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SENIOR STAFF IN CONFIDENCE

PRIME MINISTER

mb

SIR ALAN WALTERS

Besides his article in the Independent, Alan Walters has given, in the last two days, a radio interview and two television interviews. His intention has been wholly well disposed. But I suppose inevitably the mischievous press have been using his words to revive the old story that there is a rift between you and the Chancellor on economic policy. (We are separately putting into your box some briefing material for Questions tomorrow.) I have spoken to Alan this evening. I said that the press were clearly intent on causing mischief and in these circumstances, it would be better if he were to avoid making any more public pronouncements on British economic policy. Now that the press were assuming that he was going to return here, everything he said would be invested with particular importance, its meaning scrutinised for nuances and mischief makers would do all they could to cause trouble. He readily took the point and said that he would stop forthwith.

The Chancellor has made clear to Robin Butler that Alan's remarks have annoyed him, so much so that he is now saying that he thinks that he could not work with Alan if he were to return. The Chancellor may want to talk to you about this. Robin and I hope that all this will blow over, provided Alan does not make further public comment.

N. L. W.

N. L. WICKS
18 July 1988

L06AWG

File SW

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

SIR ROBIN BUTLER

I had yet another telephone call with Sir Alan Walters, this time about an article in today's Daily Mail which reports an interview with him. A copy of the article is attached for reference.

Alan was somewhat hazy about whether he had spoken to the author of the article, Geoffrey Levy, though he recalls speaking to someone from the Daily Mail. He said that the discussion was entirely about his personal life. I pointed out the sentence in the first column:

> "I'm a great admirer of Mr. Lawson, I mean, next Geoffrey Ho... er, well, I think he's done wonders."

I said that surely the conclusion meant to be drawn from this was that Chancellor Lawson was not as good a Chancellor as Chancellor Howe. I went on to say that even if Alan was to give an interview about chrysanthemums, there would be those in the media who would twist his words. His behaviour should be likened to that of a Trappist monk - absolute silence. I had to say that if he gave any further interviews, his return to No. 10 would be in serious doubt. And that would be a great pity.

Alan said that journalists would write stories even if he said nothing, and what they would write would be inaccurate. He merely wanted to put them right on the facts of his life. I said that even in such circumstances he should decline to talk to them. If he spoke to them, the "Walters story" would run. That was in nobody's interest. He should tell journalists that he had nothing to say and he could not help them. He agreed to do so.

At the end of the conversation Alan said that he had written a book review on privatisation which he thought would cause no problems. He was sending me a copy in the bag. We will look at it most carefully when it arrives.

N.L.W.

(N. L. WICKS)
28 July 1988

FILE

KK1AGZ

bc Sir Robin Butler

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

24 October 1988

Dear Alan,

I am very glad that you so readily agreed to pull out of the IEA Cato Institute Conference, at which you are billed to give a lecture on "Reaganomics, Thatcher economics and the future". Even though you undertook over a year ago to give this lecture, I am sure that this is the right decision. As you know from my letter of 20 July, the Prime Minister thinks that you should refrain from all public comment which could have, or be interpreted as having, any bearing on British economic policy. This contribution to the IEA/Cato Institute would seem to fall within that category.

Yours sincerely

Nigel

(N. L. WICKS)

Professor Sir Alan Walters

KK

file XL
cc CO

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

10 August 1988

Thank you for sending the various articles to me. This is most helpful - it not only improves my understanding of economics, but should also avoid 'problems'. I hope that you can let me see any future articles.

Andy Bearpark has told me about your commitment to give a series of lectures in the autumn and spring on international economics. I assume that all the lectures will be in the States in view of the Johns Hopkins connection. As you surmise, the media might try to use them to cause us all trouble. Indeed, I would not rule out some unscrupulous press person infiltrating himself into the lectures, persuading one of the students to let him have notes or even to produce a surreptitious tape of what you say. Could I therefore ask that you take special care to avoid anything in these remarks which could be interpreted as comment on the management of the UK economy or international agreements to which the UK has subscribed. You will also need to be on your guard for planted questions.

N. L. WICKS

Professor Sir Alan Walters.

R Wicks o.

Ref. A088/2475

MR BEARPARK

a+ flag

Many thanks for your minute of 5 August about Professor Walters. I have spoken to the Chancellor and told him about these lectures which I assumed - I hope rightly - are to take place in the United States. I suggest - and the Chancellor would be content with this - that Nigel Wicks should write as proposed, although I think that the penultimate sentence needs something more specific than "cause us embarrassment". I suggest that this sentence should read: "Could I therefore ask you that you take special care to avoid anything in these remarks which could be interpreted as comment on the management of the UK economy or international agreements to which the UK has subscribed."

FER.B

ROBIN BUTLER

9 August 1988

Econ Pol: Domestic
Monetary Policy Pt 19

PERSONAL AND CONFIDENTIAL

file
DASANS

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 August 1988

I enclose two further articles which Alan Walters has in various stages of production. I should be grateful if you could cast your eye over these, purely from the point of view of whether they might cause political embarrassment to the Chancellor. It is possible that we will receive more of these in the future, and I would like to suggest that you nominate one, or at most two, senior officials - yourself, Alex, Michael Scholar or Andrew Turnbull perhaps - who might take this on rather than sending them out to your divisions for comment. Could you please give me a ring in the course of the day if you have problems with either of these.

P. A. BEARPARK

Jonathan Taylor, Esq.
H.M. Treasury

PERSONAL AND CONFIDENTIAL

file DISANT

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

SIR ROBIN BUTLER

I spoke to Alan Walters in Washington yesterday and he explained that he is booked to give a series of lectures on the international economy at John Hoskyns in the Autumn and Spring. Press are not invited, but the potential audience is quite large - around 120 students. I have discussed this with Nigel Wicks, who has it in mind to write to Alan on the following lines:

> "Thank you for sending the various articles to me. This is most helpful - it not only improves my understanding of economics, but should also avoid 'problems'. I hope that you can let me see any future articles.
>
> Andy Bearpark has told me about your commitment to give a series of lectures in the Autumn and Spring on international economics. As you surmise, the media might try to use them to cause us all trouble. Indeed, I would not rule out some unscrupulous press person infiltrating himself into the lectures, persuading one of the students to let him have notes or even to produce a surreptitious tape of what you say. Could I therefore ask that you take especial care to avoid anything in those lectures which could cause us all embarrassment. You will also need to be on your guard for planted questions."

Nigel has asked for your advice on this draft letter, and also on whether the Treasury, and the Chancellor of the Exchequer, should be told about this. Nigel's initial view is that it may be best if you mention the matter to Mr Lawson at a suitable occasion rather than telling the Treasury officially, but he is quite happy to take advice on this.

You should also know that we are receiving a steady stream of articles from Alan which we are vetting and showing the Treasury. So far, there have been no problems.

P. A. BEARPARK
5 August 1988

CONFIDENTIAL

MR. BEARPARK

Thank you for the two articles of Alan Walters. I can see no problems in either of these. But you could once again show them to the Treasury. When you do so, could you tell the Treasury that we are sending them these articles not for correction of facts or suggestions on how to put the points better but for them to see whether their publication would cause political embarrassment to Mr. Lawson. You might also suggest to the Treasury that rather than sending the articles to Divisions for comment, they might nominate a senior official, perhaps Alex himself, Michael Scholar or Andrew Turnbull - who could run his eye over them to check that they cause no problems. Please let me know if the Treasury find any difficulties with the two articles which you sent me overnight.

Alas, the news of Alan's lectures in the autumn gives me the colly-wobbles - a very uncomfortable situation 30,000 feet above the Queensland coast! I am thinking of writing to Alan on the following lines:

> 'Thank you for sending the various articles to me. This is most helpful - it not only improves my understanding of economics, but should also avoid 'problems'. I hope that you can let me see any future articles.
>
> Andy Bearpark has told me about your commitment to give a series of lectures in the autumn and spring on international economics. As you surmise, the media might try to use them to cause us all trouble. Indeed I would not rule out some unscrupulous press person infiltrating himself into the lectures, persuading one of the students to let him have notes or even to produce a surreptitious tape of what you say. Could I therefore ask that you take especial care to avoid anything in those lectures which could cause us all embarrassment. You will also need to be on your guard for planted questions'.

CONFIDENTIAL

CONFIDENTIAL

Could you please tell Sir Robin Butler about the forthcoming lectures and show him the draft letter which I propose to send to Alan. Could you also seek Robin's advice on whether the Treasury, and more particularly the Chancellor of the Exchequer, who should be told about the lectures and about my letter to Alan. My feeling is that it would be best if Robin mentioned this to Mr. Lawson, at a suitable occasion, rather than me telling the Treasury. But I am quite happy to do so if he thinks that is the best route. Finally, could you tell Robin that we are receiving a steady stream of articles from Alan, are vetting them and are showing them to HMT; so far so good.

Let us have a word about this later today.

Sally Hayter

PP N. L. WICKS
5 August 1988

CONFIDENTIAL

File ✓

MR WICKS

The problem is that the length of Alan Walters' articles is only matched by some of the words .... I have only glancedat these two very quickly. I do not think he is expecting any reply on them.

P.B. Bearpark

4 August 1988

Ref. A088/2381

MR GRAY RB 2/8

Nigel Wicks minuted me on 28 July about his conversation with Sir Alan Walters on the article in the Daily Mail of that morning.

2. Mr Wicks mentioned in the final paragraph that Alan Walters said that he had written a book review on privatisation which he was sending in the bag. This is just to confirm my view, to which Mr Wicks assented, that it would be wise to show this review to the Treasury before giving clearance to its publication. I send this minute in case you have to act on this review while Mr Wicks is still abroad.

R.E.R.B.

ROBIN BUTLER

1 August 1988

8f0

10 DOWNING STREET
LONDON SW1A 2AA

From the Principal Private Secretary

27 July 1988

I should be grateful if you could arrange for the letter in the envelope enclosed to be delivered to Alan Walters as quickly as possible.

(N. L. WICKS)

Brian Fall, Esq., C.M.G.,
British Embassy,
Washington.

PERSONAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

SIR ROBIN BUTLER

You should know that I received from Sir Alan Walters at 1230 today an article on international co-ordination of economies which he said he had sent for publication in the winter number of the National Interest. (The National Interest is a magazine which circulates in Washington.)

I told him on the telephone at 1445 that he should withdraw the article from publication since it would be bound to revive all the embarrassment which we experienced recently. Alan readily agreed to have the article withdrawn. The editor of the National Interest was he said an old friend and there would be no difficulty about this. He wondered whether the article might be published anonymously. I drew his attention to the unfortunate experience of the Crockford's preface. He said that he did not intend to commit suicide and immediately recognised that publication, even anonymously, was not on.

I have written a further letter to Alan, a copy of which is attached.

His article, which is a powerful piece, is on the file here if you wish to read it. I would not intend to tell the Treasury of this episode.

N.L.W.

(N. L. WICKS)
27 July 1988

PERSONAL

File SLW BOV

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

27 July 1988

Dear Alan,

Thank you for sending me a copy of the article for the National Interest. Since our telephone conversation I have re-read it and am even more confirmed in the view that its publication would cause grave difficulties here. It would be taken as criticism of an aspect of British economic policy (as indeed I think it is) and the mischief-makers would stir up trouble once again. I am very glad therefore that you so readily agreed to have it withdrawn from publication. As I said in my letter of 20 July, I think that you ought not to publish anything which could be considered as commenting on British economic policy.

Yours ever

Nigel.

(N. L. WICKS)

Professor Sir Alan Walters

PERSONAL

DG2COK

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

20 July 1988

Dear Alan,

This is just to follow up our conversations of the last few days.

As you know, your public statements have become the subject of intense political interest here and the media are using what you say to create stories of rifts and antagonism between the Prime Minister and the Chancellor of the Exchequer. I know that this is exactly the opposite of what you intended, but that is how the press and the Government's enemies are playing the issue. As I told you on the telephone, and I know that the Prime Minister takes this view, if you are to return here, you must refrain from all public comment which could have, or be interpreted as having, any bearing on British economic policy. You readily agreed to do this when we spoke. I know that this is for the best.

Yours ever,

Nigel.

N. L. Wicks

Professor Sir Alan Walters

PERSONAL

D88

PERSONAL

File

DG2CUL

cc: Duty Clerk

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

20 July 1988

Dear Patrick,

Here is the letter to Alan Walters. I should be grateful if you could arrange for it to be telegrammed to Washington and delivered to Alan at his Washington address directly he wakes up at, say, 7.30 Washington time this morning. The signed text can follow by bag in the normal way. Could someone confirm to us here - by telephone to the Duty Clerk if that is most convenient - that the letter has been delivered to Alan.

Please could you ensure that knowledge of the letter is kept to the most limited circle, i.e. your Private Office and those concerned with its transmission in the FCO.

Alan's home address in Washington is:

2820 P. Street N.W.
Washington D.C. 20007

Yours sincerely

Nigel

FCO confirmed letter delivered on time NLW informed 20/7.

N. L. Wicks

Sir Patrick Wright, K.C.M.G.

PERSONAL

DG

10 DOWNING STREET

PRIME MINISTER

I think that it would be as well if I write to Alan Walters to reinforce my conversations with him of the last day or so. I attach what I propose to say. I know that Alan would not receive it ill.

Content for me to write?

N.L.W.

Yes

N. L. Wicks

19 July 1988

ec

Rle.

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

SIR ROBIN BUTLER

You should know that I have spoken again this morning to Sir Alan Walters. My conversation was prompted by the reference in this morning's 'Evening Standard' to some comments attributed to him. A copy of the article is attached.

Alan said that he recalled speaking to someone from the Standard - he thought yesterday morning. The conversation had, Alan thought, been on an unattributable basis. He did not think that he had made the comment attributed to him in the quotes in the article. But I have to say from my conversation with Alan that he may well have said something like it. I told Alan that he ought to cease all contact with the media. He said that he would do so. He had already cancelled a Thames television interview.

N.L.W.

N. L. WICKS

19 July 1988

NANCIAL
ening Standard
TUESDAY, 19 JULY, 1988 — 21

CITY EDITOR ANTHONY HILTON

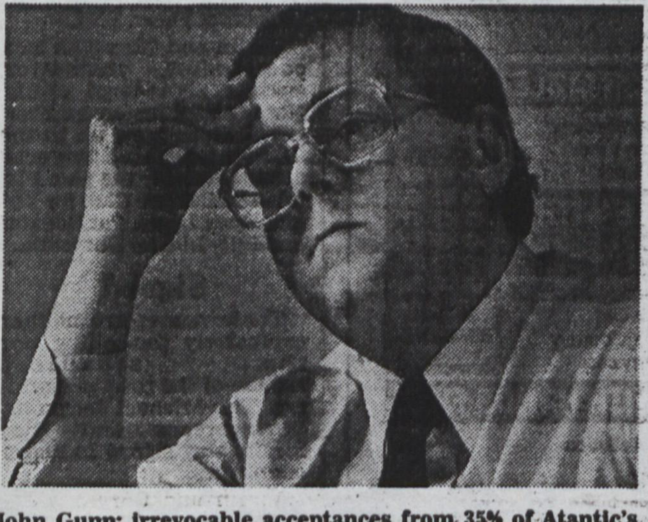
B&C swallows Atlantic in £416m deal

by Iain Jenkins

JOHN GUNN stunned the City today when he announced that his financial services group **British & Commonwealth** is buying computer leasing firm **Atlantic Computers** for £416 million.

Shares is Atlantic were suspended yesterday at 364p and the market had predicted a merger with GEC or the US computer leasing giant Comdisco which has made no secret of its UK ambitions.

But B&C had been holding talks with Atlantic for a number of months and has received irrevocable acceptances from 35% of the computer leasing firms' shareholders.



John Gunn: irrevocable acceptances from 35% of Atantic's shareholders

Premium

Atlantic has been looking for a buyer since the tragic death of the firm's founder John Foulston in a motor racing accident and Black Monday which sent its shares tumbling from a high of over 800p.

John Gunn is paying 520p a share for Atlantic—a hefty premium to the suspension price—and is offering a complex mix of shares, loanstock and what will work out at around £200 million in straight cash. Atlantic will add the vital "extra leg" that B&C has been looking for since it sold its industrial division Bricom for £359 million but the City's initial reaction was lukewarm.

B&C shares immediately fell 15p to 248p as the market reacted with the traditional scepticism of computer leasing firms which have have a rocky history on the London stockmarket.

Peter Goldie, B&C's chief executive, quickly moved to quell some of these fears, "Atlantic is a well run business. It is in a growth sector and has not been affected by the problems that have affected other computer leasing firms," he says.

"Other computer leasing firms have run into trouble over accounting for residual value.

"Atlantic takes no account of residual value and is simply a service business in a fast growing sector."

Last year Atlantic made pre-tax profits of £38 million.

Sir Alan stirs it for Nigel

by David Hellier

SIR Alan Walters, the economic guru expected to return from America as Mrs Thatcher's adviser, has hinted that he believes Nigel Lawson's reign as Chancellor is close to an end.

Commenting on speculation that the Chancellor may be out of No. 11 before the next Budget, Sir Alan told the Evening Standard: "He's been there for seven years, which is a very long time for a Chancellor. It may well be that he's thinking of moving on. It's a very demanding job and you do get tired working flat out."

Sir Alan's comments will reinforce the view in the City and Whitehall that Mrs Thatcher is clearing the ground for the appointment of a new Chancellor.

Nonsense

In the past few days Sir Alan has irritated Lawson with comments criticising the policy of shadowing the Deutschemark, abandoned in March after a rift with the Prime Minister who opposes British membership of the European Monetary System.

"We've spent 18 months or so shadowing the EMS and now I'm afraid it will take us some time to get that nonsense out of the system," says Sir Alan, who predicts a period of high interest rates, possibly up to 12%.

● Standard 50 Shares—Page 55

Secret 1% ABF stake at Hovis

THE SLEUTHS from County Natwest Woodmac have been over the Ranks Hovis McDougall share register with a fine toothcomb but so far there is no evidence of big stake-building by arbitrageurs, writes Patrick Weever.

There is a stake of about 1% which someone plainly wanted to conceal, buying through Dictat Nominees, Heseltine Nominees and Morgan Nominees.

A

MR GRAY

SIR ALAN WALTERS

Terry Perks took a telephone call late this afternoon from Sir Alan Walters reporting that he had been badly misreported by the Evening Standard in remarks about the Chancellor. The Evening Standard alleged (see attached) that in an interview he had predicted that Mr Lawson's term as Chancellor would soon end and had attacked as nonsense on Mr Lawson's policy of linking the pound to other European currencies.

Sir Alan told Terry that he had not said any of this. All that he had said, in answer to questions, was that he had seen speculation in the media about the possibility of the Chancellor leaving office. He himself had no idea how long the Chancellor would stay in his job. He further made the point that he had told the Standard that there was no difference between the Prime Minister and the Chancellor over the management of the economy, except possibly one of timing.

Sir Alan added that an Evening Standard reporter had telephoned him to apologise for the way the story had come out, claiming that this was the result of bad sub-editing.

Before Terry took the call I had had a lively afternoon Lobby on this issue. I tried to get over the point that the Prime Minister thought extremely well of both her Chancellors over the last nine years. They had run the economy in such a way that it had survived a number of severe storms - eg steel strike, Falklands conflict, miners' strike, halving of the price of oil overnight and Stock Exchange crash. There was no difference between the Prime Minister, the Chancellor or Sir Alan on the central objective of policy - to drive down inflation.

The media, I said, inevitably highlighted any negatives in Sir Alan's reported comments and ignored his praise for the Chancellor's policies.

In response to a question about the advice being given to Sir Alan, I said, more or less exactly: "There's only one thing to do when you are being misreported and that is to shut up but I have not told Sir Alan to do so".

I have not the slightest doubt that the media tomorrow will say that No 10 has told Sir Alan to shut up. Terry did in fact do so when ~~with~~ Sir Alan telephoned him for advice on whether he should issue a statement. Terry's strong advice was neither to issue a statement nor to talk to journalists any more; whatever he said would be misinterpreted.

Sir Alan promised "to keep the reptiles at bay".

BERNARD INGHAM

19 July 1988

JETS BATT
OVER THE G

Raids in run-up to the ceasefire

IRAQI jets raided Iranian factories and aircraft from each side clashed over the Gulf today only hours after Tehran said it had accepted a United Nations ceasefire order in the bloody eight-year Gulf War.

The Iraqi attack near the Iranian town of Ahvaz followed Iran's acceptance of a UN Security Council resolution calling for an immediate halt to hostilities and a withdrawal to international borders by both sides.

Tehran said its gunners brought down three Iraqi planes, and that another was downed in a dogfight over the Gulf.

Iraq later countered that its aircraft had shot down an Iranian jet during the dogfight, and a second in an attempted raid on the northern Iraqi oil centre of Kirkuk.

UN Secretary General Javier Perez de Cuellar said in New York that he hoped the ceasefire would go into effect within a week to 10 days.

An initial monitoring team of about 10 officers would spearhead a 250-strong UN truce force, he said.

In Tehran, residents greeted news of their government's acceptance of the

Continued on Page 2 Col 2

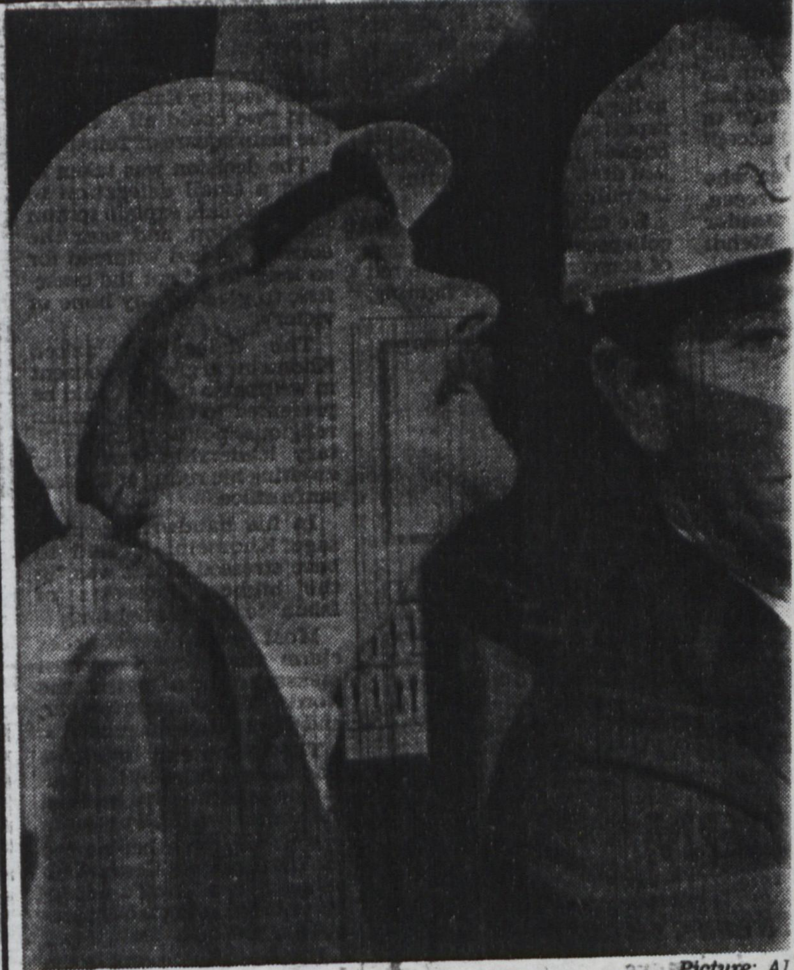
Sir Alan's new dig at Lawson

SIR Alan Walters, Mrs Thatcher's economic guru, drove the knife in again today to Chancellor Nigel Lawson.

In an interview with the Standard he predicted that Mr Lawson's term as chancellor would soon end. And he attacked as "nonsense" Mr Lawson's policy of linking the pound to other European currencies.

His public attack, for the second time in 24 hours, increased the tension between 10 Downing Street and the Treasury.

City report: Page 21



Picture: Al

NOT HIS DAY: Charles tries his hand at demolition under Len Maho

[redacted]

BA

1 Right time
2 [illegible]
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PROF OR SIR ALAN WALTERS - INTERVIEW ON POSSIBLE RETURN AND INTEREST RATES

Transc ipt from: ITN, News at One, 18 July 1988

INTERV EWER: (...... .....) .... Sir Alan, what do you make of the ne d in what is supposed to be a booming economy of having to rein in as ard as this, 6 movements in 6 weeks on interest rates?

WALTER : Well in my view the policy is now correct. We're getting back t about the level of interest rates we should have retained some few mo ths ago.

INTERV EWER: You say it is now correct but what's been wrong to cause this p oblem?

WALTER : Well I don't know, I don't think, you could call it wrong. On the contrary, I mean everyone has been insisting on the Chancellor going in to - or the Chancellor and Mrs Thatcher, going in to the Europe n monetary system. Now what happened was that the Chancellor as it ere experimented with going into the European monetary system when h shadowed the deutchemark and kept the deutchmark at about 3. And wh t happened was of course he had to reduce interest rates in Britai to stop sterling appreciating against the deutchemark. So intere t rates went down a few months ago to 7 1/2% and in my view that w s too low.

INTERV EWER: Well now how serious a mistake was that, what are the long t rm consequences going to be of that?

WALTER : I think what's going to happen while there's also other mistak s been made as we engaged in the Louvre Accorde. But my own view i that the long term results needn't be at all important. What we're oing to see is aperiod where we have to atone with these higher intere t rates for the lower interest rates we enjoyed a few months ago. undamentally though this is of course the fruits of success. I mean t e economy is growing at a splendid rate . Although inflation seems o bed rising I mean it's nowhere near the panic level, nowher near the levels at which one should take any drstic action.

