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cc PC.
cc Policy Unit

PM/84/119

PRIME MINISTER

Exchange Rate Fluctuation and Overseas Inflation

1. Peter Rees and I have exchanged minutes on 21 May and
// 4 July (copies attached) about the impact on FCO provisions of the decline in sterling and of inflation rates abroad which are running on average 2.15% higher than our own. This affects some 40% of Diplomatic Wing provisions and makes it hard to plan ahead or delegate responsibility to overseas posts under the FMI.

2. There are two separate problems - the squeeze which arises within each financial year, and the need to adjust baselines between successive years in the Survey.

3. The in-year problem can be illustrated by the 1984/85 position. We have not yet quite agreed the precise method of measuring this 'overseas price effect' in the 140 countries concerned, so the following figures are on the conservative side.

£m

	Changes since PES baseline established in October 1983, if average exchange rate and inflation differential remain as at present		
	Sterling (Trade Weighted Index calculation on October 1983 index)	Overseas Inflation (IMF indices weighted)	Total
Vote 1 (Overseas representation)	8.6	3.4	12.0
Vote 2 (International subscriptions, etc)	2.2	-	2.2
Vote 4 (British Council)	-0.2	2.3	2.1
TOTAL			16.3

The indices are fluctuating and adjustments have to be made for actual expenditure, some of which consists of payments at rates agreed previously. But we are talking of a sum exceeding 3% of the three Votes concerned; Vote 3 (BBC External Services) is happily not much affected by this problem.

4. The British Council need to know by September whether they will obtain the expected £2.1 million shortfall since otherwise they must make cuts. The same situation will arise in September next year and thereafter and their Parliamentary supporters are seeking clarification of our position. The same uncertainty affects my other programmes. I welcome Peter Rees's intention to deal with this question in a practical way, but I must have some certainty as to the final outcome both this year and in future years. In 1983/84 we were fortunate enough to be able to offset the shortfall by slippage in a BBC capital programme (though not without protest from the BBC) and by appropriating in aid certain unexpecred receipts. We also had to use up for this purpose most of my new unallocated provision, which led to criticism from the House of Commons Foreign Affairs Committee who had assumed that the provision would be used for new foreign policy initiatives. I see little prospect of being able to take advantage of such factors in offsetting the £16 million shortfall expected in 1984/85. We are investigating forward purchase of currency (Robin Ibbs has also suggested this), but that will not be possible to organise soon, nor will it help with the inflation problem. Though I will continue to offer whatever savings I can, it is vital to have the assurance that my provision will be topped up from the central Reserve if sufficient offsetting savings cannot be found.

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5. Turning to the problem of carrying forward shortfalls between successive financial years, I agree with Peter Rees that this must be dealt with in the context of the PES process. In the current survey I inserted as a marker an 'overseas price adjustment since October 1983' of £7 million, to be updated near the end of the survey (as indicated above, the figure now looks like being nearer £16 million). But I cannot agree with the Treasury that this should be considered as an additional bid just like all others. I believe it should be an adjustment to the baseline, sometimes upwards and (if sterling appreciates) sometimes downwards. My additional bids proper would be considered against other claims on available finance after deduction of this adjustment. It would thus be similar to the agreement that the MAFF baseline is adjusted to reflect changes in either direction in take-up in demand-determined agricultural support schemes. No department has so high a proportion of its expenditure overseas as FCO (I believe the MOD figure is 12%) and to treat my proposed adjustment as an additional bid is like asking me to start a hurdle race with an extra hurdle. It does not seem right that what is essentially an adjustment for forces beyond my control should be at the expense of my other bids.

6. The sort of arrangement I envisage would have a neutral effect on public expenditure in the long run. In the three years ending 1980/81 a strong pound and relatively low overseas inflation caused an overall underspend of £18 million on FCO votes which we gave back to the consolidated fund. The US State Department has a 'Buying Power Maintenance Agreement' with the Office of Management and Budget under which gains by exchange made in 'good' years are put into a fund to be drawn on in 'bad' years. The Canadian Department of External Affairs has an agreement with the Canadian Treasury to adjust automatically for exchange movements and is set a special overseas inflation rate for uplifting its cash provision.

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7. Unless we can find a solution to this problem it will be with us for many years hence and we shall be involved in controversial and time-consuming haggles at frequent intervals. You may think it useful to call a meeting with myself and Peter Rees, to whom I am copying this letter.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
11 July 1984

(1) Pl. copy to Mr. Ainscow, ODA

(2) back to me.

KGm 22/5

cc PS.
PS/Lady Young
PS/PUS.
Chief Clerk.
~~Mr Macinnes~~
Hds of: PSD
PPD.
OED.
OSTD.
Plg Staff.

FCS/84/147

CHIEF SECRETARY TO THE TREASURY

Exchange Rate Fluctuation and Overseas Inflation

1. In my minute of 23 January I recorded agreement that officials should work out a system to establish precisely what the effects of variations in the exchange rate and in overseas inflation were on the resources made available in Votes II.1, II.2 and II.4 and to deal with these effects. I also referred to this point recently in my minute of 19 April to the Prime Minister on the risen costs of the British Council. We were at one that the system to be devised should take account of that problem too.

