R7.91

covering note
cc ECON POL: Public Exp
Pt 32

SECRET

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

2 July 1985

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew,

I attach drafts of the two papers for the Cabinet discussion of public expenditure on 11 July: the Chancellor's paper on economic prospects and the Chief Secretary's paper on the Survey. I am also enclosing a draft of the Chief Secretary's memorandum for the E(A) discussion of the review of nationalised industries investment and financing.

See ECON POL Public Exp Pt 32.

The Prime Minister will have an opportunity to discuss these papers with the Chancellor and Chief Secretary at her 5.30pm meeting tomorrow. She may also have views on the timing of the E(A) discussion of the nationalised industries IFR. Possible meeting dates this year are 10 and 17 July. In the past the position of nationalised industries has usually been discussed a day or two before Cabinet. In view of the difficult background set out in the E(A) paper, there may be some advantage this year in delaying the E(A) meeting until after Cabinet has discussed the aggregate figures.

Yours ever
Rachel.

RACHEL LOMAX
Principal Private Secretary

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ECONOMIC PROSPECTS PAPER FOR CABINET

The short term prospects for the economy are broadly similar to those foreseen at Budget time. The temporary rise in inflation has gone slightly further than was then envisaged and output is rather more buoyant. But the inflation rate is still expected to subside in the second half of the year and 1986 should see continued growth and significant progress towards lower inflation. The main risks overseas, as ever, concern developments in the US economy and the oil market. At home they concern the upward drift in earnings and the pressures which will arise if we fail to hold expenditure to its present plans.

The world

2. The major 7 economies are likely to grow at around 3% this year and next, with inflation averaging about 4%. World trade - on a UK trade weighted basis - may increase more slowly than the 7-8% achieved in 1984; about 5-6% this year and next. Some overseas markets of importance to the UK (particularly the oil producers) are expected to reduce their imports.

3. In the US, there has been little real progress on the federal deficit. But though output growth has slowed down, domestic demand is still reasonably strong. A lower dollar is likely. The US current account deficit seems likely to persist and there are dangers from the growth of protectionist pressure.

4. The world oil market remains in a fragile state. Some fall in the world price seems likely, and a sharp fall a possibility.

The British Economy

5. At home the prospects continue to look reasonably good. We have now embarked on our fifth year of continuous growth in national output, and can look forward with some confidence to a sixth. Boosted by the rebound after the coal strike, output should rise by 3½ per cent this year and perhaps by a further

2½ per cent in 1986. This would be a commendable performance, bearing in mind that North Sea output is likely to start falling next year.

6. The expansion is broadly based. Real personal disposable incomes should grow by 2½-3% this year, resulting in rising personal spending. This could be faster next year as inflation falls.

7. Company profits have recovered substantially. The 1984 rate of return for industrial and commercial companies (excluding North Sea oil) was as good as at any time since 1973. (If oil is included, it was the highest since records began in 1960.) Business fixed investment is likely to remain strong in 1985 and should rise further in 1986. But there have been further economies in stockholding in the first quarter of this year. Overall, domestic demand may rise by 2% in 1985. Exports of goods and services seem to be more than holding their share of world trade and are expected to rise by 8%, after 7% growth last year. In 1986 the balance might change to 3% growth in both domestic demand and exports.

8. The recent increase in the RPI is expected to be temporary but the peak (probably in July) will be about 1% higher than was forecast at Budget time. The recovery in the exchange rate since February this year, and the prospect of a steadier, and perhaps falling, mortgage rate will result in lower inflation probably from August onwards, falling to under 5% this time next year.

9. A continuing high level of pay settlements makes progress on employment more difficult. It does not look as though there will be any decline in private sector settlements in the coming pay round. Indeed, there is some risk of a further increase. So although the forecast assumes continued tough bargaining in the public sector with public service earnings rising more slowly than in the private sector, pressures for closer parity with those in the private sector will undoubtedly increase.

10. Against this background, the prospects for unemployment are uncertain. Total employment is estimated to have risen by 600,000 between March 1983 and December 1984. This rise is more than accounted for by increases in part-time employment and self-employment. The number of full-time males in jobs fell. And as many of the new jobs have also been taken by new entrants to the labour force, unemployment has continued to rise, at an underlying rate of perhaps 10,000 to 15,000 a month. The unemployment statistics may overstate the number of people looking for jobs; a considerable proportion of the claimants who have been unemployed for a year or more are not actively seeking work. But, although the employment measures announced in the Budget have not yet had time to make any significant impact, the fact that demographic changes will add ½% to the labour force over the next two years means that a substantial drop in the unemployment count is unlikely.

