Part. A.

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PART A

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PART A

BOARDS OF GOVERNORS • 1982 ANNUAL MEETINGS • TORONTO, CANADA

INTERNATIONAL MONETARY FUND
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION

Press Release No. 12

September 6, 1982

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Statement by the Hon. DONALD T. REGAN,
Secretary of the Treasury and Governor of the
Fund and Bank for the UNITED STATES, at the
Joint Annual Discussion

I am happy to be here today, enjoying the hospitality of a neighbor with whom we share the world's longest unfortified border. I am delighted to be with you and to join in welcoming three new members to this meeting--Antigua and Barbuda, Belize, and Hungary.

Last year, President Reagan met with this group in Washington and said: "We need to recognize our progress and talk about it more...with one another. This in no way denies the immense problems we face but without some sense of what we have achieved...we will succumb to defeatism and surrender to ill-advised solutions."

During the past year, there have been major economic achievements, both in my country and in the international arena, and we would do well to recognize them. But first let me put these accomplishments in perspective.

At these meetings last year in Washington, at Helsinki, and again at the economic summit in Versailles, we were told that the U.S. budget deficit and high interest rates were the major economic problems for every other country in the world. In recognition of widespread concern and uncertainty in financial markets over the projected size of future U.S. budget deficits, we acted. In an atmosphere made difficult by domestic economic and political pressures--and despite our own unwavering commitment to incentive-oriented tax rate reductions--we asked the Congress to reduce budget deficits over the next three years by $380 billion, including the $99 billion in revenue increases which just passed the Congress. Although there are complaints about inadequate U.S. control of government expenditures, we have cut $270 billion from non-defense expenditures since taking office, in addition to the $280 billion in further cuts we are now asking for. President Reagan is personally committed to seeing these cuts through.

We are already seeing tangible results from our economic program. We have been predicting a decline in interest rates. This prediction met with entrenched skepticism, both at home and abroad. But the fact is that interest rates have been dropping for some time now. And while they are still much higher than we would like, they are far, far below their peaks.

The three-month treasury bill rate, which peaked at 16.7 per cent at the beginning of 1981, is now at 8.6 per cent. The prime rate was over 20 per cent then. Today it is 13 1/2 per cent. The federal funds rate has moved in the same period from 15 per cent to 9 per cent. These are major declines. With continued progress on inflation, we should see more in the months ahead.

The decline in long-term rates has lagged behind short-term rates. Historically, this has been the pattern, and the transition we are presently moving through is no exception. However, even long-term rates have now started downward.

In our first budget, we anticipated that the rate of consumer price increase in the United States would drop from the double-digit rates prevailing before we took office to about 8 1/2 per cent this year and a little over 6 per cent in 1983.

Our critics, back then, scoffed at such projections. But in fact we have done even better. Consumer price inflation in the first half of this year ran at a 5.1 per cent annual rate, and we expect it to be only a bit higher than that for the year as a whole. Wage increases in the United States have averaged only about 6 per cent in the first six months of 1982. Wholesale prices are up only 2.5 per cent in the same period, and one of our major automobile manufacturers has increased prices for the 1983 models by a mere 1.9 per cent--a clear indication of weakened price pressures.

At last year's Annual Meeting, President Reagan said that "each of our societies has a destiny to pursue. We have chosen ours in light of our experience, our strength, and our faith."

The theme of the United States under the Reagan Administration is by now very familiar to you: we have faith in the market mechanism. Economic decision making through private market activity simply produces more efficient results than decisions imposed by governments. And experience has demonstrated time and again that this is the case, both domestically and internationally.

In the United States, we have worked to put in place an economic program that embodies this approach. We have set our goals high--but they are attainable goals.

The declines in interest rates and inflation that I have mentioned are welcome. But they provide only the first inkling of the real benefits that the U.S. and world economies will realize from the President's economic program.

The stage has been set for a strong recovery that is becoming more probable and more imminent with each passing day. Our index of leading indicators for July rose 1.3 per cent--the fourth consecutive monthly increase. The turnaround in U.S. real GNP, which began with modestly positive growth in the second quarter, will give us stronger growth later this year, before settling back into a sustained recovery with growth in the 4 per cent range.

While countries differ greatly in culture, traditions, and present economic circumstance, we believe that there is a broad blueprint for sound economic policy which is applicable to all. A stable and noninflationary macroeconomic policy, formulated with a long-term planning horizon, and implemented steadfastly despite short-run pressures, is necessary for sustainable economic growth.

This type of macroeconomic policy must in our view be reinforced by a free-market orientation. When we allow market forces continually to adapt our economies to changing economic circumstances, adjustment is less abrupt. Governments can sometimes delay adjustment for a short time by using subsidies, protectionist measures, and capital controls--but sooner or later the adjustment has to be made.

These, then, are the components of our approach to both domestic and international economic issues: an emphasis on noninflationary, market-oriented domestic economic policies and on effective international cooperation. This is the philosophical framework which shapes our attitude toward the Fund and Bank.

The Fund continues to be the key institution of the international monetary system. In the current environment the only acceptable approach is the one the Fund is taking--an approach designed to foster economic and balance of payments adjustment.

The types of problems our nations face have not changed in character. They still include excessive inflation, high unemployment, substantial payments imbalances, and the daily burden of poverty and hunger. But in the past twelve months, there has been fundamental improvement on a number of fronts.

First and foremost, there has been broad--although not universal--improvement in the areas of inflation and payments imbalances. But we have only to look about us, or to listen to our citizens, to know that we still have a long way to go. A lasting world economic recovery, with significant reductions in unemployment, is now within our reach. But it will require continued diligence and perseverance to attain. From a worldwide perspective, the fires of inflation, while not as white-hot as they were a year or two ago, are still uncomfortably warm. In some countries, they continue to rage virtually unchecked.

Second, the experience of the past few months underscores the basic strength and resilience of the international financial system. The system is sound. It has coped with some difficult liquidity and debt problems, and I am confident that it will do so in the future.

At the same time, it is clear that the rapid growth of international debt has placed strains on the world banking system. Ironically, many current problems stem from government policies designed to stimulate rapid growth but which--because of their excesses and reliance on controls--have produced little or no growth and have greatly damaged economic performance in all respects.

All too often, governments have tried to follow overly ambitious national economic plans that exceed the real and financial resources of their nations. Confronted with the gap between aspirations and resources, the temptation is great to spend beyond one's means--a problem not unheard of in Washington. There are pressures for massive government deficit spending and temptations to monetize budget deficits, thus fueling inflation. And there are heavy pressures to borrow excessively abroad--to the point that a nation loses access to foreign credit markets altogether.

The results are inevitable: too little growth, too much inflation, too much debt. Confidence in the borrower's economy becomes shaken and money flees to other countries and to other currencies.

The lessons here for all of us--creditors and debtors--are plain. The international financial system is tough and resilient, but its resources are not inexhaustible. Societies cannot grow faster than their resources will allow. Attempts to promote unrealistic growth rates lead only to inflation.

The real solution to the problems we all face is to be found through a series of courageous and concerted steps toward adjustment.

As President Clausen said this morning: "Sustained growth in the developing countries inevitably depends on their own sound domestic policies." The same applies to all.

Without sound national economic policies, both domestic and international resources--real and financial--are misallocated, and economic and social disruptions can only increase. With sound policies, the basis is laid for reconciling the necessary prudence in lending by the private sector with the need for continued financing during the period of adjustment.

Reluctance to tackle difficult economic decisions, coupled with recent sluggishness of the world economy, has made it all the more difficult to resist the political pressures for protectionism. But one of the lessons of history is that protectionism does not pay. Free-flowing trade and investment are part of the engine which drives economic growth.

For this reason it is essential that we maintain forward momentum on trade liberalization, rather than slipping back into politically motivated protectionism. While liberalization of international trade and investment, in itself, is no panacea for our economic difficulties, it is an essential component of any sustainable long-run recovery. We have been working hard to keep up momentum for such liberalization, and that will be the central focus of our efforts at this fall's GATT ministerial meetings.

As the major international monetary institution, the IMF has a central role to play in promoting greater discipline in national economies. One obvious way it can accomplish this is through its surveillance activities.

In this context, I am pleased to note that, with the assistance of the Managing Director, we have begun the process of enhanced international economic and monetary cooperation that was agreed upon at the Versailles summit. We are hopeful that this effort will make an important contribution to greater convergence and stability in the policies of the major trading nations, and thereby to greater exchange market stability.

Another important area of the Fund's adjustment-related activities is its role in extending conditional balance of payments financing. For the Fund to have an effective role, this financing must remain temporary; and it must be directed toward support of sound adjustment programs.

The United States has urged that IMF support be directed to cases of genuine need, in order to conserve scarce financial resources; and that great care be given to the design and implementation of IMF-supported programs, to maximize the IMF's contribution to effective adjustment. We are pleased with progress in both of these areas: the Fund's current financial position is strong, as is its reputation for supporting sound economic programs on the part of its borrowers.

For the future, we must assure that the Fund maintains the capacity to respond to genuine needs for temporary financing and to cope with situations that place strains on the system as a whole. The increase in IMF quotas now under discussion in the IMF must be adequate to meet temporary balance of payments financing requirements under normal circumstances. We believe also that consideration should be given to establishment of an additional permanent borrowing arrangement, which would be available to the IMF on a contingency basis for use in extraordinary circumstances.

The United States is prepared to work closely with others in elaborating and considering this suggestion and believes that basic decisions both on it and on the quota review itself should be a realistic aim for next spring's meeting of the Interim Committee.

The programs of the World Bank and the regional development banks are a concrete response to the twin challenges of maintaining growth and vitality in the international economy, and assuring that all countries--particularly the poorest--are provided the opportunity to participate fully in a dynamic and efficient international economic system.

In February, we released the results of the most thorough U.S. examination of the multilateral development banks that had been conducted since their establishment.

In summary, our examination underscored the value of an effective MDB role in a market-oriented international system and highlighted the very considerable potential the banks have for enhancing growth and stability in developing countries:

-- as catalysts for mobilizing private sector resources;

-- as sources of sound economic policy advice and technical assistance; and

-- as financiers of viable development projects that the private sector is not well positioned to provide.

We are convinced, however, that there is considerable opportunity for the World Bank to utilize its resources more effectively. As you are no doubt aware, the United States is taking a much closer look at individual projects and is casting votes on these loans consistent with the conclusion of our study. We have abstained, for example, on some recent oil and gas loans because we felt that the role of the Bank was not adequately justified in these cases. We continue to believe that prudent operations and more innovative cofinancing techniques will enable the Bank to continue its lending program at a satisfactory level without accelerating the recently enacted general capital increase.

With regard to specific policy recommendations, we will continue to advocate a more selective approach to Bank lending, with less emphasis on lending targets, more emphasis on selecting projects that maximize use of the Bank's special skills, and greater attention to loan and project quality.

We believe that an economic environment which enhances the opportunity for private sector enterprise also enhances the prospects for sustained economic growth. In particular, the United States remains strongly committed to the objectives and catalytic role of the International Finance Corporation. We look forward to a discussion by Directors of the IFC's new five-year plan and to specific suggestions as to how the IFC's role can be strengthened.

In the months ahead, we will encourage active efforts in all the development banks to enhance the role of the private sector in development. In IFC especially, we suggest early attention to such things as:

-- appropriate involvement in more energy projects, where a catalytic or "umbrella" role can be justified;

-- within the World Bank Group, an expanded IFC program of lending/equity investments in development finance corporations (particularly privately owned); and

-- a more concerted effort to exploit four demonstrated areas of IFC comparative advantage: innovative financial intermediation and project financial packaging; effective support of private sector, market-oriented industrial activity; promotion and strengthening of capital markets in developing countries; and policy advice to improve the investment climate and framework in developing countries.

The United States also welcomes the Bank's preliminary report on the creation of a multilateral investment insurance mechanism. Such a mechanism could promote valuable additional investment capital, and we strongly encourage the Bank to continue to examine its feasibility.

There has been some criticism that the United States has de-emphasized the importance of Bank assistance to the poorest sectors and countries. This is simply not the case. In fact, many of our policy recommendations--such as increased cofinancing and accelerated graduation from the soft-loan to the hard-loan window--are designed precisely to maximize Bank resources available for the poorest nations. We are genuinely concerned about the very difficult constraints on development facing the poorest countries. We will work hard to ensure that available concessional resources are used primarily for those countries that really do not have the alternative of borrowing significantly at hard-window terms or from the private market.

We view U.S. policy objectives as consistent with, and in many important ways complementary to, existing Bank policies and procedures aimed at ensuring that the poorest sectors of recipient countries share in the benefits of growth.

A year ago, when I first addressed this body, I urged a return to the types of economic policies that gave the world such an excellent record on growth and development during the first decades after World War II--market-oriented policies to mobilize private economic activity.

The events of the intervening year have served to remind us that, while such policies will lead us to lasting economic recovery and vigorous growth, the process is not quick. Nor is it easy. We are making solid progress toward reducing inflationary pressures and restoring the basis for growth--but much more remains to be done.

The International Monetary Fund and the World Bank continue to embody sound principles. They continue to make very important contributions to world economic progress. The United States remains an energetic supporter of both the Fund and the Bank. It is clear, I am sure, that this Administration holds fast to certain principles and to certain policies. At the same time, I hope it is evident that dialogue and cooperation are also bywords of this Administration. We listen. We discuss. And thus we all have a continuing opportunity to learn from one another.

Thirty-eight years ago at Bretton Woods, another American Treasury Secretary, Henry Morgenthau, said: "We can accomplish our task only if we approach it not as bargainers but as partners--not as rivals but as men who recognize that their common welfare depends on...mutual trust and joint endeavor." And with that view still in mind, we look forward to effective cooperation with these institutions and their members in the future.

BOARDS OF GOVERNORS • 1982 ANNUAL MEETINGS • TORONTO, CANADA

INTERNATIONAL MONETARY FUND
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION

Press Release No. 33

September 7, 1982

HOLD FOR RELEASE
UNTIL DELIVERY

Statement by the Rt. Hon. Sir GEOFFREY HOWE, Chancellor of the Exchequer and Governor of the Fund for the UNITED KINGDOM, at the Joint Annual Discussion

Introduction

I should like at the outset to join my colleagues in extending a very warm welcome to our three new members--Antigua and Barbuda, Belize, and Hungary.

We are meeting a time of economic transition. Important gains have been made in the fight against inflation, but recovery remains elusive. The world economy is under strain: unemployment in the industrialized world is high and rising; falling commodity prices and high real interest rates combine to squeeze the developing world; and financial stresses on companies and countries are all too evident.

It is not only national economies that are experiencing the stresses of transition. There is also a new set of issues which the major international institutions are having to analyze and assess. There is a clear parallel between the global and the national implications of the issues that we face.

The question is: are we in the grip of a worsening disease, or has its progress been checked? We need to remember that treatment and cure can initially seem as painful--indeed more painful--than the disease, and that convalescence can be frustrating and testing. We need continually to check our diagnosis, and be sensitive in our prescription.

Preconditions of Economic Success

There are two preconditions for economic success, nationally and internationally, which are valid without regard to the state of the cycle or even the most fashionable set of equations. They are stability and flexibility.

The words "fixed but adjustable" are, of course, familiar from the founding tenets of the Fund, but it is not only in the foreign exchange markets that the need for both stability and flexibility is evident.

By stability I mean a firm economic framework, founded on fair political systems securely rooted in the rule of law, and a currency which maintains its value. I mean, too, an international exchange-rate structure which offers a reasonable measure of stability, while allowing freedom for rates to reflect differential economic performance.

By flexibility, I have in mind a willingness to promote and adjust to economic change, and a willingness and capacity to challenge market rigidities: a willingness too to check and reverse any tendency toward protectionism.

The Causes of Decline

Both of these conditions for economic success have been inadequately met in recent years. The stability of the Bretton Woods system was eroded as inflation built up in many countries. In particular, the value of the dollar was put at risk, and finally destroyed, by the inflationary consequences of simultaneous commitment to the space program, the Great Society, and the Viet Nam war. And around the world flexibility has been more and more stifled by the entrenchment of inflationary expectations, the fossilization of many market structures--particularly rigidity in labor markets--and the spread of protectionism.

The oil price shocks owed something to the growing strength of inflationary pressures. But they were reinforced by the scale of OPEC's action. The disposition of many countries was to seek to print and float their way out of trouble. It is easy to see why. But the outcome, as we all know too well, has been high inflation.

With what consequences? In the industrial countries, high unemployment. And in the developing countries, the inevitable setback to forecasts of growth that relied upon a continuation of high commodity prices and low interest rates.

The Common Objectives

Faced by these mounting problems, the international community has, during the three years that have passed since the second oil shock, moved toward a large measure of agreement on the strategic objectives we should follow to obtain a sustainable recovery. This is no mean achievement.

This agreement rests upon an increasingly clear understanding of the need for a sustained and successful fight against inflation, and for the policies that this implies. It rests on the firm control of monetary growth, and of public deficits and public spending--themes that the Managing Director has stressed frequently. It rests on the better working of markets, the reduction of costs, and the improvement of profits. It points the way perhaps to a new Fund role in surveying countries' policies, which would not be unlike its old position in relation to exchange rates. I shall have more to say about this later.

But we should note first that we have held to the objectives on which we agree. The historians will record that at Helsinki, at Versailles, and now in Toronto, commitment to the central strategy has been restated and reconfirmed.

Such continuity of strategy is crucial. But its maintenance also presents great difficulty. This is partly because the process of secure recovery is slow. Even where appropriate policies have been adopted there is no early payoff. And none of us can avoid the tensions of transition, though they express themselves in different ways in different countries.

Tensions of Transition

For the industrial economies the greatest tension concerns the adjustment of pay and inflationary expectations to the monetary framework. This is crucial, but progress has been painfully slow. As a result, profitability has been severely squeezed, and output and employment sharply reduced. Today's high levels of unemployment are the sad price, in social as well as economic terms, which we pay for past failures to tackle inflation, and for the rigidities of the labor market. The industrial economies now require a boost to profit expectations and thereby to investment. Progress is being made, but much more is required. It must be recognized more widely that the level of real wages is crucial to recovery, that excessive pay increases only delay the process. The success of some of the newly industrialized countries, where transition has been achieved with less loss of output and employment, demonstrates the resilience which greater adaptability allows.

