POLICIES NEED TO BE PURSUED WITHIN A STABLE FRAMEWORK OF FISCAL, MONETARY AND EXCHANGE RATE POLICY. PROVIDING WE DO THAT, WE CAN MAKE GRADUAL PROGRESS ON THE FURTHER REDUCTION OF THE IMBALANCES WHICH HAVE CAUSED SO MUCH CONCERN, AND SECURE FURTHER STEADY NON-INFLATIONARY GROWTH.

OF

C's speeches

CHANCELLOR'S SPEAKING NOTE FOR THE INTERIM COMMITTEE
9 APRIL 1987

WORLD ECONOMIC OUTLOOK

LET ME BEGIN BY EXTENDING A WARM WELCOME TO THE FUND'S NEW MANAGING DIRECTOR, MICHEL CAMDESSUS.

FOLLOWING IN THE IMPRESSIVE FOOTSTEPS OF HIS PREDECESSOR AND COMPATRIOT, JACQUES DE LAROSIERE, WILL NOT BE EASY.

BUT HIS EXPERIENCE AND PERFORMANCE AT THE TOP OF THE FRENCH TREASURY, AS CHAIRMAN OF THE PARIS CLUB, AND AS GOVERNOR OF THE BANK OF FRANCE, MAKE HIM EMINENTLY QUALIFIED FOR THIS DIFFICULT JOB, AND I WISH HIM WELL.

THIS AFTERNOON I HOPE TO DISCUSS THE DEBT PROBLEM, AND WILL PROPOSE A NEW APPROACH TO HELP THE VERY POOREST DEBTOR COUNTRIES OF SUB-SAHARAN AFRICA.

THIS MORNING, I SHALL DEVOTE MY REMARKS TO THE PROSPECTS FOR THE WORLD ECONOMY AS A WHOLE.

AS A NUMBER OF SPEAKERS HAVE ALREADY EMPHASISED, OVER THE PAST YEAR THE WORLD ECONOMY HAS NOT FULLY LIVED UP TO EARLIER EXPECTATIONS. A YEAR AGO, THE FUND STAFF WERE LOOKING TO 3 PER CENT GROWTH IN OUTPUT FOR THE INDUSTRIALISED COUNTRIES IN 1986, FOLLOWED BY 3 1/4 PER CENT GROWTH IN 1987. THEY NOW ESTIMATE THAT THE GROWTH OUTTURN FOR 1986 WAS 2 1/2 PER CENT AND HAVE REVISED THEIR 1987 FORECAST DOWN TO 2 1/4 PER CENT.

AS IT HAPPENS, TAKING 1986 AND 1987 TOGETHER, THE UK IS ONE OF THE FEW MAJOR COUNTRIES THAT IS OUTPERFORMING THE FUND'S GROWTH FORECASTS MADE A YEAR AGO. AND THE COMBINATION OF SUSTAINED GROWTH AND A STRENGTHENING OF PUBLIC FINANCES ENABLED ME TO CUT BOTH TAXES AND PUBLIC SECTOR BORROWING IN MY BUDGET LAST MONTH. THE UK IS CURRENTLY EXPERIENCING BOTH STEADY GROWTH OF DOMESTIC DEMAND AND VIGOROUS GROWTH OF EXPORTS.

BUT WHY HAS THIS OVERALL PERFORMANCE SHORTFALL OCCURRED? WHAT 1986 AND 1987 HAVE IN COMMON IS THAT THEY HAVE BOTH BEEN PROFOUNDLY AFFECTED BY SHOCKS TO THE WORLD ECONOMY WHICH HAVE INEVITABLY CREATED PROBLEMS OF ADJUSTMENT.

IN 1986, IT WAS THE EFFECTS OF THE COLLAPSE OF OIL AND COMMODITY PRICES THAT DOMINATED THE PICTURE. DOMESTIC DEMAND IN THE MAJOR INDUSTRIAL COUNTRIES GREW BY 3 1/2 PER CENT - MUCH AS EXPECTED. THE SHORTFALL IN WORLD OUTPUT GROWTH WAS CAUSED BY A WEAKENING IN THE IMPORTS OF THE OIL AND COMMODITY PRODUCERS, WHO WERE OBLIGED TO RESPOND RAPIDLY TO THEIR REVENUE LOSS.

IN 1987, THE CENTRAL PROBLEM IS THE DIFFICULTIES OF ADJUSTING TO THE SHARP DEPRECIATION OF THE DOLLAR. IN PARTICULAR, THERE ARE CLEAR SIGNS THAT, AS A RESULT, DOMESTIC DEMAND IN THE MAIN INDUSTRIAL COUNTRIES IS SLOWING; THAT APPEARS TO BE THE MAIN REASON FOR THE REVISION TO THE FORECAST.

IN THEORY, THE MASSIVE EXCHANGE RATE REALIGNMENT THAT HAS TAKEN PLACE SHOULD SIMPLY MEAN A REALLOCATION OF DOMESTIC DEMAND WITHIN THE INDUSTRIALISED COUNTRIES - WITH LESS IN THE US AND MORE IN JAPAN AND GERMANY. TO COMPENSATE, EXTERNAL DEMAND IN THE US SHOULD BE STRENGTHENING RELATIVE TO THAT IN JAPAN AND GERMANY. FOR THE INDUSTRIALISED COUNTRIES AS A WHOLE, DOMESTIC DEMAND AND OUTPUT SHOULD BE UNAFFECTED. IN PRACTICE, OF COURSE, IT IS MORE DIFFICULT THAN THAT. SUCH LARGE ADJUSTMENTS RARELY HAPPEN SMOOTHLY, AS WE SAW IN THE AFTERMATH OF THE OIL AND COMMODITY PRICE CHANGES. TO BE MORE SPECIFIC, JAPAN AND GERMANY ARE EVIDENTLY HAVING SOME DIFFICULTY IN SUCCESSFULLY ADJUSTING THE ORIENTATION OF THEIR ECONOMIES TOWARDS DOMESTIC DEMAND; WHILE THE US IS FINDING THE REORIENTATION TO EXTERNAL DEMAND A FRUSTRATING PROCESS. THIS FRUSTRATION, I MAY ADD, LEADS ALTERNATELY TO CALLS FOR FURTHER EXCHANGE RATE DEPRECIATION AND FOR PROTECTION. BOTH ARE FALSE TRAILS, WHICH WOULD ONLY SERVE TO MAKE THE SITUATION FAR WORSE.

EQUALLY UNDESIRABLE POLITICAL PRESSURE IN DEFICIT COUNTRIES FOR ACTION TO PROTECT THEIR MARKETS.

MEANWHILE, DURING WHAT IS BOUND TO BE AN EXTENDED PHASE OF ADJUSTMENT, THERE IS AN OVERWHELMING CASE FOR A PERIOD OF EXCHANGE RATE STABILITY. BECAUSE THE SHORT RUN EFFECTS OF DEPRECIATION ARE ADVERSE - THE FAMILIAR J-CURVE - IT IS IMPORTANT TO WAIT TO SEE MORE OF THE EFFECTS OF THE REALIGNMENT THAT HAS OCCURRED WORK THROUGH BEFORE JUMPING TO CONCLUSIONS ABOUT THE NEED FOR FURTHER REALIGNMENT. ALTHOUGH WE CANNOT BE SURE THAT WE NOW HAVE PRECISELY THE CORRECT ALIGNMENT OF EXCHANGE RATES THAT, IN THE LONG RUN, IS CONSISTENT WITH CURRENT ACCOUNT BALANCE, WE CAN BE QUITE SURE THAT REPEATED DOSES OF DEPRECIATION WILL SIMPLY PROLONG THE ADVERSE EFFECTS OF THE J-CURVE AND LEAD TO AN OVERSHOOT IN THE OPPOSITE DIRECTION. THAT IS THE LAST THING WE WANT TO SEE. I AM, THEREFORE, VERY PLEASED THAT YESTERDAY THE MAJOR INDUSTRIAL COUNTRIES WERE ABLE TO AGREE TO A FULL-HEARTED CONTINUATION OF THE PARIS AGREEMENT TO STABILISE EXCHANGE RATES.

BUT IS IS NOT ENOUGH SIMPLY TO SET OUT OBJECTIVES FOR INCREASED EXCHANGE RATE STABILITY. IF WE WILL THE ENDS WE MUST WILL THE MEANS. IT IS SOMETIMES ARGUED THAT GREATER EXCHANGE RATE STABILITY REQUIRES MORE COMPATIBLE POLICIES - BOTH FISCAL AND MONETARY - AND THEREFORE THE EMPHASIS SHOULD BE ON POLICY COORDINATION. THERE IS MUCH TRUTH IN THAT ARGUMENT. BUT AN EFFECTIVE COMMITMENT TO STABLE EXCHANGE RATES CAN ITSELF BE AN IMPORTANT DISCIPLINE TO ENCOURAGE COMPATIBLE POLICIES. IT MAY BE NO GUARANTEE OF COMPATIBILITY, BUT IT EXERCISES POWERFUL PRESSURE IN THE RIGHT DIRECTION.

WHAT THIS MEANS IS THAT EVEN THE LARGEST COUNTRIES HAVE TO BE PREPARED TO GIVE A SUBSTANTIAL WEIGHT TO EXCHANGE RATE OBJECTIVES IN THEIR CONDUCT OF DOMESTIC POLICY - IN PARTICULAR, MONETARY POLICY. OBVIOUSLY, IT IS DESIRABLE TO AVOID EXCESSIVE VOLATILITY IN INTEREST RATES AND DOMESTIC MONETARY CONDITIONS IN INDIVIDUAL COUNTRIES AND IN THE AGGREGATE. AT THE SAME TIME, WE MUST AVOID ANY TENDENCY TOWARDS EITHER AN INFLATIONARY OR

DEFLATIONARY BIAS FOR THE INDUSTRIALISED COUNTRIES AS A WHOLE. THIS UNDERLINES THE IMPORTANCE OF EXAMINING THE PERFORMANCE OF THE MAIN INDUSTRIALISED COUNTRIES AS A GROUP ON A ROUTINE BASIS.

I CONCLUDE, MR. CHAIRMAN, WITH THIS THOUGHT. THE MAIN PRINCIPLE OF SOUND ECONOMIC MANAGEMENT IS TO GET THE POLICIES RIGHT WITHOUT DELAY AND THEN STICK TO THEM EVEN THOUGH IT MAY TAKEN AN UNCOMFORTABLY LONG TIME TO SEE THE RESULTS. THAT IS WHAT WE HAVE TO DO.

CHANCELLOR'S SPEAKING NOTE FOR THE INTERIM COMMITTEE, AFTERNOON SESSION, THURSDAY, APRIL 14, 1988

WHEN WE DISCUSSED DEBT AT THESE MEETINGS A YEAR AGO, I EMPHASISED THE DISTINCTION BETWEEN THE PROBLEMS OF THE MIDDLE-INCOME DEBTORS AND THOSE OF THE VERY POOREST, PARTICULARLY IN SUB-SAHARAN AFRICA.

FOLLOWING THE UK'S PROPOSALS, TO WHICH I WILL RETURN AT THE DEVELOPMENT COMMITTEE MEETING TOMORROW, THE FUND TOO HAS RECOGNISED THE SPECIAL PROBLEMS OF THE POOREST COUNTRIES, IN PUTTING FORWARD THE NEW ENHANCED STRUCTURAL ADJUSTMENT FACILITY, WHICH WE WERE QUICK TO SUPPORT. ON THE CRITICAL ELEMENT OF THE INTEREST SUBSIDY, THE UK HAS PLEDGED THE LARGEST SINGLE CONTRIBUTION, ENOUGH TO SUBSIDISE SDR 1 BILLION OF ESAF LENDING--ONE SIXTH OF

THE MANAGING DIRECTOR'S TARGET OF SDR 6 BILLION. AND I AM PLEASED TO BE ABLE TO ANNOUNCE TODAY AGREEMENT WITH THE FUND ON THE TERMS OF OUR CONTRIBUTION. I HOPE THAT OTHERS WILL JOIN IN PLEDGING CONTRIBUTIONS AS SOON AS POSSIBLE.

BUT I WANT TO CONCENTRATE TODAY ON THE MIDDLE-INCOME DEBTORS.

I BELIEVE WE MUST STICK TO THE STRATEGY WE HAVE BEEN PURSUING, WHILE CONTINUING TO WORK FOR WAYS IN WHICH IT CAN BE REFINED AND IMPROVED. DEBTOR COUNTRIES MUST PURSUE SUITABLE POLICIES OF ECONOMIC REFORM, WITH THE HELP OF THE FUND AND THE BANK. AND DEBTOR COUNTRIES AND COMMERCIAL BANKS MUST

CONTINUE TO EXAMINE NEW MARKET SOLUTIONS TO FINANCING NEEDS.

DEALING WITH THESE DEBT PROBLEMS WILL INEVITABLY TAKE TIME, AND WILL NOT BE EASY. SO THERE WILL ALWAYS BE THE TEMPTATION TO LOOK FOR SWEEPING, GLOBAL SOLUTIONS. WE HAVE SEEN ALL SORTS OF SUGGESTIONS OVER THE PAST YEAR.

MY OWN VIEW IS THAT SEARCHING FOR A GLOBAL SOLUTION IS WRONG IN PRINCIPLE, AND UNHELPFUL IN PRACTICE.

- GLOBAL SOLUTIONS ARE WRONG IN PRINCIPLE BECAUSE NO SCHEME CAN WIPE OUT DEBT WITHOUT A COST. TO THE EXTENT THAT THAT COST IS NOT

BORNE BY THE BANKS, IT HAS TO BE BORNE BY SOMEBODY ELSE. AND THAT INEVITABLY MEANS THE TAXPAYER.

- MOREOVER, PROPOSALS FOR GLOBAL SOLUTIONS ARE UNHELPFUL IN PRACTICE, BECAUSE SO LONG AS THE TWO SIDES ARE ENCOURAGED TO HOPE THAT A FAIRY GODMOTHER WILL COME ALONG AND WIPE OUT THE DEBT AT LITTLE OR NO COST TO EITHER, THEY WILL HOLD BACK FROM FACING THE FULL REALITY OF THE SITUATION. THAT HELPS NOBODY.

WITHIN THE EXISTING STRATEGY, THE FIRST JOB FOR THE MAJOR COUNTRIES IS TO ENSURE THAT HEALTHY, NON-INFLATIONARY GROWTH CONTINUES IN THE WORLD ECONOMY, AND THAT THE OPEN TRADING ENVIRONMENT IS MAINTAINED. A SUCCESSFUL OUTCOME TO THE GATT ROUND IS VITAL, FOR DEVELOPED AND DEVELOPING COUNTRIES ALIKE.

THE INTERNATIONAL INSTITUTIONS HAVE A CENTRAL ROLE TO PLAY IN WHAT MUST BE A CASE-BY-CASE STRATEGY. IN PARTICULAR, THE IMF AND THE WORLD BANK MUST HELP THE DEBTOR COUNTRIES TO WORK OUT AND IMPLEMENT SUSTAINABLE POLICIES WHICH WILL BRING ABOUT A REAL IMPROVEMENT IN THEIR ECONOMIC PERFORMANCE. NOBODY GAINS IF PROGRAMMES ARE PUT IN PLACE WITHOUT ADEQUATE CONDITIONALITY

OR IF PROGRAMMES ARE NOT PROPERLY IMPLEMENTED. THAT MERELY MAKES THE INEVITABLE PROCESS OF ADJUSTMENT MORE DIFFICULT WHEN IT COMES, AND IN THE MEANTIME UNDERMINES THE STANDING OF THE FUND.

THERE HAS BEEN SOME CRITICISM OF THE EXISTING DEBT STRATEGY, AND OF THE IMF IN PARTICULAR, ON THE GROUNDS THAT LATTERLY MORE MONEY HAS BEEN FLOWING BACK TO THE FUND THAN HAS BEEN GOING OUT IN NEW PROGRAMMES; THIS IS CONSIDERED BY SOME TO BE PERVERSE. IT IS NOTHING OF THE SORT. IT REFLECTS THREE FACTORS. FIRST, THE EXCEPTIONAL BURST OF FUNDING IN THE WAKE OF THE 1982 DEBT CRISIS. SECOND, WE ARE NOW SEEING SOME SUCCESSFUL PAST PROGRAMMES COMING TO FRUITION; WITH THE FUND'S HELP, THE

COUNTRIES CONCERNED--NOTABLY KOREA, INDIA, AND TURKEY--HAVE TURNED ROUND THEIR EXTERNAL POSITIONS AND ARE NOW PAYING BACK THE MONEY THEY BORROWED FROM THE FUND. AND THIRD, AT THE PRESENT TIME SOME POTENTIAL NEW BORROWERS ARE UNWILLING TO COME FORWARD WITH SATISFACTORY PROGRAMMES. IT WOULD BE THE HEIGHT OF FOLLY IF THE FUND WERE TO RELAX ITS STANDARDS IN THE MISGUIDED VIEW THAT IT SHOULD FULFIL SOME ARBITRARY NET LENDING TARGET.

THE WORLD BANK, TOO, HAS A VITAL ROLE TO PLAY AND IT MUST HAVE THE RESOURCES TO DO IT. THAT IS WHY THE GENERAL CAPITAL INCREASE OF $75 BILLION IS SO IMPORTANT. I CAN ANNOUNCE TODAY THAT THE UK IS READY TO MAKE AN EARLY SUBSCRIPTION. IF THE

NECESSARY RESOLUTIONS ARE PASSED BY THE TARGET DATE OF 22 MAY, WE INTEND, SUBJECT TO THE APPROVAL OF PARLIAMENT, TO MAKE OUR INITIAL PAID-IN CASH CONTRIBUTION THIS AUGUST.

OVER THE PAST YEAR, WE HAVE SEEN SOME IMPORTANT DEVELOPMENTS IN THE APPROACH TAKEN BY COMMERCIAL BANKS. THEY HAVE TAKEN MAJOR STEPS TO STRENGTHEN THEIR BALANCE SHEETS, RAISING NEW CAPITAL AND INCREASING THEIR PROVISIONS. AND THEY, AND THE DEBTOR COUNTRIES THEMSELVES, HAVE MADE GREATER USE OF EXISTING MARKET MECHANISMS, AS WELL AS ADDDING NEW ITEMS TO THE "MENU". IT IS IMPORTANT THAT THIS PROCESS CONTINUES. IN PARTICULAR, GREATER USE SHOULD BE MADE OF "EXIT BONDS" TO ENABLE THE SMALLER BANKS TO

GET OUT OF THIS LENDING ALTOGETHER, LEAVING A MORE COMPACT GROUP OF BANKS TO HANDLE NEGOTIATIONS WITH THE DEBTOR COUNTRIES.

FINALLY, I TURN TO TWO SPECIFIC ISSUES AFFECTING THE IMF.

FIRST, I SUPPORT A GREATER USE OF THE EXTENDED FUND FACILITY. BUT, ONCE AGAIN, WE MUST PROCEED ON A CASE-BY-CASE BASIS. AND IT IS ESSENTIAL THAT WE DO NOT RELAX CONDITIONALITY FOR EFF PROGRAMMES. BY THE SAME TOKEN, STRONG PROGRAMMES DESERVE STRONG FINANCIAL SUPPORT.

SECOND, THERE HAS BEEN EXTENSIVE DISCUSSION IN THE FUND BOARD ABOUT A NEW FACILITY WHICH WOULD ADAPT THE EXISTING

COMPENSATORY FINANCING FACILITY AND ADD A NEW EXTERNAL CONTINGENCY MECHANISM. FUND PROGRAMMES SHOULD NOT BE BLOWN OFF COURSE BY UNFORESEEN EVENTS OUTSIDE THE CONTROL OF THE BORROWING COUNTRY. THE UNITED KINGDOM CAN ACCEPT THE COMPROMISE PUT FORWARD BY THE MANAGING DIRECTOR, AND I HOPE OTHERS WILL TOO.

UNCLASSIFIED

FROM: A P HUDSON

DATE: 18 May 1988

PS/CHIEF SECRETARY

cc PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lankester
Mr Scholar
Mr H P Evans
Mr Mountfield
Mr A J C Edwards
Mr Burgner
Mr Peretz
Mr Culpin
Mr Odling-Smee
Mr Pickford
Mr R I G Allen
Mr Walsh
Mr S W Matthews
Miss Symes
Mr Cropper
Mr Tyrie
Mr Call
Mr N Forman MP

CHANCELLOR'S SPEECH AT OECD MINISTERIAL, 18 MAY: FINAL VERSION

I attach the final version of the Chancellor's speech at the OECD Ministerial.

APH

A P HUDSON

CHANCELLOR'S SPEECH FOR OECD MINISTERIAL, 18 MAY 1988

World Economy and Exchange Rates

It is now clear that the world economy was a good deal stronger last year than was generally recognised at the time. At the Ministerial meeting here last year, the OECD experts expected growth to be 2 1/2 per cent in both 1987 and 1988. In fact, the world economy picked up strongly in the second half of last year, and for the year as a whole, growth in the OECD was 3 per cent. And despite the stock market collapse, activity has continued to be buoyant into 1988.

2. At the same time, useful progress has been made in correcting the current account imbalances between the major countries. As a percentage of GDP, the current account surpluses of Japan and Germany have already fallen well below their 1986 levels, and may be no more than 2 1/2 - 3 per cent of GDP by next year. The US deficit may decline from 3 1/2 per cent in 1987 to below 2 1/2 per cent next year. By any standards, this would be a major step in the right direction.

/3.

3. However, further adjustment is still needed. That requires not a further depreciation in the dollar - it is clear from yesterday's trade figures that US exports are responding strongly to the sharp fall that has already occurred - but rather a slowdown in the growth of US domestic demand, which in these circumstances is currently rising uncomfortably fast. Indeed, looking at commodity prices and other indicators, a resurgence of world inflation albeit not on the scale of the seventies looks to be a greater danger than world recession.

The Importance of the Supply Side

4. One reason for the stronger and steadier performance of recent yers has been a switch in the emphasis of economic policy. Macroeconomic policy has been directed to the control of inflation, while microeconomic measures have been used to tackle the rigidities in our economies which get in the way of healthy growth and more jobs. This assignment is not only correct; it is also crucial.

5. The key point is that the medium-term performance of an economy depends mainly on the supply side: on efficient markets and the climate of enterprise.

6. Some people still advocate demand expansion at the first sign of any slowing of growth. This is wrong for two reasons. First, it is pointless to worry unduly about small fluctuations in the pace of expansion . Growth cannot always be smooth and some fluctuations are bound to occur - indeed, by the time they have been correctly identified, it is often too late to act anyway. Second, and more important, artificial boosts to demand are not the way to sustainable growth.

7. Getting the supply side of the economy right is neither quick nor easy. It depends on a whole series of measures: removing barriers and regulations; privatising state industries; reforming taxes; and generally fostering a climate of freedom, change, and competition. These changes require hard and detailed work, and can often be highly controversial. So it is tempting in some quarters to look for a short cut through changes in macroeconomic policy. But trying to remedy poor growth performance through macroeconomic means - particularly fiscal expansion - will do no good; it can only do harm. Whereas supply-side measures will, over time, have a real and beneficial effect.

8. I very much welcome the increased attention which the OECD is giving to these questions of structural adjustment. I have no doubt that supply-side reform, rather than macroeconomic adjustments, must today be the priority for all our countries.

9. Supply-side reform has certainly been crucial in the UK. In 1979, Britain was one of the most inflexible and over-regulated of the major economies. For nine years, now, we have been gradually putting that right.

10. The job is by no means finished. But the benefits are already clear, with growth averaging 3 per cent a year for the past seven years now, productivity improving fast, and record numbers of new businesses. This has not been because of any fiscal or monetary stimulus: we have a balanced budget and interest rates above the world average. It is the supply side that has enabled the growth to come through. It is important that other major European countries - and Japan - free up and open up their markets to allow this process to occur.

Trade and Agriculture

12. Opening up markets on a world scale is of course what the GATT round is all about. This is now well underway, with the mid-term meeting coming up in Montreal in December, where it is important that we give a new impetus to the Round. In particular, we must agree principles to guide further work in the "new areas" of services, including financial services and intellectual property; and also, of course, agriculture. It is up to us in the OECD to give a lead, by actions as well as words.

13. Most of all, we have to seize the opportunity of the GATT round to get on top of the chronic problems in world agriculture.

14. The scale of the subsidies to agriculture is now well know, not least because of the excellent work of the OECD. And it is getting worse. The OECD's figures show that the net levels of assistance to agriculture in the OECD as a whole, as measured by the producer subsidy equivalents, or PSEs, have risen from 30 per cent in 1979-81 to 47 per cent in 1986. In othor words, nearly half of farmers' incomes result from Government support of one sort of another.

15. Some significant steps have already been taken to control agricultural support, notably by the European Community at the European Council at Brussels in February, and also by the United States and Japan. Rather than attack each other for the protection that remains, we must all now work together constructively to make further progress. The measures taken so far, while not to be derided, are clearly not enough.

16. I hope, therefore, we can agree at Montreal on three things:

- first, to work for liberalisation of world agricultural markets, through significant reductions in overall support and protection;

- second, to determine a framework for the GATT negotiations, that focusses specifically on an overall measure of support, such as the Producer Subsidy Equivalent;

- and third - because we clearly cannot sit on our hands until the end of the GATT round - to make, as the Cairns group has suggested, a clear multilateral commitment to specific early action that not only prevents the situation getting worse, but makes real headway towards our long-term objective.

Debt

17. Reform of agriculture is also vital for the developing countries, particularly the debtor countries.

18. I am especially concerned about the poorest debtor countries, in sub-Saharan Africa. There have some been encouraging developments since I drew attention to the special position of these countries last spring. But there is still a need for further progress on the reduction of the interest burden on official debt. We all know that there is no way in which some of the poorest countries can meet even their interest payments. Without some relief, their problems can only get worse.

