cc B/up

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PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 15 SEPTEMBER

Following discussion with the Chancellor's office I suggest the following agenda.

(i) IMF meetings. The Chancellor will have left for the IMF/IBRD annual meeting in Berlin by the time you get back from Spain. So tomorrow's meeting is your last bilateral before that. You may want to ask the Chancellor how he sees things going, and what line he is proposing to take in his speeches. (You will recall that it was this time last year that the Chancellor talked about the advantages of managed floating). The Chancellor's office claim that he has not yet really turned his mind to his Berlin speeches.

Today's Telegraph carries a story (see Flag A) that the IMF will be pressing the UK to tighten the fiscal position. I gather from the Treasury this story is based on the leak of a draft IMF document, which they are trying to get changed before the final version emerges.

(ii) Markets. You will want to have the usual stocktaking. By the time you see the Chancellor we should know the initial market reactions to tomorrow's unemployment/earnings figures and the second quarter balance of payments figures. I attach at Flag B the RPI figures to be published on Friday; they are at the top end of the earlier forecast range.

(iii) Public expenditure. You agreed with the Chancellor last week on likely personalities to serve on the Star Chamber. The Chief Secretary is now well into his first round of bilaterals, but it is probably b

too soon to have a clear view of how things are going. But the Chancellor may want to comment briefly. Once he is back from Berlin at the end of the month you will want to have a discussion with him, the Chief Secretary and Mr. Parkinson about the likely workload for the Star Chamber.

(iv) Barlow Clowes. The meeting with the Chancellor follows immediately on your bilateral with Lord Young, and you may want to pass on to the Chancellor the outcome of any discussion on Barlow Clowes. (See the Lord Young meeting folder for more material on this subject).

I also enclose for background:

Flag C: The Treasury's latest monetary assessment; see particularly the annex on MO.

Flag D: Press release of a speech by the Chancellor today.

PRG.

PAUL GRAY

14 September 1988

SLHAZV

DAILY TELEGRAPH: WEDNESDAY, 14 SEPTEMBER, 1988

IMF want Britain to reverse tax cuts

By Anne Segall, Economics Correspondent

THE INTERNATIONAL Monetary Fund is worried at the speed with which Britain has been plunged into a balance of payments deficit this year and is to demand tough action from Mrs Thatcher, including the reversal of her tax cuts.

In a confidential paper, IMF economists argue that a £11 billion deficit this year and next is too large for comfort. Although they expect the deficit to narrow as the investment boom fades, they fear slow progress will expose Britain to an international loss of confidence and a run on the pound.

The IMF recognises Britain has much more leeway because of the huge build-up of foreign assets during the boom oil years than in 1976 when Denis Healey called in the IMF to rescue Britain from a balance of payments crisis. British investments abroad are worth currently £90 billion.

Echoing the recent views of the Paris-based Organisation for Economic Co-operation and Development, the IMF believes Britain should reduce public spending or raise taxes instead of relying on higher interest rates.

Treasury Ministers have ruled out credit controls or an autumn mini-Budget to cool the economy, claiming high interest rates are the correct response.

According to Mr John Major, Chief Secretary to the Treasury, there can be no justification for higher taxes, given the Government's strong financial position.

City Comment — P25

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IMF provides weapon for Lawson

CITY COMMENT

IF IT did not come from such an eminent body as the International Monetary Fund, the suggestion that taxes in Britain are too low would be laughable. This year the Government's income will cover its spending with perhaps £10 billion to spare, a figure which would have seemed incredible a decade ago.

Yet in a paper which will emerge at next month's annual meeting of the IMF in Berlin, the fund's economists argue that fiscal policy is too loose, and must be tightened to avoid trouble.

At first sight, such a conclusion seems enough to send Nigel Lawson into orbit around Checkpoint Charlie; the IMF spends much of its effort in curbing the enthusiasm of governments to spend their citizens' money, and to accuse us of sloppy fiscal policy at a time of unprecedented government surplus is more than a bit rich.

