COVERING NOTE:

BREAKFAST MEETING WITH GORDON BROWN

SATURDAY 4 OCTOBER 2008

9.30AM AT NO.10 DOWNING STREET

Notes from the above meeting with Gordon Brown on banking issues, stressing that there needed to be a five point plan.

Subsequently on Saturday 11 October 2008 copy also given, and discussed, with Baroness Shriti Vadera.

03.10.08

CURRENT ISSUES

1. Lack of confidence in banking system:
(constant moving of deposits from one bank to another – flight to quality).

2. Liquidity shortages:
(wider definitions for acceptable assets accessible to the SLS, plus confidentiality of users / usage).

3. Banks not lending to each other:
(inter-bank libor highest on record).

4. Not lending on house mortgages:
(demand has slowed to a trickle but there also exists the banks' reluctance to lend).

5. Not lending to businesses:
(evidence of cancelling of credit lines, minimal new commitments/lending – significant increase in cost and terms).

6. Banks in survival mode:
(running down balance sheet by reducing lending and building cash deposits, accentuated for year end accounts purposes).

7. Solvency / capital:
(not enough room to withstand further substantial write-downs arising from a weakening economy, ie, wide spread mortgage arrears).

03.10.08

SOME SOLUTIONS

1. Irish style deposit guarantee.

2. Suspend Basel II regulations.

3. Temporarily put aside accounting rules requiring "stress testing" and "mark to market" of assets.

4. Government capital injections into UK banks through subscription to some form of long dated income producing equity instrument (possibly convertible into ordinary shares).

5. Cut interest rates to boost confidence.

6. The creation of a "bad bank".

7. Abolish for a period of time stamp duty on house purchases, subject to a house price limit.

...page 20

PP stands firm

'P says its £1.2bn offer for ylor Nelson Sofres is final l will not be raised unless a al bidder emerges. **Page 24**

CHNOLOGY HARDWARE

olfson warning

lfson Microelectronics said nings would be hit by the sumer spending slowdown as warned on revenues. **Page 25**

ROSPACE & DEFENCE

técoère lifeline

bus will step in to help pplier Latécoère in an effort head off further production backs. **Page 28**

NERAL RETAILERS

&S cuts spending

rks and Spencer cut costs d spending on stores amid or trading. **Page 22; Lex, Page : www.ft.com/dailyview**

ed Baker cautious

d B... sounded a cautious te after reporting higher sales d profits. **Page 24**

TOMOBILES

urope eyes US loans

ropean carmakers are bying the US for wider access $25bn (£14.2bn) in low-cost ans. **Page 29; Lex, Page 20**

ECTRICITY

cean Power buoyant

ean Power Technologies is to stal its first 150kw power buoy the coast of Oregon. **Page 25**

ARKETS

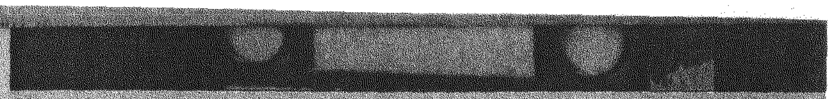
&Y on Sigma stand-by

nst & Young is on stand-by act as receiver to Sigma nance. **Page 43**

will have exclusive rights to distribute certain Aberdeen products to Japanese institutional investors.

MUTB, Japan's leading trust bank with $245bn (£139bn) of assets under management, is expected to lift its stake to 19.9 per cent following regulatory clearance. MUTB will be entitled to name a non-executive board director when its holding rises to 15 per cent.

"Aberdeen's partnership with MUTB . . . accelerates a strategic objective of establishing ourselves in Japan, a key market for us," said Martin Gilbert, chief



Attractive partnership: Martin Gilbert, Aberdeen chief, says the Japanese allia

executive of Aberdeen. MUTB went into the market yesterday and bought shares from institutional investors at an average price of 140p, an 11 per cent premium to the previous night's close.

Analysts welcomed the deal as a vote of confidence in one of the UK's biggest fund managers and Aberdeen shares closed 4.4 cent higher at 132p in spite of a broad fall in the London market, valuing the group at £846m.

The deal marks a further step in the revival of the UK fund manager after it became embroiled six years ago in the UK controversy over the selling of split capital investment trusts, vehicles that offer classes of shares with differing levels of risk and which distribute the fund's assets at a fixed date.

The group has rallied since then, buying Deutsche Bank's

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US commercial paper locks up as market shrinks $95bn in a week

By Aline van Duyn in New York and David Oakley in London

Investors have taken record amounts of money out of the commercial paper market, reducing short-term funds for even the highest-quality companies.

With stress in the financial system growing, the US commercial paper market shrank during the week ending Wednesday by the biggest amount since the Federal Reserve began to track it in 2001.

US groups sold $95bn (£54bn) less commercial paper during the week, meaning that the market has contracted by more than $200bn in the past three weeks.

"~~There is almost no segment of the credit markets or even of the banking system where companies are raising money. It is astounding and worrisome and a justification for Fed rate cuts,~~" said Tony Crescenzi, chief bond strategist at Miller Tabak Asset Management. "A continuation of this trend would be problematic . . . ~~as the commercial paper market is where entities go to raise working capital to produce everyday goods and services.~~"

Commercial paper is a type of short-term debt bought by money market funds, many of which have suffered losses on Lehman Brothers debt after it filed for bankruptcy over two weeks ago.

As a result, billions of dollars have been withdrawn from the funds, with investors losing confidence in the credit markets and instead opting to place money in safe investments such as short-term US Treasury debt.

A virtual funding freeze has affected even top-rated companies such as General Electric, the conglomerate, and AT&T, the telecoms group. Mirrored in Europe, where traders said an unusually high proportion of deals were for overnight borrowing, the freeze has intensified fears about the impact of the credit crunch.

"Most companies have counted on some new money always being available, whether it is from commercial paper or bank lines," said Eirik Winter, managing director at Citigroup Global Markets. "They have realised that you can't do that any more."

Additional reporting by Nicole Bullock

Crunch gets wider, Page 43

Companies and sectors in this issue

Companies

Sectors

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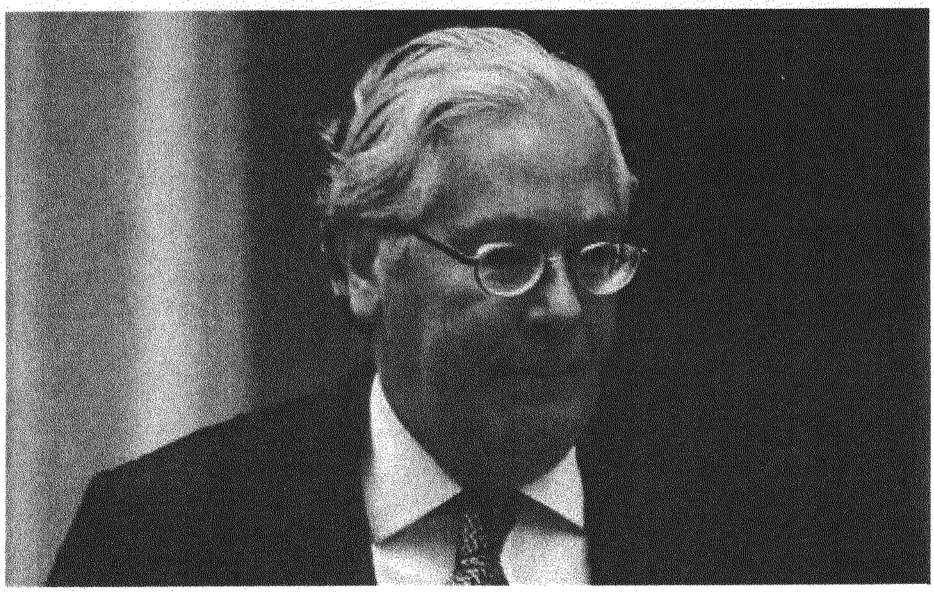
Bank of England steps up attempts to restore broken banking confidence

The Bank of England has stepped up its efforts to restore confidence between banks by making it easier for them to borrow money from the central bank.

By Angela Monaghan
Last Updated: 1:51PM BST 01 Oct 2008



Bank of England Governor Mervyn King has come under pressure to do more to help banks.

The Bank, which has drawn criticism from some for not doing enough for troubled lenders, ~~said today that it is prepared to accept a wider range of collateral from the banks it lends to.~~

Commercial banks seeking to borrow money for a week will be able to swap it for assets with lower credit ratings than the Bank of England Governor Mervyn King had previously been willing to stomach.

It comes as investors and traders around the world turn to Washington for tonight's vote by the Senate on the revised $700bn bail-out of Wall Street.

The plan, which is designed to rid banks of the now toxic, sub-prime debt accumulated during the US housing boom, is designed to get the world's banks lending again.

"This is not toxic grade stuff, but it's more generous and a wider list," said one trader of the Bank's plan.

The move comes the day after the biggest ever spike in the cost of borrowing dollars in the overnight interbank market. Overnight dollar Libor - the London interbank offered rate - more than trebled to 6.88pc, reflecting the unwillingness among banks to lend to each other at a time when peers are being bailed out on an almost daily basis by the state.

The assets the Bank of England will take on are already accepted by the Bank when it auctions money for longer periods.

One trader said that the Bank's move would be taken as a response to the spike in the rate of interest on short-term lending between banks. The problem has been that although the Bank of England, along with other central banks, are providing liquidity, only a limited number of banks are able to access it directly.

For the money markets to function properly, those banks are then required to lend to other banks.