INTERV EWER: On the other hand Sir Alan, I'm sorry to butt in, but it is sai that you are considering coming back or others are considering having you back to No 10. That might suggest that you are being brough back to apply the brakes?

WALTER : Oh that's nonsense. This is press and media speculation which s utter nonsense.

INTERV EWER: Nonsense that you're coming back or nonsense that you would e applying the brakes?

WALTERS : Well first it's nonsense that I've agreed, or there's agreem nt, that I come back, there isn't yet. But secondly, to apply the br kes drastically in my view now would be very silly. There's no sit ation that is of a crisis dimension that calls for that. What it cal s for is some tightness, some tightening ....

INTERVIEWER: Sir Alan thank you very much. .....

FILE
DA

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

SIR ROBIN BUTLER

SIR ALAN WALTERS

I spoke to Sir Alan Walters.

I explained to Alan the problems which his television and radio interviews were creating. I said that the media were assuming that he would be returning to No.10 as the Prime Minister's adviser. His remarks were therefore being scrutinised carefully by political commentators, and I was sure the Opposition. We were having to forearm the Prime Minister in case his comments were used in an attempt to embarrass the Government at PQs tomorrow. I went on to say that in these circumstances I was sure that it was right for him to avoid any public statement, both written and broadcast, about the UK economy.

Alan immediately said that he had given another interview, which he thought was about to appear on Channel 4 News. It did, some 10 minutes after our conversation. He readily undertook, in view of the background that I had described, to "stop forthwith" any further comment on British economic policy.

Twenty minutes after the Channel 4 broadcast Alan telephoned to ask what I had thought of it. He emphasised that it had been given with the best of intentions. I said that Channel 4 had given it an unhelpful spin, and had tried to resurrect the story of differences between the Prime Minister and the Chancellor. Alan again repeated that he would stop forthwith any further comment on British economic policy; indeed he had just refused to write a piece for the Daily Mail. He said that he had written an article on international economic co-ordination. He did not think that this would cause any difficulty, but would send me a copy.

N.L.W.

(N.L. WICKS)

18 July 1988

CC

PLC

10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

SIR ROBIN BUTLER

SIR ALAN WALTERS

I duly telephoned Sir Alan Walters this afternoon about his article in yesterday's Independent.

I was frank with him that certain statements in the article had caused disquiet next door, to put it mildly. He said that he had made such statements many times before. I said that I did not think that the particular paragraph to which you had drawn my attention had been said in public before. In any event, his situation had now changed as the press were apparently realising. Such statements could be replayed back to the Prime Minister at question time, to her and the Government's embarrassment. Alan readily took the point. He said that he would refrain from such statements and would clear with me anything that might conceivably cause difficulty.

N.L. WICKS

15 July 1988

fle

cc

PRIME MINISTER

You should know that some of the statements in Alan Walters' article in yesterday's Independent have riled the Chancellor - for example the reference to "Mr. Lawson's misguided shadowing of the mark". I have had a word with Alan and suggested that while no-one would want him to change his views, it would be better if he did not express them in quite that form in public. He took the point and will show me anything which might conceivably cause offence.

N.L. WICKS
15 July 1988

EL3CXT

"The Independent" Thurs 14 July '88

Money on a roller-coaster

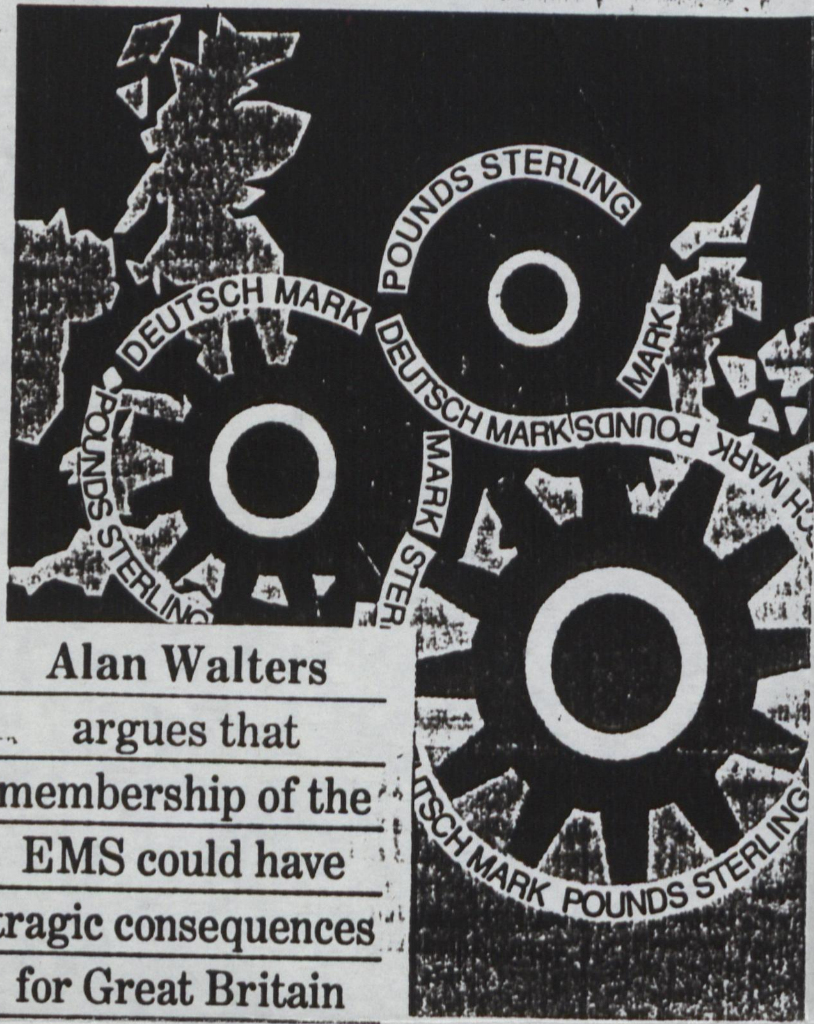
I am a firm believer in the advantages of great monetary unions, such as that of the United States. I am quite convinced, however, that the half-baked European Monetary System is a long step away from a monetary integration of a United States of Europe. The EMS is a major source of uncertainty, of massive flight of footloose capital, of great oscillations in interest rates and of repressive policies. If Britain, with its open capital markets, joined the EMS mechanism, such evil effects would be exacerbated. And the cause of monetary union would be damaged, perhaps irreparably.

First the technicalities. If Britain joined the mechanism, the EMS would fix the mark price of sterling — suppose it were fixed exactly at three marks to the pound — and *everyone* agrees that that is the "right" value at that time. But it is not really fixed for ever and a day, but only until the next "realignment", which we may assume is, say, in one year's time. Then, since prices will have been rising at about 5 per cent in Britain compared with zero in Germany, everyone knows that sterling will most likely be devalued to the next "right" value of 2.85 marks. This stately progression of stable exchange rates with periodic "realignments" has a most disruptive effect on interest rates and monetary policy.

Suppose that the deposit interest rates in Germany and Britain are 3 and 8 per cent respectively, beginning with a fixed three-mark pound to last one year. Anyone holding a deposit denominated in marks will be induced to exchange his marks for pounds, deposit pounds in Britain for up to a year, and so collect the extra interest, confident in the EMS mechanism maintaining the three-mark pound up to realignment.

Consequently money would flood into Britain from Germany — from the country with stable prices to the country with 5 per cent inflation — thus driving Germany towards deflation and Britain to yet higher levels of inflation. A perverse policy indeed! And this massive flood of money would reduce interest rates in the United Kingdom and raise them in Germany, to values of, say, 5 and 4 per cent respectively. It will also give rise to the familiar pressures on exchange rates — with sterling in such demand that it would be difficult for the authorities to keep it from appreciating above the three-mark level. The Bank of England would be busy buying marks, reducing its short-term interest rates and flooding the market with pounds in order to contain sterling's buoyancy. Furthermore, to accommodate this inflow of short-term capital, the current balance of payments of the United Kingdom would have to move sharply into a deficit. (The other possibility is that long-term capital outflows would be greatly enhanced, with, for example, British takeovers financed by these large, short-term capital inflows.)

As the year went by and as realignment day approached, there would be a great *reversal* of capital flows. Instead of the rush to lend sterling, people would now want to borrow pounds, and buy and lend marks.



Alan Walters argues that membership of the EMS could have tragic consequences for Great Britain

Realignment day would provide everyone with a sure-fire bet against sterling. But, in the run-up to realignment day, the punters would drive short interest rates in Britain sky-high — even 500 per cent overnight would not deter a punter who knew that sterling would fall 5 per cent next day. After realignment, the punters would then collect their winnings from the central banks (taxpayers), and so the cycle would begin again. The oscillation in interest rates would generate similar roller-coasters of inflationary pressures and lurches of stop-go in policies.

These are likely to be the tragic consequences of Britain joining the EMS mechanism. Unfortunately for Britain, we can witness a performance of this tragedy, currently still running, enacted by Mr Lawson's misguided shadowing of the mark during 1987 to March 1988, following the great interventions consequent upon the Louvre agreement. We saw base rates sink from 11 to 7.5 per cent, and then rise again (and here I conjecture) to some 11 or 12 per cent in the coming months. The growth rates of money, even M0 (which comprises mainly the notes and coins in circulation), have expanded, and the current balance of payments has been deteriorating rapidly into record deficits. We have yet to see the final inflationary consequences and the full fall of sterling against the mark, but, as in a Greek tragedy, the end is not in doubt; it is only a matter of time.

Then we shall see the characteristic reluctance of all countries, including Britain, to allow their currencies rapidly to be devalued, or indeed revalued, to the extent that is needed (shades of Harold Wilson in 1964-67). The procedures of the EMS, like all the bureaucratic processes of European agencies, will exacerbate this rigidity.

For example, throughout its membership of the EMS, France has suffered from a continuing overvaluation of the franc. As Bela Balassa has shown in a recent issue of *Commentaire*, this has eroded exports and generated a structural current account deficit in the balance of payments. The miserable growth rate of the French economy in the 1980s, compared with the buoyant British economy (at least until 1988) bears testimony to the negative effects of full membership of the EMS. And it is entirely understandable that the French want to have some influence over "their" (that is the Bundesbank's) monetary policy.

Small wonder also that the French (as have the Italians) retained exchange and domestic credit controls in order to mitigate the capital movements and the effects on interest rates. Even so, in Britain, after shacking-up with the EMS for these past months, there is a call for the reimposition of credit and exchange controls, for the use of the "Regulator", for import surcharges, indeed for much of the panoply of controls and fine-tuning that so ruined the economic performance of Britain in the 1970s. Ironically, by 1992 most members of the Community have promised to follow the Thatcher model by removing exchange controls and liberating credit markets, *en route* with the EMS, to a Central Bank of Europe . . . some hope.

Suppose, however, that the constituent states are willing to surrender their sovereignty to the Bundesbank or some other European authority. What is the path then to monetary union? Clearly we should examine the history of the many successful monetary unions, such as the United States, the sterling area to the early 1960s, Hong Kong's 1983 union with the dollar, and the more dubious case of Panama, to serve as guides for the union of Europe. (We should also examine the failures of systems similar to the EMS, such as Bretton Woods from the end of the 1950s to its *de facto* demise, after being battered by enormous flows of footloose money, in 1967). The essential feature of these successful unions was first *absolute fixity* of the exchange rate (no realignments), and second *monetary institutions that guaranteed such fixity*. Is Europe prepared for such draconian reforms?

Finally I realise that I am in a very small minority in my opposition to membership of the EMS. The City, the CBI and the media are convinced it would be a good thing. It is easy to see why the City financiers would welcome sure-fire bets on realignments at the expense of the taxpayer. However, I am not at all clear why the CBI likes the idea, but, since the "bare knuckles Beckett" episode (when the then CBI director-general launched a full-scale attack on the Government's economic policies, ironically at the very moment the economy had begun its recovery from the recession), perhaps one should not expect any sound economic rationalisations for their policy proposals. The media seem convinced that we are "missing the bus", although they have only recently begun to inquire the price of the ticket. European bureaucrats issue urgent warnings and dire threats in the hope of cajoling Britain into the creaking mechanism of the EMS. Germany wants us to counter the French pressures for symmetry, and France hopes that we shall join with them in modifying the Bundesbank's hard line. Meanwhile, I suspect many people in Britain are having second thoughts. I urge that they reflect calmly and deeply on such momentous issues.

Sir Alan Walters is adviser to the Office of the Vice President of the World Bank.

Mr Wicks
No 10 Downing St.

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DEREGULATION AND PRIVATIZATION

- THE LESSONS FROM THE U.K.

by

Alan Walters

May, 1988

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Alan Walters

Britain's supply side program of deregulation and privatization together with expenditures, tax, and trade union reform, first required financial and macroeconomic stability. Once this was achieved in 1982, the reforms were implemented more and more successfully, in both the economic and political senses.

The economic success can be gauged by the performance of Britain's growth rate, productivity advances, and employment growth relative to that of the large European countries. The UK, which used to grow at half the rate of Germany and France, now grows at twice their rate. This has been achieved during a disinflation and a transition from a large budget deficit to (albeit small) a budget surplus. The basis for the supply-side success seems secure.

I. AN OVERVIEW

The supply side of the Thatcher reform has been just as vital an ingredient of Britain's economic renaissance as the fiscal-monetary (or "monetarist") policies. Yet I believe it is important to stress that in Britain, perhaps as distinct from other countries, the monetary-fiscal stabilization policies were a necessary precursor, or at least accompaniment, to the supply side policies. The grand design was conceived as: first, stabilization to provide room for reform; secondly, to restore the market and the private sector; and third, to change institutional arrangements so that individuals and families can influence and eventually control those services (e.g., health and education) which have long been in the power of politicians, union officials and bureaucrats. Roughly speaking, the time periods for the major thrusts have been:

Stage 1	Stabilization	1980-1982
Stage 2	Supply side	1982-1988
Stage 3	Institution reform	1987-1992(?)

Of course, some supply side measures were taken at the earliest stages (e.g., abolition of exchange control in 1979) and some are still to be fully developed (e.g., housing reform). But the main outline is, I think, fitting.

By the end of 1982, fiscal-monetary stabilization had produced a decline in inflation from 20 percent in mid 1980 to about 5 percent at the end of 1982. Since most price, exchange rate and wage controls had been abolished, these were "true" undistorted readings. Furthermore, the budget deficit and public sector borrowing requirement had all been brought down, mainly by the budget of March 1981, from over 6 percent of GNP to about 3 percent or less. Thus the fiscal-monetary balance was clearly seen to be sustainable -- and indeed has been sustained to 1988 with the public sector borrowing requirement being negative (slightly less than 1 percent of GNP) for the first time since 1970. The monetary base has grown since 1980 at an average of about 5 percent per annum.

This has ensured that inflation has remained under control at, on the average, rather less than 5 percent for the last six years. This ambience of macro-stability has been a necessary condition for many, perhaps most, of the supply side reforms.

II. SUPPLY SIDE REFORMS

Analytically, the supply side reforms could be treated as a reassignment of property rights -- mainly from the public authorities (or other quasi-sovereign entities such as trade unions) to private individuals. As a matter of policy, however, these transfers took the form of:

(a) Deregulation -- removing most government controls from prices, wages and dividends, and from production arrangements;

(b) Privatization -- transferring not only ownership but also control to the private sector;

(c) Trade Union Reforms -- reducing the overweening powers conferred on unions since the Trades Dispute Act of 1906;

(d) Fiscal and Monetary Reforms -- to reduce marginal tax rate and, by eliminating special treatments ("loopholes"), to widen the tax base.

(e) Public Expenditure Reforms -- to restrain the inherent pressure on public spending;

(f) Welfare Reforms -- to reduce the "moral hazard" incentives (the "why work?" syndrome), and the poverty trap.

It is impossible to provide anything like a complete account of all these reforms. I propose therefore, first, to give a very brief assessment of the last four [(c) to (f)] categories and then go on to discuss (a) deregulation and (b) privatization, in some detail.

Trade union reform consisted largely in reducing the power of trade union officials and, by democratizing the unions' decision-making process, "turning the unions over to the members". Now, if the unions violate the law, the trade unions' funds can be sequestered. The reduction of union power, much aided by the high unemployment rates, has been credited with a very large supply side effect. Indeed, Matthews and Minford (1987) have attributed most of the astonishing quadrupling of productivity growth in manufacturing and the doubling of this rate in the economy as a whole, compared with the 1973-79 cycle, to the reform of the trade unions. Others, per contra, have credited, or blamed, the high levels of unemployment for the productivity gain. I must confess I can find little warrant in history for believing that high unemployment promotes productivity growth. (It certainly has done little for France and Germany in the 1980s!) The argument of Matthews and Minford seems plausible, but I would be inclined to attribute only about a third of the productivity gain to union reform.

The Thatcher approach to (d) tax reform was very different from the Reagan policy in the United States. In 1979, the first year of Thatcherism, the top rates of tax were reduced from 98 and 83 percent to 60 percent, but that was nothing like the 1981 reduction of taxes in the United States. And VAT was increased to compensate for a reduction from 35 to 33 per cent in the standard rate of tax. Indeed, in March 1981, Mrs. Thatcher put up taxes by about 2-1/2 percent of GNP, mainly by increasing income taxes -- certainly the biggest fiscal squeeze in the peacetime history of the UK. A simple-minded supply side argument would conclude that this would dramatically reduce productivity and output. (Indeed, the standard bearer of the United States supply side movement, The Wall Street Journal, pilloried the Thatcher government while it lauded the Reagan tax reductions of 1981.) In fact, exactly the opposite occurred! Productivity started rising, countercyclically at that. Gross national product, which had been falling precipitously in 1980 and the first quarter of 1981, reversed and turned strongly upward. Is this a great discrediting of supply side tax cutting? I do not think so. In 1981 the budget deficit (strictly the public sector borrowing requirement) would have been more than 6 percent of GNP and, in my view, that would have eroded entirely the credibility of the Thatcher government's resolve permanently to conquer inflation and eliminate the perennial, indeed biennial, financial crises that had plagued Britain for so long. The surge of confidence in the viability and coherence of the government's policy dominated the direct supply side effects.

From 1981, however, the public could look forward to reductions in tax rates; corporate taxes were reduced from 52 percent to 35 percent. By the 1988 budget, income tax rates had been reduced to a standard rate of 25 percent and a 40 percent maximum marginal rate -- in other words, somewhere near the levels of marginal tax rates (including state and local) in the United States. But Britain, as distinct from the United States, enjoys a budget surplus not a deficit. 1/ In other words, with suitable constraints on public spending, the tax rates are sustainable.

I would attribute perhaps 20 percent of Britain's performance to this record of stable macroeconomic conditions. In particular, maintaining a more-or-less free exchange rate regime enabled Britain to avoid the chronic overvaluation which so plagued countries, such as France, inside the EMS (see Walters, 1986, Ch.7).

On (e), public expenditure reforms, the Thatcher government has been least successful when compared with the original objectives. Although several important changes were introduced, such as the extension of cash limits on the non-demand driven items in departmental budgets, the government did not manage to bring down the levels of real public spending. Even the attempt to hold public spending at a constant real level failed. The ultimate result was a modest decline, from 1981-82, in the fraction of GDP devoted to public spending. Although this was a considerable achievement compared with previous governments (the exception being the brief period - 1975-76 - in the Wilson Labor Government), public spending remains a disappointment. Perhaps the main achievement is to redirect public spending from many wealth-destroying activities to wealth-promoting projects. But I think it has contributed only a little (5% perhaps) to Britain's renaissance.

III. DEREGULATION AND PRIVATIZATION

Deregulation and privatization are both tributaries from the same main stream. Both consist of the assignment of property rights from government and the state to private persons or corporations. For example, the abolition of rent control is an extension or reinstatement of property rights of the owners (and a curtailment of the rights of sitting tenants). Privatization is a transfer of rights in a particular form for which the recipient usually, but not always, pays a price. And in privatization, the regulatory environment determines the new owner's rights.

In the Thatcher supply side reforms, deregulation was the primary policy instrument from 1979. The Thatcher government simply had no truck with the ramshackle "accords" or "solemn and binding" undertakings (often known as Solomon Binding's) which had been the apex of the Wilson-Callaghan government's system of control. The so-called winter of discontent of 1978/79 had demonstrated once again that either controls did not work, or if they did, the effects were to make things worse. In practice, as is generally the case, the wage controls were imposed most readily in the public sector. And the public sector employees responded by taking "industrial action" (a quaint phrase that means exactly the opposite, i.e., a strike or "industrial inaction"). From May 1979, there were no wage or price controls or "accords" or "guidelines" and no agreements with the unions or employer bodies. The exceptions are, however, important. Statutory minimum wage controls remained in place for about 15 percent of the labor force. Rent controls also continued for the rapidly declining private rental sector. And, of course, the government exercised controls over the prices of many nationalized industries, as well as over the prices of many agricultural products.

It was widely predicted that, in consequence of this decontrol, there would be a runaway wage inflation. Certainly inflation did increase to a maximum of 22 percent in mid 1980, but thereafter it fell quite sharply until in early 1983 it settled at about 5 percent (and in 1987/88 was 3-1/2 percent).

In spite of the record unemployment (which has been falling rapidly over the past two years), real wage rates have increased in every year. But there have also been very large increases in productivity - so that wage costs per unit of output have risen little. Indeed, although manufacturing wages rose 8 percent last year, the productivity increase was very nearly as great, so wage costs per unit of output did not rise. The increases in unit labor costs are expected to be among the lowest in the OECD countries.

The next dramatic deregulation was the abolition of exchange controls. Dating from World War II, residents of the UK were allowed access to limited rations of foreign exchange only for purposes approved by the authorities. For example, in 1976-78, emigrants could take out of Britain only Lstg.7,000; any assets other than personal and household goods had to remain in the United Kingdom. Mrs. Thatcher abolished exchange controls "at a stroke" in 1979. Again, dire warnings of massive capital flight and sterling falling into a black hole were common. The reality was a great inflow of capital and, from January 1979 to March 1981, sterling appreciated by about 40 percent in real terms. This appreciation was in small part due to the rise in oil prices, but the main impetus came from a sharp contraction in the money supply from 1979.

In its own terms, the aboliton of exchange controls was an enormous success which paved the way for much of the deregulation that followed. It enabled the Bank of England to eliminate 700 regulatory jobs, and in the private sector it seems likely that exchange control work must have accounted for at least 10,000 equivalent jobs. In the curious accounting of national statistics, all these "jobs" contributed to GNP at least as much as their cost. Perhaps most important, the dismantling of such an edifice of bureaucracy combined with (in 1988) the rescinding of the 1947 law that legalized exchange controls, makes it very difficult and hazardous to reimpose exchange controls. With the political popularity of the freedom to dispose of one's own assets as one wishes, most observers regard reimposition as unthinkable.

Financial deregulation in domestic markets followed soon after the abolition of exchange controls. Credit rationing was eliminated in 1980 and the government set itself the task of controlling, through bill operations, only the short (7 day) money rate and allowing the yield curve freely to be settled by the market. Several restrictions, however, were retained on various kinds of security dealings and other types of credit markets. But in the "big bang" of 1985, virtually all controls and restrictions were abolished. British markets became the least restricted, with the possible exception of Hong Kong, in the world.

In view of the various hesitant retreats from financial deregulation in the United States, it is particularly important to assess British experience -- a task which I can do only superficially here. Since the "big bang", the London markets have attracted much business to the city. For example, it can now claim to have the only truly international stock exchange. The variety of financial institutions, which would not be permitted in the United States because of the Glass-Steagall Banking Act of 1933, the rapidity with which firms adapt to markets conditions, and the rate of innovation, all testify to the vigor of the free market in finance. But, you may ask, is it all "sound"? I suppose one fairly critical test came on October 19th, 1987. Compared with the freezing up of Wall Street, the London Exchange performed extraordinarily well in absorbing this massive downward plunge. There was no dealing hiatus and any investor could readily liquify his holdings. The market worked smoothly. The U.K. is now involved in introducing more protection for investors through the Financial Services Act (1986). The basic idea is to allow the financial sector to police itself, subject to a general rule book of a Securities and Investment Board, without interfering unduly in market freedom. We shall have to wait a few years for a verdict on this Act.

All this newfound freedom has given rise to what has been termed a "credit explosion". Many reputable observers view this with foreboding -- a harbinger of future inflation, which will impair many things as well as financial markets. I believe, however, that these concerns are exaggerated. What determines inflation is money, the spending or circulating media, not credit.

In sum, I judge that financial deregulation has been a great economic success on all the usual criteria. Oddly enough, I think it has also been the instigator of considerable social mobility. The financial world now, more than ever before, rewards merit rather than class and contacts. The city has opened up, and many of its stars are indeed nouveaux riches. A meritocracy in the city has counterpointed the new surge of entrepreneurship in industry. This is a revitalization that Britain had long hoped for, but until 1979, in vain.

The other major deregulations have been in the transport sector. Of course, Britain is not entirely its own master, since the EEC exercises some considerable control over inter-EEC operations. But nevertheless Britain has gone far. There is complete deregulation with free entry of: (i) all trucking; (ii) intercity bus services (combined with complete privatization); and (iii) intracity stage-bus services outside London. The results have been quite dramatic -- particularly in both bus deregulations. As I forecast in a number of articles in the 1970s, the latent demand, suppressed by regulation, was for frequent mini-bus services on urban routes. The free market has demonstrated the validity of this conjecture. Similarly, the frequency and variety of services of intercity buses has put a new complexion on cheap (unsubsidized) travel in Britain. The government intends to deregulate London's buses in 1988/89; one can confidently anticipate a vast improvement in services and a drastic cut in the subsidy. From all my research, confirmed by government experiments, one would expect that the costs of private unregulated services would be about one-third to one-half of the regulated publicly owned services. The success on a political level is evident in the absence of any outcry (other than that which is inspired by threatened union officials) against the new system. All independent enquiries have reported considerable improvements of services and lower costs of operation. It seems unlikely that any future Labour government will reregulate and renationalize, so I judge it a success politically.