For the non-oil developing countries a major tension of transition arises from the ability of OPEC to maintain high oil prices combined with the impact of disinflation on other commodity prices. Such prices have carried much of the initial burden of adjustment. Unrealistically high pay settlements in the industrial countries not only destroy jobs there, they also, through lost markets and weak prices, reduce developing country incomes already hard hit by rising energy costs. But this too is a transitional problem: as adjustment proceeds in the industrial countries, some of this burden on non-oil developing countries should be reduced.

Further tensions arise from the consequences of the indebtedness whose origins lie in years of imprudence. The impact of this problem has been before our eyes day by day in recent weeks. For developing countries the burden of debt has become greater through the combination of falling incomes and high interest rates--and, for some, of past over-borrowing. Clearly there is scope for flexibility in determining the rate of necessary structural change, taking account of developments elsewhere in the world. But it is essential to recognize the inevitable implications of changes in the balance of demand and relative prices for products and commodities. Consequent structural adjustment is unavoidable.

Transitional difficulties are of course uneven in their impact. The justice is certainly rough. But we have all seen examples of developing countries which, in spite of all the problems, have maintained a steady course by able management. I hope it is not presumptuous to refer in this connection to the particular example of India. In other cases a deteriorating situation has been effectively corrected: I have in mind Jamaica, where after years of falling living standards and steep inflation, a firm policy of monetary restraint--coupled with denationalization-- has halved inflation, and created conditions for attracting foreign investment.

Success Against Inflation

The tensions of transition can perhaps be seen as global withdrawal symptoms. For across the world the inflationary fever has been checked.

Inflationary expectations in most of the major industrial countries are changing significantly. Given the predominant weight of the United States in the world economy, and the importance of its currency in international financial markets, the progress registered there is particularly important.

And in the United Kingdom we have brought inflation down to around one third of the peak rate suffered two years ago. And the prospect, with Government borrowing following the downward path we set then, is for further falls. Elsewhere too there has been progress.

But of course there is justified worldwide anxiety about the pain of the process. We need not only strong nerves but also the determination to persuade our people that the course on which most of us here agree really is the best, and that a turnaround in policy now would only plunge us back again into rising inflation and still worse unemployment. Defeating inflation may be profoundly uncomfortable, but to be defeated by inflation would have been disastrous.

The Way Ahead

But agreement on the diagnosis, and on the proper course of treatment, does not absolve us from the need to be sensitive in our precise prescription. How can we best help each other and our common interest? Can we, without losing sight of the agreed objective or slowing the adjustment process, ease the tensions of transition?

First, we must foster both the stability of our system and its ability to adapt to change. We need more than ever the international financial institutions which we have inherited from the Bretton Woods era, and we need to defend and develop their tried and familiar roles in contributing both to stability and to change: in the one case to adjustment, in the other to development.

From time to time there are calls for new institutions. What their roles would be, and how they would be defined, is not clear. What is clear, in my view, is that this is not the time for a fundamental reappraisal of a tested institutional structure which has served us well, and never more so than at the present juncture.

As I said last year, new institutions are not the key to a better future. But we must certainly encourage the evolution of the Fund and the Bank in response to changing needs. And it is to this that I now turn.

The Development of the Multicurrency System

Last year I spoke about the network of our joint responsibilities toward each other and toward the world monetary system. I suggested that the special drawing rights (SDR) could not be a worthwhile asset unless its component currencies retained their value. I spoke also of the reciprocal obligations which would arise if the countries whose currencies are represented in the SDR in fact discharged that responsibility.

This theme was taken up in the statement issued at the Seven Power Economic Summit at Versailles, acknowledging a joint responsibility toward the world monetary system. That statement recorded the agreement of the Seven that greater stability in the system depended on convergence of policies, which would maintain the internal and external value of the currencies of the signatory countries. And it laid special emphasis on the role of the Fund. There was special reference too to the currencies constituting the SDR, and to developing multilateral cooperation in relation to them which would reinforce the Fund's role.

We need to carry forward our thinking about how a multicurrency world monetary system can best be made to work to the advantage of us all. Floating rates absolve none of us from our responsibilities toward others. It is unlikely that we shall return to a system wholly dominated by one currency. But the Versailles undertakings could prove a major step toward a more stable multicurrency system, with countries sharing the responsibility for providing the asset base of the system, and working together to ensure that currencies maintain their value.

The Versailles undertakings rightly put the emphasis on major countries following noninflationary policies, and on international cooperation. Monetary stability in a multicurrency system depends first on principal currencies--let us say for this purpose the five SDR currencies--gaining and retaining a reputation as low inflation currencies. The more important a currency is in the world, the more important this becomes in the interests of the system. There is a special reciprocal obligation among the Five. They have as well an obligation, recognized at Versailles, to other nations. Within the Five there is a particular need for cooperation on policy, a recognition by each of an international obligation and a right to urge the needs of the system on its partners.

The policymakers responsible for these currencies are the main custodians of the world money supply. Collectively they have an important role in guarding the world from inflation, though the scale of their individual responsibilities differs. Each owes it to the others, and to the whole membership of the Fund, to facilitate the exercise of this responsibility and not to make it more difficult.

A multicurrency system cannot succeed by simple resistance to change. Arguably the Bretton Woods system suffered from being too inflexible for too long. The system will have to accommodate changes in relative currency values, and the operation of markets in bringing about those changes. But the purpose of policy, reinforced by cooperation, should be to reduce volatility and instability by fostering confidence. The necessary exchange rate changes ought, with such confidence and with lower inflation rates, to be more gradual, smaller, and less feverish.

I have spoken so far of the obligations of the major currency countries. But they in turn have a right to look to others to undertake reciprocal obligations. At Versailles the major countries undertook not to make competitive devaluations, and undertook not to use currency manipulation for trade advantage. The counterpart of that ought to be a progressively more open trading system not only between them but in the rest of the world. This has a special relevance to newly industrializing countries which benefit greatly from the rapid growth of world trade.

An orderly multicurrency system has implications for the worldwide management of reserves, a matter of legitimate interest to the Fund. Reserves are there to be used in need and to ease the process of adjustment. But sharp swings in the currency composition of reserves, whether as a result of diversification or intervention, could in some circumstances add undesirably to instability.

The SDR would be more likely to be held in reserves on its own merits as a strong unit if the value of its component currencies were better maintained. SDR assets would also be increasingly attractive in the private sector. Both developments should be mutually reinforcing and would help international stability.

The Intervention Study

I have spoken about one theme taken up at Versailles. A second initiative was the decision to undertake a study of exchange market intervention. We must take care that the study does not become a purely academic exercise in analysis. It would be regrettable if each country regarded it simply as a device for justifying its present practice. The object of the exercise should not be to achieve, or justify, a widening of differences, but a meeting of minds.

The U.S. Economy: Key to the Timing of Recovery

I have emphasized already the importance of the policies of the major countries in guarding the world against inflation.

The U.S. Administration's firm and public commitment to prudent monetary and fiscal policies should be a reassurance that inflationary pressures will not once again be allowed to undermine the recovery. As many of us know from our own national experience, however, the implementation of these policies is far from easy.

The effort to control monetary growth and deficits has been accompanied by high, and at times volatile, interest rates. These not only put immediate pressure on borrowers, whether persons or companies. They also put at risk investment for the future. And they pose special problems for developing countries. We have seen, too, how they have been accompanied by a sharp rise in the dollar's exchange rate. This has reinforced the pressure on U.S. companies, leading to calls for protectionism and increasing the risk of trade warfare.

Our own experiences have taught us how complex is the operation of monetary policy. Monetary conditions need to be assessed in the light of a range of indicators: the growth of the various monetary aggregates, progress on inflation, the exchange rate, and liquidity pressures on companies.

Experience in the United States is pointing to similar conclusions. I welcome, therefore, the flexible but firm approach of the American authorities. And, of course, we all welcome the reduction in U.S. interest rates in recent weeks. We can all welcome, too, the passage by Congress of the U.S. President's tax package. My own country had to take hard decisions last year in the course of carrying through our own medium-term financial strategy. Firm monetary policies do have to be supported by stringent fiscal control if a reduction in interest rates is to be sustained. This will be particularly important as the U.S. economy picks up and private demand for credit revives.

If a sympathetic outsider may offer a view, it seems clear that an important battle has been won. But a long campaign may still lie ahead. The deficit needs to be clearly set on a declining trend for the medium term. Convincing success in that direction would bring immeasurable benefit not only to the U.S. economy but also to the rest of the world. It would give economic agents and governments everywhere the confidence that recovery, at least in the world's largest economy, was likely to be sustained and noninflationary. The medium term starts now.

Of course, if other countries are to share the benefits fully, then they, too, need to follow prudent policies. For some, the need to cut budget deficits is urgent. In others, particularly Japan, where good progress has been made on inflation and on the budget deficit, the short-term room for maneuver may be greater. A recovery of activity that is coupled with lower interest rates should ease some of the global pressures on non-oil developing countries. Renewed growth should help to increase the volume of their exports and halt the decline in commodity prices which has so worsened their terms of trade. High export earnings and lower interest rates should in turn ease the problem of servicing their debts. Some continuing, and all too often painful, adjustment of the economies of developing countries will, however, still be unavoidable. This is particularly the case for those who have overborrowed in the past.

The International Banking System

There is concern at present about the effects of such overborrowing on the international banking system. I need hardly stress the importance of sustaining its stability. In the past decade international banking has grown apace. A bigger share of savings has been made available through the major financial centers for international lending, both to companies abroad, and to sovereign borrowers. This process, made more necessary by the two oil shocks, has helped to carry the world economy through them. Technological development, especially in communications, inevitably also played a part in increasing international lending. We are moving toward a single global market.

There is little prospect that this process will be reversed or that the intermediation discharged by the banking system will be substantially transferred to international financial institutions. Their share in the total transfer of resources is likely to remain a relatively modest proportion of the total. So we all have a powerful interest in the health of the international banking system.

This is one of the contexts in which a return to more normal levels of interest rates will be valuable. Very high interest rates have helped to produce accumulations of debt of shorter and shorter maturity.

Equally valuable in this context will be our full support for the international financial institutions. An effective Fund is part of the framework within which the banking system operates: we need to demonstrate that the international community remains determined to restore the creditworthiness of its members by a judicious combination of help and programs of adjustment. And, of course, adjustment by borrowers who have problems, whether they be companies or countries, is as essential to the banks as it is to the Fund. Creditworthiness maintains the flow of resources to borrowers. It also maintains the flow of interest and repayments to banks.

In these ways we can help to underpin confidence. But there is certainly work to be done at the level of the banking system itself. The first oil shock produced tremors which gave a salutary impetus to international cooperation in banking supervision. There has been steady improvement in such cooperation and in national standards of banking supervision, covering risk assessment, prudential standards, monitoring and control. But I am sure central banking colleagues would agree that there is further progress to be made. Some recent developments testify to that. In particular it is important that there should be a watertight allocation of supervisory responsibilities, and that when agreement has been reached on a principle such as the consolidation of the accounts of banking groups, priority is given to the legal or administrative steps needed to give effect to it.

Recent events will have brought home to banks that they alone are responsible for the assessment of credit risk, and that credit risk applies to sovereign borrowers as well as to others. Proper risk analysis is a responsibility which no banking management can abdicate. What cannot be accepted is the charge that the authorities should not have allowed commercial banks to lend as much as they have. This assumes that the authorities can be better judges of credit risk than banks themselves. I can think of many actions by public administrations around the world which put a very large question mark over that proposition.

There is no alternative to tackling each problem case, whether it is a country, a corporation or a bank that is in trouble, on its merits. There can be no general and automatic system of debt relief which will spare banks the costs of imprudent lending or debtors the pain of adjustment. Rescheduling of debt can be neither automatic nor painless. Capital markets have long memories and may for a long time be reluctant to provide funds for development if borrowers take hasty decisions for the sake of temporary relief. Banks should not withdraw credit indiscriminately from a whole region because one or two countries in that region are suffering payments difficulties. But equally borrowers should not regard rescheduling as an easy way out: that could only be counterproductive.

My conclusions on current banking issues are that they must therefore be tackled in several ways. Governments have to face the need for adjustment, press home policies which reduce inflation and interest rates, sustain confidence in the international institutions. And we must try to see to it that both the banks' own risk assessment and the fabric of banking supervision recognize that the free world is increasingly one single market with a common thread of risks and responsibilities.

Financing of the Fund

This brings me to the financing role of the Fund itself, in providing an orderly framework within which private capital flows can take place. I do not subscribe to the view that the Fund should be confined to a role of lender of last resort. During the last decade many countries, both developed and developing, have tended to treat it as such. When they have already exhausted the credit available from other sources, they have had eventually to seek Fund support for an adjustment program which has necessarily been much more painful than if the difficulties had been acted upon earlier. This should not be seen as an argument for increasing the access to the Fund's resources, but rather, as the Managing Director has indeed urged, for encouraging members to approach the Fund at an early stage.

On the other hand, as he has also pointed out, members may be disinclined to make a timely approach to the Fund unless it clearly is in a position to offer resources in sufficient volume. Moreover, the structural nature of much of the maladjustment--in both developed and developing countries--tends to take longer to correct than problems of excess aggregate demand. The Fund's facilities have rightly evolved to reflect this, but the objective of adjustment supported by the Fund should still be the restoration of a member's economy over a reasonable period to a position which can be sustained from other sources of finance. We must not lose sight of the revolving character of the Fund's resources.

These considerations suggest to me that quotas will need to be increased substantially, particularly if the Fund's borrowed resources are to be gradually displaced as they mature. In my view a doubling of quotas would be excessive. A 50 per cent increase could however be regarded as the minimum required. Some of the arguments for a much larger increase seem to be based on the assumption that severe global imbalances may recur throughout the 1980s. If adjustment is successful, the scale of imbalances should however fall. If unexpectedly severe balances do recur, it would be more appropriate to augment the Fund's resources by borrowing.

As for the distribution of the quota increase, it should be achieved in a way that is uniform, fair, and systematic. It should allow quota shares to change in an orderly way over time to reflect more clearly members' positions in the world economy. The allocation of any increase in quotas according to calculated quota shares seems to meet these criteria in a straightforward and transparent fashion.

Development Issues

As with the financing of the Fund, so we must all now be concerned to ensure adequate funding for IDA. For we are learning to recognize the fact of our mutual interdependence. As Mr. Clausen pointed out in an important speech earlier this year, we live in a multipolar world. The simplistic North-South economic model of the 1960s and 1970s is no longer opposite today. With our long tradition of support for the Association and our special Commonwealth links with many of the borrowing countries, we in the United Kingdom continue to be concerned for the future of IDA.

There is a growing recognition that all the problems of developing countries cannot be solved by massively increasing aid flows. Official aid is costly to donor countries. Nor is it reasonable to expect aid to be immune from public expenditure restraints. All the more reason, as I said last year, to concentrate scarce aid funds where they are most needed in the poorest countries. The United Kingdom has a good record in this respect. And IDA is the major channel of multilateral assistance to such countries.

Earlier this year the United Kingdom announced its readiness to waive the pro rata rule that would otherwise have applied to commitments for our second payment to IDA-VI. We did this in order to help sustain IDA's lending program and in the hope that other donors would follow our example. This has indeed happened. I am glad to confirm today that we have decided to waive the pro rata condition on our third and final payment. We believe this is the most effective way of helping IDA in the short term. And we hope most strongly that the United States, as the most important donor member of IDA, will now complete its contribution to IDA-VI not later than fiscal year 1984. And we are prepared to participate with others in a special operation to provide additional resources to IDA in 1984.

Looking further ahead we attach great importance to a successful outcome to the negotiations on the Seventh Replenishment which are due to begin in Washington in the autumn. We cannot be too sanguine about the prospects for a real increase in donors' contributions over the total agreed for IDA-VI. It is generally recognized that the United Kingdom, for example, has been contributing more than is justified by its relative economic strength. This cannot continue. The Association will need to look constructively at all possible ways to increase the resources available to IDA, including perhaps the more rapid recycling of IDA funds.

For the majority of developing countries the maintenance of an open world trading system is far more important than official aid flows. All the evidence shows that it is those countries which have followed a policy of outward orientation (concentrating on export production rather than import substitution) which have been most successful in attaining their development objectives. Their major need is to retain the widest possible access to world markets for their goods. This will be one of the main issues for discussion at the ministerial meeting of GATT later this year.

Access to development capital and the encouragement of private investment are also important factors. This is where the Bank has a major role to play. Mr. Clausen's first year as President has seen some major developments. The changes in borrowing and lending rate policies recently agreed by the Executive Board represent a significant new departure. The new borrowing policy should give the Bank the necessary flexibility to tap all available sources to fund its lending program. The new system for calculating the lending rate half yearly is a necessary corollary. Although interest rates remain high for borrowers, the new system should in the long run bring them some relief by minimizing the effects of temporary fluctuations in the Bank's borrowing costs. With the Bank's borrowing and lending programs both at record levels it is in the interests of all the Bank's members to maintain the confidence of the financial markets. It is for this reason that I welcome the policy changes.

I should also like to welcome the progress made during the year on subscribing to the general capital increase. We were glad to be able to help the Bank with its problem of finding sufficient shares for the initial subscription of its newest member country, Hungary, and for existing members with justified claims for increased shareholdings. We shall seek Parliamentary authority in the autumn to enable us to take up the shares now allocated to the United Kingdom.

The Bank management, in response to the recommendations of the Development Committee's Task Force on Non-Concessional Flows, have recently circulated new proposals on cofinancing with commercial banks. It remains my view that increased cooperation between the multilateral development banks and the private sector is the best hope for increasing financial flows to the developing countries in the short term. The proposal for a new multilateral investment insurance agency is an interesting one which deserves further study. I know also that dicussions are continuing on the best means of attracting additional funds to finance energy projects in the developing countries. I hope that this will indeed prove possible. In the meantime, I welcome the priority which the Bank is already giving to lending in this sector.

Of course, none of these initiatives can do more than provide an institutional framework which is favorable to the development process. The contribution that multilateral organizations and governments (whether inside or outside the developing world) can make is limited. Real development depends on the skills, enterprise, and dedication of individuals. The real progress that has been made in recent years is to be attributed mainly to the governments and peoples of developing countries themselves: the same will be true in the future.