A statement from the Bank said it would "keep under review the list of securities eligible as collateral in these operations," signalling that it might further extend the list of collateral it is willing to lend depending on developments in the financial markets.

"The Bank of England is moving very gradually to try and get a balance between providing what is needed but not going too far. It will very grudgingly lend support but only when absolutely necessary," said John Wraith of RBC Capital Markets.

The Bank is already stricter in terms of the quality of assets it will accept than both the US Federal Reserve and the European Central Bank, so some credit strategists believe there is room for a further relaxation of the rules.

Related Content

Pressure for interest rate cut grows as manufacturing slumps

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Summary of Basel 1 and 2 Provisions.

Banks operating in the European market are subject to many EC regulatory controls, one of which concerns capital adequacy under the Basel Capital Accord. This seeks to impose in each country at least the same minimum capital standards so that the banks in any one country would not enjoy a competitive advantage by having a weaker capital requirement.

Basel 1

In 1995 Basel 1 introduced the minimum requirement that banks maintain capital of at least 8% of the aggregate of their risk weighted assets.

- Capital is broadly defined as the paid up resources that will be available, particularly on a winding up, to satisfy the obligations of the bank to its ordinary creditors. Three tiers of capital are recognised the most important being tier 1. This is core capital (principally ordinary shares and retained earnings) which must amount to at least 50% of all capital.
- The risk weighting of assets under Basel 1 was fairly simple. It categorised assets with a set of risk factors relating to customer type, amount and whether on or off balance sheet. For example, exposures to quality governments and other central banks received a 0% rating. This category required no capital allocation. Exposures to residential property required a 50% weighting and "general" exposures were allocated a 100% weighting.

The main short comings of Basel 1 relate to the over-simplification of weighting ascribed to the asset categories. For instance, all corporate borrowers were assessed as having the same possible risk of default. There was no encouragement to a bank to hold better quality assets within a category.

Basel 2 – introduced in the UK in 2007.

Basel 2 sought to remedy the over-simplified approach of Basel 1 through;

1. a) Maintaining minimum capital requirements, b) updated evaluation of a banks asset exposure calculations and c) most significantly, introduction of operational risk assessment.
2. Bank regulators benefiting from improved prudential supervision methods.
3. Established market discipline and public awareness through improved disclosure requirements of information of banks.

In overall terms Basel 2 kept the minimum 8% capital requirement but effected substantial changes for the assessment and calculation of asset risk weighting. It also introduced the concept of operational risk – this is to address losses resulting from inadequate internal processes, people, systems and external events. The quantification of operational risk overlaid across a banks portfolio of assets resulted in increased capital requirements for all banks.

A bank could adopt a Standardised Approach to asset risk weighting or, with the permission of regulators, evolve an approach based on its own risk assessment known as the Internal Ratings Based ("IRB") approach.

The Standardised Approach is based upon set parameters that are wider in scope than Basel 1 and is also dynamic to reflect improvements or adverse changes to assets.

IRB: Most banks, being active in the capital markets, will have elected the IRB approach allowing it to make its own assessment through complex internal modelling to assess credit risk of assets. Each bank will calculate its own probability of default against asset types. The regulator will only give permission for using IRB if it is satisfied that the integrity of the bank's systems for the management and rating of risk exposures is sound.

Summary

In conclusion, the calculations required under Basel 2 to establish capital adequacy are much more complex and granular. Whilst the minimum 8% capital requirement remained unchanged, the revised individual asset weightings of each class may drive a bank's capital requirements either up or down compared to Basel 1 depending on its mix of business. However, it is the additional requirement for inclusion of operational risk to cover systemic and macro economic variables through business cycles which has made additional capital a significant requirement for many banks.

ACCOUNTING STANDARDS

In essence there have been no specific major accounting standards changes under International rules (IFRS) since it was implemented in most UK plc banks in 2005. That implementation back then did highlight some rather fundamental shifts in bank accounting though, particularly bin relation to the banks security portfolios. In simple terms under old UK Gaap banks had 2 choices - either hold as "for trading" or "to maturity". Instruments held under the former were marked to market but the latter were held at cost. Guess what most banks did?

Under IFRS a 3rd choice was introduced- "available for sale". In addition if a bank makes a choice which is subsequently proven wrong ie it opts to present instrument as "held to maturity " which means it can be held at cost - but then trades it before maturity, there are some penal accounting ramifications to punish the entity. I am told that this was seen as all too difficult by many banks so most just categorised the instruments in a category that under IFRS required them to be marked to market which as you know increased the volatility of the sector's balance sheets very substantially.

~~The issues which have surfaced more over the last year or so relate "stress testing" of the valuation rules. Strictly speaking I gather that you are required to reference your market valuation to what is happening in the market place. In situations where there is thin and /or depressed trading this can give some very strange results~~. With the more recent volatility in the markets following the credit crunch commencement last year ....etc etc and recent guidance was issued to tighten up interpretations of valuation principles.

The second question related to potential delays in the US arena. I gather that as part of the $700bn rescue proposals to shore up the financial markets there are some proposals to delay the implementation of the new US financial standard (FAS 157) which is the proposed standard covering fair value accounting there. Yesterday the EU's response to that was apparently that this could herald the suspension somehow of the current IFRS s in the same area, possibly very soon. I am afraid that I havent been able to get at the detail of how that might happen but suspect that is because its not yet clear.

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SEC Loosens Accounting Rule Banks Blame for Crisis

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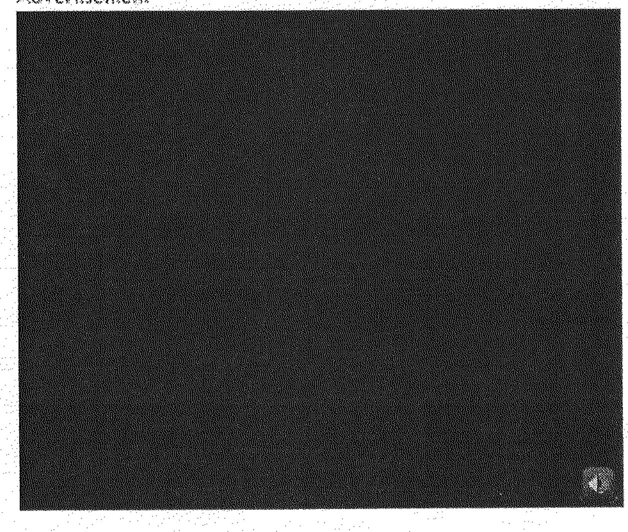

Firms Granted Leeway to Value Complex Mortgage-Related Investment

By Carrie Johnson
Washington Post Staff Writer
Tuesday, September 30, 2008; 6:24 PM

Under intense political pressure, regulators for securities and accounting standards this afternoon issued what they called a "clarification" to provisions that have come under fire from bank executives and some lawmakers for contributing to the credit crisis.

Regulators said that the new guidance will help companies figure out the value of complex mortgage-related investments at a time when there are few trading partners willing to purchase them.

Under an accounting standard that took effect last November, businesses are required to employ "fair value" accounting, in which they put a price tag on their assets even if they do not intend to sell them right away.

The standard, also known as "mark to market," has led portfolios to plunge in recent months as banks affixed fire sale prices to their assets, a move that sometimes required them to raise still more capital to meet regulatory requirements. The measure also led to clashes between corporate executives and independent auditors over how low the markdowns should be forced to dip.

In a meeting last week, lobbyists for the American Bankers Association and the Financial Services Roundtable urged the Securities and Exchange Commission to suspend or relax the accounting provision. A similar advocacy effort continues on Capitol Hill, where lawmakers are reconsidering efforts to aid the financial industry after the House yesterday failed to pass a recovery plan. That bill also would have forced a re-evaluation of the "mark to market" accounting rules.

The three-page joint statement today from the SEC and the Financial Accounting Standards Board does not do away with fair value accounting provisions altogether.

But it gives companies more leeway to employ estimates and their own judgment in many cases when they deem the market to be "disorderly" or seized by liquidity problems. It also gives companies room to determine whether the impaired value of their assets is no longer temporary, a conclusion that could trigger massive write-downs.

Regulators reminded companies today that in exchange for using more estimates and judgment, the need to disclose their methods to investors is all the more important. SEC officials sent letters reminding businesses of their obligations twice already this year, in March and September, after expressing concern that many financial institutions were using opaque measurements.

Banking groups cheered today's changes, which they said had been growing in urgency because the third fiscal quarter for many companies ends today, Sept. 30.

"This is a significant first step and adds stability, confidence, and liquidity within the capital markets," said Steve Bartlett, chief executive of the roundtable.

ABA President Edward L. Yingling said the guidance "will help auditors more accurately price assets that are difficult to value under current market conditions."

"More and more of our members in recent weeks have raised concerns that a number of accounting firms were mistakenly interpreting SFAS 157 in a way that required marking assets to fire sale values," he added.

But trade groups representing audit firms and financial analysts have warned against going too far to ease accounting provisions.

The Center for Audit Quality, a coalition of 800 accounting firms, pointed out in a letter to members of Congress today that overinflated valuations only made the savings and loan scandal of the 1980s all the more "devastating when the bubble finally burst."

Cynthia M. Fornelli, executive director of the audit center, said today's guidance "doesn't change the underlying principles" of the accounting measure.