IV. PRIVATIZATION

The thirty-five years after World War II had seen great growth of the public sector, with governments attaining what they regarded as the commanding heights of the economy. As a rule, if it was large it was soon nationalized. In Britain, nationalization did not merely include the great basic industries of coal, steel, electricity, gas, telecommunications, railways, airlines, etc. It encompassed many an undertaking which could not be construed as 'basic' at all -- such as railway hotels, warehousing, and even some public houses (bars). It also included the great services; virtually all health, about 35 per cent of the total supply of dwellings, and almost all education.

Certainly by the 1970s it was clear that the public sector was not merely a major drag on Britain's economy, but also that it involved considerable threats to liberty and even to democratic government. 2/ In 1978/79 Britain suffered a 'winter of discontent' during which many public sector services ceased to exist -- garbage collected in the streets and even gravediggers refused to bury the dead (they did, however, offer to bury a number of the living). The disgraceful behavior of the public sector undoubtedly harnessed political opinion behind the privatization movement. The ideas and the problems of privatization had been examined in 'think-tanks', notably the Institute of Economic Affairs, and some sort of program was sketched out, should the Conservative Party be returned to power. 3/ Table 1 lists the major privatizations that occurred under the first two Thatcher governments.

Table 1. - United Kingdom: Privatization of Major Public Enterprises February 1981 to January 1987

Date [a]	Enterprise	Proceeds (In millions of Stg.)
February 1981	British Aerospace	43
October 1981	Cable & Wireless	181
November 1983 [b]	Britoil	627
December 1983	Cable & Wireless	263
June 1984	Enterprise Oil	382
July 1984	Jaguar Cars	297
November 1984 [c]	British Telecom	4,090
May 1985	British Aerospace	346
August 1985	Britoil	426
December 1985	Cable & Wireless	571
December 1986 [d]	British Gas	1,796
January 1987 [e]	British Airways	415

Source: Yarrow (1986), Table 1; and data provided by the United Kingdom authorities.

a/ Dates shown indicate initial offering.
b/ Of which Stg.334 million in 1982/83 and Stg.293 million in 1983/84.
c/ Of which, Stg.1,352 million in 1984/85, Stg.1,246 million in 1985/86, and Stg.1,084 million in 1986/87. Also included is Stg.408 million generated by the sale of British Telecom stock and preference shares.
d/ Total estimated proceeds are Stg.5,090 million, with the second installment having been due in June 1987 and the third installment due in April 1988. In addition, Stg.750 million of British Gas debt was redeemed in May 1987.
e/ Total estimated proceeds are Stg.825 million, with the second installment paid in August 1987

In addition to those shown in Table 1, there have been many other small privatizations raising less than Stg.100 million each. These took the usual form of divesting the state's control of a corporation in a competitive environment. One remarkable example of these small divestitures was the National Freight Corporation (NFC), a trucking firm with storage and travel businesses, which was launched into the private sector in February 1982. The state-owned company had made losses year in and year out, and the government found it very difficult to find anyone interested in paying anything for such a moribund group. The management and workers, however, perceived their opportunity. After securing some institutional backing in the City (at present 17 percent of the shares are owned by institutions), they proposed a management/worker buy-out, for a sum of Stg.6.5 million (or about $17 million). The original shares, for which the employee or manager paid Stg.1, are now (1988) worth Stg.70. It is not hard to envisage the change in attitudes that privatization engendered. With the same workers, management and, initially, assets, but with critical changes in incentives, the NFC was transformed from a loser to a winner. In the next few years, NFC will be engaged in a massive investment program that envisages considerable expansion both at home and overseas.

Principles of Privatization

As in every society, there is a wide variety of opinion about what should be in the private sector and what should be left to the public authorities. In Britain we were not starting with a tabula rasa. We faced the reality of a large, inefficient, politicized public sector. The cost of privatization, in terms of the scarce time of administrators, the legal proceedings, the exploration of the market, the restructuring of balance sheets, and the problems of displacement on a crowded political agenda, is always substantial, and, one may add, far larger than privatization enthusiasts tend to envisage. In a democratic and free society, legal rights must be protected and due process must be observed.

The first issue then is what privatizations should have priority. Where are the gains from privatization to be greatest? Where should our effort be concentrated first?

The criteria, not mutually exclusive, may be broadly construed as the following:

(a) Competition. Those nationalized concerns that are in industries which, in the absence of government control and ownership, would be naturally highly competitive should be considered prime candidates for privatization.

(b) Rapid technological change. When an industry is either experiencing, or about to experience, rapid technological change, one should consider it a prime candidate for privatization, even it it is not naturally or inherently competitive.

(c) Constraining the Unions. It is well known that trade unions thrive in the public sector. Sheltered from the chill winds of competition, often politicized with their sponsored politicians in key legislative or executive positions, such leaders or officials of labor unions have wielded not only great economic leverage but also considerable political power. Privatization removes the ability of the concern to pass on its high wage awards and its inefficiency to the customer or to the books of the Treasury.

In commending these criteria as useful guideposts for a government's privatization policy, I do not mean to imply that one should consider only these considerations. As one may imagine, there are many others. Perhaps the most important are political factors. The political advantages to the conservatives of increasing private house ownership, for example, played a major role in the privatization of public housing. There are also many problems of precisely how the privatization is to be achieved, in what form, and in what time frame.

The objective of privatization is to transfer control to the private sector. In Anglo-Saxon law, this means selling more than 50 per cent of the voting equity to private investors. In practice it is wise to sell a larger fraction to the private sector so that the public holding is sufficiently small to be non-threatening.

Performance

One of the main presumptions of privatization is that somehow concerns must be 'put in order' before they are sold. Often, though by no means always, this implies restructuring the balance sheet, making the corporation more efficient by eliminating excess labor, changing work practices, etc. Then a reasonably hopeful story can be told in the stock offering Prospectus required by company law. (I deal with regulatory frameworks below.)

A striking feature of British experience has been the dramatic improvement in the performance of corporations that are put on the list for future privatization. Marked gains in efficiency, productivity, quality control, etc., are characteristic of those who are about to be privatized. In one sense, this is simply a recognition that "the party is over". Best prepare for the reality of competition. British Airways, Jaguar, and even British Telecom were remarkable examples of the beneficial effects of being on the program for privatization. A more recent example, a few weeks before its privatization, Rolls-Royce PLC reported a 56 percent increase in profits in 1986: from $123.5 million in 1985 to $192 million in 1986. 4/

But there is a more important reason -- and one which I find difficult to exaggerate. Privatization is an arduous process involving many obstacles. It requires great energy and drive to deliver the corporation to the market. As legal, administrative and political problems multiply apace, it is too easy for some real-world Sir Humphrey to conclude that "the time is not ripe." In order to overcome this entirely natural lethargy, the British government appointed chief executive officers in the nationalized corporations who, on the one hand, strongly believed in the privatization program and, on the other hand, would be appropriate, even ideal, chief executives of the newly privatized concern. Thus, by making suitable appointments in the public corporation, the government could <u>harness the dynamic energy of self-interest at the early stages of the long road to the private sector</u>. Remarkable examples of this are to be found in the appointment of Sir George Jefferson to British Telecom, Sir John Egan at Jaguar, and Lord King in British Airways. It is difficult to imagine that so many corporations would have eventually reached their private goal without the drive, determination and, indeed, some ruthlessness on the part of these very able men. As a corollary, once such able men are in the driving seat they can command considerable bargaining power in securing what they regard as appropriate conditions of regulation, etc., for the newly privatized firms. This has its dangers to which I return below. 5/

Capital restructuring has been characteristic of many privatizations. In the case of British Airways, for example, it was clear that most of the proceeds of substantial loans from Banks (about $1 billion with government guarantees) had not been spent on equipment and capital. It had been frittered away in inefficient scheduling, overmanning, excessive wage awards etc. It was thought best to write this down so that the balance sheet reflected the reality of its assets rather than past misdeeds. So the government recognized its loss, and the balance sheet in the Prospectus is 'clean'.

The case for restructuring the balance sheet was always most powerfully made by the market men, in particular the merchant bankers who advised on the deals. I must confess that I have never really agreed with, or perhaps understood, the argument. If British Airways were sold with the bank debt still on the books, would it not merely mean that a lower price would be obtained for the equity since the firm would carry the debt servicing charges? (Assuming of course that the value of the equity exceeded the nominal debt.) Does the state get more money for the disposal in the sense that the difference in price of the equity more than compensates for the write-offs? I do not know the answers and I must leave these questions for others to resolve.

"Natural" Monopolies and Regulation.

There is a considerable variety in the concerns that have been privatized. One important analytical distinction is between those that are inherently competitive and those which may be classed as monopolies, particularly so-called natural monopolies. In the case of competitive industries, there are few problems about releasing the hitherto publicly-owned concern into a competitive environment. If, as often occurs, under public ownership the corporation enjoyed an artificial monopoly, where, for example, new entrants were denied access, then there are the transitional problems of repealing such restrictions and allowing competition to work. It would be wrong to belittle the difficulties of eliminating such rent-creating barriers to competition.

With the great natural monopolies, however, there is a different problem. First it is necessary very much to circumscribe what can be construed as a natural monopoly as distinct from one that is fostered and protected by the state. Perhaps the most obvious example is the connection from the house or office telephone to the first system switching station. From thereon, however, there can easily be competitive arrangements for telecommunications. Similarly, the customer distribution systems for electricity and gas are natural monopolies, except for large customers; but this does not extend to the generation of electricity or the production and transport of bulk gas. Thus, the coverage of any regulatory system should extend only to these natural monopoly elements. This implies that the public needs to be protected against exploitation by British Telecom of their local link monopoly. In fact, of course, that particular monopoly is in the process of being eroded by competition from various other forms of communication such as cable, radio, etc. So one might argue for a "sun-set" type of regulation that automatically declines over time.

In Britain, we wanted to avoid the obvious and egregious wastes which were inherent in the general system of regulation of the privately owned utilities in the United States. Typically, they are controlled by the specification of a maximum rate of return on capital. Thus it pays to invest capital in the utility even though the marginal rate of return is low and well below the cost of funds, provided that, for example, the average rate of return exceeds the maximum allowed. 6/ We were also most anxious to avoid the immense bureaucratic costs and lengthy legal procedures. In practice, however, the privatized monopolies have managed to get away with some continuation of the general protection they had enjoyed as nationalized corporations. In part, this is due to the fact to which I referred above, namely that, in order to push through the process of privatization, powerful and dynamic executives were appointed who extracted from the government promises of some transitory shelter from competition.

However understandable, it is undeniably also to be regretted. But one should look at it in an appropriate perspective. First, in the two major examples, British Telecom and British Gas, there was certainly no increase in the protection from competition in the process of privatization. On the contrary, in both cases the pre-privatization period saw considerable liberalization (for example in the Telecommunication Act of 1981, which liberalized the equipment conditions for attachment to the system). Certainly there was no reduction in competition. Much of the protection was rationalized on the grounds that one needed to get competitors (such as the Mercury competitor for BT) established, and that they would only stay in the business if they had some "concessionaire" arrangement. With BT now having spent some time as a private sector corporation, we can now see that there is much more competition than appeared to be possible at the time they were privatized. 7/ As a general rule, most people, and particularly economists, underestimate the ingenuity of competitors.

Secondly, even if the monopoly is substantially the same in private as in public hands, there will be efficiency gains which will accrue ultimately to the people. The private company will have a great incentive to minimize costs, since these will augment profits by economizing on inputs of capital, labor etc. The potential for improving profits will be well known to investors and so will be reflected in the competitively determined issue price (subject to the arguments discussed above). Thus the government seller will capitalize on the expected efficiency gains from private management and control. Such gains are appropriated by the community as a whole. Similarly, any expectation that the private monopoly will exert its power to restrict output and expand profits, in the classical way described in the text books, will also be reflected in the issue price. There is, however, no apparent evidence of BT restricting its output to increase its profits, but we do not know whether there was any expectation of such behavior, nor can we measure such conjectural effects on the issue price.

In order to forestall such exploitation, however, a very simple system of regulation was established which was fully explained in the prospectus. This is often called the "RPI minus x" system. In BT it was clear that the monopoly power existed over mainly local calls; for long distance there was increasing competition. Over a five year period, BT was required to increase the price of local calls by no more than the Retail Price Index minus 3 per cent. This was the basic system of regulation used. Note that it did not control profits, nor did it require any investigation of costs. It was a simple maximum price control (allowing for inflation). Over and above this there was the Director General's Office of Telecommunications (OFTEL) which was charged with the job of promoting competition and identifying abuses. OFTEL is also charged with the task of ensuring that BT carries out its legal responsibilities to provide rural call boxes and emergency services.

So far there has been considerable satisfaction with this new regulatory arrangement. It was adapted for the recently privatized British Gas - an industry considerably larger than BT, but one with a similar local monopoly. Of course, it is too soon to give a considered account of this new approach to regulation and, in any case, I cannot do justice to the nuances in this paper. But I suspect that, in two or three years time, experience will provide an informed, if not a definitive, answer. At the very minimum, it avoids the massive wastes inherent in the British political and administrative arrangements for controlling existing nationalized industries and in the United States system of profits control. 8/

Political Considerations

There is always an abiding suspicion that the real motives for privatization are ideological. Unfortunately, it is impossible to discern motives. All one can do is find indirect and unsatisfactory indicators on what peoples' motives might have been. But fortunately, motives are irrelevant in discussing the logic of argument and the evidence of reality. We can argue the effects of privatization and gain insights from the empirical results without knowledge of the motives of the policy makers. Similarly, we can point to the political effects without ascribing motivations.

There is little doubt that privatization changed the nexus of interests of voters. Perhaps the main effect was in the privatization of dwellings (about one million privatized, covering at least two million, and perhaps as many as three million voters). The tenants became owners. As a rule, those who own their own houses are more likely to vote Conservative, and so housing disposals were in the electoral interests of Mrs. Thatcher's government.

The privatization of state-owned enterprises might be thought to offer more dubious political dividends. However, in the more recent privatizations, particularly BT and British Gas, there was a deliberate attempt to democratize the ownership, as described above. For example, of the British Gas issue, one sixth of the households that have a gas connection (incidentally, the vast majority) have also a share holding in British Gas. With British Telecom's flotation in November 1984, BT attracted 2 million investors, about a half of whom had never before bought shares, and even today BT has around 1.7 million shareholders.

The number of shareholders in the U.K. has shot up from about 3 million in 1979 to 8.5 million, or nearly 20 percent of the adult population, according to a survey commissioned by the Stock Exchange and the Treasury. 9/

Truly, this was returning industry to the people. It is far too soon to evaluate the political consequences of this considerable change in ownership. I suspect they will be found to be large and will perhaps lay the foundation for the property-owning democracy which has long been the goal of the non-socialist parties of the West.

Provisional Conclusions on Privatization

The most obvious conclusion is that privatization has been a considerable success on all the occasions it has been pursued. The extent of the success has varied, but is consistent with the principles hinted at above. In retrospect, one cannot find a single example of a privatized concern that has not experienced a considerable improvement in efficiency and performance. 10/ Perhaps the most surprising consequence has been the political popularity of privatization, even after the crash of October 19, 1987. In the case of housing, what was once a bitterly opposed policy is now embraced by all political parties, albeit with different degrees of enthusiasm, as a consensus privatization program. Indeed, it is anticipated that, if a new Thatcher government is returned in 1991 or 1992, privatization will be extended to industries now thought to be firmly in the public sector, such as London's subway system, railways and coal, and perhaps even health and education. This will truly return industry to the people.

V. THE RESULTS OF SUPPLY SIDE POLICIES

It is not possible neatly to decompose cause (from the supply side) to effect (on the performance of the U.K. economy). One could go through a list of the improvements in productivity, etc. for the various elements of privatization and deregulation. But we could record only the direct effects. It would not be possible to trace the much more important indirect benefits of deregulation, etc. For example, we could note that through quality enhancement and efficiency gains, Jaguar has probably increased productivity of both labor and capital by some 120 per cent -- but we could not measure the effects on suppliers, other industry in the area, etc.

Here I will just review some macro effects. We could compare, for example, the performance of the economy before 1980 and from 1981 onwards. [11] Certainly there is evidence of an improved 1980s' performance on the 1970s' dismal record. But such comparisons are inherently flawed. The international environment, so much a determinant of economic performance, does not stay constant. It is as misleading to compare the 1980s with the halcyon 1960s as it is with the miserable 1970s. But it is more illuminating to compare the U.K. with other countries, and particularly the great states of Europe, for the same period. Then all countries face the same international economic environment; each, so to speak, has the same handicap.

The touchstone of performance to most economists is economic growth (or perhaps per capita growth - but this matters little in the context of Western countries). The comparison of the United Kingdom with Germany and France is shown in Table 2 for the period up to 1980 and 1981 on. Since the U.K. emerged from the slump in 1981, some year or so ahead of Germany and France in 1982, one might want to make some adjustment for this timing. But the broad picture remains the same. In the 1970s and 1960s, Britain grew at about half the rate of growth of Germany and France. Since 1981, the U.K. has grown at about twice the rate of growth of the two great states of mainland Europe. Perhaps this sharp reversal in the growth league table is the clearest evidence that things have changed. Indeed, in the year just passed (1987), Britain's growth rate was 4.5 per cent whereas for Germany it was 1.7 per cent and France 1.6 per cent.

One of the special factors to which many people allude in order to explain away Britain's performance is North Sea oil. It is difficult, however, to establish that very much is due to the North Sea bounty. Probably the maximum contribution to growth was in the period 1978-1983. But 1983 saw the big fall in the oil price and North Sea revenue had already peaked. Indeed, if we take 1987 as a sample year after the oil price fall, the growth rate including oil was, as mentioned above, 4.5 per cent. However, the growth rate of the non-oil economy is calculated to come to 5.5 per cent. (Incidentally, those who believe in the oil-explanation would also have the task of explaining why the performance of both the Netherlands and Norway have been so miserable. Why did not Britain catch the Dutch disease?)

Table 2. - Growth Rates
in Real Gross National Product, 1961-87

(Percent change)

Area/Country	1961-65 annual average	1966-70 annual average	1971-75 annual average	1976-80 annual average	1981	1982	1983	1984	1985	1986	1987 a/
OECD countries b/	5.3	4.6	3.0	3.3	2.1	-0.2	2.7	4.7	3.2	2.7	2.8
United States	4.6	3.0	2.2	3.4	1.9	-2.5	3.6	6.8	3.0	2.9	2.9
Canada	5.3	4.6	5.2	3.7	3.0	-3.4	3.7	6.1	4.3	3.0	3.7
Japan	12.4	11.0	4.3	5.0	3.7	3.1	3.2	5.1	4.7	2.5	3.6
European Community c/	4.9	4.6	2.9	3.0	.2	.8	1.5	2.4	2.6	2.6	2.3
France	5.9	5.4	4.0	3.6	1.2	2.5	.7	1.4	1.7	2.1	1.6
West Germany	4.7	4.2	2.1	3.4	.0	-1.0	1.9	3.3	2.0	2.5	1.7
Italy	4.8	6.6	2.4	3.8	1.1	.2	.5	3.5	2.7	2.7	2.7
United Kingdom	3.2	2.5	2.1	1.7	-1.2	1.0	3.7	2.2	3.7	2.3	4.5
Developing countries	5.3	5.8	5.7	5.0	2.2	.9	.5	2.8	1.7	4.0	3.3
Communist countries d/	4.4	5.0	4.2	2.8	2.0	2.6	2.7	2.3	2.3	4.1	(e/)
U.S.S.R.	4.7	5.0	3.0	2.3	1.3	2.7	3.2	1.5	.8	3.8	1.0
Eastern Europe	3.9	3.8	4.9	1.9	-1.0	.9	1.9	3.5	.5	2.7	2.0
China	-.2	8.3	5.5	6.1	4.9	8.3	9.1	12.0	12.0	7.5	9.5

Source: Department of Commerce, International Monetary Fund, Organization for Economic Cooperation and Development, and Council of Economic Advisers.

a/ Preliminary estimates.
b/ OECD (Organization for Economic Cooperation and Development) includes Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and United Kingdom, not shown separately.
c/ Includes Belgium, Denmark, Greece, Ireland, Luxembourg, Netherlands, Portugal, and Spain, not shown separately.
d/ Includes North Korea and Yugoslavia, not shown separately.
e/ Not available.

Remarkably, Britain's GNP has been growing strongly since the middle of 1981 -- a record sustained expansion of seven years. One might also note that this expansion has not been fueled by increasing inflation: quite the contrary, inflation has fallen. It is now (1988) 3-1/2 per cent and seemingly fairly stable. Nor can one argue (as for the United States) that growth has been bought by massive imports of capital and sowing future trouble in the form of unsustainale budget deficits and mounting domestic and foreign debt. On the contrary again, at the end of 1986 Britain was the largest creditor nation -- exceeding in net foreign assets both Japan and Germany. [12/] And the government accounts were in surplus in 1987 and forecast to be in surplus in 1988-89.

Of course, this record of high growth is not evenly distributed over all sectors. For some reason, perhaps because of the emphasis of the economic planners such as the late Lord Kaldor, economists have always been keen to judge the performance of an economy by the behavior of the manufacturing industries (a sector which accounts for only about 25 per cent of total output). The decline of manufacturing production from 1979 to 1982 was the issue which engaged the attention of critics. It was pointed out that manufactures did not regain their 1979 peak until 1986. Certainly manufactures suffered a relative decline compared with other sectors up to 1985 (but note that since then they have been growing relatively more rapidly). Oddly enough, the same economists did not reflect on the great classical principle of relative advantage. It was well known that Britain had a relative advantage in non-manufactures, particularly services and agriculture. For example, in 1979 German productivity in manufacturing was more than twice that of Britain - but in agriculture their productivity was only half that of the U.K. It was entirely to the good that when the controls and distortions were removed, Britain reallocated its resources both between manufactures and other sectors, and within manufactures itself, to increase productivity and profits. Again the record shows this clearly. In the 1970s, productivity growth per person averaged 1.64 per cent. Productivity in manufacturing has grown dramatically over 1981-85 -- 30 per cent over a five-year period. 13/ Britain is rapidly catching up on Germany and France. Many distinguished economists believed that, in the early period 1981-83, the dramatic increases were a flash in the pan, which would not persist and even be lost in later years (see Walters, 1986, Ch.10). But the pan has flashed so long now that it must be classified as a new and brilliant jewel in the crown of the economy. In 1987, for example, the productivity increase in manufacturing was 7-1/2 per cent -- near Hong Kong or Taiwan standards. Of course, it will be said, this cannot go on and on. But we must be wary of the mistake of the "flashers" who have found their confident predictions so rudely discredited. There is much more life in supply side reforms yet.

The decline of manufactures for 1979-82 expanded what used to be regarded as politically the most explosive indicator, unemployment. Of course, it was clear that all the countries of Western Europe were experiencing an unprecedented (at least since World War II) surge in unemployment. Much statistical expertise was lavished during 1980-83 to show that unemployment was more severe in Britain than in Germany and France (as well as on the easier task of showing this in comparisons with

Table 3. - Unemployment (as % of labor force)

	1980 (avg.)	1983 (avg.)	1987 (Dec.)
Belgium	9.4	14.5	15.4
Denmark	6.1	10.7	8.0
Germany	3.3	8.6	9.0
France	6.4	9.1	10.4
Ireland	8.3	15.3	18.7
Netherlands	4.7	15.6	14.3
United Kingdom	6.3	11.7	9.4
Average: (excl. U.K.)	6.6	12.1	10.4 *

* Average of 12 EEC countries.

Sources: Commission of European Communities, Annual Economic Report, 1983-4, Brussels (for 1980 and 1983); and OECD Main Economic Indicators, February 1988, Paris (for December 1987).

the United States and Japan). By 1983, however, both the increase from 1980 and the percentage level of unemployment in the U.K. were about the same as those of the rest of the European Economic Community.

For almost two years now (January, 1988), Britain's unemployment rate has been falling very steeply by about 50,000 or 0.2 per cent a month, and is now about 9.4 per cent, whereas French unemployment still seems to be rising (at about 10.4 per cent in January,1988). Oddly enough, since the critics were mainly Keynesian in persuasion, little attention was paid to <u>employment</u>. Britain's <u>employment</u> started <u>rising</u> from mid 1983 and continued to rise through to 1988. Again this contrasts with continental Europe which continued with generally falling levels of employment over this period.

To sum up, considering the restructuring of the economy, the sharp reduction in inflation, the turnaround from an unsustainable deficit to a surplus, and the massive shakeout in industry, the picture of unemployment/employment is somewhat better than those of other EEC countries. This still does not mean that it is satisfactory. Indeed, it is a sobering thought that recent calculations of the NAIRU by Richard Layard and others suggest that 10 per cent is about as low an unemployment rate as Britain can afford; any lower rate will be associated with accelerating inflation. This calculation, if it is to be believed somewhere near the true value, illustrates how much more needs to be done in improving labor mobility, sharpening incentives and deregulating in order to improve the workings of the labor market. [14/]

VI. CONCLUSION

Even Mrs. Thatcher's worst enemies, or at least those who are not indisputably deranged, would concede that the various supply side measures which she has pioneered have had a significant effect on the growth and performance of the British economy. Perhaps most of these basic changes will not be undone by a future Labour government. Mrs. Thatcher has moved the agenda of political debate over towards a more liberal (I use that word in the European not the American sense) order.

