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30 September 1987

THE CHANCELLOR OF THE EXCHEQUER'S SPEECH TO THE IMF

Attached is the text of the speech delivered in Washington 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.

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Handwritten notes and signatures at the bottom of the page, including the name 'A.H.' and some illegible scribbles.

BOARD OF GOVERNORS 1987 ANNUAL MEETINGS, WASHINGTON DC
STATEMENT BY THE RT.HON. NIGEL LAWSON MP
CHANCELLOR OF THE EXCHEQUER
GOVERNOR OF THE FUND FOR THE UNITED KINGDOM
AT THE JOINT ANNUAL MEETINGS, SEPTEMBER 30, 1987

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I WELCOME THE PROGRESS THAT WE HAVE MADE AT THESE MEETINGS ON A NUMBER OF ISSUES OF GREAT IMPORTANCE. WE HAVE REAFFIRMED THE LOUVRE AGREEMENT. THERE IS NOW FULL SUPPORT FOR AN EARLY AND SUBSTANTIAL GENERAL CAPITAL INCREASE FOR THE WORLD BANK. AND THERE IS INCREASING RECOGNITION THAT WITHIN THE GENERAL DEBT STRATEGY, SPECIAL ACTION IS REQUIRED TO HELP THE VERY POOREST AND MOST HEAVILY INDEBTED COUNTRIES, PARTICULARLY IN SUB-SAHARAN AFRICA.

AT THE MEETINGS OF THE INTERIM AND DEVELOPMENT COMMITTEES THIS APRIL, I PUT FORWARD A THREE-POINT PROPOSAL FOR ASSISTING THESE COUNTRIES, PROVIDED THEY PURSUE APPROPRIATE ADJUSTMENT POLICIES: THE CONVERSION OF AID LOANS INTO OUTRIGHT GRANTS; LONGER REPAYMENT AND GRACE PERIODS ON PARIS CLUB RESCHEDULINGS; AND REDUCTIONS IN THE RATES OF INTEREST ON THOSE RESCHEDULINGS.

THE MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND AND THE PRESIDENT OF THE WORLD BANK HAVE PUT FORWARD COMPLEMENTARY PROPOSALS FOR HELPING THE POOREST COUNTRIES BY CONCESSIONAL INTEREST RATES, INCLUDING A SUBSTANTIAL INCREASE IN THE SIZE OF THE IMF'S STRUCTURAL ADJUSTMENT FACILITY. I SUPPORT THESE PROPOSALS, AND BELIEVE THAT HEAVY INDEBTEDNESS SHOULD BE A MAJOR FACTOR IN DETERMINING THE ALLOCATION OF FUNDS UNDER ANY ENLARGEMENT OF THE SAF.

IT IS OF THE FIRST IMPORTANCE THAT WE MAKE A REAL EFFORT TO REACH AGREEMENT ON ALL THESE PROPOSALS AT THE EARLIEST POSSIBLE DATE.

THE UK ECONOMY

I NOW TURN TO THE EXPERIENCE OF MY OWN COUNTRY DURING THE PAST YEAR. SINCE THE SHARP FALL IN THE OIL PRICE IN 1986 THE GROWTH RATE OF THE UK ECONOMY, SO FAR FROM SLOWING DOWN AS WAS EXPECTED, HAS ACTUALLY PICKED UP. AT THE SAME TIME, THE GROWTH RATE FOR THE MAJOR INDUSTRIALISED COUNTRIES AS A WHOLE HAS BEEN BELOW EXPECTATIONS. AT FIRST SIGHT THIS SEEMS PARADOXICAL. THE INDUSTRIALISED COUNTRIES IN AGGREGATE WERE SIGNIFICANT BENEFICIARIES FROM LOWER OIL PRICES WHEREAS THE UK, AS A MAJOR OIL PRODUCER AND EXPORTER, STOOD TO LOSE SIGNIFICANTLY.

WHAT HAS HAPPENED IS THAT THE UK ECONOMY HAS ADJUSTED MORE SMOOTHLY TO THE FALL IN OIL PRICES THAN MANY THOUGHT POSSIBLE. THE LATEST IMF FORECAST PUTS UK GROWTH AT 3.4 PER CENT THIS YEAR--THE FASTEST GROWTH OF ALL THE MAJOR INDUSTRIALISED COUNTRIES. AND UK MANUFACTURING PRODUCTIVITY, CURRENTLY RISING AT ABOUT 6 PER CENT, HAS CONTINUED TO EXCEED EXPECTATIONS, THUS CONTAINING THE GROWTH OF UNIT LABOUR COSTS.

THE UK'S STRONG GROWTH PERFORMANCE HAS NOT BEEN BROUGHT ABOUT BY ANY FISCAL STIMULUS. THE PUBLIC SECTOR BORROWING REQUIREMENT HAS IN FACT BEEN REDUCED TO LESS THAN 1 PER CENT OF GDP. WE HAVE BEEN ABLE TO BRING DOWN TAX RATES BY MAINTAINING A DECLINING PATH FOR PUBLIC EXPENDITURE AS A PROPORTION OF GDP. NOR HAS THERE BEEN ANY RELAXATION OF MONETARY POLICY. INTEREST RATES HAVE BEEN HELD AT LEVELS NECESSARY TO MAINTAIN SOUND ANTI-INFLATIONARY CONDITIONS. IN SHORT, IT IS THE ENTERPRISE ECONOMY THAT HAS DONE THE TRICK. ONE CONSEQUENCE OF THIS IMPROVED PERFORMANCE HAS BEEN A SIGNIFICANT DROP IN UNEMPLOYMENT, WHICH HAS FALLEN BY 400,000 OVER THE LAST 14 MONTHS.

THE STRONG GROWTH OF UK OUTPUT AND DEMAND HAS CAUSED SOME TO SUGGEST THAT THE UK ECONOMY IS IN DANGER OF OVERHEATING, WHILE OTHERS ARE FORECASTING A SLOWDOWN. SOME MANAGE TO COMBINE BOTH PREDICTIONS. BUT WHILE, AS IN MOST COUNTRIES, INFLATION IS A BIT HIGHER THAN LAST YEAR WHEN THE IMPACT OF FALLING OIL PRICES WAS GREATEST, THERE HAS BEEN NO SIGNIFICANT CHANGE IN UNDERLYING INFLATIONARY PRESSURE.

THE UK IS NOW WELL INTO ITS SEVENTH YEAR OF STEADY GROWTH AT 3 PER CENT A YEAR. DURING THAT PERIOD THERE HAVE BEEN MINOR FLUCTUATIONS, AND AFTER THE SLIGHT SPURT THIS YEAR, I WOULD EXPECT SOMETHING CLOSER TO THE 3 PER CENT AVERAGE RATE NEXT YEAR.

THE BACKGROUND TO THE LOUVRE

I NOW TURN TO THE EVOLUTION OF EXCHANGE RATE POLICY.

FOR THE FIRST 25 YEARS AFTER THE WAR, EXCHANGE RATE STABILITY WAS ACHIEVED THROUGH THE BRETTON WOODS SYSTEM. THIS FORMED A CORNERSTONE OF THE POST-WAR ECONOMIC ORDER, NOT LEAST AS A FORCE FOR FINANCIAL DISCIPLINE. BUT IT BEGAN TO BREAK DOWN IN THE LATE 1960s, AND BY THE EARLY 1970s IT HAD COLLAPSED ALTOGETHER.

THEREAFTER, WITH COUNTRIES PURSUING DIVERGENT ECONOMIC POLICIES, AND MANY SUFFERING FROM HIGH AND VOLATILE INFLATION, A SYSTEM OF FLOATING EXCHANGE RATES WAS VIRTUALLY INESCAPABLE. INDEED MANY AT THE TIME BELIEVED THIS NEW FLEXIBILITY TO BE DESIRABLE.

WITH HINDSIGHT, SOME OF THE ARGUMENTS FOR FREE FLOATING SEEM MUCH LESS COMPELLING. AND THE BELIEF THAT MARKETS WOULD PROVIDE A STABILISING INFLUENCE, THROUGH THE OPERATIONS OF MEDIUM-TERM SPECULATORS, HAS NOT BEEN BORNE OUT.

IN PARTICULAR, WE HAVE SEEN WILD GYRATIONS IN THE DOLLAR, THAT HAVE CLEARLY NOT BEEN A REFLECTION OF ECONOMIC FUNDAMENTALS, WHICH ARE ESSENTIALLY SLOW-MOVING. FEW COULD SERIOUSLY ARGUE THAT TWO DEUTSCHEMARKS TO THE DOLLAR WAS "CORRECT" IN 1979, AND AGAIN AT THE END OF 1986, AND YET THAT THREE DEUTSCHEMARKS TO THE DOLLAR WAS "CORRECT" IN 1985.

MOREOVER, THESE GYRATIONS HAVE DAMAGED GROWTH IN WORLD TRADE. BUSINESSES HAVE HAD TO DIVERT SCARCE MANAGEMENT TIME AND SKILLS TO COPING WITH CURRENCY FLUCTUATIONS, RATHER THAN IMPROVING COMPANY PERFORMANCE. AND THE MAJOR UNCERTAINTIES ABOUT EXCHANGE RATE MOVEMENTS INHIBITED RISK TAKING AND REQUIRED A SWITCHING OF RESOURCES AT A PACE THAT WAS WHOLLY UNREALISTIC.

THE EXPLANATION FOR THESE GYRATIONS IN THE DOLLAR DERIVES IN LARGE PART FROM THE NATURE OF THE FOREIGN EXCHANGE MARKETS. WE NOW HAVE GLOBAL 24-HOUR MARKETS IN WHICH TURNOVER HAS INCREASED DRAMATICALLY, WITH ONLY A SMALL PART OF THAT RELATED TO COMMERCIAL TRANSACTIONS.

THIS PRESENTS PARTICULARLY ACUTE PROBLEMS FOR THE DOLLAR, WHICH STILL DOMINATES THE WORLD'S MONEY MARKETS. IN 1986, ON THE LONDON FOREIGN EXCHANGE MARKET, 97 PER CENT OF ALL TRANSACTIONS WERE IN DOLLARS.

OF COURSE, ALL FINANCIAL MARKETS HAVE A CERTAIN AMOUNT OF SPECULATIVE FROTH. BUT TO FUNCTION WELL THEY NEED SOME PLAYERS TO TAKE A LONGER VIEW, AND SO PROVIDE A STABILISING INFLUENCE. IN FOREIGN EXCHANGE MARKETS THEY HAVE BEEN CONSPICUOUS BY THEIR ABSENCE.

THIS MEANS THAT ONCE THE DOLLAR STARTS TO MOVE IN ONE DIRECTION, IT CAN CONTINUE IN THE SAME DIRECTION FOR MONTHS AND EVEN YEARS, EVEN IF THERE IS A GENERAL CONSENSUS THAT THE RATE IS OUT OF LINE. THIS IS WHAT HAPPENED IN 1984 AND EARLY 1985. ALMOST EVERYBODY AGREED THAT THE DOLLAR WAS OVERVALUED, AND THAT, IN THE LONG RUN, IT WAS BOUND TO FALL. BUT THEY CONTINUED TO BUY DOLLARS IN THE BELIEF THAT, IN THE SHORT RUN, IT WOULD MOVE EVEN HIGHER--WHICH IS, OF COURSE, WHAT CONSEQUENTLY OCCURRED.

THE RESULT IS THAT TRENDS HAVE BEEN GREATLY MAGNIFIED. CAPITAL MOVEMENTS HAVE GENERATED FLUCTUATIONS IN THE DOLLAR; BUT EQUALLY, FLUCTUATIONS IN THE DOLLAR HAVE THEMSELVES GENERATED FURTHER CAPITAL MOVEMENTS. THIS IS HOW EXCHANGE RATES HAVE OFTEN ACQUIRED A MOMENTUM OF THEIR OWN, WHICH HAS NOT BEEN REVERSED UNTIL THEY HAVE REACHED EXTREME LEVELS OF OVER- OR UNDER-VALUATION.

BACKGROUND TO PLAZA

IT WAS A GROWING CONCERN ABOUT THIS PROCESS THAT LED TO A SMALL GROUP OF US TO MEET IN THE PLAZA HOTEL IN SEPTEMBER 1985. WE SHARED THREE PERCEPTIONS.

- FIRST, THAT THE VARIATIONS IN EXCHANGE RATES HAD PROVED DAMAGING.
- SECOND, THAT THE IMMEDIATE PROBLEM WAS THAT THE DOLLAR WAS MUCH TOO HIGH.
- AND THIRD, THAT THE TIME WAS RIGHT FOR THE AUTHORITIES OF THE MAJOR COUNTRIES TO GIVE THE MARKETS A CLEAR LEAD.

THE PLAZA AGREEMENT MARKED AN IMPORTANT STEP TOWARDS A MORE MANAGED SYSTEM. IN PRIVATE, WE DISCUSSED THE SCALE OF FALL WE SAW AS DESIRABLE, AND ALTHOUGH NO FIGURES WERE GIVEN IN PUBLIC, EVERYONE WAS AWARE THAT WE WERE LOOKING FOR SUBSTANTIAL CHANGES. WE AGREED TO COOPERATE TO BRING THAT ABOUT. AND THAT AGREEMENT PLAYED AN IMPORTANT ROLE IN SECURING A CONTINUING FALL IN THE DOLLAR OVER THE SUCCEEDING 15 MONTHS,

THE LOUVRE

THE LOUVRE ACCORD EARLIER THIS YEAR MARKED ANOTHER IMPORTANT STEP FORWARD--PLAZA II, AS I CALLED IT AT THE TIME TO EMPHASISE THE CONTINUITY. BY THEN THE BROAD OBJECTIVES AGREED AT PLAZA HAD BEEN ACHIEVED. THE YEN AND THE DEUTSCHE MARK HAD APPRECIATED BY AS MUCH AS 50 PER CENT OR SO AGAINST THE DOLLAR.

WE AGREED THAT, GIVEN THE POLICIES BEING FOLLOWED, THE DOLLAR WAS BY THEN BROADLY IN LINE WITH ECONOMIC FUNDAMENTALS AND THAT THE INTERESTS OF THE WORLD ECONOMY WOULD BEST BE SERVED BY A PERIOD OF STABILITY, TO ALLOW TIME FOR THE MAJOR ECONOMIES TO ADJUST TO THE EXCHANGE

RATE

CHANGES THAT HAD OCCURRED. WE WERE NOT, OF COURSE, THINKING IN TERMS OF RIGID EXCHANGE RATES, BUT WE DID DISCUSS THE SCALE OF FLUCTUATION, AROUND THE THEN CURRENT LEVELS, WHICH WE WOULD NOT WISH TO SEE EXCEEDED. FIGURES WERE AGREED IN PRIVATE, BUT NOT, OF COURSE, REVEALED IN PUBLIC.

IN SPITE OF WIDESPREAD SCEPTICISM WHEN IT WAS FIRST CONCLUDED SEVEN MONTHS AGO, THE AGREEMENT HAS PROVED A SUCCESS.

MANAGED FLOATING

THE MOVE TO MANAGED FLOATING HAS BEEN MADE POSSIBLE BY TWO FUNDAMENTAL CHANGES:

- FIRST, WE HAVE AT LAST RETURNED TO A WORLD OF LOW INFLATION. THE AVERAGE INFLATION RATE FOR THE MAJOR SEVEN ECONOMIES HAS FALLEN FROM 12 PER CENT IN 1980 TO ABOUT 3 PER CENT TODAY. IN THE PROCESS INFLATION DIFFERENTIALS HAVE BEEN NARROWED CONSIDERABLY.
- SECOND, THERE IS NOW A CLEAR CONSENSUS AMONG THE MAJOR COUNTRIES ABOUT THE APPROACH TO ECONOMIC POLICY. AND WE ALL AGREE ON THE NEED FOR A GREATER RELIANCE ON MARKET MECHANISMS WITHIN THE FRAMEWORK OF A FIRM MONETARY AND FISCAL POLICY.

WE HAVE BEEN ABLE TO MAKE THIS REGIME WORK
BECAUSE:

- WE HAVE CHOSEN THE RIGHT TIME TO GIVE A LEAD TO THE MARKETS. IN THIS SENSE WE HAVE BEEN WORKING WITH, RATHER THAN AGAINST, THE GRAIN OF THE MARKETS.
- WE HAVE BEEN PREPARED TO COMMIT OURSELVES PUBLICLY TO APPROPRIATE AND CONSISTENT DOMESTIC POLICIES.
- IN PARTICULAR, WE HAVE ALL BEEN PREPARED IN PRACTICE TO GIVE SIGNIFICANT WEIGHT TO EXCHANGE RATES IN THE CONDUCT OF MONETARY POLICY.

- WE HAVE BEEN PREPARED TO BACK UP OUR AGREEMENT WITH CO-ORDINATED INTERVENTION, SOMETIMES ON A SUBSTANTIAL SCALE.

- WE HAVE DELIBERATELY NOT REVEALED DETAILS OF OUR ARRANGEMENTS. AND WE HAVE WORKED WITHIN MARGINS OF A SIZE SUFFICIENT TO ALLOW US THE NECESSARY TACTICAL ROOM FOR MANOEUVRE.

A REGIME FOR THE FUTURE

I BELIEVE THAT WE CAN AND SHOULD USE THE EXPERIENCE WE HAVE GAINED TO BUILD A MORE PERMANENT REGIME OF MANAGED FLOATING. I DO NOT SEE THE PAST TWO YEARS SIMPLY AS A TEMPORARY PHASE. OUR OBJECTIVES SHOULD BE CLEAR: TO MAINTAIN THE MAXIMUM STABILITY OF KEY EXCHANGE RATES, AND TO MANAGE ANY CHANGES THAT MAY BE NECESSARY IN AN ORDERLY WAY.

LET ME MAKE IT CLEAR THAT I AM NOT SUGGESTING THAT WE CAN OR SHOULD RETURN TO BRETTON WOODS. THAT SYSTEM WAS UNDERMINED BY ITS RIGIDITY; THE MARGINS WERE TOO NARROW; IT REQUIRED A PREDICTABLE AND MECHANICAL RESPONSE FROM THE AUTHORITIES THAT MADE THEM AN EASY TARGET; NECESSARY REALIGNMENTS WERE POSTPONED TOO LONG AND CONSEQUENTLY, WHEN THEY CAME, THEY WERE INEVITABLY LARGE.

FOR THE FUTURE, IT IS IMPORTANT, THEREFORE, THAT WE CONTINUE TO KEEP AN ADEQUATE DEGREE OF FLEXIBILITY IN TERMS OF THE WIDTH OF THE BANDS WITHIN WHICH CURRENCIES ARE ABLE TO FLUCTUATE. AND, IF AND WHEN THE TIME COMES TO ADJUST ONE OF THE RATES, THAT ADJUSTMENT SHOULD BE MADE BY MOVING THE MIDPOINT WITHIN THE CONFINES OF THE EXISTING RANGE. THIS MEANS THAT THE MARKETS ARE NOT GIVEN A ONE-WAY BET, AND THE AUTHORITIES RETAIN TACTICAL FLEXIBILITY.

AS I HAVE ALREADY EMPHASISED, WHAT MADE THE PLAZA AND LOUVRE AGREEMENTS POSSIBLE WAS THAT THE COUNTRIES PARTICIPATING WERE, AND REMAIN, IN EFFECT, MEMBERS OF AN ANTI-INFLATIONARY CLUB, WITH A CLEAR COMMITMENT TO TAKING WHATEVER STEPS ARE NECESSARY TO CURB THEIR OWN INFLATION. IT IS VITAL THAT THAT COMMITMENT CONTINUES, INDIVIDUALLY AND COLLECTIVELY. A RESURGENCE OF INFLATION IN ANY INDIVIDUAL COUNTRY WOULD MAKE IT DIFFICULT FOR THAT COUNTRY TO REMAIN WITHIN THE CLUB

AT THE SAME TIME, WE MUST ALSO ENSURE THAT THERE IS NO PERSISTENT INFLATIONARY (OR FOR THAT MATTER DEFLATIONARY) BIAS FOR THE GROUP AS A WHOLE. THIS CAN BE HELPED BY:

- THE DEVELOPMENT OF INDICATORS FOR THE GROUP AS A WHOLE; THESE WILL BE MAINLY FINANCIAL BUT SPECIAL ATTENTION SHOULD ALSO BE GIVEN TO THE TREND OF WORLD COMMODITY PRICES;
- A NOMINAL FRAMEWORK FOR POLICY, IN TERMS EITHER OF A PATH FOR GDP GROWTH FOR THE GROUP AS A WHOLE, OR ONE FOR THE AVERAGE INFLATION RATE;
- AND A MEDIUM-TERM PERSPECTIVE WHEN SETTING OUT THE PATH AND IN GAUGING ACTUAL PERFORMANCE. WE SHOULD NOT BECOME INVOLVED IN AN EXERCISE IN SHORT-TERM FINE TUNING.

