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PART A

Part A.

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Chancellor's (Lawson) Papers:
Paris Economic Summit, February 1989.

DD's: 25 Years

Andrew

12/4/96.

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| CH/EXCHEQUER | |
| REC. | 17 FEB 1989 |
| ACTION | MR MELLISS ✓ 17/2 |
| COPIES TO | EST |
| | SER P MEDDLETON |
| | SER T BURNS |
| | MR WICKS |
| | MR LAWRESTER |
| | MR EVANS |
| | MR RIG ALLEN |
| | MR EDMONDS, MR TYRIE |

FROM: N L WICKS

DATE: 17 FEBRUARY 1989

PRIME MINISTER

PARIS ECONOMIC SUMMIT

The Sherpas are meeting in France on Saturday 25 and Sunday 26 February for their first full meeting to prepare for the Paris Summit. I should be grateful for your guidance on the line to take in the discussion.

2. A Sherpa discussion so long before the Summit is more justified this year. It provides an opportunity:

- to introduce the new US Sherpa (probably Richard McCormack) to the Summit arrangements; and

- to stress yet again to Attali that the Summit is an occasion for serious business, not a side show of the Revolutionary celebrations.

This year, of all years, we need to be on our guard for the perennial French hankering after the extravagant and spectacular gesture.

Agenda for Paris Summit

3. The three important international economic meetings before the Summit - Bank/Fund Spring meetings (3/4 April), GATT Trade Negotiating Committee (3 April) and the OECD Ministerial Council (31 May/1 June) - will help set the scene for the Summit.

4. At this Sherpa meeting I propose to say that the agenda for the Summit was effectively set in the Toronto Communique - rolling forward into this third Summit cycle the policies which brought success in the second, essentially:

- eradication of inflation and of inflationary expectations;
- concentration on a medium-term framework for the development and implementation of economic policies;
- improving efficiency and adaptability of economies through greater reliance on competitive forces and structural reform;
- resisting protectionism and strengthening the multilateral trading system;
- dealing with the world agricultural problem;
- continuing the strategy to address the challenge of development and tackling the burden of debt;
- increased commitment to international co-operation and an intensification of the process of international policy co-ordination through G7 etc.

5. I will suggest that the main business of the Summit should be:

(i) to examine developments under these headings during the last year; and

(ii) to agree on the action needed to carry the policies through in the years ahead.

Not the stuff for exciting Communiques - but undoubtedly the basis for sound economic policy making!

Prospects for the World Economy

6. The performance of the world economy in 1988 further demonstrated the value of applying in the G7 countries the economic policies endorsed at recent Summits; 1988 saw a high level of economic growth, sustained by strong investment with

moderate inflation in view of the high level of activity. For 1989, the outlook for growth is still promising, and there is a reasonable prospect that inflation can be contained provided that the G7 countries maintain appropriate monetary policies. But after some progress in 1988 in reducing, as a percentage of GNP, the US trade deficit and the Japanese, but not the German, surplus, it seems that the adjustment has now slowed down, if not halted. My US and French colleagues may argue that this pause in the adjustment process will cause difficulties for the world economy, such as protectionism - in reaction to the US trade deficit - or a collapse of the dollar - if there are difficulties in financing the US deficit. These fears are overdone: the Bush Administration's task in resisting protectionism should be easier than the Reagan Administration's in view of the US's higher levels of capacity utilisation. Nevertheless, the US may still press for economic stimulation in Germany and Japan by relaxing fiscal and monetary policy.

7. Regarding the German trade surpluses, I propose to be guided by the approach suggested in the letter of today from the Chancellor of the Exchequer's Private Secretary and concentrate on the need for structural reform. I believe a similar approach is appropriate for Japan. Both Kohl and Takeshita have domestic preoccupations and the Summit should provide an important opportunity to remind them not to let structural reforms slip off their political agendas. For the Germans, this means carrying forward deregulation of financial services, agriculture, and air and road transport and the reduction of industrial subsidies (particularly coal and steel). We should emphasise that such reforms will benefit the German economy generally and raise its level of growth from which its trading partners will benefit. For the Japanese, structural reform should focus particularly on the taxation and holding of land, agriculture, the distribution system and air transport. As for the US, the emphasis here should be on the need to reduce their budget deficit, not so much because of any possible improvement for their trade deficit, but because of the benefits to the US economy from reducing the share of the nation's savings pre-empted by the government sector.

8. I shall not support calls for fiscal or monetary stimulation in Germany and Japan and will caution against alarmist talk about the consequences of the slow down in the adjustment of trade flows as follows:

- adjustment of the trade flows is likely to take longer than originally expected;

- in the meantime current account surpluses and deficits ought to be financeable so long as the markets are convinced that progress has not gone into reverse and the G7 countries continue to follow the right economic policies, namely

a. monetary policies which bear down on inflation, with a view to eliminating it completely;

b. fiscal policies which provide for stability in the medium term, with a view to eliminating structural deficits so that government does not appropriate private savings;

c. structural policies to improve the efficiency of economics.

- Above all, G7 countries should avoid giving the impression to the markets that they are in disagreement about economic policies.

Other Economic issues

9. Trade and agriculture have been important topics at the past few Summits, and you will, I am sure, want this to continue. There will have been the important meeting of the Trade Negotiating Committee in April before this Summit. But regardless of how the Uruguay round negotiations are going in July, there will be scope for a message from G7 heads of government to the GATT negotiators. A structural problem common to Germany, the US and Japan, and the other Summit participants, is agriculture and you will, no doubt, wish to use the Summit to sustain the pressure

for agricultural reform. Indeed, it might be right for us to push trade and agriculture - where the French are on the defensive - to the forefront of the Summit discussions both because of the two issues' own importance and as a tactic to head off unwelcome French ambitions eg on debt. The Summit will provide a good opportunity, too, to reinforce our message that 1992 will not bring a Fortress Europe. There will also need to be some reference to dialogue with the NIEs.