11. Turning to the financial picture, the extreme nervousness in the financial markets at the turn of the year has been overcome. But there is no scope for relaxation. Experience early this year shows that the credibility of policy cannot be taken for granted. We must continue to demonstrate to a world in which most major countries have lower inflation than us, that we are determined to maintain sound financial policies and that they are consistent with bringing inflation back to a downward trend.

12. Despite some fall in North Sea oil revenues, we remain on track for the £7 billion PSBR set for 1985-86 at the time of the Budget. But to avoid any overrun on borrowing (and hence upward pressure on interest rates) we must ensure that we keep to our spending plans, both in the current and future financial years. The Chief Secretary's paper makes clear that the pressures for higher public spending remain intense. It will require great determination to maintain the firm control of expenditure which is central to our economic strategy and essential if we are to maintain any prospect of reducing the tax burden.

13. A summary of the most recent Treasury forecast is in the attached table.

Conclusion

14. In most respects, the economy is doing well. Output and employment are rising, though unemployment is not yet on a downward trend. Inflation is set to resume its decline. But there are dangers. We may have to be in a position to withstand a sharp change in the dollar, or the oil price. And we have a good way to go to match the inflation performance of our more successful competitors. At home, we face upward pressure on earnings growth with the consequent problems for employment. We must not add to these hazards by allowing public expenditure to increase beyond our plans.

15. The burden of taxation and national insurance contributions is still substantially higher than it was in 1978-79, despite a small reduction in the last Budget. Further progress towards reducing the tax burden must be made, both for the sake of employment and to maintain political credibility. If we are to secure those reductions it is essential that we agree to the Chief Secretary's proposals for the Survey. I urge my colleagues to do so.

Mr Turnbull

NDPM
AT 24/6

PRIVY COUNCIL OFFICE

WHITEHALL. LONDON SW1A 2AT

24 June 1985

Dear Leon

I attach a background note on 'Inflation, Pay and Jobs'. I hope you and other colleagues on the Economic and Social Group will be able to give it a wide circulation among your group of MPs so that they can make good use of it in presenting the Government's policies.

Yours

Willie

The Rt Hon Leon Brittan QC MP

BACKROUND NOTE

INFLATION, PAY AND JOBS

The British economy is entering its fifth successive year of economic growth after the deepest recession since the Second World War.

If we are to nurture the recovery, we need to keep the closest possible watch on two numbers - the rates of increase in inflation and our unit wage costs - and to do everything possible to slow down their rise.

The first priority is to hold down - and drive down - inflation. Recent increases in the rate of price rises to 7% this month are a reminder that inflation is not beaten yet. But the rise is temporary. Producers' output prices are rising slightly less fast than a year ago, and this month has also brought encouragement with the smallest rise (3.6%) for four years in raw material prices paid by our manufacturers.

All this bears out the Government's prediction that retail price inflation will fall appreciably from 7% in the second half of this year: a prediction supported by most outside forecasters. The Government's financial policies will ensure that, just as they have brought inflation down from a peak of over 20% in 1980.

But the outlook for jobs depends on the behaviour of pay bargainers. If they try - and succeed in - using the present hump in inflation to raise pay demands they will be directly damaging the prospects not only of those currently out of work, but also those whose jobs they are trying to make better paid.

Why?

This is because, unless matched by better efficiency, pay increases merely add to costs and so impair our chances of winning orders.

This leads on to the second number we must keep under the closest scrutiny - the rate of increase in unit wage costs, or put another way, the cost in each factory of producing a particular product.

Here again, as with inflation, our performance on unit cost increases is a long way out line with our competitors'.

Over the last three months they were up 6.4% on a year earlier - double the increase seen at this time last year. Yet the unit wage costs of our competitors have been rising either very little or even falling.

In 1984, unit wage costs actually fell by 1% in West Germany and the USA, and by 4.5% in Japan.

This is the clearest possible warning of the risks we are running in Britain of pricing British goods out of foreign markets.

Both today's inflation rate and the rate of increase in unit wage costs are too high and must be brought down.

