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RELAXATION OF EXCHANGE CONTROL MEASURES 1979

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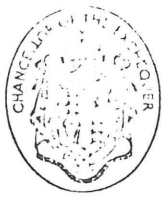

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Minister of State (Lords)
Mr. Couzens
Sir Lawrence Airey
Mr. Barratt
Mr. Littler
Mr. Bridgeman
Mr. Hancock

PS/SIR DOUGLAS WASS

NB cc Mr. Gill
Mr. Hodges
Mrs. Lomax.

D.H.
8/5.

CALL BY THE GOVERNOR OF THE BANK OF ENGLAND

The Governor will be calling on the Chancellor at the Treasury at 9.15 tomorrow morning, Wednesday 9th May. This will not be merely a courtesy call; he will wish to discuss policy matters raised in briefing the Bank has already provided for the Chancellor.

2. The Chancellor would be grateful for briefing by close of play tonight, and for advice on official support; it is possible that the Governor will wish to bring Messrs. Fforde and Kelleher; no doubt this aspect can be sorted out with the Governor's office.

MMM.

(M.A. [illegible])
8th May, [illegible]

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TELEPHONE
01 601 4444

BANK OF ENGLAND
LONDON EC2R 8AH

4th May, 1979.

My dear Chancellor,

I enclose a short paper giving some account of recent developments in the sterling exchange rate and some of the policy issues involved in managing it. You will see from this that we believe that the existence of North Sea oil is likely over the longer term to imply a rather deepseated problem of over-valuation of sterling in some sense, even if in the shorter term the present buoyancy of sterling in the markets is not maintained.

In general there are strict limits on our ability to move the exchange rate to any particular desired level. In the circumstances, however, there is a strong case for significant relaxation of exchange control. On this we have prepared a separate paper outlining a series of proposals which might be implemented at a relatively early date, perhaps at the time of the Budget. I should be glad to let you have this paper and discuss it with you whenever you are ready to receive it.

The enclosed note does not deal with the immediate situation. As I write in the wake of the Conservative victory, the rate is $2.0760, 67.3 effective. We have over the past month somewhat changed our tactics in the markets and have been intervening relatively little. This was partly to reduce the possibility of very heavy inflows, not least during the election campaign; but it also reflected a feeling that our previous tactics had become a little too predictable and that by resisting upward movements we were in danger perhaps of encouraging rather than reducing pressure.

Since the rate has already reached levels which are widely regarded as high, it may be that we shall not see much more buoyancy. In any case I think we should continue to stick

to our present line as offering the best chance that any upward movement will blow itself out. If we encountered persistent upward pressure we might have to consider whether to increase our rate of intervention again.

We have considered whether in these circumstances it would be possible to implement immediately some form of exchange control liberalisation, perhaps on an explicitly temporary basis. We have concluded, however, that this would not be a wise course; it would risk looking clumsy or hasty, granted the general expectation that you will be announcing significant measures of relaxation fairly soon; and there is in fact very little scope for useful temporary action. Moreover, the necessity to consider detailed implications, draft and print Notices, etc., means that it is likely to be unwise to introduce significant exchange control relaxations without allowing several weeks before implementation.

There is also the opposite possibility that either because the markets prove already fairly fully to have discounted a Conservative victory or because of unforeseen developments elsewhere, the rate may come under sharp downward pressure. Here too I would be inclined to let it move fairly freely for several cents; but, if a fall went on, would wish at some point to show some resistance to prevent the risk of a bandwagon effect developing.

I would welcome an early chance to discuss our broad exchange rate strategy. In the light of this I should be able to judge whether our present tactics need any modification to ensure that the strategy is successfully implemented.

Yours sincerely

Gordon Richardson

The Chancellor of the Exchequer.

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Boxes 1st paragraph
"v. difficult to
Both
main forum"

Exchange Rate Policy

1. Developments in recent years have led to a good deal of scepticism about the possibilities of actively managing an exchange rate, as many governments have tried and failed to resist the force of mobile currency flows. Total scepticism is not justified. The events of November and December last year affecting the dollar showed that at the right moment, and on the back of some more fundamental policy measures, very heavy and concerted intervention can change market expectations and validate, at least for a time, a particular pattern of exchange rates. (Total intervention in support of the dollar in November and December amounted to some $15 billion, virtually all of which has now been reversed.) But this is a long way from fine tuning an exchange rate, or from successfully pushing it up or down and then sustaining it at a desired level.

2. As exchange rates have become harder to control, they appear to have become weaker than was earlier believed in helping to bring about international adjustment, i.e. in affecting trade flows in a way that narrows payments imbalances. Cost and price effects appear to work through many economies relatively quickly -- in both directions. As a result the polarisation of countries into strong and weak blocs has been continued. The currency of a fundamentally strong economy - with productivity high and rapidly growing, relatively little inflation and a tendency to external surplus - will tend to appreciate in nominal terms, but the consequences may turn out to be a further improvement in its domestic cost and price structure and so a smaller deterioration in its external competitiveness. A weak economy may on the other hand see a smaller effect from its depreciating currency on its trade, partly because of an acceleration of its inflation. Thus, despite the [illegible] exchange rate [illegible] of recent years, the imbalances in world trade are only now [illegible] signs of diminishing.

3. Faced with these facts many countries have recently opted simply for aiming, through appropriate monetary policies and some intervention, at as much exchange rate stability as they could achieve, but with a very real awareness of the limitations of their power. In some cases the exchange rate has been left to move a fair way until it is judged that a point has been reached at which forceful official action can stabilise it: e.g. the US measures of 1st November. An alternative approach, exemplified in the emergence of EMS and the UK's own policies since the beginning of 1977 has been to lean against short run market trends (with both policy measures and intervention) but be prepared in the end to let the rate move if underlying pressures prove too strong.

4. Developments for sterling over the past couple of years illustrate this point. For the first ten months of 1977 fairly continuous upward pressure on sterling was resisted by the authorities with the twin aims of recreating a climate of stability after the violent moves in 1976 and of building up the reserves. These rose from $4 billion to over $20 billion, while sterling was held in the range $1.71-1.77¾, or 61½-62½ in effective terms. By the end of October, however, the pressures had with the dollar's weakness become virtually irresistible and the achievement of the authorities' domestic monetary objectives was being seriously threatened. The rate was therefore allowed to move freely, with intervention confined to minor smoothing operations, and the pound reached a peak of over $1.99 or 67.0 in January. In the spring, and especially after the Budget, there was substantial downward pressure from the markets: after appreciable official support, sterling ended April at around $1.83 or 61.4. For the rest of 1978 the pound moved relatively narrowly between 61 and 64, though as a result of first the marked weakness of the dollar and later its recovery, the dollar rate for sterling moved sharply. It reached a peak of just over $2.10 at the end of October, falling back as far as $1.92 as the US measures of 1st November and subsequent intervention reversed the fall in the dollar generally and ending the year at $2.04 or 64.1. Thus, over two years of great general turbulence in exchange markets, necessarily involving significant movements in the dollar rate for sterling, the rate was held in effective terms, except for relatively brief periods within the range of 61 to 64.

5. This year, however, there has been renewed upward pressure, especially since the revolution in Iran. After initial resistance the authorities decided on 5th April to let the rate move relatively freely again. There was an immediate rise to nearly $2.11 and 68.0, the highest level for three years. But it soon fell back again; and after various fluctuations during the election campaign, it closed today at $2.07½ and 67.3 - very much the same level as a month ago when we modified our intervention policy.

6. Even at these levels, however, the present and prospective position of sterling is in some ways unsatisfactory for perhaps two main reasons - one of which is likely to be temporary while the other is more deepseated. At present, exchange markets show a somewhat paradoxical picture with the fundamentally strong currencies - the DM, the Swiss franc and, especially, the yen - all exhibiting signs of weakness while the fundamentally weak currencies (or at least those belonging to countries with high inflation and low productivity) are relatively firm: examples are the dollar, the lira and the pound. The expectations of a period of broad exchange rate stability, which the November-December measures appear to have engendered, have allowed interest-rate differentials to affect capital flows in a way that they are powerless to do when prospects of immediate capital gain dominate exchange markets. Countries with higher inflation rates have tended to have higher interest rates and so attract inflows.

7. This has been especially true of sterling, where interest rates that have been necessary in the interests of money supply control against a background of a high [illegible] and relatively high and perhaps rising inflation, have looked very attractive in international terms. This has been one factor in the relative buoyancy of sterling over the past few months. How long it will persist is very difficult to predict. The stronger currencies are already beginning to raise their own interest rates and to exert tighter control over their money supplies. In this, interest

rates may also rise further, though before too long the likely onset of recession there could limit and then reverse such a movement. In due course, if the recession is at all deep, its effect on the US deficit may substantially strengthen the dollar. The net effect of all these developments is hard to assess. But one may perhaps guess that at some point, if inflation in the UK continues significantly above the average of its competitors and the current account remains in bare balance or even deficit, some downward pressure on sterling will emerge.

8. There is, however, a quite different factor in determining the strength of sterling - more deepseated and likely to prove much more long lasting: the upward pressure from the existence of North Sea oil, a factor which has increased in importance since the Iranian revolution and the subsequent increases in oil prices. This upward pressure is likely to persist and may increase as the value of output from the North Sea rises.

9. The fact that an underlying upward pressure from North Sea oil on the exchange rate is likely to persist does not of course mean that sterling is bound to remain high in absolute terms. Downward pressures from the factors mentioned earlier may outweigh the oil effect. What it means is rather that sterling may become - indeed may already be - "too high". To say this is not to deny the counter-inflationary benefits of a high exchange rate; nor is it to imply that a firm and unambiguous view can be taken of the "right" exchange rate and the "right" degree of competitiveness for British industry. The point is rather that the boost to sterling from favourable market sentiment linked, in particular, to North Sea oil, has produced a rate level that is unlikely to be compatible - save over a fairly short period - with maintenance of even the present viability of parts of non-oil manufacturing. Specifically, a rate higher than would be produced by productivity, cost and price developments in the economy as a whole* is likely in due course to reduce or squeeze out areas of activity that could remain competitive but for the artificial boost to the rate.

*Oil production in the North Sea is of course not entirely separate from the UK economy: it generates some UK employment and activity and has various spillover effects. But economic links with the economy as a whole are very small relative to its balance of payments and public revenue effects.

10. A high exchange rate, whatever its causes, will provide assistance in counter-inflation, both directly through lower import costs and indirectly through the disciplinary effect on wage settlements. But the effect on industry's investment, innovation, export capacity and indeed survival will be different according to whether the high rate comes "organically", at least partly as a consequence of the initial strengths of industry itself, or artificially, when it may be imposed on industries which are inherently weak.

11. It is likely therefore that the UK would be better off with a somewhat lower exchange rate than is likely to emerge if no action is taken to influence it. On the other hand, it is, as was stressed at the outset, extremely difficult to move exchange rates a particular distance in any direction. Stability is a benefit in itself, whatever level is being maintained, and any attempt to move the sterling rate in a world of floating exchange rates could involve unacceptable risks of losing stability. It would, moreover, be a reversal of the appropriate priorities to attempt to modify money supply policies in the interests of the exchange rate in a way different from that demanded by domestic priorities.

12. There is thus in practice likely to be relatively little freedom of manoeuvre. We should emphatically not recommend a course, sometimes suggested, that the exchange rate could be reduced below what it would otherwise be by a more aggressive intervention policy: i.e. actively selling sterling at a time when there was no natural market demand for it. It is something we have never done, because of the dangers of destabilising the exchange rate which such a policy would involve. With a widely used and widely held currency the utmost care must always be exercised in official sales of it - a lesson which the Americans learned the hard way during 1978.

13. However, there are certain possibilities. It is paradoxical in the UK's present circumstances to be maintaining the artificial boost of exchange control, designed for the opposite circumstances in which, by virtue of prolonged weakness in both the current account and the external liquidity position, sterling was judged to be chronically weak. There are many arguments for a more liberal exchange control regime than that operated at present.

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In particular, given the difficulties of rapidly stimulating domestic investment, it would seem appropriate to enable at least part of the value of the wasting asset of North Sea oil to be converted into external assets which will yield the UK a return when the oil has run out. But apart from all the broader considerations there is a strong case for relaxation, simply as a potential means of moderating upward pressure on the rate. A separate brief is available with a proposed package of relaxations which could produce, in certain circumstances, a significant outflow of exchange or downward pressure on sterling. It must be emphasised, however, that the effects of exchange control liberalisation on the exchange rate are bound to be uncertain; and, unfortunately, are likely to be less effective when confidence is strongest and more effective when it weakens.

14. A rather different approach to the problem might be sought in due course in joining the intervention mechanism of EMS. It is conceivable that this might make it easier for the authorities to hold the exchange rate at a level judged appropriate, withs better both upward and downward pressures. Again, however must be very uncertain. If there are strong market pressu either direction, membership of the EMS regime may greatly domestic monetary management. Thus this step would need careful consideration and is in any case not recommended for early decision.

15. The conclusion must be that apart from acting structurally on exchange control or a move into a fixed rate regime, which would have other disadvantages, there is little scope for positive action on the exchange rate. The future development of sterling is very difficult to forecast. Whether it strengthens further, or eases from its present position of strength, it could and should be an object of policy to moderate fluctuations, but there are strict limits as to how far one can go in resisting fundamental trends.

4th May 1979.

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For Information:

Chief Secretary
Financial Secretary
Minister of State
Minister of State (Lords)
Sir Douglas Wass
Sir Lawrence Airey
Mr Barratt
Mr Littler
Mr Bridgeman
Mrs Hedley-Miller
Mr Middleton
Mr Hancock
Mr Gill
Mr Hodges

CHANCELLOR OF THE EXCHEQUER

CALL BY THE GOVERNOR OF THE BANK OF ENGLAND

You will no doubt wish to have some preliminary discussion with the Governor, at tomorrow's meeting, about his letter and paper dated 4 May which deal with the sterling exchange rate and exchange control policy.

2. The positions of OF and the Bank of England are very close on these issues. So far as intervention policy is concerned, the Governor's recommendations in his covering letter are fully consistent with the advice in paragraphs 6 and 7 of my submission of 4 May. In particular we agree that:-

i. if the rate tends to move up again, intervention should be modest in the hope that the upward pressure will quickly blow itself out;

ii. if the rate falls, the Bank should let it fall back quite a long way before stepping in to check the momentum of any sustained fall.

3. So far as exchange control policy is concerned, you will wish to know that we have in hand a submission describing a possible package of relaxations. We shall be discussing it with the Bank in the next day or so and this will give us a chance to establish whether our ideas differ from theirs in any significant degree. I hope to let you have the submission before the end of this week.

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4. I do not suppose that you or the Governor will wish to discuss exchange control policy in detail tomorrow. However you might perhaps say that you will need to look at the final composition of the package of relaxations in the light of the Budget decisions and their likely impact on the exchange market. You might also say that you will need to consult certain of your colleagues about any exchange control measures - probably the Prime Minister and the Secretaries of State for Industry and Trade whose Departments have a strong interest.

5. If the Budget is to be on 12 June, there should be ample time for Ministers to consider the matter on the basis of the submissions from the Treasury and the Bank and for you to make an announcement in the Budget. If the Budget Day were brought forward to 5 June, the timetable would be more compressed but we still think it would be manageable.

6. We agree with the Governor that there is no point in an emergency relaxation of exchange controls. It would be very much better to wait until you can announce a balanced and considered package, preferably in the Budget context. And the rate is no longer rising at present: it fell back somewhat today.

7. In paragraph 14 of the Bank paper, reference is made to the European Monetary System. We agree with the comment that, if there were strong market pressures in either direction, membership of the EMS exchange rate regime could complicate domestic monetary management. This point is made in the draft private secretary letter to No 10 submitted today for the Prime Minister's briefing meeting on Chancellor Schmidt's visit.

K E COUZENS
8 May 1979

Mr Hodges
PS/CSC
PS/FSC
PS/MSC (C)
PS/MSC (L)
Sir D Wass
Mr Coogans
Mr Jordan-Moss
Mr Barratt
Mr Hancock
Mr Gill
Mr Middleton

Copies sent 9/5 PCH

17/5

10 DOWNING STREET

From the Private Secretary

9 May 1979

Dear Tony,

The Prime Minister has received the enclosed note from Mr. Douglas Hague on exchange controls. She would be grateful if the Chancellor would take Mr. Hague's suggestions into account in formulating his own proposals for the relaxation of exchange controls.

The Prime Minister is sure the Chancellor will wish to consult with the Governor on this subject, and I am therefore sending a copy of Mr. Hague's note to John Beverly (Governor's office).

Yours ever,

T. L. Lankester

A.M.W. Battishill, Esq.,
HM Treasury.

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TO: The Prime Minister

FROM: Douglas Hague

c.c. Chancellor of the Exchequer,
Treasury Chambers,
Great George Street, S.W.1.

DATE: 4th May 1979.

EXCHANGE CONTROL

The strength of the pound presents both an opportunity and a challenge.

The opportunity is to give the market a greater influence on the capital account of the balance of payments. Individuals and businesses should be given a greater role relative to the Treasury and Bank of England in deciding how a current balance of payments surplus should be offset, on capital account.

The challenge is to find a way of preventing the exchange rate rising too far too quickly, because of the difficulties that a high rate would cause for non-oil exporting industries. Again, the market should play a greater role, and the monetary authorities a smaller one, in determining what happens. We should therefore begin to relax exchange control.

Exchange control affects three main types of transaction:

a) finance of third-country trade in sterling;

b) direct investment overseas by U.K. companies;

c) portfolio and property investment through the dollar-premium pool.

A. Third-Country Finance

Until 1976, this was an important source of revenue for the U.K., with sterling used, for example, to finance exports of sugar from Cuba to Poland. Estimates of the amount of sterling involved range from £500m to more than £1b. Since a ban was put on the use of sterling to finance such trade, most of it has been financed in Euro-dollars. It will therefore be difficult to get back into the market, but many people in the City badly want to try. Because of this, the amount of sterling required to get back into the market would be less than £200m, but there would be a useful return on this once-for-all investment to the U.K. I recommend that we should permit third-country financing again.

B. Direct Investment

The outflow here would be larger - £300m per annum or less. The Bank of England is apparently taking a generous view of applications for finance for direct investment overseas. I recommend that this part of the exchange control system should also be abolished.

If we do so, the trade unions will argue that investment which might have taken place in the U.K. is going abroad. The answer is that this is not an either/or question. If we allow more investment overseas and that lowers the exchange rate, we shall have more investment in export industries within the U.K. as well.

C. Investment through the dollar premium

Those I have spoken to in the City agree that this type of exchange control should also be abolished, when possible, however, they worry lest relaxation here should lead to so big a capital outflow that it has to be reimposed. Phillips and Drew estimate tht total value of the portfolios of U.K. institutions (pension funds, insurance companies, investment trusts and unit trusts) at £100b, with about £8b per annum available for investment. If one adds what individuals might invest in securities and property, there is a large potential outflow.

I suggest a way of estimating the possible scale of outflow without taking an irreversable step. We could relax exchange control here, by arranging for the Bank of England to transfer foreign exchange into the premium-currency pool. One would want to give investors some indication of what was happening, perhaps by indicating the amount to be put into the pool in the next twelve months. The attraction of this idea is that one could quietly discover how much one had to put into the pool to reduce the dollar premium by a given amount. Indeed, in the end, one might be able to reduce the dollar premium to zero, and thus discover the cost of removing this type of control entirely.

I therefore suggest it as a way of moving towards the total abolition of exchange control without the risks involved in doing so completely and overtly. If the current account went into deficit, one could end, or even reverse, the procedure.

There is of course a good deal of economic theory and research lying behind this paper. I shall be delighted to go into more detail if asked.

P. C. M.

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cc: Chief Secretary
Financial Secretary
Minister of State
Minister of State (Lords)
Sir Douglas Wass
Mr. Couzens
Mr. Jordan Moss
Mr. Barratt
Mr. Hancock
Mr. Gill
Mr. Middleton
Mr. Ramell

MR. HODGES

PROFESSOR DOUGLAS HAGUE

The Chancellor has seen the copy which Professor Hague sent to him of his memorandum to the Prime Minister dated 4th May. You have the action copy under a No.10 letter of 9th May.

2. The Chancellor has commented that Professor Hague has been helping the Prime Minister as an advisor and sometimes as speech writer, and will certainly expect a personalised reply. I will acknowledge the Chancellor's copy, but perhaps you could draft a reply for the Prime Minister's signature. The Chancellor has also asked whether Professor Hague's ideas deserve serious consideration.

(M.A. HALL)
10th May, 1979

68/5

IL 15: 84/04B

SECRET

BANK OF ENGLAND (Space).
Threadneedle Street
London
EC2R 8AH

CH/EXCHEQUER
REC. 11 MAY 1979
ACTION Mr Byatt
COPIES TO CST FST PST (C) PST (L) SIR D WASS ~~SIR L AIREY~~ Mr LITTLER Mr MIDDLETON

EETCS 11 JUN 1979 31/79 TP

11th May 1979.

Mr Hancock
cc Mr. Couzens
Mr. Barratt.
Yes, I presume.

Yes.

D.H. 15/5.

My dear Chancellor,

I enclose, as promised, a note on policy towards exchange control. This argues that, in the light of the major changes in the United Kingdom's external liquidity and balance of payments position in recent years, it would be right to make an early and substantial move towards relaxation. A proposed package of measures is enclosed; but this should I think be regarded very much as a first shot. As the weakness of the exchange and domestic markets in recent days has demonstrated, we may be in for quite a difficult period for some time. I believe that it will be right to decide precisely how far it is appropriate to go on exchange control relaxation at this stage only in the light of the general thrust of all of the Government's financial and economic policies as they emerge, especially in your forthcoming budget.

Perhaps I may comment here, however, on certain features of our proposals. I believe it is important to lay as much emphasis as possible on relaxations which are likely to help business; which are least likely to lead to volatile flows; which are likely most to reduce the burden of administration; and which are most urgently required to meet our EEC obligations. At the same time I believe we should be extremely cautious in relaxing at this stage controls over potentially volatile flows.

These considerations mean moving fairly far towards full freedom for outward direct capital and personal transactions while for the time being making only minimal adjustments to our regime for portfolio investment. Unfortunately this implies that while

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in practice most reasonable non-portfolio transactions by business and persons are allowed ceilings will have to be maintained to enable monitoring to continue to avoid circumventions of the restrictions on portfolio investment.

The question of relaxing our restrictions on sterling finance of third country trade is a difficult one. On the one hand, this is pre-eminently an area of potentially volatile flows: it greatly added to our difficulties in 1976. On the other hand, there is persistent pressure from the merchants and banks for liberalisation; and certainly, in the case of the merchants, inability to use their own currency is proving a burden. Our suggestion is that we attempt to meet the conflicting considerations involved by allowing both merchants and banks to use sterling for financing third country trade, but under supervision and not to an unlimited extent. We are reasonably confident that a regime of this kind which would go a long way to satisfying their demands could be devised and operated for merchants who, as I have said, have been particularly hard hit. For banks, however, the position is more difficult and, I am bound to say, less urgent in the sense that we believe the hardship involved here is less. We are exploring ways in which we could implement and monitor individual ceilings for banks which would be sensible and equitable but I should warn you that we do not yet feel completely confident that it would be possible to propose a fully satisfactory scheme. We shall need to talk to the banks to be certain.

Since our paper was drafted we have received a note by Mr.Hague to the Prime Minister of 4th May in which he puts forward the idea of "feeding" the premium market from official reserves. I would like, if I may, to give you a considered response to this suggestion on its merits in due course. I would only say now that this does not seem to me a likely candidate for immediate action if only because our firm understanding (arising out of an earlier consideration) is that it would need legislation to allow the reserves to be used in this way.

Yours sincerely

Gordon Richardson

The Rt.Hon.Sir Geoffrey Howe, QC, MP.