10. Debt is likely to loom large at the Summit. The French have their unsatisfactory Mitterand plan already on the table. They will want to work for a Summit debt initiative or, failing that, a strong impulse to the Annual World Bank/Fund meetings in the autumn. The Japanese, too, have a "plan" and the US may produce their own initiative.

11. These ideas will be discussed by G7 Finance Ministers at the Spring Meetings. Discussion is increasingly focusing on encouraging market based debt reduction by the middle-income countries in ways which:

- encourage sustained adjustment by debtors;
- arrest the transfer from banks to the public sectors (particularly export credit agencies and also international financial institutions) of the financing burden of debtor countries; and
- preserve the proper roles of the World Bank and the Fund.

We should be able to support sensible ideas which emerge as a contribution to the evolution of the debt strategy within the principles already agreed. A key criteria for us will be that new proposals do not, unlike the Mitterand plan, transfer risk for debtor countries' debt from the private (mainly banking) sector to the public sector.

12. The French will no doubt have other development initiatives in mind - perhaps a further initiative on African debt; certainly

raising the profile of the 0.7 GNP aid commitment; and possibly their costly proposal to control flooding in Bangladesh. We will need to be ready to head off extravagant French initiatives in this area.

13. The growing interest in Eastern Bloc economic reform and the parallel debate on the proper Western response could make for useful discussion at the Summit, probably in the informal sessions rather than in the plenary. There are limits to what the West can do, or should do, to help economic reform in the Soviet Block. The Germans may want to be generous with loans; the Americans, under the eyes of Congress are inclined to caution.

The Environment

14. The environment, especially climatic change, will be a key issue. We need a "game plan" for the approach to the Summit if we are to secure our position that action should be pursued within the existing UN framework rather than by establishing new organisations. With that objective in mind, I attach at Appendix A a note, co-ordinated by the FCO, describing how we might approach the Summit. If you agree with the note, I will speak at the Sherpas' meeting on the lines of paragraphs 6-8 of the note. As you have already said, the economics of global climatic change is an important element here and a note, co-ordinated by the DOE, on the main issues is attached at Appendix B to this note. Its main message is that just as there needs to be international understanding of the science underlying the global climatic change, so there needs to be understanding of the economic issues as well. That understanding of the economics does not exist at the moment: we need to create it. If you agree, I propose to circulate a version of this note for the meeting of Sherpas in April.

15. I should be glad to know whether you are content with the approach regarding the environment.

Economic Priorities

16. So to summarise it looks, as of now, that our priorities for Paris should include:

(i) securing endorsement of the "second Summit cycle" economic policies and agreement to their continuation in the period ahead;

(ii) persuading the Germans and the Japanese to translate talk into action on structural reform;

(iii) keeping up the pressure on the US to take credible and consistent action to reduce its fiscal deficit, both this year and, even more difficult, in 1991 and beyond;

(iv) taking an active part of environmental issues and channelling initiatives into productive directions;

(v) preventing the French turning their Summit into a development spectacular;

(vi) possibly working for an informal discussion between heads of government on East/West economic issues.?

Priorities for debt and for trade and agriculture will only emerge later, though we certainly will want to ensure that pressure for reform in these last two areas is maintained. (An indication of other countries' likely priorities is in Appendix C.)

Foreign Policy Issues

17. It is much too soon to be sure which foreign policy issues will be most on Summit leaders' minds in July. Clearly, there should be a good discussion of East/West diplomacy following Gorbachev's visits to Europe, the likely NATO Summit, negotiations on the conventional forces in Europe and the various US/Soviet contacts. The Summit will also offer a useful forum to set out Western policy on the Middle East peace process. There may be further progress to report on the settlement of regional

conflicts. It has become a tradition, which you will no doubt want to continue, for Summit 7 leaders to discuss terrorism. We need to ensure that the strengthening of international co-operation to combat the drugs trade remains on the Summit agenda, a wish which it looks as if President Mitterand shares from his recent letter to you. So my line on political issues in the Sherpas' discussion would be that:

(i) events nearer the time will dictate the foreign policy agenda; but

(ii) I would expect heads of government to want to review foreign policy issues of major importance such as East/West relations and the Middle East peace process;

(iii) we attach importance to Summit 7 endorsement of post-Lockerbie measures against terrorism;

(iv) drugs remains an area where continued international co-operation is vital;

(v) foreign policy hobby-horses of individual countries of only marginal collective interest should be excluded from the agenda.

18. I should be glad to know whether you agree that I should take the approach above in the forthcoming Sherpa discussions.

19. I am sending a copy of this minute to the Foreign & Commonwealth Secretary, the Chancellor of the Exchequer and to Sir Robin Butler.

N. L. W.

N L WICKS

ENVIRONMENT: GAME PLAN FOR THE 1989 ECONOMIC SUMMIT

1. A number of serious environmental challenges face the international community. Various countries have proposed or are considering initiatives on the environment, both at the national and international level (see Annex A). In view of the global nature of these matters, HMG considers that action can best be pursued through existing organisations within the UN framework. The Paris Economic Summit could be used to give impulse to this approach.

