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MEETINGS

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TOKYO DECLARATION

Tokyo Economic Declaration

May 6, 1986

1. We, the Heads of State or Government of seven major industrialized countries and the representatives of the European Community, meeting in Tokyo for the twelfth Economic Summit, have reviewed developments in the world economy since our meeting in Bonn a year ago, and have reaffirmed our continuing determination to work together to sustain and improve the prosperity and well-being of the peoples of our own countries, to support the developing countries in their efforts to promote their economic growth and prosperity, and to improve the functioning of the world monetary and trading systems.

2. Developments since our last meeting reflect the effectiveness of the policies to which we have committed ourselves at successive Economic Summits in recent years. The economies of the industrialized countries are now in their fourth year of expansion. In all our countries, the rate of inflation has been declining. With the continuing pursuit of prudent fiscal and monetary policies, this has permitted a substantial lowering of interest rates. There has been a significant shift in the pattern of exchange rates which better reflects fundamental economic conditions. For the industrialized countries, and indeed for the world economy, the recent decline in oil prices will help to sustain non-inflationary growth and to increase the volume of world trade, despite the difficulties which it creates for certain oil-producing countries. Overall, these developments offer brighter prospects for, and enhance confidence in, the future of the world economy.

3. However, the world economy still faces a number of difficult challenges which could impair sustainability of growth. Among these are high unemployment, large domestic and external imbalances, uncertainty about the future behaviour of exchange rates, persistent protectionist pressures, continuing difficulties of many developing countries and severe debt problems for some, and uncertainty about medium-term prospects for the levels of energy prices. If large imbalances and other distortions are allowed to persist for too long, they will present an increasing threat to world economic growth and to the open multilateral trading system. We cannot afford to relax our efforts. In formulating our policies, we need to look to the medium and longer term, and to have regard to the interrelated and structural character of current problems.

4. We stress the need to implement effective structural adjustment policies in all countries across the whole range of economic activities to promote growth, employment and the integration of domestic economies into the world economy. Such policies include technological innovation, adaptation of industrial structure and expansion of trade and foreign direct investment.

5. In each of our own countries, it remains essential to maintain a firm control of public spending within an appropriate medium-term framework of fiscal and monetary policies. In some of our countries there continue to be excessive fiscal deficits which the governments concerned are resolved progressively to reduce.

6. Since our last meeting we have had some success in the creation of new jobs to meet additions to the labour force, but unemployment remains excessively high in many of our countries. Non-inflationary growth remains the biggest single contributor to the limitation and reduction of unemployment, but it needs to be reinforced by policies which encourage job creation, particularly in new and high-technology industries, and in small businesses.

7. At the same time, it is important that there should be close and continuous coordination of economic policy among the seven Summit countries. We welcome the recent examples of improved coordination among the Group of Five Finance Ministers and Central Bankers, which have helped to change the pattern of exchange rates and to lower interest rates on an orderly and non-inflationary basis. We agree, however, that additional measures should be taken to ensure that procedures for effective coordination of international economic policy are strengthened further. To this end, the Heads of State or Government:

- agree to form a new Group of Seven Finance Ministers, including Italy and Canada, which will work together more closely and more frequently in the periods between the annual Summit meetings;

- request the seven Finance Ministers to review their individual economic objectives and forecasts collectively at least once a year, using the indicators specified below, with a particular view to examining their mutual compatibility;

With the representatives of the European Community:

- state that the purposes of improved coordination should explicitly include promoting non-inflationary

economic growth, strengthening market-oriented incentives for employment and productive investment, opening the international trading and investment system, and fostering greater stability in exchange rates;

- reaffirm the undertaking at the 1982 Versailles Summit to cooperate with the IMF in strengthening multilateral surveillance, particularly among the countries whose currencies constitute the SDR, and request that, in conducting such surveillance and in conjunction with the Managing Director of the IMF, their individual economic forecasts should be reviewed, taking into account indicators such as GNP growth rates, inflation rates, interest rates, unemployment rates, fiscal deficit ratios, current account and trade balances, monetary growth rates, reserves, and exchange rates;

- invite the Finance Ministers and Central Bankers in conducting multilateral surveillance to make their best efforts to reach an understanding on appropriate remedial measures whenever there are significant deviations from an intended course; and recommend that remedial efforts focus first and foremost on underlying policy fundamentals, while reaffirming the 1983 Williamsburg commitment to intervene in exchange markets when to do so would be helpful.

The Heads of State or Government:

- request the Group of Five Finance Ministers to include Canada and Italy in their meetings whenever the management or the improvement of the international monetary system and related economic policy measures are to be discussed and dealt with;

- invite Finance Ministers to report progress at the next Economic Summit meeting.

These improvements in coordination should be accompanied by similar efforts within the Group of Ten.

8. The pursuit of these policies by the industrialized countries will help the developing countries in so far as it strengthens the world economy, creates conditions for lower interest rates, generates the possibility of increased financial flows to the developing countries, promotes transfer of technology and improves access to the markets of the industrialized countries. At the same time, developing countries, particularly debtor countries,

can fit themselves to play a fuller part in the world economy by adopting effective structural adjustment policies, coupled with measures to mobilize domestic savings, to encourage the repatriation of capital, to improve the environment for foreign investment, and to promote more open trading policies. In this connection, noting in particular the difficult situation facing those countries highly dependent on exports of primary commodities, we agree to continue to support their efforts for further processing of their products and for diversifying their economies, and to take account of their export needs in formulating our own trade and domestic policies.

9. Private financial flows will continue to play a major part in providing for their development needs. We reaffirm our willingness to maintain and, where appropriate, expand official financial flows, both bilateral and multilateral, to developing countries. In this connection, we attach great importance to an early and substantial eighth replenishment of the International Development Association (IDA) and to a general capital increase of the World Bank when appropriate. We look for progress in activating the Multilateral Investment Guarantee Agency.

10. We reaffirm the continued importance of the case-by-case approach to international debt problems. We welcome the progress made in developing the cooperative debt strategy, in particular building on the United States initiative. The role of the international financial institutions, including the multilateral development banks, will continue to be central, and we welcome moves for closer cooperation among these institutions, and particularly between the IMF and the World Bank. Sound adjustment programmes will also need resumed commercial bank lending, flexibility in rescheduling debt and appropriate access to export credits.

11. We welcome the improvement which has occurred in the food situation in Africa. Nonetheless a number of African countries continue to need emergency aid, and we stand ready to assist. More generally, we continue to recognize the high priority to be given to meeting the needs of Africa. Measures identified in the Report on Aid to Africa adopted and forwarded to us by our Foreign Ministers should be steadily implemented. Assistance should focus in particular on the medium- and long-term economic development of these countries. In this

connection we attach great importance to continued cooperation through the Special Facility for Sub-Saharan African countries, early implementation of the newly established Structural Adjustment Facility of the IMF and the use of the IDA. We intend to participate actively in the forthcoming United Nations Special Session on Africa to lay the foundation for the region's long-term development.

12. The open multilateral trading system is one of the keys to the efficiency and expansion of the world economy. We reaffirm our commitment to halting and reversing protectionism, and to reducing and dismantling trade restrictions. We support the strengthening of the system and functioning of the GATT, its adaptation to new developments in world trade and to the international economic environment, and the bringing of new issues under international discipline. The New Round should, inter alia, address the issues of trade in services and trade related aspects of intellectual property rights and foreign direct investment. Further liberalization of trade is, we believe, of no less importance for the developing countries than for ourselves, and we are fully committed to the preparatory process in the GATT with a view to the early launching of the New Round of multilateral trade negotiations. We shall work at the September Ministerial meeting to make decisive progress in this direction.

13. We note with concern that a situation of global structural surplus now exists for some important agricultural products, arising partly from technological improvements, partly from changes in the world market situation, and partly from long-standing policies of domestic subsidy and protection of agriculture in all our countries. This harms the economies of certain developing countries and is likely to aggravate the risk of wider protectionist pressures. This is a problem which we all share and can be dealt with only in cooperation with each other. We all recognize the importance of agriculture to the well-being of rural communities, but we are agreed that, when there are surpluses, action is needed to redirect policies and adjust structure of agricultural production in the light of world demand. We recognize the importance of understanding these issues and express our determination to give full support to the work of the OECD in this field.

14. Bearing in mind that the recent oil price decline owes much to the cooperative energy policies which we have pursued during the past decade, we recognize the need for continuity of policies for achieving long-term energy market stability and security of supply. We note that the current oil market situation enables countries which wish to do so to increase stock levels.

15. We reaffirm the importance of science and technology for the dynamic growth of the world economy and take note, with appreciation, of the final report of the Working Group on Technology, Growth and Employment. We welcome the progress made by the United States Manned Space Programme and the progress made by the autonomous work of the European Space Agency (ESA). We stress the importance for genuine partnership and appropriate exchange of information, experience and technologies among the participating states. We also note with satisfaction the results of the Symposium on Neuroscience and Ethics, hosted by the Federal Republic of Germany and we appreciate the decision of the Canadian Government to host the next meeting.

16. We reaffirm our responsibility, shared with other governments, to preserve the natural environment, and continue to attach importance to international cooperation in the effective prevention and control of pollution and natural resources management. In this regard, we take note of the work of the environmental experts on the improvement and harmonization of the techniques and practices of environmental measurement, and ask them to report as soon as possible. We also recognize the need to strengthen cooperation with developing countries in the area of the environment.

17. We have agreed to meet again in 1987 and have accepted the invitation of the President of the Council of the Italian Government to meet in Italy.

TOKYO SUMMIT.

X6

STATEMENT ON INTERNATIONAL TERRORISM

May 5, 1986

1. We, the Heads of State or Government of seven major democracies and the representatives of the European Community, assembled here in Tokyo, strongly reaffirm our condemnation of international terrorism in all its forms, of its accomplices and of those, including governments, who sponsor or support it. We abhor the increase in the level of such terrorism since our last meeting, and in particular its blatant and cynical use as an instrument of government policy. Terrorism has no justification. It spreads only by the use of contemptible means, ignoring the values of human life, freedom and dignity. It must be fought relentlessly and without compromise.

2. Recognizing that the continuing fight against terrorism is a task which the international community as a whole has to undertake, we pledge ourselves to make maximum efforts to fight against that scourge. Terrorism must be fought effectively through determined, tenacious, discreet and patient action combining national measures with international cooperation. Therefore, we urge all like-minded nations to collaborate with us, particularly in such international fora as the United Nations, the International Civil Aviation Organization and the International Maritime Organization, drawing on their expertise to improve and extend countermeasures against terrorism and those who sponsor or support it.

3. We, the Heads of State or Government, agree to intensify the exchange of information in relevant fora on threats and potential threats emanating from terrorist activities and those who sponsor or support them, and on ways to prevent them.

4. We specify the following as measures open to any government concerned to deny to international terrorists the opportunity and the means to carry out their aims, and to identify and deter those who perpetrate such terrorism. We have decided to apply these measures within the framework of international law and in our own jurisdictions in respect of any state which is clearly involved in sponsoring or supporting international terrorism, and in particular of Libya, until such time as the state concerned abandons its complicity in, or support for, such terrorism. These measures are:

- refusal to export arms to states which sponsor or support terrorism;

- strict limits on the size of the diplomatic and consular missions and other official bodies abroad of states which engage in such activities, control of travel of members of such missions and bodies, and, where appropriate, radical reductions in, or even the closure of, such missions and bodies;

- denial of entry to all persons, including diplomatic personnel, who have been expelled or excluded from one of our states on suspicion of involvement in international terrorism or who have been convicted of such a terrorist offence;

- improved extradition procedures within due process of domestic law for bringing to trial those who have perpetrated such acts of terrorism;

- stricter immigration and visa requirements and procedures in respect of nationals of states which sponsor or support terrorism;

- the closest possible bilateral and multilateral cooperation between police and security organizations and other relevant authorities in the fight against terrorism.

Each of us is committed to work in the appropriate international bodies to which we belong to ensure that similar measures are accepted and acted upon by as many other governments as possible.

5. We will maintain close cooperation in furthering the objectives of this statement and in considering further measures. We agree to make the 1978 Bonn Declaration more effective in dealing with all forms of terrorism affecting civil aviation. We are ready to promote bilaterally and multilaterally further actions to be taken in international organizations or fora competent to fight against international terrorism in any of its forms.

STATEMENT ON
THE IMPLICATIONS OF THE CHERNOBYL NUCLEAR ACCIDENT

May 5, 1986

1. We, the Heads of State or Government of seven major industrial nations and the Representatives of the European Community, have discussed the implications of the accident at the Chernobyl nuclear power station. We express our deep sympathy for those affected. We remain ready to extend assistance, in particular medical and technical, as and when requested.

2. Nuclear power is and, properly managed, will continue to be an increasingly widely used source of energy. For each country the maintenance of safety and security is an international responsibility, and each country engaged in nuclear power generation bears full responsibility for the safety of the design, manufacture, operation and maintenance of its installations. Each of our countries meets exacting standards. Each country, furthermore, is responsible for prompt provision of detailed and complete information on nuclear emergencies and accidents, in particular those with potential transboundary consequences. Each of our countries accepts that responsibility, and we urge the Government of the Soviet Union, which did not do so in the case of Chernobyl, to provide urgently such information, as our and other countries have requested.

3. We note with satisfaction the Soviet Union's willingness to undertake discussions this week with the Director-General of the International Atomic Energy Agency (IAEA). We expect that these discussions will lead to the Soviet Union's participation in the desired post-accident analysis.

4. We welcome and encourage the work of the IAEA in seeking to improve international cooperation on the safety of nuclear installations, the handling of nuclear accidents and their consequences, and the provision of mutual emergency assistance. Moving forward from the relevant IAEA guidelines, we urge the early elaboration of an international convention committing the parties to report and exchange information in the event of nuclear emergencies or accidents. This should be done with the least possible delay.

TOKYO DECLARATION
LOOKING FORWARD TO A BETTER FUTURE

May 5, 1986

1. We, the Heads of State or Government of seven major industrial nations and the representatives of the European Community, with roots deep in the civilizations of Europe and Asia, have seized the opportunity of our meeting at Tokyo to raise our sights not just to the rest of this century but into the next as well. We face the future with confidence and determination, sharing common principles and objectives and mindful of our strengths.

2. Our shared principles and objectives, reaffirmed at past Summits, are bearing fruit. Nations surrounding the Pacific are thriving dynamically through free exchange, building on their rich and varied heritages. The countries of Western Europe, the Community members in particular, are flourishing by raising their cooperation to new levels. The countries of North America, enriched by European and Asian cultures alike, are firm in their commitment to the realization in freedom of human potential. Throughout the world we see the powerful appeal of democracy and growing recognition that personal initiative, individual creativity and social justice are main sources of progress. More than ever we have all to join our energies in the search for a safer and healthier, more civilized and prosperous, free and peaceful world. We believe that close partnership of Japan, North America and Europe will make a significant contribution toward this end.

3. We reaffirm our common dedication to preserving and strengthening peace, and as part of that effort, to building a more stable and constructive relationship between East and West. Each of us is ready to engage in cooperation in fields of common interest. Within existing alliances, each of us is resolved to maintain a strong and credible defence that can protect freedom and deter agression, while not threatening the security of others. We know that peace cannot be safeguarded by military strength alone. Each of us is committed to addressing East-West differences through high-level dialogue and negotiation. To that end, each of us supports balanced, substantial and verifiable reductions in the level of arms; measures to increase confidence and reduce the risks of conflicts; and the peaceful resolution of disputes. Recalling the agreement between the United States and the Soviet Union to accelerate work at Geneva, we appreciate

the United States' negotiating efforts and call on the Soviet Union also to negotiate positively. In addition to these efforts, we shall work for improved respect for the rights of individuals throughout the world.

4. We proclaim our conviction that in today's world, characterized by ever increasing interdependence, our countries cannot enjoy lasting stability and prosperity without stability and prosperity in the developing world and without the cooperation among us which can achieve these aims. We pledge ourselves afresh to fight against hunger, disease and poverty, so that developing nations can also play a full part in building a common, bright future.

5. We owe it to future generations to pass on a healthy environment and a culture rich in both spiritual and material values. We are resolved to pursue effective international action to eliminate the abuse of drugs. We proclaim our commitment to work together for a world which respects human beings in the diversity of their talents, beliefs, cultures and traditions. In such a world based upon peace, freedom and democracy, the ideals of social justice can be realized and employment opportunities can be available for all. We must harness wisely the potential of science and technology, and enhance the benefits through cooperation and exchange. We have a solemn responsibility so to educate the next generation as to endow them with the creativity befitting the twenty-first century and to convey to them the value of living in freedom and dignity.

G7
SEPT 1986

UNCLASSIFIED

SAVINGRAM

BY BAG

FROM UKDEL IMF/IBRD WASHINGTON

UNCLASSIFIED

TO FCO SAVINGRAM NO. 357 OF SEPTEMBER 27, 1986 AND SAVING (FOR INFO) TO UKDEL OECD, UKMIS NEW YORK, UKMIS GENEVA, EC POSTS, TOKYO, OTTAWA, AND STOCKHOLM

IMF/IBRD 1986 ANNUAL MEETINGS: GROUP OF SEVEN FINANCE MINISTERS MEETING

Following is the Statement issued by the Group of Seven Finance Ministers at the conclusion of their meeting in Washington DC on September 27, 1985.

BEGINS

1. The Finance Ministers of seven major industrialized countries met today to conduct the first exercise of multilateral surveillance pursuant to the Tokyo Economic Declaration of their Heads of State or Government of May 6, 1986. The Managing Director of the International Monetary Fund also participated in this meeting.

2. The Ministers reviewed recent economic developments and their economic objectives and forecasts collectively, using a range of economic indicators, with a particular view to examining their mutual compatibility and to considering the need for remedial measures.

3. The Ministers noted that progress had been made in promoting steady, non-inflationary growth in their countries.

4. There is broad agreement among the Ministers on the economic outlook in their countries: Prospects for further growth in 1987 are generally favorable, and more jobs will be created, although the level of unemployment will remain high in some countries. Inflation is likely to remain low. Interest rates have fallen with particular beneficial effects for indebted developing countries.

5. However, the Ministers noted that the present scale of some current account imbalances cannot be sustained. The exchange rate changes since last year are making an important contribution towards redressing these imbalances, and their full effects will increasingly come through in the period ahead.

6. The Ministers agreed that cooperative efforts need to be intensified in order to reduce the imbalances in the context of an open, growing world economy. They noted, in this connection, that economic growth in surplus countries was improving, but such growth will need to be sustained -- and in some cases increased. Countries with major deficits must follow policies which will foster significant reductions in their external deficits, and they committed themselves, among other things, to make further progress in reducing their budget deficits in order to free resources to the external sector. These actions should help stabilize exchange rates, and all are necessary so that imbalances can be reduced sufficiently without further significant exchange rate adjustment.

7. In the circumstances, the Ministers agreed that the policies of all countries during the period immediately ahead would be formulated with the following objectives in mind:

-- To continue to follow sound monetary policies supporting non-inflationary growth and contributing to international adjustment in order to help maintain the conditions for business confidence and for lower interest rates.

-- To continue the process of removing structural rigidities in order to increase the long-term production potential of their economies.

-- To continue efforts to resist protectionist pressures.

8. The Ministers agreed that the major industrial countries bear a special responsibility to foster an open, growing world economy which is particularly important for the resolution of the international debt problem.

9. In order to fulfill their responsibilities in the context of thorough implementation of the Tokyo Economic Declaration used to achieve the objectives set out above, they agreed to the close and continuous coordination of economic policy during the period ahead.

ENDS

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TO IMMEDIATE FCO
TELEGRAM NUMBER 152 OF JANUARY

FROM LITTLER FOR NO. 10 DUTY CLERK

FOLLOWING IS TEXT OF ANNOUNCEMENT ISSUED TO PRESS BY DON REGAN IMMEDIATELY AFTER G5 MEETING THIS AFTERNOON.
BEGINS

THE MINISTERS OF FINANCE AND CENTRAL BANK GOVERNORS OF FRANCE, GERMANY, JAPAN, THE UNITED KINGDOM, AND THE UNITED STATES ANNOUNCED TODAY THAT THEY HAD MET TO DISCUSS A RANGE OF INTERNATIONAL ECONOMIC AND FINANCIAL ISSUES. THE MEETING, PART OF A REGULAR SERIES OF CONSULTATIONS AMONG THESE COUNTRIES ON ECONOMIC AND FINANCIAL MATTERS OF MUTUAL INTEREST, ALSO INVOLVED IMF MANAGING DIRECTOR DE LAROSIERE FOR A DISCUSSION OF THE ECONOMIC POLICIES AND PROSPECTS OF THE MAJOR INDUSTRIAL COUNTRIES.

THE MINISTERS AND GOVERNORS, NOTING THE RECENT DEVELOPMENTS IN THE EXCHANGE MARKETS, EXPRESSED THEIR COMMITMENT TO WORK TOWARD GREATER EXCHANGE MARKET STABILITY. TOWARD THIS END, THE MINISTERS AND GOVERNORS:

--REAFFIRMED THEIR COMMITMENT TO PURSUE MONETARY AND FISCAL POLICIES THAT PROMOTE A CONVERGENCE OF ECONOMIC PERFORMANCE AT NON-INFLATIONARY, STEADY GROWTH:

--STRESSED THE IMPORTANCE OF REMOVING STRUCTURAL RIGIDITIES IN THEIR ECONOMIES TO ACHIEVING THE OBJECTIVES OF NON-INFLATIONARY, STEADY GROWTH AND EXCHANGE MARKET STABILITY, AND EXPRESSED THEIR INTENT TO INTENSIFY EFFORTS IN THIS AREA: AND

--IN LIGHT OF RECENT DEVELOPMENTS IN FOREIGN EXCHANGE MARKETS, REAFFIRMED THEIR COMMITMENT MADE AT THE WILLIAMSBURG SUMMIT TO UNDERTAKE COORDINATED INTERVENTION IN THE MARKETS AS NECESSARY.

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attached

THE MINISTERS AND GOVERNORS BELIEVE THAT THIS APPROACH WILL PROVIDE A SOLID FRAMEWORK FOR SUSTAINING RECOVERY, REDUCING INFLATION, INCREASING EMPLOYMENT, AND ACHIEVING GREATER EXCHANGE RATE STABILITY.

ENDS

FCO PLEASE PASS IMMEDIATE DESKBY 04.45Z TO NO. 10 DUTY OFFICER AND TO PS/FOREIGN SECRETARY.

AND DESKBY 08.00Z TO PS/CHANCELLOR, SIR P. MIDDLETON, MR. CASSELL, MR. LAVELLE (HM TREASURY), PS/GOVERNOR, MR. LOEHNIS, MR. GAILL AND MR. BYATT (BANK OF ENGLAND)

WRIGHT

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PLAZA.

September 22, 1985

Announcement of the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom, and the United States

1. Ministers of Finance and Central Bank Governors of France, the Federal Republic of Germany, Japan, the United Kingdom, and the United States met today, September 22, 1985, in the context of their agreement to conduct mutual surveillance and as part of their preparations for wider international discussions at the forthcoming meetings in Seoul, Korea. They reviewed economic developments and policies in each of their countries and assessed their implications for economic prospects, external balances, and exchange rates.

2. At the Bonn Economic Summit in May 1985 the Heads of State or Government of seven major industrial countries and the President of the Commission of the European Communities issued an Economic Declaration Towards Sustained Growth and Higher Employment. In that Declaration the participants agreed that:

> The best contribution we can make to a lasting new prosperity in which all nations can share is unremittingly to pursue, individually in our own countries and cooperatively together, policies conducive to sustained growth and higher employment.

3. The Ministers and Governors were of the view that significant progress has been made in their efforts to promote a convergence of favorable economic performance among their countries on a path of steady noninflationary growth. Furthermore, they concluded that their countries are restoring the vitality and responsiveness of their economies. As a result of these developments, they are confident that a firm basis has been established for a sustained, more balanced expansion among their countries. This sustained growth will benefit other industrial countries and will help ensure expanding export markets for developing countries, thereby contributing importantly to the resolution of problems of heavily indebted developing countries.

4. They believe that this convergence of favorable economic performance has been influenced increasingly by policy initiatives undertaken by their countries. Moreover, each of their countries is committed to the implementation of further policy measures which will reinforce favorable convergence and strengthen the sustainability of the current expansion.

5. Ministers and Governors were of the view that recent shifts in fundamental economic conditions among their countries, together with policy commitments for the future, have not been reflected fully in exchange markets.

Recent Economic Developments and Policy Changes

6. Ministers and Governors expect that real growth in aggregate for their countries will be about 3 percent this year, compared to negative growth of -0.7 percent in 1982. Although this figure is down slightly from 1984, growth will be more balanced than at any time in the last four years. After the particularly rapid U.S. growth of 1983-84, there is now increased evidence of internal growth in the other countries. In particular, private investment has picked up strength. The current expansion is occurring in a context of fiscal consolidation; it is not dependent on shortlived fiscal stimulus. As a result of the changes in the components of growth, real growth in their countries can be expected to remain strong as U.S. growth moderates.

7. The current sustained expansion is occurring within a framework of declining inflation, a phenomenon that is unprecedented in the past three decades. Inflation rates are at their lowest in nearly 20 years, and they show no signs of reviving.

8. There has been a significant fall in interest rates in recent years. Apart from welcome domestic effects, this has been particularly helpful in easing the burden of debt repayments for developing countries.

9. This successful performance is the direct result of the importance given to macroeconomic policies which have reduced inflation and inflationary expectations, to continued vigilance over government spending, to greater emphasis on market forces and competition, and to prudent monetary policies.

10. These positive economic developments notwithstanding, there are large imbalances in external positions which pose potential problems, and which reflect a wide range of factors. Among these are: the deterioration in its external position which the U.S. experienced from its period of very rapid relative growth; the particularly large impact on the U.S. current account of the economic difficulties and the adjustment efforts of some major developing countries; the difficulty of trade access in some markets; and the appreciation of the U.S. dollar. The interaction of these factors -- relative growth rates, the debt problems of developing countries, and exchange rate developments -- has contributed to large, potentially destabilizing external imbalances among major industrial countries. In particular, the United States has a large and growing current account deficit, and Japan, and to a lesser extent Germany, large and growing current account surpluses.

11. The U.S. current account deficit, together with other factors, is now contributing to protectionist pressures which, if not resisted, could lead to mutually destructive retaliation with serious damage to the world economy: world trade would shrink, real growth rates could even turn negative, unemployment would rise still higher, and debt-burdened developing countries would be unable to secure the export earnings they vitally need.

Policy Intentions

12. The Finance Ministers and Governors affirmed that each of their countries remains firmly committed to its international responsibilities and obligations as leading industrial nations. They also share special responsibilities to ensure the mutual consistency of their individual policies. The Ministers agreed that establishing more widely strong, noninflationary domestic growth and open markets will be a key factor in ensuring that the current expansion continues in a more balanced fashion, and they committed themselves to policies toward that end. In countries where the budget deficit is too high, further measures to reduce the deficit substantially are urgently required.

13. Ministers and Governors agreed that it was essential that protectionist pressures be resisted.

14. Ministers recognized the importance of providing access to their markets for LDC exports as those countries continue their essential adjustment efforts, and saw this as an important additional reason to avoid protectionist policies. They welcomed the GATT preparatory meeting scheduled for late September and expressed their hope that it will reach a broad consensus on subject matter and modalities for a new GATT round.

15. In this context, they recalled and reaffirmed the statement in the Bonn Economic Declaration on the debt situation.

Sustained growth in world trade, lower interest rates, open markets and continued financing in amounts and on terms appropriate to each individual case are essential to enable developing countries to achieve sound growth and overcome their economic and financial difficulties.

16. The Ministers agreed that they would monitor progress in achieving a sustained noninflationary expansion and intensify their individual and cooperative efforts to accomplish this objective. To that end, they affirmed the statements of policy intentions by each of their countries, which are attached.

Conclusions

17. The Ministers of Finance and Central Bank Governors agreed that recent economic developments and policy changes, when combined with the specific policy intentions described in the attached statements, provide a sound basis for continued and a more balanced expansion with low inflation. They agreed on the importance of these improvements for redressing the large and growing external imbalances that have developed. In that connection, they noted that further market-opening measures will be important to resisting protectionism.

18. The Ministers and Governors agreed that exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has been the case. They believe that agreed policy actions must be implemented and reinforced to improve the fundamentals further, and that in view of the present and prospective changes in fundamentals, some further orderly appreciation of the main non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when to do so would be helpful.

The French Government intends to pursue its policy aimed at reducing inflation, moderating income growth, and achieving continued improvements in external accounts. It will further intensify its efforts to speed up structural adjustment and modernization and thus lay the basis for job creating growth.

Therefore, it is determined:

1. To pursue vigorously disinflation.

2. To secure the attainment of monetary aggregates growth targets, consistent with decelerating inflation.

3. To curb public expenditures progressively so as to lower the tax burden while reducing the government borrowing requirement.

4. To foster the investment recovery allowed for by the improved financial situation in the business sector.

5. To take further steps towards liberalization and modernization of financial markets, to increase competition in the financial sector so as to reduce financial intermediation costs and give a greater role to interest rates in monetary control.

6. To foster job creation through the implementation of an innovative and active policy in the field of education and training and by promoting constructive discussions between social partners on work organization.

7. To resist protectionism.

The Government of the Federal Republic of Germany, noting that the German economy is already embarked on a course of steady economic recovery based increasingly on internally generated growth, will continue to implement policies to sustain and extend the progress achieved in strengthening the underlying conditions for continuing, vigorous, job-creating growth in the context of stable prices and low interest rates.

In particular, the Government of the Federal Republic of Germany will implement policies with the following explicit intentions.

1. The priority objective of fiscal policy is to encourage private initiative and productive investments and maintain price stability.

2. Toward this end, the Federal Government will continue to reduce progressively the share of the public sector in the economy through maintaining firm expenditure control. The tax cuts due to take effect in 1986 and 1988 form part of the ongoing process of tax reform and reduction which the Federal Government will continue in a medium-term framework.

3. The Federal Government will continue to remove rigidities inhibiting the efficient functioning of markets. It will keep under review policies, regulations, and practices affecting labor markets in order to enhance the positive impact of economic growth on employment. The Federal Government and the Deutsche Bundesbank will provide the framework for the continuing evolution of deep, efficient money and capital markets.

4. The fiscal policy of the Federal Government and the monetary policy of the Deutsche Bundesbank will continue to ensure a stable environment conducive to the expansion of domestic demand on a durable basis.

5. The Federal Government will continue to resist protectionism.

The Government of Japan, noting that the Japanese economy is in an autonomous expansion phase mainly supported by domestic private demand increase, will continue to institute policies intended to ensure sustainable noninflationary growth; provide full access to domestic markets for foreign goods; and internationalize the yen and liberalize domestic capital markets.

In particular, the Government of Japan will implement policies with the following explicit intentions.

1. Resistance of protectionism and steady implementation of the Action Program announced on July 30 for the further opening up of Japan's domestic market to foreign goods and services.

2. Full utilization of private sector vitality through the implementation of vigorous deregulation measures.

3. Flexible management of monetary policy with due attention to the yen rate.

4. Intensified implemention of financial market liberalization and internationalization of the yen, so that the yen fully reflects the underlying strength of the Japanese economy.