Yet Mr Lawson can turn this report to his advantage; what better weapon than the conclusions of an eminent, disinterested group to beat down the demands of the state spending departments? And how agreeable to be able to remind the opposition of the history of Britain and the IMF should some of the more painful spending battles be leaked to the House of Commons.

So what is the IMF on about? It worries, as is the fashion, about our shocking trade deficit, and the way we seem incapable of meeting our own demands from our own production. This is hardly new in post-war Britain. What is new is that the private sector is making the running.

The Government's large surplus is a counter-weight to the sudden decision of consumers to stop saving and spend instead. If it was not there, we would be deep in the economic mire. With consumers in their present mood, there is a good case for aiming for a still bigger surplus.

Mr Lawson and his colleagues have done their best to distance themselves from the problem, but this is disingenuous. We are all in the same boat, and something has got to be done to fix the leak. The IMF reckons there is little scope for cutting public spending; whether or not it is right, the political momentum to do so is certainly absent now.

We have got to be persuaded to spend less of our own money, and in economics terms, it makes little difference whether it is forcibly taken off us in taxes or whether we decide to save instead. The appetite to save is certainly there, as the astonishing rush of money into Business Expansion Schemes linked to residential property shows. The Government's original estimate of £125m this year is likely to be wrong by at least a factor of two.

Despite the doubtful prospects for hosue prices, investors are going for something which they see as an alternative to leaving money on deposit, or hazarding the stock market.

In macro-economics terms, the amounts are small. To make a serious impact on spending will take an attractive, safe investment—and as readers of this column know by now, that points to a proper new issue of National Savings Certificates. The IMF would approve.

Rudd makes a modest wager

NIGEL Rudd, the chairman of Raine Industries, is prepared to bet half a million pounds that the rival bid from Tarmac for roofing specialists Ruberoid is sent to the Monopolies Commission.

Yesterday he came up with an ingenious solution to the dilemma facing the Ruberoid shareholders and all it will cost Raine is an extra £500,000 in underwriting fees. In the context of a £128m bid, it is a modest price.

If enough Ruberoid shareholders accept Raine's 254p a share cash offer by 1 pm today, he will allow them to switch to Tarmac's 280p if the Office of Fair Trading lets Tarmac's bid go through unchallenged.

Raine's cash and share alternative will not close today but the stock market slide has pushed the value of this bid down to 234p, and out of investors' calculations.

The trick is that Raine has undertaken not to declare its bid unconditional if its shareholding (18·6 p.c.) plus acceptances pass 50 p.c., as is normal in contested bids, unless or until Tarmac's offer lapses. As long as the bid is not unconditional, Ruberoid shareholders can withdraw acceptances should Tarmac be allowed to proceed.

Tarmac has bought 11·3p.c. of Ruberoid in the market—it appeared not to want any yesterday—and has the board's 5·4 p.c. under its belt. Its hurdle remains the OFT.

The Raine ploy is elegant but, short of pulling out entirely, there was little else it could do. Getting a higher bid underwritten is out of the question in these markets. But the shareholders in Ruberoid should be grateful—and they should accept this morning if they physically can. Whether their board will take such a generous view is another matter.

A 'chute without a ripcord

TODAY a group of money managers meets to decide whether to abandon a rule which they made to guarantee the safety of their clients' money. The rule, if it goes, will be a casualty of the cost of regulation which has been imposed on them from outside and gives no such guarantee.

The group is the Association of Independent Fund Managers, whose rules say that member firms must not themselves hold their clients' money or shares. These must instead be held by independent custodians—banks or trust companies. It guards against managers who, like Norton Warburg and so many others, muddle up their own pockets with their clients'. The AIFM requires its members to produce auditors' certificates, every year, showing that the books have been examined and the rule is being kept.

Member firms bear the cost of this regulation—auditors' fees soon clock up. Now they also pay the cost of official regulation, through Imro (the Investment Management Regulatory Organisation) and the Securities and Investments Board. Some now jib at paying to be regulated twice over. At today's annual general meeting, the AIFM will consider amending its rule, so that it is recommended but not enforced.