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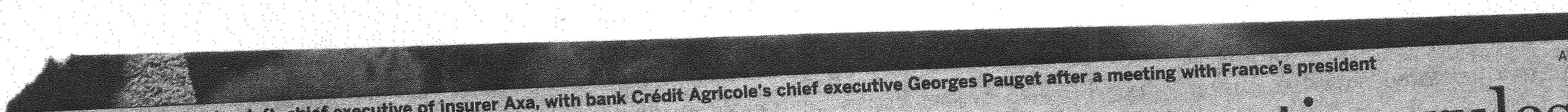

AP

Crisis talks: Henri de Castries, left, chief executive of insurer Axa, with bank Crédit Agricole's chief executive Georges Pauget after a meeting with France's president

Sarkozy seeks more flexibility on accounting rules

Market Regulation

By Jennifer Hughes in London and Ben Hall in Paris

The pressure on regulators and rulemakers to ease "fair value" accounting standards in an effort to help end the financial crisis has been intensified by politicians.

~~Nicolas Sarkozy, French president, is to urge his European counterparts this week to back changes that would introduce more flexibility in the accounting rules~~, while David Cameron, leader of the British opposition, yesterday said the rules had made the crisis worse and needed to be addressed.

Fair value requires companies to report the bulk of their financial holdings at their current market price. Falling house prices and plunging markets have led banks to write down the value of their assets, many of which are linked to mortgage loans, by hundreds of billions. This has weakened their balance sheets, undermining banks' capital reserves and prompting fears of further downward spirals in prices.

A number of banks have called for a suspension of the rules in favour of being able to use their own internal estimates of the final values of their holdings when the underlying debt matures – a move that would bolster their reported balance sheets.

Mr Sarkozy is seeking to give political momentum to EU efforts to tighten financial market rules after France became yesterday the latest European government to use public money – €3bn ($4.21bn, £2.37bn) of it – to bail out Dexia, the Belgian-French banking group. The president called a "crisis meeting" of French banks and insurers to discuss the financial turmoil.

He had hoped to hammer out a common European position on regulation at a summit hastily convened in Paris for Friday with his German, British and Italian counterparts, as well as the presidents of the European Commission and European Central Bank. However, the meeting might have to be delayed because of conflicting schedules.

The French government has been at pains to emphasise the relative stability of domestic banks, which benefit from large retail businesses to help balance their investment banking operations.

But Mr Sarkozy is keen to respond to mounting public concern and take action, even though the EU has rejected a call for a US-style blanket rescue.

The French leader wants Germany, Italy and Britain to back moves to inject flexibility into EU fair value standards. France holds the EU's rotating presidency until December.

Banks and insurers have complained that so-called mark-to-market rules – a snapshot of value – forced them constantly to write down the value of their assets, putting them under further financial pressure.

But auditors, regulators and investor groups have supported fair value and the transparency it brings.

"Politicians are looking for a simple answer here and there aren't any," Sam diPiazza, head of PwC, the biggest global accounting firm, said in an interview with the Financial Times yesterday. "To suggest you don't track and report fair values means you end up in a world where management still knows the real prices as do market counterparties, but not the investors."

~~The International Accounting Standards Board,~~ which sets rules for more than 100 countries including the European Union, is due to hold an extraordinary board meeting tomorrow to discuss the role of accounting in the credit crunch. But ~~it is not expected to soften its fair value rules.~~

Additional reporting by Joanna Chung

Dexia bail-out, Page 21

Record decline in US home

Inflation falls but ECB looks se

FT 02.10.08

Photo: Getty Images

The six options for Gordon Brown

Tarp: Troubled Asset Relief Programme

	1 Extend special liquidity scheme	2 Government guarantee on mortgage securities	3 Government guarantee on all deposits & investments in banks	4 A UK version of Tarp – the $700bn US bail-out	5 Creation of a 'bad bank'	6 Capital injections into banks
Pros	Allows banks to swap new mortgages for Treasury bills. Little taxpayer risk. Ensures banks do not have to sell illiquid assets at firesale prices	Banks will be able to secure funding for mortgage lending	The Irish solution has stabilised its banks – an approach to be reserved for a time when the whole banking system is going down	Could end the vicious circle of falling prices, weaker banks and forced sales of assets	Nationalises the weakest elements of banks once they are bust, leaving behind a viable entity	Restores a bank's finances to a healthy position, allowing it to lend again to profitable borrowers. Less expensive than many alternatives
Cons	Scheme is wholly unsuited to banks short of capital that cannot lend	Taxpayers take over the mortgage business; no exit strategy; undermines incentives for private banks to sort out their own mess and resume profitable lending	The ultimate in moral hazard. Private sector takes all the profit; taxpayers take all the risks	Ownership of mortgage-backed securities is not the fundamental problem for British banks. Hard to value assets. Expensive	For use when banks have already passed the point of no return. Expensive	Not necessarily suited to the sudden funding problems hitting banks. Even a well-capitalised bank can suffer a bank run
Likelihood	Quite likely as banks' liquidity problems have mounted	Politically attractive but Mervyn King, Bank governor, hates the idea, making it difficult to sell	Only if things get really, really bad	Unlikely	Likely when individual banks fail. A form of bad bank already exists for Northern Rock and Bradford & Bingley assets	Likely if banks cannot find other sources of capital for an extended period

10 DOWNING STREET
LONDON SW1A 2AA

THE PRIME MINISTER

Dear Aidan

It was great to talk. I look forward to meeting you again. Shriti Vadera will be in touch.

With best wishes to the family

[redacted]

TELEPHONE [redacted]

FACSIMILE [redacted]

15 October 2008 **BY EMAIL**

PRIVATE & CONFIDENTIAL

The Right Hon. Gordon Brown MP
Prime Minister
10 Downing Street
London SW1

Dear Gordon.

Thank you for taking the time out of your busy schedule to drop in at short notice at The Telegraph Business reception last evening. We were very pleased that you were able to attend.

The work at The Telegraph continues, the energy and enthusiasm is high and, although the path ahead is long, we are proud of what has been achieved so far.

Thank you once again.

Kind regards.

Yours sincerely

[redacted]

Aidan S. Barclay

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THE PRIME MINISTER

Dear Andrew and [redacted]

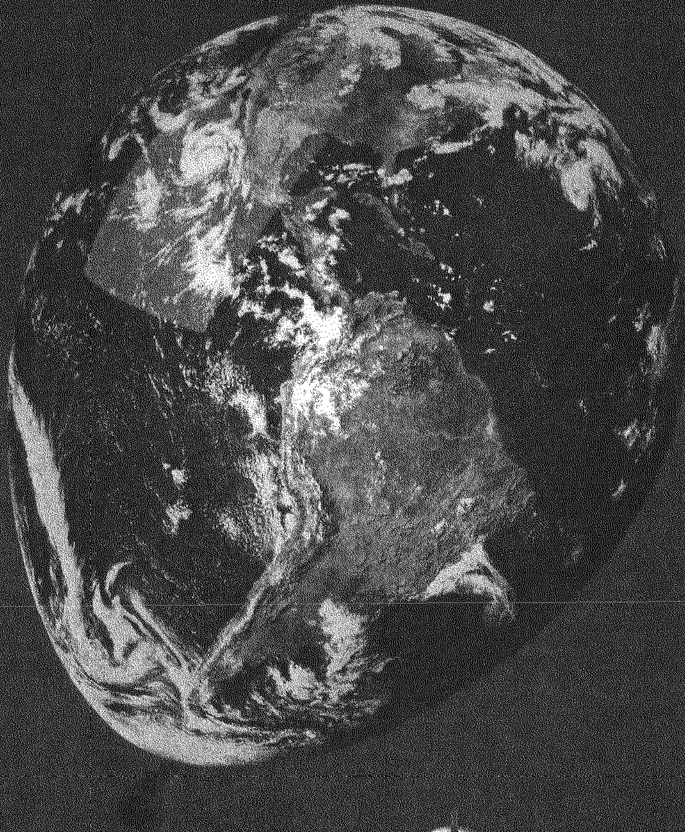
It was great to have you for dinner. Thank you for the [illegible]. I enclose 'The World we Created'

With best wishes

[redacted]

"An essential read . . . an insightful and entertaining book."
— ALAN GREENSPAN

DAVID M. SMICK



THE WORLD IS CURVED

HIDDEN DANGERS TO THE GLOBAL ECONOMY

THE MORTGAGE CRISIS WAS ONLY THE BEGINNING...

[redacted]

Tel: [redacted]
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Fax Transmittal

To:	[redacted]	**From:**	[redacted]
	Office of the Prime Minister	**Pages:**	16, including this cover sheet
Fax No:	[redacted]	**Date:**	21 November 2008
Re:	**Message for the Prime Minister from Mr Aidan Barclay**		

Dear [redacted]

Further to our telephone conversation just now, I am faxing herewith a copy of a speech entitled: *Deflation: Making Sure "It" Doesn't Happen Here,* which was made by Ben Bernanke to the National Economists Club in November 2002.

Mr Barclay, who is currently away, has recently been made aware of this speech and thought the Prime Minister might find it of interest. In particular, he would like to draw Mr Brown's attention to the section starting on page 6, entitled: *Curing Deflation*.

I would be grateful if you could pass a copy of the speech to Mr Brown.