5. Fiscal policy will continue to focus on the twin goals of reducing the central government deficit and providing a pro-growth environment for the private sector. Within that framework, local governments may be favorably allowed to make additional investments in this FY 1985, taking into account the individual circumstances of the region.

6. Efforts to stimulate domestic demand will focus on increasing private consumption and investment through measures to enlarge consumer and mortgage credit markets.

The United Kingdom Government, noting that the British economy has been experiencing steady growth of output and domestic demand over the past four years, will continue to pursue policies designed to reduce inflation; to promote sustained growth of output and employment; to reduce the size of the public sector; to encourage a more competitive, innovative, market orientated private sector; to reduce regulation and increase incentives throughout the economy; and to maintain open trading and capital markets free of foreign exchange controls.

In particular, the United Kingdom Government intends:

1. To operate monetary policy to achieve further progress towards price stability and to provide a financial environment for growing output and employment; and to buttress monetary policy with a prudent fiscal policy.

2. To continue to reduce public expenditure as a share of GDP and to transfer further substantial parts of public sector industry to private ownership.

3. To reduce the burden of taxation in order to improve incentives and to increase the efficient use of resources in the economy.

4. To take additional measures to improve the effective working of the labour market, including the reform of Wages Councils and improvements in youth training; and implement proposals to liberalize and strengthen competition within financial markets.

5. To resist protectionism.

The United States Government is firmly committed to policies designed to: ensure steady noninflationary growth; maximize the role of markets and private sector participation in the economy; reduce the size and role of the government sector; and maintain open markets.

In order to achieve these objectives, the United States Government will:

1. Continue efforts to reduce government expenditures as a share of GNP in order to reduce the fiscal deficit and to free up resources for the private sector.

2. Implement fully the deficit reduction package for fiscal year 1986. This package passed by Congress and approved by the President will not only reduce by over 1 percent of GNP the budget deficit for FY 1986, but lay the basis for further significant reductions in the deficit in subsequent years.

3. Implement revenue-neutral tax reform which will encourage savings, create new work incentives, and increase the efficiency of the economy, thereby fostering noninflationary growth.

4. Conduct monetary policy to provide a financial environment conducive to sustainable growth and continued progress toward price stability.

5. Resist protectionist measures.

Ch/ (1) Content for me to send letter to No 10 below?

(2) I understand the consensus at G7 today was that progress on rankings could only be made now in bilateral between you and Beregovoy and that he will now seek this. Mr Wicks will have views on tactics (back tomorrow) but I would have thought we should say 'no point: we've made our offer. It's Jacques the others you need to talk to now.

(3) A date in the period 27–29 March is now under consideration for the Interim Committee. We've told Mr Wicks, without commitment, that 28 is better than 27 or 29 but why not wait till the main Spring meetings in May.

Informal ECOFIN then surely??

Ch/ex
30/31 March
and 1 April

CONFIDENTIAL

cc Mr Pike

FROM: SIR T BURNS
DATE: 3 APRIL 1987

CHANCELLOR

cc Financial Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Evans
Mr Peretz
Mr Odling-Smee

POST-LOUVRE: THE NEXT STEPS

You asked me to record my views about how we might take the Paris Agreement forward. This note sets out a possible approach. It has been assembled quickly. Obviously we need to look at the particular arrangements in much more detail. I put it forward with the aim of stimulating discussion.

2. I begin with the presumption that we would prefer to see greater exchange rate stability over the medium term. Although some exchange rate changes have reflected oil price shocks and changes in underlying performance many have not. A casual observation of the path of the effective exchange rates of the major industrial countries demonstrates that fluctuations have been much greater than was expected; and much greater than could possibly be justified by the underlying economic circumstances. The interaction of the currency markets has led to exchange rates running in one direction for sustained periods during which very large shifts in real exchange rates have taken place. Once the tide has turned we have then seen sustained movements in the opposite direction which have virtually unwound all the previous real exchange rate change. (See Chart 1).

3. It is becoming increasingly evident that these large swings in real exchange rates have damaged the performance of the major industrial economies. They do not adapt quickly to change, and substantial shifts of emphasis between domestic and external demand, and between tradeables and non-tradeables have been disrupting. Forward markets can help companies to cover shorter term transactions but cannot reduce the risk of expanding or contracting capacity in particular countries.

4. At the same time we recognise that it would not be feasible to direct policy exclusively towards exchange rate stability. There are other important considerations. The first is that, from time to time, changes in the underlying performance of the economies will require significant real exchange rate changes. Second, the scale and volatility of capital flows mean it may be impossible to put rigid limits on exchange rate variation. Third, it is important to avoid excessive volatility in interest rates and domestic monetary conditions in the individual countries and in the aggregate. Otherwise we would have merely solved one problem and created many others. And finally it is important that greater exchange rate stability should be combined with a maintenance of low inflation. We need to avoid any procedures that have a built-in inflationary or deflationary bias for the industrial countries, as a whole.

5. It is sometimes argued that greater exchange rate stability requires more compatible policies - both fiscal and monetary - and therefore the emphasis should be on policy co-ordination. There is much truth in this argument. But attempts to co-ordinate policy may not be sufficient. We have seen that only small differences in policy stance can create very large swings in real exchange rates. This points to an explicit focus on exchange rate movements. Past experience suggests that an effective commitment to stable exchange rates can itself be an important discipline to produce compatible policies. It is no guarantee of compatibility but it exercises pressure in the appropriate direction.

6. What follows is conditional upon the acceptance of the objective of greater exchange rate stability. I attempt to outline an approach that would gradually achieve that objective. As far as possible it is based upon our own experience of operating policy and attempts to extend that approach to international policy co-ordination. If in the process it turns out that the disadvantages and the problems are too great, then this would be a clear indication that it would be futile to try to go any further.

7. My starting point is that there should be two components:

- an agreement to give significant weight to exchange rate changes in the operation of financial policy - primarily monetary but also fiscal;

- an agreement to develop a nominal framework to monitor and to control the average inflation rate of the G7 collectively.

In other words we need a nominal framework to pin down the average inflation rate of the G7 and to combine it with steady growth; and an exchange rate discipline to keep individual countries' performance reasonably close to the average whilst permitting some differences.

Agreement to foster exchange rate stability

8. The agreement to foster exchange rate stability might have the following components:

- a "reference range" for each currency expressed in terms of its own rate against the SDR; initially this could be plus or minus 5 per cent. These ranges themselves would have to be revised periodically;

- an agreement by each country involved to give significant weight to movements of exchange rates relative to the reference range in the operation of monetary policy. There would be no absolute requirement to keep exchange rates within the reference range but it would be a requirement to take explicit action - either intervention or interest rate changes - if there were signs of the exchange rate moving outside the range;

- countries would be called to account for their actions during the previous period on a regular basis; particularly to explain any sustained deviation of the exchange rate from

its reference range. G7 Ministers might meet 3 or 4 times a year to review developments and the ranges. Deputies would meet more often;

- there would be a role for judicious tactical intervention, preferably of a concerted nature. But we would not normally look to massive and sustained intervention to defend the limits of ranges. Any intervention would have to remain largely unsterilised. In other words it would be important that countries allowed their intervention to ease or tighten monetary conditions;

- the main policy instrument for responding to movements of the exchange rate towards the edges of its reference range would be interest rates. This would mean that most monetary authorities would have to give relatively more weight to the exchange rate in their operation of policy than they are accustomed to;

- initially the reference ranges would be unpublished, although it would be necessary to accept that this may not be possible for long. Eventually the aim would be to publish ranges to act as an anchor for exchange rate expectations.

Agreement to control G7 Inflation Rate

9. Any exchange rate agreement needs to be buttressed by a mechanism to stabilise the average inflation rate of the individual countries. If this is absent persistent inflationary or deflationary biases might emerge. In the Bretton Woods system US monetary policy played this role and until the mid '60s it played it quite effectively. Subsequently US inflation picked up and the progressive failure of the dollar to fulfil its role as an anchor for price stability was an important reason for the crumbling of the system.

10. The aggregate inflation control component of the agreement could be developed from the present surveillance methodology but in a much simpler form. An important component would be an agreement to establish a clear nominal framework for the average of the G7 countries. We would have to compute accepted indicators for the G7 as a whole and agree to conduct policy in aggregate so that performance was in line with the overall inflation objective.

11. Following our own experience we would prefer this to be done by setting medium term objectives for money GDP, although I accept that this carries little weight with other countries and initially we may have to consider inflation and output separately. These objectives would have to be monitored. We would wish to use similar procedures to those we currently employ in the UK; but it is likely that the Fed and Bundesbank have their own ways of looking at these things. The aim would be to agree on monetary aggregates and other financial indicators, including general economic indicators, which would be taken into account in assessing monetary conditions at G7 level.

12. In this process I would give an important role to non-oil commodity prices. They are the most flexible prices in the world economy and respond most quickly to changes in monetary conditions. Although they only have a small direct weight in consumer prices (about 10 per cent), generally if commodity prices are falling this is a sign that there is continuing downward pressure upon money GDP and inflation and vice versa. For the aggregate G7 economies the level of commodity prices would play much the same role as the exchange rate for individual countries.

13. As well as procedures for assessing monetary conditions there would also have to be arrangements for deciding who does what when there is an agreed need for an aggregate adjustment. In practice this would be reviewed at the same time as the balance of policy in individual countries.

Some Questions

Why Now?

The recent reversal of the dollar and the accompanying rise of the Yen and DM are extra evidence of the unnecessary shifts in exchange rates we have seen over the past 6 years. In addition the constellation of exchange rates is now better than it has been for 5 years. This would also be a convenient moment to begin from the point of view of world inflation. The indicators continue to point to an absence of inflationary pressure and the objective would be to lock in the present low rate.

What would signal the need for a change in reference rates?

Changes in reference rates would obviously have to be a matter for mutual agreement. In practice they would often be the result of persistent market pressures in one direction or another that seem to call for an inappropriate monetary response. For example if a country was experiencing persistent upward pressure on its exchange rate despite recent interest rate reductions and there was a threat of excessive growth of money GDP there would be a clear suggestion that the exchange rate should be revised upwards.

What would signal the need for a change of fiscal policy?

The presumption would be against fiscal policy changes as a way of keeping within the reference ranges because it should normally be set in a medium term context. However the persistent use of monetary policy to keep to the exchange rate objectives could lead to a level of interest rate and/or a pattern of current account surpluses/deficits which were unsatisfactory and/or unsustainable. At this stage fiscal policy correction could be the way to restore balance while keeping within the exchange rate reference rates. In these circumstances fiscal policy changes might be an important adjunct to changes in reference rates.

How detailed should intervention procedures be?

Not very detailed. I see no immediate prospect of setting up a G7 equivalent of EMS. In addition I doubt if it would be desirable. The important next step is to get some shift of behaviour - not a complete change. It follows that we would not be looking for complicated intervention rules, diversion indicators, or open-ended intervention when limits are reached.

What would have changed?

The biggest change would be the acceptance by countries, particularly Germany and the US, that exchange rate changes have a significant weight in monetary policy decisions and that domestic money indicators have a smaller weight. The other major change would be the increased emphasis on developments in the G7 economy as a whole.

What are the implications for the objective indicators exercise?

Most of it would be unnecessary. A simplified version would be directed towards the aggregate G7. For individual countries indicators would be directed towards supporting the exchange rate objectives. By far the most important "real" variable is the growth of domestic demand.

What interest rates response would we expect for given exchange rate changes?

There is no obvious rule. It would be for individual countries to choose but partner countries would have to be persuaded it was sufficient.

What powers of enforcement exist?

None other than potential exclusion from the club and having to explain and defend actions to member countries.

Why monitor money GDP growth?

We have found it useful as a focus for monetary policy design although recognise that policy could also be framed in terms of an inflation target. Money GDP represents the growth of total cash spending in the economy. Experience suggests that if it can be gradually reduced the result is steady growth of real output at close to productive potential and gradually declining inflation.

What are the implications for the present stance of policy in the G7 as a whole?

See Tables 1 and 2. The oil price decline has produced a reduction in the growth of G7 money GDP. In other words most of the benefits have been taken in the form of lower inflation rather than faster output growth. If anything I would conclude that policy in aggregate has been too tight whilst recognising a wide margin of uncertainty about the timing of the effect of lower oil prices. Policy tightness also shows up in the behaviour of commodity prices. After falling in the 12 months up to last August we have had 6 months of virtual stability despite the low level of real commodity prices. This also suggests some room for an easing of the overall policy stance. I would not want to go too far in response to recent events given the overrun of individual countries' monetary targets but in my view that is the direction in which to move.

What implications for the present stance of monetary policy in individual countries?

Continued Yen and DMark strength combined with dollar weakness suggests that, if anything, there is further scope for Japanese and German interest rates to fall. US rates may have to rise but as there may be some room for an easing in the aggregate G7 stance this is less urgent.

What are the implications for the present stance of fiscal policy in individual countries?

By historical standards, interest rates in Germany and Japan are already at very low levels although on crude calculations "real" interest rates remain high; and current account imbalances are expected to persist. In general this points to a further tightening of US fiscal policy and less urgency for fiscal consolidation in Japan and Germany. However we have argued that, if anything, fiscal policy in the G7 in aggregate is too easy; the bulk of the adjustment should be in the US.

Are present exchange rates satisfactory?

We have had a big exchange rate correction. It will take time to have an effect and meanwhile J-curve effects hide progress. A period of stability whilst the effects come through could be welcome. We may then have to conclude that a further change is necessary but it should be gradual and come at a later stage.

Are any other actions necessary?

Clearly Europe has to continue to do what it can to strengthen the supply performance of the economy. Lower taxes, greater labour market flexibility and more deregulation would help. And Japan has to take much more active steps to open its markets to other countries. It is not possible to have free movement of capital and such widespread restrictions on trade. This can only lead to huge imbalances in the world economy that invite retaliation - both on trade and capital movements.

Is this simply target zones?

There are clear similarities to proposals for target zones with soft buffers. But the emphasis is on the nominal

exchange rate rather than real rates; and a key part of the proposal is emphasis on the G7 inflation rate as a whole. In particular it attempts to build on the framework we have been developing for the operation of policy in the UK.

Next Steps?

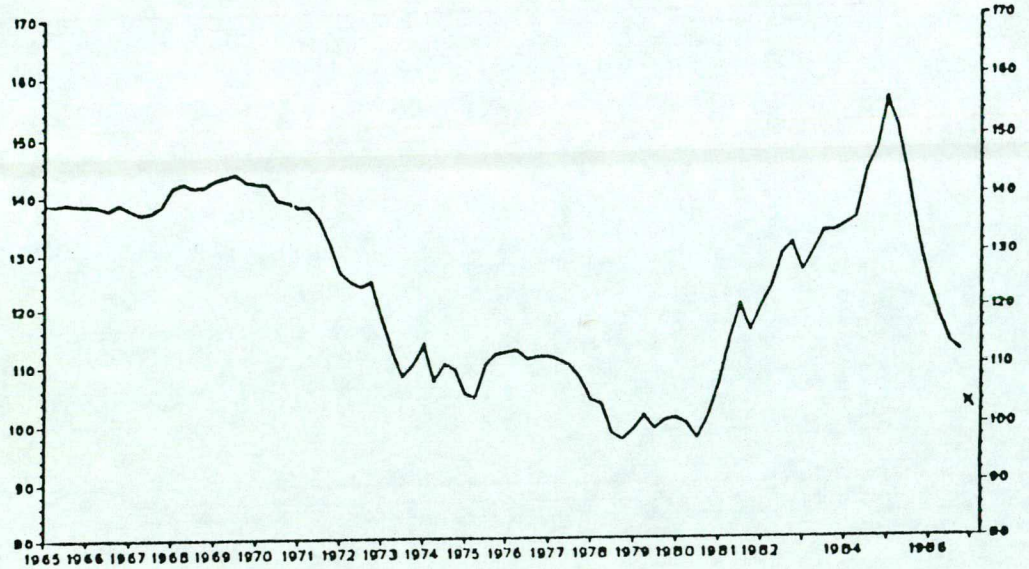
If there was any interest in principle the next steps would be to develop in more detail the relevant indicators and to give more thought to the circumstances that would justify a change in the reference range.

Stephen

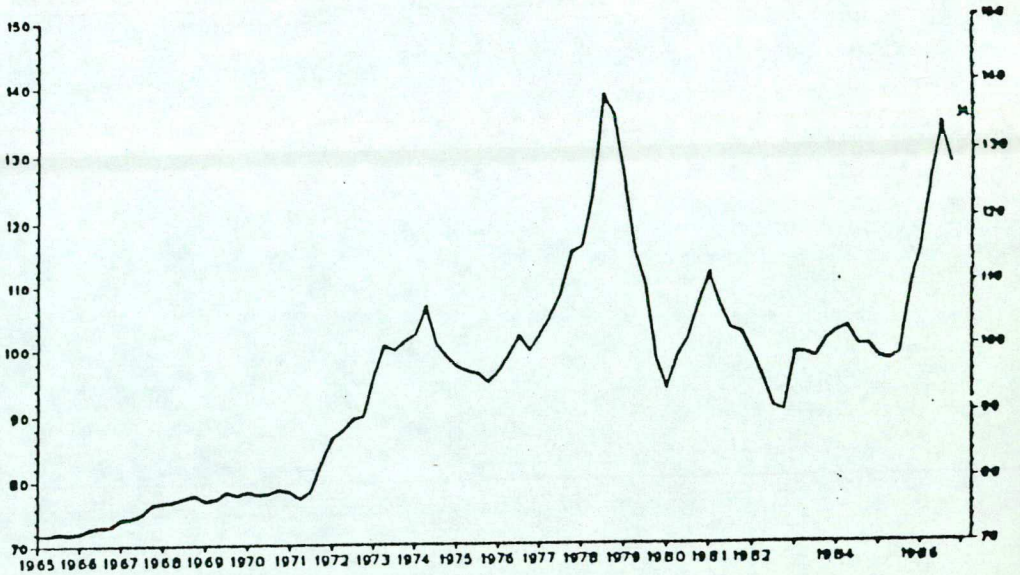
PP T BURNS

Chart 1

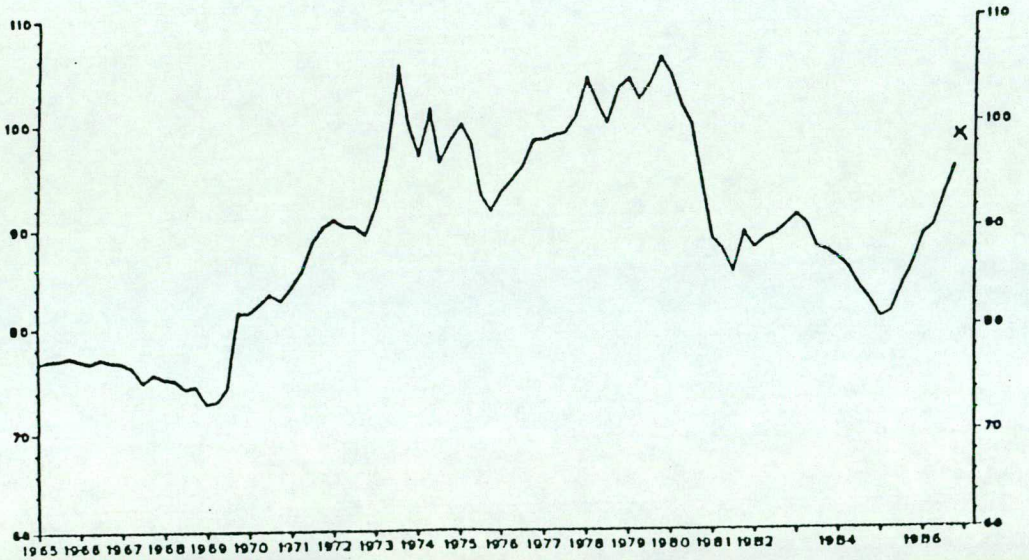
REAL EFFECTIVE EXCHANGE RATE, 1980 = 100
UNITED STATES



REAL EFFECTIVE EXCHANGE RATE, 1980 = 100
JAPAN



REAL EFFECTIVE EXCHANGE RATE, 1980 = 100
GERMANY



REAL EFFECTIVE EXCHANGE RATE, 1980 = 100
FRANCE

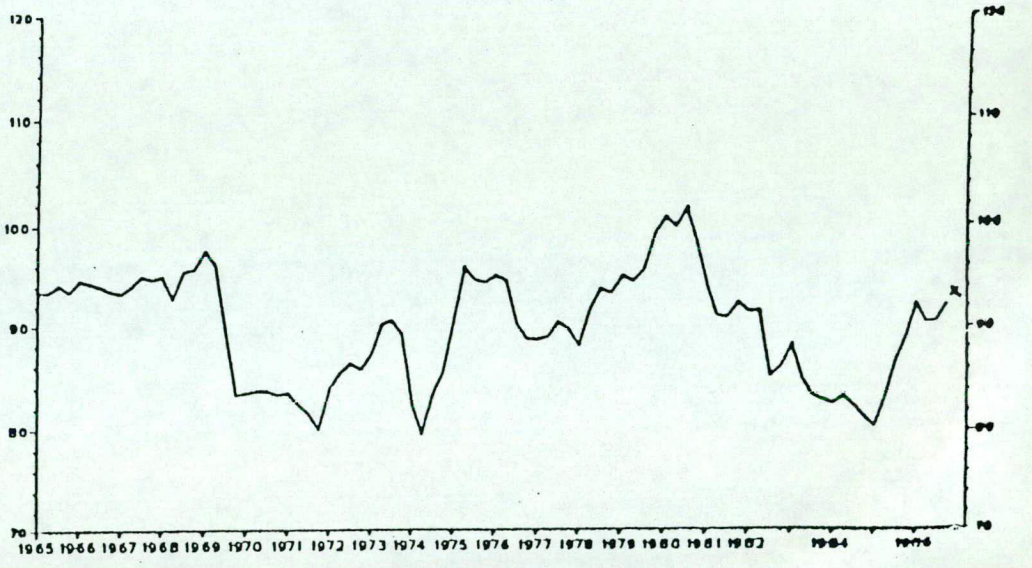
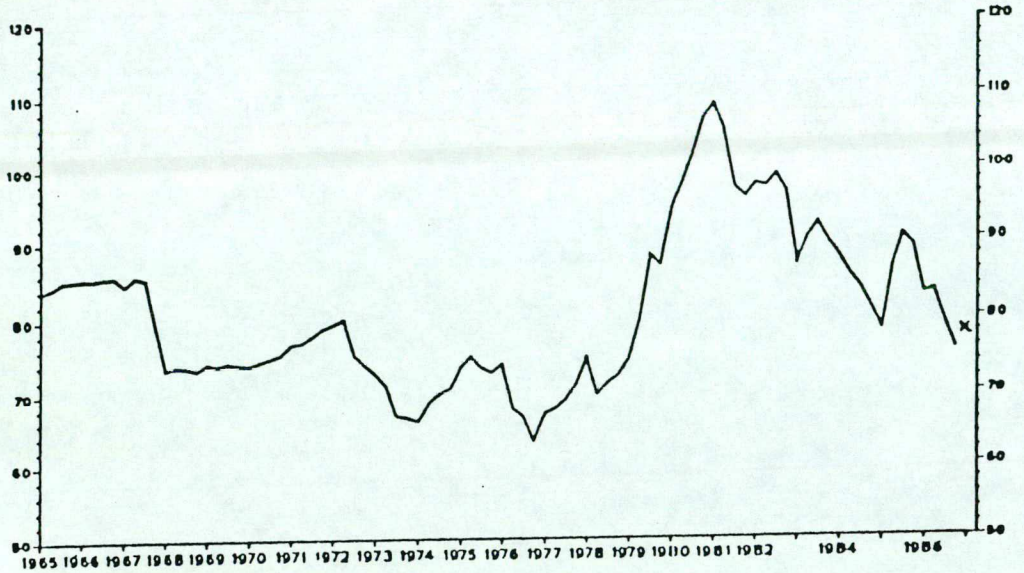
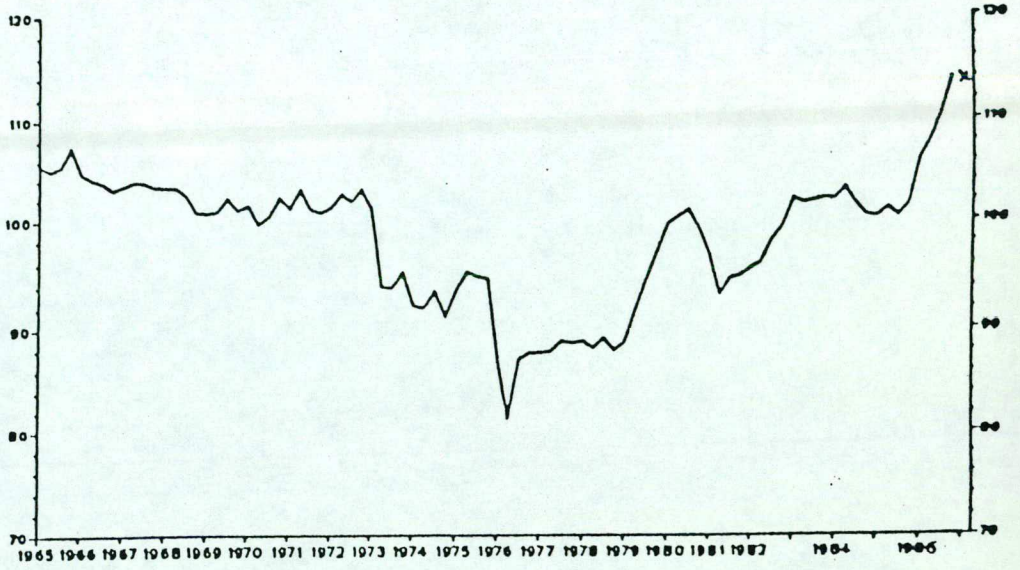


Chart 1 (cont.)

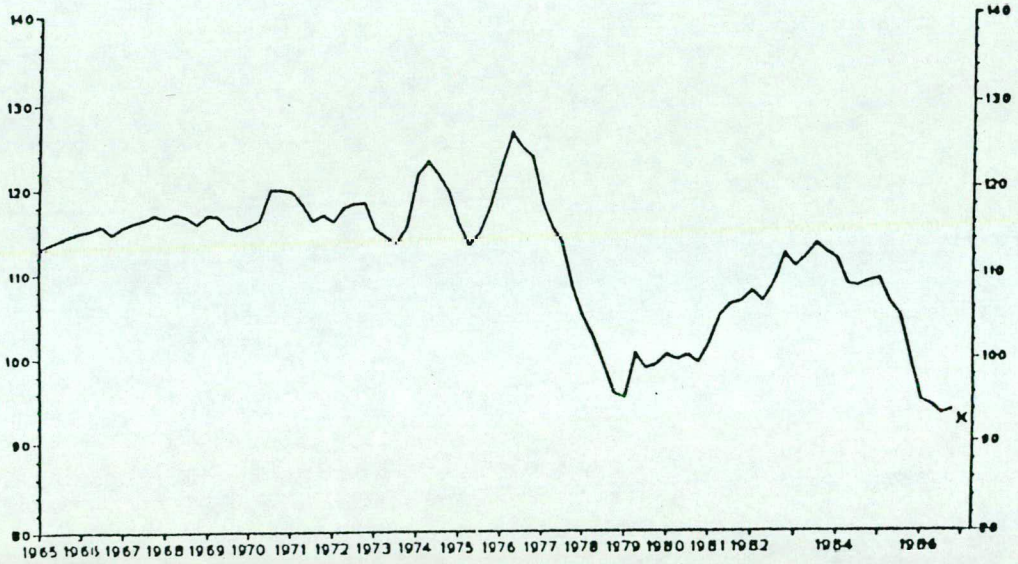
REAL EFFECTIVE EXCHANGE RATE, 1980 = 100
UK



REAL EFFECTIVE EXCHANGE RATE, 1980 = 100
ITALY



REAL EFFECTIVE EXCHANGE RATE, 1980 = 100
CANADA



KEY ECONOMIC INDICATORS FOR THE G7 COUNTRIES

	Nominal GNP	Real GNP	GNP Deflator	Consumer prices
Annual percentage changes				
1980	10.5	1.1	9.3	12.0
1981	10.4	1.6	8.7	9.9
1982	6.2	-0.6	6.8	7.0
1983	7.4	2.8	4.5	4.4
1984	9.1	5.0	3.9	4.4
1985	6.9	3.0	3.8	3.8
1986	5.7	2.5	3.1	1.9
Change from four quarters earlier (per cent)				
1985 Q1	6.6	2.8	3.7	4.0
Q2	7.0	3.1	3.8	4.2
Q3	7.2	3.2	3.9	3.9
Q4	7.1	2.9	4.1	3.6
1986 Q1	6.4	2.7	3.6	3.1
Q2	6.3	2.7	3.5	1.8
Q3	5.7	2.4	3.2	1.6
Q4	5.0	2.3	2.6	1.4
Change from twelve months earlier (per cent)				
1986 Oct				1.4
Nov				1.3
Dec				1.3
1987 Jan				1.3
Feb				1.7 (est)
Mar				

KEY FINANCIAL INDICATORS FOR THE G7 COUNTRIES

	Narrow Money (M1)	Broad Money	Three-month interest rate (per cent)	Commodity prices (SDRs, 1980 = 100)
Annual percentage changes				
1980	5.8	9.4	12.7	100.0
1981	6.5	10.1	14.2	95.1
1982	6.9	9.5	11.7	89.9
1983	10.3	10.5	9.2	102.7
1984	7.5	7.9	9.7	105.7
1985	8.3	8.6	8.5	96.0
1986	11.4	8.2	7.1	87.0
Changes from four quarters earlier				
1985 Q1	7.4	9.3	9.1	102.5
Q2	7.6	8.8	8.6	99.4
Q3	9.0	8.4	8.2	92.1
Q4	9.9	7.8	8.3	90.1
1986 Q1	9.8	7.6	8.2	93.7
Q2	11.0	7.9	7.0	90.8
Q3	11.6	8.5	6.5	81.3
Q4	12.7	8.8	6.6	82.4
Changes from twelve months earlier				
1986 Oct	12.2	8.6	6.6	81.8
Nov	13.1	8.8	6.6	83.6
Dec	12.7	8.8	6.7	81.9
1987 Jan			6.7	80.3
Feb			6.6	81.7
Mar			6.4	82.9

PWP

This communiqué follows intensive discussion over the telephone by G7 Finance Ministers over the past few weeks.

It shows clearly that there is continuing close international co-operation over economic and financial policy.

G7
8 APRIL 1987

April 8, 1987

STATEMENT OF THE GROUP OF SEVEN

1. The Finance Ministers and Central Bank Governors of seven major industrial countries met today. They continued the process of multilateral surveillance of their economies pursuant to the arrangements for strengthened economic policy coordination agreed at the 1986 Tokyo Summit of their Heads of State or Government. The Managing Director of the International Monetary Fund also participated in the meeting.

2. The Ministers and Governors reaffirmed the commitment to the cooperative approach agreed at the recent Paris meeting, and noted the progress achieved in implementing the undertakings embodied in the Louvre Agreement. They agreed, however, that further actions will be essential to resist rising protectionist pressures, sustain global economic expansion, and reduce trade imbalances. In this connection they welcomed the proposals just announced by the governing Liberal Democratic Party in Japan for extraordinary and urgent measures to stimulate Japan's economy through early implementation of a large supplementary budget exceeding those of previous years, as well as unprecedented front-end loading of public works expenditures. The Government of Japan reaffirmed its intention to further open up its domestic markets to foreign goods and services.

