

DESKBY 070001Z

IMMEDIATE  
CONFIDENTIAL

CONFIDENTIAL

DESKBY 070001Z

FM F C O 061903Z OCT 81

TO IMMEDIATE UKDEL MELBOURNE

TELEGRAM NUMBER 235 OF 6 OCTOBER.

*Get. Get.  
P.W. 4/10*

FOLLOWING FOR WHITMORE, PRIME MINISTERS' PARTY, FROM SCHOLAR,  
10, DOWNING STREET :  
MIPT : NOTE BY ALAN WALTERS ON THE HEATH SPEECH :

THE VICIOUS CIRCLE.

THE EASIEST WAY TO SEE THAT HEATHS' VICIOUS CIRCLE IS A  
PIECE OF PREPOSTEROUS NONSENSE IS TO REVERSE IT. HE SAYS THAT  
COMPLETING THE VICIOUS CIRCLE IS THAT QUOTE "PRICES HAVE INCREASED,  
THE RATE OF INFLATION HAS GONE UP, THE MONEY SUPPLY HAS INCREASED,  
UNEMPLOYMENT HAS GONE UP, THE RATE OF BANKRUPTCIES HAVE INCREASED,  
INDUSTRIAL BASE HAS BEEN FURTHER ERODED, THE GOVERNMENTS'  
BORROWING REQUIREMENT HAS INCREASED AND AS A RESULT THERE IS MORE  
PRESSURE TO RAISE INTEREST RATES AGAIN - TO BE FOLLOWED INEVITABLY  
BY THE SAME VICIOUS CIRCLE, IT IS THIS THAT MUST BE BROKEN UNQUOTE.

IT FOLLOWS, THEREFORE, THAT ALL WE HAVE TO DO IS HAVE A TINY  
DECREASE IN INTEREST RATES AND THEN WE ARE LOCKED INTO A WONDERFUL  
VIRTUOUS CIRCLE BECAUSE, SYMMETRICALLY, PRICES WILL DECREASE, THE  
RATE OF INFLATION WILL GO DOWN, THE MONEY SUPPLY WILL DECREASE,  
UNEMPLOYMENT WILL GO DOWN, THE RATE OF BANKRUPTCIES WILL FALL AND  
THE INDUSTRIAL BASE WILL EXPAND, ETC ONTO ANOTHER FALL IN INTEREST  
RATES TO BE FOLLOWED INEVITABLY BY THE SAME VIRTUOUS CIRCLE. BUT IF  
WE DIDN'T OBSERVE ANY SUCH VIRTUOUS CIRCLE WHEN INTEREST RATES  
FELL IN 1975, 1980 OR EVEN 1981.

THE HEATH DOGMA IS QUITE REMARKABLE. SURELY THOSE COUNTRIES WITH HIGH INTEREST RATES SUCH AS THE UNITED STATES, FRANCE, ETC SHOULD REALISE THAT THE ONLY THING THEY NEED TO DO IS BRING INTEREST RATES DOWN AND THEN HAPPILY SWING AROUND MR HEATH'S VIRTUOUS CIRCLE. ARE THEY TOO STUPID TO REALISE THAT THERE IS SUCH A WONDERFUL VIRTUOUS CIRCLE JUST BELOW THEIR 20% RATES? BUT PERHAPS MR HEATH'S VIRTUOUS CIRCLE ONLY APPLIES TO BRITAIN, JUST AS HIS VICIOUS CIRCLE MAY BE THOUGHT TO BE APPROPRIATE ONLY FOR THE U.K. BUT THE POINTS HE MAKES ARE PERFECTLY GENERAL AND MUST BE APPLICABLE TO ALL OTHER SIMILAR WESTERN ECONOMIES. I CONCLUDE THEREFORE THAT THEY MUST ALL BE STUPID, AT LEAST THAT MUST BE MR HEATH'S IMPLIED VIEW.

THE YEARS OF MONETARISM, THE METHODS AND THE MISTAKES.

HEATH'S DESCRIPTION OF THE MONETARIST EXPERIMENT AS THOUGH IT BEGAN WITH THE INTERNATIONAL MONETARY FUND AND THE LABOUR GOVERNMENT IS A TRAVESTY OF THE FACTS. HE SAYS THE ATTEMPT WAS QUOTE TO RUN A COMPLICATED, SOPHISTICATED ECONOMY PURELY BY MONETARY MEANS AND THE PRESENT GOVERNMENT HAS TRIED TO MANAGE THE ECONOMY SOLELY BY THE USE OF INTEREST RATES.....UNQUOTE THIS IS OF COURSE RUBBISH. THE VARIOUS BUDGETS AND PARTICULARLY THE ONE IN MARCH 1981 WERE THOUGHT TO BE A VERY SIGNIFICANT SQUEEZE ON THE ECONOMY AND INDEED WAS WIDELY RESENTED BY MANY OF MR HEATH'S PERSUASION. BUT IN ADDITION THE POINT IS THAT THE NEW MONETARY ARRANGEMENTS INTRODUCED FROM APRIL THIS YEAR DO NOT USE ADMINISTERED INTEREST RATES, BUT ALLOW INTEREST RATES TO BE DETERMINED VERY LARGELY BY MARKET FORCES.