IN RECENT MEETINGS WE HAVE PUT A LOT OF EFFORT INTO DEVELOPING PERFORMANCE INDICATORS FOR INDIVIDUAL COUNTRIES. I HAVE TO SAY THAT I HAVE CONSIDERABLE DOUBTS WHETHER WE CAN USEFULLY TAKE THAT EXERCISE MUCH FURTHER. I BELIEVE IT WOULD BE FAR MORE USEFUL TO DEVOTE

OUR EFFORTS TO MONITORING THE PERFORMANCE OF THE GROUP AS A WHOLE, SO THAT WE CAN ENSURE THAT WE MAINTAIN THE CORRECT NON-INFLATIONARY STANCE OF POLICY.

CURRENT ACCOUNT IMBALANCES

SOME FEARS HAVE BEEN EXPRESSED THAT THE LOUVRE AGREEMENT WILL BE UNDERMINED BY THE PERSISTENCE OF CURRENT ACCOUNT IMBALANCES BETWEEN THE MAJOR COUNTRIES. I DO NOT BELIEVE THIS NEED BE SO.

WHAT WE ARE SEEING IS NOT ALTOGETHER SURPRISING. IT IS THE FAMILIAR J-CURVE EFFECT, AND ALTHOUGH THE IMBALANCES REMAIN LARGE, TRADE VOLUMES ARE ADJUSTING.

IN ANY CASE, THERE IS NO 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. CLEARLY THERE ARE LIMITS TO THE ACCUMULATED EXTERNAL LIABILITIES OR ASSETS THAT CAN BE SUSTAINED

WITHOUT CREATING MAJOR ANXIETIES FOR CAPITAL MARKETS. BUT 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 NECESSARILY HAVE THEIR COUNTERPARTS IN CURRENT ACCOUNT SURPLUSES AND DEFICITS.

THE PRESENT COMBINATION OF DEFICITS AND SUPPLUSES HAS EMERGED OVER SEVERAL YEARS DURING WHICH THE GROWTH OF DOMESTIC DEMAND IN GERMANY AND JAPAN HAS BEEN CONSISTENTLY BELOW THE GROWTH OF OUTPUT, WHILE IN THE UNITED STATES IT HAS BEEN 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 ARTIFICIALLY 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.

CONCLUSION

IN CONCLUSION, I BELIEVE THAT EXTERNAL STABILITY SHOULD NOW COMPLEMENT THE INTERNAL FINANCIAL STABILITY THAT WE HAVE ALREADY ACHIEVED. IT WILL REMEDY A MAJOR WEAKNESS IN THE WORLD FINANCIAL ORDER AND PROVIDE A SOUNDER BASIS FOR THE PROSPERITY WE ALL SEEK.

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

MIDDLE-INCOME DEBTORS

WHILE IT IS TRUE THAT THE DEBT BURDEN FOR MANY COUNTRIES HAS RISEN, THE BASIC OBJECTIVE OF THE DEBT STRATEGY REMAINS THE SAME: TO ENABLE THE DEBTOR COUNTRIES TO RESTORE THEIR ECONOMIES TO HEALTH AND TO REGAIN NORMAL ACCESS TO THE WORLD'S CAPITAL MARKETS.

FOR THE MIDDLE-INCOME DEBTORS, THIS IS A REALISTIC OBJECTIVE. WITH THEIR NATURAL AND HUMAN RESOURCES, AND THEIR INDUSTRIAL BASE, THEY HAVE THE CAPACITY TO REFORM THEIR ECONOMIES AND SERVICE THEIR DEBTS, PROVIDED THAT WORLD ECONOMIC GROWTH AND AN OPEN TRADING ENVIRONMENT ARE MAINTAINED.

TWO THIRDS OF THE DEBT OF THE MIDDLE-INCOME COUNTRIES AS A WHOLE IS OWED TO THE COMMERCIAL BANKS. THIS MEANS THAT THE MANAGEMENT OF DEBT PROBLEMS IS ABOVE ALL A MATTER BETWEEN THE DEBTOR COUNTRIES AND THE BANKS.

MANY SCHEMES HAVE BEEN PUT FORWARD FOR GLOBAL SOLUTIONS TO THE PROBLEMS OF DEBT, USUALLY INVOLVING DIRECTLY OR INDIRECTLY AN ASSUMPTION OF THE BANKS' RESPONSIBILITIES BY THE GOVERNMENTS OF INDUSTRIAL COUNTRIES. THIS IS NOT ON. IT IS FOR THE BANKS AND THE DEBTOR COUNTRIES ALIKE TO FACE UP REALISTICALLY TO THEIR RESPONSIBILITIES. I WELCOME WHOLE-HEARTEDLY THE SUBSTANTIAL INCREASES THAT MANY MAJOR BANKS HAVE MADE THIS YEAR IN THEIR PROVISIONS AGAINST SOVEREIGN DEBT. THIS HAS BEEN SEEN IN THE MARKET AS A PROPER COMMERCIAL RECOGNITION OF REALITY.

IT IS ALSO CONSISTENT WITH A MORE MARKET ORIENTATED APPROACH TO THE WAYS IN WHICH MIDDLE-INCOME DEBTORS CAN MEET THEIR FINANCIAL NEEDS. THE MARKETING OF DEBT, DEBT-EQUITY SWAPS, AND DEBT BUY-BACK SCHEMES ALL HAVE A

GROWING ROLE TO PLAY. IT IS FOR THE BANKS AND THE DEBTOR COUNTRIES, POSSIBLY WITH THE HELP OF THE INTERNATIONAL FINANCIAL INSTITUTIONS, TO DECIDE IF AND HOW THEY APPLY IN EACH CASE.

I AM GLAD TO SEE A MORE WELCOMING ATTITUDE ON THE PART OF GOVERNMENTS OF MANY DEVELOPING COUNTRIES TO INWARD PRIVATE INVESTMENT. BUT FURTHER SUBSTANTIAL ENCOURAGEMENT BY THESE GOVERNMENTS IS NEEDED. THERE IS CLEARLY THE POTENTIAL FOR GREATER INVESTMENT FLOWS FROM THE INDUSTRIALISED COUNTRIES. JAPAN, WITH ITS HIGH RATE OF SAVING, PROVIDES AN OBVIOUS SOURCE. A HIGHER PROPORTION OF CAPITAL FLOWS TO THE DEVELOPING COUNTRIES SHOULD TAKE FORMS IN WHICH RISKS ARE EXPLICITLY SHARED BETWEEN LENDERS AND BORROWERS.

FOR COUNTRIES SEEKING ADDITIONAL INFLOWS OF CAPITAL, THE APPROPRIATE POLICY FRAMEWORK MUST BE IN PLACE. BUT THE RECORD OF ADJUSTMENT TO DATE HAS BEEN MIXED. DESPITE ALL THE POLITICAL DIFFICULTIES, STRONGER ADJUSTMENT IS ESSENTIAL TO ATTRACT NEW INFLOWS. IN A FEW COUNTRIES,

NOTABLY MEXICO, WE CAN ALREADY SEE THE EFFECT OF POLICY REFORMS IN STEMMING AND THEN REVERSING CAPITAL FLIGHT - AN ACHIEVEMENT OF THE FIRST IMPORTANCE.

THE IFIs

THE INTERNATIONAL INSTITUTIONS CLEARLY HAVE AN IMPORTANT ROLE IN HELPING TO RESOLVE DEBT PROBLEMS, ABOVE ALL BY HELPING TO PUT IN PLACE THE CONDITIONS FOR SUSTAINABLE POLICIES TO ACCOMPANY THE PROVISION OF FINANCE. THE STRATEGY WE HAVE EVOLVED ENVISAGES AN INCREASING ROLE FOR THE WORLD BANK, AND A GENERAL CAPITAL INCREASE IS NOW URGENT. I THEREFORE WARMLY WELCOME THE ANNOUNCEMENT BY THE GOVERNMENT OF THE UNITED STATES THAT THEY CAN NOW SUPPORT A SUBSTANTIAL GCI, AND I HOPE THAT IT CAN BE AGREED AND PUT INTO PLACE AS SOON AS POSSIBLE.

MR. CHAIRMAN, THE DEBT STRATEGY HAS EVOLVED IN IMPORTANT WAYS SINCE WE LAST MET. I WELCOME THE INCREASED FLEXIBILITY WITH WHICH THESE PROBLEMS ARE BEING APPROACHED.

POOREST, AND MOST INDEBTED, COUNTRIES

THERE IS NOW WIDESPREAD AGREEMENT THAT THE PROBLEMS OF THE POOREST AND MOST HEAVILY-INDEBTED COUNTRIES, ESPECIALLY IN SUB-SAHARAN AFRICA, WHOSE DEBT IS MOSTLY TO GOVERNMENTS AND TO THE IFIs, ARE UNIQUELY DIFFICULT AND NEED SPECIAL TREATMENT.

AT OUR LAST MEETING IN APRIL I LAUNCHED AN INITIATIVE WITH THREE PROPOSALS FOR ADDITIONAL HELP TO THESE COUNTRIES, PROVIDED THEY ARE PURSUING SATISFACTORY ADJUSTMENT POLICIES.

- FIRST, THAT AID LOANS SHOULD BE CONVERTED INTO OUTRIGHT GRANTS;
- SECOND, THAT WE SHOULD GIVE LONGER REPAYMENT AND GRACE PERIODS IN RESCHEDULING LOANS;
- AND THIRD, THAT WE SHOULD LOWER THE INTEREST RATES CHARGED ON THESE RESCHEDULINGS TO WELL BELOW MARKET LEVELS.

THERE HAS BEEN VERY CONSIDERABLE PROGRESS ON THE FIRST TWO OF THESE PROPOSALS. MANY COUNTRIES INCLUDING THE UK HAVE ALREADY WRITTEN OFF AID LOANS; AND CREDITOR COUNTRIES IN THE PARIS CLUB HAVE AGREED LONGER REPAYMENT AND GRACE PERIODS FOR RESCHEDULED LOANS TO FIVE COUNTRIES.

IT IS THE THIRD ELEMENT IN THESE PROPOSALS, REDUCED INTEREST RATES, THAT HAS PROVED THE MOST DIFFICULT FOR OTHER CREDITOR COUNTRIES TO ACCEPT. BUT ONE WAY OR ANOTHER, IT IS ABSOLUTELY ESSENTIAL. OTHERWISE, EVEN WITH GENEROUS GRACE PERIODS, THE BURDEN OF DEBT WILL CONTINUE TO RISE RAPIDLY. THESE COUNTRIES DO NOT HAVE THE RESOURCES EVEN TO MEET THE INTEREST BURDEN ON THEIR DEBTS. AT SOME POINT, WE WILL HAVE TO FACE THE INEVITABILITY OF GIVING RELIEF; SOME BUDGETARY COST TO CREDITOR COUNTRIES IS UNAVOIDABLE. TO DELAY GIVING THAT RELIEF MERELY PROLONGS THE UNCERTAINTIES WHICH THESE VERY POOR COUNTRIES FACE, AND MAKES THEIR STRUGGLE TO ADJUST EVEN MORE PAINFUL.

LAST WEEK, THE COMMONWEALTH FINANCE MINISTERS' MEETING IN BARBADOS ENDORSED THE UK PROPOSALS AND - I QUOTE FROM THE COMMUNIQUE - "STRONGLY RECOMMENDED THEM TO THE CREDITOR COUNTRIES FOR EARLY APPROVAL".

COMPLEMENTARY PROPOSALS HAVE BEEN PUT FORWARD BY THE FUND AND THE BANK. THE MANAGING DIRECTOR HAS PROPOSED A SUBSTANTIAL ENLARGEMENT OF THE RESOURCES OF THE STRUCTURAL ADJUSTMENT FACILITY, SO AS TO PROVIDE MORE CONCESSIONARY LENDING TO THE POORER COUNTRIES. I WELCOME THIS APPROACH. IT HAS TO BE SEEN IN TANDEM WITH MY OWN PROPOSAL FOR DEALING WITH BILATERAL OFFICIAL DEBTS. I BELIEVE THAT THE UK PROPOSALS COULD AND SHOULD BE LINKED TO THE PROPOSED SAF ENLARGEMENT, BY THE POOREST, DEBT-DISTRESSED COUNTRIES BEING GIVEN SPECIAL ACCESS TO THE EXTRA SAF FUNDS. THE UK STANDS READY TO MAKE A CONTRIBUTION ON THE BASIS THAT ALL MAJOR COUNTRIES DO SO AS WELL.

MR. CHAIRMAN, SPECIFIC PROPOSALS FOR HELPING THE POOREST COUNTRIES WERE WELCOMED BY THE HEADS OF GOVERNMENT AT THE VENICE SUMMIT. A CONCLUSION WAS URGED BY THE END OF THIS YEAR. IT IS VITAL WE DISCHARGE THIS RESPONSIBILITY.

CHANCELLOR'S SPEAKING NOTE FOR THE DEVELOPMENT COMMITTEE
MORNING SESSION
SEPTEMBER 28, 1987

I HAVE READ WITH GREAT INTEREST THE REPORT BY THE PRESIDENT OF THE WORLD BANK THAT FORMS THE FOCUS OF OUR DISCUSSIONS.

THE WORLD BANK HAS A CRUCIAL ROLE TO PLAY. IT IS AN UNRIVALLED SOURCE OF PROFESSIONAL EXPERTISE AND KNOWLEDGE OF DEVELOPMENT AND DEVELOPING COUNTRIES. IT IS UNIQUELY PLACED TO PROVIDE ADVICE AND SUPPORT FOR ECONOMIC REFORMS TO SECURE STRUCTURAL ADJUSTMENT AND GROWTH.

THE SUCCESS OF THE BANK'S PROJECTS DEPENDS ON HAVING THE RIGHT ECONOMIC ENVIRONMENT IN PLACE, AND IN PARTICULAR IN REMOVING DISTORTIONS IN EXCHANGE RATES, INTEREST RATES AND PRICES MORE GENERALLY. IT IS IMPORTANT THAT, BOTH IN ITS PROJECT LENDING AND IN ITS PROGRAM LENDING, THE BANK SHOULD CONTINUE TO PROMOTE A FREEING OF MARKETS. THE BANK MUST ALSO STRENGTHEN ITS

EFFORTS TO ENSURE THAT THE PROJECTS AND PROGRAMS IT SUPPORTS DO NOT LEAD TO ENVIRONMENTAL DEGRADATION AND ARE SUSTAINABLE IN THE LONGER RUN. WE SHALL BE FOLLOWING THE PROGRESS IN THIS AREA CLOSELY.

WITH THE CONCLUSION OF ITS REORGANISATION, THE BANK IS NOW BETTER PLACED TO RESPOND TO THE NEEDS OF ITS BORROWERS. I BELIEVE THE EXECUTIVE BOARD SHOULD NOW CONSIDER HOW IT CAN PLAY A MORE EFFECTIVE ROLE IN GUIDING THE BANK, AND I LOOK FORWARD TO SEEING THE REPORT OF THE SPECIAL COMMITTEE OF EXECUTIVE DIRECTORS THAT HAS RECENTLY BEEN ESTABLISHED TO LOOK INTO THIS.

THE AGENDA FOR THE WOLD BANK IS AN IMPOSING ONE. IT WILL NOT BE ABLE TO PERFORM THE FUNCTIONS WE REQUIRE OF IT UNLESS ITS MEMBERS PROVIDE IT WITH THE RESOURCES IT NEEDS. IDA 8 WILL BE THE ESSENTIAL SOURCE OF CONCESSIONARY FINANCE FOR THE POOREST DEVELOPING COUNTRIES. NOW THAT WE HAVE REACHED AGREEMENT ON ITS SIZE, THE UK WILL DO ITS PART IN GETTING ITS CONTRIBUTION TO IDA 8 THOUGH QUICKLY. WE MUST NOW ACT, TOO, ON A

GENERAL CAPITAL INCREASE FOR THE BANK. THE NEED IS URGENT. THE UNITED KINGDOM IS LOOKING TO AN EARLY CONCLUSION ON A SUBSTANTIAL INCREASE. I WELCOME THE PROPOSALS BY THE BANK TO INCREASE THE SHARE OF IDA THAT IS GIVEN IN SUPPORT OF POLICY REFORM, AND TO IMPROVE COORDINATION AMONG DONORS. WE ARE READY TO JOIN IN FURTHER DISCUSSIONS AS TO HOW THIS EFFORT COULD BE REINFORCED.

TRADE AND AGRICULTURE

EVEN MORE IMPORTANT FOR THE DEVELOPING COUNTRIES IS THE NEED TO OPEN UP MARKETS AND ENCOURAGE WORLD TRADE TO EXPAND FASTER. PROTECTIONISM IMPOSES COSTS ON ALL OF US. ON PRODUCERS IN DEVELOPING COUNTRIES, WHOSE EXPORT MARKETS ARE RESTRICTED. ON CONSUMERS WHO CANNOT BUY WHAT THEY WANT FROM WHERE THEY WANT AT THE LOWEST PRICES. IT MAKES NO SENSE TO ENCOURAGE DEVELOPING COUNTRIES--AND ESPECIALLY THE VERY POOREST--TO INCREASE THEIR EXPORTS IF AT THE SAME TIME WE CLOSE OUR MARKETS TO THEM.

THE URUGUAY GATT ROUND HAS GOT OFF TO A GOOD START: BETTER THAN AT THE SAME POINT OF THE TOKYO ROUND. THE NEXT IMPORTANT MILESTONE IS THE PRESENTATION OF SUBSTANTIVE PROPOSALS IN GENEVA THIS AUTUMN, IN PREPARATION FOR NEXT YEAR'S DETAILED NEGOTIATIONS. THE UNITED KINGDOM IS FULLY COMMITTED TO THIS PROCESS. BUT OTHERS MUST ALSO PLAY THEIR PART; INCLUDING THE MORE ADVANCED DEVELOPING COUNTRIES, WHO HAVE GAINED SO MUCH FROM GATT IN RECENT YEARS AND MUST NOW TAKE ON A GREATER SHARE OF ITS OBLIGATIONS.

ABOVE ALL, AGRICULTURE NEEDS TO BE PROPERLY EXPOSED TO MARKET FORCES. OVER THE PAST EIGHTEEN MONTHS IT HAS MOVED RIGHT TO THE TOP OF THE INTERNATIONAL AGENDA. FOR THE FIRST TIME, IT HAS BEEN INCLUDED IN A GATT ROUND. WE ARE ALL COMMITTED TO PRESENTING COMPREHENSIVE PROPOSALS BY THE END OF THIS YEAR; AND SOME COUNTRIES HAVE ALREADY DONE SO. A FREER MARKET FOR FARM PRODUCE IS CRUCIAL FOR DEVELOPMENT, AND ABOVE ALL FOR THE DEVELOPMENT OF THE POORER COUNTRIES, WHOSE GROWTH--AS THE WORLD BANK HAS SHOWN--HAS LAGGED SO CONSPICUOUSLY IN THE PAST DECADE

BEHIND THAT OF THOSE DEVELOPING COUNTRIES WITH A
MANUFACTURING BASE.

ACTION IS NEEDED BY DEVELOPING COUNTRIES AND
INDUSTRIAL COUNTRIES ALIKE. DEVELOPING COUNTRIES CAN
MAKE MAJOR GAINS BY NOT OVERTAXING THEIR FARMERS AND BY
PAYING THEM THE WORLD MARKET PRICE FOR THEIR PRODUCE.
BUT IT IS ABOVE ALL ESSENTIAL THAT THE EXCESSIVE LEVELS
OF SUPPORT FOR AGRICULTURE IN OECD COUNTRIES ARE CUT BACK
SHARPLY. THAT WILL PROVIDE VITAL HELP TO THE FOOD
PRODUCERS IN THE POORER COUNTRIES. THE POTENTIAL GAINS
ARE ENORMOUS. LAST YEAR'S WORLD DEVELOPMENT REPORT
ESTIMATED THAT DEVELOPING COUNTRIES COULD GAIN
\$20 BILLION A YEAR FROM LIBERALISATION OF WORLD
AGRICULTURE--FIVE TIMES THE PROJECTED ANNUAL FLOWS FROM
IDA 8.