With kind regards

The Federal Reserve Board

Remarks by Governor Ben S. Bernanke

Before the National Economists Club, Washington, D.C.
November 21, 2002

Deflation: Making Sure "It" Doesn't Happen Here

Since World War II, inflation--the apparently inexorable rise in the prices of goods and services--has been the bane of central bankers. Economists of various stripes have argued that inflation is the inevitable result of (pick your favorite) the abandonment of metallic monetary standards, a lack of fiscal discipline, shocks to the price of oil and other commodities, struggles over the distribution of income, excessive money creation, self-confirming inflation expectations, an "inflation bias" in the policies of central banks, and still others. Despite widespread "inflation pessimism," however, during the 1980s and 1990s most industrial-country central banks were able to cage, if not entirely tame, the inflation dragon. Although a number of factors converged to make this happy outcome possible, an essential element was the heightened understanding by central bankers and, equally as important, by political leaders and the public at large of the very high costs of allowing the economy to stray too far from price stability.

With inflation rates now quite low in the United States, however, some have expressed concern that we may soon face a new problem--the danger of deflation, or falling prices. That this concern is not purely hypothetical is brought home to us whenever we read newspaper reports about Japan, where what seems to be a relatively moderate *deflation*--a decline in consumer prices of about 1 percent per year--has been associated with years of painfully slow growth, rising joblessness, and apparently intractable financial problems in the banking and corporate sectors. While it is difficult to sort out cause from effect, the consensus view is that deflation has been an important negative factor in the Japanese slump.

So, is deflation a threat to the economic health of the United States? Not to leave you in suspense, I believe that the chance of significant deflation in the United States in the foreseeable future is extremely small, for two principal reasons. The first is the resilience and structural stability of the U.S. economy itself. Over the years, the U.S. economy has shown a remarkable ability to absorb shocks of all kinds, to recover, and to continue to grow. Flexible and efficient markets for labor and capital, an entrepreneurial tradition, and a general willingness to tolerate and even embrace technological and economic change all contribute to this resiliency. A particularly important protective factor in the current environment is the strength of our financial system: Despite the adverse shocks of the past year, our banking system remains healthy and well-regulated, and firm and household balance sheets are for the most part in good shape. Also helpful is that inflation has recently been not only low but quite stable, with one result being that inflation expectations seem well anchored. For example, according to the University of Michigan survey that underlies the index of consumer sentiment, the median expected rate of inflation during the next five to ten years among those interviewed was 2.9 percent in October 2002, as compared with 2.7 percent a year earlier and 3.0 percent two years earlier--a stable record indeed.

The second bulwark against deflation in the United States, and the one that will be the focus of my remarks today, is the Federal Reserve System itself. The Congress has given the Fed the responsibility of preserving price stability (among other objectives), which most definitely implies avoiding deflation as well as inflation. I am confident that the Fed would take whatever means necessary to prevent significant deflation in the United States and, moreover, that the U.S. central bank, in cooperation with other parts of the government as needed, has sufficient policy instruments to ensure that any deflation that might occur would be both mild and brief.

Of course, we must take care lest confidence become over-confidence. Deflationary episodes are rare, and generalization about them is difficult. Indeed, a recent Federal Reserve study of the Japanese experience concluded that the deflation there was almost entirely unexpected, by both foreign and Japanese observers alike (Ahearne et al., 2002). So, having said that deflation in the United States is highly unlikely, I would be imprudent to rule out the possibility altogether. Accordingly, I want to turn to a further exploration of the causes of deflation, its economic effects, and the policy instruments that can be deployed against it. Before going further I should say that my comments today reflect my own views only and are not necessarily those of my colleagues on the Board of Governors or the Federal Open Market Committee.

Deflation: Its Causes and Effects

Deflation is defined as a general decline in prices, with emphasis on the word "general." At any given time, especially in a low-inflation economy like that of our recent experience, prices of some goods and services will be falling. Price declines in a specific sector may occur because productivity is rising and costs are falling more quickly in that sector than elsewhere or because the demand for the output of that sector is weak relative to the demand for other goods and services. Sector-specific price declines, uncomfortable as they may be for producers in that sector, are generally not a problem for the economy as a whole and do not constitute deflation. Deflation *per se* occurs only when price declines are so widespread that broad-based indexes of prices, such as the consumer price index, register ongoing declines.

The sources of deflation are not a mystery. Deflation is in almost all cases a side effect of a collapse of aggregate demand--a drop in spending so severe that producers must cut prices on an ongoing basis in order to find buyers.[1] Likewise, the economic effects of a deflationary episode, for the most part, are similar to those of any other sharp decline in aggregate spending--namely, recession, rising unemployment, and financial stress.

However, a deflationary recession may differ in one respect from "normal" recessions in which the inflation rate is at least modestly positive: Deflation of sufficient magnitude may result in the nominal interest rate declining to zero or very close to zero.[2] Once the nominal interest rate is at zero, no further downward adjustment in the rate can occur, since lenders generally will not accept a negative nominal interest rate when it is possible instead to hold cash. At this point, the nominal interest rate is said to have hit the "zero bound."

Deflation great enough to bring the nominal interest rate close to zero poses special problems for the economy and for policy. First, when the nominal interest rate has been reduced to zero, the *real* interest rate paid by borrowers equals the expected rate of deflation, however large that may be.[3] To take what might seem like an extreme example (though in fact it occurred in the United States in the early 1930s), suppose that deflation is proceeding at a clip of 10 percent per year. Then someone who borrows for a year at a nominal interest rate of zero actually faces a 10 percent *real* cost of funds, as the loan must be repaid in dollars whose purchasing power is 10 percent greater than that of the dollars borrowed originally. In a period of sufficiently severe deflation, the real cost of borrowing becomes prohibitive. Capital investment, purchases of new homes, and other types of spending decline accordingly, worsening the economic downturn.

Although deflation and the zero bound on nominal interest rates create a significant problem for those seeking to borrow, they impose an even greater burden on households and firms that had accumulated substantial debt before the onset of the deflation. This burden arises because, even if debtors are able to refinance their existing obligations at low nominal interest rates, with prices falling they must still repay the principal in dollars of increasing (perhaps rapidly increasing) real value. When William Jennings Bryan made his famous "cross of gold" speech in his 1896 presidential campaign, he was speaking on behalf of heavily mortgaged farmers whose debt burdens were growing ever larger in real terms, the result of a sustained deflation that followed America's post-Civil-War return to the gold standard.[4] The financial distress of debtors can, in turn, increase the fragility of the nation's financial system--for example, by leading to a rapid increase in the share of bank loans that are delinquent or in default. Japan in recent years has certainly faced the problem of "debt-deflation"--the deflation-induced, ever-increasing real value of debts. Closer to home, massive financial problems, including defaults, bankruptcies, and bank failures, were endemic in America's worst encounter with deflation, in the years 1930-33--a period in which (as I mentioned) the U.S. price level fell about 10 percent per year.

Beyond its adverse effects in financial markets and on borrowers, the zero bound on the nominal interest rate raises another concern--the limitation that it places on conventional monetary policy. Under normal conditions, the Fed and most other central banks implement policy by setting a target for a short-term interest rate--the overnight federal funds rate in the United States--and enforcing that target by buying and selling securities in open capital markets. When the short-term interest rate hits zero, the central bank can no longer ease policy by lowering its usual interest-rate target.[5]

Because central banks conventionally conduct monetary policy by manipulating the short-term nominal interest rate, some observers have concluded that when that key rate stands at or near zero, the central bank has "run out of ammunition"--that is, it no longer has the power to expand aggregate demand and hence economic activity. It is true that once the policy rate has been driven down to zero, a central bank can no longer use its *traditional* means of stimulating aggregate demand and thus will be operating in less familiar territory. The central bank's inability to use its traditional methods may complicate the policymaking process and introduce uncertainty in the size and timing of the economy's response to policy actions. Hence I agree that the situation is one to be avoided if possible.

However, a principal message of my talk today is that a central bank whose accustomed policy rate has been forced down to zero has most definitely *not* run out of ammunition. As I will discuss, a central bank, either alone or in cooperation with other parts of the government, retains considerable power to expand aggregate demand and economic activity even when its accustomed policy rate is at zero. In the remainder of my talk, I will first discuss measures for preventing deflation--the preferable option if feasible. I will then turn to policy measures that the Fed and other government authorities can take if prevention efforts fail and deflation appears to be gaining a foothold in the economy.

Preventing Deflation

As I have already emphasized, deflation is generally the result of low and falling aggregate demand. The basic prescription for preventing deflation is therefore straightforward, at least in principle: Use monetary and fiscal policy as needed to support aggregate spending, in a manner as nearly consistent as possible with full utilization of economic resources and low and stable inflation. In other words, the best way to get out of trouble is not to get into it in the first place. Beyond this commonsense injunction, however, there are several measures that the Fed (or any central bank) can take to reduce the risk of falling into deflation.

First, the Fed should try to preserve a buffer zone for the inflation rate, that is, during normal times it should not try to push inflation down all the way to zero.[6] Most central banks seem to understand the need for a buffer zone. For example, central banks with explicit inflation targets almost invariably set their target for inflation above zero, generally between 1 and 3 percent per year. Maintaining an inflation buffer zone reduces the risk that a large, unanticipated drop in aggregate demand will drive the economy far enough into deflationary territory to lower the nominal interest rate to zero. Of course, this benefit of having a buffer zone for inflation must be weighed against the costs associated with allowing a higher inflation rate in normal times.

Second, the Fed should take most seriously--as of course it does--its responsibility to ensure financial stability in the economy. Irving Fisher (1933) was perhaps the first economist to emphasize the potential connections between violent financial crises, which lead to "fire sales" of assets and falling asset prices, with general declines in aggregate demand and the price level. A healthy, well capitalized banking system and smoothly functioning capital markets are an important line of defense against deflationary shocks. The Fed should and does use its regulatory and supervisory powers to ensure that the financial system will remain resilient if financial conditions change rapidly. And at times of extreme threat to financial stability, the Federal Reserve stands ready to use the discount window and other tools to protect the financial system, as it did during the 1987 stock market crash and the September 11, 2001, terrorist attacks.