And pay bargainers, who are only too ready to blame the Government for unemployment, must recognise - and the workers whose jobs depend on what they do must make them recognise - that they have a direct responsibility for the level of unemployment.

Efficiency and competitiveness in industry and commerce are the key to jobs, for they are the key to sustaining economic growth. So what is needed today is realism and restraint by pay bargainers who accept and acknowledge the contribution they have to make to keeping people in work and to getting more people now out of work into productive jobs.

~~cc Richard Hatfield~~
Keep for 6 weeks

The Sampson Letter

18th June 1985
No. 19

A fortnightly report on world politics and finance

Europe's new challenge: the view from Paris

France is now more than ever the key piece in the Western jigsaw of politics and technology, as President Mitterand pits his own Eureka programme as the civilian rival (or parallel?) to Reagan's Star Wars.

But how seriously worked out are the French proposals? Last week I was in Paris talking to French government experts and advisers. I came back more convinced that there is a real movement towards closer co-operation - which should show itself at the Milan summit on June 28 - from which no major technological company can afford to stay aloof.

The outward political signs, it is true, are not too hopeful. Mitterand is disenchanted with Kohl, particularly since he used the veto to protect cereal prices a month ago. The Americans' tactless diplomacy over Star Wars threatens to divide Europeans further. The football massacre in Brussels has hardly improved the spirit of Europe - least of all in Britain.

But there is some hope in Paris that Mrs Thatcher - partly because of 'Britain's shame' - will lean over backwards at Milan to show herself a good European. And Mitterand, whatever his other setbacks, is still staking his reputation on forging closer European unity - particularly in technology.

HOW THEY FOUND EUREKA

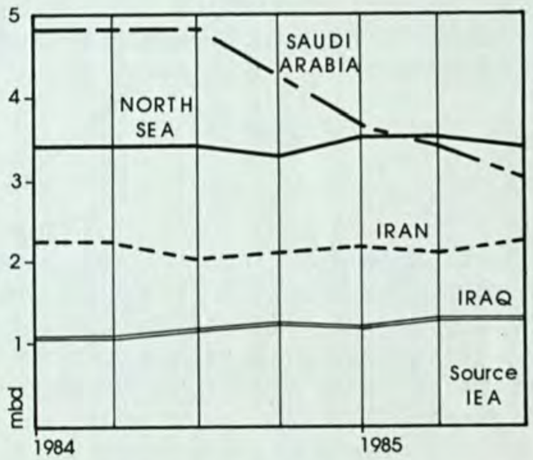
The French commitment to Eureka still looks rather vague. But it is more thought-through than it looks to others. As one of Mitterand's advisers put it to me last week:

We had the idea of Eureka in January, at a sherpa meeting before the Bonn summit. It was suddenly clear that the Americans had their own Star Wars project, MITI in Japan had its programme, and Europe had nothing. Then we consulted companies, and realised that they were waiting for governments to lead.

European co-operation in high-tech today is like the European coal and steel community - and later Euratom - in the fifties. Why did Britain stay out then?

The French were determined to see Star Wars as a challenge to which Europe must respond: the word <u>défi</u> runs through their memos. Another of the President's aides reported in a note on March 25:

'Europe indirectly finances Star Wars research; by the movement of capital towards the US it makes good the budget deficit and the greed (boulimie) of the



THIS LETTER looks at the implications of the growing oil-glut, to which the North Sea now contributes more than Saudi Arabia (p.6)

It also includes:

- *Lt-Gen Abrahamson on Star Wars research in Europe (p.3)*
- *Basil de Ferranti on European protection (p.8)*
- *Reports from Brunei on the Sultan and Harrods (p.4)*
- *Malaysia and the Russian chocolate-eaters (p.4)*

ANTHONY SAMPSON

Treasury.. the leitmotiv of the US Congress is how to make Europe pay for this defence effort.'

But Europe, the note continued, should have the means to do something on its own - even though France and Germany spend only $29b on research and development, compared to $110b spent by the US.

When Mitterand proclaimed the Eureka plan at the Bonn summit in March it still sounded very vague. But (one adviser said), 'We could have made it less vague. We did prepare a thorough 500-page document in typically French style. But we wanted to leave the discussion open to other countries'.