WE MUST CONTINUE TO KEEP THIS ISSUE IN THE
FOREFRONT OF OUR AGENDA. IT IS TOO SERIOUS A MATTER TO
BE LEFT TO AGRICULTURE MINISTERS ALONE.

PRIVATE INVESTMENT

WE MUST ALSO LIBERATE INVESTMENT FLOWS, AS WELL AS TRADE. I AM PARTICULARLY GLAD TO SEE THE INCREASING RECOGNITION AMONG SOME DEVELOPING COUNTRIES OF THE VALUE TO THEM ON INWARD INVESTMENT. AND THE PRESIDENT'S REPORT DRAWS ATTENTION TO THE IMPORTANCE OF THIS. BUT A GREAT DEAL MORE REMAINS TO BE DONE. ACTION BY HOST GOVERNMENTS TO MAKE INWARD INVESTMENT WELCOME AND TO PROVIDE AN APPROPRIATE ECONOMIC ENVIRONMENT IS ESSENTIAL IF THE BENEFITS FROM THESE FLOWS ARE TO BE REALISED.

THESE CAN BE VERY SUBSTANTIAL. THE UNITED KINGDOM ABOLISHED ALL ITS EXCHANGE CONTROLS IN 1979. AND OVER THE LAST FIVE YEARS, NET PRIVATE DIRECT INVESTMENT IN DEVELOPING COUNTRIES HAS TOTALLED \$12 BILLION.

THE WORLD BANK GROUP HAS AN IMPORTANT ROLE TO PLAY IN ENCOURAGING PRIVATE INVESTMENT FLOWS. I WELCOME THE SETTING UP OF THE MULTILATERAL INVESTMENT GUARANTEE AGENCY. THE UK WAS AN EARLY SIGNATORY AND WE HAVE

ALREADY EMBARKED ON THE PARLIAMENTARY PROCEDURE FOR RATIFICATION. I HOPE THAT MIGA CAN BEGIN ITS OPERATIONS AS SOON AS POSSIBLE.

I AM ALSO GLAD TO SEE THE IFC CONTINUING ITS INNOVATIVE AND WIDE RANGING APPROACH, PROMOTING BOTH DIRECT AND PORTFOLIO INVESTMENT AND GIVING ADVICE.

THE POOREST COUNTRIES

I TURN NOW TO THE PROBLEMS OF THE POOREST COUNTRIES WHICH WE ALL AGREE TO BE DIFFERENT, BOTH IN SCALE AND IN KIND, FROM THOSE OF THE MIDDLE INCOME DEBTORS. THE SIZE OF THEIR DEBT IS TYPICALLY A GOOD DEAL HIGHER IN RELATION TO THEIR GDP. FOR THE SUB-SAHARAN AFRICAN COUNTRIES, THE DEBT TO GDP RATIO IS NOW 77 PER CENT. FOR THE FORESEEABLE FUTURE, THEY WILL NOT BE WITHIN SIGHT OF CREDITWORTHINESS. AND TWO-THIRDS OF THEIR DEBT IS OWED TO OTHER GOVERNMENTS AND TO INTERNATIONAL INSTITUTIONS, RATHER THAN TO THE COMMERCIAL BANKS.

THAT IS WHY, AT THE SPRING MEETINGS, I LAUNCHED A THREE-POINT INITIATIVE FOR LIGHTENING THE DEBT BURDEN ON THE POOREST, MOST DEBT-DISTRESSED COUNTRIES IN SUB-SAHARAN AFRICA, PROVIDING THEY FOLLOW APPROPRIATE ADJUSTMENT POLICIES. I PROPOSED:

- FIRST, CONVERTING AID LOANS INTO OUTRIGHT GRANTS;
- SECOND, ALLOWING LONGER REPAYMENT AND GRACE PERIODS IN RESCHEDULING LOANS;
- AND THIRD, REDUCING THE INTEREST RATES CHARGED ON THESE DEBTS TO WELL BELOW MARKET LEVEL.

THERE HAS BEEN USEFUL PROGRESS ON THE FIRST TWO OF THESE BUT THE PROPOSAL FOR REDUCED INTEREST RATES ON OFFICIAL DEBTS IS PROVING MORE CONTROVERSIAL. I BELIEVE IT IS OF CRITICAL IMPORTANCE IF WE ARE TO MAKE ANY REAL PROGRESS IN EASING THE DEBT BURDEN OF THE POOREST COUNTRIES.

THE HEART OF THE PROBLEM FOR THE POOREST COUNTRIES IS THAT, WITHOUT SOME RELIEF, THEY CANNOT EVEN MEET THEIR INTEREST PAYMENTS. SO THESE ARE ADDED TO THEIR DEBT, AND THE BURDEN MOUNTS EXPONENTIALLY.

SINCE 1982 THE DEBT BURDEN OF THE SUB-SAHARAN AFRICAN COUNTRIES HAS INCREASED BY NO LESS THAN 60 PER CENT. AND THE PROBLEM IS STILL GETTING WORSE. IT WILL CONTINUE TO DO SO UNLESS WE REDUCE THEIR INTEREST CHARGES, SO THAT THESE COUNTRIES CAN KEEP UP WITH THEIR CURRENT OBLIGATIONS. THE LONGER WE WAIT, THE WORSE THE PROBLEMS WILL BECOME.

THIS MEETING SHOULD KNOW THAT THE UK PROPOSALS I HAVE SET OUT AGAIN TODAY WERE ENDORSED BY THE COMMONWEALTH FINANCE MINISTERS' MEETING AT BARBADOS LAST WEEK.

THE MANAGING DIRECTOR OF THE FUND HAS MADE A COMPLEMENTARY PROPOSAL FOR A SUBSTANTIAL ENLARGEMENT OF THE STRUCTURAL ADJUSTMENT FACILITY. I WELCOME THIS.

THE SAF IS OF SPECIAL IMPORTANCE TO THE POOREST AND MOST DEBT-DISTRESSED COUNTRIES AS WAS RECOGNISED AT THE VENICE ECONOMIC SUMMIT IN JUNE. I BELIEVE THAT THE NEW SAF MONEY SHOULD BE GEARED PARTICULARLY TOWARDS THE NEEDS OF THESE COUNTRIES. THEY SHOULD GIVEN SPECIALLY FAVOURABLE ACCESS TO THE EXTRA SAF FUNDS. I HOPE THAT THE EXECUTIVE BOARD OF THE FUND, IN DEVELOPING THE CRITERIA FOR ACCESS, WILL CONSIDER HOW THIS MIGHT BE ACHIEVED.

INCREASED RESOURCES FOR THE POOREST COUNTRIES WILL ONLY HELP IF ACCOMPANIED BY ECONOMIC ADJUSTMENT AND REFORM. THAT IS WHY BOTH PROPOSALS NEED ADEQUATE CONDITIONALITY. OTHERWISE WE THROW GOOD MONEY AFTER BAD. I BELIEVE THIS IS INCREASINGLY RECOGNISED BY THE DEVELOPING COUNTRIES THEMSELVES.

WHILE IN THE FACE OF DAUNTING PROBLEMS A FEW OF THESE COUNTRIES HAVE LARGELY ABANDONED THEIR REFORM EFFORTS, SOME ARE MAKING REAL ~~PROGRESS~~ ^{PROGRESS}. THE WORLD BANK PAPER BEFORE US SHOWS THAT IN THE GAMBIA AND IN TANZANIA THE FINANCIAL PERFORMANCE OF THEIR PUBLIC ENTERPRISES

HAS IMPROVED SIGNIFICANTLY IN RECENT YEARS; AND IN GHANA, GREATER INCENTIVES FOR FARMERS HAVE STIMULATED FOOD PRODUCTION.

THESE EXAMPLES ARE EVIDENCE THAT, DESPITE THE ENORMOUS SCALE OF THE PROBLEMS, REAL PROGRESS CAN BE MADE. SUCH EFFORTS NEED TO BE REINFORCED.

CONCLUSIONS

I HOPE THAT THIS COMMITTEE CAN GIVE THREE CLEAR MESSAGES IN ITS COMMUNIQUE. FIRST, THAT GOVERNMENTS MUST TAKE EARLY STEPS TO REDUCE BARRIERS TO TRADE AND SUBSIDIES FOR AGRICULTURE. SECONDLY, THAT AN EARLY AND SUBSTANTIAL INCREASE IN THE WORLD BANK'S CAPITAL SHOULD BE PUT IN PLACE SO THAT IT CAN PLAY ITS FULL PART IN ASSISTING LONG-TERM DEVELOPMENT. THIRDLY, THAT THIS COMMITTEE ACCEPTS THE OVERRIDING PRIORITY OF HELPING THE LOW-INCOME HEAVILY INDEBTED COUNTRIES IN SUB-SAHARAN AFRICA, BOTH MULTILATERALLY THROUGH THE SAF AND BILATERALLY THROUGH THE LINES I HAVE INDICATED.

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, *NEEDS* TO SAY, WE NEED TO DO IT WITHOUT ANY *RECURSUS* 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.*
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WE SHALL BE DISCUSSING THE REVIEW OF QUOTAS THIS AFTERNOON. ~~IT~~ ^{THE U.S. SIDE} SEEMS TO ME CLEAR THAT THERE IS NO NEED TO TAKE ANY URGENT DECISIONS ON THAT ^{ALONE} BUT IT IS IMPORTANT IN THE MEANTIME THAT WE SHOULD RETAIN ENLARGED ACCESS, AT PRESENT LEVELS.

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pwp

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MORNING SESSION, SUNDAY, SEPTEMBER 27, 1987

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cc PS/EST
Sir P. Middleton
Mr Cassell
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Mr Mountfield
Mr Walsh
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CHANCELLOR'S SPEAKING NOTE FOR THE INTERIM COMMITTEE
AFTERNOON SESSION
SUNDAY 27 SEPTEMBER, 1987

MIDDLE-INCOME DEBTORS

ONE FEATURE WHICH HAS EMERGED CLEARLY FROM DISCUSSIONS IN THIS COMMITTEE IS THAT DEBT PROBLEMS DIFFER ENORMOUSLY BETWEEN COUNTRIES OR GROUPS OF COUNTRIES, AND WE MUST LOOK FOR DIFFERENT SOLUTIONS. THAT IS WHY WE HAVE, RIGHTLY, ADOPTED THE CASE-BY-CASE APPROACH, WHICH MUST CONTINUE,

WHILE THE DEBT BURDEN FOR MANY COUNTRIES HAS RISEN, THE BASIC OBJECTIVE OF THE DEBT STRATEGY REMAINS THE SAME: TO ENABLE THE DEBTOR COUNTRIES TO RESTORE THEIR ECONOMIES TO HEALTH AND TO REGAIN NORMAL ACCESS TO THE WORLD'S CAPITAL MARKETS.

FOR THE MIDDLE-INCOME DEBTORS, THIS IS A REALISTIC OBJECTIVE. WITH THEIR NATURAL AND HUMAN RESOURCES, AND THEIR INDUSTRIAL BASE, THEY HAVE THE CAPACITY TO REFORM THEIR ECONOMIES AND SERVICE THEIR DEBTS, PROVIDED THAT WORLD ECONOMIC GROWTH AND AN OPEN TRADING ENVIRONMENT ARE MAINTAINED.

TWO THIRDS OF THE DEBT OF THE MIDDLE-INCOME COUNTRIES AS A WHOLE IS OWED TO THE COMMERCIAL BANKS. THIS MEANS THAT THE MANAGEMENT OF DEBT PROBLEMS IS ABOVE ALL A MATTER BETWEEN THE DEBTOR COUNTRIES AND THE BANKS.

MANY SCHEMES HAVE BEEN PUT FORWARD FOR GLOBAL SOLUTIONS TO THE PROBLEMS OF DEBT, USUALLY INVOLVING DIRECTLY OR INDIRECTLY AN ASSUMPTION OF THE BANKS' RESPONSIBILITIES BY THE GOVERNMENTS OF INDUSTRIAL COUNTRIES. THIS IS NOT ON. IT IS FOR THE BANKS TO FACE UP REALISTICALLY TO THEIR RESPONSIBILITIES. I WELCOME WHOLE-HEARTEDLY THE SUBSTANTIAL INCREASES THAT MANY MAJOR BANKS HAVE MADE THIS YEAR IN THEIR PROVISIONS AGAINST

SOVEREIGN DEBT. THAT IS A PROPER COMMERCIAL RECOGNITION OF REALITY.

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

MIDDLE-INCOME DEBTORS

ONE FEATURE WHICH HAS EMERGED CLEARLY FROM DISCUSSIONS IN THIS COMMITTEE IS THAT DEBT PROBLEMS DIFFER ENORMOUSLY BETWEEN COUNTRIES OR GROUPS OF COUNTRIES, AND WE MUST LOOK FOR DIFFERENT SOLUTIONS, THAT IS WHY WE HAVE, RIGHTLY, ADOPTED THE CASE-BY-CASE APPROACH, WHICH MUST CONTINUE.

WHILE THE DEBT BURDEN FOR MANY COUNTRIES HAS RISEN, THE BASIC OBJECTIVE OF THE DEBT STRATEGY REMAINS THE SAME: TO ENABLE THE DEBTOR COUNTRIES TO RESTORE THEIR ECONOMIES TO HEALTH AND TO REGAIN NORMAL ACCESS TO THE WORLD'S CAPITAL MARKETS.

FOR THE MIDDLE-INCOME DEBTORS, THIS IS A REALISTIC OBJECTIVE. WITH THEIR NATURAL AND HUMAN RESOURCES, AND THEIR INDUSTRIAL BASE, THEY HAVE THE CAPACITY TO REFORM THEIR ECONOMIES AND SERVICE THEIR DEBTS, PROVIDED THAT WORLD ECONOMIC GROWTH AND AN OPEN TRADING ENVIRONMENT ARE MAINTAINED.

TWO THIRDS OF THE DEBT OF THE MIDDLE-INCOME COUNTRIES AS A WHOLE IS OWED TO THE COMMERCIAL BANKS. THIS MEANS THAT THE MANAGEMENT OF DEBT PROBLEMS IS ABOVE ALL A MATTER BETWEEN THE DEBTOR COUNTRIES AND THE BANKS.

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BOARDS OF GOVERNORS • 1987 ANNUAL MEETINGS • WASHINGTON, D.C.

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL MONETARY FUND

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Press Release No. 44

September 30, 1987

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

I welcome the progress that we have made at these meetings on a number of issues of great importance. We have reaffirmed the Louvre agreement. There is now full support for an early and substantial general capital increase for the World Bank. And there is increasing recognition that within the general debt strategy, special action is required to help the very poorest and most heavily indebted countries, particularly in sub-Saharan Africa.

At the meetings of the Interim and Development Committees this April, I put forward a three-point proposal for assisting these countries, provided they pursue appropriate adjustment policies: the conversion of aid loans into outright grants; longer repayment and grace periods on Paris Club reschedulings; and reductions in the rates of interest on those reschedulings.

The Managing Director of the International Monetary Fund and the President of the World Bank have put forward complementary proposals for helping the poorest countries by concessional interest rates, including a substantial increase in the size of the Fund's structural adjustment facility (SAF). I support these proposals, and believe that heavy indebtedness should be a major factor in determining the allocation of funds under any enlargement of the SAF.

It is of the first importance that we make a real effort to reach agreement on all these proposals at the earliest possible date.

The U.K. Economy

I now turn to the experience of my own country during the past year. Since the sharp fall in the oil price in 1986, the growth rate of the U.K. economy, so far from slowing down as was expected, has actually picked up. At the same time, the growth rate for the major industrial

countries as a whole has been below expectations. At first sight, this seems paradoxical. The industrial countries in aggregate were significant beneficiaries from lower oil prices, whereas the United Kingdom, as a major oil producer and exporter, stood to lose significantly.

What has happened is that the U.K. economy has adjusted more smoothly to the fall in oil prices than many thought possible. The latest Fund forecast puts U.K. growth at 3.4 percent this year--the fastest growth of all the major industrial countries. And U.K. manufacturing productivity, currently rising at about 6 percent, has continued to exceed expectations, thus containing the growth of unit labor costs.

The United Kingdom's strong growth performance has not been brought about by any fiscal stimulus. The public sector borrowing requirement has in fact been reduced to less than 1 percent of GDP. We have been able to bring down tax rates by maintaining a declining path for public expenditure as a proportion of GDP. Nor has there been any relaxation of monetary policy. Interest rates have been held at levels necessary to maintain sound anti-inflationary conditions. In short, it is the enterprise economy that has done the trick. One consequence of this improved performance has been a significant drop in unemployment, which has fallen by 400,000 over the last 14 months.

The strong growth of U.K. output and demand has caused some to suggest that the U.K. economy is in danger of overheating, while others are forecasting a slowdown. Some manage to combine both predictions. But while, as in most countries, inflation is a bit higher than last year when the impact of falling oil prices was greatest, there has been no significant change in underlying inflationary pressure.

The United Kingdom is now well into its seventh year of steady growth at 3 percent a year. During that period there have been minor fluctuations, and after the slight spurt this year, I would expect something closer to the 3 percent average rate next year.

The Background to the Louvre

I now turn to the evolution of exchange rate policy.

For the first 25 years after World War II, exchange rate stability was achieved through the Bretton Woods system. This formed a cornerstone of the postwar economic order, not least as a force for financial discipline. But it began to break down in the late 1960s, and by the early 1970s it had collapsed altogether. Thereafter, with countries pursuing divergent economic policies, and many suffering from high and volatile inflation, a system of floating exchange rates was virtually inescapable. Indeed, many at the time believed this new flexibility to be desirable.

With hindsight, some of the arguments for free floating seem much less compelling. And the belief that markets would provide a stabilizing influence, through the operations of medium-term speculators, has not been borne out.

In particular, we have seen wild gyrations in the dollar that have clearly not been a reflection of economic fundamentals, which are essentially slow moving. Few could seriously argue that two deutsche mark to the dollar was "correct" in 1979, and again at the end of 1986, and yet that three deutsche mark to the dollar was "correct" in 1985. Moreover, these gyrations have damaged growth in world trade. Businesses have had to divert scarce management time and skills to coping with currency fluctuations, rather than improving company performance. And the major uncertainties about exchange rate movements inhibited risk taking and required a switching of resources at a pace that was wholly unrealistic.

The explanation for these gyrations in the dollar derives in large part from the nature of the foreign exchange markets. We now have global 24-hour markets in which turnover has increased dramatically, with only a small part of that related to commercial transactions. This presents particularly acute problems for the dollar, which still dominates the world's money markets. In 1986, on the London foreign exchange market, 97 percent of all transactions were in dollars.

Of course, all financial markets have a certain amount of speculative froth. But to function well they need some players to take a longer view, and so provide a stabilizing influence. In foreign exchange markets, they have been conspicuous by their absence.

This means that once the dollar starts to move in one direction, it can continue in the same direction for months and even years, even if there is a general consensus that the rate is out of line. This is what happened in 1984 and early 1985. Almost everybody agreed that the dollar was overvalued, and that, in the long run, it was bound to fall. But they continued to buy dollars in the belief that, in the short run, it would move even higher--which is, of course, what consequently occurred.

The result is that trends have been greatly magnified. Capital movements have generated fluctuations in the dollar; but equally, fluctuations in the dollar have themselves generated further capital movements. This is how exchange rates have often acquired a momentum of their own, which has not been reversed until they have reached extreme levels of over- or undervaluation.

Background to Plaza

It was a growing concern about this process that led ~~to~~ a small group of us to meet in the Plaza Hotel in September 1985. We shared three perceptions:

- first, that the gyrations in exchange rates had proved damaging;
- second, that the immediate problem was that the dollar was much too high; and
- third, that the time was right for the authorities of the major countries to give the markets a clear lead.

The Plaza agreement marked an important step toward a more managed system. In private, we discussed the scale of fall we saw as desirable, and although no figures were given in public, everyone was aware that we were looking for substantial changes. We agreed to cooperate to bring that about. And that agreement played an important role in securing a continuing fall in the dollar over the succeeding 15 months.