Policy towards Exchange Control

1. Exchange control has now been in continuous operation - though the severity of the regime has varied from time to time - for forty years. A brief description of the present regime is attached as Appendix 1 to this paper.

2. Throughout almost all of the past forty years, sterling has been weak or potentially weak. The current account has never been strong - and, for the years after the OPEC price rise, was in large deficit. But more important than the weakness of the current account has been - for most of the period - the weakness of the UK's external liquidity position. The reserves have been exiguous on almost any criterion, while there have been large external liabilities - both publicly and privately held - which were short-term in form and potentially volatile.

3. These underlying conditions help to explain why UK exchange control has been more severe than that in any other industrialised country (except perhaps Sweden). (A short account of the exchange control regimes operated in other Group of Ten countries is attached as Appendix 2 in case it is useful: but it is not suggested that the Chancellor read it.) The underlying conditions also explain the form which the UK's exchange control has taken.

4. In recent years there have been no restrictions on current transactions. Thus exchange control has not been used to influence the current balance directly - though over the longer term there must have been many indirect effects on the current account, especially on net interest, profits and dividends, which have probably been on balance adverse.

5. The primary aim of exchange control has in fact been to affect the structure of the UK's external asset/liability position in various ways. There have been continuous attempts to improve the liquidity of the UK's external balance sheet or prevent its deterioration. In particular, there has been a consistent aim to increase the holdings of official reserves rather than the holdings of net external assets by the private sector. There has also been a continuing concern to minimise the exposure of the UK overall balance of payments to volatile capital movements (though there has not, in recent times, been any attempt to constrain the ability of non-residents to withdraw funds from this country).

6. This does not fully describe the purposes to which exchange control has been put. For a few months at the end of 1971, before the Smithsonian agreement, exchange controls were used to deter inflows in order to relieve the upward pressure on the exchange rate; but this was exceptional and increasingly unsuccessful. Exchange controls also serve other purposes. For example, the control over banks' foreign exchange dealing positions which is necessary for external policy reasons, is also necessary for prudential reasons. Similarly, the exchange control regime devised for the commodity markets also facilitates supervision of these markets by the Bank. While in principle such matters could be handled in other ways, the Exchange Control Act has in practice been a convenient way of doing so.

7. These special considerations apart, one may say that the underlying thrust of exchange control has been to enable the authorities to have more control over the exchange rate against downward pressure and more ability to withstand short-term volatile pressures. The fact that non-resident movements have not been controlled has, however, strictly limited the extent to which the authorities have in practice been able to withstand or moderate the pressures from volatile flows. It is also perhaps fair to say that exchange control has necessarily concentrated on the short-term at the expense of longer-term considerations.

8. Over the past couple of years there have been some major changes in the UK's external position. The reserves have risen from around $5 billion at the end of 1976 to over $21½ billion at present (though part of this improvement represents a revaluation of gold and non-dollar components). On the liabilities side, there is $23½ billion of official debt outstanding; but this is contractual and with repayment dates reasonably spread over time. The official sterling balances have, on the other hand, been run down to, effectively, working levels; and the UK is committed to keeping them there. Private sterling holdings have continued to rise year by year to stand now at £5½ billion; but these have in the past not proved very volatile: for example, they did not fall even in 1976. Thus the structure and liquidity of the capital account has notably improved.

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Despite this, the UK economy remains vulnerable to short-term capital flows in both directions. Sterling's role as a reserve currency has been virtually abolished, but the facilities of the City of London mean that it is still widely held and traded in, so that there is more scope for substantial volatile movements in sterling than for the currency of any other industrial country except the US and perhaps Germany and Switzerland.

9. The current account has also greatly strengthened: after a number of years of deficits on a substantial scale (the UK ran a cumulative deficit of £7½ billion from 1973 to 1976) we are now roughly in balance or perhaps small surplus. Two special factors, working in opposite directions, have been of great importance here. On the one hand, North Sea oil is now contributing £4½ billion per annum to the current account - and the contribution is likely to rise steadily to reach £8½ billion (at 1977 prices) in 1985. On the other hand, our net contribution to the EEC Budget is likely to amount to £780 million this year. Over time, the net effect of these two factors seems certain to be strongly and increasingly positive, both on the current balance and, more pervasively, on market sentiment. The result is likely to be a tendency to hold the exchange rate higher than the general condition of the non-oil economy and the non-oil balance of payments would otherwise imply.

10. This does not mean that we can necessarily expect the exchange rate to remain strong, as it has been in recent weeks. The non-oil balance of payments is in serious deficit and may well deteriorate further, so that there is no guarantee that the current account as a whole will remain in surplus. But even if the exchange rate should show a tendency to weakness, it is a reasonable guess that, over the next few years, market forces, together with appropriate domestic policies, will result in an exchange rate judged to be too high rather than one which is judged too low. (Our separate brief on exchange rate policy dated 4th May argued this point in greater depth.)

11. The foregoing suggests two broad conclusions for exchange control policy. First, that the UK's external balance sheet and the

forces acting on the sterling exchange rate have altered radically from those which have broadly pertained since the war and which have provided a principal justification for the present exchange control regime. But, secondly, that the rate is nevertheless likely to remain fragile and its prospects uncertain, so that one must be cautious in removing too completely or too rapidly the whole array of measures which have hitherto helped to provide some stability for the rate. Such arguments for caution are reinforced by the fact that after forty years of continuous control it is impossible to say in advance how big any reaction to their total abolition might be; and by the thought that it would be embarrassing and might indeed be difficult to re-impose the previous degree of control after it had been relaxed.

12. The situation therefore would seem to call for a substantial initial package of relaxations, but stopping well short of complete abolition and concentrating on those measures which are likely to produce the most long-term benefit to the UK or to get rid of those features of the present regime which are particularly widely disliked or particularly burdensome to administer. At the same time it would seem wise to proceed more cautiously towards those controls aimed particularly at limiting volatile flows.

13. A package aimed at meeting these various criteria is set out at the end of this note. Broadly it recommends major relaxations in the fields of outward direct investment and personal transactions; some movement towards the restoration of the use of sterling by both merchants and banks for third country trade; and only minor relaxations in control over outward portfolio investment. The intention of the package would essentially be to allow all reasonably-sized non-portfolio capital transactions by companies and persons. However, while a regime of control over portfolio investment is maintained, it will be necessary to keep ceilings on all non-portfolio transactions and to continue to monitor them, to prevent a complete circumvention of the rules for portfolio. This necessity will unfortunately limit the degree to which savings in administration can be made in both the Bank of England and in the commercial banks at this first stage.

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14. In the light of the reactions to this package of measures and developments in the UK economy and balance of payments it is to be hoped that it will be possible to proceed steadily by further stages towards effectively getting rid of exchange control altogether. In any event we would hope to follow the proposed package with a series of second-order changes aimed at simplifying the regime and its administration.

15. The proposals recommended for the initial package are listed in broad terms with, in each case, some comments on their nature and significance and estimate of their maximum potential outflow effect. It should be emphasised that these estimates can be little more than guesses. In particular, if sterling were to be very strong there might be little outflow at all. Moreover, of course, if it were decided to let the relaxations fully affect the exchange rate directly, there would be no official intervention to meet the demands for foreign currency and hence no outflows, simply a downward pressure on the rate. Subject to these caveats, the maximum potential outflow in the first full year (if it were met with official exchange) might be, say, £1½ billion, of which about half would be once and for all.

16. These relaxations should be welcome to our partners in the EEC. We have of course a Treaty obligation to liberalise many specific forms of capital movements within the EEC although the more obvious types of potentially volatile movements are excluded. Under the terms of our Accession, we should long since have freed from restriction outward direct and portfolio investment, emigration, gifts and holiday homes. We have in fact been authorised by the Commission to maintain restrictions in these areas on grounds of our balance of payments difficulties. This case increasingly lacks conviction and is in any event due to be reviewed by the Commission before end-September. It seems likely that if something like the package of relaxations proposed in this note had by then been implemented we would receive authority to maintain our remaining restrictions for a further period. We might, however, meet some pressure from the Commission to make specific relaxations for intra EEC transactions. We should resist this. Our proposals are for worldwide relaxation. This is not only justifiable on its own merits, but it will also improve our standing under the

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OECD code and, in particular, avert US protests about UK discrimination against them in matters of exchange control - on which subject they have already shown themselves to be sensitive.

17. Finally, it is obvious that relaxations cannot be decided on and introduced overnight. Detailed policies have to be agreed and Notices drafted and printed: ill-prepared relaxations could be damaging to the Government and to the Bank. The time necessary to implement a decision to alter an existing control obviously depends on the complexity of what is proposed. In particular, the proposal to reintroduce sterling finance for third country trade will need to be discussed with the banks and with the various representative bodies of the merchants before it can be fully articulated and implemented. In the case of other changes, it would be our objective to implement immediately after announcement if at all possible.

11th May 1979.

SCHEDULE OF PROPOSED EXCHANGE CONTROL RELAXATIONS

Area of relaxation	Proposed measure	Comments
1. Outward direct investment Estimated maximum potential outflow: £700 mn. annually.	(a) A generous ration of official exchange (say, £5 mn. per project per annum) for new outward direct investment as currently defined (i.e., expertise by the investor and participation in management).	Authorisation by Bank of England is still necessary to rule ou disguised portfolio but possible to delegate provision of additional capital for existing investments.
	(b) Existing borrowing repayable in five equal annual instalments. (New borrowing repayable over five years to the extent that repayment cannot be met from the ration.)	Authorisation by Bank of England necessary.
	(c) Abandon the two-thirds requirement.	This rule is burdensome administrativel and causes a good deal of bad feeling with those investors who are subject to it. (It applies only where the UK parent has a majority shareholding.)
2. Outward portfolio investment		
(a) Estimated at a maximum of £50 mn. annually.	(a) Official exchange to be allowed to meet the interest on foreign currency borrowing taken to finance portfolio investment.	At present interest has to be met from the income and any shortfall from investment currency.
(b) Nil	(b) In the case of portfolios financed by borrowing, investors no longer to be required to maintain cover in the form of foreign currency securities, the market value of which is at least equal to 115% of the borrowing.	Both of these changes will tend to reduce the premium in the investment currency market by encouragin the use of borrowing and, in the second case, by releasing premiumworthy securities.

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SCHEDULE OF PROPOSED EXCHANGE CONTROL RELAXATIONS (CONTINUED)

Area of relaxation	Proposed measure	Comments
3. Personal capital Estimated maximum effect:		
(a) £175 mn. once for all.	(a) Uniform emigration allowance of £200,000.	Would be delegated (as now).
(b) Negligible	(b) Uniform dependants' and gifts allowances combined at £10,000.	Would be delegated (as now).
(c) £10 mn. annually.	(c) £100,000 per annum in official exchange for holiday homes.	No premium on sale, even where premium originally paid. No further delegation possible while holiday homes restricted to one per family unit. This relaxation is recommended because the present restrictions require an excessive administrative effort to prevent a negligible capital outflow.
4. Miscellaneous	(a) Reintroduction of sterling finance for third country trade.	Monitoring would involve returns to the Bank of England.
(a) (i) £250 mn. once for all.	(i) by merchants subject to monitoring and, if need be, limits;	In the case of:- (i) the method of monitoring should be discussed with the appropriate trade association before implementation.
(ii) Say £400 mn.	(ii) by banks subject to monitoring and within a predetermined overall ceiling, to be reviewed from time to time.	(ii) both the method of monitoring and of liberalisation will need to be discussed with the banks before implementation.

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SCHEDULE OF PROPOSED EXCHANGE CONTROL RELAXATIONS (CONTINUED)

Area of relaxation	Proposed measure	Comments
4. Miscellaneous (cont.)		
(b) £50 mn. annually.	(b) Remove restriction on import of gold coin.	

APPENDIX 1

The Structure of Exchange Control

Exchange control restrictions are not applied to current account transactions because of IMF and other international obligations. However, these transactions have to be monitored to ensure that they are not capital transactions in disguise. Not all capital transactions are restricted - by and large non-residents are free to invest their capital in this country and to repatriate the income and liquidation proceeds. The brunt of our restrictive controls (as opposed to monitoring controls) therefore falls on capital transactions by residents. (But monitoring controls tends to complicate and introduce delays into the system.)

There are three broad categories of capital transactions which exchange control rules permit, subject to various conditions. They are outward direct investment, outward portfolio investment in foreign currency securities and certain specified personal capital transactions (emigration, holiday homes, gifts and legacies). Anything which cannot be accommodated under one or other of these headings is unlikely to be allowed - basically because anything else is likely to open the door further to short-term and/or speculative transactions (see paragraph 8 re leads and lags).

Outward Direct Investment

Most outward direct investment is financed from profit retentions (companies controlled by UK residents are expected to repatriate two-thirds of net taxes profits). Almost all the rest is financed by foreign currency borrowing - either by the subsidiary under parent guarantee or by the parent itself. Guarantees are rarely called and hence direct investment financed by the borrowing of subsidiaries rarely affects our market. Borrowing taken by the parent itself is repayable with official exchange to the extent that the parent can demonstrate that the investment had produced benefits received in this country across the exchanges. So far as outward direct investment is concerned, therefore, the principal and intended effect of Exchange Control

is to defer the initial cost to the reserves/official market. This illustrates one important characteristic of Exchange Control, namely, that it is focussed primarily on the UK's short-term external financial position.

Outward Portfolio Investment

Outward portfolio investment in foreign currency securities is allowed by means of investment currency or by means of foreign currency borrowing, subject to some fairly onerous conditions. Such foreign currency borrowing can be repaid only out of the sales proceeds of the securities or with investment currency. The effect of the controls in this area, therefore, is to ensure that no part of the cost can fall on the reserves/official market at any time. (We did, of course, make a minor relaxation for certain EEC securities under which borrowing may be repaid with official exchange over five years.)

Personal Capital Movements

So far as the various personal capital movements are concerned, the rules vary according to the transaction: there is a ration of official exchange for emigrants but any balance of sterling assets is released after four years; holiday homes are restricted to one per family unit and, if bought from non-residents, must be paid for through the investment currency market; there is an annual limit on gifts, but legacies may be freely remitted in official exchange. None of these items is really important in terms of potential cost, but all need a degree of restriction in order to buttress other parts of the control.

Transactions by Banks

It would, of course, be impossible for Exchange Control to fulfil its objectives unless it also restricted banks' operations for their own account. Each bank is therefore subject to a combined limit on its open position against sterling and its spot against forward position in foreign currency.

The Effects of Exchange Control

The main practical effects of Exchange Control may be summarised as follows:-

(a) It defers the outflow of resident capital to finance direct investment overseas.

(b) It prevents the outflow of resident capital to finance portfolio investment overseas.

(c) It prevents resident and non-resident speculation against sterling by most of the more obvious methods.

However, there are powerful factors affecting the country's external position which Exchange Control does not, or cannot, control. Thus, there are no restrictions on payments for current account transactions, no restrictions on the introduction of non-resident capital into this country or its repatriation and very little chance of moderating leading and lagging within wide margins on either current or capital account, whether by residents or non-residents.

EEC Obligations

In practical terms our obligations under the Directives are to liberalise within the EEC direct investment, investment in real estate, specified personal capital movements (gifts, legacies, and various transfers and payments arising from emigration and immigration), trade credit up to five years, certain miscellaneous transactions of a minor nature and operations in quoted securities. We have Commission authority to maintain restrictions on outward direct investment, gifts by residents, purchase of holiday homes by residents, emigrants' capital and operations in foreign currency securities by residents.

EXCHANGE CONTROL IN G.10 COUNTRIES

SUMMARY

1. The IMF summarise the situation as:

	Exchange Control restrictions on:	
	Current Transactions	Capital transactions by residents
Belgium	No	No
Canada	No	No
France	No	Yes
Germany	No	No
Italy	Yes	Yes
Japan	No	Yes
Netherlands	No	No
Sweden	No	Yes
USA	No	No

Italian current account restrictions have little practical significance.

2. Capital

On the capital side the table above is concerned with transactions by residents. The attached country notes also cover operations by non-residents and indicate, where appropriate, other (non-EC) devices used to control flows. Many countries have arrangements to prevent "undesirable" investment in local industry. Non-resident issues on local capital markets are generally subject to some sort of control, not necessarily for external reasons.

In summary, and to the best of our knowledge, the individual country positions are:

(a) Belgium - Most capital transactions may be effected without restriction through the free market although certain operations including some direct investment attract the official rate.

(b) France - All capital transactions are subject to controls but these are operated very liberally to the extent that in most cases permissions are automatic. Lending to non-residents is strictly controlled.

(c) Italy - Inward and outward movements of non-resident capital are free. A deposit requirement (basically 50%) applies to outward transfers of resident-owned capital for both portfolio and direct investment. The issue of securities to non-residents is restricted.

(d) Japan - Inward direct investment is strictly controlled, inward portfolio requires approval which at present is usually given. Outward direct investment is subject to approval only for the banking and securities industries, while outward portfolio investment is subject to approval which is freely given. Lending to non-residents is controlled.

(e) Netherlands - Following major simplification in September 1977, most capital transactions either enjoy blanket freedom or are permitted by general licence. Borrowing from non-residents is still restricted and the issue of securities to non-residents also requires permission.

(f) Sweden - Control of outward direct and inward and outward portfolio investment is restrictive. Inward direct investment is relatively free.

(g) Canada, Germany and the USA - Apart from some residual restrictions on capital inflow in Germany there are no exchange controls in these countries.

Sweden appears to operate the most restrictive controls.

COUNTRY NOTES

BELGIUM

Controls are administered jointly with Luxembourg. From 1955 the authorities have relied largely on a two-tier spot foreign exchange market to influence capital flows. Since 1971 the system has operated broadly as follows:-

(a) current transactions (other than interest, profits and dividends) are settled through the official market;

(b) IPD, and the repatriation of certain foreign long-term investments, can be channelled through either market;

(c) other capital transactions must go through the free market, apart from certain direct investments and capital transfers which, when individually licensed, may go through the official market.

While, in theory, speculative pressures should be reflected mainly on the financial (free) rate, in practice the two rates rarely diverge significantly. The reasons for this probably include evasion of the cumbersome monitoring mechanism, substitutability between the two markets resulting from (b) above, intervention by the central bank in the financial market, and leads and lags in commercial payments.

From time to time the authorities have introduced temporary measures such as changes to timing rules for commercial payments and restrictions on the payment of interest on, and the growth in, certain non-resident deposits. No such restrictions are in effect at the present, although the rules on commercial payments (to counter leads and lags) are rigidly enforced.

CANADA

No exchange controls (since 1951). Inward direct investment is subject to approval by the Foreign Investment Review Agency.

FRANCE

Capital movements are subject to extensive controls but, in practice, are treated in a liberal manner.

(a) Inward direct investment by non-residents and by non-resident controlled French companies must be declared to the Ministry of Economics. Prior authorisation is required for most transactions involving the import of capital. Authorisation is usually automatic, subject to foreign currency financing conditions, which are liberally applied where a new company is being established, but more strictly to the purchase of or participation in an existing company. A transactions control is used to prevent "undesirable" investments, but does not apply to investments by residents of the EEC and of former French colonies and dependencies.

(b) Outward direct investment must be reported to the Ministry of Economics, and requires prior authorisation if a capital movement in excess of F.Fcs.3 mn. is involved. Again, authorisation is virtually automatic. Foreign exchange financing requirements (generally 50%) are only applied to investments in excess of F.Fcs.10 mn.

(c) Borrowing abroad generally requires the prior authorisation of the Minister of Economics. Lending abroad is subject to authorisation by the Bank of France; lending in francs is effectively prohibited. The prior authorisation of the Minister of Economics is required for most foreign issues on the French capital market.

(d) Inward and outward portfolio investment in quoted securities is freely permitted. For non-quoted securities, authority from the Bank of France is required.

After a period of almost complete liberalisation, extensive exchange controls were re-imposed following the 1968 disturbances. In the following five years, the controls were liberalised and tightened as need arose. An improvement in the external situation following the devaluation of the franc in August 1969 led to some relaxations, particularly on outward investment. The dollar crisis of early 1971 brought controls against inflows. A dual exchange market was introduced in August 1971, comprising an official market for trade, trade-related current

invisibles and current official transactions and a financial market for all others. The dual market was suspended and controls on trade transactions relaxed when France joined the snake in March 1973, and most current and personal transactions were liberalised in August 1973. Since then, the only changes have been minor amendments to the controls on direct investment.

GERMANY

There has been both resident and non-resident convertibility since 1958.

The strength of the economy has led to inflow, to which the authorities have responded with a variety of controls:-

(a) Discriminatory reserve requirements on banks' non-resident liabilities; these were suspended last May. Non-interest-bearing deposits were also required on companies' direct foreign borrowings in the early 1970s.

(b) Preferential outward swaps with the commercial banks, which were abandoned in 1971.

(c) Restrictions on interest payments on non-resident accounts (not currently in force).

(d) Bans on non-resident net purchases of securities; at present purchases of money market paper and securities with under four years to maturity are prohibited.

(e) Foreign borrowing required authorisation until 1974.

A two-tier market has been considered but rejected because of administrative difficulties.

ITALY

Although the Italians have aimed during the post-war period, and particularly in the late 1950s and the 1960s when the current account was regularly in strong surplus, to liberalise exchange controls, pressures in recent years have been such that a series of ad hoc measures have had to be imposed. Although there has been renewed liberalisation as the economy has stabilised, many restrictions remain. These include:-

1. Current transactions

(a) Visible trade: Advance payments for most imports must be made with foreign currency borrowed from authorised banks; a similar scheme for deferred export payments was abolished last year. Deferred payments arrangements on exports and imports were designed to benefit the official reserves.

(b) Invisibles: Travel allowances are fairly stringent, although additional allocations of foreign exchange can be granted for preferred purposes. There are also restrictions on exports of bank notes by non-resident travellers, and generally on exports of large-denomination notes.

2. Capital transactions

(a) Inward and outward movements of non-resident capital are free, other than certain loans which require authorisation.

(b) A deposit requirement applies to outward transfers by residents for direct and portfolio investments, financial loans, real estate purchases and personal capital movements; a non-interest-bearing lira deposit, normally equivalent to 50% of the transfer, is required, although in practice this is not applied for direct investments, for insurance companies, or for certain EEC transactions. Specific authorisation for direct investments is required in certain cases, but is normally granted. Resident portfolio investment in foreign financial institutions requires prior approval, although in practice investment in foreign funds authorised to be traded in Italy is free, such trading only being permitted if, for instance, Italian securities are included in the portfolio. Financial loans and credits (other than certain transactions with EEC countries) are severely restricted.

(c) Security issues by non-residents on Italian capital markets are normally restricted to international institutions.

Other attempts to ease pressure on the lira have included a short-lived dual foreign exchange market, severe import deposit requirements, taxes and deposit requirements on foreign exchange transactions, and an amnesty on illegally-exported capital.

JAPAN

Capital controls appear to be as follows:

(i) Outward direct investment: no formal approval is needed except in the banking and securities industries.

(ii) Outward portfolio investment: permission is freely given.

(iii) Inward direct investment in certain (mainly primary) industries has to be licensed. Licences are also needed where intended foreign participation exceeds prescribed percentages, and where the Japanese firm concerned does not consent. (Effectively, therefore, control can be tight.)

(iv) Inward portfolio investment technically requires approval but this is granted freely.

(v) Lending to non-residents is controlled. Yen bond issues can be made in Tokyo and by selected borrowers (mainly governments). Underwriters of such issues are subject to close official guidance, as is bank lending in foreign currency, and almost certainly in yen also. Banks must match 60% of outstanding drawings on medium- and long-term loans with borrowings of one year or more. Euro-yen bonds (only three so far) also require approval.

Capital controls are pervasive and have changed frequently since 1968. Laws are generally restrictive but particular restrictions can be eased administratively. (Legislation now imminent should make the system generally liberal, with exceptions.) Informal controls ("guidance") are of major importance.

In 1968 most capital transactions required prior approval. Subsequently the trend has been towards liberalisation, but with short periods when controls on inflows or, less frequently, outflows have been intensified.