Over the following weeks an interministerial team has been meeting in Paris every Saturday to firm up the proposals. A government memo on Eureka, dated May 1, stressed the need for agreed objectives before broaching the 'vast palette of scientific knowledge'. It described Eureka as being made up of:

* a political commitment to master the technologies of the future.
* an improvement and reorientation of the existing R & D programmes.
* a pragmatic application of agreed programmes.
* a policy of stimulating innovation by opening up markets, fiscal incentives and measures in specific sectors.

EUROPE VERSUS THE COMMUNITY?

How far can Eureka provide a real push to technological unity in Europe? The British (see my last Letter) have been sceptical that the French are being bureaucratic and étatiste, and that they will never open up their own government contracts - least of all in telecom - to foreigners.

But the French strongly deny this. 'We don't want Eureka to be bureaucratic', said one aide. 'It should be a go-between (you remember the film?). And we did offer to open up telecom bidding reciprocally with Britain: it was Plessey which refused to let foreigners break into their market.'

And both the French and British agree that they must not link technological plans too closely to the European Community, whose President Jacques Delors (rather embarrassingly) will put forward his own plans for technology at the Milan Summit in two weeks' time.

Mitterand's team want to keep Eureka away from the Community. As one of them said: 'We can't have every member including the Irish and the Greeks insisting on their own share - le juste retour. We want to include Sweden, Switzerland and others.'

And Mrs Thatcher is very wary of EEC projects like ISPRA or CERN, and of the EEC research budget which has just doubled. She dreads companies leaning on government subsidies. She wants to keep research co-operation as informal as possible, with a top committee of officials - including Sir Robin Nicholson, the chief scientific adviser who is much in play - to short-cut bureaucracies.

Star Wars, in the meantime, has the huge attraction to techno-companies, even in France, of offering funds. Most French aerospace chiefs, including Henri Martre of Aerospatiale, have carefully kept their distance from Washington, knowing their dependence on French government.

But the President of the succesful aerospace company Matra, Jean-Luc Lagardere, said last week that it was already in contact with the Americans, and that it had sufficient areas of excellence to collaborate as equals. He said it was 'inept' to set Eureka against Star Wars. 'We must be pragmatic, and not play toreadors'.

The British accept that Star Wars research will go ahead, but they now have more reservations. The minister of defence Michael Heseltine is becoming more overtly anti-American - fuelled by his dislike of Cap Weinberger.

Mrs Thatcher remains loyal to Washington; but she has become more interested in Eureka. And her advisers are worried that the advanced computer systems developed for Star Wars, which will remain very secretive (see Abrahamson opposite), will give IBM and the other Americans a still longer lead.

LAST-REEL DIPLOMACY

And many European governments in NATO share the same fears about Reagan's sentimental rhetoric and approach to Star Wars - the 'last-reel diplomacy' of a President who is waiting for the final happy ending against the sunset.

There remain many obstacles in the way of Eureka. However successful the 'go-betweens' they are unlikely to achieve any real direction or push (it seems to me) without major government funding.

Many Europeans, including some high-tech leaders (like Philip Hughes of Logica - see my last Letter), hope that Eureka can respond to social challenges to technology - in health, education or communications - to counterbalance the defence challenge. But new breakthroughs in computing are unlikely to happen without pressure from major contracts.

The French, British and Germans are still a long way from agreeing, and from breaking away from their own bureaucratic constraints; while Star Wars is setting a faster pace for collaboration in a different direction.

But I believe nevertheless that the challenge of Star Wars will provoke a constructive European response, in which even the French and British - in spite of their ancient rivalries - will collaborate.

The French want big systems

'French companies are looking for big projects with high stakes', says Albert Bressand, the French diplomat who runs the research project Promethée, analysing what's wrong with Europe:

They know - even Dassault - that they've run out of projects on their own. But they don't like the idea of isolated research that's implied in Star Wars: they want systems, not bits of systems, which can make Eureka into a bargaining-counter with the Americans. They don't want to be sous-traitants - though the American word subcontractor may sound better.

They're worried about the secrecy of working for Americans. There's a danger that the politicising in Star Wars will infect other industries - including the Community's Esprit programme.

The French too often see programmes in terms of their own production. That was why the government didn't use Apple computers, which were the most suited for children, for French schools. The priority should have been to spread consumption of computers, but they turned it into helping French production. The Europeans must be on the leading edge of consumption, like the Japanese.