The Louvre

The Louvre accord earlier this year marked another important step forward--Plaza II, as I called it at the time to emphasize the continuity. By then the broad objectives agreed at Plaza had been achieved. The yen and the deutsche mark had appreciated by as much as 50 percent or so against the dollar.

We agreed that, given the policies being followed, the dollar was by then broadly in line with economic fundamentals and that the interests of the world economy would best be served by a period of stability, to allow time for the major economies to adjust to the exchange rate changes that had occurred. We were not, of course, thinking in terms of rigid exchange rates, but we did discuss the scale of fluctuation, around the then current levels, which we would not wish to see exceeded. Figures were agreed in private, but not, of course, revealed in public.

In spite of widespread skepticism when it was first concluded seven months ago, the agreement has proved a success.

Managed Floating

The move to managed floating has been made possible by two fundamental changes:

- First, we have at last returned to a world of low inflation. The average inflation rate for the major seven economies has fallen from 12 percent in 1980 to about 3 percent today. In the process, inflation differentials have been narrowed considerably.

- Second, there is now a clear consensus among the major countries about the approach to economic policy. And we all agree on the need for a greater reliance on market mechanisms within the framework of a firm monetary and fiscal policy.

We have been able to make this regime work because:

- We have chosen the right time to give a lead to the markets. In this sense we have been working with, rather than against, the grain of the markets.
- We have been prepared to commit ourselves publicly to appropriate and consistent domestic policies.
- In particular, we have all been prepared in practice to give significant weight to exchange rates in the conduct of monetary policy.
- We have been prepared to back up our agreement with coordinated intervention, sometimes on a substantial scale.
- We have deliberately not revealed details of our arrangements. And we have worked within margins of a size sufficient to allow us the necessary tactical room for maneuver.

A Regime for the Future

I believe that we can and should use the experience we have gained to build a more permanent regime of managed floating. I do not see the past two years simply as a temporary phase. Our objectives should be clear: to maintain the maximum stability of key exchange rates, and to manage any changes that may be necessary in an orderly way.

Let me make it clear that I am not suggesting that we can or should return to Bretton Woods. That system was undermined by its rigidity; the margins were too narrow; it required a predictable and mechanical response from the authorities that made them an easy target; necessary realignments were postponed too long, and consequently, when they came, they were inevitably large.

For the future, it is important, therefore, that we continue to keep an adequate degree of flexibility in terms of the width of the bands within which currencies are able to fluctuate. And, if and when the time comes to adjust one of the rates, that adjustment should be made by moving the midpoint within the confines of the existing range. This means that the markets are not given a one way bet, and the authorities retain tactical flexibility.

As I have already emphasized, what made the Plaza and Louvre agreements possible was that the countries participating were, and remain, in effect, members of an anti-inflationary club, with a clear

commitment to taking whatever steps are necessary to curb their own inflation. It is vital that that commitment continues, individually and collectively. A resurgence of inflation in any individual country would make it difficult for that country to remain within the club.

At the same time, we must also ensure that there is no persistent inflationary (or for that matter deflationary) bias for the group as a whole. This can be helped by:

- the development of indicators for the group as a whole; these will be mainly financial but special attention should also be given to the trend of world commodity prices;
- a nominal framework for policy, in terms either of a path for GDP growth for the group as a whole, or one for the average inflation rate; and
- a medium-term perspective when setting out the path and in gauging actual performance. We should not become involved in an exercise in short-term fine tuning.

In recent meetings we have put a lot of effort into developing performance indicators for individual countries. I have to say that I have considerable doubts whether we can usefully take that exercise much further. I believe it would be far more useful to devote our efforts to monitoring the performance of the group as a whole, so that we can ensure that we maintain the correct noninflationary policy stance.

Current Account Imbalances

Some fears have been expressed that the Louvre agreement will be undermined by the persistence of current account imbalances between the major countries. I do not believe this need be so.

What we are seeing is not altogether surprising. It is the familiar J-curve effect, and although the imbalances remain large, trade volumes are adjusting.

In any case, there is no 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. Clearly there are limits to the accumulated external liabilities or assets that can be sustained without creating major anxieties for capital markets. But 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 necessarily have their counterparts in current account surpluses and deficits.

The present combination of deficits and surpluses has emerged over several years during which the growth of domestic demand in the Federal Republic of Germany and Japan has been consistently below the growth of output, while in the United States it has been 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 shortcut 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 artificially low dollar. The benefits to the current account would be small compared to the damage to U.S. 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.

Conclusion

In conclusion, I believe that external stability should now complement the internal financial stability that we have already achieved. It will remedy a major weakness in the world financial order and provide a sounder basis for the prosperity we all seek.

BOARD OF GOVERNORS 1987 ANNUAL MEETINGS, WASHINGTON DC
STATEMENT BY THE RT.HON. NIGEL LAWSON MP
CHANCELLOR OF THE EXCHEQUER
GOVERNOR OF THE FUND FOR THE UNITED KINGDOM
AT THE JOINT ANNUAL MEETINGS, SEPTEMBER 30, 1987

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I WELCOME THE PROGRESS THAT WE HAVE MADE AT THESE MEETINGS ON A NUMBER OF ISSUES OF GREAT IMPORTANCE. WE HAVE REAFFIRMED THE LOUVRE AGREEMENT. THERE IS NOW FULL SUPPORT FOR AN EARLY AND SUBSTANTIAL GENERAL CAPITAL INCREASE FOR THE WORLD BANK. AND THERE IS INCREASING RECOGNITION THAT WITHIN THE GENERAL DEBT STRATEGY, SPECIAL ACTION IS REQUIRED TO HELP THE VERY POOREST AND MOST HEAVILY INDEBTED COUNTRIES, PARTICULARLY IN SUB-SAHARAN AFRICA.

AT THE MEETINGS OF THE INTERIM AND DEVELOPMENT COMMITTEES THIS APRIL, I PUT FORWARD A THREE-POINT PROPOSAL FOR ASSISTING THESE COUNTRIES, PROVIDED THEY PURSUE APPROPRIATE ADJUSTMENT POLICIES: THE CONVERSION OF AID LOANS INTO OUTRIGHT GRANTS; LONGER REPAYMENT AND GRACE PERIODS ON PARIS CLUB RESCHEDULINGS; AND REDUCTIONS IN THE RATES OF INTEREST ON THOSE RESCHEDULING

THE MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND AND THE PRESIDENT OF THE WORLD BANK HAVE PUT FORWARD COMPLEMENTARY PROPOSALS FOR HELPING THE POOREST COUNTRIES BY CONCESSIONAL INTEREST RATES, INCLUDING A SUBSTANTIAL INCREASE IN THE SIZE OF THE IMF'S STRUCTURAL ADJUSTMENT FACILITY. I SUPPORT THESE PROPOSALS, AND BELIEVE THAT HEAVY INDEBTEDNESS SHOULD BE A MAJOR FACTOR IN DETERMINING THE ALLOCATION OF FUNDS UNDER ANY ENLARGEMENT OF THE SAF.

IT IS OF THE FIRST IMPORTANCE THAT WE MAKE A REAL EFFORT TO REACH AGREEMENT ON ALL THESE PROPOSALS AT THE EARLIEST POSSIBLE DATE.

THE UK ECONOMY

I NOW TURN TO THE EXPERIENCE OF MY OWN COUNTRY DURING THE PAST YEAR. SINCE THE SHARP FALL IN THE OIL PRICE IN 1986 THE GROWTH RATE OF THE UK ECONOMY, SO FAR FROM SLOWING DOWN AS WAS EXPECTED, HAS ACTUALLY PICKED UP. AT THE SAME TIME, THE GROWTH RATE FOR THE MAJOR INDUSTRIALISED COUNTRIES AS A WHOLE HAS BEEN BELOW EXPECTATIONS. AT FIRST SIGHT THIS SEEMS PARADOXICAL. THE INDUSTRIALISED COUNTRIES IN AGGREGATE WERE SIGNIFICANT BENEFICIARIES FROM LOWER OIL PRICES WHEREAS THE UK, AS A MAJOR OIL PRODUCER AND EXPORTER, STOOD TO LOSE SIGNIFICANTLY.

WHAT HAS HAPPENED IS THAT THE UK ECONOMY HAS ADJUSTED MORE SMOOTHLY TO THE FALL IN OIL PRICES THAN MANY THOUGHT POSSIBLE. THE LATEST IMF FORECAST PUTS UK GROWTH AT 3.4 PER CENT THIS YEAR--THE FASTEST GROWTH OF ALL THE MAJOR INDUSTRIALISED COUNTRIES. AND UK MANUFACTURING PRODUCTIVITY, CURRENTLY RISING AT ABOUT 6 PER CENT, HAS CONTINUED TO EXCEED EXPECTATIONS, THUS CONTAINING THE GROWTH OF UNIT LABOUR COSTS.

THE UK'S STRONG GROWTH PERFORMANCE HAS NOT BEEN BROUGHT ABOUT BY ANY FISCAL STIMULUS. THE PUBLIC SECTOR BORROWING REQUIREMENT HAS IN FACT BEEN REDUCED TO LESS THAN 1 PER CENT OF GDP. WE HAVE BEEN ABLE TO BRING DOWN TAX RATES BY MAINTAINING A DECLINING PATH FOR PUBLIC EXPENDITURE AS A PROPORTION OF GDP. NOR HAS THERE BEEN ANY RELAXATION OF MONETARY POLICY. INTEREST RATES HAVE BEEN HELD AT LEVELS NECESSARY TO MAINTAIN SOUND ANTI-INFLATIONARY CONDITIONS. IN SHORT, IT IS THE ENTERPRISE ECONOMY THAT HAS DONE THE TRICK. ONE CONSEQUENCE OF THIS IMPROVED PERFORMANCE HAS BEEN A SIGNIFICANT DROP IN UNEMPLOYMENT, WHICH HAS FALLEN BY 400,000 OVER THE LAST 14 MONTHS.

THE STRONG GROWTH OF UK OUTPUT AND DEMAND HAS CAUSED SOME TO SUGGEST THAT THE UK ECONOMY IS IN DANGER OF OVERHEATING, WHILE OTHERS ARE FORECASTING A SLOWDOWN. SOME MANAGE TO COMBINE BOTH PREDICTIONS. BUT WHILE, AS IN MOST COUNTRIES, INFLATION IS A BIT HIGHER THAN LAST YEAR WHEN THE IMPACT OF FALLING OIL PRICES WAS GREATEST, THERE HAS BEEN NO SIGNIFICANT CHANGE IN UNDERLYING INFLATIONARY PRESSURE.

THE UK IS NOW WELL INTO ITS SEVENTH YEAR OF STEADY GROWTH AT 3 PER CENT A YEAR. DURING THAT PERIOD THERE HAVE BEEN MINOR FLUCTUATIONS, AND AFTER THE SLIGHT SPURT THIS YEAR, I WOULD EXPECT SOMETHING CLOSER TO THE 3 PER CENT AVERAGE RATE NEXT YEAR.

THE BACKGROUND TO THE LOUVRE

I NOW TURN TO THE EVOLUTION OF EXCHANGE RATE POLICY.

FOR THE FIRST 25 YEARS AFTER THE WAR, EXCHANGE RATE STABILITY WAS ACHIEVED THROUGH THE BRETTON WOODS SYSTEM. THIS FORMED A CORNERSTONE OF THE POST-WAR ECONOMIC ORDER, NOT LEAST AS A FORCE FOR FINANCIAL DISCIPLINE. BUT IT BEGAN TO BREAK DOWN IN THE LATE 1960s, AND BY THE EARLY 1970s IT HAD COLLAPSED ALTOGETHER.

THEREAFTER, WITH COUNTRIES PURSUING DIVERGENT ECONOMIC POLICIES, AND MANY SUFFERING FROM HIGH AND VOLATILE INFLATION, A SYSTEM OF FLOATING EXCHANGE RATES WAS VIRTUALLY INESCAPABLE. INDEED MANY AT THE TIME BELIEVED THIS NEW FLEXIBILITY TO BE DESIRABLE.

WITH HINDSIGHT, SOME OF THE ARGUMENTS FOR FREE FLOATING SEEM MUCH LESS COMPELLING. AND THE BELIEF THAT MARKETS WOULD PROVIDE A STABILISING INFLUENCE, THROUGH THE OPERATIONS OF MEDIUM-TERM SPECULATORS, HAS NOT BEEN BORNE OUT.

IN PARTICULAR, WE HAVE SEEN WILD GYRATIONS IN THE DOLLAR, THAT HAVE CLEARLY NOT BEEN A REFLECTION OF ECONOMIC FUNDAMENTALS, WHICH ARE ESSENTIALLY SLOW-MOVING. FEW COULD SERIOUSLY ARGUE THAT TWO DEUTSCHEMARKS TO THE DOLLAR WAS "CORRECT" IN 1979, AND AGAIN AT THE END OF 1986, AND YET THAT THREE DEUTSCHEMARKS TO THE DOLLAR WAS "CORRECT" IN 1985.

MOREOVER, THESE GYRATIONS HAVE DAMAGED GROWTH IN WORLD TRADE. BUSINESSES HAVE HAD TO DIVERT SCARCE MANAGEMENT TIME AND SKILLS TO COPING WITH CURRENCY FLUCTUATIONS, RATHER THAN IMPROVING COMPANY PERFORMANCE. AND THE MAJOR UNCERTAINTIES ABOUT EXCHANGE RATE MOVEMENTS INHIBITED RISK TAKING AND REQUIRED A SWITCHING OF RESOURCES AT A PACE THAT WAS WHOLLY UNREALISTIC.

THE EXPLANATION FOR THESE GYRATIONS IN THE DOLLAR DERIVES IN LARGE PART FROM THE NATURE OF THE FOREIGN EXCHANGE MARKETS. WE NOW HAVE GLOBAL 24-HOUR MARKETS IN WHICH TURNOVER HAS INCREASED DRAMATICALLY, WITH ONLY A SMALL PART OF THAT RELATED TO COMMERCIAL TRANSACTIONS.

THIS PRESENTS PARTICULARLY ACUTE PROBLEMS FOR THE DOLLAR, WHICH STILL DOMINATES THE WORLD'S MONEY MARKETS. IN 1986, ON THE LONDON FOREIGN EXCHANGE MARKET, 97 PER CENT OF ALL TRANSACTIONS WERE IN DOLLARS.

OF COURSE, ALL FINANCIAL MARKETS HAVE A CERTAIN AMOUNT OF SPECULATIVE FROTH. BUT TO FUNCTION WELL THEY NEED SOME PLAYERS TO TAKE A LONGER VIEW, AND SO PROVIDE A STABILISING INFLUENCE. IN FOREIGN EXCHANGE MARKETS THEY HAVE BEEN CONSPICUOUS BY THEIR ABSENCE.

THIS MEANS THAT ONCE THE DOLLAR STARTS TO MOVE IN ONE DIRECTION, IT CAN CONTINUE IN THE SAME DIRECTION FOR MONTHS AND EVEN YEARS, EVEN IF THERE IS A GENERAL CONSENSUS THAT THE RATE IS OUT OF LINE. THIS IS WHAT HAPPENED IN 1984 AND EARLY 1985. ALMOST EVERYBODY AGREED THAT THE DOLLAR WAS OVERVALUED, AND THAT, IN THE LONG RUN, IT WAS BOUND TO FALL. BUT THEY CONTINUED TO BUY DOLLARS IN THE BELIEF THAT, IN THE SHORT RUN, IT WOULD MOVE EVEN HIGHER--WHICH IS, OF COURSE, WHAT CONSEQUENTLY OCCURRED.

THE RESULT IS THAT TRENDS HAVE BEEN GREATLY MAGNIFIED. CAPITAL MOVEMENTS HAVE GENERATED FLUCTUATIONS IN THE DOLLAR; BUT EQUALLY, FLUCTUATIONS IN THE DOLLAR HAVE THEMSELVES GENERATED FURTHER CAPITAL MOVEMENTS. THIS IS HOW EXCHANGE RATES HAVE OFTEN ACQUIRED A MOMENTUM OF THEIR OWN, WHICH HAS NOT BEEN REVERSED UNTIL THEY HAVE REACHED EXTREME LEVELS OF OVER- OR UNDER-VALUATION.

BACKGROUND TO PLAZA

IT WAS A GROWING CONCERN ABOUT THIS PROCESS THAT LED TO A SMALL GROUP OF US TO MEET IN THE PLAZA HOTEL IN SEPTEMBER 1985. WE SHARED THREE PERCEPTIONS.

- FIRST, THAT THE GYRATIONS IN EXCHANGE RATES HAD PROVED DAMAGING.
- SECOND, THAT THE IMMEDIATE PROBLEM WAS THAT THE DOLLAR WAS MUCH TOO HIGH.
- AND THIRD, THAT THE TIME WAS RIGHT FOR THE AUTHORITIES OF THE MAJOR COUNTRIES TO GIVE THE MARKETS A CLEAR LEAD.

THE PLAZA AGREEMENT MARKED AN IMPORTANT STEP TOWARDS A MORE MANAGED SYSTEM. IN PRIVATE, WE DISCUSSED THE SCALE OF FALL WE SAW AS DESIRABLE, AND ALTHOUGH NO FIGURES WERE GIVEN IN PUBLIC, EVERYONE WAS AWARE THAT WE WERE LOOKING FOR SUBSTANTIAL CHANGES. WE AGREED TO COOPERATE TO BRING THAT ABOUT. AND THAT AGREEMENT PLAYED AN IMPORTANT ROLE IN SECURING A CONTINUING FALL IN THE DOLLAR OVER THE SUCCEEDING 15 MONTHS.

THE LOUVRE

THE LOUVRE ACCORD EARLIER THIS YEAR MARKED ANOTHER IMPORTANT STEP FORWARD--PLAZA II, AS I CALLED IT AT THE TIME TO EMPHASISE THE CONTINUITY. BY THEN THE BROAD OBJECTIVES AGREED AT PLAZA HAD BEEN ACHIEVED. THE YEN AND THE DEUTSCHE MARK HAD APPRECIATED BY AS MUCH AS 50 PER CENT OR SO AGAINST THE DOLLAR.

WE AGREED THAT, GIVEN THE POLICIES BEING FOLLOWED THE DOLLAR WAS BY THEN BROADLY IN LINE WITH ECONOMIC FUNDAMENTALS AND THAT THE INTERESTS OF THE WORLD ECONOMY WOULD BEST BE SERVED BY A PERIOD OF STABILITY, TO ALLOW TIME FOR THE MAJOR ECONOMIES TO ADJUST TO THE EXCHANGE

CHANGES THAT HAD OCCURRED. WE WERE NOT, OF COURSE, THINKING IN TERMS OF RIGID EXCHANGE RATES, BUT WE DID DISCUSS THE SCALE OF FLUCTUATION, AROUND THE THEN CURRENT LEVELS, WHICH WE WOULD NOT WISH TO SEE EXCEEDED. FIGURES WERE AGREED IN PRIVATE, BUT NOT, OF COURSE, REVEALED IN PUBLIC.

IN SPITE OF WIDESPREAD SCEPTICISM WHEN IT WAS FIRST CONCLUDED SEVEN MONTHS AGO, THE AGREEMENT HAS PROVED A SUCCESS.

MANAGED FLOATING

THE MOVE TO MANAGED FLOATING HAS BEEN MADE POSSIBLE BY TWO FUNDAMENTAL CHANGES:

- FIRST, WE HAVE AT LAST RETURNED TO A WORLD OF LOW INFLATION. THE AVERAGE INFLATION RATE FOR THE MAJOR SEVEN ECONOMIES HAS FALLEN FROM 12 PER CENT IN 1980 TO ABOUT 3 PER CENT TODAY. IN THE PROCESS INFLATION DIFFERENTIALS HAVE BEEN NARROWED CONSIDERABLY.

- SECOND, THERE IS NOW A CLEAR CONSENSUS AMONG THE MAJOR COUNTRIES ABOUT THE APPROACH TO ECONOMIC POLICY. AND WE ALL AGREE ON THE NEED FOR A GREATER RELIANCE ON MARKET MECHANISMS WITHIN THE FRAMEWORK OF A FIRM MONETARY AND FISCAL POLICY.