FOOTNOTES

1/ This road to a budget surplus has been associated with a sharp increase in the current account deficit of the balance of payments in 1987 and 1988. This constitutes yet another refutation of the New Cambridge School and the conventional wisdom widely publicized in the United States that the US current account deficit is largely a consequence of the federal budget deficit.

2/ For example, it was widely thought that no government could possibly rule without the consent of the National Union of Mineworkers. The union had toppled the government of Edward Heath in 1974 and had been the power behind the Wilson and Callaghan governments of 1974-79.

3/ It would be wrong to imagine that the privatization movement was embraced with any enthusiasm by the Conservative Party. After all, when it was in power in the 1950s, early 1960s and early 1970s, it had done little or nothing to reverse the trend towards public ownership. The real drive behind the program came from the Prime Minister and her group of ministers.

4/ Wall Street Journal, March 20, 1987, page 8. (See also Appendix for the profit record of other privatized companies.)

5/ Of course, as the performance of the public corporation improves, there are always the faint-hearted supporters who will say that, since the concern is now in good shape and earning profits there is no reason for privatization. Just as when there is a leaky roof, while it is raining one cannot repair it since one will get wet, whereas when it is fine there is no need to repair it. Nevertheless I have heard such arguments used to delay or abort privatization.

6/ Unfortunately the civil servants were enamored with the United States system, and it was only after long argument that they conceded that alternatives might be superior.

7/ The concrete evidence for this statement derives from the accounts and report at the 1987 shareholders meeting. Vigorous competition was blamed for limiting profits. It was quite clear that such effective competition was something of a surprise to the analysts. The main competitor, Mercury, has captured 37 percent of the market of major telecommunications users, particularly in the City, where 18 out of 19 financial institutions are using Mercury. (Financial Times, March 23, 1987, p.7.)

8/ It is of interest to recall that, for reasons which I need not discuss, I suggested an alternative method of control called an "output-related profits tax." Pour encourager les autres, the lower the rate of growth of the monopoly's output, the higher the rate of tax on profits. A superficial view of such a tax would be that it is a perversity; normally one would have a lower rate of tax for low earnings and a higher rate on higher earnings. But this tax rate decreases with respect to output increases above a preset trend line. It was meant to discourage monopolistic restrictions on output growth. Although, as I expected, the rather startling form of such a tax inhibited its use, I still think there is a place for such an arrangement in the control of utilities.

9/ This statement was made by Mr. Norman Lamont, Financial Secretary to the Treasury, on March 18, 1987.

10/ With some trepidation, I would even include British Petroleum Co. on this list, although I would conjecture that it gained least from privatization.

11/ Mrs. Thatcher came to power in mid 1979, but her policies did not begin to bite until 1981 onwards.

12/ At the end of 1986, the figures for net foreign assets were in US$ billion: USA - 275; Japan - 179; Germany - 114; and U.K. - 186. See Bank of England (1987, p.536).

13/ See The Chancellor of the Exchequer's Mansion House speech, October 17, 1985.

14/ Minford and Peel (op.cit.) argue that one of the big factors explaining the poor working of the labor market is the lack of physical mobility due to the housing laws on rent restrictions, etc. I find their case persuasive.

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APPENDIX. - BRITISH TELECOM

The British Telecom (BT) sale was not only the largest ever (until British Gas) and the most successful public flotation in the world, it also has led to a revolution in the development of telecommunications in Britain. In addition to opening the market to increased competition, there is now an explicit regulatory environment in the form of a licensing system with the powers of the Director General's Office of Telecommunications (OFTEL), the Monopolies and Mergers Commission, and the courts to police it.

But perhaps the most interesting changes are in the management structure and attitudes of BT itself. As Sir George Jefferson describes it (in the Quilter Goodison lecture 1985), before privatization BT was an administration, a branch of government, rather than a business. Its staff were effectively district commissioners administering a government-controlled service through a board consisting principally of part-timers who tried to take detailed decisions on most issues centrally. By 1980, despite a turnover of about $8 billion, it had only one profit center. The accounts, which had been qualified for years, were of the simple Civil Service cash-book variety. The government wished to break up the nationalized concern into regional companies before disposition. It was, however, strongly argued that to sort out the accounting complexities of any such division would delay the privatization for at least two years. This sounds like an excuse -- but, alas, there was ample evidence that it was true.

Staffing arrangements were typically of the civil service forms -- owing more to hierarchy and ease of negotiations. It is quite remarkable that one trade union covered all workers in the nationalized concern right up to board level. Departmental compartmentalization with vertical hierarchies emphasized that the organization was meant to serve internal interests rather than the customer. The commercial development of the business was centered on engineering concepts rather than market and commercial needs. The customers, although they frequently called BT to complain, did not call the tune. In fact, it was rather difficult for any new subscribers to call anyone, since they normally could not get the standard telephone on demand and had to join a waiting list usually for a shared "party" line.

Much has changed. The old vertical hierarchies are being broken down. Instead of the civil-service procedure of "passing the buck", managers are now being encouraged to manage. Promotions and appointments now depend more on suitability and success rather than seniority and status. There is, however, no wholesale change of personnel. On the contrary, as Sir George Jefferson emphasized, the existing personnel were as good as one could obtain in private business. State ownership had shackled them and never allowed them to develop more than a small fraction of their potential. In sum, the "culture" of BT has changed.

One would expect that these changes would be reflected gradually in the profits of BT and, due to competition, in the prices and growth of privatization as BT began to adapt to the new environment. So they did. And this has continued with an increase of 22 percent in profits for 1985/6 compared with 1984/5. OFTEL reported in November 1986 that BT's prices have fallen 89.5 percent over the last three years, and that unit costs had fallen by 5 percent per annum in the last two years. A massive investment program (costing about $3 billion per annum) is under way, spreading digital technology and optical fibres throughout the system.

Mr Wicks Sept 29th.

Nigel,

This has got to proof stage, but I do not think that there is any smoking gun here.

A

13 Monetary and Fiscal Policy in the UK

Alan Walters

13.1 INTRODUCTION

Some twenty-three years ago, a most distinguished group of British economists, all associated with the National Institute of Economic and Social Research, wrote a book, *The British Economy in 1975* (ed. Wilfred Beckerman, London, 1965). A feature of that book, which today may seem most remarkable but in those days was hardly noticed, was that money, monetary policy, and the exchange rate were not mentioned, even *en passante*. Inflation, it was thought, would be controlled by incomes policies, and the co-operative spirit of unions and management. Fiscal policy was the major lever in ensuring that aggregate demand was sufficient to create the full employment level of output and to ensure that there was only an acceptably small percentage of unemployed. Beckerman *et al.* recommended an expansion of government spending to ensure this blissful state.

Monetary policy, to paraphrase the late Lord Kaldor, should be concerned mainly with the maintenance of 'orderly' (financial) markets'; and broadly speaking, the Radcliffe Committee Report (1959) had endorsed Kaldor's view. Liquidity was the important determinant of monetary conditions, but since no one could define it, there seemed to be few constraints on monetary policy.

Some eleven years later, in December 1976, Mr Healey, then Chancellor of the Exchequer, signed the famous, or infamous, letter of intent to the IMF. Monetary restraints had been introduced by the Treasury some time earlier in the April budget, but clearly the IMF commitment implied that they were to be taken much more seriously as a central feature of the economic policy of the UK.

It would be nice to report that between 1965 and 1975 an intellectual revolution caused this change. The arguments of monetarists, and particularly of Freidman and his followers, were quite pursuasive, but I fear that they would have had little effect on British policy except for the massive macroeconomic errors of the Heath government. 'Competition and Credit Control' (CCC), introduced in 1971, intended to sweep away the controls on credit markets so that the allocation of credit could be determined by cost, but it also swept away the inhibitions those controls exercised over the expansion of the money supply, especially since the authorities were unwilling to tolerate interest rates they thought politically unacceptable. The money supply, on all measures, increased sharply and inflation duly followed. Two major lessons on monetary policy emerged from the turmoil. The first was that rapid increases in monetary growth should be avoided. The second was that monetary policy should be considered in close conjunction with fiscal policy. Possibly a third macroeconomic lesson was that expansionary fiscal and monetary policies did not solve the problem of unemployment.

Such lessons, however, did not penetrate every politician or policy-maker. In the period from the first election of 1974, the Labour government embarked on a very rapid expansion of public spending financed by a large increase in the public sector financial deficit to 7.2 per cent of the GDP in 1975–6, which soon gave rise to the sterling crisis of July 1975. It was undoubtedly this bitter experience of escalating interest rates, depleted reserves, collapsing sterling, inflation at 26 per cent (end of 1975) etc., rather than intellectual conversion of the cabinet, that gave rise to the first commitments to a monetarist constraint in April, 1976.[1] Politicians may be impervious to ideas but not to experience, particularly if it is thought to affect elections.

Of course in 1976 it was not, indeed could never be, the pure stuff of monetarism. The choice of M3 and later sterling M3 as the aggregate to be monitored and contained meant a considerable departure from the 'medium of exchange' definition of money. More than half of M3 consisted of interest bearing deposits which were rarely, if ever, used as a medium of exchange.[2] This, however, did not seem at the time to be a significant issue since, with the exception of débâcle of CCC, the correlation of all the major monetary aggregates has been very close, and there seemed no obvious reason why such affinity should not continue.[3]

But M3 had two other advantages. The first is that it was closely related to fiscal variables, and particularly the PSBR. If we suppose that there are no changes in the non-deposit liabilities of the banking system, we can decompose the change in (sterling) M3 into:

plus	PSBR less sales of debt to non-bank domestic sector
minus	Lending to private sector in sterling
	External financing of public and private deficits.

In effect, the constraint on the expansion of M3 could be, and was, translated, via assumptions about the private sector lending and external finance, to a permissible PSBR and budget deficit. Indeed, John Fforde has suggested that the main effect of monetary objectives was to provide some discipline on the PSBR and other budgetary constraints.[4]

There was another important institutional reason for adopting an M3 target. After its brief and unseemly flirtation with CCC, Britain returned to

its system of extensive credit controls and rationing. The constraint on M3 could be translated into the containment of bank lending, external borrowing, etc., and was familiar to officials in the Bank and Treasury. Thus the new targets were not new after all; they were simply new arrangements of old targets. Similarly the mechanisms were not new; they were the old mechanisms (bank rate, after October 1972 minimum lending rate, operations in the bill market, credit controls, exchange controls, etc.) with somewhat different rationalisations. There was clearly no suggestion of a system of monetary base control as in Germany or Switzerland.

One would have imagined that the use of M3 and its association with fiscal policy from 1976 onwards would have ensured that monetary (or more strictly M3) policy and fiscal policy were usually, if not always, in harmony. One should not see, for example, the pattern of loose fiscal and tight monetary policy that was observed in the United States in 1980–83. Such a consistent monetary and fiscal policy would make it difficult to disentangle the effects of each.[5] I shall argue that, fortunately for the analyst, there have been significant divergencies between fiscal and monetary policy, certainly before the 1976 accord and on several key occasions afterwards. These have been largely a consequence of accidents or misinterpretations, which have given grist for the analytical mill.

13.2 NEO-CLASSICISTS AND RATIONAL EXPECTATIONS

It is necessary to review briefly the rival theories of macroeconomic policy so that we know where we are, or should be, according to our beliefs about the efficacy of markets and policy. The Keynesian view of the economy asserted that many markets – particularly the labour market – did not work in the sense that although there was excess supply (of people seeking jobs) the wage rate did not fall – at least it did not fall in the short or even medium term sufficient to clear the market. Unemployment persisted. Similar arguments were applied to the product markets, and it was pointed out that prices, particularly of manufactures, were sticky and did not respond readily to changes in demand. Many Keynesians were content to rest these propositions on general statements about the non-competitive nature of markets, but Keynes himself was concerned to stress the maze of uncertainty and risk within which decisions of great moment were taken. The upshot, however, was that there was no clearly argued case for regarding these markets as failures.

The reactions to this have taken two forms. First the neoclassicists have argued that, in the absence of villains or governments or other parties preventing free contractual arrangements, the microeconomics must require price adjustments and so the markets must clear. There will be no frustrated buyers or sellers, such as the unemployed who would be willing to work at below the market wage (and at or below their marginal productivity) but cannot find jobs. It is alleged that Keynesians cannot justify a theory that has obviously flawed microfoundations.[6] This pure form of the new classical macroeconomics has markets that clear and where the normal principles of demand and supply are applied. It is, however, a travesty to suggest that the new classicists thought attributed *all* the massive unemployment in the United States or Great Britain of 1932 to workers' choice for leisure rather than income, or to job-search, or to the cushioning effects of unemployment and welfare benefits.[7] But the new classicists did identify such optimising causes of apparent joblessness which had been thrust aside by Keynesians and largely pooh-poohed by NKs. Explanations for 'market failures' have been sought from the behaviour of government, the theory of information, which itself was much developed by George Stigler at Chicago, and above all from a new *forward*-looking approach to the formation of expectations (the so-called 'rational expectations' or RE).

RE, in its stark form, simply asserts that people form expectations by taking into account all the information to which they have access, and then with full knowledge of the economic model, including the government's policy rules, they will form expectations that are *consistent* with that model and information set.[8] RE asserted that private sector agents would not make systematic errors (that is to say, reduce their profits or utility) which were avoidable by taking their knowledge of data and model into account. In particular this raised the spectre that monetary and fiscal policy could be ineffective in terms of real output and employment. Where prices respond fully to demand and supply, any counter-cyclical monetary expansion may not be effective because producers will fully anticipate the consequences and raise prices rapidly. All the kick of the monetary expansion will be dissipated in the price rise more or less immediately. Thus known policy rules will have no effect on real output or employment.[9] Only unanticipated or surprise policies will have an effect – and then only until people discern the new government behaviour pattern. This is widely known as the 'policy ineffectiveness' proposition. It applies to interest rate policy rules, such as those which adjust interest rates to eliminate deviations in output and prices, as much as to quantitative monetary growth rules; indeed, unless there is some fix on a *nominal* magnitude, prices will be indeterminate. Anything can happen to inflation.

The combination of rational expectations and new classical market clearing propositions have undermined and at least made ambiguous the expected effects of monetary policy in counter-cyclical operations.[10] Of course one might well argue that, with markets clearing and even without rational expectations, there is little point in pursuing counter-cyclical monetary policy; the 'problem' has been assumed away. But it is not enough to assert that the market clearing model is clearly inappropriate because of, for example, the persistence of high rates of unemployment.

The crucial distinction between the NC and Keynesian approach is that, although the NC allow costs of making adjustments in *real* variables, they do not see any reason why there should be any significant lag in the adjustment of nominal variables such as prices. In the Keynesian models also there are costs and lags in adjusting real variables. But the Keynesian models, as distinct from the NC, also have a large role for lags and costs in the adjustment of *nominal* variables – and particularly wages. Indeed, most of the characteristic results of the Keynesian models derive from the differential rate of adjustment of wage rates, prices, etc., through overlapping contract arrangements. The Keynesian argument is that in a crucial sense the price system does not work, and hence the presumption that government should pursue contra-cyclical policies.

Many, perhaps most, RE models have included price and particularly wage adjustment processes, sometimes specified in terms of contracts, which take time to adjust to the final market clearing conditions. In fact such processes are a reflection of our ignorance of the underlying nature of optimisation, including the problems of identification, information and compliance. Nevertheless, such temporary stickiness in prices and wages in the Keynesian models does enable monetary policy to have real effects, and there arises at least the possibility of an effective counter-cyclical policy.[11] Normally it is supposed that different sets of prices react at different speeds with wages the most important laggard. Thus an increase in money first affects prices and so reduces real wages; this accounts for the temporary upturn in output and employment, which is later eliminated and reversed as nominal wages catch up and perhaps even cause an overshoot in real wages. The long-run result is, of course, higher prices.

Another noteworthy contribution of new classicism is to show that, under certain pure assumptions – in particular that people live for ever, or that they pursue full-bequest policies to their heirs – different mixtures of bond and tax finance of a given level of public spending has no effect on real output. If an increase in government expenditure is financed by increasing taxes (i.e. the deficit remains the same) then it will have exactly the same effects on output as if the deficit and the borrowing increased by the amount of the spending increase. Whether we finance by deficit or by tax increases is immaterial, at least as far as private consumption is concerned. The rationalisation of this result arises from the fact that people know that, if taxes are not raised this year to pay for increased spending, taxes will certainly be raised in future years in order to service the debt. Thus, with an increased deficit and bond finance, people will save more in order to pay their future tax bills, and so the deficit will not increase aggregate demand or output. The dissaving of the government is offset by the increase in private saving.[12] The NC position on an *expansion* of public expenditure, however financed, is that it will crowd out private spending and thus have little if any effect on permanent demand

and output. However, because of the costs of making real adjustments, there will be a financing effect on the transitory path of output.[13]

13.3 NEW KEYNESIANS[14]

The main elements of New Keynesianism (I think NK, rather than NEWKS) are:

(1) Some propositions about the high costs of information to firms which give rise, in particular, to the argument that increments in wages promote productivity gains, which explain, not the rigidity, but the relative stickiness of wages;
(2) The asymmetry in information in capital markets which are, of course, imperfect, and which implies that there is too little equity and firms are driven to use bank or bond finance with its attendant risks, and this is exacerbated by the fact that production risks cannot be shifted;
(3) The perversity that affects labour markets also is manifest in credit markets, where, because of the asymmetry of information, increasing interest rates may lower the return on capital – due to adverse selection or additional riskiness;
(4) Monetary policy exerts influence but rarely and when it does it is through the availability of credit which affects investment, but this will not be effective in a recession when there is a shortage of willing borrowers.[15]

On the monetary side, the NK view is quite clear. Since credit is a close substitute, money is not required for transactions. And, in any case, the relationship between transactions and income is not one-to-one since most transactions are asset sales and purchases. Although the NK view is that governments can influence market interest rates, it is asserted that this is not 'an important' mechanism by which government controls economic activity. It is through credit availability that monetary policy works – and then only in non-recessionary phases of the trade cycle.[16] Greenwald and Stiglitz do not tell us whether they believe that an increase in the monetary growth rate would lead to inflation in the long run, but the drift of their discussion is clearly against such a conclusion. However, I think most NKs would accept that long-run result, albeit with many reservations and doubts about the definition of money, etc.

13.4 REALITY AND THE NK

Although one may complain about the basis of the NK's process, there is, in the Greenwald Stiglitz account, a considerable description of the pathology of a recession. It would be interesting, but far beyond my present plans, to

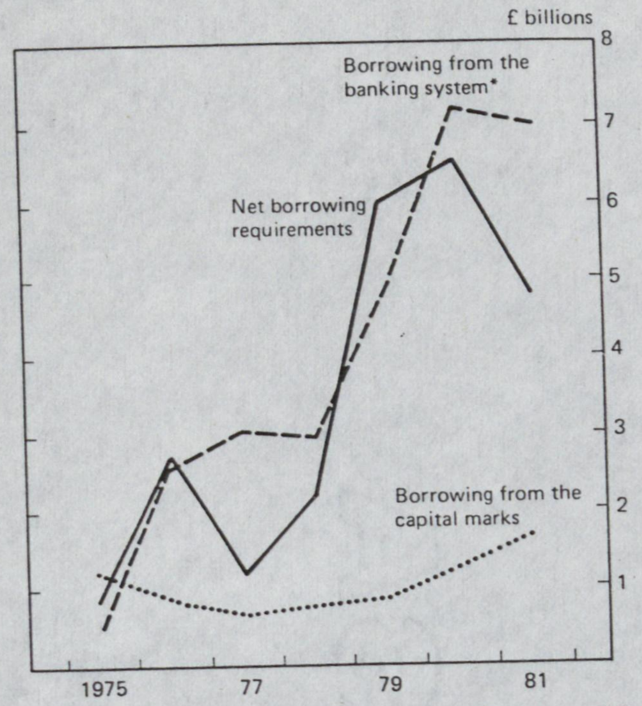
of

review all past recessions to see how they shape up to the NK outline. A more modest task is to assess the monetary aspects of the recent recession (or indeed depression) of the early 1980s – clearly the most severe for the United Kingdom in post-war years – in terms of the NK's outline.

There is some correspondence between the NK account of the performance of labour markets and the reality of the 1980s. (But I must leave to others the explanation of why, in the presence of massive unemployment real wages continue to increase in the United Kingdom and not fall, as they did in the United States.) On the monetary conditions, however, there is no correspondence whatsoever. The NK view that 'banks may be willing to lend to any "good" prospect at the going interest rate, but there is a shortage of willing borrowers' appears to be the opposite of what actually occurred. Of course much depends on the definition of the dates of the recession, but I assume that most NKs would define the recession phase in the United Kingdom to include the period when there was thought to be a considerable amount of excess capacity.[17] Clearly this must cover the years 1980 through to at least 1983. Throughout this period, bank lending to the private sector surged far beyond both government targets and economists' expectations. There was a plethora, not a shortage, of willing borrowers. The banks did not languish with excess reserves for which they could not find suitable borrowers. On the contrary, the banks were bidding vigorously for deposits in order to expand their highly profitable loans.

The increase in the private sector demand for loans was in part explained by the asymmetry of the recession. Corporations, particularly producers of tradeable manufactures, were hard hit by the appreciation of sterling. But, with little adjustment in wages, this appreciation improved both the wealth and liquidity of households, so they increased deposits in the financial sector, made attractive by the high real rates of interest that emerged from the government's effort to contain bank lending, an important item in the sterling M3 aggregate. The financial sector's capacity to lend was also augmented by deregulation – particularly the removal of the corset and of exchange controls.

It has been suggested (by a reviewer) that the NK position would be that 'bank-financed new capital fell somewhat in 1979–81'. Although Greenwald and Stiglitz do not specify that they are concerned only with financing new capital in their article, it would be ungenerous not to consider such an interpretation. There are no data on 'bank-financed new capital'. We can only compare bank lending to industrial and commercial companies with data on capital formation. Fig 13.1 shows how bank lending *rose* from an annual rate of £2 bn in 1978 to an annual rate of £7 bn in current pounds in 1980 and 1981 – a three-and-a-half-fold increase.[18] On the other hand, total private investment *fell* by about £8 bn (at 1980 prices) – divided between £5 bn in stocks and £3 bn fixed.[19] It is, of course, conceivable, but surely most unlikely, that these data are consistent with the NK story. A 250 per cent



*Including commercial bills held by the Issue Department of the Bank of England.

Figure 13.1 Industrial and commercial companies' finance.

Source: Bank of England Quarterly Bulletin, vol. 23, no. 2 (June 1983) p. 205.

increase in bank lending is very difficult to rationalise in terms of the moribund lending inactivity which NK suppose is typical of the recession. The evidence shows that there was a dramatic increase in bank-financed lending for new capital, particularly in the service and energy industries.[20] All this requires a more detailed analysis that I can give here. But I believe that there is sufficient evidence to reject the NK vision of languishing bank lending being unable to lift investment out of the doldrums.[21]

It is more difficult to establish whether, as NK assert, interest rates were not '(an important) mechanism by which government controls activity'.[22] We shall have to defer the examination of interest rate effects in the context of fiscal as well as monetary policy. Certainly – and a point which does not discredit the NK view – the high interest rates (and they were very high until March 1981) did not appear to have an immediate impact on the volume of loans to the private sector.[23] But changes in interest rates, especially when most of the loans are at floating rates, have profound effects other than those

on changes in loan demand, on profitability and bankruptcy and so on the level of activity.

I conclude, therefore, that the NK description of the financial characteristics of an economy in recession does not merely lack verisimilitude, but appears to be the antithesis of reality. But it may be objected that verisimilitude is not an appropriate evaluation; one might argue that the real test is whether the NK version gives new and useful insights into the monetary effects on macroeconomic processes. This remains unproven.

13.5 THREE RECESSIONS: MONETARY VERSUS FISCAL POLICY

In much of the discussion of economic policy, the general thrust is to find ways of avoiding, on the one hand, substantial and sustained recessions (depressions) and, on the other hand, persistent inflation. It is unlikely, and probably undesirable, that we can avoid most mild recessions or price changes. But the deep and lasting recessions just like persistent inflation are to be avoided. In this section I review the efficacy of monetary and fiscal policy during the three recessions, 1956–8, 1973–6, and 1979–82.[24] These are the only three post-war recessions in which the annual index of real GNP actually fell, although it must be noted that the fall in the average GDP estimate for the 1957–8 period was very small. (See table 4 of *Economic Trends 1985*.) These three recessions were clearly the most sustained and deepest of the post-war years.

Throughout the discussion of these recessions, the monetary base (M0) or transactions balances (M1) will be used as the basic indicator of monetary policy. The standard argument against the use of M0 is that it is endogenous – in this context it is determined by demand. The Bank of England supplies whatever M0, that is bankers' balances at the Bank and currency, which the private sector want. True – but that does not invalidate M0, suitably interpreted, as a measure of the monetary stance. The main monetary instruments of the Authorities are interest rates and joint open market operations. A monetary squeeze is engineered through raising short-term market interest rates through Bank Rate, MLR and money market operations. The change in interest rates has an effect on M0 (and usually M1) one to two quarters later as people adjust their currency and balances to the new interest rates. In this sense then the Authorities, albeit determine a systematic component of M0.

With this chain of causation, it is natural to ask why one uses M0 rather than interest rates as an indicator of monetary policy. The main reason is the difficulty of interpreting *real* rates from the observed nominal counterparts. Quite small changes in inflationary expectations have large proportional changes, magnified by the tax system, on real interest rates: during two of the periods examined here, inflationary expectations were going through dramatic changes and hence measures of real interest rates had very large elements of uncertainty; hence the choice of M0. Another consequence of choosing M0 is that it does lag some three to six months behind monetary policy (i.e. interest rate changes). This contemporaneous movement of M0 and real output are consistent with a *lead* of monetary policy of as long as six months or so. But throughout the discussion the relevant changes in nominal interest rates will be recorded, so the reader who is suspicious of M0 can follow the story with interest rates instead.