Third, as suggested by a number of studies, when inflation is already low and the fundamentals of the economy suddenly deteriorate, the central bank should act more preemptively and more aggressively than usual in cutting rates (Orphanides and Wieland, 2000; Reifschneider and Williams, 2000; Ahearne et al., 2002). By moving decisively and early, the Fed may be able to prevent the economy from slipping into deflation, with the special problems that entails.

As I have indicated, I believe that the combination of strong economic fundamentals and policymakers that are attentive to downside as well as upside risks to inflation make significant deflation in the United States in the foreseeable future quite unlikely. But suppose that, despite all precautions, deflation were to take hold in the U.S. economy and, moreover, that the Fed's policy instrument--the federal funds rate--were to fall to zero. What then? In the remainder of my talk I will discuss some possible options for stopping a deflation once it has gotten under way. I should emphasize that my comments on this topic are necessarily speculative, as the modern Federal Reserve has never faced this situation nor has it pre-committed itself formally to any specific course of action should deflation arise. Furthermore, the specific responses the Fed would undertake would presumably depend on a number of factors, including its assessment of the whole range of risks to the economy and any complementary policies being undertaken by other parts of the U.S.

government.[7]

Curing Deflation

Let me start with some general observations about monetary policy at the zero bound, sweeping under the rug for the moment some technical and operational issues.

As I have mentioned, some observers have concluded that when the central bank's policy rate falls to zero--its practical minimum--monetary policy loses its ability to further stimulate aggregate demand and the economy. At a broad conceptual level, and in my view in practice as well, this conclusion is clearly mistaken. Indeed, under a fiat (that is, paper) money system, a government (in practice, the central bank in cooperation with other agencies) should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero.

The conclusion that deflation is always reversible under a fiat money system follows from basic economic reasoning. A little parable may prove useful: Today an ounce of gold sells for $300, more or less. Now suppose that a modern alchemist solves his subject's oldest problem by finding a way to produce unlimited amounts of new gold at essentially no cost. Moreover, his invention is widely publicized and scientifically verified, and he announces his intention to begin massive production of gold within days. What would happen to the price of gold? Presumably, the potentially unlimited supply of cheap gold would cause the market price of gold to plummet. Indeed, if the market for gold is to any degree efficient, the price of gold would collapse immediately after the announcement of the invention, before the alchemist had produced and marketed a single ounce of yellow metal.

What has this got to do with monetary policy? Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.

Of course, the U.S. government is not going to print money and distribute it willy-nilly (although as we will see later, there are practical policies that approximate this behavior).[8] Normally, money is injected into the economy through asset purchases by the Federal Reserve. To stimulate aggregate spending when short-term interest rates have reached zero, the Fed must expand the scale of its asset purchases or, possibly, expand the menu of assets

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that it buys. Alternatively, the Fed could find other ways of injecting money into the system--for example, by making low-interest-rate loans to banks or cooperating with the fiscal authorities. Each method of adding money to the economy has advantages and drawbacks, both technical and economic. One important concern in practice is that calibrating the economic effects of nonstandard means of injecting money may be difficult, given our relative lack of experience with such policies. Thus, as I have stressed already, prevention of deflation remains preferable to having to cure it. If we do fall into deflation, however, we can take comfort that the logic of the printing press example must assert itself, and sufficient injections of money will ultimately always reverse a deflation.

So what then might the Fed do if its target interest rate, the overnight federal funds rate, fell to zero? One relatively straightforward extension of current procedures would be to try to stimulate spending by lowering rates further out along the Treasury term structure--that is, rates on government bonds of longer maturities.[9] There are at least two ways of bringing down longer-term rates, which are complementary and could be employed separately or in combination. One approach, similar to an action taken in the past couple of years by the Bank of Japan, would be for the Fed to commit to holding the overnight rate at zero for some specified period. Because long-term interest rates represent averages of current and expected future short-term rates, plus a term premium, a commitment to keep short-term rates at zero for some time--if it were credible--would induce a decline in longer-term rates. A more direct method, which I personally prefer, would be for the Fed to begin announcing explicit ceilings for yields on longer-maturity Treasury debt (say, bonds maturing within the next two years). The Fed could enforce these interest-rate ceilings by committing to make unlimited purchases of securities up to two years from maturity at prices consistent with the targeted yields. If this program were successful, not only would yields on medium-term Treasury securities fall, but (because of links operating through expectations of future interest rates) yields on longer-term public and private debt (such as mortgages) would likely fall as well.

Lower rates over the maturity spectrum of public and private securities should strengthen aggregate demand in the usual ways and thus help to end deflation. Of course, if operating in relatively short-dated Treasury debt proved insufficient, the Fed could also attempt to cap yields of Treasury securities at still longer maturities, say three to six years. Yet another option would be for the Fed to use its existing authority to operate in the markets for agency debt (for example, mortgage-backed securities issued by Ginnie Mae, the Government National Mortgage Association).

Historical experience tends to support the proposition that a sufficiently determined Fed can peg or cap Treasury bond prices and yields at other than the shortest maturities. The most striking episode of bond-price pegging

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occurred during the years before the Federal Reserve-Treasury Accord of 1951.[10] Prior to that agreement, which freed the Fed from its responsibility to fix yields on government debt, the Fed maintained a ceiling of 2-1/2 percent on long-term Treasury bonds for nearly a decade. Moreover, it simultaneously established a ceiling on the twelve-month Treasury certificate of between 7/8 percent to 1-1/4 percent and, during the first half of that period, a rate of 3/8 percent on the 90-day Treasury bill. The Fed was able to achieve these low interest rates despite a level of outstanding government debt (relative to GDP) significantly greater than we have today, as well as inflation rates substantially more variable. At times, in order to enforce these low rates, the Fed had actually to purchase the bulk of outstanding 90-day bills. Interestingly, though, the Fed enforced the 2-1/2 percent ceiling on long-term bond yields for nearly a decade without ever holding a substantial share of long-maturity bonds outstanding.[11] For example, the Fed held 7.0 percent of outstanding Treasury securities in 1945 and 9.2 percent in 1951 (the year of the Accord), almost entirely in the form of 90-day bills. For comparison, in 2001 the Fed held 9.7 percent of the stock of outstanding Treasury debt.

To repeat, I suspect that operating on rates on longer-term Treasuries would provide sufficient leverage for the Fed to achieve its goals in most plausible scenarios. If lowering yields on longer-dated Treasury securities proved insufficient to restart spending, however, the Fed might next consider attempting to influence directly the yields on privately issued securities. Unlike some central banks, and barring changes to current law, the Fed is relatively restricted in its ability to buy private securities directly.[12] However, the Fed does have broad powers to lend to the private sector indirectly via banks, through the discount window.[13] Therefore a second policy option, complementary to operating in the markets for Treasury and agency debt, would be for the Fed to offer fixed-term loans to banks at low or zero interest, with a wide range of private assets (including, among others, corporate bonds, commercial paper, bank loans, and mortgages) deemed eligible as collateral.[14] For example, the Fed might make 90-day or 180-day zero-interest loans to banks, taking corporate commercial paper of the same maturity as collateral. Pursued aggressively, such a program could significantly reduce liquidity and term premiums on the assets used as collateral. Reductions in these premiums would lower the cost of capital both to banks and the nonbank private sector, over and above the beneficial effect already conferred by lower interest rates on government securities.[15]

The Fed can inject money into the economy in still other ways. For example, the Fed has the authority to buy foreign government debt, as well as domestic government debt. Potentially, this class of assets offers huge scope for Fed operations, as the quantity of foreign assets eligible for purchase by the Fed is several times the stock of U.S. government debt.[16]

I need to tread carefully here. Because the economy is a complex and interconnected system, Fed purchases of the liabilities of foreign governments have the potential to affect a number of financial markets, including the market for foreign exchange. In the United States, the Department of the Treasury, not the Federal Reserve, is the lead agency for making international economic policy, including policy toward the dollar; and the Secretary of the Treasury has expressed the view that the determination of the value of the U.S. dollar should be left to free market forces. Moreover, since the United States is a large, relatively closed economy, manipulating the exchange value of the dollar would not be a particularly desirable way to fight domestic deflation, particularly given the range of other options available. Thus, I want to be absolutely clear that I am today neither forecasting nor recommending any attempt by U.S. policymakers to target the international value of the dollar.

Although a policy of intervening to affect the exchange value of the dollar is nowhere on the horizon today, it's worth noting that there have been times when exchange rate policy has been an effective weapon against deflation. A striking example from U.S. history is Franklin Roosevelt's 40 percent devaluation of the dollar against gold in 1933-34, enforced by a program of gold purchases and domestic money creation. The devaluation and the rapid increase in money supply it permitted ended the U.S. deflation remarkably quickly. Indeed, consumer price inflation in the United States, year on year, went from -10.3 percent in 1932 to -5.1 percent in 1933 to 3.4 percent in 1934.[17] The economy grew strongly, and by the way, 1934 was one of the best years of the century for the stock market. If nothing else, the episode illustrates that monetary actions can have powerful effects on the economy, even when the nominal interest rate is at or near zero, as was the case at the time of Roosevelt's devaluation.