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19. Creditor countries may wish to choose different ways of reducing the burden. But, as I said in Washington last month, what is important is that, in one way or another, all creditor countries join in giving relief.

Conclusion

20. In conclusion, Mr Chairman, let me say this. The world economy is doing better than most people predicted. And it should continue to improve, provided we use the right tools for the right jobs, so as to hold inflation down, prevent exchange rate turbulence, and, above all, reform the supply side of our economies, reducing both internal and external barriers to competition.

NH13/52A

UNCLASSIFIED

P7

FROM: A P HUDSON

DATE: 3 June 1988

MR SAUNDERS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns 2nd
Mr Anson
Mr Phillips
Mr Odling-Smee
Mr Culpin
Miss Peirson
Mr Turnbull
Mr Gieve
Mr Pickford
Mr Griffiths
Mr Satchwell
Mr Cropper
Mr Tyrie
Mr Call
Mr N Forman MP

CHANCELLOR'S SPEECH TO LEICESTERSHIRE BMA, 3 JUNE

I attach the final version of this speech.

2. The Chancellor is extremely grateful for all the work you have put in to the speech.

APH

A P HUDSON

638/6/141

CHANCELLOR OF THE EXCHEQUER'S SPEECH TO LEICESTERSHIRE BMA, 3 JUNE 1988

Today is an auspicious anniversary. Forty years ago this very day, the then Government announced its acceptance of the recommendations of the second of the Spens Committee's reports on the remuneration of consultants and specialists, which cleared the way for the acceptance by the medical profession of the concept of the National Health Service. You may not be surprised to learn that I do not have similarly momentous tidings for you this evening. Instead, let me share some thoughts on where we now find ourselves, forty years on.

The NHS today has more resources at its disposal, and is treating more patients, than ever before. Hospital activity has increased by over 20 per cent since 1979 alone. Over the same period, the money spent on the NHS has increased by nearly 40 per cent in real terms. The number of front-line staff, doctors and dentists, nurses and midwives, has grown by 15 per cent.

The Health Service is not only growing: it is also changing. Looking back at the history of the first 40 years, what is striking is that, while it is recognisably the same organisation as that which emerged in the aftermath of 1945, it has changed dramatically over the years. The objectives remain the same; but the structure, the individual services which it provides and the skills of the people working within it have all changed to a remarkable extent. There has been a steady evolutionary process from the very start, and which continues today. Thus, the Government has opened discussions with the medical profession about the proposals in last autumn's primary care White Paper. And, in its clinical grading review and its response to the Project 2000 proposals on nurse training, it has embarked on the biggest structural reform of the nursing profession this century.

In this and in many other ways, the NHS is changing all the time. Indeed, although anniversaries are helpful staging posts along the road of development, they are inevitably somewhat arbitrary. One thing however has been constant throughout those 40 years, and that is debate. Debate about what the NHS is doing and what it should be doing in the future. There is a long and sometimes stormy history of debate about health care in this country, which has stimulated and helped shape the changes that have come about. So the current debate is nothing new.

In that long debate, certain issues recur over and over again. One of these is the tension between the necessarily finite resources available to the NHS, and the seemingly infinite demands that are made upon it.

It was Richard Crossman who said:

> "the pressure of demography, the pressure of technology, the pressure of democratic equalisation will always together be sufficient to make the standard of social services regarded as essential to a civilised community far more expensive than that community can afford".

The plain fact is that so long as you have a system from which the price mechanism has deliberately been excluded, and services appear to be free, it is inevitable that demand will outstrip available resources. That is one reason why, right from the early days, when Aneurin Bevan was complaining of the "cascades of medicine pouring down British throats", charges have been seen as having a useful part to play, not simply as a means of raising revenue, but also of bringing home to the public the cost of health care and deterring unnecessary demands on the service.

Another recurrent subject of debate over the years has been the nature of the relationships between Government, the medical professions and the service. Right from the start there has been discussion and argument about how services should be delivered, by whom, and for what remuneration. At times there has been a considerable coincidence of views, at other times less so. Sometimes the Government has taken the lead on an issue, sometimes (notably with the Porritt report in the 1960s and in the development of new techniques and services which have greatly added to the quality of care within the NHS) it has been the profession. But there has always been a dialogue.

Third, there has been the fight against bureaucracy. In such an intensely personal service such as the NHS, the need to keep bureaucracy to a minimum is paramount. And yet the NHS is a very large and complex organisation - indeed Britain's largest, by a mile. It employs over a million people, almost 10 times as many as ICI, and 20 times as many as Marks and Spencers. So it needs formidable management skills and structures if it is to work well. This inherent tension, between the requirements of individual care on the ground and of efficient organisation at the centre is ever present. Much of the history of the NHS has been tied up with trying to resolve or at least reduce it.

Turning now to the NHS of today, it is the same themes which tend to provoke most debate. I have, however, been struck by the consensus which seems to have emerged in the last few months about the need for further reform. The status quo has fewer defenders than it did before the Government embarked on its present review. Perhaps I could say a little about what seem to me the main challenges now facing the NHS.

First and most obvious is its sheer size. Not only can this make it appear monolithic and impersonal to the outsider and to the patient - the customer. But it also makes for an enormous management task. It is therefore a serious failing that management information systems in the NHS are in general less than comprehensive. There needs to be detailed, up-to-the-minute, and easily accessible information about the treatment being given to patients, waiting lists, and the use made of beds. Without that, it is difficult if not impossible to maximise efficiency while delivering an adequate service to the patient.

Information enables managers to tackle problems like underused operating theatres and the wasteful use of professionally qualified staff on less skilled duties. And a proper information base is needed to ensure that resources are allocated in the fairest and most effective way.

I am therefore heartened by some of the developments in the last few years. The wider use of performance indicators is a step in the right direction, and we can build on this, for example, by improving value for money auditing. The Audit Commission have shown the way here in the work they have done for local authorities.

The most promising development so far is undoubtedly the resource management initiative. It is generating considerable enthusiasm at the five sites where experimental projects are being funded, even among people who were initially sceptical. Resource management is sometimes mistaken for just a budgeting exercise. While the financial information it generates is important, it offers much more than that. Not least, it enables doctors to compare their own methods of treatment with those of their colleagues, in terms of speed, effectiveness, and cost - the peer review arrangements which I know many doctors would like to see. More and more health authorities are showing interest in this work, and I hope it will be extended right across the service before too long.

This growing awareness of cost allows a more commercial approach to develop in the management of the NHS. Once the NHS has a clear idea of its own costs, it is better able to compare them with the alternatives. The policy of competitive tendering for non-clinical support services has been a great success, with savings so far running at more than £100 million a year, which can then be spent on improving health care. Armed with better cost information, NHS managers should be able to develop and even extend the policy of competitive tendering, and to consider whether contracting some clinical services out to the private sector would give better value for money - as with the present waiting list initiative, which has involved some contracting out to private hospitals.

Looked at like this, it is clear that an expanding private sector presents an opportunity, not a threat, to the NHS. I can think of few other areas of British life where so great a gulf is popularly perceived between the public and private sectors. It is one that we need to bridge. The co-operation that is developing on the ground between health authorities and the providers of private health care is most welcome. As this proceeds, there may be a growing appreciation that the public and private health care sectors have much to offer each other, and that patients can do nothing but benefit from increased co-operation between them. The scope for the NHS buying more clinical services from the private sector will increase, as will its scope for selling services to, and sharing facilities with, private hospitals.

Those who go to the private sector directly relieve the burden of demand on the NHS. And the number of people with the potential to do so is growing. Around 5½ million people are now covered by some form of private medical insurance, a figure which is growing all the time. Roughly a third of all policy holders are insured through the medium of employer-paid schemes, and the number of people covered by such schemes is currently rising at about 3 per cent a year. This growth is a welcome development. But I believe that even more could be achieved by the development of more imaginative health insurance products. The low cost scheme recently introduced by BUPA is a welcome sign of this, particularly in the better access it offers to the elderly.

It is possible to take a stage further the argument about the growing commercial awareness of NHS management and the opportunities presented by expansion of the private sector. This has been done by the advocates of what has come to be known as the "internal market". They argue that health authorities should buy the best and most cost-effective treatment for patients wherever that might be. The authority could go to the local NHS hospital, a local private hospital, or a hospital somewhere else in the country, depending on relative efficiency, quality and cost, as in any other market.

Those who favour this approach argue that it would generate competition and hence improve efficiency, while retaining the essential characteristic of universal access to the NHS, largely free at the point of use.

The theoretical attractions of this model are clear. But all experience has shown that we need to be cautious in approaching major organisational change in the public services. The practicalities of change always need to be explored carefully. Some regional health authorities are currently examining these issues, and the results that emerge from their studies should be of considerable value.

The final challenge I want to touch on tonight is whether the NHS has yet got right its relationship with the medical profession. This again is a debate which has punctuated the history of the NHS. I must confess I have never understood how it can be possible for doctors - who must in the final analysis determine how resources are used - to stand aside from responsibility for resources and their allocation. The future success of the health service lies in harnessing the energy and resourcefulness of doctors to the management skills of the managers.

Doctors have made an immeasurable contribution to the success of the NHS. The Government must ensure that they can continue to do so. But all parts of the NHS and all interests within it are having to face up to the possibility of change. Not even the medical profession can be immune from that.

This applies to hospital doctors and general practitioners alike. It may well be that it is in the hospitals that the greatest scope for change exists. But let it never be forgotten that it is the GP who is the true cornerstone of the system, dealing with the great majority of medical problems himself or herself, and regulating the flow of patients to the hospital system. All of us have had cause at some time to be grateful to our GPs. And their pivotal role in the system gives them a crucial responsibility for ensuring that the NHS's resources are used to best effect. They need to see that treatment is given where it can be done most cost-effectively. They need to exercise restraint over their own costs, lest their non-cash-limited status puts under pressure the cash-limited hospital sector within the overall resources available for the NHS. And they must actively seek the information they need to ensure the most cost-effective treatment for their patients.

The current Government review clearly has a range of problems to address. We are not unique in this. Other countries have tried different ways of organising health care. They, too, have run up against problems, some echoing our concerns in the UK, others facing different problems. A remarkable number - including Norway and Denmark, West Germany and France, the Netherlands and New Zealand - are at this very moment reviewing the way in which health care is provided. And there have of course been major changes in the United States over the last few years.

I would not like to pretend that, at the end of the day, the Government will come up with a solution to all our concerns which satisfies everybody. In whatever emerges there must inevitably be trade-offs. The more that health authorities seek to purchase the most cost-effective care for their local population, the less scope there may be for the patient to choose for himself between different hospitals. And doctors may need to balance traditional ideas of clinical freedom against greater responsibility for resources.

Some themes, however, do emerge. I have already touched on some, like better costings and management information, and better value for money auditing. Whatever changes may emerge from the Review, these objectives will need to be pursued with vigour.

There is always a risk at a time of public debate about the NHS, and health care, and especially when the Government is engaged on a review, that all eyes will be turned to identifying defects and all talk will be about remedying them. In these circumstances it is important, perhaps especially for politicians, to underline the debt we owe, day in, day out, up and down the country to the thousands of individual decisions and actions by doctors, nurses, and other health care workers, that go to make up the reality of less pain and better health. Whenever I hear the words "it goes without saying" I expect what follows actually to be vital. Recognising the debt that patients owe to those who care for them is in that category, it needs to be said.

In conclusion, now is a time of challenge for us all: for the health service, for the Government, and for the medical profession. I have sketched out some of the ways in which I suspect we should be moving. Whether more fundamental reform is needed must await the conclusions of the Government's Review. But, whatever the outcome, I would like to think that the service will continue its historic traditions of development and change, so that the service it offers to patients in the future satisfies the needs of the nation as well as, if not better than, it has done in the past.

Sir T. Burns 11/2.

H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-270 5238
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P7

10 June 1988

CHANCELLOR SAYS AGREEMENT ON DEBT INITIATIVE CLOSE

"A major UK objective at the Toronto Summit will be to secure agreement on the initiative I launched in Washington in the Spring of last year, to relieve the debt burden on the poorest, most heavily indebted countries, mainly in sub-Saharan Africa", the Chancellor of the Exchequer, the Rt Hon Nigel Lawson MP, said yesterday.

"The recent statements by US Secretary James Baker, and by President Mitterrand, make it clear that a consensus is now emerging."

The full text of the Chancellor's statement is attached, together with Notes for Editors.

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG

50/88

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The starting point of my initiative was to recognise that the problems of the poorest countries are of a different order from those of the middle income debtors of Latin America and elsewhere.

- The middle income debtors have the resources to get themselves on the road to recovery. And most of their debt is owed to the commercial banks. So it is primarily for the debtor countries and the banks to work out how to manage the debts.
- On the other hand, the poorest countries are not in a position to solve their debt problems themselves. And since most of the debt is owed

to governments, it is for governments to help these countries to work out a solution.

At last year's Economic Summit in Venice, we succeeded in getting this vital distinction accepted for the first time, although we were unable to secure final agreement on the nuts and bolts.

My initiative has three parts.

- First, writing off aid loans: the UK has written off nearly £1,000 million worth now, with nearly £300 million for sub-Saharan Africa.
- Second, longer repayment periods for other Government loans, such as loans made by export credit agencies.
- And third a reduction in interest rates on those loans.

These special concessions would apply only to those countries which are not only poor and heavily indebted, but - crucially - are pursuing proper economic recovery policies.

It is essential not merely to give the debtor countries more time to pay, but also actually to reduce the burden. The plain fact is that the poorest countries cannot even meet their interest payments at present. The unpaid interest is therefore added to the total debt burden, so that the payments due the following year are higher still. Until we can break this vicious circle, the problem can only get worse.

The other Summit countries have gradually come round to accepting this logic. The Italians joined in at the Venice Summit, and the Canadians at last Autumn's Commonwealth Heads of Government Meeting in Vancouver. Last week, the Americans indicated their willingness to make a move in this direction. And yesterday, the French accepted the proposals, with a partial write-off of debts as an alternative to the interest rate reduction.

The task at the Summit is finally to agree on a firm plan of action. Over the past 14 months, we have taken every opportunity to argue the case for this scheme. It is encouraging that these efforts are now bearing fruit. And it is vital that they should, to offer a clear way forward to some of the poorest countries in the world."

NOTES FOR EDITORS

Background to the Chancellor's proposals

The Chancellor first put forward his proposals for helping to reduce the debt burdens of the poorest countries in his speech to the Interim Committee at the IMF Spring Meeting in Washington in April 1987. It received a wide measure of - but not universal - support. At UK insistence, the argument that special action was needed to help these countries was subsequently agreed at the Venice Summit in June 1987; the Communique said "We recognise that the problems of some of the poorest countries, primarily in sub-Saharan Africa, are uniquely difficult and needs special treatment". It went on that "agreement should be reached, especially in the Paris Club, on longer repayments and grace periods". But, reflecting the reluctance on the part of some countries, to agree to interest subsidies, the Communique did not go further than saying that "consideration should be given to the possibility of applying lower interest rates".

The Chancellor's proposals were welcomed at the meeting of Commonwealth Finance Ministers in Barbados in September 1987, and fully endorsed at the Commonwealth Heads of Government Meeting in Vancouver in October 1987, when the Canadians threw their support behind the proposals. The Chancellor maintained the pressure in his speech to the Development Committee of the IMF and World Bank in Washington in April of this year.

Considerable progress has already been made on the first two of the Chancellor's proposals: many countries have now written off aid loans; and the Paris Club has agreed to extended reschedulings for 10 countries. But agreement on an interest rate subsidy has proved harder to secure. The Chancellor has continued to press hard for agreement on this, most recently at the IMF Spring Meeting in Washington in April, and at the OECD Ministerial Meeting in Paris in May.

Action by IMF and World Bank

In Spring 1987, the Managing Director of the IMF, Michel Camdessus, launched a parallel proposal for an enlargement of the IMF's Structural Adjustment Facility, to provide additional concessionary lending to the poorest countries, providing they followed IMF-approved programmes. The UK was among the first to support this proposal, and has made the largest single contribution to the interest rate subsidy, enough to subsidise SDR 1 billion of ESAF lending, a sixth of the total.

The World Bank, too, has recognised the special problems of the poorest countries, with its Special Programme of Assistance for Africa.

Recent developments

Last week, US Treasury Secretary James Baker moved towards accepting the Chancellor's proposals, saying that there were legal and policy difficulties for the US in giving interest rate subsidies, but they could agree to a scheme so that countries which were able to do so could provide concessional interest rate reschedulings for the poorest countries; other countries would consider a broader range of maturities for rescheduled debt.

This week, the Germans announced that they would write off further aid loans; while they too had difficulties over giving an interest rate subsidy, they would be prepared to consider the variant put forward by the US.

In a letter to his Summit colleagues this week, President Mitterrand proposed a further variant, under which creditor countries would have a choice of writing off a third of their rescheduled export credit claims, with a 10 year repayment period for the rest; or providing lower interest rates with a repayment period of about 15 years; or providing no interest rate subsidy, but accepting a repayment period of up to 25 years.

Eligibility

The countries which would be eligible for relief under the Chancellor's initiative would be those who are

- very poor, with income of less than $425 a year;
- very heavily indebted, with high debt service ratios;
- implementing proper adjustment policies, in line with a programme agreed with the International Monetary Fund.

mjd 4/184An

UNCLASSIFIED

FROM: A P HUDSON
DATE: 10 June 1988

PS/ECONOMIC SECRETARY

P7

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Sir P Middleton
Sir T Burns — 2
Sir G Littler
Mr Lankester
Mr H P Evans
Mr Mountfield o/r
Mr Walsh
Mr Bottrill
Mr Gieve
Mr Pickford
Mr Cropper
Mr Tyrie
Mr Call
Mr N Forman MP
Mr Gray (No.10)
Mr Footman (Bank)
Mr L Parker (FCO)

CHANCELLOR'S PRESS STATEMENT ON SUB-SAHARAN AFRICA, 9 JUNE

... I attach the final version of the press statement which was issued last night.

AH

A P HUDSON

CHANCELLOR SAYS AGREEMENT ON DEBT INITIATIVE CLOSE

"A major UK objective at the Toronto Summit will be to secure agreement on the initiative I launched in Washington in the Spring of last year, to relieve the debt burden on the poorest, most heavily indebted countries, mainly in sub-Saharan Africa. The recent statements by US Treasury Secretary James Baker, and by President Mitterrand, make it clear that a consensus is now emerging.

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- And third a reduction in interest rates on those loans.

These special concessions would apply only to those countries which are not only poor and heavily indebted, but - crucially - are pursuing proper economic recovery policies.

It is essential not merely to give the debtor countries more time to pay, but also actually to reduce the burden. The plain fact is that the poorest countries cannot even meet their interest payments at present. The unpaid interest is therefore added to the total debt burden, so that the payments due the following year are higher still. Until we can break this vicious circle, the problem can only get worse.

The other Summit countries have gradually come round to accepting this logic. The Italians joined in at the Venice Summit, and the Canadians at last Autumn's Commonwealth Heads of Government Meeting in Vancouver. Last week, the Americans indicated their willingness to make a move in this direction. And yesterday, the French accepted the proposals, with a partial write-off of debts as an alternative to the interest rate reduction.

The task at the Summit is finally to agree on a firm plan of action. Over the past 14 months, we have taken every opportunity to argue the case for this scheme. It is encouraging that these efforts are now bearing fruit. And it is vital that they should, to offer a clear way forward to some of the poorest countries in the world."

mjd 1/89A

CONFIDENTIAL

FROM: A C S ALLAN
DATE: 22 June 1988

MR H P EVANS

<u>Complete Records</u>

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lankester
Mr Mountfield
Mr Peretz
Mr Gieve
Mr Cropper
Mr Cassell (Washington)

P7

<u>Extracts</u>

Mrs Lomax) Tokyo Stock Exchang
Mr Ilett)

Mr Monck)
Mr Burgner) Airbus
Mr Waller)

CHANCELLOR'S BILATERALS IN WASHINGTON

... I attach records of the Chancellor's bilaterals in Washington.

ACSA

A C S ALLAN

1077/6/153

CONFIDENTIAL

NOTE FOR THE RECORD

cc: Sir G Littler
Mr Gieve

CHANCELLOR'S BILATERAL WITH SECRETARY BAKER

The Chancellor had a bilateral with Secretary Baker in Toronto, on Saturday evening, 18 June. Mulford was summoned for the last part of the bilateral.

US Political Scene

Baker wanted to stay on as Treasury Secretary until the end of his term, but was being pressed very hard to run the Bush campaign. He was not keen to do this, but thought he would have to unless there was a marked improvement in the polls. If he did move, it would be in August.

Sub-Sahara African Debt

Baker accepted that it was important to reach agreement at Toronto, but said he could not go back to Congress for new legislation. The Chancellor said he thought the minimum move for the US would be to extend repayment periods to twenty five years, and to accept subordination. Baker did not cavil at 25 years, but had not considered subordination. He did not know what was legally possible, and asked Mulford to investigate.

Commodity Indicator

Baker wanted the communique to say that in April G7 had agreed to develop a commodity indicator; that had now been done. The Chancellor pointed out the risks, and put the idea of using levels as well as changes. Baker was interested, and asked Mulford to investigate.

Zones, coordination, etc

Baker made no mention of plans for zones or objectives for policy indicators.

G7 study on Intervention

Baker was content for this now to be taken forward, on the terms agreed.

CONFIDENTIAL

Unitary Tax

Baker was not aware of the latest position. The Chancellor said he would write.

MIGA

Baker said the Administration had had to make concessions to Congress to get MIGA through. He thought the US was only mandated to use "best endeavours" to secure acceptable labour conditions.

Japanese debt initiative

Baker was very cross with the Japanese initiative, which he saw as the first step towards the IMF taking the burden off the commercial banks. The Chancellor commented that there should be no question of substantive discussion to Toronto: the proposals had arrived far too late; and involved to IMF, who were not represented. Baker planned to speak to Miyazawa.

ACSA

A C S ALLAN

NOTE FOR THE RECORD

cc: Sir G Littler
Mr Gieve

CHANCELLOR'S BILATERAL WITH MICHAEL WILSON

The Chancellor had a bilateral with Wilson in Toronto on Saturday evening, June 18.

Commodity Indicator

Wilson was extremely worried about the commodity indicator; he didn't like the inclusion of oil at all. The best way out seemed to be to have as many different indicators as possible.

Sub-Saharan African Debt

The Chancellor explained his thoughts to Wilson and said he would let him have an advance copy of the UK paper. It would be helpful to have as much as possible in the Communique. Wilson said there was not much in the early draft.

Speech in Ontario

Wilson pressed the Chancellor to make a speech in Ontario in October.

A C S ALLAN

NOTE FOR THE RECORD

cc: Sir G Littler
Mr Gieve

CHANCELLOR'S BILATERAL WITH MIYAZAWA

The Chancellor had a bilateral with Miyazawa in Toronto on Sunday morning, June 19.

Sub-Saharan African Debt

Miyazawa explained that Japan was planning to write off all aid loans extended over the last ten years, as repayments fell due. This amounted to $100-200 million a year, totalling $5.5 billion over 35 years. The Japanese constitution required an individual Act for each loan repayment written off (Miyazawa blamed this on the US occupation forces!), and so the forgiveness for aid debts would be implemented by means of matching aid grants.

He maintained that a similar approach would not be possible for export credit debts, whether to write off principal or to provide concessional interest rates. This was because of the different structure of export credit loans, where an independent agency provided a guarantee to private sector lending.

Japan was prepared to lengthen the repayment periods to 25 years, and would choose this option. Miyazawa would prefer these arrangements to be settled bilaterally between creditors and debtors, but would not press this if there was a consensus in favour of a coordinated approach in the Paris Club.

Tokyo Stock Exchange

The Chancellor said the United Kingdom was still very concerned to see a further opening up of the Tokyo Stock Exchange; BZW in particular had an important claim for a seat. Miyazawa said he was aware of the British concerns. He was at pains to stress that there had been no discrimination in the selection of new members last year: that had been based strictly on the length of time the firms has been established in Tokyo, and BZW were only recent arrivals. He thought it would be some time before the membership could be further expanded, and he noted that the Tokyo Stock Exchange was a club controlled by its members not the Japanese Government. The Chancellor said the UK Government looked to the Japanese to use whatever influence it had, and hoped to see early progress. The present position inevitably affected the way the Japanese presence in the City was seen.

Japanese economy

In a brief discussion about the Japanese economy, Miyazawa said he saw no reason for Japanese interest rates to move from the present levels. There was no inflationary pressures in Japan, and the economy (and consumers in particular) were benefitting for cheap imports of electronic goods from the NICs.

Miyazawa agreed that progress needed to be made on modernising the Japanese distribution system, but felt this would happen naturally: with full employment, school leavers had a wide variety of job opportunities and were much less likely to join "mom and pop" in the corner store.

Exchange rate stability

Miyazawa was chiefly concerned about recent talk (and actions) by the Bundesbank, and hoped that nothing would be done to rock the boat on exchange rate stability.

Middle income debt

Miyazawa failed to take the opportunites to raise this himself, and so the Chancellor did, saying that it needed further study and he doubted if progress would be made in Toronto. Miyazawa had clearly spoken to Baker and said that with the US presidential election and the difficulties in Congress over GCI, he was concerned not to raise difficulties.

ACS

A C S ALLAN

NOTE FOR THE RECORD

cc: Sir G Littler
Mr Gieve

CHANCELLOR'S BILATERAL WITH STOLTENBERG

The Chancellor had a bilateral with Stoltenberg in Toronto on Sunday morning, June 19.

German interest rates

Stoltenberg said the Bundesbank would raise its securities repurchase rate by 1/4 per cent on Tuesday. But this would be presented not as a policy-induced move, but as following movements in market rates which had already taken place.