HEATH CLAIMS THAT THE OSCILLATIONS IN STERLING WERE EXACERBATED BY THE DECISION NOT TO USE EXCHANGE CONTROLS. DOES THIS MEAN THEN THAT THE FALL OF THE POUND TO DOLLARS 1.53 IN 1976 WAS SAVED FROM FALLING EVEN FURTHER BY THE EXISTENCE OF EXCHANGE CONTROLS? HE ALSO STATES THAT AS A RESULT OF THE RISE TO DOLLARS 2.43 FIRMS FOUND THEIR PROFITS DISAPPEAR AND THEIR EXPORT MARKETS LOST NEVER TO BE REGAINED. THE EVIDENCE CONTRADICTS THIS. EXPORTS REMAINED HIGH AND INDEED EXPANDED IN VALUE TERMS OVER THIS PERIOD. PRESUMABLY HE HAS NEVER LOOKED AT THE STATISTICS BUT HAS PROCEEDED FROM DOGMA.

THERE IS A CONFUSION THROUGHOUT. HE SAYS THAT A FALL IN THE LEVEL OF STERLING WILL ADD 3% TO OUR RATE OF INFLATION. WHAT HE MEANS IS THAT IT WILL ADD 3% TO THE PRICE LEVEL. THIS SORT OF CONFUSION PERSISTS THROUGHOUT THE WHOLE PAPER.

HEATH ATTRIBUTES ALL BANKRUPTCIES TO HIGH INTEREST RATES. HE DOESN'T MENTION HIGH REAL WAGE RATES WHICH WERE A CONSEQUENCE OF THE WAGES EXPLOSION OF 1972/83. WAGES ARE A FAR MORE IMPORTANT ITEM IN ANY FIRMS' ACCOUNTS.

HE SAYS THAT IT IS NOT SURPRISING LAST YEAR THE UNITED KINGDOM WAS AT THE BOTTOM OF THE GROWTH TABLE IN THE WEST. AS FAR AS I AM AWARE IT HAS BEEN AT THE BOTTOM OF THE GROWTH TABLE OF THE WEST DURING THE LAST 33 YEARS. I BELIEVE THAT ONLY THE REPUBLIC OF IRELAND HAS MANAGED TO DO WORSE. SO THAT IS CERTAINLY NOTHING NEW AND CANNOT BE ATTRIBUTED TO THE PRESENT GOVERNMENTS' POLICY.

HE FAILS ALSO TO MENTION THE EXPANSION OF THE SERVICE INDUSTRIES. HE SINGLES OUT ONLY AGRICULTURE WHICH HE BELIEVES THE EXPANSION WAS DUE TO THE LACK OF UNRESTRAINED MARKET MECHANISMS.

HE SAYS THAT PROFITS DECLINED AND THE FALL IS CONTINUING THIS YEAR. I BELIEVE THIS IS UNTRUE AND IS CONTRADICTED BY THE EVIDENCE IN THE RECENT FINANCIAL TIMES REVIEW.

THE QUOTATION FROM THE TIMES IS INTERESTING BUT IF WE TAKE THE PERIOD FROM THE PEAK OUTPUT IN MARCH 1973 TO THE LOW IN DECEMBER 1973 WE FIND THAT THE DECLINE WAS RATHER MORE THAN NINE PERCENT POINTS. THIS SEEMS TO BE A LITTLE MORE THAN THE SEVEN AND THREE-QUARTERS FROM 1979-1981. SO MR HEATHS' POLICY IN 1973/74 FOLLOWED BY THE LABOUR GOVERNMENT IN 1975 MANAGED TO SECURE A DECLINE WHICH WAS RATHER GREATER THAN THE ONE WE HAVE SEEN RECENTLY.

UNDERSTANDABLY HE DOES NOT REFER TO THIS IN WHAT HE CALLS THE MYTHS OF THE 19UP'S.

THE MYTHS OF THE SEVENTIES.

