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FORM OF DOCUMENT	CORRESPONDENTS OR TITLE	DATE	RESTRICTION
	1. memo case, Reynolds to Board of Governors, 11/23/76		
1a. table	The External Financial Position of the U.K. Public Sector (2 pp.)	11/16/76	C(A)
	2. memo case, Reynolds to Board of Governors, 1/28/77		
2a. memo	R. H. Mills, Jr. to Mr. Reynolds, re $1.5 billion Eurodollar loan to Britain (3 pp.)	1/28/77	C
3. memo	R. H. Mills, Jr. to Ted Truman re Euro-dollar loan to United Kingdom (2 pp.)	1/27/77	C
4. memo	copy of item 2a (3 pp.)	1/28/77	C
5. memo	Ted Truman to Burns re Euro-dollar loan to U.K (2 pp.)	2/15/77	C

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 23, 1976

To Board of Governors

From John E. Reynolds

Subject: Attached Material on the United Kingdom

The attached papers supplement David Howard's November 15 briefing on the United Kingdom.

Attachments

ACTION REPORT

DATE

▶ SUMMARY

CONTACT

PHONE

PLAYERS

ACTION TAKEN

DATE ACTION

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 23, 1976

To Mr. Reynolds

From David H. Howard

Subject: Attached Material on the United Kingdom

The attached papers present background information on the United Kingdom. For your convenience, a copy of my November 15, 1976 Board briefing on the United Kingdom is also attached.

Attachments:

(1) Monetary Policy in the United Kingdom.

(2) Domestic Credit Expansion in the United Kingdom.

(3) The U.K. Public Sector Borrowing Requirement.

(4) U.K. Public Expenditure.

(5) Major Policy Steps in the United Kingdom in 1976.

(6) The November 18 Measures.

(7) Sterling Balances.

(8) A Sterling Float.

(9) Note to Governor Wallich on the U.K.'s External Assets and Liabilities.

(10) Note by Scott B. Brown: Assessment of the Impact of North Sea Oil on the U.K. Balance of Payments.

(11) U.K. Political Situation.

(12) Board Briefing, November 15, 1976.

(13) Economic and Financial Indicators.

David H. Howard
November 22, 1976

Monetary Policy in the United Kingdom

Broadly speaking, U.K. macroeconomic policy has two purposes: bringing inflation down with a minimum cost in increased unemployment; and shifting resources from the public sector into private investment -- particularly investment in export industries. (The note, "Major Policy Steps in the United Kingdom in 1976," presents a chronology of recent policy measures.) This note outlines present U.K. macroeconomic policies in general terms, and then discusses U.K. monetary policy in more detail.

1. Present Policies

The United Kingdom is now pursuing a monetary policy based upon a growth rate target for M_3 of 12 per cent during the fiscal year that began in April. The recent increases in the Minimum Lending Rate and the rate of supplementary reserve deposits were adopted to carry out this money growth target, rather than as new policy steps. In the letter of intent to the IMF in connection with the U.K.'s credit drawings earlier this year, the U.K. government committed itself to a £9 billion increase in domestic credit during the present fiscal year. (See the note, "Domestic Credit Expansion in the United Kingdom" for an explanation of this concept.)

In July, the U.K. government announced some spending cuts and tax increases for the next fiscal year and, at the same time, forecast a public sector borrowing requirement for this fiscal year of £11-1/2 billion (9 per cent of nominal GDP) and one of £9 billion (6 per cent of GDP) for the next fiscal year. However, because of the faltering recovery, the borrowing requirement <u>under current policies</u>, may be as high as £11 billion (7.5 per cent of GDP) next fiscal year.

The U.K. government has been successful in persuading the U.K.'s powerful unions to accept an incomes policy that roughly halved the rate of wage inflation during the first year of the policy (through July 1976). The second phase of the policy, in which wage increases are limited to an average of 4-1/2 per cent, was shaken by the settlement of a seamen's dispute that seemed to point the way to a loophole in the policy (in the form of fringe benefits). Nevertheless, the policy -- aided by high levels of unemployment -- is expected to hold for a second year (through July 1977), and again roughly halve the rate of wage inflation.

Other important aspects of U.K. economic policy include a price control system that amounts to a price and profit monitoring system, minimal -- at least so far -- trade restrictions, and an industrial strategy aimed at the refurbishment of the capital stock of British industry through government assistance.

2. <u>The U.K. Money Supply Target</u>

The quantitative money supply growth target in the United Kingdom is aimed at three major objectives: (1) improvement of confidence, particularly on foreign exchange markets; (2) imposition of a budget restraint on the public sector; and (3) prevention of a renewal of massive inflationary pressure. However, the state of monetary economic science in the United Kingdom is such that there is no way of knowing that any one number, e.g., 12 per cent, is an appropriate target. In fact, one U.K. Treasury source claims that the model used to formulate the target actually generated a target range of 10-14 per cent (which was stipulated to be consistent with likely private sector industrial investment) rather than the announced 12 per cent (the mid-point of the range). Authorities had so little confidence even in the 10-14 per cent range that they did not want to commit themselves <u>in public</u> to it until after they had gained some experience operating with a quantitative money target. However, events forced their hand. Unfortunately, by backing into a publicly-announced money target they have committed themselves to a perhaps overly restrictive or at least overly inflexible target without gaining the full favorable confidence/ expectations effects that a firm, early commitment might have had.

The 12 per cent M_3 growth target, given M_3 expansion through October, implies a 5 per cent growth (S.A.A.R.) for the rest of the fiscal year (9 per cent if a 14 per cent target is used). Given a likely growth in nominal GDP of some 16 per cent (S.A.A.R.), monetary policy will indeed be tight between now and next April if the U.K. government is to succeed in hitting the target.

3. <u>Control of the U.K. Money Supply</u>

Besides the monetary squeeze necessitated by the 12 per cent M_3 target, there are several problems having to do with monetary control that call into question the U.K.'s ability to adhere closely to any specific quantitative money supply target.

The size of the public sector borrowing requirement has made the control of monetary expansion difficult and has elevated sales of government bonds to nonbanks to a position of extreme importance.

Bond sales to nonbanks are important to monetary control in the United Kingdom -- they are the equivalent of open-market sales in the United States. However, a peculiar, self-imposed constraint has impaired the Bank of England's ability to sell bonds aggressively; thus, the government's broker in the past has usually only followed the market price down, he has not usually initiated a decline in price. The Bank considers it to be a breach of faith with the market to sell at one price one day and then to sell at a lower price the next day unless the going market price has come down in the meantime "on its own accord." In practice, however, typically, and certainly lately, the price of bonds has not come down on its own accord, but, rather, has declined in response to the government's manipulation of the Treasury bill rate and/or the

Minimum Lending Rate. However, raising short rates has the immediate effect of narrowing the yield gap between short and long rates and, other things being equal, actually encourages -- for awhile -- lenders to stay short rather than go long. Furthermore, the present bond sales strategy is based upon selling on a rising market, which means that rates of interest must be forced so high that nearly everyone expects them to fall. Large amounts of sales of bonds may require several interest rate cycles -- perhaps with increasing amplitudes -- and with a quantified money supply target and borrowing requirement forecast, it is at least questionable how effective such a strategy is likely to be, since lenders in such a case are not easily fooled.

Although there is some evidence that the government's broker is becoming more flexible and even aggressive in his selling techniques, the basic sales strategy has not changed, as witnessed by the October changes in the Minimum Lending Rate. The October measures show that the government is continuing to operate by way of the short end of the market and that it is still trying to set yields at such a high rate that lenders will expect that they can move downward only.

4. <u>Alternative Monetary Measures</u>

If present monetary measures do not succeed in curbing money supply growth sufficiently there are several options available to the U.K. government. The most obvious one is to reduce the public sector borrowing requirement and thus ease the burden on monetary policy. Monetary policy options include credit controls (such as those imposed on November 18), import deposits, higher rates of supplementary reserve deposits, higher interest rates, and new techniques of bond sales. Of course, the money supply target itself could be changed. It is probably too late to change the public sector borrowing requirement for the current fiscal year and the monetary policy options mentioned above would make the present private credit conditions still tighter and thus endanger the U.K.'s medium-term economic growth prospects.

A reasonable alternative to further tightening of bank lending to the private sector for investment purposes would be for the U.K. authorities to operate as if the 12 per cent target were a 10-14 per cent target range. On the basis of the discussion of the apparent origin of the 12 per cent figure in section 2 above, it would appear that a target of 10-14 per cent would not represent a substantive change of policy, although it might be viewed as a softening of policy. A 14 per cent upper limit would mean that M_3 growth during the remainder of the fiscal year could be 9 per cent (S.A.A.R.) rather than the 5 per cent (S.A.A.R.) implied by the 12 per cent target. 10 per cent growth is still fairly restrictive but achieving it probably would not constitute as much of a danger to private investment as would the 6 per cent figure.

For next fiscal year, however, further cuts in the borrowing requirement would be useful since its size is the fundamental cause of the U.K.'s present difficulties of monetary control.

David H. Howard
November 22, 1976

Domestic Credit Expansion in the United Kingdom

In an open economy such as the U.K.'s, published money stock statistics are not always an adequate indicator of monetary conditions since an external deficit (surplus) tends to reduce (increase) the recorded rate of growth of the money supply. The concept of domestic credit expansion (D.C.E.) has been developed to adjust the recorded change in the domestic money supply for the effects of the external deficit or surplus; that is, D.C.E. is an adjusted money supply growth indicator.

Broadly speaking, D.C.E. is the increase in the money supply plus official financing (i.e., overseas lending to public sector and change in reserves). However, several idiosyncrasies of U.K. data series complicate the actual computational formulae for D.C.E. Of these formulae, the simplest is:

(1) D.C.E. = public sector borrowing requirement
<u>less</u> sales of public sector debt to non-bank private sector
<u>plus</u> bank lending to the private sector.

Unfortunately, not all of these data are available as promptly or as frequently as one would like. Formulae employing more rapidly and frequently available data are:

(2) D.C.E. = bank lending to public sector
<u>plus</u> bank lending to private sector
<u>plus</u> increase in notes and coin in circulation with public
<u>plus</u> overseas lending to public sector;

(3) D.C.E. = increase in M_3
plus overseas lending to public sector
plus some adjustments;

and ,

(4) D.C.E. = official financing
plus bank lending to public and private sectors, and in sterling to overseas
plus increase in currency in circulation with the public.

For the purposes of determining the domestic impact of a given D.C.E. target, formula (1) is perhaps the most useful since, typically, a public sector borrowing requirement will be given also. However, for the purposes of determining a rough D.C.E. target, it is probably best to think in terms of the sum of desirable M_3 expansion plus a desirable amount of official financing.

David H. Howard
November 22, 1976

The U.K. Public Sector Borrowing Requirement

A great deal of the concern about the future of the U.K. economy has centered on the size of the public sector borrowing requirement (PSBR). During the fiscal year 1975-76, the PSBR was £10-1/2 billion -- about 10 per cent of nominal GDP (at market prices). For the current fiscal year that began April 1, the U.K. government expects the PSBR to be £11-1/2 billion, greater in absolute terms but one percentage point less than last year's PSBR as a per cent of nominal GDP. (See Table 1 for past data on the PSBR.) The PSBR is usually interpreted as the government budget deficit and often compared with other countries' budget deficits. This comparison usually indicates that the U.K.'s budget deficit as a percentage of GDP exceeds substantially the budget deficits of most other industrial countries. Such a comparison can be misleading, however, -- and hence any derived conclusions may be erroneous -- unless the PSBR concept is clearly understood. This note discusses the PSBR concept.

The U.K. public sector accounts include the central government, local governments, the social security system, and public enterprises (nationalized industries). The inclusion of nationalized industries is in marked contrast with practice in many other countries where such industries are partly or wholly excluded from the public sector accounts. The relative importance of public enterprises in the U.K. economy --

during recent years their capital expenditures have been about 3-4 per cent of GDP -- can lead to a significant overstatement of the size of the U.K. public sector relative to that of other countries. Since public enterprises, like their private counterparts, typically borrow to finance some of their investment, inclusion of such enterprises in the public sector accounts tends to overstate the U.K. borrowing requirement relative to those reported by other countries. Furthermore, the PSBR includes borrowing done by the public sector to finance loans to other sectors of the economy and, thus, is not strictly comparable to budget deficits reported by some other countries (although some lending of this type is included in the U.S. federal budget).

It is important to distinguish between two concepts of the public sector deficit: the PSBR and what is called the public sector financial deficit (PSFD). The PSBR and the PSFD are defined as follows:

PSFD = current government expenditure
+ public capital expenditure on physical assets
+ net public capital transfer payments
- government receipts.