Star Wars and secrecy

The chief of the Star Wars research in Washington, Lieut-Gen Jim Abrahamson, flew to London for two days last week (Pan Am economy class) to report to American ambassadors in Europe. I asked him whether he was worried by the European complaints that Star Wars would fragment them and encourage a brain drain:

No, I'm not worried - it's part of a process of debate and explanation. We're not trying to take bunches of scientists over to the US: in fact it's just the opposite, US scientists will be going over to Europe, and some may well stay there.

We're looking for brilliant teams of creative people who can take a portion of technology and push it forward in a constructive way. We hope there will be European teams who can take a leadership position, and can use research for their own interests - including applying the technology to conventional military battles.

NATO didn't really refuse to endorse Star Wars at their Lisbon meeting. It was like forgetting to say to your wife 'I love you today, baby'.

We all should have the same interest in protecting sensitive technology and preventing an illegal and improper technical flow to the East. That not only erodes our own advantage, but costs money to make up for the erosion. Well over half the research in the US is unclassified. Command and control systems, with their complex computer software, are probably the most highly protected.

The key to any restrictions is the mutual decision about sensitivity. The people who get the main benefit from the research are the teams who are creating knowledge, who know what they're doing. If the US pays for the research it has the right to use it without paying royalties; but that doesn't stop the team applying it to military projects in their own country.

Defense research pushes civilian technology forward in a dramatic way, as it did with micro-wave ovens. Sensors are already being used to help paraplegics walk. It's hogwash to suggest that space research can't be applied to civilian uses.

People and pointers

THE SULTAN OF HARRODS

Can a billion-dollar business remain indefinitely with no visible owner? The extraordinary story of Harrods and its British department stores is now taking a new twist.

Three months ago, after visiting Brunei, I first revealed that the real owner of Harrods was almost certainly not the Egyptian Al-Fayed family, but the Sultan of Brunei for whom they acted as agents. Now the Sultan's ownership is widely assumed: 'The Bruneians all assume it', says a friend just returned from Brunei 'and they're proud of it'.

But the saga has a new episode; for it has become clear that the Sultan has now virtually disowned Mohamed Al-Fayed. Having first asked the British government to give Al-Fayed VIP treatment - including highly-prized privileges at airports - he has since withdrawn the request.

The Sultan has apparently turned against Al-Fayed (as he earlier turned against his previous financial adviser Adnan Khashoggi, Al-Fayed's ex-brother-in-law) - partly because of his handling of the Harrods bid. Thus Harrods is left with no evident link with its owner - except through a secret guarantee to a Lichtenstein bank.

And the Sultan himself is now, according to my Brunei sources, behaving rather oddly. He has missed polo-games; he is growing a beard; Khashoggi has been back to Brunei.

There have been open rifts between the Sultan and his father, the much more austere previous Sultan: they have been praying at different mosques. Mrs Thatcher's visit to Brunei two months ago was uneasy: the Sultan was thought to be upset that she did not curtsey.

This month the Sultan was supposed to receive an honorary degree at the American College in Paris, which his representative in London would have accepted for him; but the Sultan cancelled it - without telling the college.

The British government is in an embarrassing position over Harrods, having first stopped Tiny Rowland from buying it, and then allowed the Al-Fayeds to. (Though Rowland has since behaved so badly, by trying to smear the Al-Fayeds in his paper The Observer, that he has spoilt his own case).

Kleinwort's, who negotiated the Harrods deal, are still more embarrassed - having stated firmly that 'there is no hidden hand' behind the Al-Fayeds, which few people can now believe. There are rumours that senior heads will soon roll at Kleinwort's; and that their blunder cost them the lucrative business of privatising British Gas, which last week went to Rothschilds instead.

Where will this odd story end? There is no obvious reason why the Sultan should not openly own Harrods, as he owns the Dorchester hotel. But to keep such a major financial asset in limbo will only embarrass everyone in the end.

OPEC, NIGERIA AND PRIVATE JETTIES

Professor Tam David-West, the Nigerian oil minister, is acquiring a reputation for speeches of refreshing candour - which are all the more interesting in view of Nigeria's pivotal position in OPEC.

In a recent outburst in Jos (reproduced in the current OPEC Bulletin) he enlivened his audience by explaining:

Quick-money devices are often resorted to by quite a good number of Nigerians. Illegal oil deals, illegal bunkering, smuggling, unauthorised crude oil allocations, fronting, conmen, etc, all conspire to disrupt and even destroy the economy.