Controls on inflows, notably 1971-72 and 1977-78, have included restrictions on purchases of Japanese securities, reserve requirements on non-resident free-yen accounts and controls over borrowing from non-residents. These have been accompanied by a more liberal approach to outflows, notably by opening Tokyo to foreign yen bond issues and encouraging syndicated bank lending in yen and dollars.

In the 1974-75 crisis, however, restrictions on inward

portfolio investment were relaxed and reserve requirements on non-resident free-yen accounts abolished. Controls over outflows were tightened (outward portfolio and foreign currency lending to non-residents).

NETHERLANDS

In 1977 the exchange control system was simplified by conversion to a "positive basis": with a few explicit exceptions all prohibitions under the Exchange Control Decree of 1945 were lifted by ministerial order. However, the legislation to enforce controls remains on the statute book. Restrictions currently include:-

(i) The placing of foreign issues in the Netherlands requires permission (in order to regulate pressures on the domestic capital market).

(ii) "Capital inflows resulting from borrowing require permission", so that undesirable upward pressures on the exchange rate can be countered; a ban on such borrowing was lifted in January.

(iii) Residents have to effect international payments through authorised banks, for monitoring purposes.

During the late 1950s the Dutch external position improved and by 1963 current transactions had been liberalised, most capital transactions had become subject to general license, and the capital markets had been re-opened for approved foreign bond issues.

The Dutch have over the years attempted to counter inflows by:-

(a) setting up a separate free foreign exchange market for capital transactions;

(b) restricting banks' net foreign liabilities;

(c) establishing a closed circuit for non-resident bond holdings, effectively preventing further foreign acquisitions;

(d) prohibiting interest payments on certain non-resident accounts and imposing negative interest charges on their growth; and imposing discriminatory reserve ratios on external deposits.

None of these controls is currently in effect.

SWEDEN

Although current payments are exempt from controls, many restrictions on residents' capital transactions remain. Outward direct investment requires individual authorisation, which is normally granted only if the balance of payments is to benefit. Transfers on emigration and real estate purchases abroad are subject to ceilings. Foreign borrowing by residents requires authorisation, but is normally permitted if its term exceeds five years and if it will bring long-term benefit to the balance of payments, but residents are not normally permitted to extend financial loans to non-residents. Authorised banks are given ceilings on their net external positions. Authorisation is not normally granted for residents to purchase foreign securities from non-residents.

Non-residents usually receive authorisation to make direct investments in Sweden, as long as not more than 50% is financed domestically, but issues of bonds and shares in Sweden are not normally permitted. Portfolio investments by non-residents in domestic currency securities are normally only permitted through switch operations. Non-residents can, however, freely purchase foreign securities from residents.

Exchange controls on capital transactions, in force since 1939, were initially primarily to assist domestic monetary policy, but over the past ten years or so have been maintained on balance of payments grounds. Indeed, in recent years the aim has been to encourage inflows, primarily through long-term borrowing.

USA

No exchange controls.

Between July 1963 and January 1974, an Interest Equalisation Tax was in force which was designed to increase the cost to foreigners of long-term borrowing on the US capital market: the tax rate was adjusted periodically. In February 1965 a Voluntary Foreign Credit Restraint programme was introduced to restrain the growth in foreign claims on US banks and non-bank financial institutions; and to limit the growth in company direct investment abroad. This programme was tightened in 1966, 1967, and again in January 1968 when controls on company investment were made mandatory and a moratorium was imposed on net transfers by US investors to developed European countries. All this was dismantled in 1974.

EF(2)CS
11 JAN 1980

For Information:

Chief Secretary
Financial Secretary
Sir Douglas Wass
Sir Fred Atkinson
Sir Lawrence Airey
Mr Barratt
Mr Littler
Mr Jordan-Moss
Mr Hancock
Mrs Hedley-Miller
Mr Hodges

Mr McMahon) Bank of
Mr Dawkins) England

CHANCELLOR OF THE EXCHEQUER

EXCHANGE CONTROL RELAXATIONS

1. I attach a paper about exchange control relaxations prepared in the Treasury but reflecting also a good deal of consultation with the Bank. In preparing the paper, and this cover note, we have also had in mind the paper dated 4 May from Professor Douglas Hague which No 10 sent on to the Treasury on 9 May.

2. The purpose of the paper is to start the process of deciding on the relaxations which could be announced in the Budget and to take your view in particular on the priority areas for relaxation.

3. We are all agreed that, quite apart from the Government's political commitment, the time has come to make a substantial move to reduce exchange controls. However I suggest that you may want to take account of the following factors in deciding on the scale and direction of the relaxations.

4. The first point is that sterling is a more exposed currency than those of our European neighbours, with the possible exception now only of the German mark. London is still the largest European financial centre, sterling is still an important trading currency, the London market in Government stock is the largest outside the United States, we still have a high proportion of major international companies relative to GNP and a high proportion of overseas assets. We are probably still more "internationalised" financially than any of our European partners. This helps to make sterling a relatively volatile currency: it is easy to get into and out of it. It is not wholly fair to quote as an example of volatility

what has happened since 20 March, in view of the election and the previous Government's change in intervention tactics in early April. However it is true that between 20 March and 10 April sterling rose 4% on the dollar and 5% on the effective rate, and that after intermediate ups and downs it is now 3% below 10 April on the dollar and 2½% on the effective rate.

5. The second point I would like to make is that some types of exchange control relaxation seem more likely to increase this volatility than others. Greater freedom on personal transactions and on direct investment overseas look less likely to do this than relaxations on the use of sterling in third country trade and portfolio investment. The distinction is not clear cut. Relaxations on direct investment are more likely to effect the financing of overseas investment than whether it takes place at all. Accordingly a switch to financing in sterling by a company investing overseas could be just as much a bet on the future course of sterling as a portfolio investment in US or European securities. On the whole however we think there is less likely to be a swift reaction to, say, a patch of sterling weakness in the direct investment field than in portfolio investment or third country trade. Moreover relaxations on direct investment can be of direct help to British industry. To the extent that it increased investment, it would mean a build up of more assets for the post-oil period. There were some relaxations, later reversed, on direct investment in the EEC in 1972/3. For all these reasons we would recommend priority of relaxation for direct overseas investment. The illustrative package discussed in the attached paper is shaped accordingly.

6. My third point relates to the impact on sterling of exchange control relaxations, and to the Budget. I think it very likely that the impact of the Budget proper on the exchange markets will be much more important than the impact of exchange control relaxations. If the Budget impresses the market as leading to a lower PSBR and lower M3 growth, the impact on sterling will be favourable and will not be much offset by exchange control relaxations, perhaps the contrary. Per contra if the market is disappointed about the

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monetary prospect, the exchange control relaxations would probably simply add a bit to the adverse effect on sterling.

7. This is logical enough. Much more use is likely to be made of exchange control relaxations if sterling looks weak than if it looks strong. My fourth point is therefore to say that we cannot offer very useful estimates of the probable impact of particular relaxations on the capital account. We must ask that our guesses be taken with a pinch of salt.

8. Fifthly, I would not expect exchange control relaxation to do a very great deal to offset the effects on the exchange rate of North Sea oil. This is partly a question of scale. There is also the Dutch experience: large overseas investment, but the guilder has stayed very strong. Market sentiment is weightier than moderate changes in flows.

9. Finally, he would be a bold man who would say with complete confidence that we have put balance of payments troubles behind us for a decade or more because of North Sea oil. We are in bare balance on current account and real personal disposible income has been rising fast and looks like going on doing so in the immediate future. We have a heavy propensity to import. It is, alas, not inconceivable that we could get into deficit at some point in spite of North Sea oil.

10. We have discussed the attached paper with the Bank, whose perceptions of what ought to be done are, I think,close to our own, though there may be some differences of emphasis. We would like to consult also the Departments of Trade and Industry when we have your approval and an indication of your views. We may also have a problem with the European Commission. The relaxations in our illustrative package do not distinguish between the EEC and the rest of the world and it is possible that they will press for some differentiation. Meanwhile the US are already pressing us <u>not</u> to differentiate in any relaxations we decide to make. They have been very hot on "discrimination".

11. The conclusions I would recommend to you, with the broad agreement of the Bank as described, are:-

i. make a substantial first move in the Budget but take relaxation in stages;

ii. give priority to relaxation on direct investment, but with a useful move on the use of sterling in third country trade by merchants, who were hit hardest by the 1976 restrictions and then represented two-thirds of the field;

iii. reserve a final decision on scale until we are sure of the post-Budget PSBR and M3 target, and can take a view of their likely impact on the market.

12. May we have authority to discuss with the Departments of Trade and Industry, and also very cautiously and tentatively with the European Commission, relaxations on the lines of the illustrative package in the paper attached?

KEC

K E COUZENS
11 May 1979

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EXCHANGE CONTROL

The Chancellor has indicated on several occasions that he would like to make an early relaxation of exchange control. Some action here has been widely expected and would be welcomed by the CBI and others. This paper summarises the case for relaxation and illustrates the sort of package that could be announced in the Budget.

2. The first argument for relaxation is that it is becoming increasingly difficult to justify our present elaborate exchange control regime. Controls have economic costs. They distort particular decisions about the best use of resources. They also impose administrative costs - not only on government departments and the Bank of England but also on the commercial banks, the stockbrokers and the solicitors who act as the Bank's unpaid agents* and on the individuals and firms who have to comply with them.

3. If it is generally agreed that the controls are necessary to achieve some important national objective, then such costs are willingly borne. For several reasons that condition is increasingly less fulfilled than it once was. North Sea oil has provided a new source of strength to our external position - though it remains to be seen whether even North Sea oil will be enough to offset for long other adverse trends in our economic performance and circumstances. Moreover, and more important, it is no longer generally accepted that exchange controls permit the government to run the economy at a higher pressure of demand. Inflation is now widely regarded as the prior constraint.

4. More positively, some would argue that relaxation of exchange control would be a good way of improving the outlook for the non-oil sector of the economy. The argument is that the exchange rate is being maintained unnaturally high by North Sea oil thus reducing competitiveness and running down our manufacturing base. Views differ on the strength of this argument. It is probable that exchange control relaxations would improve competitiveness for a time; but no one can say for sure how long such an effect would last. Sooner or later the initial gain in competitiveness is likely to be eroded by a higher rate of inflation than would otherwise have occurred.

5. There are other arguments for relaxation:-

(i) Because of the EEC Treaty provisions, we need the authority of the Commission to maintain our exchange control regime. This will become increasingly difficult to secure if we do not agree to move towards the fulfilment of our obligations.

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* The cost to the Bank of England has been separately identified at £14 million a year (compared with public sector costs in collecting VAT of £85 million in 1977/78).

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(ii) The United States and Germany have also been pressing us to relax our present regime.

(iii) We rely on the co-operation of the business community to administer our regime. We are more likely to continue to secure it if we show early progress with relaxation.

(iv) Some small but useful public expenditure savings could be secured.

6. There is thus a good case for an immediate package of relaxations. On the other hand we must not forget that sterling is a particularly exposed currency. The outlook for our exchange rate is very uncertain. We must not take excessive risks that could jeopardize the achievement of other Government objectives. And we certainly would not want to be forced to reimpose controls which the Government had taken public credit for abolishing.

Effects of relaxing controls

7. The precise macro-economic consequences of relaxing exchange controls depend on the particular monetary and exchange rate policies being pursued by the government at the time. This paper looks only at the direct effect that relaxation might be expected to have in stimulating balance of payments outflows.

8. Exchange controls cause companies and individuals to hold, in net terms, more sterling assets and fewer foreign currency assets than they would otherwise. While current controls allow a good deal of overseas investment to take place, both direct and portfolio, they severely restrict the amount of investment that can be financed out of official exchange (that is, foreign currency purchased in the foreign exchange market at the current market rate). The main effect of the relaxations discussed in this paper would be to allow investors to use sterling resources to acquire overseas assets, instead of requiring them, as now, to match these assets with foreign currency liabilities. They would thereby be permitted to increase the net foreign currency component in their portfolios.

9. The impact of relaxing controls on balance of payments flows is likely to be much greater in the short run than in the long. The main outflow will result from a once-over rearrangement of asset holdings. In some cases this 'stock shift' effect may take years rather than months to accomplish where direct investment plans have to be modified or existing financing arrangements run off. But eventually, once firms have succeeded in shifting their assets to reflect their preferred balance between domestic and foreign currency assets, the scale of outflows is likely to be much reduced. Even in the long run, however,

there is likely to be some continuing effect on capital flows, since a higher proportion of additional investible funds will tend to go overseas in the absence of controls. On the other hand, there will be an increased flow of income from abroad, as a result of a higher stock of foreign assets, which will benefit the current account.

10. The proportion of their total net assets which firms and individuals wish to hold in sterling at any point in time is of course highly sensitive to speculative factors. The effect of relaxing exchange controls at the outset and thereafter is therefore likely to be critically dependent on the state of confidence in sterling. Whenever sterling is strong, people will prefer to hold sterling assets rather than sell them. Conversely, whenever confidence in sterling is very weak, then the outflows could be very large as investors took the opportunity to switch out of sterling on a substantial scale.

11. It is not possible to estimate the effects of particular relaxations with any assurance. Much depends on how far advantage is taken of the relaxation. Some restrictions have been in force for forty years, and we can have little idea of how people would behave in their absence. If exchange controls - especially on portfolio investment - were abolished altogether, the outflow of sterling could be very large indeed. Moreover confidence in sterling is not yet as firmly established as we should like. In the short term much depends on how the Budget is received. Looking further ahead, there are fears about inflation. Given all these uncertainties we ought not to proceed too rapidly to dismantle our exchange controls. We should retain a significant basis of control for the time being, together with all the powers conferred on the Treasury by the Exchange Control Act 1947.

12. The rest of this paper outlines an illustrative package of exchange control changes. We are not at this stage firmly recommending this particular combination of measures, which is one of many combinations which might be devised. But it does in our view constitute a balanced and internally consistent example of the sort of package which should be examined further when we are in a position to assess the likely effect on the balance of payments, confidence, and the exchange rate of the Budget and of other relevant policy decisions. It is extremely difficult to estimate - even approximately - the outflow which individual relaxations might generate. The total effect in the coming financial year might be about £¾-£1½ billion with a lesser continuing effect thereafter. This range is intended to cover the most likely outcomes on reasonably neutral assumptions about what may happen to confidence in sterling. But if confidence in sterling were either exceptionally strong or exceptionally weak the outflow could be outside this range.

13. The general considerations to be taken into account in choosing which relaxations to put into the package include:

i. how far a relaxation would tend to result in volatile and destabilising capital flows;

ii. whether there is reason to suppose that some particular benefit to the UK will follow from the measure in question;

iii. the cost of the existing control, both for the authorities and for those affected by the control (particularly in commerce and industry) whose co-operation is needed for the system to be effective;

iv. the preservation of a coherent and credible exchange control system covering the restrictions which have to remain;

v. international obligations and pressures, particularly under the EEC Treaty (see paragraph 5(i) above).

14. As explained in paragraph 6 above, we advocate a gradual approach to the dismantling of exchange control. We think that in these first and immediate measures the Chancellor should give priority to relaxations of controls on outward direct investment. Once portfolio controls are dismantled, other controls become redundant or impossible to enforce: UK residents would in practice be able to hold foreign currency balances with little hindrance so that we should be widely exposed to destabilising capital flows. The same problem does not arise in the case of outward direct investment and it is possible to confine the effect of relaxations of relevant controls to that area.

15. Some would argue that controls on outward direct investment should be retained on the grounds that overseas investment competes directly with domestic investment for scarce financial and managerial resources and creates capacity abroad which may displace UK exports. In our view, the balance of evidence on these issues, though far from conclusive, suggests that such fears are unjustified.

16. Other positive arguments for giving priority to outward direct investment controls are:

i. it would be very difficult to justify continued restrictions on the freedom of firms undertaking direct investment overseas to choose between the possible ways of financing it if at the same time portfolio investors had been given substantial freedom of choice.

ii. although, in general, our controls affect the financing of overseas investment rather than the investment itself, it is probable that some small firms are impeded in their investment decisions by the existence of controls. Relaxation in this area would be consistent with the Government's desire to simplify procedures affecting small firms.

iii. the CBI have indicated a preference for relaxations on outward direct if it is necessary to proceed one step at a time.

iv. the EEC Commission have expressed a clear preference for an early move in this area - indeed our Treaty obligation was to liberalise here first.

17. On the whole, therefore, we would advise putting the main weight of an initial relaxation on outward direct investment, and in our illustrative package we have included the following:

i. the introduction of a "ration" of official exchange of £2m per project per year. This means that investors will be able to draw on their domestic sterling resources up to this limit; under existing rules only a minority of investments qualify for sterling finance (see (ii) below), and others have generally to use borrowed foreign currency or retained profits;

ii. the enlargement of the super-criterion facility. At present this allows investors who can recover the cost of their investment within 18 months to use official exchange up to a limit of £250,000 or half the cost of the investment, whichever is greater. The EEC figure is £500,000 with a pay-back period of 3 years. In future the pay-back period would be 3 years worldwide and would allow the whole cost of the investment to be met from sterling resources;

iii. the provision of official exchange without limit for investment in the exploration for and exploitation of raw materials needed by UK industry. We particularly favour this. Anything which encourages these activities benefits the UK as a major consumer of raw materials; investing here is a risky business and there is a particularly good case for allowing companies to use internally generated capital rather than borrowed foreign currency;

iv. to allow companies who will still be required to borrow foreign currency (or who prefer to do so, as many will) to repay it in annual instalments over five years from the date of borrowing. At present they can only repay as matching benefits are received in the UK. Existing borrowing could be repaid in five

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equal instalments from the date of the relaxation. In practice many companies prefer to keep their foreign currency borrowing long after they are entitled to repay it; but more freedom would be welcome to investors and would streamline the controls.

v. to reduce the proportion of overseas earnings which outward investors are required to repatriate from two thirds to one half (and thus to increase the proportion that they can reinvest overseas from one third to one half). While we limit access to official exchange for investors who have no overseas earnings it would be unreasonable to allow investors who do have such earnings unlimited use of what amounts to official exchange (i.e. forgone inflows); but it is consistent with a £2m ration to reduce the size of the repatriation requirement.

vi. greater freedom for UK companies to use the disinvestment proceeds of one investment to pay off unrelated borrowing taken for another investment. This is a minor technical relaxation for the bigger companies which follows logically from (iv).

These relaxations - the largest part of the package - would be likely to produce continuing outflows (though the outflows might be largest in early years as some of the existing stock of foreign currency borrowing was run down). In due course there will be an increased and continuing inflow on current account as net IPD flows increase. The ration of £2 million per project per year would have the greatest single effect; possibly £¼ to £½ billion annually. This estimate allows for the possibility that many firms are likely to want to continue to match the currencies of their assets and liabilities by borrowing foreign currency. When the other elements are added the total cost to the balance of payments of this part of the package reaches a range of £¼ to £¾ billion per year. A breakdown is in the table at Annex A.

18. It would be possible to go further than our illustrative package. One possibility would be to introduce a £5m direct investment "ration", which would subsume the relaxations at paragraph 17(ii) and (iii) above and would be simpler to administer. On the other hand it would be a good deal more expensive.

Outward portfolio investment

19. Outward portfolio investment under current rules is allowed only through the investment currency market or, in some cases, through foreign currency borrowing. Total abolition of the controls would be likely to cause a very substantial outflow in the short

term: the level of the investment currency premium (now around 25% but quite recently between 40% and 60%) shows a considerable potential demand for foreign currency securities. The economy would also become more exposed to the risk of volatile movements of capital by UK residents. Also, freedom for portfolio investment would make it very hard to prevent evasion of such controls as remained in other areas. These disadvantages apply, albeit to a lesser extent, to liberalising in stages. But, in any case, more study is needed of the practical problems which would be raised by gradual relaxation of the portfolio rules. We have for example considered the possibility (also advocated by Mr Hague in the paper he sent to the Prime Minister on 4 May) of feeding money into the investment currency market in order to reduce the premium. We hope to give this idea, which would need legislation, further consideration along with other possibilities later in the summer, perhaps for inclusion in a later package. The present package does however include two modest gestures;

i. abolish 115% cover needed for loan portfolios. Present rules require residents investing overseas to maintain cover, in the form of foreign currency securities or investment currency, worth 115% of the value of loans taken out for portfolio investment. This has the effect of increasing the premium at times when overseas Stock Exchanges are falling and is an irritant for investors;

ii. allow official exchange for interest payments. Present rules require interest on foreign currency borrowing to be met out of income from the securities purchased or from additional foreign currency borrowing; any shortfall has to be financed by buying investment currency. (In any case, we have recently had legal advice that within the EEC these rules are in breach of our EEC obligations.)

(i) above will not cause any outflow. (ii) could cause an annual outflow of £30-40m.

Third country trade

20. Up to 1976 sterling could be used more or less freely by merchants to finance any third-country trade and by banks to finance trade involving a country in the Overseas Sterling Area. UK merchants protested vigorously when this was stopped and they were obliged to borrow foreign currency (though at least some merchants may now prefer this, especially if sterling stays strong). It would not be prudent to allow sterling to be used generally for third country trade. To do so would, as we saw in 1976, greatly increase the scope for speculative flows; and it would also be a step back towards a wider use of sterling as an international and reserve currency, with the restrictions and constraints that accompany that role. Nevertheless, it could be argued that it is unduly restrictive in present circumstances to prevent UK merchants from using their own currency to finance

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their business; they say that the present rule reduces their profits and it certainly complicates their business. At the same time, there has been pressure from UK banks for the facility to be restored to them. There are some who would like a relaxation to be extended to the banks if a scheme could be devised for doing this on a controlled basis. But banks are much better able than merchants to react very quickly to exchange and interest rate variations, so that including them would increase sterling's exposure to volatile capital movements.

21. We ourselves think that it would be reasonable to allow UK resident merchants (not banks) to finance third-country trade in sterling. This might cause a once-for-all outflow in the region of £¾ billion, which could be significantly larger if sterling is weak. We would also expect a continuing outflow as this business grew over time.

Foreign currency retentions

22. The present control allows companies to maintain foreign currency accounts if their business justifies this. Normally these must be surrendered for sterling each month (except for sums needed for known commitments in the coming month). The one month period could in both cases be doubled to two months. This would reduce the transactions costs incurred by firms who now have to switch into sterling and then back out into foreign currency to finance their regular business. It is not expected significantly to increase opportunities for "leading and lagging" which are already considerable in the normal course of commercial payments: the outflow might be £100-£200 million.

Controls on individuals

23. Although the controls on individuals are insignificant in economic terms, some of them will need to remain (for example on emigration), even after the relaxation of the direct investment rules, in order to prevent evasion of the controls on portfolio investment. In general, however, the controls on individuals are time consuming (in proportion to the sums involved), petty, and should be kept to a minimum. We think we might:

(i) On private property; allow official exchange for the purchase of one overseas private property per family (up to £100,000). At present investment currency must be used. This requirement is disproportionately expensive to administer and enforce; it raises numerous technical problems; it is exceedingly unpopular with the public (reflected in complaints to Treasury Ministers and to the Ombudsman); and we require Commission authorisation to maintain it, at least within the Community. Ministers would have to face some complaints from existing property owners, who would no longer be entitled to the premium if they sell their properties (this is essential for technical reasons which can be outlined

in more detail if Ministers wish). We would however be able to justify this because the Bank have always taken care to say that the premium can be recovered on sale under current rules, thus avoiding any commitment for the future. There is no statutory right to the premium. The outflow might be £5-10m annually;

(ii) On emigration allowances; increase the allowance of initial official exchange per family unit to £150,000 worldwide (at present: £80,000 for EEC; £40,000 elsewhere). The balance of an emigrants' assets will continue to be released after 4 years. The possible outflow might be £75-150m; the main effect is likely to be once-for-all, spread over a year or so. In addition, assuming some growth in the cash value of assets owned by emigrants, there could be a small continuing effect.