PSBR = PSFD
+ net lending to other sectors.

There are also central government analogues to the PSBR and PSFD called the central government borrowing requirement (CGBR), which includes net lending to local government and public enterprises, and the central government financial deficit (CGFD).

Most interest both inside and outside the United Kingdom centers on the public sector borrowing requirement rather than on the public sector financial deficit, probably because the PSBR is the more relevant concept for considering the potential for governmental monetary expansion. However, with regard to crowding-out it can be argued that the PSFD is the concept of interest since it excludes government lending to other sectors. Furthermore, a case can be made for excluding borrowing for capital expenditures by nationalized industries because some of such borrowing would take place even if the industries involved were in the private sector. On the other hand, the U.K. public sector conducts its lending to the other sectors and runs the nationalized industries in a way that in some respects resembles a social welfare program (e.g., as a means of preserving specific jobs). The existence of lending to other sectors and the relative importance of public enterprise capital expenditures means that the PSBR figure exaggerates the potential crowding-out -- both financial and "real" -- but correcting for this bias is not easy. Simply deducting the items mentioned would tend to underestimate the potential crowding-out problem. Under these circumstances it might seem best to continue to concentrate on the PSBR, particularly since nearly all public discussion pertains to this magnitude, but to remember that it tends to exaggerate any potential crowding-out problems.

An additional problem in interpreting the U.K. data is that the PSBR and PSFD as reported are not cyclically adjusted. The U.K.

government does not calculate a "full-employment" budget. However, the National Institute of Economic and Social Research estimates that the PSBR during this fiscal year and the next are roughly 7 per cent and 4 per cent of nominal GDP (respectively) on a cyclically-adjusted basis, compared with 9 per cent and 6 per cent on an unadjusted basis. Lending to other sectors represents about 1 per cent of nominal GDP. In addition, since nationalized industries' fixed capital expenditures are included when calculating the PSBR, even a fiscally neutral PSBR, i.e., a "balanced" budget, would probably involve a sizeable deficit in order to reflect that amount of borrowing for industrial investment that would take place even if the nationalized industries were in the private sector. Thus, <u>some</u> of the remaining cyclically-adjusted deficit merely reflects the public sector accounting system used.

David H. Howard
November 22, 1976

U.K. Public Expenditure

The amount of public sector spending and the size of the U.K. public sector are considered below in section 1. The second section is concerned with the problem of public expenditure control in the United Kingdom.

1. The Size of the Public Sector

The argument has been made that the U.K. public sector is "too big" and is a basic cause of much of the U.K.'s present economic difficulties. In fact, the present Labour government seems to accept this argument at least in part. However, even quantifying the size of the public sector -- let alone deciding on a limit beyond which the public sector would be "too big" -- is fraught with difficulties. Perhaps the best approach is to look at several different definitions of the public sector's size and observe the trends. The attached Table 1 presents such an exercise. The various measures of the size of the public sector presented in the table indicate a trend toward a larger public sector, and that this trend cannot be explained by changes in nationalized industries. The conclusion to be drawn from Table 1 is that the amount of resources claimed or allocated by the government, relative to GDP, has been increasing in the United Kingdom.

2. Public Expenditure Control

Traditionally, U.K. public spending plans have been made in "real" terms, i.e., in constant prices. In an inflationary environment this means that the nominal amount of government spending increases with inflation and that government spending units have little incentive to resist price (and wage) increases. Recently, prices paid by the government have increased relatively more than have prices in general, thus increasing still further the amount of nominal government spending. The U.K. government has realized this problem and recently (in April) instituted a cash limits system, starting in the current fiscal year, whereby most real spending plans are translated into nominal spending ceilings based on an assumed rate of inflation. If inflation exceeds the assumed rate, the cash limits remain in effect and thus real spending must be reduced. Inflation during the present fiscal year is exceeding the rate assumed when the cash limits were calculated; and the U.K. government has recently announced its intention <u>not</u> to revise the limits.

A major factor in the recent increase in total U.K. public spending has been the spending by local governments. The central government does not directly control local spending but it does control the amount of budget subsidy that each local government body receives as well as its borrowing activity. Until recently this subsidy made up any shortfall between local current spending and local revenues (borrowing is limited to capital expenditures). The central government now appears determined to hold the line on the subsidies to local governments and, failing an increase in local taxes (property taxes), local government spending should now be under better control.

Table 1

Indicators of the Size of the U.K. Public Sector

	Public Sector Expenditures (as a per cent of nominal GDP at market prices)			Public Corporations[d]: Expenditures on Wages and Salaries, etc. as a per cent of:		Public Corporations[d]: Gross Domestic Fixed Capital Formation as a per cent of:	
	Total[a]	Goods and Services[b]	Consumption[c]	Total Labor Income	GDP	Total Gross Domestic Fixed Capital Formation	GDP
1964	38.5	24.5	16.6	10.3	6.1	19.6	3.6
1965	39.7	24.8	17.0	10.0	6.0	19.9	3.6
1966	40.3	25.7	17.3	9.7	5.8	21.1	3.8
1967	43.7	27.4	18.1	10.1	6.0	22.2	4.1
1968	44.1	26.7	17.8	10.4	6.1	19.8	3.7
1969	42.7	25.5	17.5	10.2	6.0	17.4	3.2
1970	43.1	26.2	17.9	10.1	6.0	17.9	3.3
1971	43.0	26.4	18.3	10.1	6.0	17.9	3.3
1972	43.6	26.3	18.7	10.3	6.2	15.4	2.8
1973	44.9	26.7	18.7	10.0	6.0	14.8	2.9
1974	51.6	29.7	20.7	10.4	6.8[e]	16.6	3.3
1975	53.2	31.8	22.4	n.a.	n.a.	18.7	3.7

Notes: a. Includes all expenditures (including transfer payments and capital expenditures) by the central government, local authorities, and nationalized industries, except current expenditures of nationalized industries.

b. Excludes expenditures on transfer payments, debt interest, and loans to the private sector and overseas.

c. Excludes (in addition to the items mentioned in note b.) public sector investment, e.g., capital expenditures of nationalized industries.

d. The public corporations, or nationalized industries, include: various public utilities (i.e., coal, electricity, and gas), British Steel Corporation, the Post Office (which includes telephone service), various air and surface transportation industries, and British National Oil Corporation. (Note that these are capital-intensive industries.) The Labour government is now in the process of nationalizing the aircraft and shipbuilding industries.

e. This mainly reflects public sector wage increases, but some minor local authority functions were reclassified as public corporations in 1974 as well.

Sources: Economic Trends; National Income and Expenditure.

David H. Howard
November 22, 1976

Major Policy Steps in the United Kingdom in 1976

I. Monetary Policy

A. Special Deposits

1. January 19: The Bank of England temporarily reduced the rate of special deposits (i.e., supplementary reserves deposited at the Bank of England) from 3 to 2 per cent until February 10. The measure was intended to offset the impact of large sales of fixed-interest securities by the central government at a time when substantial tax payments were coming due.

2. September 16: The Bank of England announced an increase in the special deposit rate of 1 per cent, bringing the total rate of special deposits to 4 per cent. The additional deposits were made on the basis of 1/2 per cent on September 28 and a further 1/2 per cent on October 6.

3. October 7: The Bank of England announced an increase in the special deposit rate of 2 per cent, bringing the total rate of special deposits to 6 per cent. The additional deposits are to be made on the basis of 1 per cent on November 2 and 1 per cent on December 14.

4. November 18: The Bank of England re-introduced the supplementary special deposit scheme that sets a guideline for the growth of the interest-bearing liabilities of banks and deposit-taking institutions. The particular guidelines announced allow an expansion of interest-bearing liabilities of 3 per cent during the first 6 months and 1/2 per cent per month for the next 6 months.

B. Money Supply Growth

1. April 6: In his Budget message, Chancellor Healey was interpreted as implying a target rate of growth for M_3 equal to the rate of growth of nominal national income.

2. July 22: Chancellor Healey forecast a rate of growth for the money supply of about 12 per cent for fiscal 1976-77 (i.e., the twelve months beginning April 1976). This forecast has been widely interpreted as a target for M3 growth.

3. October 7: Government measures make it clear that the U.K. authorities are indeed pursuing a monetary policy intended to achieve a 12 per cent growth in M_3 during the current fiscal year.

C. Changes in the Minimum Lending Rate (MLR)

1. January 2: MLR lowered from 11.25 to 11 per cent.
2. January 16: MLR lowered from 11 to 10.75 per cent.
3. January 23: MLR lowered from 10.75 to 10.5 per cent.
4. January 30: MLR lowered from 10.5 to 10 per cent.
5. February 6: MLR lowered from 10 to 9.5 per cent.
6. February 27: MLR lowered from 9.5 to 9.25 per cent.
7. March 5: MLR lowered from 9.25 to 9 per cent.
8. April 23: MLR raised from 9 to 10.5 per cent.
9. May 21: MLR raised from 10.5 to 11.5 per cent.
10. September 10: MLR raised from 11.5 to 13 per cent.
11. October 7: MLR raised from 13 to 15 per cent. The usual formula for pegging the MLR to the Treasury Bill Tender was suspended.
12. November 19: MLR lowered from 15 to 14.75 per cent.

II. Fiscal Policy

1. February 19: The U.K. government published its spending plans for each of the next four fiscal years (beginning April 1976). Although there were some cuts in various programs, real public spending was still scheduled to increase during each of the next four years, albeit at a much slower rate than it had in the recent past.

2. April 6: The U.K. government's Budget was presented to Parliament. There were minor changes in taxation announced, but the Budget's outstanding feature was its offer of personal tax relief conditional on the size of the wage increase to be allowed under the second phase of the U.K.'s incomes policy.

3. May 5: The U.K. government and the Trades Union Congress agreed to a 4-1/2 per cent (on average) pay raise limit during the second phase of the U.K. incomes policy (i.e., during the twelve months starting August 1, 1976). In return, the government reduced personal income taxes by some £930 million. The public sector borrowing requirement was forecast to be £12 billion (9-1/2 per cent of GDP at market prices).

4. July 22: The U.K. government announced plans to cut public sector spending by £1 billion (in 1976 prices) during the fiscal year that will begin April 1977. The government also proposed an increase of two percentage points in employers' social security contributions beginning April 1977. The increase will yield about £900 million in additional revenue in fiscal 1977-78.

At the same time, the U.K. government revised its forecast of the public sector borrowing requirement in fiscal 1976-77 to be £11-1/2 billion (9 per cent of GDP). For fiscal 1977-78, the public sector borrowing requirement is now forecast to be about £9 billion (6 per cent of GDP).

III. Incomes Policy

August 1: Policy instituted whereby wage increases are limited to an average of 4-1/2 per cent during the ensuing twelve months. Workers making less than £50 per week are to receive a £2-1/2 per week raise; those making £80 per week are to receive a £4 per week raise; and those earning between £50 and £80 per week are to receive a five per cent raise. This policy replaced the earlier guideline by which all raises were limited to no more than £6 per week (about 10 per cent of average weekly earnings). Price controls remain in effect but have been liberalized somewhat.

David H. Howard
November 22, 1976

The November 18 Measures

On November 18 the British government announced a tightening of exchange controls on U.K. banks and merchants and the re-introduction of the supplementary special deposit scheme on the banking system and deposit-taking institutions. This note is based upon early -- and sketchy -- news stories.

1. Exchange Control

In a move intended to support the pound sterling during the next 6 months and remove a potential source of pressure during any future sterling crisis, the U.K. authorities have prohibited British banks and merchants from lending domestic sterling to finance trade between foreign countries. The banks and merchants may still use Eurosterling or foreign currency to finance such trade. Previously, British banks and merchants were allowed to lend sterling up to 6 months in order to finance trade involving residents of the Overseas Sterling Area (roughly, the old Commonwealth). British banks and merchants will still be able to finance in sterling U.K. trade as well as that of Ireland and a few other countries. During the next 6 months, there should be a reflow of several hundred million pounds sterling as previous borrowings are paid and no new borrowing is allowed. Some repayments will be accomplished by running down sterling balances, rather than by purchasing sterling in the exchange markets.

