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10 DOWNING STREET

From the Principal Private Secretary

SIR ROBERT ARMSTRONG

DISCUSSION PAPER FOR SECOND MEETING OF PERSONAL REPRESENTA-
TIVES ON 17-19 FEBRUARY 1984

The Prime Minister has now considered the discussion paper for the meeting of Personal Representatives which you submitted with your minute of 3 February (A084/409). She is content that you should circulate it, subject to the following points:-

- Paragraph 5: The reference in the 5th line might read:
"high nominal interest rates"
- Paragraph 9: The Prime Minister suggests leaving out the words from "and continues" to the end, on the grounds that OPEC's agreement on prices and production can be regarded as capable of imposing such pressures on the quotas that the agreement would break and cause prices to fall.
- Paragraph 11: At the end of the second sentence the words "low inflation and steady growth" should be substituted for "the rise in nominal national incomes".
- Paragraph 14: At the end of the second sentence the words "and would reduce the danger of trade restrictions continuing to mount for lack of such a forum" might be included.

/Paragraph 21:

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Paragraph 21: In the first indent; third line: the words "and eventually eliminate" might be inserted after "reduce".

In the second indent, the meaning of "or where other policy instruments are less easily used" is not clear and these words might be omitted.

In the sixth indent: the Prime Minister has doubts about ^{including the two sentences beginning} "It might also include an increased role for the World Bank" until the future of IDA is clearer.

Paragraph 22: In the third indent, the Prime Minister suggests inserting the words "in the long term as well as the short term" after "the problem of international debt".

Annex A:

Paragraph 40: The last words could be read as implying that higher oil prices would promote world trade: this could be avoided by ending the paragraph at "restrain imports".

F.R.B.

10 February 1984



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Prime Minister

Comments from Alan
marked on paras 5, 9,
11, 14, 21 and 22
of the paper.

Content that I should
authorise Sir R. Armstrong
to circulate the paper, subject
to considering these amendments?

Yes - I accept FERB

Alan's amendments 9.2.
not

MR. BUTLER

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1. Rose P1. tell Sir Alan H.G. PM
agreed with his comments and was
very grateful for them

2. C.F. P1. file with papers for Economic Summit

Generally I have no substantial objections, but there are one or two points which need clarification. The Treasury paper, pages 6, 8 and 10 were missing, so I have a rather elliptical idea of what the Treasury were saying.

MAIN PAPERPara 5

This refers to the level of international interest rates being "high". It is true that they are high in nominal terms relative to the history of the last 35 years, they are not high in real terms, except relative to the period of the great inflation from 1965-1979. US Treasury bills now yield about 8.5%, if we deduct marginal tax at roughly 30% rate this gives us a yield after tax of 6.0%. The inflation rate over three months is generally thought to be about 4% so the real yield after tax is only 2.0%. Similarly, long term Treasury bonds yield 11.5%. Allowing for marginal tax again at 30%, this gives the after tax yield of 8.0%. We do not know inflation in the long run but the Treasury forecast for the United States that it will be $5\frac{3}{4}\%$ in the first half of 1985 so this gives us a long term real interest rate after tax of slightly more than 2%. These are not high real rates of interest and they are entirely consistent with the yields after tax on sterling indexed gilts.

I think it would be better to say that there are high nominal interest rates which reflect the expectations of inflation of some 6% or so, in the United States. We might also add that these high rates of inflation are partly the consequence of the persistent federal deficits expected in the United States.

(Incidentally the Bank of England study in the December Bank of England Quarterly Bulletin supports these comments on the fact that the level of real interest rates is now about "normal".)

Para 9

It looks as though we are seeking price maintenance and are supporting OPEC's artificial restrictions on oil production. As you know, OPEC, by restricting output severely, will produce great pressures to break the quotas. And when they do break them, the price will fall dramatically. This would add to "instability".

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Para 11

It is suggested that monetary growth has now come down to the growth rate of nominal income and somehow that this is desirable. I think it would be better to say that monetary growth has been made more consonant with "low inflation and steady growth".

Para 14

I understood that the argument for a new round to follow the completion of the Tokyo round in 1985 was because it was thought that without a new focus there would be increasing danger of a continuation of the present mounting trade restrictions. This is not mentioned in para 14 as an argument for a new round. I also believe that there is a good argument for concentrating a new round on quantitative restrictions including perhaps the VRAs.

Para 21

I am a little unhappy about settling for "lower inflation". Is it not time to say that the ultimate aim is price stability in the long run, with money wages increasing in line with real productivity?

I cannot understand the phrase "where other policy instruments are less easily used". It sounds rather sinister.

It looks as though the idea of a World Bank bank for loans to poorer developing countries without access to commercial markets is some sort of replacement for the lack of IDA replenishment. It seems to me to be premature to propose such a new role for the World Bank until the future of IDA is clear.

Para 22

In the "Strategy for Dealing with Debt" I think it would be wise to stress that the Summit should consider seriously the long term implications of short term measures.

I have not commented on the Treasury paper as I am not sure what the status of the Treasury paper is. Is it to be distributed at the Summit meeting? If it is so to be designated then I think it needs careful editing. For example, in para 40 there is a suggestion that a higher price of oil will promote world trade!