Airbus

Stoltenberg had been fighting hard on this. But Bangemann had now switched to supporting a higher subsidy, and Franz-Joseph Strauss had been pressing this for a long time. As a result, this issue had come to dominate discussions with the coalition partners. Chancellor Kohl had now come down in favour of the increased subsidy. Stoltenberg would try to secure some points, for example on offsetting public expenditure savings, but the cause was lost.

Wise men at Hanover

Stoltenberg was clearly embarrassed on the subject (the Prime Minister had raised it with him in the corridor!). He claimed not to know what Kohl intended, but suspected it would include wise men.

Tax approximation

Stoltenberg had no objection to the UK proposal being fed in to the committee that was examining all this. He thought little would happen under the Greek Presidency, but that the Commission would continue to press this even if Cockfield went.

Sub-Saharan Africa Debt

Stoltenberg said the German delegation had been preparing communique language based on how far they might move. They were prepared to write off some old aid loans; and they felt the communique should spell out what had been achieved so far on measures to help alleviate these problems. They were ready for the communique to have a commitment to take some unspecified action on export credit debt, but did not want to go into detail: they felt that it was not appropriate for Heads of Government, and should be handled in the Paris Club.

ACSA

A C S ALLAN

ps4/41H

UNCLASSIFIED

FROM: A P HUDSON
DATE: 27 June 1988

MR BENT

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Byatt
Mr D J L Moore
Mr Odling-Smee
Mr Culpin
Mr M L Williams
Mr Gieve
Mrs M E Brown
Mr Pickford
Mr Houston
Miss Simpson
Mr Neilson
Mr Jessop
Mr Cropper
Mr Tyrie
Mr Call
Mr N Forman MP

P7

CHANCELLOR'S SPEECH AT ADAM SMITH INSTITUTE PRIVATISATION SEMINAR, 27 JUNE: FINAL VERSION

The Chancellor was most grateful for the contributions from you and others to his speech on privatisation today. I attach the final version.

APH

A P HUDSON

CHANCELLOR OF THE EXCHEQUER'S SPEECH TO THE ADAM SMITH INSTITUTE CONFERENCE ON PRIVATISATION, 27 JUNE 1988

THE FRONTIERS OF PRIVATISATION

Privatisation has swept the world. And there could be no better evidence than the audience here today. I am proud that this country pioneered the concept - indeed, the very word "privatisation" has passed into a number of languages, including Japanese. And I am glad to welcome you all here today to learn more about the British experience. No hosts could be more appropriate than the Institute which takes its name from Adam Smith.

I myself have been involved in the privatisation programme, one way or another, from the beginning. First, when, as Financial Secretary to the Treasury between 1979 and 1981, I was given the responsibility under Geoffrey Howe, for getting the programme off the ground. Then for a short time as Secretary of State for Energy, when my first task was the privatisation of the huge government stake in North Sea oil, at that time the largest privatisation ever. And now, since 1983, as Chancellor of the Exchequer, responsible for the co-ordination of the biggest privatisation programme the world has ever known.

But privatisation, although a programme without precedent and an outstanding success in its own right, has to be seen in context.

This time last week, I was at the Economic Summit in Toronto. We have now had fourteen Summits, two complete cycles of meetings in each of the seven Summit countries. Throughout the world, economic thinking has changed dramatically between the first cycle and the second.

- During the first cycle, co-ordinated fiscal expansion was seen as the key to faster economic growth. But, as we all now know, the policies of the seventies led instead to accelerating inflation, with growth disappointingly slow.

- **During the second cycle of Summits, the consensus has shifted towards using macro-economic policies to control inflation, and stimulating growth by freeing up markets and pursuing other structural reforms designed to improve the supply performance of our economies. The result has been that, during this second cycle, the Summit countries have seen the longest period of economic growth in post-war history.**

This is the 'eighties revolution. It is a revolution which has spread far beyond the seven countries who meet at the Summits, and encompasses governments of different political persuasions, in very different circumstances, all around the world. A belief in Government action as the way to economic success has been replaced by a belief in markets.

Relying on markets means reducing tax rates, and restructuring the tax system to reduce distortions and biases. It means getting rid of unnecessary rules and regulations. And it means subjecting as much of the economy as possible, including the public sector, to competitive forces. It is in this context that privatisation has its natural and rightful place.

For privatisation is an integral part of a free market approach to the economy. But the case for it does not rest on theory. It rests, in Britain, on the practical evidence of the performance of the nationalised industries before 1979, and on the performance of the privatised companies since then.

The State sector in Britain was more extensive by 1979 than it had ever been before. The nationalised industries accounted for one-tenth of national output, more than a seventh of total fixed investment, and some 1½ million employees. But so far from living up to the original ideals of efficiency and commitment to the public good, they were a heavy burden on the rest of the economy. Their losses and borrowing amounted to nearly £3 billion a year. Their record on investment, productivity, and industrial relations was poor. And their service to the public was the butt of endless jokes.

This was in no way the fault of those who worked in those industries. It was inherent in the system itself. Clearly, this situation could not be allowed to go on. Not only was the financial cost substantial. Since the nationalised industries dominated the key sectors of transport, energy, communications, and steel, their inefficiency was an intolerable drag on the economy as a whole.

The problems of State ownership were not new. Adam Smith himself advocated the sale of crown lands in The Wealth of Nations, commenting:

- "When the crown lands had become private property, they would, in the course of a few years, become well improved and well cultivated."

And it was not difficult to see why the nationalised industries had not lived up to the high ideals set by their founders. Managers cannot manage properly if all their decisions are second-guessed by politicians and civil servants. Investment can be better planned and appraised if the finance depends on the commercial judgement of the capital markets. And a crucial stimulus is taken away if managers and the workforce know that, in the end, their financial position is underwritten by the State, and survival does not depend on responding to the market.

For those State-owned industries not immediately ready for privatisation, the first step, therefore, was to replicate the disciplines of the market-place as closely as possible. This involved setting the nationalised industries a firm framework, agreeing a corporate plan, setting clear financial targets, often accompanied by objectives for cost reduction, and monitoring performance. But within that framework, management was given as much freedom as possible.

The nationalised industries have responded well, and in many cases performance has been transformed, particularly by the prospect of privatisation. British Steel, operating in a particularly difficult sector of the world economy, made a net loss of nearly £1.8 billion in 1979-80, but is now back in profit, and set to be the next major privatisation. But reforming industries within the

State sector can only achieve a certain amount. The target has always been privatisation.

The early privatisations were ordinary commercial businesses - British Aerospace, Amersham International, National Freight, and Britoil - most of which were already in competition with private firms. These broke new ground in a number of ways, not least in stimulating wider share ownership in general, and employee share ownership in particular. This has been a crucial secondary objective of the privatisation programme, right from the start. Privatisation, as Geoffrey Howe explained in his 1979 Budget Speech, is

> "An essential part of our long-term programme for permitting the widest possible participation by the people in the ownership of British industry. This objective - wider public ownership in the true meaning of the term - has implications not merely for the scale of our programme but also for the methods of the sales we shall adopt."

The next radical step forward came in November 1984, with the sale of British Telecom. Taking a vast, near-monopoly utility out of State hands was a completely new departure.

The case for privatising the utilities is essentially the same as for other nationalised industries. Managements are enabled to manage. Finance is raised from the capital markets, rather than the taxpayer. And the company gets the vital spur both of knowing that its success depends on satisfying its customers and of seeing its performance reflected in its share price. But the special circumstances of the utilities required radical new developments in the method of privatisation, both in preparing the industry and in making a success of the sale.

Thus to reinforce commercial disciplines, and prevent the exploitation of monopoly, British Telecom was placed under a regulatory regime, which was specially devised as part of the preparation for privatisation. And we licensed Mercury, a brand new telecommunications company, to compete nationally with BT wherever practicable. Mercury is now beginning to reap the benefits of its investment in the business market in the UK. It has recently moved into new markets, both domestic and international, and will shortly be providing public call boxes, in direct competition with BT.

The other new feature of the Telecom sale was, of course, its sheer size. At nearly £4 billion, it was then by far the largest UK share sale ever - indeed the largest anywhere in the world.

Without a healthy economy and a sophisticated financial system, a privatisation of this size would probably have been impossible. Certainly, many so-called experts were highly sceptical at the time. In the event, it was not only achieved with ease, but also gave us the opportunity for a quantum jump in the extension of share ownership. This was achieved by a wholly new approach to selling shares, including TV and press advertising; special mini-prospectuses aimed at potential new investors, rather than City institutions; the chance to pay in instalments; and special encouragement to small investors not merely to buy the shares but to hold them, through such devices as free bonus shares after a qualifying period of years. Many argued at the time that these techniques would prove an expensive flop, and that ordinary people would simply not be interested in buying shares. In fact, the UK public offer was nearly nine times over-subscribed, with shares allocated to more than 2 million investors, most of them first-time share-buyers.

These techniques were improved, and used again, two years later, for the even larger sale of British Gas. This time, nearly 5 million people bought shares. That is in itself a measure of the dramatic change in public attitudes. People who, at the outset, may well have been suspicious of the privatisation programme are now participating in it. And they have held on to their shares. After the initial flurry of selling, share registers have been remarkably stable, and British Gas still has nearly 3 million shareholders. What's more, over half of them report that they check the share price every week.

These sales broke new ground. Since then, other large-scale flotations, of British Airways, Rolls Royce, and BAA, the former British Airports Authority, have each attracted more than a million investors. At the same time, there have been a number of other privatisations, using, where necessary, different approaches, but equally important for the aim of getting businesses into the private sector.

- Companies within British Shipbuilders have been sold individually to interested buyers.
- The Royal Ordnance Factories were sold in a trade sale to British Aerospace.
- The National Bus Company was privatised by selling 70 regional operating companies separately, essentially via management buy-outs, with the express aim of promoting competition. This was a complicated route to follow, and certainly not an easy option for the Government. Nevertheless, it was completed eight months ahead of the statutory deadline.

So there is no single right way to privatise a nationalised industry. The point is to look carefully at each industry, and decide on the best method in that particular case,to promote competition wherever possible, to promote wider share ownership wherever possible, and always to stimulate a better service for the customer.

Seventeen major businesses have now been returned to the private sector. And just as the case against the nationalised industries was based not on dogma but on their performance in practice, so an important test of privatisation is how the privatised companies have actually done.

The great majority have seen higher output, higher investment, better industrial relations and morale, and higher profits. Let me take three particularly notable examples.

- Cable & Wireless has experienced steady growth in sales, profits, investment, and employment.

- **Jaguar, which performed dismally in the 1970s, has seen production at an all-time high, investment up substantially, and 2,000 new jobs.**

- The National Freight Corporation, which was privatised through a management and employee buy-out in 1982, has expanded its business, opened major new distribution centres, and embarked on acquisitions on the other side of the Atlantic. Its shares are now trading at over 40 times their original price.

Success of this sort benefits the workforce, the shareholders (who typically include the great majority of the employees who are always offered shares on favourable terms), and the economy as a whole. Not least, it is good news for the customer, because a private sector company will not succeed for long - indeed, it may not survive for long - if it does not satisfy its customers. For example, it was pressure from consumers, backed by the regulator, which prompted British Telecom to repair its call boxes more quickly, so that over 90 per cent are now in working order, compared to 75 per cent in October. It is most unlikely that the improvement would have occurred so remarkably quickly if BT had remained nationalised and with no competitor - and the emerging competition from Mercury will help to keep standards high.

The privatisation programme has also succeeded in its objective of radically widening share ownership in this country. Helped by the special arrangements, millions of people have bought shares for the first time, in a privatisation. And this has contributed to a threefold increase in the number of shareholders since 1979, which now extends to one in five of the adult population.

One particular objective has been to encourage employees to acquire shares in the companies they work for - a valuable way of enhancing their commitment to the firm. Special incentives have therefore been given for employees to acquire shares in every privatisation where a majority shareholding has been sold in a stock market flotation. As a result, 90 per cent of those employees who were eligible have become shareholders in their companies.

The privatisation programme has thus transformed a substantial sector of the British economy, and brought about the largest extension of share ownership we have ever seen. These achievements give the lie to the old accusation that the only reason for privatisation was to raise money. Indeed, with the UK Budget deficit now almost entirely eliminated even without a penny piece from privatisation sales, this charge could scarcely be more ludicrous.

It is now well over seven years since the first British company was privatised, as the first step in a long-term programme. And as privatisation and the extension of share ownership have gone ahead, public attitudes have changed remarkably. In the early days, privatisation was derided as a short-term gimmick; now, it is an established part of the political and economic landscape, not only in Britain but around the world. At first, it was greeted with hostility; now it is a manifest success. And whereas once, people thought each privatisation might be the last, now they look ahead to the next one and beyond.

The plain fact is that this Government has continually pushed back the frontiers of what was thought capable of being returned to the private sector. And as the programme continues, the frontiers will be pushed back further still.

Let me be quite clear. The privatisation programme will go on. The stock market collapse last October was certainly dramatic at the time. But there is no reason to think that it has undermined the capacity of the London market to support worthwhile new issues. Indeed, though the crash meant that the BP share sale did not bring wider share ownership, as we had hoped, it did demonstrate the ability of underwriters and sub-underwriters in London to meet their commitments in full at a testing time. So the events of last October have in no sense slowed the momentum of the privatisation programme.

Preparations are now well under way for four major new privatisations: British Steel and Girobank in the next year or so; and Electricity and Water later this Parliament, with the major preparatory legislation planned for the Parliamentary session starting this November.

Electricity privatisation will be a truly massive undertaking, both in scale and complexity. An industry once thought a natural State monopoly is not merely being sold to the public, but being sold in a way specifically designed to promote competition. In England and Wales alone - and a separate sale will take place in Scotland - the present Central Electricity Generating Board will be divided into three companies. One will own 30 per cent of the generating capacity, all non-nuclear. The second will own the remainder, both fossil-fuelled and nuclear. And the national grid will be formed into a third company and transferred into the ownership of the twelve Electricity Area Boards, who will themselves be privatised as twelve distribution companies.

The new distribution companies will be able to obtain their supply not just from the two competing generating companies in England and Wales, but also from any other source they wish. In particular, they will be able to buy power from private generators, both existing and new, who will be given fair access terms to enter the market. The generating function accounts for some three-quarters of the distribution companies' costs, so they will have a strong incentive to contract with the most efficient generating companies. Real competition in generation will thus develop over time.

Privatising the ten Water authorities in England and Wales will also provide a powerful stimulus to greater efficiency, with the companies competing for finance from the capital markets. Investors, large and small, will be able to compare the performance of the different authorities, which will, of course, be reflected in their share price.

Both Electricity and Water will be subjected to a demanding regulatory regime, covering both the prices they charge and the standard of service to the customer. And both will be designed as wider share ownership issues.

Alongside these two large-scale privatisations, the programme of other smaller sales goes on. Plans have already been announced for the sale of further sections of British Shipbuilders. British Aerospace has made an offer for the Rover Group. And Girobank is to be sold to a trade buyer. Again, the approach varies with the circumstances of the industry. But the objective remains the same: to return the industries to private hands, with all the benefits that brings.

We have already privatised nearly 40 per cent of the State commercial sector that we inherited in 1979. By the time the present programme is complete, some 60 per cent will be back in private hands. And we do not intend to stop there.

Consider for a moment the main nationalised industries that will then remain. Private capital can be introduced into the coal industry, by liberalising present licensing arrangements for private mines. Depending on progress towards viability, British Coal itself will be a candidate for future privatisation. Privatisation of British Rail also remains a distinct possibility for the future - a variety of suggestions are emerging already.

Whatever is decided in individual cases, one thing is quite clear. The burden of proof on privatisation has changed completely. Not so long ago, the question was, why privatise a State-owned industry? Now, thanks to the manifest success of privatisation, the question is, why should any industry stay in the State-owned sector?

This question is being asked not simply by the Government. It is also coming from the management of the industries, who can see for themselves the advantages enjoyed by industries that have been privatised. It is coming from investors, large and small, who can see the potential of businesses that are currently held back by the constraints of being in the public sector. And increasingly it will come from customers looking for a more responsive service.

In other words, we have pushed back the frontiers of what is thought capable of being privatised so far that no nationalised industry is completely out of consideration. That is a truly logical development. Though the idea that it is simply not the Government's job to run industries is scarcely a new one. Some of us have thought that all along. As I put it some years ago now, "the business of Government is not the government of business".

We have come a long way since 1979. And in the process, we have created the real prospect that, in due course, the nationalised industry sector as we now know it will to all intents and purposes disappear altogether.

The industries themselves, of course, will <u>not</u> disappear. They will go from strength to strength, in a more dynamic, competitive environment, giving better service for their customers. That is the point of privatisation - the reason we embarked on it, and the reason it will continue, here and around the world.

ps4/50H

UNCLASSIFIED

FROM: A P HUDSON
DATE: 30 June 1988

MR GIEVE

P7

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns — 2
Mr Scholar
Mr Odling-Smee
Mr Culpin
Mr Sedgwick
Mr Hibberd
Mr S J Davies
Miss Simpson
Mr Patterson
Mr P Davis
Mr Cropper
Mr Tyrie
Mr Call

Mr N Forman MP

CHANCELLOR'S PRESS RELEASE IN KENSINGTON, 30 JUNE

... I attach the final version of the Chancellor's press release today, which is being issued through Central Office.

APH

A P HUDSON

1294/6/58

STATEMENT BY THE CHANCELLOR OF THE EXCHEQUER,

THE RT HON NIGEL LAWSON MP, AT THE KENSINGTON BY-ELECTION,

30 JUNE 1988

The British economy is as sound and strong as it has been for half a century. The Opposition have tried to use this week's trade figures to pretend otherwise. But on the things which matter to ordinary people, the facts speak for themselves.

- Inflation at its lowest levels for 20 years.

- More new jobs created last year than for 30 years.

- Unemployment falling faster than for 40 years.

- The longest period of strong and steady economic growth for 50 years.

- And living standards at their highest level ever.

There's no reason whatsoever why the trade deficit should bring this success story to an end. Indeed, it's not unusual for a country to have a trade deficit at a time of rapid growth. British manufacturers are set to increase their investment by no less than 16 per cent this year, and are buying the machines and equipment they need to produce tomorrow's exports. What's more, the deficit comes after seven years of continuous surplus. Over time, it will come down again: meanwhile, it is something we can readily finance. And in sharp contrast to the United States, our position is backed by the strength of a Budget surplus.

I am determined to keep Britain's economy on the right track. That means keeping a very close watch on inflation, which is why I put up interest rates earlier this week, to nip any inflationary pressures in the bud. And that's why I shall continue to encourage enterprise, on which all our success and prosperity depends.

These policies have delivered five years of healthy growth combined with low inflation. And if we stick to them, we shall go from strength to strength.

EMBARGOED UNTIL 1945 hours

Sir T. Burns   cc PS/CST

Mr Scholar

Mr Culpin

Miss O'Mara

Mr Gieve

Mr Cropper

Mr Tyrie

Mr Call

I attach the final version of the IEA speech.

AH

21.7

For filing!

NH13/33A

CHANCELLOR OF THE EXCHEQUER'S SPECIAL LECTURE TO THE INSTITUTE OF ECONOMIC AFFAIRS, 21 JULY 1988

"THE STATE OF THE MARKET"

Introduction

The history of Western civilisation cannot be divorced from the development of the market economy. Today, that may sound like a truism. But even ten years ago, it would have struck a rather radical note. For over the post-War period, the benefits of the market economy - freedom, choice, and competition - were increasingly lost from view, in the apparently inexorable advance of the scope and power of the State.

It is not difficult to see why that happened, particularly in this country. The use of State power in the Second World War had led to military victory. Those who shaped post-War Britain saw no reason why the power of the State should not be equally successful in achieving the peace-time goals of economic and social progress. This preoccupation led to the paradox that the post-War economic recovery, which owed much to the unwinding of wartime controls and regulations, was frequently presented as a triumph for planning and control.

For many years after the War, the tide of ideas flowed in the direction of planning and statism. But there were some who never lost their faith in the market economy, and who kept its torch alight. Foremost among them was the Institute of Economic Affairs, and I pay tribute to the great work that you did. And although the market economy is now firmly back in the ascendancy, that in no way diminishes the need for those of us who believe in it, inside and outside Government, to put the general case for market forces, to highlight the specific benefits of allowing them to operate freely, and to see where they need to be extended further. That is what I would like to do today.

The Return to the Market

The legacy we inherited was one of 40 years of a fundamentally misconceived approach to economic policy. The post-War consensus was that growth was achieved through expanding the budget deficit, with the State taking a major role in directing resources in the economy, and that inflation should be tackled by direct controls on prices and incomes.

This approach not only failed to deliver economic success. It did grave damage to the economy. While inflation rocketed, excessive interference and controls meant that important markets ceased to work properly, and some barely worked at all.

That is why the restoration of the market stood alongside the defeat of inflation at the centre of our economic strategy in 1979.

The extension of competition

The most dramatic restoration of the market framework has been achieved through the privatisation programme. Already, 17 major businesses, with over 650,000 employees, have been returned to private hands. By the time the privatisations that have already been announced are complete, getting on for two-thirds of the State commercial sector we inherited in 1979 will be back in the private sector. With the unfolding success of privatisation, the programme has extended into areas which most people would have thought impossible in 1979. Businesses which were once thought natural monopolies, that could be run only by the State, are being subjected, wherever practicable, to competition, and exposed to the disciplines of the private sector.

The extension of competition has been a major theme of the privatisation programme, with the licensing of Mercury to compete with British Telecom, the ending of other Telecom monopolies, and now the plan to introduce competition into the generation of electricity. And progress has also been made in breaking down long-established private sector monopolies, such as the solicitors' monopoly over conveyancing and the opticians' monopoly over the supply of spectacles.

An important incidental benefit of privatisation has been the boost it has given to wider share ownership. Indeed, since 1979 the number of shareholders has trebled. This in turn should help to improve the working of the equity market by reducing the concentration of share ownership in the hands of a relatively small number of large institutions. And I expect to see a further significant extension of share ownership as some building societies take advantage of the power to convert themselves into limited companies under the legislation we enacted in 1986.

In yet other areas of industry, the scope for market forces has been extended simply because the Government has deliberately reduced its interference in the affairs of the private sector.

Industrial policy under previous Governments meant trying to override the market. Governments tried to prop up firms that were dying because there was no longer a market for their product, or because they had been consistently less efficient than their competitors. The argument was, of course, that these firms needed time to turn themselves round. But the practical effect was simply to divert resources from profitable ventures into unprofitable ones.

Traditional regional policies had proved singularly ineffective in solving the problems of regions which suffered from the disappearance of traditional industries. Indeed, they had the perverse effect of subsidising capital in areas where more jobs were needed. And the counterpart of regional incentives was the bureaucratic control imposed by the system of industrial development certificates, which throttled new development in areas where it might have flourished, such as the Midlands. And Government's attempts to "pick winners" bore very little fruit, wasting taxpayers' money which could have been better used by the private sector.

The combined effect of propping up decaying industries and trying to direct the growth of new ones was effectively to put into abeyance the market forces which should have been creating and responding to new opportunities. That is what we have made room for by abandoning old-style industrial policy, by abolishing industrial development certificates, and by winding down and re-casting regional policy. As a result, the market is now generating new opportunities and new jobs in those areas where once it was thought only Government could do so. A wide range of new business is setting up in, for example, the North East of England and those parts of South Wales which suffered so much from the decline of traditional heavy industries.

The removal of regulation

Throughout the economy the operation of normal market forces was constrained in 1979 by a battery of direct controls: controls on prices, incomes, and dividends, among other things. These were all swept away at a very early stage. Management was at long last set free to manage; and the consequent (and long overdue) improvement in the quality of British management has played a particularly important part in Britain's economic renaissance.

The most striking example of the effects of deregulation at work is in the financial sector. The historic decision to abolish all exchange controls in 1979 opened up a new range of investment opportunities for Britons wishing to invest abroad, and, by improving the rate of return on investment in the UK, encouraged foreign investment in this country. The abolition of the corset and other controls on the behaviour of the banks and building societies has greatly increased the flexibility of the financial markets, and widened the choices available to consumers. And coupled with that, the changes associated with the Big Bang have given the London markets the freedom they need to maintain and enhance London's role as the financial centre of Europe, if not the world.

Housing finance, too, has changed dramatically. In 1979, mortgages were still basically the preserve of a building society cartel, which maintained a system of mortgage rationing and mortgage queues. This has now been transformed into a highly competitive and innovative market-place, with immeasurably more choice - and less delay - for the customer. But the new freedom does mean that borrowers have to exercise a great deal more self-discipline about the extent to which they commit themselves, and lenders for their part can and should assist in this.

Privatisation, again, has massively enlarged the housing market with the sale to council and new town tenants of well over a million public sector houses and flats. The remaining challenge is to revive the private rented sector, a classic example of a market suffocated by excessive regulation. The Government's proposal to lift restrictions on new tenancies are currently before Parliament. And I decided, in this year's Budget, to give this long-overdue reform a kick-start by extending Business Expansion Scheme tax relief, for the next five years, to the provision of private rented accommodation under the assured tenancy scheme. I was interested to note today the announcement of the first BES company set up to provide rented accommodation - not in London, but in Glasgow.

The labour market

Perhaps the most serious market malfunction in the years up to 1979 was to be found in the labour market. The proper framework of law which is now in place has transformed industrial relations, so that stoppages are at their lowest levels for over half a century. And the continuing rapid rise in the number of people in work suggests that that unhappy phase in our history, when employers saw taking on extra employees as taking on extra trouble, is now behind us.

A properly working labour market is the key to more jobs. The superior flexibility of the United States labour market is the main reason why their unemployment is so much lower than that of Europe. Although the market here works better than it used to, there is clearly still some way to go. A wider spread of profit-related pay, encouraged by the tax relief I introduced last year, and better labour mobility, following deregulation of the housing market, should both help.