2. Supplementary Special Deposit Scheme

In an effort to curb excessive money supply growth and in particular to hit the 12 per cent M_3 growth target, the U.K. authorities have re-introduced the supplementary special deposit scheme that had been in effect between December 1973 and February 1975. The scheme sets up a guideline for the growth of the interest-bearing liabilities of each bank and deposit-taking institution. The particular guidelines announced November 18 allow an expansion of interest-bearing liabilities of 3 per cent during the first 6 months and 1/2 per cent per month for the next 2 months. The base period for calculating the expansion will be the average during the 3 months, August, September, and October. No supplementary deposits will be required during the first 6 months of the scheme, but after that period 5 per cent of any excess of 0-3 per cent must be deposited with the Bank of England; 25 per cent of a 3-5 per cent excess; and 50 per cent of an excess larger than 5 per cent. The deposits do not bear interest.

The main purpose of the measures is to curb money supply growth. Evidently the decision was made that conventional measures, for example, sales of government bonds to non-banks (see the attached paper, "Monetary Policy in the United Kingdom") were inadequate and so the supplementary special deposit scheme was reactivated.

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David H. Howard
November 22, 1976

Sterling Balances

1. The Problem

The term "sterling balances" refers to either (a) exchange reserves in sterling held by central monetary institutions or (b) that figure plus banking and money-market sterling liabilities to non-resident holders other than central monetary institutions. As can be seen in the attached tables, on either definition, sterling balances have declined sharply this year due mainly to withdrawals by the central monetary institutions of oil-exporting countries. The decline in their dollar value this year was even steeper -- from balances of all holders of \$14.8 billion at the end of December 1975, to \$10.3 billion at the end of September 1976.

The sterling balances are beyond the reach of present U.K. exchange controls. They present a problem to the U.K. government because they create uncertainty and instability on exchange markets due to their size and actual or potential volatility. When the U.K. authorities are trying to defend the exchange value of sterling, all of the sterling balances, regardless of their maturity, are implicit short-term dollar liabilities. The alternative to redeeming them with dollars is an exchange depreciation.

In order to cope with the sterling balances, the U.K. government has expressed its hope for international assistance in funding the balances, i.e., restructuring the debt represented by the balances.

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2. Costs and Benefits of Funding Sterling Balances (to the United Kingdom)

The costs and benefits to the United Kingdom of funding the sterling balances depend on the specific arrangements that might be adopted. Transforming an implicit short-term dollar liability into an explicit medium or long-term one is or is not profitable depending on the relative rates of interest and expected changes in the sterling exchange rate. However, the intangible benefits of removing the sterling balances as an overhang on the market, e.g., the benefit from improved confidence, would help to stabilize, or at least to normalize, the exchange market for sterling.

Certain specific types of funding arrangements do have identifiable disadvantages for the United Kingdom. An exchange-rate guarantee can be costly when conventional purchasing power comparisons suggest a depreciation is to be expected. Use of high interest rates to avoid the depreciation (or the need for compensation) is also costly. Another possible disadvantage is that if the United Kingdom assumes an explicit dollar obligation, it loses the option of reducing the size of the implicit dollar liability represented by the sterling balances through exchange depreciation. (An option which was extremely successful at reducing the size of sterling balances in dollar terms this year.)

3. Potential Sterling-Balance Withdrawals

As of end-September, total sterling balances were £ 6.2 billion ($10.3 billion at the current exchange rate) and thus would seem to pose a massive threat to sterling's exchange rate. However, there are reasons to believe that potential withdrawals from sterling are quite a bit less than £ 6.2 billion. First, sterling balances held by holders other than central monetary institutions (£ 3.4 billion on September 30) have been remarkably stable during this extremely turbulent year for sterling, and have in fact risen lately. Since most of this amount is held by banks and companies, it is reasonable to presume that they are primarily "working balances." For this reason, plus their stability so far this year, it might be assumed that, at most, £ .5 billion will be withdrawn from these holdings during the next few years.

Turning to central monetary institutions, it is probably safe to assume that holdings by EEC countries and international organizations will be constant if only to avoid putting further pressure on the U.K. situation. "Other countries" appear to have already adjusted their holdings during the second quarter; it might be assumed that, at most, another £ 100 million will be withdrawn by them. Of the oil exporters' holdings, one might estimate that at least £ 200 million would be needed as minimum working balances. Thus, £ 1.3 billion represents the maximum amount of further withdrawals by the central monetary institutions of the oil exporters; moreover, withdrawals of this size would involve substantial liquidation of long-term holdings by the oil-exporters which have been stable this year at about £ 700 million. Therefore, a reasonable maximum estimate of the amount of sterling balance withdrawals during the next few years would be £ 1.9 billion ($3.2 billion at the current exchange rate) consisting of £ 1.4 billion

($2.34 billion) in balances held by central monetary institutions and £ .5 billion ($.84 billion) in balances held by other non-residents.

4. The Sterling Balance Problem in 1977 and 1978

The U.K.'s current account deficit is likely to be about $2.5 billion in 1977 and near zero in 1978. Exchange controls limit the scope for capital outflows (including, to an extent, further changes in the timing of payments for commercial transactions) other than withdrawals of sterling balances. Assuming capital outflows in 1977 and 1978 will consist solely of sterling balance withdrawals -- the right domestic policies might actually reverse the capital outflow experienced so far this year -- the U.K. authorities would need $5.7 billion (i.e., to cover the current account deficit plus maximum sterling balance withdrawals) to keep the pound sterling approximately at its present value. (Intervention sales of dollars to defend the exchange rate is, in effect, a method of funding the sterling balances.)

The IMF loan, after repayment of drawings on the G-10 standby, will provide Britain with $2.4 billion. So far in 1976, U.K. public sector bodies have borrowed at an annual rate of $3 billion from various Euro-market sources. Assuming that the United Kingdom can continue to finance its current account deficit with Euro-currency loans -- in effect, consumption loans -- until North Sea oil production swings the current account into surplus, some $2.5 billion from the Euro-market might reasonably be available to the U.K. public sector in 1977. The remainder of the funds needed to finance the maximum likely external deficit of $5.7 billion -- $.8 billion -- could be supplied from existing reserves.

The above calculations suggest the conclusion that the sterling balance problem might prove to be manageable in 1977 and 1978 without a special funding operation if the United Kingdom can continue to borrow from the Euro-market in 1977 at roughly the 1976 rate. On the other hand, such an operation might, if accompanied by appropriate domestic economic policies, help to restore confidence in sterling and contribute to a final long-run solution of the problem of sterling as a reserve currency.

RESTRICTED

November 22, 1976

Sterling holdings of non-residents held in the United Kingdom (£ millions)

End of Period	Total	Holdings of International Organizations	Holdings of central monetary institutions: Total[1/]	Non-oil exporters	Oil exporters (of which long-term)		Short-term holdings by other non-residents[2/]: Total[1/]	Oil exporters[2/]
1962	3,863	89	2,223				1,551	
1963	4,102	105	2,335				1,662	
1964	4.140	110	2,326				1,704	
1965	4,074	104	2,214				1,756	
1966	3,988	117	2,187				1,684	
1967	3,690	101	2,001				1,588	
1968	3,380	117	1,803				1,460	
1969	3,726	173	2,146				1,407	
1970	4,220	182	2,365				1,673	
1971	5,622	210	3,030				2,382	
1972	5,909	251	3,361				2,291	
1973	5,934	300	3,379	2,420	959	(103)	2,255	314
1974	7,134	331	4,303	1,202	3,101	(423)	2,500	344
1975	7,330	386	3,716	877	2,838	(624)	3,228	466
1976 March	7,253	400	3,616	994	2,622	(703)	3,237	474
June	6,335	396	2,715	751	1,964	(721)	3,224	444
Sept.[3/]	6,189	377	2,379	838	1,541	(714)	3,433	448
MEMORANDUM:								
1976 Sept. ($ million)	10,336	630	3,973	1,399	2,573	(1,192)	5,733	748

1/ Excludes holdings of IBRD and other international institutions included in column (2).

2/ Includes some official agencies.

3/ Confidential until publication in mid-December 1976.

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Sterling Balances

Date	Exchange Reserves in Sterling Held by Central Monetary Institutions: Total	Government Stocks	External Deposits	Treasury Bills	Banking and Money-Market Liabilities to Other External Holders: Total	External Deposits	Treasury Bills
1. Total:							
1975: Dec. 31	4,102	1,143	1,698	1,261	3,228	3,202	26
1976: Mar. 31	4,016	1,133	1,503	1,380	3,237	3,229	8
June 30	3,111	1,134	1,081	896	3,224	3,213	11
Sept. 30	2,756	1,108	991	657	3,433	n.a.	n.a.
2. EEC:							
1975: Dec. 31	124	25	46	53	774	752	22
1976: Mar. 31	171	27	29	115	750	746	4
June 30	113	27	43	43	776	770	6
Sept. 30	200	27	97	76	896	n.a.	n.a.
3. Oil Exporters:							
1975: Dec. 31	2,839	624	1,382	833	466	466	-
1976: Mar. 31	2,622	703	1,147	772	474	474	-
June 30	1,964	721	784	459	444	444	-
Sept. 30	1,541	714	626	201	448	n.a.	n.a.
4. Other Countries:							
1975: Dec. 31	753	374	202	177	1,988	1,984	4
1976: Mar. 31	823	322	233	268	2,013	2,009	4
June 30	638	269	180	189	2,004	1,999	5
Sept. 30	638	251	211	176	2,089	n.a.	n.a.
5. International Organizations other than the IMF:							
1975: Dec. 31	386	120	68	198	-	-	-
1976: Mar. 31	400	81	94	225	-	-	-
June 30	396	117	74	205	-	-	-
Sept. 30	377	116	57	204	-	-	-

David H. Howard
November 22, 1976

A Sterling Float

Despite intervention sales of nearly $7 billion, sterling has fallen some 36 cents against the dollar since March 1, 1976. The question arises as to whether the U.K. government should continue its policy of "managed" floating or, instead, adopt one of "clean" floating, i.e., little or no intervention.

The U.K.'s economic strategy is based in part on an export-led recovery. Thus, it is of utmost importance that its exports be competitive and, hence, that the exchange value of its currency be realistic. A clean float would probably ensure a realistic exchange rate. A clean float, of course, would economize on foreign exchange reserves, and, in the U.K. case, would probably further diminish the dollar value of the sterling balances. Finally, one might reasonably expect private market participants to move <u>into</u> sterling at some point and thus cushion sterling's fall even without official intervention.

There are, however, several advantages of an intervention policy that resists, if not arrests, sterling's decline. Any depreciation of sterling raises the sterling price of imports and, with a variable time lag, exports. Intervention sales avoid some of these domestic price level effects, and thus reduce the inflation rate -- at least temporarily. Such a consideration is of particular importance in the United Kingdom where adherence to the incomes policy's wage limits is generally perceived to depend greatly on the government's success in reducing inflation in the short term. Another advantage, in the U.K. case, is that intervention sales of dollars extinguish external sterling balances (when, of course, one of the sources of the pressure on sterling is from sterling balance holders). In effect, intervention turns some short-term external sterling liabilities into (typically) medium-term external dollar liabilities bearing lower <u>nominal</u> rates of interest. (The extent to which the exchange market pressure is met through intervention or depreciation affects the price at which this type of refunding takes place.) Intervention sales of foreign exchange also provide the government with sterling finance, and, by strengthening the pound, they also dispel somewhat expectations of interest rate increases and thereby encourage sales of government bonds. Finally, intervention, by helping to finance a current-account deficit, has brought forward some of the increased U.K. consumption made possible by North Sea oil.

Besides the sale of foreign exchange, alternative intervention methods available to the U.K. authorities include domestic interest rate manipulation and import controls. There are three major disadvantages to using higher interest rates to protect sterling: (1) such rates would perpetuate, or even increase, the sterling balance problem; (2) higher domestic interest rates tend to discourage domestic investment; and (3) the higher interest rates increase the future sterling debt-service burden, but the sterling cost (i.e., the dollar interest rate and the change in sterling's exchange value) of the funds used in intervention sales must also be considered when choosing between the two alternatives on this criterion.

Import controls would strengthen the exchange rate somewhat but would tend to raise the domestic price level (via restricting supply and substitution of more expensive domestic products) and thus be counter to the ultimate goal of dampening the effect of depreciation on inflation in the short run. Furthermore, import controls would promote inefficiency in British industry and invite retaliation from abroad.