Conclusions

I have spoken today about some of the tensions in this period of economic transition: stresses on companies, banks, and nations. I have spoken of the need for both stability and flexibility, a need never greater than in such a transitional period. And I have described the nature of the generally-agreed strategy to defeat inflation, the progress which has been achieved, and the particular actions which ought in my view now to be taken. They can be summarized under five headings.

First, and most obviously, we must maintain and sustain the central institutions, the Fund and the Bank. That means support for their key roles, in surveillance and advice on adjustment policies, and in providing development finance. And it means support through the assurance of adequate additional resources, for example, by reaching early agreement on a substantial increase in Fund quotas, and through the timely release of agreed contributions to IDA-VI.

Secondly, and hardly less obviously, we must continue to pursue responsible financial policies. This means a firm but flexible approach to monetary policy, taking into account all monetary indicators and avoiding excessive tightness or easing of financial conditions. And it means that we must continue to reduce budget deficits, putting further downward pressure on interest rates. In this respect we look particularly to the United States. For companies--or countries--facing difficulties at present, lower interest rates are an urgent requirement.

Thirdly, we must work for greater exchange rate stability. This certainly means building on the joint responsibilities recognized at the Versailles summit, which could involve a fuller and more secure expression of the original purposes of the Bretton Woods agreement than we have seen for many years.

Fourthly, governments of almost all industrial countries, including my own, need to persuade their peoples of the need for pay restraint, permitting labor costs to adjust and profitability to increase. We must also remove unnecessary controls, encourage flexibility in goods and labor markets, and avoid resort to protectionism.

Finally, countries with excessive debts must like the rest of us follow appropriate adjustment policies, and private sector banks will need to show a matching responsibility. The former should accept that rescheduling can only be effective if accompanied by the right policy changes; the latter that adequate supervision and prudent individual risk assessments are essential components of a stable system.

It is not, I hope, immodest to commend these five points to the attention of all our countries. The more closely we are able to observe them during the months ahead, the more we shall succeed in shortening the transition and abating its pain. And the more we are able to adhere to them in the years beyond that, the sounder will be the foundations of the recovery for which we are striving together.

SECRET

cc CST
FST
EST
Sir K. Couzens
Mr Littler
Mr Carey
Mr Lavelle
Mr Peretz

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

Hon Donald Regan
Secretary
US Treasury
Washington DC 20220

8 September 1982

Dear Don

ARGENTINA

In the course of Tim McNamar's discussions in Toronto with the Argentine delegation about the reciprocal ending of sanctions between the United Kingdom and Argentina, the Argentine representatives said that "the good offices of the United States authorities are welcome, to consider, at a proper moment, reciprocal lifting of trade restrictions". We included in the Memorandum, which was the final basis of agreement, a paragraph noting this statement.

2. As you know, we would be glad to remove all remaining restrictions (other than the trade in arms) between Argentina and ourselves. The Argentines were however not ready to go beyond the ending of financial sanctions. In accordance with an understanding we reached with Tim McNamar, I am writing to ask if you would be ready to take up the Argentine suggestion that they might welcome your good offices at a reasonably early date, and seek a reciprocal removal of trade restrictions (except on arms) as speedily as may be. It seems to us, as I think it did to Tim McNamar, that the general context of the preparations for the GATT Ministerial meeting would be an appropriate one, just as the IMF context was helpful on financial restrictions. We would however very much hope that the November GATT meeting itself would be the latest point for the removal of the trade restrictions and that this could rather be linked to an appropriate preparatory stage in late September of October. I am sure you would agree that it is desirable to keep up the momentum of a return to normality for the Argentines whether in the area of debt rescheduling and an IMF application, or in getting rid of trade restrictions between Argentina and the UK.

3. We are still very much concerned about the Argentine restrictions on UK air services, which are in breach of the ICAO agreement on overflying. It has not so far been possible to make any progress on this but we intend to return to that too at a later stage.

CHANCELLOR OF THE EXCHEQUER

4. May I take this opportunity to express my very warm thanks to you for making Tim McNamar available for this exercise in Toronto, and to him for his tireless efforts there.

With every good wish

Yours ever

Geoffrey

GEOFFREY HOWE

GRS 300
SECRET
DESKBY 100900
FM WASHINGTON 100037Z SEP 82
TO IMMEDIATE FCO
TELNO 2999 OF 9 SEP 82

SECRET

PUP

M I P T : ARGENTINA : REMOVAL OF FINANCIAL RESTRICTIONS

FOLLOWING IS TEXT OF SECRETARY REGAN'S REPLY:

BEGINS
DEAR SIR GEOFFREY:
I AM IN RECEIPT OF YOUR TRANSMISSION VIA D.M.D. THOMAS DATED SEPTEMBER 9, 1982.

OBVIOUSLY, WE WERE DELIGHTED TO BE HELPFUL IN TORONTO. YOU ARE CORRECT THAT ''THE ARGENTINE REPRESENTATIVES SAID THAT THE GOOD OFFICES OF THE UNITED STATES AUTHORITIES ARE WELCOME, TO CONSIDER, AT A PROPER MOMENT, RECIPROCAL LIFTING OF TRADE RESTRICTIONS''.

WE WILL, OF COURSE, CONTINUE TO PROVIDE OUR GOOD OFFICES ON TRADE MATTERS AS YOU REQUEST. AS TO TIMING, TIM DISCUSSED THE USE OF A GATT MINISTERIAL PREPARATION MEETING, WHICH SHOULD BE IN LATE SEPTEMBER OR EARLY OCTOBER. THE ARGENTINE DELEGATION INDICATED, THAT ALTHOUGH THEY PERSONALLY DID NOT HAVE AUTHORITY TO NEGOTIATE TRADE MATTERS, THEY FELT THE GATT FORUM WOULD BE AN APPROPRIATE ONE.

AS TO YOUR CONCERNS ABOUT RESTRICTIONS ON U.K. AIR SERVICES, WE WILL ATTEMPT TO CONTINUE TO REPRESENT YOUR POSITION TO THE ARGENTINES. AS YOU KNOW, WE REACHED THE JUDGMENT IN TORONTO THAT THE ARGENTINE DELEGATION THERE SIMPLY DID NOT HAVE THE AUTHORITY TO EVEN NEGOTIATE ON THAT MATTER. WE WOULD ANTICIPATE ATTEMPTING, AS SOON AS PRACTICAL, TO SECURE A COMMITMENT FROM THE ARGENTINES THAT THEY WOULD DISCUSS THIS MATTER SO THAT THE APPROPRIATE INDIVIDUALS WOULD BE AT A GATT PRE-MINISTERIAL MEETING.

THANK YOU FOR YOU KIND WORDS ABOUT TIM. I AGREE WITH YOU.

SINCERELY,

DONALD T. REGAN
ENDS

2. FCO PLEASE PASS ADVANCE COPY (DESKBY 100900Z) TO SIR K COUZENS (TREASURY).

ADVANCED AS REQUESTED

WRIGHT

LIMITED
ERD
FID
SAmD
MAED
ESID
PS

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PS/MR MARTEN
PS/PUS
SIR J. BULLARD
MR GIFFORD
MR THOMAS
MR ADAMS
MR URE

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MR LITTLER
} TREASURY
MR FRANKLIN
MR ROBERTS
} D.O.T.
MR LOEHNIS
MR BALFOUR
} BANK OF ENGLAND

SECRET

Mr Hall, 13/9/82

The Chancellor has asked to see a copy of this article on Mr MacGregor.

Mark Dodd
20/9/82

With the compliments of

THE BRITISH EMBASSY

WASHINGTON, D.C.

Chaucher

As I See It

Veteran metalman Ian MacGregor sees a decade of woe for steelmen—but probably a higher living standard for the rest of us.

A turnaround for steel? Forget it

By Rosemary Brady

ALTHOUGH THE CURRENT squabble over cheap European steel imports to the U.S. will probably be resolved soon, the industry's fundamental troubles worldwide will persist throughout the decade, says Ian MacGregor.

MacGregor, 69, a Scottish-born American, former chairman of Amax Inc., and a partner of Lazard Freres Co., arrived in Britain two years ago to put British Steel Corp.'s house in order. He has done remarkably well—scaling down capacity, trimming the troubled company's work force by over 40,000 and chopping losses in half, to $640 million, last year.

MacGregor says the steel industry will see both "vast improvements in technology" and still more dramatic reductions in size over the next decade, as the industrial world shifts toward a service economy. He is not optimistic about the industry's near-term future—not in the U.S., not in Europe. Even Japan's future isn't secure. The nature of the steel industry has changed in more ways than one.

MacGregor: At the turn of the century, steel was a cheap substitute for wood. But today we're selling a sophisticated set of engineering materials. A piece of motor-car body sheet 25 years ago was just a plain piece of low-carbon steel. Today there is a very sophisticated piece of metal-sheet steel, with physical characteristics that have been worked into it so that it is just as resistant as the piece twice as thick.

Or take a tin can. Today we make steel cans that are three-thousandths of an inch thick and still they are strong enough to withstand the pressure generated by carbonated liquids. And I would say you are going to see vast changes and improvements in this decade. But the industry has to shrink because we're downsizing the use of all materials since everything is more expensive: We have to use them more efficiently.

Ian MacGregor of British Steel
A miner at $2 an hour can't support many people.

Fine, except that Europe isn't downsizing its steel industry.

MacGregor: Europe's steel industry is oversized for the type of economy it has today. Take Luxembourg, whose market consumes 5% of its steel and has to export 95%. At one time they were close to good coke and coal. And they were close to indigenous low-grade iron ores that they could get into their blast furnaces at quite low cost. But the technology has changed, and low-grade iron ores are no longer competitive. And coal in Luxembourg is no longer low-cost, and the government has to find some way to subsidize its coal and coke production, as the Germans do for exactly the same reasons. Germany has to export a major portion of its production. Holland has to export a major proportion of its production. Belgium has to export about 70%. France exports 30% of production. These countries used to have, like Britain, overseas dependencies. And one of the commodities that went to their overseas dependencies was steel. These markets have long since disappeared. But the industry hasn't been expected [by European politicians] to take account of that.

Has Britain under Margaret Thatcher done better?

MacGregor: In Britain we have an industry that can produce about 15 million tons, whereas 10 years ago, 15 years ago, we had capacity to produce maybe up to 25 million tons. But Britain has the political will to do what has to be done. I don't see that to the same extent in other European countries.

What about the steel industry in the U.S.?

MacGregor: The U.S. has been reasonably insulated from competition. It wasn't until the Nixon price controls came off [in 1973] that U.S. Steel was operating for the first time in many years in a free market. And U.S. companies looked as if they were going to become fairly profitable. Then along came the environmentalists in the 1970s to clean up the steel industry. This resulted in the U.S. falling far behind Japan in regard to installing new equipment and new techniques because the capital wasn't available. Many of the techniques that are being so well applied by the Japanese are the result of U.S. research and development.

And what about the Japanese?
MacGregor: People will move on in the steel industry just as the textile industry was rationalized. I remember short of 15 years ago there were heated arguments over the Japanese capturing U.S. textile business. Ten years later the Japanese were on the same side of the table as the Americans, talking about Taiwan, Singapore and places like Malaysia, Sri Lanka and Korea stealing their textile business. We'll see the same thing take place in the steel industry.

Which are the problem countries in the steel industry?
MacGregor: Brazil, South Africa—and Spain, which is a totally artificial steel industry. And there's a big upsurge in imports from countries behind the Iron Curtain, where price is what you have to sell the stuff at to generate foreign exchange.

What you are really saying about steel is that its restructuring is part of the transition to postindustrial society. What is this society going to be like?
MacGregor: Let me put it this way. We can produce our needs, our basic market needs, with a smaller percentage of our work force. And therefore the income these people produce is going to be spent on other things. And as we become more efficient and their incomes rise, they will buy increasing quantities of supporting materials and equipment.

The best example I can give you is from my old company Amax, mining coal in Indiana. Coal mining was done by stripping off the overcoating with a gigantic shovel, run by a man who was probably earning about $50,000 a year. He started as a miner at $2 an hour. As a miner at $2 an hour he wasn't able to support very many people in the economy, but as a dragline operator at $50,000 a year, he supports a hell of a lot of people and generates employment.

My dragline operator, as opposed to the miner, gets all his clothes cleaned at the dry cleaner. Previously his wife scrubbed them and hung them out on the back stoop. Now she goes to the cultural pursuits of the local women's institute. She didn't do that before. And he has two

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OA. 2171
2189

14/9/82.

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H.M. EXCHEQUER
14 SEP 1982
ACTION Mr Hawtin 14.9.
COPIES TO CST, FST, EST, MST(C), MST(R), Sir D Wass, Sir K Couzens, Mr Littler, Mr Carey, Mr Ridley.

PM/82/77

THE PRIME MINISTER

US Oil and Gas Measures (Pipeline)

1. We agreed in Cabinet on 9 September to maintain our efforts to achieve a solution to the problem acceptable both to the United States and to the European Governments concerned.

2. As you know, I shall be discussing the problem, and broader questions of East/West economic relations, with George Shultz and my French, FRG and Italian colleagues at a meeting in New York at the end of this month.

3. A possible solution to our dispute with the Americans would be for the Europeans to agree a package of measures affecting the Soviet Union in the fields Shultz has suggested - credit, COCOM, oil and gas equipment, and alternative energy sources - which could be offered to the Americans in exchange for their withdrawing the retroactive application of their measures of December and June. Although we must clearly not offer measures which damage the interests of our exporters, we would need to offer enough to enable President Reagan to present them to the American public as a significant contribution by the Europeans to the exercise of pressure on the Russians. This will not be easy. Our European partners, particularly the French, are inclined to argue that it is not for us to offer concessions to the Americans. I nevertheless believe that this approach offers the best available possibility of resolving this damaging transatlantic dispute.

4. I enclose a list of possible measures, which has been agreed inter-departmentally at official level. It is the maximum that officials think the UK could, or should, offer without prejudice to our legitimate commercial interests. You will see that officials have not thought it right to offer concessions on future sales

/of

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of oil and gas equipment to the Soviet Union.

5. I invite colleagues to agree that this list should, as appropriate, be used as our guideline in our contacts with the other Europeans to establish whether it could form the basis of a possible package.

6. I am copying this minute to OD colleagues, the Secretary of State for Industry and Sir Robert Armstrong.

(FRANCIS PYM)

Foreign and Commonwealth Office

14 September 1982

A. 'Further restriction of credits to the Soviet Union'

i. Establishment of information and monitoring systems (eg. half-yearly review meetings, quarterly exchanges of statistical information).

ii. Agreement, where appropriate, to reduce the level of exposure and increase premium charges.

iii. In cases of official financing to apply strictly Consensus minima of 12.15 - 12.4%

iv. To limit official support to 75% of total value.

v. To try to prevent side financing in excess of 10% of contract price.

vi. Not to exceed Franco-Soviet protocol terms:

Under FF30M - 5 years credit
FF30 - 100M - 7 years credit
Over FF100M - 8 and half years credit

vii. No official support for credits financing local costs.

B. 'Further tightening of COCOM regulations'

i. Agreement in principle that the COCOM List should be extended to cover new advanced technology items; details will of course have to be settled in the List Review (examples:items on robotics and hovercraft)

ii. Work on strengthening COCOM system to be speeded up (ie. Export Controls Sub-Committee) including facilitating enforcement by cutting out unnecessary items during course of List Review.

iii. Agreement to consider favourably US proposals to improve communications within COCOM.

iv. Acceptance of Technology Note.

v. Repeat our agreement to 'conduct special sessions in order to receive and exchange reports from military and defence specialists' (HLM III (iii).

vi. An undertaking to be flexible on procedure during List Review discussions.

vii. Readiness to implement a tighter regime for cases for Poland and the Soviet Union (eg. a no general exceptions policy for Poland, a reduction of the permitted exceptions for the Soviet Union).

C. 'Restricting prospective sales of oil and gas equipment to the Soviet Union'

..../

D. '<u>Examining alternative energy sources</u>'

i. We can refer to existing IEA study of gas security issues

ii. Repeat NAC undertaking to 'reflect' on East/West trade issues including energy: Invite Americans to suggest how this might be pursued.

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10 DOWNING STREET

From the Private Secretary

BoE

Whole Document

CH/EXCHEQUER
REC. 17 SEP1982
ACTION Mr Peretz
COPIES TO CST, FST, EST, MSTC, MSTR, Sir D Wass, Sir K Couzens, Mr Littler, Mr Lovelle Mr Carey, Mr Ridley

M17/9

15 September 1982

Dear John,

Removal of financial restrictions on Argentina

I am writing to record the events over the last two days which have ended in the laying of a further statutory instrument lifting our financial restrictions on Argentina as from midnight last night.

On Monday evening at 2000 hours the Prime Minister had a short meeting with the Governor of the Bank of England about the events which had taken place in Buenos Aires on Monday. The Secretary of State for Energy (who happened to be here for another meeting), Mr. D.C. Peretz (HM Treasury) and Mr. Alan Walters were also present. The Governor explained that the Argentines were saying that if they lifted their financial restrictions as earlier envisaged by Presidential decree, they would be liable to challenge in the courts and they were therefore proposing to obtain legislative authority from their Parliament. They had told the Americans that this would take probably until Wednesday. The question for decision was whether we should hold up the lifting of our restrictions until the Argentinians were ready to move. After a brief discussion it was agreed that we should do so, and on Monday night a new statutory instrument was prepared and signed by the Prime Minister. It was also agreed that we should take a low-key approach in public, referring to technical problems at the Argentine end.

Later on Monday evening we received a statement by the Argentine Junta (appended at annex A to this letter) which, among other things, asserted that the British Government were making a spontaneous proposal to lift restrictions, and denied that there had been any prior agreement with the Argentine government. At about the same time the Bank of England received a secret telex from the Central Bank of Argentina, regretting the unforeseen and unavoidable delay in lifting the sanctions, and giving the clear undertaking that the restrictions would be lifted at 1000 a.m. Argentine time on Wednesday 16 September. (The text of this message is at annex B.)