Tax reform

I have mentioned a couple of special tax reliefs which I have introduced, with the aim of helping specific markets to work better. But this approach to tax policy has been the exception rather than the rule. For the starting point in a market economy must be that the tax system should raise the necessary money to pay for public spending with the minimum of distortion to the market economy. That means, in turn, a presumption in favour of low marginal rates and against a proliferation of special tax breaks.

The tax system in 1979 was very far from this ideal. Marginal rates, particularly the top rates of income tax, were among the highest in the world - indeed, with the highest rate on investment income standing at 98 per cent, there was precious little scope for any other country to beat us. And the 52 per cent rate of corporation tax was made tolerable only by exceptionally generous incentives for investment in plant and machinery, and in certain types of industrial building, which served to promote investment driven by tax relief rather than by genuine commercial reasons.

Today we have one of the lowest rates of corporation tax in the world, at 35 per cent, coupled with allowances much more closely related to the depreciation of the asset. And within income tax, the new single higher rate of 40 per cent is among the lowest in the world, and the 25 per cent basic rate is the lowest since the War. At the same time, a number of significant tax breaks have either been reduced or eliminated.

Progress on reducing the overall tax burden has been rightly subordinated to the overriding need to bring down public borrowing and to maintain a firm fiscal stance. But it is already abundantly clear that the reduction in marginal rates, which is the critical thing for incentives, and the parallel reduction in tax breaks have improved the working of the enterprise economy.

Thus, compared to 1979, we have a much smaller State sector, less interference in industry, fewer regulations and controls, lower tax rates, and fewer tax-induced distortions - in short, the restoration of the market, across the board.

Of course, much remains to be done: not least, further privatisation and still lower tax rates. And there is also the challenge of bringing our free market principles to bear in further liberalising international trade, through the GATT round, and in shaping the single European market that will come into being in 1992. There are two broad approaches which Europe could adopt: the bureaucratic one of ensuring that all Member States conform to some common system of over-regulation; or the free market one of abolishing as many rules and regulations as possible, consistent with a proper legal framework for business. It is vital for the success of the European economy that we go down the second route, and at the same time make our markets as open as possible to the rest of the world.

For I believe there can be no doubt that the transformation of Britain's economic performance during the 'eighties, a transformation now acknowledged throughout the world, is above all due to the supply side reforms we have introduced to allow markets of all kinds to work better.

Markets and Macroeconomic Policy

So the Government's responsibilities in microeconomic policy are clear: to ensure that markets work as well as possible, and then to allow them to do so. Let me now turn to the Government's responsibilities in macroeconomic policy, and how these affect the working of markets, and in particular the financial markets.

The Government has to take responsibility for maintaining the value of the currency - that is, avoiding inflation - not least because it is the monopoly supplier of currency.

It is an interesting aside, incidentally, that - although all governments are monopoly issuers of currency in practice - there is no necessary reason why they should be. In a paper published by the IEA some ten years ago, Fritz Hayek proposed, to quote the title, the Denationalisation of Money.

But this is not a form of privatisation that we, or for that matter any other country, have so far espoused, and this Government has accepted its responsibilities for the value as well as the creation of the currency. We have accepted that the State has a clear responsibility to maintain the internal value of the currency -

that is, to avoid domestic inflation - and, within that context, to maintain the external value of the currency - the exchange rate.

There is nothing new about these dual responsibilities. The heyday of the market economy in the second half of the last century and the early part of this was accompanied by a firm financial framework secured by two disciplines. The first was that the State ran a balanced budget. The second was that currencies were linked to gold, which maintained both their internal and their external value.

The first of those disciplines has now, I am glad to say, been restored in this country. Its advantages are clear. The balanced budget ensures that the State makes no claim either on the nation's savings, or on flows from overseas. It gives the private sector a stable environment in which to plan ahead, with confidence in the financial stability of the economy - one of the prime objectives of the Medium-Term Financial Strategy. And a sound fiscal policy is an important buttress in maintaining the value of the currency.

As for monetary policy, the ultimate objective - stable prices - is not in doubt. But the means of getting there - how monetary policy should be operated - has proved more complex.

Experience in the 'eighties has demonstrated that, while the essential thesis - that monetary policy is the only weapon for bearing down on inflation - remains as valid as ever, the practical process of monetary control has become more complicated. The abolition of the various controls within the financial system, which I described earlier, and which has brought enormous benefits, has made it difficult to rely solely on monetary targets.

At the same time, the ending of controls inevitably places more weight on short-term interest rates, as the essential instrument of monetary policy. To attempt to reinstate the direct controls of earlier years would not only be needlessly damaging to the financial sector. It would also be ineffective: controls which could even to some extent be circumvented in the 1970s would be all the more easily circumvented in the sophisticated markets of today.

Short-term interest rates are of course the market route to the defeat of inflation. At one time it was feared that Governments would not be prepared to adjust interest rates sufficiently often, sufficiently promptly, or sufficiently far to enable this process to work. It has been one of the most important achievements of this Government over the years to demonstrate that this is not so, and that interest rates are indeed an effective weapon.

I mentioned a moment ago that we have to assess monetary conditions as a whole. With separate national currencies in an international financial market-place, it is inevitable that the exchange rate plays an important part in determining monetary conditions. So Governments have to come to terms with the behaviour of the foreign exchange market.

Left entirely to its own devices, we have seen in recent years how destabilising and disruptive that behaviour can be. The dollar, which of course remains by far the most important international currency, stood at around DM1.80 in February 1980, then rose to nearly DM3.50 at its peak in February 1985, before falling back to around DM1.80 again at the time of the Louvre accord in February 1987. Swings of this magnitude cannot possibly be explained by any parallel changes in the fundamentals of the United States and German economies. It is rather that movements in exchange rates tend to be dominated by short-term views.

Yet Governments are a part of this particular market, whether they like it or not, not least because they are the monopoly manufacturers of the currencies being traded. And they can afford to take a long view. The experience of the 'sixties and the 'seventies showed conclusively the folly, and indeed futility, of Governments trying to maintain exchange rates regardless of changes in the economic fundamentals. But what the authorities of the major nations have sought to do with the dollar, with some success, through the Plaza and Louvre accords, has been to help to keep them in line with fundamentals, whether that means a gradual move or staying the same, and thus to avoid the wild gyrations which can be so damaging to business and industry. It is not without interest that - contrary to many expectations voiced at the time, and indeed subsequently, notably after the stock market crash last October - the dollar is now at roughly the same level against the deutschemark as at the time of the Louvre meeting.

In a free economy, the Government has, by definition, very few levers with which to achieve its essential responsibility of ensuring a firm and stable financial framework. And deregulation, with all its advantages for the rest of the economy, has actually reduced the number of levers. So it is vital that the available ones are deployed effectively.

The Government's job, then, is to deal with the financial framework, which it can influence, rather than the activities of businesses and individuals within that framework, where any influence it does exert is likely to be for the worse.

Indeed, I would maintain that provided the overall fiscal, monetary and exchange rate framework is sound, and markets are working effectively, the results of the private sector's economic activity should not normally be something in which it is sensible for the Government to interfere.

Current Account

If that is so, it has considerable relevance to the topical issue of the current account of the balance of payments.

It is clear, first of all, that there are very considerable differences between the present period of current account deficit, and previous episodes in the UK - or indeed the present experience in the United States. For in the UK now, the Government's own finances are very sound indeed. The public sector finances are more or less in balance, even before taking account of the proceeds of privatisation. So the current account deficit is clearly not associated with excessive spending and borrowing by the Government.

No doubt a part of the deficit reflects the fact that the UK economy is currently growing a little too fast, above its sustainable rate, and will have to slow down. And as it does, the deficit will diminish.

But that is only part of the story. For there is no iron law that the private sector's finances must be in balance, in any given year or period of years. Sometimes savings will exceed investment; sometimes the reverse will happen. If domestic savings exceed domestic investment, there will be a capital outflow and a current surplus; if domestic investment exceeds domestic savings, there will be a capital inflow and a current deficit.

Looked at like this, it would in fact be very surprising if the current accounts of the major countries were always in balance. Net capital flows are inevitable and indeed desirable, given differing propensities to save and differing investment opportunities. And a country whose investment opportunities are sufficiently attractive to generate a net capital inflow will by definition have a current account deficit.

Some see a current account deficit as a sign of economic weakness. "Britain in the red" as the newspaper headlines are wont to put it. But of course a current account deficit is manifestly not at all like a company running at a loss. A better analogy is with a profitable company raising funds overseas - either borrowing, or reducing its holdings of overseas assets, or attracting new equity. A company with greater investment opportunities than it could finance from retained profits would look for additional funds from outside. A country in a similar position will draw on the savings of the world, particularly in today's global markets.

The main reason for the present deficit appears to be that the UK economy has entered a phase which combines a set of circumstances we have not seen together for some considerable time.

- Investment is rising rapidly. The latest survey by the Department of Trade and Industry projects that manufacturing investment will rise by 16 per cent this year, as business confidence rides high.
- Individuals have seen their wealth rise sharply in the 1980s. At the beginning of the decade, personal net financial wealth was only about 25 per cent higher than annual personal disposable income, whereas at the end of

1987 it was more than double personal disposable income. It is thus not surprising that individuals now feel they can safely spend more - in many cases by adding to their borrowing rather than by spending their capital. This, too, is in essence a reflection of increased confidence.

- So net saving is low.
- And consumer spending is high.

This combination of circumstances leads to a current account deficit. But to repeat, that deficit is entirely the result of private individuals and businesses making choices about their own financial affairs.

And in the same way that the current account deficit has arisen from private sector behaviour, it is likely to reduce through private sector behaviour as well, as the gap between private sector savings and private sector investment closes once more. It is only in the unlikely event of this failing to occur over a sustained period that it would be warranted for the Government to intervene by deliberately generating additional public sector savings, through an even larger Budget surplus.

I do not propose to make any forecast about how long this process will take, and how long the current account deficit will last. As everybody who follows the figures will know, it is difficult enough to be confident about what has already happened, let alone what is going to happen in the future! But what matters - and this is the point of using this extended example in the context of the role of the State in the market - is that, provided the firm financial framework is in place, a period of private sector induced current account deficit should give no cause for concern, particularly given our exceptionally high level of net overseas assets.

But the proviso about a firm financial framework is crucial, and has a number of facets.

- It depends on the public finances staying in balance. The current account deficits of the 1970s reflected excessive Government borrowing and spending, which it was certainly the Government's job to correct.

- It means remaining vigilant for signs of inflationary pressures, whatever the source, and standing ready to tighten monetary conditions by raising interest rates whenever such pressures emerge.
- And it implies not accommodating increases in costs by a depreciation of the exchange rate.

Conclusion

The rehabilitation of market forces in the early 1980s was seen at first as an aberration from the post-war consensus. But I have little doubt that, as a longer perspective develops, history will judge that intervention and planning were the aberration, and that the market economy is the normal, healthy way of life.

Needless to say, belief in the free market system does not imply that markets are infallible, any more than examples of irrational market behaviour undermine the system. What matters is that free markets bring greater benefits, and fewer (and more readily corrected) costs than Statism.

And this is a truth increasingly recognised around the world: the lesson that the way to economic success is through the market place - which means privatisation, deregulation, tax reduction, and tax reform. Nor is this view confined to governments of the right: it is being vigorously put into practice by left-of-centre governments in Spain, Australia, and New Zealand. Nor is the new awakening confined to the West. China has now embarked on installing the price mechanism, after 30 years of official prices, fixed at the same levels. As the official Chinese newspaper recently put it:

> "Reasonable prices and rational price structure are formed through market exchanges in line with the requirements of supply/demand law ... intense market competition and changes in the supply/demand relationship and prices are not bound to the subjective will of government officials."

The Chinese may, I suppose, have seen the benefits of free markets at first hand in Hong Kong. So the fact that Soviet Russia, too, is embarking on the free market route is, if anything, more remarkable. Mr Gorbachev's recent speech to the special conference of the Communist Party of the Soviet Union, illustrates how far attitudes are changing.

I quote:

> "Regulation by the State was extended to an inordinately wide sphere of public activity. The striving to take detailed centralised planning and control into every nook and cranny of life literally swaddled society and became a serious inhibition of people's initiative ....
>
> "The slow acceleration of the output of consumer goods can largely be explained by our badly-arranged economic mechanism and by the poor incentives ....
>
> "A key place in the new thinking is occupied by the concept of free choice."

The whole world is watching with interest to see what actions follow these words. But the reference to "free choice" is a significant one. For it reveals the eternal truth that economic freedom and political freedom go hand in hand. Both have been developed in the West, and are now being tentatively extended in the East. And if it is the case that the prospects, not merely for world prosperity but for world peace, too, are better today than they have been for half a century, then historians of the future may well conclude that it was the rediscovery of the power and beneficence of the market which played the critical role in bringing this about.

CHANCELLOR'S SPEAKING NOTE FOR THE
INTERIM COMMITTEE
MORNING SESSION, SEPTEMBER 25, 1988

WORLD ECONOMY

MR. CHAIRMAN, WE WILL BE DISCUSSING MANY IMPORTANT ASPECTS OF THE WORLD ECONOMY TODAY AND IN LATER MEETINGS. I HOPE TO SPEAK THIS AFTERNOON ABOUT THE DEBT PROBLEMS OF DEVELOPING COUNTRIES. BUT I MAKE NO APOLOGY FOR FOCUSING NOW ON THE PERFORMANCE OF THE MAJOR INDUSTRIAL COUNTRIES FOR THIS IS VITAL NOT ONLY FOR THEIR OWN PROSPERITY BUT FOR THE REST OF THE WORLD AS WELL.

2. DESPITE ALARMS AND JITTERS THE WORLD ECONOMY HAS PERFORMED WELL OVER THE PAST YEAR. IT HAS ENJOYED 4 PER CENT GROWTH, SOMETHING OF AN INVESTMENT BOOM, DECLINING

UNEMPLOYMENT, AND ONLY A SMALL PICK-UP IN INFLATION. THIS GOOD PERFORMANCE CONTRASTS WITH SOME OF THE PESSIMISM PREVAILING AT LAST YEAR'S ANNUAL MEETINGS WHICH, FOR MANY, WAS REINFORCED BY THE STOCK MARKET CRASH A COUPLE OF WEEKS LATER.

3. THE MAJOR INDUSTRIAL COUNTRIES HAVE NOW SEEN SIX YEARS OF UNINTERRUPTED GROWTH AT AN AVERAGE RATE OF 3 1/2 PER CENT A YEAR, THE BEST PERFORMANCE FOR OVER TWENTY YEARS.

4. THE KEY HAS BEEN OUR SUCCESS IN GETTING INFLATION DOWN AND KEEPING IT DOWN. THE AVERAGE INFLATION RATE OF THE INDUSTRIAL COUNTRIES HAS FALLEN STEADILY FROM 1980 ONWARDS. NOT SURPRISINGLY IT PICKED UP AFTER THE ONCE AND FOR ALL EFFECTS OF LOWER OIL PRICES HAD WORKED THROUGH THE SYSTEM,

BUT EVEN SO THIS YEAR THE AVERAGE INFLATION RATE IS LESS THAN HALF OF WHAT IT WAS SIX YEARS AGO.

5. OVER THAT PERIOD THERE HAVE BEEN TIMES WHEN GROWTH HAS BEEN SLIGHTLY ABOVE TREND OR SLIGHTLY BELOW TREND. THAT IS SCARCELY SURPRISING. NOR SHOULD WE BE SURPRISED THAT THE RECORD OF PREDICTING THESE UPS AND DOWNS HAS BEEN POOR. BUT THERE HAS BEEN A DISTRESSING TENDENCY TO EXTRAPOLATE THE LATEST FLUCTUATIONS, PARTICULARLY IF THEY HAVE BEEN IN A PESSIMISTIC DIRECTION. EVENTS HAVE PROVED THE WISDOM OF DISREGARDING THESE PREDICTIONS WHEN JUDGING THE STANCE OF POLICY.

6. THE MAJOR NATIONS HAVE INCREASINGLY

CONTRIBUTED TO THE LENGTH AND STEADINESS OF THE CURRENT UPSWING IN TWO WAYS. ONE IS THE SHARED CONVICTION THAT SUSTAINED ECONOMIC GROWTH DEPENDS CRUCIALLY ON SUPPLY SIDE, MICRO-ECONOMIC, POLICIES SUCH AS TAX REFORM, DEREGULATION, COMPETITION, PRIVATISATION, AND IN GENERAL REDUCED INTERFERENCE BY GOVERNMENT IN THE ECONOMY. THE SECOND HAS BEEN THE PURSUIT OF CAUTIOUS MONETARY AND FISCAL POLICIES.

7. FISCAL POLICY HAS BEEN CONDUCTED WITH GREATER EMPHASIS GIVEN ON ACHIEVING A SUSTAINABLE MEDIUM-TERM PATH - WHICH, IN MOST CASES, HAS MEANT WORKING TOWARDS LOWER STRUCTURAL BUDGET DEFICITS. I AM CONVINCED THAT WE MUST CONTINUE WITH THIS APPROACH, WITH A BALANCED BUDGET AS THE ULTIMATE OBJECTIVE. OBVIOUSLY THE PRECISE FISCAL

POSITION WILL VARY WITH THE BUSINESS CYCLE. BUT WE MUST CONTINUE TO RESIST THOSE SIREN VOICES WHO WANT TO GO FURTHER THAN THIS AND USE FISCAL POLICY IN A VAIN ATTEMPT AT SHORT-TERM DEMAND MANAGEMENT. FISCAL POLICY IS PARTICULARLY UNSUITED TO THIS ROLE; IT TAKES TOO LONG TO PUT CHANGES INTO PLACE; FINE TUNING IS IMPOSSIBLE, AND THE ONLY UNAMBIGUOUS CONSEQUENCE IS DISRUPTION OF THE SUPPLY PERFORMANCE OF THE ECONOMY.

8. CORRECTLY, MONETARY POLICY HAS BEEN THE PRIME INSTRUMENT FOR CONTROLLING INFLATION. THE AUTHORITIES OF THE MAIN INDUSTRIAL COUNTRIES HAVE BEEN PREPARED TO RAISE INTEREST RATES WHEN MONETARY CONDITIONS APPEAR TO BE GETTING TOO LOOSE - AND THEY HAVE BEEN PREPARED TO REDUCE THEM WHEN MONETARY CONDITIONS RISK BEING UNNECESSARILY

TIGHT.

9. A YEAR AGO THERE WAS SOME ANXIETY ABOUT THE UPWARD DRIFT IN INTEREST RATES. BUT IT IS NOW CLEAR THAT THIS VIEW WAS MISPLACED. OUTPUT WAS GROWING RAPIDLY AND HIGHER INTEREST RATES WERE CONSISTENT WITH THE REMARKABLE STRENGTH OF THE INDUSTRIAL COUNTRIES' ECONOMIES.

10. THE STOCK MARKET CRASH COMPLICATED THE PICTURE. IN THE AFTERMATH OF THE CRASH THERE WAS A REAL DANGER THAT THE DAMAGE TO CONFIDENCE MIGHT FEED ON ITSELF AND LEAD TO A WORLD SLUMP. THE AUTHORITIES RIGHTLY EASED MONETARY POLICY IN RESPONSE TO THIS, RECOGNISING THAT THAT ACTION INEVITABLY CARRIED SOME RISK OF INCREASING INFLATIONARY PRESSURES. AT THAT TIME THE OVERRIDING NEED

WAS TO AVERT THE THREAT OF A MAJOR COLLAPSE IN CONFIDENCE. BUT ONCE IT BECAME CLEAR THAT THE DANGER HAD PASSED IT WAS NECESSARY TO UNWIND THE EASING OF MONETARY POLICY.

11. THE GENERAL LEVEL OF INTEREST RATES IS NOW HIGHER THAN IT WAS LAST YEAR. WHILE WE MUST CONTINUE TO BE WATCHFUL, SOME OF THE DANGER SIGNS OF A POTENTIAL RESURGENCE OF INFLATION, WHICH HAD EMERGED EARLIER THIS YEAR, SUCH AS RAPIDLY RISING COMMODITY PRICES, HAVE RECEDED. HAVING TAKEN EFFECTIVE MONETARY ACTION, I BELIEVE THE INDUSTRIAL COUNTRIES NOW HAVE A GOOD OPPORTUNITY TO EXPERIENCE A FURTHER EXTENSION OF THE LONG-STANDING EXPANSION IN ACTIVITY, WITHOUT BEING UNDERMINED BY RISING INFLATION.

12. THE SUCCESSFUL WAY IN WHICH WE HAVE HANDLED THIS DIFFICULT PERIOD HAS ONCE AGAIN UNDERLINED THE VALUE OF INTERNATIONAL FINANCIAL COOPERATION. I WOULD LIKE TO PAY A TRIBUTE TO JIM BAKER, WHO PLAYED A VITAL ROLE IN THIS, AND I VERY MUCH WELCOME SECRETARY BRADY'S COMMITMENT AT YESTERDAY'S G7 MEETING TO CONTINUE WHOLEHEARTEDLY THE PROCESS OF COOPERATION WE HAVE EVOLVED, AND WISH HIM WELL.

13. ENHANCED G7 COOPERATION PLAYED A VITAL ROLE AT AN EARLIER STAGE IN WARDING OFF THE DANGERS OF PROTECTIONISM, WHICH WE STILL NEED TO FIGHT. THE FALL OF THE DOLLAR FROM ITS EXCESSIVE LEVEL IN EARLY 1985, COMBINED WITH SOME REDUCTION OF THE US BUDGET DEFICIT, HAS HELPED BEGIN THE PROCESS OF REDUCING THE US CURRENT ACCOUNT DEFICIT.

14. LOOKING TO THE LONGER-TERM, THE ABSORPTION BY THE UNITED STATES GOVERNMENT, FOR A FURTHER LONG PERIOD, OF A SIZABLE SHARE OF THE WORLD'S NET SAVINGS WOULD NOT BE IN ANYONE'S INTEREST. SO WE LOOK TO THE NEW US ADMINISTRATION TO TAKE EARLY AND EFFECTIVE ACTION TO REDUCE ITS BUDGET DEFICIT STILL FURTHER.

15. G7 COOPERATION HAS ALSO BEEN EVIDENT IN THE IMPORTANT STEPS TAKEN OVER THE PAST EIGHTEEN MONTHS TO REDUCE EXCESSIVE FLUCTUATIONS OF EXCHANGE RATES. SUCH FLUCTUATIONS CAN BE VERY DAMAGING TO THE LONGER-TERM SUPPLY PERFORMANCE OF OUR ECONOMIES AND, WITHIN THE FRAMEWORK OF A DETERMINED ANTI-INFLATIONARY POLICY, GOVERNMENTS HAVE AN IMPORTANT ROLE TO PLAY.

FOLLOWING THE STOCK MARKET CRASH SOME EXCHANGE RATE FLUCTUATIONS WERE UNAVOIDABLE. BUT THE OBJECTIVE OF REDUCING INSTABILITY WAS RETAINED AND REFLECTED IN THE SUCCESSFUL COORDINATED EXCHANGE RATE INTERVENTION IN JANUARY. I AM PLEASED THAT YESTERDAY'S G7 MEETING REAFFIRMED OUR COMMITMENT TO PURSUE POLICIES ~~PRICES~~ THAT ARE LIKELY TO MAINTAIN EXCHANGE RATE STABILITY AND TO CONTINUE TO COOPERATE CLOSELY TO THIS END.

16. SOME MAY SAY THAT THE SERIES OF PROBLEMS AND DIFFICULTIES WE HAVE BEEN THROUGH INDICATE THE FRAGILITY OF THE WORLD ECONOMY. THOUGH MANY DIFFICULTIES CLEARLY REMAIN, THE TRUTH IS RATHER THAT THE EXPERIENCE WE HAVE SHARED OVER THESE PAST SIX YEARS PROVIDES THE STRONGEST POSSIBLE TESTIMONY TO THE ROBUSTNESS OF THE WORLD

ECONOMY AND THE CORRECTNESS OF THE POLICIES WE HAVE BEEN FOLLOWING.

IMF QUOTAS

17. FINALLY, MR. CHAIRMAN, I WOULD LIKE TO SAY A WORD ABOUT THE REVIEW OF FUND QUOTAS. WE MUST MAKE SURE THAT THE FUND HAS THE RESOURCES IT NEEDS. BUT I SEE NO GOOD CASE FOR A SUBSTANTIAL INCREASE IN QUOTAS, AS SOME HAVE PROPOSED. THAT IS NOT JUSTIFIED BY ANY PROJECTION OF FUND LENDING, EVEN ALLOWING FOR A SUBSTANTIAL REDUCTION IN THE USE OF BORROWINGS. THE FUND HAS NOT BEEN CONSTRAINED IN ITS NEW LENDING BY LACK OF RESOURCES BUT BY A RELUCTANCE OF COUNTRIES TO AGREE PROGRAMMES WITH ADEQUATE CONDITIONALITY. THE APPROPRIATE SIZE FOR A QUOTA INCREASE IS A MATTER WE SHALL CLEARLY

HAVE TO COME BACK TO AT THE SPRING MEETINGS NEXT YEAR.

CHANCELLOR'S SPEAKING NOTE FOR THE
INTERIM COMMITTEE
AFTERNOON SESSION, 25 SEPTEMBER, 1988

MIDDLE INCOME DEBT

MR. CHAIRMAN, MIDDLE INCOME DEBT REMAINS A SERIOUS PROBLEM. BUT I AM CONVINCED THAT WE MUST CONTINUE WITH THE EXISTING STRATEGY. IN PARTICULAR, I WELCOME THE G7'S REITERATION YESTERDAY OF ITS OPPOSITION TO TRANSFERRING RISKS FROM THE PRIVATE TO THE PUBLIC SECTOR.

