PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 6 OCTOBER

You will be having your weekly bilateral with the Chancellor after Cabinet tomorrow.

I have agreed with the Chancellor's office that there need only be a thin agenda. You may want to have a brief word about the state of the markets, but this week has been very quiet and there are no decisions to be considered. The main item is for you to compare notes with the Chancellor on Party Conference speeches. I am told the Chancellor has not yet really addressed what he will be saying on Thursday, although I suspect the flavour may be similar to that of his IMF speech (enclosed at flag A for reference).

One particular item the Chancellor plans to announce next Thursday is the introduction of a new National Savings Instrument later in the year. I have not got full details of this, but the idea is to have a taxable capital bond. If he does not raise it you may like to ask the Chancellor about this.

I am still discussing with the Treasury the best timing for the next Seminar with the Chancellor, Peter Middleton and Terry Burns. I don't think there is any need for you to mention this tomorrow.

PRG.

PAUL GRAY
5 October 1988

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FILE

BOARDS OF GOVERNORS • 1988 ANNUAL MEETINGS • BERLIN (WEST)

INTERNATIONAL MONETARY FUND
THE WORLD BANK GROUP
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
MULTILATERAL INVESTMENT GUARANTEE AGENCY

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Statement by the Rt. Hon. NIGEL LAWSON,
Chancellor of the Exchequer and
Governor of the Fund for the UNITED KINGDOM,
at the Joint Annual Discussion

In my remarks today I shall deal briefly first with some international debt issues, then with the state of the world economy, then turn to the vexed question of the external imbalances between the major nations, and finally say a few words about the experience of my own country.

International Debt Issues

This has been a year of achievement for the Fund and the Bank. We have taken important steps over the past year to help the poorest, most indebted countries. We now have in place the World Bank's Special Program of Assistance for Africa and the Fund's enhanced structural adjustment facility. The United Kingdom is making substantial funds available to both.

I am particularly delighted that agreement has now been reached by all the creditors in the Paris Club on the scheme for easing the burden of official debt of the poorest, most heavily indebted countries, especially in sub-Saharan Africa.

The World Bank is now beginning to benefit from its capital increase: I hope other countries will follow the United Kingdom and subscribe quickly. The extra resources will be of special benefit to the middle-income debtors, always provided that the right economic framework is in place--and that means a Fund program.

I welcome the determination of the Fund not to be rushed into supporting macroeconomic programs before they are satisfied about the soundness of those programs and the commitment of the authorities to persevere in implementing them.

The market is now playing a larger part in the resolution of debt problems--through debt-equity swaps, debt conversions, and buybacks--in ways that reduce the burden of debt. I would hope to see banks and debtors take this approach further.

The Bretton Woods institutions are playing a major role in the resolution of debt problems. This role will be damaged unless the problem of arrears is contained and reversed--and I have made a number of proposals. In particular, for the poorest countries with the bulk of arrears, shadow programs leading to a backdated drawing on the enhanced structural adjustment facility should make a major contribution.

But we must look beyond the international financial institutions in our search for ways of sustaining the world economy, raising living standards, and reducing poverty. There is a growing acceptance that the role of the private sector in development needs to be expanded, and especially the role of private capital flows. To achieve this, barriers in developing countries will need to come down.

Barriers to international trade must also come down. We in the creditor countries must overcome the political problems of opening up our markets further to the exports of developing countries--just as governments in debtor countries need to overcome the political difficulties involved in carrying through reform programs, including trade liberalization. At the midterm meeting in Montreal we must all work together to achieve concrete results.

World Economy

This year's Annual Meetings have been held in a very different atmosphere from that prevailing last year. Then, many were worried about the danger of an imminent slowdown in world growth, and doubted whether G-7 cooperation and policy coordination was strong enough; the stock market crash a few weeks later reinforced those concerns. Now, we can see that growth picked up rather than slowed down; and our success in averting the potentially very damaging effects of the stock market crash has demonstrated the strength and value of G-7 cooperation.

This satisfactory performance has been made possible by our common commitment to sound public finance and a firm monetary policy. This has involved a willingness to raise interest rates, when--as, for example, this summer--there have been signs in some countries of inflationary pressures re-emerging. At the same time, there has been increasing recognition of the need to pursue supply-side reforms, to remove the barriers and restrictions which hold back performance. And we are increasingly seeing the benefits of this.

As we go ahead, there will inevitably be fluctuations around the medium-term trend, but that is unavoidable and does not matter. What does matter is that, by sticking to this strategy, there is every prospect that

this greatly improved performance of the world economy in the 1980s can be continued into the 1990s.