THIS IS MEA NON CULPA AT ITS VERY WORST. HE SAYS THAT NONE OF THE DOCTRINAIRE MONETARISTS EXPLAIN HOW INFLATION WAS CAUSED BY A RISE IN EXTERNAL COMMODITY PRICES IN LATE 1973. THIS IS SIMPLY NOT TRUE. INDEED IT WAS EXPLAINED IN A LETTER TO THE PRIME MINISTER SIGNED BY PROFESSOR HARRY JOHNSON, MYSELF AND A GROUP OF OTHER ECONOMISTS. MR HEATH CLAIMS HE WAS IMPORTING INFLATION. I SHOWED IN AN ARTICLE PUBLISHED IN AN INTERNATIONAL CURRENCY REVIEW, WHICH

WAS APPENDED TO THE LETTER TO MR HEATH, THAT BRITAIN WAS IN FACT EXPORTING INFLATION. THE FACT OF THE MATTER IS THAT THE RATE OF INFLATION IN BRITAIN IN 1974 WAS 14.7% AND AT THE SAME TIME THE BALANCE OF PAYMENTS DEFICIT WAS NEARLY 10 BILLION, WHICH WAS MORE THAN SUFFICIENT TO FINANCE THE INCREASED COST OF IMPORTS. WE WERE LIVING ON TICK AND HAVING AN INFLATION AS WELL. THE ANALYSIS IS ALL SET OUT IN THE ICR PAPER.

FURTHERMORE WE SHOW HOW THEY COULD HAVE AVOIDED THE PRICE INCREASES OF IMPORTS HAVING SUBSTANTIAL EFFECT ON INFLATION. ITS EASY TO SEE HOW THIS WAS DONE. AFTER ALL SWITZERLAND, GERMANY, TAIWAN AND MANY OTHER COUNTRIES DID IT MUCH MORE SUCCESSFULLY. THE CLAIM THAT BRITAIN KEPT THE RATE OF INFLATION DOWN IN THE EARLY SEVENTIES MORE SUCCESSFULLY THAN ANY OTHER WESTERN COUNTRY IS, OF COURSE, LUDICROUS. JUST QUITE WRONG. THE TREASURY WILL SUPPLY EVIDENCE.

NEW DIRECTIONS, THE INTERNATIONAL POSITION.

~~HEATH ASSUMES THAT THE HIGH INTEREST RATES IN THE UNITED STATES WILL CONTINUE FOR MANY YEARS - QUOTE OVER A LONG PERIOD OF TIME UNQUOTE. HE MUST THEREFORE KNOW MUCH MORE THAN ANY OF THE EXPERTS.~~

~~HISTORICALLY HIGH INTEREST RATES FOR MANY YEARS, .~~



→ S THAT THE HIGH INTEREST RATES IN THE UNITED STATES WILL CONTINUE FOR MANY YEARS - QUOTE OVER A LONG PERIOD OF TIME UNQUOTE. HE MUST THEREFORE KNOW MUCH MORE THAN ANY OF THE EXPERTS.

HISTORICALLY HIGH INTEREST RATES OF THE ORDER WE ARE EXPERIENCING TODAY HAVE RARELY, IF EVER, PERSISTED FOR MORE THAN A FEW MONTHS. RECALL THE SITUATION IN THE END OF 1974 AND 1975 WHEN INTEREST RATES IN THE UK WERE AT ALL TIME HIGHS AND THE YIELD ON CONSOLS WAS EQUAL TO ITS PRICE. WITHIN A FEW WEEKS, HOWEVER, THE STOCK MARKET HAD EXPERIENCED THE STEEPEST RISE IN ITS HISTORY AND ALMOST DOUBLED, AND INTEREST RATES TUMBLED AND FINALLY, IN 1975 AND 1976 THEY WERE AT VERY LOW RATES. AMERICAN INTEREST RATES HAVE BEEN HIGH ONLY FOR ABOUT THREE MONTHS. AND THERE ARE ALREADY SIGNS OF THEIR EASING. THE BANKS CUT THE US PRIME RATES TODAY TO 10 PERCENT. YET HEATH SUGGESTS PROBABLY THE MOST FAR-REACHING DRASTIC STRUCTURAL CHANGES TO CUT OURSELVES OFF FROM THE GREAT LEADER OF WESTERN DEMOCRACY.