OVER THE PAST YEAR, THE SOUNDNESS OF THE PRESENT DEBT STRATEGY HAS AGAIN BEEN DEMONSTRATED. THERE HAS BEEN GENERAL ACCEPTANCE OF THE NEED FOR COOPERATIVE

SOLUTIONS WITHIN THE FRAMEWORK WE HAVE IN PLACE. BRAZIL, FOR EXAMPLE, RECOGNISED THAT UNILATERAL ACTION WAS NOT IN ITS BEST INTERESTS, AND I AM GLAD THAT A NEW IMF PROGRAMME IS NOW IN PLACE.

BUT THE DEBT STRATEGY DOES NOT STAND STILL. IT HAS CONTINUED TO EVOLVE, AND I WELCOME THE WIDENING OF THE OPTIONS ON THE MENU. CHILE, FOR EXAMPLE, HAS PURSUED AN ACTIVE POLICY OF ATTRACTING FOREIGN EQUITY, AND BY DEBT/EQUITY SWAPS AND OTHER MARKET SOLUTIONS HAS SUCCEEDED IN REDUCING ITS DEBT BURDEN SIGNIFICANTLY.

I SEE NO REASON WHY OTHER MIDDLE-INCOME DEBTOR COUNTRIES SHOULD NOT DO THE SAME. INDEED, MARKET-BASED APPROACHES - INCLUDING DEBT/EQUITY SWAPS, DEBT CONVERSIONS AND BUY-

BACKS - HAVE THE POTENTIAL TO CONTRIBUTE MUCH MORE TO NEW FINANCING PACKAGES, AND IN WAYS THAT REDUCE THE BURDEN OF DEBT. THE MAIN IMPETUS MUST COME FROM NEGOTIATIONS, CASE-BY-CASE, BETWEEN THE BANKS AND THE DEBTOR COUNTRIES.

SOME COUNTRIES, HOWEVER, ARE HAMPERED BY THE CONCENTRATION OF THEIR DEBT IN THE PUBLIC SECTOR. INDEED THREE QUARTERS OF ALL THE FOREIGN DEBT OF LATIN AMERICA IS NOW IN THE PUBLIC SECTOR. IT IS ABUNDANTLY CLEAR THAT MOST PRODUCTIVE INVESTMENT IS USUALLY, AND FOR GOOD REASON, DONE IN THE PRIVATE SECTOR; STATE-RUN INDUSTRIES IN GENERAL HAVE A SORRY RECORD. IT IS THEREFORE VITAL THAT COUNTRIES SHOULD PURSUE POLICIES WHICH PROVIDE AN ATTRACTIVE CLIMATE FOR PRIVATE INVESTMENT, AND SHOULD RESTRICT THEIR FISCAL

DEFICITS SO AS TO FREE RESOURCES FOR THE PRIVATE SECTOR.

IN A WORLD OF INCREASINGLY MOBILE CAPITAL, THERE IS GREAT SCOPE FOR ATTRACTING NEW PRIVATE INVESTMENT - IF THE CLIMATE IS RIGHT. THIS BRINGS NOT JUST FINANCE, BUT TECHNICAL KNOW-HOW AND MANAGEMENT EXPERIENCE. I WELCOME THE CONCLUSION OF THE WORLD BANK'S PRIVATE SECTOR DEVELOPMENT REVIEW GROUP THAT, IN ITS LENDING, THE BANK SHOULD PAY MORE ATTENTION TO OVERCOMING THE FACTORS WHICH DETER PRIVATE DIRECT INVESTMENT. AND MIGA IS NOW IN PLACE, BOTH TO OFFER ADVICE ON WAYS OF ATTRACTING INWARD INVESTMENT AND TO OFFER GUARANTEES AGAINST NON-COMMERCIAL RISKS.

CREDITOR COUNTRIES MUST PLAY THEIR PART TOO, BY REMOVING BARRIERS TO INTERNATIONAL CAPITAL FLOWS. THE UNITED KINGDOM REMOVED ALL SUCH RESTRICTIONS IN 1979. ITS PRIVATE DIRECT INVESTMENT IN DEVELOPING COUNTRIES NOW AMOUNTS TO AS MUCH AS THE WHOLE OF THE REST OF THE EUROPEAN COMMUNITY PUT TOGETHER.

ARREARS

ARREARS AT THE FUND AND THE BANK ARE A GROWING PROBLEM. AT THE FUND, ARREARS HAVE RISEN TENFOLD, FROM $ 1/4 BILLION AT THE END OF 1984 TO $ 2-1/2 BILLION AT THE END OF 1987.

ARREARS ON THIS SCALE ARE DAMAGING TO EVERYONE. IN PARTICULAR, THEY ARE DAMAGING TO OTHER BORROWERS. THE SHORTFALL IN THE FUND'S INCOME HAS TO BE MADE GOOD, IN PART, BY BORROWING COUNTRIES PAYING HIGHER LOAN CHARGES. ARREARS ARE ALSO DAMAGING TO THE FUND: IF THE PROBLEM IS NOT DEALT WITH IT WILL IN THE LONGER TERM HARM ITS BASIC FINANCIAL STRENGTH. THE COUNTRIES IN ARREARS ARE DAMAGED TOO, SINCE THEY ARE

EFFECTIVELY CUT OFF FROM VIRTUALLY ALL SOURCES OF EXTERNAL FINANCE.

THE CURRENT TREND MUST THEREFORE BE REVERSED.

THE FIRST PRIORITY MUST BE TO PERSUADE COUNTRIES IN ARREARS TO PURSUE, IN AGREEMENT WITH THE FUND, THE SORTS OF ECONOMIC POLICIES THAT WILL GRADUALLY RESTORE THEIR ECONOMIES TO HEALTH. THE LONGER THAT COUNTRIES DELAY DOING THIS, THE MORE INTRACTABLE THE PROBLEM BECOMES.

FOR MANY OF THE VERY POOR COUNTRIES IN ARREARS IT IS CLEAR THAT, EVEN SO, THEY WILL NOT BE ABLE TO PAY OFF THEIR ARREARS WITHOUT SOME HELP. THAT WAS WHY I PROPOSED AT THE DEVELOPMENT COMMITTEE MEETING IN THE SPRING

THAT THOSE COUNTRIES IN ARREARS AT THE IMF WHICH WERE ELIGIBLE FOR THE ESAF, AND WHICH SUCCESSFULLY OPERATED AN APPROVED IMF SHADOW PROGRAM FOR A PERIOD OF, SAY, A YEAR SHOULD BE ELIGIBLE FOR A BACKDATED DRAWING ON THE ESAF.

FOR COUNTRIES WHICH DO NOT COOPERATE WITH THE INTERNATIONAL INSTITUTIONS, IN THIS WAY, WE MUST IMPOSE FIRM MEASURES. IMF QUOTA INCREASES FOR THESE COUNTRIES SHOULD BE FROZEN; AND THE BANK SHOULD NOT NORMALLY CONSIDER NEW LOAN PROPOSALS AND SHOULD NOT MAKE FURTHER DISBURSEMENTS OF STRUCTURAL ADJUSTMENT LOANS.

I AM GLAD TO SAY THAT MY PROPOSAL ON THE USE OF THE ESAF HAS RECEIVED WIDESPREAD SUPPORT IN THE FUND BOARD, AND FROM THE

MANAGING DIRECTOR IN PARTICULAR. BY ITSELF IT MAY NOT PROVIDE ENOUGH RESOURCES, AND IT WILL NEED SUPPORT FROM OTHER SOURCES, INCLUDING AID. I KNOW, HOWEVER, THAT SOME COUNTRIES DO NOT LIKE THE PROPOSAL. BUT I HOPE THAT ON REFLECTION THEY WILL RECOGNISE THAT IT OFFERS A CONSTRUCTIVE CONTRIBUTION TO THE ARREARS PROBLEM AND THERE ARE NO OTHER SOLUTIONS ON THE TABLE.

I WOULD JUST LIKE TO MAKE TWO OTHER POINTS ON THE PROBLEM OF ARREARS. FIRST, IT REINFORCES THE NEED FOR STRONG FUND PROGRAMMES: WEAK PROGRAMMES ARE A RECIPE FOR CREATING NEW PROBLEMS OF ARREARS IN THE FUTURE; AND IT VITAL TOO THAT THE BANK SHOULD CONFINE ITS POLICY-BASED LENDING TO THOSE COUNTRIES WHERE A SOUND MACROECONOMIC FRAMEWORK IS IN PLACE - THIS IN PRACTICE

MEANS A FUND PROGRAMME. SECOND, THE PROBLEM OF ARREARS DEMONSTRATES THE FOLLY OF WORRYING ABOUT REFLOWS TO THE FUND. NOTHING IS MORE ABSURD THAN THE FUND BEING CRITICISED FOR ARREARS WHEN LOANS ARE NOT REPAID, AND CRITICISED FOR NEGATIVE NET LENDING WHEN LOANS ARE REPAID. REPAYMENTS ARE A SIGN OF SUCCESS NOT FAILURE.

CONCLUSICN

IN CONCLUSION, MR CHAIRMAN, LET ME SAY THAT I FULLY UNDERSTAND THE IMMENSE POLITICAL DIFFICULTIES WHICH GOVERNMENTS IN DEBTOR COUNTRIES FACE IN CARRYING THROUGH THESE NECESSARY PROGRAMMES OF ECONOMIC REFORM AND ADJUSTMENT. IT REQUIRES A HIGH QUALITY OF POLITICAL LEADERSHIP, WHICH MANY HERE HAVE DEMONSTRATED. IN RETURN, IT IS ESSENTIAL THAT CREDITOR COUNTRIES FACE UP TO WHAT ON THE WHOLE ARE THE LESS ACUTE POLITICAL DIFFICULTIES OF OPENING UP THEIR MARKETS TO IMPORTS FROM THE DEVELOPING COUNTRIES.

CHANCELLOR'S SPEAKING NOTE FOR THE

DEVELOPMENT COMMITTEE

MONDAY 26 SEPTEMBER 1988

MUCH HAS HAPPENED SINCE WE MET IN THE SPRING. AGREEMENT HAS BEEN REACHED ON A GENERAL CAPITAL INCREASE, AND THE UNITED KINGDOM WAS THE FIRST COUNTRY TO SUBSCRIBE IN FULL. I HOPE OTHER COUNTRIES WILL FOLLOW SUIT AS SOON AS THEY CAN.

2. DISCUSSIONS HAVE ALSO BEGUN ON THE NINTH REPLENISHMENT OF IDA. I BELIEVE A SUBSTANTIAL REPLENISHMENT IS JUSTIFIED TO MAINTAIN THE BANK'S CONCESSIONAL LENDING TO ITS VERY POOREST MEMBERS, ESPECIALLY IN AFRICA.

3. AND WE HAVE REACHED AGREEMENT OVER THE PAST YEAR ON A NUMBER OF IMPORTANT MEASURES TO EASE THE DEBT PROBLEMS OF THE POOREST

COUNTRIES.

4. THE BANK LAUNCHED ITS SPECIAL PROGRAMME OF ASSISTANCE FOR AFRICA LAST DECEMBER. THE UK HAS PLEDGED 250 MILLION POUNDS OVER THREE YEARS TO SUPPORT IT.

5. THE IMF'S ENHANCED STRUCTURAL ADJUSTMENT FACILITY IS NOW IN PLACE. TWO COUNTRIES HAVE ALREADY RECEIVED ESAF LOANS. BUT WE ARE STILL SLIGHTLY SHORT OF THE MANAGING DIRECTOR'S TARGET OF A FULLY SUBSIDISED TRUST FUND OF 6 BILLION SDRS. I HOPE THIS IS REACHED SOON. THE UK FOR ITS PART HAS MADE THE LARGEST SINGLE SUBSIDY CONTRIBUTION.

6. MOST OF ALL, I WELCOME THE AGREEMENT THAT HAS NOW BEEN REACHED ON A SCHEME FOR

REDUCING THE DEBT BURDEN OF THE POOREST AND MOST HEAVILY INDEBTED COUNTRIES, ESPECIALLY IN SUB-SAHARAN AFRICA, WHICH ARE PURSUING SOUND ADJUSTMENT PROGRAMS.

7. UNDER THIS AGREEMENT CREDITOR COUNTRIES CAN CHOOSE ONE OF THREE WAYS OF REDUCING THE DEBT SERVICE BURDEN: REDUCING INTEREST RATES, WRITING OFF PART OF THE DEBT, OR RESCHEDULING OVER SUBSTANTIALLY LONGER PERIODS. EACH OF THESE ENTAILS A DEGREE OF CONCESSION FROM CREDITOR COUNTRIES. THE UK HAS ALWAYS MADE IT CLEAR THAT IT WILL BE OFFERING A REDUCTION IN INTEREST RATES, AND I AM GLAD THAT A NUMBER OF OTHER COUNTRIES WILL BE DOING THE SAME.

8. IT HAS TAKEN US MUCH TIME AND EFFORT TO REACH AGREEMENT SINCE I FIRST PROPOSED THE

IDEA IN THE SPRING OF 1987. THE NEXT STEP IS TO IMPLEMENT THE SCHEME AS QUICKLY AS POSSIBLE ON A COUNTRY BY COUNTRY BASIS.

9. MEANWHILE THE INDUSTRIALISED COUNTRIES NEED TO DO MUCH MORE TO HELP DEVELOPING COUNTRIES, AND HELP THEMSELVES AT THE SAME TIME, BY ROLLING BACK PROTECTION AND OPENING UP THEIR MARKETS. PROTECTION DENIES CONSUMERS A FREE CHOICE, AND PUTS UP PRICES. IT FOSTERS INEFFICIENCY BY INSULATING DOMESTIC PRODUCERS FROM COMPETITION, AND DISCOURAGING THEM FROM CONCENTRATING ON AREAS OF GENUINE COMPARATIVE ADVANTAGE. TOO OFTEN WE SEE DECLINING INDUSTRIES THAT ALWAYS NEED MORE TIME FOR ADJUSTMENT, AND ANTI-DUMPING DUTIES IMPOSED OSTENSIBLY IN THE INTERESTS OF FAIRNESS.

10. IMF AND WORLD BANK STUDIES SUGGEST THAT PROTECTION BY INDUSTRIALISED COUNTRIES COSTS THE DEVELOPING COUNTRIES MORE THAN TWICE THE AMOUNT OF OFFICIAL AID THEY RECEIVE - AND THIS PROTECTION IS STILL INCREASING.

11. IN PARTICULAR, SOME OF THE NEWLY INDUSTRIALISED ECONOMIES NEED TO OPEN UP THEIR MARKETS. IT IS ABSURD THAT THESE DYNAMIC ECONOMIES STILL MAINTAIN HIGH LEVELS OF PROTECTION. THEIR SUCCESS BRINGS WITH IT THE OBLIGATION TO OBSERVE FULLY THE RULES OF GATT.

12. DEVELOPING COUNTRIES ALSO NEED TO LIBERALISE THEIR TRADE POLICIES. I WAS GREATLY ENCOURAGED TO SEE FROM A RECENT IMF

PAPER THAT THIS IS BEGINNING TO HAPPEN. BUT MORE NEEDS TO BE DONE.

13. IN THE URUGUAY ROUND WE NEED TO ACHIEVE SUBSTANTIAL REDUCTIONS IN ALL TYPES OF PROTECTION. THE MID TERM MEETING IN MONTREAL THIS DECEMBER MUST PRODUCE CONCRETE RESULTS. OF PARTICULAR IMPORTANCE TO DEVELOPING COUNTRIES WOULD BE A SPECIFIC AGREEMENT TO REDUCE BARRIERS TO THE IMPORT OF TROPICAL PRODUCTS. IN OTHER IMPORTANT AREAS, ESPECIALLY AGRICULTURE, SERVICES AND TEXTILES, WHERE DISCUSSIONS ARE NOT SO FAR ADVANCED, WE MUST REACH AGREEMENT AT MONTREAL ON A FRAMEWORK FOR NEGOTIATIONS. AND WE CLEARLY NEED TO STRENGTHEN GATT AS AN INSTITUTION.

14. THE EUROPEAN COMMUNITY HAS EMBARKED ON

DISMANTLING INTERNAL BARRIERS TO TRADE WITH THE OBJECT OF COMPLETING A FREE INTERNAL MARKET BY 1992. THE UK IS DETERMINED THAT EUROPE SHOULD NOT RAISE FRESH BARRIERS AGAINST THE REST OF THE WORLD.

15. ANOTHER ASPECT OF LIBERALISATION IS THE LIFTING OF BARRIERS TO PRIVATE INVESTMENT IN DEVELOPING COUNTRIES, BOTH DIRECT AND PORTFOLIO. THE WORLD BANK CAN ENCOURAGE THIS, PARTICULARLY THROUGH THE IFC AND MIGA. I WELCOME THE RECOMMENDATION OF THE PRIVATE SECTOR DEVELOPMENT REVIEW GROUP THAT IN ITS LENDING THE BANK SHOULD PAY GREATER ATTENTION TO THE REMOVAL OF ARTIFICIAL RESTRAINTS ON INWARD DIRECT INVESTMENT. I ALSO WELCOME THE INCREASING READINESS OF DEVELOPING COUNTRIES TO ENCOURAGE FOREIGN INVESTMENT, AS WAS

DEMONSTRATED BY THE CONCLUSIONS OF LAST WEEK'S COMMONWEALTH FINANCE MINISTERS MEETING IN CYPRUS. BUT THERE IS STILL A LONG WAY TO GO BEFORE THE REGULATORY AND FISCAL POLICIES ARE IN PLACE THAT WILL ENABLE PRIVATE INVESTMENT TO PLAY ITS FULL PART.

16. FINALLY, MR. CHAIRMAN, WE LOSE AS MUCH FROM SQUANDERING OUR ENVIRONMENTAL WEALTH AS FROM SQUANDERING ANY OTHER ECONOMIC RESOURCE. WE IN THE UK FULLY SUPPORT THE BANK'S INCREASED ATTENTION TO THE ENVIRONMENT IN ITS WORK.

DARDS OF GOVERNORS • 1988 ANNUAL MEETINGS • BERLIN (WEST)

I[illegible] RNATIONAL MONETARY FUND
THE W[illegible]D BANK GROUP
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
MULTILATERAL INVESTMENT GUARANTEE AGENCY

J

Press Release No. 37

September 28, 1988

HOLD FOR RELEASE
UNTIL DELIVERY

Statement by the Rt. Hon. NIGEL LAWSON,
Chancellor of the Exchequer and
Governor of the Fund for the UNITED KINGDOM,
at the Joint Annual Discussion

In my remarks today I shall deal briefly first with some international debt issues, then with the state of the world economy, then turn to the vexed question of the external imbalances between the major nations, and finally say a few words about the experience of my own country.

International Debt Issues

This has been a year of achievement for the Fund and the Bank. We have taken important steps over the past year to help the poorest, most indebted countries. We now have in place the World Bank's Special Program of Assistance for Africa and the Fund's enhanced structural adjustment facility. The United Kingdom is making substantial funds available to both.

I am particularly delighted that agreement has now been reached by all the creditors in the Paris Club on the scheme for easing the burden of official debt of the poorest, most heavily indebted countries, especially in sub-Saharan Africa.

The World Bank is now beginning to benefit from its capital increase: I hope other countries will follow the United Kingdom and subscribe quickly. The extra resources will be of special benefit to the middle-income debtors, always provided that the right economic framework is in place--and that means a Fund program.

I welcome the determination of the Fund not to be rushed into supporting macroeconomic programs before they are satisfied about the soundness of those programs and the commitment of the authorities to persevere in implementing them.

this greatly improved performance of the world economy in the 1980s can be continued into the 1990s.

Current Account Imbalances

A widespread concern at these meetings has been the existence and scale of the current account imbalances between the major countries. Over the postwar period, it has not been unusual for many of the smaller industrial countries to run current account deficits or surpluses for many years. Denmark, for example, has had a continuous current account deficit for a quarter of a century, while Switzerland has had a persistent current account surplus.

But between the postwar "dollar gap" and 1983 there was virtually no experience of significant and sustained imbalances among the major industrial economies. Since then the picture has changed dramatically. The Federal Republic of Germany has had a current surplus of over 2 1/2 percent of GDP every year since 1985, and Japan every year since 1984. Conversely, the United States has had a current deficit of over 2 1/2 percent of GDP in every year since 1984. This year the United Kingdom also seems likely to have a current deficit of this size, and there is some concern about how long that, too, will persist.

There is still no agreement about a number of key aspects of these imbalances: the reason for their emergence; how long they can persist without causing serious problems; the appropriate response and role of governments; and the mechanisms by which imbalances are reduced. These are the topics I wish to discuss today.

When we look at the balance of payments, it is important to consider not merely the current account but also the capital account. Net capital flows are an equal and opposite counterpart to a current account imbalance. A country that is attracting net inflows of capital from overseas to supplement domestic savings must, by definition, be running a current account deficit. Conversely, a country in current account surplus must by definition be engaged in net investment overseas.

In other words, the current account reflects the difference between domestic savings and domestic investment. For example, a current account surplus may reflect either a shortage of attractive investment at home, or a very high level of domestic savings.

As we have seen, in the smaller countries there have long been examples where a significant portion of domestic savings has been invested overseas, or, conversely, where a significant portion of domestic investment has been financed by savings from abroad.

What has emerged over the past five years has been the sustained use of Japanese and German savings to make good the shortfall of savings in the United States, and to finance investment there. This has been made possible by the profound changes that have taken place in world capital

To summarize: large-scale current imbalances reflect differences in domestic savings and investment behavior in a world of free financial markets. Does the government then have any role at all in seeking to correct them?

First and foremost, the government has a responsibility to curb inflation by maintaining a sound monetary policy. If monetary conditions are too lax, the authorities have to tighten them. A tightening of monetary policy, through higher interest rates, will boost savings and hence reduce the current account deficit. But that is not the object of the exercise. And current account imbalances would occur even in a world of zero inflation.

The conduct of monetary policy also has implications for the exchange rate, and the exchange rate itself is an important factor in monetary policy decisions. It follows that the exchange rate cannot be assigned the task of balancing the current account, and it is a mistake to think that the automatic response to a current account deficit should be a lower exchange rate. Significant currency changes can at times be necessary, when, as for example with the dollar in 1985, exchange rates have clearly moved out of line with economic fundamentals. But it is wrong to assume that a current account deficit is sufficient evidence of this.

Governments do, however, have a clear role when a current account deficit is accompanied by a budget deficit. In those circumstances, they have a responsibility over time to reduce, and possibly eliminate, the deficit, and hence their call on private sector savings. The position is totally different when, as in the United Kingdom, there is no budget deficit at all and the current account deficit is entirely the result of private sector decisions. Generally speaking, it would be quite wrong for the public sector to seek to run an ever-increasing budget surplus in an attempt to offset private sector behavior, not least because private sector behavior is by its nature self-correcting over time.

To the extent that the deficit is the result of higher private sector investment, the adjustment mechanism is evident: the future returns will finance the original investment. To the extent that the deficit is the result of low net private sector savings, this too should correct itself in time. The main source of fluctuations in net savings is changes in the amount of borrowing by the private sector. There is a limit to the amount of debt which the private sector will be willing--or can afford--to undertake. Once that limit has been reached, the savings ratio will rise again. Moreover, higher debt means higher interest payments in the future, which will reduce disposable income and consumption. Thus, higher consumption now is at the expense of consumption in the future.

It is only in the unlikely event that the self-correcting mechanisms threaten to stretch over so long a period that the creditworthiness constraint to which I have alluded comes into play that it would be appropriate for the government to run a larger budget surplus in order to offset the lack of private sector savings.

financial markets is completed, and people judge that they are close to the prudent limit of indebtedness. And over time this will reduce the current account deficit.

Some may be puzzled why the existence of a current account deficit is so newsworthy in the United Kingdom. The truth is that we are prisoners of the past, when U.K. current account deficits were almost invariably associated with large budget deficits, poor economic performance, low reserves, and exiguous net overseas assets. The present position could not be more different. The output and productivity of the United Kingdom are both growing strongly. The official reserves are high, and net overseas assets are greater as a proportion of GDP than in any other major industrial country. And the public sector finances are in sizable surplus. By any standards, the United Kingdom's creditworthiness is high.

The decline of savings in the United Kingdom at a time of high investment opportunities appears to be a particularly striking example of a worldwide trend. Increasing capital flows between countries can satisfactorily complete the balance of savings and investment for an individual country. But there remains the question of the balance of savings and investment opportunities for the world as a whole. This may well be at least as important an issue in the coming years as the handling of current account imbalances.

BOARDS OF GOVERNORS • 1988 ANNUAL MEETINGS • BERLIN (WEST)

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I am particularly delighted that agreement has now been reached by all the creditors in the Paris Club on the scheme for easing the burden of official debt of the poorest, most heavily indebted countries, especially in sub-Saharan Africa.

The World Bank is now beginning to benefit from its capital increase: I hope other countries will follow the United Kingdom and subscribe quickly. The extra resources will be of special benefit to the middle-income debtors, always provided that the right economic framework is in place--and that means a Fund program.

I welcome the determination of the Fund not to be rushed into supporting macroeconomic programs before they are satisfied about the soundness of those programs and the commitment of the authorities to persevere in implementing them.

The market is now playing a larger part in the resolution of debt problems--through debt-equity swaps, debt conversions, and buybacks--in ways that reduce the burden of debt. I would hope to see banks and debtors take this approach further.

The Bretton Woods institutions are playing a major role in the resolution of debt problems. This role will be damaged unless the problem of arrears is contained and reversed--and I have made a number of proposals. In particular, for the poorest countries with the bulk of arrears, shadow programs leading to a backdated drawing on the enhanced structural adjustment facility should make a major contribution.

But we must look beyond the international financial institutions in our search for ways of sustaining the world economy, raising living standards, and reducing poverty. There is a growing acceptance that the role of the private sector in development needs to be expanded, and especially the role of private capital flows. To achieve this, barriers in developing countries will need to come down.