2. I am encouraged to hear that officials have made some progress in agreeing a system of assessment which will enable us to enjoy a sufficient degree of certainty as to the losses actually suffered. I understand, however, that further progress on the procedures to be adopted thereafter is held up by failure to agree on the practical outcome to be expected from the new system.

3. It was my intention, and I had understood it to be yours, that an arrangement to deal with the unique problem of exchange rate fluctuation and differential inflation rates should do more than merely identify the magnitude of the loss and formalise the procedure by which a bid was

/submitted

submitted in the annual PES round or for consideration against the Central Reserve. We need, in addition, to agree on suitable words to convey the presumption that a shortfall conclusively demonstrated will be made good by the provision of funds additional to those which would otherwise have been available to the programmes concerned as a result of the negotiations in the PES round. Likewise, any surplus provision due to favourable exchange rate/overseas inflation movements would be deducted from the baseline. This is what I meant by saying that the important thing was to secure an agreed starting point for the annual PESC ritual. The agreement to agree was to be an agreement to agree on substance. It would defeat the whole object of the exercise to conclude that these adjustments should be considered as ordinary additional PES bids like all the others. It is precisely that conclusion which I should not be able to accept.

4. I therefore invite you to consider whether the discussions at official level should now be resumed, taking as their basis a joint objective which might be formulated as follows:

'After taking account of unplanned underspends and such savings as FCO Ministers agree can be made without compromising our foreign policy requirements, shortfalls in the provisions made for expenditure on Votes II.1, II.2 and II.4 resulting from variations in the exchange rate and from differences in inflation at home and overseas should be made up from Central Funds unless a collective Ministerial decision is taken to do otherwise.'

(GEOFFREY HOWE)

Foreign and Commonwealth Office

21 May 1984

Finance Dept cc ...
&PS
PS/Lady Young
PS/PUS
Chief Clerk
Mr MacInnes
Hds of PSD
PPD
OED
OSTD
Planning Staff
cc: Mr Ainscow ODA

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Sir Geoffrey Howe QC MP
Secretary of State for Foreign Affairs
Foreign & Commonwealth Office
Downing Street
LONDON
SW1A 2AL

4 July 1984

Dear Geoffrey

EXCHANGE RATE FLUCTUATION AND OVERSEAS INFLATION

Thank you for your letter of 21 May. I too am glad that our agreement to agree is close to achieving a method of measuring the effects of exchange rate movements and overseas inflation on FCO (and British Council) expenditure.

A presumption, however, is as you know a tricky concept in law and even more so, as far as I am concerned, in public expenditure. The whole purpose of cash planning is that there should not be a presumption that there will be compensation for price increases.

I accept that the FCO may sometimes face greater problems than other departments in accommodating price increases because a higher proportion of your expenditure is in foreign currency; and I hope we can leave it that we will deal with the question of FCO resources in a practical way between us. But this has to be against the background of the overall public expenditure position and within the PES process: that is what PES is for. You will no doubt plead your cause with your usual skill; but I must demur at the suggestion that in the matter of offsetting savings you should be sole judge as well as advocate.

Yours ever
Peter

PETER REES

JUL 1984

CGPC

FCS/84/191

CHIEF SECRETARY, HM TREASURY

Expenditure on Overseas Activities

1. I should like to set the record straight on some points in your letter of 27 June which commented on the paper attached to my minute to the Prime Minister of 28 May.

2. On aid, I do not think it right to suggest that the effect on the aid budget of expenditure decisions was deliberate. Naturally the aid programme cannot be exempt from the pressures on public expenditure generally; but there has been no decision to give it lower priority. And if comparison is to be made with richer countries, as your letter suggests, the right way to do this is to look at aid as a proportion of GNP. Ours has been declining substantially in recent years from 0.52% in 1979 to 0.35% in 1983 and for the last two years has fallen below the OECD average. Moreover, it is now substantially less than the figures for our major European partners and the prospect is that our percentage will continue to fall.

3. You refer to the slight increase in non-aid activities. But you have not acknowledged the important point in my paper that the costs of peace-keeping, military aid and overseas students' scholarships (which were previously financed by other Departments) have been added to those of the FCO. After allowing for these transfers there has been a 2% real decrease in non-aid funds. Moreover, there is undoubtedly a further volume decline during this period because of adverse movements in sterling and overseas inflation. In 1984/85 we calculate that if the inflation differential and the average exchange rate remain the same until the end of the year, the adverse effect on the four Diplomatic Wing votes since the PES baselines were settled in November 1983 will be £15 million. The addition to my overseas representation

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programme which you mention met only half the shortfall in the preceding 12 months for sterling alone and did not deal with higher overseas inflation.