WE HAVE BEEN ABLE TO MAKE THIS REGIME WORK
BECAUSE:

- WE HAVE CHOSEN THE RIGHT TIME TO GIVE A LEAD TO THE MARKETS. IN THIS SENSE WE HAVE BEEN WORKING WITH, RATHER THAN AGAINST, THE GRAIN OF THE MARKETS.
- WE HAVE BEEN PREPARED TO COMMIT OURSELVES PUBLICLY TO APPROPRIATE AND CONSISTENT DOMESTIC POLICIES.
- IN PARTICULAR, WE HAVE ALL BEEN PREPARED IN PRACTICE TO GIVE SIGNIFICANT WEIGHT TO EXCHANGE RATES IN THE CONDUCT OF MONETARY POLICY.

- WE HAVE BEEN PREPARED TO BACK UP OUR AGREEMENT WITH CO-ORDINATED INTERVENTION, SOMETIMES ON A SUBSTANTIAL SCALE.

- WE HAVE DELIBERATELY NOT REVEALED DETAILS OF OUR ARRANGEMENTS. AND WE HAVE WORKED WITHIN MARGINS OF A SIZE SUFFICIENT TO ALLOW US THE NECESSARY TACTICAL ROOM FOR MANOEUVRE.

A REGIME FOR THE FUTURE

I BELIEVE THAT WE CAN AND SHOULD USE THE EXPERIENCE WE HAVE GAINED TO BUILD A MORE PERMANENT REGIME OF MANAGED FLOATING. I DO NOT SEE THE PAST TWO YEARS SIMPLY AS A TEMPORARY PHASE. OUR OBJECTIVES SHOULD BE CLEAR: TO MAINTAIN THE MAXIMUM STABILITY OF KEY EXCHANGE RATES, AND TO MANAGE ANY CHANGES THAT MAY BE NECESSARY IN AN ORDERLY WAY.

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LET ME MAKE IT CLEAR THAT I AM NOT SUGGESTING THAT WE CAN OR SHOULD RETURN TO BRETTON WOODS. THAT SYSTEM WAS UNDERMINED BY ITS RIGIDITY; THE MARGINS WERE TOO NARROW; IT REQUIRED A PREDICTABLE AND MECHANICAL RESPONSE FROM THE AUTHORITIES THAT MADE THEM AN EASY TARGET; NECESSARY REALIGNMENTS WERE POSTPONED TOO LONG AND CONSEQUENTLY, WHEN THEY CAME, THEY WERE INEVITABLY LARGE.

FOR THE FUTURE, IT IS IMPORTANT, THEREFORE, THAT WE CONTINUE TO KEEP AN ADEQUATE DEGREE OF FLEXIBILITY IN TERMS OF THE WIDTH OF THE BANDS WITHIN WHICH CURRENCIES ARE ABLE TO FLUCTUATE. AND, IF AND WHEN THE TIME COMES TO ADJUST ONE OF THE RATES, THAT ADJUSTMENT SHOULD BE MADE BY MOVING THE MIDPOINT WITHIN THE CONFINES OF THE EXISTING RANGE. THIS MEANS THAT THE MARKETS ARE NOT GIVEN A ONE-WAY BET, AND THE AUTHORITIES RETAIN TACTICAL FLEXIBILITY.

AS I HAVE ALREADY EMPHASISED, WHAT MADE THE PLAZA AND LOUVRE AGREEMENTS POSSIBLE WAS THAT THE COUNTRIES PARTICIPATING WERE, AND REMAIN, IN EFFECT, MEMBERS OF AN ANTI-INFLATIONARY CLUB, WITH A CLEAR COMMITMENT TO TAKING WHATEVER STEPS ARE NECESSARY TO CURB THEIR OWN INFLATION. IT IS VITAL THAT THAT COMMITMENT CONTINUES, INDIVIDUALLY AND COLLECTIVELY. A RESURGENCE OF INFLATION IN ANY INDIVIDUAL COUNTRY WOULD MAKE IT DIFFICULT FOR THAT COUNTRY TO REMAIN WITHIN THE CLUB

AT THE SAME TIME, WE MUST ALSO ENSURE THAT THERE IS NO PERSISTENT INFLATIONARY (OR FOR THAT MATTER DEFLATIONARY) BIAS FOR THE GROUP AS A WHOLE. THIS CAN BE HELPED BY:

- THE DEVELOPMENT OF INDICATORS FOR THE GROUP AS A WHOLE; THESE WILL BE MAINLY FINANCIAL BUT SPECIAL ATTENTION SHOULD ALSO BE GIVEN TO THE TREND OF WORLD COMMODITY PRICES;
- A NOMINAL FRAMEWORK FOR POLICY, IN TERMS EITHER OF A PATH FOR GDP GROWTH FOR THE GROUP AS A WHOLE, OR ONE FOR THE AVERAGE INFLATION RATE;
- AND A MEDIUM-TERM PERSPECTIVE WHEN SETTING OUT THE PATH AND IN GAUGING ACTUAL PERFORMANCE. WE SHOULD NOT BECOME INVOLVED IN AN EXERCISE IN SHORT-TERM FINE TUNING.

IN RECENT MEETINGS WE HAVE PUT A LOT OF EFFORT INTO DEVELOPING PERFORMANCE INDICATORS FOR INDIVIDUAL COUNTRIES. I HAVE TO SAY THAT I HAVE CONSIDERABLE DOUBTS WHETHER WE CAN USEFULLY TAKE THAT EXERCISE MUCH FURTHER. I BELIEVE IT WOULD BE FAR MORE USEFUL TO DEVOT

OUR EFFORTS TO MONITORING THE PERFORMANCE OF THE GROUP AS A WHOLE, SO THAT WE CAN ENSURE THAT WE MAINTAIN THE CORRECT NON-INFLATIONARY STANCE OF POLICY.

CURRENT ACCOUNT IMBALANCES

SOME FEARS HAVE BEEN EXPRESSED THAT THE LOUVRE AGREEMENT WILL BE UNDERMINED BY THE PERSISTENCE OF CURRENT ACCOUNT IMBALANCES BETWEEN THE MAJOR COUNTRIES. I DO NOT BELIEVE THIS NEED BE SO.

WHAT WE ARE SEEING IS NOT ALTOGETHER SURPRISING. IT IS THE FAMILIAR J-CURVE EFFECT, AND ALTHOUGH THE IMBALANCES REMAIN LARGE, TRADE VOLUMES ARE ADJUSTING.

IN ANY CASE, THERE IS NO 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. CLEARLY THERE ARE LIMITS TO THE ACCUMULATED EXTERNAL LIABILITIES OR ASSETS THAT CAN BE SUSTAINED

WITHOUT CREATING MAJOR ANXIETIES FOR CAPITAL MARKETS, BUT 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 NECESSARILY HAVE THEIR COUNTERPARTS IN CURRENT ACCOUNT SURPLUSES AND DEFICITS.

THE PRESENT COMBINATION OF DEFICITS AND SUPPLUSES HAS EMERGED OVER SEVERAL YEARS DURING WHICH THE GROWTH OF DOMESTIC DEMAND IN GERMANY AND JAPAN HAS BEEN CONSISTENTLY BELOW THE GROWTH OF OUTPUT, WHILE IN THE UNITED STATES IT HAS BEEN 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 ARTIFICIALLY 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.

CONCLUSION

IN CONCLUSION, I BELIEVE THAT EXTERNAL STABILITY SHOULD NOW COMPLEMENT THE INTERNAL FINANCIAL STABILITY THAT WE HAVE ALREADY ACHIEVED. IT WILL REMEDY A MAJOR WEAKNESS IN THE WORLD FINANCIAL ORDER AND PROVIDE A SOUNDER BASIS FOR THE PROSPERITY WE ALL SEEK,

TO: HM TREASURY FAX OPERATOR
FROM: UKDEL IMF/IBRD, WASHINGTON

PLEASE PASS THE FOLLOWING PAGES IMMEDIATELY TO:

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Mr. H.G. Walsh
Mr. Stephen Pickford *

and fax to:

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Mr. K.G.W. Frost

IMF/IBRD Groups, Bank of England (fax no. 601 5561)

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THANKS.

ll
DMR
30/ix/87

cc PS/EST
Sir P. Middleton
Mr Cassell
Mr Lovelle
Mr Peretz
Mr Mountfield
Mr S.W. Matthews
Mr Cropper
Mr Hudson
PS/Governor (Bank)
Mr Norgrove (No 10)



OUTGOING FAX

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KEYNES
CONFERENCE

15/9

CHANCELLOR'S INTRODUCTORY REMARKS TO THE
KEYNES CONFERENCE, 15 SEPTEMBER 1987

IT IS MY PLEASANT TASK TO WELCOME ALL
THOSE TAKING PART IN THIS CONFERENCE.

THE FACT THAT IT IS ENTITLED "KEYNES'S
GENERAL THEORY AFTER 50 YEARS" WHILE
BEING HELD ON THE 51ST ANNIVERSARY OF THE
PUBLICATION OF THAT SEMINAL WORK WILL,
INCIDENTALLY, SURPRISE ONLY THOSE
UNFAMILIAR WITH THE REVISIONIST HABITS OF
THE CENTRAL STATISTICAL OFFICE.

I WARMLY COMMEND THE NATIONAL ECONOMIC DEVELOPMENT OFFICE, AND IN PARTICULAR ~~THEIR~~ ^{ITS} ADMIRABLE ECONOMIC DIRECTOR, WALTER ELTIS, FOR THEIR ENTERPRISE IN ORGANISING THIS CONFERENCE.

IT HAS CLEARLY BEEN CAREFULLY DESIGNED TO ILLUMINATE MOST OF THE KEY ISSUES WHICH LIE AT THE HEART OF MACRO-ECONOMIC POLICY IN THE MODERN WORLD, AND WALTER HAS ASSEMBLED AN IMPRESSIVE CAST OF ECONOMISTS TO ARGUE THEM OUT.

"THE DIFFICULTY" WROTE KEYNES IN HIS FOREWORD TO THE GENERAL THEORY, "LIES NOT IN THE NEW IDEAS, BUT IN ESCAPING FROM THE

OLD ONES, WHICH RAMIFY, FOR THOSE BROUGHT UP AS MOST OF US HAVE BEEN, INTO EVERY CORNER OF OUR MINDS".

FOR MOST OF US HERE TODAY, I SUSPECT, THE IDEAS WITH WHICH WE WERE BROUGHT UP WERE KEYNESIAN IDEAS.

CERTAINLY THAT IS TRUE IN MY CASE, HAVING READ PPE AT OXFORD IN THE EARLY 'FIFTIES, WITH THE ENDEARINGLY ECCENTRIC ROY HARROD, KEYNES'S PUPIL AND BIOGRAPHER, AS MY ECONOMICS TUTOR.

OF COURSE, PRACTICAL KEYNESIANISM IN THOSE DAYS - AND I WAS ALWAYS MORE

INTERESTED IN THE PRACTICAL APPLICATION OF ECONOMICS TO POLICY: MY TASTE FOR THEORY WAS SATISFIED BY PHILOSOPHY - PRACTICAL KEYNESIANISM IN THOSE DAYS WAS RATHER DIFFERENT FROM WHAT IT WAS SUBSEQUENTLY TO BECOME.

THE FIRST TEXT I WAS GIVEN TO READ WAS THE 1944 EMPLOYMENT POLICY WHITE PAPER: THEN SEVEN YEARS OLD AND THE LOCUS CLASSICUS OF THE APPLICATION OF KEYNESIAN THEORY TO PRACTICAL POLICY.

ONE OR TWO QUOTATIONS CONVEY THE FLAVOUR:

"ACTION TAKEN BY THE GOVERNMENT TO
MAINTAIN EXPENDITURE WILL BE

FRUITLESS UNLESS WAGES AND PRICES
ARE KEPT REASONABLY STABLE.

THIS IS OF VITAL IMPORTANCE TO ANY
EMPLOYMENT POLICY, AND MUST BE
CLEARLY UNDERSTOOD BY ALL SECTORS OF
THE PUBLIC".

AGAIN,

"IT WOULD BE A DISASTER IF THE
INTENTION OF THE GOVERNMENT TO
MAINTAIN TOTAL EXPENDITURE WERE
INTERPRETED AS EXONERATING THE
CITIZEN FROM THE DUTY OF FENDING FOR
HIMSELF AND RESULTED IN A WEAKENING
OF PERSONAL ENTERPRISE.

FOR IF AN EXPANSION OF TOTAL EXPENDITURE WERE APPLIED TO CURE UNEMPLOYMENT OF A TYPE DUE, NOT TO ABSENCE OF JOBS, BUT TO FAILURE OF WORKERS TO MOVE TO PLACES AND OCCUPATIONS WHERE THEY WERE NEEDED, THE POLICY OF THE GOVERNMENT WOULD BE FRUSTRATED AND A DANGEROUS RISE IN PRICES MIGHT FOLLOW".

AND AGAIN,

"NONE OF THE MAIN PROPOSALS CONTAINED IN THIS PAPER INVOLVES DELIBERATE PLANNING FOR A DEFICIT ON THE NATIONAL BUDGET IN YEARS OF SUB-NORMAL TRADE ACTIVITY ... TO THE

EXTENT THAT THE POLICIES PROPOSED IN THIS PAPER AFFECT THE BALANCING OF THE BUDGET IN A PARTICULAR YEAR, THEY CERTAINLY DO NOT CONTEMPLATE ANY DEPARTURE FROM THE PRINCIPLE THAT THE BUDGET MUST BE BALANCED OVER A LONGER PERIOD".

AND SO ON.

IT WAS THE SUBSEQUENT DEGENERATION OF SO-CALLED KEYNESIAN POLICY THAT LED TO THE APPALLING AND DEEPLY DAMAGING HOLOCAUST OF INFLATION IN THE 1970s - SOMETHING WHICH KEYNES HIMSELF, THE AUTHOR OF A TREATISE ON MONEY, WOULD HAVE REGARDED WITH HORROR.

NEVERTHELESS IT IS HARD TO DENY THAT THERE IS INFLATIONARY BIAS AT THE HEART OF THE GENERAL THEORY.

IF IT TOOK SOME TIME FOR THE OVERRIDING NEED FOR MACRO-ECONOMIC POLICY TO BE DIRECTED TOWARDS THE SUPPRESSION OF INFLATION TO DAWN ON ME, I CAN ONLY PLEAD THE FACT THAT, IN THOSE DAYS, THE INFLATIONARY DANGER WAS LESS OBVIOUS.

DURING THE FIRST 10 YEARS AFTER I WENT DOWN FROM OXFORD, FOR EXAMPLE, INFLATION IN BRITAIN OSCILLATED ABOUT AN AVERAGE OF BARELY 3 PER CENT, WITH NO SIGN OF ANY ACCELERATION.

INSTEAD, MY GROWING DISENCHANTMENT BEGAN WITH, ON THE ONE HAND, DISTASTE FOR THE INCREASING TENDENCY FOR GOVERNMENT INTERVENTION IN THE MICRO-ECONOMY, OF WHICH INCOMES POLICY, OF WHICH I WAS PUBLICLY CRITICAL RIGHT FROM THE START, WAS PERHAPS THE PRIME BUT BY NO MEANS THE ONLY EXAMPLE; AND, ON THE OTHER HAND, DISAPPOINTMENT WITH BRITAIN'S OVERALL ECONOMIC PERFORMANCE COMPARED WITH OUR MAJOR COMPETITORS - ALTHOUGH HERE I WAS PERHAPS SLOW TO SPOT THAT OUR MOST SUCCESSFUL COMPETITORS WERE THOSE WHOSE POLICIES WERE LEAST INFLUENCED BY KEYNESIANISM.

UNLIKE MOST OF THE KEYNESIANS, KEYNES HIMSELF WAS OF COURSE A FREE-MARKET MAN THROUGH AND THROUGH.

INDEED, ONE OF THE PURPOSES OF THE GENERAL THEORY WAS TO DEMONSTRATE THAT UNEMPLOYMENT COULD BE CONQUERED IN THE CONTEXT OF A FREE ECONOMY - SOMETHING WHICH MANY IN THE 1930S HAD COME TO DOUBT, JUST AS MANY IN THE 1970S HAD COME TO DOUBT THAT INFLATION COULD BE CONQUERED IN A FREE DEMOCRACY.

BUT THE TURNING POINT, FOR ME AS NO DOUBT FOR MANY (THOUGH CLEARLY NOT ALL) OTHERS, WAS WHEN INFLATION BEGAN TO TAKE OFF IN THE LATE 'SIXTIES.

IT THEN BECAME CLEARLY THE PRE-EMINENT ECONOMIC CHALLENGE, AS IT HAS REMAINED EVER SINCE.

I SUPPOSE THE VIEWS I FINALLY ARRIVED AT CAN BE SUMMARISED IN TERMS OF TWO INTER-CONNECTED REVERSALS OF THE POST-WAR CONVENTIONAL WISDOM.

THE FIRST IS THE CONVICTION THAT THE RECIPE FOR ECONOMIC SUCCESS IS THE GREATEST PRACTICABLE MARKET FREEDOM WITHIN AN OVERALL FRAMEWORK OF FIRM FINANCIAL DISCIPLINE - PRECISELY HOW THAT FINANCIAL DISCIPLINE IS BEST APPLIED BEING ESSENTIALLY A SECOND-ORDER

QUESTION, THOUGH CLEARLY ONE OF
CONSIDERABLE PRACTICAL AND OPERATIONAL
IMPORTANCE.

THIS CONTRASTS WITH THE APPROACH THAT
CULMINATED IN THE DEBACLE OF THE 1970s, IN
WHICH EVER-INCREASING EROSION OF MARKET
FREEDOM WAS ACCOMPANIED BY THE
PROGRESSIVE ABANDONMENT OF FINANCIAL
DISCIPLINE.

THE SECOND REVERSAL IS THAT WHICH I SET
OUT IN MY MAIS LECTURE IN 1984.

THAT IS TO SAY, INSTEAD OF SEEKING TO USE
MACRO-ECONOMIC POLICY TO PROMOTE GROWTH
AND MICRO-ECONOMIC POLICY TO SUPPRESS

INFLATION - OR THE SYMPTOMS OF
INFLATION - WE MUST DIRECT MACRO-ECONOMIC
POLICY TO THE SUPPRESSION OF INFLATION
AND RELY ON MICRO-ECONOMIC (OR SUPPLY
SIDE) POLICY TO PROVIDE THE CONDITIONS
CONDUCTIVE TO IMPROVED ECONOMIC
PERFORMANCE IN TERMS OF GROWTH AND
EMPLOYMENT.

I BELIEVE THAT ANY DISPASSIONATE OBSERVER
MUST CONCEDE THAT, DESPITE THE PROBLEMS
THAT UNDOUBTEDLY REMAIN, THE EXPERIENCE
OF THE PAST EIGHT YEARS, AND IN
PARTICULAR THE PAST FIVE YEARS, HAS
VINDICATED THIS NEW (THOUGH IN HISTORICAL
TERMS OLD) APPROACH.

THE BUDGET DEFICIT, EVEN WITHOUT THE BENEFIT OF PRIVATISATION PROCEEDS, HAS BEEN MORE THAN HALVED, AND REAL INTEREST RATES HAVE BEEN CONSISTENTLY HISTORICALLY HIGH, WHILE A SUCCESSION OF SUPPLY SIDE REFORMS DESIGNED TO ALLOW THE MARKET TO WORK BETTER HAVE BEEN INTRODUCED.

THE RESULT HAS NOT MERELY BEEN FIVE YEARS OF LOW INFLATION - THOUGH IT NEEDS TO BE LOWER STILL - BUT A SUSTAINED PERIOD OF GROWTH AT SOME 3 PER CENT A YEAR THAT IS ALMOST UNPRECEDENTED IN BRITISH ECONOMIC HISTORY AND DURING WHICH WE HAVE OUT-PERFORMED MOST OF OUR PRINCIPAL COMPETITORS.

I MENTIONED EARLIER MY CONCERN THAT THE GENERAL THEORY, DESPITE THE FACT THAT IT IS UNQUESTIONABLY A WORK OF CONSIDERABLE SUBSTANCE WHICH HAS PROFOUNDLY INFLUENCED ECONOMIC THINKING THROUGHOUT THE WORLD, AND INDEED DESPITE KEYNES'S EARLIER WORKS, EMBODIES A SOMEWHAT CAVALIER ATTITUDE TOWARDS INFLATION.