2. Objectives for the Paris Summit

- a) Summit should concentrate on worldwide environmental issues requiring international action, notably climate change, avoiding regional issues;
- b) Summit participants should have a serious and well prepared debate on the economic aspects of dealing with climate change;
- c) Summit should stimulate work in existing organisations suitably strengthened, not create new ones.

This approach should be advanced, as necessary, to counter more ambitious French ideas for a new supra-national body with powers to improve sanctions on countries who fail to observe environmental standards and to pay 'compensation' to those that have difficulty in meeting them.

3. Arguments in support of objectives

The following arguments could be developed at the Sherpas' meeting on 24-26 February:

- i) Essential that action be taken internationally, not by individual countries. Climate change is a truly global problem.
- ii) First step will be to secure a common understanding of the problems involved, and to pursue them on the basis of

shared research. We are already a considerable way down that road, but it will be some time (years rather than months) before full scientific results are available.

iii) Priorities for action should be:

- a) To establish general principles and urge all countries to conform to them.
- b) To reinforce those principles by a set of global targets, allocated among countries.

At the present stage of scientific research it might not be possible to specify the targets. But a general framework should be agreed, possibly in the form of a new UN Convention. Separate protocols would be concluded, containing precise targets, when the scientific evidence is available on which such targets could be based.

- iv) Further work is needed to outline measures which are economically viable and socially and politically acceptable to respond to the scientific findings and to ensure that the targets are actually met. Market based measures to be preferred to a regulatory approach (see para 6 below).
- v) Special factors apply to developing countries. Proposals from developed countries should be consistent with the concept of sustainable development. We should encourage the LDCs to: take action to help preserve their own environmental resources, eg conserve their forests; and to invest in energy saving technology. Developed countries would have to recognise that there could be substantial resource costs in achieving the active support and co-operation of the LDCs.
- vi) No need for new international institutions. Problems should be dealt with within existing organisations such as UNEP, which should be strengthened as necessary. Since

world-wide coverage is required, the UN system is the obvious focus for action - any new institutions would simply duplicate existing bodies (see Annex A).

4. Attitude of G7 partners

The French Prime Minister, Rocard, will table his proposals at a meeting of Heads of Government on 11 March. The French claim to be supported by the Germans. They have also approached the UK, Japan, and Canada, all of whom are hesitant about Rocard's plan. They have not approached the US or the European Commission or Italy.

5. We could expect the UK approach to be endorsed by the US. Our stress on economic measures could have some appeal to the Germans. The Canadians are already working on a Convention on the protection of the atmosphere. But all G7 partners will have to consider their approach to the Rocard Plan.

6. Next Steps

At the February Sherpas' meeting Mr Wicks, in support of the arguments proposed in paragraph 3 above, might promise a UK paper on the economics of environmental protection to stimulate discussion at the third meeting of Personal Representatives, on 7-9 April. (Tactically, it would be too early to table this in February; it would be better to seek general backing for our approach first.) The Department of the Environment, in consultation with other Departments, have provided a draft (Appendix B); it draws on the paper submitted as Annex I to the Cabinet Office note on climate change.

7. Mr Wicks could draw on Annex A, in order to underline the work in progress in existing organisations. He could, if appropriate, circulate to sherpas a note on these lines. But we will not be ready to discuss our wider ideas.

8. In addition to securing a statement on the environment in the Summit declaration (recording the results of the leaders' discussions, giving a strong stimulus to work within the UN, and

possibly referring to the drawing up of a Convention on Global Climate, the Summit could also stimulate further work in the OECD and the World Bank; these bodies could concentrate on the economic policy options for developed and developing countries consistent with effective and realistic action on these global environmental problems.

ECONOMIC RELATIONS DEPARTMENT
February 1989

ANNEX A

EXISTING ENVIRONMENTAL BODIES/INITIATIVES

I Organisations within the UN Framework

Vienna Convention on the Protection of the Ozone Layer: first meeting of contracting parties. This is an umbrella convention: no particular initiative envisaged/needed.

Helsinki, April 1988

Montreal Protocol: first meeting of contracting parties. This meeting will start the ball rolling on the review process and one of the purposes of the UK Conference on Saving the Ozone Layer is to give political impetus to this process. It will be completed at the London review meeting (see below) in 1990. We have already called for a speedier implementation of the Montreal undertakings: this will be pursued particularly in the EC framework, but the main difficulties will arise in persuading the developing countries to adopt tougher restrictions.

Helsinki, May 1989

UNEP: 15th (biannual) Governing Council. Regular event: massive agenda covering all UNEP's work programme. The Executive Director is likely to call for increased national contributions: we should be able to respond with increased support.

Nairobi,
15-26 May 1989

Inter-Governmental Panel on Climate Change. Second meeting. This joint WMO/UNEP body was set up in November 1988, and the UNGA called for a report in early 1990. The Geneva meeting will review progress to date in the three working groups. It is in the context of the Panel's eventual report that we shall be considering a possible convention on global climate.

Geneva,
June/July 1989

Second World Climate Conference: this will consider the report of the Inter-Governmental Panel.

mid/late 1990

Montreal Protocol: second meeting of contracting parties. This meeting will review the Protocol, following the first meeting in Helsinki (see above).

London, April 1990

UN Conference on the Environment and Development.

1992

This Conference will mark the 20th Anniversary of the 1972 Stockholm Conference on the Human Environment,

/which

which established UNEP. The agenda, date and venue have yet to be determined: the Executive Director of UNEP has been charged with producing a report for the UNGA this year.

UN General Assembly.