3. The Ministers and Governors reaffirmed the view that around current levels their currencies are within ranges broadly consistent with economic fundamentals and the basic policy intentions outlined at the Louvre meeting. In that connection they welcomed the strong implementation of the Louvre agreement. They concluded that present and prospective progress in implementing the policy undertakings at the Louvre and in this statement provided a basis for continuing close cooperation to foster the stability of exchange rates.

INDICATORS TEXT

CONFIDENTIAL

April 8, 1987

Economic Policy Coordination

We have agreed on refinements of the Tokyo arrangements on closer economic policy coordination. The objectives of the agreement are (1) simplification of the indicators and (2) the provision of greater discipline to the process.

The Establishment of Economic Objectives and Projections

In order to provide a framework for surveillance, each country will present, early in the year, the medium-course of its intended policies and establish its economic objectives and projections. In this context, a small group of indicators that measure domestic and external economic performance and policies will be used with a special focus on those which reflect interactions among our economies. The objectives and projections will in some cases be quantified; in others they may be more general in nature. Broad, mutually consistent objectives will be developed also for the group as a whole. Both the collective and individual country objectives and projections are to be consistent and will serve as standards against which to assess country policies and performance. Initially, the objectives and projections involve the following key variables: growth, domestic demand, inflation, current account balances, budget performance, monetary conditions and exchange rates.

Review Process

The Ministers and Governors will meet regularly to develop objectives and projections, to review national economic policies and performance, and to assess current trends and prospects.

In order to assist in these meetings, the IMF will develop further the approach taken in the initial surveillance exercise by preparing papers for each meeting. Such papers, including tables on the indicators, will examine economic developments and prospects in each country, and assess the progress and problems in achieving the objectives and projections. In this context, an assessment will be made of the possible need for policy action to assure that current and prospective trends are consistent with achievement of the objectives or to modify them.

In order to assist in this assessment, interim performance indicators will be developed. In selecting the interim performance indicators, attention will be focused on specific measures from a range of variables such as those referred to in the Tokyo Communique. The selection of interim performance indicators may vary from year to year to cover in the best possible way the full range of the underlying economic policies and performance.

Ministers and Governors will meet to review progress and prospects and undertake best efforts to reach understandings regarding appropriate remedial action if necessary. Substantial deviations from the intended course will lead to consultations. When circumstances warrant, a special meeting of Ministers and Governors would be convened.

Role of IMF Managing Director

The Managing Director of the IMF would be invited to express his views about underlying economic policies, performance, and prospects and to offer his advice on improvements in policies, including exchange rates, necessary for the smooth functioning of the international monetary system.

The Role of Exchange Rates

Exchange rates are one of the key variables in the international adjustment process. A common understanding of the role of exchange rates is essential to reaching judgments concerning the extent to which imbalances are expected to be reduced through exchange rates or by other adjustment measures. In connection with their consideration of desirable adjustments of underlying policy fundamentals, Ministers and Governors will seek to reach informal, confidential understandings on the appropriateness of exchange rates and, if necessary, of desired exchange rate changes, taking into account the established economic objectives and projections. If they agree that it would be helpful either to stabilize or to promote adjustment of exchange rates, they will seek joint action to that end. This could, under certain circumstances, involve the use of ranges.

ANNEX C4:
LOUVRE COMMUNIQUE

[redacted] ANNEX C4 - LOUVRE COMMUNIQUE

STATEMENT

1. Ministers of Finance and Central Bank Governors of six major industrialized countries met today in Paris to conduct multilateral surveillance of their economies in the framework of the Tokyo Economic Declaration of May 6, 1986 pursuant to which the group of seven Finance Ministers was formed. The Ministers and Governors, using a range of economic indicators, reviewed current economic developments and prospects. The Managing Director of the IMF participated in the discussions.

2. The Ministers and Governors were of the view that further progress had been made since the Tokyo Summit in their efforts to achieve a sustainable, non-inflationary expansion. Their national economies are now in the fifth year of expansion, and the prospects are for continued growth this year, although the level of unemployment remains unacceptably high in some countries. A high degree of price stability has been attained, and there have been substantial reductions in interest rates. Exchange rate adjustments have occurred which will contribute importantly in the period ahead to the restoration of a more sustainable pattern of current accounts.

3. Progress is being made in reducing budget deficits in deficit countries, and fundamental tax reforms are being introduced to improve incentives, increase the efficiency of economies, and enhance the prospects of higher growth. Other important structural reforms are also being carried forward, including deregulation of business to increase efficiency and privatization of government enterprises to strengthen reliance on private entrepreneurs and market forces.

4. These positive developments notwithstanding, the Ministers and Governors recognize that the large trade and current account imbalances of some countries pose serious economic and political risks. They agreed that the reduction of the large unsustainable trade imbalances is a matter of high priority, and that the achievement of more balanced global growth should play a central role in bringing about such a reduction.

5. The Ministers and Governors reaffirmed their concern over continuing pressures for protectionism. They agreed that efforts to deal with economic problems by erecting trade barriers were self-defeating and pledged to intensify their efforts to resist protectionism and reaffirmed their strong support for the new round of trade negotiations. They welcomed the progress made in the preparatory work for the new GATT round and the recent positive conclusions of discussions between the United States and the European Community on bilateral trade issues.

6. The Ministers and Governors recognized that the major industrial countries have a special responsibility to follow policies which foster an open, growing world economy in order to support the efforts of developing countries, especially debtor countries, to restore steady growth and viable balance of payments positions. They noted that the progress achieved by many debtor countries toward these ends have not solved all the problems and stressed the importance of all participants in the strengthened debt strategy reinforcing their cooperative efforts.

7. The Ministers and Governors agreed to intensify their economic policy coordination efforts in order to promote more balanced global growth and to reduce existing imbalances. Surplus countries committed themselves to follow policies designed to strengthen domestic demand and to reduce their external surpluses while maintaining price stability. Deficit countries committed themselves to follow policies designed to encourage steady, low-inflation growth while reducing their domestic imbalances and external deficits. To this end, each country has agreed to the following undertakings.

The Government of Canada's policy is designed to sustain the current economic expansion through its fifth year and beyond. In the budget for 1987/88, the Government has cut the fiscal deficit for the third consecutive year and remains committed to further progressive reduction. Canada will propose shortly an extensive reform of its tax system. It will continue with its policies of regulatory reform, privatization and liberalization of domestic markets. It will vigorously pursue trade liberalization bilaterally with the United States and multilaterally within the Uruguay round. Monetary policies will continue to aim at the reduction of inflation and be consistent with orderly exchange markets.

The Government of France will reduce the central government budget deficit by 1 percent of GNP from 1986 to 1988 and in the same period will implement a tax cut program of the same order of magnitude (1 percent of GNP) with substantial tax rate cuts for corporations and individuals. It will pursue in 1987 its privatization program (with a projected $6 to $7 billions sale of assets) and reinforce the liberalization of the French economy, especially of labor and financial markets.

The Government of the Federal Republic of Germany will pursue policies to diminish further the share of public expenditures in the economy and to reduce the tax burden for individuals and corporations with a comprehensive tax reform aimed at reinforcing the incentives for private sector activity and investment. In addition, the Government will propose to increase the size of the tax reductions already enacted for 1988. The Federal Government will emphasize policies that enhance market forces in order to foster structural adjustment and innovation. Short-term interest rates, although already at a very low level in international comparison, have further dropped substantially during the last few weeks. Monetary policy will be directed at improving the conditions for sustained economic growth while maintaining price stability.

The Government of Japan will follow monetary and fiscal policies which will help to expand domestic demand and thereby contribute to reducing the external surplus. The comprehensive tax reform, now before the Diet, will give additional stimulus to the vitality of the Japanese economy. Every effort will be made to get the 1987 budget approved by the Diet so that its early implementation be ensured. A comprehensive economic program will be prepared after the approval of the 1987 budget by the Diet, so as to stimulate domestic demand, with the prevailing economic situation duly taken into account. The Bank of Japan announced that it will reduce its discount rate by one half percent on February 23.

The United Kingdom Government will maintain conditions for continuing the steady growth of GDP of the past five years and will continue to work to reduce inflation by following a prudent monetary policy. On external account the aim will be broad balance over the medium term. The share of public expenditure in the economy will continue to fall and the burden of taxation will be reduced, while public sector borrowing is maintained at low level. These and other measures to strengthen the supply performance of the economy, such as the privatization programme, will reinforce improvement over recent years in the growth of productivity.

The United States Government will pursue policies with a view to reducing the fiscal 1988 deficit to 2.3 % of GNP from its estimated level of 3.9 % in fiscal 1987. For this purpose, the growth in government expenditures will be held to less than 1 percent in fiscal 1988 as part of the continuing program to reduce the share of government in GNP from its current level of 23 percent. The United States will introduce a wide range of policies to improve its competitiveness and to enhance the strength and flexibility of its economy. Monetary policy will be consistent with economic expansion at a sustainable non-inflationary pace.

8. The Ministers and Governors noted that a number of newly industrialized economies were playing an increasingly important role in world trade. These economies have achieved strong growth based significantly on their access to open, growing export markets. Recently, some have accumulated trade surpluses which have contributed importantly to the present unsustainable pattern of global imbalances, thus increasing protectionist pressures. The Ministers and Governors considered that it is important that the newly industrialized developing economies should assume greater responsibility for preserving an open world trading system by reducing trade barriers and pursuing policies that allow their currencies to reflect more fully underlying economic fundamentals.

9. The Ministers and Governors also agreed to additional refinements in the use of economic indicators for the multilateral surveillance arrangements approved in the Tokyo Economic Declaration. As part of these refinements, they will :

- periodically review medium-term economic objectives and projections involving domestic and external variables. The medium-term objectives and projections are to be mutually consistent and will serve as a basis for assessing national policies and performance ;

- regularly examine, using performance indicators, whether current economic developments and trends are consistent with the medium-term objectives and projections and consider the need for remedial action.

Initially, the objectives and projections will involve the following key variables : growth, inflation, current accounts/trade balances, budget performance, monetary conditions and exchange rates.

10. The Ministers and Governors agreed that the substantial exchange rate changes since the Plaza Agreement will increasingly contribute to reducing external imbalances and have now brought their currencies within ranges broadly consistent with underlying economic fundamentals, given the policy commitments summarized in this statement. Further substantial exchange rate shifts among their currencies could damage growth and adjustment prospects in their countries. In current circumstances, therefore, they agreed to cooperate closely to foster stability of exchange rates around current levels.

Paris, February 22, 1987

Venice Communique

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prep.

(Final Version)

For Budget

VENEZIA SUMMIT CONFERENCE

Venezia Economic Declaration

Introduction

1. We, the Heads of State or Government of the seven major industrialized countries and the representatives of the European Community, have met in Venice from 8 to 10 June 1987, to review the progress that our countries have made, individually and collectively, in carrying out the policies to which we committed ourselves at earlier Summits. We remain determined to pursue these policies for growth, stability, employment, and prosperity for our own countries and for the world economy.

2. We can look back on a number of positive developments since we met a year ago. Growth is continuing into its fifth consecutive year, albeit at lower rates. Average inflation rates have come down. Interest rates have generally declined. Changes have occurred in relationships among leading currencies which over time will contribute to a more sustainable pattern of current account positions and have brought exchange rates within ranges broadly consistent with economic fundamentals. In volume terms the adjustment of trade flows is under way, although in nominal terms imbalances so far remain too large.

Macroeconomic policies and exchange rates

3. Since Tokyo, the Summit countries have intensified their economic policy coordination with a view to ensuring internal consistency of domestic policies and their international compatibility. This is essential to achieving stronger and sustained global growth, reduced external imbalances and more stable exchange rate relationships. Given the policy agreements reached at the Louvre and in Washington, further substantial shifts in exchange rates could prove counterproductive to efforts to increase growth and facilitate adjustment. We reaffirm our commitment to the swift and full implementation of those agreements.

4. We now need to overcome the problems that nevertheless remain in some of our countries: external imbalances that are still large; persistently high unemployment; large public sector deficits; and high levels of real interest rates. There are also continuing trade restrictions and increased protectionist pressures, persistent weakness of many primary commodity markets, and reduced prospects for developing countries to grow, find the markets they need and service their foreign debt.

5. The correction of external imbalances will be a long and difficult process. Exchange rate changes alone will not solve the problem of correcting these imbalances while sustaining growth. Surplus countries will design their policies to strengthen domestic demand and reduce external surpluses while maintaining price stability. Deficit countries, while following policies designed to encourage steady low-inflation growth, will reduce their fiscal and external imbalances.

6. We call on other industrial countries to participate in the effort to sustain economic activity worldwide. We also call on newly industrialized economies with rapid growth and large external surpluses to assume greater responsibility for preserving an open world trading system by reducing trade barriers and pursuing policies that allow their currencies more fully to reflect underlying fundamentals.

7. Among the Summit countries, budgetary discipline remains an important medium-term objective and the reduction of existing public sector imbalances a necessity for a number of them. Those Summit countries which have made significant progress in fiscal consolidation and have large external surpluses remain committed to following fiscal and monetary policies designed to strengthen domestic growth, within a framework of medium-term fiscal objectives. Monetary policy should also support non-inflationary growth and foster stability of exchange rates. In view of the outlook for low inflation in many countries, a further market-led decline of interest rates would be helpful.

Structural policies

8. We also agree on the need for effective structural policies especially for creating jobs. To this end we shall:

- promote competition in order to speed up industrial adjustment;

- reduce major imbalances between agricultural supply and demand;

- facilitate job creating investment;

- improve the functioning of labour markets;

- promote the further opening of internal markets;

- encourage the elimination of capital market imperfections and restrictions and the improvement of the functioning of international financial markets.

Multilateral surveillance and policy coordination

9. We warmly welcome the progress achieved by the Group of Seven Finance Ministers in developing and implementing strengthened arrangements for multilateral surveillance and economic coordination as called for in Tokyo last year. The new process of coordination, involving the use of economic indicators, will enhance efforts to achieve more consistent and mutually compatible policies by our countries.

10. The Heads of State or Government reaffirm the important policy commitments and undertakings adopted at the Louvre and Washington meetings of the Group of Seven, including those relating to exchange rates. They agree that, if in the future world economic growth is insufficient, additional actions will be required to achieve their common objectives. Accordingly, they call on their Finance Ministers to develop, if necessary, additional appropriate policy measures for this purpose and to continue to cooperate closely to foster stability of exchange rates.

11. The coordination of economic policies is an ongoing process which will evolve and become more effective over time. The Heads of State or Government endorse the understandings reached by the Group of Seven Finance Ministers to strengthen, with the assistance of the International Monetary Fund (IMF), the surveillance of their economies using economic indicators including exchange rates, in particular by:

- the commitment by each country to develop medium-term objectives and projections for its economy, and for the group to develop objectives and projections, that are mutually consistent both individually and collectively; and

- the use of performance indicators to review and assess current economic trends and to determine whether there are significant deviations from an intended course that require consideration of remedial actions.

12. The Heads of State or Government consider these measures important steps towards promoting sustained non-inflationary global growth and greater currency stability. They call upon the Group of Seven Finance Ministers and Central Bank Governors to:

- intensify their coordination efforts with a view to achieving prompt and effective implementation of the agreed policy undertakings and commitments;

- monitor economic developments closely in cooperation with the Managing Director of the IMF; and

- consider further improvements as appropriate to make the coordination process more effective.

Trade

13. We note rising protectionist pressures with grave concern. The Uruguay Round can play an important role in maintaining and strengthening the multilateral trading system, and achieving increased liberalization of trade for the benefit of all countries. Recognizing the interrelationship among growth, trade and development, it is essential to improve the multilateral system based on the principles and rules of the General Agreement on Tariffs and Trade (GATT) and bring about a wider coverage of world trade under agreed, effective and enforceable multilateral discipline. Protectionist actions would be counterproductive, would increase the risk of further exchange rate instability and would exacerbate the problems of development and indebtedness.

14. We endorse fully the commitment to adopt appropriate measures in compliance with the principles of stand-still and rollback which have been reaffirmed in the Ministerial Declaration on the Uruguay Round. It is important to establish in the GATT a multilateral framework of principles and rules for trade in services, trade-related investment measures and intellectual property rights. This extension of the multilateral trading system would also be beneficial to developing countries in fostering growth and enhancing trade, investment and technology transfers.

15. Basing ourselves on the Ministerial Declaration on the Uruguay Round and on the principles of the GATT, we call on all Contracting Parties to negotiate comprehensively, in good faith and with all due despatch, with a view to ensuring mutual advantage and increased benefits to all participants. Canada, Japan, the United States and the European Community will table a wide range of substantive proposals in Geneva over the coming months. Progress in the Uruguay Round will be kept under close political review. In this context the launching, the conduct and the implementation of the outcome of the negotiations should be treated as parts of a single undertaking; however, agreements reached at an early stage might be implemented on a provisional or definitive basis by agreement prior to the formal conclusion of the negotiations, and should be taken into account in

assessing the overall balance of the negotiations.

16. A strong, credible, working GATT is essential to the well-being of all trading countries and is the best bulwark against mounting bilateral protectionist pressures. The functioning of the GATT should be improved through enhancing its role in maintaining an open multilateral system and its ability to manage disputes; and through ensuring better coordination between the GATT and the IMF and the World Bank. We consider that it would be useful to have, as appropriate, in the course of the negotiations, a meeting of the Trade Negotiating Committee at the Ministerial level.

Agriculture

17. At Tokyo we recognized the serious nature of the agricultural problem. We agreed that the structure of agricultural production needed to be adjusted in the light of world demand, and expressed our determination to give full support to the work of the OECD in this field. In doing so, we all recognized the importance of agriculture to the well-being of our rural communities. In the past year, we have actively pursued the approach outlined at Tokyo, and we take satisfaction from the agreement in the Ministerial Declaration adopted in Punta del Este on the objectives for the negotiations on agriculture in the Uruguay Round.

18. We reaffirm our commitment to the important agreement on agriculture set out in the OECD Ministerial communique of May 13, 1987; in particular, the statement of the scope and urgency of the problem which require that a concerted reform of agricultural policies be implemented in a balanced and flexible manner; the assessment of the grave implications, for developed and developing countries alike, of the growing imbalances in supply of and demand for the main agricultural products; the acknowledgment of shared responsibility for the problems as well as for their equitable, effective and durable resolution; the principles of reform and the action required. The long-term objective is to allow market signals to influence the orientation of agricultural production, by way of a progressive and concerted reduction of agricultural support, as well as by all other appropriate means, giving consideration to social and other concerns, such as food security, environmental protection and overall employment.

19. We underscore our commitment to work in concert to achieve the necessary adjustments of agricultural policies, both at home and through comprehensive negotiations in the Uruguay Round. In this as in other fields, we will table comprehensive proposals for negotiations in the coming months to be conducted in accordance with the mandate in the Ministerial Declaration, and we intend to review at our next meeting the progress achieved and the tasks that remain.

20. In the meantime, in order to create a climate of greater confidence which would enhance the prospect for rapid progress in the Uruguay Round as a whole and as a step towards

the long-term result to be expected from those negotiations, we have agreed, and call upon other countries to agree, to refrain from actions which, by further stimulating production of agricultural commodities in surplus, increasing protection or destabilizing world markets, would worsen the negotiating climate and, more generally, damage trade relations.

Developing countries and debt

21. We attach particular importance to fostering stable economic progress in developing countries, with all their diverse situations and needs. The problems of many heavily indebted developing countries are a cause of economic and political concern and can be a threat to political stability in countries with democratic regimes. We salute the courageous efforts of many of these countries to achieve economic growth and stability.

22. We underline the continuing importance of official development assistance and welcome the increased efforts of some of our countries in this respect. We recall the target already established by international organizations (0,7%) for the future level of official development assistance and we take note that overall financial flows are important to development. We strongly support the activities of international financial institutions, including those regional development banks which foster policy reforms by borrowers and finance their programmes of structural adjustment. In particular:

- we support the central role of the IMF through its advice and financing and encourage closer cooperation between the IMF and the World Bank, especially in their structural adjustment lending;

- we note with satisfaction the contribution made by the Eighth replenishment of the International Development Association (IDA);

- we support a general capital increase of the World Bank when justified by increased demand for quality lending, by its expanded role in the debt strategy and by the necessity to maintain the financial stability of the institution;

- in the light of the different contributions of our countries to official development assistance, we welcome the recent initiative of the Japanese government in bringing forward a new scheme which will increase the provision of resources from Japan to developing countries.

23. For the major middle-income debtors, we continue to support the present growth-oriented case-by-case strategy. Three elements are needed to strengthen the growth prospects of debtor countries: the adoption of comprehensive macroeconomic and structural reforms by debtor countries themselves; the enhancement of lending by international financial institutions, in particular the World Bank; and adequate commercial bank lending in support of debtor country reforms. We shall play our part by helping to sustain growth and expand trade. A number of debt agreements have allowed some resumption of growth,

correction of imbalances, and significant progress in restoring the creditworthiness of some countries. But some still lack adequate policies for structural adjustment and growth designed to encourage the efficient use of domestic savings, the repatriation of flight capital, increased flows of foreign direct investment, and in particular reforms of financial markets.

24. There is equally a need for timely and effective mobilization of lending by commercial banks. In this context, we support efforts by commercial banks and debtor countries to develop a "menu" of alternative negotiating procedures and financing techniques for providing continuing support to debtor countries.

25. Measures should be taken, particularly by debtor countries, to facilitate non-debt-creating capital flows, especially direct investment. In this connection, the Multilateral Investment Guarantee Agency (MIGA) should begin to serve its objectives as soon as possible. It is important to maintain flexibility on the part of export credit agencies in promptly resuming or increasing cover for countries that are implementing comprehensive adjustment programmes.

26. We recognize the problems of developing countries whose economies are solely or predominantly dependent on exports of primary commodities the prices of which are persistently depressed. It is important that the functioning of commodity markets should be improved, for example through better information and greater transparency. Further diversification of these economies should be encouraged, with the help of the international financial institutions, through policies to support their efforts for improved processing of their products, to expand opportunities through market access liberalization, and to strengthen the international environment for structural change.

27. We recognize that the problems of some of the poorest countries, primarily in sub-Saharan Africa, are uniquely difficult and need special treatment. These countries are characterized by such features as acute poverty, limited resources to invest in their own development, unmanageable debt burdens, heavy reliance on one or two commodities, and the fact that their debt is owed for the most part to governments of industrialized countries themselves or to international financial institutions. For those of the poorest countries that are undertaking adjustment effort, consideration should be given to the possibility of applying lower interest rates to their existing debt, and agreement should be reached, especially in the Paris Club, on longer repayment and grace periods to ease the debt service burden. We welcome the various proposals made in this area by some of us and also the proposal by the Managing Director of the IMF for a significant increase in the resources of the Structural Adjustment Facility over the three years from January 1, 1988. We urge a conclusion on discussions on these proposals within this year.

28. We note that UNCTAD VII provides an opportunity for a discussion with developing countries with a view to arriving at a

common perception of the major problems and policy issues in the world economy.

Environment

29. Further to our previous commitment to preserve a healthy environment and to pass it on to future generations, we welcome the report by the environment experts on the improvement and harmonization of techniques and practices of environmental measurement. Accordingly, we encourage the United Nations Environment Programme (UNEP) to institute a forum for information exchange and consultation in cooperation with the International Organization for Standardization (ISO) and the International Council of Scientific Union (ICSU), assisted by other interested international organizations and countries, so that continuing progress in this important field can be ensured. The priority environmental problems identified by the environment experts in their report should receive full attention.

30. We underline our own responsibility to encourage efforts to tackle effectively environmental problems of worldwide impact such as stratospheric ozone depletion, climate change, acid rains, endangered species, hazardous substances, air and water pollution, and destruction of tropical forests. We also intend to examine further environmental issues such as stringent environmental standards as an incentive for innovation and for the development of clean, cost-effective and low-resource technology as well as promotion of international trade in low-pollution products, low-polluting industrial plants and other environmental protection technologies.

31. We welcome the important progress achieved since Tokyo, particularly in the International Atomic Energy Agency, in enhancing effective international cooperation, with regard to safety in the management of nuclear energy.

Other issues

32. We welcome the initiative of the Human Frontier Science Programme presented by Japan, which is aimed at promoting, through international cooperation, basic research on biological functions. We are grateful for the informal opportunities our scientists have had to take part in some of the discussions of the feasibility study undertaken by Japan. We note that this study will be continued and we would be pleased to be kept informed about its progress.

33. We welcome the positive contribution made by the Conference of High Level Experts on the future role of education in our society, held in Kyoto in January 1987.

34. We shall continue to review the ethical implications of developments in the life sciences. Following the Conferences sponsored by Summit governments - by Japan in 1984, by France in 1985, by the Federal Republic of Germany in 1986 and by Canada in 1987 - we welcome the Italian government's offer to host the next bioethics Conference in Italy in April, 1988.

Next Economic Summit

35. We have agreed to meet again next year and have accepted the invitation of the Canadian Prime Minister to meet in Canada.

* * * * *

Réforme fiscale 1987

Perspectives économiques et financières

le 18 juin 1987

L'honorable
Michael H. Wilson
Ministre des Finances

Réforme fiscale 1987

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Canada

Avant-propos

Depuis septembre 1984, le gouvernement s'est efforcé d'atteindre l'objectif d'une croissance économique soutenue et de créer des emplois productifs pour les Canadiens. Notre *Programme de renouveau économique* exposait la philosophie de gestion économique du gouvernement et les orientations qu'il se proposait de suivre pour offrir de nouvelles possibilités aux Canadiens et redonner à l'économie sa vitalité.

Nous nous sommes donnés pour tâche de rétablir le sens des responsabilités dans la gestion des finances publiques et de réduire la taille de l'État dans l'économie. Chose toute aussi importante, nous avons commencé à modifier le rôle de l'État dans l'économie, un rôle qui favorise l'esprit de risque et d'entreprise, et qui récompense le succès au lieu de subventionner l'effort.

Dans le budget de février 1987, j'ai publié un document intitulé *Un programme de renouveau économique: principes et progrès*, qui démontrait les progrès considérables accomplis en 2 1/2 ans seulement. Nous avons sensiblement réduit le déficit; nous avons réduit de moitié le taux de croissance de la dette publique; et comme promis, nous avons atteint cet objectif principalement grâce au contrôle des dépenses et à une bonne gestion. D'importantes initiatives structurelles ont été prises dans un large éventail de domaines afin de promouvoir une économie vigoureuse et dynamique.

La réforme globale de la fiscalité constitue un élément important de notre programme de renouveau économique. Le régime fiscal actuel fait de plus en plus obstacle à une croissance soutenue de l'économie. Trop de décisions économiques sont prises dans le secteur privé en fonction des encouragements fiscaux plutôt qu'économiques; les incitations à travailler, à épargner et à investir sont battues en brèche; nos entreprises sont désavantagées tant sur le marché intérieur qu'à l'étranger. La réforme fiscale globale éliminera en bonne partie ces distorsions et iniquités, renforcera les incitations à épargner et à travailler et débouchera sur une économie plus efficiente et plus compétitive.

La réforme globale de la fiscalité sera mise en oeuvre en deux étapes. À la première étape, les taux statutaires d'imposition des particuliers et des sociétés seront abaissés et l'assiette fiscale sera élargie. Suivront, à la deuxième étape, l'élimination des surtaxes sur les particuliers et les sociétés, de nouvelles diminutions de l'impôt direct des particuliers et une amélioration du crédit remboursable au titre de la taxe de vente, parallèlement au remplacement de cette dernière par une taxe de vente multi-stades ayant une large assiette. Pour le moment, alors que d'importantes décisions doivent encore être prises au sujet de l'option particulière à adopter en matière de taxe de vente et du calendrier de mise

en oeuvre, il n'est pas possible d'intégrer la deuxième étape de la réforme globale de la fiscalité à nos projections économiques et financières à moyen terme.

Je présente par conséquent dans ce document des projections économiques et financières détaillées à moyen terme qui tiennent compte de la première des deux étapes de la réforme fiscale. Fondamentalement, l'économie canadienne est saine, et il n'existe aucune tension ou déséquilibre intérieur portant à croire que l'expansion actuelle ne peut se poursuivre. Moyennant une croissance raisonnable de l'économie mondiale, le Canada peut obtenir une expansion économique soutenue au cours des prochaines années et réaliser de nouveaux progrès dans l'application de nos quatre principes financiers et le redressement des finances du pays.

Par ailleurs, il existe des risques et des incertitudes à ne pas négliger, et des défis à relever. Ils sont abordés clairement dans ce document. La conjoncture internationale actuelle, qui présente d'importants déséquilibres commerciaux et financiers, pose des risques appréciables. Il convient d'y faire face de manière efficace en prenant des mesures d'orientation coordonnées dans les pays industriels si l'on veut que l'expansion mondiale soit soutenue. C'est pour moi un motif d'encouragement de voir que les pays membres du Groupe des Sept ont convenu de la nécessité de prendre des mesures positives de ce genre et qu'ils se sont engagés à adopter les initiatives requises. La montée du protectionnisme aux États-Unis et ailleurs fait peser une grave menace sur le maintien d'un système ouvert d'échanges mondiaux et les perspectives de renforcement de la croissance internationale. J'estime que les pourparlers commerciaux bilatéraux en cours entre le Canada et les États-Unis ainsi que notre participation à la série de négociations commerciales multilatérales du GATT en Uruguay peuvent contribuer de manière importante à atténuer les risques protectionnistes qui menacent le Canada.

La réforme fiscale nous aidera aussi à relever ces défis. En améliorant notre compétitivité internationale et en renforçant la structure de l'économie intérieure, nous serons mieux en mesure de nous adapter et de prospérer dans une conjoncture internationale mouvante et incertaine. La réforme fiscale nous permettra d'asseoir encore plus solidement une croissance économique soutenue et une amélioration constante du bien-être économique et social de tous les Canadiens.

Michael Wilson

L'honorable Michael H. Wilson
Ministre des Finances

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1. Introduction et aperçu

Depuis l'automne 1984, des progrès appréciables ont été réalisés dans la réduction de la vulnérabilité croissante des finances du Canada grâce à des mesures de fond marquées au coin du sens des responsabilités et de la persistance. D'importantes initiatives structurelles ont également été prises afin de soutenir le renouveau économique. Cependant, le régime fiscal canadien faisait de plus en plus obstacle à la vigueur et à la croissance de l'économie à long terme. Des mesures ont été prises dans les recents budgets ainsi qu'à d'autres occasions afin d'éliminer les lacunes du régime actuel. Il est cependant devenu évident qu'une refonte globale du régime fiscal était nécessaire si l'on voulait qu'il contribue au renouveau économique.

La réforme globale de la fiscalité améliorera la structure et le rendement de l'économie canadienne. Les avantages économiques des réformes proposées de l'impôt des particuliers, de l'impôt des sociétés et de la taxe de vente sont présentés au chapitre 2. La réforme fiscale encouragera l'épargne et l'investissement, favorisera la croissance de la productivité et améliorera la compétitivité internationale du Canada. Ces avantages ne seront pas obtenus du jour au lendemain – l'effet de ces améliorations structurelles sur le fonctionnement de notre économie sera ressenti au cours des prochaines années à mesure qu'un nombre croissant de décisions économiques seront prises dans le contexte du nouveau régime fiscal.

