 Prime Minister 1

Are you content for the Chancellor to proceed as proposed?

Yes MT

TL 25/5

cc Mr Wolfson

cc Mr Hoskyns

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01-233 3000

PRIME MINISTER

(Mr Nott - Flag B - broadly supports these proposals, though he would have liked to go further. However, I think the Chancellor and the Governor have to make the final judgement).

EXCHANGE CONTROLS

One of our objectives is the liberalisation of our exchange control regime consistently with our EEC Treaty obligations. The present strength of sterling makes it appropriate to take a substantial first step in the Budget. I have therefore been considering with the Bank of England and Treasury officials the form of an initial package of relaxations. I have taken account of the suggestions put to you recently by Douglas Hague.

Flag A

It would not be sensible to attempt to dismantle our controls overnight. Our elaborate and restrictive regime has been in existence for 40 years. It is therefore very difficult to predict how all the companies and individuals would react to a massive liberalisation. The effects in the short run on the exchange rate could be destabilising. The world environment is particularly uncertain. One of the possibilities that we cannot exclude is a United States recession with a revival of the dollar that might cause a large outflow from sterling. The stability of sterling is important to our other policies. I conclude that we should proceed with exchange control relaxations one step at a time.

That being so, there are compelling arguments for starting with outward direct investment. I believe that, on balance, this will be helpful to British industry and exports. A big move to relax these controls can be made without jeopardising the

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remaining regime, and, in particular, the controls over outward portfolio investment where the risk of big and volatile capital flows is much greater. It is not possible to go the other way round and to make a large relaxation of controls on portfolio while attempting to retain controls on outward direct.

At present the rules are complex. Their overall effect is to require the bulk of outward direct investment to be financed either by foreign currency borrowing or by the reinvestment of overseas earnings. The most important relaxations I propose to make are

(i) the introduction of a ration of offical exchange of £5 million per investment project per year and

(ii) the abolition of the rule which restricts the reinvestment of profits earned overseas by requiring the repatriation of at least two-thirds of net taxed earnings.

These would be accompanied by changes affecting repayment of foreign currency borrowing.

It is practicable to make significant changes also in the controls affecting individuals without undermining the portfolio controls. I therefore propose to make substantial relaxations in the rules concerning emigration allowances, holiday homes, cash gifts and payments to dependants and travel allowances. The reference to "holiday homes" involves some political risk, but it is an area of control which is particularly labour-intensive (and so expensive to operate) for a limited return. On the whole I think it would be

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easier to dispose of in the context of a large package of this kind than to deal with it separately later.

I should also like to take this opportunity to reverse in part the decision in 1976 to deny sterling finance for third country trade. This is an area in which experience has shown speculation can be severe if confidence in the existing rate for sterling is weakened. The imposition of the control in 1976 played an important part in restoring confidence in sterling. On the other hand it also placed our merchants at a competitive disadvantage and denied banks a useful source of earnings. The Bank of England on my instructions are now consulting the City interests concerned to see whether a scheme could be worked out that would enable both merchants and banks to benefit from a relaxation of the rules without excessive risk of volatile flows. I understand that there should be no difficulty on a scheme for the merchants, but that I may be obliged to consider that it would be imprudent to extend the concession to the banks. If so, I would propose to add a different concession to the package in lieu of the concession to the banks: namely the doubling of the present period of one month for which firms generally can retain foreign currency earnings before they are required to convert them into sterling.

Fuller details of the relaxations I have in mind are set out in the Annex to this minute. You will see that the list also includes two modest initial steps on portfolio investment and the abolition of the gold coins control introduced in 1975. Final decisions will need to wait until I have the Bank of England's further advice on third country trade and also until I am able to assess the probable effect of the Budget as a whole on the exchange rate. So long as our policies command the confidence of the financial markets (in particular, our determination to cut public expenditure and to control the PSBR and the

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monetary aggregates), it is unlikely that the relaxations listed in the Annex will cause a substantial outflow from sterling.

When announcing these relaxations I propose to say that I will be studying over the months ahead further proposals for a gradual relaxation of exchange control extending into the field of portfolio investment. I would explain that further relaxations would be announced when conditions were appropriate and that the speed of relaxation would be influenced by the effect of international events on sterling as well as by the speed, with which we were able to solve our economic problems.

Officials have taken very informal soundings of Commission officials to find out how a package of the sort I envisage would be likely to be viewed by the Commission. This is important because our ability to keep the remaining exchange controls to which our EEC Treaty obligations apply depends on continued authorisation by the Commission. Also, in three minor respects, my proposals remove discrimination in favour of the Community. (At present the controls on outward direct investment, emigration allowances and cash gifts all have a more generous allowance for the Community than for the rest of the world. These discriminations add to the complexity of the exchange control regime and we are under strong pressure from the Americans to make our relaxations non-discriminatory.) The Commission would also prefer faster progress on portfolio; but Commission officials do not deny that there are important technical obstacles to be overcome before a controlled programme of relaxation for portfolio investment could be introduced.

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I am advised that the Commission are likely to go along with my proposed package provided that they are seen to have been consulted. I therefore intend to invite Commission officials to London to discuss the details of the package with the Treasury and the Bank about a week before the Budget. I will speak to Mr. Ortoli on the telephone myself a day or two before the Budget; and we shall invite the Commission to issue a Press Notice on Budget day simultaneously with ours so as to make it quite clear that they were fully consulted.

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I should be glad to know that you are content that I should proceed on the lines described above. Detailed work on the preparation of exchange control notices and other relevant documents is already in hand. To ensure no misunderstandings or confusion, the commercial banks and other exchange control agents should receive these notices by the morning after the announcement. To get them out on Budget Day, the texts need to be put in final form ready for printing no later than next Wednesday 30th May.

I am sending copies of this minute to the Secretaries of State for Foreign and Commonwealth Affairs, Industry and Trade, the Governor of the Bank of England and Sir John Hunt.

M A Hall.

(GEOFFREY HOWE)

(Approved by the Chancellor of the Exchequer and signed in his absence)

23rd May, 1979