THIS IS SEEN, FOR EXAMPLE, IN THE NOTION, IMPLICIT IN THE GENERAL THEORY, THAT INFLATION IS A USEFUL WAY OF CURING UNEMPLOYMENT BY REDUCING REAL WAGES.

THIS ATTITUDE WAS NO DOUBT A PRODUCT OF THE CIRCUMSTANCES OF THE GREAT SLUMP IN WHICH THE BOOK WAS WRITTEN.

BUT IT IS SHARED, WITH NO SIMILAR EXCUSE,
BY THOSE WHO ADVOCATE SO-CALLED KEYNESIAN
POLICIES TODAY.

IT IS NOT SHARED BY THIS GOVERNMENT,
NOR, INDEED, IS IT SHARED BY THE BRITISH
PEOPLE - OTHERWISE I DO NOT FOR A MOMENT
BELIEVE WE WOULD HAVE BEEN SO
CONVINCINGLY RE-ELECTED TO A THIRD TERM
OF OFFICE.

PEOPLE KNOW IN THEIR BONES, NOW, NOT
MERELY THE IMMENSE ECONOMIC AND SOCIAL
HARM THAT ACCELERATING INFLATION IS
LIKELY TO INFLICT, BUT ALSO HOW DIFFICULT
AND PAINFUL IT IS TO BRING IT UNDER

CONTROL ONCE IT HAS BEEN ALLOWED TO TAKE OFF.

MOREOVER, LOOKING BACK, IT MUST SURELY BE CLEAR THAT THE SUCCESS OF SO-CALLED KEYNESIAN POLICIES IN THE 'FIFTIES WAS NOT SOMETHING THAT CAN NOW BE REPEATED.

IT IS TRUE THAT THE EXCHANGE RATE REGIME OF BRETTON WOODS IMPOSED A DEGREE OF FINANCIAL DISCIPLINE WHICH PREVENTED THE EXCESSES THAT WERE LATER TO OCCUR.

BUT IT IS ALSO, I BELIEVE, THE CASE THAT FOR MANY YEARS AFTER THE WAR WE WERE LIVING IN A TRANSITIONAL PHASE: NOT ONLY DID MONEY ILLUSION PERSIST FOR A

CONSIDERABLE TIME, BUT EVEN THOUGH FINANCIAL DISCIPLINE WAS GRADUALLY BEING ERODED, PEOPLE FOR SOME TIME BEHAVED AS IF IT WERE STILL IN PLACE - JUST AS FOR SOME YEARS AFTER THE RESTORATION OF FINANCIAL DISCIPLINE BY THE PRESENT GOVERNMENT, PEOPLE BEHAVED AS IF IT WERE NOT THERE. HENCE TO A CONSIDERABLE EXTENT THE HIGH LEVEL OF UNEMPLOYMENT WE HAVE SADLY EXPERIENCED.

I SHALL NOT, I REGRET, BE ABLE TO STAY TO LISTEN TO YOUR DISCUSSIONS, BUT I HAVE ARRANGED TO BE GIVEN A FULL REPORT OF THEM.

FOR YOU WILL BE DEALING WITH SOME OF THE
KEY QUESTIONS OF PRACTICAL IMPORTANCE TO
ME IN THE DISCHARGE OF MY
RESPONSIBILITIES, AND I LOOK FORWARD TO
BENEFITTING FROM YOUR DELIBERATIONS.

CHANCELLOR'S INTRODUCTORY REMARKS TO THE KEYNES CONFERENCE,
15 SEPTEMBER 1987

It is my pleasant task to welcome all those taking part in this Conference.

The fact that it is entitled "Keynes's General Theory after 50 Years" while being held on the 51st anniversary of the publication of that seminal work will, incidentally, surprise only those unfamiliar with the revisionist habits of the Central Statistical Office.

I warmly commend the National Economic Development Office, and in particular their admirable Economic Director, Walter Eltis, for their enterprise in organising this Conference. It has clearly been carefully designed to illuminate most of the key issues which lie at the heart of macro-economic policy in the modern world, and Walter has assembled an impressive cast of economists to argue them out.

"The difficulty" wrote Keynes in his Foreword to the General Theory, "lies not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds".

For most of us here today, I suspect, the ideas with which we were brought up were Keynesian ideas. Certainly that is true in my case, having read PPE at Oxford in the early 'fifties, with the endearingly eccentric Roy Harrod, Keynes's pupil and biographer, as my economics tutor.

Of course, practical Keynesianism in those days - and I was always more interested in the practical application of economics to policy: my taste for theory was satisfied by philosophy - practical Keynesianism in those days was rather different from what it was subsequently to become.

The first text I was given to read was the 1944 Employment Policy White Paper: then seven years old and the locus classicus of the application of Keynesian theory to practical policy. One or two quotations convey the flavour:

"Action taken by the Government to maintain expenditure will be fruitless unless wages and prices are kept reasonably stable. This is of vital importance to any employment policy, and must be clearly understood by all sectors of the public".

Again,

"It would be a disaster if the intention of the Government to maintain total expenditure were interpreted as exonerating the citizen from the duty of fending for himself and resulted in a weakening of personal enterprise. For if an expansion of total expenditure were applied to cure unemployment of a type due, not to absence of jobs, but to failure of workers to move to places and occupations where they were needed, the policy of the Government would be frustrated and a dangerous rise in prices might follow".

And again,

"None of the main proposals contained in this Paper involves deliberate planning for a deficit on the National Budget in years of sub-normal trade activity ... to the extent that the policies proposed in this Paper affect the balancing of the Budget in a particular year, they certainly do not contemplate any departure from the principle that the budget must be balanced over a longer period".

And so on.

It was the subsequent degeneration of so-called Keynesian policy that led to the appalling and deeply damaging holocaust of inflation in the 1970s - something which Keynes himself, the author of A Treatise on Money, would have regarded with horror. Nevertheless it is hard to deny that there is inflationary bias at the heart of the General Theory.

If it took some time for the overriding need for macro-economic policy to be directed towards the suppression of inflation to dawn

on me, I can only plead the fact that, in those days, the inflationary danger was less obvious. During the first 10 years after I went down from Oxford, for example, inflation in Britain oscillated about an average of barely 3 per cent, with no sign of any acceleration.

Instead, my growing disenchantment began with, on the one hand, distaste for the increasing tendency for Government intervention in the micro-economy, of which incomes policy, of which I was publicly critical right from the start, was perhaps the prime but by no means the only example; and, on the other hand, disappointment with Britain's overall economic performance compared with our major competitors - although here I was perhaps slow to spot that our most successful competitors were those whose policies were least influenced by Keynesianism.

Unlike most of the Keynesians, Keynes himself was of course a free-market man through and through. Indeed, one of the purposes of the General Theory was to demonstrate that unemployment could be conquered in the context of a free economy - something which many in the 1930s had come to doubt, just as many in the 1970s had come to doubt that inflation could be conquered in a free democracy.

But the turning point, for me as no doubt for many (though clearly not all) others, was when inflation began to take off in the late 'sixties. It then became clearly the pre-eminent economic challenge, as it has remained ever since.

I suppose the views I finally arrived at can be summarised in terms of two inter-connected reversals of the post-War conventional wisdom. The first is the conviction that the recipe for economic success is the greatest practicable market freedom within an overall framework of firm financial discipline - precisely how that financial discipline is best applied being essentially a second-order question, though clearly one of considerable practical and operational importance. This contrasts with the approach that culminated in the debacle of the 1970s, in which ever-increasing erosion of market freedom was accompanied by the progressive abandonment of financial discipline.

The second reversal is that which I set out in my Mais lecture in 1984. That is to say, instead of seeking to use macro-economic policy to promote growth and micro-economic policy to suppress inflation - or the symptoms of inflation - we must direct macro-economic policy to the suppression of inflation and rely on micro-economic (or supply side) policy to provide the conditions conducive to improved economic performance in terms of growth and employment.

I believe that any dispassionate observer must concede that, despite the problems that undoubtedly remain, the experience of the past eight years, and in particular the past five years, has vindicated this new (though in historical terms old) approach.

The budget deficit, even without the benefit of privatisation proceeds, has been more than halved, and real interest rates have been consistently historically high, while a succession of supply side reforms designed to allow the market to work better have been introduced.

The result has not merely been five years of low inflation - though it needs to be lower still - but a sustained period of growth at some 3 per cent a year that is almost unprecedented in British economic history and during which we have out-performed most of our principal competitors.

I mentioned earlier my concern that the General Theory, despite the fact that it is unquestionably a work of considerable substance which has profoundly influenced economic thinking throughout the world, and indeed despite Keynes's earlier works, embodies a somewhat cavalier attitude towards inflation. This is seen, for example, in the notion, implicit in the General Theory, that inflation is a useful way of curing unemployment by reducing real wages. This attitude was no doubt a product of the circumstances of the great slump in which the book was written. But it is shared, with no similar excuse, by those who advocate so-called Keynesian policies today.

It is not shared by this Government. Nor, indeed, is it shared by the British people - otherwise I do not for a moment believe we would have been so convincingly re-elected to a third term of office. People know in their bones, now, not merely the immense economic and social harm that accelerating inflation is likely to inflict, but also how difficult and painful it is to bring it under control once it has been allowed to take off. Moreover, looking back, it must surely be clear that the success of so-called Keynesian policies in the 'fifties was not something that can now be repeated.

It is true that the exchange rate regime of Bretton Woods imposed a degree of financial discipline which prevented the excesses that were later to occur. But it is also, I believe, the case that for many years after the War we were living in a transitional phase: not only did money illusion persist for a considerable time, but even though financial discipline was gradually being eroded, people for some time behaved as if it were still in place - just as for some years after the restoration of financial discipline by the present Government, people behaved as if it were not there: hence to a considerable extent the high level of unemployment we have sadly experienced.

I shall not, I regret, be able to stay to listen to your discussions, but I have arranged to be given a full report of them. For you will be dealing with some of the key questions of practical importance to me in the discharge of my responsibilities, and I look forward to benefitting from your deliberations.

FT CENTENARY
DINNER

11/2/88

RM14.8

FINANCIAL TIMES DINNER, 11 FEBRUARY

MR CHAIRMAN, MY LORD MAYOR,

LORD CHANCELLOR, YOUR EXCELLENCIES,

YOUR GRACES, MY LORDS, SHERIFFS,

LADIES AND GENTLEMEN.

~~THIS IS A FINE COPY FROM THE FINANCIAL TIMES~~ ^{CARRIED AT} ~~THE FINANCIAL TIMES~~

IT MUST BE CLEAR TO ALL OF YOU THAT I AM
NOT MAKING THIS SPEECH.

NOR INDEED AM I HERE TONIGHT WITH THE ...

FINANCIAL TIMES.

FOR I AM IN BUDGET PURDAH.

AND IT IS A WELL-ESTABLISHED AND
SOUNDLY-BASED TRADITION THAT, DURING THE
MONTH OR TWO IMMEDIATELY PRIOR TO THE
BUDGET, THE CHANCELLOR OF THE EXCHEQUER

MAKES NO SPEECHES AND AVOIDS THE COMPANY OF PRETTY WELL EVERYONE, BUT MOST PARTICULARLY OF THE PRESS.

BUT TONIGHT, FOR THE FIRST TIME IN ALMOST FIVE YEARS AS CHANCELLOR, I HAVE GIVEN MYSELF A SPECIAL DISPENSATION TO BREAK THE IRON RULES OF BUDGET PURDAH.

I HAVE DONE SO FOR TWO REASONS.

FIRST, THIS IS A GREAT AND SPECIAL OCCASION, MARKING AS IT DOES THE CENTENARY OF ONE OF THE GREAT NEWSPAPERS OF THE WORLD.

AND SECOND, BECAUSE I MYSELF HAD THE GREAT GOOD FORTUNE TO BE PART OF THE FT DURING ITS GOLDEN AGE, IN THE 'FIFTIES, UNDER THE OUTSTANDING EDITORSHIP OF GORDON NEWTON. IT WAS AN EXPERIENCE, AND AN EDUCATION, THAT HAS STOOD ME IN GOOD STEAD EVER SINCE.

AND OF COURSE, IT WAS TREMENDOUS FUN.

I HAVE NO TIME, IN MY ^{VERY} BRIEF REMARKS THIS EVENING, TO CHART THE HISTORY OF THE FIRST HUNDRED YEARS OF THE FT.

IN ANY CASE, IT IS WHOLLY UNNECESSARY ^{FOR ME} TO DO SO.

FOR THE PAPER HAS ITSELF COMMISSIONED A GREAT WORK OF PIETY, BY YOUNG DR DAVID KYNASTON, TO MARK THE CENTENARY, WHICH DOES JUST THAT.

I ~~CAN'T~~ SAY THAT I HAVE YET READ IT FROM COVER TO COVER.

IT IS, AS GORDON NEWTON WAS WONT TO SAY, A VERITABLE MAGNUS OPUM.

AND I DON'T HAVE MUCH TIME TO READ OPUMS IN THIS JOB.

BUT I HAVE DIPPED INTO IT.

I BEGAN, WHERE I SUPPOSE WE ALL DO, WITH THE INDEX.

LOOKING THROUGH THE REFERENCES TO MYSELF, I TURNED UP A BRIEF ACCOUNT OF THE CHOICE OF THE SUCCESSOR TO GORDON NEWTON AS EDITOR, AND READ THE FOLLOWING:

"THERE WAS SOME POSSIBILITY OF NIGEL LAWSON RETURNING TO THE FOLD, BUT WHEN APPROACHED HE EXPRESSED UNWILLINGNESS TO SERVE AN INITIAL PROBATIONARY PERIOD AS EDITOR OF THE INVESTORS CHRONICLE."

I HAVE TO SAY I STILL FIND IT HARD TO DECIDE WHICH WAS THE GREATER INSULT: THE SUGGESTION THAT I SHOULD EDIT THE

INVESTORS CHRONICLE OR THE VIEW THAT I
NEEDED A PROBATIONARY PERIOD.

BUT ALL'S WELL THAT ENDS WELL.

AND I AM PARTICULARLY GLAD THAT THE PAPER
NOW HAS AS ITS EDITOR MY PROTÉGÉ, GEOFF
OWEN, WHO STARTED 30 YEARS AGO AS A
FEATURE WRITER ON THE FINANCIAL TIMES WHEN I WAS FEATURES
EDITOR.

WITH THE EXCEPTION OF SAM BRITTON, THE
~~UNDOUBTED~~ ADAMS STAR OF ~~THE~~ FT AND FOR MANY
YEARS PAST, MOST OF US FROM THE 'FIFTIES
VINTAGE HAVE LONG SINCE GONE OUR SEPARATE
WAYS, AND A NEW GENERATION WITH NEW

WAYS

~~CONVENTIONS~~ HAS TAKEN OVER - NOT IN ALL RESPECTS A CHANGE FOR THE BETTER.

DR KYNASTON'S OPUM QUOTES THIS, FROM AN FT LEADER IN THE 'FIFTIES: (WRITTEN, I SUSPECT, BY WILLIAM ROSS-MOSES)

"THE RIGHT RELATIONSHIP BETWEEN CHANCELLOR AND TREASURY OFFICIALS IS PERHAPS THAT OF A VIGOROUS SWASHBUCKLER WHOM THE OFFICIALS CONTRIVE TO RESTRAIN."

NOWADAYS THIS TIMELESS AND LIGHT-HEARTED OBSERVATION IS SERVED UP ANNUALLY AS A SENSATIONAL NEWS STORY.

BUT THE FT REMAINS, AS I HAVE ALREADY OBSERVED, ONE OF THE GREAT NEWSPAPERS OF THE WORLD - AND, INDEED, A NATIONAL INSTITUTION.

FOR ALL ITS FAULTS, IT WOULD IN MY ~~PERSONAL~~ ^{VIEW} OPINION BE A SAD DAY IF IT WERE EVER TO LOSE ITS INDEPENDENCE OF OTHER NEWSPAPER GROUPS.

IT IS GOOD TO SEE SO MANY OLD FRIENDS AND FORMER COLLEAGUES HERE THIS EVENING.

IT WOULD BE INVIDIOUS TO MENTION SOME AND NOT OTHERS.

BUT I AM PARTICULARLY PLEASED YOU HAVE INVITED PAUL VOLCKER, THE OUTSTANDING

CENTRAL BANKER OF HIS GENERATION, TO
SPEAK THIS EVENING.

HE AND I HAVE BEEN COLLEAGUES OVER THE
YEARS IN THE G5 AND G7 - AND ON ONE
NEVER-TO-BE-FORGOTTEN OCCASION, THE G6.

AND NOW, UNLIKE ME, HE IS FREE TO SPEAK,
UNFETTERED BY THE CONSTRAINTS NOT ONLY OF
BUDGET PURDAH, BUT FOR ALMOST THE FIRST
TIME IN A VERY LONG AND IMMENSELY
DISTINGUISHED CAREER, UNFETTERED BY THE
CONSTRAINTS OF PUBLIC OFFICE OF ANY KIND.

TIMID HIS EXIT TO PERFECTION - WHO NOT PERHAPS FOR REST OF US

IN EVERY SENSE, HE IS A MAN OF EXCEPTIONAL
STATURE - WHICH MAKES ALL THE MORE
REMARKABLE HIS ACHIEVEMENT, DURING A
PERIOD OF PARTICULARLY DELICATE

INTERNATIONAL FINANCIAL NEGOTIATIONS IN THE 'SEVENTIES, OF GETTING INTO AND OUT OF TOKYO UNNOTICED BY THE PRESS.

TONIGHT'S

SO I GLADLY LEAVE THE MEAT IN ~~THE~~ SANDWICH TO PAUL.

BUT I WOULD JUST, VERY BRIEFLY, SAY THIS. THE OLD DEBATE BETWEEN KEYNESIANISM AND MONETARISM IS BECOMING INCREASINGLY DATED.

THE BATTLES THAT HAD TO BE FOUGHT HAVE BEEN FOUGHT AND WON.

A NEW CONSENSUS HAS EMERGED OVER THE CONDUCT OF DOMESTIC ECONOMIC POLICY, WITH FINANCIAL DISCIPLINE AT ITS HEART, AND

WHICH ONLY A FEW DINOSAURS WOULD NOW DISPUTE.

THE PROBLEMS FOR THE FUTURE LIE IN THE INTERNATIONAL SPHERE, AND THE IMPACT OF THESE FORCES ON OUR NATIONAL ECONOMIES.

HOW TO COME TO TERMS WITH THE IMPLICATIONS OF GLOBAL FINANCIAL MARKETS OF ALL KINDS, FULLY EQUIPPED AS THEY ARE WITH THE LATEST DEVELOPMENTS IN INFORMATION TECHNOLOGY.

WHAT IS THE RIGHT BALANCE BETWEEN SUPERVISORY REGULATION AND MARKET FREEDOM?

WHAT IS THE PRACTICAL SCOPE, AND WHAT ARE THE PRACTICAL LIMITS, OF INTERNATIONAL CO-OPERATION IN A WORLD OF GLOBAL

FINANCIAL MARKETS AND INDEPENDENT SOVEREIGN STATES?

THESE ARE THE ISSUES WE NEED URGENTLY TO BE ADDRESSING NOW.

HOW MUCH EASIER IT ALL WAS WHEN THE FINANCIAL TIMES WAS FIRST LAUNCHED, A HUNDRED YEARS AGO - A TIME WHEN IT TOOK ELEVEN DAYS TO GET TO NEW YORK WHEN THE WEATHER WAS GOOD, AND A FORTNIGHT IF IT WAS BAD.

AND FORTY DAYS TO GET TO TOKYO BY THE QUICK ROUTE VIA ITALY, EGYPT AND SHANGHAI.

AND WHEN GOVERNMENT WAS SO MUCH SMALLER
AND BUDGET SPEECHES SO MUCH LONGER.

IN PREPARATION FOR MY OWN NEXT EFFORT ON
THE IDES OF MARCH, ^{- HISTORIC OCCASION} I TOOK A LOOK AT THE
BUDGET SPEECH OF MARCH 1888.

THE CONSERVATIVE CHANCELLOR OF THE
EXCHEQUER THEN WAS GOSCHEN - REMEMBERED
NOW PROBABLY ONLY AS THE MAN
LORD RANDOLPH CHURCHILL FORGOT.