13.5.1 1956–8 recession

It is not difficult to demonstrate that there was a substantial monetary squeeze dating from early 1955, as is illustrated in Figure 13.2, panel 3. Bank rate was increased from 3 per cent to 4.5 per cent in February, rising to 5 per cent in February 1956. The annual increase in the money supply had been between £235 and £268 million for the previous three years, and might be thought to be a remarkable manifestation of Friedman's celebrated 'rule'. But then the higher Bank rate in 1955 was associated with a sharp *reduction* of the money stock by £248 million (see Supplement to *Bank of England Quarterly Bulletin*, September 1969). In terms of the narrow money supply, a period of three years in which the expansion had been steady at about 4 to 4.5 per cent a year was reversed in 1955 to a 3.3 per cent *contraction* at the trough and a 1.2 per cent contraction on the average for the year. The reduction in the rate of growth of the *real* money supply was even more sharp. The further reduction of the money supply continued into the first half of 1956, when it started at last to grow again but at a slower rate than in the early 1950s.

During the first three quarters of 1955 fiscal policy was clearly expansionary. Although the budget of 1954 had been more or less neutral, expansionary measures had been introduced in August. And these were followed by the election budget of 1955, with six pence off the standard rate of tax. After the election the give-aways of the election budget were gradually taken back, beginning with increased purchase taxes in October 1955, being later followed in early 1956 by planned reductions in government spending and reductions in investment allowances. But the expansionary effects of the decisions of economic policy included in the budget of spring 1955 were difficult to contain, let alone reverse, and the expansion continued throughout 1956 and into 1957. After a 5 per cent increase in general government spending from 1954 to 1955, there was, in nominal terms, almost a 9 per cent increase from 1955 to 1956 compared with a little more than 4 per cent increase in revenues.[25] Although this is not a neat picture of fiscal management, it undoubtedly demonstrates that the fiscal stance was expansionary

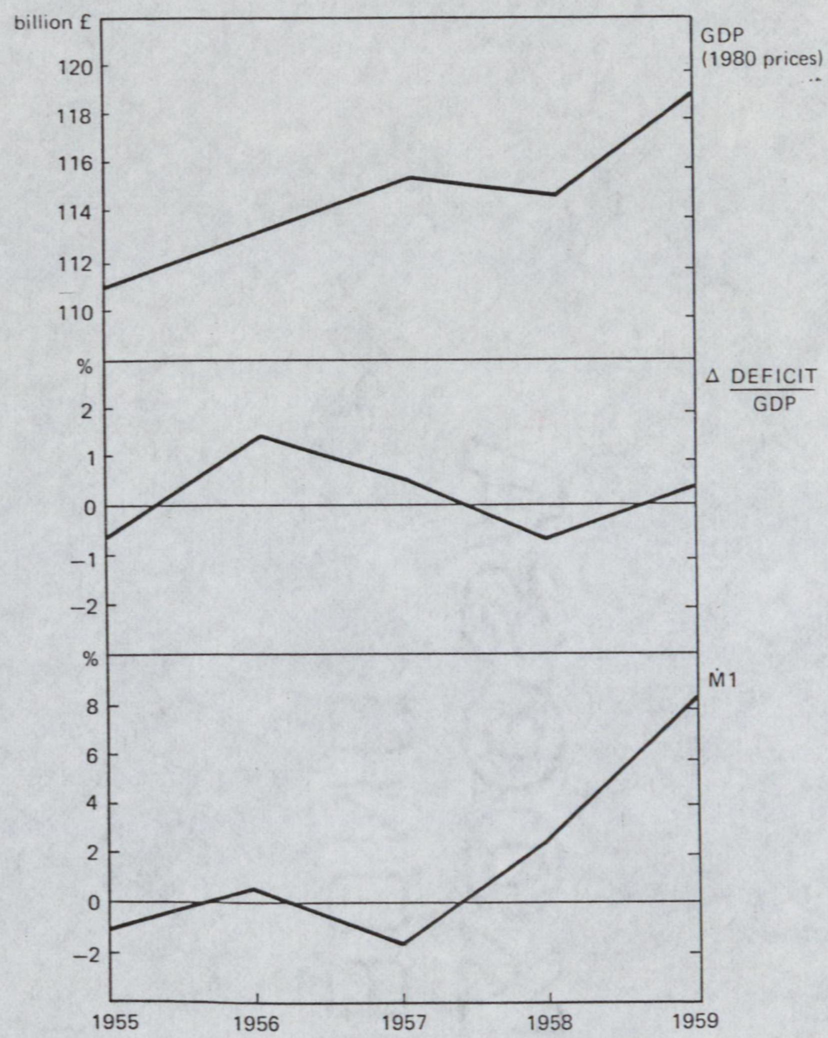


Figure 13.2

between 1955 and 1956. This is confirmed by the annual data representing the change in the budget deficit as a percentage of the GDP at market prices, shown in Figure 13.2, panel 2.

The contrast between the expansionary fiscal policy and the sharply contractionary monetary policy provides almost laboratory conditions for a test of the effects of monetary and fiscal policy on real output. Perhaps the most sensitive indicator of output was the index of industrial production. This showed a sharp and sustained rise during the reocvery phase 1952 to

1954; but this slackened off throughout 1955 until there was a sharp decline in the first months of 1956 followed by stagnation until the third quarter of 1958. As for GDP, the rate of growth had averaged 4 per cent for three years 1952–5, then it fell to 1 per cent for two years, 1956–7, finally reaching stagnation in 1958, as shown in Figure 13.2, panel 1. Clearly, in 1955–7, the economy failed to respond to the fiscal stimulus and succumbed to the monetary contraction.

But it is often said stopping booms is no problem for monetary contractions, but that starting a recovery with money is like pushing on a string. But there was very little push exerted on that string until 1957, as illustrated in Figure 13.2, panel 3.[26] Indeed, both in terms of the monetary aggregates and in terms of Bank rate, it is clear that the monetary squeeze continued through virtually to the end of 1957; then throughout 1958 a much easier monetary policy was pursued. This timing accords well with the rise of the industrial production index – which might be dated either in the last quarter of 1958 or the first quarter of 1959. And GDP showed a sharp upturn in 1959 compared with 1958.

Although the upturn in activity is *consistent* with a monetary explanation, we cannot point to a contrary path for fiscal policy. General government spending (in nominal terms) continued to expand at about 8 per cent per annum for 1956 to 1957, that is to say only fractionally less than the expansion in 1955–6. Similarly there was no clear intimation of fiscal squeeze in the figures for the deficit. As shown in Figure 13.2, there was a reduction in the deficit in 1958 and an increase in 1959. Since the upturn in the economy occurred in late 1958 or early 1959, one cannot claim that it was the fiscal expansion of 1959 that ignited the recovery – but not can one plausibly argue that the relatively mild fiscal contraction of 1958 sparked the recovery. Fiscal policy was much of a muchness, and nothing like the sharp change in monetary policy. We must rest content with the weak conclusion that the case for monetary causation has to be seriously considered, but we cannot demonstrate a clear perverse reaction to fiscal policy.

To summarise this recession and recovery, we have good evidence that the monetary explanation of the 1956 downturn in activity fits the facts rather well. This is reinforced by the evidence that fiscal policy over the critical period of 1955–6 was substantially expansionary and not contractionary. This confirms the power of a contractionary monetary policy to offset an expansionary fiscal stance and to prick the bubble of a boom. For the upturn, however, the results are more equivocal, mainly because although the very sharp monetary expansion was followed, with the usual lag, by the recovery of output, fiscal policy might be construed as at least neutral and even modestly expansionary contemporaneous with the recovery. The recovery, therefore, might also, but more dubiously, be claimed as a consequence of fiscal policy.[27]

13.5.2 1974–6 recession

One may characterise this recession as one of bad luck (with the commodity and oil price rises), compounded by bad policies (those of Heath magnified by Wilson). Fortunately again for the task of separating fiscal from monetary effects, the policies which started in some sort of harmony of rampant expansion in 1971–2, diverged markedly in 1973. Then monetary policy became markedly contractionary, but fiscal policy continued to be strongly expansionist until the first months of 1976. (See Figure 13.3, where the growth rates of M0 and GDP, and the changes in the PSBR as a percent of GDP are illustrated.)

There is some doubt about the exact dates of the monetary squeeze. The M1 series is the first to turn down from its rate of growth of around 15 per cent in 1972. The early months of 1973 was the fairly clear turning point, and in the following year the annual growth rate of *real* M1 fell to zero. (The

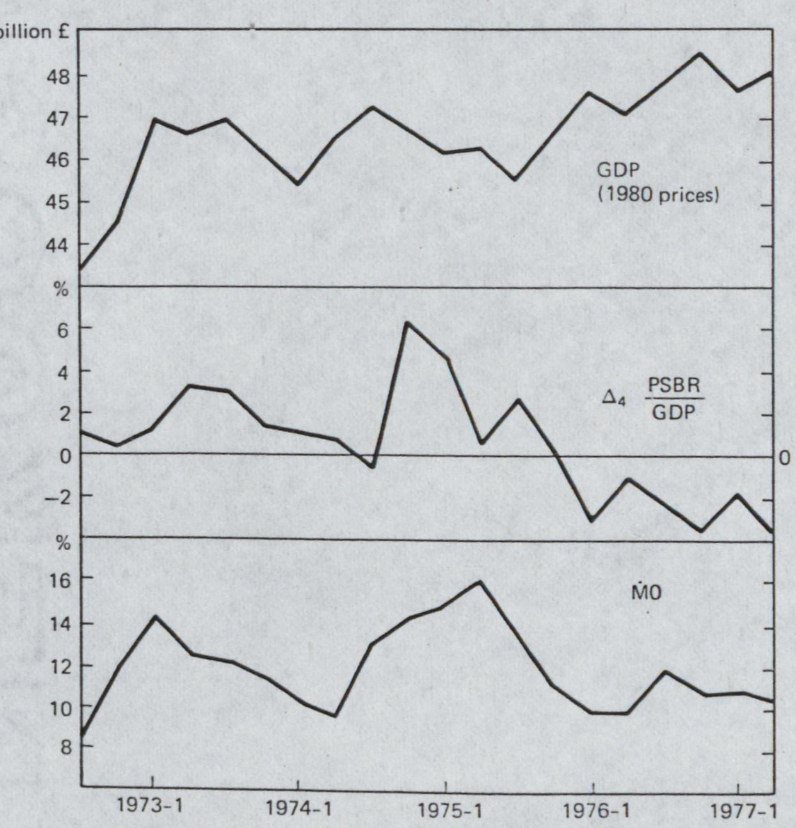


Figure 13.3

first sight it appears that there is a good fiscal explanation for the upturn. Over 1974 to 1975 there was a record increase in the PSBR (in nominal terms) from 6.4 bn to 10.2 bn (with a similar increase in the financial deficit), an increase of about 3.6 per cent of GDP. There a fiscalist might be tempted to rest his case, and claim the upturn as his own. But, alas, one must explain why the fiscal stimuli during the previous two years – of about equal magnitude measured in terms of the increase in the deficit (or PSBR) as a percentage of GDP – did not work.[33] Furthermore, if one adjusts to exclude the cyclical effects, the adjusted deficit shows that the fiscal stance was *very sharply contractionary from the first quarter of 1975*.[34] Similarly, weighting and adjusting for inflation gives the same pattern of a sharp squeeze in fiscal policy in the months before the upturn of activity. Clearly there is no case for attributing the recovery to fiscal policy; on the contrary, the recovery took off in spite of the reduction in fiscal stimulus.

The role of monetary policy in the recovery appears to be more convincing. Monetary growth (M1) had stopped in the second quarter of 1974. Monetary expansion started again in the last quarter of 1974 and by the first quarter of 1975 there was a 19 per cent growth and it remained well above 16 per cent for six quarters, that is to say to mid-1976.[35] A money-output causal interpretation would suggest that the lag is at least six months and probably nine to twelve months is the appropriate range. This is broadly consistent with the lag which has emerged from previous studies of the effects of money on output.

On this deep recession of the mid-1970s, the conclusion on the relative roles of monetary and fiscal policy are similar to those of the recession of the 1950s. There is, however, a significant difference. In the 1950s the attribution of recovery to monetary as distinct from fiscal policy was clearly equivocal. In the 1970s, however, we can be more confident that the recovery was stimulated by monetary expansion which dominated the supposed contractionary effects of a reduction in the fiscal deficit.

13.5.3 1979–82 recession

This was the deepest and most persistent recession since the Second World War.[36] Perhaps its most distinctive and painful feature was the rise in unemployment and the persistence of such joblessness at very high levels, until it started to decline from 1986. (Note, however, that employment started expanding from late 1982.) Indeed, many left-inclined intellectuals would argue that the recession was really a prolonged slump from 1980 with no foreseeable end in sight. In this chapter I have taken output, not unemployment, as the indicator for the cyclical movements, and this will be used in interpreting this recession. The upturn in output began in mid-1981 and growth has continued unabated for the period 1981–7 (see Figure 13.5).

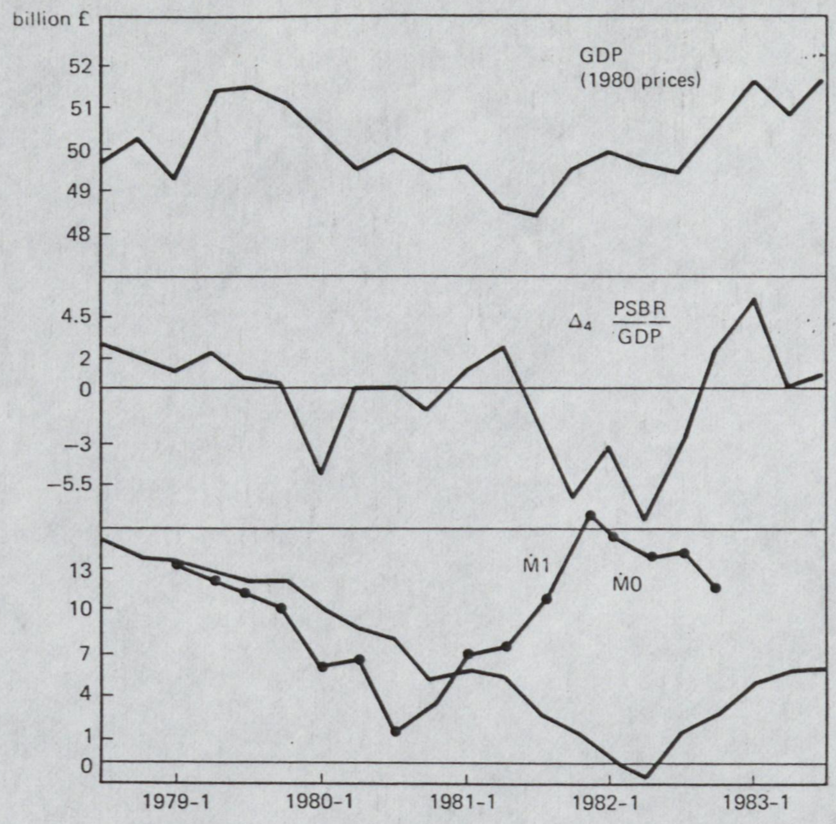


Figure 13.5

First we examine the causes of the downturn in 1979. After a sustained rise for more than three and a half years, the output index surged in the spring and peaked in the second quarter of 1979. If a fiscal squeeze were to be the cause of this relapse, one would expect to find evidence of fiscal tightening during the financial year 1978–9. Yet on all the fiscal measures reported in the NIESR study of David Savage (1982), there was an *expansionary* fiscal policy in operation during FY 1978/9.[37] As far as fiscal policy is concerned, the economy behaved perversely.

Monetary (M1) growth had reached a peak of 25 per cent in the first quarter of 1978. In the subsequent five quarters, that is to the second quarter of 1979, it fell to 12.5 per cent. (The fall in real M1 growth was even steeper.) This monetary squeeze is confirmed by the rise of the Minimum Lending Rate from 6.5 per cent in the first quarter of 1978 to 14 per cent by the first quarter of 1979. All this evidence leads to the conclusion that there was a severe monetary contraction in the course of 1978. And, as can be seen from Figure 13.5, this contraction continued throughout 1979. (As a matter of fact, in terms of the growth rate of M1, it continued until the third quarter of 1980.)

Yet again for the upper cyclical turning point, we observe the precursors of fiscal ease and monetary squeeze. Of course, in this case the fiscal stimulus was modest and the monetary contraction severe.[38] For analytic purposes it would have been nice if the policies had been more evenly matched; then we could have made more confident judgements about the relative efficacy. We have to make do with what evidence we have. Fortunately, in the following recovery there occurred a combination of a severely contractionary fiscal policy with a monetary policy which was decisively (and deliberately) stimulative.

The fall in the rate of growth of M1 ceased in the third quarter of 1980. By the first quarter of 1981, the growth rate had increased from its low of 2.5 per cent to 7.5 per cent. The fall in interest rates had been only slightly less dramatic than the previous rise. From a peak of 17 per cent in the first half of 1980, MLR was reduced to 14 per cent in November and was brought down to 12 per cent in March 1981. Both monetary growth and interest rates are consistent with expansionary monetary policies from the third quarter of 1980.[39]

The fiscal contraction began modestly in the Autumn Statement (November 1980) with both small cuts in public expenditure (about 700 million) and an increase in National Insurance Contributions and oil taxes. But the draconian squeeze came with the budget of 11 March 1981. The financial deficit for FY 1981–2 was reduced by 2.6 percentage points of GDP compared with the 1980–81 outturn (see Figure 13.5). Cyclically adjusted the percentage reduction in the deficit was an astonishing 4.1 per cent. Certainly it is the largest budgetary squeeze recorded in the post-war years and, war years apart, probably the largest ever in the United Kingdom.

In spite of this massive fiscal contraction, the economy turned decisively by the third quarter of 1981 from the precipitous downward plunge of 1980. And to date (September 1987) there has been no cyclical contraction in subsequent years.

The experience of the 1981 recovery is important because, first, it provides some evidence that monetary policy is not 'pushing on a string'; the economy did appear to respond strongly to the easier monetary conditions, contrary to the NK view.[40] Secondly, the effect of fiscal conditions cannot be interpreted in terms such as the change in the public sector deficit or indeed any of the complex variations of that original concept, to produce an expansionary fiscal indicator.[41] But our immediate purpose is to point out the domination of a moderate monetary expansion over the draconian budgetary squeeze – surely one of the important examples of the effects of modern macroeconomic management. The failure of the 1981 fiscal contraction to produce the dire effects so confidently predicted by both academic economists and

(retired) chief economic advisers appears to have excited little critical re-examination of the phenomenon.[42]

13.6 REFLECTIONS ON THE RECESSIONS

The evidence from the three recessions, although equivocal in some respects, does suggest that monetary conditions were important determinants of activity with results which were consistent with what have come to be called monetarist predictions. As for fiscal policy, one cannot in truth say that it was not important; on the contrary it was on occasion, as in 1981, very important, but not in the way portrayed in the Keynesian or NK framework.[43]

The crucial ingredient which can serve to explain the strange effects of fiscal policy can be summed up in the word 'credibility'. Both 1976 and 1980 were situations where continuation of, let alone expansion of, the large running fiscal deficits and borrowing requirements were simply inconsistent with the rest of the government's policy. And in a real sense the budget is the main instrument over which the government has more or less complete control. (With price and wage controls or guidelines etc., the public has self-justified scepticism. The absurd case of the 'six pounds' (a week) wage increase under Mr Callaghan was a prime example.) A borrowing requirement does have implications for the nexus of interest rates, inflation and foreign borrowings. The point was that, notwithstanding the condition of the real economy in 1980, anything but a tight fiscal squeeze would have destroyed credibility in the feasibility of the Thatcher programme. Scepticism about the political will would have quickly ensued. In my judgement, there would have followed a financial crisis as the markets passed speedy judgement on the borrowing and the implications. Interest rates would have soared instead of sinking. The 1976 period is very similar in its sequence of severe fiscal tightening followed by lower interest rates and monetary expansion and recovery.

This suggests that the tightening of fiscal policy was a necessary, but not sufficient, condition for the easing of monetary policy and the onset of the recovery. This is a very different 'harmony' of fiscal and monetary policy from that which is usually promoted.

Notes

1. In 1968/69, the Labour Chancellor Roy Jenkins promised the IMF that domestic credit expansion (DCE) would be less than £900 million per year. But this was *not* the same as controlling the money stock (see A. A. Walters, *Money in Boom and Slump* (Institute of Economic Affairs, London, 2nd ed., 1969).

2. It will be noted that only the monetary base is net wealth to the private sector. Commercial bank deposits, on the other hand, are *liabilities* of the bank as well as assets to the depositors, so they net out.
3. See, for example, David K. Sheppard, *The Growth and Role of UK Financial Institutions, 1880–1962* (Methuen, London, 1971).
4. John Fforde, 'Setting Monetary Objectives', *Bank of England Quarterly Bulletin*, vol. 23(2) (June 1983) p. 203.
5. To avoid dispute, it should be noted that I am not discussing the subtleties of assignment theory of Tinbergen, Meade and Mundell. An interesting historical aside, relevant to this issue, was the theory put forward by the New Cambridge School in the early 1970s. The policy consequencies of this theory was that the exchange rate should be used to ensure full employment and that the financial deficit of the public sector should determine the deficit on the current balance of payments. I do not think that the New Cambridge School had any discernible effects on policy, largely because the assumption on which their theory was based, namely a constant financial surplus of the private sector, was clearly discredited by the data from 1972 onwards.
6. See Alan S. Blinder, 'Keynes, Lucas, and Scientific Progress', *American Economic Review*, Papers and Proceedings, vol. 77(2) (May 1987) pp. 130–36. Professor Blinder argues that it is more 'scientific' to base macroeconomics on broad empirical generalisations rather than a fully articulated micro-foundation of the underlying co-operative arrangements through market processes. And if the broad empirical generalisations are inconsistent with the elementary market behaviour, it is best to turn a blind eye to the fundamentals of the markets and rely on the broad brushes of the macro-artist.
7. This is suggested in B. Greenwald and J. E. Stiglitz, 'Keynesian, New Keynesian and Classical Economics', *Oxford Economic Papers*, vol. (39) (1987) p. 119. The authors discuss New Classical economics as though the NCs meant it to be a description of reality. I doubt whether any NC author thought of the models in such terms. For the most part the NC movement was calling attention to aspects of micro-adjustment which, in terms of the caricature of such models, might serve to explain some of the disappointment with conventional Keynesian models.
8. I would still at this late day continue to urge that 'consistent' expectations is a much better description than 'rational' expectations. I so described it in what I believe was the first application to macroeconomic phenomena in 'Consistent Expectations, Distributed Lags and the Quantity Theory', *Economic Journal*, 1971, vol. 81, pp. 273–81. Expectations are consistent with both the information set and the model; rationality is another and much more far-reaching matter.
9. This 'ineffectiveness' result, however, was established only for the Sargent and Wallace Keynesian type of model (with a Phillips adjustment) when RE were substituted for adaptive expectations.
10. Much depends on the speed with which the private sector acquires information. The original formulations (by Sargent and Wallace) assumed that in period t the rate of interest was known only for period $t-1$. If, however, the private sector know the current rate of interest, *any* optimum rule is very difficult to disentangle and the results become volatile and dependent on the particular values of the model. See M. B. Canzoneri, D. A. Henderson, and K. S. Rogoff, 'The Information Content of the Interest Rate and Optimal Monetary Policy', *Quarterly Journal of Economics*, vol. 98(4) (Nov. 1983) pp. 545–66.

11. One might wonder, however, why monetary policy should be employed in eliminating deviations of output and employment that arise from contractual or informational lacunae. Surely would it not be best to concentrate on the contractual and information nexus as such. Of course this would require that the precise non-price elements be specified and a joint theory of contracts, monitoring, compliance, sanctions, and information be developed. As is well known, excess monetary expansion would generate long-run persistent inflation and much reduce the information content in the price system, which must give rise to further 'stickiness' and costs.
12. The seminal paper is by Robert Barro, 'Are Government Bonds Net Wealth?', *Journal of Political Economy*, vol. 82(6) (Nov.–Dec. 1974) pp. 1095–117. There has been much dispute on the applicability of this 'irrelevance of tax and bond finance' proposition. As I understand it, the evidence does suggest that the form of financing does have real effects, but less than those which arise from simply adding the deficit to aggregate demand. For a survey of the empirical studies on Barro's proposition, see Giancarlo Perasso, 'The Ricardian Equivalence Theorem and the Consumption Function: a Survey of the Literature', *Rivista Internazionale di Scienze Economiche e Commerciali*, forthcoming.
13. See Chapter 2 of my *Britain's Economic Renaissance* (Oxford University Press, 1986).
14. Because I am thought to be unsympathetic to various varieties of Keynesians (though I hope not to Keynes himself), I restrict this review largely to the account of Greenwald and Stiglitz (1987). It may well be argued that their account differs considerably from that of James Tobin, Robert Eisner and many other distinguished Keynesians. Perhaps so, but I doubt if the differences in the effects of monetary and fiscal policy are so large as to limit the critique that follows to this one clique of New Keynesians. Besides, the debate about 'what Keynes really meant' is alive and well among Keynesians and an agreement looks far from being within reach.
15. It must be recognised that Keynes himself was very much aware of the importance of monetary policy in determining real output (via the real rate of interest). On the topic of Keynes and monetary policy, see John F. Brothwell, 'The General Theory After Fifty Years: Why Are We Not All Keynesians Now?', *Journal of Post Keynesian Economics* (Summer 1986) pp. 531–47.
16. It must here be noted that other distinguished NKs would tend to put their trust in variations in tax rates rather than in government spending. Thus they fully reject the 'irrelevance of finance' argument of Robert Barro.
17. The normal NIESR assumption for this period was a trend rate of growth of potential GDP of 2.5 per cent per annum – the same as that actually experienced between the peaks of 1973 and 1979. But if one adopted a definition based on unemployment, then the period would be much longer.
18. *Bank of England Quarterly Bulletin*, vol. 23, no. 2 (June 1983) p. 205.
19. *Economic Trends*, October 1983, pp. 8, 16. These figures are for the whole of the private sector and include houses as well as the investment of non-corporate businesses. The investment of public corporations fell about £500 m, but government investment fell by about £2.5 bn – all over the period 1978/9 to 1981/2.
20. Note also that borrowing from the capital markets also approximately doubled from 1978 to 1981. (*Bank of England Quarterly Bulletin*, vol. 23, no. 2 (June 1983) p. 205).
21. If the NK view is simply that in a recession investment is low – then, of course, that is neither new nor interesting.