More form will need to be given to the 20th Anniversary Conference, and there will be pressure, before the Report of the Inter-Governmental Panel, for action on climate change.

September/December
1989

II Other International Fora

CHOGM.

The Commonwealth Secretariat envisage a Declaration on the Environment. Interdepartmental discussion is proceeding on the best way of focussing this.

Kuala Lumpur,
18-24 October 1989

III National Initiatives

UK Conference on Saving the Ozone Layer.

5-7 March 1989

French inspired meeting of Heads of Government to launch the Rocard initiative with a Declaration on the Environment.

The Hague,
11 March 1989

UK Ministerial Seminar on Climate Change.

April 1989

Japanese Conference on global environmental issues (climate change, tropical forests, pollution in developing countries).

Tokyo,
11-13 September 19

Dutch Ministerial Conference on Climate Change.

Not known

Finnish Conference on Environmental Protection of the Arctic.

Not known

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PARIS ECONOMIC SUMMIT: ECONOMIC ASPECTS OF THE ENVIRONMENT

The Problem

1. Environment now a major policy issue. Global issues particularly to the fore. UK favours pragmatic approach based on sound science. But must also have an economic basis to decision-making, since environmental protection incurs costs, uses resources, and entails decisions about priorities.

2. Climate change a classic example. UNEP/WMO already have in hand a research programme to analyse the science, the impacts and the possible responses. Assessments are needed of the implications of adapting to changing climate, of making changes where adapting is not possible and of preventing emissions of greenhouse gases. There are diverse sources of greenhouse gases and a variety of options, with different cost implications, for controlling production and build-up of those gases.

3. UK strongly supports the present scientific approach. But it lacks an economic dimension, which would enable us to cost options, to analyse the benefits of those options in order to produce an order of priorities, to test the sustainability of those options in terms of resource use, and to assess the optimal timing of response measures. Such an approach would enable the world community to make well-informed decisions about:-

a. The trade-off between the acceptable amount of climate warming, and the feasible/economic degree of emission reduction to be achieved.

b. The allocation of emission reductions between different gases, and different countries.

c. The timing of remedial measures.

Major Economic Issues

4. The big issues to be tackled in terms of the economics of climate change include:-

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- a. The extent to which market mechanisms (realistic fuel pricing, carbon taxes and levies, trading in emission permits, charges, and other financial instruments) can be used to achieve environmental objectives in combination with regulation. We need to develop ways and means of working with the grain in economic terms, allowing sufficient flexibility for the market to play its part in finding least cost solutions to environmental problems.
 - b. How to avoid some countries becoming free-riders, and living off other people's virtuous actions.
 - c. The extent of possible losses of competitiveness for those who act virtuously, and how to avoid them.
 - d. How to square the circle between global environmental interests, and an individual country's national economic interest (eg the UK as a large coal burner would find difficulty in complying with any likely global carbon reduction target that a world climate convention might arrive at).
 - e. Whether, and if so how, to use aid mechanisms (bilateral and multi-lateral) and other financial inducements (debt?) to transfer resources to developing countries both for remedial measures (eg forestry) and to encourage environmentally desirable action (eg phasing out CFCs).
 - f. How to achieve the optimal timing of adaptation measures and of arrangements to prevent emissions. This would substantially affect the level of costs incurred by the UK and other countries.
5. The use of the market (item 4(a) above) is particularly important. Price signals need to reflect environmental considerations in order to achieve optimal decisions. At present market mechanisms are probably under-used in environmental protection, and we need to develop ideas about their level and timing. But they cannot be the whole answer. Property rights (see

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paragraph 6(f) below) on which this depends are more difficult to establish at the international than the national level. The free-rider problem (item 4(b)) requires special attention to incentives and probably a degree of regulation to achieve international fairness, and the centrally planned economies are less amenable to market pressures. Getting the right balance between market and regulation is crucial.

Methodological Issues

6. Climate change presents conventional economics with a number of problems involving data, technical methods and incentives:-

a. The data is poor, especially when split down to regional or local level. Uncertainty is high. It will take years before matters are improved. So both costs and benefits are difficult to assess accurately.

b. The impacts are distant and uncertain, but very probably irreversible.

c. What is the appropriate precautionary response when dealing with high degrees of uncertainty combined with a possibly catastrophic outcome?

d. The effects are international, and intergenerational. How do we value our children's continued well-being? What do we mean in practice by the Brundtland concept of "sustainable development"?

e. There are many non-quantifiable aspects - including, at present, how to take account of consumption of natural resources.

f. Underlying the economics of the environment is the concept of property rights (to air, for example) and how to allocate them internationally. Can rights to discharge pollutants, for example, be traded between countries and if so how? What is clear is that international externalities require international action.

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7. Techniques such as cost-benefit analysis, discount rates, resource accounting etc need refining for tackling issues having these characteristics. The challenge that faces us is how to develop and present these techniques, on a multi-disciplinary basis, in order to aid the decision-making process.

Diagnosis

8. Need to set analytical work in hand, alongside scientific work, to refine data and analytical methods, so guiding the choice of policies. This should be done well before the deliberations get underway and decisions are due. Several disciplines involved. The centrally planned economies would have particular difficulty in accepting a market-based approach but may appreciate the need for improved incentives. Also we need to reflect the different viewpoints of developed and developing worlds. All this suggests that OECD and the World Bank, both of whom are already working in this area, might be the right agents. But the work should be fed into the UN so that the science and the economics develop together. UNEP are currently not strong on economics, but should perhaps be encouraged to increase their interest in this direction.