During the course of Tuesday 14 September the Governor was informed by his counterpart in the Argentine Central Bank that an announcement would be made at 1900 hours Argentine time (2300 hours our time) that the restrictions were being removed from midnight. A Presidential decree would be published. There would be a Communiqué from the Argentine Ministry of Economy, and perhaps

/ also a

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a. ɔ a Communiqué from the Argentine Central Bank. The Presidential decree would both empower the Ministry of Economy to lift the financial restrictions, and also instruct them to do so. The Ministry of Economy's Communiqué would announce that it had ordered the Central Bank to put this into effect at the opening of business on Wednesday 15 September, by issuing instructions to the financial institutions concerned. On the basis of this information and of advance texts of the documents obtained by the Governor from his Argentine counterpart, the Prime Minister agreed that, provided it was confirmed that these announcements were in fact made in Buenos Aires, our own restrictions could be lifted in parallel.

On receipt of a message from the Argentine Central Bank substantially in the same form as that which had been promised, and with independent confirmation from news agencies that the announcements had been made in Buneos Aires, we made our own announcement shortly after midnight last night. The necessary new statutory instrument, which was signed by the Prime Minister last night, is, I understand, being laid this morning.

I am sending a copy of this letter and enclosures to Brian Fall (Foreign and Commonwealth Office) and Tim Allen (Governor of the Bank of England's Office).

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
HM Treasury.

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STATEMENT BY ARGENTINE JUNTA A
ON MONDAY 13 SEPTEMBER

In view of cable received from abroad with respect to a proposal from Great Britain for the lifting of financial restrictions, it is expressly stated:-

1) The Bank of England has sent to the Central Bank of Argentina a telex proposing the lifting of financial restriction applied on account of the conflict with Malvinas Islands.

2) The Bank of England requests the Central Bank of Argentina reciprocity insofar as the lifting of measures which were imposed by the Argentine Government.

3) This spontaneous proposal of the Government of Great Britain is not repeat not the consequence of any prior agreement with our Government.

4) The result of the said proposal, the Central Bank of Argentina is studying several alternatives.

5) These circumstances would create mitigating conditions vis-a-vis the United Nations for the problem of Malvinas, especially in the European sector. On the other hand, they would produce a positive action for the internal reactivation in this country and furthermore would unlock the conditions for the refinancing of the Argentine external debt.

6) The study of the solution on this proposal has nothing to do with the formal cessation of hostility and does not alter in absolute the maintenance of other measures.

7) The Argentine reply will be given considering the most convenient interest in this country.

8) Any other information or version of these facts has no validity. The Ministry of Economy is the only responsible source.

B

TELEX FROM BANK OF ARGENTINA TO BANK OF ENGLAND RECEIVED ON MONDAY 13 SEPTEMBER

We reiterate our reply to your cable dated September 12. However, due to technical and legal difficulties, we shall be able to implement the lifting of our restrictions only on Wednesday September 15 at 10 am Argentine time, coinciding with the time of opening of operations in our banking and financial markets. We regret this unforeseen and unavoidable delay. Utmost secrecy is indispensable and therefore required from you.

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EXCHEQUER
REC. 16 SEP 1982
ACTION Mr Hawtin
COPIES TO CST, FST, EST, Sir A Wass, Sir K Couzens, Mr Littler, Mr Carey, Mr Ridley

M16/9

10 DOWNING STREET

From the Private Secretary

15 September 1982

Dear Francis,

US Oil and Gas Measures (Pipeline)

The Prime Minister has seen the minute of 14 September by the Foreign and Commonwealth Secretary. Mrs Thatcher is sympathetic to the approach proposed by Mr. Pym, namely that the Europeans should try to agree upon a package of measures affecting the Soviet Union which could be offered to the Americans in exchange for their withdrawal of the retroactive application of the measures they have taken in respect of the pipeline. Subject to the views of OD colleagues, she agrees that discussions could commence with the other Europeans to establish whether the list annexed to Mr. Pym's minute could form the basis of a possible package. If difficulties arise in formulating an agreed position on the proposal, the Prime Minister would like to be consulted during her visit to the Far East.

I am copying this letter to the Private Secretaries to members of OD, the Secretary of State for Industry and Sir Robert Armstrong.

Yours ever

John Coles.

F.N. Richards, Esq.,
Foreign and Commonwealth Office.

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GR 630
UNCLASSIFIED
FM WASHINGTON 152210Z SEP 82
TO ROUTINE FCO
TELEGRAM NUMBER 3048 OF 15 SEPTEMBER
INFO UKREP BRUSSELS
INFO SAVING PARIS, BONN

SIR ROY DENMAN'S SPEECH TO US CHAMBER OF COMMERCE ON US-EC TRADE ISSUES

1. IN HIS FIRST MAJOR SPEECH SINCE ARRIVING IN WASHINGTON TO HEAD THE EC COMMISSION DELEGATION, SIR ROY DENMAN TO-DAY GAVE A TOUGH DEFENCE OF THE COMMUNITY POSITION ON STEEL, THE PIPE-LINE AND THE CAP, AT A LUNCH GIVEN BY THE US CHAMBER OF COMMERCE (TEXT FOLLOWS BY BAG TO KINCHEN ECD(E) AND BOURKE (OT2 DOT)).

2. US-EC RELATIONS WERE , HE SAID QUOTE GOING THROUGH THE ROUGHEST PATCH IN LIVING MEMORY. UNQUOTE ON STEEL HE ARGUED THAT THE COMMUNITY HAD KEPT ITS SIDE OF THE OECD CONSENSUS BARGIN. NOR DID HE ACCEPT THAT EC STEEL IMPORTS AT JUST OVER 5 PERCENT OF THE US MARKET COULD BE DEEMED TO CAUSE INJURY TO THE US INDUSTRY. HE WAS QUOTE DISAPPOINTED UNQUOTE BY THE UNHELPFUL INDUSTRY RESPONSE TO THE AGREEMENT NEGOTIATED WITH THE ADMINISTRATION ON 6 AUGUST. FAILURE TO IMPLEMENT THAT AGREEMENT WOULD LEAD TO QUOTE A VERY SERIOUS SITUATION UNQUOTE FOR THE EC INDUSTRY.

3. ON THE PIPE-LINE HE DOUBTED WHETHER THE US EMBARGO WAS COMPATIBLE WITH INTERNATIONAL LAW, GIVEN ITS EXTRA-TERRITORIAL IMPLICATIONS AND RETROACTIVE EFFECT. QUOTE FOREIGN BUYERS UNQUOTE HE SAID QUOTE WILL BE RELUCTANT TO SIGN UP AND PAY FOR TRANSFERS OF TECHNOLOGY WITH WHAT THEY ARE BOUND NOW TO CONSIDER AN UNRELIABLE PARTNER. UNQUOTE

4. HE DREW THE PARALLEL BETWEEN GRAIN SALES AND THE PIPELINE. THERE WERE, INEFFECT TWO PIPELINES. ONE QUOTE BEGINS IN IOWA AND ENDS IN MOSCOW UNQUOTE. TURNING TO AGRICULTURE, THE US ATTACK ON THE CAP IN GATT WAS INCOMPATIBLE WITH THE UNDERSTANDING REACHED IN THE TOKYO ROUND. THE CURRENT RASH OF GATT CASES WAS COMPLETELY OVER-LOADING THE SYSTEM. QUOTE IT RISKS BLOWING THE DISPUTE SETTLEMENT PROCESS IN THE GATT AND WITH IT THE RULE OF LAW IN WORLD TRADE. UNQUOTE MOREVOER, THE US HAD VERY RESTRICTIVE IMPORT ARRANGEMENTS FOR SUGAR AND DAIRY PRODUCTS AND WAS INCREASING ITS EXPORTS MUCH FASTER THAN THE COMMUNITY.

/5. SETTING

5. SETTING THESE ISSUES IN PERSPECTIVE, DENMAN CONCLUDED THAT THERE WAS A TENDENCY TO BLAME US DIFFICULTIES ON OUTSIDE SOURCES AND THAT THE US ATTITUDE IN FOREIGN TRADE POLICY DISCUSSIONS WAS QUOTE A GOOD DEAL MORE EXTREME THAN ANYTHING WE HAVE SEEN FOR A LONG TIME. UNQUOTE BUT THE US WAS NOW INCREASINGLY DEPENDENT ON ITS EXPORTS AND ON TRADE WITH THE EC QUOTE... THE TRADING RELATIONSHIP BETWEEN EUROPE AND THE US IS FUNDAMENTAL TO THE PRESERVATION OF THE OPEN WORLD TRADING SYSTEM ON WHICH THE PROSPERITY OF THE WEST DEPENDS UNQUOTE. WITH QUOTE THE SOVIET EMPIRE GOING THROUGH ITS WORST AND MOST REAMSHACKLE MOMENTS SINCE THE OCTOBER REVOLUTION UNQUOTE IT WAS AN EXTRAORDINARY TIME FOR THE US AND EC TO ATTACK EACH OTHER. THOUGH DIFFERENCES COULD NOT BE SWEPT UNDER THE CARPET, IT WAS IMPORTANT TO SEEK ACCOMMODATION BY OPEN DISCUSSION OR QUOTE DISCREET BILATERAL EXPLORATION UNQUOTE.

6. IN ANSWER TO QUESTIONS HE WAS CAUTIONS ABOUT THE PROSPECTS FOR SETTLING THE PIPE-LINE DISPUTE. IT INVOLVED VERY DIFFICULTY ISSUES WHICH COULD NOT EASILY BE RESOLVED. ON THE GATT MINISTERIAL HE STRESSED THE NEED FOR A REAFFIRMATION OF GATT PRINCIPLES BUT ALSO FOR THE ADOPTION OF A PRACTICABLE RATHER THAN AN OVER-AMBITIOUS PROGRAMME OF WORK FOR FURTHER STUDY IN THE GATT.

7.FCO PLEASE ADVANCE TO HADLEY (MAFF) BOURKE DOT BENDER DOI.

FCO PASS SAVING PARIS, BONN

WRIGHT

[ADVANCED/REPEATED AS REQUESTED]

EAST/WEST ECONOMIC ISSUES - SIBERIAN PIPELINE

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TO IMMEDIATE FCO

TELEGRAM NUMBER 3052 OF 15 SEPTEMBER

INFO PRIORITY BONN, PARIS, ROME, UKMIS NEW YORK, UKDEL NATO

SIBERIAN PIPELINE

1. I CALLED TODAY ON MCCORMACK, WHO HAS REPLACED HORMATS AS ASSISTANT SECRETARY ON THE ECONOMIC SIDE OF THE STATE DEPARTMENT. HE WAS AFFABLE AND TALKATIVE, AND (GIVEN HIS BACKGROUND AS A FORMER AIDE TO THE RIGHTWING SENATOR HELMS) ENCOURAGINLY OPEN-MINDED ABOUT SOLUTIONS TO OUR CURRENT PROBLEMS.

2. HE WAS PARTICULARLY CONCERNED ABOUT THE PIPELINE, HE EMPHASIZED THAT NO-ONE IN THE ADMINISTRATION WANTED OUR DISAGREEMENTS HERE TO SPILL OVER INTO WIDER ISSUES, AND SO FEED THE PREJUDICES OF THOSE ORDINARY AMERICANS WHO STILL HANKER AFTER WITHDRAWAL FROM ENTANGLING ALLIANCES. BUT ANY SETTLEMENT WOULD HAVE TO MEET THE PRESIDENT'S OBJECTIVE OF FIRM ACTION AGAINST THE RUSSIANS OVER POLAND. AND IT COULD NOT BE DONE BY MIRRORS: THERE WERE ENOUGH EXPERT PEOPLE (WHO EXPRESSED THEIR VIEWS PUBLICLY THROUGH THE WALL STREET JOURANL) WHO WOULD GO THROUGH THE DETAILS OF ANY AGREED ARRANGEMENTS FOR PUTTING ECONOMIC PRESSURE ON THE RUSSIANS TO SEE WHETHER IT MATCHED UP WITH THEIR REQUIREMENTS. IT WOULD BE POLITICALLY DIFFICULT FOR THE PRESIDENT TO BACK A SETTLEMENT WHICH COULD NOT WITHSTAND THIS CRITICAL SCRUTINY.

3. MCCORMACK ASKED HOW THE ARRANGEMENTS WERE GOING FOR A MEETING IN NEW YORK BETWEEN YOURSELF, SHULTZ, AND YOUR EUROPEAN COLLEAGUES. I HINTED AT THE HESITATIONS OF CHEYSSON, AND THE DIFFICULTY THAT GENSCHER WOULD NOW PROBABLY HAVE IN COMING TO NEW YORK BY 26 SEPTEMBER. MCCORMACK SAID THAT SHULTZ WAS UNDER INSTRUCTIONS FROM THE PRESIDENT TO AWAIT EUROPEAN PROPOSALS AT THE MEETING. HE ASKED WHETHER EUROPEAN OFFICIALS WOULD BE MEETING BEFOREHAND TO PUT TOGETHER A PACKAGE OF PROPOSALS, AND WHETHER YOU YOURSELF WOULD BE PREPARED TO EXPOUND THEM. I SAID THAT YOU HAD ALREADY GONE TO CONSIDERABLE LENGTHS TO GET THE MEETING TOGETHER, AND WOULD BE PREPARED TO CHAIR IT EVEN THOUGH A MEETING ON AMERICAN SOIL WOULD MORE NATURALLY BE CHAIRED BY SHULTZ HIMSELF. I DID NOT KNOW WHETHER THE EUROPEANS WOULD BE ABLE TO PUT FORWARD SPECIFIC PROPOSALS: THEY WOULD CERTAINLY WANT TO HEAR SHULTZ'S VIEWS. THE

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MOST NATURAL OUTCOME OF A MINISTERIAL MEETING WOULD BE BROAD AGREEMENT ON THE PRINCIPLES OF A SETTLEMENT WHICH WOULD SUBSEQUENTLY BE WORKED OUT IN DETAIL BY OFFICIALS. THE AMERICANS WOULD DOUBTLESS INSIST ON SOME KIND OF GUARANTEE THAT A SETELEMENT WOULD NOT SUBSEQUENTLY BE UNDERMINED BY PUBLIC STATEMENTS IN EUROPE: THE EUROPEANS (WHATEVER THE POSITION OF THE WALL STREET JOURNAL) MIGHT LOOK FOR A SIMILAR GUARANTEE FROM THE AMERICANS.

ADVANCE TO EVANS, J C THOMAS, BROOMFIELD (EESD) AND GOWLLAND (TRED).

FCO PLEASE PASS GREY, KNIGHTON, SUNDERLAND, AYLING (DOT).

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TO PRIORITY FCO
TELEGRAM NUMBER 3074 OF 16 SEPTEMBER 1982
INFO BONN, PARIS, ROME, UKMIS NEW YORK, UKDEL NATO, UKREP BRUSSELS.

MIPT (NOT TO ALL): SIBERIAN PIPELINE

1. DURING MY INTRODUCTORY CALL TODAY, BURT (STATE DEPARTMENT) EXPRESSED US APPRECIATION FOR OUR EFFORTS TO BRING TOGETHER THE FIVE FOREIGN MINISTERS IN NEW YORK. HE NOTED THAT EVEN IF THIS MEETING DID NOT MATERIALISE, THERE WOULD BE OTHER DISCUSSIONS, BILATERAL AND ELSEWHERE, WHICH WOULD PROVIDE AN OPPORTUNITY TO MAKE PROGRESS. HE ACCEPTED THAT THE SHULTZ-CHEYSSON MEETING ON 26 SEPTEMBER MIGHT HELP TO BREAK THE PRESENT LOG-JAM.

2. BURT EMPHASISED THAT THE ADMINISTRATION WERE NOT LOOKING FOR A COSMETIC SOLUTION. IT WAS IMPORTANT THAT SUBSTANTIAL PROPOSALS FOR A SOLUTION SHOULD EMERGE IN THE NEW YORK EXCHANGES. OTHERWISE, IT MIGHT BE BETTER GIVEN THE EXPECTATIONS THAT WOULD BE AROUSED, TO DEFER DISCUSSIONS RATHER THAN HAVE A SERIES OF STERILE EXCHANGES. HE AGREED THAT IT WOULD BE UNREALISTIC TO EXPECT MINISTERS THEMSELVES TO SETTLE ALL THE PROBLEMS IN SUCH A SHORT TIMESCALE, AND THAT THE BEST RESULT MIGHT BE FOR THEM TO SET IN TRAIN A WORK PROGRAMME WHICH COULD EVENTUALLY LEAD TO SOLUTIONS. HOWEVER, IN THAT CASE IT WOULD BE NECESSARY TO FIND IN NEW YORK ENOUGH POSSIBILITIES TO MAKE SUCH A PROCESS WORTHWHILE.

3. REFERRING TO THE US PROPOSAL FOR FURTHER DISCUSSIONS ON COCOM (MY TELNO 3042), BURT NOTED THAT THIS INITIATIVE SHOULD NOT BE SEEN AS A NEW STEP, BUT AS A FOLLOW-UP TO THE JANUARY HIGH-LEVEL MEETING, WHERE ALL SIDES COMMITTED THEMSELVES TO IMPROVE THE PRESENT PROCEDURES. IN HIS MESSAGE TO YOU, SHULTZ HAD MADE IT CLEAR THAT COCOM WAS ONE AREA WHERE THE US WAS READY FOR DISCUSSIONS RELEVANT TO THE PIPELINE DISPUTE. EVEN HAD THIS NOT BEEN THE CASE, THE US WOULD STILL HAVE WISHED TO PURSUE THE EARLIER EXCHANGES.

4. BURT CONCLUDED THAT THE PERFECT SOLUTION TO THE PIPELINE PROBLEM, IN US EYES, WOULD BE AGREEMENT ON SOME WAY IN WHICH, WHILE CURRENT DIFFERENCES WITHIN THE ALLIANCE WERE MINIMIZED, THE SAME PENALTIES WERE EXACTED FROM THE RUSSIANS AND THE POLES AND THE SAME EFFECT WAS PRODUCED AS THE PRESENT US MEASURES WERE DESIGNED TO ACHIEVE.