Le climat économique international et les perspectives à moyen terme de l'économie canadienne, compte tenu de la première étape de la réforme fiscale, sont exposés au chapitre 3. Le contexte économique comporte à la fois des risques et des possibilités. Les perspectives de 1987 n'ont guère changé depuis le budget de février 1987, la poursuite d'une croissance modérée de la production et de l'emploi étant prévue pour cette année. L'inflation devrait rester modérée et le taux de chômage devrait continuer à baisser.

À moyen terme, on prévoit une expansion soutenue de l'économie canadienne. Après 1987, les principaux risques et incertitudes des perspectives économiques et financières tiennent principalement à la persistance d'importants déséquilibres internationaux. Une action coordonnée des pays membres du Groupe des Sept (G-7) afin de régler ces déséquilibres de manière opportune et concertée représente à la fois un défi et la possibilité d'édifier une économie mondiale plus saine. La réforme fiscale, les négociations commerciales canado-américaines et les autres initiatives structurelles que le gouvernement a prises et qu'il continue de mettre en oeuvre contribueront à assurer la capacité du Canada de rivaliser dans un contexte international incertain et de plus en plus concurrentiel.

La réforme fiscale influe sensiblement non seulement sur les perspectives économiques du Canada, mais également sur la réalisation persistante des objectifs financiers du gouvernement. La réforme globale de la fiscalité atténuera l'instabilité des recettes fédérales, facilitant ainsi la planification financière. Le chapitre 4 indique l'effet produit sur les recettes et les dépenses publiques par les changements proposés de l'impôt direct des particuliers et des sociétés, à la première étape de la réforme fiscale. Pour s'assurer que les changements ne font pas obstacle à de nouveaux progrès dans l'application des principes financiers, des modifications provisoires de la taxe de vente fédérale actuelle sont proposées, de même que des initiatives visant à améliorer la gestion des rentrées fiscales. Ces mesures sont également décrites au chapitre 4.

Le chapitre 5 offre une mise à jour de la situation financière pour 1986-87 et 1987-88, et donne un aperçu des perspectives financières à moyen terme, à la lumière des principes financiers du gouvernement. On estime maintenant que le déficit de l'exercice 1986-87 sera de $31 milliards, soit un milliard de moins que prévu dans le budget de février 1987. Pour l'exercice 1987-88, on prévoit un déficit de $29.3 milliards, le même chiffre que dans le budget de février 1987.

Compte tenu du plan quinquennal actuel de dépenses et d'une croissance économique modérée, les perspectives à moyen terme sont conformes aux principes d'une gestion financière s'inspirant du sens des responsabilités, qui ont guidé la politique financière du gouvernement depuis novembre 1984 et qui ont été rappelés dans le Discours du Trône d'octobre 1986. Le déficit fédéral devrait tomber à 3.4 pour cent du produit intérieur brut (PIB) d'ici 1991-92, une amélioration spectaculaire par rapport au niveau de 8.6 pour cent enregistré en 1984-85. La croissance de la dette publique devrait ralentir constamment et le rapport entre la dette et le PIB se stabiliser d'ici 1991-92.

2. Les avantages économiques d'une réforme globale de la fiscalité

Introduction

Le régime fiscal canadien est devenu un obstacle à la croissance économique – trop de décisions économiques sont déterminées par les encouragements fiscaux plutôt que par des encouragements économiques. Cela nuit à la capacité productive du Canada et compromet la compétitivité et la croissance futures. Des taux marginaux élevés d'impôt des particuliers, une complexité croissante et un sentiment d'injustice de plus en plus répandu réduisent les incitations à travailler davantage, à épargner et à faire preuve de l'esprit d'entreprise si indispensable à une économie dynamique. Ces effets négatifs du régime d'impôt direct des particuliers et des sociétés sur l'économie sont aggravés par le recours à un régime de taxe de vente qui désavantage les fabricants intérieurs et décourage les investissements intérieurs et les exportations.

Ce chapitre a pour objet d'exposer les avantages économiques à long terme qu'on peut attendre d'une réforme globale de la fiscalité. La réforme fiscale vise à réduire l'importance des concessions fiscales sélectives, à abaisser de façon cohérente les taux statutaires d'imposition des particuliers et des sociétés, et à éliminer les distorsions produites par le régime actuel de taxe de vente. La réforme fiscale se fera en deux étapes. La première est axée sur une réforme de l'impôt direct des particuliers et des sociétés. La deuxième éliminera les surtaxes de 3 pour cent sur le revenu, réduira de nouveau l'impôt des particuliers et améliorera le crédit remboursable au titre de la taxe de vente, parallèlement à une réforme fondamentale du régime de la taxe de vente.

Effets économiques de la réforme de l'impôt des particuliers

Les principaux éléments de la réforme de l'impôt direct des particuliers, à la première étape, consistent en:

- une réduction des taux marginaux d'impôt sur le revenu et du nombre de paliers d'impositions;
- l'élimination ou la réduction de nombreuses concessions fiscales particulières; et
- la transformation de la plupart des exemptions et déductions en crédits d'impôt.

Lorsque la réforme de la taxe de vente sera mise en oeuvre, la surtaxe frappant les particuliers sera éliminée et leurs impôts feront l'objet de nouvelles réductions, à la deuxième étape de la réforme fiscale.

Les avantages économiques à long terme de la réforme de l'impôt des particuliers proviendront de l'accroissement des incitations à travailler et à épargner. Les estimations quantitatives de ces avantages sont forcément imprécises parce que ces derniers résulteront de transformations structurelles de l'économie et d'un changement de comportement des particuliers, qui se produiront sur une longue période. Malgré la difficulté de mesurer précisément ces effets, des analyses macroéconomiques et microéconomiques des propositions de réforme de l'impôt des particuliers indiquent que les avantages éventuels de cette réforme pour le rendement à moyen et à long terme de l'économie canadienne seront probablement appréciables.

Encouragements à l'offre de travail

L'une des grandes caractéristiques de la réforme de l'impôt direct des particuliers est l'abaissement des taux marginaux d'imposition pour la grande majorité des Canadiens. Cela signifie que les Canadiens garderont une plus forte proportion, bien plus forte dans de nombreux cas, de chaque dollar supplémentaire gagné. Des revenus après impôt plus élevés inciteront plus de Canadiens à entrer sur le marché du travail et, pour ceux qui ont déjà un emploi, à travailler plus longtemps et à produire davantage.

Les modèles économiques de l'offre de travail permettent de penser que les changements fiscaux que comporte la première étape de la réforme de l'impôt des particuliers entraîneront une hausse appréciable de l'offre de travail, par le jeu combiné d'une hausse des taux de participation et de l'augmentation des heures de travail effectuées par personne employée. Les estimations classiques de ces modèles indiquent que l'offre de travail pourrait être accrue de façon permanente d'au moins 0.5 pour cent. Cette estimation se situe toutefois vers le bas de l'échelle des effets possibles. Des estimations empiriques plus élevées de la sensibilité de l'offre de travail à l'augmentation des salaires après impôt portent à croire que cette offre s'accroîtrait de 1 pour cent ou plus. La deuxième étape de la réforme fiscale renforcera ces encouragements.

Le potentiel économique à long terme est directement lié à la croissance de l'offre de travail dans l'économie. Certes, le moment auquel les effets incitatifs de la réforme fiscale entraîneront une hausse de l'offre de travail au Canada dépendra de la conjoncture de l'emploi et ces hausses ne seront probablement observées qu'à long terme, mais elles auront un effet positif important sur les perspectives économiques du Canada. La compétitivité internationale du Canada s'en trouvera améliorée, ainsi que la balance commerciale, et un plus grand nombre d'emplois seront créés. Une hausse de l'emploi fera augmenter la demande intérieure, entraînant ainsi une augmentation de l'offre de travail et des possibilités d'emploi.

Encouragements à l'épargne

Une réforme globale de la fiscalité incitera davantage les particuliers à épargner. À la première étape de la réforme, l'effet total sur l'épargne globale des particuliers sera sans doute négligeable, l'effet positif de la baisse des taux statutaires d'imposition des particuliers étant largement compensé par l'élargissement de l'assiette fiscale. Lorsque la surtaxe frappant les particuliers sera éliminée et que leurs impôts seront encore réduits, à la deuxième étape de la réforme fiscale, on observera par contre une hausse du rendement marginal après impôt de l'épargne, ce qui stimulera de manière appréciable l'épargne des particuliers. Dans l'ensemble, la réforme fiscale pourrait accroître le taux d'épargne des particuliers de jusqu'à 1 point de pourcentage, soit près de $4 milliards (dollars courants).

Un taux plus élevé d'épargne intérieure à long terme devrait fournir une masse de capitaux plus importante et moins coûteuse aux activités d'investissement. La hausse de l'investissement accroîtra la capacité de production de l'économie canadienne, faisant ainsi progresser la productivité et la compétitivité. Lorsque l'équilibre se fera entre l'épargne et l'investissement intérieurs, le compte courant de la balance des paiements devrait s'améliorer. Une diminution de l'importance relative de l'épargne étrangère fera augmenter le revenu national.

Effets économiques de la réforme de l'impôt des sociétés

Dans le budget de février 1986, des mesures avaient été prises afin de réduire les taux statutaires d'imposition des sociétés, d'éliminer le crédit d'impôt général à l'investissement et d'abolir la déduction de 3 pour cent relative aux stocks. D'autres changements seront apportés au régime fiscal des sociétés à la première étape de la réforme globale de la fiscalité, à savoir:

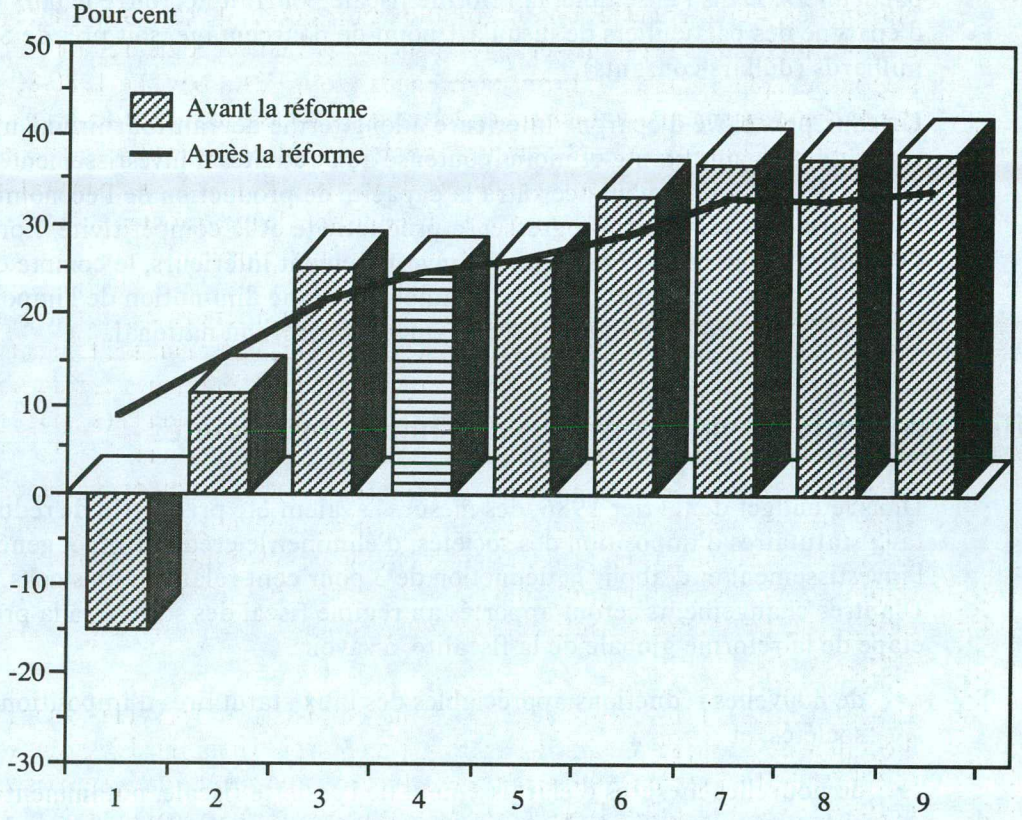
- de nouvelles réductions appréciables des taux statutaires d'imposition des sociétés; et
- de nouvelles mesures d'élargissement de l'assiette fiscale, notamment des réductions des taux de déduction pour amortissement, l'élimination de la déduction pour épuisement gagné, des limitations des frais d'entreprise et d'importantes mesures applicables au secteur de la finance, de l'assurance et de l'immobilier.

À la deuxième étape de la réforme fiscale, la surtaxe frappant les sociétés sera éliminée, et le remplacement de l'actuel régime de taxe fédérale de vente fera disparaître d'importantes distorsions qui nuisent actuellement aux entreprises.

La réforme de l'impôt des sociétés aura pour principal effet de réduire les écarts de fardeau fiscal entre les divers secteurs et les différents biens d'équipement. Des écarts importants entre les taux marginaux d'imposition de divers secteurs signifient que des projets qui produisent des taux de rendement très différents avant impôt peuvent devenir également rentables après impôt. Grâce à un rétrécissement des écarts entre les taux marginaux d'imposition de divers secteurs

Graphique 2.1

Taux d'imposition fédéral-provincial sur les nouveaux investissements des grandes sociétés, par secteur (1)



1 - Mines
2 - Pétrole et gaz
3 - Agriculture, forêts et pêche
4 - Ensemble des secteurs (2)
5 - Fabrication
6 - Services
7 - Construction
8 - Commerce de détail
9 - Commerce de gros

(1) Les taux d'impôt provincial sont les taux en vigueur au 1er mai 1987. Les valeurs reposent sur l'hypothèse que les provinces adoptent des mesures parallèles d'élargissement de l'assiette mais ne modifient pas leurs taux.
(2) Ensemble du secteur non financier.

qui résultera de la réforme de l'impôt des sociétés, le régime fiscal de ces dernières faussera moins les décisions d'investissement (Graphique 2.1).

La réforme de l'impôt des sociétés réduira également le handicap fiscal relatif dont souffrent actuellement les secteurs et les entreprises intensifs en main-d'oeuvre. Cela est dû à la réduction des encouragements fiscaux qui incitent actuellement à remplacer le facteur travail par du capital dans le processus de production. La diminution des distorsions des techniques de production qui sont dues à des considérations fiscales devrait améliorer l'efficience économique.

Le régime fiscal des sociétés influe sur un grand nombre de décisions des entreprises. Un autre effet important du régime actuel de taux statutaires d'imposition élevés est d'inciter les entreprises à financer leurs achats de biens en s'endettant plutôt qu'en utilisant leurs fonds propres. La période 1980-82 démontre clairement combien un endettement excessif des sociétés peut nuire à l'économie. Les taux réduits d'imposition des sociétés qui résulteront de la réforme fiscale diminueront la valeur fiscale des déductions d'intérêt, accroissant ainsi le coût relatif après impôt de l'emprunt et réduisant l'encouragement fiscal à se financer par l'emprunt plutôt que par des capitaux propres.

Pour tenir compte des priorités canadiennes, on maintiendra certains avantages fiscaux offerts aux sociétés. La recherche et le développement sont essentiels à l'accroissement de la compétitivité à long terme et à l'augmentation du potentiel de croissance de l'économie. Des dispositions fiscales avantageuses pour les investissements en R&D continueront d'assurer aux Canadiens l'un des régimes fiscaux les plus favorables à ces chapitres dans le monde industriel. La valeur incitative des crédits régionaux d'impôt à l'investissement sera maintenue, les taux de crédit étant réduits en proportion directe de l'abaissement des taux statutaires d'imposition. Un régime préférentiel continuera d'être accordé aux petites entreprises pour tenir compte de leur contribution à la création d'emplois et à l'innovation.

Les effets quantitatifs des changements du régime fiscal des sociétés sont difficiles à évaluer de manière précise. Le transfert d'environ $1 milliard par an du fardeau fiscal fédéral au secteur des sociétés entraînera, à court et à moyen terme, une légère hausse du coût du capital pour les usagers, qui pourrait entraîner un niveau de capital un peu plus faible que souhaité. À long terme, cependant, la réduction des disparités entre les taux effectifs d'imposition des sociétés permettra aux facteurs économiques de jouer un plus grand rôle que par le passé dans les décisions d'investissement. Il en résultera une amélioration qualitative du stock de capital et, peut-être, une hausse des investissements. Cette réduction de la variabilité des taux effectifs d'imposition des sociétés pourrait à elle seule accroître de 0.3 pour cent, à long terme, la productivité et la production réelle de l'économie canadienne, d'après les estimations d'un modèle d'équilibre général.

La deuxième étape de la réforme fiscale, grâce au remplacement du régime actuel de taxe de vente et de la taxation cachée qu'il entraîne sur les intrants d'entreprise par une taxe de vente multi-stades ayant une large assiette, augmentera sensiblement les incitations à investir pour les sociétés et améliorera la compétitivité des entreprises canadiennes.

Effets économiques de la réforme de la taxe de vente

Les effets que produira sur le rendement global de l'économie la réforme de la taxe de vente qui sera entreprise à la deuxième étape de la réforme fiscale seront sensiblement plus marqués que l'incidence économique de la première étape de la réforme. Le but de la réforme de la taxe de vente est de remplacer le régime actuel, avec ses nombreuses distorsions, par une taxe de vente multi-stades ayant une large assiette, qui sera plus neutre dans ses effets sur l'activité économique. Un régime réformé de taxe de vente influera moins sur l'affectation efficiente des ressources dans l'économie et accroîtra la compétitivité internationale du Canada.

Voici les principales distorsions économiques causées par le régime actuel de taxe fédérale de vente.

Taxation des intrants d'entreprise

- La taxation des intrants des entreprises plutôt que des ventes finales produit un certain nombre de graves effets négatifs sur le rendement de l'économie. À l'heure actuelle, environ la moitié du produit de la taxe fédérale de vente provient de la taxation des intrants d'entreprise comme les fournitures de bureau, les matériaux de construction et de nombreuses catégories de machines et de matériel ne servant pas à la production. La taxe appliquée à ces intrants devient un élément de coût pour les autres biens et services dans la production desquels entrent ces intrants et, par conséquent, un élément caché du prix de presque tous les biens et services dans l'économie, même s'ils ne sont pas directement assujettis à la taxe. Comme les éléments de taxation directe et indirecte du prix final diffèrent selon les biens et services, en fonction de leur processus de production et de distribution, la taxe fausse les prix relatifs et entraîne une mauvaises affectation des ressources.

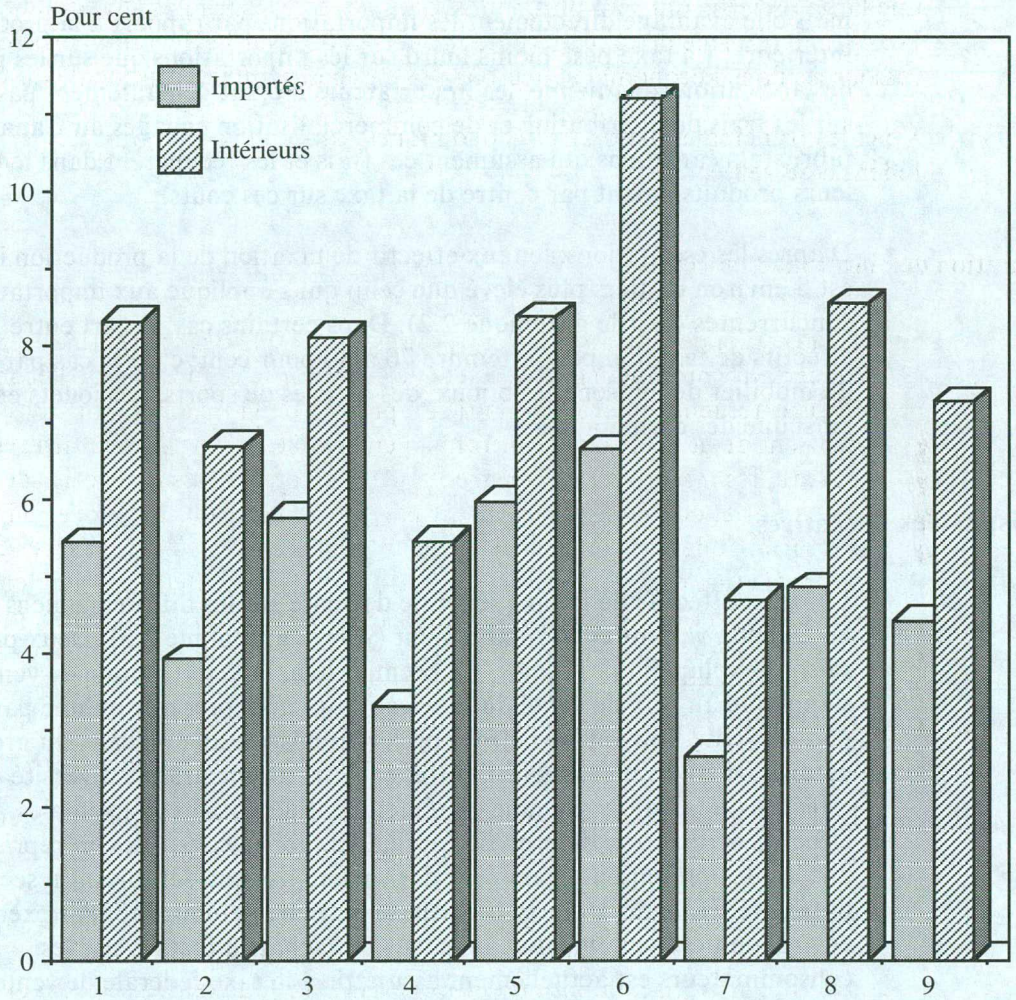
- Le fait d'imposer la taxe aux premières étapes du processus de production entraîne également une amplification de l'effet de la taxe sur les prix finals (sur des articles directement taxés). Les marges des grossistes et des détaillants s'appliquent souvent à une valeur après taxe et, donc, à la taxe elle-même. Les taxes sur les ventes au détail s'appliquent au prix final taxe fédérale comprise, imposant donc une taxe sur la taxe. De cette façon, l'effet caché de la taxe fédérale de vente sur les prix à la consommation devient plus important que la taxe elle-même.

- La taxation des intrants d'entreprise rend les biens d'équipement plus coûteux pour ces dernières. Les investissements réels sont donc réduits, ce qui diminue le potentiel de production de l'économie.

- Enfin, une bonne partie de la taxe sur les intrants d'entreprise se répercute sur le prix des exportations. Même si ces dernières ne sont pas directement taxées, les taxes sur les intrants d'entreprise augmentent d'environ 0.9 pour cent le prix effectif de vente des exportations. Cela équivaut à bien plus de 10 pour cent des marges bénéficiaires moyennes des exportateurs

Graphique 2.2

Taux effectifs de la taxe fédérale de vente sur certains produits intérieurs et importés



1- Pneus
2- Mobilier de maison
3- Appareils électroménagers
4- Verrerie et produits du verre
5- Téléviseurs, radios, stéréos
6- Machines et matériel de bureau
7- Bijoux
8- Jouets et jeux
9- Cosmétiques

canadiens et risquent de les handicaper gravement sur un marché international de plus en plus concurrentiel, en particulier lorsque les entreprises étrangères ne paient aucune taxe sur leurs intrants.

Régime préférentiel des importations

- Non seulement l'actuelle taxe fédérale de vente désavantage les exportations, mais elle avantage directement les importations par rapport à la production intérieure. La taxe pèse moins lourd sur les importations que sur les produits de fabrication canadienne, les importateurs n'étant généralement pas taxés sur les frais de distribution et de commercialisation engagés au Canada. Les fabricants canadiens qui assument ces frais et les récupèrent dans le prix de leurs produits paient par contre de la taxe sur ces coûts.

- D'après les estimations, le taux effectif de taxation de la production intérieure est d'environ un tiers plus élevé que celui qui s'applique aux importations concurrentes (voir le graphique 2.2). Dans certains cas, l'écart entre les taux effectifs de taxation peut atteindre 70 à 80 pour cent; c'est le cas par exemple du mobilier de maison, des bijoux, des articles de sports, des jouets et des jeux ainsi que des cosmétiques.

Distorsions allocatives

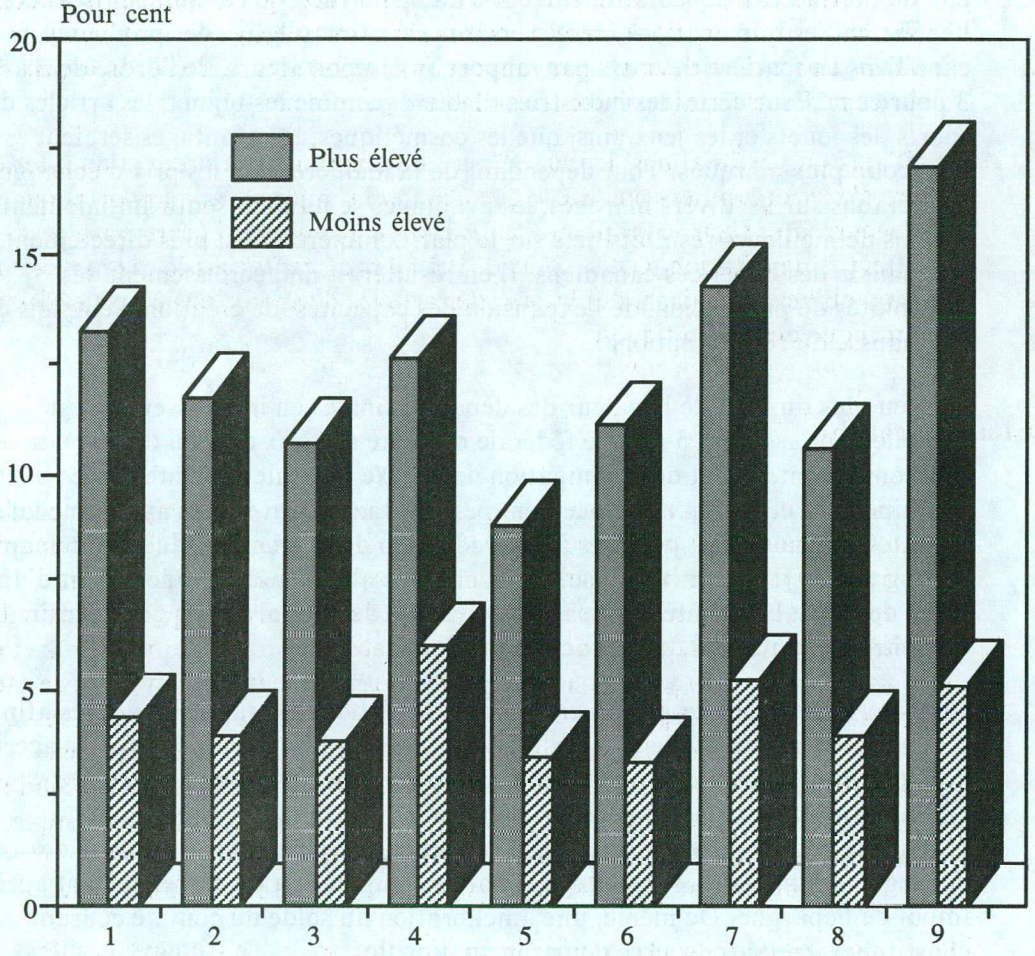
- Les taux effectifs de la taxe fédérale de vente sur les différents biens produits au Canada varient considérablement (voir le graphique 2.3). Deux principales raisons expliquent ces écarts. En premier lieu, la taxe fédérale de vente s'applique au prix de vente du fabricant, qui ne représente qu'une partie du prix de vente final, et les marges prélevées ensuite aux niveaux du gros et du détail varient d'un produit à l'autre, entraînant une grande diversité de taux effectifs de taxation. Comme en témoignent de nombreux exemples, les taux effectifs de taxation de produits similaires fabriqués par des entreprises différentes présentent également des variations considérables. En second lieu, la taxe fédérale de vente a une assiette extrêmement étroite. Par exemple, environ le tiers seulement de la valeur des achats effectués par les consommateurs est actuellement assujettie à la taxe fédérale de vente.

- Cette variabilité des taux effectifs de taxation selon les secteurs, et même selon les fabricants d'un même secteur, a pour effet que les décisions d'affectation économique sont faussées par l'influence de la taxe de vente. Il en résulte en fin de compte une diminution globale de l'efficience avec laquelle les ressources sont allouées dans l'économie canadienne.

Une réforme de la taxe de vente qui élimine ces distorsions améliorera la structure et le rendement de l'économie canadienne. Outre qu'une telle réforme apportera des améliorations structurelles, l'adoption d'une taxe multi-stades ayant une large assiette aura d'appréciables effets à court et à moyen terme sur l'ensemble de l'économie. Les taux de croissance de la production et de l'emploi augmenteront

Graphique 2.3

Taux effectifs de la taxes fédérale de vente sur certains produits de fabrication intérieure



1-Pièces d'automobiles
2-Textiles à usage domestique
3-Ustensiles de cuisine
4-Appareils électroménagers
5-Ampoules électriques et lampes
6-Fournitures de bureau et papeterie
7-Articles de sports
8-Couvertures, draps et serviettes
9-Cosmétiques

sous l'effet d'une hausse des investissements et d'une évolution favorable de la balance commerciale du Canada. Ces effets seront observés parce qu'une taxe de vente multi-stades ayant une large assiette éliminera la taxe sur les intrants des entreprises, soumettra les produits intérieurs et les importations à un régime égal et répartira le fardeau de la taxe de manière plus équitable sur un éventail plus large de biens et de services.

La réforme du régime de la taxe de vente améliorera la compétitivité de l'économie canadienne. L'élimination de la taxe sur les intrants des entreprises abaisserait d'environ 0.9 pour cent les prix de revient des exportateurs canadiens par rapport à ceux de leurs concurrents. La disparition de l'avantage fiscal dont bénéficient les importations améliorerait la situation relative des producteurs canadiens en matière de coûts par rapport aux importateurs, de l'ordre de 2 à 3 pour cent. Pour certaines industries de biens, comme les bijoux, les articles de sports, les jouets et les jeux ainsi que les cosmétiques, les avantages seraient beaucoup plus marqués. Tout dépendant de la manière dont les prix d'échange sont établis sur les divers marchés, les avantages se feraient sentir initialement par le biais de meilleurs résultats nets sur le plan commercial ou, plus directement, par une hausse des bénéfices canadiens. Il en résulterait un accroissement des possibilités de production, de l'expansion des capacités, de création d'emplois et une hausse du revenu national.

Un peu plus du tiers de la valeur des dépenses finales en investissement est actuellement assujetti à la taxe fédérale de vente au taux de 8 ou de 12 pour cent. Par conséquent, l'effet de l'élimination de la taxe fédérale de vente sur les biens d'équipement et de son remplacement par une taxe multi-stades ayant une large assiette équivaudrait à peu près à une réduction de 4 pour cent du coût du capital. À long terme, il pourrait en résulter une hausse allant jusqu'à 4 pour cent d'un stock de capital souhaité. L'expansion du stock de capital qui en découlerait accroîtrait le potentiel de production du Canada.