Other negative factors in the economy were the 'Private Jetty Culture' - about 200 of these existed during the last civilian administration, most of them depots for smuggling and illegal deals especially in oil - the 'Container Culture' and the 'Commission Culture'... Unless and until we resolve these contradictions in our daily lives, Nigeria will continue to be a moral cripple and an economic invalid.

David-West concluded by attacking critics who suggest that Nigeria should leave OPEC altogether, to produce as much oil as it wants. It would, he said, be 'clearly a desperate or panic action'. Nigeria anyway could not produce much more than 2 million barrels a day; and OPEC could team up to price Nigeria out of the market. He went on:

I have often likened such a situation to the withdrawal of a person from membership of a Secret Society. Once in, it is advisable to stay in, even if not-so-happy. Because the maverick members could be eliminated 'in the interests' of the Organization.

A number of leading OPEC countries could easily unleash such an attack since their production price per barrel is very low. We must not forget for one moment that we are OPEC's weakest link.

BROKEN CROCKERY?

Chester Crocker, the urbane diplomat in charge of Africa at the State Department, was in London last week, quietly defending his policy of 'constructive engagement' towards South Africa.

He insists that his policy is still essential, despite Pretoria's apparent bad faith with Washington in both Mozambique and Angola, where rebel armies are now clearly supported from South Africa.

It is not a question, he says, of trusting South Africa or anyone else - 'trust is a matter for family members, or lovers' - but of dealing with the real forces in the region.

But the next few weeks may reveal more about the real forces, or their limitations. June 16 marks the anniversary of the Soweto uprising in Johannesburg nine years ago; and later this month the African National Congress will hold a major conference in Tanzania to discuss future strategy in South Africa. Its new slogan is 'Make South Africa Ungovernable' - a prospect which looks ominously imminent now that several black townships are virtually no-go areas.

The militancy of Congress raises a new question for Crocker - and for the British Foreign Office. Does constructive engagement extend to engaging with the black leadership - including Mandela?

<u>Commodities and Countries</u>

WAITING FOR RUSSIAN CHOCOLATE

On top of Africa's other commodity problems come the troubles of cocoa. Not only is an imminent cocoa glut in West Africa pushing down prices; but Malaysia threatens to by-pass Africa altogether by huge plantings of cocoa - as it has already done with oil palm.

It is partly the familiar pattern, like sugar or copper, of too much production, too little consumption. The cocoa lobby has had some success: the Japanese are taking to cocoa-drinking, and chocolate is increasingly being sold to the West as a high-energy sports food, with Mars (for instance) sponsoring the London Marathon.

But the West still seems almost saturated with chocolate, and developing countries are not very keen - partly because it melts in the heat.

Next month the producers will meet to try, once again, to stabilise prices in the International Cocoa Organisation. But neither the US (the biggest consumer) nor Ivory Coast (the biggest producer) belong to it; and there are no funds for buffer-stocks.

World consumption looks like declining through 1985, and the producers look longingly towards the Russians who have an almost unlimited appetite for chocolate - if they can afford it.

<u>Top Cocoa Producers</u> ('000 tonnes raw)

	1974/75	1979/80	1984/85
Ivory Coast	242	379	505
Brazil	273	294	396
Ghana	377	285	170
Nigeria	214	169	150
Cameroun	118	124	114
Malaysia	13	32	100
Ecuador	78	98	80

Source: Gill & Duffus

The oil-slide: how it hits Saudis, Britons or Texans

The oil-price, as this Letter has repeatedly warned, is now feeling the full strain of the summer slump. The two weeks until the next OPEC meeting on June 30 will be very tense.

'There's nothing to suggest that OPEC can coalesce, even round a lower number' reports a well-placed informant in the British National Oil Corporation (soon to be disbanded). 'It's hard to imagine what can reverse the downward drift. The IEA figures for world demand look bad enough - and they are always over-optimistic, as the oil companies which supply them admit'.

OPEC is becoming more obviously worried. King Fahd has made clear that Saudi Arabia won't tolerate more cheating (without actually mentioning Nigeria). 'It's one thing to be the swing producer' as one oilman put it: 'it's another to look like an idiot'.