Fiscal Policy

Each of the policy options I have discussed so far involves the Fed's acting on its own. In practice, the effectiveness of anti-deflation policy could be significantly enhanced by cooperation between the monetary and fiscal authorities. A broad-based tax cut, for example, accommodated by a program of open-market purchases to alleviate any tendency for interest rates to increase, would almost certainly be an effective stimulant to consumption and hence to prices. Even if households decided not to increase consumption but instead re-balanced their portfolios by using their extra cash to acquire real and financial assets, the resulting increase in asset values would lower the cost of capital and improve the balance sheet positions of potential borrowers. A money-financed tax cut is essentially equivalent to Milton Friedman's famous "helicopter drop" of money.[18]

Of course, in lieu of tax cuts or increases in transfers the government could increase spending on current goods and services or even acquire existing real or financial assets. If the Treasury issued debt to purchase private assets and the Fed then purchased an equal amount of Treasury debt with newly created money, the whole operation would be the economic equivalent of direct open-market operations in private assets.

Japan

The claim that deflation can be ended by sufficiently strong action has no doubt led you to wonder, if that is the case, why has Japan not ended its deflation? The Japanese situation is a complex one that I cannot fully discuss today. I will just make two brief, general points.

First, as you know, Japan's economy faces some significant barriers to growth besides deflation, including massive financial problems in the banking and corporate sectors and a large overhang of government debt. Plausibly, private-sector financial problems have muted the effects of the monetary policies that have been tried in Japan, even as the heavy overhang of government debt has made Japanese policymakers more reluctant to use aggressive fiscal policies (for evidence see, for example, Posen, 1998). Fortunately, the U.S. economy does not share these problems, at least not to anything like the same degree, suggesting that anti-deflationary monetary and fiscal policies would be more potent here than they have been in Japan.

Second, and more important, I believe that, when all is said and done, the failure to end deflation in Japan does not necessarily reflect any technical infeasibility of achieving that goal. Rather, it is a byproduct of a longstanding political debate about how best to address Japan's overall economic problems. As the Japanese certainly realize, both restoring banks and corporations to solvency and implementing significant structural change are necessary for Japan's long-run economic health. But in the short run, comprehensive economic reform will likely impose large costs on many, for example, in the form of unemployment or bankruptcy. As a natural result, politicians, economists, businesspeople, and the general public in Japan have sharply disagreed about competing proposals for reform. In the resulting political deadlock, strong policy actions are discouraged, and cooperation among policymakers is difficult to achieve.

In short, Japan's deflation problem is real and serious; but, in my view, political constraints, rather than a lack of policy instruments, explain why its deflation has persisted for as long as it has. Thus, I do not view the Japanese experience as evidence against the general conclusion that U.S. policymakers have the tools they need to prevent, and, if necessary, to cure a deflationary recession in the United States.

Conclusion

Sustained deflation can be highly destructive to a modern economy and should be strongly resisted. Fortunately, for the foreseeable future, the chances of a serious deflation in the United States appear remote indeed, in large part because of our economy's underlying strengths but also because of the

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determination of the Federal Reserve and other U.S. policymakers to act preemptively against deflationary pressures. Moreover, as I have discussed today, a variety of policy responses are available should deflation appear to be taking hold. Because some of these alternative policy tools are relatively less familiar, they may raise practical problems of implementation and of calibration of their likely economic effects. For this reason, as I have emphasized, prevention of deflation is preferable to cure. Nevertheless, I hope to have persuaded you that the Federal Reserve and other economic policymakers would be far from helpless in the face of deflation, even should the federal funds rate hit its zero bound.[19]

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Footnotes

1. Conceivably, deflation could also be caused by a sudden, large expansion in aggregate supply arising, for example, from rapid gains in productivity and broadly declining costs. I don't know of any unambiguous example of a supply-side deflation, although China in recent years is a possible case. Note that a supply-side deflation would be associated with an economic boom rather than a recession. Return to text

2. The nominal interest rate is the sum of the real interest rate and expected inflation. If expected inflation moves with actual inflation, and the real interest rate is not too variable, then the nominal interest rate declines when inflation declines--an effect known as the Fisher effect, after the early twentieth-century economist Irving Fisher. If the rate of deflation is equal to or greater than the real interest rate, the Fisher effect predicts that the nominal interest rate will equal zero. Return to text

3. The real interest rate equals the nominal interest rate minus the expected rate of inflation (see the previous footnote). The real interest rate measures the real (that is, inflation-adjusted) cost of borrowing or lending. Return to text

4. Throughout the latter part of the nineteenth century, a worldwide gold shortage was forcing down prices in all countries tied to the gold standard. Ironically, however, by the time that Bryan made his famous speech, a new cyanide-based method for extracting gold from ore had greatly increased world gold supplies, ending the deflationary pressure. Return to text

5. A rather different, but historically important, problem associated with the zero bound is the possibility that policymakers may mistakenly interpret the zero nominal interest rate as signaling conditions of "easy money." The Federal Reserve apparently made this error in the 1930s. In fact, when prices are falling, the real interest rate may be high and monetary policy tight, despite a nominal interest rate at or near zero. Return to text

6. Several studies have concluded that the measured rate of inflation overstates the "true" rate of inflation, because of several biases in

standard price indexes that are difficult to eliminate in practice. The upward bias in the measurement of true inflation is another reason to aim for a measured inflation rate above zero. Return to text

7. See Clouse et al. (2000) for a more detailed discussion of monetary policy options when the nominal short-term interest rate is zero. Return to text

8. Keynes, however, once semi-seriously proposed, as an anti-deflationary measure, that the government fill bottles with currency and bury them in mine shafts to be dug up by the public. Return to text

9. Because the term structure is normally upward sloping, especially during periods of economic weakness, longer-term rates could be significantly above zero even when the overnight rate is at the zero bound. Return to text

10. S See Hetzel and Leach (2001) for a fascinating account of the events leading to the Accord. Return to text

11. See Eichengreen and Garber (1991) and Toma (1992) for descriptions and analyses of the pre-Accord period. Both articles conclude that the Fed's commitment to low inflation helped convince investors to hold long-term bonds at low rates in the 1940s and 1950s. (A similar dynamic would work in the Fed's favor today.) The rate-pegging policy finally collapsed because the money creation associated with buying Treasury securities was generating inflationary pressures. Of course, in a deflationary situation, generating inflationary pressure is precisely what the policy is trying to accomplish.

An episode apparently less favorable to the view that the Fed can manipulate Treasury yields was the so-called Operation Twist of the 1960s, during which an attempt was made to raise short-term yields and lower long-term yields simultaneously by selling at the short end and buying at the long end. Academic opinion on the effectiveness of Operation Twist is divided. In any case, this episode was rather small in scale, did not involve explicit announcement of target rates, and occurred when interest rates were not close to zero. Return to text

12. The Fed is allowed to buy certain short-term private instruments, such as bankers' acceptances, that are not much used today. It is also permitted to make IPC (individual, partnership, and corporation) loans directly to the private sector, but only under stringent criteria. This latter power has not been used since the Great Depression but could be invoked in an emergency deemed sufficiently serious by the Board of Governors. Return to text

13. Effective January 9, 2003, the discount window will be restructured into a so-called Lombard facility, from which well-capitalized banks will be able to borrow freely at a rate above the federal funds rate. These changes have no important bearing on the present discussion. Return to text

14. By statute, the Fed has considerable leeway to determine what assets to accept as collateral. Return to text

15. In carrying out normal discount window operations, the Fed absorbs virtually no credit risk because the borrowing bank remains responsible for repaying the discount window loan even if the issuer of the asset used as collateral defaults. Hence both the private issuer of the asset and the bank itself would have to fail nearly simultaneously for the Fed to take a loss. The fact that the Fed bears no credit risk places a limit on how far down the Fed can drive the cost of capital to private nonbank borrowers. For various reasons the Fed might well be reluctant to incur credit risk, as would happen if it bought assets directly from the private nonbank sector. However, should this additional measure become necessary, the Fed could of course always go to the Congress to ask for the requisite powers to buy private assets. The Fed also has emergency powers to make loans to the private sector (see footnote 12), which could be brought to bear if necessary. Return to text

16. The Fed has committed to the Congress that it will not use this power to "bail out" foreign governments; hence in practice it would purchase only highly rated foreign government debt. Return to text

17. U.S. Bureau of the Census, *Historical Statistics of the United States, Colonial Times to 1970*, Washington, D.C.: 1976. Return to text

18. A tax cut financed by money creation is the equivalent of a bond-financed tax cut plus an open-market operation in bonds by the Fed, and so arguably no explicit coordination is needed. However, a pledge by the Fed to keep the Treasury's borrowing costs low, as would be the case under my preferred alternative of fixing portions of the Treasury yield curve, might increase the willingness of the fiscal authorities to cut taxes.

Some have argued (on theoretical rather than empirical grounds) that a money-financed tax cut might not stimulate people to spend more because the public might fear that future tax increases will just "take back" the money they have received. Eggertson (2002) provides a theoretical analysis showing that, if government bonds are not indexed to inflation and certain other conditions apply, a money-financed tax cut will in fact raise spending and inflation. In brief, the reason is that people know that inflation erodes the real value of the government's debt

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and, therefore, that it is in the interest of the government to create some inflation. Hence they will believe the government's promise not to "take back" in future taxes the money distributed by means of the tax cut. Return to text

19. Some recent academic literature has warned of the possibility of an "uncontrolled deflationary spiral," in which deflation feeds on itself and becomes inevitably more severe. To the best of my knowledge, none of these analyses consider feasible policies of the type that I have described today. I have argued here that these policies would eliminate the possibility of uncontrollable deflation. Return to text

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2002 Speeches

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15 September 2009

PRIVATE & CONFIDENTIAL

The Right Hon. Gordon Brown, MP
Prime Minister
10 Downing Street
London SW1A 2AA

Dear Gordon,

Many thanks for your hospitality on Monday evening. It was very good to catch up again after a while and we very much enjoyed the conversation.