Les réformes proposées entraîneront aussi des économies supplémentaires afin d'aider à financer cette hausse des investissements. L'importance relative accrue donnée à la taxe de vente plutôt qu'aux impôts directs, accompagnée de l'élimination des surtaxes, accroîtra le niveau d'épargne dans l'économie. L'épargne accrue proviendra de deux sources principalement. La hausse de l'épargne des ménages sera favorisée par une augmentation du rendement après impôt de l'épargne. De même, une amélioration du solde du compte courant constituera une autre source d'épargne nationale.

Les estimations de la perte globale de production réelle résultant des distorsions qu'entraîne l'actuelle taxe fédérale de vente, à la lumière de l'analyse d'un modèle d'équilibre général, vont jusqu'à 1.5 pour cent du PIB, soit environ $8 milliards (dollars courants). Ce «manque à produire» est dû principalement à la taxation des intrants d'entreprise et au handicap que la taxe fédérale de vente fait peser sur les biens canadiens sur les marchés intérieurs et à l'exportation. Un régime réformé de taxe de vente nationale, libéré de ces distorsions et neutre dans ses effets sur les biens et services, pourrait se traduire par des gains réels de production encore plus appréciables à long terme.

Les améliorations structurelles permises par la réforme de la taxe de vente seront considérables. La mise en oeuvre d'une taxe de vente multi-stades ayant une large assiette serait vraisemblablement suivie d'une stimulation appréciable de la demande, sous l'effet de l'amélioration de la balance commerciale nette et d'une hausse des investissements pour satisfaire à l'augmentation du stock de capital souhaité. Cela accroîtra la croissance réelle du PIB ainsi que les possibilités d'emplois.

Pour des raisons évidentes, le remplacement d'une taxe fédérale de vente ayant une assiette étroite par une taxe multi-stades s'appliquant à une large assiette aura un certain effet sur les prix des biens et services non taxés auparavant. Cet effet serait plus marqué si les taxes provinciales sur les ventes au détail existantes étaient remplacées simultanément par un régime national. Cette hausse ponctuelle du prix de biens et services qui ne sont actuellement pas taxés sera compensée dans une certaine mesure par les réductions de prix dues à l'abaissement des taux de la taxe sur les produits actuellement taxables. De plus, pour nombre de Canadiens, cette hausse de coût serait neutralisée ou plus que compensée par le crédit remboursable au titre de la taxe de vente, l'abolition de la surtaxe sur le revenu des particuliers et de nouvelles réductions de l'impôt des particuliers. Il ne faudrait pas attendre trop longtemps pour voir l'évolution des prix revenir à la normale. De ce fait, le rajustement ponctuel des prix ne devrait pas se répercuter sur la détermination des autres prix, ni faire augmenter les prix à l'exportation.

3. Les perspectives économiques de 1987 à 1992

Introduction

Le budget de février 1987 ne présentait des prévisions économiques et financières que pour les exercices 1986-87 et 1987-88. On reconnaissait alors qu'une réforme globale de la fiscalité aurait d'importantes répercussions sur les perspectives économiques et financières à moyen terme du Canada. Ce chapitre présente des projections économiques jusqu'en 1992, qui tiennent compte des mesures proposées à la première étape d'une réforme globale de la fiscalité.

Perspectives économiques internationales à court terme

Les perspectives des économies internationale et canadienne dépendent beaucoup de l'évolution des déséquilibres qui caractérisent actuellement la situation financière et commerciale internationale. L'énorme déficit commercial des États-Unis et les importants excédents de l'Allemagne et du Japon, combinés à d'importants déficits gouvernementaux dans certains pays comme les États-Unis, sont préoccupants. Ces déséquilibres, joints aux pressions croissantes qui s'exercent sur les pays en développement lourdement endettés, représentent un grave défi pour le maintien d'une croissance économique saine à l'échelle mondiale.

Des mesures ont été prises en vue de régler les déséquilibres internationaux de façon coordonnée. Le déficit budgétaire est en voie de réduction aux États-Unis, encore que le rythme de résorption future demeure incertain. Une certaine stimulation a été pratiquée dans les pays d'outre-mer, notamment au Japon, où l'on promet de faire plus.

En l'absence de mesures d'orientation suffisantes, d'importants réalignements des taux de change étaient nécessaires et se sont produits. Cependant, le recours exclusif à des modifications des taux de change n'est ni satisfaisant, ni souhaitable pour obtenir les rajustements nécessaires à moyen terme. D'autres modifications de fond sont requises afin de réduire la demande de crédit du gouvernement américain et d'encourager une plus forte croissance de la demande intérieure dans d'autres pays.

L'expansion de la production réelle au Japon et dans les principaux pays européens membres de l'Organisation de coopération et de développement économiques (OCDE) a été d'environ 2.5 pour cent en moyenne en 1986. Cependant, après trois années de croissance attribuable aux échanges commerciaux, la principale source

d'expansion en 1986 s'est sensiblement déplacée pour passer des exportations nettes à la demande intérieure dans ces pays. Ce redressement de la demande intérieure finale, en particulier en Allemagne et au Japon, a cependant été moins marqué que prévu et, combiné à la diminution des excédents commerciaux en dollars constants, il s'est traduit par une croissance réelle globale moins satisfaisante que prévu. L'inflation a été très faible au regard des normes récentes dans les principaux pays d'outre-mer membres de l'OCDE à cause d'une appréciation de leurs monnaies par rapport au dollar américain et de la baisse du prix international du pétrole.

Les perspectives économiques internationales pour 1987 et 1988 sont présentées au Tableau 3.1. Les résultats économiques du Japon et des principaux pays européens devraient être analogues à ceux de 1986, avec cependant une inflation un peu plus rapide. Les excédents commerciaux du Japon et de l'Allemagne devraient fléchir quelque peu vers la fin de l'année et tout au long de 1988. De nouvelles diminutions des soldes réels des échanges réduiront la croissance de la production. À défaut d'autres initiatives de fond, la progression de la demande intérieure finale, notamment en Allemagne et au Japon, sera au mieux modérée. Par conséquent, le rythme de croissance de la demande intérieure finale dans les pays d'outre-mer risque de ne pas être suffisamment élevé pour compenser l'effet de la détérioration prévue de leur solde commercial sur leurs perspectives de croissance de la production réelle et de l'emploi. Un sujet de préoccupation tout particulier est le fait que, avec l'incertitude des marchés de change, l'attente d'une nouvelle hausse de leurs monnaies par rapport au dollar américain, dans le monde des affaires, freinera les investissements en Allemagne et au Japon.

La hausse de la production réelle devrait être de 2.5 pour cent en 1987 aux États-Unis, soit la même qu'en 1986. On prévoit pour 1988 une croissance de 3 pour cent du PNB réel. Sous-tendant cette légère amélioration de la croissance réelle de la production, est l'attente d'un renversement marqué de la composition de la production, passant de la demande intérieure au commerce extérieur. Étant donné que le taux prévu d'augmentation de la demande intérieure finale réelle devrait être bien en-deçà de 2 pour cent tant en 1987 qu'en 1988, l'amélioration continue du solde de la balance commerciale en dollars constants devrait être la principale source de croissance économique. Cette amélioration au chapitre commercial proviendra en bonne partie du fléchissement du dollar américain, sur une base pondérée par les échanges, depuis le début de 1985. En termes nominaux, cependant, le solde du compte courant ne devrait pas marquer d'amélioration sensible avant 1988, en raison des délais d'ajustement du volume des échanges à la dépréciation du dollar américain.

L'inflation mesurée par l'indice des prix à la consommation (IPC) a fortement diminué aux États-Unis en 1986, s'établissant à 1.9 pour cent en moyenne pour l'année et descendant à 1.1 pour cent vers la fin de l'année. La baisse est attribuable en bonne partie à la chute des prix de l'énergie. Le taux d'inflation, hors énergie, a été d'un peu moins de 4 pour cent en 1986. En 1987 et 1988, l'inflation devrait être de 4 pour cent en moyenne, encore que les variations trimestrielles de l'inflation américaine puissent dépasser temporairement les

Tableau 3.1

Perspectives économiques internationales à court terme

	1986	1987	1988
	(variations annuelles en pourcentage, sauf indication contraire)		
États-Unis			
PNB réel	2.5	2.5	3.0
Demande intérieure finale	3.6	1.3	1.5
Volume des exportations nettes (milliards de dollars de 1982)	−147.8	−122.3	−68.5
IPC	1.9	3.5	4.2
Emploi	2.3	2.0	1.6
Solde du compte courant (milliards de $)	−140.6	−148.8	−131.0
Taux des effets commerciaux à 90 jours[1] (en pourcentage)	6.7	6.4	6.4
Taux des obligations des sociétés AAA (en pourcentage)	9.0	8.8	8.6
Autres grands pays de l'OCDE			
PNB/PIB réels			
Europe[2]	2.4	2.3	2.2
Japon	2.5	2.7	3.3
Inflation (IPC)			
Europe[2]	2.3	2.9	3.1
Japon	0.6	0.3	1.5
Prix du pétrole (hypothèse)			
West Texas intermédiaire à Chicago (É-U.$/baril)	15.50	17.70	17.70

[1] Rendement annuel moyen

[2] Moyenne pondérée de l'Allemagne, de la France, du Royaume-Uni et de l'Italie

4 pour cent, à mesure que les prix de l'énergie se redresseront et que les prix des importations commenceront à se ressentir davantage de la dépréciation du dollar américain. Jusqu'ici, les prix des importations aux États-Unis n'ont réagi que partiellement au fléchissement du dollar.

Les marchés financiers des États-Unis ont reflété ces derniers mois l'incertitude générale que suscitent au niveau international les déséquilibres commerciaux et financiers. Un regain de tension à la baisse du dollar américain sur les marchés de change s'est manifesté depuis le début de 1987, en particulier par rapport au yen japonais. Devant ces tensions et la hausse de l'inflation aux États-Unis, les taux d'intérêt se sont orientés à la hausse dans ce pays en mars et en avril derniers.

Cette réaction du marché financier pourrait être pour une bonne part une réaction exagérée au taux récent d'inflation aux États-Unis et à l'incertitude qui entoure l'évolution future des déséquilibres commerciaux et financiers aux États-Unis. La faiblesse du dollar est due en grande partie à la déception que cause l'absence de progrès dans la résorption des déficits commercial et budgétaire des États-Unis. En volume, cependant, la balance commerciale s'améliore, ce qui devrait se répercuter sur le déficit nominal du compte courant. Le déficit budgétaire devrait lui aussi baisser par rapport à son sommet de l'exercice 1986 et continuer à s'améliorer. La hausse de l'inflation est due en bonne partie à l'épuisement des effets temporaires de la baisse des prix de l'énergie en 1986 et au relèvement en une seule fois du prix des importations à cause de la forte baisse du dollar américain. La hausse fondamentale des coûts reste modérée. De plus, la croissance de la demande intérieure est faible aux États-Unis, de sorte qu'aucune intensification des tensions sur les marchés du crédit n'apparaît.

Ces facteurs portent à croire que les hausses de taux d'intérêt observées ces derniers mois aux États-Unis pourraient s'inverser. On suppose dans les projections que les taux d'intérêt à court terme diminuent légèrement aux États-Unis d'ici la fin de l'année par rapport à leurs niveaux moyens de mai 1987 et qu'ils demeurent relativement constants en 1988.

En ce qui concerne les produits de base, on prévoit une légère hausse des prix dans l'ensemble au niveau international par rapport à leurs faibles niveaux actuels en général. Les prix internationaux des céréales devraient rester déprimés, en raison de subventions excessives à l'agriculture dans un certain nombre de pays. Les prix internationaux du pétrole fluctuent sensiblement à l'heure actuelle. Le prix du pétrole devrait s'établir en moyenne à près de É.-U. $18 le baril en 1987 et 1988.

Évolution récente de l'économie canadienne

Affichant une croissance réelle de 3.1 pour cent de la production en 1986, le Canada a été celui des principaux pays de l'OCDE qui a enregistré la plus forte expansion économique. Pourtant, le rythme de croissance a été inégal pendant l'année, et certains secteurs et certaines régions ont beaucoup souffert d'une évolution négative au plan international.

Le profil de croissance de la production en 1986 a été en grande partie tributaire des variations de l'investissement en stocks. Une rapide augmentation des stocks au premier semestre a fait place à une progression beaucoup plus faible en moyenne au second semestre et à un déstockage au dernier trimestre de l'année. Bien qu'un raffermissement de la demande intérieure finale et du volume des exportations nettes pendant l'année ait partiellement compensé l'influence des variations des stocks sur la production réelle, le rythme de progression globale de la production s'est notablement ralenti au second semestre. Cependant, comme le rajustement consécutif à un rythme insoutenable d'augmentation des stocks se sera vraisemblablement achevé avant la fin de 1986, l'économie devrait revenir à un taux de croissance plus élevé. Les statistiques mensuelles du PIB au premier trimestre de 1987 indiquent une vive accélération de la croissance économique.

Le profil de croissance économique a également varié de manière appréciable en 1986 selon les secteurs et les régions, en grande partie sous l'effet d'une évolution défavorable au niveau international pour deux grands produits, le pétrole et les céréales. Les prix du pétrole avaient chuté de plus de 50 pour cent entre la fin de 1985 et le milieu de 1986, et les prix à l'exportation du gaz naturel ont également accusé une baisse sensible. Aussi, une réduction rapide et notable de l'emploi et de l'investissement dans le secteur pétrolier n'a pas tardé à se manifester. De même, les cours mondiaux des céréales ont dégringolé, les prix de 1986 étant à leur plus bas depuis 10 ans, ayant baissé de plus de 20 pour cent par rapport à 1985. Il en est résulté des difficultés économiques et des incertitudes appréciables dans les principales régions céréalières du pays. Outre qu'ils ont eu des effets sensibles sur les résultats économiques régionaux en 1986 et au début de 1987, ces facteurs ont joué un rôle notable dans la hausse du déficit du compte courant du Canada.

Partant d'un déficit de $0.6 milliard en 1985, le solde du compte courant du Canada s'est sensiblement détérioré en 1986 pour afficher un déficit de $8.8 milliards. Comme il vient d'être indiqué, la chute marquée des prix internationaux du pétrole, du gaz naturel et des céréales, ainsi que la faiblesse persistante du prix d'autres produits de base, ont beaucoup contribué à cette dégradation. D'importants réalignements par rapport aux devises des pays d'outre-mer ont également joué un rôle notable en faisant monter le prix, et donc la valeur nominale, des importations en provenance de ces pays.

Le Canada garde une fiche impressionnante en matière de création d'emplois. La progression de 2.9 pour cent de l'emploi en 1986 a été la plus forte augmentation enregistrée depuis 1980 et le taux le plus élevé, de loin, parmi les grands pays industrialisés. En outre, un fort accroissement a de nouveau été enregistré depuis le début de 1987. En fait, de juillet 1986 à mai 1987, l'emploi s'est accru à un rythme annuel de 3.7 pour cent. Le Canada a aussi eu l'un des taux les plus rapides de croissance de la population active parmi les grands pays membres de l'OCDE. La population active a augmenté de 1.8 pour cent en 1986. Cette forte hausse a quelque peu atténué l'effet de la création d'emplois sur la baisse du taux de chômage, mais des progrès appréciables sont enregistrés. Le taux de chômage était de 9.1 pour cent en mai, contre 10 pour cent à la fin de 1985 et un sommet de 12.8 pour cent pendant la récession de 1981-1982.

L'inflation, mesurée par l'indice des prix à la consommation, s'est maintenue autour de 4 pour cent en 1986 pour la troisième année de suite. L'effet d'une baisse appréciable du prix des produits pétroliers raffinés a été compensé par une hausse des prix des aliments, des taxes et du coût du logement. Les prix des importations ont eux aussi augmenté sensiblement, sous l'effet de la baisse de plus de 10 pour cent, sur une base pondérée sur les échanges, du dollar canadien par rapport aux monnaies de nos principaux partenaires commerciaux entre le début de 1985 et la fin de 1986. La hausse des coûts salariaux est restée modérée, les règlements s'établissant à 3.4 pour cent en moyenne en 1986, et l'économie canadienne a bénéficié d'une croissance satisfaisante de la productivité au cours de la reprise.

Suivant l'évolution enregistrée au niveau international, les marchés financiers canadiens ont affiché récemment de grandes fluctuations. Par rapport aux sommets records atteints juste avant le budget de février 1986, les taux d'intérêt canadiens à court terme avaient baissé de près de 400 centièmes à la fin de 1986. Le renforcement appréciable du dollar canadien au début de 1987 a permis aux taux d'intérêt canadiens de fléchir encore jusqu'en mars de plus de 100 centièmes. Depuis, cependant, le redressement des taux d'intérêt aux États-Unis a exercé certaines pressions à la hausse sur les taux à court terme au Canada, qui sont revenus aux niveaux observés à la fin de 1986.

Perspectives économiques à court terme au Canada

Les perspectives économiques mises à jour pour 1987 ressemblent beaucoup à celles que présentait le budget de février 1987. L'activité économique devrait se développer à un rythme modéré pendant l'année au Canada, avec une certaine diminution de l'inflation et du taux de chômage et une stabilité relative sur les marchés financiers. Les statistiques récentes de la production et de l'emploi confirment tout à fait cette opinion et portent à croire que la croissance sera beaucoup plus vigoureuse que le croyaient de nombreux prévisionnistes du secteur privé au début de 1987.

Les perspectives à court terme de l'économie canadienne sont résumées au tableau 3.2 et au graphique 3.1. Le produit intérieur brut (PIB) réel devrait progresser de 2.8 pour cent cette année et de 3.0 pour cent en 1988. Ces taux annuels moyens de croissance sont légèrement inférieurs à celui de 1986, mais le rythme d'expansion devrait être sensiblement plus vigoureux que l'an dernier au cours de cette année et de l'an prochain. Le rythme annuel de croissance de la fin de 1986 à la fin de 1988 devrait être le double de la hausse de 1.6 pour cent du PIB réel enregistrée entre le quatrième trimestre de 1985 et le même trimestre de 1986.

L'expansion de la production canadienne à court terme devrait être alimentée par les investissements non énergétiques et une reconstitution des stocks par rapport aux bas niveaux de la fin de 1986. La dernière enquête de Statistique Canada sur les intentions d'investissements privés et publics laisse prévoir une hausse de 6.2 pour cent des investissements non énergétiques cette année, soit environ 3 pour cent en termes réels. Les perspectives d'investissement dans le secteur de l'énergie devraient compenser en partie cette vigueur. Le retour des stocks à des niveaux plus normaux cette année et l'an prochain contribuera sensiblement à la croissance réelle de la production.

L'activité domiciliaire a été très intense récemment, les mises en chantier mensuelles de logements s'établissant à 222,000 (en taux annuels) en moyenne depuis le milieu de 1986. L'activité devrait demeurer vigoureuse sur ce marché, les mises en chantier de logements devant se situer en moyenne à 200,000 en 1987 et 1988. Cette vigueur est due à la forte croissance de l'emploi et des revenus, à la confiance des consommateurs et à une conjoncture financière relativement favorable. Le rythme élevé des mises en chantier de logements signifie que la demande contenue de logements qui s'était accumulée au début des années 80 est maintenant en voie d'être satisfaite.

Tableau 3.2

Perspectives et résultats de l'économie canadienne: principaux indicateurs, 1986 à 1988

	1986 (observé)	1987 (prévision)	1988 (prévision)
	(variations annuelles en pourcentage, sauf indication contraire)		
Dépenses (en volume)			
Produit intérieur brut (PIB)	3.1	2.8	3.0
Consommation	4.0	2.7	3.1
Investissement résidentiel	13.2	6.6	−3.9
Investissement non résidentiel des entreprises	−0.8	1.6	4.9
Machines et équipement	5.4	4.4	5.3
Construction non résidentielle	−7.7	−1.9	4.5
Dépenses publiques	0.5	1.8	1.0
Demande intérieure finale	3.1	2.6	2.4
Variation des stocks (en milliards de dollars de 1981)	3.8	1.5	2.9
Exportations	3.1	2.9	2.5
Importations	5.1	0.7	1.7
Exportations nettes (en milliards de dollars de 1981)	16.4	19.4	20.8
Solde du compte courant (en milliards de dollars courants)	−8.8	−7.6	−8.3
Mises en chantier (en milliers d'unités)	200	209	192
Prix et coûts			
IPC	4.1	3.9	3.8
Indice implicite des prix du PIB	2.8	3.5	3.7
Règlements salariaux moyens	3.4	3.5	3.7
Marché du travail			
Population active	1.8	1.9	1.8
Emploi	2.9	2.3	2.1
Taux de chômage (en pourcentage, quatrième trimestre)	9.4	9.1	8.9
Revenus			
Revenus des particuliers	6.9	6.2	6.0
Bénéfices des sociétés	−4.9	10.2	16.6
Taux d'épargne des particuliers (en pourcentage)	11.3	10.5	9.5
Hypothèses concernant le marché financier			
Taux des effets commerciaux à 90 jours (en pourcentage)			
Nominal	9.2	7.8	7.6
Réel[1]	5.1	3.9	3.8
Moyenne McLeod Young Weir des taux nominaux des obligations à long terme des sociétés (en pourcentage)	10.8	10.6	9.4

[1] Les taux d'intérêt réels sont les taux nominaux diminués de la variation en pourcentage de l'indice des prix à la consommation.

La progression de la consommation devrait être satisfaisante, mais moins rapide que les années précédentes. La très forte hausse des achats de biens durables depuis 1983 a maintenant permis de satisfaire en grande partie la demande qui existait à cet égard après la récession de 1981-1982. La composition de la consommation intérieure devrait faire une plus large place aux biens et services autres que les biens durables, et notamment que les automobiles.

Les dépenses publiques en biens et services devraient augmenter beaucoup plus lentement que la production globale, sous l'effet des mesures prises par les deux paliers de gouvernement pour restreindre la croissance de leurs dépenses.

Une certaine amélioration, en volume, du solde des échanges est prévue, mais le déficit nominal du compte courant devrait être analogue, cette année et l'an prochain, à celui de 1986. La faible croissance de la demande intérieure finale aux États-Unis, notamment dans les secteurs de l'automobile et du bâtiment, et la persistance d'excédents internationaux de gaz naturel et de céréales, combinées aux faibles prix de ces produits, devrait faire obstacle dans une mesure importante à toute amélioration appréciable du solde du compte courant à court terme. Le rythme de résorption du déficit du compte courant au cours des quelques prochaines années dépendra dans une mesure déterminante de la compétitivité internationale de l'économie canadienne.

Le rythme de croissance de la production cette année et l'an prochain devrait instaurer un climat propice au maintien d'une forte progression de l'emploi et de la population active, tandis que le taux de chômage continuera de diminuer. On s'attend à ce que plus de 550,000 nouveaux emplois soient créés de la fin de 1986 à la fin de 1988. Cela devrait permettre au taux de chômage de baisser graduellement à un niveau inférieur à 9 pour cent d'ici l'an prochain.

L'inflation devrait être légèrement inférieure à 4 pour cent cette année et l'an prochain, avant de descendre à 3 pour cent à moyen terme. La hausse fondamentale des coûts devrait rester modérée, mais certaines pressions à la hausse seront exercées sur les prix par les hausses de taxes et le logement. À l'inverse du large écart observé en faveur des États-Unis sur le plan de l'inflation en 1986, le taux d'inflation au Canada devrait devenir inférieur à celui des États-Unis d'ici 1988.

Les taux d'intérêt devraient diminuer légèrement par rapport à mai 1987. Le taux des effets commerciaux à 90 jours devrait s'établir à 7.8 pour cent en moyenne cette année, niveau qui était déjà prévu dans le budget de février 1987, avant de fléchir à 7.6 pour cent en 1988. Le rendement des obligations des entreprises devrait marquer une baisse plus sensible d'ici 1988, sous l'effet non seulement de l'évolution prévue des marchés financiers aux États-Unis, mais aussi de l'amélioration attendue de l'inflation relative au Canada et des progrès constants obtenus dans la réduction du déficit budgétaire dans notre pays. Néanmoins, compte tenu de l'inflation, les taux d'intérêt devraient rester considérablement supérieurs aux moyennes historiques au cours des deux prochaines années.

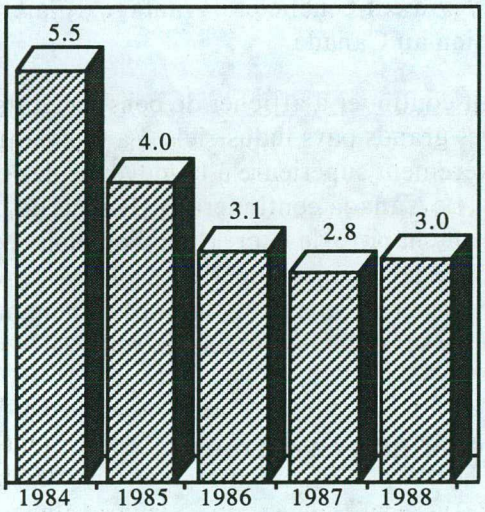
Les résultats économiques des secteurs et des régions ont divergé sensiblement en 1986. La chute des prix du pétrole et des céréales a eu des effets négatifs prononcés sur la production et l'emploi dans les provinces des Prairies et de l'Atlantique, tandis que le renforcement de la demande intérieure et internationale de produits manufacturés stimulait la croissance dans le Centre du Canada. Le raffermissement récent des prix du pétrole et de quelques autres produits de base, combiné au réalignement appréciable du dollar canadien par rapport aux monnaies des pays d'outre-mer, devrait contribuer à un meilleur équilibre des

Graphique 3.1

Résultats et perspectives de l'économie canadienne: 1984-1988

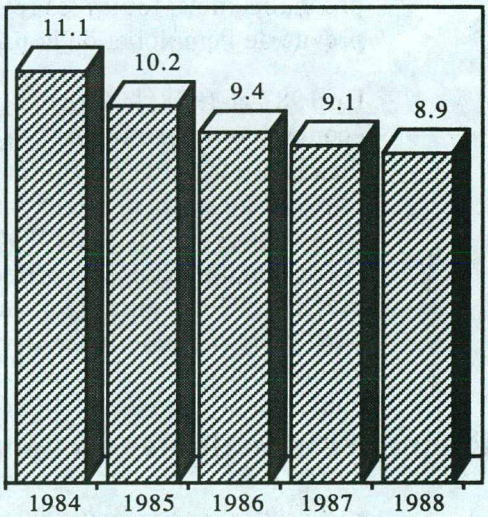
Taux de croissance du PIB réel

pour cent



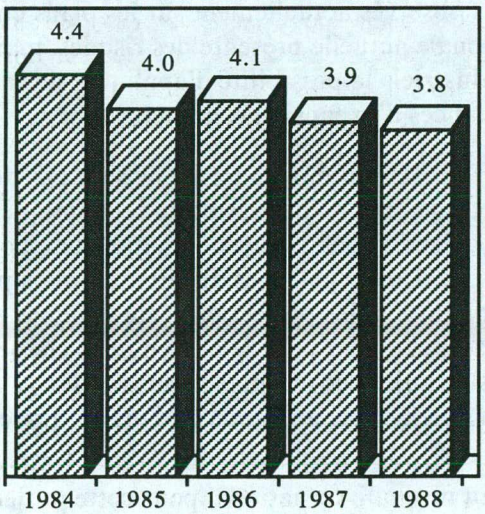
Taux de chômage - quatrième trimestre

pour cent



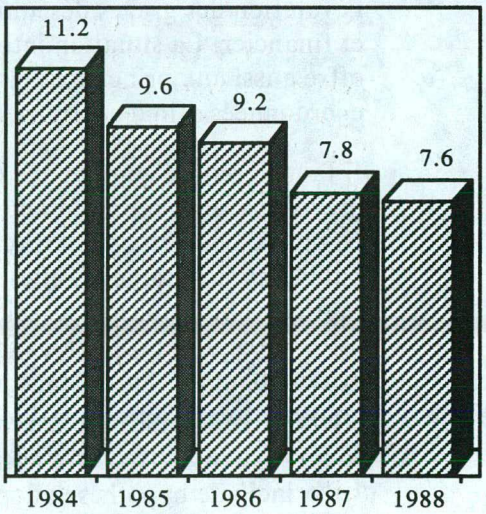
Taux d'inflation (IPC)

pour cent



Taux des effets commerciaux à 90 jours

pour cent



Remarque: Les chiffres de 1987 et 1988 sont des prévisions.

résultats économiques des secteurs et des régions cette année et l'an prochain. Toutefois, les faibles prix internationaux des céréales continueront de limiter gravement les revenus agricoles, notamment dans l'Ouest canadien.

Un certain nombre d'indicateurs économiques récents, présentés au graphique 3.2, indiquent une généralisation de l'activité économique dans les régions et les secteurs. L'enquête de Statistique Canada sur les intentions d'investissements privés et publics montre un meilleur équilibre des projets d'investissement des entreprises entre les divers secteurs et régions en 1987 qu'en 1986. De même, la croissance de l'emploi s'est nettement améliorée dans l'Ouest et dans la région de l'Atlantique au second semestre de 1986 et au début de 1987, tout en demeurant vigoureuse dans les régions centrales, et en particulier au Québec. Au cours des 18 prochains mois, toutes les régions devraient bénéficier davantage de la croissance prévue de l'emploi et de la production au Canada.

En 1987 et 1988, le Canada devrait continuer à afficher de bons résultats économiques par rapport aux autres grands pays industriels. La croissance réelle du PIB au Canada devrait être légèrement supérieure à la moyenne des pays de l'OCDE au cours des deux années. Le Canada continuera également de distancer les autres grands pays de l'OCDE au chapitre de la création d'emplois. Même si l'inflation dans notre pays devrait être légèrement supérieure à la moyenne de l'OCDE, l'écart entre la hausse des prix au Canada et chez nos principaux partenaires commerciaux devrait être sensiblement moins marqué qu'en 1986.

Risques et incertitudes économiques à moyen terme

Les perspectives de l'économie canadienne jusqu'au début des années 90 dépendront dans une large mesure aussi bien de la politique économique intérieure que de l'évolution et de la stabilité de la situation économique internationale. Les perspectives de réalisation de cette évolution et de cette stabilité dépendront de l'évolution des graves déséquilibres observés actuellement sur les plans commercial et financier. La situation internationale actuelle présente des risques, mais elle offre aussi aux principaux pays industriels la possibilité d'appliquer des mesures coordonnées afin d'accroître les chances d'expansion soutenue.

Il faut se rendre compte que des projections à moyen terme ne sont pas des prévisions; elles représentent plutôt une opinion des résultats économiques possibles, conformément aux hypothèses d'évolution économique et de politiques publiques sur lesquelles elles reposent. Des hypothèses différentes, mais peut-être tout aussi plausibles, pourraient conduire à des projections économiques assez différentes. Les projections faites actuellement pour le moyen terme dépendront évidemment des hypothèses posées au sujet des mesures prises par les gouvernements aux États-Unis, en Allemagne, au Japon et dans les autres pays.