Yamani repeats his threats of a price-war in retaliation. But it's hard to imagine the Saudis actually risking making drastic price-cuts while demand is so slack.

In the meantime Iran is reported to be discounting by $4 a barrel, and Iraq is pushing ahead with its pipeline - which should be pumping at least another 200,000 barrels a day by October, and perhaps half a million next year.

And for the last month (see front page box) the North Sea has been producing more than Saudi Arabia - an apparent economic absurdity. The British will produce about 200,000 barrels a day less during maintenance-work in the summer, but this does not reflect any deliberate cut-back.

OPEC members are both angry and baffled by Britain's all-out production. 'Won't it seem rather foolish when the oil is running out in the 'nineties?', asked a Nigerian diplomat. 'Is it part of a conspiracy to push the price down?'

WILL IT REVIVE EUROPE?

Certainly with all this high production and low demand, the surprise is that the price is not falling still faster. 'It shows that the market is still very imperfect and inefficient' says the London oil consultant Joe Roeber of Roeber Associates.

And the falling price produces its own kinks in the graph. 'It's rather like money at a time of high inflation' as George Soros of the Quantum Fund points out: 'when oil is going down, no-one wants to be holding too much - which produces temporary shortages'.

But the downward trend, I believe, will still continue, and the debate is hotting up as to how that will affect the ailing economies of the West.

There's little doubt that a lower oil-price will stimulate European industry, while offsetting the inflationary fears which so worry the Germans and British. In a rigorous survey in the current Amex Bank Review my colleague Richard O'Brien is very bearish about oil, and shows how 'the oil-price is now threatening to break through a significant long run trend line'. He concludes:

Even if real interest rates stay unchanged, a fall in inflation due to lower oil prices would pull down interest rates, further helping corporate cash flows. Given the present slowdown in the US economic expansion, and the increasing reliance on Europe to keep recovery going, a fall in European oil prices would be particularly timely.

But I still have a major reservation about the benefit to Europe. For the fact is that it was higher oil prices which stimulated Japanese technology after 1979, forcing companies to push up exports to pay for the oil.

If the Europeans enter a new era of cheap oil, they could well relax their already inadequate technological effort still further, becoming still less competitive with Japan and the US.

OIL, POUNDS AND DOLLARS

And for the British the falling oil-price is bound to be worrying, just when the pound looks better-placed against the dollar. For whatever the cheap-oilers may say about providing more jobs, the loss of oil revenues would be more serious for sterling than the gain to manufacturers.

'For the time being the high interest-rates in Britain are neutralising the falling oil-price', says Richard Dale of Rothschild's: 'but the effects of interest-rates can wear off. The markets tend to think of only one factor at a time. For a time people were worrying about Britain being a one-commodity country. Now they've forgotten oil for a bit. But if the price takes a real knock the oil factor will be back with a vengeance.'

The consequences for the US are obviously more complex, since bad news for Texas is good news for the East Coast. But the news from Texas will be very bad if the price falls below $23 or $22; and insiders in Texan banks report serious worries about the prospect of oil and Mexico going down together.

At present Washington has no intention of introducing import tariffs, even if the oil-price sinks suddenly. And certainly the Texan lobby is not what it was.

But a fall below $23 would seriously affect new oil-drilling, and bring new shocks to the banking system. And the pressure to introduce tariffs - from bankers, oil companies and Texans - would (I suspect) become irresistible.

An import tariff would make much sense for Americans - not least in helping to finance the deficit. But it would do nothing to stem the downward drift of the oil-price in the rest of the world - and might well accelerate it.

Latin America: the outward flow and debtor-power

The new round of brinkmanship between Argentina and the IMF has once again reminded bankers of the fragility of their debt agreements in Latin America.

In the meantime the political implications are deepening. I have received this letter from Stephany Griffith-Jones, the Chilean economist at the Institute of Development Studies:

Dear Anthony,

The fundamental fact remains that the Latin American continent has since 1982 been a net exporter of financial resources - particularly to the US.

Between 1982 and 1984 the net transfer averaged approximately US $25b annually - around 25% of the region's total exports of goods and services. Negative net transfers have not only curtailed present Latin American growth, but also endangered future growth by a sharp decline in investment levels. According to the recent report of the Inter-American Development Bank the ratio of investment declined from 26% of GNP in 1981 to 20% in 1983.