(iii) On cash gifts and dependants' allowances; combine these allowances and raise the annual limit to £10,000. (The present annual limits are £1500 (£3,000 for EEC) on gifts, and an additional £2,000 for dependants.) There is a good case for this; we cannot pretend to police the present distinction, and the rule bites harshly on older UK residents with relatives overseas. The extra outflow is likely to be negligible;

(iv) On travel allowances; allow banks to issue £1,000 per journey (£500 at present). In principle we do not restrict expenditure on travel, but applications for more than £500 per journey go to the Bank of England. An increase in the limit will save time and public irritation and cut costs. Any additional outflow would be very small.

Gold coins etc

24. One specialised part of the control covers gold coins, medals etc. Changes are needed (because of a recent European Court decision) and it would probably be best to take this opportunity to abolish these controls outright. A separate submission is being made on this subject. The outflow might be between £50 and £100 million annually, but this would depend critically on confidence in sterling.

Conclusion

25. This package is intended merely to demonstrate what sort of relaxations might (as other policies allow) be made in present circumstances. Once we have seen how they work in practice, a series of consequential modifications, essentially of a tidying-up nature, would probably be needed on which Ministers would be consulted as appropriate.

26. We would hope however to be in a position to implement the initial changes as soon as they are announced. The timetable in which decisions would have to be taken in order to make this possible depends to a considerable extent on the nature of the decisions. If the Chancellor decided to include a package broadly on the lines of that presented in this paper in his Budget statement, we would ideally need to know the details by 24 May, assuming that the Budget is on 12 June. If on the other hand the Chancellor wished to adopt a quite different approach, we would need to know as soon as possible because there are important operational constraints to be taken into account.

27. We should be grateful if the Chancellor would now authorise us to consult the other departments concerned (namely the FCO and the Department of Industry and Trade), and also to take informal and confidential soundings of the Commission in Brussels, so that Treasury Ministers will be able to take their views into account when reaching final decisions on the composition of the package.

ANNEX A

ILLUSTRATIVE PACKAGE : Note to summary table

The attached table shows estimates of the outflows which might be generated by the relaxations listed above. The total effect is estimated to be around £¾-1½ billion. This range is intended to cover the most likely outcomes on fairly neutral assumptions about what may happen to confidence in sterling. But if confidence in sterling were either exceptionally strong or exceptionally weak then the outflows could be outside this range.

The estimates have been prepared for the package as a whole. Since there is some overlap between the direct investment options considered, the effects of some of the measures taken individually would tend to be larger than shown here. The figuring treats the £2m annual ration per project as the prior relaxation, since it is the largest. The effects of other measures are additional, on the assumption that companies can take advantage of the ration. On its own, however, the raw materials concession might generate an outflow of about £100-200m, while the repayment of foreign currency borrowing over five years might have an effect of up to £¼ billion.

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cc: Chief Secretary
Financial Secretary
Sir Douglas Wass
Sir Fred Atkinson
Sir Lawrence Airey
Mr. Barratt
Mr. Littler
Mr. Jo[illegible]
Mr. Hancock
Mrs. Hedley-Miller
Mr. Hodges
Mr. McMahon) Bank of
Mr. Dawkins) England

MR. COUZENS

EXCHANGE CONTROL RELAXATIONS

The Chancellor has seen your minute of 11th May and the letter from the Governor of the Bank of England, of the same date.

2. The Chancellor is content that you should now proceed as proposed in your paragraph 12 with discussions with the Departments of Trade and Industry, and, on a more tentative basis, with the European Commission.

3. He would be grateful if the Financial Secretary and Mr. Ridley (to whom I am copying these papers) could consider the suggestions made, with a view to an early meeting with them and the officials concerned.

(M.A. HALL)
14th May, 1979

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cc: Financial Secretary
Mr. Couzens
Mr. Barratt
Mr. Hancock

MR. HODGES

EXCHANGE CONTROL: ARTICLE FROM "THE BANKER"

The Chancellor would be grateful for any comments you might have on the attached article by Mr. John Chown in "The Banker".

(M.A. HALL)
15th May, 1979

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Exchange control for ever?

John Chown

Any comments?

Place on E.C. file

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A new government in the United Kingdom opens the prospect of a relaxation of exchange controls. The author argues that there should be no messing about. They should be abolished

Robert Miller and John Wood* have written a timely pamphlet on a topical subject. They discuss the workings and history of exchange control, the arguments for and against it that were used during the debate on its introduction, and those brought forward to justify its retention today. Predictably, they stress the libertarian arguments.

> Exchange controls curtail individual freedom. They give enormous powers to the authorities which can be abused and which other Western countries dispense with.

Most of the arguments in favour of exchange controls can be dismissed by hard economic logic. But one argument cannot, and it may be decisive. If there were no exchange controls, a government would be seriously restricted in its ability to influence domestic markets, and to ensure that businessmen pursue 'higher' social purposes instead of merely supplying what the public wants. They will be restricted in their right to harry and overtax capital which will simply go elsewhere. Many politicians will find such limitations on their power (benevolent of course) over the rest of us quite unacceptable.

This pamphlet is therefore relevant only on the assumption that our country will one day have a government with a clear mandate and intention to dismantle economic controls, to reduce bureaucracy and to restore individual freedom of choice. Any such government will face many technical financial problems and will need all the help that it can get from its friends in the City, particularly on such abstruse matters as exchange control.

Belief in the virtue of exchange control is not, I hope, an affectation very common amongst readers of *The Banker* and very few words need be employed in dissuading them from it. I therefore propose to leave the task of persuasion to Messrs Miller and Wood (writing for a larger and less specialist readership) and to concentrate on those technicalities of more immediate City interest.

A programme

I take issue with the authors on one of their conclusions. They say:

> the abolition of exchange control would pose few technical problems. . . . A simple Treasury statutory order could remove those regulations which interfere most with the free working of the exchange market. A debate in Parliament would be desirable but not obligatory because no legislation would be required and . . . The Treasury Orders under Section 31 of the Act . . . do not have to be confirmed by motions in either house.

This is a correct statement of the legal position. But it is not, in my view, enough simply to issue an order under Section 31, nor is it correct to say that there are no 'technical problems'.

We have to avoid two dangers. If exchange control is abolished too hastily and without thought to the consequences there could be real economic costs. The opponents of abolition (whether socialists who prefer a servile population or bureaucrats who merely wish to preserve their accustomed jobs) would quite unnecessarily be given ammunition, and control might be reimposed. If a new broom minister *proposes* control be swept away without analysis of the consequences, he will be playing into the hands of the forces of bureaucratic inertia.

On the other hand, if the policy were unduly cautious and the remnants of control retained (the Conservative government muffed the opportunity to complete the job in 1962 when the dollar premium virtually disappeared) there are three disadvantages. First, although the short-term

*Exchange Control for Ever' Robert Miller and John B. Wood Institute of Economic Affairs, 2 Lord North Street, London SW1P 3LB. Price £1·50.

distortions of control might disappear, a substantial part of the bureaucratic cost would remain. (Miller and Wood estimate that 4,650 people are employed at a cost of £50 millions per annum.) Second, if abolition is thought to be only temporary, the danger of a flight of capital is greater. Third, total abolition (and only total abolition) removes a dangerous weapon from the hands of a future government with sinister aims.

It follows that what we require is a well-conceived programme for the *total* abolition of exchange control. There are problems, and these must be faced up to rather than dismissed. I do not have all the answers, and I hope that others better qualified than I am will take up and develop the theme of this article. Some of the apparent problems can in fact be dismissed fairly easily.

Present Bank of England rules do little to discourage overseas direct investment;* abolition would hardly affect the volume of such investment. The 'exporting jobs' argument against foreign investment is based on spurious economics. Using it as an argument for exchange control is, in addition, based on a technical misunderstanding of how the control operates.

Emigration and tax avoidance

Exchange control, as at present operated, inconveniences but does not discourage those who wish to emigrate for tax reasons. Messrs Miller and Wood have given rather more weight to this point than is justified. (They do not mention that income on blocked capital can be remitted freely—often an important point.) Prevention of tax avoidance can hardly have been a major motive for keeping on exchange control which, for the first 25 years of its peace-time operation, did not apply to transactions with such tax havens as the Bahamas.

Flight of capital?

Third, would the abolition of exchange control lead to a flight of capital by UK residents? A *temporary* suspension of controls eventually expected to be reimposed would undoubtedly encourage a lot of people to make a dash for freedom while they could. It would be very different if abolition were complete. Legislation should be repealed so that it can only be reimposed by a new Act of Parliament. The machinery of control should be totally and completely dismantled. In these circumstances, one would actually expect some return of capital. Many people have, legally or illegally, money or investments abroad. This may represent left over holiday cash or casual foreign earnings which should have been repatriated but wasn't, or the assets of a businessman who has deliberately (and with consent) ensured that he has operations abroad by way of a 'life boat'.

*They do influence the method of finance; this is discussed below.

Control of broad economic policy?

Exchange control does not really open out any major policy options that would not otherwise exist, but it merely postpones (in the past by years, but now only perhaps by months or even weeks) unpalatable economic measures which would have to be taken anyway. Although theoretically these delays *could* be used by politicians and officials to 'buy time' for the benefit of the economy, history does not relate a case where time so bought is exchanged for anything other than short-term political advantage. In practice they separate cause and effect by a period just sufficiently long to hide the nature of the relationship from the more economically innocent of our rulers. Abolition, by concentrating the mind on reality, would *improve* the quality of economic management.

There are problems, and these are of two kinds. First there would be established a somewhat different equilibrium position for the economy from that existing today. This new equilibrium will, I suggest, be little different from, and certainly healthier than the present position.

The second effect is a transitional one. Even though the economy may be able to develop a healthy equilibrium in the absence of exchange control the act of removing control requires an adjustment from one equilibrium to another which could, in some circumstances, have serious consequences for the economy. The removal of exchange control in circumstances where there is a strong possibility of reimposition is a very unattractive compromise.

Pent-up demand for foreign assets

There are two ways in which there could be a major switch from sterling into foreign currency: portfolios might be diversified, and currency borrowings might be unscrambled.

At present a UK resident wishing to buy foreign portfolio securities has to purchase investment currency across the dollar premium. There are now some £8,000 millions of foreign portfolio securities owned by UK investors, but the *net* outflow is small and mainly financed by borrowing.

These figures tell us that some investors have been prepared to pay a very material premium in order to invest in non-UK securities. British investors are, and have been for at least a century, internationally minded. We are a small exporting country and a typical British investor would regard an international spread as being just as important to him as an American investor would regard spreading his investment between different industries. If it were not for the dollar premium undoubtedly a higher proportion of British portfolio funds would be diversified into overseas securities.

British investors might typically regard it as prudent to have three-quarters of the equity portion

of their portfolios invested in Britain and the other quarter spread amongst other countries. The market capitalisation of company securities in the United Kingdom at end-1976 was £240 billions. This compares with £8 billions of foreign currency securities. If UK investors decided to hold even 15 per cent of their portfolios abroad, and were free to do so, this would result in an outflow of £28 billions! This has nothing whatsoever to do with any lack of confidence.

One of the difficulties is that investors in other countries are more nationalistic. Americans have little inclination, and arguably little need, to invest elsewhere. The so-called 'interest equalisation tax' (their equivalent of exchange control on portfolio investment) was far clumsier and far worse administered than the UK system, but most Americans were inconvenienced hardly at all by its existence. Continental Europeans have tended to invest at home and in any case are less familiar with equity investment. It would be far easier to permit and encourage British investors to invest abroad if we were more certain of a two-way traffic in foreigners investing in UK shares.

Direct investment

For the past few years most direct investment, except for small sales and service offices, has had to be financed by foreign currency borrowing. Subject to this, the Bank of England has given permission for any properly conceived direct investment; the abolition of exchange control will have little effect on the volume of investment. (There may be some increase in investment by smaller companies who have been deterred by complications they did not properly understand.)

The most important effect is likely to be that some proportion of future foreign investment will be financed in sterling and a proportion of existing currency borrowings will be paid off from sterling sources.

A highly unsatisfactory Parliamentary answer (on the tax treatment point) suggested that outstanding currency borrowings are of the order of $20 billions. We would expect a fairly high proportion of currency borrowings to remain undisturbed and a *relatively high proportion of future foreign investment to be financed by matching currency borrowings*. At present, there is a tax anomaly affecting foreign borrowing. If this remains uncorrected, there may be a greater incentive to finance in sterling.

There are two other factors affecting direct investment flows. First, under the Exchange Control Act, direct investors can be obliged to repatriate part of their earnings. With the abolition of exchange control, they would be free to leave earnings abroad. Some companies maintain flexibility by leaving profits abroad until they are actually directed to repatriate by the Bank of England. If companies were free to manage their currency assets without restriction they might, on balance, bring more rather than less of their profits home. Second, UK resident companies controlled by non-residents may not be permitted to borrow *resident* sterling. In the absence of control one would expect foreign controlled UK companies to borrow rather more of their working capital requirements in sterling.

Borrowings for portfolio investments

In the last ten years, partly as a reaction to the old 'quarter surrender' rule many institutional (and some private) investors have also been permitted to borrow foreign currency for the purchase of foreign portfolio securities.

When exchange control is removed investors will be able to use sterling to pay off these currency borrowings. They may not always wish to do so. An investment trust working in part on borrowed money may wish to match liabilities in the currency of the assets. An individual portfolio investor would not normally borrow; unit trusts are prohibited from borrowing and can only use the currency loan route by maintaining a back-to-back sterling deposit. Other investors may also have maintained back-to-back deposits either on their own initiative or as a requirement of their bankers. One would

expect many such arrangements to be unwound as soon as the abolition or relaxation of exchange control makes this possible.

Economic effects of freedom

Taking these factors together, it follows that in reaching a new equilibrium there could be substantial transfers, amounting to billions of dollars, mainly arising from diversification and the unscrambling of loans.

It is difficult to gauge the scale of movement and what the equilibrium position would be. I would welcome any attempt by readers to refine these figures. One obvious way of testing the waters is first to allow the dollar premium to fall almost to zero. This could be done in various ways, including open market operations, 'leaking' official reserves into the premium pool, or the UK government could issue investment currency securities for the benefit of the reserves.

I have great faith in the efficiency of financial markets to handle movements of this kind. It was after all markets, and not governments, which saw to the recycling of petrodollars. The main effects will be as follows.

1. There will be movement of funds across the exchanges depressing the exchange rate.
2. Existing holders of premium worth securities will suffer a windfall loss, partly mitigated by the effects of (1). This probably need not concern us as investors can be presumed to have known the risks they were taking. Investors typically regard premium paid securities as a hedge. This was part of their portfolio on which they accepted they might lose if the British economy and body politic took a turn for the better, but which gave them some protection against a less satisfactory outcome.
3. As a result of switching, UK security prices might fall. This is, in part, a self-correcting mechanism. It inhibits further sales and encourages inward foreign investment.
4. In principle, there could also be a rise in the market prices of those foreign securities particularly favoured by British investors. This factor is obviously less important.
5. To the extent to which new foreign investments were financed by selling sterling fixed interest securities drawing on bank deposits or by borrowing sterling there would be an upward pressure on sterling interest rates. This is the main correcting mechanism.

Even if confidence in sterling, in the British economy and the British government is high at the relevant time the abolition of exchange control will result in substantial movement across the exchanges, mainly resulting from the unwinding of foreign currency loans and the diversification of assets. UK residents may borrow or withdraw from deposits several *billion* pounds, pushing upwards interest rates, and use these pounds to buy dollars, pushing down the sterling spot exchange rate. The figures are substantial and the impact effects of freedom could be dramatic. This problem is not as serious as it sounds for three reasons.

First, in given economic circumstances, a falling exchange rate and rising interest rates are likely to make sterling deposits relatively attractive to foreigners and equilibrium may well be maintained by the inflow of foreign capital.

Second, these movements are not *outflows of assets* but merely the *transformation* of an asset from one form into another. If a well-advised UK resident individual or company borrows sterling to buy dollar assets he expects this transaction to improve the performance of his assets. The net worth of the country and its citizens is unchanged, but the composition of the items in the balance sheet is altered. This should *improve* the performance of the general collection of assets and enhance the prosperity of the nation. We have grown too accustomed to examining national income figures in terms of mere cash. An individual does not become poorer if he withdraws money from the bank and invests it in productive assets. However, to pursue the analogy he may *risk* becoming poorer if he does not maintain a prudent proportion of his assets in readily realisable form.

Third, and in present circumstances, the abolition of exchange control may counterbalance the 'Dutch disease'. In late 1977, and again more recently, foreign money has flowed into the UK, keeping the exchange rate at what is arguably too high a level for trade purposes. In 1977 it was seriously suggested that we should impose *new* controls on *inward* investment instead of *relaxing* controls on outward investment! (There are those who regard British bureaucracy as a lame duck industry in need of a job creation scheme.)

A more constructive proposal (which was put forward in a detailed memorandum to Mr Harold Lever at the time) was to conduct open market operations in the dollar premium market.

For instance, on March 28 sterling was $2·05, and the dollar premium was, sharply down over the month, 25 per cent. This implies an exchange rate for investment currency of $1·64. If exchange control were abolished, the exchange rate would settle down at somewhere between these two figures. My guess is that it would be nearer the 'official' figure—say $1·90 or $1·95. At this rate, money supply targets could be met without action which might affect the exchange markets, and (arguably) manufacturing industry would be more competitive.

There are material problems. The economic gains from abolition are substantial. North Sea Oil gives us a splendid opportunity to break with restrictions.

EFCS - pq
Chancellor has seen

EF(2)CS
11 JAN 1980

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir Douglas Wass
Mr Couzens
Mr Barratt
Mr Hancock
Mr Unwin

EXCHANGE CONTROL: MR CHOWN'S ARTICLE IN 'THE BANKER' FOR MAY 1979

(Mr Hall's note of 15 May).

1. Mr Chown's article contains some interesting points and sensible remarks but I think his main thesis is mistaken. He argues that, despite problems and risks which he perceives, the right course would be immediate and total abolition of exchange control, including repeal of the legislation, and that this would result in a better equilibrium for the economy. But he clearly recognises the problem of transition. In his own words:

> 'Even though the economy may be able to develop a healthy equilibrium in the absence of exchange control the act of removing control requires an adjustment from one equilibrium to another which could, in some circumstances have serious consequences for the economy. The removal of exchange control in circumstances where there is a strong possibility of reimposition is a very unattractive compromise'.

2. Mr Chown does not attempt to show that our circumstances are already such that no painful economic adjustment would be required. But he does reckon that, even if confidence were high at the time, abolition would result in a movement of perhaps several billion pounds across the exchanges. He suggests that this would not be all that serious on the grounds that the effect on the exchange and interest rates would encourage inflows and counterbalance the 'Dutch disease' and also because, whatever the cash flow, UK assets would tend to be improved. This line of argument however, takes too little account of other possible influences on market sentiment or of the shorter term risks to the economy involved in total freedom for the more volatile capital flows.

3. Despite his plea for total abolition, Mr Chown seems attracted by a more gradual approach, since he refers to 'testing the waters' by engineering a fall in the investment currency premium. This is like the idea put forward in Professor Hague's note of 4 May of 'feeding the pool'. It would require legislation but I

have arranged to examine it with the Bank of England from the technical angle as part of our further study of how best to make further progress in relaxing exchange controls beyond an initial package, particularly as regards outward portfolio investment.

6. One could comment on a number of less major points in the article. I would only now add that when Mr Chown refers to the Institute of Economic Affairs pamphlet's estimate that 4,650 people are employed on exchange control at a cost of £50m a year, he is quoting what is honestly described by the authors (Miller and Wood) as a 'guesstimate'. The economic costs obviously go beyond the Bank and the Treasury to those of the authorised banks etc but we have no sound basis for estimating the total; and some of Miller and Wood's assumptions, eg of 1,000 full-time employed on the control in foreign banks in London and of an annual cost of £10,000 per head, are pretty arbitrary, so it would be unwise to accept their figures.

C H W HODGES
16 May 1979

CONFIDENTIAL EXC/84/04 (P)

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Minister of State - Commons
Minister of State - Lords
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Mr Couzens
Sir Anthony Rawlinson
Mr Barratt
Mr Littler
Mr Jordon-Moss
Mr Dixon
Mr Hancock
Mrs Hedley-Miller
Mr Hodges
Mr Ridley
Mr McMahon) Bank of England
Mr Dawkins)

EXCHANGE CONTROL

I have discussed the papers we have had from the Treasury and the Ban of England with officials. This minute records my conclusions.

2. Clearly we should take a substantial first step in dismantling controls as soon as possible. It would be best to announce this in t Budget; it goes well with our general strategy. Clearly also we shou take final decisions on exchange control in the context of other Budg decisions (particularly on our fiscal and monetary stance).

3. On the assumption that at that stage you see no reason to draw back from measures of the order of those discussed in the papers we ha seen, I recommend the relaxations in the summary table at Annex A. Th main points are as follows.

N. to 64
18 mm

EXC/34/04 (P)

65

CONFIDENTIAL

Outward direct investment

4. I agree with the Governor and officials that we should [illegible] investment controls before controls on portfolio investment. We ough to make our controls as simple as possible. For this reason I prefer the ration of £5 million per project per year, as proposed by the Ban to the more complicated proposals in the Treasury's illustrative pack I also prefer the Bank's porposal to abolish outright the requiremen that two-thirds of overseas earnings must be brought back to this country (and cannot therefore be reinvested overseas). I have been informed that officials of the Departments of Industry and Trade and FCO take the same view; and that Treasury officials see no objection. subject to a final judgement being made on the size of the package when the broad shape of the Budget is settled. Department of Industi officials would like to add the unlimited relaxation for raw materia in the Treasury package to a £5 million ration. This would introduc a complication into the scheme which I would prefer to avoid. But, if the Secretary of State endorses his officials' view, we could think again.

5. For doctrinal reasons at least some elements in the trade union movement will attempt to present this as a licence for the export of jobs. I am confident that it is not; but we will need to convince the public that the trade union view is misguided, and I have asked officials to marshall the evidence.

Measures affecting individuals

6. Emigration. I would rather increase the allowance to £200,000 worldwide (the Bank figure) than to the £150,000 in the Treasury's illustrative package, for the purely presentational reason that £150,0 was the figure proposed by the late Administration for their wealth ta

7. Holiday homes. I agree that we should abolish the requirement to use investment currency to buy overseas property. It seems sensibl to allow individuals a ration of £100,000 a year for this purpose. I less happy with the suggestion that we should continue to limit these properties to one per family. It is odd to allow £100,000 for one ho but to forbid £50,000 each for two. I have asked officials to look a this point further.

8. I draw your attention to one particular difficulty. Property own who have paid the premium and would up to now have recovered it on sa will no longer be able to do so; and some may well complain. Some wh are by no means rich will feel they have lost out. But the proposal is defensible; and those affected will have to acknowledge that the consequence of a policy of dismantling controls is bound to be the elimination of the premium sooner or later.

Cash gifts/dependants allowances

9. I have accepted official advice that we should combine these allowances and raise their total to £10,000 per year. (We may be abl to take some credit for this in due course with the immigrant groups chiefly affected and their countries of origin.)

Travel allowances

10. Again it seems appropriate to double the existing allowance to £1,000, as officials have suggested.

Measures which relate to trade

11. Third-country trade. There is a difference of view here between the Bank and the Treasury. Both suggest that UK merchants should be allowed to use sterling for third-country trade; the Bank thinks that

banks should benefit also. The Treasury are concerned that the extension of the concession to banks would increase the volatility of the potential outflows. Experience is that, if sterling weakens, speculation in this area can be considerable. The Bank would like to work out a way of allowing the banks limited access to sterling for this purpose; this requires consultation in the City, and in order to save time I have authorised the Bank to consult those concer in confidence and without prejudice to your decision. I have also authorised consultations with the merchants to permit the Bank to wor out the mechanics of the proposed concession to them.