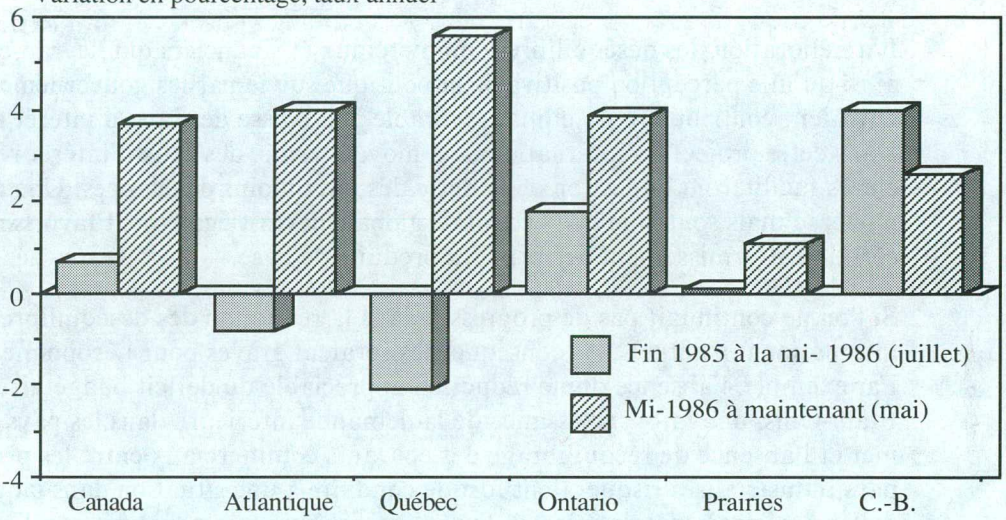
La principale hypothèse adoptée au niveau international pour cette projection à moyen terme est que les grands déséquilibres internationaux s'amélioreront progressivement, sans perturbation appréciable du système économique

Graphique 3.2

Indicateurs des résultats récents des économies régionales

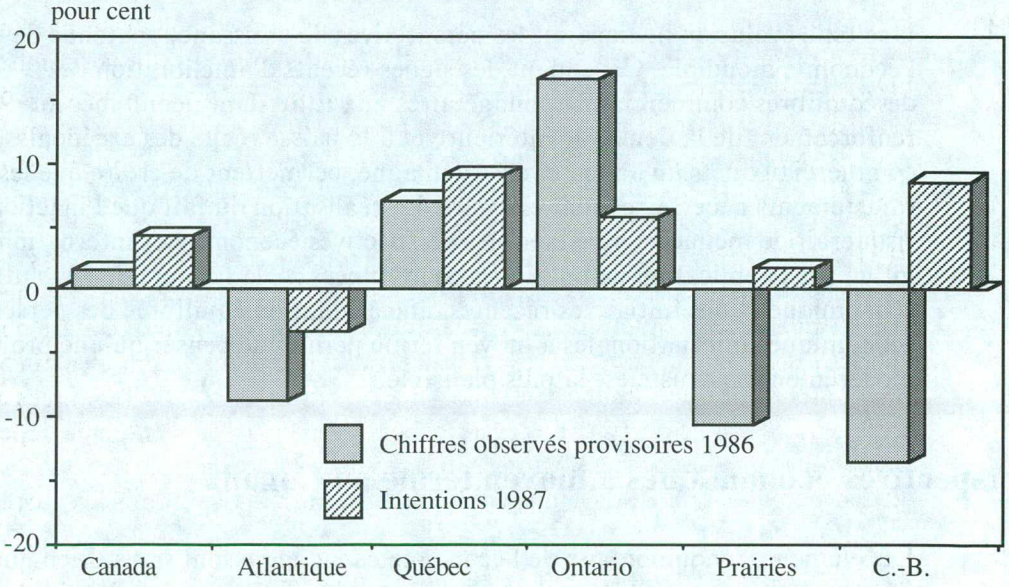
Croissance régionale de l'emploi depuis décembre 1985

Variation en pourcentage, taux annuel



Croissance régionale des investissements des entreprises* (en dollars courants)

pour cent



* Enquête sur les intentions d'investissements publics et privés, Statistique Canada, mars 1987.

international. La baisse qu'a déjà subi le dollar américain, combinée à une plus forte croissance de la demande intérieure dans les principaux pays d'outre-mer de l'OCDE, devrait entraîner une amélioration continue du solde commercial des États-Unis. Les objectifs de déficit de Gramm-Rudman-Hollings ne seront probablement pas atteints, mais on prévoit une réduction appréciable du déficit des États-Unis au cours des exercices 1987 et 1988, et l'administration américaine s'est engagée à continuer de résorber de façon appréciable le déficit à moyen terme. En outre, les pays du Groupe des Sept ont convenu de mettre en oeuvre leurs politiques d'une manière coordonnée, ce qui devrait encore réduire les déséquilibres internationaux actuels.

L'amélioration des déséquilibres commerciaux et financiers qui devrait en résulter, ainsi qu'une perception positive de la politique suivie par les gouvernements, devraient contribuer à un climat favorable à la baisse des taux d'intérêt réels. Dans cette projection internationale à moyen terme, des taux d'intérêt réels moins élevés faciliteront la gestion de la dette des pays moins développés. Une croissance modérée mais soutenue de l'économie globale devrait également favoriser un certain raffermissement des prix des produits de base.

Si l'on ne continuait pas de progresser dans la réduction des déséquilibres internationaux actuels, les conséquences seraient graves pour l'économie mondiale. Par exemple, l'absence d'une réduction appréciable du déficit budgétaire aux États-Unis, une faible croissance de la demande intérieure dans les pays d'outre-mer et l'absence de rééquilibrage des courants commerciaux entre les principaux pays industrialisés risqueraient fort de conduire à une situation dans laquelle le dollar américain dégringolerait, le protectionnisme augmenterait aux États-Unis, les taux d'intérêt internationaux grimperaient et les dangers de perturbation financière dus à l'endettement international des pays en développement s'accroîtraient.

Une telle évolution menacerait les perspectives de croissance soutenue de l'économie mondiale. Cependant, les signes récents d'amélioration des déséquilibres commerciaux et budgétaires aux États-Unis, combinés au renforcement de la demande intérieure et à la baisse réelle des excédents commerciaux nets au Japon et en Allemagne, permettent de croire que les rajustements nécessaires sont en cours. La réalisation du fait que l'inaction risquerait de menacer gravement les perspectives économiques internationales influe sur l'application de politiques coordonnées. À la lumière de l'évolution économique et des initiatives récentes, une évaluation équilibrée des perspectives économiques internationales à moyen terme permet de penser qu'une projection modérément optimiste est la plus plausible.

Perspectives économiques à moyen terme au Canada

Les éléments fondamentaux de l'économie canadienne sont sains. Bien que notre économie en soit maintenant à sa cinquième année d'expansion, les signes caractéristiques d'un essoufflement – hausse de l'inflation et des coûts, stocks excessifs et faiblesse du marché de l'habitation – ne se manifestent pas. Grâce à la

confiance élevée des consommateurs, au redressement des investissements et à un cadre d'orientation stable, le Canada a de bonnes chances de continuer à enregistrer une croissance relativement vigoureuse de la production et de l'emploi. Cela devrait permettre une baisse continue et graduelle du taux de chômage à moyen terme.

La première étape de la réforme globale de la fiscalité accroîtra le potentiel de l'économie canadienne à moyen et long terme. Les changements proposés de l'impôt direct des particuliers et des sociétés renforceront les incitations à travailler et à investir et amélioreront la qualité du stock de capital, accroissant ainsi la productivité. Ces effets positifs ne seront toutefois obtenus que graduellement.

La deuxième étape de la réforme fiscale, qui comprend le remplacement de l'actuelle taxe de vente ainsi qu'une amélioration du crédit remboursable au titre de cette dernière, l'élimination des surtaxes sur le revenu et de nouvelles réductions des impôts des particuliers complétera et renforcera les encouragements de la première étape dans le sens d'une augmentation de l'offre de travail et de l'épargne. Cependant, le principal effet économique de la deuxième étape de la réforme fiscale sera constitué par ses effets fortement positifs sur la compétitivité de l'industrie canadienne et les encouragements offerts aux entreprises pour qu'elles investissent. La réforme globale de la fiscalité se traduira par une affectation plus efficiente des ressources dans l'économie canadienne, une économie plus concurrentielle sur le marché global et un potentiel accru de croissance et de création d'emplois dans les années 90.

Les faits saillants des projections à moyen terme de l'économie canadienne sont présentés au Tableau 3.3 et au graphique 3.3. La croissance réelle du PIB devrait être de 3 pour cent en moyenne sur l'ensemble de la période 1989 à 1992, permettant au taux de chômage de descendre au-dessous de 8 pour cent d'ici les années 90. L'économie canadienne devrait continuer d'afficher des résultats satisfaisants en matière de coûts unitaires de main-d'oeuvre, ce qui devrait contribuer à stabiliser le taux fondamental d'inflation aux alentours de 3 pour cent. Une situation concurrentielle favorable globalement pour les sociétés canadiennes et un certain redressement des prix des produits de base devraient favoriser l'amélioration continue du compte courant et alimenter une croissance des bénéfices suffisante pour financer des investissements appréciables. Dans un contexte caractérisé par des taux d'intérêt modérés au niveau international et une bonne tenue de l'inflation au Canada, il y aurait possibilité que les taux d'intérêt canadiens diminuent encore à moyen terme.

Tableau 3.3

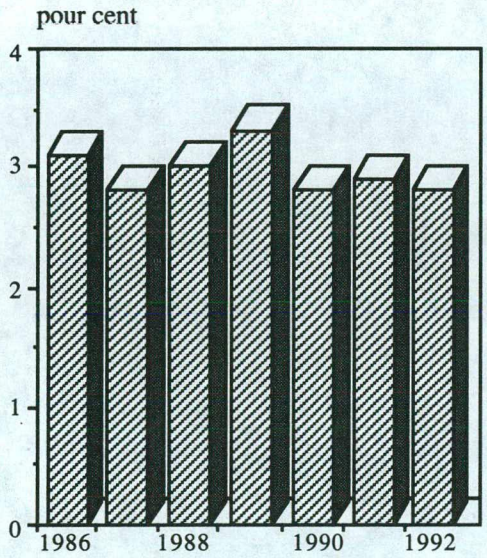
Perspectives économiques à moyen terme: principaux indicateurs économiques

	1986	1987	1988	Moyenne 1989-92
	(variation en pourcentage, sauf indication contraire)			
PIB réel	3.1	2.8	3.0	3.0
Emploi	2.9	2.3	2.1	2.2
Taux de chômage (en pourcentage, quatrième trimestre)	9.4	9.1	8.9	8.0
Inflation (IPC)	4.1	3.9	3.8	3.0
Taux des effets commerciaux à 90 jours	9.2	7.8	7.6	7.2

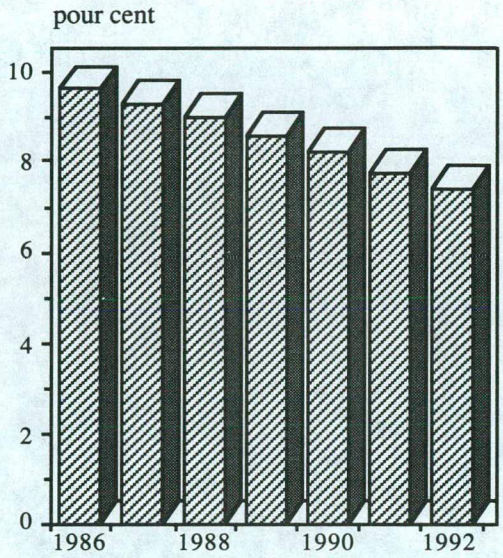
Graphique 3.3

Perspectives à moyen terme de l'économie canadienne: principaux indicateurs

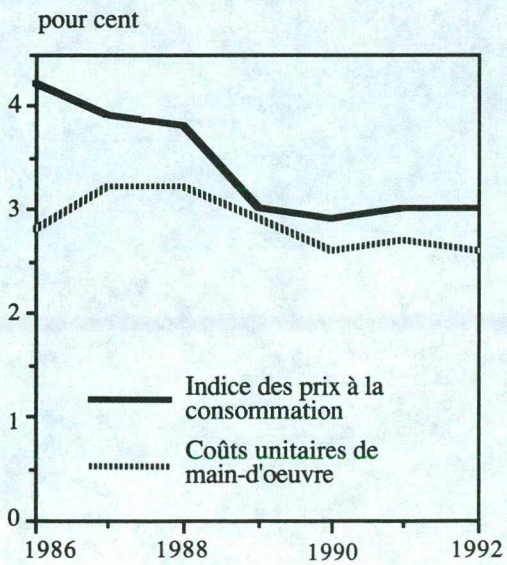
Taux de croissance du PIB réel



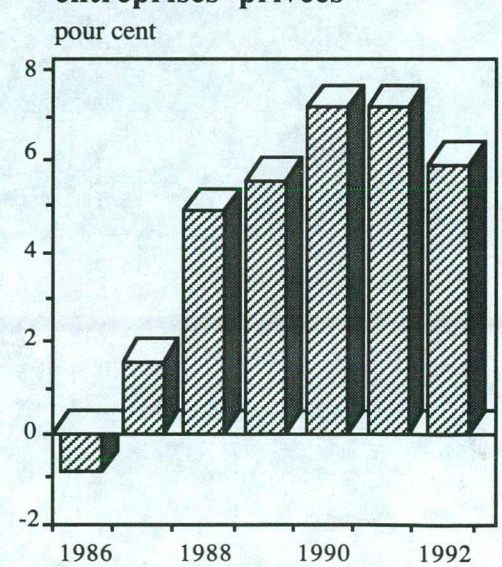
Taux de chômage



Inflation



Taux de croissance des investissements non résidentiels réels des entreprises privées



4. Incidences financières de la première étape de la réforme globale de la fiscalité

Introduction

L'évolution des années 70 et 80 a montré combien les recettes fédérales pouvaient être sensibles tant à la conjoncture économique qu'aux changements de la politique publique. Cette sensibilité tient en partie à l'influence des facteurs économiques sur les recettes publiques, par exemple les variations des prix des produits de base et la récession de 1981-82. Cependant, les changements discrétionnaires apportés au régime fiscal dans les années 70 et au début des années 80, ainsi que les importants changements fiscaux à l'étranger, ont aussi sensiblement accru la variabilité des recettes fédérales. Cette variabilité a réduit la capacité du gouvernement d'établir sa planification financière aussi bien à court qu'à moyen terme. En fait, elle a occasionnellement obligé le gouvernement à procéder, en cours de route, à des corrections imprévues qui peuvent perturber la planification financière.

L'expérience des années 80 a mis en relief des tendances préoccupantes du régime fiscal, qui ont rendu les recettes fédérales moins prévisibles et moins stables. En particulier, certains facteurs nouveaux ont eu tendance à affaiblir le rapport existant entre les sommes gagnées à titre de revenu et celles qui sont comptées dans le revenu aux fins de l'impôt, ainsi qu'entre le revenu comptabilisé aux fins de l'impôt et les sommes effectivement versées en impôt. Ce problème est dû à la multiplication de concessions fiscales sélectives et à leur utilisation croissante par les contribuables cherchant à réduire leur impôt. Certes les facteurs économiques auront toujours une influence sur les rentrées fiscales; mais une réforme globale de la fiscalité contribuera à réduire la variabilité des recettes fiscales du gouvernement fédéral et à les rendre plus prévisibles, améliorant ainsi le cadre global de la planification fiscale.

L'abaissement des taux statutaires d'imposition des particuliers et des sociétés, l'élimination de concessions fiscales sélectives et l'élargissement de l'assiette de l'impôt direct qui sont proposés à la première étape d'une réforme globale de la fiscalité ont trois grandes conséquences financières. Elles:

- réduiront la variabilité des recettes fédérales;
- influeront sur les projections à moyen terme du déficit fédéral; et
- nécessiteront des mesures connexes pour s'assurer que la première étape de la réforme fiscale est compatible avec les principes de gestion financière du gouvernement.

Amélioration de la stabilité financière à la première étape de la réforme fiscale

Depuis une dizaine d'années, le volume des recettes produites par le régime fiscal est devenu moins stable et plus difficile à prévoir. Ces problèmes sont attribuables en partie à une évolution économique défavorable, par exemple de fortes variations du prix des produits de base à la fin des années 70 et au milieu des années 80, et l'effet marqué de la récession de 1981-82 sur les revenus, les assiettes fiscales et les recettes.

De plus, les décisions prises par le gouvernement ont modifié le régime fiscal dans le sens, en général, d'un rétrécissement des assiettes et d'une hausse des taux d'imposition. La multiplication des concessions fiscales sélectives a des conséquences permanentes sur la stabilité et le caractère prévisible des recettes fiscales du gouvernement fédéral:

- En premier lieu, les concessions fiscales réduisent directement l'assiette des impôts. Pour maintenir les rentrées, il faut relever les taux d'imposition. De plus, comme l'État n'est pas toujours en mesure de prévoir exactement l'utilisation de ces mesures préférentielles, ces dernières réduisent directement la capacité globale de prévision des recettes fédérales et rendent la planification financière incertaine.

- En deuxième lieu, le recours croissant aux dispositions fiscales préférentielles a sensiblement modifié le rapport entre les impôts payés et les revenus gagnés, aussi bien d'un secteur à l'autre qu'à l'intérieur des secteurs. Ainsi, même avec un revenu global donné dans l'économie, les variations de compositions de ce revenu peuvent être lourdes de conséquences sur les recettes fédérales. Il s'agit là d'une source importante de difficultés dans la prévision des recettes. Des variations de compositions de ce genre ont été souvent observées pendant la première moitié des années 80. Par exemple, la proportion croissante des transferts et des revenus de placement dans le revenu total des particuliers – deux éléments qui subissent des taux effectifs de taxation inférieurs à celui des revenus salariaux – a eu pour résultat de réduire le produit de l'impôt des particuliers entre 1981 et 1984.

- En troisième lieu, l'interaction de taux d'imposition élevés et d'assiettes fiscales étroites a stimulé des activités de plus en plus audacieuses d'évitement fiscal, qui ont encore diminué l'assiette des impôts. Cela se manifeste dans les échanges croissants de pertes fiscales entre les entreprises imposables et non imposables, au cours des dernières années.

Si on n'y mettait pas un frein, l'érosion des assiettes fiscales se poursuivrait jusqu'à la fin des années 80, produisant de nouvelles pressions à la hausse des taux d'imposition de façon qu'on puisse continuer de progresser vers la réalisation des objectifs financiers. Le gouvernement a tenté de régler ce problème en prenant diverses initiatives fiscales au cours des dernières années, mais la perspective de nouvelles tensions dues à des facteurs aussi bien intérieurs qu'internationaux est devenue plus grave.

Par exemple, l'assiette de la taxe fédérale de vente est extrêmement vulnérable. Son étroitesse même encourage les fabricants à chercher à faire exonérer leurs produits. L'ampleur et la diversité des exemptions actuelles de taxe de vente ont entraîné plusieurs contestations visant à faire exonérer des articles qui sont actuellement taxables. De même, la tendance croissante des entreprises à restructurer leurs activités en passant par des sociétés de commercialisation pour réduire leur assujettissement à la taxe de vente, en particulier à la lumière de la jurisprudence récente, fait aussi peser des risques considérables sur l'assiette actuelle de la taxe de vente.

En outre, les réductions des taux statutaires d'imposition des sociétés aux États-Unis et dans d'autres pays accroissent la possibilité que des activités productrices de revenu réel quittent le pays et que les opérations financières subissent des changements visant à faire apparaître plus de bénéfices imposables dans les juridictions qui pratiquent des taux moins élevés. Une telle évolution aurait pour résultat une nouvelle dégradation appréciable des recettes fournies à l'État par l'impôt des sociétés.

Les initiatives proposées dans le cadre de la première étape d'une réforme globale de la fiscalité amélioreront considérablement la stabilité et le caractère prévisible des recettes fiscales fédérales. L'élargissement de l'assiette des impôts et l'élimination des concessions fiscales sélectives, joints à l'abaissement des taux d'imposition, une plus grande convergence des taux statutaires maximums d'imposition des particuliers et des sociétés et des règles générales anti-évitement enrayeront l'érosion des assiettes fiscales qui se serait certainement produite en leur absence.

Effets directs des mesures touchant l'impôt des particuliers et des sociétés sur les recettes et les dépenses

La partie A du tableau 4.1 présente les effets directs sur les recettes et les dépenses des mesures touchant l'impôt direct des particuliers et des sociétés à la première étape de la réforme fiscale.

Les changements apportés à l'impôt direct des particuliers abaisseront sensiblement les taux statutaires d'imposition, élargiront l'assiette de l'impôt en réduisant les concessions fiscales, amélioreront l'équité du régime et permettront à environ 850,000 Canadiens à revenu modeste de ne payer aucun impôt fédéral sur le revenu grâce à la conversion des exemptions en crédits. Dans l'ensemble, ces propositions entraîneront une réduction de l'impôt fédéral à payer pour la grande majorité des Canadiens. La plupart des propositions touchant l'impôt des particuliers seront entièrement mises en oeuvre au cours de l'année d'imposition 1988, mais le rajustement des tables de retenues le 1er juillet 1988 entraînera d'importants remboursements au cours de l'exercice 1989-90. D'ici 1991-92, les propositions de réforme fiscale réduiront le produit de l'impôt direct des particuliers d'environ $2 1/2 milliards par an.

Tableau 4.1

Incidences financières de la première étape de la réforme fiscale

A. Effet direct total sur les recettes et les dépenses des mesures touchant l'impôt des particuliers et des sociétés	1988-89	1989-90	1990-91	1991-92
		(millions de dollars)		
Effet sur les recettes				
Impôt direct des particuliers				
Conversion des exemptions en crédits et réductions des taux marginaux d'imposition	−2,185	−5,910	−4,600	−4,905
Élargissement de l'assiette et autres mesures	480	2,070	2,255	2,495
Réduction nette de l'impôt des particuliers	−1,705	−3,840	−2,345	−2,410
Impôt direct des sociétés				
Réduction des taux d'imposition	−635	−1,545	−1,645	−1,665
Mesures élargissant l'assiette	1,165	2,170	2,810	3,190
Augmentation nette de l'impôt des sociétés	530	625	1,165	1,525
Réduction nette totale des recettes	−1,175	−3,215	−1,180	−885
Effet sur les dépenses				
Hausse des paiements de Financement des programmes établis et de péréquation	340	360	385	395
B. Mesures connexes touchant les recettes				
Changement de la taxe fédérale de vente et du crédit remboursable au titre de cette dernière				
Déplacement de la taxe fédérale de vente au niveau du gros pour certains articles et changement du régime des sociétés de commercialisation	295	310	315	330
Taxe de 10 pour cent sur les services spécifiés de câblodiffusion et de télécommunications	870	945	1,000	1,055
Taxation de la peinture et du papier peint au taux général	60	60	65	65
Hausse du crédit remboursable de $20 par adulte et de $10 par enfant	−120	−150	−155	−160
Hausse nette du produit de la TFV	1,105	1,165	1,225	1,290
Gestion des rentrées fiscales				
Accélération des retenues à la source et acomptes provisionnels d'impôt des particuliers		1,100		
Accélération des remises de taxes de ventes et d'accise	1,600			
Hausse totale des recettes résultant de la gestion des rentrées fiscales	1,600	1,100		
Augmentation nette totale des recettes	+2,705	+2,265	+1,225	+1,290
Effet de la première étape de la réforme fiscale sur le déficit	−1,190	1,310	340	−10

De même, les changements apportés à l'impôt direct des sociétés abaisseront les taux statutaires d'imposition et élargiront l'assiette de cet impôt d'environ 20 pour cent. La variation des taux effectifs moyens d'imposition des sociétés selon les secteurs sera sensiblement réduite. Dans l'ensemble, ces changements accroîtront la part de l'impôt des sociétés dans l'ensemble des recettes fédérales. Le produit de cet impôt est ainsi augmenté d'environ $500-$600 millions au cours des exercices 1988-89 et 1989-90. Lorsque les mesures seront entièrement mises en oeuvre, la hausse du produit de l'impôt des sociétés passera à environ $1.5 milliard d'ici 1991-92.

Les mesures touchant l'impôt des particuliers et des sociétés sur les recettes entraîneraient globalement, en l'absence d'autres initiatives, une hausse du déficit de $1.2 milliard en 1988-89 et de $3.2 milliards en 1989-90, alors que les mesures fiscales seraient presque entièrement mises en oeuvre pendant une période transitoire de deux ans. Au-delà de cette période, l'effet de ces changements sur les recettes contribuera à augmenter le déficit d'environ $1 milliard par an. De plus, ces mesures ajouteront directement $350 à $400 millions par an au déficit en raison d'une hausse des dépenses de péréquation et de l'augmentation des versements en espèces au titre du Financement des programmes établis (FPE), à la suite des changements de valeur des points d'impôt.

Mesures connexes visant à assurer une gestion financière responsable

Un principe important de la réforme fiscale est d'assurer la neutralité fondamentale de ses effets financiers. Comme la réforme de la taxe de vente sera mise en oeuvre lors d'une deuxième étape, une gestion financière s'inspirant du sens des responsabilités oblige à se procurer des recettes supplémentaires au moyen du régime actuel de taxe de vente. Ces hausses de recettes sont présentées dans la partie B du tableau 4.1.

Jusqu'à ce que le nouveau régime de taxe de vente puisse être mis en place, le gouvernement propose un certain nombre de changements provisoires de l'actuelle taxe fédérale de vente. Ces mesures atténueront certaines des graves distorsions concurrentielles qui existent actuellement et diminueront les possibilités d'évitement fiscal. Jointes à l'augmentation des recettes produites par la réforme de l'impôt des sociétés, ces mesures apporteront un supplément de recettes afin de financer la réforme de l'impôt des particuliers. Les mesures consistent à:

- déplacer le point d'application de la taxe des fabricants aux sociétés de commercialisation lorsque ces dernières sont liées aux fabricants. Cela réduira les possibilités d'évitement fiscal indû;
- déplacer le point de taxation de certains produits au niveau du grossiste afin de réduire l'avantage concurrentiel des importations;
- étendre la taxe de vente à la plupart des services de télécommunications, (les frais des lignes téléphoniques résidentielles seront exonérés) au taux de

10 pour cent et porter de 8 à 10 pour cent le taux de taxation des services de câblodiffusion; et

- soumettre la peinture et le papier peint au taux général de la taxe de vente plutôt qu'au taux réduit applicable aux matériaux de construction.

De plus, le gouvernement portera l'actuel crédit remboursable au titre de la taxe de vente de $50 à $70 par adulte et de $25 à $35 par enfant. Les crédits augmentés seront réduits de 5 pour cent du revenu familial net au-delà de $16,000.

Dans l'ensemble, ces mesures devraient accroître les recettes de $1.1 à $1.3 milliard par an.

Le gouvernement propose aussi, dans le cadre de la réforme fiscale, un certain nombre de nouvelles mesures visant à renforcer l'observation du régime et à en faciliter l'administration. Dans le cadre des efforts déployés pour administrer plus efficacement le régime fiscal pour le compte de tous les contribuables, le gouvernement a entrepris d'examiner d'autres possibilités afin d'accélérer la perception des sommes dues. À la suite de cet examen, le gouvernement propose des mesures supplémentaires qui compléteront l'accélération des retenues à la source pour les gros employeurs, annoncée dans le budget de février 1987. Ces mesures ne représenteront pas une augmentation des taxes et impôts dus, mais une accélération du moment auquel les sommes déjà dues à l'État doivent lui être versées. Elles comportent une accélération des remises de taxes fédérales de vente et d'accise, une nouvelle accélération du versement des retenues à la source effectuées par les gros employeurs et une accélération des versements trimestriels d'acomptes provisionnels par les particuliers.

Comme le montre la partie B du tableau 4.1, l'accélération des remises de taxes de vente et d'accise entraînera une hausse ponctuelle de recettes de $1.6 milliard en 1988-89, tandis que celle des retenues à la source et des acomptes provisionnels entraînera un accroissement ponctuel des recettes de $1.1 milliard en 1989-90. Ces initiatives de gestion se traduiront aussi par des économies permanentes sous la forme d'une diminution des frais de service de la dette publique.

L'effet cumulatif des mesures présentées au tableau 4.1 sur le déficit et la dette nette, sur l'ensemble de la période 1988-89 à 1991-92, est négligeable.

Rééquilibrage de la composition des recettes fiscales fédérales

Le tableau 4.2 trace l'évolution des trois principales sources de recettes fédérales depuis le début des années 70. Un certain nombre de tendances se dégagent. L'importance relative de l'impôt direct des particuliers a beaucoup augmenté, tandis que la part de l'impôt direct des sociétés et celle de la taxe de vente diminuaient sensiblement. Ce changement de la répartition des recettes fiscales du gouvernement fédéral s'explique par une combinaison de mesures d'orientation prises dans les années 70 et au début de la décennie 80 et de l'effet inégal de la conjoncture économique de la fin de la décennie 1970 et du début des années 80 sur la composition et l'ampleur des assiettes fiscales correspondantes.

La part du produit de la taxe de vente a nettement diminué au milieu des années 70 à cause, en grande partie, des réductions des taux de cette taxe et d'un rétrécissement de son assiette dû à l'extension des exemptions. La baisse de la part de l'impôt des sociétés pendant la deuxième moitié des années 70 a été en grande partie le résultat de changements d'orientation entraînant à la fois un recours accru aux concessions fiscales et une réduction des taux. La hausse de la part représentée par l'impôt direct des particuliers est due à l'évolution des autres parts ainsi qu'à la tendance à la hausse du revenu des particuliers en proportion du revenu national pendant les années 70.

Outre l'effet permanent des changements d'orientation sur la répartition des recettes fiscales pendant les années 70, les effets extrêmement différents de la récession de 1981-1982 sur les assiettes fiscales ont encore modifié l'équilibre des recettes fiscales fédérales au cours des années 80. En particulier, la récession a fortement réduit les bénéfices des sociétés, dont les impôts ont diminué en conséquence. En outre, les pertes accumulées pendant la récession, combinées aux dispositions de report des pertes prévues dans le régime fiscal, ont ralenti le redressement du produit de l'impôt des sociétés pendant la reprise. Aussi la part de l'impôt des sociétés est-elle passée de 24.3 pour cent de l'ensemble des recettes apportées par les impôts directs des particuliers et des sociétés et par la taxe de vente, en 1980-81, à 17.9 pour cent en 1985-86. La récession a également limité la croissance de la consommation, atténuant ainsi la part de la taxe de vente. Par contre, la croissance du produit de l'impôt des particuliers souffrait elle aussi des changements de taille et de composition de l'assiette de cet impôt au cours de la première moitié des années 80, mais l'effet a été moins marqué que sur les autres sources de recettes fiscales, de sorte que la part de cet impôt a encore augmenté.

Depuis 1984-85, le raffermissement de la croissance de l'impôt des particuliers et des ventes intérieures assujetties à la taxe fédérale de vente, combiné aux mesures fiscales touchant les taux de l'impôt personnel et de la taxe fédérale de vente, ont accru l'importance de ces sources de recettes fiscales. Sauf en 1984-85, la part représentée par l'impôt des sociétés a continué de diminuer, de sorte que pour 1987-88 on estime qu'elle ne représentera que 15.6 pour cent de l'ensemble des recettes fournies par l'impôt des particuliers, l'impôt des sociétés et la taxe de vente, la plus faible proportion en plus de 20 ai. Cette nouvelle baisse est due principalement aux faibles prix des produits de base et à une intensification de l'évitement fiscal.