22. Bruce Greenwald and Joseph E. Stiglitz, 'Keynesian, New Keynesian and New Classical Economics', Working Paper 2160, *National Bureau of Economic Research* (Cambridge, Mass., Feb. 1987) p. 31.
23. Indeed it was widely thought that, during the depths of the recession, increases in interest rates *increased* rather than decreased the demand for credit, since the corporations were so desperate that they would have to finance the increased interest charge by borrowing more. For obvious reasons this had to be a fleeting transitory phenomenon. Ultimately changes in interest rates do affect the demand for loans in the traditional way.
24. There is the problem that the data will not reveal the *true* underlying relationship. In fact although one may find that the money supply is a prime determinant of real output some six months or so later, this observation could come from a system where the oscillations in activity are due *only* to unexpected monetary variations. See Thomas J. Sargent, 'The Observational Equivalence of Natural and Unnatural Rate Theories of Macroeconomics', *Journal of Political Economy*, vol. 84 (1976) pp. 31–40. In the comparison here I do not need to take issue on the nature of the expectations, but I would concede that, from the circumstantial evidence, in the last two deep recessions, the monetary movements were largely a surprise.
25. *Economic Trends*, 1985, table 153. If one adjusted for cyclical variations in unemployment, there would be virtually no difference to the figures. Unemployment did not start increasing until 1957–5 (see *ibid.* table 103). Furthermore, it is noteworthy that in an OECD study for the period 1955–65, the UK central government automatic stabilisers were *negative*, that is they were *destabilisers*. See Bent Hansen, *Fiscal Policy in Seven Countries 1955–1965* OECD, Paris 1969) table 2.6, p. 69.
26. The 'net money supply' (roughly M1) reported by Sheppard (*The Growth and Role of UK Financial Institutions, 1880–1962*) was (in billions of pounds sterling):

1951	1952	1953	1954	1955	1956	1957	1958
8.45	8.65	8.98	9.35	9.05	9.19	9.52	9.84

Thus it took three years to restore the nominal stock of money to its 1954 level. Similarly Bank rate peaked at 7 per cent in September 1957 and was brought down sharply in 1958 to 4 per cent.
27. This recession was the backdrop to the deliberations of the Radcliffe Committee (1959) and no doubt had much to do with the general conclusion that quantitative monetary controls were ineffective in managing the economy. But in one sense Radcliffe was correct. The reduction in the money supply had little effect on inflation until the latter half of 1957 – when at last prices stabilised, and the retail price index remained more or less constant through to the first half of 1960. The lag was indeed long – at least two years, perhaps three – before the effect of monetary contraction on prices could conceivably be claimed as a manifestation of a monetarist prediction. The decline of inflation coincided with the decline in interest rates. This period is also worthy of note because it has some claim to being the first (very mild) case of stagflation.
28. Thereafter MLR was relaxed to a low of 7.5 per cent in mid-1973.
29. Note also the 'weighting' items of the government accounts to reflect the degree of 'kick' expected in fiscal stimulus makes little difference to this assessment. Similarly, calculating the 'real' surplus by taking account of the inflationary erosion of public debt will not affect much the *differences* in the public sector deficits or PSBRs. See my *Britain's Economic Renaissance*, Chapter 4.

30. It must also be borne in mind that M3 was much affected by the changes instituted under CCC. The rapid increase in the rate of growth in 1972, especially in interest-bearing assets, was partly a consequence of the new freedom. One might take the point much further and argue that the *acceleration* in the growth rate of M3 ceased in the first quarter of 1973.
31. There remains the question: did the economy simply hit the 'full employment ceiling' as described by Sir John Hicks in his *Contribution to the Theory of the Trade Cycle* (Oxford, 1951), and would not this have occurred, as a consequence of such previous expansionary policies, whether or not there was a monetary squeeze? The ramifications of such a question are many; but it is worth noting that the economy did not expand along a 2 or 3 per cent path marking the 'potential' growth of the economy. Instead, there was a sharp *contraction*.
32. Note, however, that using the production index, *Economic Trends* table 82, one would strictly date it as the third quarter of 1975.
33. The data, representing changes from one calendar year to another in percentages of GDP at market prices, are:

	1971–2	1972–3	1973–4	1974–5	1975–6	1976–7
PSBR	0.8	2.6	1.9	2.2	−2.6	−3.1
PSFD	1.9	1.4	1.9	1.6	−0.7	−2.5

A psotive value indicates an expansionary fiscal policy, and a negative value a contractionary policy.
34. See David Savage, 'Fiscal Policy 1974/5–1980/1: Description and Measurement', *National Institute Economic Review*, vol. 99 (Feb. 1982).
35. If one uses the monthly rates of change of M1 and smooths these values with a 12-monthly moving average, the turning point in the smoothed series comes early in 1974. This timing is consistent with the movement of nominal interest rates.
36. I have discussed this recession and the role of monetary and fiscal policy at some length in *Britain's Economic Renaissance*, so the account in this chapter will be brief.
37. The *increase* in the financial deficit as a percentage of GDP at market prices compared with FY 1977/8 was:

Unadjusted	0.81
Cyclically adjusted	1.06
Weighted	0.44
Weighted and cyclically adjusted	0.58

The increase in the PSBR as a percentage of GDP is of a similar order. It will be noted that the financial deficit for 1977/8 decreased, as a percentage of GDP, from that of 1976/7. But the whole thrust of fiscal policy in the Keynesian and NK context is that the economy will react in months not years. So we can dismiss the earlier squeeze as the NK cause of the 1979 downturn.
38. In analysing the downturn, many economists have argued that, with much more fiscal stimulus in 1979, perhaps even late in 1979, the downturn could have been dampened if not reversed. For reasons set out in my *Britain's Economic Renaissance*, I think that such fiscal expansionism would have exacerbated the downturn because it would have created deficits which would be seen by the markets to imply massive retrenchment in the near future. Not the stuff on which to build offsets to a recession or a confident recovery.

39. Note that the growth rate of M1 continued to rise until it reached a plateau of about 15 per cent per annum, where it rested for about four years. The monetary expansion was, as it were, a permanent phenomenon – and I think was seen to be so by the market.
40. One important feature of the recovery is the apparent divergence in timing of the M1 and M0 indicators. The growth rate of M0 declined to the second quarter of 1982, and lagged the change in the growth rate of M1 by about 20 months. There are many plausible explanations such as deregulation and the payment of interest on checking balances – but it does cast doubt on using such indicators for short-run purposes.
41. For additional reflections on the problem, see my *Britain's Economic Renaissance*, Chapters 4 and 5.
42. So far as I am aware, there have been few considered accounts of the outcome by any of the 364 economists who signed the famous 31 March letter to *The Times* which predicted that 'present policies will deepen the depression, erode the industrial base of our economy and threaten its social and political stability'. The reactions might be generally classified into first those who say that, since unemployment continued to grow, there was no recovery, and second, those who argue that in 1982–3 and in subsequent years fiscal policy (particularly in terms of the public sector financial deficit) became modestly expansionary and so ensured expansion. A possible sophistication on this latter theme is to suggest that the 1981 budget was seen to lay the foundations for subsequent expansionary fiscal policy. And it was the *anticipation* of future budget relaxation that sparked the recovery in the latter half of 1981. Of course such an argument, for which there is much to be said, makes nonsense of conventional fiscal policy. It may be thought that the fiscal squeeze in 1981 had its main effects on inflation rather than on real output. Certainly inflation fell steeply in 1981 and 1982 – but it had been falling since the middle of 1980. And what many believe to have been the main ingredient in disinflation, the exchange rates peaked in the first quarter of 1981 and then sterling steadily depreciated as monetary policy was eased. The timing of the fall in inflation was broadly in line with the monetary contraction of 1978–9 – roughly a two-year lag.
43. An example of Keynesian views in 1985 of the effects of the budget squeeze is illuminating. James Tobin wrote of the 1981 policies: 'While Reagan and Volcker were converting cyclical deficits into structural deficits, their counterparts in Britain ... were converting cyclical deficits into structural surpluses. Their tax increases and spending cuts hit their economies while they were down ... contractionary fiscal policies prolonged recession and retarded recovery, even as spillover of American demands into foreign markets provided some relief.' 'The Fiscal Revolution: Disturbing Prospects', *Challenge* (Jan./Feb. 1985), p. 15. Yet later in that article, Tobin argues for a reduction of the US federal deficit because of crowding-out and unnecessarily high interest rates. He recommends (in more or less full employment) a combination of lower deficits and more expansionary monetary policy – indeed shades of British policy in 1980–81, except that there was massive unemployment.

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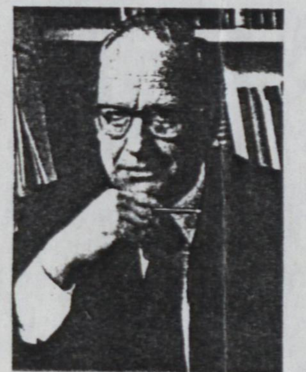

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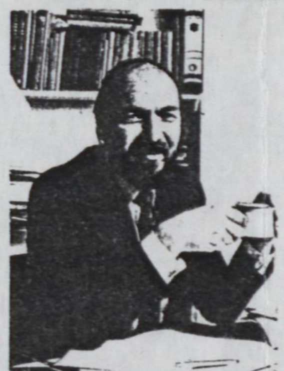

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International Coordination of Economies

Coordination in Markets of the World

One of God's greatest gifts to mankind was the free price system. As I type this article on my word-processor, I reflect on what a wonder of coordination and cooperation has been achieved in such an instrument. Technical experts in electronics, designers, managers and workers in countries as disparate as Taiwan, Korea, the United Kingdom, the United States, and no doubt many others have cooperated to produce this marvel. Those who have so conjoined in this production do not know one another, have never met and will never meet; often they speak different languages and have different mores and beliefs. Yet they cooperate and coodinate their efforts, not through the direction of some supermanager, but through their own free choice among the teaming options offered by the free price system. Each person's effort to improve his conditions is guided, as though by some divine purpose, to produce the miracles of coordination and cooperation that makes our civilization. 1/

The coordination induced among individuals and firms by the price system has been well documented. It is now widely accepted, even in the Eastern Bloc countries that had hitherto condemned capitalism and poured

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1/ One should mention that various collectives of bishops, rather than seeing the exercise of one's free will in the price system as a great gift from God, have condemned the free price system as iniquitous and unfair, and even a work of the devil. (See Walter Block, The U.S. Bishops and their Critics: An Economic and Ethical Perspective, The Fraser Institute, Vancouver, 1986.)

obloquy on the price mechanism, as the only effective way of organising production and distribution. But it is natural to enquire: surely if the price mechanism is so successful in coordinating individuals and firms, will it not be equally successful in coordinating the economic affairs of nation states?

Coordination in National Policies

Let us see what this implies. First let us assume, however dubious it may be, that the governments of each country pursue policies that are in the interests of their own inhabitants. This is the inter-governmental analogue of individuals and private firms pursuing their own ends. The inhabitants of all countries, we may suppose, want to be as wealthy as possible - with perhaps some reservations about the need to ensure that there are no large fluctuations in wealth and income. So the government's role is to ensure that its inhabitants get free access to international markets to trade at whatever prices are available.

This is, of course, the great classical and liberal (I use this term in the European sense) case for free trade. And free trade includes not only transactions in goods and services but also freedom to purchase and sell any foreign currency and assets. Thus will producers and consumers in the United States freely coordinate their activities with producers and consumers in other countries. The role of a benign government is to facilitate this cooperation. The most obvious way to ensure coordination is for governments to promote free trade and unrestricted capital mobility. Notwithstanding the recent eruptions of petty protectionism, there is a widespread belief in the virtues of open markets for both goods and capital.

National Objectives and Coordination

After free trade, the most important requirement is that there be broad stability in the general level of prices of goods and services. Then people will have a stable measuring rod, that is money, with which they can make their coordinating decisions and chart their progress. Virtually the only instrument by which governments may secure this stability is monetary and fiscal policy. The ultimate objective of domestic monetary-fiscal policies is to promote relatively stable growth in a non-inflationary environment - or at least that is what governments profess. But even among Western nations there are considerable differences about what levels of inflation may be regarded as tolerable; for example, Germany regards an inflation rate of 4 percent as quite beyond the pale, whereas I suspect that most governments of the United States would regard that rate with equanimity. But willy-nilly, Germany and the United States can happily rub along together with stable prices and a 4 percent inflation respectively, provided that no-one succeeds in fixing the dollar-mark exchange rate.

There is no need for any explicit or overt coordination of government policies. It is true that any undue expansion of the money supply in the United States will have some effect in Germany. The additional demand in the United States will suck in imports from Germany, and, to pay for them, dollars will flow out of the United States into the accounts of German exporters. This will increase demand and prices in Germany - but the pressure in Germany will be modest compared with that in the United States. The overwhelmingly main effect of the Fed's expansion will be felt on inflation and activity in the United States. The Federal Reserve Board will have by far the greatest incentive to bring its own monetary policy into line with its 4 percent target inflation rate. Similarly, by far the main effect of any undue expansion by the Bundesbank will be in the German, rather than the American, rate of inflation. The spillovers will be of the second order of smalls. 2/ The implications are clear: coordination is already achieved by each government pursuing its own policy of price stability or low inflation.

Of course there may be modest benign coordination - such as the governments explaining in detail what their domestic objectives and policies are. Coming clean on policies will reduce uncertainties, misinterpretations of data and information, and all those suspicions which abound in international surveillance. Just as it may well be useful to monitor one another's economies and trade knowledge about the efficacy of policies. But the basic result - that it is best for each government simply to pursue its own self interest - is a fortunate one. It is easy to implement. Experience suggests that it is very difficult to pursuade governments to follow policies which they believe to be inimical to national interests.

Spillovers and Global Objectives

The champions of international policy coordination, however, argue that surely gains can be made by joint decision making. It will be in the interests of the whole concert of nations if each country agrees to adjust its policy to take into account all the side effects and spillovers. Jointly, it is argued, we can achieve much more than we can if each acted selfishly.

2/ Incidentally this result, so obvious to common sense, has been confirmed by numerous econometric studies.

The first point to note about this argument is that, on its own assumptions, it is logically impeccable. Obviously, if Germany and the United States knew all the effects, both domestic and international, of their policies, they could clearly get together and fashion a joint arrangement which was, in aggregate, superior to the sum of their individual efforts. This is a species of a more general proposition widely applied to micro-markets for goods and services: with perfect knowledge and unlimited powers, one could always improve on a free market. Externalities, social costs and various other effects can be taken into account by a benign knowledgable bureaucracy in regulating markets. I believe, however, that through reflection and experience, we are now most skeptical about the efficacy of benign bureaucratic regulation, partly because of the political temptations, but mainly because of the prevailing ignorance of the myriad of interacting processes that comprise markets. We know little about individual micro-markets, but we know very little indeed about the macroeconomic processes and the dynamics of forces that determine the fate of national economies. Any joint-coordination of national policies would be based on pretentions which are completely unwarranted by the corpus of knowledge of economists, and is likely to do harm rather than good.

Secondly, even if one accepts the potentially beneficial effect of coordination, it is difficult to see how all the ships of state will be kept on course. There is unlikely to be any system of sanctions with which they could be kept in line. And if there were such sanctions, shots over the bow, such as refusal to lend support for the currency or, even, the imposition of tariff or other trade restrictions, the invocation of such sanctions would be bad *per se* and even their mere threat would surely scatter, if not scuttle, the convoy of cooperating nations. Coordination, therefore, will depend upon 'good will' or a 'community of interests' etc. -- rather a weak reed, I fear, on which to rely. A coordinated convoy of ships travels at the speed of the slowest. It may be asked, however, how can the concert of nations prevent a particular country, say the United States, from pursuing a policy of inflationary excess (as indeed it did from the early 1960s), in response to short term political pressures, when it is well known that such excess is not in the abiding interests of the inhabitants of the United States? The reality is that not much can be done. It is just possible that if, in the 1960s, the Fed and a previous Treasury had entered into some multilateral understanding that they would adhere to non-inflationary policies, then the invocation of such an agreement may have had some effect in restraining the government -- but, again, it would be unwise to count on such pressures being effective. If a government finds it imperative to pursue inflationary policies, it will.

Exchange Rate Coordination

How can the other countries avoid importing the inflation of the United States (to continue with this purely hypothetical example)? Of course, one certain way actually to import the inflation is to fix the dollar exchange rate. If the dollar exchange rate of the Dmark were fixed at 1.85 marks to the dollar, then Germany would indeed import the inflation of the United States. The influx of German exports to the United States would give rise to a flood of dollars into Germany, and in order to prevent this flood depressing the dollar and revaluing the mark, the German government would have to buy the dollars with marks. Such an increase in the quantity of marks would transfer the inflation to Germany. 3/

Such a tranmission of inflation can be largely, if not entirely, avoided by simply not managing the exchange rate. If neither Germany nor the United States tried to peg the rate at 1.85, the mark would appreciate and United States imports from Germany would decline. There would be virtually no net outflow of dollars and the United States would suffer most of the inflationary effects of its unwise policies. Germany would largely escape the American inspired inflation.

A flexible exchange rate has much to recommend it. Those who misbehave substantially suffer the consequences of their folly. The fixed exchange rate system operates rather like an international welfare system; the costs of the misdeeds of one are borne in some degree by every nation. To avoid misunderstanding, I must emphasise that, even with flexible exchange rates, Germany would be better off if the United States did not inflate. With all the benefits of exchange rate adjustments, it is still necessary for Germany to adapt to the new international prices and exchange rates. And the transition is unlikely to be peaceful and smooth. Indeed, the appreciation of the mark is likely to overshoot the ultimate values at which it will

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3/ It is often claimed that there is no need for the Germans to create new marks since they can acquire all the marks they need by selling long term mark bonds. Experience has shown, however, that this so-called "sterilization" of the exchange rate intervention is effective only in the short term; ultimately the quantity of marks and the inflation rate must increase.

settle. [4/] Germany will have some headaches, but they will avoid the full fever of inflation.

The general conclusion to be drawn from these arguments is that, first, it is best for every country to pursue stable fiscal and monetary policies. This will ensure that there is no undue pressure on exchange rates and, apart from the normal vicissitudes occasioned by droughts, acts of God and electoral foibles, the values of currencies should remain stable. It is the resort to inflationary finance that causes the trouble, and all the recriminations which exacerbate international relations for many years thereafter. But since one cannot guarantee that all nations will always act responsibly (in the interests of their inhabitants), a second conclusion is that it is best to leave exchange rates flexible. This will contain the damage.

Deficits and Dollars in the 1980s

Broadly speaking, this was the position of the United States government and perhaps most governments of the industrialized nations in the early 1980s. The United Kingdom was the epitomy of this virtuous policy; from 1980 onwards her budget deficits steadily decreased, the rate of monetary growth was substantially reduced and the exchange rate was left largely to

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4/ The overshooting phenomena arises from the fact that the increased quantity of dollars will have an immediate effect on the market, rather like a glut of strawberries at the beginning of summer. In order to induce asset holders to absorb this new dollar glut, the price of dollars, relative to the mark, will have to fall sharply. Once this stock adjustment is over, the dollar will settle at a somewhat higher value. So rough and circuitous is the adjustment road, that most authorities believe that governments should not take that route, or, if they do, then the bumps should be smoothed and the corners cut.

market forces. The United States pursued a similar monetary and exchange rate policy, but, for reasons which are still the subject of controversy, the federal budget deficit increased to new highs -- about 6 percent of GNP.

That persistent but declining deficit has been alleged to be the source of so many evils and has much colored the views of Europeans and Japanese governments and central bankers. In particular, the deficits have been blamed for the high real interest rates on world markets, the high deficits on the current account of the U.S. balance of payments, and for the extraordinary appreciation of the dollar (more than 40 percent in real terms) to the end of 1984, as well as for the fall in the dollar from February 1985 onwards. It is argued that the high dollar, in turn, fueled the protectionist movement which eventually delivered the Trade Bill of 1988.

There is little doubt that the soaring dollar, and all its consequences on both agriculture and rust-belt industries, produced a change in the United States government's laissez-faire policy on exchange rates. Mr. Baker thought that exchange rates should be managed to bring the dollar back to levels which he regarded as acceptable. At the Plaza agreement in September 1985, the main industrial nations agreed on concerted intervention to bring the dollar down to what they regarded as "equilibrium" levels. As usual, the joint interventions only got under way some eight or nine months <u>after</u> the dollar had started to fall rapidly. Indeed, looking at the path of the dollar over the period of the Plaza interventions, it is quite impossible to detect any effect whatsoever. The pace of the fall was the same both before and after Plaza. But this in no way inhibited the participants from admiring their own perspicacity; Plaza was reckoned a success.

In my view, the fall of the dollar has a much simpler explanation - and has virtually nothing to do with the budget deficit, the trade deficit, or the assorted Plaza interventions. The rise of the dollar was largely occasioned by the tight monetary policy pursued by the Fed, with some relaxation in 1982/3, during the 1980-84 period. From the end of 1984, however, monetary growth virtually tripled and continued high throughout 1985 and 1986. It was simply the increase in the quantity of dollars, relative to the quantitities of yen and marks, that generated the fall of the dollar. [5/]

"Saving" the Dollar - Louvre, the Crash, and Inflation

But the continued fall of the dollar at the end of 1986 caused fears of overshooting and the inflationary consequences in the United States. The Louvre agreement among the G7 countries in February 1987 aimed at supporting the dollar where it was, on the presumption that exchange rates were then about at the right levels. The market however demurred. It clearly anticipated a further decline. So the world's private investors held off buying dollar bonds. Accepting their Louvre obligations, the central banks (primarily of Japan and Germany) rallied around and bought the excess offerings of dollar financial paper...to an amount of more than $140 billion during 1987. Interest rates on dollar paper pushed up sharply in mid 1987 and contributed towards the crash of Wall Street. Then it was clear that the

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5/ A very similar pattern occurred in the great sterling appreciation of 1979-81. Because of a fierce monetary squeeze from 1979, sterling appreciated just about as much as the dollar did in the 80s, that is to say by about 40-45 percent in real terms. The easing of monetary policy in 1981 saw a rapid depreciation of sterling - but fortunately the government abjured intervention, and Britain secured a stable monetary system and stable non-inflationary growth thereafter.

Louvre objective was unattainable. From Black Monday (October 19th) on, the dollar depreciated a further 6 to 7 percent against the G7 currencies (excluding the Canadian dollar).

The sad effects of this Louvre fiasco will continue to haunt the Western world for some years to come. One quite ludicrous consequence of the German intervention was an increase in German taxes! The Bundesbank reported nearly $4bn losses on its 1987 exchange rate interventions (mainly through buying depreciating US dollars), which increased the budget deficit and so, according to the finance ministry, called for increased tax revenue. But much more important was the fact that there had been a great expansion of marks, pounds, yen, etc., in order to buy up these excess dollars. These large stocks of money and liquid assets hang over the economies of the West, creating many fears of inflation and recession.

The mid-1980s have been so reminiscent of the last great period of interventions to maintain fixed exchange rates - in 1969-1972 during the last years of Bretton Woods. Then there was a massive increase in monetary expansion which culminated in the great inflation and recession of the mid 1970s. I fear that we are about to learn these painful lessons all over again.

The Discipline of Capital Flight

True the world has changed these last 20 years. But the main change in international finance has been, first, the enormous growth of footloose capital and second, the increased speed with which this capital can be transferred between currencies and countries. As events in 1987 showed, even the coodinated efforts of the world's great central banks (which did not hesitate to reach deep into the taxpayers' pockets) could not hold the dollar; the markets won.

This has upset many people. Distinguished economists such as Nobel Laureat James Tobin, have urged, quite rightly in my view, that goverments will never be able adequately to coordinate exchange rates (I think that by that they mean regulate exchange rates which they - the economists - believe are appropriate) unless this flood of "hot money", as it is pejoratively called, is controlled or at least contained. Suggestions have been made for more "friction" to be introduced in the system, perhaps in the form of controls or perhaps in the form of a world-wide transactions tax on currency switches. This would put the individual's savings at the mercy of national governments - similar to, but I hope not so extreme as, the situation which one observes in the third world and Eastern bloc countries. Even so, the experience of the 1960s shows that it would still be impossible to sustain exchange rates different from the market's solution - and so there would be calls for yet higher barriers. A terrible price to pay for the vanities of governments and their economic advisors. Adam Smith's immortal prose reminds us of such follies:

> The statesman, who should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it. 6/

6/ An Inquiry into the Nature and Causes of the Wealth of Nations, ed. R.H. Campbell, A.S. Skinner, and W.B. Todd. Oxford, Clarendon Press 1976, p.456.

Free capital markets will remain one of the most effective means by which governments are reminded of the errors of their ways. We should honor, not excoriate, those thousands of international speculators who, with their own hot money, police so effectively the follies of statesmen.