Though there are still economic uncertainties ahead, like you, I believe that the worst has passed. In the UK at least, this is largely thanks to your early grasp of the issues and your leadership, though I am not convinced that the voters will show their appreciation for it.

Perhaps the voting public have always taken for granted the handling of the big issues but tend to vote on smaller ones that affect them personally.

It is my personal view that it is far too early to assume that the economies can sustain recovery without continued government support for a while. The economic road ahead will be long and slow.

Meanwhile, best of luck at the G20 meeting and I hope those in authority in the USA manage to understand the international dimensions.

Thank you once again.

Yours sincerely

[redacted]

Aidan S. Barclay

Regards to Sarah and the boys.

e-mailed

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LONDON SW1A 2AA

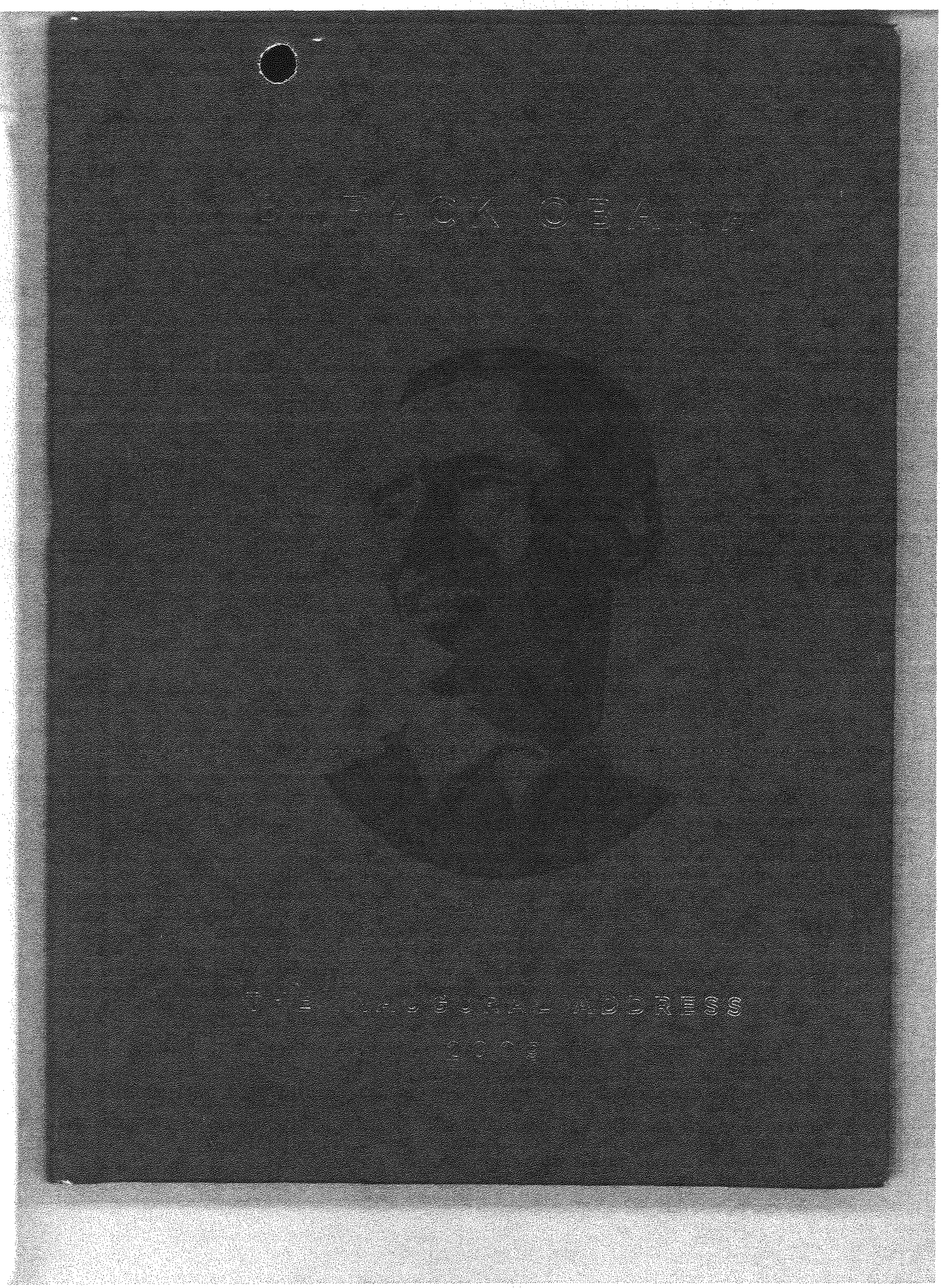
THE PRIME MINISTER

To Aidan,

A memento

of 2009,

with best wishes



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From: William Lewis, Editor in Chief

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8th January 2010

Dear Adam,

I thought you might like to see the file note I wrote and sent to the Editors following the Gordon Brown breakfast.

Best,

The Daily Telegraph The Sunday Telegraph Telegraph.co.uk

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MEMO

TO: Tony Gallagher – Editor, Daily Telegraph, Ian MacGregor - Editor, Sunday Telegraph, [redacted] Executive Editor, [redacted] -Digital Editor

FROM: William Lewis - Managing Director, Digital and Editor in Chief

DATE: 8TH January 2010

I thought I would give you a briefing on my breakfast meeting this week with Gordon Brown.

As you are aware, the Prime Minister has expressed concern that the Telegraph (among others) has in recent weeks carried content which he believes to be unfair and unbalanced. While I believe that much of his criticism is misplaced, I also think it is encumbent upon us to ensure we maintain our very high standards of balance and fairness in our political reporting and comment.

This is particularly vital in the run up to a general election, during which the preservation and enhancement of our hard earned reputation for being firm but fair will be even more important for the Telegraph brand.

This does not mean that, on occasion, we will not administer a robust 'kicking' when we feel one is warranted. I told the Prime Minister as much in our meeting and he accepted this. However, I also gave him a categoric assurance on behalf of the whole of the Telegraph that, over the course of any given week or month, he will be able to see that we have been fair and balanced in our reporting of him, and that he will have been given every opportunity to put his case as and when merited.

I further pointed out that the Prime Minister and his team needed to give us more to work with on occasion. I think he took this on board – but we shall wait and see.

For Distribution to CPs

TELEPHONE

FACSIMILE

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22 January 2010

PRIVATE & CONFIDENTIAL

The Right Hon. Gordon Brown, MP
Prime Minister
10 Downing Street
London SW1A 2AA

Dear Gordon,

First of all, may I wish you and Sarah and the boys all the very best of Health and Happiness for 2010.

Secondly, a belated thank you for sending me a copy of the Speeches of Barak Obama. It was very kind of you to think of me. It will make a valuable contribution to my collection.

By way of return, although I am quite sure you have great difficulty in finding time to read, if you do have a spare moment you might like to page through the enclosed book: **Outliers**, by Malcolm Gladwell, which is quite thought provoking.

With one or two matters in mind, I am conscious that we should probably be having a chat in the not-too-distant future, however I have some travelling to do in the next few weeks and am rather busy on a recent acquisition. (Our delivery business, HDNL, acquired the DHL UK logistics business and we will shortly be in the process of completing this. I enclose a copy of the press release for your interest).

I will be in touch with your office some time in February with a view to fixing up a breakfast, if you have time to see me.

Kind regards.

Yours sincerely

Aidan S. Barclay

Encs.

HOME DELIVERY NETWORK

5 January 2010

HOME DELIVERY NETWORK ANNOUNCES ACQUISITION OF DHL's DOMESTIC B2B AND B2C PARCEL DELIVERY BUSINESS

Home Delivery Network Limited (HDN) is pleased to announce it has reached agreement with Deutsche Post DHL to acquire its UK domestic business-to-business and business-to-consumer parcel delivery operations, DHL Domestic. The combined businesses will have annual sales of more than £600 million and will deliver more than 180 million parcels a year.

The combination of HDN and DHL Domestic will create a sustainable delivery business in which customers will continue to experience high quality standards of service while benefiting from a broader product offering. HDN believes that the two businesses will be ideally positioned to exploit the continued growth in a sector that is being driven by the expansion of e-commerce in which there is increasing overlap between B2B and B2C customers.

HDN will continue to provide best-in-class service for the combined customer base. Their increased scale will result in a more efficient business that will be capable of withstanding intensifying competition from a wide range of traditional B2C and B2B carriers, as well as challenging the Royal Mail more effectively.

This transaction will provide greater security to its customers, people and other partners. There will be a sizeable investment from HDN to ensure that the businesses will achieve their long term prospects. DHL Domestic will continue to trade under the DHL Domestic name until the two businesses are fully integrated.

The transaction does not include DHL's UK International Time Definite and Same Day express services. DHL's other UK businesses DHL Freight, DHL Global Forwarding, DHL Supply Chain, DHL Global Mail and Williams Lea are unaffected by this move.