Sans la réforme fiscale, l'augmentation de l'importance relative de l'impôt des particuliers aurait continué. Les mesures fiscales prévues à la première étape de la réforme abaisseront la part de l'impôt des particuliers et accroîtront celle de l'impôt des sociétés ainsi que de la taxe de vente. La part de l'impôt des sociétés passera d'un creux de 15.6 pour cent en 1987-88 à 17.2 pour cent d'ici 1991-92. La deuxième étape de la réforme poursuivra le rééquilibrage des principales sources de recettes fiscales, la taxe fédérale de vente étant remplacée par une taxe de vente multi-stades ayant une large assiette, tandis que l'impôt des particuliers subira d'autres réductions et que les surtaxes des particuliers et des sociétés seront abolies.

Tableau 4.2

Structure des principales sources de recettes fiscales fédérales

Exercices	Impôt direct des particuliers	Impôt direct des sociétés	Taxe fédérale de vente	Ensemble
		(pour cent)		
Évolution				
1971-72 à 1975-76	57.6	22.9	19.5	100.0
1976-77 à 1980-81	59.4	23.3	17.3	100.0
1981-82 à 1985-86	64.6	19.0	16.4	100.0
Projection pour l'année courante				
1987-88	65.1	15.6	19.4	100.0
Projection pour la première étape de la réforme fiscale				
1991-92	62.9	17.2	19.9	100.0

Remarque: Les chiffres étant arrondis, le total pourra ne pas correspondre à la somme des éléments.

5. Les principes financiers

Introduction

Ce chapitre expose les perspectives d'évolution des dépenses, des recettes et du déficit à la lumière des quatre principes d'une gestion financière conforme au sens des responsabilités qui était annoncée dans le Discours du Trône d'octobre 1986. L'évolution des recettes présentée dans ce chapitre tient compte de la première étape de la réforme fiscale, évoquée au chapitre 4. L'évolution des dépenses reflète les programmes en cours du gouvernement du Canada, mis à jour en fonction des changements de perspectives économiques ainsi que des effets automatiques de la première étape de la réforme fiscale sur les dépenses fédérales.

Stratégie financière

La stratégie financière à moyen terme du gouvernement s'inspire de quatre principes:

- ramener la croissance de la dette publique au niveau de l'expansion économique à moyen terme, c'est-à-dire stabiliser le rapport dette/PIB;
- réduire chaque année le déficit de manière constante et appréciable;
- réduire sensiblement, année après année, les besoins financiers de l'État; et
- veiller à ce que la majeure partie de ces progrès soit obtenue grâce à des compressions de dépenses et à une bonne gestion.

Ces principes ont été vigoureusement appliqués depuis l'automne 1984. Si bien des progrès ont été accomplis, des facteurs imprévus, dus principalement à une évolution défavorable au plan international, ont également ralenti les progrès financiers par rapport aux prévisions. En particulier, la chute des prix du pétrole et des céréales en 1986 et la possibilité que ces prix ne reviennent pas aux niveaux antérieurs avant la fin de la décennie se sont traduites par un manque à gagner important pour l'économie canadienne, par rapport à ce qui était prévu lors du budget de février 1986. Cet élément a exercé des pressions à la hausse sur le déficit à moyen terme, par le jeu de la baisse des prix du pétrole sur le produit de l'impôt des sociétés et de la chute des prix des céréales sur certains programmes de dépenses statutaires.

Des mesures ont été prises en 1986 pour atténuer l'effet de ces facteurs sur le déficit de 1986-87, mais les efforts qui auraient été nécessaires pour compenser

Comme le montre le tableau 5.1, le rythme de résorption du déficit devrait se ralentir temporairement pendant les exercices 1988-89 et 1989-90. Cela est dû à l'effet continu de la baisse des prix du pétrole et des céréales en 1987-88 et au-delà, ainsi qu'au passage aux régimes réformés d'impôt direct des sociétés et des particuliers.

Si l'on passe aux années 90, le déficit et les besoins financiers devraient afficher une baisse appréciable. D'ici 1991-92, le déficit fédéral, selon les projections, baisserait d'encore 20 pour cent par rapport au niveau estimatif de 1987-88, la diminution prévue étant de 40 pour cent pour les besoins financiers. Le rapport dette/PIB devrait se stabiliser d'ici 1991-92, résultat qui représenterait une étape clé dans la stratégie financière à moyen terme du gouvernement. Ces améliorations reposent, comme l'indique le tableau 5.2, sur une baisse constante des dépenses en proportion du PIB et une stabilité relative des recettes par rapport à ce dernier.

Tableau 5.2

Principaux indicateurs financiers à moyen terme

	1986-87[a]	1987-88[b]	1988-89[b]	1991-92[b]
Dépenses de programmes				
En milliards de dollars	89.4	95.7	99.1	108.2
En pourcentage du PIB	17.7	17.8	17.3	15.7
Programmes statutaires				
En milliards de dollars	52.2	56.6	59.0	63.6
En pourcentage du PIB	10.3	10.5	10.3	9.2
Programmes non statutaires				
En milliards de dollars	37.3	39.1	40.1	44.7
En pourcentage du PIB	7.4	7.3	7.0	6.5
Service de la dette publique				
En milliards de dollars	27.1	28.5	30.1	34.3
En pourcentage du PIB	5.4	5.3	5.2	5.0
Dépenses budgétaires				
En milliards de dollars	116.5	124.2	129.1	142.6
En pourcentage du PIB	23.1	23.1	22.5	20.7
Recettes budgétaires				
En milliards de dollars	85.6	94.9	100.2	119.1
En pourcentage du PIB	16.9	17.6	17.5	17.3
Produit intérieur brut				
En milliards de dollars	505.2	537.8	573.9	688.4

Remarque: Les chiffres étant arrondis, le total pourra ne pas correspondre à la somme des éléments.

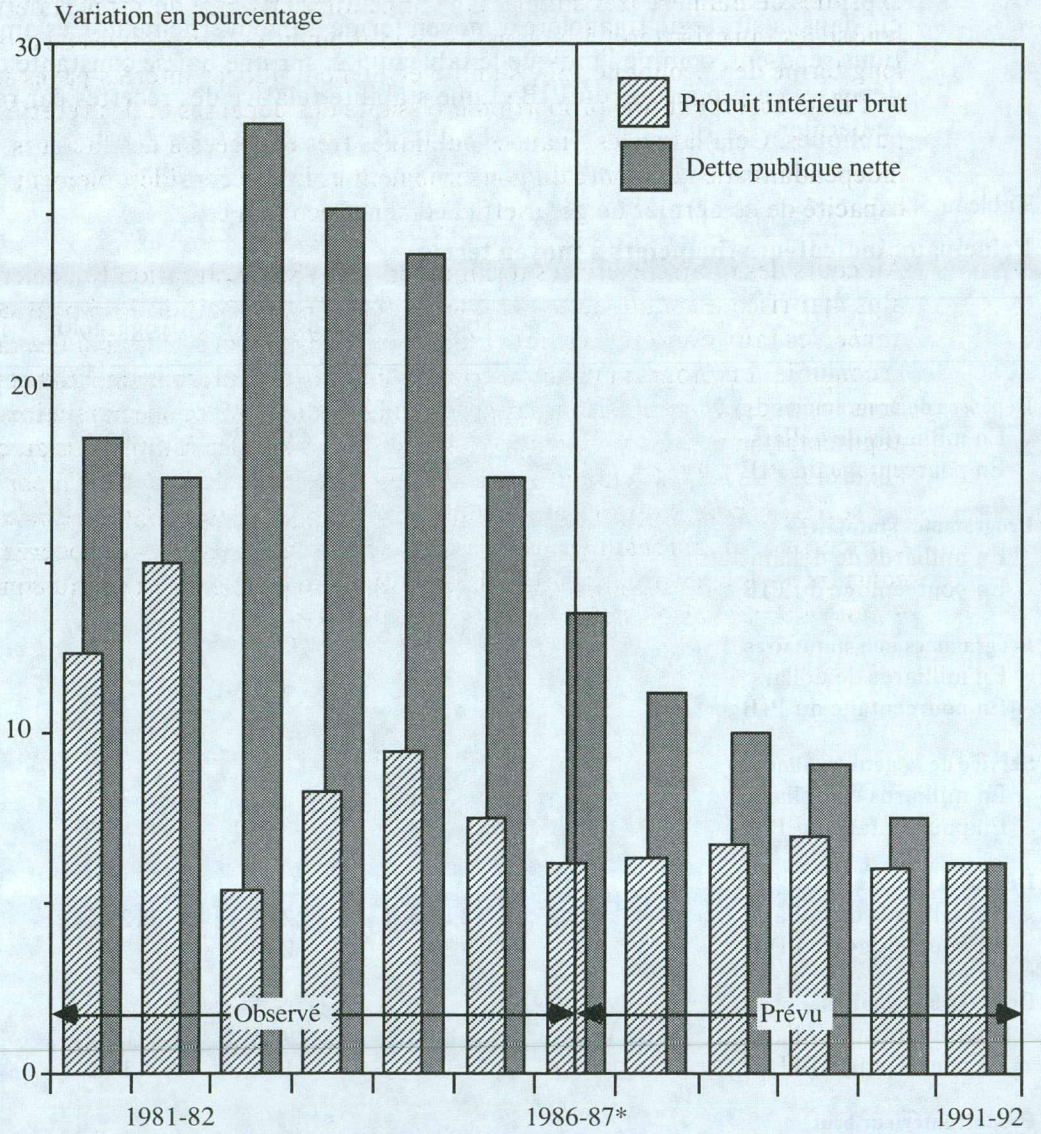
[a] Estimation

[b] Projection

Graphique 5.1

Principes de planification financière

Produit intérieur brut et dette publique nette



*Les estimations de 1986-87 sont fondées sur les États des opérations financières, publiés mensuellement. Les données définitives seront publiées à la fin de l'été.

Le reste du chapitre est consacré à un examen des perspectives financières à moyen terme dans le contexte des quatre principes financiers.

Les principes financiers en perspective

Principe: Ramener le rythme de croissance de la dette publique à celui de l'économie (Graphique 5.1)

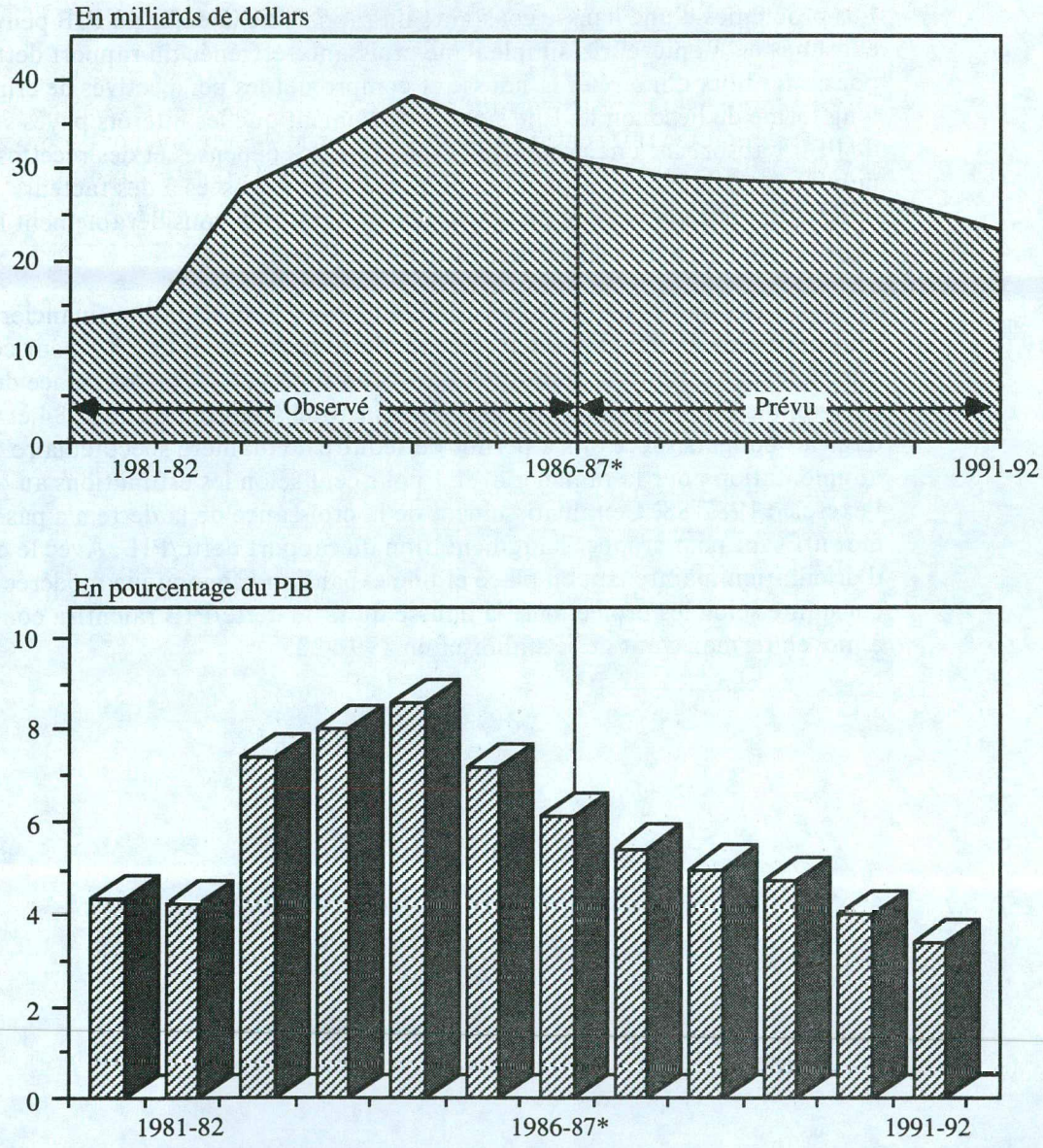
Les problèmes d'une hausse constante du rapport de la dette au PIB peuvent être exprimés de manière très simple. Une croissance effrénée du rapport dette/PIB pousse les taux d'intérêt à la hausse et compromet les perspectives de croissance à long terme de l'économie. Elle signifie également que les intérêts payés sur la dette de l'État absorbent une proportion croissante des dépenses et des recettes publiques. Cela laisse les finances publiques très exposées à des facteurs indépendants de la volonté du gouvernement et limite considérablement la capacité de ce dernier de gérer efficacement l'économie.

Au cours des quatre exercices terminés en 1984-85, la situation financière n'était plus maîtrisée. Pendant cette période, la dette augmentait de 23.5 pour cent par année, les taux d'intérêt restant de beaucoup supérieurs à la croissance de l'économie. Le programme de restriction institué à l'automne de 1984 et poursuivi dans les budgets successifs a permis de réduire de manière spectaculaire cette augmentation pour la ramener à 11.1 pour cent selon les estimations au cours de l'exercice 1987-88. Ce ralentissement de la croissance de la dette n'a pas encore été suffisant pour stopper l'augmentation du rapport dette/PIB. Avec le cadre d'orientation maintenant en place et une expansion économique modérée mais constante selon les projections, la hausse du ratio dette/PIB ralentira constamment à moyen terme, avant de se stabiliser en 1991-92.

Graphique 5.2

Principes de planification financière

Le déficit



* Les estimations de 1986-87 sont fondées sur les États des opérations financières, publiés mensuellement. Les données définitives seront publiées à la fin de l'été.

Principe: Réduire de façon constante et appréciable le déficit budgétaire chaque année (Graphique 5.2)

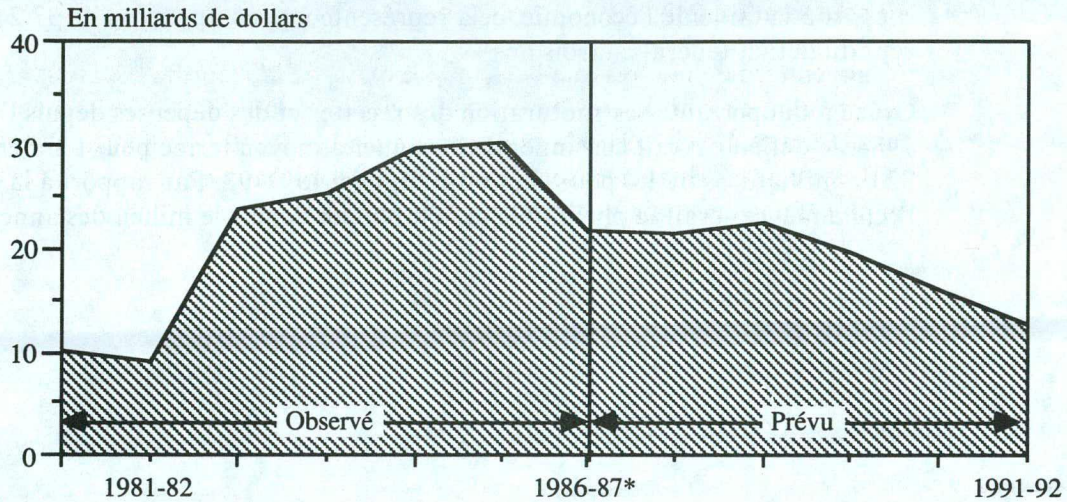
La réduction du déficit d'année en année est la condition nécessaire à la stabilisation du rapport dette/PIB. Le gouvernement a commencé à corriger le problème du déficit à l'automne de 1984 et les progrès réalisés ressortent clairement du graphique 5.2. Après que le déficit ait culminé à $38.3 milliards en 1984-85, des mesures vigoureuses de résorption ont contribué à une réduction projetée de plus de $9 milliards du déficit fédéral jusqu'à l'exercice 1987-88. Par rapport à la taille de l'économie, cela représente une compression de 37.2 pour cent du déficit fédéral en trois ans.

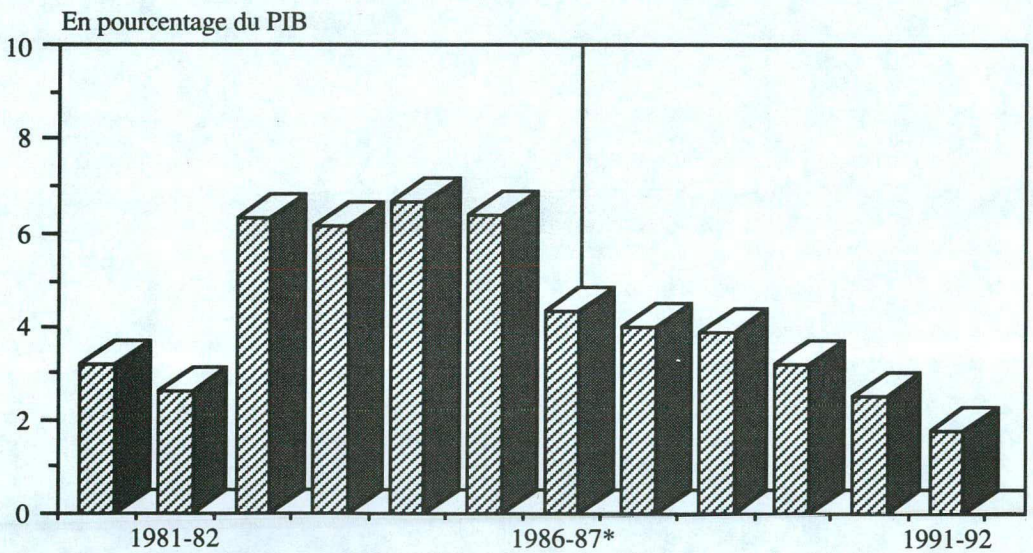
Grâce à l'importante restructuration des recettes et des dépenses depuis l'automne 1984, le déficit devrait continuer de diminuer à moyen terme pour tomber à $23.5 milliards, soit 3.4 pour cent du PIB, d'ici 1991-92. Par rapport à la taille de l'économie, ce serait le plus faible déficit obtenu depuis le milieu des années 70.

Graphique 5.3

Principes de planification financière

Besoins financiers





* Les estimations de 1986-87 sont fondées sur les États des opérations financières, publiés mensuellement. Les données définitives seront publiées à la fin de l'été.

Principe: Assurer une réduction appréciable, année en année, des besoins financiers (Graphique 5.3)

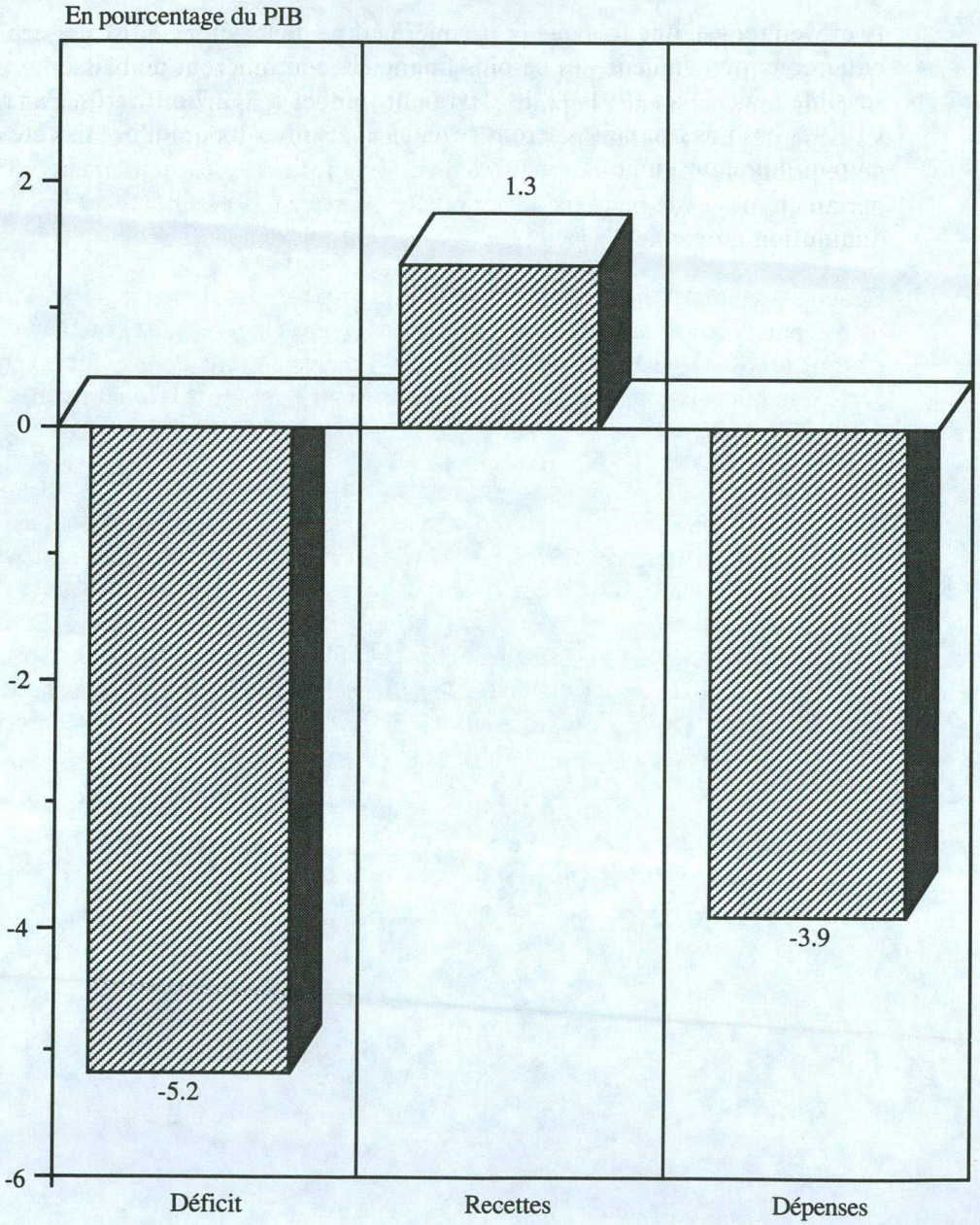
Les besoins financiers constituent l'indicateur le plus complet des demandes nettes de capitaux imposées directement par l'État aux marchés financiers privés. Plus ces demandes sont faibles, plus il reste de capital à la disposition des autres emprunteurs. Après avoir atteint $29.8 milliards en 1984-85, les besoins financiers, opérations de change exclues, devraient descendre à $21.3 milliards en 1987-88. Par rapport au PIB, cela représente une diminution de près de 40 pour cent en trois ans.

À moyen terme, une fois que la première étape de la réforme fiscale sera entièrement en vigueur, les besoins financiers continueront de baisser sensiblement. D'ici 1991-92, ils devraient tomber à $12.7 milliards. Par rapport au PIB, les besoins financiers seront revenus à des niveaux qui n'ont pas été observés en plus d'une décennie.

Graphique 5.4

Principes de planification financière

Contribution à la réduction du déficit 1984-85 à 1991-92



Principe: Faire du contrôle des dépenses et d'une bonne gestion les principaux outils de restrictions financières (Graphique 5.4)

Les dépenses augmentèrent rapidement au début des années 80, tant dans l'absolu que par rapport à la taille de l'économie. Leur croissance était due à des initiatives discrétionnaires, comme les subventions accrues dans le secteur de l'énergie, et à des facteurs non discrétionnaires comme la hausse des prestations d'assurance-chômage et du service de la dette publique. La croissance rapide des dépenses s'est manifestée par la montée sans précédent des dépenses fédérales en proportion de l'économie – de 19.3 pour cent du PIB en 1979-80 à 24.6 pour cent en 1984-85.

Les mesures prises à l'automne 1984 et dans les budgets suivants ont eu un effet spectaculaire en inversant cette tendance. Après avoir augmenté de plus de 14 pour cent par année depuis le début de la décennie jusqu'à la fin de 1984-85, les dépenses de programmes (ensemble des dépenses fédérales, moins service de la dette publique) ont vu leur rythme de croissance ramené à seulement 3.3 pour cent par an en moyenne pendant la période terminée en 1987-88. Cela représente une diminution moyenne d'à peu près 1 pour cent des dépenses réelles de programmes.

Grâce au maintien des restrictions, l'augmentation des dépenses devrait n'être que de 3.1 pour cent en moyenne par année à moyen terme. Le taux moyen d'inflation devrait lui aussi s'établir aux environs de 3 pour cent par année en moyenne, de sorte que la croissance réelle des dépenses fédérales serait faible ou nulle de 1989-90 à 1991-92.

De 1985-86 à 1991-92, les compressions de dépenses sont la principale source de réduction du déficit. Comme l'indique le tableau 5.3, la baisse du déficit, de 8.6 pour cent du PIB en 1984-85 à 3.4 pour cent en 1991-92, provient surtout de la vive baisse des dépenses fédérales en pourcentage du PIB. La décroissance des dépenses budgétaires, de 24.6 pour cent du PIB en 1984-85 à 20.7 pour cent, selon les projections, en 1991-92, représente 75 pour cent de la réduction du déficit en proportion du PIB. La hausse de 1.3 point de pourcentage du rapport entre les recettes et le PIB, sur l'ensemble de la période de 1985-86 à 1987-88, représente 25 pour cent de la diminution du déficit.

Tableau 5.3

Bilan financier, 1985-86 à 1991-92

Bilan: Période de sept ans	1984-85	1991-92	Variation[1]	Contribution[1] à la réduction du déficit
	(en pourcentage du PIB)			(pour cent)
Recettes budgétaires	16.0	17.3	1.3	25
Dépenses budgétaires	24.6	20.7	−3.9	75
Déficit	8.6	3.4	−5.2	100
Composantes des dépenses				
Dépenses de programmes	19.6	15.7	−3.9	73
Service de la dette publique	5.1	5.0	−0.1	2

Remarque: Les chiffres étant arrondis, le total pourra ne pas correspondre à la somme des éléments.

[1] Un signe positif indique une contribution à la baisse du déficit en proportion du PIB.

Risques et incertitudes à moyen terme: nécessité d'une marge de manoeuvre financière

Si bien des progrès ont été accomplis vers une solution des problèmes financiers du Canada, les événements récents ont montré la vulnérabilité de la stratégie financière à des événements indépendants de la volonté du gouvernement. Cela met en lumière la nécessité d'une volonté constante de veiller à ce que le plan financier ne s'écarte de la voie tracée.

L'économie canadienne est actuellement dans sa cinquième année d'expansion et a de bonnes chances de poursuivre une croissance régulière pour les prochaines années. Cependant, les perspectives économiques et financières du Canada à moyen terme dépendront de l'évolution économique internationale, et en particulier de la mesure dans laquelle les principaux pays industrialisés parviendront à régler les déséquilibres commerciaux et financiers actuels. Étant donné l'ampleur des risques et des incertitudes qui pèsent actuellement sur l'économie internationale, il est d'autant plus important de continuer à progresser dans l'amélioration et le renforcement de la structure fondamentale de l'économie canadienne. Ces progrès donneront au Canada plus d'indépendance dans la gestion de ses affaires économiques et financières.

Annexe

Tableau A-1

Principales sources de recettes fiscales fédérales: niveaux

Exercice	Impôt direct des particuliers	Impôt direct des sociétés	Taxe de vente	Total
		(millions de dollars)		
1971-72	7,227	2,396	2,653	12,276
1972-73	8,378	2,920	3,052	14,350
1973-74	9,226	3,710	3,590	16,526
1974-75	11,710	4,836	3,866	20,412
1975-76	12,709	5,748	3,515	21,972
1976-77	14,634	5,363	3,929	23,926
1977-78	13,988	5,280	4,427	23,695
1978-79	14,656	5,654	4,729	25,039
1979-80	16,808	6,951	4,698	28,457
1980-81	19,837	8,106	5,429	33,372
1981-82	24,046	8,118	6,148	38,312
1982-83	26,330	7,139	5,842	39,311
1983-84	26,967	7,286	6,561	40,814
1984-85	29,254	9,379	7,592	46,225
1985-86	33,008	9,210	9,345	51,563
1986-87[a]	37,900	9,815	12,000	59,715
1987-88[b]	42,620[c]	10,200	12,675	65,495[c]
1988-89[b]	44,320	11,100	14,755[d]	70,175[d]
1989-90[b]	45,810[c]	12,300	15,995	74,105[c]
1990-91[b]	51,920	14,100	16,965	82,985
1991-92[b]	56,640	15,505	17,930	90,075

[a] Estimation.

[b] Projection.

[c] Compte non tenu de l'effet sur les recettes de l'accélération des versements d'impôt direct des particuliers et des acomptes trimestriels, les impôts dus n'étant pas modifiés.

[d] Compte non tenu de l'effet sur les recettes de l'accélération des remises de taxes de vente et d'accise, les taxes dues n'étant pas modifiées.

Tableau A-2

Principales sources de recettes fiscales fédérales: répartition
(En pourcentage de l'ensemble des recettes provenant de l'impôt des particuliers, de l'impôt des sociétés et de la taxe de vente)

Exercice	Impôt direct des particuliers	Impôt direct des sociétés	Taxe de vente	Total
		(pour cent)		
1971-72	58.9	19.5	21.6	100.0
1972-73	58.4	20.3	21.3	100.0
1973-74	55.8	22.4	21.7	100.0
1974-75	57.4	23.7	18.9	100.0
1975-76	57.8	26.2	16.0	100.0
1976-77	61.2	22.4	16.4	100.0
1977-78	59.0	22.3	18.7	100.0
1978-79	58.5	22.6	18.9	100.0
1979-80	59.1	24.4	16.5	100.0
1980-81	59.4	24.3	16.3	100.0
1981-82	62.8	21.2	16.0	100.0
1982-83	67.0	18.2	14.9	100.0
1983-84	66.1	17.9	16.1	100.0
1984-85	63.3	20.3	16.4	100.0
1985-86	64.0	17.9	18.1	100.0
1986-87[a]	63.5	16.4	20.1	100.0
1987-88[b]	65.1[c]	15.6	19.4	100.0
1988-89[b]	63.2	15.8	21.0[d]	100.0
1989-90[b]	61.8[c]	16.6	21.6	100.0
1990-91[b]	62.6	17.0	20.4	100.0
1991-92[b]	62.9	17.2	19.9	100.0

Remarque: Les chiffres étant arrondis, le total pourra ne pas correspondre à la somme des éléments.

