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RECORD OF A DISCUSSION IN ROME AT 12.15 PM ON WEDNESDAY, 7 JULY 1982 BETWEEN THE CHANCELLOR OF THE EXCHEQUER AND THE ITALIAN MINISTERS OF THE TREASURY AND THE BUDGET

Present:-

Chancellor
Mr. J.G. Littler
Mr. J.O. Kerr

Mr. M.J. Richardson
(HM Embassy, Rome)

Minister Andreatta
Minister La Malfa
Signor F. Galimberti (Economic Adviser to Sig. Andreatta)
Professor P. Savona (Economic Adviser to Sig. La Malfa)
Signor Badini (Counsellor, Office of the Prime Minister)

WORLD ECONOMY

1. At Signor Andreatta's request, the Chancellor gave his assessment of the US scene. Since the Helsinki Interim Committee meetings the Administration had achieved the appearance of agreement on the size of the prospective budget deficits, but no agreement on credible ways and means. He was doubtful about the Administration's ability to deliver. And, as well as the certainty that US fiscal policy was too lax, there was also now a suspicion that monetary policy might be too tight. Interest rates were likely to stay high for some time to come: this would be bound to hamper recovery world-wide, and increase the particular difficulties of less developed countries. The climb out of recession would remain slow, and uneven.

2. The Chancellor added that it was of course to some extent feasible to decouple US and European interest rates. In London rates had been falling all this year, and our markets appeared to accept a strikingly large disparity with US rates. The key was our performance on controlling monetary growth and borrowing. Provided European governments contrived to go on reducing their deficits, and borrowing, a measure of independence was feasible.

3. Signor Andreatta thought that the level of public debt in the US was not unprecedently high. Perhaps the greater problem was monetary policy: should the Federal Reserve be encouraged to loosen monetary targets? The Chancellor interjected that any such encouragement would have to be on a very private basis; and Signor Andreatta agreed, referring to Basle channels. He asked whether the Chancellor had much faith in the study of intervention, commissioned at Versailles, and now commencing. The Chancellor thought it just conceivable that the study might do some good: he had the impression that American hostility to intervention had softened a little. His own view, and he thought that of the Italian authorities - Signor Andreatta agreed - was that intervention, though no long term solution, was helpful in smoothing sharp movéments, and preventing overshoots. But there were still many sceptics in Washington.

UK ECONOMY

4. Signor Andreatta asked about the prospects for the UK economy. Progress made against inflation was remarkable, but the key question now must presumably be how to stimulate recovery without producing a new inflationary spiral. The Chancellor said that our own forecasts were very much inline with those for the UK economy in the latest OECD Outlook. Recovery was hesitant, but inflation should continue to fall, and this in itself would help to create the conditions for growth. Productivity had greatly improved, and we were now recovering lost ground on competitiveness. Perhaps the most important requirement now would be to sustain pay moderation as output picked up.

5. Signor La Malfa asked about the UK balance of payments, and about the risk of damage to manufacturing industries from the strength of sterling. The Chancellor foresaw no problem over the balance of payments, though the surplus this year would be below last year's, given larger import volumes. Sterling's strength in 1979/80 had undoubtedly been damaging to exports of manufactures, and some contraction in manufacturing industry was a probably inevitable consequence of North Sea oil. But the real problem had been the strikingly low productivity of old-fashioned British industries: this was now

beginning to be remedied.

ITALIAN ECONOMY

6. Signor Andreatta said that in Italy too the recent productivity performance had been good, largely as a result of changes in the industrial relations structure. Targets of 16, 13 and 10 per cent had been set for wage increases in the three years to 1984: this was ambitious, given average 20 per cent increases in the recent past, but essential if inflation were to be brought down to 10 per cent by 1984. Italy faced particular problems from the high dollar rate, given that a high proportion of her import trade in raw materials and semi-manufactured goods, and a low proportion of her trade in manufactured exports, was with the dollar area. Monetary conditions in Italy were very tight, and short term interest rates around 19 per cent. Although current expenditure (less the cost of servicing public sector debt, some 7 per cent of GNP) was being controlled fairly tightly, and kept below the rate of growth of GNP, the burden of current expenditure plus debt-servicing was increasing substantially in real terms. The Italian Government was therefore now preparing an imminent package of tax increases and spending cuts: provided it went through, and wages did not exceed the 16 per cent target, inflation should not rise above its present level - 13 per cent - for the rest of this year.

7. After a brief discussion of how to handle union objections to job creation schemes involving rewards below minimum wages, Signor La Malfa described the nature of the black economy in Italy. He and the Chancellor agreed that the high flexibility and productivity of the black economy had to be set against the revenue evasion.

INDEXATION

8. Signor La Malfa then explained the current debate about wage indexation and the "scala mobile". All parties agreed that changes were required, for the "scala mobile" undesirably compressed differentials. But how, and how far, to press reform was a highly contentious political issue. Equally difficult was the question of whether increases in public sector investment, eg in energy saving, could be offset by reductions in current expenditure. Parliament would vote for increased investment, but also for the maintenance of

current expenditure. The Chancellor said that this problem was not unfamiliar. He also outlined the UK indexation procedures for pensions and social security benefits.

9. Signor Andreatta expressed interest in the de-restriction of indexed gilts, and particularly on whether Bank of England and Treasury views had been identical. He explained that the Italian government had authorisation from Parliament to issue indexed bonds, but had not done so because of Central Bank worries about the spread of indexation in the economy generally. The Chancellor said that there were respectable intellectual arguments both ways: one which had weighed heavily with him was that the existence of indexed stock might act as a "sleeping policeman" to discourage future governments from stimulating inflationary pressures.

EC BUDGET

10. The Chancellor then turned to the EC budget, and explained that the UK still found it absurd and unacceptable that a country with below average GNP should apparently be expected to accept the prospect of very substantial and steadily rising budget contributions. The UK did not insist on being a net recipient: we were prepared to be modest net contributors. But we thought it important that the Community adopt a solution which would last as long as the problem remained. The repeated arguments on this issue were damaging to the Community. But he had to warn that it would be an illusion to suppose that we would drop our case or be content with unsatisfactory interim solutions.

11. Referring to the problem of the 1982 Refunds to the UK, Signor Andreatta said that the Italian Government did not find it tolerable that it should be asked to subsidise the Federal Republic of Germany. Nor, he said, would Italy agree to the raising of the VAT 1 per cent ceiling. The UK problem could best be solved by an extension of Community-financed activities in the industrial and energy sectors. Until that happened, temporary solutions were unavoidable. Italy accepted that CAP costs should be controlled, but by limits on intervention funds rather than physical limits on

production.

12. The Chancellor, agreeing that limitations on the growth of CAP expenditure were highly desirable, thought it optimistic to suppose that they would be speedily secured. He also expressed scepticism about the chances of securing a solution to the budgetary problem by expanding the scope of Community financing. He well understood the Italian difficulty with the Germans over contributions to the net refunds agreed on 25 May, but there could be no question of the UK accepting any reductions in the net refunds which would be due under that agreement.

13. The meeting ended at 1330.

J.O. KERR
9 July 1982

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