Foreign currency retention

12. I think it would be wise to leave decisions here until we have seen whether the Bank can come up with a workable scheme for extendin the third country trade concession to the banks. If they cannot, then the retention concession would be a suitable consolation prize for the banks. If they can, I would judge it unnecessary.

Gold coins

13. I agree with official advice that we abolish this part of the control completely. There are strong legal reasons for doing so.

Portfolio investment

14. This presents us with our main problem for the future. While portfolio controls last, we will have to maintain most of the present apparatus of exchange control, even after relaxing the rules on direct investment and individuals, so as to prevent evasion. But officials have not been able to devise a workable plan for the gradual relaxatio of controls in this area. They will start work on the definition of a series of options as soon as decisions on the Budget package have be taken and they will let us have a report before the summer recess. Th are substantial technical problems to be solved.

15. In the meantime I agree with the two minor proposals listed in Annex A.

Staff

16. The savings in Bank staff that will result from the proposals in Annex A will not be large because of the need to retain the basic apparatus of exchange control while controls over portfolio investmen remain. But, even so, they are worth having. The Bank estimate them provisionally at some 50 to 60 posts (out of a total of 700 employed exchange control in the Bank).

The EEC Commission

17. The proposals decribed above would remove several existing discriminations in favour of the Community (those relating to the super-criterion, emigration allowances and cash gifts). As a result, the new regime will be simpler - and the Americans will be pleased. The Financial Counsellor in Brussels, Mr Fitchew, has taken informal soundings of the Commission's officials to check whether a package on the lines of Annex A would be likely to cause them difficulty for thi or any other reason. Their reaction suggests that the Commission are likely to be more worried about presentation than substance. They wa to be seen to have been fully consulted. Even though they might have preferred more and not less discrimination in favour of the Community and would certainly have welcomed more rapid progress toward the removal of portfolio controls, it is unlikely that they will make an of either point, provided that their sensitivities are respected. Fo this purpose, Mr Fitchew has made three suggestions:-

(i) Commission officials should be invited to London about a week before the Budget to discuss the proposals with officials in detail. This would enable the Commission to say that they had been formally consulted.

(ii) You should telephone Mr Ortoli a day or so before the Budget to tell him in broad terms what you had decided to do following the meeting with the Commission officials.

(iii) The Commission should issue a Press Notice on Budget Day simultaneously with ours so as to make it clear to the pub that they were fully consulted.

I can see no reason to reject these suggestions. They seem a small price to pay for the Commission's goodwill.

Next steps

18. If you agree with my proposals, I suggest that the appropriate n step would be for you to minute the Prime Minister with copies to the Foreign and Commonwealth Secretary and the Secretaries of State for Trade and Industry. EF2 division will provide a draft when your decision is known. If you would like to discuss further, I should be happy to have a further meeting with you and the officials concerned.

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ANNEX A

PROPOSED EXCHANGE CONTROL RELAXATION

Outward [illegible] investment

(i) A ration of official exchange of £5 million per project per for new outward direct investment.

(ii) Existing foreign currency borrowing to be repayable in five equal annual instalments - this replaces the "matching benefits" rule

(iii) New borrowing also to be repayable over five years (to the extent that repayment cannot be met from the ration).

(iv) Abolition of the requirement that two-thirds of overseas earnings must be repatriated.

(v) Disinvestment proceeds to be allowed to be used to pay off unrelated borrowing.

Controls on individuals

(i) Private property: replacement of the present requirement that investment currency must be used by a ration of official exchang of £100,000 per family per year. Further consideration to be given to whether this should be confined to one property per family.

(ii) Emigration allowances: increase the initial allowance of official exchange per family unit to £200,000 worldwide. (At present it is £80,000 for the EEC and £40,000 elsewhere).

(iii) Cash gifts and dependants allowances: combine these allowance and raise the annual limit to £10,000. (At present, they are £1,500 - £3,000 in the EEC - for gifts, plus £2,000 for dependants).

(iv) Travel allowances: allow banks to issue £1,000 per journe (instead of £500 now).

Third country trade

The reintroduction of sterling finance for third country trade. Decis on whether it should be confined to UK merchants or extended to banks and on the precise nature of the scheme to be taken after consultatio now proceeding.

Foreign currency retentions

If it is decided not to extend the third country trade concession to banks, permission for firms to retain foreign currency for two months (instead of one month now).

Outward portfolio investment

(i) Official exchange to be allowed to meet the interest on foreign currency borrowing taken to finance portfolio investment.

(ii) Abolition of the present rule that 115 per cent of the value of loans taken out for portfolio investment must be covered by foreign currency securities or investment currency.

Gold coins

Remove restriction on import of gold coin.

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Minister of State - Commons
Minister of State - Lords
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Mr Couzens
Sir Anthony Rawlinson
Mr Barratt
Mr Littler
Mr Jordan-Moss
Mr Dixon
Mr Hancock
Mrs Hedley-Miller
Mr Hodges
Mr Ridley
Mr McMahon)
Mr Dawkins) Bank of Englan

EXCHANGE CONTROL

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Outward direct investment

I agree with the [illegible] and officials that we should [illegible] direct investment controls before controls on portfolio investment. We ought to make our controls as simple as possible. For this reason I prefer the ration of £5 million per project per year, as proposed by the Bank, to the more complicated proposals in the Treasury's illustrative package. I also prefer the Bank's porposal to abolish outright the requirement that two-thirds of overseas earnings must be brought back to this country (and cannot therefore be reinvested overseas). I have been informed that officials of the Departments of Industry and Trade and the FCO take the same view; and that Treasury officials see no objection, subject to a final judgement being made on the size of the package when the broad shape of the Budget is settled. Department of Industry officials would like to add the unlimited relaxation for raw materials in the Treasury package to a £5 million ration. This would introduce a complication into the scheme which I would prefer to avoid. But if the Secretary of State endorses his officials' view, we could think again.

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8. I draw your attention to one particular difficulty. Property owners who have paid the premium and would up to now have recovered it on sale will no longer be able to do so; and some may well complain. Some who are by no means rich will feel they have lost out. But the proposal is defensible; and those affected will have to acknowledge that the consequence of a policy of dismantling controls is bound to be the elimination of the premium sooner or later.

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banks should benefit also. The Treasury are concerned that the extension of the concession to banks would increase the volatility [illegible] potential outflows. Experience is that, if sterling weakens, speculation in this area can be considerable. The Bank would like to work out a way of allowing the banks limited access to sterling for this purpose; this requires consultation in the City, and in order to save time I have authorised the Bank to consult those con in confidence and without prejudice to your decision. I have also authorised consultations with the merchants to permit the Bank to out the mechanics of the proposed concession to them.

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77

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15 MAY 1979

78

ANNEX A

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Remove restrictions on import of gold coin.

CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Minister of State - Commons
Minister of State - Lords
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Mr Couzens
Sir Anthony Rawlinson
Mr Barratt
Mr Littler
Mr Jordon-Moss
Mr Dixon
Mr Hancock
Mrs Hedley-Miller
Mr Hodges
Mr Ridley
Mr McMahon) Bank of England
Mr Dawkins)

RELAXATIONS OF EXCHANGE CONTROL

You will by now have read my minute of 18 May recording my recommendai for the initial package of exchange control relaxations. There are on or two further points about the proposed package which are worth maki at this stage.

First, it represents, in addition to an important relaxation, a fairly substantial simplification, which will be welcome.

Second, the proposed £5 million ration (per project per year) for outw direct investment is, in practice, only one step away from complete freedom for direct investment overseas. If things go well, you ought to be in a position to take this further step before too long - perhap even by the autumn.

Third, the total capital outflow that might result from the proposed package is estimated by the Treasury and the Bank in the range £750 million to £1650 million in the first year, of which between £300 million and £750 million might be a continuing flow. These figures are, of necessi however, highly speculative.

Finally, I am aware the proposed relaxations on holiday homes could well stimulate a fair amount of political flak without bringing any benefit to industry or to the economy generally, and certainly it would be possible to defer this to the portfolio package I decided to include it, however, in the light of the evidence that of all aspects of the present exchange control system, this is far and away the most expensive to administer and enforce and apparen gives rise to the greatest amount of friction with the public. Insof as holiday homes are in the EEC, moreover, it is not at all popula with the Community and/we will require Commission authorisation to maint it. A half way house, I suppose, might be to confine the proposed liberalisation to holiday homes in Community countries. This would certainly be popular with the EEC, but I have not discussed this with officials.

NL

NIGEL LAWSON
22 May 1979

EF.

EXC/84/04 DC - are you content that we suggest a reply to No 10 as recommended

CONFIDENTIAL

cc for Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Couzens
Mr Barratt (o/r)
Mr Jordan-Moss

Chancellor of the Exchequer

MR HANCOCK

23/5.

cc to Mr Middleton
Mr Gill
Mr McIntyre

EXCHANGE CONTROL : PROFESSOR HAGUE'S IDEAS
(Mr Hall's Note of 10 May)

1. The Chancellor has asked whether the ideas in the paper sent to the Prime Minister and him by Professor Douglas Hague deserve serious consideration; and we are to draft a reply for the Prime Minister's signature. No.10 sent the paper also to the Governor of the Bank, who told the Chancellor in his letter of 11 May that he would like in due course to give a considered response to Professor Hague's suggestion of "feeding" the investment currency pool from the official reserves.

2. Professor Hague has said that lying behind his paper there is a good deal of economic theory and research. This does not however show very clearly though a somewhat naive and dogmatic presentation. However, the three types of transac he identifies are perhaps the most obvious candidates for some relaxation, as he appreciated from our own and the Bank's advice. But Professor Hague shows little awareness of exchange control's general aim of being able to limit when confiden is weak the more speculative and volatile capital movements by UK residents (although, prompted by City contacts, he does see the need to be careful in respect of outward portfolio investment). He gives no real basis for his estima of outflow, which seem to us much too low to be likely.

3. The specific suggestion for intervention by the authorities in the investment currency market would, as has been mentioned, require legislation, the nature of which would need careful thought. Granted the statutory power, feeding the pool would be a way of bringing down the premium. This would both tend to encourage more outward portfolio investment at some "cost" in official exchange and reduce the balance sheet problems for investors if and when the premium was abolished. But it would also face the authorities with tricky problems of quantity and timing and expose them to complaint from investors whose expectations about the level of the premium at a given moment were affected by official intervention. Nor would it necessarily provide such an easy way of estimating how much liberalisation would cost. Nevertheless, it is an option which merits and requires further close study; and we and the Bank

are putting this in hand as part of the work aimed at a report for Treasury Ministers about outward portfolio investment before the Summer Recess.

4. The Chancellor may like to suggest a reply to Professor Hague from the Prime Minister on the lines of the attached draft.

C H W HODGES
23 May 1979

Pl. type as draft.

DRAFT REPLY FROM : PRIME MINISTER

TO : PROFESSOR DOUGLAS HAGUE

COPIES TO: CHANCELLOR OF THE EXCHEQUER

GOVERNOR OF THE BANK OF ENGLAND

I was grateful to you for sending your paper~~s~~ on exchange control of 4 May to Geoffrey Howe and me. We shall be taking your well-timed suggestions into account in judging how best to proceed with relaxing controls which are obviously now more restrictive than they need to be. I cannot of course anticipate what ~~the Chancellor~~ he will decide to do; but I can say that, as you might expect, all the areas you mention are being thoroughly explored.

EXC/84/04 (D)

CONFIDENTIAL

23 MAY 1979

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1. FINANCIAL SECRETARY

2. CHANCELLOR

PPS/ FST content with draft minute, as amended, for the Chancellor to send to the PM. Please note the need for urgency.

PCJ 23.5.79.

cc Principal Private Secretary
Chief Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Sir Laurence Airey
Sir Fred Atkinson
Mr Couzens
Sir Anthony Rawlinson
Mr Littler
Mr Jordan-Moss
Mr Dixon
Mrs Hedley-Miller
Mr Hodges
Mr Ridley
Mr Dawkins - B of E

RELAXATIONS OF EXCHANGE CONTROL

I refer to your minute to the Chancellor of 18 May, Mr Battishill's reply recording the Chancellor's reactions dated 21 May and your further minute of 22 May. Unless the Chief Secretary and Mr Ridley have new points to raise, I think I am right in saying that the only outstanding issues are:-

(i) whether third country trade should be extended to banks (with consequences for the retentions rules); and

(ii) whether the holiday homes concession should apply to only one home or more.

2. The Bank of England hope to let us have a note for Ministers early next week reporting on their consultations in the City about the third country trade concessions. In this case I am afraid that it is unlikely that it will be possible for an exchange control notice to be circulated on Budget Day so as to be available to banks and other agents on 13 June. We think it probable that the Chancellor will not be able to do more than announce in his Budget Speech that the concession will be made leaving full details to be announced later.

3. On holiday homes, we aim to let you have a further note tonight. The issue seems to me to be a straightforward question of political judgement and I would hope that our note will enable a decision on the nature of the relaxation to be taken so that it can be announced in the Budget. As you know we are anxious to see this change made soon because of the relatively high cost of administering this control.

4. Mr Battishill tells me that the Chancellor has asked for a draft minute to send to the Prime Minister and other Cabinet colleagues with a direct interest in his proposals. I attach a draft for the purpose. You will see that I have explained the problem about third country trade in the minute but relegated the holiday home point to the Annex. I hope you will think that appropriate.

5. It would be advantageous if this minute could go out today. As recorded in paragraph 11 of the draft, the exchange control notices that are to be distributed on Budget Day (so as to be available to banks etc next morning) need to be in final form ready for printing not later than next Wednesday 30 May. Given the spring holiday, this does not allow a great deal of time for other Ministers to consider the matter.

D.H.

D J S HANCOCK
23 May 1979

CONFIDENTIAL

DRAFT MINUTE FOR THE CHANCELLOR TO SEND TO THE PRIME MINISTER

COPIES TO:
Foreign and Commonwealth Secretary
Secretary of State for Industry
Secretary of State for Trade
Governor of the Bank of England
Sir John Hunt

EXCHANGE CONTROL

One of our objectives is the liberalisation of our exchange control regime consistently with our EEC Treaty obligations. The present strength of sterling makes it appropriate to take a substantial first step in the Budget. I have therefore been considering with the Bank of England and Treasury officials the form of an initial package of relaxations. I have taken account of the suggestions put to you recently by Douglas Hague.

2. It would not be sensible to attempt to dismantle our controls overnight. Our elaborate and restrictive regime has been in existence for 40 years. It is therefore very difficult to predict how all the companies and individuals affected by our existing controls would react to a massive liberalisation. The effects in the short run on the exchange rate could be highly destabilizing. The world environment is particularly uncertain and dangerous. One of the possibilities that we cannot exclude is a United States recession with a revival of the dollar that might cause a large outflow from sterling. The stability of sterling is important to our other policies. I conclude that we should proceed with exchange control relaxations one step at a time.

3. That being so, there are compelling arguments for starting with outward direct investment. I believe that, on balance, this will be helpful to British industry and exports. A big move to relax these controls can be made without jeopardizing the remaining regime, and, in particular, the controls over outward portfolio investment where the risk of big and volatile capital flows is much greater. It is not possible to go the other way round and to make a large relaxation of con on portfolio while attempting to retain controls on outward direct.

4. The most important relaxations I propose to make are

(i) the introduction of a ration of official exchange of £5 mill. per investment project per year and

(ii) the abolition of the rule which restricts the reinvestment o profits earned overseas by requiring the repatriation of at least two-thirds of net taxed earnings.

These would be accompanied by changes affecting repayment of foreign currency borrowing. ~~which, with reinvested profits, is how most outward direct investment has had to be financed up to now.~~

5. It is practicable to make significant changes also in the controls affecting individuals without undermining the portfolio controls. I therefore propose to make substantial relaxations in the rules concerning emigration allowances, holiday homes, cash gifts and payments to dependants and travel allowances.

 Exc/84/04 (D) 89

6. I should also like to take this opportunity to reverse in part the decision in 1976 to deny sterling finance for third country trade. This is an area in which experience has shown speculation can be severe i[illegible] in the existing [illegible]rling is w[illegible] imposition of the control in 1976 played an important part in restoring confidence in sterling. On the other hand it also placed our merchants at a competitive disadvantage and denied banks a useful source of earnings. The Bank of England on my instructions are now consulting the City interests concerned to see whether a scheme could be worked out that would enable both merchants and banks to benefit from a relaxation of the rules without excessive risk of volatile flows. ~~I may decide~~ that it would be imprudent to extend the concession to the banks. If so, I would propose to add a different concession to the package in lieu of the concession to the banks: namely the doubling of the present period of one month for which firms generally can retain foreign currency earnings before they are required to convert them into sterling.

7. Fuller details of the relaxations I have in mind are set out in the Annex to this minute. You will see that the list also includes two modest initial steps on portfolio investment and the abolition of the gold coins control introduced in 1975. Final decisions will need to wait until I have the Bank of England's further advice on third country trade and also until I am able to assess the probable effect of the Budget as a whole on the exchange rate. So long as our policies command the confi of the financial markets (in particular, our determination to cut publi expenditure and to control the monetary aggregates), it is unlikely that the relaxations listed in the Annex will cause a substantial outflow fro sterling.

8. When announcing these relaxations I propose to say that I will be studying over the months ahead further proposals for a gradual relaxation of exchange control extending into the field of portfolio inv[illegible] would explain that [illegible] relaxations [illegible] announced when conditions were appropriate and that the speed of relaxati would be influenced by the effect of international events on sterling as well as by the speed with which we were able to solve our economic problems.

9. Officials have taken very informal soundings of Commission officia to find out how a package of the sort I envisage would be likely to be viewed by the Commission. This is important because our ability to keep the remaining exchange controls to which our EEC Treaty obligations apply depends on continued authorisation by the Commission. Also, in three minor respects, my proposals remove discrimination in favour of the Community. (At present the controls on outward direct investment emigration allowances and cash gifts all have a more generous allowance for the Community than for the rest of the world. These discriminations add to the complexity of the exchange control regime and we are under strong pressure from the Americans to make our relaxations non-discrimina The Commission would also prefer faster progress on portfolio; but Commission officials do not deny that there are important technical obstacles to be overcome before a controlled programme of relaxation for portfolio investment could be introduced.

10. I am advised that the Commission are likely to go along with my proposed package provided that they are seen to have been consulted. I therefore intend to invite Commission officials to London to discuss

the details of the package with the Treasury and the Bank about a week before the Budget. I will speak to Mr Ortoli on the telephone myself a day or two before the Budget; and we shall invite the Commission to issue a Press Notice on Budget day simultaneously with ours so as to make it quite clear that they were fully consulted.

11. I should be glad to know that you are content that I should proceed on the lines described above. Detailed work on the preparation of exchange control notices and other relevant documents is already in hand. To ensure no misunderstandings or confusion, the commercial banks and other exchange control agents should receive these notices by the morning after the announcement. To get them out on Budget Day, the texts need to be put in final form ready for printing not later than next Wednesday 30 May.

12. I am sending copies of this minute to the Secretaries of State for Foreign and Commonwealth Relations, Industry and Trade, the Governor of the Bank of England and Sir John Hunt.

CONFIDENTIAL

p4 92

PRINCIPAL PRIVATE SECRETARY

cc. Financial Secretary
Minister of State (C)
Minister of State (T)
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Mr Couzens
Sir Anthony Rawlinson
Mr Barratt
Mr Littler
Mr Jordan-Moss
Mr Dixon
Mr Hancock
Mrs Hedley-Miller
Mr Hodges
Mr Ridley
Mr McMahon) Bank of Eng
Mr Dawkins)

EXCHANGE CONTROL

This is to record that the Chancellor and the Chief Secretary discussed this subject briefly at the meeting of Treasury Ministers this morning. The Chief Secretary said that he agreed with the Chancellor's comments recorded in your minute of 21 May, and had nothing to add at this stage.

A C PIRIE
23rd May 1979

cc. also to:
Mr Ellett
Mr McLtyre
CCR
26/6/79

PS/PMSR
PS/MSR (C)
PS/MSR (L).
Sir D Wass.
Sir L Airy
Sir F Atkinson
Mr Goodens
Sir A Rawlinson
Mr Littler
Mr Jordan-Moss
Mr Dixon
Mrs Hedley-M
Mr Hodges
Mr Ridley
Mr Hancock

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

EXCHANGE CONTROLS

One of our objectives is the liberalisation of our exchange control regime consistently with our EEC Treaty obligations. The present strength of sterling makes it appropriate to take a substantial first step in the Budget. I have therefore been considering with the Bank of England and Treasury officials the form of an initial package of relaxations. I have taken account of the suggestions put to you recently by Douglas Hague.

It would not be sensible to attempt to dismantle our controls overnight. Our elaborate and restrictive regime has been in existence for 40 years. It is therefore very difficult to predict how all the companies and individuals would react to a massive liberalisation. The effects in the short run on the exchange rate could be destabilising. The world environment is particularly uncertain. One of the possibilities that we cannot exclude is a United States recession with a revival of the dollar that might cause a large outflow from sterling. The stability of sterling is important to our other policies. I conclude that we should proceed with exchange control relaxations one step at a time.

That being so, there are compelling arguments for starting with outward direct investment. I believe that, on balance, this will be helpful to British industry and exports. A big move to relax these controls can be made without jeopardising the

On to pm
23.v.79
"ONE STEP AT A TIME"

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

remaining regime, and, in particular, the controls over outward portfolio investment where the risk of big and volatile capital flows is much greater. It is not possible to go the other way round and to make a large relaxation of controls on portfolio while attempting to retain controls on outward direct.

At present the rules are complex. Their overall effect is to require the bulk of outward direct investment to be financed either by foreign currency borrowing or by the reinvestment of overseas earnings. The most important relaxations I propose to make are

(i) the introduction of a ration of offical exchange of £5 million per investment project per year and

(ii) the abolition of the rule which restricts the reinvestment of profits earned overseas by requiring the repatriation of at least two-thirds of net taxed earnings.

These would be accompanied by changes affecting repayment of foreign currency borrowing.

It is practicable to make significant changes also in the controls affecting individuals without undermining the portfolio controls. I therefore propose to make substantial relaxations in the rules concerning emigration allowances, holiday homes, cash gifts and payments to dependants and travel allowances. The reference to "holiday homes" involves some political risk, but it is an area of control which is particularly labour-intensive (and so expensive to operate) for a limited return. On the whole I think it would be

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

easier to dispose of in the context of a large package of this kind than to deal with it separately later.

I should also like to take this opportunity to reverse in part the decision in 1976 to deny sterling finance for third country trade. This is an area in which experience has shown speculation can be severe if confidence in the existing rate for sterling is weakened. The imposition of the control in 1976 played an important part in restoring confidence in sterling. On the other hand it also placed our merchants at a competitive disadvantage and denied banks a useful source of earnings. The Bank of England on my instructions are now consulting the City interests concerned to see whether a scheme could be worked out that would enable both merchants and banks to benefit from a relaxation of the rules without excessive risk of volatile flows. I understand that there should be no difficulty on a scheme for the merchants, but that I may be obliged to consider that it would be imprudent to extend the concession to the banks. If so, I would propose to a a different concession to the package in lieu of the concession to the banks: namely the doubling of the present period of one month for which firms generally can retain foreign currency earnings before they are required to convert them into sterling.

Fuller details of the relaxations I have in mind are set out in the Annex to this minute. You will see that the list also includes two modest initial steps on portfolio investment and the abolition of the gold coins control introduced in 1975. Final decisions will need to wait until I have the Bank of England's further advice on third country trade and also until I a able to assess the probable effect of the Budget as a whole on the exchange rate. So long as our policies command the confidence of the financial markets (in particular, our determination to cut public expenditure and to control the PSBR and the

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

I am advised that the Commission are likely to go along with my proposed package provided that they are seen to have been consulted. I therefore intend to invite Commission officials to London to discuss the details of the package with the Treasury and the Bank about a week before the Budget. I will speak to Mr. Ortoli on the telephone myself a day or two before the Budget; and we shall invite the Commission to issue a Press Notice on Budget day simultaneously with ours so as to make it quite clear that they were fully consulted.