## HOW TO REGAIN CONTROL OF OUR SITUATION.

HEATH DOESNT UNDERSTAND WHAT DETERMINES INTEREST RATES. HE SAYS THAT THE COMMUNITY MUST BE ABLE TO ADJUST AND COORDINATE THEIR INTEREST RATES WITHOUT HAVING TO ELEVATE THEM TO AMERICAN LEVELS. BUT THE COMMUNITY DO NOT HAVE INTEREST RATES WHICH ARE ANYWHERE NEAR THE AMERICAN LEVEL. THE WEST GERMAN MARK FOR EXAMPLE IS AT A LITTLE MORE THAN 11 PERCENT AND IS FALLING. OUTSIDE THE COMMUNITY THE SWISS FRANC IS ABOUT 7 PERCENT AND ALSO FALLING. THE POINT IS THAT THE EXPECTED RATE OF APPRECIATION OF THE CURRENCY, WHICH IS RELATED TO THE EXPECTED RATE OF INFLATION, ALSO VERY MUCH AFFECTS INTEREST RATES. THE LOW SWISS AND GERMAN RATES AND THE LOW JAPANESE RATES, AT ABOUT 6.1/2 PERCENT, REFLECT THE LOW EXPECTED RATE OF INFLATION IN GERMANY, SWITZERLAND AND JAPAN. THE REFERENCE TO THE EMS IS GARBLED AND MIGHT MEAN ANYTHING OR NOTHING.

### ACTION BY THE EUROPEAN COMMUNITY.

THE MISCONCEPTIONS HERE ARE VERY NUMEROUS. HEATH WANTS A VAST EXCHANGE CONTROL SYSTEM WITHIN THE COMMUNITY AND THIS TO BE USED TO STOP ''HOT MONEY POURING IN OR CAPITAL FLOWING OUT.''  OUR EXCHANGE CONTROL SYSTEM APPLIED ONLY TO RESIDENTS OF THE UNITED KINGDOM. THE AMOUNT OF HOT MONEY OR COLD MONEY OWNED BY THEM WAS VERY SMALL COMPARED WITH THE AMOUNT OWNED BY NON RESIDENTS WHO WERE NOT SUBJECT TO SUCH CONTROL. EVEN WITH THE FULL PANOPLY OF EXCHANGE CONTROLS IN 1967/68 AND IN 1976 THERE WAS THE MOST ENORMOUS CAPITAL MOVEMENTS WHICH THE RESERVES COULD NOT BEAR. HEATH SEEMS TO THINK THAT EXCHANGE CONTROLS WITHIN A COUNTRY, THAT IS APPLYING TO RESIDENTS, WILL SOMEHOW STOP NON RESIDENTS SPECULATING AGAINST THAT CURRENCY. THIS IS DEMONSTRABLY FALSE. HEATHS IDEAS ABOUT EURO-CURRENCIES ARE, TO PUT IT MILDLY, NAIVE. IF YOU TRY TO IMPOSE CONTROLS ON THE EURO-BANKS IN LONDON, FOR EXAMPLE, THEY WILL SIMPLY MOVE ELSEWHERE. HEATHS RECIPE IS ONE FOR ABOLISHING OUR MOST SUCCESSFUL INDUSTRY, THE BANKING BUSINESS. IT WOULD FLOW QUICKLY TO SWITZERLAND, SINGAPORE AND OTHER AREAS OUTSIDE THE REACH OF MR HEATHS REGULATORS. I WOULD GUESS THAT THE UNITED STATES WOULD VERY MUCH WELCOME THE EURO BANKING INDUSTRY INTO NEW YORK AND OTHER GREAT CITIES IN THE UNITED STATES. IT HAS ALREADY PASSED LEGISLATION THAT MAKES IT MUCH EASIER FOR EURO-BANKS TO OPERATE STATESIDE. 

## WORLD DEMAND AND INTERNATIONAL TRADE.

THIS IS A PLUG FOR BRANDT. THE VAST MAJORITY OF THE INTERNATIONAL TRADE OCCURS BETWEEN DEVELOPED WESTERN COUNTRIES. HEATHS ARGUMENT IMPLIES HERE THAT WE SHOULD SUPPLY INTERNATIONAL INSTITUTIONS WITH FUNDS SO THAT THEY CAN CHANNEL THEM TO COUNTRIES SUCH AS TANZANIA ETC AND THEY WILL HELP BRITAIN PULL HERSELF OUT OF THE RECESSION. THE POINT IS THAT IN THE DEVELOPING WORLD THE MAIN ENGINES OF GROWTH ARE THE FREE ENTERPRISE ECONOMIES, TAIWAN, HONG KONG, BRAZIL, MEXICO, ETC. THE PROVISION OF FUNDS FOR TANZANIANS WILL BE MORE LIKELY TO INHIBIT GROWTH AND TRADE RATHER THAN PROMOTE IT. THE SUBSIDY FOR OVERSEAS STUDENTS APPEARS TO BE ANOTHER BIT OF BRANDTS SPECIAL PLEADING.