If it is true that the U.K. incomes policy and domestic stability depend on minimizing the price-level effects of the pressure on sterling, some amount of exchange market intervention appears to be justified -- particularly since such intervention has the useful side-benefit of reducing the long-run sterling balance problem. However, it is important that intervention not be allowed to jeopardize the U.K.'s export competitiveness since the viability and solvency of the U.K. economy depend a great deal on a strong export performance in the short and medium term.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 16, 1976

To Governor Wallich

From David H. Howard

Subject: The U.K.'s external assets and liabilities

The attached tables summarize the U.K.'s external financial position. Table 1 presents a complete accounting of the U.K.'s external assets and liabilities as of the end of 1975, expressed in sterling. The Bank of England publishes this information annually. A detailed breakdown of the various entries is available in the attached Bank of England Quarterly Bulletin article. Two of the entries can be readily updated: "official reserves" at the end of October were worth £3.0 billion (an increase of £.3 billion); and "official financing liabilities" at the end of October were worth £9.4 billion (an increase of £5 billion accounted for by a £1.2 billion increase due to sterling's depreciation, as well as IMF and Eurocurrency borrowings of £2.8 billion and G-10 standby drawings of £1 billion).

Table 2 presents details on official reserves and official financing liabilities as of the end of October in dollar terms. Table 2 also presents what information is available on the U.K.'s potentially available financial resources, its estimated repayment schedule in the 1970's, and the repayment schedule for major loans. There is very little information on interest rates and payments. Recent Eurocurrency borrowing has been at 1-1/4 per cent above interbank rate, the interest rate for the IMF Oil Facility drawing is 7-3/4 per cent, and 4-6 per cent (depending on time of repayment) for the IMF first credit tranche.

In Table 1 some of the liabilities included in "total public sector borrowing (other than official financing)" are a part of the sterling balances. For your information, Table 3 presents the latest information available on the sterling balances (the September figures are confidential).

Attachments.

David H. Howard
November 16, 1976

Table 1
U.K. External Assets and Liabilities[1/]
(end-1975; £ billions)

I.	<u>External Assets</u>		
	Private Sector		89.4
	of which:		
	total private investment abroad	23.4	
	total banking and commercial claims	66.0	
	Public Sector		4.9
	of which:		
	total public sector lending, etc.	2.2	
	official reserves	2.7	
	Total identified external assets		94.3
II.	<u>External Liabilities</u>		
	Private Sector		81.8
	of which:		
	total overseas investment in the private sector	14.1	
	total banking and commercial liabilities	67.7	
	Public Sector		10.7
	of which:		
	total public sector borrowing (other than official financing)[2/]	6.4	
	official financing liabilities	4.4	
	Total identified external liabilities		92.5

Notes: 1. Totals may not exactly equal the sum of their parts due to rounding.
2. Over 70 per cent of this entry consisted of sterling liabilities.

Source: Bank of England Quarterly Bulletin, June 1976, pp. 206-211. The article (attached) contains details on the various entries.

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This form marks the file location of item number 1a as listed on the pink form (GSA Form 7122, Withdrawal Sheet) at the front of the folder.

Table 3

Sterling Balances

Date	Exchange Reserves in Sterling Held by Central Monetary Institutions: Total	Government Stocks	External Deposits	Treasury Bills	Banking and Money-Market Liabilities to Other External Hold: Total	External Deposits	Treasury Bills
1. Total:							
1975: Dec. 31	4,102	1,143	1,698	1,261	3,228	3,202	26
1976: Mar. 31	4,016	1,133	1,503	1,380	3,237	3,229	8
June 30	3,111	1,134	1,081	896	3,224	3,213	11
Sept. 30	2,756	1,108	991	657	3,433	n.a.	n.a.
2. EEC:							
1975: Dec. 31	124	25	46	53	774	752	22
1976: Mar. 31	171	27	29	115	750	746	4
June 30	113	27	43	43	776	770	6
Sept. 30	200	27	97	76	896	n.a.	n.a.
3. Oil Exporters:							
1975: Dec. 31	2,839	624	1,382	833	466	466	-
1976: Mar. 31	2,622	703	1,147	772	474	474	-
June 30	1,964	721	784	459	444	444	-
Sept. 30	1,541	714	626	201	448	n.a.	n.a.
4. Other Countries:							
1975: Dec. 31	753	374	202	177	1,988	1,984	4
1976: Mar. 31	823	322	233	268	2,013	2,009	4
June 30	638	269	180	189	2,004	1,999	5
Sept. 30	638	251	211	176	2,089	n.a.	n.a.
5. International Organizations other than the IMF:							
1975: Dec. 31	386	120	68	198	-	-	-
1976: Mar. 31	400	81	94	225	-	-	-
June 30	396	117	74	205	-	-	-
Sept. 30	377	116	57	204	-	-	-

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

To Mr. Siegman

From Scott B. Brown

Date November 1, 1976

Subject: Assessment of the Impact of North Sea Oil on the U.K. Balance of Payments

In recent months, officials of the British Treasury and Department of Energy referred in public statements to the impending dramatic impact of North Sea oil on the U.K. balance of payments. According to the latest estimates, both official and private, Britain is expected to achieve net self-sufficiency for oil by 1980, and may become a net exporter of oil for more than a decade thereafter. This note and the attached table attempt to summarize the potential impact of North Sea oil on the balance of payments.

The pace of development of British offshore oil fields has fluctuated widely during the first half of this decade. Optimism of the early 1970's concerning the volume and profitability of eventual oil production was dampened by the unforeseen technical difficulties and costliness of oil production in deep water, and by uncertainty as to government policies toward taxation and ownership of oil enterprises. More recently, the announcement of government policy measures has contributed to an upturn in North Sea activity during the past year, as the government adopted a more favorable stance toward taxation and private ownership than had been anticipated. A petroleum revenue tax was adopted in March 1975, which set the maximum government share in any enterprise's oil revenues at about 60 per cent (including the existing 12.5 per cent royalty). It was subsequently announced that the government would probably waive some of the tax and royalty payments of small oil fields, in light of their higher average fixed and production costs, in order to make their development more attractive. In late 1975 and early 1976, government control was extended not by requiring sale of a majority interest in all oil fields to the state oil company, as had been feared, but rather by requiring that the state oil company have first option to buy oil produced in the British North Sea at prevailing oil prices. Developments relating to the future course of world oil prices have also helped spur North Sea development: the fact that oil prices now are expected to be at least constant, and perhaps rising, in real terms in the foreseeable future has reduced the need for British oil firms to guard against the financial hazard (to them) of a drop in oil prices.

According to the latest official forecasts, production of U.K. offshore oil is expected to rise from the 8 million barrels produced in 1975 to over 750 million barrels in 1980,[1/] slightly greater than forecast consumption[2/] in that year. Production should exceed domestic consumption until at least 1987, making the United Kingdom a net exporter of oil for the 1980's. At forecast rates of production, proved oil reserves[3/] of 10 billion barrels would sustain peak production of over 900 million barrels per year until

1/ Forecast production levels from the Department of Energy report, "Development of the oil and gas resources of the United Kingdom, 1976," are shown in the attached Table at line L.

2/ Oil consumption is assumed to grow 4 per cent per year from its 1975 level of about 570 million barrels, in line with the forecasts in the 1974 OECD document Energy Prospects to 1985.

3/ Proved reserves are those which on available evidence are virtually certain to be technically producible and commercially producible at current oil prices.

about 1989; the total of all proved, probable, and possible offshore oil reserves,[4/] about 23 billion barrels, would sustain this peak until the next century.[5/] Whereas in past years forecasts of production and revenues from North Sea oil have been subject to a high degree of uncertainty (mostly due to uncertainties as to production techniques and government policy), more recent estimates seem to be firmer.

As the attached table demonstrates, it is likely under reasonable assumptions that the effect of North Sea oil production and investment on the British current account will be positive starting in 1977. In 1977 the effect of oil on the current account will be positive by about $1 billion (i.e., the total U.K. current account deficit would be $1 billion worse than the predicted $2.5 billion for 1977 without the effect of oil). In 1978, a year in which the total current account, both oil and non-oil, is expected to be nearly in balance, North Sea oil will have a positive effect of about $2.7 billion on the current account; the effect of oil on the current account rises each year thereafter, reaching over $20 billion by 1990. Due to large capital inflows in the 1970's to finance North Sea investment, the effect on the total balance of payments was already positive in 1975 (about $700 million); this effect of North Sea oil also rises each year until at least 1990, when it is predicted to be over $20 billion.

The assumptions on which this analysis is based are detailed in footnotes to the table. The key assumption is that of an oil price which

4/ Probable reserves are those felt to have a better than 50 per cent chance of being technically and commercially producible; possible reserves have a significant, but less than 50 per cent, probability.
5/ In the event that no increases in proved reserves occur by the mid-1980's, U.K. offshore oil production levels would probably be considerably lower than peak production during the late 1980's.

rises by 15 per cent in 1977, and by 5 per cent per year thereafter in nominal terms (implying a constant or slightly rising price in real terms). The projected totals arrived at here are not altered much by slight changes in the assumptions.

Aside from the impact of North Sea oil on the U.K. balance of payments, one other effect is of crucial importance — the government revenue obtainable through taxation of oil producers. While the exact effective tax rate depends on future cost conditions and the tax relief given to smaller producers, an average effective rate of about 50 per cent would yield government revenue ranging from about 1 per cent of nominal GDP in 1977 to about 2.5 per cent during the mid-1980's.

Attachment

IMPACT OF NORTH SEA OIL ON THE
U.K. BALANCE OF PAYMENTS
1975 - 1990
(In billions of current U.S. dollars; forecasts for 1983-1990 on next page)

November 1, 1976

	1975	1976	1977	1978	1979	1980	1981	1982
I. BALANCE OF PAYMENTS EFFECT								
A. Value of North Sea oil produced (=Line L x Price) 1/	0.1	1.5	3.9	6.3	9.1	11.8	14.7	15.4
B. Imports of equipment for North Sea development 2/	1.7	1.6	1.7	2.0	1.4	0.4	0	0
C. Effect of North Sea on trade balance (=Line A-Line B)	-1.6	-0.1	2.1	4.3	7.6	11.3	14.7	15.4
D. Interest payments on cumulative foreign borrowing for North Sea investment (Line K), plus profits repatriated by foreign owners 3/	0.3	0.7	1.1	1.6	2.0	2.2	2.3	2.1
E. Effect of North Sea on current account (=Line C-Line D)	-1.9	-0.8	1.0	2.7	5.6	9.1	12.4	13.3
F. Net capital flow for North Sea development (=Line J)	2.6	2.9	2.9	3.0	1.6	-0.8	-2.6	-3.0
G. Effect of North Sea on balance of payments (=Line E + Line F)	0.7	2.1	3.9	5.7	7.2	8.3	9.8	10.2
II. FOREIGN CAPITAL FLOWS AND INTEREST								
H. Capital inflow for North Sea investment 2/	2.6	2.9	3.1	3.7	2.9	1.1	0	0
I. Repayments 4/	0.01	0.1	0.2	0.7	1.3	1.9	2.6	3.0
J. Net capital flow due to North Sea (=Line H-Line I)	2.6	2.9	2.9	3.0	1.6	-0.8	-2.6	-3.0
K. Interest payments on foreign investment in North Sea 5/	0.3	0.5	0.7	1.0	1.1	1.0	0.8	0.6
III. OIL PRODUCTION AND CONSUMPTION (In millions of barrels)								
L. Average official production forecast 6/	8	128	292	456	621	767	913	913
M. Domestic oil consumption 7/	570	593	617	641	667	693	721	750

All footnotes are on a separate page, following this table.

IMPACT OF NORTH SEA OIL ON THE
U.K. BALANCE OF PAYMENTS
(In billions of current U.S. dollars)

November 1, 1976

	1983	1984	1985	1986	1987	1988	1989	1990
I. BALANCE OF PAYMENTS EFFECT								
A. Value of North Sea oil produced (=Line L x Price)[1]	16.2	17.0	17.9	18.8	19.7	20.7	21.7	22.8
B. Imports of equipment for North Sea development[2]	0	0	0	0	0	0	0	0
C. Effect of North Sea on trade balance (=Line A-Line B)	16.2	17.0	17.9	18.8	19.7	20.7	21.7	22.8
D. Interest payments on cumulative foreign borrowing for North Sea investment (Line K), plus profits repatriated by foreign owners[3]	2.0	1.9	1.9	1.9	2.0	2.1	2.2	2.3
E. Effect of North Sea on current account (=Line C-Line D)	14.2	15.1	16.0	16.9	17.7	18.6	19.5	20.5
F. Net capital flow for North Sea development (=Line J)	-2.7	-2.2	-1.5	-0.8	-0.2	0	0	0
G. Effect of North Sea on balance of payments (=Line E + Line F)	11.4	12.9	14.5	16.1	17.5	18.6	19.5	20.5
II. FOREIGN CAPITAL FLOWS AND INTEREST								
H. Capital inflow for North Sea investment[2]	0	0	0	0	0	0	0	0
I. Repayments[4]	2.7	2.2	1.5	0.8	0.2	0	0	0
J. Net capital flow due to North Sea (=Line H-Line I)	-2.7	-2.2	-1.5	-0.8	-0.2	0	0	0
K. Interest payments on foreign investment in North Sea[5]	0.4	0.2	0.1	0.02	0	0	0	0
III. OIL PRODUCTION AND CONSUMPTION (In millions of barrels)								
L. Average official production forecast[6]	913	913	913	913	913	913	913	913
M. Domestic oil consumption[7]	780	811	844	877	913	949	987	1027

All footnotes are on a separate page, following this table.