9. The ultimate objective is to incorporate the environmental dimension appropriately and quantitatively into everybody's economic decision-taking.

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ANNEX: ECONOMIC ISSUES: POSITIONS OF OTHER G7 COUNTRIES

- France - Wants to give prominence to debt (particularly middle-income) and environment issues, and to give a general developmental flavour to their Summit (eg flood prevention in Bangladesh). Could be difficult on agriculture.
- US - Likely to urge the Germans and Japanese to take macroeconomic action to stimulate their economies. On debt, hostile to transfer of risk, but anxious to do something for Latin America. Could raise 1992, regionalism etc, and will press EC countries to move on agriculture. Position on its twin deficits not yet fully developed.
- Japan - Can point to reduction of its current account surplus as a % of GDP. Keen to take a high profile on debt issues as part of their bid for position in the IFIs. Showing interest in environment. Likely to want to secure further reference to their Human Frontier Science Programme. Could raise 1992 etc. Cautious on agriculture.
- FRG - Defensive on its current account surplus. Control of inflation clear domestic priority. Likely to be sceptical of new initiatives on debt. Traditional concern with environment. Inflexible on agriculture.
- Canada - Similar scepticism on debt. Indications new government may give environment increased attention, particularly in context of World Bank. Strong interest in moving Uruguay Round negotiations forward, especially agriculture.
- Italy - Raised environment issues at last minute before Toronto. Concern about FRG surpluses.

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

20 February, 1989.

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| CH/EXCHEQUER | |
| REC. | 20 FEB 1989 |
| ACTION | Mr. MELLISS |
| COPIES TO | EST, Sir P. MIDDLETON, Sir T. BURNS, Mr WICKS, Mr LANKESTER, Mr H. PEVANS, Mr R. J. G. ALLEN, Mr EDMONDS, Mr TYRRE. |

✓ 20/2

Dear Nigel,

PARIS ECONOMIC SUMMIT

The Prime Minister has gone through your minute of 17 February, in which you seek guidance on the line to take at the Sherpas' meeting on 25/26 February to prepare for the Paris Economic Summit. She is in general well content with what you propose, in particular paragraphs 16 and 17. She also agrees that you should offer to circulate the paper on the Economic Aspects of the Environment at a future meeting.

The Prime Minister has made a number of detailed comments which you will want to take into account:

- on paragraph 4 of your minute, describing the agenda set by the Toronto Economic Summit, she has suggestions on the last two tirets. On debt, she suggests "continuing the existing strategy". And on international policy coordination, she suggests rephrasing to read: "increased commitment to international cooperation on sound economic and monetary policies". This is to avoid any ambiguity about the subjects for cooperation.

- on paragraph 7, the Prime Minister has asked whether we have any figures for comparative industrial subsidies in EC countries.

- on the note entitled: Environment - Game Plan for the 1989 Economic Summit, the Prime Minister has commented in relation to paragraph 3(iii) that we should take action now where the need is plain already. She has also asked whether we could not produce the first draft of a new UN Convention.

- on paragraph 3(v), the Prime Minister has never liked the phrase 'sustainable development'. She thinks we should talk about progressive development which maintains balance in the world's systems.

- she agrees that it is best to delay circulating the paper on the Economics of Environmental Pollution until

the April meeting. Otherwise there is a risk that it will be hijacked by others.

I am copying this letter to the Private Secretaries to the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, and Sir Robin Butler.

*Yours sincerely,
C.D. Powell*

C.D. Powell

N.L. Wicks, Esq., C.V.O., C.B.E.
HM Treasury.

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| CH/EXCHEQUER | |
| REC. | 213 21 MAR 1989 |
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FROM: N L WICKS
DATE: 21 MARCH 1989

PRIME MINISTER

On balance, I agree with Mr. Wick's comments re para 9.

PARIS ECONOMIC SUMMIT

Attali has insisted on calling a further Sherpa meeting for the weekend of 7-9 April. He wants his Summit preparations to take account of the outcome of the Spring IMF/World Bank Meetings in Washington and of the Trade Negotiating Committee's discussion on agriculture and trade in Geneva. Sherpas will also consider the Summit discussion of the environment following the London and The Hague conferences. I will generally be guided by the line in my minute of 17 February subject to your comments conveyed in Charles Powell's letter of 20 February. But you may wish to have this brief update on the main subjects likely to arise at the Sherpa meeting. There is a small point on Summit organisation on which I seek your views in paragraph 9.

World Economic Prospects, Debt, Trade etc

2. Since the Sherpas met in February, the world economy has shown further signs of strong growth and there are more indications in some countries of inflationary pressures. There is increasing evidence, too, that the adjustment of the trade imbalances has stalled and signs that the US Budget deficit negotiations have run into, not unexpected, heavy weather. The French may try to argue that these developments support the case for some international economic/monetary initiative. They may possibly have some support from the US. Our line, which is likely to be supported by the Canadians, Germans and Japanese will be to stress the importance of controlling inflation and of sound monetary and fiscal policies and for continued structural reform.

3. The Sherpas will also consider the Interim Committee's discussion of US Secretary Brady's proposals on middle income debt. We are unlikely to want to go beyond what is agreed in the Interim Committee.

4. Progress on the Uruguay Round depends crucially on agriculture, which will be the main topic for discussion at the TNC in Geneva. If agriculture falls into place, it may be possible to unblock the three unresolved issues (intellectual property, textiles and safeguards) and confirm agreements provisionally reached in Montreal. This should provide a fruitful background for the Summit to urge for early and far reaching action in the rest of the Round. But if the TNC in Geneva fails, and progress is still blocked in July, the Summit may have a role in unblocking the negotiations.