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TO IMMEDIATE FCO

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TELEGRAM NUMBER 3068 OF 16 SEPTEMBER 1982

INFO IMMEDIATE BONN, PARIS, UKDEL NATO, ROME, MODUK (FOR PS/S OF S)

TRANSATLANTIC RELATIONS AND THE PIPELINE

1. I HAD A LONG AND EXTEMELY FRIENDLY TALK IN MY FIRST CALL ON WEINBERGER THIS AFTERNOON.

2. WEINBERGER SAID THAT HE HAD ENJOYED HIS MEETINGS WPTH THE PRIME MINISTER, YOU AND MR NOTT IN LONDON. HE HAD FOUND UNEMPLOYMENT VERY MUCH ON THE PRIME MINISTER'S MIND. HE WELL UNDERSTOOD OUR PREOCCUPATION WITH THIS. HE FELT THAT THERE HAD BEEN A NUMBER OF MISUNDERSTANDINGS ABOUT THE PIPELINE. AFTER THE OTTAWA SUMMIT, THERE HAD NOT BEEN MUCH FOLLOW UP AND PEOPLE HAD BEGUN TO THINK THAT THE PROBLEM HAD BEEN SET ASIDE. IT HAD BEEN DISAPPOINTING THAT LITTLE PROGRESS HAD BEEN MADE IN TERMS OF TRYING TO FIND ALTERNATIVE ENERGY SOURCES. THE VERSAILLES SUMMIT HAD NOT PRODUCED, AS THE AMERICANS HAD HOPED (AND, THEY BELIEVED, WE HADBL AGREEMENT ON RESTRAINT ON CREDITS FOR THE SOVIET UNION. MITTERRAND HAD IMMEDIATELY MADE THIS CLEAR TO THE PRESS, AND THIS HAD NOT BEEN APPRECIATED HERE.

3. I SAID THAT THEEUROPEANS HAD BEEN TAKEN BY SURPRISE BY A DECISION AFFECTING EMPLOYMENT AND OUR COMPANIES. DIFFERENT EXPLANATIONS SEEMED AT TIMES TO BE GIVEN FOR THE ACTION WHICH HAD BEEN TAKEN. AT TIMES THIS WAS SAID TO BE DIRECTED AT THE SITUATION IN POLAND: AT OTHERS TOWARDS DAMAGING THE SOVIET ECONOMY. WEINBERGER AGREED THAT THERE HAD BEEN A GOOD DEAL OF CONFUSION. THE PRESIDENT'S AIM, HE INSISTED, WAS TO ACHIEVE AN IMPROVEMENT IN THE SITUATION IN POLAND BY MAKING THE SOVIET UNION PAY A PRICE OVER THE PIPELINE. THE PIPELINE WOULD ENERGISE THE SOVIET INDUSTRIAL SYSTEM AND EARN HIGH AMOUNTS OF HARD CURRENCY. IT WAS BEING BUILT AT WESTERN EXPENSE. THESE GAINS WOULD INCREASE THE SOVIET ABILITY TO SUSTAIN THEIR MILITARY BUILD UP, WHICH WE SHOULD THEN BE OBLIGED AT GREAT EXPENSIVE TO GO ON TRYING TO MATCH, WEINBERGER AGREED THAT THE PIPELINE QUESTION SHOULD NOT AFFECT WHAT HE WENT OUT OF HIS WAY TO DESCRIBE AS OUR SPECIAL RELATIONSHIP: OR DISRUPT NATO, WHICH WAS THE KEY TO WESTERN SECURITY.

4. I SAID THAT, AS HE KNEW, WE HAD BEEN TRYING TO LOOK FOR WAYS OF ACHIEVING A SIMILARFOBJECTIVE BY DIFFERENT MEANS. WEINBERGER SAID THAT THE PRESIDENT COULD NOT RETREAT FROM THE BASIC IDEA THAT SOMETHING PRACTICAL MUST BE DONE TO TRY TO HELP THE POLES. HE HAD HIMSELF BEEN TRYING TO PUSH SOME US MILITARY PROCUREMENT TOWARDS JOHN BROWN IN AN ATTEMPT TO HELP WITH JOBS (WE HAVE BEEN TOLD BY HIS STAFF THAT WEINBERGER HAS BEEN TRYING TO GET US NAVAL ORDERS PLANED WITH JOHN BROWN). HE HOPED THAT WE COULD TAKE ANOTHER LOOK AT THE QUESTION OF ALTERNATIVE ENERGY SOURCES FOR WESTERN EUROPE. HE WAS CONSCIOUS THAT THE GERMANS AND FRENCH HAD A VERY STRONG COMMITMENT TO EAST/WEST TRADE.

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5. I SAID THAT, HAVING SPENT OVER FIVE YEARS IN GERMANY, WE SHOULD NOT UNDERESTIMATE THEIR STRONG EMOTIONAL COMMITMENT TO DETENTE. AS A DIVIDED COUNTRY THEY NEEDED A RELATIONSHIP WITH THE GDR, AND HENCE WITH THE SOVIET UNION. WEINBERGER SAIE THAT THE AMERICANS HAD ALSO HAD HIGH HOPES FOR DETENTE. THEY HAD HOPED THAT THIS WOULD LEAD TO A SLOWING DOWN OF SOVIET MILITARY EXPENDITURE: AND HAD INDEED ASSUMED THAT IT WOULDDO SO, CUTTING BACK US DEFENCE SPENDING. BUT THE CONTARY HAD HAPPENED.

6. WEINBERGER WENT ON TO REFER TO THE PRESIDENT'S INITIATIVES ON ARMS CONTROL. I SAID THAT THIS WAS VERY IMPORTANT IN EUROPE. THOSE WHO WERE IN FAVOUR OF STRENGTHENING OUR DEFENCES FOUND THAT THE MOST EFFECTIVE ANSWER TO THEIR OPPONENTS WAS TO BE ABLE TO DEMONSTRATE THAT WE WERE ACTIVIELY ENGAGED IN SERIOUS DISCUSSIONS ABOUT ARMS LIMITATION. THE VICE PRESIDENT HAD ASSURED ME OF THE PRESIDENT'S DETERMINATION TO PROCEED WITH THIS. IF HE DID, THIS WOULD DO MORE THAN ANYTHING ELSE TO UNDERCUT PACIFIST TENDENCIES. WEINBERGER SAID HE WAS IN NO DOUBT OF THE PRESIDENT'S SERIOUSNESS ON THIS POINT. SOME HERE HAD FELT THAT HIS PROPOSALS WERE TOO RADICAL AND THAT THE RUSSAINS MIGHT NOT COME TO THE NEGOTIATING TABLE. IN FACT THEY HAD BEEN WELL RECEIVED: THE RUSSIANS WERE NEGOTIATING. THE PRESIDENT'S CRITICISM OF SALT II HAD BEEN DIRECTED TO THE FACT THAT IT HAD NOT BROUGHT ABOUT EFFECTIVE ARMS REDUCTIONS.

7. I EXPRESSED MY WARM THANKS FOR THE ROLE WEINBERGER HAD PLAYED IN HELPING US OVER THE FALKLANDS. THE PRESIDENT, WHEN I SAW HIM, HAD TALKED OF THE SPECIAL RELATIONSHIP. THERE WAS NO DOUBT THAT THIS EXISTED IN THE DEFENCE AND INTELLIGENCE FIELDS. WEINBERGER STRONGLY AGREED AND EXPRESSED CONFIDENCE NOTHING WOULD SHAKE THOSE LINKS. HIS ROLE HAD BEEN TO CUT THROUGH THE BUREAUCRATIC PROCESSES AND ENSURE THAT THE SUPPLIES WE WANTED WERE MADE IMMEDIATELY AVAILABLE TO US. THE RESULTS HAD BEEN ENORMOUSLY GRATIFYING. THE PERFORMANCE OF THE BRITISH FORCES AND THE COORDINATION BETWEEN THEM HAD BEEN MAGNIFICENT. THE RAPIDITY AND COMPLETENESS WITH WHICH THE TASK FORCE HAD BEEN PUT TOGETHER HAD BEEN REMARKABLE. IT WAS AS IT WE HAD BEEN PLANNING FOR THIS KIND OF OPERATION FOR YEARS (I ASSURED HIM THAT WE WERE IN FACT BETTER AT IMPROVISATION EXCLAM). THE MOST IMPRESSIVE FEATURE OF ALL HAD BEEN THE

NATIONAL MORALE SHOWN IN RESPONDING TO THE CRISIS. I ASSURED HIM THAT AS SOON AS WE HAD COMPLETED OUR EVALUATION OF THE LESSONS TO BE DRAWN FROM THE CONFLICT, WHICH HAD TO BE DONE WITH DUE THOROUGHNESS, THE RESULTS WOULD BE MADE AVAILABLE TO HIM.

3. FOR WEINBERGER'S REMARKS ON THE MIDDLE EAST SEE MIFT.

WRIGHT

EAST/WEST ECONOMIC ISSUES - SIBERIAN PIPELINE

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FROM: J O KERR
DATE: 17 September 1982

CHANCELLOR

TALKS IN WASHINGTON: 20 SEPTEMBER

Our programme is :-

a. 10.00 a.m. Secretary Regan
b. 11.00 a.m. Mr Stockman, OMB
c. 1.00 p.m. Volcker: FRB
d. 4.00 p.m. Shultz, State.

2. The attached briefs are in 7 sections, as follows:-

1. The US Economy: The $ and the Defecit. (Regan, Stockman, Volcker)
2. The IMF/IBRD issues. (Regan, Shultz)
[3. Monetary issues, and Interest Rates] (Background to Volcker)
4. Trade issues, including Steel, Shipping. (Shultz, Regan)
5. The Pipeline. (" ")
6. Countries in trouble, particularly Mexico. (Regan, Volcker, Shultz : background)
7. Argentina. (Regan)
8. Unitary Taxation (Regan)

3. You will note that brief 2 covers an aide memoire which we could, if appropriate, hand over.

J O KERR

17/9/82.

(1)

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PRINCIPAL PRIVATE SECRETARY

cc Sir K Couzens (or)
Mr Littler
Mr Lavelle
Mr Peretz
Mr Graham

CHANCELLOR'S MEETING WITH MR REGAN

The Chancellor asked for suggestions for a fresh topic that he might discuss with Mr Regan. I attach a note on prospects for the US dollar on which it might be helpful to take Mr Regan's mind. You will note that we inevitably return to the question of the budget deficit but I hope that we stalk it through a different route. And the value of the dollar is of interest in its own right.

2. I am also attaching an updated version of our Toronto brief on the US economy. Mr Lavelle is sending you separately our contribution on IMF/IBRD issues.

A Bottrill

A BOTTRILL

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PROSPECTS FOR THE US DOLLAR

Points to make

(i) The dollar has been particularly strong in the past two years. This is partly a response to the counter-inflationary thrust of US policies. It also reflects the relatively strong US current account.

(ii) A stable and healthy dollar is in the interests of the international system as a whole. We all have a concern, therefore, that there should not be unduly large fluctuations in either direction. The dollar's present height may contain an element of 'overshooting', and there could be some unwinding in future.

(iii) The slowdown in US cost increases has been impressive but has not fully matched the rise in the dollar, and the US has lost competitiveness. This may in time be reflected in a less strong current account - particularly if domestic demand recovers strongly.

(iv) A firm exchange rate is part of the process of reducing inflation by monetary restraint but the dollar's steep rise suggests that monetary conditions may have been exceptionally tight.

(v) There may be parallels with UK experience in 1980 and early 1981 when sterling was particularly strong - partly as a result of oil factors but partly as a result of high domestic interest rates relative to those abroad. We drew two lessons at the time.

(vi) The first was that we needed to adjust our policies. By reducing the budget deficit we were able to take some of the strain off monetary policy and lower interest rates. Sterling's subsequent decline in the summer of 1981 owed something to this shift as well as to the turnround in the oil market.

(vii) Our second conclusion was that we needed to take account of the exchange rate in interpreting movements in the monetary aggregates. These are particularly difficult to assess at times of

rapid institutional change or when there are sharp shifts in the external demand for a currency. We concluded that the level of the exchange rate gave a valuable additional reading about the tightness of overall monetary conditions.

(viii) We know that Mr Regan is looking hard for ways of reducing the US budget deficit and we welcome this. It should lead to lower US interest rates which will be welcome both domestically and internationally - but could have as a side effect some lowering of the dollar.

(ix) We welcome also Mr Volcker's recent remarks about the need to interpret US monetary evidence flexibly. Our own experience suggests it might be sensible to include the value of the dollar as one of the principal factors to be taken into account.

(x) Just as there has been concern about the strength of the dollar, so an over-rapid downward adjustment would also be a cause for concern. The correct thrust and balance of domestic policies is the key to orderly exchange rate developments, and thus the way to meet the Versailles commitment to seek to create a more stable international environment - without excessive rises or falls in exchange rates.

Background

1. The dollar's effective rate has risen by more than 30 per cent in the past two years. Its upward path, however, has also been marked by sharp fluctuations. The steep rises of the spring and summer of 1981 were followed by a period of relative softness last winter. Since the beginning of the current year, however, the trend has generally again been upwards and in spite of the fall in US interest rates since June the dollar remains close to its peak level.

	\$ effective rate 1975 = 100	£/\$	£ effective rate 1975 = 100
1980 Q3	91.9	2.38	96.7
4	94.3	2.39	100.2
1981 Q1	96.5	2.31	101.4
2	105.5	2.08	97.8
3	111.1	1.84	90.6
4	107.4	1.88	89.7
1982 Q1	111.7	1.85	91.2
2	115.7	1.78	90.3
16 September	122.7	1.71	91.6

2. The dollar's strength has been a cause of concern to other industrial countries, worried about 'importing' inflation. It has also added to the burden of LDC debts, and may have helped to keep up world real oil prices.

3. The strength of the dollar has reflected probably partly the relative strength of the US current account which has been in surplus for most of the past two years at a time when almost all other industrial countries, except the UK and latterly Japan, have been running deficits. The dollar's strength may also have reflected partly the attractions of the US for investors at a time of great political and economic uncertainty in the world.

4. The main explanation for the dollar's rise, however, is almost certainly the relatively high level of US interest rates in the past two years. The differential between US and overseas rates has varied periodically and may help to account for some of the dollar's short-term fluctuations but the strong counter-inflationary commitment of the US Administration and the Fed's continued efforts at monetary restraint have been powerful forces underpinning the dollar.

3-month money market interest rates

	US	Germany	UK
1981 Q1	15.8	11.4	13.4
2	16.8	13.1	12.5
3	17.3	12.8	14.3
4	13.2	11.2	15.6
1982 Q1	14.3	10.2	14.4
2	14.1	9.2	13.4
July	13.4	9.4	12.4
August	10.6	9.0	11.2
Sept 10	10.6	8.2	11.0

5. The prospects, however, are that at least some of these favourable factors may begin to unwind over the coming months. The rise in the dollar has been accompanied by a loss of more than 40 per cent in US competitiveness in terms of relative unit labour costs over the past two years. US costs are still rising more rapidly than those in major competitors such as Germany and Japan. This loss of competitiveness may be expected to result in some weakening of the external position with a lag.

6. The US current balance was in surplus of \$4½ billion last year and showed \$4½ billion surplus in the first half of this year - partly helped by low oil imports. The OECD and IMF both forecast a surplus of about £10 billion for 1982 as a whole. Both, however, expect the surplus to disappear next year, and the OECD actually expects a small deficit of about \$5 billion to emerge.

7. The size of any deficit will reflect not only competitiveness effects but also the relative strength of any recovery in the US economy. Our own view is that the adverse effects of lost competitiveness may be greater than the OECD and IMF allow. The Administration of course is also forecasting a strong recovery in demand, and at the OECD examination of the US earlier this year, Jerry Jordan of the Council of Economic Advisers spoke of a possible \$20-40 billion US current deficit next year.

8. The emergence of a deficit at a time when the US will be trying to reduce interest rates could lead to a downward adjustment of the dollar. Our own view is that although US interest rates will probably remain firm over the coming months, some continued flexibility in monetary policy with M1 growth at or slightly above target could lead to a further gradual decline in US interest rates next year. This could be accompanied by a relatively orderly decline in the dollar, but might involve sharp changes.

9. Our main concern is that the present 'overshooting' of the dollar exchange rate should first be contained by securing better fiscal support for monetary policy but that then any unwinding should take place in an orderly and gradual way. We should aim to avoid a repeat of the 1977-78 experience when lost competitiveness, strong

recovery in the US economy and relaxed monetary policies led to a current deficit of $14 billion a year and a steep fall in the dollar.

10. The situation is different now, but it still seems worthwhile to urge the Administration to have a care for the value of the dollar - to avoid overshooting in an upward direction followed by the risk of an unduly precipitate downward adjustment later. It is all part of the Versailles commitment to consider the impact of policies on others. Interest rates and exchange rates are the principal ways in which shocks are transmitted.

BRIEF ON US ECONOMY

SUMMARY

The US economy has not yet pulled out of the recession, although inflation has been reduced substantially. Interest rates have recently fallen and the dollar's rise has been checked. Forecasts of output growth in the US of $3\frac{1}{2}$-$4\frac{1}{2}$% for 1983 seem optimistic although some recovery is likely.

TEXT

1. The recovery from the trough of the business cycle in mid-1980 has been hesitant and faltered as output fell back sharply at the end of 1981. Total output fell by 5.1% in the first quarter of this year and rose only marginally by 1.3% (both at annualised rates) in the second quarter. GNP in the second quarter was 2% lower than a year ago while industrial production which has continued to fall is now 10% lower than a year earlier. Retail sales rose by only 1% in July, after a sharp fall in June, notwithstanding tax cuts at the start of the month, and although interest rates have fallen back considerably it is still too early to be confident about the extent or timing of the upturn in output.

2. After falling at the start of the year the annual rate of consumer price inflation has levelled off recently reaching $6\frac{1}{2}$%. The growth in earnings has continued to moderate falling to $6\frac{1}{2}$% in July. Price rises earlier this year were held back as US domestic oil prices fell in line with spot prices and as profit margins were squeezed. Oil prices have now hardened and margins might recover suggesting the decline in CPI inflation may level off and the rate stabilise around the $5\frac{1}{2}$ per cent - $7\frac{1}{2}$ per cent average.

3. Short-term interest rates have declined fairly steadily since mid-June when they reached over 15%. Falling demand for credit as a result of the recession and some relaxation of the monetary stance may have contributed to the easing in interest rates. The Federal Reserve's discount rate has been cut repeatedly in recent weeks and is now down to 10%. Three month rates have fallen by five points from 15% at the start of July to below 10% at the end of August though recently they have risen again to around 11%. Real rates are now down to 4%-5%, broadly equivalent to those elsewhere. Growing concern during this week over the Fed's intentions towards buoyant monetary growth may block any further fall in interest rates. (but Friday's US Money figures were not as bad as some expected.)