I should be glad to know that you are content that I should proceed on the lines described above. Detailed work on the preparation of exchange control notices and other relevant docume is already in hand. To ensure no misunderstandings or confusior the commercial banks and other exchange control agents should receive these notices by the morning after the announcement. To get them out on Budget Day, the texts need to be put in final form ready for printing no later than next Wednesday 30th May.

I am sending copies of this minute to the Secretaries of State for Foreign and Commonwealth Affairs, Industry and Trade, the Governor of the Bank of England and Sir John Hunt.

M Hall.

(GEOFFREY HOWE)

(Approved by the Chancellor of the Exchequer and signed in his absence)

23rd May, 1979

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ANNEX

PROPOSED EXCHANGE CONTROL RELAXATIONS

Outward direct investment

(i) A ration of official exchange of up to £5 million per project per year for new outward direct investment.

(ii) Abolition of the requirement that at least two-thirds of overseas earnings must be repatriated.

(iii) Existing foreign currency borrowing to be repayable in five equal annual instalments - this replaces the "matching benefits" rule.

(iv) New borrowing also to be repayable over five years (to the extent that repayment cannot be met from the ration).

(v) Disinvestment proceeds to be allowed to be used to pay off unrelated borrowing.

Controls on individuals

(i) Private property: replacement of the present requirement that investment currency must be used by a ration of official exchange of £100,000 per family per year. Further consideration to be given to whether this should be confined to one property per family.

(ii) Emigration allowances: increase the initial allowance of offici exchange per family unit to £200,000 worldwide. (At present it is £80,000 for the EEC and £40,000 elsewhere).

(iii) Cash gifts and dependants allowances: combine these allowances and raise the annual limit per donor to £10,000. (At present, they are £1,500 - £3,000 in the EEC - for gifts, plus £2,000 for dependants.)

(iv) Travel allowances: allow banks to issue £1,000 per journey (instead of £500 now).

Third country trade

The re-introduction of sterling finance for third country trade. Decisions on whether it should be confined to UK merchants or extended to banks and on the precise nature of the scheme to be taken after consultation now proceeding.

Foreign currency retentions

If it is decided not to extend the third country trade concession to banks, permission for firms to retain for two months foreign currency sufficient to cover two months' needs (instead of one month in both cases now).

Outward portfolio investment

(i) Official exchange to be allowed to meet the interest on foreign currency borrowing taken to finance portfolio investment.

(ii) Abolition of the present rule that 115 per cent of the value of loans taken out of portfolio investment must be covered by foreign currency securities or investment currency.

Gold coins

Remove all restrictions on import of and dealing in gold coins.

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CONFIDENTIAL

MR HANCOCK DH 23/5.

cc for Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (I)
Sir Douglas Wass
Mr Couzens
Mr Barratt (or)
Mr Jordan-Moss
Mr Ridley

cc to Mr Ilett
Mr McIntyre
Mr D A Dawkins B/E

EXCHANGE CONTROL : HOLIDAY HOMES ABROAD

The Financial Secretary, when endorsing the proposal for an official exchange ration of £100,000 per year for purchase of property abroad for private use, was less happy with the suggestion of continuing to limit these properties to 1 per family, since he thought this could seem rather paternalistic; and he asked officials to look further at the point. The Chancellor has however expressed some doubt about the case for allowing the use of official exchange for a second holiday home.

2. The Bank have reviewed the question whether allowing more than one private overseas property purchase per family would undermine the present policy that no portfolio investment in property can be allowed. They have concluded and I agree that, since most property investment can be done as a direct investment, there would be no serious exchange control difficulty involved and indeed the administrative task might be slightly reduced because the number of properties owned could be ignored. Although property cannot be controlled as effectively as securities, the risk here does not depend on the number of properties allowed. The question is therefore purely one for political judgement.

3. It would however be a pity in my view to defer the relaxation on private property to a later package since it would help to reduce friction with the public and save on administration and enforcement. I should also advise against liberalisation only for properties in other EEC countries: most existing holiday homes are outside the Community e.g. Spain, and I do not believe we should gain any extra credit from the Commission for discriminating in this way, which would certainly complicate administration.

CONFIDENTIAL

7. As you know, if we are to get the relevant exchange control notice printed in time, we need a decision by 30 May.

C H W HODGES
23 May 1979

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34/04 (D)

10

cc Chancellor of the Exchequer
Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Couzens
Mr Barratt O/R
Mr Jordan-Moss
Mr Hancock
Mr Ilett
Mr McIntyre
Mr Dawkins B/E

NTROL : HOLIDAY HOMES ABROAD

al Secretary has noted the points made in your minute of

PCD

P C DIGGLE

24 May 1979

CONFIDENTIAL EXC/54/04 (D) 102

CHANCELLOR OF THE EXCHEQUER
Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir L Airey
Sir F Atkinson
Sir A Rawlinson
Mr Couzens
Mr Barratt
Mr Littler
Mr Jordan-Moss
Mr Dixon
Mr Hancock
Mrs Hedley-Miller
Mr Hodges
Mr Ridley
Mr McMahon) Bank of England
Mr Dawkins)

EXCHANGE CONTROL

I have been thinking about Mr Battishill's minute of 21 May in response to mine of 18 May.

You suggest that a separate opportunity should be found to present the case for relaxations of outward direct investment to the TUC. I think we should see the evidence first before deciding how best to use it. I do not see any immediate purpose in a separate presentation of the case to the TUC, over and above the case we shall be presenting to Parliament and people, although no doubt the subject will feature in your informal contacts with trade union leaders and possibly also in the forum of NEDC under your chairmanship. I agree that it would be useful to try to persuade the CBI to make the case publicly, independently of whatever we may do.

NIGEL LAWSON
24 May 1979

CONFIDENTIAL

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CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Sir L Airey
Sir F Atkinson
Sir A Rawlinson
Mr Couzens
Mr Barratt
Mr Littler
Mr Jordan-Moss
Mr Dixon
Mr Hancock
Mrs Hedley-Miller
Mr Hodges
Mr Ridley
Mr McMahon) Bank of England
Mr Dawkins)

EXCHANGE CONTROL

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NIGEL LAWSON
24 May 1979

786/5

CONFIDENTIAL

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

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From the Secretary of State

Sent 29/5
Mr Hodges
PS/CSS
PS/MSS
PS/MSS (C)
PS/MSS (L)
Sir D Wass
Mr Gozney
Sir L Airs
Sir F Atk
Mr Litt
Mr Jordan
Mr Dixon
Mrs Hedley
Mr Hawe
Mr Ridl
Sir A Rawlinson

The Rt Hon Sir Geoffrey Howe MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
SW1

25 May 1979

Dear Chancellor of the Exchequer,

EXCHANGE CONTROLS

Thank you for copying to me your minute of 23 May to the Prime Minister.

As you know I share your view that the liberalisation of exchange controls would be helpful to British industry and exports. I believe also that a firm move to dismantle the constraint of these controls could be an important sign to the outside world of the Government's determination to tackle bottle-necks on the supply side of the economy.

In this respect I was assuming that you would remove all controls on overseas direct investment, since there can be little firm evidence that it would create substantial flows across the exchanges - and it would be seen as a symbolic gesture to markets indicating considerable self-confidence on the part of the in-coming Government. Announced with firm fiscal and monetary policies, embracing significant reductions in public spending, the two measures taken together, might well have the perverse effect of actually strengthening Sterling. The argument that our policies on exchange controls should be dictated by the impact of consequent moves in the exchange rate on exports is not one that I accept at this particular juncture, not least because it is so difficult to predict.

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Your proposals therefore whilst welcome as far as they go may, I suggest, be regarded by markets as being unduly timid. For this reason they may not bring about the full political and economic benefits which might otherwise have been obtained. Undoubtedly they will meet criticism from the TUC which will be repeated each time that you take a further step. It is ironic that our outward capital flows should still be more tightly controlled than in almost any other major western industrial country, in spite of North Sea Oil. It is the excessive caution of successive governments in this area of policy that has brought about this situation - and I am disappointed that we cannot grasp this useful opportunity by taking a more courageous step.

The re-introduction of Sterling financing for third country trade is welcome. I accept that it would be unwise to abandon controls on portfolio investments at this stage but I fully support the limited steps that you are taking here at this time and I note your intention to study further relaxations in this field as circumstances permit.

I am copying this to the Prime Minister, the Secretaries of State for Foreign and Commonwealth Affairs and Industry, the Governor of the Bank of England and to Sir John Hunt.

Yours sincerely,

T. Allans

JOHN NOTT
(approved by the Secretary of State
and signed in his absense)

CONFIDENTIAL EXC/84/04 (D) ETCSP9

EF(2)CS

11 JAN 1980

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CHANCELLOR OF THE EXCHEQUER

CHIEF SECRETARY TO THE TREASURY
Minister of State - Commons
Minister of State - Lords
Sir Douglas Wass
Mr Couzens
Mr Barratt
Mr Jordon-Moss
Mr Hancock
Mr Hodges
Mr Ilett
Mr McIntyre
Mr Ridley
Mr D A Dawkins - Bank of Engla

EXCHANGE CONTROL: HOLIDAY HOMES ABROAD

I understand that the Prime Minister has approved the proposals for th relaxation of exchange controls in the forthcoming Budget as contained in your minute to her of 23 May. This leaves, as the only item of the package still - and now urgently - requiring a firm decision, the ques of whether the proposed ration of £100,000 of official exchange, per family per year, for the purchase of private property overseas should or should not be further circumscribed by the requirement that each fam may purchase only one property.

I do not consider this to be a decision of the first importance. Howev the Treasury and the Bank have agreed that the absence of this second condition would further ease the administrative task of policing this particular control, and it does seem to me unnecessarily paternalistic to tell people that they can have £100,000 of official exchange to purchase a holiday home in Provence but not even £80,000 if they wish to purchase a modest villa on the Costa Brava and a chalet in Brittany. I would therefore recommend, on balance, that we do not impose the "one home" restriction. As I understand it, there is no need for the notice to refer to the number of holiday homes at all: it would merely make clear that there was to be a ration of £100,000 for a purchase of overseas property.

[illegible] in my [illegible] 22 M[illegible]ned that [illegible] £5 million ration for ~~complete~~ outward direct investment would, in practice, be only one step away from complete freedom for direct investment overseas and that all being well you ought to be in a position to take this further step quite soon. I would hope you might feel able to foreshadow this in your Budget statement.

NL.

NIGEL LAWSON
29 May 1979

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cc: Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr. Couzens
Mr. Barr (o/r)

Mr. Jordan-Moss
Mr. Hancock
Mr. Hodges 5/vi
Mr. Middleton
Mr. Gill
Mr. McIntyre

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

29th May, 1979

Dear Tim,

MR. DOUGLAS HAGUE

You wrote to Tony Battishill on 9th May, enclosing a note from Mr. Douglas Hague on the exchange controls. The Chancellor also received a copy direct from Mr. Hague. The Chancellor suggests that the Prime Minister may like to reply on the lines of the attached draft.

I am copying this letter to John Beverly.

Yours ever,

MAH

(M. A. HALL)

T. Lankester Esq.,

43/6

DRAFT REPLY FROM : PRIME MINISTER

TO : PROFESSOR DOUGLAS HAGUE

COPIES TO: CHANCELLOR OF THE EXCHEQUER

GOVERNOR OF THE BANK OF ENGLAND

I was grateful to you for sending your paper on exchange control of 4th May to Geoffrey Howe and me. We shall be taking your well-timed suggestions into account in judging how best to proceed with relaxing controls which are obviously now more restrictive than they need to be. I cannot of course anticipate what ~~Sir~~ Geoffrey will decide to do; but I can say that, as you might expect, all the areas you mention are being thoroughly explored.

EXC/54/04 (D) 110

CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary

29 May 1979

Sent. 29/5

MR. HODGES
PS/CST
PS/FST
PS/MST (C)
PS/MST (L)
SIR D. WASS
MR COUZENS
SIR L. AIREY
SIR A. RAWLINSON
SIR F. ATKINSON
MR. LITTLER
MR. JORDAN MOORE
MR. DIXON
MRS. HEDLEY-MILLER
MR. HANCOCK
MR RIDLEY

Dear Martin,

EXCHANGE CONTROLS

The Prime Minister has considered the Chancellor's minute of 23 May on the above subject. She has also seen Mr. Nott's letter of 25 May, which broadly welcomes the Chancellor's proposals but argues that they should go rather wider.

The Prime Minister understands the reasoning behind Mr. Nott's suggestion that the exchange control relaxation should be more ambitious than the Chancellor proposes; but she considers that the precise degree of relaxation which can be immediately contemplated must be a matter for the judgement of the Chancellor and the Governor, and she therefore agrees that the Chancellor should proceed on the lines set out in his minute.

I am sending copies of this letter to Paul Lever (Foreign and Commonwealth Office), Andrew Duguid (Department of Industry), Tom Harris (Department of Trade), John Beverly (Bank of England), and Martin Vile (Cabinet Office).

Yours ever,

Tim Lankester

Martin Hall, Esq.,
HM Treasury.

CONFIDENTIAL

10 DOWNING STREET

29 May 1979

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1

Dear Geoffrey,

A quick note on your minute to the Prime Minister on exchange controls, of 23 May.

On page 2, you refer to "the introduction of a ration of official exchange of £5m per investment project per year".

It occurred to me that any self-respecting management would be able so to define and structure their operations, in "project" terms, as to yield as many £5m chunks as they wanted. But I am sure that someone at your end will have thought of that.

Yours ever

JOHN HOSKYNS

CH/EXCHEQUER	
REC.	30 MAY 1979
ACTION	MR HODGES
COPIES TO	CST FST MST(C) MST(L) SIR D WASS SIR L AIREY SIR F ATKINSON MR COWZENS SIR A RAWLINSON MR LITTLER MR JORDAN-MOSS MR DIXON MRS HEDLEY-MILLER

MR HANCOCK
MR RIDLEY

270/8

Confidential

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Sir Douglas Wass
Mr Couzens
Mr Barratt
Mr Hancock
Mr Ilett
Mr McIntyre

Mr Dawkins B

EXCHANGE CONTROLS : PROPOSED LIBERALISATIONS FOR EMIGRATION AND PRIVATE PROPERTY

Subject to colleagues' agreement, Treasury Ministers have decided that, as part of the package of exchange control relaxations to be announced on Budget Day, there should be change in the rules governing the emigrants' allowance and the purchase of private property abroad. The emigrants' basic allowance is to be raised to £200,000 compared with the existing £80,000 for emigration to other EEC countries and with £40,000 for the rest of the world. Purchase of private property abroad will be permitted with official exchange (a ration of £100,000 per family unit), whereas under present rules people have to pay the premium

in the investment currency market.

2. This note is to make the Financial Secretary aware that the combined effect of these changes might be the subject of some public criticism. The effect is perhaps best shown by taking as an example a ~~the~~ family which has just moved out to Spain. Their basic allowance is £40,000. They will have paid the premium for house-purchase (unless, which is probably rare, they are able to borrow the necessary funds in Spain). Only to the extent that they do not utilise their basic allowance can they recover the premium element of the cost. After 12 June, they will not get the premium if they decide to sell their home. And while they will then be able to take out upto £160,000 of hitherto restricted assets under the new emigration rules, they will observe that those deciding to emigrate ~~to Spain~~ after 12 June will be able to utilise upto £300,000 of

official exchange straightaway - the £200,000 ~~emigrants'~~ basic allowance, plus £100,000 for a private property if they buy before they emigrate.

3. This contrast in treatment suggests two possible sources of criticism. The first might be from those who have recently settled abroad under the present rules. They might argue that the government should compensate them for the loss of the premium on their properties. Our defence is that people have to arrange their affairs as best they can under the prevailing rules and that there has been no guarantee that the premium arrangements would continue indefinitely. Further the end of the premium for private property transactions is a necessary corollary of the government's decision to make official exchange available for that purpose.

4. A second criticism might be that the rich

are getting an enormous increase in the amount of official exchange they can take out of the country on emigration — from £40,000 to £300,000 for non-EEC emigration if property is bought before emigration. The answer to that is that the government believe a substantial relaxation of the rules is called for and that, in any case, under present rules, all emigrants' assets are freed after four years so that the effect of the relaxation on the balance of payments ~~over a period of years~~ is only to bring forward ~~the o~~ part of the outflow.

4. Some of this potential criticism could be avoided if we netted off the private property ration from the emigration allowance, so that emigrants could not take more than £200,000 out initially, including the cost of their new home abroad. ~~But there would be a large loop hole~~. ~~As the property ration is to be an annual one, emigrants could simply utilise it in~~ But that would add ~~some administrative~~ complexity to the

new rules in areas where ~~of~~ one of the major reasons for liberalisation is to reduce ~~relatively heavy~~ administrative costs which are heavy in relation to the economic importance of the controls. Moreover, it could be said to be at odds with the general spirit of the relaxations.

5. The Financial Secretary is recommended to agree that the proposals stand in their present form i.e. with no netting off of the property ration from the emigrants' basic allowance.

Exc / 344/04 (D)

EF

Copies sent to PCH

Mr Hodges
PS/CST
PS/FST
PS/MST(C)
PS/MST(L)
Sir D Wass
Sir L Hivey
Sir F Atkinson
Mr Gourgens
Sir A Rawlinson
Mr Littler
Mr Jordan-Moss
Mr Dixon
Mrs Heidley-Mill
Mr Hancock
Mr Ridley

CHANCELLOR OF THE EXCHEQUER

EXCHANGE CONTROLS

You sent Peter Carrington a copy of your minute of 23 May to the Prime Minister outlining a package of exchange control relaxations which you propose to announce in your forthcoming budget speech.

In his absence at a NATO meeting in The Hague, I am writing to say that I welcome your proposal to introduce some relaxations to our exchange control regime. I accept that the imminence of the budget makes it difficult to do more at this stage and I welcome your intention to keep the possibility of further relaxations under study. If we are to relax portfolio investment controls, as I think we should, I hope we shall do so sooner rather than later.

That said, I accept that the package is a valuable first step. If the proposed removal of controls generates an increase in the flow of direct investment overseas, including to the developing countries, this may to some extent offset cuts we are having to make in our official Aid Programme. It should also help to increase the diversity and security of our raw material supplies. Finally, it should help us counter the criticism which we have been under from both the Commission and the Americans over our current exchange control practices. I am glad that you will be giving the Commission advance notice of what you intend.

/I

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I am sending copies of this minute to the Prime Minister, the Secretaries of State for Industry and Trade, the Governor of the Bank of England and to Sir John Hunt.

I.H.G.

30 May 1979 I H G

EF

CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State - Commons
Minister of State - Lords
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Mr Couzens
Sir Anthony Rawlinson
Mr Barratt - o.r.
Mr Littler
Mr Jordan-Moss
Mr Dixon
Mrs Hedley-Miller
Mr Hodges
Mr Ridley
Mrs Lomax
Mr McMahon)
Mr Dawkins)
B of E

EXCHANGE CONTROL RELAXATION

You asked whether it would be possible to increase the size of the package on exchange control on the lines suggested by Mr Nott in his letter dated 25 May.

2. Mr Nott's suggestion related only to outward direct investment. He did not comment on the personal relaxations and he explicitly said that he accepted that it would be unwise to abandon controls on portfolio.

3. So far as outward direct investment is concerned, Mr Nott suggested that all controls should be removed. So long as we retain controls over portfolio investment, it would not be possible to abandon the monitoring of applications. But you could introduce an unlimited allowance for overseas direct investment with continued monitoring of all applications to enable the Bank of England to satisfy themselves that the applications were genuine.

4. The Treasury's original proposal was for a £2 million ration with a number of other relaxations that would be likely to be less expensive than the Bank's recommendation of a £5 million ration. The reason for our more modest suggestions was that we wanted to limit the cost to the balance of payments capital account. But we were persuaded that, given the sort of Budget that you intend to introduce, the extra cost of moving to a £5 million ration would not be serious, whereas the £5 million ration would be simpler and administratively superior.

5. A further move from a £5 million ration to unlimited official exchange for outward direct investment would similarly be unlikely to involve substantial extra cost, provided it were not exploited as a means of evading the restrictions on outward portfolio. There is a risk that this might happen since capital transferred to any overseas subsidiary might be used to invest in securities rather than in the real business of the company. The risk is more apparent in the case of the subsidiaries and branches of banks whose business is after all in financial assets. We do not rate the risk very highly and it is true that a ration of £5 million would not provide complete protection. Nevertheless it would be safer to wait until we were in a position to make a move on portfolio before allowing an unlimited amount of official exchange for outward direct investment. Our intention had therefore been to think further about the degree of risk while preparing options on the relaxation of portfolio. If we were satisfied that the risk was manageable, our intention had been to recommend an unlimited allowance for outward direct investment to be introduced at the same time as the first major relaxation of portfolio.

6. The exchange control notices that are to be distributed on Budget Day are being sent to the printer tonight. In order to keep your options open, we have during the course of the day drafted a new alternative notice on outward direct investment which makes the allowance of official exchange unlimited for new proje and provides for the repayment of new borrowing at any time. We hope that this new Notice will also be ready for circulation on Budget Day.

7. We are also as a matter of urgency seeing what evidence we can collect about the possible extra cost of increasing the concession in this way. We will report the result as soon as it is available.

8. I frankly doubt whether it is worth changing plans at this stage. Just as it is true that the extra cost to the capital account of the increased concession is not likely to be large, it is also true that the extra benefit to particular firms is unlikely to be very significant. Many large firms will prefer to continue to borrow in foreign currency in order to match their liabilities against their foreign currency assets. The Prime Minister went out of her way to give support to the judgment of what it would be prudent at this stage to do as expressed in your minute of 23 May. I therefore suggest that it would be better to leave the package as described in that minute and consider the case for an unlimited ration of foreign exchange for outward direct at the time when you receive our analysis of the possibilities for a major relaxation of portfolio controls later in the year.

9. The Bank are consulting the Governor about the results of their discussions with the City interests concerned with third country trade and a report to Ministers will be made shortly.

D.H.

D J S HANCOCK
30 May 1979

Confidential

Efcs 122 pa

FINANCIAL SECRETARY

cc Chief Secretary
Minister of State (Commons)
Minister of State (Lords)
Sir Douglas Wass
Mr. Couzens
Mr. Barratt
Mr. Jordan-Moss
Mr. Hancock
Mr. Hodges
Mr. Ilett
Mr. McIntyre
Mr. Ridley
Mr. Dawkins (Bank of England

Mr Wes

EXCHANGE CONTROL : HOLIDAY HOMES ABROAD

The Chancellor accepts the recommendations in your minute of 29th May. He is concerned that the "holiday homes" relaxation should be played in as low a key as possible.

(M. A. HALL)
31st May, 1979

EF2CS

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State (Commons)
Minister of State (Lords)
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Mr Couzens
Sir Anthony Rawlinson
Mr Jordan-Moss
Mr Littler
Mr Dixon
Mr Hancock
Mrs Hedley-Miller
Mr Ridley
Mr Ilett

EXCHANGE CONTROL: "RATION" OF OFFICIAL EXCHANGE FOR OUTWARD DIRECT INVESTMENT PROJEC

Mr Hoskyns at No. 10, in his letter to you of 29 May, has said it occurred to him that any self-respecting management would be able so to define and structure their operations, in "project" terms, as to yield as many £5 million chunks of official exchange as they wanted.

2. We believe that, in practice, companies investing abroad are most unlikely to structure their operations primarily by reference to methods of financing; and an applicant would in any case have to satisfy the Bank of England that each ration would relate to a recognisably distinct project. Accumulating "chunks" of official exchange might still be possible, particularly by deliberate misrepresentation. But the Bank's experience of administering the £1 million ration for investments in the EEC between 1972 and 1974 was that companies did not go in for this. In general, indeed, we doubt if investing companies think it prudent to mislead the authorities on such matters, specially in relation to large transactions.