BUT HIS BUDGET SPEECH OF 1888, OF WELL
OVER THREE HOURS IN DURATION, ~~WELL~~ REPAYS
READING.

HE CLEARLY BELIEVED IN KEEPING A BEADY EYE
ON THE BANK OF ENGLAND.

AS HE INFORMED THE HOUSE,

"THERE HAS ALSO BEEN A SAVING OF
£15,000 TO WHICH I SHOULD LIKE TO
ALLUDE.

IT IS A SAVING WHICH I HAVE SECURED
BY WATCHING MORE CLOSELY THE
BALANCES AT THE BANK OF ENGLAND THAN
HAS HITHERTO BEEN DONE."

HE WAS COMMENDABLY GENEROUS TO HIS
COLLEAGUES.

IN HIS OWN WORDS,

"I AM ALSO THANKFUL - AND AS
CHANCELLOR OF THE EXCHEQUER I SAY
THIS - NOT AS A MEMBER OF THE

CABINET - I AM ESPECIALLY GRATEFUL TO THE FOREIGN MINISTER THAT WE HAVE BEEN ABLE TO KEEP OUT OF THOSE PETTY WARS WHICH BREAK IN SO UNEXPECTEDLY SOMETIMES UPON THE ASSETS OF THE CHANCELLOR OF THE EXCHEQUER, AND WHICH UPSET HIS BEST CALCULATIONS AND DESTROY HIS MOST SANGUINE HOPES."

AND HE WAS, AS EVER, PLAGUED BY THE PROBLEM OF EXCESSIVE LOCAL GOVERNMENT SPENDING. AS HIS GRAND:

"AND HERE, I AM PLACED IN A SOMEWHAT UNPLEASANT POSITION - NAMELY, THAT,

HAVING A SATISFACTORY BALANCE OF £2,377,000 TO DISPOSE OF, I SEE HAVOC AND DEVASTATION WROUGHT UPON THAT BALANCE BY MY RT. HON. FRIEND THE PRESIDENT OF THE LOCAL GOVERNMENT BOARD."

DESPITE THAT, BY INCREASING INDIRECT TAXATION - INCLUDING AN EXTRA TAX ON BOTTLED WINES AND A NEW TAX ON WHAT HE DESCRIBED AS "PLEASURE HORSES" - GOSCHEN WAS ABLE IN 1888 TO ACHIEVE HIS OVERRIDING OBJECTIVE OF REDUCING INCOME TAX FROM SEVENPENCE IN THE £ - OR SOME 3 PER CENT IN TODAY'S TERMS - TO WHAT HE CONSIDERED

THE CORRECT LEVEL FOR PEACETIME OF SIXPENCE IN THE £.

WITHIN THE PRIVACY OF THESE FOUR WALLS, AND STRICTLY OFF THE RECORD, I MUST WARN YOU THAT I DO NOT EXPECT TO BE ABLE TO EMULATE GOSCHEN NEXT MONTH.

BUT IF MUCH HAS CHANGED SINCE 1888, SOME THINGS HAVE NOT.

LONDON THEN WAS THE FINANCIAL CAPITAL OF THE WORLD.

THE COMPETITION IS A GOOD DEAL FIERCER TODAY; BUT FREED FROM UNNECESSARY RESTRICTIONS AND CONTROLS, AND IN A

BENIGN POLITICAL AND ECONOMIC CLIMATE,
LONDON HAS ONCE AGAIN THE CHANCE TO
ESTABLISH ITSELF AS THE FINANCIAL CAPITAL
OF THE WORLD.

AND THAT IS YET ANOTHER GOOD REASON, ON
THIS HISTORIC OCCASION, TO ASK YOU TO RISE
AND DRINK A TOAST TO THE NEWSPAPER ON
WHICH SO MANY OF US HAVE AT ONE TIME OR
ANOTHER WORKED, AND WHICH WE HONOUR ON ITS
CENTENARY ^{TODAY} ~~DAY~~ - THE FINANCIAL TIMES.

**CHANCELLOR OF THE EXCHEQUER'S SPEECH AT THE FINANCIAL TIMES
CENTENARY DINNER, 11 FEBRUARY**

It must be clear to all of you that I am not making this speech. Nor indeed am I here tonight with the Financial Times. For I am in Budget Purdah. And it is a well-established and soundly-based tradition that, during the month or two immediately prior to the Budget, the Chancellor of the Exchequer makes no speeches and avoids the company of pretty well everyone, but most particularly of the press.

But tonight, for the first time in almost five years as Chancellor, I have given myself a special dispensation to break the iron rules of Budget Purdah. I have done so for two reasons.

First, this is a great and special occasion, marking as it does the centenary of one of the great newspapers of the world.

And second, because I myself had the great good fortune to be part of the FT during its golden age, in the 'fifties, under the outstanding editorship of Gordon Newton. It was an experience, and an education, that has stood me in good stead ever since. And of course, it was tremendous fun.

I have no time, in my brief remarks this evening, to chart the history of the first hundred years of the FT. In any case, it is wholly unnecessary to do so. For the paper has itself commissioned a great work of piety, by young Dr David Kynaston, to mark the centenary, which does just that. I cannot say that I have yet read it from cover to cover. It is, as Gordon Newton was wont to say, a veritable magnum opus. And I don't have much time to read opus in this job. But I have dipped into it.

I began, where I suppose we all do, with the index. Looking through the references to myself, I turned up a brief account of the choice of the successor to Gordon Newton as editor, and read the following:

"There was some possibility of Nigel Lawson returning to the fold, but when approached he expressed unwillingness to serve an initial probationary period as Editor of the Investors Chronicle."

I have to say I still find it hard to decide which was the greater insult: the suggestion that I should edit the Investors Chronicle or the view that I needed a probationary period. But all's well that ends well.

And I am particularly glad that the paper now has as its Editor my protege, Geoff Owen, who started 30 years ago as a feature writer when I was Features Editor.

With the exception of Sam Brittan, the undoubted star of today's FT and for many years past, most of us from the 'fifties vintage have long since gone our separate ways, and a new generation with new conventions has taken over - not in all respects a change for the better. Dr Kynaston's opum quotes this, from an FT leader in the 'fifties:

"The right relationship between Chancellor and Treasury officials is perhaps that of a vigorous swashbuckler whom the officials contrive to restrain."

Nowadays this timeless and light-hearted observation is served up annually as a sensational news story.

But the FT remains, as I have already observed, one of the great newspapers of the world - and, indeed, a national institution. For all its faults, it would in my personal opinion be a sad day if it were ever to lose its independence of other newspaper groups.

It is good to see so many old friends and former colleagues here this evening. It would be invidious to mention some and not others. But I am particularly pleased you have invited Paul Volcker, the outstanding central banker of his generation, to speak this evening. He and I have been colleagues over the years in the G5 and G7 - and on one never-to-be-forgotten occasion, the G6. And

now, unlike me, he is free to speak unfettered by the constraints not only of Budget Purdah, but for almost the first time in a very long and immensely distinguished career, unfettered by the constraints of public office of any kind. In every sense, he is a man of exceptional stature - which makes all the more remarkable his achievement, during a period of particularly delicate international financial negotiations in the 'seventies, of getting into and out of Tokyo unnoticed by the press.

So I gladly leave the meat in the sandwich to Paul. But I would just, very briefly, say this. The old debate between Keynesianism and monetarism is becoming increasingly dated. The battles that had to be fought have been fought and won. A new consensus has emerged over the conduct of domestic economic policy, with financial discipline at its heart, and which only a few dinosaurs would now dispute. The problems for the future lie in the international sphere, and the impact of these forces on our national economies. How to come to terms with the implications of global financial markets of all kinds, fully equipped as they are with the latest developments in information technology. What is the right balance between supervisory regulation and market freedom? What is the practical scope, and what are the practical limits, of international co-operation in a world of global financial markets and independent sovereign states? These are the issues we need urgently to be addressing now.

How much easier it all was when the Financial Times was first launched, a hundred years ago - a time when it took eleven days to get to New York when the weather was good, and a fortnight if it was bad. And forty days to get to Tokyo by the quick route via Italy, Egypt and Shanghai. And when Government was so much smaller and Budget speeches so much longer.

In preparation for my own next effort on the Ides of March, I took a look at the Budget speech of March 1888. The Conservative Chancellor of the Exchequer then was Goschen - remembered now probably only as the man Lord Randolph Churchill forgot. But his Budget speech of 1888, of well over three hours in duration, well

repays reading. He clearly believed in keeping a beady eye on the Bank of England. As he informed the House,

"There has also been a saving of £15,000 to which I should like to allude. It is a saving which I have secured by watching more closely the balances at the Bank of England than has hitherto been done."

He was commendably generous to his colleagues. In his own words,

"I am also thankful - and as Chancellor of the Exchequer I say this - not as a Member of the Cabinet - I am especially grateful to the Foreign Minister that we have been able to keep out of those petty wars which break in so unexpectedly sometimes upon the assets of the Chancellor of the Exchequer, and which upset his best calculations and destroy his most sanguine hopes."

And he was, as ever, plagued by the problem of excessive local government spending:

"And here, I am placed in a somewhat unpleasant position - namely, that, having a satisfactory balance of £2,377,000 to dispose of, I see havoc and devastation wrought upon that balance by my Rt. Hon. Friend the President of the Local Government Board."

Despite that, by increasing indirect taxation - including an extra tax on bottled wines and a new tax on what he described as "pleasure horses", Goschen was able in 1888 to achieve his overriding objective of reducing income tax from sevenpence in the £ - or some 3 per cent in today's terms - to what he considered the correct level for peacetime of sixpence in the £.

Within the privacy of these four walls, and strictly off the record, I must warn you that I do not expect to be able to emulate Goschen next month.

But if much has changed since 1888, some things have not. London then was the financial capital of the world. The competition is a good deal fiercer today; but freed from unnecessary restrictions

and controls, and in a benign political and economic climate, London has once again the chance to establish itself as the financial capital of the world. And that is yet another good reason, on this historic occasion, to ask you to rise and drink a toast to the newspaper on which so many of us have at one time or another worked, and which we honour on its centenary day - the Financial Times.

A

A sturdy independence, not just of other groups, but of dogmatic political affiliation has long been a characteristic of the FT. But the paper has hardly ~~caused~~^{exacerbated} controversy.

For example, the ancestor paper, the Financial News, launched a fierce ^{attack} on Lloyd George's 'people's Budget' of 1909.

One of its writers, a man named Lawson, wrote a series of articles, subsequently reprinted as a pamphlet with the collective title 'Lloyd George Finance; or, the Gentle Art of Robbing Hen-Roosts'.

However, Chancellor's have been able, at times, to have the last word.

According to Doctor Kynaston, Paul Einzig, who became Political Correspondent of the FT at the start of World War II, was a particular and consistent thorn in the Government's side.

One of my predecessors, Kingsley Wood, remarked 'the first thing I do every morning is to read Einzig's column in the Financial News, and it always makes me sick'.

His successor, Sir John Anderson, felt so strongly about it that he tried to have Einzig arrested, and in the end persuaded the editor of the Financial News to deliver an ultimatum to Einzig 'forbidding publication of anything likely to displease the Treasury'.

Apparently Einzig complied.

But it was not a tradition that lasted.

Which is probably a good job.

○ FT SPEECH: POSSIBLE NEW
PARA FOR CONCLUSION 1

B

I do not intend to take out
a crystal ball and speculate
on what the FT will be
reporting in 100 years' time.

It is difficult enough to forecast
the economy a year ahead -
though I would say that the
Treasury has a rather better
record at this than most of
the organisations reported in the
FT.

2

But let me just say this.

Whatever developments take
place - in economic policy,
in international economic
co-operation, and in the nature
of markets in London and abroad -
all ~~the~~ of us who are involved will
benefit immeasurably from the
issues being aired, reported, and
discussed, often ~~in~~ ⁱⁿ greater ^{depth} ~~length~~
than elsewhere, in the Financial
Times.

Those of us who turned from being commentators into players may not always agree with what our successors say.

~~But they must always be free to say it~~

But we benefit from the fact that they are able to say it.

16/12

~~XXXXXXXXXXXX~~

STOCK EXCHANGE
XMAS LUNCAL



PH

FROM: A P HUDSON

DATE: 16 December 1987

MRS LOMAX

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Scholar
Mr Odling-Smee
Mr Culpin
Mr Pickford
Mr R I G Allen
Mr Ilett
Mr A C S Allan
Mr Neilson
Mr Blower
Mr Cropper
Mr Tyrie
Mr Call
Mr N Forman MP
Mr Norgrove No.10
Mr Footman (Bank)

**CHANCELLOR'S SPEECH AT STOCK EXCHANGE CHRISTMAS LUNCH:
FINAL VERSION**

... I attach the final version of the speech. Many thanks to you and all in FIM who contributed.

APH

A P HUDSON

**CHANCELLOR'S SPEECH AT STOCK EXCHANGE
CHRISTMAS LUNCH, 16 DECEMBER 1987**

At this lunch, two years ago, we were looking ahead, with a mixture of excitement and apprehension, to the Big Bang of October 1986. At this lunch, a year ago, some were wondering what great event could be organised to mark the first anniversary of the Big Bang in October 1987.

Now we know.

Not perhaps the event we would have chosen.

But we should have realised that we could rely on dear old market forces to do the thing for us.

I understand there is no truth in the rumour that you are to follow your two best sellers, English Barometers 1680-1860, and Ormolu: The Work of Matthew Boulton, with a slim volume of memoirs entitled 'From Bang to Crash'.

One of the problems of a sharp fall in business, such as has accompanied the sharp fall in prices, is that it gives market participants time to engage in speculation of a non-pecuniary nature.

If anything, an even more hazardous occupation.

Much current speculation is about what the markets are trying to tell us - what is their message?

I think the message of the markets is clear.

It is that they were far too high three months ago.

What I find more puzzling is what the markets were trying to tell us three months ago.

Certainly, the fall was unusually sudden.

But I wouldn't want to draw any profound conclusions from the fact that virtually the whole of the 27 per cent fall in equity markets over the past two months occurred in the first two weeks.

What is perhaps more striking is the further evidence recent events have provided that we are now in an era of global markets.

Not that the share prices have moved in exactly the same way in every market.

A lot depends on what your base date is.

But if you compare equity prices now with a year ago - a conventional statistical comparison - it shows both London and Wall Street standing almost exactly where they were a year ago, but the less liquid markets of Continental Europe down some 30 per cent over the same period.

But it is scarcely surprising that, in an era of global markets, nations tend to move together to a considerable extent.

The great trend of our times towards globalisation - with all its risks and opportunities - was, of course, formally recognised here with the formation of the International Stock Exchange in 1986; and you have been adjusting to this sea change ever since - and are continuing to do so.

Indeed, this is admirably epitomized by the attendance at today's lunch, and I welcome those from overseas firms who are here for the first time.

For the City of London has not only consolidated its position as the undisputed financial centre of Europe: it is, in many areas, the number one financial centre in the world.

No firm with any aspiration to be a major player on the world financial scene can afford not to have a significant presence in London.

That doesn't mean, of course, that we aren't equally keen to see British firms spreading their wings in the major financial centres overseas.

I welcome today's announcement by the Tokyo Stock Exchange that it will shortly be admitting to its membership Barings, County NatWest, Kleinworts, and Schrodgers (the order is alphabetical).

And I have to say to our Japanese friends that there are other UK firms who would also like a fair crack of the whip, so I trust there will be a further round of licences before too long.

Meanwhile, I am confident that London will demonstrate - as indeed, by and large, it has since mid-October - that in foul weather as well as fair, it can lead the world.

And it will do so as part of an economy that is in very good shape, and I am determined that will remain so.

All the evidence that has emerged since the equity collapse in October has confirmed that so far from there being any incipient signs of recession, the British economy is moving ahead even more strongly than was previously realised.

And although our performance has been well above the world average, that is also true for the world economy.

Some slow down in growth next year would not be surprising, but it is a slow down from a more vigorous expansion that we thought we had - certainly no recession.

And just as growth will continue, so will this Government's commitment to wider share ownership, whether through privatisation - with British Steel now added to the list - or in other ways.

The appetite for share ownership that we have demonstrated exists among the people at large in this country is no mere ephemeral product of the longest bull market in history.

It is a permanent feature of immense social importance with potential for further growth.

You have only to walk and talk on the shop floor of a company whose employees hold shares to sense that - even now.

So I offer you as a New Year's resolution - particularly now that you have so much more time to think - a determination to find ways of serving this new market of the future even better than you do today.

4/12

REFORMING
AGRICULTURE



PWP

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

David Norgrove Esq
10 Downing Street
LONDON
SW1

1 December 1987

Dear David,

CHANCELLOR'S DRAFT PRESS RELEASE ON AGRICULTURE

The Chancellor thinks it could be helpful if he were to put out a press release on agriculture from a speaking engagement he has in Leicestershire this Friday, 4 December. The aim is to show how agricultural reform is necessary not simply to keep down the cost of the European Budget, but because of its implications for world trade.

I attach a draft. The Chancellor would be grateful for the Prime Minister's reaction by lunchtime on Thursday, if possible.

I am copying this to Tony Galsworthy (FCO), Shirley Stagg (MAFF), and Roger Lavelle (Cabinet Office).

Tours sincerely,

Andrew Hudson

A P HUDSON

C.

I have marked the comments from
No 10 and MAFF; FCO are content.

~~Subject to~~ Once you have finalised it,
we can release through CCO, with
ID7 drawing the key journalists'
attention to it.

AH

OK

EXTRACT FROM THE CHANCELLOR OF THE EXCHEQUER'S SPEECH
DRAFT PRESS RELEASE, 4 DECEMBER
TO HARBOROUGH CONSERVATIVE ASSOCIATION, 4 DECEMBER 1987

Reforming Agriculture - the wider context

As the Common Market heads of government meet for this week-end's European Council, agriculture is once again top of the agenda. It is vital that a satisfactory solution is found to the problems, not just for the European Community, but for the world economy as a whole.

The Common Agricultural Policy cost European taxpayers over £15 billion last year, and, if nothing is done, the figure could be over £20 billion next year. Three quarters of the cost last year went on the storage and disposal of surplus production. And on top of that, families in Europe have to pay far more for their food than they would do if world markets operated more freely.

We cannot go on this way. There is increasing acceptance in Europe that reform is needed. The UK has long been advocating this, and earlier this year the European Commission set out its own proposals for stabilisers to control budgetary costs. The job this weekend is to agree on a programme of action,

and the UK will be making every effort to ensure a successful outcome.

MAFF x

But agricultural ^{support and} protection is not just a European problem. The United States and Japan both ~~provide~~ ~~massive~~ support ~~for~~ their farmers, with much the same results as in Europe. ~~And~~ Among the main losers from all this ~~protection~~ are the developing countries, who ought to have a comparative advantage in agriculture, but find the odds stacked heavily against them.

through subsidies or protection, on a massive scale, x

The scale of agricultural support is a major distortion in the world economy. And reform is all the more important in this difficult period following the worldwide stock market collapse.

One of the key concerns at the present time, not least in the financial markets, is the fear of a lurch into protectionism. That would pose a major threat to continued economic success. By starting to reduce the scale of agricultural protection, Europe could signal to the world its commitment to maintaining and enhancing the open trading system. That has never been more important than it is today.

PM

The Americans and the Japanese - as well as ^{we} ~~the~~ Europeans - must not only resist further

PM

agriculture, so that surpluses can be eliminated.

MAFF →

protection, but ^{we should all} scale down ^{substantially} ~~radically~~ the support ~~they give to farmers.~~

^{we} This will obviously be easier if we all act together. Discussions ^{are taking place} will in due course ~~take place in the~~ ^{in the new GATT round, which is dealing comprehensively with the issue of} ~~GATT, which includes~~ ^{agricultural support and protection} ~~agriculture~~ for the first time.

But these negotiations will inevitably take time, and it is important that all countries make a start on reform now.

This weekend's discussions are vital not just for the European budget, but for world trade and world prosperity. Agricultural reform is already overdue. We can ill afford to delay it any further.



PLW

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

Charles Powell Esq
10 Downing Street
LONDON
SW1

3 December 1987

Dear Charles,

CHANCELLOR'S PRESS RELEASE ON AGRICULTURE, 4 DECEMBER

Thank you for your letter of 3 December.