Current Account Imbalances

A widespread concern at these meetings has been the existence and scale of the current account imbalances between the major countries. Over the postwar period, it has not been unusual for many of the smaller industrial countries to run current account deficits or surpluses for many years. Denmark, for example, has had a continuous current account deficit for a quarter of a century, while Switzerland has had a persistent current account surplus.

But between the postwar "dollar gap" and 1983 there was virtually no experience of significant and sustained imbalances among the major industrial economies. Since then the picture has changed dramatically. The Federal Republic of Germany has had a current surplus of over 2 1/2 percent of GDP every year since 1985, and Japan every year since 1984. Conversely, the United States has had a current deficit of over 2 1/2 percent of GDP in every year since 1984. This year the United Kingdom also seems likely to have a current deficit of this size, and there is some concern about how long that, too, will persist.

There is still no agreement about a number of key aspects of these imbalances: the reason for their emergence; how long they can persist without causing serious problems; the appropriate response and role of governments; and the mechanisms by which imbalances are reduced. These are the topics I wish to discuss today.

When we look at the balance of payments, it is important to consider not merely the current account but also the capital account. Net capital flows are an equal and opposite counterpart to a current account imbalance. A country that is attracting net inflows of capital from overseas to supplement domestic savings must, by definition, be running a current account deficit. Conversely, a country in current account surplus must by definition be engaged in net investment overseas.

In other words, the current account reflects the difference between domestic savings and domestic investment. For example, a current account surplus may reflect either a shortage of attractive investment at home, or a very high level of domestic savings.

As we have seen, in the smaller countries there have long been examples where a significant portion of domestic savings has been invested overseas, or, conversely, where a significant portion of domestic investment has been financed by savings from abroad.

What has emerged over the past five years has been the sustained use of Japanese and German savings to make good the shortfall of savings in the United States, and to finance investment there. This has been made possible by the profound changes that have taken place in world capital

markets. We have seen a worldwide move to deregulation, the development of a wide range of new financial instruments, and a massive growth of mobile capital. Against this background it is not at all surprising that substantial imbalances have emerged: indeed, what would be more surprising would be if in each country domestic savings exactly equaled domestic investment and capital inflows precisely matched capital outflows.

In the past, significant current account deficits in the major countries were not sustained, because of the unwillingness or inability of capital markets to finance such large flows. As a result, the private sector had to rely almost entirely on domestic savings to finance its investment; and financial market pressures forced governments to adjust domestic policies in the face of emerging current account deficits.

But today there is clearly no reason why, with free access to world capital markets, domestic investment should be limited to what can be financed from domestic savings. The recent imbalances have continued because capital markets have brought together investment opportunities and savers in different countries.

Inevitably, the pattern of savings and investment is likely to differ between countries, for cultural and demographic, as well as for economic, reasons; indeed it is also likely to change over time.

In a deregulated world, where market forces are given a much bigger role, savers will diversify their investments and seek out the most profitable opportunities. It is therefore natural for capital to move between countries to reflect differences in saving propensities and rates of return just as it moves between regions of a country or between generations.

Despite the evidence that current account imbalances can persist, there is an understandable concern that they cannot continue unchecked. A particular worry is the arithmetic of debt accumulation and debt service costs. Persistent large imbalances do become a problem as flows compound and therefore by definition become unsustainable. But even for deficits of the size we have seen recently in the major countries, this problem emerges quite slowly. As the OECD has suggested, the effective constraint is not so much the size of a current account imbalance as a country's overall creditworthiness, in which net overseas assets play an important part.

There is also a concern that long before this constraint is reached, financial markets will take fright. Given the well-known volatility of these markets, it is clearly necessary for governments not just to pursue sound financial policies, but also to be prepared from time to time to exercise a stabilizing influence, as I discussed in my speech to these meetings last year. But, as experience has shown, this applies as much when the current account is in surplus as when it is in deficit. One of the paradoxes of much contemporary comment is that current deficits are seen as unsustainable, while surpluses are seen as endemic.

To summarize: large-scale current imbalances reflect differences in domestic savings and investment behavior in a world of free financial markets. Does the government then have any role at all in seeking to correct them?

First and foremost, the government has a responsibility to curb inflation by maintaining a sound monetary policy. If monetary conditions are too lax, the authorities have to tighten them. A tightening of monetary policy, through higher interest rates, will boost savings and hence reduce the current account deficit. But that is not the object of the exercise. And current account imbalances would occur even in a world of zero inflation.