4. On manpower you say that the Diplomatic Service reduction since 1979 has not kept pace with the Home Civil Service. But this needs to be considered in the light of the previous 11 years when Diplomatic Service manpower went down by 10.7% while the Home Civil Service grew by 6.1%. You refer to the merger of the separate Foreign and Commonwealth Offices in 1968. Not all mergers lead to manpower savings. I believe our performance since 1968 has been more than adequate. You say that our target reduction of 5.2% from now until 1988 is slightly below that set for the rest of the Civil Service. The latter figure depends considerably on the change of status of 18,000 staff in the Royal Ordnance factories. Once these are allowed for, the average reduction for the rest of the Civil Service falls to 3% and the FCO target is in fact higher than that of the majority of Civil Service Departments.

5. I am puzzled that you should say that the Comptroller and Auditor General commented adversely on the rate of reduction of Diplomatic staff and our manpower control system in his latest report. I can see no wording in the report to justify the first assertion. As far as the second is concerned, the report describes the FCO as operating a well ordered system and says "The proportion of posts inspected, the proportion of savings recommended on the posts examined and the proportion of recommendations implemented have been higher for Diplomatic Service inspections than for Home Civil Service staff inspections".

6. You say that the PAC has criticised the rate of rationalisation of our Overseas Estate. Such criticism could quickly be met if you could agree to the PAC's endorsement in their latest report of "the idea of enabling receipts from disposals to be used to finance further estate rationalisation", ie asset recycling with end-year flexibility.

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7. You refer to the number of additional bids for the Diplomatic Wing in this year's Public Expenditure Survey, some of which you rightly say are very small. This is because I have been scrupulous in abiding by the guidelines you circulated about placing bids in order of priority and supporting them with precise output measures and details of the action needed if the bids were not met. Not many Departments seem to have adhered to these guidelines. With a relatively small budget my internal control requires fine tuning and each item has been carefully thought out. I am not pressing for all new commitments to be financed from outside my existing provision. I have absorbed as many as I can.

8. Finally, I do not agree with your comment about my approach to options for reductions. I am satisfied that if standards acceptable to Government and Parliament are to be maintained by the FCO, there cannot be a further round of chipping away at the tools available to me. We have reached the point where, if further financial cuts are to be met, consideration will have to be given to abandoning functions or geographical coverage.

8. I am sending copies of this letter to the Prime Minister, the Lord President, Secretary of State for Defence and to Sir Robert Armstrong.

GEOFFREY HOWE

Foreign and Commonwealth Office
9 July, 1984

- 9 JUL 1984

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Await comments from Lord President & Defence Secretary B/u on 6 July CDP.

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Geoffrey Howe QC MP
Secretary of State for Foreign and Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
LONDON
SW1P 2AL

27 June 1984

Dear Secretary of State

EXPENDITURE ON OVERSEAS ACTIVITIES

— with DB

I was interested to read the paper you sent to the Prime Minister on 28 May.

I accept, of course, that your department has been obliged to make economies since 1979 - particularly on the Aid Programme. However the same is true of other departments and it does not seem to me that the FCO have fared particularly badly.

The reduction in aid reflects a deliberate decision on our priorities. We cannot expect to devote the same resources to overseas activities as countries that are richer than we are and we have deliberately built up our defence effort very substantially over the last few years.

As you note, the overall provision for non-aid activities has slightly increased in real terms since 1979. While movements in exchange rates and overseas inflation had an adverse effect in 1983, they were favourable in the previous 4 years (and were indeed, up to 1981/82, reflected in underspending against your cash limits). The adverse movement in 1983/84 did not lead to a reduction in activities because of windfall savings elsewhere and we have agreed a specific addition to your programme to reflect the impact in the current year.

Turning to manpower, the reduction since 1979 in the Diplomatic Service has not kept pace with that in the Home Civil Service (10 per cent compared with 14 per cent). And for the future the target reduction of 5.2 per cent by 1988 for the Diplomatic Service remains slightly below that set for the rest of the Civil Service. The reduction since 1979 followed those achieved after the merger of the separate Foreign and Commonwealth Offices in 1968, but I am not convinced that we have yet exhausted the possibility of sensible pruning and I was interested to see the Comptroller and Auditor General commented adversely on the rate of reduction of diplomatic staff and your manpower control system in his latest report. That followed, of course, the PAC's criticism of the rate of rationalisation of your overseas estate.

Against that background, I was disappointed to learn that in this year's public expenditure survey, you have submitted a substantial additional bid for the Aid Programme, no less than 28 additional bids for the Diplomatic wing, some of which are very small, and options for reduction which can scarcely be your favoured method of achieving a marginal reduction in your total budget (including, for example, the ending of all commercial work in North America).

We face severe pressures for increased public spending in a number of fields and it will be very difficult to hold to the plans to which we are all committed. It will require all Departments to consider very carefully what are their priorities and what savings can be made in their overall budgets. I am sure that you will join in that process and will not press for all new commitments to be financed from outside your existing provision.

I am sending copies of this letter to the Prime Minister, the Lord President, the Secretary of State for Defence, and to Sir Robert Armstrong.

Yours sincerely

J.G. Gieve

for PETER REES

[Approved by the Chief Secretary]

Foreign Pol

PT 2 strategy

28 JUN 1984

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