3. A draft reply to Mr Hoskyns is attached.

C H W HODGES
31 May 1979

DRAFT REPLY FROM CHANCELLOR OF THE EXCHEQUER

TO JOHN HOSKYNS ESQ

10 Downing Street

London SW1

Thank you for your note of 29 May about my minute to the Prime Minister on exchange controls.

Companies will have to satisfy the Bank of England that each official exchange ration of up to £5 million would relate to a recognisably distinct project. Misrepresentation is always possible but experience of administering the £1 million ration for investments in the EEC from 1972 to 1974 was that companies did not go in for this. They seem even less likely to want to with the size of ration now envisaged.

SECRET

EXC/84/04 (D)

125

TELEPHONE
01 · 601 4444

BANK OF ENGLAND
LONDON EC2R 8AH

31st May 1979.

Mr Hancock
CST
FST
IST(C)
MS(B)
Sir D Wass

Sir L Airey
Mr Bridgeman
Mr Ridley

Mr Coudy
Mr Hodges
Mrs Gilmore
Mr Middleton

My dear Chancellor

We have now made enquiries of the banks in order to establish whether it would be practicable to allow them to finance third country trade in sterling within some overall limit and subject to monitoring. I am afraid we have not been able to find a method of allocating a limit to each bank which we should regard as satisfactory. Moreover, some banks doubt whether it would be operationally possible always to remain within a limit; while others do not believe they would even be able to monitor the extent to which they were financing third country trade in sterling. In these circumstances, we would not recommend proceeding with the proposed relaxation at present.

We have also been consulting the various trade associations about the possibility of monitoring the merchants' use of sterling to finance third country trade, if this were once more to be allowed. We are already confident that there is no insuperable obstacle to an adequate system of monitoring. We shall next need to establish with the merchants the exact form of reporting; and, since we propose to delegate to the banks as much as possible of the business of giving permissions to merchants, we shall also need to discuss with the banks the text of an appropriate notice. We would be in a position to do this as soon as there was an announcement of the Government's intention to restore to merchants the possibility of financing third country trade in sterling. Implementation would follow as soon as possible after we had completed our consultations.

Yours sincerely

Gordon Richardson

The Rt.Hon.Sir Geoffrey Howe, QC, MP.

CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State (L)
Minister of State (C)
Sir Douglas Wass
Sir Lawrence Airey
Mr Couzens
Mr Bridgeman
Mr Cowdy
Mr Hodges
Mrs Lomax
Mr Ilett

You asked for urgent advice on the Governor's letter of 31 May about the proposed exchange control relaxation for third country trade.

2. Frankly, I am not at all surprised that the Bank have been unable to devise a scheme for extending the concession to banks in a way that would limit the cost. That now having been established, we would strongly agree with the Governor that the proposal for granting the concession to banks should be dropped out of the Budget package. Our experience in 1976 showed how rapidly leading and lagging can build up in this area and it would not be consistent with the prudent and gradual approach to exchange control relaxation which you have endorsed to give the banks an open-ended concession to finance third country trade in sterling. The risks of volatility here are much greater than those associated with outward direct investment.

3. I therefore recommend that you now approve the proposal in the original Treasury submission, namely:-

(i) Permission for UK resident merchants to finance third-country trade in sterling without limit but subject to monitoring; and

(ii) Permission for firms to retain foreign currency receipts for two months and also to keep sums needed for known commitments for the coming two months (instead of one month in each case as now).

4. It will not now, in the time available, be possible to print exchange control notices for either of these concessions so that they will be ready to be circulated on Budget Day. In any case, as you will see from the Governor's letter, further consultations are needed with the banks about the text of the notice applying to third country trade. However, there is no reason why you should not announce the intention to make these two concessions in the Budget Speech and in the associated Treasury Press Notice.

5. May we proceed accordingly?

D.H.

D J S HANCOCK
1 June 1979

2/3

cc: Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Mr. Couzens
Sir Anthony Rawlinson
Mr. Barratt (or)
Mr. Littler
Mr. Jordan-Moss
Mr. Dixon
Mrs. Hedley-Miller
Mr. Hodges
Mrs. Lomax
Mr. Ridley
Mr. McMahon) Bank of Engla
Mr. Dawkins)

MR. HANCOCK

As I told you yesterday on the telephone, the Chancellor agrees with the conclusions in paragraph 8 of your minute of 30th May.

2. He would however be interested in any figuring you are able to provide on the likely consequences of Mr. Nott's suggestions.

MAH

(M.A. HALL)
1st June, 1979

EL

SECRET

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CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Minister of State - Commons
Minister of State - Lords
Sir Douglas Wass
Mr Couzens
Sir L Airey
Sir Anthony Rawlinson
Sir F Atkinson
Mr Littler
Mr Jordon-Moss
Mr Dixon
Mrs Hedley-Miller
Mr Hancock
Mr Hodges
Mr Ridley

EXCHANGE CONTROLS

I have read Keith Joseph's letter to you of 1 June suggesting that, in addition to the substantial liberalisation of outward direct investment already agreed, there should be an immediate and complete relaxation for outward direct investment in raw material supplies.

As you know, the new exchange control notices have already been printed without this proposal; thus its inclusion in the package now would be a very obvious afterthought.

In previous minutes I have expressed the hope that you would be able to introduce a further package of exchange control relaxation, all being well, in the autumn. I would suggest that Keith's proposal might form part of this second stage package - if, indeed, it is not subsumed in a complete relaxation of outward direct investment controls

I cannot believe that the postponement of this move for a period of three months would have any adverse industrial or strategic consequences.

NIGEL LAWSON
4 June 1979

CONFIDENTIAL

EXC/ESU/04 (E) 130

cc Principal Private Secretary
PS/Chief Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir D Wass
Sir L Airey
Mr Couzens
Mr F Jones
Mr Dixon
Mr Unwin
Mr Butt
Mr P G Davies
Mr Hodges
Mr Allan
Mr Ilett
Mr Ridley
Mr Dawkins - Bank of England

PUBLIC PRESENTATION OF EXCHANGE CONTROL PACKAGE

The Financial Secretary was grateful for your comment of 1 June suggesting how you plan to prepare the ground for the public presentation of the Exchange Control package. He is content with what you propose; but, while he has considered your idea of a personal invitati to Len Murray (paragraph 3) he has decided not to pursue it.

PCD

P C DIGGLE
4 June 1979

CONFIDENTIAL

EF(2)CS

14 JUN 1979

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MR DAWKINS

cc Mr Hodges
Mr Ilett
Mr McIntyre
Mr Ramell
Mr Allan

EXCHANGE CONTROL - MEETING WITH COMMISSION

I see no need for a meeting before we see the Commission at 10 a.m. tomorrow morning. But if you feel we should meet beforehand, I am free from 9 a.m. onwards.

2. I had it in mind to make an opening statment on the following lines:-

(i) Our new Government has a very different approach to economic policy from its predecessor. Its approach to exchange control is fundamental different.

(ii) For political reasons they are anxious to make an important first step in the direction of relaxation at the first opportunity, which is the Budget on 12 June. Hence the rush. Otherwise we would, of course, have given the Commission more time to consider these matters.

(iii) The Government's motive is not to get the exchange rate down but to remove distortions.

(iv) There are in any case considerable risks and uncertainties in our balance of payments prospect.

(v) This explains why the Government has decided on a gradual approach to relaxation.

(vi) But, unlike their predecessors, they have a very strong general disposition to make further moves if circumstances permit.

(vii) Explain why they have decided to give priority to outward direct investment in the first move.

(viii) It follows from the fact that the main motive is to remove distortions that we do not want to discriminate in favour of the Community. Our aim is to simplify the controls. I might refer delicately to the spirit behind the Treaty which presumably is that the return on capital will be highest if

it is allowed to flow freely in accordance with market judgements. any case other Community countries do not discriminate.

(ix) At that point I would hand round a piece of paper showing th package we are considering. I would stress that it is still very m under consideration. Final decisions will not be taken until the Chancellor has assessed the effect of his Budget as a whole on the exchange rate and the outlook for the balance of payments. But, if we did decide to drop any part of it, it would be most unlikely to be that part relating to outward direct investment.

(x) We should, of course, be very glad to consider any suggestic that the Commission might have to make in our post-Budget review o further steps towards relaxation. We have already noted their sug for Community bonds and we will, of course, consider that along wi suggestions for early moves on portfolio.

3. As you see, I am not proposing to say anything about Community proc I thought it would be tactically best to take the line that that is their and that we will be ready to fall in with anything they think appropriate. will reduce the chances of our being held to ransom as suggested in Ohlma recent interview with Fitchew.

4. If you are unhappy about any of this, could you give me a ring?

D.H.

D J S HANCOCK
4 June 1979

EXC/84/04 (E)

CONFIDENTIAL

Chancellor

Two minutes from the FST bros.

4/6.

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Minister of State
Minister of State
Sir Douglas Wass
Sir Lawrence Airey
Mr Couzens
Mr Bridgeman
Mr Hancock
Mr Hodges
Mr Cowdy
Mrs Lomax
Mr Ilett

EXCHANGE CONTROL: RELAXATION FOR THIRD COUNTRY TRADE.

I agree with Mr Hancock's minute of 1 June - but I could not wish the qualification in his paragraph 3(i) "but subject to monitoring" to see the light of day. This is an internal matter.

NL

NIGEL LAWSON
4 June 1979

134

FINANCIAL SECRETARY

EF(2)09
13 JUN 1979

cc Principal Private Secretary
PS/Chief Secretary
PS/Minister of State - Commons
PS/Minister of State - Lords
Sir D Wass
Sir L Airey
Sir F Atkinson
Mr Couzens
Mr Barratt (o.r.)
Mr Byatt
Mr F Jones
Mr Cassell
Mr Dixon
Mr Middleton
Mr Unwin
Mr Gill
Mr Hodges
Mrs Lomax
Mr Allan
Mr Ilett
Mr Ridley
Mr Dawkins)
Mr Walker) B of E
Mr Sangster)

EXCHANGE CONTROL: ARGUMENTS FOR AND AGAINST RELAXATION

Attached to this minute is a note which surveys the arguments that are customarily deployed for and against the relaxation of exchange controls. We have prepared it chiefly as a means of increasing our collective understanding of these arguments. I thought you might like to glance at it before the Budget as background for the subsequent debates. It is rather long - but I have added an index to the front to guide you quickly to the parts you may want to read. The justification for a gradual approach to the relaxation of exchange control in paragraphs 47 to 50 may prove to be useful. You may also care to note paragraph 6 which makes the point that the argument that floating rates have made exchange controls redundant is not conclusive. They could be part of a policy to hold up the exchange rate so as to contain inflation.

2. I particularly wish to draw your attention to one important implication for the way in which the Government explains its reasons for relaxing exchange controls. It is quite frequently argued in favour of exchange control relaxations that they will get down the exchange rate and thus increase competitiveness and improve the balance of trade on non-oil account. The following examples of the use of this argument come to mind:-

(i) Repeated articles and editorials in the Financial Times and the Economist about the so-called "Dutch disease".

(ii) The CBI Budget representations said that controls "may well be artificially holding up the exchange rate above its true level, thus eroding our industrial and commercial base". Sir Adrian Cadbury advanced that argument in support of exchange control relaxation when he saw the Chancellor with the CBI delegation on 23 May.

(iii) Officials of the IMF and the Commission have tended on occasion to take that line.

(iv) The Americans have done so in the preliminary discussions for the Tokyo Summit.

(v) I noticed that in your own article in the Financial Weekly for 20 April you said: "The last thing we can afford is to allow British goods to be priced out of export markets now, when we are going to need those export markets back again as soon as the oil earnings begin to decline in, say, ten years time."

3. The implications of the arguments surveyed in the attached paper are wide ranging and we cannot claim to have achieved a consensus within the Treasury on these issues. A good deal of work has been done - and a good deal is still going on. But on the particular point of whether exchange control relaxation would increase competitiveness to a significant degree and for a significant period of time, the attached paper does, I think, at least show - in paragraphs 24 - 42 - that this is a very controversial question. It cannot, in my view, be seriously maintained that relaxation of exchange control is a way of getting down the nominal rate that automatically avoids the offsetting disadvantages for inflation of other means of depreciation. All that I think can be said with any degree of confidence is that, other things being equal, the domestic monetary consequences of getting the rate down in that way are less likely to be expansionary than if it were done by intervention.

4. I conclude that any claim that our exchange control package will help to cure the Dutch disease would be likely to arouse as much opposition as support and that

the Government would be on much firmer ground if it based its case for exchange control relaxation on what the attached note describes as the microeconomic arguments (see paragraphs 43 to 46). These are difficult to deny. And one can go on to argue that those who wish to retain the exchange control regime in all its present rigour and complexitiy need to be able to demonstrate that the e[illegible]fits justify the costs. In this way one can place the onus of proof on the Government's critics.

5. There is another quite separate reason for avoiding the argument that exchange control relaxation is intended as a means of increasing competitiveness. Whatever t motive for a Government action, it is risky for Government spokesmen to say that it was intended to secure a depreciation in the exchange rate. Once that feeling got abroad, the short term consequences for the exchange rate could be very destabilizin

6. I note that the Secretary of State for Trade has stated as his view that we should not use the competitiveness argument to defend the exchange control package (his letter to the Chancellor dated 25 May refers).

7. We are currently preparing briefing for the Budget on the assumption that the competitiveness argument is to be avoided and that the justification should be based on the microeconomic arguments coupled with the need for a gradual approach. You will no doubt let us know if you dissent.

8. We hope to let you have on Wednesday evening, 6 June, a note about the evidence on the relationship between exchange controls, outward investment, jobs and exports.

D.H.

D J S HANCOCK
4 June 1979

SECRET

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CHANCELLOR OF THE EXCHEQUER

cc Sir D Wass
Mr Couzens
Mr Hancock
Mr Hodges
Mr McMahon - Bank of England

EXCHANGE CONTROL RELAXATIONS AND THE TRADE FIGURES

I have seen Mr Couzens' note of earlier today.

Your exchange control package was, very deliberately, a cautious one - and you will recall John Nott's comment, in his letter of 25 May, that in his opinion, the proposals would "be regarded by markets as being unduly timid".

While I believe you were right to err on the side of caution, I feel that to be panicked by the latest trade figures into watering the package down still further would indeed give force to John Nott's objections. I would not, therefore, recommend dropping the proposed permission for merchants to finance third country trade in sterling (which John Nott incidentally in his note specifically applauded). I have no strong views, however, on the concession to banks on retention; this could well wait until the time is right (and the method decided) for dealing with the question of the finance of third country trade by banks in general.

NIGEL LAWSON
5 June 1979

303/5

EC

C 138

SECRET

For Information:
Fin. Sec.
Sir Douglas Wass
Mr Hancock
Mr Hodges

CHANCELLOR OF THE EXCHEQUER

Mr McMahon - Bank of England

EXCHANGE CONTROL RELAXATIONS AND THE TRADE FIGURES

You asked on Friday last about the possible impact of the trade figures which are to be published on Friday on the exchange control relaxations. I support the recommendations in the attached note. In particular I would recommend that you should not now commit yourself in the Speech to the relaxation for merchants on sterling and third country trade, or to the concession on retentions.

You will wish to tell the Prime Minister about this. If you agree we will submit a draft minute.

KEC.

K E COUZENS
5 June 1979

enc

SECRET

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T. EXCHANGE CONTROL PACKAGE AND THE TRADE FIGURES

We have been considering whether it would be advisable to reduce the scope of the exchange control relaxations in response to the trade figures and the latest reports on the money supply the CGBR.

2 We do not advise cancellation of the package. It would be bad for the Government's credibility not to make any relaxation of exchange control at all given the expectations that exist. A failure to take some steps in the direction of relaxation might be interpreted as a sign of a lack of self-confidence in the Government's own policie which would be damaging to confidence.

3. In any case it remains true that our external position is still basically sound. We have large reserves and our overseas debts are well under control. Although the private sterling balances have risen this year, the official balances are no longer a problem. The outlook for the current account may not be as good as it was before we had the recent news; but it will benefit from increasing North Sea oil production over the years ahead. The revised forecast is not dramatically changed by the new information. The real oil price may well continue to rise and this should be good for sterling. Finally, we expect the Budget to be well received by the markets: in particular, the Government's commitment to a tight monetary policy will protect the exchange rate against strong downward pressure.

4. A further factor is that the exchange rate is erratically high. Last year we regarded any effective rate over 62½ as a strong rate for sterling. Today the effective rate is over 67½. Complaints about the loss of competitiveness from industry are increasing and, if it were not for the effect of the Budget on the RPI, there would be a good deal to be said for allowing the rate to settle back a bit.

5. The announcement of the trade figures may well bring downward pressure on the rate; but we would not expect the announcewent of the exchange control package to have a marked effect immediately. As Mr Nott said in his recent letter, the impact effect could actually be favourable to sterling. In time, of course, we estimate that the package will cause a capital outflow of the order of £1 - £1½ billion, assuming that confidence is not seriously disturbed. But this effect will be spread over a year or so (and there will be a continuing cost of around £¾ billion a year thereafter).

6. In the light of the above, we have considered whether there is a case for dropping some parts of the package. Our first conclusion is that the package relating to outward direct investment should be preserved in toto. These flows are not particularly volatile. Many firms will continue to finance their overseas investment with foreign currency borrowing in order to match their foreign currency assets with foreign currency liabilities. The outward direct concessions are the centrepiece of the package and are in themselves an impressive move. Our reserves are sufficiently large to enable us to mitigate the effect of the outflow on the exchange rate if that were desired - ie to finance part of the relaxation from the reserves by intervention.

7. The expected effect of the following on the capital account is so small that to delete them would bring no significant benefit in the form of reduced outflows. They all have merit as ways of simplifying our system of controls:-

(i) The cash gifts and dependants allowances

(ii) The concessions for private property overseas

(iii) Travel allowances

(iv) The two minor relaxations affecting portfolio.

8. This leaves the following items of the package for consideratic The figures to the right of the list are the estimated outflow from the capital account in the first full year.

		£ ~~billion~~ m
(i)	Emigration allowances	75-150
(ii)	Gold coins and medals	50-100
(iii)	Sterling finance for merchants	100-300
(iv)	Retentions	100-200

9. Although the estimated outflow for emigration allowances is quite significant, the effect is once-for-all. It is not a vehicle for speculation against sterling. We suggest therefore that this item should be retained.

10. We are obliged to make some change in the rules relating to gold coins because of a recent ruling of the European Court. We have considered whether the Chancellor could drop the announcement of complete de-control from the Budget package and wait for a month or so to see how things developed. Our thought was that, if the outlook

for the exchange rate then appeared to be shaky, a more modest relaxation consistent with our legal obligatins could be substituted for total abolition. The problem is that the exchange control notices for gold coins, travel and emigration cross-refer to each other. It is too late to print new notices for despatch on Budget Day. To drop gold coins would thus mean either dropping travel and emigration as well or saying that a detailed announcement on travel and emigration would follow. It scarcely seems worthwhile truncating or complicating the package in this way.

11. The final two items - third country trade and retentions - are those where the risk of volatility (if confidence in sterling were weak) is most important. But the concession for third country trade for merchants has a great deal to be said for it as a way of removing an impediment to the transaction of profitable business. The Chancellor may therefore like to consider the following suggestion which would leave open the possibility of reducing the scale of the relaxations if appropriate but also enable him to implement his original plan if confidence after the trade figure announcement and the Budget remain sound. In his Budget Speech (and the associated Treasury Press Notice) he should <u>not</u> say that he <u>intends</u> to make a concession for UK-resident merchants, but only that he is studying that proposal. As he already knows, further discussions with the ~~banks~~ City are in any case required before a scheme can be finalized. If things go well, he could then at a later stage announce the intended package. If things go badly, he could simply say that the time was not ripe for making this further relaxation.

12. He could also drop all reference to the retentions concession from the Budget Speech and the Press Notice. If things go well, that proposal could be announced at the time that the sterling finance for third country trade concession was announced. And, if they went badly, the proposal could be dropped and no one would know that it had ever been contemplated.

13. Two detailed points arising from the above suggestion may be worth mentioning. First, before a relaxation for merchants could be implemented, the Bank would need to consult with the banks about the draft exchange control notice and with the merchants about a draft reporting form. It would not be advisable to initiate consultations on formal documents until we were fairly sure that there was a good chance of the concession being implemented. This would suggest that there should be a pause between the Budget and the beginning of the consultations to see how markets reacted.

14. The second point concerns jute. The jute traders have been particularly adamant that the restriction on sterling finance damages their trade. The main source of jute is Bangladesh and the Bangladesh authorities have said that they wished to trade only in sterling. They will quote in dollars but only at an uncompetitive rate. The result is particularly galling to UK merchants because all their competitors in Europe are trading in sterling whereas they are not allowed to do so. There is therefore a case to be considered for making a special concession to jute traders even if it is decided not to proceeed with the general concession for UK resident merchants.

Conclusion

15. We recommend that the proposals for third country trade and retentions should be handled as described in paragraphs 11 and 12 above; but that the rest of the package remain intact.

CONFIDENTIAL

PRINCIPAL PRIVATE SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State - Commons
PS/Minister of State - Lords
Sir Douglas Wass
Mr Couzens
Mr Unwin
Mr Hodges
Mr Ridley
Mr Cropper

BUDGET SPEECH - DRAFT OF 5 JUNE

I should like to make two suggestions on the passage on exchange control.

Paragraph E2

2. I suggest the phrase "in a world of floating exchange rates" be deleted and "in the world in which we now live" substituted. My reason is that I think there is a good deal more to it than floating exchange rates. Even with a floating rate regime, exchange controls tend to keep the exchange rate higher than would otherwise be the case. It is therefore arguable that they can contribute to the Government's counter-inflation policies. It is not therefore, as I see it, simply floating rates which have made the difference, but the combination of that with North Sea oil and the Government's determination to maintain tight monetary policies which will be good for confidence. This combination of circumstances gives us an opportunity to relax our severely restrictive exchange control regime.

3. Another important reason for deleting the reference to floating rates is that it sounds as though the Government has already made up its mind not to join the European Monetary System. It would be unfortunate if our Community partners drew that inference. (The actual words of the Budget Speech are studied by the Commission and others with great care.)

Paragraph E3

4. Expand the end of the third sentence to read "..... in accordance with our obligations under the EEC Treaty and I have consulted the Commission about the decisions I am announcing today."

5. The Chancellor authorised discussions with Commission officials this week. The meeting took place this morning. Among other matters that will be reported separately, the Commission representatives particularly asked that there should be a reference to consulting the Commission in the Budget Speech and in the associated Treasury Press Notice. We hope that the Chancellor will agree to this; it will help to secure their co-operation.

D.H.

D J S HANCOCK
5 June 1979

SECRET

E6 JUN 1979

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1. MR HANCOCK D.H. 5/6.
2. FINANCIAL SECRETARY
3. CHANCELLOR OF THE EXCHEQUER

cc for: Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Couzens
Sir L Airey
Sir F Atkinson
Sir A Rawlinson
Mr Jordan-Moss
Mr Littler
Mr Dixon
Mrs Hedley-Miller
Mr Unwin
Mr Ridley
Mr Ilett
Mr McIntyre

EXCHANGE CONTROLS: INDUSTRY SECRETARY'S LETTER OF 1 JUNE
LIBERALISATION FOR RAW MATERIALS INVESTMENT

1. Sir Keith Joseph's letter of 1 June accepts the Chancellor's general approach to relaxation, while giving his reasons for believing that it is as important fully to liberalise outward portfolio as direct investment. He hopes for progress "perhaps in the autumn when it may be clear that further moves would not be disruptive". This part of the letter can be briefly acknowledged. But the Industry Secretary also suggests as an extension to the proposals for 12 June agreed by the Prime Minister (No 10's letter of 29 May) an immediate and complete relaxation for outward direct investment in raw material supplies.