FOOTNOTES

1/ The price used assumes a price rise of 15 per cent in 1977, and a price rise of 5 per cent per year in nominal terms thereafter (implying a constant or slightly rising price in real terms). Prices for 1975 and 1976 are price of Arabian "Marker" crude oil.

2/ Source: Wood, McKenzie and Company, North Sea oil forecast of June 1976.

3/ A 20 per cent profit rate is assumed, with half of total profits accruing to foreign owners who repatriate them.

4/ On the basis of data on Eurodollar credits for North Sea oil development in 1975 and 1976, assumes an average maturity of 7 years, payable in five equal installments in the last five years of the credit.

5/ Interest payments estimated from interest rates on Eurodollar credits for North Sea development. The interest rate is assumed to be variable, and approximately 1.5 percentage points higher than the six-month London Eurodollar offer rate. For computational purposes, a rate of 9 per cent in 1975, 8 per cent in 1976, and 8 per cent thereafter is used; interest is assumed paid on cumulative total of net borrowing.

6/ Average of high and low production forecasts in the April, 1976 Department of Energy report, "Development of the Oil and Gas Resources of the United Kingdom, 1976".

7/ Forecasts for 1976-1980 assume a growth rate of oil consumption of 4 per cent per year from the 1975 level, approximately equal to that assumed in the OECD document, Energy Prospects to 1985.

David H. Howard
November 9, 1976

U.K. Political Situation

Next election: October 1979, or earlier.

Government: Labour

Representation in House of Commons

Labour:	312
Conservative:	278
Liberals:	13
Scottish Nationalists:	11
Ulster Protestants:	10
Welsh Nationalists:	3
Scottish Labour:	2
Ulster Catholics:	2
Total:	631
Needed for a majority:	316

The Labour party can count on support from Scottish Labour and the Ulster Catholics. Thus, Labour has an effective majority of one. However, the opposition parties are rarely united, so on most issues Labour has a larger majority.

BOARD BRIEFING
David H. Howard
November 15, 1976

The United Kingdom is presently negotiating a $3.9 billion loan from the IMF. Any such international loan to the U.K. government will have policy conditions attached to it. These conditions should have two objectives: ensuring that the United Kingdom can repay its official debts, and the establishment of a stronger and more stable British economy. These two objectives are inter-related because policies that encourage a competitive external sector and an investment-led recovery also will ensure that the U.K. public sector is able to repay its official debts on time.

On foreign exchange markets, the pound sterling has been under considerable pressure. Since March 1, sterling has depreciated 19 per cent against the dollar, despite net intervention sales of $6.8 billion. The pressure has come primarily from the U.K.'s sizeable current-account deficit and changes in the timing of payments for commercial transactions, but pressure also has come from holders of sterling balances, mainly the central monetary institutions of some oil-producing countries. During the second and third quarters of 1976, about £1 billion in sterling balances were drawn down, leaving some £1.5 billion held by OPEC and £1.2 billion by other central monetary institutions. Other, mostly private, holdings of sterling balances -- now about £3.4 billion -- actually rose during this period.

Sterling's weakness has led to the U.K.'s application to the IMF for credit. In addition, U.K. government leaders have expressed their hope for supplementary international assistance to cope with the sterling balance problem. An IMF loan and any supplementary assistance would, of course, add to the U.K.'s foreign currency denominated debt.

The U.K. public sector is already deeply in debt to overseas creditors. Public sector bodies owe some $15 billion from official short and medium-term foreign currency borrowing. Of this amount, the U.K. government owes some $2 billion to the IMF from earlier drawings, and $1.5 billion to the Group of Ten countries and Switzerland, including $300 million each to the Federal Reserve System and the U.S. Treasury, which is due December 9. Aside from the drawings on the G-10 standby, no significant amounts of the U.K.'s official debts must be repaid until 1979.

The United Kingdom has $4.7 billion in reserves, of which $3.8 billion is held in foreign exchange and SDRs. Some credits through the European Community may be available to supplement reserves, but the bulk of any additional lending must come from the IMF, the stronger economies, and/or Eurocurrency loans.

Current U.K. macroeconomic policy has three major aspects. First, the public sector borrowing requirement is expected to be 9 per cent of nominal GDP this fiscal year. The government had expected to reduce this to 6 per cent of GDP in fiscal 1977-78, but because of the faltering recovery, the borrowing requirement, under current policies, may be as high as 7.5 per cent of GDP. Second, monetary policy is based upon a target growth rate for M_3 of 12 per cent during the fiscal year that began in April. Apparently, the government's intention is to reduce further the rate of monetary expansion in the next fiscal year. The third major aspect of U.K. macroeconomic policy is an incomes policy that roughly halved the rate of wage inflation during its first year, starting August 1975. There are no indications that the U.K. government has formulated plans for the incomes policy beyond July 1977, when the present phase expires.

Broadly speaking, these macroeconomic policies have two purposes: bringing inflation down with a minimum of unemployment; and shifting resources from the public sector into private investment -- particularly investment in export industries. The principal question about the U.K. economy is whether the government's current policies are adequate to restore external and internal stability to the economy; this question is presently being examined by the IMF mission how in the United Kingdom.

Under present policies, the consensus forecast for the U.K. economy is not favorable. Real GDP growth is likely to be no higher than 2-3 per cent during the next year or so. No significant improvement is expected in the unemployment rate -- now at 5.4 per cent. In fact, it may edge higher during the next several months. The outlook for private investment -- once expected to be buoyant towards the end of 1976 -- is now clouded by high interest rates. Because of the substantial depreciation of sterling this year, inflation is unlikely to decelerate much from its present rate of about 14 per cent until at least the second half of 1977, although the incomes policy is expected to hold fairly well through July 1977. This year's current-account deficit will be close to $3.3 billion, with next year's expected to be somewhat lower -- perhaps $2.5 billion. However, export volume is expected to grow fairly strongly and North Sea Oil should move the current account to near balance in 1978. The United Kingdom is expected to be self-sufficient in oil by 1979 or 1980.

Although there is general agreement that U.K. policies have recently moved in the right direction, in the Staff's view a faster movement is required. In particular, the reduction in the public sector borrowing requirement should be accelerated. It is probably too late to affect the current fiscal year, but in fiscal 1977-78 the borrowing requirement might be reduced further -- to perhaps £8 billion, 5.5 per cent of GDP. A reasonable course for monetary policy would be to aim at a growth rate for M_3 of 10-14 per cent in the current fiscal year, decelerating to 6-10 per cent in the next fiscal year. Exchange market intervention should be limited to the minimum consistent with avoiding as much as possible declines in the external value of sterling that would undermine the U.K. incomes policy, and industrial relations in general.

These policy prescriptions are based on the following considerations: A reduction in the public sector borrowing requirement would ease the burden on monetary policy and improve exchange market confidence. This reduction can be accomplished by means of spending cuts or tax increases. From a structural point of view, spending cuts are preferable. There is little scope for increasing direct taxes, although there may be room for raising indirect taxes, which are relatively low in the United Kingdom. The high level of unemployment as well as political constraints, such as the need to maintain public support for the incomes policy, impair the government's ability to tighten fiscal policy, but some further tightening is desirable and probably feasible. In fact, there are reports that the government is putting together such a package for fiscal 1977-78.

Because of excessive money growth during the first half of the current fiscal year -- 18 per cent (S.A.A.R.) -- monetary policy would have to be very tight in the second half if the 12 per cent M_3 growth target is to be met. Operating with a 10-14 per cent range, rather than a specific 12 per cent target, would allow greater flexibility in monetary policy and tend to encourage private sector investment, the revival of which is a crucial element in the government's medium-term economic strategy. Further cuts in the borrowing requirement for fiscal 1977-78 should allow a substantial reduction in money growth in the next fiscal year, perhaps to a 6-10 per cent range, without endangering private investment.

The United Kingdom faces conflicting objectives with respect to the exchange value of sterling: depreciation, through its domestic price-level effects, undermines acceptance of wage restraint, but it also helps to ensure the price-competitiveness of U.K. goods. A compromise policy might be adopted that aimed at minimizing the amount of intervention by resisting only depreciations that are judged by the U.K. authorities to be serious threats to the incomes policy. The financial resources necessary for this type of internention could come from Euro-currency loans and, if available, the IMF loan, as well as from existing reserves.

In conclusion, these policy adjustments imply some tightening of U.K. fiscal policy in order to accelerate the already planned shift of resources from the public to the private sector. Such a shift appears to be necessary if Britain is to stabilize its economy and meet its external obligations. If these policies were included as conditions to an IMF loan, they would be more credible not only because of the IMF's approval, but also because of the increased likelihood that the U.K. government would adhere to them. In addition, a comprehensive package, such as the one outlined, should improve confidence -- both internal and external -- more than would the same measures introduced piecemeal.

UNITED KINGDOM: ECONOMIC INDICATORS
(SEASONALLY ADJUSTED, UNLESS OTHERWISE INDICATED)

November 23, 1976

	1973	1974	1975	1975 II	1975 III	1975 IV	1976 I	1976 II	1976 III	1976 APR	1976 MAY	1976 JUNE	1976 JULY	1976 AUG	1976 SEPT	1976 OCT
REAL GDP, 1970=100	109.5	110.2	108.0	107.6	106.9	107.6	109.0	108.1	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
REAL GDP, PER CENT CHANGE (1)	5.3	0.6	-2.0	-2.1	-0.7	0.7	1.3	-0.8	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
INDUSTRIAL PRODUCTION 1970=100	109.9	106.1	101.0	99.8	99.4	100.3	101.5	102.0	101.6	102.0	104.0	100.1	101.8	100.8	102.3	N.A.
INDUSTRIAL PRODUCTION PER CENT CHANGE (1)	7.6	-3.4	-4.8	-4.6	-0.4	0.9	1.2	0.5	-0.4	0.3	2.0	-3.8	1.7	-1.0	1.5	N.A.
UNEMPLOYMENT RATE(%)	2.6	2.5	3.9	3.6	4.2	4.8	5.2	5.3	5.5	5.2	5.3	5.3	5.4	5.5	5.5	5.4
WHOLESALE PRICES (NSA) PER CENT CHANGE (1)	7.3	23.4	24.1	5.8	3.8	3.0	3.9	3.6	4.0	1.4	1.6	1.0	1.3	1.6	1.3	1.5
CONSUMER PRICES (NSA) PER CENT CHANGE (1)	9.2	16.0	24.2	9.5	4.4	3.4	3.6	3.7	2.3	1.9	1.1	0.5	0.2	1.4	1.3	1.8
AVERAGE EARNINGS PER CENT CHANGE (1)	N.A.	17.5	26.7	4.0	7.5	4.0	2.9	2.6	N.A.	-0.1	2.4	-0.6	2.2	1.4	N.A.	N.A.
MONEY STOCK (M1) PER CENT CHANGE (1)	9.8	3.0	19.6	7.1	6.6	2.8	3.5	3.4	4.6	2.0	-0.1	-1.0	3.1	2.0	2.3	-1.7
MONEY STOCK (M3) PER CENT CHANGE (1)	27.4	19.4	10.0	2.0	2.6	1.7	2.0	2.7	4.3	1.3	0.6	0.5	1.9	1.5	2.4	1.2
BUDGET DEF.(-) OR SUR.(+) AS PER CENT OF GNP	-3.6	-4.8	-9.1	-8.8	-11.6	-7.1	-8.5	-6.4	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
EXPORTS, FOB ($ BILLION)	28.2	36.5	41.6	10.4	9.9	10.5	10.9	10.9	10.8	3.6	3.6	3.6	3.5	3.6	3.7	3.6
IMPORTS, FOB ($ BILLION)	33.8	48.8	48.7	12.0	12.0	11.9	11.8	12.6	12.9	4.1	4.3	4.3	4.4	4.2	4.3	4.2
TRADE BALANCE($BIL)	-5.6	-12.3	-7.1	-1.6	-2.1	-1.4	-1.0	-1.8	-2.1	-0.5	-0.7	-0.6	-1.0	-0.5	-0.6	-0.6
CURRENT ACCOUNT BALANCE ($ BILLION)	-2.7	-8.8	-3.8	-0.8	-1.2	-0.6	-0.1	-1.0	-1.3	-0.2	-0.4	-0.4	-0.7	-0.2	-0.4	-0.3

(1) PER CENT CHANGE FROM PREVIOUS PERIOD.
QUARTERLY CHANGES AT QUARTERLY RATES: MONTHLY
CHANGES AT MONTHLY RATES.