Constitutions and Coordination

But suppose, nevertheless, that governments continue to hanker after exchange rate pegging in one or another of its many forms. One might well ask whether it is even possible for governments to honor their obligations. One fundamental difficulty, which I have ignored up to now by the bland assumption that governments could deliver on any feasible economic policy, is that some central banks - in particular the Fed and the Bundesbank - are constitutionally independent of government. And in fiscal policy, the President of the United States has said that he does not control the budget. (As a matter of fact, I am not quite sure whether anybody controls the budget of the United States, but for the sake of the argument I will assume that Congress does so.) Before one plans coordination on a galactic scale, one had best do some earnest coordination at home. Although the last occasion on which there was happy coordination between Congress and the President was in the LBJ era. This ushered in the collapse of Bretton Woods and the great inflation of the 1970s. Hardly a recommendation for coordination at any level.

An Agenda for Coordination

These arguments lead me to suggest a very modest agenda - with no claims for originality - which recognises clearly both how little we know and what can be realistically achieved. First, each country should set their monetary and fiscal policies in accordance with domestic objectives. The countries can usefully exchange information on exactly what those measures are and how they are to be implemented. (Such information should, in any case, be in the public domaine.) Likewise, friendly pursuasion by one agency or another is quite tolerable, provided it does not result in a crusade of one government against the policy of another. Second, there should be no attempt, through internationally coordinated intervention, to move market exchange rates to what economic advisors regard as appropriate levels. If a particular government wishes to intervene to secure a rate different from the markets, then that is its prerogative. But its own taxpayers should pay for the consequences. Third, international coordination should not merely continue but be stepped up in the field of trade and capital movements liberalization. Although it is in the domestic interests of a country to reduce barriers, experience suggests that the political pressure of joint international undertakings, such as GATT, are useful adjuncts and may be used to offset domestic protectionist pressure groups. Fourth, such modest coordination is best pursued quietly but persistently in an atmosphere of negotiation and compromise. When, as in 1985-77, Mr. Baker tells Germany, through the world media, that it is pursuing a policy that is bad for them and bad for the world, such recrimination will merely raise hackles about sovereignty and the meddling of one country in the domestic affairs of another. If the United States wishes to make its view on German economic policy known to the Germans, then it is best done quietly and in what used to be called a gentlemanly manner.

Finally, I would warn that, however disappointing the recent attempts at exchange rate coordination have been, I suspect that many more will be essayed in the years ahead. Indeed suggestions are already being made that the United States and Japan join as members of the existing exchange rate bloc in the European Monetary System, to form one big system rather like the old Bretton Woods arrangement, but, of course, without the hegemony of the dollar. The powerful interest groups pushing the Western world along such dangerous paths should not be underestimated. Our free currency and capital markets are human and imperfect. But they are infinitely preferable to any arrangement imposed by a gaggle of governments. Blessed indeed are our freedoms.

1. Mr. Fricker – to see

2. CF – p.c.

RRC6 25/7

Committee on Banking Regulations
and
Supervisory Practices

July 1988

INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS

Introduction

1. This report presents the outcome of the Committee's[1] work over several years to secure international convergence of supervisory regulations governing the capital adequacy of international banks. Following the publication of the Committee's proposals in December 1987, a consultative process was set in train in all G-10 countries and the proposals were also circulated to supervisory authorities worldwide. As a result of those consultations some changes were made to the original proposals. The present paper is now a statement of the Committee agreed by all its members. It sets out the details of the agreed framework for measuring capital adequacy and the minimum standard to be achieved which the national supervisory authorities represented on the Committee intend to implement in their respective countries. The framework and this standard have been endorsed by the Group of Ten central-bank Governors.

2. With a view to implementation as soon as possible, it is intended that national authorities should now prepare papers setting out their views on the timetable and the manner in which this accord will be implemented in their respective countries. This document is being circulated to supervisory authorities worldwide with a view to encouraging the adoption of this framework in countries outside the G-10 in respect of banks conducting significant international business.

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1 The Basle Committee on Banking Regulations and Supervisory Practices comprises representatives of the central banks and supervisory authorities of the Group of Ten countries (Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States) and Luxembourg. The Committee meets at the Bank for International Settlements, Basle, Switzerland.

3. Two fundamental objectives lie at the heart of the Committee's work on regulatory convergence. These are, firstly, that the new framework should serve to strengthen the soundness and stability of the international banking system; and secondly that the framework should be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks. The Committee notes that, in responding to the invitation to comment on its original proposals, banks have welcomed the general shape and rationale of the framework and have expressed support for the view that it should be applied as uniformly as possible at the national level.

4. Throughout the recent consultations, close contact has been maintained between the Committee in Basle and the authorities of the European Community in Brussels who are pursuing a parallel initiative to develop a common solvency ratio to be applied to credit institutions in the Community. The aim has been to ensure the maximum degree of consistency between the framework agreed in Basle and the framework to be applied in the Community. It is the Committee's hope and expectation that this consistency can be achieved, although it should be noted that regulations in the European Community are designed to apply to credit institutions generally, whereas the Committee's framework is directed more specifically with banks undertaking international business in mind.

5. In developing the framework described in this document the Committee has sought to arrive at a set of principles which are conceptually sound and at the same time pay due regard to particular features of the present supervisory and accounting systems in individual member countries. It believes that this objective has been achieved. The framework provides for a transitional period so that the existing circumstances in different countries can be reflected in flexible arrangements that allow time for adjustment.

6. In certain very limited respects (notably as regards some of the risk weightings) the framework allows for a degree of national discretion in the way in which it is applied. The impact of such discrepancies on the overall ratios is likely to be negligible and it is not considered that they will compromise the basic objectives. Nevertheless, the Committee intends to monitor and review the application of the framework in the period ahead with a view to achieving even greater consistency.

7. It should be stressed that the agreed framework is designed to establish minimum levels of capital for internationally active banks. National authorities will be free to adopt arrangements that set higher levels.

8. It should also be emphasised that capital adequacy as measured by the present framework, though important, is one of a number of factors to be taken into account when assessing the strength of banks. The framework in this document is mainly directed towards assessing capital in relation to credit risk (the risk of counterparty failure) but other risks, notably interest rate risk and the investment risk on securities, need to be taken into account by supervisors in assessing overall capital adequacy. The Committee is examining possible approaches in relation to these risks. Furthermore, and more generally, capital ratios, judged in isolation, may provide a misleading guide to relative strength. Much also depends on the quality of a bank's assets and, importantly, the level of provisions a bank may be holding outside its capital against assets of doubtful value. Recognising the close relationship between capital and provisions, the Committee will continue to monitor provisioning policies by banks in member countries and will seek to promote convergence of policies in this field as in other regulatory matters. In assessing progress by banks in member countries towards meeting the agreed capital standards, the Committee will therefore take careful account of any differences in existing policies and procedures for setting the level of provisions among countries' banks and in the form in which such provisions are constituted.

9. The Committee is aware that differences between countries in the fiscal treatment and accounting presentation for tax purposes of certain classes of provisions for losses and of capital reserves derived from retained earnings may to some extent distort the comparability of the real or apparent capital positions of international banks. Convergence in tax régimes, though desirable, lies outside the competence of the Committee and tax considerations are not addressed in this paper. However, the Committee wishes to keep these tax and accounting matters under review to the extent that they affect the comparability of the capital adequacy of different countries' banking systems.

10. This agreement is intended to be applied to banks on a consolidated basis, including subsidiaries undertaking banking and financial business. At the same time, the Committee recognises that ownership structures and the position of banks within financial conglomerate groups are undergoing significant

changes. The Committee will be concerned to ensure that ownership structures should not be such as to weaken the capital position of the bank or expose it to risks stemming from other parts of the group. The Committee will continue to keep these developments under review in the light of the particular regulations in member countries, in order to ensure that the integrity of the capital of banks is maintained. In the case of several of the subjects for further work mentioned above, notably investment risk and the consolidated supervision of financial groups, the European Community has undertaken or is undertaking work with similar objectives and close liaison will be maintained.

11. This document is divided into four sections. The first two describe the framework: Section I the constituents of capital and Section II the risk weighting system. Section III deals with the target standard ratio; and Section IV with transitional and implementing arrangements.

I. THE CONSTITUENTS OF CAPITAL

(a) Core capital (basic equity)

12. The Committee considers that the key element of capital on which the main emphasis should be placed is equity capital[2] and disclosed reserves. This key element of capital is the only element common to all countries' banking systems; it is wholly visible in the published accounts and is the basis on which most market judgements of capital adequacy are made; and it has a crucial bearing on profit margins and a bank's ability to compete. This emphasis on equity capital and disclosed reserves reflects the importance the Committee attaches to securing a progressive enhancement in the quality, as well as the level, of the total capital resources maintained by major banks.[3]

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2 Issued and fully paid ordinary shares/common stock and non-cumulative perpetual preferred stock (but excluding cumulative preferred stock).

3 One member country, however, maintains the view that an international definition of capital should be confined to core capital elements and indicated that it would continue to press for the definition to be reconsidered by the Committee in the years ahead.

13. Notwithstanding this emphasis, the member countries of the Committee also consider that there are a number of other important and legitimate constituents of a bank's capital base which may be included within the system of measurement (subject to certain conditions set out in sub-section (b) below).

14. The Committee has therefore concluded that capital, for supervisory purposes, should be defined in two tiers in a way which will have the effect of requiring at least 50 per cent. of a bank's capital base to consist of a core element comprised of equity capital and published reserves from post-tax retained earnings (tier 1). The other elements of capital (supplementary capital) will be admitted into tier 2 up to an amount equal to that of the core capital. These supplementary capital elements and the particular conditions attaching to their inclusion in the capital base are set out below and in more detail in Annex 1. Each of these elements may be included or not included by national authorities at their discretion in the light of their national accounting and supervisory regulations.

(b) Supplementary capital

(i) Undisclosed reserves

15. Unpublished or hidden reserves may be constituted in various ways according to differing legal and accounting régimes in member countries. Under this heading are included only reserves which, though unpublished, have been passed through the profit and loss account and which are accepted by the bank's supervisory authorities. They may be inherently of the same intrinsic quality as published retained earnings, but, in the context of an internationally agreed minimum standard, their lack of transparency, together with the fact that many countries do not recognise undisclosed reserves, either as an accepted accounting concept or as a legitimate element of capital, argue for excluding them from the core equity capital element.

(ii) Revaluation reserves

16. Some countries, under their national regulatory or accounting arrangements, allow certain assets to be revalued to reflect their current value, or something closer to their current value than historic cost, and the resultant revaluation reserves to be included in the capital base. Such revaluations can arise in two ways:

(a) from a formal revaluation, carried through to the balance sheets of banks' own premises; or

(b) from a notional addition to capital of hidden values which arise from the practice of holding securities in the balance sheet valued at historic cost.

Such reserves may be included within supplementary capital provided that the assets are considered by the supervisory authority to be prudently valued, fully reflecting the possibility of price fluctuations and forced sale.

17. Alternative (b) is relevant to those banks whose balance sheets traditionally include very substantial amounts of equities held in their portfolio at historic cost but which can be, and on occasions are, realised at current prices and used to offset losses. The Committee considers these "latent" revaluation reserves can be included among supplementary elements of capital since they can be used to absorb losses on a going-concern basis, provided they are subject to a substantial discount in order to reflect concerns both about market volatility and about the tax charge which would arise were such gains to be realised. A discount of 55 per cent. on the difference between the historic cost book value and market value is agreed to be appropriate in the light of these considerations. The Committee considered, but rejected, the proposition that latent reserves arising in respect of the undervaluation of banks' premises should also be included within the definition of supplementary capital.

(iii) General provisions/general loan loss reserves

18. General provisions or general loan-loss reserves are created against the possibility of future losses. Where they are not ascribed to particular assets and do not reflect a reduction in the valuation of particular assets, these reserves qualify for inclusion in capital and it has been agreed that they should be counted within tier 2. Where, however, provisions have been created against identified losses or in respect of a demonstrable deterioration in the value of particular assets, they are not freely available to meet unidentified losses which may subsequently arise elsewhere in the portfolio and do not possess an essential characteristic of capital. Such specific or earmarked provisions should therefore not be included in the capital base.

19. The Committee accepts, however, that, in practice, it is not always possible to distinguish clearly between general provisions (or general loan loss

reserves) which are genuinely freely available and those provisions which in reality are earmarked against assets already identified as impaired. This partly reflects the present diversity of accounting, supervisory, and, importantly, fiscal policies in respect of provisioning and in respect of national definitions of capital. This means, inevitably, that initially there will be a degree of inconsistency in the characteristics of general provisions or general loan-loss reserves included by different member countries within the framework.

20. In the light of these uncertainties, the Committee intends during the transitional period (see paragraphs 45 to 50 below) to clarify the distinction made in member countries between those elements which should conceptually be regarded as part of capital and those which should not qualify. The Committee will aim to develop before the end of 1990 firm proposals applicable to all member countries, so as to ensure consistency in the definition of general provisions and general loan-loss reserves eligible for inclusion in the capital base by the time the interim and final minimum target standards fall to be observed.

21. As a further safeguard, in the event that agreement is not reached on the refined definition of unencumbered resources eligible for inclusion in supplementary capital, where general provisions and general loan-loss reserves may include amounts reflecting lower valuations for assets or latent but unidentified losses present in the balance sheet, the amount of such reserves or provisions that qualify as capital would be phased down so that, at the end of the transitional period, such items would constitute no more than 1.25 percentage points, or exceptionally and temporarily up to 2.0 percentage points, of risk assets within the secondary elements.

(iv) Hybrid debt capital instruments

22. In this category fall a number of capital instruments which combine certain characteristics of equity and certain characteristics of debt. Each of these has particular features which can be considered to affect its quality as capital. It has been agreed that, where these instruments have close similarities to equity, in particular when they are able to support losses on an on-going basis without triggering liquidation, they may be included in supplementary capital. In addition to perpetual preference shares carrying a cumulative fixed charge, the following instruments, for example, may qualify for inclusion: long-term preferred shares in Canada, titres participatifs and titres subordonnés à durée

indéterminée in France, Genussscheine in Germany, perpetual debt instruments in the United Kingdom and mandatory convertible debt instruments in the United States. The qualifying criteria for such instruments are set out in Annex 1.

(v) **Subordinated term debt**

23. The Committee is agreed that subordinated term debt instruments have significant deficiencies as constituents of capital in view of their fixed maturity and inability to absorb losses except in a liquidation. These deficiencies justify an additional restriction on the amount of such debt capital which is eligible for inclusion within the capital base. Consequently, it has been concluded that subordinated term debt instruments with a minimum original term to maturity of over five years may be included within the supplementary elements of capital but only to a maximum of 50 per cent. of the core capital element, and subject to adequate amortisation arrangements.

(c) **Deductions from capital**

24. It has been concluded that the following deductions should be made from the capital base for the purpose of calculating the risk-weighted capital ratio. The deductions will consist of:

(i) goodwill, as a deduction from tier 1 capital elements;

(ii) investments in subsidiaries engaged in banking and financial activities which are not consolidated in national systems. The normal practice will be to consolidate subsidiaries for the purpose of assessing the capital adequacy of banking groups. Where this is not done, deduction is essential to prevent the multiple use of the same capital resources in different parts of the group. The deduction for such investments will be made against the total capital base. The assets representing the investments in subsidiary companies whose capital had been deducted from that of the parent would not be included in total assets for the purposes of computing the ratio.

25. The Committee carefully considered the possibility of requiring deduction of banks' holdings of capital issued by other banks or deposit-taking institutions, whether in the form of equity or of other capital instruments. Several G-10 supervisory authorities currently require such a deduction to be made in order to discourage the banking system as a whole from creating cross-holdings of

capital, rather than drawing capital from outside investors. The Committee is very conscious that such double-gearing (or "double-leveraging") can have systemic dangers for the banking system by making it more vulnerable to the rapid transmission of problems from one institution to another and some members consider these dangers justify a policy of full deduction of such holdings.

26. Despite these concerns, however, the Committee as a whole is not presently in favour of a general policy of deducting all holdings of other banks' capital, on the grounds that to do so could impede certain significant and desirable changes taking place in the structure of domestic banking systems.

27. The Committee has nonetheless agreed that:

(a) individual supervisory authorities should be free at their discretion to apply a policy of deduction, either for all holdings of other banks' capital, or for holdings which exceed material limits in relation to the holding bank's capital or the issuing bank's capital, or on a case-by-case basis;

(b) where no deduction is applied, banks' holdings of other banks' capital instruments will bear a weight of 100 per cent.;

(c) in applying these policies, member countries consider that reciprocal cross-holdings of bank capital designed artificially to inflate the capital position of the banks concerned should not be permitted;

(d) the Committee will closely monitor the degree of double-gearing in the international banking system and does not preclude the possibility of introducing constraints at a later date. For this purpose, supervisory authorities intend to ensure that adequate statistics are made available to enable them and the Committee to monitor the development of banks' holdings of other banks' equity and debt instruments which rank as capital under the present agreement.

II. THE RISK WEIGHTS

28. The Committee considers that a weighted risk ratio in which capital is related to different categories of asset or off-balance-sheet exposure, weighted according to broad categories of relative riskiness, is the preferred method for assessing the capital adequacy of banks. This is not to say that other methods of

capital measurement are not also useful, but they are considered by the Committee to be supplementary to the risk weight approach. The Committee believes that a risk ratio has the following advantages over the simpler gearing ratio approach:

(i) it provides a fairer basis for making international comparisons between banking systems whose structures may differ;

(ii) it allows off-balance-sheet exposures to be incorporated more easily into the measure;

(iii) it does not deter banks from holding liquid or other assets which carry low risk.

29. The framework of weights has been kept as simple as possible and only five weights are used - 0, 10, 20, 50 and 100 per cent. There are inevitably some broad-brush judgements in deciding which weight should apply to different types of asset and the weightings should not be regarded as a substitute for commercial judgement for purposes of market pricing of the different instruments.

30. The weighting structure is set out in detail in Annexes 2 and 3. There are six aspects of the structure to which attention is particularly drawn.

(i) Categories of risk captured in the framework

31. There are many different kinds of risks against which banks' managements need to guard. For most banks the major risk is <u>credit risk</u>, that is to say the risk of counterparty failure, but there are many other kinds of risk - for example, investment risk, interest rate risk, exchange rate risk, concentration risk. The central focus of this framework is credit risk and, as a further aspect of credit risk, country transfer risk. In addition, individual supervisory authorities have discretion to build in certain other types of risk. Some countries, for example, will wish to retain a weighting for open foreign exchange positions or for some aspects of investment risk. No standardisation has been attempted in the treatment of these other kinds of risk in the framework at the present stage.

32. The Committee considered the desirability of seeking to incorporate additional weightings to reflect the investment risk in holdings of fixed rate domestic government securities - one manifestation of interest rate risk which is of course present across the whole range of a bank's activities, on and off the balance sheet. For the present, it was concluded that individual supervisory authorities should be free to apply either a zero <u>or</u> a low weight to claims on the

domestic government (e.g. 10 per cent. for all securities or 10 per cent. for those maturing in under one year and 20 per cent. for one year and over). All members agreed, however, that interest rate risk generally required further study and that if, in due course, further work made it possible to develop a satisfactory method of measurement for this aspect of risk for the business as a whole, consideration should be given to applying some appropriate control alongside this credit risk framework. Work is already under way to explore the possibilities in this regard.

(ii) Country transfer risk

33. In addressing country transfer risk, the Committee has been very conscious of the difficulty of devising a satisfactory method for incorporating country transfer risk into the framework of measurement. In its earlier, consultative, paper two alternative approaches were put forward for consideration and comment. These were, firstly, a simple differentiation between claims on domestic institutions (central government, official sector and banks) and claims on all foreign countries; and secondly, differentiation on the basis of an approach involving the selection of a defined grouping of countries considered to be of high credit standing.

34. The comments submitted to the Committee by banks and banking associations in G-10 countries during the consultative period were overwhelmingly in favour of the second alternative. In support of this view, three particular arguments were strongly represented to the Committee. Firstly, it was stressed that a simple domestic/foreign split effectively ignores the reality that transfer risk varies greatly between different countries and that this risk is of sufficient significance to make it necessary to ensure that broad distinctions in the credit standing of industrialised and non-industrialised countries should be made and captured in the system of measurement, particularly one designed for international banks. Secondly, it was argued that the domestic/foreign split does not reflect the global integration of financial markets and the absence of some further refinement would discourage international banks from holding securities issued by central governments of major foreign countries as liquid cover against their Euro-currency liabilities. To that extent a domestic/foreign approach would run counter to an important objective of the risk weighting framework, namely that it should encourage prudent liquidity management. Thirdly, and most importantly, the member states of the European Community are firmly

committed to the principle that all claims on banks, central governments and the official sector within European Community countries should be treated in the same way. This means that, where such a principle is put into effect, there would be an undesirable asymmetry in the manner in which a domestic/foreign split was applied by the seven G-10 countries which are members of the Community compared with the manner in which it was applied by the non-Community countries.

35. In the light of these arguments, the Committee has concluded that a defined group of countries should be adopted as the basis for applying differential weighting coefficients, and that this group should be full members of the OECD or countries which have concluded special lending arrangements with the IMF associated with the Fund's General Arrangements to Borrow. This group of countries is referred to as the OECD in the rest of the report.

36. This decision has the following consequences for the weighting structure. Claims on central governments within the OECD will attract a zero weight (or a low weight if the national supervisory authority elects to incorporate interest rate risk); and claims on OECD non-central government public-sector entities will attract a low weight [see (iii) below]. Claims on central governments and central banks outside the OECD will also attract a zero weight (or a low weight if the national supervisory authority elects to incorporate investment risk), provided such claims are denominated in the national currency and funded by liabilities in the same currency. This reflects the absence of risks relating to the availability and transfer of foreign exchange on such claims.

37. As regards the treatment of interbank claims, in order to preserve the efficiency and liquidity of the international interbank market there will be no differentiation between short-term claims on banks incorporated within or outside the OECD. However, the Committee draws a distinction between, on the one hand, short-term placements with other banks which is an accepted method of managing liquidity in the interbank market and carries a perception of low risk and, on the other, longer-term cross-border loans to banks which are often associated with particular transactions and carry greater transfer and/or credit risks. A 20 per cent. weight will therefore be applied to claims on all banks, wherever incorporated, with a residual maturity of up to and including one year; longer-term claims on OECD incorporated banks will be weighted at 20 per cent;

and longer-term claims on banks incorporated outside the OECD will be weighted at 100 per cent.

(iii) Claims on non-central-government, public-sector entities (PSEs)

38. The Committee concluded that it was not possible to settle on a single common weight that can be applied to all claims on domestic public-sector entities below the level of central government (e.g. states, local authorities, etc.), in view of the special character and varying creditworthiness of these entities in different member countries. The Committee therefore opted to allow discretion to each national supervisory authority to determine the appropriate weighting factors for the PSEs within that country. In order to preserve a degree of convergence in the application of such discretion, the Committee agreed that the weights ascribed in this way should be 0, 10, 20 or 50 per cent. for domestic PSEs but that PSEs in foreign countries within the OECD should attract a standard 20 per cent. weight. These arrangements will be subject to review by the Committee in pursuit of further convergence towards common weights and consistent definitions in member countries and in the light of decisions to be taken within the European Community on the specification of a common solvency ratio for credit institutions.

Commercial companies owned by the public sector will attract a uniform weight of 100 per cent. inter alia in order to avoid competitive inequality vis-à-vis similar private-sector commercial enterprises.

(iv) Collateral and guarantees

39. The framework recognises the importance of collateral in reducing credit risk, but only to a limited extent. In view of the varying practices among banks in different countries for taking collateral and different experiences of the stability of physical or financial collateral values, it has not been found possible to develop a basis for recognising collateral generally in the weighting system. The more limited recognition of collateral will apply only to loans secured against cash or against securities issued by OECD central governments and specified multilateral development banks. These will attract the weight given to the collateral (i.e. a zero or a low weight). Loans partially collateralised by these assets will also attract the equivalent low weights on that part of the loan which is fully collateralised.

40. As regards loans or other exposures guaranteed by third parties, the Committee has agreed that loans guaranteed by OECD central governments,

OECD public-sector entities, or OECD incorporated banks will attract the weight allocated to a direct claim on the guarantor (e.g. 20 per cent. in the case of banks). Loans guaranteed by non-OECD incorporated banks will also be recognised by the application of a 20 per cent. weight but only where the underlying transaction has a residual maturity not exceeding one year. The Committees intends to monitor the application of this latter arrangement to ensure that it does not give rise to inappropriate weighting of commercial loans. In the case of loans covered by partial guarantees, only that part of the loan which is covered by the guarantee will attract the reduced weight. The contingent liability assumed by banks in respect of guarantees will attract a credit conversion factor of 100 per cent. (see sub-section (vi) below).

(v) Loans secured on residential property

41. Loans fully secured by mortgage on occupied residential property have a very low record of loss in most countries. The framework will recognise this by assigning a 50 per cent. weight to loans fully secured by mortgage on residential property which is rented or is (or is intended to be) occupied by the borrower. In applying the 50 per cent. weight, the supervisory authorities will satisfy themselves, according to their national arrangements for the provision of housing finance, that this concessionary weight is applied restrictively for residential purposes and in accordance with strict prudential criteria. This may mean, for example, that in some member countries the 50 per cent. weight will only apply to first mortgages, creating a first charge on the property; and that in other member countries it will only be applied where strict, legally-based, valuation rules ensure a substantial margin of additional security over the amount of the loan. The 50 per cent. weight will specifically not be applied to loans to companies engaged in speculative residential building or property development. Other collateral will not be regarded as justifying the reduction of the weightings that would otherwise apply.[4]

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4 One member country feels strongly that the lower weight should also apply to other loans secured by mortgages on domestic property, provided that the amount of the loan does not exceed 60 per cent. of the value of the property as calculated according to strict legal valuation criteria.