Environment

5. The Summit discussion of environment ought to be a good deal clearer after this Sherpa meeting. The conferences in London and The Hague have taken place. I have circulated the UK paper on the Economics of Environmental Protection (a copy of which is attached). The IAEA Secretary General has sent a paper on "Responses to Global Warming" as a subject for the Paris Summit to most G7 Energy Ministries. It stresses the environmental advantages of nuclear power and suggests that the Paris Summit communique could include words to this effect. I am sure that we should support appropriate wording.

6. The Germans should have more to say about their initiative on a code of conduct for the importers of tropical timber. Tropical timber conservation is likely to be a sensitive issue, particularly in countries like Malaysia, and will need careful handling; we will not want an argument about this with Dr Mahathir at CHOGM. The French may have completed their paper on A Saharan Observatory. The DOE are pursuing the apparent US scepticism, evinced by my US Sherpa colleague, about the scientific evidence of global warming. There is consensus among British scientists that CO₂ emissions are already contributing to higher temperatures.

Money Laundering and Insider Trading

7. Each country should have produced a note for the French on national regulations covering these subjects. This should enable the French to be rather more precise on what President Mitterrand

had in mind in his suggestion for Summit discussion of these issues. Our object remains to steer international co-operation towards the appropriate existing bodies.

Chemical Weapon Precursors

8. At the last Sherpas meeting the Germans raised, rather tentatively, the idea of greater control over CW precursors. They may bring up their ideas more formally this time. I think that we should support the inclusion of a short passage in the Paris Summit communique, to expand on the line you took at Toronto ("We seek the early establishment of a comprehensive, effectively verifiable and truly global ban on chemical weapons").

Summit Organisation

9. Finally, a point about organisation of the Paris Summit. At both Venice and Toronto there were separate sessions for Heads of Government, Foreign and Finance Ministers on the morning of the first full day. At Paris, a plenary session is planned instead. This will significantly reduce the time available for discussion among Finance and Foreign Ministers and preparation of the relevant parts of the Summit declaration.

| | <u>Venice</u> | <u>Toronto</u> | <u>Paris</u> |
|----------------|-----------------------|--|----------------------------------|
| Day of arrival | - | pm: separate sessions | pm: separate sessions |
| First full day | am: separate session | am: separate session/ political declaration/ plenary | am: plenary |
| | pm: plenary | pm: plenary informal session | pm: plenary/ informal session |
| Second day | am: plenary | am: plenary | am: plenary |
| | pm: joint declaration | pm: economic declaration | pm: plenary/joint declaration |

I shall ask Attali whether this change has any significance. It would be helpful to know whether you, or the Foreign Secretary and

the Chancellor of the Exchequer, had views on the arrangements for the morning of the first full day.

10. I am sending a copy of this minute to the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer and to Sir Robin Butler.

N.L.W.

N L WICKS

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PARIS ECONOMIC SUMMIT: ECONOMIC ASPECTS OF THE ENVIRONMENT

The Problem

1. Environment now a major policy issue. Global issues rightly particularly to the fore. UK favours pragmatic approach based on sound science. But must also have an economic basis to decision-making, since environmental protection incurs costs, uses resources, and entails decisions about priorities.

2. Climate change a classic example. UNEP/WMO already have in hand a research programme to analyse the science, the impacts and the possible responses. Assessments are needed of the implications of adapting to changing climate, of making changes where adapting is not possible and of preventing emissions of greenhouse gases. There are diverse sources of greenhouse gases and a variety of options, with different cost implications, for controlling production and build-up of those gases.

3. UK strongly supports the present scientific approach. But it lacks an economic dimension, which would enable us to cost options, to analyse the benefits of those options in order to produce an order of priorities, to test the sustainability of those options in terms of resource use, and to assess the optimal timing of response measures. Such an approach would enable the world community to make well-informed decisions about:-

a. The trade-off between the acceptable amount of climate warming, and the feasible/economic degree of emission reduction to be achieved.

b. The allocation of emission reductions between different gases, and different countries.

c. The timing of remedial measures.

Major Economic Issues

4. The big issues to be tackled in terms of the economics of climate change include:-

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a. The extent to which market mechanisms (realistic fuel pricing, carbon taxes and levies, current subsidies to fuels, trading in emission permits, charges, and other financial instruments) can be used to achieve environmental objectives in combination with regulation. We need to develop ways and means of working with the grain in economic terms, allowing sufficient flexibility for the market to play its part in finding least cost solutions to environmental problems.

b. How to avoid some countries becoming free-riders, and living off other people's virtuous actions.

c. The extent of possible losses of competitiveness for those who act virtuously, and how to avoid them.

d. How to square the circle between global environmental interests, and an individual country's national economic interest.

e. Whether, and if so how, to use aid mechanisms (bilateral and multi-lateral) and other financial inducements (debt?) to transfer resources to developing countries both for remedial measures (eg forestry) and to encourage environmentally desirable action (eg phasing out CFCs).

f. How to achieve the optimal timing of adaptation measures and of arrangements to prevent emissions. This would substantially affect the level of costs incurred by individual countries.

5. The use of the market (item 4(a) above) is particularly important. Price signals need to reflect environmental considerations in order to achieve optimal decisions. At present market mechanisms are probably under-used in environmental protection, and we need to develop ideas about their level and timing. But they cannot be the whole answer. Property rights (see

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paragraph 6(f) below) on which this depends are more difficult to establish at the international than the national level. The free-rider problem (item 4(b)) requires special attention to incentives. The centrally planned economies are less amenable to market pressures. Getting the right balance between market and regulation is crucial.