4. The US external current account improved to an estimated $3.2bn in the second quarter. Although export volumes declined partly as a result of the 25% loss of competitiveness over the past 18 months the fall in the volume of imports, especially oil, due to the recession was much greater which meant an improvement in the surplus. The effective dollar rate rose during July and reached a new peak of 122.7 in mid-August despite falling US interest rates. The resilience of the dollar results from the lower inflation rate, firm monetary policy and a strong current account. The effective dollar rate has recently dropped a couple of points but has since recovered to around 122.2.

PROSPECTS

5. The Administration's mid-year review, published on 30 July predicted output to fall by 0.7% this year and to grow by 4½% in 1983 compared to the less optimistic forecast of 3½% growth next year from the Congressional Budget Office (CBO). The IMF staff, however, are forecasting a smaller increase in GNP of around 2% in 1983. Assuming the implementation of announced policies, the staff are predicting inflation, as measured by the GNP deflator, to fall fairly sharply in 1982 to 6½% and to fall further in 1983 to 5½%.

6. Growth of 2%-3%, next year, however, would almost certainly be insufficient to bring down the current high unemployment rate which the IMF staff believe will remain in the 9%-10% bracket to the end of 1983. The lagged effects of the loss of competitiveness and the recovery in activity makes the external current account deteriorate turning into a deficit of perhaps $4bn-$5½bn on the OECD's and IMF's reckoning though WEP is forecasting a much bigger deficit.

POLICY

7. US policy remains committed to reducing inflation by firm control over monetary growth accompanied by a reduction in the size of prospective budget deficits. Concern over the lack of recovery and the growing number of company failures have helped to underline the need for a flexible application of policy over the cycle.

The poor state of corporate finances and other indicators of financial distress such as the collapse of the Penn Square Bank have been accompanied by a slight relaxation of the monetary stance. In his statement to Congress on 20 July, confirming the existing monetary targets of 2½%-5½% for M1, 6%-9% for M2 etc, Paul Volcker explained that "... growth around the top of these ranges would be fully acceptable. Moreover ..... growth somewhat above the targeted ranges would be tolerated for a time when economic uncertainty and turbulence were leading to stronger than anticipated demands for money. In these circumstances the Federal Reserve does not plan to respond strongly to various 'bulges' or 'valleys' in monetary growth that seem likely to be temporary." In explaining Fed policy, Volcker went on to emphasize the importance of a complementary fiscal stance and stressed the need to bring the fiscal deficit under control otherwise interest rates may have to be higher.

9. The Administration's latest mid-year reviews presented at the end of July forecast the federal budget deficit for fiscal year 1983 to be $115bn compared to $104bn only a few weeks earlier. As a percentage of GNP, budget deficits are to be halved from 3.6% to 1.8% over the fiscal years 1983 to 1985. These estimates rely on admittedly optimistic growth assumptions whereas the CBO estimates the deficit for fiscal year 1983 to be around $155bn using lower but still quite high growth assumptions. Moreover earlier the CBO predicted the deficit remaining around a $150bn over the medium term in sharp contrast to the declining profile envisaged by the Administration's forecast.

10. Clearly some major steps must be taken towards achieving these fiscal objectives before the Annual Report of the President in February, if the budgetary stance is to complement rather than hinder the flexible execution of monetary policy. In particular, after the acceptance of the tax bill, the thrust of fiscal policy over the medium term should now be directed towards reducing public expenditure, which may require cuts over and above these already envisaged, and aimed at increasing savings. If no reasonable progress is achieved the Federal Reserve will be faced with a difficult dilemma which may involve interest rates being somewhat higher than otherwise. In turn these unfavourable developments could inhibit or even jeopardise the recovery in the US and elsewhere.

HM TREASURY
14 September 1982

C/ Regan [illegible]

(2)

CONFIDENTIAL

FROM: R G LAVELLE

DATE: 17 September 1982

C. I suspect Regan may ask you if you want the Interim Cttee Chair. The answer must presumably be that you'd do it if that was the general wish (ie if the US, Canada + Co are prepared to [illegible] for us; and the mixed constituencies to block a [illegible] [illegible]?). [illegible]

CHANCELLOR

cc: Mr Littler
Mr Bottrill
Mr Beastall

CHANCELLOR'S TALKS IN WASHINGTON: IMF/IBRD ISSUES

As requested in Mr Kerr's minute of 15 September I attach:

(i) a background note summarising the stage reached on the main IMF/IBRD issues at Toronto, and how we would like the US position on them to develop;

(ii) an aide memoire for the Chancellor's use, in a form which could, if thought useful, be handed over to Secretary Regan.

This material draws heavily on contributions from Messrs Bottrill and Beastall.

2. The aide memoire is not too easy to get right. It is not easy to judge, for example, how wedded the Americans are to their Special Fund idea and how it may be worked up. In general it got a fairly unenthusiastic reception at Toronto. But the Fund may well write it up sympathetically - partly for reasons of self-interest. If they do, and even if it still gets nowhere much, discussion should at least ensure that the GAB question is properly aired.

3. It would be useful in discussion to see what, if anything, the Americans made of the various criticisms of the Special Fund. But we have not put this in terms in the Aide Memoire. For the rest, I think the most useful things to do are to push away a bit at quota size, distribution techniques and IDA. These are points which we can safely spell out in a note to be left with them.

R G LAVELLE

CONFIDENTIAL

BILATERAL WITH MR REGAN

IMF/IBRD ISSUES: BACKGROUND NOTE

Eighth Quota Review

We are concerned that the momentum of the Eighth Quota Review should be maintained and that the US should be ready to talk realistic figures on the size of increase at an early stage now. There is potentially a wide measure of agreement in the Interim Committee that the level of quotas should be increased to around SDR 100 billion. We should represent to Mr Regan that this is a considerable reduction from the early bids by the LDCs and the Fund staff. This achievement owes much to the work by the more pragmatic of the industrial countries (Germany and ourselves). It has not been helped by US indecision.

2. We shall want to put down markers in Executive Board discussions that access limits to Fund resources will need to be reviewed but we would not want to muddy discussion of the overall level of quotas at this stage.

3. On the distribution of quotas, we believe that the US and ourselves have a community of interest in securing a gradual and orderly adjustment of quota shares. The US, however, has shown signs of opting for more selective increases which would be arbitrary and would damage both our positions. The table included in the Annex to the aide memoire demonstrates this. US thinking on this - as on so much else of IMF business - is hard to fathom.

US proposal for a Special Fund and the GAB Review

4. The Toronto decision to remit discussion of the US proposal for a new special fund to the Executive Board seems to us a useful way of getting the US off the hook. The Fund staff apparently intend to prepare a broad paper on official borrowing facilities, including the GAB bilateral deals and the US proposal.

It is conceivable that the staff will take the opportunity to suggest a new facility which will meet the contingency the Americans have in mind. We shall need to judge this on its merits. Meanwhile, we are concerned that these discussions should not hinder the more immediate negotiation of the third tranche of the SAMA loan.

? Saudi ?

5. Up to now, the US proposal has had attracted more criticism than support. It was judged a diversionary tactic from the quota review (which Regan denied). It lacked definition, people said, in most important respects: size, membership, conditionality rules. Some clearly felt that it largely represented an attempt by the US to get help with problems on their own back yard but with new rules ('a second IMF'). The Germans said they hoped it was not simply intended to bail out commercial bankers. And the timing of its introduction was unclear: the immediate problems to which it seemed to be addressed would clearly have had to be tackled by other means.

6. As regards the GAB itself, we are still thinking round the case for increase.

7. The GAB total has remained largely unchanged at about $\$6\frac{1}{2}$ billion since its establishment in 1961-62. This was equivalent to 40 per cent of total Fund quotas then and 60 per cent of the G10 participants' quotas. The corresponding figures now are 11 per cent of total quotas and 20 per cent of G10 quotas. The proportions would be even less, after the Eighth Quota Review, if the GAB were left unaltered. In addition, only half the GAB is typically useable at any one time.

8. There are conflicting arguments about the need for an increase in the GAB. On the one hand, OPEC has helped provide liquidity to the Fund. Floating exchange rates and the growth of the Euromarkets have lessened G10 members' need for recourse to the Fund. The FRBNY's swap network and the establishment of EC financing mechanisms have also provided alternative sources of finance.

CONFIDENTIAL

FROM: C J CAREY
DATE: 17 September 1982

PRINCIPAL PRIVATE SECRETARY

cc Sir D Wass
Mr Littler
Mr Lavelle
Mr Hawtin
Mr Peretz
Mr Bottrill
Mrs Bennett

BRIEFING FOR CHANCELLOR'S TALKS IN WASHINGTON: PROBLEM COUNTRIES

It occurs to me that as additional background to his discussions in Washington the Chancellor may like to have a copy of the attached summary of the major debt problem situations in Latin America and East Europe. The note has been prepared with a view to including it in a dossier of material about the international banking scene which we hope to send to the Prime Minister next week (as a follow-up to the 1 September Seminar). It includes a paragraph about Mexico, on which Mr Hawtin has sent you a separate brief in response to your original request. We are still awaiting comments on the note from the Bank, but on the Latin American side at any rate we shall be surprised if they suggest major changes.

CJC

(C J CAREY)

The version of this that goes to No 10 will be beefed up, (by JGL) and will include France,

DRAFT

NOTES ON PROBLEM COUNTRIES, SEPTEMBER 1982

A - LATIN AMERICA

Argentina

Total indebtedness $37 billion. The rapid deterioration in Argentina's creditworthiness has been exacerbated by the inflationary policies adopted by the Bignone regime. With mounting overdues on repayments of capital and interest, there seems no prospect that Argentina can meet the massive debt service due in the remainder of the year. The reciprocal removal of UK-Argentine financial sanctions has cleared an obstacle to the major rescheduling which now looks inevitable. The IMF has agreed to send a mission to Buenos Aires for preliminary talks about the financial support programme which would need to accompany a rescheduling operation. Internal political instability is bound to complicate the negotiations. ECGD remain off cover.

Bolivia - Total indebtedness [$ billion]

Has been in dire financial straits for some time. Negotiations with the IMF have collapsed, causing the suspension of a rescheduling agreement with commercial banks signed last April. Last week the Central Bank announced that its foreign exchange reserves were exhausted and that an interest repayment due to Bank of America would have to be delayed. But it is doubtful if the banks will actually call a formal default. UK exposure is small; ECGD has been off cover for some time.

Brazil

Total indebtedness $81 billion, making it the second largest debtor after Mexico. Under Planning Minister Delfim Neto, has pursued generally responsible economic policies and kept debt maturities long. But there are uncertainties about Brazil's short term prospects: policy relaxations before the elections due in November, a deteriorating current account performance and greater caution by the banks following events in Argentina and Mexico may cause problems in meeting this year's external borrowing programme, which still requires another $4 billion to be raised. If Neto - who has consistently opposed domestic pressures for rescheduling - were to go, this could spark a crisis of confidence. But confidence should be helped by a package of austerity measures just announced (involving an increase in the banks' compulsory reserve requirements) which indicates that the authorities are alive to the dangers of over-relaxing their grip on the economy. ECGD remains open for cover, but new commitments are being carefully controlled.

Cuba

The Cuban authorities formally approached the UK and other Western creditor countries at the end of last month to request a rescheduling of its medium and long term debts. We and other creditors have insisted on multilateral negotiations. Rescheduling is sought on debts of over $1 billion out of total indebtedness in excess of $3 billion. Cuba's non-membership of the IMF is a complicating factor. The UK is not a major creditor; ECGD is off cover.

Mexico

Although an international support operation, involving a BIS/FED $1.85 billion package of short term assistance, was quickly mounted last month, there has been little progress so far in negotiations with the IMF and the second and third tranches of the BIS facility have not yet been released. The prospects for agreement on the sort of adjustment programme that the IMF will require as a condition for support have been clouded by political uncertainties in the transitional period before the change of President in December. Developments in the next few weeks will be crucial. ECGD cover has not been completely withdrawn, but is under tight control and largely confined to business already in the pipeline.

B - EAST EUROPE

Yugoslavia

Has failed to come to grips with increasingly severe payments imbalances resulting from high growth and investment rates in the late 1970s. Total indebtedness rose to $19 billion by the end of last year, and there are now increasing signs that Yugoslavia will have great difficulty in avoiding a debt rescheduling. The Yugoslavs put their financing gap for the second half of 1982 at $600 million. The Governor of the Bank of Yugoslavia is to visit London later this month to seek further loans from British banks but the latter are unlikely to be enthusiastic. ECGD, which has a substantial exposure (£700 million) is now virtually off cover, except for short term business.

Poland - Total indebtedness $27 billion

Convertible currency obligations falling due in 1982 amount to $10 billion, virtually none of which has been paid. But progress is being made on the rescheduling of unguaranteed banking debt due in 1982, and an agreement may be signed in the Autumn, under which the Poles will receive back about half the interest due this year in the form of a 3 year credit. Official rescheduling is still stalled on political grounds (principally by Americans and French), following the imposition of martial law. The effect is to allow Poland de facto 100% rescheduling of both principal and interest on official debt. Arguably, Polish insolvency has now to a large extent been discounted

by the banks, many of which (eg in Germany) have written off a proportion of their loans.

Hungary - Total indebtedness $6 billion
Faces short term liquidity problems, and a substantial debt burden over the next few years. The immediate position has been eased by a $210 million BIS support package earlier in the year and a new commercial bank loan of $260 million. Prospects depend on the outcome of current negotiations with the IMF over a stand-by arrangement which will require tough adjustment measures. Rescheduling remains a possibility. ECGD commitments are modest and under tight control.

Romania - Total indebtedness $9 billion
Agreement with Western Government creditors on the reschedulin of official debts was reached in July. An agreement with the banks has yet to be signed, but broadly equivalent terms have been proposed. An IMF standby agreement, withdrawn because of a build up of payments arrears, has been re-activated. But there remain doubts whether the Romanian authorities are prepared to take the necessary adjustment measures to strengthen the external position, restore banking confidence and avoid the need for further reschedulings. ECGD is off cover.

(6)

Carey's / Hawtin's
[illegible]

CONFIDENTIAL

FROM: M V HAWTIN
DATE: 17 SEPTEMBER 1982

PRINCIPAL PRIVATE SECRETARY

cc. Sir D Wass
Mr Littler
Mr Carey
Mr Lavelle
Mr Peretz
Mr Bottrill
Mrs Bennett

BRIEFING FOR CHANCELLORS' TALKS IN WASHINGTON: MEXICO

1. There has been little in the way of new developments since the Chancellor and the Governor reported on the state of play to the Prime Minister, following their return from the IMF meeting in Toronto.

2. I understand from the Bank that Mexican negotiations with the IMF have been held up because the Minister of Finance (Mr Silva Herzog) has been out of action with appendicitis. Mr Herzog has sent what appears to be intended to be a reassuring message to the Bank of England, to the effect that negotiations with the Fund are continuing. But it remains to be seen whether Herzog will be given political authority for the negotiating brief he needs to satisfy the Fund's conditions.

3. Meanwhile, the second and third tranches of the BIS/FED facility (due on 10 and 20 September) have still to be released. The BIS are apparently still sorting out some technical questions relating to the security position, though, given the slow progress with the IMF, this may be a convenient pretext for not releasing further funds.

4. The Mexican authorities have clarified the position of the treatment of inter-bank lending under the three month moratorium on capital repayments. Short term, unsecured lending by London banks to Mexican branches in London will be treated as inter-bank lending and repaid on the due date.

5. An advisory group of thirteen banks in New York (representing over 1000 banks involved) has been meeting to attempt to sort out the position on commercial bank lending after the three month moratorium on capital repayments. The banks' approach to rescheduling is bound to be conditional on the outcome of the IMF negotiations.

6. ECGD cover has not been completely withdrawn, but is under tight control and largely confined to business already in the pipeline.

7. The Minister of State FCO/(Mr Onslow) is visiting Mexico next week and will be having discussions with political leaders.

M V HAWTIN

cc. Mr Jaggers (Bank of England)
Mr Appleyard (FCO)

CONFIDENTIAL

FROM: M V HAWTIN
DATE: 17 SEPTEMBER 1982

PRINCIPAL PRIVATE SECRETARY

cc. Minister of State (C)
Sir K Couzens (o.r.)
Mr Littler
Mr Carey
Mr Bottrill
Mr Beastall
Mr Atkinson
Mr Denison
Mr Adams
Mr Anson (Washington)

MEXICO: SICARTSA STEEL MILL

1. In your minute to me of 10 September you asked for a note on the suggestion that the Mexicans might be under pressure to cancel the Sicartsa Steel Plate Mill contract which was awarded to the UK last year.

2. We had indeed heard of this, and there was some interdepartmental discussion at the Export Guarantees Committee meeting on 10 September of what the UK position should be.

Project Details

3. The contract in question was placed with Davy Loewy last Autumn for a Plate Mill, as part of the expansion of the Sicartsa Steel Works. The contract was valued at £350 million with a UK content of £200 million and represented Mexico's largest ever export order. A grant of £35 million from the ATP was provided, together with export credit at a fixed rate of 7¾%, with repayment over 13 years after a two year grace period. Following the award of the contract, the Prime Minister signed a Memorandum of Understanding about the project with President Portillo in Mexico City on her return from the Cancum Summit. This emphasised HMG's commitment to the successful completion of the project which represents 28,000 man years of work for UK industry. Apart from the UK, France, West Germany and Japan also have a substantial interest in other contracts for the expansion of the Sicartsa works.

The Possibility of Cancellation

4. Both Davy Loewy and Sidermex (the Mexican Steel Company) have expressed concern that the project's future may be affected by the IMF involvement in Mexico's financial crisis. The suggestion is that the Americans may be gunning for cancellation of the project, on the grounds that world over-capacity in steel making renders the project unnecessary and perhaps with an eye to possible export benefits for their own steel industry. It is by no means clear how much substance there is in these rumours. It is of course possible that the Mexican authorities themselves will wish to reassess the project, which in spite of its very favourable financing terms will still involve a considerable burden of local costs.

The UK Position

5. The Departments of Trade and Industry and FCO are exercised about the possible adverse political, industrial and commercial implications for the UK which might arise from cancellation of this project, and have suggested that UK representatives at the IMF should be briefed to lobby against any pressures for cancellation. But there is a question of whether cancellation might in fact be to the UK's economic advantage. The project was heavily subsidised by the UK Exchequer; with ATP, export credit and a small grant under the Science and Technology Act, the overall level of subsidy was over 60%. There must now also be increasing concern about the repayment risk to ECGD.