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FINANCIAL INDICATORS -- UNITED KINGDOM

(dollar amounts in millions)

	1975	1976							Week ended					
	YEAR	QI	QII	QIII	AUG	SEPT	OCT	NOV 1-22	OCT 13	OCT 20	OCT 27	NOV 3	NOV 10	NOV 17
EXCHANGE RATE (CENTS PER POUND, END OF PERIOD)	202.35	191.59	178.50	166.00	177.75	166.00	158.80	164.00	165.41	164.63	158.30	160.75	163.33	166.45
WEIGHTED AVERAGE (May 1970=100; E.O.P.)	72.58	68.32	65.75	60.00	64.55	60.00	57.45	59.30	59.20	59.19	58.46	57.37	58.85	59.55
SDR VALUE OF POUND (E.O.P.)	1.7285	1.6567	1.5542	1.4498	1.5421	1.4498	1.3908	1.4432	1.4297	1.4162	1.3843	1.3804	1.4187	1.4306
SHORT TERM INTEREST RATE (E.O.P.)	10.81	8.75	11.19	12.81	11.19	12.81	15.25	14.50	14.44	15.00	15.38	15.00	14.67	14.69
LONG TERM INTEREST RATE (E.O.P.)	14.49	13.95	13.64	14.76	14.00	14.76	15.50	14.74	15.40	15.19	15.31	15.29	14.93	15.01
RESERVES (IFS, E.O.P.)	5,459	5,917	5,302	5,217	5,044	5,217	4,762P	4,650P						
AVAILABLE IMF CREDIT TRANCHES (E.O.P.)	3,278	4,695	3,851	3,888	3,866	3,888	3,890P	3,888P						
INTERVENTION, PURCHASES (+) OR SALES (-)														
OF DOLLARS	242	-900	-3,732	-1,582	-636	-675	-372	-112	-69	-106	-106	-13	-25	-19
(OF OTHER CURRENCIES; $ EQUIVALENT)														
SWAP ACTIVITY														
DRAWINGS (+), REPAYMENTS (-)	--	--	200	100	--	100	--	--		--	--	--	--	
SWAP LINE -- 3,000														

RESTRICTED-CONTROLLED

November 23, 1976

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 15, 1976

To Chairman Burns

From Charles J. Siegman CJS

Subject: Reuters Reports on Chancellor Healey's Economic Program

Attached are selected excerpts as reported on Reuters on Chancellor Healey's economic policy statement delivered to the House of Commons today. Note report (first item) that refers to a $500 million swap offer by the U.S. Treasury and the Federal Reserve to strengthen U.K. reserves.

The initial foreign exchange market response has been a weakening of sterling by 1 per cent.

The new package of measures will be summarized in today's International Digest.

Attachment

cc: Governor Wallich

1605 : HEALEY ANNOUNCES SWAP ARRANGEMENT WITH U S:

LONDON DEC 15 -- CHANCELLOR OF THE EXCHEQUER DENIS HEALEY INTENDS TO STRENGTHEN THE RESERVES WITH 500 MLN DLRS WHICH HAS BEEN OFFERED BY THE US TREASURY AND THE FEDERAL RESERVE

MORE

1613 :SWAP ARRANGEMENT 2 LONDON:

HEALEY TOLD PARLIAMENT THAT IN ADDITION THE BUNDESBANK HAS OFFERED THE BANK OF ENGLAND A STANDBY FACILITY OF 350 MLN DLRS BY WAY OF FURTHER SUPPORT.

IN COMMENTING ON TALKS RECENTLY ON THE PROBLEM OF THE STERLING BALANCES, HEALEY SAID THESE TALKS REVEALED "A GENERAL DESIRE ON THE PART OF THOSE CONCERNED TO ACHIEVE A SATISFACTORY ARRANGEMENT FOR THE STERLING BALANCES, AND

I BELIEVE IT WILL BE POSSIBLE TO REACH AN AGREEMENT BEFORE LONG."

MORE

NNNN

1556 : HEALEY ANNOUNCES 2.5 BILLION STG SPENDIN

CUTS OVER TWO YEARS:

LONDON, DEC. 15 -- CHANCELLOR OF THE EXCHEQUER DENIS HEALEY SAID THE GOVERNMENT HAS DECIDED TO REDUCE PUBLIC SPENDING PROGRAMMES FURTHER BY ONE BILLION STG IN 1977/78 AND 1.5 BILLION IN 1978/79 AT 1976 SURVEY PRICES.

MORE

1603 : SPENDING CUTS 2 LONDON:

AMONG THE CUTS HEALEY ANNOUNCED WERE IN DEFENCE WHERE HE SAID THE GOVERNMENT WAS LOOKING TO THAT SECTOR FOR SAVINGS OF 100 MLN STG IN 1977/78 AND 200 MLN IN 1978/79.

HEALEY SAID THERE WOULD BE A REDUCTION IN HOUSING CAPITAL PROGRAMMES. THIS REDUCTION WOULD OFFSET MOST OF THE LIKELY EXCESS SPENDING NEXT YEAR AND WOULD CONTRIBUTE A SAVING OF 200 MLN STG IN THE FOLLOWING

NNNN

1701 : CORRECTION -- SPENDING CUTS LONDON:

IN "SPENDING CUTS 3 LONDON," PLSE READ SECOND SENTENCE AS....THIS WOULD SAVE ABOUT 270 RPT 270 MLN STG NEXT YEAR....CORRECTING FIGURE.

REUTER

NNNN

1557 : SPENDING CUTS 3 LONDON:

NEW CONSTRUCTION WOULD BE SUSPENDED OR CURTAILED IN SEVERAL OTHER CENTRAL AND LOCAL GOVERNMENT PROGRAMMES. THIS WOULD SAVE ABOUT 27 MLN STG NEXT YEAR AND OVER 300 MLN STG IN 1978/79.

REUTER

1646 : SPENDING CUTS 4 LONDON:

HEALEY SAID "THE PLANNED PROGRAMME FOR PHASING OUT THE GOVERNMENT'S FOOD SUBSIDIES WILL BE ACCELERATED AND WILL BE COMPLETED IN 1977/78, SAVING 160 MLN TSG IN THAT YEAR AND ABOUT 60 MLN IN THE FOLLOWING YEAR.

THIS WILL ADD LESS THAN ONE QUARTER PCT TO THE RETAIL PRICE INDEX OVER 1977/78.

HE ALSO ANNOUNCED SAVINGS ON EDUCATION OF 20 MLN STG IN 1977/78 AND 30 MLN IN 1978/79.

REUTER

1631 : HEALEY FORECASTS CURRENT PUBLIC SECTOR BORROWING REQUIREMENT:

LONDON, DEC. 15 -- CHANCELLOR OF THE EXCHEQUER DENIS HEALEY IN HIS LETTER OF INTENT TO THE IMF SAID THE GOVERNMENT'S MOST RECENT FORECAST SHOWS THE PUBLIC SECTOR BORROWING REQUIREMENT IN THE CURRENT FINANCIAL YEAR TO BE 11.2 BILLION STG.

THIS CONTRASTED WITH THE FIGURE OF 12 BILLION STG FORECAST WHEN HE REQUESTED A STANDBY ARRANGEMENT OF 700 MLN SPECIAL DRAWING RIGHTS IN THE FIRST IMF CREDIT TRANCHE IN DECEMBER LAST YEAR.

MORE

1639 : HEALEY FORECASTS 2 LONDON:

REFERRING TO THE GOVERNMENT'S DECISION TO REDUCE PUBLIC SPENDING IN THE NEXT TWO FISCAL YEARS, HEALEY SAID IN THE LETTER HE WISHED TO GIVE THE MAXIMUM POSSIBLE HELP TO INDUSTRY AND TO AVOID UNNECESSARY UNEMPLOYMENT.

"I THEREFORE INTEND TO INCREASE EXPENDITURE ON INCENTIVES FOR INDUSTRIAL INVESTMENT AND EXPANSION AND ON MEASURES TO REDUCE UNEMPLOYMENT IN EACH OF THE TWO YEARS 1977/78 AND 178/79 BY 200 MLN STG." THIS EXPENDITURE WOULD BE FINANCED BY AN INCREASE OF 10 PCT IN DUTIES ON ALCOHOL AND TOBACCO.

REUTER

1538 :HEALEY ANNOUNCES PUBLIC SECTOR BORROWING REQUIREMENT REDUCTION:

LONDON, DEC 15 - CHANCELLOR OF THE EXCHEQUER DENIS HEALEY ANNOUNCED THE GOVERNMENT IS TO REDUCE THE PUBLIC SECTOR BORROWING REQUIREMENT TO ABOUT 8.7 BILLION STG IN 1977/78 AND TO SOMEWHAT LESS IN THE FOLLOWING YEAR.

MORE

1543 :BORROWING 2 LONDON:

HEALEY TOLD THE HOUSE OF COMMONS THE REDUCTION IN THE PSBR WOULD BE NEARLY TWO BILLION STG IN 1977/78 AND NEARLY THREE BILLION STG IN 1978/79.

HE SAID "EXPRESSED AS A PERCENTAGE OF GROSS DOMESTIC PRODUCTION, PUBLIC SECTOR BORROWING REQUIREMENT WILL FALL STEADILY FROM NINE PCT IN THE CURRENT YEAR TO ABOUT SIX PCT IN 1977/78 AND RATHER OVER FIVE PCT IN 1978/79."

MORE

1547 : BORROWING 3 LONDON:

TO ACHIEVE THESE OBJECTIVES, HEALEY SAID, THE GOVERNMENT WAS PROPOSING ADJUSTMENTS TO CURRENT PLANS AMOUNTING TO 1.5 BILLION STG IN 1977/78 AND TWO BILLION STG IN 1978/79.

"I AM THEREFORE ANNOUNCING THE SPECIFIC MEASURES THIS AFTERNOON WHICH AMOUNT TO SOME 1.5 BILLION STG IN EACH YEAR.

"IN ADDITION THE GOVERNMENT WILL MAKE A FURTHER FISCAL ADJUSTMENT OF ABOUT 500 MLN STG IN 1978/79." HEALEY SAID IT WAS TOO SOON TO SAY WHAT FORM THIS FURTHER ADJUSTMENT WOULD TAKE.

1650 : HEALE SAYS PROSPECT OF INCOME TAX CUT IN

NEXT BUDGET:

LONDON, DEC. 15 -- CHANCELLOR OF THE EXCHEQUER DENIS HEALEY SAID HE BELIEVED THERE WOULD BE PROSPECTS FOR INCOME TAX CUTS IN HIS NEXT BUDGET.

HOWEVER, HE MADE THIS STATEMENT TO THE COMMONS CONDITIONAL ON A SATISFACTORY AGREEMENT BEING REACHED WITH THE TRADES UNION CONGRESS AND THE CONFEDERATION OF BRITISH INDUSTRY ON THE NEXT PAY ROUND AND A JUDGEMENT THAT IT COULD BE

DONE WITHOUT INCREASING THE PUBLIC SECTOR BORROWING REQUIREMENT ABOVE 8.7 BILLION STG IN 1977/78.

MORE

1657 : PROSPECT 2 LONDON:

"A CENTRAL OBJECTIVE OF GOVERNMENT POLICY IS TO CONTINUE THE ATTACK ON INFLATION. TO MAINTAIN A CONTINUED FALL IN INFLATION THROUGH TO 1978, WE SHALL NEED AGREEMENT BETWEEN THE TUC AND THE GOVERNMENT HOW TO PURSUE THE ATTACK ON INFLATION WHILE PERMITTING GREATER FLEXIBILITY IN PAY NEGOTIATION IN THE PERIOD AFTER JULY 1977," HE SAID.

"I HOPE IT WILL BE POSSIBLE FOR US TO REACH AGREEMENT ON THIS IN TIME FOR ME TO TAKE ACCOUNT OF THE OUTCOME IN SETTLING THE LEVELS OF INCOME TAX IN THE NEXT BUDGET."