But it has not been fully understood that negative transfers also cause a shift in the bargaining position between creditors and debtors. When funds flow into a developing country, the greater bargaining strength lies in the lenders, who must ultimately decide to transfer funds and can impose their conditions.

But when the net funds flow outwards, the debtor government has potentially the greater bargaining strength, as it must decide to repay and ultimately to transfer the funds. The debtor can not only resist the conditions of the lender, but can impose his own.

It would seem an attractive option for large Latin American debtor governments to refuse to make transfers over, say, three to five years - which would reduce their servicing of the debt to the same levels as new inflows of capital. It would not imply a default but be postponing debt-servicing till feasible.

Such a measure could be made consistent with some proposals, such as interest capping, which are being discussed amongst central and private bankers in industrial countries. It could avoid major disruptions of the banking system.

Undoubtedly it would require some additional public funds from industrial countries, but they would be small in relation to the potential cost of an outright default. And more rapid growth in Latin America would clearly benefit exporters in industrial countries, and in the long-term the banks themselves.

Such a proposal may seem perhaps too radical. However, last year's Commonwealth Report on the Debt Crisis, chaired by Lord Lever, insisted that any satisfactory solution must urgently 'put an end to the premature outflows of resources from developing countries'. More surprisingly 'Business Latin America' - representing the largest multinational companies in the continent - has recently followed a similar line.

But only the debtors can transform general discussions into policy action.

Yours sincerely,

Stephany Griffith-Jones

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Is the European Community going more protectionist?

Developing countries are increasingly worried that the European Community is extending its protectionism beyond simple tariffs, with the help of its 'New Commercial Instrument'.

But another viewpoint is expressed in this letter I have received from Basil de Ferranti, the chairman of the Ferranti computer company who is also a (Conservative) Member of the European Parliament.

Dear Anthony,

I believe the New Commercial Instrument marked a breakthrough in deciding what goods to allow into the Community. It effectively extended Community preference into the non-tariff area.

The original cornerstone achievement of the EEC was the common external tariff which enabled member states to remove their internal tariffs, and established the principle of Community preference. However, all of us sordidly engaged in trade know only too well that tariffs have long since ceased to be an effective protectionist device. All countries use differing technical standards, testing procedures, safety laws and blatantly nationalistic purchasing policies to protect their faltering and probably incompetent firms from the challenge of competition.

The New Commercial Instrument, agreed by the European Council last December, provides the framework for member states to decide jointly whether goods from outside should be allowed into the Community market, or excluded for not meeting technical specifications, for dumping or unfair trading practices.

This could enable the whole Community to make foolish decisions to protect its own industries. But it does allow the Community to play a common negotiating hand to persuade other countries - which all have comparable arrangements - to reduce their non-tariff trade barriers.

The New Commercial Instrument now gives the Community real clout; but the conventional wisdom in Brussels pretends that it does not exist, in order to avoid frightening the world - particularly the Third World - into believing that the Community has gone protectionist.

This is a wholly mistaken policy. We should be proclaiming that the Community is determined to use its commercial clout to reduce trade barriers throughout the world.

Yours ever,

BASIL DE FERRANTI

Japan, Owen and Africa

Can part of Japan's surplus be effectively deployed by providing credit to Africa? David Owen, leader of the British SDP, sent me a bold proposal he put to the Japanese in Tokyo this month - which develops the ideas of the International Commission on Humanitarian Issues (he is a member) in the book Famine:

Although your aid budget is large, if one looks at aid plus defence spending Japan falls to the bottom of the league table of western democracies as a proportion of GNP. Japan cannot expect to have its aid programme assessed by its major trading partners without taking into account your low defence spending...

I would propose that Japan establishes a Japanese Credit Bank for Africa. It would work through small African community groups and voluntary agencies to provide concessional soft credit to the farmer. It would also have to establish links with the national banking structure in Africa.

Repayments on loans would be ploughed straight back into the African countryside. As the loans would have soft easy repayment schedules, this is an aid scheme. It is not in any way profit making. It requires that knowledge be built up of the client communities. This would provide marvellous opportunities for young Japanese staff to learn about African societies.

Although there are existing credit schemes in Africa, they have only limited success. The real pioneering work has so far been done in Asian rural communities. So no doubt there is already a reservoir of knowledge about such schemes in Japanese aid circles ...

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