I attach the final version of the Press Release, incorporating your amendment, and those in Shirley Stagg's 2 December letter.

I am copying this to Lyn Parker (FCO), Shirley Stagg (MAFF), and Roger Lavelle (Cabinet Office).

Yours sincerely,

Andrew Hudson

A P HUDSON

**EXTRACT FROM THE CHANCELLOR OF THE EXCHEQUER'S SPEECH TO
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We cannot go on this way. There is increasing acceptance in Europe that reform is needed. The UK has long been advocating this, and earlier this year the European Commission set out its own proposals for stabilisers to control budgetary costs. The job this weekend is to agree on a programme of action, and the UK will be making every effort to ensure a successful outcome.

But agricultural support and protection is not just a European problem. The United States and Japan both support their farmers, through subsidies or protection, on a massive scale, with much the same results as in Europe. Among the main losers from all this protection are the developing countries, who ought to have a comparative advantage in agriculture, but find the odds stacked heavily against them.

The scale of agricultural support is a major distortion in the world economy. And reform is all the more important in this difficult period following the worldwide stock market collapse.

One of the key concerns at the present time, not least in the financial markets, is the fear of a lurch into protectionism. That would pose a major threat to continued economic success. By starting to reduce the scale of agricultural protection, Europe could signal to the world its commitment to maintaining and enhancing the open trading system. That has never been more important than it is today.

The Americans and the Japanese - as well as we Europeans - must not only resist further protection, but we should all scale down substantially the support we give to agriculture, so that surpluses can be eliminated. This will obviously be easier if we all act together. Discussions are taking place in the new GATT round, which is dealing comprehensively with the issue of agricultural support and protection for the first time. But these negotiations will inevitably take time, and it is important that all countries make a start on reform now.

This weekend's discussions are vital not just for the European budget, but for world trade and world prosperity. Agricultural reform is already overdue. We can ill afford to delay it any further.

AMERICAN
CHAMBER
OF
COMMERCE

24/11

CHANCELLOR OF THE EXCHEQUER'S SPEECH TO
AMERICAN CHAMBER OF COMMERCE, 24 NOVEMBER
Mr Chairman, ~~My~~ Excellency, Mr Lewis, L.L.C.

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 THEIR 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 AFTER 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 SPIKE 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.



PHF

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

25 November 1987

Lyn Parker Esq
PS/Secretary of State
Foreign and Commonwealth Office
Downing Street
LONDON SW1

Dear Lyn,

CHANCELLOR'S SPEECH TO AMERICAN CHAMBER OF COMMERCE

... You may like to have the attached copy of the Chancellor's speech yesterday to the American Chamber of Commerce.

Yours sincerely,

Andrew Hudson

A P HUDSON



H. M. TREASURY

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

Facsimile: 270 5244

Telex: 9413704

NOT FOR PUBLICATION, BROADCAST
OR USE ON CLUB TAPES BEFORE
2.30 pm GMT ON TUESDAY, 24 NOVEMBER 1987

24 November 1987

WORLD ECONOMY: THE NEXT STEPS

Attached is the text of a speech delivered today in London by the Chancellor of the Exchequer, the Rt Hon Nigel Lawson, MP to a meeting of the American Chamber of Commerce held jointly with the Canadian Chamber of Commerce.

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG

81/87

CHANCELLOR OF THE EXCHEQUER'S SPEECH

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 dizzy 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 their 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 after 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.

CH/EX

GLASGOW

23/11

PWP



FROM: A P HUDSON

DATE: 23 November 1987

PS/ECONOMIC SECRETARY

- cc PS/Chief Secretary
- PS/Financial Secretary
- PS/Paymaster General
- Sir P Middleton
- Sir T Burns
- Mr Sedgwick
- Mr Culpin
- Mr R I G Allen
- Mr A M White
- Miss Simpson
- Mr Ilett
- Mr Cropper
- Mr Tyrie
- Mr Call

- Mr N Forman MP

SPEECH TO GLASGOW BUSINESSMEN: 23 NOVEMBER

... I attach the final version of the Chancellor's press release today from his speech to Glasgow businessmen. The Chancellor's speech itself will build around this.

A handwritten signature in black ink, appearing to be "A P HUDSON".

A P HUDSON

EXTRACT FROM CHANCELLOR OF THE EXCHEQUER'S SPEECH IN
GLASGOW, 23 NOVEMBER 1987

The results of this month's CBI survey of manufacturing industry, published today, are of particular interest. For they are the first to show the state of British industry after the world stock market collapse. And the picture that emerges is profoundly encouraging. A record balance of firms reporting order books above normal. And, in particular, a record balance of firms reporting export order books above normal.

All in all, excellent prospects and business confidence as robust as ever.

Within the overall UK picture, Scotland's economy has also made great advances. You would not get that impression from those who wish to run Scotland down. The puzzling thing is that Scotland's most assiduous denigrators are Scots themselves. But Scottish business and industry itself has not been idle these past eight-and-a-half years: far from it.

Between 1979 and 1986 manufacturing productivity in Scotland increased by over 5 per cent a year compared with 3 $\frac{1}{4}$ per cent a year in the UK as a whole. Unemployment in Scotland is now falling fast - down by over 30,000 so far this year. And Scottish living standards are higher than in most of the regions of England.

What has to be recognised is that Scotland's economy is going through a major transition, as the older heavy industries give way to new growth sectors. This has been a painful process, but

Scotland's manufacturing industry has emerged fitter and more competitive. The development of the electronic components sector and financial services are just two examples of the new direction of Scottish industry.

I know that there is a view in some quarters that the decline in manufacturing employment is a sign of "deindustrialisation", as they call it. This is doubly misguided. First, manufacturing output is going from strength to strength. And second, the growth of service jobs is a feature of most modern economies. Moreover, services such as insurance and finance and tourism make a direct contribution to wealth creation in their own right. It is folly not to exploit them to the full.

Tourism, for example, already puts some £1,400 million into the Scottish economy each year, and, unlike many other industries, it benefits virtually all parts of Scotland. Again, there is the financial services industry, the fastest-growing sector in Scotland. This already employs around 80,000 people and has increased its manpower by some 27 per cent over the last decade. The range of financial services now available in Scotland is unparalleled in the United Kingdom outside the City of London. Expansion of services such as finance and tourism must be a vital ingredient in the strategy to attract new investment to Scotland, and generally to promote Scotland as a good place to invest and to work.

But despite the undoubted success so far, there is still a barrier along Scotland's road to prosperity. That barrier is the pervasive presence of a hostile attitude to enterprise and wealth creation, to the enterprise culture on which economic success in a free society depends. That is not to say that there is no enterprise in Scotland - of course there is. Rather that it is frequently swamped by an overriding sense of dependence on the State. Large areas of Scottish life are sheltered from market forces, and exhibit the culture of dependence rather than that of enterprise.

The origin of this dependence culture is complex. The former predominance of heavy industries, most of them State-owned - coal,

steel, shipbuilding - in Scotland's economy played a part, bolstering the view that economic decisions should be made by the political process rather than in the market place. The interventionist role of big Government may have been rejected nationally in three successive elections, but it is a notion that still lingers in Scotland more than anywhere else in the UK.

Another feature of Scotland which underpins this dependence is housing. While nationally only a fifth of families now live in council accommodation, in Scotland the proportion is a half. And even the Eastern bloc countries can't beat the more than 80% council housing of parts of Glasgow. The process of being allocated a house and the petty restrictions on making alterations or improvements have undermined individual self-confidence.

When you add to this sense of dependence a political climate which is hostile to enterprise, the economic achievements I mentioned earlier are all the more remarkable.

Happily, powerful forces of change are at work. Ownership, whether it is of home or shares, has played a major part in changing attitudes in the rest of the UK. The privatisation programme and the council house Right to Buy legislation have contributed hugely to the establishment of the enterprise culture. They will help reshape attitudes in Scotland, too.

The development of private sector solutions to the problems experienced in Scotland's cities will be a great challenge to Scottish businessmen. A vigorous financial services sector stands ready to support them.

I am confident that attitudes will increasingly change, and indeed will force change on paternalistic local authorities. The policies that have brought growing prosperity to other parts of the UK will work in Scotland too. The last thing Scotland needs is soft Labour policies.

This essentially optimistic view of Scotland's potential is shared by the country's business leaders. Even the Fraser of Allander

Institute predicts strong Scottish performance compared with the UK as a whole. And such confidence will be crucial to Scotland's success. The self-confidence of individuals to take more control of their own life; and the confidence of businesses to invest in the future.

Scotland today represents an attractive investment opportunity. Ford certainly thought so when they announced recently their planned new components plant in Dundee. And HCI want to base in Scotland a business serving countries as far afield as the Middle East. This will bring welcome jobs to Clydebank. If someone had said a few years ago that a private hospital would bring jobs to Clydebank they would have been ridiculed. Yet that is now precisely what is in prospect.

I do not believe that current international uncertainties threaten this encouraging picture to any significant extent. The British economy is sounder and stronger than at any time since the War. Our rate of growth is the fastest of all the major nations in the world. And we will work together with those other nations to pursue sensible and appropriate policies. The only real threat to Scotland is the entrenchment of the anti-enterprise culture: all those who wish greater prosperity for Scotland should strive to expunge the ghost of dependence and embrace the spirit of enterprise.

That is the way forward for Scotland.

TELFORD

13 / 11

pwp



FROM: A P HUDSON
DATE: 12 November 1987

MR WILLMER - IR

cc PS/Financial Secretary
Miss Sinclair
Mr Towers
Mr J M G Taylor
Mr Cropper
Mr Call
PS/IR
Mr Pinder - IR

CHANCELLOR'S SPEAKING NOTE FOR TELFORD, 13 NOVEMBER

... I attach the final version of the Chancellor's speaking note for his visit to Telford tomorrow.

AH

A P HUDSON

CHANCELLOR'S SPEAKING NOTE FOR TELFORD, 13 NOVEMBER

I welcome the opportunity to be present today, at what is another landmark in the development of the Inland Revenue's computerisation programme.

In various capacities, I have been involved in a number of the previous landmarks. Although a pilot study had begun in 1977, under the previous Government, it was in 1980 that we took the decision that the Revenue should go ahead with plans for the computerisation of Pay-As-You-Earn.

I was Financial Secretary to the Treasury at the time, and I remember well the discussions that we had about this project. It was clearly an ambitious one, covering hundreds of tax offices, and affecting the vast majority of taxpayers. It involved a substantial commitment of time and resources. The risks were considerable - if it went wrong, not only would the time and money be wasted, but the smooth flow of billions of pounds of Government revenue could be in danger. And previous Government computer projects had scarcely been an unqualified success. We therefore began cautiously with a pilot system in the West Midlands, and the Revenue took up residence here in Telford in 1981.

By the time I returned to the Treasury as Chancellor in June 1983, it was clear that the project was going very well. The success of the pilot project enabled me to decide in July 1984 that the new system should be extended to the whole country. I said - and here I am quoting - "the process should be completed by the end of 1987 or early 1988, which was precisely the date we planned when we began in 1980".

That was three years ago, and I am glad to say that PAYE is now computerised throughout the country.

By any standards, the computerisation programme is a major achievement. A few statistics give a flavour of the scale of the

Project. The records of 28 million taxpayers have been computerised. Some 27,000 visual display units have been installed in over 600 tax offices. More than 35,000 staff have been trained in the new techniques, and 11 regional computer centres have been set up.

All this amounts to one of the biggest on-line computerisation projects in Europe.

What is more, the computers have come in at a time when there have been significant changes on other fronts within the Revenue, affecting not just Head Office and those in Telford planning the system, but also tax offices across the country. There have been changes to the structure of the tax system, changes to tax rates and allowances, and changes in working practices. And all this has been achieved without any delay or disruption to the timetable for computerisation.

The process of computerisation goes on. The computerised system for taxing the self-employed, known as CODA, is operating in two regions already, and is due to be extended nationwide next spring. The National Tracing System is up and running, and plans are well under way for the on-line computerisation of Corporation Tax assessing, and for a new computer system for the collection service, which is now the focus of the development effort here. The Revenue's information technology programme is thus one of the most extensive in the country today.

This is the answer to those who, quite unfairly, criticise the Inland Revenue as a staid institution, populated by stick-in-the-muds who are resolutely opposed to change of any kind. Nothing could be further from the truth. In fact, the Revenue is changing at a very rapid rate indeed. What remains unchanged is the commitment to providing an efficient service to the public. The computers help here, of course, by taking away many of the mundane and boring aspects of the work, and thus leaving staff more time to concentrate on the more difficult parts of the job.

● should like to take this opportunity to congratulate and thank all those whose hard work and commitment has made COP - the computerisation of PAYE - such a success. The lead has been taken by Steve Matheson - about whom more anon - and his outstanding team, both here in Telford and in London. But the success of the project has, of course, also depended on the efforts of a much wider group of people: the outside consultants in what has been a very fruitful example of collaboration between the public sector and the private sector; the Property Services Agency; the suppliers - ICL, British Telecom, Plessey, and many others; the Revenue's senior management who have superintended the project; and the tens of thousands of staff in tax offices all over the country, who have adapted quickly to the new way of working. I should like to thank everybody who has been involved.

The new building is symbolic of the continuing development of the Revenue's effort on information technology. I know that the Revenue are very grateful for the help given by Telford Development Corporation in their early days in the area, and ever since. And I know also that Telford values the presence of the Revenue as an increasingly important employer, with over 1200 staff now.

Finally, a word about Steve Matheson. It was at the specific request of Sir Lawrence Airey, the former Chairman of the Inland Revenue, that the new building was named after Steve. No doubt this was partly because of Lawrence's characteristic modesty. And the term "Airey house" is already in use for a particular type of post-War prefab. But while it must be very rare for a building to be named after a serving civil servant - rather like the convention that statues are not erected to people who are still alive - it is also very rare for a civil servant, or for that matter a businessman, to have played as decisive a part in a major project as Steve Matheson has done in COP.

I understand that he returned to the Inland Revenue in 1977, from a spell on secondment in the Chancellor of the Exchequer's office. Not knowing what to do with someone with this sort of experience, they asked him to dust off some previous ideas about computerising PAYE. He has been involved in the project ever since, and the

Results of his labours are visible in every tax office in the country. While I know that he would be the first to praise the people who worked for him and with him, it has been his personal drive and enthusiasm which has galvanised the team, and made the project a success.

Let me take just one example. Two or three years ago, the then Financial Secretary to the Treasury, John Moore, visited Telford. Because of Parliamentary business, he was unable to arrive until midnight. Nonetheless, Steve managed to get his full team assembled, bright-eyed and bushy-tailed, waiting to receive him. That shows leadership qualities of a high order.

Let me conclude by thanking all concerned for the work they have done in preparing for today. I am sure that the success of the Telford Development Centre will continue in the new building.

OPPOSITION
DAY
DEBATE

5/11

CONFIDENTIAL

PLW



FROM: A P HUDSON

DATE: 2 November 1987

PS/FINANCIAL SECRETARY

cc: PS/CST
PS/PMG
PS/EST
Sir P Middleton
Sir T Burns
Mr H P Evans
Mr Peretz
Mrs Lomax
Mr Sedgwick
Mr Scholar
Mr R I G Allen
Miss O'Mara
Mr A C S Allan
Mrs M E Brown
Miss Simpson
Mr Neilson
Mr Cropper
Mr Tyrie
Mr Call
Mr N Forman MP

CHANCELLOR'S SPEECH FOR OPPOSITION DAY DEBATE

... I attach, for information, the Chancellor's outline of his speech for Thursday Opposition Day Debate.

2. Alex Allan will be drafting the section on BP, and I shall draft the rest, with help from the Special Advisers on the political points.

3. I would be grateful for answers to the Chancellor's queries, and for the various blanks to be filled in, which I think fall as follows:

- (a) Mrs Brown to confirm BP's own attitude to the sale, and to supply figures and anecdotes on small investors (Section 1).
- (b) On Section 3, most of the figures will be in the Autumn Statement brief, but it would be helpful if EB and EA could stand ready to provide any others.



- (c) Can anybody offer statements from industrialists about the renaissance of manufacturing?
 - (d) Mr Neilson to confirm and illustrate the point on the 1974 crash.
 - (e) Mr Tyrie to provide quotations, and check the Labour Manifesto, on Labour's attitude to import controls (Section 5), and to establish what John Smith MP said about the income tax cut during the Election Campaign (Section 7).
4. Please could I have all this material by close today if possible, and close tomorrow at the latest.

A handwritten signature in black ink, appearing to be 'A P HUDSON'.

A P HUDSON

CHANCELLOR'S OUTLINE OF SPEECH FOR OPPOSITION DAY DEBATE,
5 NOVEMBER

1. BP

Tribute to City - strong view of sub-underwriters that issue should go ahead, despite their losses - and it has gone ahead - success story - City can hold its head high. Underwriters, in my view should not have made the clause 8 approach they did - they should have said: of course we accept our obligations, but let's discuss how to deal with after market problems.

Instead, forced to go through legal procedures (re "proper underwriting risk"), wasting time which could have been put to better use, and putting in baulk HMT relations with Bank (explain why).

Fortunately, all's well that ends well: scheme that I devised and decided to implement, using the Issue Department of the Bank appears to have done the trick.

(NB heightened drama).

Meanwhile, Opposition made monkeys of themselves; when Smith thought I was going to abort the sale, he said it should go ahead and underwriters not be let off the hook, and then when he realised I had said it should go ahead, he said it shouldn't (ie underwriters should be let off the hook).

[Get quotation.]

Then he professed concern about the effect on BP, and attacked the steps I had taken to ensure an orderly market in BP shares [which I think BP has welcomed].

[I don't think, either, that BP ever asked for issue to be pulled - please check.]

Section should culminate with ringing reaffirmation of privatisation and wider share ownership.

Re former, note that £5 billion already in the bag for 1988-89 from part payments of earlier privatisations; re latter, get figures to show small investors flocking to buy BP part-paid as soon as dealing began (plus anecdotes).

(PS jokes about Bryan Gould and wider share ownership appropriate in this context).

2. Deficit Finance

Warned that US budget deficit would end in tears - and it has.

Whereas we - equally committed to lower taxes - were prepared initially to put taxes up to get deficit down (especially 1981), and did so, reaching strong position, set out in Autumn Statement, USA did not.

Result: become world's largest debtor and collapse of confidence.

Remedy clear.

But it ill becomes Labour to lecture us: indeed, an apologetic silence would be more becoming, since throughout my time as Chancellor they have been exhorting us to emulate the big deficit policies of the US (get plenty of quotes) and castigate us for not so doing.

They failed, too, to recognise what was good about the US: labour market flexibility, deregulation, enterprise economy etc.

Of course, US deficit not simply a question of size, but their inability to finance it from own savings, and hence reliance on overseas finance, which has become more and more reluctant.

Yet if they had combined vigorous methods to cut it with higher interest rates to attract finance, this would have been far less likely to tip US into recession than what has now happened as a result of their failure to do this.

3. Manufacturing

Smith always majors on this. We need good figures on manufacturing (output, investment, productivity, and profitability).

Note that manufacturing output fell under Labour (1973-74 to 1978-79, or whatever the best measure is) whereas it will have risen under us; productivity growth lamentable under Labour but phenomenal under us; investment of infinitely better quality; and profitability higher.

Quote CBI surveys (and statements from industrialists) in support of manufacturing's renaissance.

But of course go on to say rest of economy also important, and quote overall figures (including overall business investment) - carefully selected - plus trend of employment/unemployment.

As for current account deficit, better have defensive stuff about cumulative surplus under us (quantify) compared to cumulative deficit under Labour.

4. Stock Market Crash

Labour had theirs in 1974: considerably bigger and largely home grown (check), whereas ours comes from USA. Reuse relevant section from Stock Exchange speech.

5. Protectionism

Big danger at the present time.

Compare 1930s.

Get quotations showing Labour's hankering for import controls (check their manifesto).

6. Statesmanship

Suitable material from Mansion House Speech recycled.

UK in forefront of development of international co-operation.

What we are working for now.

How to minimise adverse economic consequences of crash and indeed exploit silver linings.

Contrast UK's leadership role today with its mendicant role under Labour.

7. Reversal of the 2p Cut

The last of the late lamented Hattersley's crystal balls (get quotations).

Does Smith endorse it or doesn't he?

(Incidentally, highly desirable to see what he said on this during Election Campaign).