Barriers to international trade must also come down. We in the creditor countries must overcome the political problems of opening up our markets further to the exports of developing countries--just as governments in debtor countries need to overcome the political difficulties involved in carrying through reform programs, including trade liberalization. At the midterm meeting in Montreal we must all work together to achieve concrete results.

World Economy

This year's Annual Meetings have been held in a very different atmosphere from that prevailing last year. Then, many were worried about the danger of an imminent slowdown in world growth, and doubted whether G-7 cooperation and policy coordination was strong enough; the stock market crash a few weeks later reinforced those concerns. Now, we can see that growth picked up rather than slowed down; and our success in averting the potentially very damaging effects of the stock market crash has demonstrated the strength and value of G-7 cooperation.

This satisfactory performance has been made possible by our common commitment to sound public finance and a firm monetary policy. This has involved a willingness to raise interest rates, when--as, for example, this summer--there have been signs in some countries of inflationary pressures re-emerging. At the same time, there has been increasing recognition of the need to pursue supply-side reforms, to remove the barriers and restrictions which hold back performance. And we are increasingly seeing the benefits of this.

As we go ahead, there will inevitably be fluctuations around the medium-term trend, but that is unavoidable and does not matter. What does matter is that, by sticking to this strategy, there is every prospect that

this greatly improved performance of the world economy in the 1980s can be continued into the 1990s.

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A widespread concern at these meetings has been the existence and scale of the current account imbalances between the major countries. Over the postwar period, it has not been unusual for many of the smaller industrial countries to run current account deficits or surpluses for many years. Denmark, for example, has had a continuous current account deficit for a quarter of a century, while Switzerland has had a persistent current account surplus.

But between the postwar "dollar gap" and 1983 there was virtually no experience of significant and sustained imbalances among the major industrial economies. Since then the picture has changed dramatically. The Federal Republic of Germany has had a current surplus of over 2 1/2 percent of GDP every year since 1985, and Japan every year since 1984. Conversely, the United States has had a current deficit of over 2 1/2 percent of GDP in every year since 1984. This year the United Kingdom also seems likely to have a current deficit of this size, and there is some concern about how long that, too, will persist.

There is still no agreement about a number of key aspects of these imbalances: the reason for their emergence; how long they can persist without causing serious problems; the appropriate response and role of governments; and the mechanisms by which imbalances are reduced. These are the topics I wish to discuss today.

When we look at the balance of payments, it is important to consider not merely the current account but also the capital account. Net capital flows are an equal and opposite counterpart to a current account imbalance. A country that is attracting net inflows of capital from overseas to supplement domestic savings must, by definition, be running a current account deficit. Conversely, a country in current account surplus must by definition be engaged in net investment overseas.

In other words, the current account reflects the difference between domestic savings and domestic investment. For example, a current account surplus may reflect either a shortage of attractive investment at home, or a very high level of domestic savings.

As we have seen, in the smaller countries there have long been examples where a significant portion of domestic savings has been invested overseas, or, conversely, where a significant portion of domestic investment has been financed by savings from abroad.

What has emerged over the past five years has been the sustained use of Japanese and German savings to make good the shortfall of savings in the United States, and to finance investment there. This has been made possible by the profound changes that have taken place in world capital

markets. We have seen a worldwide move to deregulation, the development of a wide range of new financial instruments, and a massive growth of mobile capital. Against this background it is not at all surprising that substantial imbalances have emerged: indeed, what would be more surprising would be if in each country domestic savings exactly equaled domestic investment and capital inflows precisely matched capital outflows.

In the past, significant current account deficits in the major countries were not sustained, because of the unwillingness or inability of capital markets to finance such large flows. As a result, the private sector had to rely almost entirely on domestic savings to finance its investment; and financial market pressures forced governments to adjust domestic policies in the face of emerging current account deficits.

But today there is clearly no reason why, with free access to world capital markets, domestic investment should be limited to what can be financed from domestic savings. The recent imbalances have continued because capital markets have brought together investment opportunities and savers in different countries.

Inevitably, the pattern of savings and investment is likely to differ between countries, for cultural and demographic, as well as for economic, reasons; indeed it is also likely to change over time.

In a deregulated world, where market forces are given a much bigger role, savers will diversify their investments and seek out the most profitable opportunities. It is therefore natural for capital to move between countries to reflect differences in saving propensities and rates of return just as it moves between regions of a country or between generations.

Despite the evidence that current account imbalances can persist, there is an understandable concern that they cannot continue unchecked. A particular worry is the arithmetic of debt accumulation and debt service costs. Persistent large imbalances do become a problem as flows compound and therefore by definition become unsustainable. But even for deficits of the size we have seen recently in the major countries, this problem emerges quite slowly. As the OECD has suggested, the effective constraint is not so much the size of a current account imbalance as a country's overall creditworthiness, in which net overseas assets play an important part.

There is also a concern that long before this constraint is reached, financial markets will take fright. Given the well-known volatility of these markets, it is clearly necessary for governments not just to pursue sound financial policies, but also to be prepared from time to time to exercise a stabilizing influence, as I discussed in my speech to these meetings last year. But, as experience has shown, this applies as much when the current account is in surplus as when it is in deficit. One of the paradoxes of much contemporary comment is that current deficits are seen as unsustainable, while surpluses are seen as endemic.

To summarize: large-scale current imbalances reflect differences in domestic savings and investment behavior in a world of free financial markets. Does the government then have any role at all in seeking to correct them?

First and foremost, the government has a responsibility to curb inflation by maintaining a sound monetary policy. If monetary conditions are too lax, the authorities have to tighten them. A tightening of monetary policy, through higher interest rates, will boost savings and hence reduce the current account deficit. But that is not the object of the exercise. And current account imbalances would occur even in a world of zero inflation.

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It is only in the unlikely event that the self-correcting mechanisms threaten to stretch over so long a period that the creditworthiness constraint to which I have alluded comes into play that it would be appropriate for the government to run a larger budget surplus in order to offset the lack of private sector savings.

The U.K. Economy

Over the past year, the United Kingdom has shared many of the experiences of other industrial countries--but in an even more pronounced fashion. Output, investment, and domestic demand have all grown much faster than expected.

At the same time, the supply performance of the British economy has improved further. The continued rapid growth of manufacturing productivity has convinced even the most skeptical critics that a major change of behavior has taken place. This improved productivity performance is reflected in the slow growth of manufacturing costs, rising profitability, higher rates of return on capital, and a strong export performance.

Combined with public expenditure restraint, this has had a dramatic effect on the public finances. Last year we had a budget surplus--a public sector debt repayment--of approaching 1 percent of GDP. This year I budgeted for a further debt repayment of the same scale. It is now clear that it will be considerably larger than this. Yet, despite the tightening of fiscal policy, the current account has moved into sizable deficit.

Private sector savings have fallen, while private sector investment is surging. The fall in personal savings has been largely caused by a substantial increase in personal borrowing, partly as a result of greater confidence in the future and partly as individuals have adjusted to the increased wealth resulting from higher house prices.

At the same time, the deregulation of financial markets has made it easier for consumers to use the collateral of asset values to increase the level of borrowing. For the personal sector as a whole, the level of borrowing in relation to income is now almost on a par with that of the United States.

The fall in saving has coincided with a welcome growth in investment. This investment is crucial if the better growth rate is to be sustained. However, the investment boom, superimposed on strong consumer spending began to generate inflationary pressures. The government responded by a sharp tightening of monetary policy.

The temporary edging up of inflation, which has been exaggerated by higher mortgage rates, will reverse some time in the course of next year. There are already signs that the higher interest rates are beginning to take the steam out of the housing market.

They will also boost savings, and this will speed up the adjustment that will be brought about in any event by the self-correcting mechanisms I have described. In particular, the growth of personal borrowing will slow as the once-for-all adjustment to the new climate of deregulation in

financial markets is completed, and people judge that they are close to the prudent limit of indebtedness. And over time this will reduce the current account deficit.

Some may be puzzled why the existence of a current account deficit is so newsworthy in the United Kingdom. The truth is that we are prisoners of the past, when U.K. current account deficits were almost invariably associated with large budget deficits, poor economic performance, low reserves, and exiguous net overseas assets. The present position could not be more different. The output and productivity of the United Kingdom are both growing strongly. The official reserves are high, and net overseas assets are greater as a proportion of GDP than in any other major industrial country. And the public sector finances are in sizable surplus. By any standards, the United Kingdom's creditworthiness is high.

The decline of savings in the United Kingdom at a time of high investment opportunities appears to be a particularly striking example of a worldwide trend. Increasing capital flows between countries can satisfactorily complete the balance of savings and investment for an individual country. But there remains the question of the balance of savings and investment opportunities for the world as a whole. This may well be at least as important an issue in the coming years as the handling of current account imbalances.

H. M. TREASURY

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28 SEPTEMBER 1988

THE CHANCELLOR OF THE EXCHEQUER'S SPEECH TO THE IMF

Attached is the text of the speech delivered in West Berlin today by the Rt Hon Nigel Lawson MP, Chancellor of the Exchequer, at the Joint Annual Meeting of the International Monetary Fund and the International Bank for Reconstruction and Development.

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG

81/88

Statement by the Rt. Hon. NIGEL LAWSON,
Chancellor of the Exchequer and
Governor of the Fund for the UNITED KINGDOM,
at the Joint Annual Discussion

In my remarks today I shall deal briefly first with some international debt issues, then with the state of the world economy, then turn to the vexed question of the external imbalances between the major nations, and finally say a few words about the experience of my own country.

International Debt Issues

This has been a year of achievement for the Fund and the Bank. We have taken important steps over the past year to help the poorest, most indebted countries. We now have in place the World Bank's Special Program of Assistance for Africa and the Fund's enhanced structural adjustment facility. The United Kingdom is making substantial funds available to both.

I am particularly delighted that agreement has now been reached by all the creditors in the Paris Club on the scheme for easing the burden of official debt of the poorest, most heavily indebted countries, especially in sub-Saharan Africa.

The World Bank is now beginning to benefit from its capital increase: I hope other countries will follow the United Kingdom and subscribe quickly. The extra resources will be of special benefit to the middle-income debtors, always provided that the right economic framework is in place--and that means a Fund program.

I welcome the determination of the Fund not to be rushed into supporting macroeconomic programs before they are satisfied about the soundness of those programs and the commitment of the authorities to persevere in implementing them.

The market is now playing a larger part in the resolution of debt problems--through debt-equity swaps, debt conversions, and buybacks--in ways that reduce the burden of debt. I would hope to see banks and debtors take this approach further.

The Bretton Woods institutions are playing a major role in the resolution of debt problems. This role will be damaged unless the problem of arrears is contained and reversed--and I have made a number of proposals. In particular, for the poorest countries with the bulk of arrears, shadow programs leading to a backdated drawing on the enhanced structural adjustment facility should make a major contribution.

But we must look beyond the international financial institutions in our search for ways of sustaining the world economy, raising living standards, and reducing poverty. There is a growing acceptance that the role of the private sector in development needs to be expanded, and especially the role of private capital flows. To achieve this, barriers in developing countries will need to come down.

Barriers to international trade must also come down. We in the creditor countries must overcome the political problems of opening up our markets further to the exports of developing countries--just as governments in debtor countries need to overcome the political difficulties involved in carrying through reform programs, including trade liberalization. At the midterm meeting in Montreal we must all work together to achieve concrete results.

World Economy

This year's Annual Meetings have been held in a very different atmosphere from that prevailing last year. Then, many were worried about the danger of an imminent slowdown in world growth, and doubted whether G-7 cooperation and policy coordination was strong enough; the stock market crash a few weeks later reinforced those concerns. Now, we can see that growth picked up rather than slowed down; and our success in averting the potentially very damaging effects of the stock market crash has demonstrated the strength and value of G-7 cooperation.

This satisfactory performance has been made possible by our common commitment to sound public finance and a firm monetary policy. This has involved a willingness to raise interest rates, when--as, for example, this summer--there have been signs in some countries of inflationary pressures re-emerging. At the same time, there has been increasing recognition of the need to pursue supply-side reforms, to remove the barriers and restrictions which hold back performance. And we are increasingly seeing the benefits of this.

As we go ahead, there will inevitably be fluctuations around the medium-term trend, but that is unavoidable and does not matter. What does matter is that, by sticking to this strategy, there is every prospect that

this greatly improved performance of the world economy in the 1980s can be continued into the 1990s.

Current Account Imbalances

A widespread concern at these meetings has been the existence and scale of the current account imbalances between the major countries. Over the postwar period, it has not been unusual for many of the smaller industrial countries to run current account deficits or surpluses for many years. Denmark, for example, has had a continuous current account deficit for a quarter of a century, while Switzerland has had a persistent current account surplus.

But between the postwar "dollar gap" and 1983 there was virtually no experience of significant and sustained imbalances among the major industrial economies. Since then the picture has changed dramatically. The Federal Republic of Germany has had a current surplus of over 2 1/2 percent of GDP every year since 1985, and Japan every year since 1984. Conversely, the United States has had a current deficit of over 2 1/2 percent of GDP in every year since 1984. This year the United Kingdom also seems likely to have a current deficit of this size, and there is some concern about how long that, too, will persist.

There is still no agreement about a number of key aspects of these imbalances: the reason for their emergence; how long they can persist without causing serious problems; the appropriate response and role of governments; and the mechanisms by which imbalances are reduced. These are the topics I wish to discuss today.

When we look at the balance of payments, it is important to consider not merely the current account but also the capital account. Net capital flows are an equal and opposite counterpart to a current account imbalance. A country that is attracting net inflows of capital from overseas to supplement domestic savings must, by definition, be running a current account deficit. Conversely, a country in current account surplus must by definition be engaged in net investment overseas.

In other words, the current account reflects the difference between domestic savings and domestic investment. For example, a current account surplus may reflect either a shortage of attractive investment at home, or a very high level of domestic savings.

As we have seen, in the smaller countries there have long been examples where a significant portion of domestic savings has been invested overseas, or, conversely, where a significant portion of domestic investment has been financed by savings from abroad.

What has emerged over the past five years has been the sustained use of Japanese and German savings to make good the shortfall of savings in the United States, and to finance investment there. This has been made possible by the profound changes that have taken place in world capital

markets. We have seen a worldwide move to deregulation, the development of a wide range of new financial instruments, and a massive growth of mobile capital. Against this background it is not at all surprising that substantial imbalances have emerged: indeed, what would be more surprising would be if in each country domestic savings exactly equaled domestic investment and capital inflows precisely matched capital outflows.

In the past, significant current account deficits in the major countries were not sustained, because of the unwillingness or inability of capital markets to finance such large flows. As a result, the private sector had to rely almost entirely on domestic savings to finance its investment; and financial market pressures forced governments to adjust domestic policies in the face of emerging current account deficits.

But today there is clearly no reason why, with free access to world capital markets, domestic investment should be limited to what can be financed from domestic savings. The recent imbalances have continued because capital markets have brought together investment opportunities and savers in different countries.

Inevitably, the pattern of savings and investment is likely to differ between countries, for cultural and demographic, as well as for economic, reasons; indeed it is also likely to change over time.

In a deregulated world, where market forces are given a much bigger role, savers will diversify their investments and seek out the most profitable opportunities. It is therefore natural for capital to move between countries to reflect differences in saving propensities and rates of return just as it moves between regions of a country or between generations.

Despite the evidence that current account imbalances can persist, there is an understandable concern that they cannot continue unchecked. A particular worry is the arithmetic of debt accumulation and debt service costs. Persistent large imbalances do become a problem as flows compound and therefore by definition become unsustainable. But even for deficits of the size we have seen recently in the major countries, this problem emerges quite slowly. As the OECD has suggested, the effective constraint is not so much the size of a current account imbalance as a country's overall creditworthiness, in which net overseas assets play an important part.

There is also a concern that long before this constraint is reached, financial markets will take fright. Given the well-known volatility of these markets, it is clearly necessary for governments not just to pursue sound financial policies, but also to be prepared from time to time to exercise a stabilizing influence, as I discussed in my speech to these meetings last year. But, as experience has shown, this applies as much when the current account is in surplus as when it is in deficit. One of the paradoxes of much contemporary comment is that current deficits are seen as unsustainable, while surpluses are seen as endemic.

To summarize: large-scale current imbalances reflect differences in domestic savings and investment behavior in a world of free financial markets. Does the government then have any role at all in seeking to correct them?

First and foremost, the government has a responsibility to curb inflation by maintaining a sound monetary policy. If monetary conditions are too lax, the authorities have to tighten them. A tightening of monetary policy, through higher interest rates, will boost savings and hence reduce the current account deficit. But that is not the object of the exercise. And current account imbalances would occur even in a world of zero inflation.

The conduct of monetary policy also has implications for the exchange rate, and the exchange rate itself is an important factor in monetary policy decisions. It follows that the exchange rate cannot be assigned the task of balancing the current account, and it is a mistake to think that the automatic response to a current account deficit should be a lower exchange rate. Significant currency changes can at times be necessary, when, as for example with the dollar in 1985, exchange rates have clearly moved out of line with economic fundamentals. But it is wrong to assume that a current account deficit is sufficient evidence of this.

Governments do, however, have a clear role when a current account deficit is accompanied by a budget deficit. In those circumstances, they have a responsibility over time to reduce, and possibly eliminate, the deficit, and hence their call on private sector savings. The position is totally different when, as in the United Kingdom, there is no budget deficit at all and the current account deficit is entirely the result of private sector decisions. Generally speaking, it would be quite wrong for the public sector to seek to run an ever-increasing budget surplus in an attempt to offset private sector behavior, not least because private sector behavior is by its nature self-correcting over time.

To the extent that the deficit is the result of higher private sector investment, the adjustment mechanism is evident: the future returns will finance the original investment. To the extent that the deficit is the result of low net private sector savings, this too should correct itself in time. The main source of fluctuations in net savings is changes in the amount of borrowing by the private sector. There is a limit to the amount of debt which the private sector will be willing--or can afford--to undertake. Once that limit has been reached, the savings ratio will rise again. Moreover, higher debt means higher interest payments in the future, which will reduce disposable income and consumption. Thus, higher consumption now is at the expense of consumption in the future.

It is only in the unlikely event that the self-correcting mechanisms threaten to stretch over so long a period that the creditworthiness constraint to which I have alluded comes into play that it would be appropriate for the government to run a larger budget surplus in order to offset the lack of private sector savings.

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financial markets is completed, and people judge that they are close to the prudent limit of indebtedness. And over time this will reduce the current account deficit.

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FROM: A P HUDSON
DATE: 30 September 1988

PS/CHIEF SECRETARY

cc PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Lankester
Mr Odling-Smee
Mr Culpin
Mr Peretz
Mr Sedgwick
Mr H P Evans
Mr Walsh
Mr S W Matthews
Miss Simpson
Mr Cropper
Mr Tyrie
Mr Call
Mr Gray (No.10)
Mr Footman (Bank)

Keep

1988 ANNUAL MEETINGS: CHANCELLOR'S SPEECHES

... I attach the Chancellor's speeches at the International Meetings.

APH

A P HUDSON

6 29/9/88

CHANCELLOR'S SPEAKING NOTE FOR THE
INTERIM COMMITTEE
MORNING SESSION, SEPTEMBER 25, 1988

WORLD ECONOMY

MR. CHAIRMAN, WE WILL BE DISCUSSING MANY IMPORTANT ASPECTS OF THE WORLD ECONOMY TODAY AND IN LATER MEETINGS. I HOPE TO SPEAK THIS AFTERNOON ABOUT THE DEBT PROBLEMS OF DEVELOPING COUNTRIES. BUT I MAKE NO APOLOGY FOR FOCUSING NOW ON THE PERFORMANCE OF THE MAJOR INDUSTRIAL COUNTRIES FOR THIS IS VITAL NOT ONLY FOR THEIR OWN PROSPERITY BUT FOR THE REST OF THE WORLD AS WELL.

2. DESPITE ALARMS AND JITTERS THE WORLD ECONOMY HAS PERFORMED WELL OVER THE PAST YEAR. IT HAS ENJOYED 4 PER CENT GROWTH, SOMETHING OF AN INVESTMENT BOOM, DECLINING

UNEMPLOYMENT, AND ONLY A SMALL PICK-UP IN INFLATION. THIS GOOD PERFORMANCE CONTRASTS WITH SOME OF THE PESSIMISM PREVAILING AT LAST YEAR'S ANNUAL MEETINGS WHICH, FOR MANY, WAS REINFORCED BY THE STOCK MARKET CRASH A COUPLE OF WEEKS LATER.

3. THE MAJOR INDUSTRIAL COUNTRIES HAVE NOW SEEN SIX YEARS OF UNINTERRUPTED GROWTH AT AN AVERAGE RATE OF 3 1/2 PER CENT A YEAR, THE BEST PERFORMANCE FOR OVER TWENTY YEARS.

4. THE KEY HAS BEEN OUR SUCCESS IN GETTING INFLATION DOWN AND KEEPING IT DOWN. THE AVERAGE INFLATION RATE OF THE INDUSTRIAL COUNTRIES HAS FALLEN STEADILY FROM 1980 ONWARDS. NOT SURPRISINGLY IT PICKED UP AFTER THE ONCE AND FOR ALL EFFECTS OF LOWER OIL PRICES HAD WORKED THROUGH THE SYSTEM,

BUT EVEN SO THIS YEAR THE AVERAGE INFLATION RATE IS LESS THAN HALF OF WHAT IT WAS SIX YEARS AGO.

5. OVER THAT PERIOD THERE HAVE BEEN TIMES WHEN GROWTH HAS BEEN SLIGHTLY ABOVE TREND OR SLIGHTLY BELOW TREND. THAT IS SCARCELY SURPRISING. NOR SHOULD WE BE SURPRISED THAT THE RECORD OF PREDICTING THESE UPS AND DOWNS HAS BEEN POOR. BUT THERE HAS BEEN A DISTRESSING TENDENCY TO EXTRAPOLATE THE LATEST FLUCTUATIONS, PARTICULARLY IF THEY HAVE BEEN IN A PESSIMISTIC DIRECTION. EVENTS HAVE PROVED THE WISDOM OF DISREGARDING THESE PREDICTIONS WHEN JUDGING THE STANCE OF POLICY.

6. THE MAJOR NATIONS HAVE INCREASINGLY

CONTRIBUTED TO THE LENGTH AND STEADINESS OF THE CURRENT UPSWING IN TWO WAYS. ONE IS THE SHARED CONVICTION THAT SUSTAINED ECONOMIC GROWTH DEPENDS CRUCIALLY ON SUPPLY SIDE, MICRO-ECONOMIC, POLICIES SUCH AS TAX REFORM, DEREGULATION, COMPETITION, PRIVATISATION, AND IN GENERAL REDUCED INTERFERENCE BY GOVERNMENT IN THE ECONOMY. THE SECOND HAS BEEN THE PURSUIT OF CAUTIOUS MONETARY AND FISCAL POLICIES.

7. FISCAL POLICY HAS BEEN CONDUCTED WITH GREATER EMPHASIS GIVEN ON ACHIEVING A SUSTAINABLE MEDIUM-TERM PATH - WHICH, IN MOST CASES, HAS MEANT WORKING TOWARDS LOWER STRUCTURAL BUDGET DEFICITS. I AM CONVINCED THAT WE MUST CONTINUE WITH THIS APPROACH, WITH A BALANCED BUDGET AS THE ULTIMATE OBJECTIVE. OBVIOUSLY THE PRECISE FISCAL

POSITION WILL VARY WITH THE BUSINESS CYCLE. BUT WE MUST CONTINUE TO RESIST THOSE SIREN VOICES WHO WANT TO GO FURTHER THAN THIS AND USE FISCAL POLICY IN A VAIN ATTEMPT AT SHORT-TERM DEMAND MANAGEMENT. FISCAL POLICY IS PARTICULARLY UNSUITED TO THIS ROLE; IT TAKES TOO LONG TO PUT CHANGES INTO PLACE; FINE TUNING IS IMPOSSIBLE, AND THE ONLY UNAMBIGUOUS CONSEQUENCE IS DISRUPTION OF THE SUPPLY PERFORMANCE OF THE ECONOMY.

8. CORRECTLY, MONETARY POLICY HAS BEEN THE PRIME INSTRUMENT FOR CONTROLLING INFLATION. THE AUTHORITIES OF THE MAIN INDUSTRIAL COUNTRIES HAVE BEEN PREPARED TO RAISE INTEREST RATES WHEN MONETARY CONDITIONS APPEAR TO BE GETTING TOO LOOSE - AND THEY HAVE BEEN PREPARED TO REDUCE THEM WHEN MONETARY CONDITIONS RISK BEING UNNECESSARILY

TIGHT.

9. A YEAR AGO THERE WAS SOME ANXIETY ABOUT THE UPWARD DRIFT IN INTEREST RATES. BUT IT IS NOW CLEAR THAT THIS VIEW WAS MISPLACED. OUTPUT WAS GROWING RAPIDLY AND HIGHER INTEREST RATES WERE CONSISTENT WITH THE REMARKABLE STRENGTH OF THE INDUSTRIAL COUNTRIES' ECONOMIES.

10. THE STOCK MARKET CRASH COMPLICATED THE PICTURE. IN THE AFTERMATH OF THE CRASH THERE WAS A REAL DANGER THAT THE DAMAGE TO CONFIDENCE MIGHT FEED ON ITSELF AND LEAD TO A WORLD SLUMP. THE AUTHORITIES RIGHTLY EASED MONETARY POLICY IN RESPONSE TO THIS, RECOGNISING THAT THAT ACTION INEVITABLY CARRIED SOME RISK OF INCREASING INFLATIONARY PRESSURES. AT THAT TIME THE OVERRIDING NEED

WAS TO AVERT THE THREAT OF A MAJOR COLLAPSE IN CONFIDENCE. BUT ONCE IT BECAME CLEAR THAT THE DANGER HAD PASSED IT WAS NECESSARY TO UNWIND THE EASING OF MONETARY POLICY.