Methodological Issues

6. Climate change presents conventional economics with a number of problems involving data, technical methods and incentives:-

a. The data is poor, especially when split down to regional or local level. Uncertainty is high. It will take years before matters are improved. So both costs and benefits are difficult to assess accurately.

b. The impacts are distant and uncertain, but very probably irreversible.

c. What is the appropriate precautionary response when dealing with high degrees of uncertainty combined with a possibly catastrophic outcome?

d. The effects are international, and intergenerational. How do we value our children's continued well-being? What do we mean in practice by the Brundtland concept of "sustainable development"?

e. There are many non-quantifiable aspects - including, at present, how to take account of consumption of natural resources.

f. Underlying the economics of the environment is the concept of property rights (to air, for example) and how to allocate them internationally. Can rights to discharge pollutants, for example, be traded between countries and if so how? What is clear is that international externalities require international action.

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7. Techniques such as cost-benefit analysis, discount rates, resource accounting etc need refining for tackling issues having these characteristics. The challenge that faces us is how to develop and present these techniques, on a multi-disciplinary basis, in order to aid the decision-making process.

Diagnosis

8. Need to set analytical work in hand, alongside scientific work, to refine data and analytical methods, so guiding the choice of policies. This should be done well before the deliberations get underway and decisions are due. Several disciplines involved. The centrally planned economies would have particular difficulty in accepting a market-based approach but may appreciate the need for improved incentives. Also we need to reflect the different viewpoints of developed and developing worlds. All this suggests that OECD and the World Bank, both of whom are already working in this area, might be the right agents. But the work should be fed into the UN so that the science and the economics develop together. UNEP are currently not strong on economics, but should perhaps be encouraged to increase their interest in this direction. The European Community might also have a role in working up techniques.

9. The ultimate objective is to incorporate the environmental dimension appropriately and quantitatively into everybody's economic decision-taking.



FROM: J M G TAYLOR

DATE: 22 March 1989

A handwritten signature in dark ink, appearing to be 'PMP'.

MR MELLISS

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Lankester
Mr H P Evans
Mr Ilett
Mr R I G Allen
Mr Kroll
Mr Edmonds
Mr Tyrie

PARIS ECONOMIC SUMMIT

The Chancellor has seen Mr Wicks' minute of 21 March to the Prime Minister.

2. He has commented that he would prefer to retain the original format for the Summit organisation (Mr Wicks' paragraph 9) ie to have separate sessions for Heads of Government, Foreign and Finance Ministers on the morning of the first full day.

A handwritten signature in dark ink, appearing to be 'JMG'.

J M G TAYLOR

cc PFG
EST
S. J. P. N. G. L. L. L.
S. J. T. N. G. L. L. L.
FROM: ALEX GIBBS
DATE: 22 March 1989
and as below

Principal Points Secretary
I think it better for
you to write to

MR WICKS

N. C. U. letter attached

- cc Mr Lankester
- Mr R I G Allen
- Mr Evans
- Mr Melliss
- Mr Edmonds
- Mr Hood
- Mr Tyrie

N. C. U.

30.3

OK content for me
to write as proposed?

COMPARISONS OF INDUSTRIAL SUBSIDIES

Charles Powell's minute of 20 February entitled "Paris Economic Summit" noted that the Prime Minister has asked whether we have any figures for comparative industrial subsidies in EC countries.

2. Mr Melliss discussed the question of international comparisons of subsidies with the OECD recently. It seems that the Secretariat are at the beginning of a project on this which is due for completion in the autumn. They hope to use the results of a questionnaire on industrial subsidies but are not too optimistic; some countries are extremely secretive about their subsidy programmes. The first draft of the EPC report to Ministers on surveillance of structural reform made a plea for greater transparency of subsidies but we have argued that OECD cannot wait for this to happen before they do their work on measurement. Indeed, without pressure in international fora, many countries would be quite happy for their subsidy programmes to remain obscure.

3. There are however some comparative figures, produced by the European Commission in their "First Survey of State Aids in the EC". They are far from perfect: the numbers are not up to date, the most recent data being for 1986, and the coverage is idiosyncratic. The figures are based on a legal definition of "State aids to undertakings" in Articles 92 and 93 of the treaty of Rome which cover subsidies to specific businesses or goods that "threaten to distort competition or affect trade between Member States". The data on measures which satisfy this definition are based in part on information supplied by members (not always checked by reference to countries' own budget

reports), in part on information already available to the Commission, in part on "other official or non-official sources" and in part on Commission estimates discussed bilaterally with Members. There are almost certainly substantial gaps in these numbers and it would be rash to assume that the figures are strictly comparable between countries. The figures do aim to be comprehensive, however, by covering subsidies to industry and agriculture. This is the only study of subsidies which has any claim to comparability, and the trend over time in individual countries should be captured tolerably well.

4. Table 1 shows total subsidies on this definition as a percentage of GDP for the four largest European economies. It shows a substantial reduction for the UK over the period, whilst German subsidies remained broadly constant, the French achieved some reduction in 1986 and the Italians first increased but then reduced subsidies, although not to their 1981 level. The average for the EEC10 over 1981-86 was 3.0%; the UK was comfortably below this level throughout.