Brian Gaunt, HDN chief executive, said: *"This transaction is great news for customers of both HDN and DHL Domestic. The growth of e-commerce has transformed our marketplace and with it the demands of our customers. Combining these businesses will enable us to offer our clients a wider variety of propositions and a more efficient service. However our immediate focus will be to maintain the exceptionally high standards of service that our customers have come to expect from both businesses."*

Ken McCall, CEO of DHL Express UK, said: "It was important to us to divest our own parcel business to a company that we can trust. HDN is a strong and well-respected player in the B2C field and thus ideally complements the B2B focused services we currently offer. This will certainly create an unrivalled service for all UK domestic parcel customers. We remain committed to ensuring our domestic parcel customers receive DHL's usual high standards of service and will work closely with HDN to ensure a smooth transition process. It will absolutely be business as usual for these customers."

The transaction was agreed today and is subject to clearance by the appropriate regulatory bodies.

ENDS

For further information:

HDN
[redacted] Chairman
[redacted] Chief Executive

Brunswick Group
[redacted]

[redacted]

Notes to Editors:

The combined businesses:

- The combined businesses wiii have annuai revenues of more than £600 miiiion and wiil deiiver more than 180 miiiion parceis a year
- it wiii be able to pick-up and deiiver to every singie UK address every single day
- The combined businesses wiii have expertise across a host of sectors inciuding the pharmaceuticai, teiecommunications, retaii and financiai services industries

Home Delivery Network:

- Home Delivery Network Limited is one of the fastest growing and most respected parcel delivery business in the UK
- The Company has an enviable client base spanning many of the country's largest and most trusted retail businesses
- HDN believes that great consumer service and choice of delivery proposition helps its clients drive their revenues upwards. The company has been at the vanguard of major innovations in the industry, including offering Saturday and evening deliveries, investing in technology to make deliveries safe and secure, and offering consumers the chance to "track and trace" their parcels realtime throughout the delivery process
- HDN delivers to every UK postcode through 50 parcel depots, four 2-man operations sites which distribute heavy and large items throughout the UK, and two national sort centres at Shaw in Oldham and Droitwich in Worcestershire. It has its headquarters in Whiston, Merseyside

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11 FEB 2010

10 DOWNING STREET
LONDON SW1A 2AA

THE PRIME MINISTER

10 February 2010

Dear Aidan

Thank you for your letter of 22 January and for kindly sending me a copy of Outliers by Malcolm Gladwell. I look forward to reading it.

I hope it will be possible to meet you soon for breakfast.

Yours sincerely

Mr Aidan S Barclay

BY HAND

F

~~Day~~

[redacted]

TELEPHONE

[redacted]

FACSIMILE

[redacted]

12 April 2010

<u>PRIVATE & CONFIDENTIAL</u>

The Right Hon. Gordon Brown, MP
Prime Minister
10 Downing Street
London SW1A 2AA

Dear Gordon,

I hope you are keeping well.

Thank you for sending me a copy of your book of speeches: **The Change We Choose**. It was kind of you to think of me.

I look forward to reading through it over the coming weeks.

Kind regards.

Yours sincerely

[redacted]

Aidan S. Barclay

P.S. With best wishes to Sarah and the boys.

For Distribution to CPs

10 DOWNING STREET
LONDON SW1A 2AA

THE PRIME MINISTER

1 April 2010

Dear Aidan

In the last three years, Britain has been through some truly momentous changes. The worldwide recession, the withdrawal of British troops from Iraq, the acceleration of technology and science, the crisis of trust in our democracy and the transformation of our public services with new legally-binding guarantees have all made this a significantly different country than the one I was honoured to be given the chance to lead in June 2007.

On the day I moved into Downing Street, I promised to do my utmost. The speeches in this book cover the key policy areas where I have focussed my energies and where I believe this Government has changed the world for the better and forever.

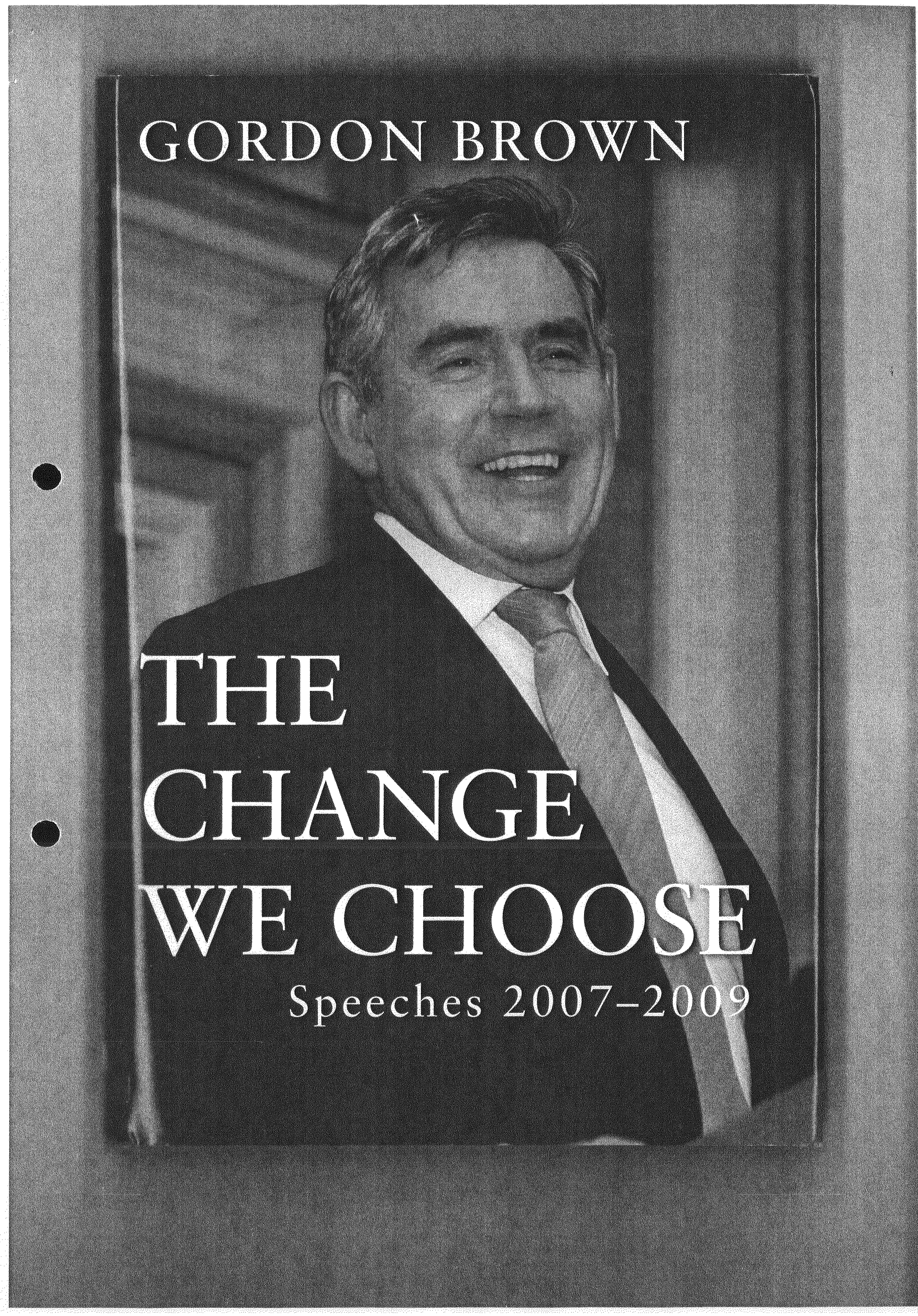
The work of change is never easy, and it is never complete. But I hope over the course of this volume you will read about the power of progressive Government to do good and be inspired by some of the amazing things that are happening in our country and our world.

I truly believe that working together we can make our country even more democratic, more green, more hi-tech, more equal, more prosperous and more fair. That is our task in the years to come and that's the change I choose.

With best wishes,

Yours sincerely

Mr Aidan Barclay


GORDON BROWN
THE CHANGE WE CHOOSE
Speeches 2007–2009

[redacted]

From: Tony Gallagher [redacted]
Sent: 13 May 2010 18:28
To: [redacted]

Dear Aidan,

[redacted] Gordon Brown's foreign affairs advisor and key No 10 aide, went out of his way to praise our fairness and balance during the election campaign when he visited us last week.

"You carried more policy stories from us than anyone else over the past three weeks. We've got no complaints," he said.

[redacted] our political correspondent who followed him round) has been terrific."

He highlighted the fact we've done the election far better than The Times.

Kind regards
Tony

GB FIVE

[redacted]

From: [redacted]
Sent: 10 November 2010 15:16
To: [redacted]
Cc: [redacted]
Subject: Draft

Hi [redacted]

Murdoch has asked me to forward to you the draft response from him to GB for AB's information.

[redacted]

Dear Gordon

Thank you for your email and I am really sorry that these events have led to this sad situation. However, I believe it would be worthwhile making a concerted effort on our part to get this right, especially with your book being published in the near future. Having said that, it is not just for the book, but to ensure that we improve dramatically on the relationship and build on this thereafter.

To this end, Aidan would like to invite you and, if you think it appropriate, also Sarah, depending of course on her other commitments, to visit his office for tea with both editors, Tony Gallagher and Ian MacGregor, as well as me, to discuss this and all issues going forward.

Aidan feels, as I do, that you should be afforded the proper respect shown to a former Prime Minister in every sense and whenever we get it wrong, we should be quick to apologise and correct any mistakes.

This will also allow the Editors first hand to explain their position and, at the end of this, establish a meaningful and successful relationship going forward.

Very best

Murdoch