11. THE GENERAL LEVEL OF INTEREST RATES IS NOW HIGHER THAN IT WAS LAST YEAR. WHILE WE MUST CONTINUE TO BE WATCHFUL, SOME OF THE DANGER SIGNS OF A POTENTIAL RESURGENCE OF INFLATION, WHICH HAD EMERGED EARLIER THIS YEAR, SUCH AS RAPIDLY RISING COMMODITY PRICES, HAVE RECEDED. HAVING TAKEN EFFECTIVE MONETARY ACTION, I BELIEVE THE INDUSTRIAL COUNTRIES NOW HAVE A GOOD OPPORTUNITY TO EXPERIENCE A FURTHER EXTENSION OF THE LONG-STANDING EXPANSION IN ACTIVITY, WITHOUT BEING UNDERMINED BY RISING INFLATION.

12. THE SUCCESSFUL WAY IN WHICH WE HAVE HANDLED THIS DIFFICULT PERIOD HAS ONCE AGAIN UNDERLINED THE VALUE OF INTERNATIONAL FINANCIAL COOPERATION. I WOULD LIKE TO PAY A TRIBUTE TO JIM BAKER, WHO PLAYED A VITAL ROLE IN THIS, AND I VERY MUCH WELCOME SECRETARY BRADY'S COMMITMENT AT YESTERDAY'S G7 MEETING TO CONTINUE WHOLEHEARTEDLY THE PROCESS OF COOPERATION WE HAVE EVOLVED, AND WISH HIM WELL.

13. ENHANCED G7 COOPERATION PLAYED A VITAL ROLE AT AN EARLIER STAGE IN WARDING OFF THE DANGERS OF PROTECTIONISM, WHICH WE STILL NEED TO FIGHT. THE FALL OF THE DOLLAR FROM ITS EXCESSIVE LEVEL IN EARLY 1985, COMBINED WITH SOME REDUCTION OF THE US BUDGET DEFICIT, HAS HELPED BEGIN THE PROCESS OF REDUCING THE US CURRENT ACCOUNT DEFICIT.

14. LOOKING TO THE LONGER-TERM, THE ABSORPTION BY THE UNITED STATES GOVERNMENT, FOR A FURTHER LONG PERIOD, OF A SIZABLE SHARE OF THE WORLD'S NET SAVINGS WOULD NOT BE IN ANYONE'S INTEREST. SO WE LOOK TO THE NEW US ADMINISTRATION TO TAKE EARLY AND EFFECTIVE ACTION TO REDUCE ITS BUDGET DEFICIT STILL FURTHER.

15. G7 COOPERATION HAS ALSO BEEN EVIDENT IN THE IMPORTANT STEPS TAKEN OVER THE PAST EIGHTEEN MONTHS TO REDUCE EXCESSIVE FLUCTUATIONS OF EXCHANGE RATES. SUCH FLUCTUATIONS CAN BE VERY DAMAGING TO THE LONGER-TERM SUPPLY PERFORMANCE OF OUR ECONOMIES AND, WITHIN THE FRAMEWORK OF A DETERMINED ANTI-INFLATIONARY POLICY, GOVERNMENTS HAVE AN IMPORTANT ROLE TO PLAY.

FOLLOWING THE STOCK MARKET CRASH SOME EXCHANGE RATE FLUCTUATIONS WERE UNAVOIDABLE. BUT THE OBJECTIVE OF REDUCING INSTABILITY WAS RETAINED AND REFLECTED IN THE SUCCESSFUL COORDINATED EXCHANGE RATE INTERVENTION IN JANUARY. I AM PLEASED THAT YESTERDAY'S G7 MEETING REAFFIRMED OUR COMMITMENT TO PURSUE POLICIES ~~PRICES~~ THAT ARE LIKELY TO MAINTAIN EXCHANGE RATE STABILITY AND TO CONTINUE TO COOPERATE CLOSELY TO THIS END.

16. SOME MAY SAY THAT THE SERIES OF PROBLEMS AND DIFFICULTIES WE HAVE BEEN THROUGH INDICATE THE FRAGILITY OF THE WORLD ECONOMY. THOUGH MANY DIFFICULTIES CLEARLY REMAIN, THE TRUTH IS RATHER THAT THE EXPERIENCE WE HAVE SHARED OVER THESE PAST SIX YEARS PROVIDES THE STRONGEST POSSIBLE TESTIMONY TO THE ROBUSTNESS OF THE WORLD

ECONOMY AND THE CORRECTNESS OF THE POLICIES WE HAVE BEEN FOLLOWING.

IMF QUOTAS

17. FINALLY, MR. CHAIRMAN, I WOULD LIKE TO SAY A WORD ABOUT THE REVIEW OF FUND QUOTAS. WE MUST MAKE SURE THAT THE FUND HAS THE RESOURCES IT NEEDS. BUT I SEE NO GOOD CASE FOR A SUBSTANTIAL INCREASE IN QUOTAS, AS SOME HAVE PROPOSED. THAT IS NOT JUSTIFIED BY ANY PROJECTION OF FUND LENDING, EVEN ALLOWING FOR A SUBSTANTIAL REDUCTION IN THE USE OF BORROWINGS. THE FUND HAS NOT BEEN CONSTRAINED IN ITS NEW LENDING BY LACK OF RESOURCES BUT BY A RELUCTANCE OF COUNTRIES TO AGREE PROGRAMMES WITH ADEQUATE CONDITIONALITY. THE APPROPRIATE SIZE FOR A QUOTA INCREASE IS A MATTER WE SHALL CLEARLY

HAVE TO COME BACK TO AT THE SPRING MEETINGS NEXT YEAR.

CHANCELLOR'S SPEAKING NOTE FOR THE
INTERIM COMMITTEE
AFTERNOON SESSION, 25 SEPTEMBER, 1988

<u>MIDDLE INCOME DEBT</u>

MR. CHAIRMAN, MIDDLE INCOME DEBT REMAINS A SERIOUS PROBLEM. BUT I AM CONVINCED THAT WE MUST CONTINUE WITH THE EXISTING STRATEGY. IN PARTICULAR, I WELCOME THE G7'S REITERATION YESTERDAY OF ITS OPPOSITION TO TRANSFERRING RISKS FROM THE PRIVATE TO THE PUBLIC SECTOR.

OVER THE PAST YEAR, THE SOUNDNESS OF THE PRESENT DEBT STRATEGY HAS AGAIN BEEN DEMONSTRATED. THERE HAS BEEN GENERAL ACCEPTANCE OF THE NEED FOR COOPERATIVE

SOLUTIONS WITHIN THE FRAMEWORK WE HAVE IN PLACE. BRAZIL, FOR EXAMPLE, RECOGNISED THAT UNILATERAL ACTION WAS NOT IN ITS BEST INTERESTS, AND I AM GLAD THAT A NEW IMF PROGRAMME IS NOW IN PLACE.

BUT THE DEBT STRATEGY DOES NOT STAND STILL. IT HAS CONTINUED TO EVOLVE, AND I WELCOME THE WIDENING OF THE OPTIONS ON THE MENU. CHILE, FOR EXAMPLE, HAS PURSUED AN ACTIVE POLICY OF ATTRACTING FOREIGN EQUITY, AND BY DEBT/EQUITY SWAPS AND OTHER MARKET SOLUTIONS HAS SUCCEEDED IN REDUCING ITS DEBT BURDEN SIGNIFICANTLY.

I SEE NO REASON WHY OTHER MIDDLE-INCOME DEBTOR COUNTRIES SHOULD NOT DO THE SAME. INDEED, MARKET-BASED APPROACHES - INCLUDING DEBT/EQUITY SWAPS, DEBT CONVERSIONS AND BUY-

BACKS - HAVE THE POTENTIAL TO CONTRIBUTE MUCH MORE TO NEW FINANCING PACKAGES, AND IN WAYS THAT REDUCE THE BURDEN OF DEBT. THE MAIN IMPETUS MUST COME FROM NEGOTIATIONS, CASE-BY-CASE, BETWEEN THE BANKS AND THE DEBTOR COUNTRIES.

SOME COUNTRIES, HOWEVER, ARE HAMPERED BY THE CONCENTRATION OF THEIR DEBT IN THE PUBLIC SECTOR. INDEED THREE QUARTERS OF ALL THE FOREIGN DEBT OF LATIN AMERICA IS NOW IN THE PUBLIC SECTOR. IT IS ABUNDANTLY CLEAR THAT MOST PRODUCTIVE INVESTMENT IS USUALLY, AND FOR GOOD REASON, DONE IN THE PRIVATE SECTOR; STATE-RUN INDUSTRIES IN GENERAL HAVE A SORRY RECORD. IT IS THEREFORE VITAL THAT COUNTRIES SHOULD PURSUE POLICIES WHICH PROVIDE AN ATTRACTIVE CLIMATE FOR PRIVATE INVESTMENT, AND SHOULD RESTRICT THEIR FISCAL

DEFICITS SO AS TO FREE RESOURCES FOR THE PRIVATE SECTOR.

IN A WORLD OF INCREASINGLY MOBILE CAPITAL, THERE IS GREAT SCOPE FOR ATTRACTING NEW PRIVATE INVESTMENT - IF THE CLIMATE IS RIGHT. THIS BRINGS NOT JUST FINANCE, BUT TECHNICAL KNOW-HOW AND MANAGEMENT EXPERIENCE. I WELCOME THE CONCLUSION OF THE WORLD BANK'S PRIVATE SECTOR DEVELOPMENT REVIEW GROUP THAT, IN ITS LENDING, THE BANK SHOULD PAY MORE ATTENTION TO OVERCOMING THE FACTORS WHICH DETER PRIVATE DIRECT INVESTMENT. AND MIGA IS NOW IN PLACE, BOTH TO OFFER ADVICE ON WAYS OF ATTRACTING INWARD INVESTMENT AND TO OFFER GUARANTEES AGAINST NON-COMMERCIAL RISKS.

CREDITOR COUNTRIES MUST PLAY THEIR PART TOO, BY REMOVING BARRIERS TO INTERNATIONAL CAPITAL FLOWS. THE UNITED KINGDOM REMOVED ALL SUCH RESTRICTIONS IN 1979. ITS PRIVATE DIRECT INVESTMENT IN DEVELOPING COUNTRIES NOW AMOUNTS TO AS MUCH AS THE WHOLE OF THE REST OF THE EUROPEAN COMMUNITY PUT TOGETHER.

ARREARS

ARREARS AT THE FUND AND THE BANK ARE A GROWING PROBLEM. AT THE FUND, ARREARS HAVE RISEN TENFOLD, FROM $ 1/4 BILLION AT THE END OF 1984 TO $ 2-1/2 BILLION AT THE END OF 1987.

ARREARS ON THIS SCALE ARE DAMAGING TO EVERYONE. IN PARTICULAR, THEY ARE DAMAGING TO OTHER BORROWERS. THE SHORTFALL IN THE FUND'S INCOME HAS TO BE MADE GOOD, IN PART, BY BORROWING COUNTRIES PAYING HIGHER LOAN CHARGES. ARREARS ARE ALSO DAMAGING TO THE FUND: IF THE PROBLEM IS NOT DEALT WITH IT WILL IN THE LONGER TERM HARM ITS BASIC FINANCIAL STRENGTH. THE COUNTRIES IN ARREARS ARE DAMAGED TOO, SINCE THEY ARE

EFFECTIVELY CUT OFF FROM VIRTUALLY ALL SOURCES OF EXTERNAL FINANCE.

THE CURRENT TREND MUST THEREFORE BE REVERSED.

THE FIRST PRIORITY MUST BE TO PERSUADE COUNTRIES IN ARREARS TO PURSUE, IN AGREEMENT WITH THE FUND, THE SORTS OF ECONOMIC POLICIES THAT WILL GRADUALLY RESTORE THEIR ECONOMIES TO HEALTH. THE LONGER THAT COUNTRIES DELAY DOING THIS, THE MORE INTRACTABLE THE PROBLEM BECOMES.

FOR MANY OF THE VERY POOR COUNTRIES IN ARREARS IT IS CLEAR THAT, EVEN SO, THEY WILL NOT BE ABLE TO PAY OFF THEIR ARREARS WITHOUT SOME HELP. THAT WAS WHY I PROPOSED AT THE DEVELOPMENT COMMITTEE MEETING IN THE SPRING

THAT THOSE COUNTRIES IN ARREARS AT THE IMF WHICH WERE ELIGIBLE FOR THE ESAF, AND WHICH SUCCESSFULLY OPERATED AN APPROVED IMF SHADOW PROGRAM FOR A PERIOD OF, SAY, A YEAR SHOULD BE ELIGIBLE FOR A BACKDATED DRAWING ON THE ESAF.

FOR COUNTRIES WHICH DO NOT COOPERATE WITH THE INTERNATIONAL INSTITUTIONS, IN THIS WAY, WE MUST IMPOSE FIRM MEASURES. IMF QUOTA INCREASES FOR THESE COUNTRIES SHOULD BE FROZEN; AND THE BANK SHOULD NOT NORMALLY CONSIDER NEW LOAN PROPOSALS AND SHOULD NOT MAKE FURTHER DISBURSEMENTS OF STRUCTURAL ADJUSTMENT LOANS.

I AM GLAD TO SAY THAT MY PROPOSAL ON THE USE OF THE ESAF HAS RECEIVED WIDESPREAD SUPPORT IN THE FUND BOARD, AND FROM THE

MANAGING DIRECTOR IN PARTICULAR. BY ITSELF IT MAY NOT PROVIDE ENOUGH RESOURCES, AND IT WILL NEED SUPPORT FROM OTHER SOURCES, INCLUDING AID. I KNOW, HOWEVER, THAT SOME COUNTRIES DO NOT LIKE THE PROPOSAL. BUT I HOPE THAT ON REFLECTION THEY WILL RECOGNISE THAT IT OFFERS A CONSTRUCTIVE CONTRIBUTION TO THE ARREARS PROBLEM AND THERE ARE NO OTHER SOLUTIONS ON THE TABLE.

I WOULD JUST LIKE TO MAKE TWO OTHER POINTS ON THE PROBLEM OF ARREARS. FIRST, IT REINFORCES THE NEED FOR STRONG FUND PROGRAMMES: WEAK PROGRAMMES ARE A RECIPE FOR CREATING NEW PROBLEMS OF ARREARS IN THE FUTURE; AND IT VITAL TOO THAT THE BANK SHOULD CONFINE ITS POLICY-BASED LENDING TO THOSE COUNTRIES WHERE A SOUND MACROECONOMIC FRAMEWORK IS IN PLACE - THIS IN PRACTICE

MEANS A FUND PROGRAMME. SECOND, THE PROBLEM OF ARREARS DEMONSTRATES THE FOLLY OF WORRYING ABOUT REFLOWS TO THE FUND. NOTHING IS MORE ABSURD THAN THE FUND BEING CRITICISED FOR ARREARS WHEN LOANS ARE NOT REPAID, AND CRITICISED FOR NEGATIVE NET LENDING WHEN LOANS ARE REPAID. REPAYMENTS ARE A SIGN OF SUCCESS NOT FAILURE.

CONCLUSION

IN CONCLUSION, MR CHAIRMAN, LET ME SAY THAT I FULLY UNDERSTAND THE IMMENSE POLITICAL DIFFICULTIES WHICH GOVERNMENTS IN DEBTOR COUNTRIES FACE IN CARRYING THROUGH THESE NECESSARY PROGRAMMES OF ECONOMIC REFORM AND ADJUSTMENT. IT REQUIRES A HIGH QUALITY OF POLITICAL LEADERSHIP, WHICH MANY HERE HAVE DEMONSTRATED. IN RETURN, IT IS ESSENTIAL THAT CREDITOR COUNTRIES FACE UP TO WHAT ON THE WHOLE ARE THE LESS ACUTE POLITICAL DIFFICULTIES OF OPENING UP THEIR MARKETS TO IMPORTS FROM THE DEVELOPING COUNTRIES.

CHANCELLOR'S SPEAKING NOTE FOR THE DEVELOPMENT COMMITTEE

MONDAY 26 SEPTEMBER 1988

MUCH HAS HAPPENED SINCE WE MET IN THE SPRING. AGREEMENT HAS BEEN REACHED ON A GENERAL CAPITAL INCREASE, AND THE UNITED KINGDOM WAS THE FIRST COUNTRY TO SUBSCRIBE IN FULL. I HOPE OTHER COUNTRIES WILL FOLLOW SUIT AS SOON AS THEY CAN.

2. DISCUSSIONS HAVE ALSO BEGUN ON THE NINTH REPLENISHMENT OF IDA. I BELIEVE A SUBSTANTIAL REPLENISHMENT IS JUSTIFIED TO MAINTAIN THE BANK'S CONCESSIONAL LENDING TO ITS VERY POOREST MEMBERS, ESPECIALLY IN AFRICA.

3. AND WE HAVE REACHED AGREEMENT OVER THE PAST YEAR ON A NUMBER OF IMPORTANT MEASURES TO EASE THE DEBT PROBLEMS OF THE POOREST

COUNTRIES.

4. THE BANK LAUNCHED ITS SPECIAL PROGRAMME OF ASSISTANCE FOR AFRICA LAST DECEMBER. THE UK HAS PLEDGED 250 MILLION POUNDS OVER THREE YEARS TO SUPPORT IT.

5. THE IMF'S ENHANCED STRUCTURAL ADJUSTMENT FACILITY IS NOW IN PLACE. TWO COUNTRIES HAVE ALREADY RECEIVED ESAF LOANS. BUT WE ARE STILL SLIGHTLY SHORT OF THE MANAGING DIRECTOR'S TARGET OF A FULLY SUBSIDISED TRUST FUND OF 6 BILLION SDRS. I HOPE THIS IS REACHED SOON. THE UK FOR ITS PART HAS MADE THE LARGEST SINGLE SUBSIDY CONTRIBUTION.

6. MOST OF ALL, I WELCOME THE AGREEMENT THAT HAS NOW BEEN REACHED ON A SCHEME FOR

REDUCING THE DEBT BURDEN OF THE POOREST AND MOST HEAVILY INDEBTED COUNTRIES, ESPECIALLY IN SUB-SAHARAN AFRICA, WHICH ARE PURSUING SOUND ADJUSTMENT PROGRAMS.

7. UNDER THIS AGREEMENT CREDITOR COUNTRIES CAN CHOOSE ONE OF THREE WAYS OF REDUCING THE DEBT SERVICE BURDEN: REDUCING INTEREST RATES, WRITING OFF PART OF THE DEBT, OR RESCHEDULING OVER SUBSTANTIALLY LONGER PERIODS. EACH OF THESE ENTAILS A DEGREE OF CONCESSION FROM CREDITOR COUNTRIES. THE UK HAS ALWAYS MADE IT CLEAR THAT IT WILL BE OFFERING A REDUCTION IN INTEREST RATES, AND I AM GLAD THAT A NUMBER OF OTHER COUNTRIES WILL BE DOING THE SAME.

8. IT HAS TAKEN US MUCH TIME AND EFFORT TO REACH AGREEMENT SINCE I FIRST PROPOSED THE

IDEA IN THE SPRING OF 1987. THE NEXT STEP IS TO IMPLEMENT THE SCHEME AS QUICKLY AS POSSIBLE ON A COUNTRY BY COUNTRY BASIS.

9. MEANWHILE THE INDUSTRIALISED COUNTRIES NEED TO DO MUCH MORE TO HELP DEVELOPING COUNTRIES, AND HELP THEMSELVES AT THE SAME TIME, BY ROLLING BACK PROTECTION AND OPENING UP THEIR MARKETS. PROTECTION DENIES CONSUMERS A FREE CHOICE, AND PUTS UP PRICES. IT FOSTERS INEFFICIENCY BY INSULATING DOMESTIC PRODUCERS FROM COMPETITION, AND DISCOURAGING THEM FROM CONCENTRATING ON AREAS OF GENUINE COMPARATIVE ADVANTAGE. TOO OFTEN WE SEE DECLINING INDUSTRIES THAT ALWAYS NEED MORE TIME FOR ADJUSTMENT, AND ANTI-DUMPING DUTIES IMPOSED OSTENSIBLY IN THE INTERESTS OF FAIRNESS.

10. IMF AND WORLD BANK STUDIES SUGGEST THAT PROTECTION BY INDUSTRIALISED COUNTRIES COSTS THE DEVELOPING COUNTRIES MORE THAN TWICE THE AMOUNT OF OFFICIAL AID THEY RECEIVE - AND THIS PROTECTION IS STILL INCREASING.

11. IN PARTICULAR, SOME OF THE NEWLY INDUSTRIALISED ECONOMIES NEED TO OPEN UP THEIR MARKETS. IT IS ABSURD THAT THESE DYNAMIC ECONOMIES STILL MAINTAIN HIGH LEVELS OF PROTECTION. THEIR SUCCESS BRINGS WITH IT THE OBLIGATION TO OBSERVE FULLY THE RULES OF GATT.

12. DEVELOPING COUNTRIES ALSO NEED TO LIBERALISE THEIR TRADE POLICIES. I WAS GREATLY ENCOURAGED TO SEE FROM A RECENT IMF

PAPER THAT THIS IS BEGINNING TO HAPPEN. BUT MORE NEEDS TO BE DONE.

13. IN THE URUGUAY ROUND WE NEED TO ACHIEVE SUBSTANTIAL REDUCTIONS IN ALL TYPES OF PROTECTION. THE MID TERM MEETING IN MONTREAL THIS DECEMBER MUST PRODUCE CONCRETE RESULTS. OF PARTICULAR IMPORTANCE TO DEVELOPING COUNTRIES WOULD BE A SPECIFIC AGREEMENT TO REDUCE BARRIERS TO THE IMPORT OF TROPICAL PRODUCTS. IN OTHER IMPORTANT AREAS, ESPECIALLY AGRICULTURE, SERVICES AND TEXTILES, WHERE DISCUSSIONS ARE NOT SO FAR ADVANCED, WE MUST REACH AGREEMENT AT MONTREAL ON A FRAMEWORK FOR NEGOTIATIONS. AND WE CLEARLY NEED TO STRENGTHEN GATT AS AN INSTITUTION.

14. THE EUROPEAN COMMUNITY HAS EMBARKED ON

DISMANTLING INTERNAL BARRIERS TO TRADE WITH THE OBJECT OF COMPLETING A FREE INTERNAL MARKET BY 1992. THE UK IS DETERMINED THAT EUROPE SHOULD NOT RAISE FRESH BARRIERS AGAINST THE REST OF THE WORLD.

15. ANOTHER ASPECT OF LIBERALISATION IS THE LIFTING OF BARRIERS TO PRIVATE INVESTMENT IN DEVELOPING COUNTRIES, BOTH DIRECT AND PORTFOLIO. THE WORLD BANK CAN ENCOURAGE THIS, PARTICULARLY THROUGH THE IFC AND MIGA. I WELCOME THE RECOMMENDATION OF THE PRIVATE SECTOR DEVELOPMENT REVIEW GROUP THAT IN ITS LENDING THE BANK SHOULD PAY GREATER ATTENTION TO THE REMOVAL OF ARTIFICIAL RESTRAINTS ON INWARD DIRECT INVESTMENT. I ALSO WELCOME THE INCREASING READINESS OF DEVELOPING COUNTRIES TO ENCOURAGE FOREIGN INVESTMENT, AS WAS

DEMONSTRATED BY THE CONCLUSIONS OF LAST WEEK'S COMMONWEALTH FINANCE MINISTERS MEETING IN CYPRUS. BUT THERE IS STILL A LONG WAY TO GO BEFORE THE REGULATORY AND FISCAL POLICIES ARE IN PLACE THAT WILL ENABLE PRIVATE INVESTMENT TO PLAY ITS FULL PART.

16. FINALLY, MR. CHAIRMAN, WE LOSE AS MUCH FROM SQUANDERING OUR ENVIRONMENTAL WEALTH AS FROM SQUANDERING ANY OTHER ECONOMIC RESOURCE. WE IN THE UK FULLY SUPPORT THE BANK'S INCREASED ATTENTION TO THE ENVIRONMENT IN ITS WORK.

OARDS OF GOVERNORS • 1988 ANNUAL MEETINGS • BERLIN (WEST)
INTERNATIONAL MONETARY FUND
THE WORLD BANK GROUP
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
MULTILATERAL INVESTMENT GUARANTEE AGENCY

J

Press Release No. 37

September 28, 1988

HOLD FOR RELEASE
UNTIL DELIVERY

Statement by the Rt. Hon. NIGEL LAWSON,
Chancellor of the Exchequer and
Governor of the Fund for the UNITED KINGDOM,
at the Joint Annual Discussion

In my remarks today I shall deal briefly first with some international debt issues, then with the state of the world economy, then turn to the vexed question of the external imbalances between the major nations, and finally say a few words about the experience of my own country.

International Debt Issues

This has been a year of achievement for the Fund and the Bank. We have taken important steps over the past year to help the poorest, most indebted countries. We now have in place the World Bank's Special Program of Assistance for Africa and the Fund's enhanced structural adjustment facility. The United Kingdom is making substantial funds available to both.

I am particularly delighted that agreement has now been reached by all the creditors in the Paris Club on the scheme for easing the burden of official debt of the poorest, most heavily indebted countries, especially in sub-Saharan Africa.

The World Bank is now beginning to benefit from its capital increase: I hope other countries will follow the United Kingdom and subscribe quickly. The extra resources will be of special benefit to the middle-income debtors, always provided that the right economic framework is in place--and that means a Fund program.

I welcome the determination of the Fund not to be rushed into supporting macroeconomic programs before they are satisfied about the soundness of those programs and the commitment of the authorities to persevere in implementing them.

this greatly improved performance of the world economy in the 1980s can be continued into the 1990s.