Table 1: Total aid as % of GDP 1981-86

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|---------|------|------|------|------|------|------|
| UK | 2.0 | 2.0 | 1.9 | 2.3 | 1.5 | 1.3 |
| Germany | 2.5 | 2.6 | 2.5 | 2.5 | 2.6 | 2.5 |
| France | 2.8 | 2.7 | 2.9 | 2.8 | 2.8 | 2.2 |
| Italy | 4.4 | 5.6 | 6.7 | 5.9 | 5.6 | 5.6 |

Source: EC First Survey on State Aids

5. Table 2 shows industrial and regional aid as a percentage of gross value added in industry, and so comes closer to answering the Prime Minister's question about comparative industrial subsidies. Subsidies to agriculture and fisheries are excluded. The UK does well out of this comparison, having halved its subsidies on this measure between 1981 and 1986. Germany and France have achieved some reduction, Italy the reverse. The EEC10 average over the period was 6.2%.

Table 2: Industry and Regional aid as % of gross value added in industry 1981-86

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
|---------|------|------|------|------|------|------|
| UK | 5.2 | 4.5 | 3.8 | 3.9 | 3.1 | 2.6 |
| Germany | 3.1 | 3.2 | 3.0 | 3.3 | 3.1 | 2.7 |
| France | 4.9 | 4.3 | 5.3 | 5.4 | 5.8 | 3.8 |
| Italy | 11.9 | 15.2 | 20.7 | 18.2 | 16.6 | 16.8 |

Source: EC First Survey on State Aids

6. One other possible source is the set of National Accounts put together by OECD. Subsidies on a national accounts definition are current transfers from the government to a trading concern. Table 3 shows these subsidies as a percentage of GDP for 1985-87. The comparison once again reflects well on the UK.

Table 3: Direct Subsidies as % of GDP

| | 1985 | 1986 | 1987 |
|-------------|------|------|------|
| UK | 2.0 | 1.6 | 1.4 |
| Germany | 2.1 | 2.1 | 2.2 |
| France | 2.3 | 2.3 | 2.4 |
| Italy | 2.8 | 3.0 | 2.6 |
| OECD Europe | 2.4 | 2.4 | 2.3 |

Source: OECD National Accounts.

7. I attach a draft letter to Charles Powell which reports the EC figures and notes our reservations about them.

Alex Gibbs

A GIBBS

CP

For type (over)

DRAFT LETTER FOR PS/CHANCELLOR TO SEND TO:

C D Powell Esq
10 Downing Street
LONDON
SW1

COMPARISONS OF EUROPEAN SUBSIDIES

I am sorry that we have not replied before now to your letter of 20 February on the Paris Economic Summit in which you recorded that the Prime Minister had asked whether there were figures for comparative industrial subsidies in EC countries. The reason for our delay in replying is that the figures are not easily available.

2. The main source of comparative figures is the European Commission's "First Survey of State Aids in the EC". But the numbers are not up-to-date, the most recent data being for 1986, and their coverage is patchy and probably inconsistent. The comparisons between countries should therefore be treated with caution, though the trend over time for individual countries should provide a more reliable picture.

3. Table 1 below shows total subsidies, including subsidies to both industry and agriculture, as a percentage of GDP in the UK, Germany, France and Italy. Table 2 shows industrial and regional aid (excluding agriculture) as a percentage of value added in industry. The UK's progress in reducing subsidies is reflected in both tables.

Table 1: Total aid as % of GDP 1981-86

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Source: OECD National Accounts

• We are encouraging the OECD Secretariat to do some work on measuring individual countries' subsidy programmes which we hope will provide more reliable comparative figures. But the Secretariat will have an uphill struggle in persuading some countries to disclose the full extent of their subsidies.

JMG T-

P-5-

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10 DOWNING STREET
LONDON SW1A 2AA

| | |
|--------------|--|
| CH/EXCHEQUER | |
| REC'D | 28 MAR 1989 |
| DATE | Mr MELLISS |
| TO | EST. SIR P. MIDDLETON SCT. BURNS, Mr WICKS Mr LANKESTER, Mr H.P. EVANS, Mr ILETT, Mr ALLEN, Mr KROLL, Mr EDMONDS, Mr IYRIG. |

✓
28/3

From the Private Secretary

MR. WICKS
H.M. TREASURY

ppw/p

PARIS ECONOMIC SUMMIT

The Prime Minister was grateful for your minute of 21 March with its round up of the main subjects likely to arise at the Sherpa meeting on 7-9 April. I have confirmed that she attaches importance to having separate sessions for Heads of Government on the first full day of Economic Summits and would hope that the French would agree to abide by this practice.

I am sending a copy of this minute to the Private Secretaries to the Foreign and Commonwealth Secretary and the Chancellor of the Exchequer and to Sir Robin Butler.

CHARLES POWELL
23 March 1989

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PWP

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

4 April 1989

C D Powell Esq
No.10 Downing Street
London SW1

CC PMG
EST
Sir P. Middleton
Sir T. Burns
Mr Wickes
Mr Monck
Mr Canister
Mr Big Allen
Mr Evans
Mr McMiss --- Mr Gibbs
Mr Edmunds
Mr Hurd
Mr Tyne

Dear Charles

COMPARISONS OF EUROPEAN SUBSIDIES

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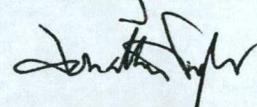
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Source: OECD National Accounts

We are encouraging the OECD Secretariat to do some work on measuring individual countries' subsidy programme which we hope will provide more reliable comparative figures. But the Secretariat will have an uphill struggle in persuading some countries to disclose the full extent of their subsidies.

Yours sincerely

J M G TAYLOR
Private Secretary