6. But, leaving aside the political and commercial pressures in the opposite direction, the following considerations temper the budgetary case for cancellation:-

a. the ATP support was front-end loaded, and only £3 million has yet to be paid over

b. repayments of the export credit are not due to begin until around 1990, ie. hopefully well outside the time frame of Mexico's current acute financial problems

c. cancellation of the project by the Mexicans would involve significant termination costs. Since these could be funded by drawings from the ECGD loan, some ECGD exposure would remain unsupported by an asset to generate income to meet repayments.

IMF Review

7. The normal practice is for the recommendations of the IMF's review team on the economic adjustments needed in a country seeking IMF support to be couched in broad macroeconomic terms. It is not the practice to single out particular sectors of the economy, still less particular projects, and it would be neither appropriate nor useful for the UK to indulge in lobbying on a specific project within the IMF. We therefore agreed with departments at last Friday's meeting that the right approach is to let the IMF review take its course; and consult further as necessary on briefing for our Executive Director when the IMF report is available. At that time, it should be possible to take into account the results of the review of British contracts in Mexico for which the Trade Secretary received a remit from Cabinet on 9 September.

M V HAWTIN

CONFIDENTIAL

FROM: DAVID PERETZ

DATE: 17 September 1982

(7)

[Exchange with Regan]

MR KERR

cc Mr Littler
Mr Carey
Mr Lavelle
Mr Hawtin

CHANCELLOR'S TALKS IN WASHINGTON: 20 SEPTEMBER

As requested, I am attaching two pages of briefing on the Argentine. AEF will be letting you have a peice on Mexico.

2. Although this is up to date at the time of writing, there may be more to report on Monday. If necessary we will have to let the Chancellor have an update by telegram early on Monday.

DLCP

D L C PERETZ

ARGENTINA

The reciprocal lifting of financial sanctions went ahead at midnight (London time) on 14 September after a last minute hitch at the Argentine end that caused a 24 hour delay. The hitch did not appear until late on Monday 13 September, some 24 hours after the Argentines had assured the Bank of England they were ready to proceed on 13 September, and its precise nature is still unclear. The Argentines assured the Americans (McNamar) and the Bank of England that it was no more than an unforeseen legal problem. Other reports suggest a last minute objection from the Junta.

2. The move has been generally welcomed in the UK press, and in the City. The 24 hour delay has been clearly understood by all to have been the Argentines' fault. The expected attempt in Buenos Aires to dress up the moves for internal consumption as a UK initiative to which the Argentine authorities agreed, after careful study, has cut little ice outside Argentina.

3. The Argentines may now be moving towards agreement with the IMF somewhat sooner than originally expected; according to press reports a fund team is due to leave for Buenos Aires for discussions in the next few days.

4. It is still a little early to be sure how the reciprocal removal of financial sanctions is working in practice. British banks are moving to regularise their relations with Argentine borrowers, and have been told that funds have been set aside (in the so called "escrow" account) for the purpose of paying off interest and capital repayments due. There have been some large transactions reported to the Bank moving Argentine funds between accounts at different UK banks in London; but there is no information yet about transactions moving funds out of London.

5. In Buenos Aires there have been press reports that Argentine official overseers are still in British companies, despite the Toronto understanding that they would be withdrawn by administrative action. The Bank have confirmation from Lloyds that the overseers were still in place on Wednesday 15 September. This may be no more than administrative delay.

6. When you meet Mr Regan it might be worth saying, without necessarily stressing any particular reference to this last point, that we would welcome US reports about how the removal of Argentine restrictions is working in practice in Buenos Aires: we would like confirmation that they are actually delivering their side of the deal. You could also reiterate your thanks for the US help as intermediaries both in Toronto, and over the last few days in getting the Toronto understandings implemented; and remind Mr Regan that we are looking for early progress in getting trade sanctions lifted, at the latest we hope before the November GATT meeting. We are still hoping to make use of the welcome given by the Argentines in Toronto to US good offices in this respect.

Mr Kerr

FROM: DAVID PERETZ
DATE: 17 September 1982

MR ~~LITTLER~~ — 2nd

cc Mr Carey
Mr Lavelle
Mr Hawtin
Mr Perfect

ARGENTINA

I received the following situation report from the Bank of England (Mr Crawford) late this afternoon.

(a) The clearing banks now report that some current payments of interest on Argentine loans have been received.

(b) It is clear there has been no large or sudden withdrawal of funds from London. There has been a good deal of movement between one account and another.

(c) The Banco de la Nacion has confirmed to one clearer that it will be paying all the back interest and capital due.

(d) In Buenos Aires the Central Bank has spoken to foreign banks about rescheduling. British banks are apparently ready to consider the Argentine proposals.

2. We could send the gist of this to Washington by telegram on Monday morning as further background briefing for the Chancellor before he meets Mr Regan. But I do not think it adds very materially to the brief he already has.

DLCP

D L C PERETZ

cc Mr L Appleyard - FCO

17/9/82.

(4)

VISIT OF CHANCELLOR OF THE EXCHEQUER TO WASHINGTON: 20 SEPTEMBER

EC-US TRADE ISSUES

(except Siberian Gas Pipeline for which separate brief provided)

POINTS TO MAKE

Steel

1. Appreciate US industry facing serious problems. But EC unanimous it is unfair to regard our exports as the cause.

2. Nonetheless UK consistently favoured a negotiated settlement. Therefore welcomed outline agreement reached between the Commission and US Department of Commerce on 6 August. Disturbing that US industry is seeking revised terms.

3. Community is today meeting in Brussels to consider arrangements for implementation on urgent basis. Hope Administration can prevail upon US industry to accept that existing deal is best available.

'Reciprocity' Legislation

4. Had hoped draft reciprocity legislation was stalled, thanks in large measure to Mr Brock's own efforts. Disturbed at reports there is now renewed pressure from Congress and Senate for early progress. Appreciate this is prompted mainly by frustration with Japanese. But legislation is protectionist in inspiration. Urge Administration to continue to do their utmost to resist. Enactment would be seen as major threat to fabric of open trading system.

Agriculture (If raised)

5. A delicate area. But counterproductive for US to attack EC arrangements which can be shown to be compatible with special GATT provisions on agriculture. Some of the more liberal EC Member States are beginning to show signs of increased awareness of US concerns. UK supports efforts to develop a constructive dialogue between the US and the EC as a whole. But it is not realistic to seek rapid and revolutionary changes in the basic CAP mechanisms any more than it would be to expect the US to allow its waiver from GATT obligations in the agriculture sector simply to lapse.

Manufacturing Clause in US Copyright Law

6. Very disappointed at Congressional override of Presidential veto. The Community is taking steps in GATT.

Shipping

7. Concerned at possibility of move by the US to protectionist policy of cargo reservations. Inconsistent with US efforts to promote work in international form on liberalisation of trade in services.

8. (If challenged on EC willingness to accept UNCTAD liner code) We are insisting on terms which have the effect of controlling protectionist ambitions of developing countries while leaving our markets open to international competition and avoiding discrimination between OECD countries. US appears to be contemplating measures which could shut other countries out entirely.

ESSENTIAL FACTS

Steel

9. An EC/US outline agreement was reached on 6 August between Davignon and US Commerce Secretary Baldrige, which provided for export restraint by EC producers in return for withdrawal of US complaints of dumping and subsidisation. Subsequently US industry representatives have taken the line in public that the terms secured by the Administration were not good enough. The US Administration have not, however, asked the Community to renegotiate, although they have made known informally to the Commission and Member States the points which the US steel industry would like to see reopened. We believe that the Administration has an obligation to convince their industry that the existing deal is the best available.

10. At the Commission's recommendation the Community is continuing to work out its internal arrangements so as to be in a position to implement on schedule on 1 October. The outstanding questions are the share-out of export entitlements between individual EC producers, and the conclusion of a parallel arrangement on pipe and tube. We hope these points, as well as the more substantial difficulties which remain on the US side

and which Davignon is travelling to Washington to discuss with US officials on 18/19 September, can all be resolved in time for the 20/21 September Council to agree the legal instruments necessary for implementation. But if any aspect remains uncertain a special Council later this month or early next will almost certainly be required. The absolute cut-off date for any agreed solution is the final determination of injury in the US dumping and subsidisation cases. This is due to be announced on 8 or 12 October, but the US International Trade Commission may take the crucial vote as early as 30 September.

'Reciprocity' Legislation

11. Pressure is reported to be mounting again in Washington for progress on 'reciprocity' legislation. A number of draft bills were introduced by individual Congressmen and Senators at the beginning of this year. They seem, however, to have been successfully stalled following testimony to the relevant Congressional committee by Mr Brock in the Spring. If enacted they would

(a) make the US Administration more susceptible to political pressure for trade retaliation;

(b) extend the Administration's existing discretion to take retaliatory action; and

(c) make the key criterion for action against a particular category of imports the extent to which the supplier country concerned maintains barriers against US exports of the same product or service.

12. Although principally intended as a warning shot at Japan, this development is viewed with concern by all trading partners of the US because of the extent to which it departs from the normal GATT principle that member countries' import regimes should be assessed overall. This has formed the basis for successive rounds of Multilateral Trade Negotiations, the results of which provide a reasonable basis for the expectation that the development of trade will produce a broad balance of advantage. It is true that in the case of Japan this expectation has not been realised and frustration on the part of Japan's trading partners is understandable. But the EC is reluctant to respond with unilateral measures and is taking the responsible course of using the GATT dispute settlement machinery to make its case.

Agriculture (If raised)

13. Under the influence of Agriculture Secretary Block US have been aligning themselves with Australia and other exporters of temperate agricultural produce to mount an attack in the GATT on two central CAP mechanisms, namely:

(i) variable import levies which ensure protection from import competition for domestic producers, and

(ii) export restitutions paid from the Community budget which permit the disposal of high cost surpluses on world markets at the prevailing world market price.

14. Despite variable levies the Americans in fact have a substantial trade surplus with the EC in the agricultural sector - $7 Billion in 1980. Their primary target is the export restitution system and in this connection they have been pursuing a whole series of cases in the GATT, but so far at least have had little success in their attempts to demonstrate that EC practice infringes GATT rules. The GATT in fact contains special provisions which permit the subsidisation of exports of primary products so long as

the world market price is not undercut and the exporting country does not obtain a 'more than equitable share' of world markets.

15. Nonetheless other Member States as well as the UK have become concerned at the extent to which tension in the agriculture sector is threatening to damage the Community's overall relationship with the US. The Dutch have been orchestrating informal contacts between themselves, the Germans, the UK and the US. A confidential one-off meeting took place in Bonn on 28 July (UK represented by Mr Buchanan-Smith and US by Mr Lodwick, Under-Secretary, US Department of Agriculture) but, unfortunately, seems to have achieved little in the way of increased understanding.

16. The message we are trying to get across is that it is simply not realistic for the Americans to imagine that they will succeed in forcing the Community to abandon variable levies and export restitution payments altogether (nor indeed are they well placed to try, given the restrictions which they impose on agricultural imports and their own policy of export sales on non-commercial terms - also the possibility that they may soon introduce an export subsidy scheme of their own). There may however be scope for some accommodation based on agreed market shares and we

should like to help promote this if we can. However in view of known UK reservations about the present operation of the CAP it would be counterproductive for us to take the lead within the EC. If we eventually succeed in securing agreement that the CAP must be adjusted so as to limit production of high-cost surpluses this in turn should have the effect of controlling export restitution payments and help ease relations with the US and other competing exporters. But this can only happen in the longer term.

Manufacturing Clause in US Copyright Law

17. A longstanding piece of highly protectionist legislation which effectively restricts the importation of books by US authors printed outside North America. The Bill to renew the Clause from 30 June 1982 until 1986 was vetoed by President Reagan, an indication that the US Administration are aware of the restrictive nature of the legislation. But the President's veto was overriden by Congress. The Community has requested consultations with the Americans under GATT Article XXXIII.1.

Shipping

18. The US merchant fleet is uncompetitive due to high labour and construction costs. It has been maintained in the past by subsidies which are now being

withdrawn. President Reagan has an election commitment to strengthen the US merchant marine.

19. During consultations held in London on 28/29 July at the request of the US Government to discuss international shipping policy, the representatives of the major European maritime countries and Japan were informed that the US Government was considering the possibility of entering into bilateral cargo sharing agreements with developing countries. The effect of such agreements would be to limit, or perhaps eliminate, the trading opportunities of cross traders on those routes.

20. The Secretary of State for Trade recently wrote to US Trade Representative Brock (with a copy to Shultz) to draw attention to our concern. Should the US conclude one such agreement, pressure would increase for others. This would have serious consequences for the UK and our OECD partners, and could threaten close cooperation in NATO on the merchant marine strategic plan. Introduction of such a measure by the US would make a strange contrast with US efforts to promote work in OECD and GATT on liberalisation of trade in services.

17/9/82.

(5)

VISIT OF CHANCELLOR OF EXCHEQUER TO WASHINGTON, 20 SEPTEMBER 1982

PIPELINE

POINTS TO MAKE

1. We must resolve this dispute quickly. 5 Foreign Ministers' meeting in UNGA margins next week crucial. This must create political will to sort out quarrel. Will require good will and spirit of compromise on both sides.

2. British have played main role in getting two sides together. Am sure you will do your best to help us. But we must say frankly that some of our European colleagues are very upset about the impact of your measures on their companies, and are not inclined to compromise.

3. (As appropriate.) We object to your measures as extraterritorial, unilateral, retrospective (although we agreed in NATO to exempt existing contracts), ineffective (will not stop pipeline, nor advance reconciliation in Poland), and which divide Alliance, thus benefitting Moscow.

4. (As appropriate.) This dispute highlights need to reach agreed analysis of Soviet and East European economies, and to ensure West's economic policies are consistent with its political and security objectives. We are ready to play full and constructive role in this.

VISIT OF CHANCELLOR OF EXCHEQUER TO WASHINGTON, 20 SEPTEMBER 1982

PIPELINE

ESSENTIAL FACTS

1. Agreement in principle that Foreign Ministers meet à cinq (plus Presidency and Commission) in New York end-September. UK to host and chair, Mr Shultz to speak first. Agenda not yet fixed. Mr Shultz has suggested discussion of credit, COCOM, and oil and gas equipment restrictions, and alternative (non-Soviet) energy resources, and hinted that concessions on these would enable Americans to lift retroactive application of measures.

2. French very reluctant to attend, arguing that time is on European side, no hurry to talk, let alone offer concessions. FRG keen to talk, agree in principle to offer cosmetic concessions. Italians keen to talk. UK has prepared 'package' of minor concessions on contingency basis.

3. Two French, one Italian, one UK (John Brown) companies now affected by US sanctions. FRG companies expected to ship equipment for pipeline soon. PTI 1(3) directions now issued to 6 British companies.

Financial Times Friday September 17 1982

Reagan 'misguided on grain exports to Soviet Union'

BY ANATOLE KALETSKY IN WASHINGTON

THE REAGAN Administration is totally misguided in its contention that U.S. grain exports to the Soviet Union can weaken the Soviet economy by draining it of hard currency, according to an economic analysis issued by Wharton Econometrics yesterday.

"The Soviet Union would be roughly $32bn (£18.8bn) worse off each year if it had to produce domestically the 46m tonnes of grain which it is buying this year on world markets," the report says.

The idea that U.S. grain exports hurt the Soviet economy, while European technology exports assist the Soviets is a basic tenet of President Ronald Reagan's foreign policy.

It is frequently repeated by U.S. officials attempting to refute European charges that President Reagan is inconsistent in banning exports of pipeline technology, while lifting the Carter Administration's embargo on grain exports.

The Wharton study shows that the "financial drain theory is incorrect," because it ignores the Soviet Union's "comparative disadvantage" in grain production.

This means that it costs the Soviet Union very much more, in dollar terms, to produce a tonne of wheat internally than it does to buy it on the world market.

On the world market, the Soviet Union can buy one tonne of wheat by selling 0.625 tonnes of oil, the study says. But in terms of the rouble prices used inside the Soviet Union, one tonne of wheat is equivalent to 3.3 tonnes of additional oil production.

Taking other factors into account, the study estimates that by importing an extra tonne of grain in 1982, the Soviets save sufficient resources to produce an extra 2.8m tonnes of oil, worth about $700m in the world market.

But it would spend only $160m to purchase this grain. By producing additional natural gas instead of oil, the Soviet Union could increase its gains from buying more grain to about $2bn for every extra tonne of grain imported.

The Soviet Union would import far more grain than it does at present if it were not for Soviet fears of over-dependence.

If the country follows the policy of increasing self-sufficiency which some Soviet leaders have recently advocated, in the wake of the Carter grain embargo, they would have to divert significant resources from efficient to inefficient sectors of their economy.

Strasbourg condemns pipeline embargo

STRASBOURG — The European Parliament yesterday condemned the U.S. embargo on American technology for the Soviet natural gas pipeline and asked Washington to lift the sanctions.

The Parliament said the embargo could have a serious effect on the economies of Western Europe and "represents a unilateral rupture . . . in the climate of international commercial commerce."

Later, Viscount Etienne Davignon, Commissioner, said Western Europe would be able to do without Soviet natural gas supplies, representing about 4 per cent of total energy consumption by the 1990s, when additional community and Norwegian supplies come on stream.

"We are setting up a security system which will make it possible for us to do without the 4 per cent that w[illegible] come from the Soviet Union, thanks to our relations with our own producers and with Norway," he said. "In other words, the Community is not being naïve at all."

One of the arguments advanced by Washington against the pipeline project is that Europe's energy dependence on Moscow will make it susceptible to political pressure.

Viscount Davignon said that the Commission would not have supported additional gas contracts with the Soviet Union "if at the same time the Community had not taken the necessary measures to find out what would happen if political pressure were brought to bear on Europe through its gas suppliers."

Several Western European countries have signed contracts with the Soviet Union to supply a total of about 40 bn cubic metres of natural gas a year through the controversial Siberian pipeline beginning in 1984-85. Russian gas exports to Europe amount to about 24 bn cubic metres a year.

According to EEC statistics, indigenous production of natural gas is expected to increase over the next decade. Norwegian officials have emphasised however thaat their country will not be able to become an important alternative to the Soviet Union for gas supplies until the mid-1990s at the earliest.