Current Account Imbalances

A widespread concern at these meetings has been the existence and scale of the current account imbalances between the major countries. Over the postwar period, it has not been unusual for many of the smaller industrial countries to run current account deficits or surpluses for many years. Denmark, for example, has had a continuous current account deficit for a quarter of a century, while Switzerland has had a persistent current account surplus.

But between the postwar "dollar gap" and 1983 there was virtually no experience of significant and sustained imbalances among the major industrial economies. Since then the picture has changed dramatically. The Federal Republic of Germany has had a current surplus of over 2 1/2 percent of GDP every year since 1985, and Japan every year since 1984. Conversely, the United States has had a current deficit of over 2 1/2 percent of GDP in every year since 1984. This year the United Kingdom also seems likely to have a current deficit of this size, and there is some concern about how long that, too, will persist.

There is still no agreement about a number of key aspects of these imbalances: the reason for their emergence; how long they can persist without causing serious problems; the appropriate response and role of governments; and the mechanisms by which imbalances are reduced. These are the topics I wish to discuss today.

When we look at the balance of payments, it is important to consider not merely the current account but also the capital account. Net capital flows are an equal and opposite counterpart to a current account imbalance. A country that is attracting net inflows of capital from overseas to supplement domestic savings must, by definition, be running a current account deficit. Conversely, a country in current account surplus must by definition be engaged in net investment overseas.

In other words, the current account reflects the difference between domestic savings and domestic investment. For example, a current account surplus may reflect either a shortage of attractive investment at home, or a very high level of domestic savings.

As we have seen, in the smaller countries there have long been examples where a significant portion of domestic savings has been invested overseas, or, conversely, where a significant portion of domestic investment has been financed by savings from abroad.

What has emerged over the past five years has been the sustained use of Japanese and German savings to make good the shortfall of savings in the United States, and to finance investment there. This has been made possible by the profound changes that have taken place in world capital

To summarize: large-scale current imbalances reflect differences in domestic savings and investment behavior in a world of free financial markets. Does the government then have any role at all in seeking to correct them?

First and foremost, the government has a responsibility to curb inflation by maintaining a sound monetary policy. If monetary conditions are too lax, the authorities have to tighten them. A tightening of monetary policy, through higher interest rates, will boost savings and hence reduce the current account deficit. But that is not the object of the exercise. And current account imbalances would occur even in a world of zero inflation.

The conduct of monetary policy also has implications for the exchange rate, and the exchange rate itself is an important factor in monetary policy decisions. It follows that the exchange rate cannot be assigned the task of balancing the current account, and it is a mistake to think that the automatic response to a current account deficit should be a lower exchange rate. Significant currency changes can at times be necessary, when, as for example with the dollar in 1985, exchange rates have clearly moved out of line with economic fundamentals. But it is wrong to assume that a current account deficit is sufficient evidence of this.

Governments do, however, have a clear role when a current account deficit is accompanied by a budget deficit. In those circumstances, they have a responsibility over time to reduce, and possibly eliminate, the deficit, and hence their call on private sector savings. The position is totally different when, as in the United Kingdom, there is no budget deficit at all and the current account deficit is entirely the result of private sector decisions. Generally speaking, it would be quite wrong for the public sector to seek to run an ever-increasing budget surplus in an attempt to offset private sector behavior, not least because private sector behavior is by its nature self-correcting over time.

To the extent that the deficit is the result of higher private sector investment, the adjustment mechanism is evident: the future returns will finance the original investment. To the extent that the deficit is the result of low net private sector savings, this too should correct itself in time. The main source of fluctuations in net savings is changes in the amount of borrowing by the private sector. There is a limit to the amount of debt which the private sector will be willing--or can afford--to undertake. Once that limit has been reached, the savings ratio will rise again. Moreover, higher debt means higher interest payments in the future, which will reduce disposable income and consumption. Thus, higher consumption now is at the expense of consumption in the future.

It is only in the unlikely event that the self-correcting mechanisms threaten to stretch over so long a period that the creditworthiness constraint to which I have alluded comes into play that it would be appropriate for the government to run a larger budget surplus in order to offset the lack of private sector savings.

financial markets is completed, and people judge that they are close to the prudent limit of indebtedness. And over time this will reduce the current account deficit.

Some may be puzzled why the existence of a current account deficit is so newsworthy in the United Kingdom. The truth is that we are prisoners of the past, when U.K. current account deficits were almost invariably associated with large budget deficits, poor economic performance, low reserves, and exiguous net overseas assets. The present position could not be more different. The output and productivity of the United Kingdom are both growing strongly. The official reserves are high, and net overseas assets are greater as a proportion of GDP than in any other major industrial country. And the public sector finances are in sizable surplus. By any standards, the United Kingdom's creditworthiness is high.

The decline of savings in the United Kingdom at a time of high investment opportunities appears to be a particularly striking example of a worldwide trend. Increasing capital flows between countries can satisfactorily complete the balance of savings and investment for an individual country. But there remains the question of the balance of savings and investment opportunities for the world as a whole. This may well be at least as important an issue in the coming years as the handling of current account imbalances.

H. M. TREASURY

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20 OCTOBER 1988

THE CHANCELLORS'S MANSION HOUSE SPEECH

Attached is the text of the speech to be made by the Chancellor of the Exchequer, the Rt Hon Nigel Lawson, MP, at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House tonight.

PRESS OFFICE
HM TREASURY
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87/88

CHANCELLOR OF THE EXCHEQUER'S MANSION HOUSE SPEECH 1988

Introduction

It is with very great pleasure that I rise once again at this great annual occasion to respond to the toast "prosperity to the public purse and the health of the Chancellor of the Exchequer". Not least because the toasting your recent predecessors have done has been so conspicuously successful. I refer not so much to my health - though there is nothing wrong with that, I am glad to say - but to the prosperity of the public purse.

Last year, for only the second occasion since our Queen ascended the throne, this country secured a Budget surplus. This year, that surplus will be even larger. And I intend to see that there is a substantial surplus next year, too.

In one respect - and one respect only - this is a sad occasion. For it is Nicholas Goodison's last appearance here as Chairman of the Stock Exchange.

During his twelve year tenure of that office - a record unmatched since the War - Nicholas has led the Stock Exchange out of the Restrictive Practices Court, through Big Bang, and into the modern world. He has presided with wisdom and real leadership over the most far reaching changes any one can remember in a vitally important part of the City. By acting as midwife to the International Stock Exchange, he has played a critical and decisive part in consolidating London's position as a global financial centre. And he has consistently championed the cause of wider share ownership.

I thank him most warmly for all he has done, and wish him, and his successor, well for the future.

Global Markets

When we last dined here, a year ago, it was in the aftermath of the worldwide Stock Market crash that has come to be known as Black

Monday. An event which, among other things, was a perhaps uncomfortably vivid reminder of the extent to which we now live in a global market place.

Although we now take it for granted that the financial sector is one of the most international of all, this was not really the case for most of the post-war period. Governments throughout the world were rightly determined to avoid the damage done by protectionism in the 1930s, and committed themselves to free trade and open markets. But, at the same time, far reaching controls on the movement of capital became accepted, for the most part, as a fact of life. Over the past few years all that has changed; we now have a degree of freedom that has not existed since before the First World War. And the development of information technology has completed the task of making the global financial market-place a reality.

The consequences of global markets go to the very heart of the conduct of economic policy.

Finance Ministers and Central Bank Governors today have to come to terms with a world in which the amount of mobile capital is far larger than it has ever been before.

This has a number of advantages. Savers have a wider range of opportunities, and borrowers have access to a much larger pool of funds. There is now no reason why investment should be financed exclusively from domestic sources. Net capital flows between countries are inevitable and desirable, and may last for some years in the same direction, with current account imbalances as the inevitable counterpart.

But by the same token, the scale of capital flows, and the fact that domestic savers no less than foreign lenders can move their money to other countries, imposes a discipline on policy, irrespective of the state of the current account balance.

Monetary policy has had to adapt, since the expansion in global capital flows has increased the potential for exchange rate volatility, as we have seen with the dollar. As a result, all the major countries have now recognised the need to pursue policies that will promote a reasonable degree of exchange rate stability. And for over three years, now, there has been international co-operation to that end.

But the discipline imposed by mobile capital extends beyond the exchange rate. To attract the savings needed to finance investment, whether those savings originate at home or abroad, countries need to maintain an overall policy stance that commands the confidence of investors.

That clearly means a sound fiscal and monetary policy and a firm stand against inflation. But it also means regulatory and tax policies that make for business success. For example, no country can afford a tax regime which drives away top managers, entrepreneurs, and scientists, any more than a tax regime which deters capital investment. It was to ensure that Britain can retain, attract and motivate such people that I introduced the far-reaching personal tax reforms contained in this year's Budget.

So the globalisation of markets has implications going well beyond the operation of the markets themselves. It affects the whole conduct of economic policy, macroeconomic and microeconomic alike.

<u>1992</u>

That conclusion has profound implications for our approach to the completion of the single European market in 1992.

I have spoken before about the two routes which Europe could adopt: either on the one hand, liberalisation and deregulation to the greatest extent practicable, with markets open to the world; or, on the other, an inward-looking bureaucratic imposition of harmonised regulation based on some average of the existing practices, good and bad alike, of the various member states.

It is vital, not just for this country but for Europe as a whole, that the first approach is adopted. For the Community cannot insulate itself from the global market, any more than an individual country can. There is abundant evidence of the benefits of free trade - indeed, that is the reason for completing the single market in the first place. But these benefits will be put at risk if Europe fails to respond to the challenges offered by the wider world market.

So I welcome the statement from the European Commission yesterday that "1992 Europe will not be a fortress Europe but a partnership Europe", committed to seeking a greater liberalisation of international trade. It is imperative that this commitment to an open EC market is put into practice.

In financial services, more than almost any other sector, all countries would stand to lose if the Community were to try to erect a wall between itself and the rest of the world. Before long, the business would simply go elsewhere.

I take very seriously the widespread concern in the City - which yesterday's statements from Brussels may not have completely allayed - about the Commission's proposals to make access to the European financial market conditional on some form of reciprocity.

The right approach is the one adopted in the recently approved Capital Liberalisation Directive. Those Community countries who had not already done so agreed not just to abolish remaining restrictions on capital movements between Member States, but to seek to achieve the same degree of liberalisation erga omnes - that is, with the rest of the world as well. And they did so, frankly, because no other approach makes sense in today's global markets.

Finally on 1992, let me say this.

There are some who claim that the single market can operate successfully only if Europe moves to monetary union, by which they mean a common currency.

This is manifest nonsense: a view held only by politicians who know little about economics and promoted by economists who are oblivious to the realities of politics.

The current talk about all this is not new. It has surfaced before, at the time of the Werner Report some 18 years ago. If I may quote what I wrote in the Sunday Times at the time, November 1970:

> "A national currency lies at the very heart of national sovereignty. A common currency is something that can only properly follow political union: it cannot precede it. It is significant that whereas the Zollverein or customs union paved the way to the German Federation a century ago, it was only after Prussia and Bismarck had achieved a political union, with blood and iron, that a common German currency could be born."

And so far as the European Community is concerned that political union is not on the agenda.

I think I can fairly claim to have demonstrated my commitment to international financial co-operation, both among the major powers and within Europe; and I would like to see that co-operation taken further. But I find myself in wholehearted agreement with Herr Karl-Otto Pöhl, the President of the German Bundesbank, when he wrote recently:

> "One does not have to be a defeatist about European integration to doubt whether there is really political scope for such fundamental decisions and the sacrifices of national sovereignty that would be required by the creation of a European central bank and currency."

Funding and monetary policy

To return to the home front, I mentioned at the start how we have progressed from public sector borrowing to the net repayment of public sector debt.

But this does not affect our overall funding policy which remains the same as it has been in recent years: a full fund, which neutralises the impact of the public sector on the monetary system and does neither less nor more than that. I said a full fund, but now that we are repaying debt, I should perhaps now say a full unfund over the year as a whole.

That means, in our new circumstances, that the Bank of England are now required to purchase gilts rather than to sell them. It does not necessarily mean that the required unfunding will be fully completed within the course of the financial year, as I explained in rather different circumstances on this occasion last year. But it does mean, among other things, that there will be no more gilt auctions for the foreseeable future.

The strength of the public finances provides an important buttress to monetary policy in the fight against inflation.

When I spoke here last year, in the immediate aftermath of the stock market crash, I said that this country was well placed to cope with the repercussions of the crash, and that the improved performance of recent years would not be blown away by a financial blizzard.

There were some, I recall, who thought that was verging on the Panglossian. In the event, the economy has forged ahead.

As far as monetary policy is concerned, the ride has not always been a smooth one. At times interest rates have had to come down, first in response to the crash itself, and later when upward pressure on the exchange rate became intense. More recently interest rates have had to go up, as evidence emerged that monetary conditions were too loose and the strength of domestic demand became increasingly apparent. But the point is that the necessary action has been taken.

I have little doubt that historians of the future will judge that the loosening of monetary policy in the wake of the crash, even though it may have stored up some problems later on, was infinitely to be preferred to the terrifying risks attendant on doing nothing at that fragile time.

Meanwhile, the tightening of monetary policy in the summer has already had an impact on the housing market, with price rises slowing and new mortgage commitments sharply down. This is particularly important, given the central role that the housing market has played in the sharp decline in the savings ratio in this country.

Inevitably, however, it will take some time before the full effects come through. But although I cannot share the almost magical properties assigned to interest rate changes by those who profess to see enormous consequences in the reduction of base rates to $7\frac{1}{2}$ per cent for all of two weeks, interest rates will do the job - which, of course, is why every other major nation relies on them in the conduct of policy. And in Britain today, with the household sector a substantial net payer of interest for the first time ever, interest rates can be expected to be more effective than at any time in the past.

As a result, inflation is likely to peak during the course of next year. But it may well take until the following year before we see a significant reduction in the current account deficit.

UK economy

After several years of strong growth at a little over 3 per cent a year we have now had two years - 1987 and 1988 - in which growth has been rather faster. Following that spurt, it is now likely that we will see a year or two of slower growth as the economy catches its breath.

But that is no cause for alarm. The underlying supply performance of the economy has improved dramatically as a result of the policies we have pursued - including deregulation, competition, and improved incentives - and it will be possible to combine the necessary slowing down with what is, by historical standards, a perfectly respectable growth rate.

I can assure you, my Lord Mayor, that the Government will continue to do all in its power to ensure that the years ahead are years of prosperity, not just for the public purse, but for the whole nation.

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CHANCELLOR OF THE EXCHEQUER'S SPEECH TO AMERICAN CHAMBER OF COMMERCE, 24 NOVEMBER 1988.

It is still only a little over five weeks since the worldwide stock market collapse. But that is not too soon to draw out some of the lessons, and consider the way forward.

What I want to do today, therefore, is to set out the steps that I believe need to be taken to keep the world economy on a course that avoids the twin dangers of recession on the one hand and renewed inflation on the other.

In large measure, the stock market collapse has simply been the inevitable correction of an unprecedentedly long and vigorous bull market which, like all bull markets, overreached itself. Despite the fact that both London and Wall Street have fallen as much as 30 per cent or so from their summer peaks, they are still no lower than they were a year ago.

But this collapse of confidence in the financial markets, however explicable in terms of a reaction to previous excesses, cannot fail to have some adverse effect on economic activity. Whether that effect is serious or not will depend, above all, on the way in which the governments of the major nations set about tackling the imbalances in the world economy with which the markets are now somewhat belatedly preoccupied.

To find the origins of these imbalances it is necessary to go back to the years prior to 1985, when the United States allowed its fiscal deficit to rise dramatically, far outstripping its own capacity to finance it out of its own domestic savings. It thus had to be financed by capital flows from overseas. And since the balance of payments always has to balance, the massive capital inflow was inevitably accompanied by an equally massive current account deficit. It was in this way that, within a few years, the United States turned an international creditor position built up over generations into that of a major international debtor.

At the same time, the markets pushed the external value of the dollar to ever dizzier heights, wholly divorced from economic fundamentals. As a result of all this, voices in the United States' Congress calling for the protectionist shutters to be put up became increasingly dominant.

It was primarily to meet this protectionist threat, and to deal with these imbalances, that the Finance Ministers of the five major industrial nations met in New York more than two years ago, and resolved to act together. We agreed to encourage a fall in the dollar against other major currencies. It did fall, very substantially. We agreed to resist the forces of protectionism. By and large, we have succeeded in doing so. And the United States accepted the urgent need to reduce its budget deficit. And it has reduced it, with the deficit for fiscal 1987 some $73 billion, or about a third below the deficit for fiscal 1986.

Thus when we met in Paris in February of this year, the decision to continue with the strategy - which also involved the surplus countries seeking to play their part in reducing the global imbalances by stimulating economic activity in their own countries - was taken against a background of sufficient adjustment to warrant fostering a period of exchange rate stability. Such stability, if attainable, provides a far better climate for world trade than a perpetuation of the wild gyrations in the dollar that had caused so much of the trouble in the first place.

The purpose of this necessarily brief account is to put recent events in context. The problem of the global imbalances had long since been identified and the policy prescriptions accepted. And considerable progress had been made.

But it was a slow process. Markets became restive and impatient. The US deficit was increasingly being financed, not by voluntary private flows of capital, but by central bank intervention, on a scale which was manifestly unsustainable. And the US authorities, too, were becoming impatient, and - provoked partly by events overseas - showed it, both in their comments on the Louvre accord and in their apparent unwillingness to allow interest rates to rise - a posture that seemed inconsistent, not merely with sustaining exchange rate stability, but even more fundamentally with attracting the funds needed to finance the deficit.

The fall in the financial markets was, in part at least, a reflection of fears of the breakdown of the common strategy on which we had embarked to reduce the imbalances. But in fact there is no other course that will solve that problem, without risking the twin dangers of recession and inflation. That is why it is important to seek to rebuild and reinforce that strategy.

The first pre-requisite, therefore, following the stock market collapse, was a renewed attack by the United States on its Budget deficit. I explained what was necessary, and why, in my speech at the Mansion House three weeks ago.

Accordingly, I warmly welcome the agreement that has now been reached. Secretary Baker had a difficult task in a pre-election year, and by dint of an enormous effort, to which I pay tribute, he has secured a successful outcome. I know that some have expressed disappointment about the size of the reductions, or their composition. But that overlooks what has been achieved: an agreement between the Administration and both parties in Congress to a package which includes cuts in all major spending programmes and increases in taxation - something that many once thought would be impossible. It is now up to Congress to complete the details and approve the package as soon as possible. Then the first major hurdle will have been overcome.

But there remain others.

The second hurdle is the need for the two big surplus countries, Japan and more particularly Germany, to commit themselves to further action to improve their economic momentum - and in the case of Japan, to open its markets more fully to imports. Precisely how they do this is, of course, a matter for them, so long as the action they take is adequate.

I believe it will be. It is encouraging, in particular, that the Bundesbank has already begun to acknowledge its own key role in the promotion of world economic stability with a modest reduction in short-term interest rates.

And then there is the third hurdle: the need, given appropriate economic policies, including the resolute avoidance of protectionism, to agree on concerted action designed to ensure a further period of exchange rate stability, albeit one that takes into account the decline in the dollar that has occurred so far. The alternative, a sharp further fall in the dollar, is not merely wholly unnecessary: it would be harmful to all concerned. For the United States, it would risk an upsurge in inflation and ultimately higher interest rates than any defence of the dollar stability would require. For the rest of the world, it would threaten a further dislocation to world trade and a further slowdown in economic activity.

Success in restoring stability will depend both on the pursuit of the right policies by deficit and surplus countries alike, and on their determination to give the necessary priority to maintaining stability, not simply by intervention, whose role, though important, is inevitably limited, but even more by the maintenance of appropriate interest rate differentials.

Interest rates in the United States will have to be set at a level that can both support the dollar and finance the deficit so long as it persists. That may well not mean higher interest rates now, but it does imply the readiness to act if and when the need arises. By the same token, surplus countries, and in particular Germany, will have to give more attention to world interest rate differentials, and monetary conditions in the industrialised world as a whole, in setting <u>their</u> rates.

The short point is this. International co-operation is the only sure way to keep the world economy on an even keel. The problems of the world economy, and in particular the persistence of current account imbalances, are unlikely to be solved if countries give overriding weight to domestic indicators of monetary policy to the exclusion of external indicators, any more than if they put short-term political objectives ahead of attention to economic fundamentals.

Ever since the dramatic worldwide collapse in the equity markets, I have made clear my view that, once the United States had completed its arrangements to reduce still further its budget deficit - and that of course includes the necessary Congressional approval - there should be an early meeting of the Group of Seven Finance Ministers and Central Bank Governors to work out a wider international agreement, in which Britain, of course, would play a full part. But let me be absolutely frank. There would be little point in holding a G7 meeting at all unless all those involved were prepared to contribute wholeheartedly to the stabilisation of the dollar. That is the third and final hurdle to be overcome.

I trust it will be. The world - and not least the United States - has suffered enough over the past ten years from huge swings in the external value of the dollar not to want to accept this as some kind of malign inevitability.

Of course, the approach I have outlined today will not produce overnight results. The correction of trade imbalances is bound to take time. And, indeed, the effect of the dollar fall over the past four weeks could well mean a further delay before the US trade balance shows a significant improvement - the notorious "J" curve. But given the right framework, I am confident that the innate resilience and dynamism of the US economy will make itself felt.

Nor, of course, is there any need for trade imbalances to disappear altogether. Indeed, since perfect current account balance throughout the world - even if the defective international statistics made that possible - would necessarily mean no net international capital flows at all, any such outcome is inherently improbable and certainly undesirable.

I have spoken so far of the major industrial nations of the world, who will be sitting round the table when the G7 meeting takes place. But there are others, too, who will have to be prevailed upon to play their part - Taiwan and Korea, in particular, who regard open markets abroad as their right, yet engage in widespread protection at home against imports from developed countries. Their economies are now too important to be lost beneath the radar screen. Taiwan alone, heavily protected, and with its currency closely linked to the dollar, now has a current account surplus of some \$20 billion - almost a quarter of its GDP, compared with around 4 per cent for Germany and Japan. And its foreign exchange reserves of \$65 billion are sufficient to cover as much as three years' imports.

On this issue, as on so many others, the United States and Europe have a common interest which will be best served by acting together. Meanwhile, I am confident that, provided those of us in positions of responsibility in the major nations of the world keep our heads and, together, pursue the right policies with patience and determination, there will be no question of a world recession.

It is fortunate that, given the difficult period we have now entered, the British economy is particularly well placed. We have the advantage that our Election is behind us, and not just in front of us, and has resulted in the return, with a large majority, of a Government whose commitment to sound finance and business success is not in doubt. And on the economic front, the public finances are exceptionally strong, and the economy itself is in robust health, with business confidence high, and investment intentions unimpaired, as yesterday's CBI monthly inquiry, based on a survey taken <u>after</u> the stock market fall, has clearly demonstrated.

There is, of course, a clear link between sound public finances and a strong economy. But even now, there are some who do not seem to appreciate what it is.

When I last had the pleasure of addressing the American Chamber of Commerce, shortly after my 1985 Budget, I mentioned the pressure I was then under from some quarters to borrow more money and spend more, so as to boost demand in the economy and achieve faster growth and more jobs.

That pressure was nothing new. Ever since we first began to reduce Government borrowing, we had been assured that this would remove any possibility of achieving growth and reducing unemployment. We rejected that advice, and have reduced Government borrowing steadily. As a result, this year, even if we had not had any privatisation proceeds at all, it looks as if the public sector borrowing requirement would have been as low as 1½ per cent of GDP. With privatisation proceeds, it is down to only one quarter of one per cent of GDP.

I do not need to theorise about the benefits that have been brought by this policy, coupled as it has been with a readiness to keep interest rates at whatever level is necessary to curb inflation, and supply side measures to free up markets and break down rigidities. The facts speak for themselves. We are in our seventh year of steady growth. Inflation remains low. And over a million and a quarter more jobs have been created since 1983 - more than in the rest of Europe put together.

Growth this year has been particularly rapid, and looks like turning out at 4 per cent, faster than any other major industrial country. But this is no flash in the pan. Growth in the UK has been above 3 per cent in three out of the last four years.

The current year has also seen a welcome fall in unemployment. In spite of the rapid growth in the number of jobs, unemployment in Britain continued to rise, albeit modestly, until June of last year. But since then it has fallen dramatically - faster than at any time since the War, and faster than in any other major industrial country. And all regions, not just the South-East, are sharing in this welcome progress.

Peering into the future is a particularly tricky business at the moment. But I see no reason why the pattern of steady growth, low inflation, and falling unemployment should not continue.

The plain fact is that the British economy is sounder than it has been since the War. Not only are the public finances strong. Britain's industrial performance has been transformed.

Productivity in manufacturing industry has shot up during the 1980s after a dismal performance in the 1960s and 1970s, rising faster than in any other major nation, even including Japan. Industrial relations have improved out of all recognition. Business profitability has improved for five years in succession - the best performance for more than a generation. And after decades of decline, British manufacturers are successfully maintaining their share of expanding world trade.

In one sense, I may be preaching to the converted, because many of you here today are here because you have invested in Britain. Out of 322 new foreign investment decisions made in the UK last year, over half were made by US companies. I understand that 96 of the Fortune top 100 American manufacturing companies have investments in the UK. That form of endorsement is worth far more than mere words.

When I spoke to you last time, we had just seen the end of a year-long coal strike - a trauma which would once have thrown the economy right off course, but which we were able to take in our stride. Since then, the oil price has collapsed - and again, although a major oil-exporting nation - we have taken it in our stride. Just as we have taken in our stride the sharp rise and fall of the dollar over the past four years. So I am confident that we can equally take the current world difficulties in our stride.

The task over the coming weeks is to agree on the right solution to those difficulties, and to co-operate in implementing that solution. I can assure you that this country will play its full part.