REUTER

1619 : HEALEY SAYS WITTEVEEN SUPPORTS ECONOMIC STRATEGY:

LONDON DEC 15 -- THE MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND JOHANNES WITTEVEEN HAS TOLD CHANCELLOR OF THE EXCHEQUER DENIS HEALEY THAT HE SUPPORTS BOTH THE ECONOMIC STRATEGY AND THE MEASURES THE BRITISH GOVERNMENT IS TAKING TO SUPPORT ITS APPLICATION FOR 3.9 BILLION DLRS FROM THE IMF, HEALEY TOLD PARLIAMENT.

MORE

1624 : WITTEVEEN 2 LONDON:

HEALEY TOLD THE COMMONS OF WITTEVEEN'S SUPPORT AND SAID THE MANAGING DIRECTOR WAS PREPARED TO RECOMMEND ACCEPTANCE OF HIS (HEALEY'S) REQUEST FOR A STANDBY ARRANGEMENT.

IN DETAILING THE STANDBY ARRANGEMENTS, HEALEY SAID THAT THEY THIS TIME COVERED A TWO YEAR PERIOD "SO THAT WE CAN MAKE THE NECESSARY STRAINS ON THE SOCIAL CONTRACT AND THE INDUSTRIAL STRATEGY."

MORE

1625 :WITTEVEEN 3 LONDON:

IN TOTAL THE UK SHOULD BE ABLE TO DRAW UP TO NEARLY FOUR BILLION DLRS OF WHICH 1.15 BILLION DLRS COULD BE DRAWN IMMEDIATELY WITH OVER ONE BILLION DLRS MORE BEFORE THE END OF 1977.

"THIS, I AM CONFIDENT, WILL TRANSFORM THE EXTERNAL FINANCING POSITION IN 1977," HE ADDED.

"BEFORE THE FUND BOARD MEETS THERE WILL BE A MEETING OF THE GROUP OF TEN COUNTRIES, WHO STAND

READY, UNDER THE GENERAL ARRANGEENTS TO BORROW, TO PROVIDE THE FUND WITH THE USEABLE CURRENCIES IT NEEDS FOR LARGE DRAWINGS IF ITS OWN AVAILABLE CURRENCIES ARE INADEQUATE."

MORE

1633 :WITTEVEEN 4 LONDON:

HEALEY SAID "I AM CONFIDENT THAT, IN A MATTER OF DAYS AFTER THE END OF THE YEAR THE OPERATION WILL BE COMPLETE AND THE RESERVES REPLENISHED".

REUTER

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date January 28, 1977

To Board of Governors

Subject:

From John E. Reynolds

Attached, in response to your request, is a note by Mr. Mills concerning the Euro-dollar loan to Britain.

Attachment

GERALD R. FORD LIBRARY

This form marks the file location of item number 2a

as listed on the pink form (GSA Form 7122, Withdrawal Sheet)

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HANDLE THE ATTACHED DOCUMENT IN ACCORDANCE WITH INTERNAL INFORMATION SECURITY PROCEDURES FOR RESTRICTED INFORMATION

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 30, 1977

To Mr. Reynolds

Subject: The U.K. Budget and General Economic Situation

From David H. Howard

RESTRICTED

On March 29, Chancellor of the Exchequer Denis Healey presented to Parliament the British government's budget for the fiscal year beginning April 1977. Highlights of the proposed budget include:

-- Reductions in personal income taxes amounting to some £1.3 billion in a full year.

-- An additional reduction in the basic rate of personal income taxation (from 35 per cent to 33 per cent) amounting to about £1 billion in a full year. This reduction is conditional on a satisfactory agreement being reached on wage policy for the third phase of U.K. incomes policy, which is to begin in August.

-- Increases in indirect taxes amounting to about £800 million.

-- Spending programs for the next two years totaling £400 million, including about £200 million for employment subsidies.

-- In his budget message, the Chancellor said that on unchanged policies, the public sector borrowing requirement (PSBR) in fiscal 1977/78 would have been £7.5 billion -- well below the £8.7 billion target set in December. The budget measures --including the conditional tax cut of £1 billion --are expected to result in a PSBR of £8.5 billion in 1977/78 (6 per cent of GDP). (The first year PSBR increase --£1 billion-- is less than the full-year net revenue reduction -- £1.5 billion-- because of lags in revenue collection, and because the tax cut will tend to increase economic activity.) Domestic credit expansion (DCE) in 1977/78 is expected to be within the £7.7 billion ceiling announced in December, and sterling M3 growth, according to the Chancellor, should be in the 9 to 13 per

RESTRICTED

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date March 30, 1977

To Board of Governors

Subject: The U.K. Budget and General Economic Situation

From John E. Reynolds

Attached, for your information, is a note by David Howard on the U.K. budget (announced yesterday) and on the general economic situation in the United Kingdom.

Attachment.

cent range. Thus, the forecasts for both the PSBR and DCE are consistent with the conditions for the IMF stand-by agreed upon in December. The budget measures should add perhaps 1/2 per cent to output by mid-1978, according to the Chancellor.

-- Initial exchange market reaction to the budget has been very favorable.

This note presents further details of the proposed budget and also discusses the general economic situation in the United Kingdom, the government's expenditure plans, and the status of the U.K.'s incomes policy.

1. General Economic Situation

The crisis atmosphere in the United Kingdom has abated; in particular, the pound sterling has been strong in recent months and interest rates have fallen from the extraordinarily high levels reached toward the end of last year. In fact, U.K. authorities have recently been acting to restrain the upward movement of sterling -- through the purchase of foreign exchange reserves -- and the downward movement of interest rates -- through the temporary suspension of the formula by which the Bank of England's Minimum Lending Rate is related to the Treasury bill tender rate.

The current account in February was in surplus by some $50 million after an average deficit of $270 million in the two previous months. British foreign currency reserves have been rebuilt as a result of drawings on the recently negotiated IMF and Eurodollar loans, an unwinding of leads and lags in commercial payments, the new restrictions on sterling financing of third-country trade, and a capital inflow induced by an upturn in investor confidence in the U.K. economy and the prospect of capital gains to be made as U.K. interest rates declined from their crisis levels.

Official sterling balances (excluding those held by international organizations other than the IMF) fell slightly between December 8 and January 19, but confidential data just received from the Bank of England indicate that between January 19 and February 16, these balances rose somewhat; and the latest figure on these official balances indicates a level just slightly above the December 8 level. There was a moderate rise in the private holdings of sterling balances during December, but there was little change between the end of last year and February 16. On April 4, the Bank of England will present to official sterling balance holders the detailed terms on its foreign currency bonds to be issued in connection with the 1977 Basle sterling balance agreement.

Industrial production increased by 1 per cent in January and unemployment (seasonally adjusted) fell slightly in March for the second straight month. However, with GDP expected to grow at only about 2 per cent annual rate during 1977, increases in unemployment are more likely than further decreases. Price inflation has accelerated recently, but the pound's recent strength should help to reverse this trend. The incomes policy has held fairly well -- between July 1976 and January 1977, average earnings increased at an annual rate of about 11 per cent while retail prices excluding those of seasonal foods increased nearly 19 per cent (annual rate).

The growth rates of the monetary aggregates have declined in recent months, and the February levels (seasonally adjusted) of M1 and M3 are actually below the levels prevailing last September. It appears that sterling M3 growth will be about 9 per cent for the banking year ending in April, and DCE is forecast to be about half of the DCE ceiling (agreed upon with the IMF) of £9 billion for banking year 1976/77. In addition, the public sector borrowing requirement for fiscal 1976/77 is now forecast to be £8.8 billion (7 per cent of GDP) -- well within the December forecast of £11.2 billion.)

2. Details of the Budget

a. Personal income taxation. Various personal tax allowances were raised and the threshold levels for the higher tax brackets (i.e., those higher than the basic rate) were increased, as were the threshold levels for payment of the tax surcharge on investment income. These measures take effect immediately and involve a reduction in tax revenue of some £1.3 billion in a full year. It is also proposed that the basic rate of personal taxation be reduced from 35 per cent to 33 per cent if and when there is a satisfactory agreement on the next phase of wage restraint. Such a reduction would mean a decrease in revenue of about £960 million in a full year. The Chancellor did not offer any specific indication of what would constitute a satisfactory agreement.

b. Corporate taxation. Corporate tax rates remain the same, but the level below which the small company preferential rate applies was increased, and tax relief for inventory appreciation is to be continued for two more years. There were also some relatively minor changes in business taxes.

c. Indirect taxes. Duties on gasoline, heavy oil, and cigarettes were raised, and the excise duties on various motor vehicles were increased. These tax increases will produce £810 million in a full year and are expected to make retail prices about 1 per cent higher by the end of 1977 than they would have been otherwise. There was no change in the value-added tax.

d. Spending. Extensions of various employment subsidy programs amounting to an additional £214 million during the next 2 years were announced, and some £100 million will be spent on construction in inner-city areas over the next two years. Some other minor programs were also announced by the Chancellor. The spending plans announced by the Chancellor are to be financed mostly by budget reserves and previously appropriated funds.

e. Other. The Chancellor's other proposals include a tightening of exchange controls on U.K. companies controlled by non-residents, and a tax break for overseas earnings of employees who are U.K. residents.

3. U.K. Government Spending Plans

Earlier this year, the British government announced its spending plans -- in real terms -- for fiscal years 1977/78 and 1978/79; see Table 1. (Some figures were announced for the two subsequent fiscal years as well, but they do not reflect December's changes in spending plans and will probably be revised downward this summer.)

The spending plans confirm those announced in December in conjunction with the U.K.'s application for an IMF loan. According to the U.K. government, the ratio of total public expenditure (row 1 in the table) to GDP in market prices is expected to decline from 46 per cent in 1975/76 to 42-43 per cent in 1978/79. (This implies a 2.8 per cent annual rate of growth of real GDP between 1975/76 and 1978/79.)

The data for fiscal year 1976/77 indicate that actual government expenditures are expected to be within previously planned limits. In addition, the plans for the next two fiscal years indicate an intent to hold down government spending. The British government has been criticized for the nature of the cuts made in its spending plans, since the bulk of the reductions fall on capital projects and transfers rather than current spending. Hence, a major part of any unemployment effects of the cuts will fall on the private sector rather than on the public sector, and will do little to reduce the size of the government's direct resource claims. Table 2 indicates how the changes in spending plans since last February are distributed.

4. Incomes Policy.

As expected, the British government is again offering tax concessions as part of an agreement with the Trades Union Congress (TUC) on wage restraint. As an additional incentive for labor's compliance to a third year of some sort of wage restraint, the government has proposed an extended and revised system of price controls. The present system -- which is scheduled to expire this summer -- operates on the basis of profit margins and allows most cost increases to be reflected in higher prices, although every price increase has to be approved. The proposed price-control system -- to be in effect for an indefinite period -- will continue to control profit margins but will no longer require that individual price increases be justified by cost increases. However, large companies will continue to be obliged to submit proposed price changes to the Price Commission, which will be empowered to make investigations and stop any proposed price increase for up to a year. The criteria by which the Commission is to judge the appropriateness of price changes are vague, subjective, and explicitly not related mechanically to costs. Uncertainty over the criteria to be used in practice has led British industry to protest the proposed system.

Although the wage agreement with the TUC has not yet been concluded, it appears that it will be more flexible than the last two years' agreements. It is important that the next phase of the U.K.'s incomes policy -- to begin August 1 -- be more flexible with regard to such factors as pay differentials, incentive schemes, and new fringe benefits (the miners have already negotiated a new fringe benefit -- early retirement -- to be effective in August); another year of inflexible restraint would further distort the wage structure and inhibit constructive changes in industrial relations. In any case, it is unlikely that the TUC and/or the individual labor unions would be willing to accept another year of wage restraint as rigid as has been in force for the last two years. Although the incomes policy seems to have improved British industrial relations during the past two years, recently it has become an irritant. Many of the recent labor problems in the U.K. auto industry, in particular, seem to stem from the erosion of traditional pay differentials among skilled workers.

In his budget message, the Chancellor was careful not to commit the government on what would constitute a satisfactory wage agreement, thereby leaving the government with room to maneuver. Bargaining over phase three should begin in earnest now. According to the Chancellor, the proposed tax measures would increase the take-home pay of a married man earning £80 per week (roughly average earnings for men) by £2 a week (2-1/2 per cent), as much as would a 4-1/2 per cent increase in pre-tax wages.

