PRIME MINISTER

cc Mr. Ridley

This note from Douglas Hague argues for a big, and early, relaxation of exchange controls. I suggest that we ask the Chancellor to take this into account in preparing his Budget: I am sure he will be considering the possibilities for exchange control relaxation. And I could write on your behalf to Douglas Hague telling him this. Do you agree?

Yes. MT

R.

8 May 1979

The Chancellor & I had a brief word about this yesterday but he must consult with the Governor first. MT.

TO: The Prime Minister

FROM: Douglas Hague

c.c. Chancellor of the Exchequer,
Treasury Chambers,
Great George Street, S.W.1.

DATE: 4th May 1979.

EXCHANGE CONTROL

The strength of the pound presents both an opportunity and a challenge.

The opportunity is to give the market a greater influence on the capital account of the balance of payments. Individuals and businesses should be given a greater role relative to the Treasury and Bank of England in deciding how a current balance of payments surplus should be offset, on capital account.

The challenge is to find a way of preventing the exchange rate rising too far too quickly, because of the difficulties that a high rate would cause for non-oil exporting industries. Again, the market should play a greater role, and the monetary authorities a smaller one, in determining what happens. We should therefore begin to relax exchange control.

Exchange control affects three main types of transaction:

a) finance of third-country trade in sterling;

b) direct investment overseas by U.K. companies;

c) portfolio and property investment through the dollar-premium pool.

A. Third-Country Finance

Until 1976, this was an important source of revenue for the U.K., with sterling used, for example, to finance exports of sugar from Cuba to Poland. Estimates of the amount of sterling involved range from £500m to more than £1b. Since a ban was put on the use of sterling to finance such trade, most of it has been financed in Euro-dollars. It will therefore be difficult to get back into the market, but many people in the City badly want to try. Because of this, the amount of sterling required to get back into the market would be less than £200m, but there would be a useful return on this once-for-all investment to the U.K. I recommend that we should permit third-country financing again.

B. Direct Investment

The outflow here would be larger - £300m (per annum) or less. The Bank of England is apparently taking a generous view of applications for finance for direct investment overseas. I recommend that this part of the exchange control system should also be abolished.

If we do so, the trade unions will argue that investment which might have taken place in the U.K. is going abroad. The answer is that this is not an either/or question. If we allow more investment overseas and that lowers the exchange rate, we shall have more investment in export industries within the U.K. as well.

C. <u>Investment through the dollar premium</u>

Those I have spoken to in the City agree that this type of exchange control should also be abolished, when possible, However, they worry lest relaxation here should lead to so big a capital outflow that it has to be reimposed. Phillips and Drew estimate tht total value of the portfolios of U.K. institutions (pension funds, insurance companies, investment trusts and unit trusts) at £100b, with about £8b per annum available for investment. If one adds what individuals might invest in securities and property, there is a large potential outflow.

I suggest a way of estimating the possible scale of outflow without taking an irreversable step. We could relax exchange control here, by arranging for the Bank of England to transfer foreign exchange into the premium-currency pool. One would want to give investors some indication of what was happening, perhaps by indicating the amount to be put into the pool in the next twelve months. The attraction of this idea is that one could quietly discover how much one had to put into the pool to reduce the dollar premium by a given amount. Indeed, in the end, one might be able to reduce the dollar premium to zero, and thus discover the cost of removing this type of control entirely.

I therefore suggest it as a way of moving towards the total abolition of exchange control without the risks involved in doing so completely and overtly. If the current account went into deficit, one could end, or even reverse, the procedure.

There is of course a good deal of economic theory and research lying behind this paper. I shall be delighted to go into more detail if asked.

J. C. H.