It would be very much better if the official regulators adopted this simple and fireproof rule as their own. The AIFM vainly suggested that it should be binding on all investment managers, except those who were big and strong enough to be licensed under the Banking Act to take deposits. Savers, as usual, can now expect the worst of all worlds.

R14/9

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The Rt Hon Nigel Lawson MP (Blaby)
Chancellor of the Exchequer

Release Time: 14.00 hours, Wednesday, 14 September 1988 316/88

Extract from a speech by the Rt. Hon. Nigel Lawson MP (Blaby), Chancellor of the Exchequer, to the East London Conservative Group at Hornchurch, on Wednesday, 14 September 1988.

THE TRANSFORMATION OF THE SUPPLY SIDE

A fair amount of attention has understandably been paid in recent weeks to the demand side of the economy. But that should not obscure the dramatic - and continuing - improvement in the supply side, which is the key to the transformation of the British economy in the 1980s.

Today's figures show manufacturing output at an all-time high and growing fast - up 6½ per cent on a year ago. And the efficiency of manufacturing industry has improved out of all recognition.

- Output per head, where we fell woefully behind our competitors in the 1960s and 1970s, has risen faster than in any other major country in the 1980s. And this improvement goes on. Productivity is up 7% in the past year.

- Businesses are also making much better use of their plant and machinery. Company profitability has risen to the highest levels for nearly twenty years.

.../ better methods

Printed and published by Conservative Central Office, 32 Smith Square, London SW1P 3HH.

- Better methods of stock control have helped industry avoid the pronounced stock cycles which proved so destabilising in the past.

- And manufacturing exports are up 8½ per cent on a year ago.

Based on this success, firms have embarked on a massive increase in investment, to expand capacity, boost productivity further, and improve the quality of their products. The June Investment Intentions Survey from the DTI indicates that manufacturing investment may rise by as much as 16% this year, one of the biggest increases since the immediate post-War years. And equally important, the quality of investment is much higher.

Moreover - and this is a further indication of the transformation of the British economy - the rapid growth in demand and in output has been achieved while inflation has remained low. While the growth in earnings clearly needs to slow down, it has so far largely been matched by increased productivity, so that unit wage costs have scarcely risen at all over the last two years. Recorded inflation will inevitably show a significant increase both in the August RPI figure, which is published on Friday, and similarly in the October figure, as a result of the perverse way we - unlike almost all other industrial countries - include mortgage interest payments in our RPI. But this increase will be only a temporary blip, and indeed reflects the firm action we have taken to ensure that inflationary pressures remain under control.

One of the lessons of the 1980s is that the key to sustainable growth lies in the supply side of the economy. The current exceptional strength of consumer demand is temporary. But the improvement to the supply side is permanent, and will be of lasting benefit in the years to come.

ENDS

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 6 SEPTEMBER

Markets

The main item for the agenda is a general stocktaking on the markets following the decision to raise interest rates to 12 per cent. You will recall that in your talk with him this afternoon Alan Walters thought that, on present evidence, 12 per cent should be enough. I think that is probably right. But you will want to be aware of the latest MO figures (Flag A) which remain uncomfortably high. Today's market report is at Flag B.

Scottish CBI Speech

I have let the Chancellor have a copy of your draft CBI speech for Thursday. I do not yet know how he reacts to it. Presumably if he has any worries he will raise them.

Star Chamber Membership

I understand the Chancellor may raise the question of Star Chamber membership. All that has been settled so far is that Mr Parkinson will be the Chairman. The Treasury had been thinking in terms of Mr Clarke as one of the members, but following the reshuffle it is unlikely he will now be available (he will probably wish to be seen to be fighting his corner by taking the health programme to the Star Chamber).

It then becomes rather difficult to see how a strong Star Chamber team can be assembled. In the past total membership has been either 4 or 5, and we should probably be aiming for the higher number. The conceivable candidates are:-.

- the Lord President - I assume you would want him on to