## SUSTAINING RECOVERY.

THE FIRST POINT IS, IF NOT AN OBVIOUS ERROR, THEN AT LEAST VERY MISLEADING. THE PROCESS OF RECOVERY IN BRITAIN HAS BEEN ASSOCIATED WITH A VERY RAPID INCREASE IN IMPORTS OF MANUFACTURED GOODS. THIS HAS CAUSED THE BALANCE OF TRADE TO DETERIORATE. A TARIFF ON IMPORTS OF MANUFACTURED GOODS IS THE BASIS OF THE KALDOR/BENN PROPOSALS FOR A SIEGE ECONOMY. THE SECOND POINT SEEMS TO IMPLY THAT WE ARE JOINING EMS IN ORDER TO DEVALUE THE POUND. THIS MAY WELL BE FIRMLY IN HEATHS MIND. BUT IT HAS ITS OWN RATHER VICIOUS LITTLE CIRCLE OF DEVALUATION LEADING TO AN INCREASE IN THE PRICE LEVEL WHICH AGAIN CAUSES ANOTHER DEVALUATION ETC. ON HIS THIRD POINT I THINK HE HAS SOME SUBSTANCE, BUT AGAIN IT IS ECONOMICS WITHOUT PRICE. HE DOES NOT MENTION THE IMPORTANCE OF ADEQUATE REWARDS FOR SKILLS AND THE IMPORTANCE OF EXPANDING DIFFERENTIALS. AND FINALLY WE COME TO THAT DREADFUL VICIOUS CIRCLE AGAIN. HE SEEMS TO HAVE GOT HIS CONCEPT FROM READING ABOUT THE NONSENSE PURVEYED IN DEVELOPMENT ECONOMICS AS THE "VICIOUS CIRCLE OF POVERTY". THIS CONCEPT WAS DESTROYED UTTERLY BY PETER BAUER IN "DISSENT ON DEVELOPMENT" PAGE 31 ET SEQUENTA.

CONSENSUS POLITICS.

THIS IS ALTOGETHER STRANGE SINCE HEATH EARLIER SAID THAT THE CALLAGHAN ADMINISTRATION HAD CARRIED ON MONETARIST POLICIES WHICH WERE FOLLOWED BY THE PRESENT GOVERNMENT. DOES THIS NOT SHOW A HIGH DEGREE OF CONSENSUS? IT IS ALSO ODD INDEED TO SEE FRANCE, OVER THE PAST 30 YEARS, REFERRED TO AS A CONSENSUS COUNTRY. IT NEARLY HAD CIVIL WAR AND THE FOURTH REPUBLIC FELL OVER THIS PERIOD.

THE ANSWER TO THE MAN IN THE STREET.

THESE ARE MORE LIKE RED HERRINGS FROM THE MAN IN THE DOCK. WE OUGHT TO UTTERLY REFUTE THE PROPOSITION THAT INCREASING DIRECT TAXES INCREASE INFLATION. IT DOESNT. IT INCREASES THE PRICE LEVEL. IF INDIRECT TAXES INCREASED INFLATION, THEN REDUCTION OF INDIRECT TAXES SHOULD DECREASE INFLATION "AT A STROKE." THEN ON HEATHS RECIPE ALL WE NEED TO DO TO DECREASE INFLATION IS TO DECREASE INDIRECT TAXES AND GO ON DOING SO UNTIL INFLATION IS OUT OF THE SYSTEM. IN PRINCIPLE ONE COULD NOT MERELY DECREASE INDIRECT TAXES BUT SUPPLY THEIR COROLLARY SUBSIDIES TO ENSURE THAT INFLATION WAS ZERO OR EVEN NEGATIVE. TO SAY THIS IS SIMPLY TO DEMONSTRATE THAT IT IS A NONSENSE. INTERESTINGLY, HEATH NVEVER MENTIONS REAL WAGES AS THE CAUSE OF UNEMPLOYMENT NOR DOES HE TALK ABOUT THE LOW RATE OF RETURN ON CAPITAL. ALSO THERE IS NO MENTION OF AN INCOMES POLICY. BUT JUST AS CLEARLY AS HE WAS DRIVEN TO ONE IN 1973, SO WOULD HE BE BY ANY OF THE MEASURES HE HAS OUTLINED, SUPPOSING ONE COULD MAKE SENSE OF THEM, IN THIS PAPER. AS A FINAL MATTER OF FACT, AS A PROPORTION OF THE GDP THE LAST LABOUR GOVERNMENT RAN THE BIGGEST BUDGET DEFICIT IN HISTORY.

CARRINGTON

NNNN