AP

Shipping Policy Division

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John Kerr Esq
PS/Chancellor of the Exchequer
HM Treasury
Great George Street
London SW1

17 September 1982

Dear Mr Kerr,

Following your telephone conversation with Anna Butterworth earlier today, I attach a background brief and line to take on shipping for the Chancellor to use during his visit to the United States. It would be appropriate for the Chancellor to raise this matter with Secretary Shultz if they are discussing protectionist issues generally.

If the Chancellor is making any general speeches on the subject of protectionism, it would also be extremely useful if shipping could be mentioned. Although a US protectionist policy in shipping is a potential rather than an actual threat, we are viewing it very seriously because of the widespread effects such action would have, not only on shipping but on world trade generally.

The following is the sort of package which might be included in a speech:-

I am particularly concerned at the current threat, emanating mainly from developing countries, to the competitive environment in world shipping. If protectionist pressures are not resisted within the developed world, shipping would inevitably become less efficient and more expensive. We must no longer make the mistake of viewing shipping as an isolated service industry. Most of the world's trade is carried in ships, and additional costs arising from protectionist policies would inevitably be borne by exporters and consumers, thus affecting the whole of the world's trading system. Consultations are currently taking place between the US and her maritime partners on how to respond to this threat within the OECD. It is vitally important that they should reach an agreement maintaining competitive principles between OECD shipping lines.

Yours sincerely

Sarah Chambers

Sarah Chambers
Shipping Policy Division

cc Mr Lane SP
Mr Bowke OT2
Mr Kinshen FCO

SHIPPING: THREAT OF PROTECTIONISM

Background

1 The US Administration is in the process of reviewing its policy towards shipping. There is considerable pressure on them from developing countries who wish to protect their own nascent merchant fleets, to enter into restrictive bilateral cargo-sharing agreements which would limit or exclude competition from shipping lines of third countries. Similar protectionist pressures are coming from some US shipping interests.

2 If the US was to adopt protectionist policies:-

(a) it would set a precedent other OECD countries might quickly follow;

(b) it would harm the UK shipping industry because over two thirds of its earnings are in trades with third countries;

(c) widespread protectionist policies would also increase shipping costs, thus having a very dangerous effect on world trade most of which is still carried by sea.

3 Consultations are taking place between the USA and her major maritime OECD partners, in the hope of reaching agreement on a common response to developing country pressures, designed to avoid discrimination between OECD lines and to preserve international competition.

4 The Foreign Secretary raised this matter when he met Secretary Shultz, and Lord Cockfield is in correspondence with the United States Trade Representative, and the Secretaries for Commerce and Transportation.

Line to take

1 The UK and our major maritime partners in Europe are deeply concerned about the threat to the competitive environment in world shipping, and hope that we and the US can work together to maintain the principle of open competition between OECD shipping lines.

2 I understand that the United States Trade Representative is in correspondence with the UK Secretary of State for Trade on this matter, and we are much encouraged by the current United States approach. Great effort will be needed on the part of all concerned at the next round of consultations in the autumn to ensure that collective resistance to protectionist pressures can be maintained.

FROM: R H WILSON
DATE: 17 September 1982

8600

MR KERR

cc Sir Kenneth Couzens
Mr Carey
Mr Lavelle
Mr Bottrill
Mr Hawtin
Mr Peretz

CHANCELLOR'S TALKS IN WASHINGTON: 20 SPETEMBER

I attach briefing provided by the Department of Industry on steel as requested in your undated minute of last week to Mr Littler.

J.S. Longhurst

pp R H WILSON

STEEL EXPORTS TO THE USA

Points to make

1. Important that steel Arrangement negotiated in August is implemented. If deal f~~l~~ounders, and punitive duties imposed on BSC and other European exporters, cost in terms of lost exports to USA and resulting instability of European market would be enormous.

2. Hope, therefore, that US Administration doing its utmost to get American industry to accept the deal. Blame for any job losses in the UK (resulting from partial closure of US market if duties imposed) likely to be laid at America's door.

3. In any case, duties will not limit exports from Netherlands, Luxembourg or, to any significant extent, Germany. Comprehensive Arrangement best solution.

Background

4. The US steel industry lodged anti-dumping and countervailing complaints against European exporters of a range of products in January of this year. If the cases run to their conclusion, BSC is likely to face countervailing duties of 20% (in October) and anti-dumping duties of 7-18% depending on the product (from the end of the year). Exporters from France, Italy and Belgium are similarly affected. The Dutch and Luxembourgers have been judged not guilty of dumping or unfair subsidisation, and the Germans have escaped with the likelihood only of some anti-dumping duties. If, however, the US market is partially closed, the excess steel unable to gain access to that market is likely to result in severe instability in Europe.

5. In early August the Commission and US Department of Commerce reached agreement on an Arrangement under which the EC would restrict exports of 11 carbon and stainless steel products by licensing from 1 October 1982 to 31 December 1985. In return, the US industry would withdraw its complaints and undertake not to mount fresh ones. The US industry has refused so far to accept this deal, arguing that the quantities envisaged are too high and the product coverage inadequate. They also want a separate restraint agreement on EC exports of pipe and tube, on which talks are likely to get under way in earnest at the end of September.

6. Time is running out. The US International Trade Commission is due to make a final determination of injury in the countervailing cases by 8 October, after which definitive duties will be imposed.

7. EC Commission Vice President Davignon is visiting Washington over the weekend of 18/19 September, and will report on any developments to the Foreign Affairs Council on 20 September.

Mineral and Metals Division 2A
Department of Industry
Room 821

16 September 1982

FROM: R H WILSON
DATE: 17 September 1982

MR KERR

CHANCELLOR'S SPEECH TO THE ECONOMIC CLUB IN NEW YORK

We spoke. I attach:

(i) Some defensive supplementaries on steel;

(ii) A background note by DOI on the US/EC steel dispute generally;

At a brief glance this overlaps slightly with some of the stuff which the Foreign Office have sent you, in Richard's letter of 17 September which I have just seen. But it also goes beyond it quite usefully and would not need too much tailoring to be put together with it.

R.H.W.

R H WILSON

Steel Exports to US Defensive Supplementaries

Statement 1: US Industry going through difficult time. Need to protect ourselves.

Answer: Recognise difficulties of low capacity utilisation facing US industry. We have similar problems in Europe. This is part of a world-wide problem and blame cannot be laid at the door of imports from the EC.

Statement 2: It is reasonable for US industry to seek redress against unfair and subsidised imports.

Answer 2: Do not accept basis of Department of Commerce calculations alleging that BSC benefits from export subsidies. Tax payers' money is being used for restructuring the Corporation and restoring it to commercial viability. Indeed Commerce Secretary Baldridge has himself publicly praised BSC's restructuring efforts.

Statement 3: Agreement negotiated with EC not satisfactory.

Answer 3: The arrangement, as with any agreement, represents a compromise for both sides. US industry should bear in mind that the arrangement should serve to restrain exports from the EC as a whole including those countries whose exports will not be hit to a great extent by the Department of Commerce's determinations of dumping and subsidisation. It is noteworthy that their exports to the US have recently increased significantly.

BACKGROUND AS AT 6/9/82

STEEL EXPORTS TO THE USA

Last January, the US Administration announced positive countervailing and anti-dumping findings against the exports of a number of Community steel producers, including BSC.

If the US steel cases run their full course, BSC faces countervailing duties of 20.33% (announced on 25 August in the Department of Commerce's final determination) and anti-dumping duties of 7.48-18.8%, depending on the product (preliminary determination, announced on 10 August). The Department of Commerce will be announcing their final anti-dumping determination on 25 October. The private sector has emerged fairly unscathed, but would suffer indirectly from the imposition of duties as a result of the likely disruption of the EC market that would follow virtual closure of the US market to major European exporters. The French, Belgiams and Italians face large countervailing duties; and they and the Germans face anti-dumping duties.

The Commission and US Department of Commerce reached agreement on 6 August on a deal under which the EC would restrain its exports of 11 carbon and stainless steel products to 5.75% of the US market by means of export licensing, from 1 October 1982 to 31 December 1985, in return for which the US industry would withdraw its complaints. It is not yet clear whether the US industry will accept this arrangement. They have made excessive and unacceptable counter-proposals, in terms of reductions in the market shares of EC exports and greater product coverage. There is no disposition within the EC to return to the negotiating table on this basis; the Community is putting the ball firmly back into the US court. The US side have also made it clear that their acceptance of the deal depends on some kind of assurances being worked out on pipes and tubes. Fact-finding talks with the US will take place on 7/8 September.

BRITISH STEEL CORPORATION

Faced with a declining market the BSC has been forced to restructure substantial amounts of steelmaking capacity. Manned capacity has fallen from 21½ million tonnes in 1979 to 14.4 million tonnes in 1981. As you will see from the table below since March 1979 a total of 82,300 jobs have been shed. As a result productivity throughout the Corporation has improved considerably and some of the major plants now operate at best European (ie German) standards of efficiency.

The Corporation's new Plan for 1982-85 envisages a modest increase in man capacity to 15.3 million tonnes per annum with retention of the existing plant configuration (5 major works plus Sheffield) and a slimming of the workforce to about 88,000 in 1984/85 through general productivity demanning. The target set for the Corporation - to achieve break-even in 1982/83 and to achieve increasing profits after interest in subsequent years - are regarded as realistic provided that there are no serious disruptions to the steel market.

Financial Year:	1975/6	1976/7	1977/8	1978/9	1979/80	1980/1	1981/2
Liquid steel production (m tonnes)	17.2	19.7	17.4	17.3	14.1	11.9	14.0
Number of employees in UK at end of period '000s	210.2	207.9	196.9	186.0	166.4	120.9	103.7
Number of jobs lost since previous year '000s	18.1	2.3	11.0	10.9	19.6	45.5	17.2

Since March 1979, when employment in the Corporation stood at 186,000, a total of 82,300 jobs have been shed - over 44% of the March 1979 workforce.

Employment now stands at only 49% of the March 1976 figure. 106,500 jobs have been shed since March 1976

Employment at the beginning of the period (ie at end March 1975) was 228.3. So since March 1975, 124,600 jobs have been shed. Employment at March 1982 was 45% of the March 1975 level.

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EC/US STEEL.

SUMMARY.
1. THE COUNCIL EXPRESSED REGRET AT US FAILURE TO GIVE A CLEAR SIGNAL ON THE AUGUST AGREEMENT BUT REAFFIRMED EC'S INTENTION TO IMPLEMENT THE ARRANGEMENTS THECOMMISSION AUTHORISED TO CONTINUE TO EXPLORE THE GROUND ON PIPE AND TUBE. A FURTHER COUNCIL WILL PROBABLY BE NEEDED IN EARLY OCTOBER AGAINST A NEW DEADLINE OF 15 OCTOBER.

DETAIL.
2. DAVIGNON REPORTED ON HIS VISIT TO THE USA (HAVING COME STRAIGHT FROM THE AIRPORT). THE ONLY CONCRETE DEVELOPMENT WAS A POSTPONEMENT OF THE DATE OF THE ITC VOTE, SO THAT 15 OCTOBER WAS NOW THE NEW DEAD-LINE. THE US ADMINISTRATION WAS STILL TRYING HARD TO PERSUADE US INDUSTRY TO WITHDRAW ITS CASES. THE ALTERNATIVE OF FIXING QUOTAS UNILATERALLY WAS NOT ACCEPTABLE AS IT IMPLIED EC ACCEPTANCE THAT ITS EXPORTS WERE IN BREACH OF THE GATT. IN ANY CASE QUOTAS WOULD NEED TO BE RELATIVELY SEVERE TO SECURE US INDUSTRY COOPERATION. THE COUNCIL SHOULD THEREFORE SEND A MESSAGE THAT NO PROBLEMS REMAINED ON THE EC SIDE TO PREVENT IMPLEMENTATION. IT WAS ESSENTIAL TO AVOID GIVING US INDUSTRY ANY IMPRESSION THAT BY HOLDING OUT THEY WOULD GET MUCH MORE.

3. ON BURDEN-SHARING, THE COMMISSION INTENDED TO MAKE NO FINAL RECOMMENDATION UNTIL AFTER THE US HAD INDICATED ACCEPTANCE OF THE AGREEMENT. TECHNICAL PROBLEMS IN CONNECTION WITH A COMMUNITY RESERVE AND THE ENTITLEMENT OF TRADERS TO RECEIVE LICENCES NEEDED TO BE CLEARED UP. HOWEVER, PIPES AND TUBES WAS THE MAJOR ISSUE. THE US NOW UNDERSTOOD THAT THERE WOULD BE NO FURTHER PROGRESS UNTIL THE POSITION ON THE MAIN AGREEMENT HAD BEEN CLARIFIED. EQUALLY, THE /COUNCIL

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COUNCIL HAD TO RECOGNISE THAT THERE WOULD BE NO SETTLEMENT WITHOUT A COMMITMENT IN PIPES AND TUBES COMPARABLE TO THE ONE ON BULK STEEL. THERE WAS NEARLY A YEAR'S STOCK OF PIPES AND TUBES ON THE US MARKET, SO A MAJOR REDUCTION IN EC EXPORTS WAS INEVITABLE. THE PROBLEM WAS HOW TO TRANSLATE THIS INT A FORM ACCEPTABLE TO THE US. SUBJECT TO OUR AVOIDING ANTI-TRUST VIOLATION, THE US WERE NOT INSISTING ON ANY PARTICULAR MECHANISM.

4. DIK (NETHERLANDS) MAINTAINED THE DUTCH RESERVATION ON INCLUDING TIN-PLATE. DAVIGNON SHARPLY OBSERVED THAT HTIS AMOUNTED TO REJECTION OF THE AGREEMENT BUT DIK SAID THAT HE WAS ONLY CONCERNED TO SEE THAT DUTCH INTERESTS WERE PROPERLY LOOKED AFTER IN THE BURDEN SHARING EXERCISE.

5. FOR THE UK, YOU EXPRESSED DISAPPOINTMENT AT THE FAILURE OF THE US TO BRING THE AGREEMENT INTO EFFECT ON THE DUE DATE. THE COMMUNITY WAS NOT TO BLAME FOR THE SITUATION. DAVIGNON SHOULD BE AUTHORISED TO NEGOTIATE ON PIPES AND TUBES.

6. CHANDERNAGOR (FRANCE) AND COLOMBO (ITALY) AGREED TO INCLUDING PIPES AND TUBES BUT STRESSED THE IMPORTANCE OF NOT WEAKENING ON THE TERMS ALREADY NEGOTIATED. VAFIS (GREECE) SAID THAT GREECE EXPORTED A TYPE OF TUBE WHICH WAS NOT AVAILABLE FROM STOCKS IN THE USA. DAVIGNON AGREED. TINDEMANS (BELGIUM) WELCOMED THE DISCUSSION AND SAID THAT IT WOULD BE FATAL TO GIVE ANY HINT THAT THE EC WAS PREPARED TO MAKE FURTHER CONCESSIONS ON THE AUGUST AGREEMENT.

7. CORTERIER (FRG) SAID THAT HE COULD NOT ACCEPT THAT THE COMMISSION SHOULD BE GIVEN A MANDATE TO NEGOTIATE ON PIPES AND TUBES. WITHOUT A CLEAR REACTION FROM US INDUSTRY ON THE EXISTING DEAL, THE EC WOULD BE BUYING A PIG IN A POKE. THE ISSUE OF LICENCES FOR TRADERS WAS VERY IMPORTANT, BECAUSE OF TRADITIONAL FRG PATTERNS OF TRADE. AT YOUR REQUEST DAVIGNON MADE IT CLEAR THAT FURTHER EXPLORATORY TALKS WOULD BE CONFINED TO PIPES AND TUBES AND THE EC INDUSTRY WOULD BE CLOSELY CONSULTED. THE TRADERS ISSUE COULD BE DEALT WITH BY GETTING THEM TO OBTAIN LICENCES FROM THE PRODUCERS. IF GERMAN TRADERS COULD GET LICENCES DIRECT, THIS WOULD INTRODUCE AN ELEMENT OF INSECURITY INTO THE SYSTEM, SINCE THE STEEL COULD COME FROM ANY MEMBER STATE. CORTERIER INSISTED THAT THE EC SHOULD NOT BUY AGREEMENT BY OFFERING A VRA ON PIPES AND TUBES AS THESE CAUSED NO PROBLEMS FOR US INDUSTPY. THE FRG HAD NEVER AGREED TO THE REFERENCE TO THIS SECTOR IN THE AUGUST LETTER TO THE USA. DAVIGNON RETORTED THAT AN AGREEMENT WAS NECESSARY TO AVOID SECTION 3Ø1 ACTION.

IMPLEMENTATION BY 15 OCTOBER. THE COUNCIL ALSO NOTED THAT THE COMMISSION WOULD CONTINUE EXPLORATORY TALKS ON PIPE AND TUBE.

9. DAVIGNON TOLD THE MINISTER FOR TRADE OVER LUNCH THAT HIS MAIN CONCERN HAD BEEN TO GET A GENERAL ENDORSEMENT FROM THE COUNCIL FOR THE AGREEMENT AND FOR FURTHER DISCUSSIONS ON PIPES AND TUBES. HE WOULD BE TELEPHONING BALDRIDGE TONIGHT TO TELL HIM THAT THE COUNCIL'S ATTITUDE WAS POSITIVE. HE EXPECTED BALDRIDGE THEN TO FORMULATE PROPOSALS (BY IMPLICATION FOR AMENDMENTS TO THE 6 AUGUST AGREEMENT), BUT INSISTED THAT THE COMMISSION WOULD NOT RECOMMEND MORE THAN COSMETIC CHANGES. ONCE THE US PROPOSALS WERE RECEIVED HE (DAVIGNON) WOULD CONSULT CAPITALS. IN REPLY TO A QUESTION FROM MR REES, DAVIGNON SAID HE EXPECTED CONTINUING DIFFICULTIES WITH THE GERMANS (OPSSIBLY MUCH GREATER AFTER A CHANGE OF GOVERNMENT) BUT DID NOT THINK THAT THIS WOULD IN THE END BLOCK AN AGREEMENT.

FCO ADVANCE TO :-

FCO - EVANS BULLARD HANNAY THOMAS CROWE BROOMFIELD
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