2. In commenting on the initial package, recommended by the Financial Secretary, the Chancellor said (note of 21 May) that he too would prefer to avoid complicating the £5 million ration for direct investment with a more generous provision for raw materials but that he would be prepared to think again if Sir Keith Joseph pressed the matter.

3. As the printing deadline of 30 May is past, the scheme could not be introduced immediately even if the intention were to be announced on 12 June. Should we be able to go ahead quite soon with complete liberalisation of outward direct investment in conjunction with a first major move on outward portfolio, it would hardly be worth complicating the rules with a raw materials scheme for only a short time. However, the future is still uncertain and, if progress after the Budget package has to be more gradual, freeing raw materials investment would remain a good priority candidate.

4. I suggest a reply sympathising with the idea and explaining that the £5 million ration should cover most of the raw materials field, which could be mentioned in the Budget speech, but that whether to go for complete liberalisation here needs to be considered further in the light of the post-Budget situation on the external front. A draft is attached.

or in the Treasury Press Notice D.H.

SECRET

C H W HODGES
5 June 1979

SECRET EXC/84/04 (E) pl retype

DRAFT REPLY FROM: CHANCELLOR OF THE EXCHEQUER

TO: Rt Hon Sir Keith Joseph Bt. MP.
Secretary of State for Industry
Ashdown House
123 Victoria Street
LONDON SW1E 6RB

Copies to: Prime Minister
Secretary of State for Foreign and Commonwealth Affairs
Secretary of State for Trade
Governor of the Bank of England
Secretary of the Cabinet

EXCHANGE CONTROLS

Thank you for your letter of 1 June. It is helpful to have your views on portfolio relaxation and I shall of course take careful account of these in our further studies over the months ahead.

As regards your suggestion about raw material supplies, I have much sympathy with the industrial and strategic case you mention. In practice, however, I believe that the £5 million ration should go a long way to meet the needs of companies for both exploration and exploitation. We can refer to ~~I am ready to say a word on~~ the raw materials point ~~in announcing the ration on 12 June~~ in order to stress its importance from an industrial policy standpoint. But there are still uncertainties about our external position, ~~particularly as to the current account in the shorter term;~~ and I should therefore prefer to see how things look after the Budget before deciding on any extension of the initial package of relaxations. Whether ~~I can accept the industrial importance of such~~ introducing a special raw materials scheme would then be a good move may of course depend on how soon we could envisage complete liberalisation for outward direct investment, in parallel perhaps with a first major relaxation on the portfolio front.

I am copying this letter to the Prime Minister, the Secretaries of State for Foreign and Commonwealth Affairs and for Trade, the Governor of the Bank of England and Sir John Hunt.

SECRET

CHANCELLOR OF THE EXCHEQUER

cc Sir D Wass
Mr Couzens
Mr Hancock
Mr Hodges
Mr McMahon - Bank of England

EXCHANGE CONTROL RELAXATIONS AND THE TRADE FIGURES

I have seen Mr Couzens' note of earlier today.

Your exchange control package was, very deliberately, a cautious one - and you will recall John Nott's comment, in his letter of 25 May, that in his opinion, the proposals would "be regarded by markets as being unduly timid".

While I believe you were right to err on the side of caution, I feel that to be panicked by the latest trade figures into watering the package down still further would indeed give force to John Nott's objections. I would not, therefore, recommend dropping the proposed permission for merchants to finance third country trade in sterling (which John Nott incidentally in his note specifically applauded). I have no strong views, however, on the concession to banks on retention this could well wait until the time is right (and the method decided) for dealing with the question of the finance of third country trade by banks in general.

NIGEL LAWSON
5 June 1979

EF

10 DOWNING STREET

THE PRIME MINISTER

6 June 1979

Sent to 7/6

Mr Hodges
PS/CSS
PS/FSS
PS/MSS(C)
PS/MSS(L)
Sir D Wass
Mr Coggins
Mr Jordan-Moss
Mr Barratt
Mr Hancock
Mr Gill
Mr Middleton
Mr Ramell.

I was grateful to you for sending your paper on exchange control of 4 May to Geoffrey Howe and me. We shall be taking your well-timed suggestions into account in judging how best to proceed with relaxing controls which are obviously now more restrictive than they need to be. I cannot of course anticipate what Geoffrey will decide to do; but I can say that, as you might expect, all the areas you mention are being thoroughly explored.

(MT)

Professor Douglas Hague, C.B.E.

CONFIDENTIAL

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CHANCELLOR OF THE EXCHEQUER

cc PS/Financial Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir D Wass
Mr Couzens
Mr Unwin
Mr Hodges
Mr Ridley 6/6
Mr Cropper

BUDGET SPEECH - DRAFT OF 5 JUNE

Paragraph E3

It really would be much to our advantage if the Exchange Control decision was presented as our very own, which had happy EEC consequences. If the decision is presented as essentially a response to EEC obligations it will be more difficult to defend.

JOHN BIFFEN
6th June 1979

J. Biffen
approves as
UK not
EC decision

66/6

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cc: Financial Secretary
Sir Douglas Wass
Mr. Hancock
Mr. Hodges
Mr. McMahon - Bank of Engla

MR. COUZENS

EXCHANGE CONTROL RELAXATIONS AND THE TRADE FIGURES

The Chancellor discussed this afternoon with the Financial Secretary and you whether it was necessary to modify the agreed exchange control package in the light of the known trade figures.

2. The Chancellor concluded, on balance, that it was possible to go ahead with the relaxation for merchants on sterling and third country trade, notwithstanding the risk of volatility acknowledged in the OF advice. The Chancellor also concluded, on the other hand, that the retentions concession could usefully be deferred for the time being.

(A.M.W. BATTISHILL)
6th June, 1979

FINANCIAL SECRETARY

cc Principal Private Secretary
PS/Chief Secretary
PS/Minister of State - Co
PS/Minister of State - Lo
Sir Lawrence Airey
Mr Couzens
Mr Barratt - o.r.
Mr F Jones
Mr Dixon
Mr Butt
Mr Middleton
Mr Gill
Mr Hodges
Mrs Lomax
Mr Allan
Mr Horton
Mr McIntyre
Mr Ridley
Mr Willetts - B of E
Mr Benjamin)
Mr Gent) DOI
Mr Mountfield)
Mr Ekins-Dawkes)
Mr Coates) Trade
Mr Gore-Booth - (FRD FCO)

EXCHANGE CONTROL AND OUTWARD DIRECT INVESTMENT

As promised I am sending you tonight our latest draft of our background brief on exchange controls and outward direct investment. It is mainly the work of Mr Ilett but he has consulted the Bank and the other departments listed above.

2. The draft is, I am afraid, still rather rough in places and most of it was written before your meeting this morning to decide the line that you wished to take in the Budget Debate. Our next task is to prepare speaking notes on the lines you requested. We hope to let you have them by the weekend.

3. For the benefit of other recipients, the main points we will be making in the speaking notes will be the following:-

(i) Although the Government would not expect that the relaxations will lead to a dramatic increase in outward direct investment, it would expect the relaxations to encourage small firms to invest overseas.

(ii) To the extent that they do so, that will be a benefit to the economy in the longer term since the investment will yield an income that will improve the current account of the balance of payments when the benefit from oil begins to decline.

(iii) The current account will also benefit in future years to the extent that, as a result of the relaxations, overseas investment that would have taken place anyway is financed in sterling and not in foreign currency. This is because the foreign currency proceeds of the investment will not be reduced as now by the need to repay foreign currency debt.

4. The speaking notes will also expand on the Chancellor's announcement that the Government hopes that it will be able before long to make further relaxations of exchange controls. It will state the arguments for thinking that these also will benefit and not harm the economy - particularly in relation to the controls over portfolio investment.

D.H.

D J S HANCOCK
6 June 1979

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DRAFT 6 JUNE 1979

EXCHANGE CONTROL

OUTWARD DIRECT INVESTMENT: GENERAL BRIEF

This brief covers the balance of payments and industrial/ employment policy arguments for the Budget relaxations. It does not deal with wider considerations - eg internatic obligations and exchange rate policy. Our present exchange controls on outward direct investment are intended to influence the financing of such investment, not the investment itself. The effect of the relaxations will be to allow UK companies investing abroad to use sterling to finance their investments to a substantial extent if they so wish. They remove unnecessary restrictions on the way companies go about their business and they reduce distortic in the market mechanism. Many investors will certainly prefer to go on borrowing foreign currency in order to matc liabilities with assets. But those who want to use sterlir resources will (subject to the generous limits announced) now be allowed to do so.

2. The change in the rules is therefore unlikely to provoke a substantial increase in the general level of overseas investment, although we do expect an increase in the level of investment by small firms. The encouragement to small firms to invest at home or abroad according to where they judge their commercial interests to lie is welcome to the Government and is consistent with their general approach to economic policy-making. But the fundamental decision the Government has taken in making these relaxations relates <u>not</u> to the question whether outward direct investment is in the national interest (thoug they are sure it is) <u>but</u> to the question whether our externa financial position is still vulnerable enough to justify maintaining restrictions on the ways in which companies may finance their investments.

Direct Balance of Payments Effects

3. The initial effect of the measures on the balance of payments is to allow an outflow on capital account which would not otherwise have occurred. The size of this outflow is not easy to predict. With the Government adhering to firm monetary and fiscal policies at home, the underlying demand for sterling should remain fairly strong. Under these conditions, relaxing controls is unlikely to trigger a major speculative outflow of a size seriously to disrupt the foreign exchange markets. But the uncertainties are inevitably very great. Accordin the Government intend to proceed cautiously, and to dismant controls in stages.

4. The effect of exchange control relaxations on the economy depends on what other policies are being pursued. For example, if the Government are adhering to a money supply target and the rate is floating, relaxation is likely to mean a somewhat lower exchange rate, and, at least for a time, rather higher domestic interest rates. In the short run, the capital outflow due to relaxation will be financed by an inflow of short term funds. Subsequently there will be an improvement in the current account (which may only be temporary) brought about by the gain in competitiveness resulting from the lower exchange rate.

5. In addition, there will be a permanent strengthenin of the current account as the continuing benefits flow in from the interest, profits and dividends on the increase in the stock of our net overseas assets. Thus exchange con relaxation will help to build up a source of income to replace that now provided by North Sea oil.

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Finance for investment in the UK

6. The first point to settle before we ca be confident that an outflow which is acceptable on balance of payments grounds will not damage investment in the UK is whether it will cut short funds for domestic investment.

7. This is unlikely, though there could be an incre in the cost of finance in the UK if there was more competition for funds. There is no evidence that UK domestic investment has been thwarted by lack of finance. Reddaway (see paragraph 18 below) found tha "the companies in our sample were virtually unanimou in saying that (in our 10-year period) shortage of finance had not forced upon them a choice between expansion at home and capital expenditure overseas", a reaction he tested before accepting. More recentl the evidence to the Wilson Committee has made it cle that it is not the shortage of finance which is behi the present unsatisfactory level of domestic investment but a widespread lack of confidence.

The Industrial Implications

8. It is sometimes suggested by the TUC and others that to allow overseas investment is, more or less, licence the export of UK jobs. Anything which facilitates outward investment is therefore likely t be bad for exports and employment. [In private, TUC leaders may doubt this but in public they remain unconvinced by arguments to the contrary.] The rela tions may well cause some increase in outward investment, most probably by small firms who could or woul not arrange the Euro-currency loans etc. required in the past. The TUC have however, argued that exchange control is an inadequate instrument of policy in this area. They want a tripartite Investment Review Agenc which would decide on individual cases (paragraph 88 of the TUC Economic Review 1979). They say (Paragrap 195 of the Review) that their main interest is in the

big multinationals. These are of course the companie best equipped to cope without access to sterling, and therefore least likely to change their investment plans because of exchange controls. This underlines further the point that up to now at least the TUC really been looking for the introduction of a new typ of control and not the intensification of the existin one. Their proposals amount to a suggestion that private investment should be directed by the State. This is obviously unacceptable to the Government - and the trade union movement will be obliged to acce that, whatever they may say in public . Despite the rather entrenched position on this matter, it is possible that trade union opinion generally, will be influenced by an effective statement of the Government' case.

9. In theory, a conflict between overseas investmen and ~~direct~~ domestic investment would arise if the two were substituted and overseas investment created productio capacity which competed with UK goods. The bulk of the evidence does not suggest that this often happens in practice:-

(i) much investment is in projects which could not possibly take place in the UK: investments in raw materials exploration, service industries etc;

(ii) other investment is in projects directly designed to promote UK exports: investments in marketing and distribution, in trade promotion etc;

(iii) some investment could in principle take place in the UK but would not then be able to capture the market it was aimed at: transport costs from the UK may be very high; or import restrictions might shut out UK exports;

(iv) much investment is in maintaining and restoring existing overseas business rather than creating new projects which could be sited in the UK.

This is not to deny that some overseas investment does take place at the expense of investment in the UK: but it can only be a relatively small part of total investment.

10. The most important published study of this subject is still that by Professor Reddaway (Department of Applied Economics, Cambridge) written between 1965 and 1968 (interim report in 1967 and final report at the end of 1968). He acknowledged that there might be balance of payments reasons for controlling capital outflows. He said that nothing emerged more clearly from his work than the divergencies in the rate of return from different overseas investments. He found no evidence that UK companies forewent suitable domestic investment projects in favour of overseas ones; and that, after allowing for the external financing charge, the net return to the balance of payments (from post-foreign tax profits, additional continuing UK exports, knowledge-sharing etc) of overseas investment averaged about 4¾%.

11. One of Reddaway's comments could be cited in support of restrictions. This is that the social rate of return on domestic investment was higher than that on foreign investment, because the tax and employment benefits etc from foreign investment accrue to foreigners. This is not surprising, and would only be relevant if it were shown that the foreign investment in question had been undertaken in place of home investment. There is no suggestion in Reddaway (or elsewhere - see paragraphs 12-14 below)

that this is often so. However since Reddaway the return before tax on domestic investment has fallen quite sharply. It averaged less than 7% over the period 1965-74, against over 11% between 1955 and 1964. The [illegible] evidence we [illegible] that [illegible] return on outward direct investment has not fallen by nearly as much and may even have risen slightly.

12. Reddaway's general conclusions have been borne out by subsequent work. The NEDC carried out a surve in 1977/8. 31 Sector Working Parties (SWPs) commente on the reasons behind overseas investment in their sectors. ~~It~~ "stated specifically that the location of investment was not a matter of genuine choice between home and overseas, and other answers implied this. The main reasons given for the decision to invest ove seas related to the overseas market - eg to overcome tariff barriers, protect/develop market position, establish marketing and service facilities, and to meet overseas Government pressure. Half of the SWPs thought that overseas investment would stimulate exports (as Reddaway found). Many thought that if no investments had taken place some overseas markets wou be lost to the UK. Of the five who commented on the employment effects, three thought overseas investment would promote employment in the UK and only one feare that it might have an unfavourable effect in the UK. No SWP thought that exports were reduced by outward investment.

13. A paper put to the NEDC in July 1977 by the Departments of Industry and Trade attempted to assess how far outward investment in theory competes with domestic investment, i.e., to put the question the other way round, the extent to which they are self-evidently complementary. It is worth quoting the conclusion, if only because it was grossly misquoted - as an argument for further controls - in the TUC

Economic Review 1979 (paragraph 194). The paper said that "considerably less than 35% of overseas investment could have displaced UK exports but it is equally possible that such investment may have stimulated exports". (The TUC said that up to 35% of outward investment was in competition with domestic investment). The paper added that firms appear generally to prefer to invest at home if there are no compellin reasons for investing overseas. Life is simpler that way.

14. An interesting international parallel is provided by the German IFO Institute, who published a study of German outward direct investment in January 1977. Its conclusions were on the same lines as those of Reddaway and the NEDC; overseas investment secures sales by being nearer to the market, which may be necessary for a number of reasons - transport costs, import restrictions, perishability of goods, after-sales service etc. Higher input costs at home do however influence investment decisions; studies of UK have generally concluded (not altogether surprisingly) that this is not usually a problem in the UK, though it may have been in some cases.

15. A further criticism of outward investment carri out by UK firms is that we have a higher stock of ove seas investment than anybody except the USA, and that this is responsible for our poor record of domestic investment. The reason is mainly historical. It is true that after the war the Germans and Japanese concentrated heavily on domestic investment, with great success; and that we failed to do so. But in recent years both Germany and Japan have greatly increased their share of new overseas investment. The United Nations Centre on Transnational Corporations has shown that between 1967 and 1976 the UK's share of new investment flows has fallen from 17% to 11%, while

that of Germany has risen from 2.2% to 7% and that of Japan from 1.4% to 7%. This reflects the growing strength of these countries, and indeed it may now

Conclusion

16. The evidence is not entirely conclusive and so of it is now rather old (though the Reddaway Report remains the most thorough that we have). It is nonetheless striking that there is a wide measure of agreement both that outward investment benefits the balance of payments and that in general it favours exports and employment in the home country. Exchang controls do not appear to restrain outward direct investment to a significant degree. To the extent that they do do so, however, there is an economic ca for relaxing the controls (providing this does not lead to destabilising outflows). Given the change in our external situation and prospects since the time when tough exchange controls on outward direct inves ment were imposed, the burden of proof is now on tho who want to maintain controls to justify their continued existence. Controls involve administrative costs, both for the Governments and for those who have to comply with them. In any case, the kind of control which h existed up to now does not provide a suitable mechan for influencing investment decisions on industrial policy grounds; and an investor who is discouraged b restrictions on the use of sterling is far more likely to be prevented from making an investment whi is in the national interest than one which is not. is possible that the occasional case might genuinely threaten UK jobs which would not otherwise have been at risk, but the balance of experience and theory suggests that the overall damage which would be done b maintaining generally unnecessary controls, whether o financing or anything else, would be greater than the damage caused in individual instances by the absence Government interference.

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CONFIDENTIAL

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Ch

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Sir Lawrence Airey
Sir Fred Atkinson
Mr Couzens
Sir Anthony Rawlinson
Mr Barratt - o.r.
Mr Littler
Mr Jordan-Moss
Mr Dixon
Mrs Hedley-Miller
Mr Hodges - Mr Middleton
Mrs Lomax
Mr Ridley
Mr McMahon) B of E
Mr Dawkins)

EXCHANGE CONTROL RELAXATION

Mr Hall's minute of 1 June said that you would be interested to see any figures we are able to provide on the extra cost of introduing an unlimited allowance for overseas direct investment (by comparison with the package of relaxations to be announced in the Budget).

2. Our best central estimate of the effect on the capital account of the outward direct investmentpackage to be announced in the Budget is something of the order of £$\frac{3}{4}$ billion a year. But this is subject to a very wide margin of error. A comparable central estimate of the effect of total abolition might be of the order of £1 billion. But the methods used to produce these figures are too by and large to enable one to take the difference between them literally and to say that the estimated outflow from the increase from one concession to the other is £$\frac{1}{4}$ billion. The fact of the matter is that we do not have any firm basis for making estimates with that degree of precision.

3. The Bank have examined the exchange control records to see if they could provide any direct evidence of the size of the additional outflows. In 1978 authorization was given for 100 projects of over £5 million to be financed by foreign currency borrowing. Most of these were under £15 million. But this

information does not get one very far. The question is how much of this will be financed in sterling once the firms concerned are able to use sterling. Projects of this magnitude will mainly involve large multi-national companies. Once they have soaked up any excess sterling liquidity, such companies are unlikely to adopt financing methods for large projects which would leave them exposed to currency fluctuations. There is likely to be a limit to the amount of spare sterling cash they will have available for foreign investment. It is therefore probable that most of the large projects which would in principle qualify for additional official exchange if there were an unlimited ration would in practice continue to be financed in foreign currency.

4. I am sorry that we are not able to be more exact.

D.H.

D J S HANCOCK
6 June 1979

SECRET

E1

PRINCIPAL PRIVATE SECRETARY

cc Chief Secretary
Minister of State - Commons
Minister of State - Lords
Sir D Wass
Mr Couzens
Sir L Airey
Sir F Atkinson
Sir A Rawlinson
Mr Jordan-Moss
Mr Littler
Mr Dixon
Mrs Hedley-Miller
Mr Unwin
Mr Ridley
Mr Ilett
Mr McIntyre

DRAFT REPLY TO SIR KEITH JOSEPH ON EXCHANGE CONTROLS

The Financial Secretary has slightly redrafted Mr Hodges' draft letter for the Chancellor to send to the Secretary of State for Industry in reply to his letter of 1 June on exchange control. The only substantiv change is the omission of the proposed reference to the raw materials concession in the Budget speech.

PCD

P C DIGGLE
6 June 1979

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DRAFT REPLY FROM: CHANCELLOR OF THE EXCHEQUER

To: Rt Hon Sir Keith Joseph Bt MP
Secretary of State for Industry
Ashdown House
123 Victoria Street
LONDON
SW1E 6RB

Copies to:

Prime Minsiter
Secretary of State for Foreign and Commonwealth Affairs
Secretary of State for Trade
Governor of the Bank of England
Secretary of the Cabinet

EXCHANGE CONTROLS

Thank you for your letter of 1 June. It is helpful to have your views on portfolio relaxation and I shall of course take careful account of these in our further studi over the months ahead.

As regards your suggestion about raw material supplies, I have much sympathy with the industrial and strategic case you mention. In practice, however, I believe that the £5 million ration should go a long way to meet the needs of companies for both exploration and exploitation. But there are still uncertainties about our external position, and I should therefore prefer to see how things look after the Budget before deciding on any extension of the initial package of relaxations. Whether introduci a special raw materials scheme would then be a good move may of course depend on how soon we could envisage complete liberalisation for outward direct investment, in parallel perhaps with a first major relaxation on the portfolio front.

I am copying this letter to the Prime Minister, the Secretaries of State for Foreign and Commonwealth Affairs and for Trade, the Governor of the Bank of England and Sir John Hunt.

166

1. MR HANCOCK D.H. 5/6.
2. FINANCIAL SECRETARY
3. CHANCELLOR OF THE EXCHEQUER

cc for: Chief Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Couzens
Sir L Airey
Sir F Atkinson
Sir A Rawlinson
Mr Jordan-Moss
Mr Littler
Mr Dixon
Mrs Hedley-Miller
Mr Unwin
Mr Ridley
Mr Ilett
Mr McIntyre

EXCHANGE CONTROLS: INDUSTRY SECRETARY'S LETTER OF 1 JUNE
LIBERALISATION FOR RAW MATERIALS INVESTMENT

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2. In commenting on the initial package, recommended by the Financial Secretary, the Chancellor said (note of 21 May) that he too would prefer to avoid complicating the £5 million ration for direct investment with a more generous provision for raw materials but that he would be prepared to think again if Sir Keith Joseph pressed the matter.

3. As the printing deadline of 30 May is past, the scheme could not be introduced immediately even if the intention were to be announced on 12 June. Should we be able to go ahead quite soon with complete liberalisation of outward direct investment in conjunction with a first major move on outward portfolio, it would hardly be worth complicating the rules with a raw materials scheme for only a short time. However, the future is still uncertain and, if progress after the Budget package has to be more gradual, freeing raw materials investment would remain a good priority candidate.

4. I suggest a reply sympathising with the idea and explaining that the £5 million ration should cover most of the raw materials field, which could be mentioned in the Budget speech, but that whether to go for complete liberalisation here needs to be considered further in the light of the post-Budget situation on the external front. A draft is attached.

G H H HODGES

IF 531821309

ET404 RET 135682040-000010 RT ID: TY

EL-BV-OB-0-54-0014-2-03-02

SKP:TCZ00033341-00025 CUST:CI 26

REF1 033341 NRM

File Desc 2: PO-CH/GH/0175 PART A 1

Srv: 16/03 12:30pm GMT For: RQBY

IRENE RIPLEY

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CUSTOMER ID

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PLUS BOX NUMBER

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