The conduct of monetary policy also has implications for the exchange rate, and the exchange rate itself is an important factor in monetary policy decisions. It follows that the exchange rate cannot be assigned the task of balancing the current account, and it is a mistake to think that the automatic response to a current account deficit should be a lower exchange rate. Significant currency changes can at times be necessary, when, as for example with the dollar in 1985, exchange rates have clearly moved out of line with economic fundamentals. But it is wrong to assume that a current account deficit is sufficient evidence of this.

Governments do, however, have a clear role when a current account deficit is accompanied by a budget deficit. In those circumstances, they have a responsibility over time to reduce, and possibly eliminate, the deficit, and hence their call on private sector savings. The position is totally different when, as in the United Kingdom, there is no budget deficit at all and the current account deficit is entirely the result of private sector decisions. Generally speaking, it would be quite wrong for the public sector to seek to run an ever-increasing budget surplus in an attempt to offset private sector behavior, not least because private sector behavior is by its nature self-correcting over time.

To the extent that the deficit is the result of higher private sector investment, the adjustment mechanism is evident: the future returns will finance the original investment. To the extent that the deficit is the result of low net private sector savings, this too should correct itself in time. The main source of fluctuations in net savings is changes in the amount of borrowing by the private sector. There is a limit to the amount of debt which the private sector will be willing--or can afford--to undertake. Once that limit has been reached, the savings ratio will rise again. Moreover, higher debt means higher interest payments in the future, which will reduce disposable income and consumption. Thus, higher consumption now is at the expense of consumption in the future.

It is only in the unlikely event that the self-correcting mechanisms threaten to stretch over so long a period that the creditworthiness constraint to which I have alluded comes into play that it would be appropriate for the government to run a larger budget surplus in order to offset the lack of private sector savings.

The U.K. Economy

Over the past year, the United Kingdom has shared many of the experiences of other industrial countries--but in an even more pronounced fashion. Output, investment, and domestic demand have all grown much faster than expected.

At the same time, the supply performance of the British economy has improved further. The continued rapid growth of manufacturing productivity has convinced even the most skeptical critics that a major change of behavior has taken place. This improved productivity performance is reflected in the slow growth of manufacturing costs, rising profitability, higher rates of return on capital, and a strong export performance.

Combined with public expenditure restraint, this has had a dramatic effect on the public finances. Last year we had a budget surplus--a public sector debt repayment--of approaching 1 percent of GDP. This year I budgeted for a further debt repayment of the same scale. It is now clear that it will be considerably larger than this. Yet, despite the tightening of fiscal policy, the current account has moved into sizable deficit.

Private sector savings have fallen, while private sector investment is surging. The fall in personal savings has been largely caused by a substantial increase in personal borrowing, partly as a result of greater confidence in the future and partly as individuals have adjusted to the increased wealth resulting from higher house prices.

At the same time, the deregulation of financial markets has made it easier for consumers to use the collateral of asset values to increase the level of borrowing. For the personal sector as a whole, the level of borrowing in relation to income is now almost on a par with that of the United States.

The fall in saving has coincided with a welcome growth in investment. This investment is crucial if the better growth rate is to be sustained. However, the investment boom, superimposed on strong consumer spending began to generate inflationary pressures. The government responded by a sharp tightening of monetary policy.

The temporary edging up of inflation, which has been exaggerated by higher mortgage rates, will reverse some time in the course of next year. There are already signs that the higher interest rates are beginning to take the steam out of the housing market.

They will also boost savings, and this will speed up the adjustment that will be brought about in any event by the self-correcting mechanisms I have described. In particular, the growth of personal borrowing will slow as the once-for-all adjustment to the new climate of deregulation in

financial markets is completed, and people judge that they are close to the prudent limit of indebtedness. And over time this will reduce the current account deficit.

Some may be puzzled why the existence of a current account deficit is so newsworthy in the United Kingdom. The truth is that we are prisoners of the past, when U.K. current account deficits were almost invariably associated with large budget deficits, poor economic performance, low reserves, and exiguous net overseas assets. The present position could not be more different. The output and productivity of the United Kingdom are both growing strongly. The official reserves are high, and net overseas assets are greater as a proportion of GDP than in any other major industrial country. And the public sector finances are in sizable surplus. By any standards, the United Kingdom's creditworthiness is high.

The decline of savings in the United Kingdom at a time of high investment opportunities appears to be a particularly striking example of a worldwide trend. Increasing capital flows between countries can satisfactorily complete the balance of savings and investment for an individual country. But there remains the question of the balance of savings and investment opportunities for the world as a whole. This may well be at least as important an issue in the coming years as the handling of current account imbalances.