TABLE 1

U.K. PUBLIC EXPENDITURE PLANS
£ MILLION AT 1976 PRICES

	1976/77	1977/78	1978/79
Total public expenditure, including sale of BP shares as a negative expenditure	53,698	52,502	53,130
(Percentage change from previous year)	(+1.4)	(-2.2)	(+1.2)
Total public expenditure, excluding sale of BP shares	53,698	53,002	53,130
(Percentage change from previous year)	(+1.4)	(-1.3)	(+0.2)
Total public expenditure, excluding government loans and capital grants to the nationalized industries, sale of BP shares, and debt interest *	50,900	49,800	49,800
(Percentage change from previous year)	(+ .8)	(-2.2)	(0.0)

* This total apparently is the one reported in the IMF Document, United Kingdom -- Request for Standby Arrangement, December 16, 1976.

SOURCE: The Government's Expenditure Plans: I, London, January 1977.

TABLE 2

CHANGES IN PUBLIC EXPENDITURE PROGRAMS SINCE
LAST YEAR'S WHITE PAPTER ON PUBLIC EXPENDITURE
£ MILLION AT 1976 PRICES

	1976/77	1977/78	1978/79
Current expenditure on goods and services	+ 171	- 215	- 158
Capital expenditure on goods and services	- 60	- 755	- 735
Subsidies and grants	- 138	+ 247	+ 741
Other transfers	+ 107	- 901 *	- 497
Total	+ 80	-1,624	- 649

* Includes the sale of BP shares as a negative expenditure.
SOURCE: The Government's Expenditure Plans: II, London, February 1977.

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UNITED KINGDOM: ECONOMIC INDICATORS
(SEASONALLY ADJUSTED, UNLESS OTHERWISE INDICATED)

MARCH 30, 1977

	1974	1975	1976	1975 IV	1976 I	1976 II	1976 III	1976 IV	1977 I	1976 SEPT	1976 OCT	1976 NOV	1976 DEC	1977 JAN	1977 FEB	1977 MAR
REAL GDP, 1970=100	110.1	107.8	109.0	107.4	109.2	108.4	108.6	109.7	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
REAL GDP, PER CENT CHANGE (1)	0.5	-2.1	1.1	0.7	1.7	-0.7	0.2	1.0	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
INDUSTRIAL PRODUCTION 1970=100	106.3	101.1	102.2	100.4	101.9	102.5	101.6	102.8	N.A.	102.5	102.5	103.0	102.9	103.9	N.A.	N.A.
INDUSTRIAL PRODUCTION PER CENT CHANGE (1)	-3.4	-5.0	1.1	1.1	1.5	0.6	-0.8	1.2	N.A.	1.7	0.0	0.5	-0.1	1.0	N.A.	N.A.
UNEMPLOYMENT RATE(%)	2.5	3.9	5.3	4.7	5.1	5.2	5.5	N.A.	5.5	5.5	5.5	N.A.	5.5	5.6	5.5	5.5
WHOLESALE PRICES (NSA) PER CENT CHANGE (1)	23.4	24.1	16.4	3.0	3.9	3.6	4.1	4.8	N.A.	1.3	1.6	2.0	1.1	3.2	1.3	N.A.
CONSUMER PRICES (NSA) PER CENT CHANGE (1)	16.0	24.2	16.6	3.4	3.6	3.7	2.3	4.6	N.A.	1.3	1.8	1.4	1.3	2.6	1.0	N.A.
AVERAGE EARNINGS PER CENT CHANGE (1)	17.5	26.6	15.8	3.6	3.3	3.1	2.7	2.7	N.A.	-0.4	1.1	1.2	1.8	0.1	N.A.	N.A.
MONEY STOCK (M1) PER CENT CHANGE (1)	3.0	19.6	16.6	2.8	3.5	3.4	4.5	1.3	N.A.	2.3	-1.8	1.2	0.9	-1.6	1.3	N.A.
MONEY STOCK (M3) PER CENT CHANGE (1)	19.4	10.0	10.7	1.7	1.9	2.8	4.6	3.5	N.A.	2.5	1.2	0.4	-0.7	-1.2	-0.3	N.A.
BUDGET DEF.(-) OR SUR.(+) AS PER CENT OF GNP	-4.8	-9.1	-6.2	-10.4	-5.5	-8.4	-5.9	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
EXPORTS, FOB ($ BILLION)	37.2	42.6	44.4	10.5	10.8	10.8	11.0	11.7	N.A.	3.8	3.8	3.8	4.1	4.2	4.2	N.A.
IMPORTS, FOB ($ BILLION)	49.4	49.7	50.8	11.8	11.9	12.5	13.1	13.3	N.A.	4.5	4.3	4.5	4.5	5.1	4.5	N.A.
TRADE BALANCE($BIL)	-12.2	-7.1	-6.5	-1.3	-1.1	-1.7	-2.0	-1.6	N.A.	-0.6	-0.5	-0.7	-0.4	-0.9	-0.3	N.A.
CURRENT ACCOUNT BALANCE ($ BILLION)	-7.8	-3.7	-2.5	-0.5	-0.2	-0.8	-0.9	-0.6	N.A.	-0.3	-0.2	-0.4	0.0	-0.5	0.1	N.A.

(1) PER CENT CHANGE FROM PREVIOUS PERIOD. QUARTERLY CHANGES AT QUARTERLY RATES; MONTHLY CHANGES AT MONTHLY RATES.

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THE SECRETARY OF THE TREASURY
WASHINGTON

2

JAN 14 1977

Dear Mr. Chairman:

With respect to the official sterling balances facility that has been the subject of extensive discussion among the U.S. Treasury, the Federal Reserve System, the Bank of England and the governors of the other central banks represented at the BIS in Basle, I should like to confirm the following agreement between the Treasury and the Federal Reserve.

In light of the agreement that has now been reached in Basle and of our existing mutual understanding about the prospective implementation of that agreement we agree to the following arrangements for joint Federal Reserve-U.S. Treasury participation in the facility.

-- If the U.S. is required to provide financing to the BIS in support of that facility, the funds will be provided initially by the Federal Reserve through its existing swap arrangement with the BIS, taking the form of a usual three-month swap renewable three times.

-- Should the Federal Reserve be called upon to provide financing under the terms of the facility continuously for more than one year, in light of the close cooperation between the Treasury and Federal Reserve, such financing will be provided to the Federal Reserve System by the U.S. Treasury, acting through the Exchange Stabilization Fund.

-- Risk associated with U.S. financing of the facility, whether such financing is provided by the Federal Reserve or the Exchange Stabilization Fund, will be borne equally by the Federal Reserve and the Exchange Stabilization Fund.

I understand that the BIS has agreed, as part of the sterling balance facility, to make every effort to finance any U.K. drawing by raising funds in other markets, thereby limiting the need for official financing for the facility.

Sincerely yours,

Bill

William E. Simon

The Honorable
Arthur F. Burns
Chairman, Federal Reserve Board
Washington, D. C.

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April 4, 1977

TO: Chairman Burns

FROM: Ted Truman EMT

I have reread Secretary Simon's letter to you of January 14 concerning the official sterling balances facility. The letter does promise an unambiguous Treasury take over of any Federal Reserve claims under the facility that are continuously outstanding for more than one year.

A copy of the letter is attached.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 4, 1977

To Chairman Burns

From David H. Howard

Subject: The Effects of the Proposed Changes in U.K. Personal Income Taxation

Attached is a table showing the effects on different income groups of the personal income tax changes proposed in the U.K. budget, which you requested at this morning's briefing. For your information, I have attached another table presenting the U.K.'s personal income tax schedule before and after the changes proposed in the budget.

Attachment.

David H. Howard
April 4, 1977

Effects of All Income Tax Changes Proposed in U.K. Budget

Single Person; All Earned* Income (£)

Earned Income	Fiscal 1976/77 Income Tax	Fiscal 1976/77 Average Rate	Fiscal 1976/77 Marginal Rate	Proposed Fiscal 1977/78 Income Tax	Proposed Fiscal 1977/78 Average Rate	Proposed Fiscal 1977/78 Marginal Rate	Proposed Reductions in Taxes Total	Proposed Reductions in Taxes Percentage of Income
2,500	617.75	24.7	35.0	559.35	22.4	33.0	58.40	2.3
4,000**	1,142.75	28.6	35.0	1,054.35	26.4	33.0	88.40	2.2
5,000	1,492.75	29.9	35.0	1,384.35	27.7	33.0	108.40	2.2
6,000	1,856.00	30.9	40.0	1,714.35	28.6	33.0	141.65	2.4
7,000	2,294.25	32.8	45.0	2,058.00	29.4	40.0	236.25	3.4
8,000	2,782.50	34.8	50.0	2,467.75	30.8	45.0	314.75	3.9
9,000	3,320.75	36.9	55.0	2,927.50	32.5	50.0	393.25	4.4
10,000	3,909.00	39.1	60.0	3,437.25	34.4	55.0	471.75	4.7
15,000	7,235.50	48.2	70.0	6,516.50	43.4	70.0	719.00	4.8
20,000	10,948.75	54.7	75.0	10,176.25	50.9	75.0	772.50	3.9
25,000	15,039.95	60.2	83.0	14,181.85	56.7	83.0	858.10	3.4

* It is proposed that the tax surcharge on investment income be 15 per cent on investment income over £2,000 (for those under 65 years old) and 10 per cent on such income between £1,500 and £2,000.

** Approximately average earnings for men.

David H. Howard
April 4, 1977

1. The U.K.'s Proposed Personal Income Tax Schedule

Taxable Income (£)	Proposed Tax Rate	Former Tax Rate
0-6,000	33	35-40
6,000-7,000	40	45-50
7,000-8,000	45	50-55
8,000-9,000	50	55-60
9,000-10,000	55	60
10,000-12,000	60	65
12,000-14,000	65	70
14,000-16,000	70	70-75
16,000-21,000	75	75-83
over 21,000	83	83

2. The U.K.'s Proposed Investment Income Tax Surcharge Schedule

Investment Income (£)	Proposed Tax Rate	Former Tax Rate
Under 65 years old:		
0-1,500	0	0-10
1,500-2,000	10	10
over 2,000	15	15
65 years old and over:		
0-2,000	0	0-10
2,000-2,500	10	10
over 2,500	15	15

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 18, 1977

To Chairman Burns

From Larry Promisel

Subject: The Pound Sterling's Recent Strength and U.K. Reserves

Attached is a short note in reply to the question that you raised at last Friday's briefing.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 18, 1977

To Mr. Promisel

Subject: The Pound Sterling's Recent Strength and U.K. Reserves

From David H. Howard

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The pound sterling has been quite strong so far this year -- since January 1, sterling has appreciated some 1-1/2 per cent on a trade-weighted basis and net intervention purchases of dollars by the Bank of England have been about $4.4 billion. Such intervention purchases, plus loans from the IMF and commercial banks, have helped to increase U.K. exchange reserves from $4.1 billion at the end of December to $9.6 billion at the end of March.

The turnaround in sterling's position stems in part from an increase in confidence in the United Kingdom following the December IMF loan agreement, the January sterling balance agreement, and the Eurodollar loan also announced in January. The increase in confidence made sterling interest rates appear very attractive, and encouraged a reversal of the shift in the timing of commercial payments that took place last year. In addition, North Sea oil flows have become more noticeable, further boosting confidence. March's budget -- with its adherence to the conditions of the IMF agreement -- reinforced this upturn in confidence. Finally, perhaps $1 - 1-1/2 billion of the capital inflow in recent months has been due to a change in U.K. exchange controls that restricted the use of sterling finance of third-country trade.

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The pound sterling is likely to continue to exhibit some external strength in the longer run, at least relative to what might be expected to occur given its high rates of inflation, because of the effect of North Sea oil on the U.K.'s current account. The U.K. authorities probably will continue to build reserves rather than allow a significant appreciation of sterling in order to be able to meet the U.K.'s external debt payments in future years, and to keep U.K. exports of manufactured goods competitive. Between 1977 and 1985, the U.K. public sector must pay or roll-over some $18 billion in external debts. In addition, at the end of 1976, official reserves as a per cent of the U.K.'s annual import bill were much less than they had been earlier in the 1970's. Thus, a case could be made for accumulating reserves rather than letting the exchange rate rise. Furthermore, the agreement with the IMF included something of a commitment by the United Kingdom to maintain a "competitive" exchange rate. A final -- short-term -- reason for avoiding a sterling appreciation now is that the third phase of the U.K.'s incomes policy is yet to be negotiated, and until it is, the market for sterling is likely to be unsettled. (For example, a discouraging statement by a union leader on April 14 weakened sterling and the Bank of England sold dollars.) Therefore, keeping sterling from rising now may keep it from falling precipitously later this year.