(vi) Off-balance-sheet engagements

42. The Committee believes that it is of great importance that all off-balance-sheet activity should be caught within the capital adequacy framework. At the same time, it is recognised that there is only limited experience in assessing the risks in some of the activities; also that for some countries, a complex analytical approach and detailed and frequent reporting systems cannot easily be justified when the amounts of such business, particularly in the newer, more innovative instruments, are only small. The approach that has been agreed, which is on the same lines as that described in the Committee's report on the supervisory treatment of off-balance-sheet exposures issued to banks in March 1986, is comprehensive in that all categories of off-balance-sheet engagements, including recent innovations, will be converted to credit risk equivalents by multiplying the nominal principal amounts by a credit conversion factor, the resulting amounts then being weighted according to the nature of the counterparty. The different instruments and techniques are divided into five broad categories (within which member countries will have some limited discretion to allocate particular instruments according to their individual characteristics in national markets):

(a) those which substitute for loans (e.g. general guarantees of indebtedness, bank acceptance guarantees and standby letters of credit serving as financial guarantees for loans and securities) - these will carry a 100 per cent. credit risk conversion factor;

(b) certain transaction related contingencies (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions) - a 50 per cent. credit risk conversion factor;

(c) short-term, self-liquidating trade-related contingent liabilities arising from the movement of goods (e.g. documentary credits collateralised by the underlying shipments) - a 20 per cent. credit risk conversion factor;

(d) commitments with an original maturity[5] exceeding one year (the longer maturity serving broadly as a proxy for higher risk facilities) and all NIFs and RUFs - a 50 per cent. credit risk conversion factor.

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5 In order to facilitate data collection, during the transitional period up to end-1992, but not beyond, national supervisory authorities will have discretion to apply residual maturity as a basis for measuring commitments.

Shorter-term commitments or commitments which can be unconditionally cancelled at any time, it is agreed, generally carry only low risk and a nil weight for these is considered to be justified on de minimis grounds;

(e) interest and exchange rate related items (e.g. swaps, options, futures) - the credit risk equivalent amount for these contracts will be calculated in one of two ways (see below and Annex 3).

43. Special treatment is needed for the items in (e) above because banks are not exposed to credit risk for the full face value of their contracts, but only to the cost of replacing the cash flow if a counterparty defaults. Most members of the Committee accept that the correct method of assessing the credit risk on these items is to calculate the current replacement cost by marking to market and to add a factor to represent potential exposure during the remaining life of the contract. Some member countries, however, are concerned about the consistency of this method in relation to the rest of the system which only makes broad distinctions between relative risks for on-balance-sheet items, particularly for banks where these off-balance-sheet items currently constitute only a very small part of the total risks. They would prefer to apply an alternative approach consisting of conversion factors based on the nominal principal sum underlying each contract according to its type and maturity. The Committee has concluded that members will be allowed to choose either of the two methods. The details of the two alternative methods are set out in Annex 3.

III. A TARGET STANDARD RATIO

44. In the light of consultations and preliminary testing of the framework, the Committee is agreed that a minimum standard should be set now which international banks generally will be expected to achieve by the end of the transitional period. It is also agreed that this standard should be set at a level that is consistent with the objective of securing over time soundly-based and consistent capital ratios for all international banks. Accordingly, the Committee confirms that the target standard ratio of capital to weighted risk assets should be set at 8 per cent. (of which the core capital element will be at least 4 per cent.). This is expressed as a common minimum standard which international banks in member countries will be expected to observe by the end of 1992, thus allowing a

transitional period of some four-and-a-half years for any necessary adjustment by banks who need time to build up to those levels. The Committee fully recognises that the transition from existing, sometimes long-established, definitions of capital and methods of measurement towards a new internationally agreed standard will not necessarily be achieved easily or quickly. The full period to end-1992 is available to ensure progressive steps towards adjustment and banks whose ratios are presently below the 8 per cent. standard will not be required to take immediate or precipitate action.

IV. TRANSITIONAL AND IMPLEMENTING ARRANGEMENTS

(i) Transition

45. Certain transitional arrangements have been agreed upon to ensure that there are sustained efforts during the transitional period to build up individual banks' ratios towards the ultimate target standard; and to facilitate smooth adjustment and phasing in of the new arrangements within a wide variety of existing supervisory systems.

46. The transitional period will be from the date of this paper to the end of 1992, by which latter date all banks undertaking significant cross-border business will be expected to meet the standard in full (see paragraph 50 below). In addition, there will be an interim standard to be met by the end of 1990 (see paragraph 49 below).

47. Initially no formal standard or minimum level will be set. It is the general view of the Committee, however, that every encouragement should be given to those banks whose capital levels are at the low end of the range to build up their capital as quickly as possible and the Committee expects there to be no erosion of existing capital standards in individual member countries' banks. Thus, during the transitional period, all banks which need to improve capital levels up to the interim and final standards should not diminish even temporarily their current capital levels (subject to the fluctuations which can occur around the time new capital is raised). A level of 5 per cent. attained by application of the framework and transitional arrangements is considered by some countries to be a reasonable yardstick for the lower capitalised banks to seek to attain in the short term. Individual member countries will, of course, be free to set, and announce, at the outset of the transitional period the level from which they would expect all

their banks to move towards the interim and final target standard. In order to assess and compare progress during the initial period of adjustment to end-1990 in a manner which takes account both of existing supervisory systems and the new arrangements, the Committee and individual supervisory authorities will initially apply the basis of measurement set out in paragraph 48 below.

48. In measuring the capital position of banks at the start of the transitional period, a proportion of the core capital may be made up of supplementary elements up to a maximum of 25 per cent. of core capital elements, reducing to 10 per cent. by end-1990. In addition, throughout the transitional period up to end-1992, subject to more restrictive policies which individual authorities may wish to apply, term subordinated debt may be included without limit as a constituent of supplementary elements and the deduction from tier 1 capital elements in respect of goodwill may be waived.

49. At end-1990 there will be an interim minimum standard of 7.25 per cent. of which at least half should be core capital. However, between end-1990 and end-1992 up to 10 per cent. of the required core elements may be made up of supplementary elements. This means, in round figures, a minimum core capital element of 3.6 per cent., of which tier 1 elements should total at least 3.25 per cent., is to be achieved by the end of 1990. In addition, from end-1990, general loan loss reserves or general provisions which include amounts reflecting lower valuations of assets or latent but unidentified losses present in the balance sheet will be limited to 1.5 percentage points, or exceptionally up to 2.0[6] percentage points, of risk assets within supplementary elements.

50. At end-1992 the transitional period ends. The minimum standard will then be 8 per cent., of which core capital (tier 1, equity and reserves) will be at least 4 per cent., supplementary elements no more than core capital and term subordinated debt within supplementary elements no more than 50 per cent. of tier 1. In addition, general loan loss reserves or general provisions (having the characteristics described in paragraph 49) will be limited at end-1992 to 1.25 percentage points, or exceptionally and temporarily up to 2.0[6] percentage points, within supplementary elements.

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6 These limits would only apply in the event that no agreement is reached on a consistent basis for including unencumbered provisions or reserves in capital (see paragraphs 20 and 21).

For ease of reference, the arrangements described in paragraphs 45 to 50 are summarised in a table at Annex 4.

(ii) Implementation

51. The arrangements described in this document will be implemented at national level at the earliest possible opportunity. Each country will decide the way in which the supervisory authorities will introduce and apply these recommendations in the light of their different legal structures and existing supervisory arrangements. In some countries, changes in the capital régime may be introduced, after consultation, relatively speedily without the need for legislation. Other countries may employ more lengthy procedures, and in some cases these may require legislation. In due course the member states of the European Community will also need to ensure that their own domestic regulations are compatible with the Community's own legislative proposals in this field. None of these factors needs result in any inconsistency in the timing of implementation among member countries. For example, some countries may apply the framework in this report, formally or informally, in parallel with their existing system, certainly during the initial period of transition. In this way banks can be assisted to start the necessary process of adjustment in good time before substantive changes in national systems are formally introduced.

July 1988

Annex 1

Definition of capital included in the capital base

(To apply at end-1992 - see Annex 4
for transitional arrangements)

A. Capital elements

Tier 1 (a) Paid-up share capital/common stock

(b) Disclosed reserves

Tier 2 (a) Undisclosed reserves

(b) Asset revaluation reserves

(c) General provisions/general loan loss reserves

(d) Hybrid (debt/equity) capital instruments

(e) Subordinated term debt

The sum of Tier 1 and Tier 2 elements will be eligible for inclusion in the capital base, subject to the following limits.

B. Limits and restrictions

(i) The total of Tier 2 (supplementary) elements will be limited to a maximum of 100 per cent. of the total of Tier 1 elements;

(ii) subordinated term debt will be limited to a maximum of 50 per cent. of Tierr 1 elements;

(iii) where general provisions/general loan loss reserves include amounts reflecting lower valuations of asset or latent but unidentified losses present in the balance sheet, the amount of such provisions or reserves will be limited to a maximum of 1.25 percentage points, or exceptionally and temporarily up to 2.0 percentage points, of risk assets;[1]

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1 This limit would only apply in the event that no agreement is reached on a consistent basis for including unencumbered provisions or reserves in capital (see paragraphs 20 and 21).

(iv) asset revaluation reserves which take the form of latent gains on unrealised securities (see below) will be subject to a discount of 55 per cent.

C. Deductions from the capital base

From Tier 1: Goodwill

From total capital:

(i) Investments in unconsolidated banking and financial subsidiary companies

N.B. The presumption is that the framework would be applied on a consolidated basis to banking groups.

(ii) Investments in the capital of other banks and financial institutions (at the discretion of national authorities).

D. Definition of capital elements

(i) **Tier 1:** includes only permanent shareholders' equity (issued and fully paid ordinary shares/common stock and perpetual non-cumulative preference shares) and disclosed reserves (created or increased by appropriations of retained earnings or other surplus, e.g. share premiums, retained profit,[2] general reserves and legal reserves). In the case of consolidated accounts, this also includes minority interests in the equity of subsidiaries which are less than wholly owned. This basic definition of capital excludes revaluation reserves and cumulative preference shares.

(ii) **Tier 2: (a) undisclosed reserves** are eligible for inclusion within supplementary elements provided these reserves are accepted by the supervisor. Such reserves consist of that part of the accumulated after-tax surplus of retained profits which banks in some countries may be permitted to maintain as an undisclosed reserve. Apart from the fact that the reserve is

2 Including, at national discretion, allocations to or from reserve during the course of the year from current year's retained profit.

not identified in the published balance sheet, it should have the same high quality and character as a disclosed capital reserve; as such, it should not be encumbered by any provision or other known liability but should be freely and immediately available to meet unforeseen future losses. This definition of undisclosed reserves excludes hidden values arising from holdings of securities in the balance sheet at below current market prices (see below).

(b) **Revaluation** reserves arise in two ways. Firstly, in some countries, banks (and other commercial companies) are permitted to revalue fixed assets, normally their own premises, from time to time in line with the change in market values. In some of these countries the amount of such revaluations is determined by law. Revaluations of this kind are reflected on the face of the balance sheet as a revaluation reserve.

Secondly, hidden values or "latent" revaluation reserves may be present as a result of long-term holdings of equity securities valued in the balance sheet at the historic cost of acquisition.

Both types of revaluation reserve may be included in Tier 2 provided that the assets are prudently valued, fully reflecting the possibility of price fluctuation and forced sale. In the case of "latent" revaluation reserves a discount of 55 per cent. will be applied to the difference between historic cost book value and market value to reflect the potential volatility of this form of unrealised capital and the notional tax charge on it.

(c) **General provisions/general loan loss reserves**: provisions or loan loss reserves held against future, presently unidentified losses are freely available to meet losses which subsequently materialise and therefore qualify for inclusion within supplementary elements. Provisions ascribed to impairment of particular assets or known liabilities should be excluded. Furthermore, where general provisions/general loan loss reserves include amounts reflecting lower valuations of assets or latent but unidentified losses already present in the balance sheet, the amount of such provisions or reserves eligible for inclusion will be limited to a maximum of 1.25 percentage points, or exceptionally and temporarily up to 2.0 percentage points.[3]

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3 This limit would apply in the event that no agreement is reached on a consistent basis for including unencumbered provisions or reserves in capital (see paragraphs 20 and 21).

(d) **Hybrid (debt/equity) capital instruments**. This heading includes a range of instruments which combine characteristics of equity capital and of debt. Their precise specifications differ from country to country, but they should meet the following requirements:

- they are unsecured, subordinated and fully paid-up;
- they are not redeemable at the initiative of the holder or without the prior consent of the supervisory authority;
- they are available to participate in losses without the bank being obliged to cease trading (unlike conventional subordinated debt);
- although the capital instrument may carry an obligation to pay interest that cannot permanently be reduced or waived (unlike dividends on ordinary shareholders' equity), it should allow service obligations to be deferred (as with cumulative preference shares) where the profitability of the bank would not support payment.

Cumulative preference shares, having these characteristics, would be eligible for inclusion in this category. In addition, the following are examples of instruments that may be eligible for inclusion: long-term preferred shares in Canada, titres participatifs and titres subordonnés à durée indéterminée in France, Genussscheine in Germany, perpetual subordinated debt and preference shares in the United Kingdom and mandatory convertible debt instruments in the United States. Debt capital instruments which do not meet these criteria may be eligible for inclusion in item (e).

(e) **Subordinated term debt**: includes conventional unsecured subordinated debt capital instruments with a minimum original fixed term to maturity of over five years and limited life redeemable preference shares. During the last five years to maturity, a cumulative discount (or amortisation) factor of 20 per cent. per year will be applied to reflect the diminishing value of these instruments as a continuing source of strength. Unlike instruments included in item (d), these instruments are not normally available to participate in the losses of a bank which continues trading. For this reason these instruments will be limited to a maximum of 50 per cent. of Tier 1.

Risk weights by category of on-balance-sheet asset

0%	(a)	Cash[1]
	(b)	Claims on central governments and central banks denominated in national currency and funded in that currency
	(c)	Other claims on OECD[2] central governments[3] and central banks
	(d)	Claims collateralised by cash or OECD central-government securities[3] or guaranteed by OECD central governments[4]
0, 10, 20 or 50% (at national discretion)	(a)	Claims on domestic public-sector entities, excluding central government, and loans guaranteed[4] by such entities
20%	(a)	Claims on multilateral development banks (IBRD, IADB, AsDB, AfDB, EIB)[5] and claims guaranteed by, or collateralised by securities issued by such banks[4]
	(b)	Claims on banks incorporated in the OECD and loans guaranteed[4] by OECD incorporated banks

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1 Includes (at national discretion) gold bullion held in own vaults or on an allocated basis to the extent backed by bullion liabilities.

2 The OECD comprises countries which are full members of the OECD or which have concluded special lending arrangements with the IMF associated with the Fund's General Arrangements to Borrow.

3 Some member countries intend to apply weights to securities issued by OECD central governments to take account of investment risk. These weights would, for example, be 10 per cent. for all securities or 10 per cent. for those maturing in up to one year and 20 per cent. for those maturing in over one year.

4 Commercial loans partially guaranteed by these bodies will attract equivalent low weights on that part of the loan which is fully covered. Similarly, loans partially collateralised by cash or securities issued by OECD central governments and multilateral development banks will attract low weights on that part of the loan which is fully covered.

5 Claims on other multilateral development banks in which G-10 countries are shareholding members may, at national discretion, also attract a 20 per cent. weight.

(c) Claims on banks incorporated in countries outside the OECD with a residual maturity of up to one year and loans with a residual maturity of up to one year guaranteed by banks incorporated in countries outside the OECD

(d) Claims on non-domestic OECD public-sector entities, excluding central government, and loans guaranteed[4] by such entities

(e) Cash items in process of collection

50% (a) Loans fully secured by mortgage on residential property that is or will be occupied by the borrower or that is rented

100% (a) Claims on the private sector

(b) Claims on banks incorporated outside the OECD with a residual maturity of over one year

(c) Claims on central governments outside the OECD (unless denominated in national currency - and funded in that currency - see above)

(d) Claims on commercial companies owned by the public sector

(e) Premises, plant and equipment and other fixed assets

(f) Real estate and other investments (including non-consolidated investment participations in other companies)

(g) Capital instruments issued by other banks (unless deducted from capital)

(h) All other assets

Annex 3

Credit conversion factors for off-balance-sheet items

The framework takes account of the credit risk on off-balance-sheet exposures by applying credit conversion factors to the different types of off-balance-sheet instrument or transaction. With the exception of foreign exchange and interest rate related contingencies, the credit conversion factors are set out in the table below. They are derived from the estimated size and likely occurrence of the credit exposure, as well as the relative degree of credit risk as identified in the Committee's paper "The management of banks' off-balance-sheet exposures: a supervisory perspective" issued in March 1986. The credit conversion factors would be multiplied by the weights applicable to the category of the counterparty for an on-balance-sheet transaction (see Annex 2).

	Instruments	Credit conversion factors
1.	Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances)	100%
2.	Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions)	50%
3.	Short-term self-liquidating trade-related contingencies (such as documentary credits collateralised by the underlying shipments)	20%

4.	Sale and repurchase agreements and asset sales with recourse,[1] where the credit risk remains with the bank	100%
5.	Forward asset purchases, forward forward deposits and partly-paid shares and securities,[1] which represent commitments with certain drawdown	100%
6.	Note issuance facilities and revolving underwriting facilities	50%
7.	Other commitments (e.g. formal standby facilities and credit lines) with an original[2] maturity of over one year	50%
8.	Similar commitments with an original[2] maturity of up to one year, or which can be unconditionally cancelled at any time	0%

(N.B. Member countries will have some limited discretion to allocate particular instruments into items 1 to 8 above according to the characteristics of the instrument in the national market.)

Foreign exchange and interest rate related contingencies

The treatment of foreign exchange and interest rate related items needs special attention because banks are not exposed to credit risk for the full face value of their contracts, but only to the potential cost of replacing the cash flow (on contracts showing positive value) if the counterparty defaults. The credit equivalent amounts will depend inter alia on the maturity of the contract and on the volatility of the rates underlying that type of instrument.

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1 These items are to be weighted according to the type of asset and not according to the type of counterparty with whom the transaction has been entered into. Reverse repos (i.e. purchase and resale agreements - where the bank is the receiver of the asset) are to be treated as collateralised loans, reflecting the economic reality of the transaction. The risk is therefore to be measured as an exposure on the counterparty. Where the asset temporarily acquired is a security which attracts a preferential risk weighting, this would be recognised as collateral and the risk weighting would be reduced accordingly.

2 But see footnote 5 in the main text.

Despite the wide range of different instruments in the market, the theoretical basis for assessing the credit risk on all of them has been the same. It has consisted of an analysis of the behaviour of matched pairs of swaps under different volatility assumptions. Since exchange rate contracts involve an exchange of principal on maturity, as well as being generally more volatile, higher conversion factors are proposed for those instruments which feature exchange rate risk. Interest rate contracts[3] are defined to include single-currency interest rate swaps, basis swaps, forward rate agreements, interest rate futures, interest rate options purchased and similar instruments. Exchange rate contracts[3] include cross-currency interest rate swaps, forward foreign exchange contracts, currency futures, currency options purchased and similar instruments. Exchange rate contracts with an original maturity of 14 calendar days or less are excluded.

A majority of G-10 supervisory authorities are of the view that the best way to assess the credit risk on these items is to ask banks to calculate the current replacement cost by marking contracts to market, thus capturing the current exposure without any need for estimation, and then adding a factor (the "add-on") to reflect the potential future exposure over the remaining life of the contract. It has been agreed that, in order to calculate the credit equivalent amount of its off-balance-sheet interest rate and foreign exchange rate instruments under this **current exposure method**, a bank would sum:

- the total replacement cost (obtained by "marking to market") of all its contracts with positive value and
- an amount for potential future credit exposure calculated on the basis of the total notional principal amount of its book, split by residual maturity as follows:

Residual maturity	Interest Rate Contracts	Exchange Rate Contracts
Less than one year	nil	1.0%
One year and over	0.5%	5.0%

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3 Instruments traded on exchanges may be excluded where they are subject to daily margining requirements. Options purchased over the counter are included with the same conversion factors as other instruments, but this decision might be reviewed in the light of future experience.

No potential credit exposure would be calculated for single currency floating/floating interest rate swaps; the credit exposure on these contracts would be evaluated solely on the basis of their mark-to-market value.

A few G-10 supervisors believe that this two-step approach, incorporating a "mark to market" element, is not consistent with the remainder of the capital framework. They favour a simpler method whereby the potential credit exposure is estimated against each type of contract and a notional capital weight allotted, no matter what the market value of the contract might be at a particular reporting date. It has therefore been agreed supervisory authorities should have discretion[4] to apply the alternative method of calculation described below, in which credit conversion factors are derived without reference to the current market price of the instruments. In deciding on what those notional credit conversion factors should be, it has been agreed that a slightly more cautious bias is justified since the current exposure is not being calculated on a regular basis.

In order to arrive at the credit equivalent amount using this **original exposure method**, a bank would simply apply one of the following two sets of conversion factors to the notional principal amounts of each instrument according to the nature of the instrument and its maturity:

Maturity[5]	Interest Rate Contracts	Exchange Rate Contracts
Less than one year	0.5%	2.0%
One year and less than two years	1.0%	5.0% (i.e. 2% + 3%)
For each additional year	1.0%	3.0%

It is emphasised that the above conversion factors, as well as the "add-ons" for the current exposure method, should be regarded as provisional and may be subject to amendment as a result of changes in the volatility of exchange rates and interest rates.

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4 Some national authorities may permit individual banks to choose which method to adopt, it being understood that once a bank had chosen to apply the current exposure method, it would not be allowed to switch back to the original exposure method.

5 For interest rate contracts, there is national discretion as to whether the conversion factors are to be based on original or residual maturity. For exchange rate contracts, the conversion factors are to be calculated according to the original maturity of the instrument.

Careful consideration has been given to the arguments put forward for recognising **netting**, i.e. for weighting the net rather than the gross claims arising out of swaps and similar contracts with the same counterparties. The criterion on which a decision has been based is the status of a netting contract under national bankruptcy regulations. If a liquidator of a failed counterparty has (or may have) the right to unbundle the netted contracts, demanding performance on those contracts favourable to his client and defaulting on unfavourable contracts, there is no reduction in counterparty risk. Accordingly, it has been agreed that:

- banks may net contracts subject to novation,[6] since it appears that counterparty risk is genuinely reduced by the substitution of a novated contract which legally extinguishes the previous obligation. However, since under some national bankruptcy laws liquidators may have the right to unbundle transactions undertaken within a given period under a charge of fraudulent preference, supervisory authorities will have national discretion to require a phase-in period before a novation agreement can be recognised in the weighting framework;
- banks may not for the time being net contracts subject to close-out clauses.[7] The effectiveness of such agreements in an insolvency has not yet been tested in the courts, nor has it been possible to obtain satisfactory legal opinion that liquidators would not be able to overturn them. However, the Committee does not wish to discourage market participants from employing clauses which might well afford protection in certain circumstances in some national jurisdictions and would be prepared to reverse its conclusion if subsequent decisions in the courts support the integrity of close-out netting agreements.[8] In any event, the Committee will continue its work to assess the acceptability of various forms of netting.

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6 Netting by novation as defined in this context is a bilateral contract between two counterparties under which any obligation to each other to deliver a given currency on a given date is automatically amalgamated with all other obligations for the same currency and value date, legally substituting one single net amount for the previous gross obligations.

7 Close-out as defined in this context refers to a bilateral contract which provides that, if one of the counterparties is wound up, the outstanding obligations between the two are accelerated and netted to determine the counterparty's net exposure.

8 The other principal form of netting, payments netting, which is designed to reduce the counterparty risk arising out of daily settlements, will not be recognised in the capital framework since the counterparty's gross obligations are not in any way affected.

Once the bank has calculated the credit equivalent amounts, whether according to the current or the original exposure method, they are to be **weighted** according to the category of counterparty in the same way as in the main framework, including concessionary weighting in respect of exposures backed by eligible guarantees and collateral. In addition, since most counterparties in these markets, particularly for long-term contracts, tend to be first-class names, it has been agreed that a 50 per cent. weight will be applied in respect of counterparties which would otherwise attract a 100 per cent. weight.[9] However, the Committee will keep a close eye on the credit quality of participants in these markets and reserves the right to raise the weights if average credit quality deteriorates or if loss experience increases.

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9 Some member countries reserve the right to apply the full 100 per cent. weight.

Transitional arrangements

Annex 4

	Initial	End-1990	End-1992
1. Minimum standard	The level prevailing at end-1987.	7.25%	8.0%
2. Measurement formula	Core elements plus 100%	Core elements plus 100% (3.625% plus 3.625%)	Core elements plus 100% (4% plus 4%)
3. Supplementary elements included in core	Maximum 25% of total core	Maximum 10% of total core (i.e. 0.36%)	None
4. Limit on general loan loss reserves in supplementary elements*	No limit	1.5 percentage points, or exceptionally up to 2.0 percentage points	1.25 percentage points, or exceptionally and temporarily up to 2.0 percentage points
5. Limit on term subordinated debt in supplementary elements	No limit (at discretion)	No limit (at discretion)	Maximum of 50% of Tier 1
6. Deduction for goodwill	Deducted from Tier 1 (at discretion)	Deducted from Tier 1 (at discretion)	Deducted from Tier 1

* This limit would only apply in the event that no agreement is reached on a consistent basis for including unencumbered provisions or reserves in capital (see paragraphs 20 and 21).