[a] Estimation.

[b] Projection.

[c] Compte non tenu de l'effet sur les recettes de l'accélération des versements d'impôt direct des particuliers et des acomptes trimestriels, les impôts dus n'étant pas modifiés.

[d] Compte non tenu de l'effet sur les recettes de l'accélération des remises de taxes de vente et d'accise, les taxes dues n'étant pas modifiées.

Tableau A-3

Principales sources de recettes fiscales fédérales en proportion du produit intérieur brut (PIB)

Exercice	Impôt direct des particuliers	Impôt direct des sociétés	Taxe de vente	Total
		(pour cent)		
1971-72	7.4	2.5	2.7	12.6
1972-73	7.7	2.7	2.8	13.2
1973-74	7.2	2.9	2.8	13.0
1974-75	7.7	3.2	2.5	13.4
1975-76	7.4	3.4	2.0	12.8
1976-77	7.4	2.7	2.0	12.1
1977-78	6.4	2.4	2.0	10.9
1978-79	6.1	2.3	2.0	10.4
1979-80	6.1	2.5	1.7	10.3
1980-81	6.4	2.6	1.8	10.8
1981-82	6.8	2.3	1.7	10.8
1982-83	7.0	1.9	1.6	10.5
1983-84	6.7	1.8	1.6	10.1
1984-85	6.6	2.1	1.7	10.4
1985-86	6.9	1.9	2.0	10.8
1986-87[a]	7.5	1.9	2.4	11.8
1987-88[b]	7.9[c]	1.9	2.4	12.2[c]
1988-89[b]	7.7	1.9	2.6[d]	12.2[d]
1989-90[b]	7.5[c]	2.0	2.6	12.2[c]
1990-91[b]	8.0	2.2	2.6	12.8
1991-92[b]	8.2	2.3	2.6	13.1

Remarque: Les chiffres étant arrondis, le total pourra ne pas correspondre à la somme des éléments.

[a] Estimation.

[b] Projection.

[c] Compte non tenu de l'effet sur les recettes de l'accélération des versements d'impôt direct des particuliers et des acomptes trimestriels, les impôts dus n'étant pas modifiés.

[d] Compte non tenu de l'effet sur les recettes de l'accélération des remises de taxes de vente et d'accise, les taxes dues n'étant pas modifiées.

Table A-3

Major Federal Tax Revenue Sources as Percentages of Gross Domestic Product (GDP)

Fiscal year	Personal income tax	Corporate income tax	Sales tax	Total
		(per cent)		
1971-72	7.4	2.5	2.7	12.6
1972-73	7.7	2.7	2.8	13.2
1973-74	7.2	2.9	2.8	13.0
1974-75	7.7	3.2	2.5	13.4
1975-76	7.4	3.4	2.0	12.8
1976-77	7.4	2.7	2.0	12.1
1977-78	6.4	2.4	2.0	10.9
1978-79	6.1	2.3	2.0	10.4
1979-80	6.1	2.5	1.7	10.3
1980-81	6.4	2.6	1.8	10.8
1981-82	6.8	2.3	1.7	10.8
1982-83	7.0	1.9	1.6	10.5
1983-84	6.7	1.8	1.6	10.1
1984-85	6.6	2.1	1.7	10.4
1985-86	6.9	1.9	2.0	10.8
1986-87[a]	7.5	1.9	2.4	11.8
1987-88[b]	7.9[c]	1.9	2.4	12.2[c]
1988-89[b]	7.7	1.9	2.6[d]	12.2[d]
1989-90[b]	7.5[c]	2.0	2.6	12.2[c]
1990-91[b]	8.0	2.2	2.6	12.8
1991-92[b]	8.2	2.3	2.6	13.1

[a] Estimate

[b] Projection

[c] Excludes the revenue impact of the acceleration of personal income tax and quarterly remittances as the tax liability is unaffected.

[d] Excludes the revenue impact of the acceleration of sales and excise tax remittances as the tax liability is unaffected.

Note: Details may not add due to rounding.

Table A-2

Major Federal Tax Revenue Sources: Shares

(As percentage of total personal/corporate/sales tax revenues)

Fiscal year	Personal income tax	Corporate income tax	Sales tax	Total
		(per cent)		
1971-72	58.9	19.5	21.6	100.0
1972-73	58.4	20.3	21.3	100.0
1973-74	55.8	22.4	21.7	100.0
1974-75	57.4	23.7	18.9	100.0
1975-76	57.8	26.2	16.0	100.0
1976-77	61.2	22.4	16.4	100.0
1977-78	59.0	22.3	18.7	100.0
1978-79	58.5	22.6	18.9	100.0
1979-80	59.1	24.4	16.5	100.0
1980-81	59.4	24.3	16.3	100.0
1981-82	62.8	21.2	16.0	100.0
1982-83	67.0	18.2	14.9	100.0
1983-84	66.1	17.9	16.1	100.0
1984-85	63.3	20.3	16.4	100.0
1985-86	64.0	17.9	18.1	100.0
1986-87[a]	63.5	16.4	20.1	100.0
1987-88[b]	65.1[c]	15.6	19.4	100.0
1988-89[b]	63.2	15.8	21.0[d]	100.0
1989-90[b]	61.8[c]	16.6	21.6	100.0
1990-91[b]	62.6	17.0	20.4	100.0
1991-92[b]	62.9	17.2	19.9	100.0

[a] Estimate

[b] Projection

[c] Excludes the revenue impact of the acceleration of personal income tax and quarterly remittances as the tax liability is unaffected.

[d] Excludes the revenue impact of the acceleration of sales and excise tax remittances as the tax liability is unaffected.

Note: Details may not add due to rounding.

Annex

Table A-1

Major Federal Tax Revenue Sources: Levels

Fiscal year	Personal income tax	Corporate income tax	Sales tax	Total
		(millions of dollars)		
1971-72	7,227	2,396	2,653	12,276
1972-73	8,378	2,920	3,052	14,350
1973-74	9,226	3,710	3,590	16,526
1974-75	11,710	4,836	3,866	20,412
1975-76	12,709	5,748	3,515	21,972
1976-77	14,634	5,363	3,929	23,926
1977-78	13,988	5,280	4,427	23,695
1978-79	14,656	5,654	4,729	25,039
1979-80	16,808	6,951	4,698	28,457
1980-81	19,837	8,106	5,429	33,372
1981-82	24,046	8,118	6,148	38,312
1982-83	26,330	7,139	5,842	39,311
1983-84	26,967	7,286	6,561	40,814
1984-85	29,254	9,379	7,592	46,225
1985-86	33,008	9,210	9,345	51,563
1986-87[a]	37,900	9,815	12,000	59,715
1987-88[b]	42,620[c]	10,200	12,675	65,495[c]
1988-89[b]	44,320	11,100	14,755[d]	70,175[d]
1989-90[b]	45,810[c]	12,300	15,995	74,105[c]
1990-91[b]	51,920	14,100	16,965	82,985
1991-92[b]	56,640	15,505	17,930	90,075

[a] Estimate

[b] Projection

[c] Excludes the revenue impact of the acceleration of personal income tax and quarterly remittances as the tax liability is unaffected.

[d] Excludes the revenue impact of the acceleration of sales and excise tax remittances as the tax liability is unaffected.

Table 5.3

The Fiscal Record, 1985-86 to 1991-92

Record: Seven-year period	1984-85	1991-92	Change	Contribution[1] to change
	(as a percentage of GDP)			(per cent)
Budgetary revenues	16.0	17.3	1.3	25
Budgetary expenditures	24.6	20.7	−3.9	75
Deficit	8.6	3.4	−5.2	100
Expenditure components				
Program expenditures	19.6	15.7	−3.9	73
Public debt charges	5.1	5.0	−0.1	2

Note: Figures may not add due to rounding.

[1] A positive sign indicates a contribution to a reduction in the deficit as a ratio to GDP.

Risks and Uncertainties in the Medium Term: The Need for Fiscal Flexibility

While much progress has been made in tackling Canada's fiscal problems, recent events have shown the vulnerability of the fiscal strategy to events that are beyond the government's control. This in turn highlights the need for continued resolve to ensure that the fiscal plan is not thrown off track.

The Canadian economy is currently in its fifth year of economic expansion, and is well positioned to continue to grow steadily over the years ahead. But Canada's medium-term economic and fiscal prospects will be affected by international economic developments, in particular the progress the major industrial economies make in resolving current trade and fiscal imbalances. With the extent of the risks and uncertainties presently in the international economy, it is all the more important that continued progress be made in improving and strengthening the underlying structure of the Canadian economy. Such progress will provide Canada with a greater degree of independence in managing its fiscal and economic affairs.

Principle: To Make Expenditure Control and Good Management the Primary Focus of Fiscal Restraint (Chart 5.4)

Expenditures grew rapidly in the early 1980s, both in absolute terms and relative to the size of the economy. This growth reflected discretionary initiatives, such as increased energy-related subsidies, and non-discretionary factors such as higher unemployment insurance payments and public debt charges. The rapid rise in expenditures was evident in the unprecedented expansion of federal spending relative to the size of the economy – from 19.3 per cent of GDP in 1979-80 to 24.6 per cent in 1984-85.

The actions introduced in the fall of 1984 and in subsequent budgets have had a dramatic impact on reversing this trend. After growing by more than 14 per cent per year from the beginning of the decade through 1984-85, the rate of growth of program spending (total federal government spending excluding public debt servicing costs) has since been cut to just 3.3 per cent per year, on average, through 1987-88. This represents annual average declines in real program spending of roughly 1 per cent.

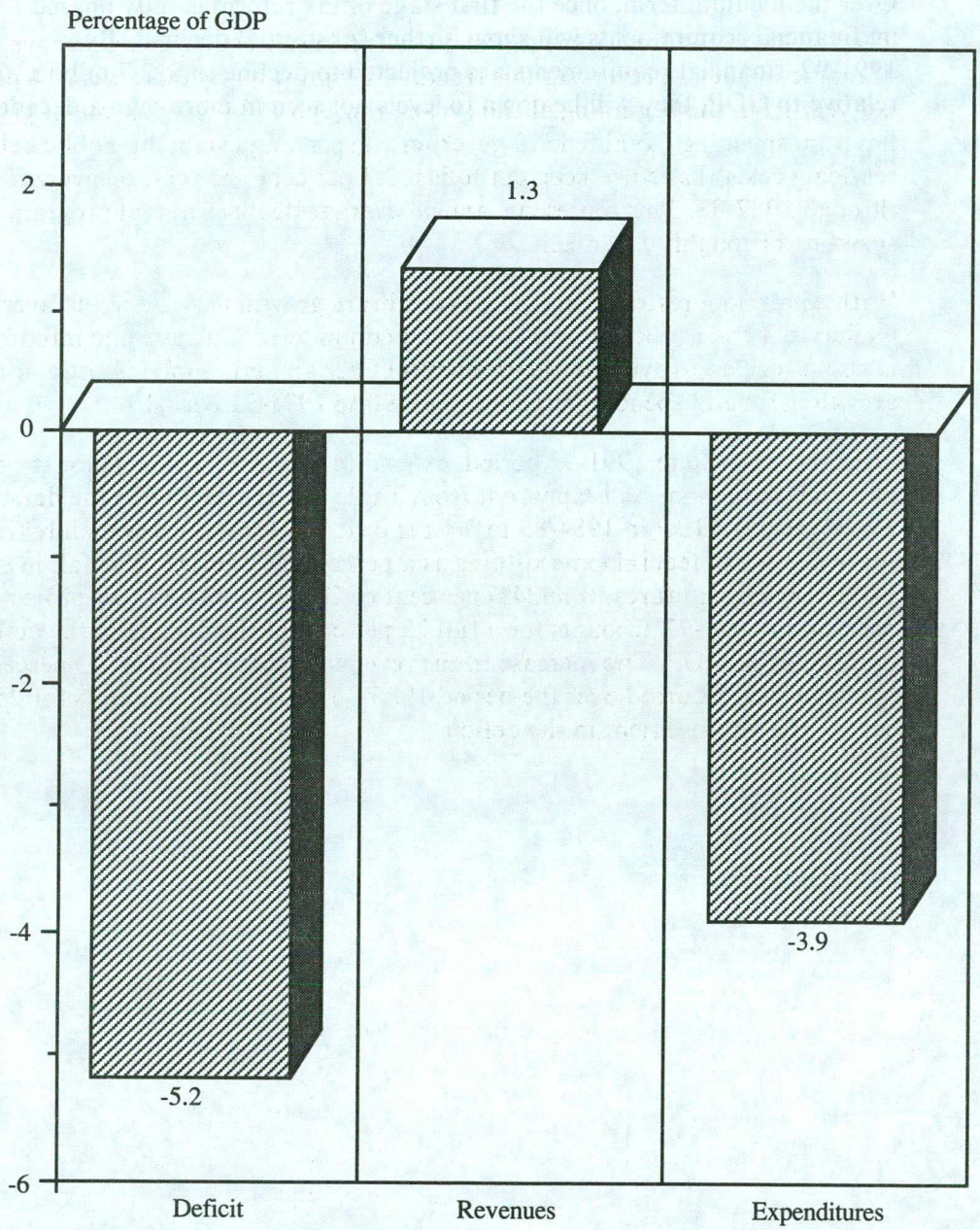
With continuing restraint in place, expenditure growth is projected to average a moderate 3.1 per cent per year over the medium term. The average inflation rate is also projected to average about 3 per cent per annum, implying little or no real growth in federal spending over the 1989-90 to 1991-92 period.

Over the 1985-86 to 1991-92 period, expenditure control accounts for the majority of deficit reduction. As is apparent from Table 5.3, the decline in the deficit from 8.6 per cent of GDP in 1984-85 to 3.4 per cent in 1991-92 arises mainly from the sharp decline in federal expenditures as a percentage of GDP. The fall in budgetary expenditures from 24.6 per cent of GDP in 1984-85 to a projected 20.7 per cent in 1991-92 accounts for a full 75 per cent of the decline in the deficit as a percentage of GDP. The increase in the revenue-to-GDP ratio of 1.3 percentage points, which occurred over the period 1985-86 to 1987-88, accounts for 25 per cent of the improvement in the deficit.

Chart 5.4

The Fiscal Planning Principles

Contributions to Deficit Reduction 1984-85 to 1991-92



Principle: To Ensure Substantial Year-Over-Year Reductions in Financial Requirements (Chart 5.3)

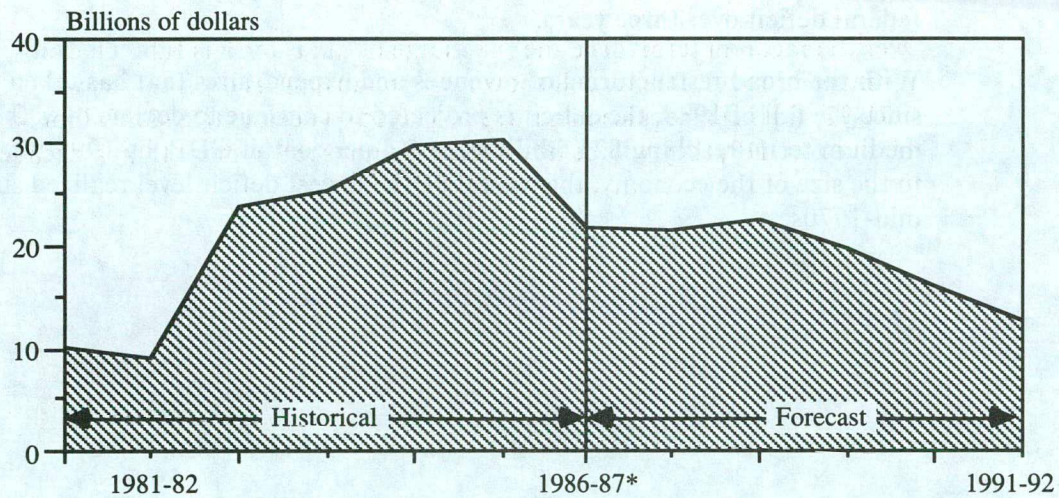
Financial requirements are the most comprehensive measure of the net borrowing demands the government puts directly on private capital markets. The lower these demands are, the more room there is for other borrowers to raise the capital they need. After reaching $29.8 billion in 1984-85, financial requirements, excluding foreign exchange requirements, are projected to drop to $21.3 billion in 1987-88. Relative to GDP this represents a decline of almost 40 per cent over three years.

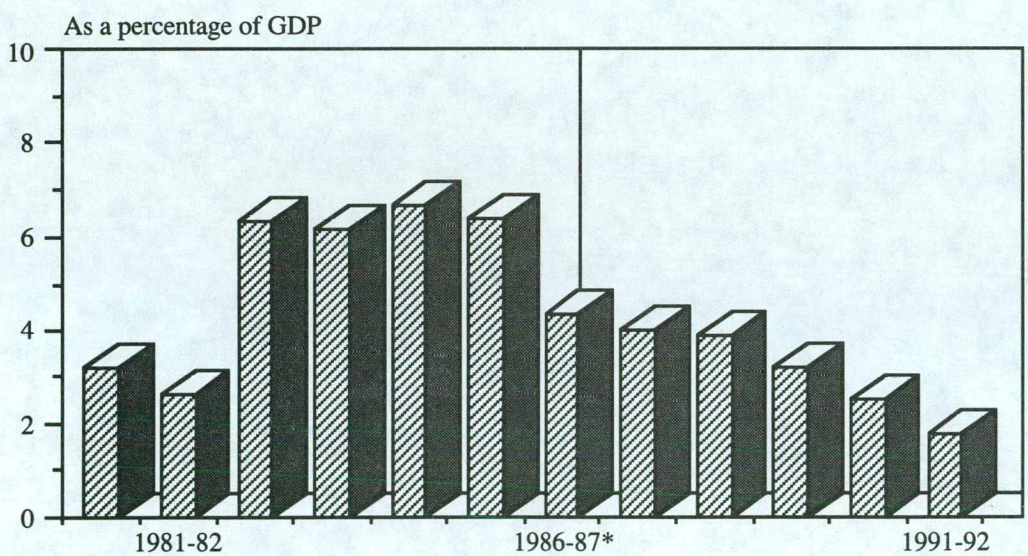
Over the medium term, once the first stage of tax reform is fully phased in, financial requirements will show further substantial declines. By 1991-92, financial requirements are projected to decline to $12.7 billion, and relative to GDP, they will be down to levels not seen in more than a decade.

Chart 5.3

The Fiscal Planning Principles

Financial Requirements





* The estimate for 1986-87 is based on published monthly Statements of Financial Operations. Final data will be published in late summer.

Principle: To Achieve Continuing, Sizeable Year-Over-Year Reductions in the Budgetary Deficit (Chart 5.2)

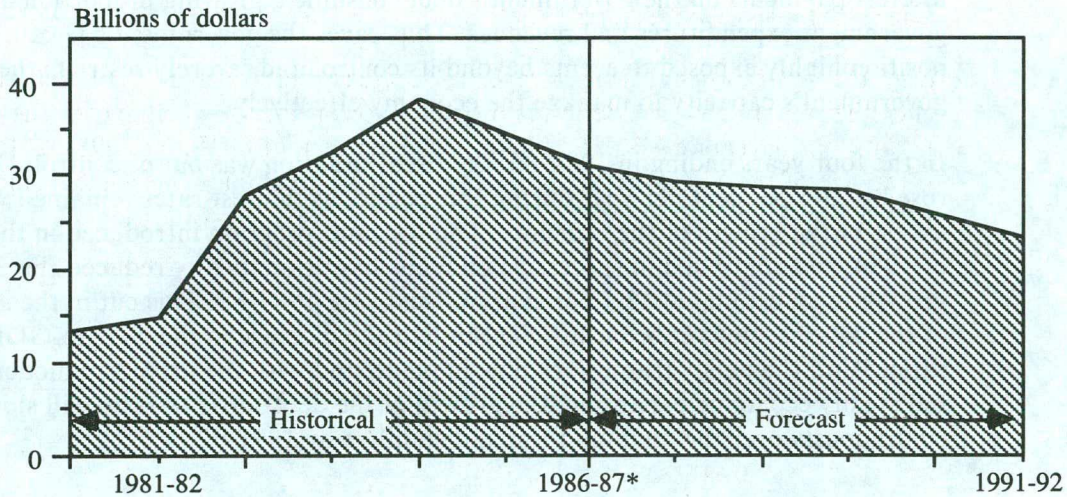
Continuous reductions in the deficit are the key to stabilizing the debt-to-GDP ratio. The government began correcting the deficit problem in the fall of 1984 and the progress is clearly demonstrated in Chart 5.2. Since the deficit peaked in 1984-85 at $38.3 billion, strong deficit reduction action has contributed to a projected reduction in the federal deficit of over $9 billion by fiscal year 1987-88. Relative to the size of the economy this represents a cut of 37.2 per cent in the federal deficit over three years.

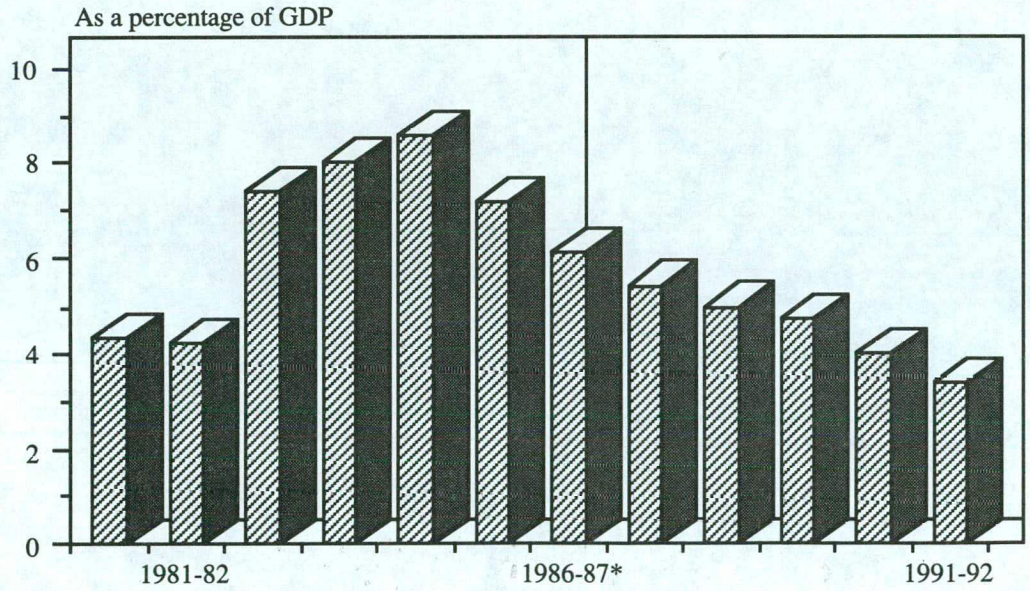
With the broad restructuring of revenues and expenditures that has taken place since the fall of 1984, the deficit is projected to continue to decline over the medium term, reaching $23.5 billion, or 3.4 per cent of GDP, by 1991-92. Relative to the size of the economy, this would be the lowest deficit level realized since the mid-1970s.

Chart 5.2

The Fiscal Planning Principles

The Deficit





* The estimate for 1986-87 is based on published monthly Statements of Financial Operations. Final data will be published in late summer.

Fiscal Principles in Perspective

Principle: To Reduce the Growth of the Public Debt to No More Than the Growth of the Economy (Chart 5.1)

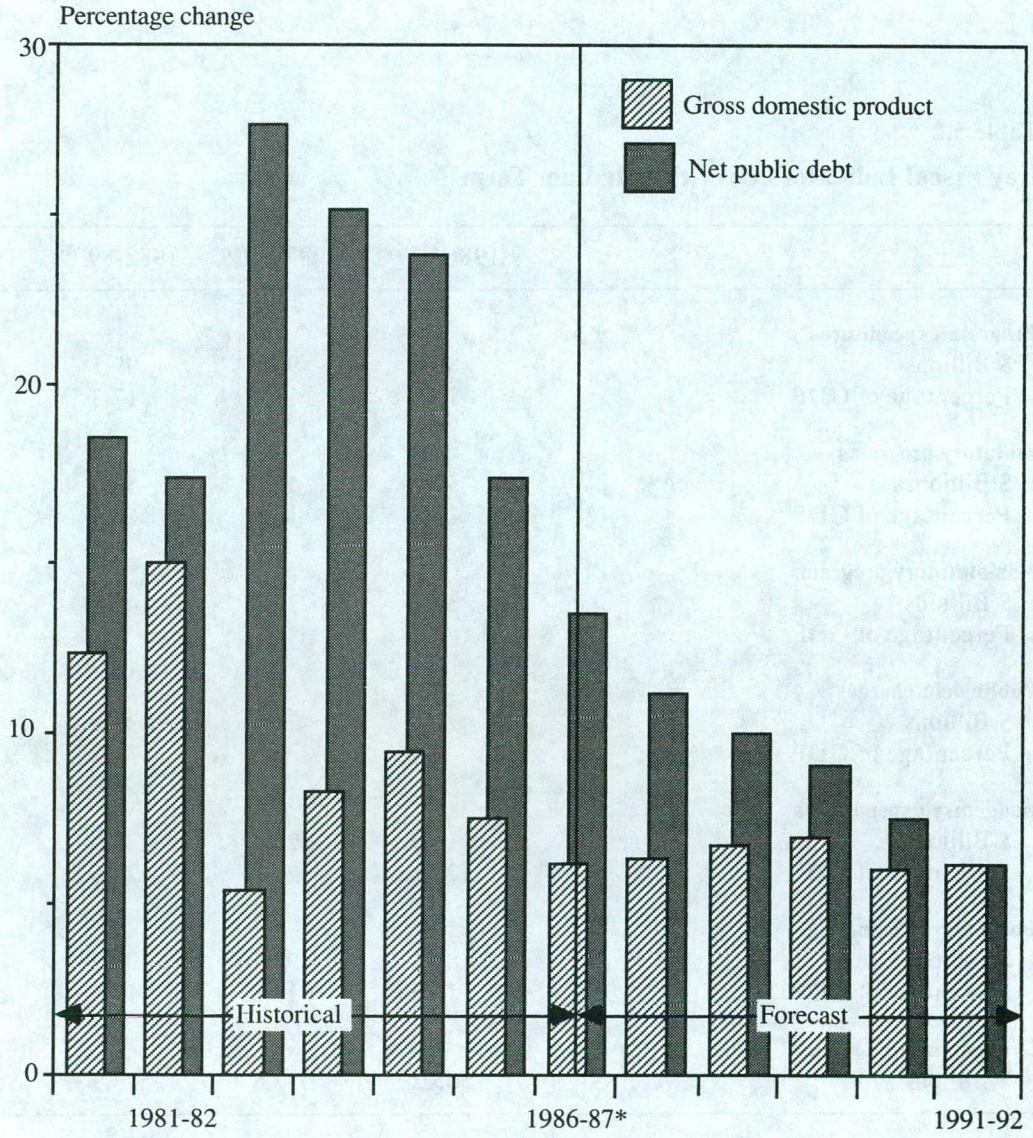
The problems of a continuously rising debt-to-GDP ratio can be put very simply. Unchecked growth in the debt-to-GDP ratio puts upward pressure on interest rates and threatens the economy's long-term growth prospects. It also means that interest payments on the government's debt consume a growing proportion of government expenditures and revenues. This leaves the government's fiscal position highly exposed to events beyond its control and severely restricts the government's capacity to manage the economy effectively.

In the four years ending in 1984-85, the fiscal situation was out of control. Debt rose by 23.5 per cent per year during this period, as interest rates remained well in excess of the growth of the economy. The restraint program introduced in the fall of 1984, and continued in successive budgets, has dramatically reduced this growth to an estimated 11.1 per cent in fiscal year 1987-88. This cut in the growth of the debt has not yet been sufficient to halt the increase in the debt-to-GDP ratio. With the policy framework now in place, and with the projected moderate but steady economic expansion, the growth of the debt-to-GDP ratio will slow continuously over the medium term and stabilize by 1991-92.

Chart 5.1

The Fiscal Planning Principles

Gross Domestic Product and Net Public Debt



*The estimate for 1986-87 is based on published monthly Statements of Financial Operations. Final data will be published in late summer.

Looking ahead to the 1990s, the deficit and financial requirements are projected to show substantial declines. By 1991-92, the federal deficit is projected to decline a further 20 per cent from the estimated 1987-88 level, and financial requirements will be down 40 per cent from the estimated level for 1987-88. The debt-to-GDP ratio is expected to stabilize by 1991-92, constituting a key milestone in the government's medium-term fiscal strategy. Underlying these improvements, as shown in Table 5.2, are steadily declining expenditures as a percentage of GDP and a relatively stable ratio of revenues to GDP.

The remainder of this chapter examines the medium-term fiscal outlook in the context of the four fiscal principles.

Table 5.2

Key Fiscal Indicators Over the Medium Term

	1986-87[a]	1987-88[b]	1988-89[b]	1991-92[b]
Program expenditures				
$ Billions	89.4	95.7	99.1	108.2
Percentage of GDP	17.7	17.8	17.3	15.7
Statutory programs				
$ Billions	52.2	56.6	59.0	63.6
Percentage of GDP	10.3	10.5	10.3	9.2
Non-statutory programs				
$ Billions	37.3	39.1	40.1	44.7
Percentage of GDP	7.4	7.3	7.0	6.5
Public debt charges				
$ Billions	27.1	28.5	30.1	34.3
Percentage of GDP	5.4	5.3	5.2	5.0
Budgetary expenditures				
$ Billions	116.5	124.2	129.1	142.6
Percentage of GDP	23.1	23.1	22.5	20.7
Budgetary revenues				
$ Billions	85.6	94.9	100.2	119.1
Percentage of GDP	16.9	17.6	17.5	17.3
Gross domestic product				
$ Billions	505.2	537.8	573.9	688.4

[a] Estimate

[b] Projection

Note: Details may not add due to rounding.

Table 5.1

The Medium-Term Outlook for the Deficit, Financial Requirements, and Net Public Debt

	1986-87[a]	1987-88[b]	1988-89[b]	1989-90[b]	1990-91[b]	1991-92[b]
Budgetary deficit						
$ Billions	31.0	29.3	28.9	28.6	26.1	23.5
Percentage of GDP	6.1	5.4	5.0	4.7	4.0	3.4
Financial requirements						
$ Billions	21.6	21.3	22.3	19.7	16.0	12.7
Percentage of GDP	4.3	4.0	3.9	3.2	2.5	1.8
Net public debt						
$ Billions	264.5	293.8	322.8	351.4	377.5	401.0
Percentage of GDP	52.4	54.6	56.2	57.3	58.2	58.2

[a] Estimate

[b] Projection

disruptive to the economy than a somewhat slower pace of deficit reduction. Nevertheless, this choice was made in a way that ensures continuing progress with respect to all four fiscal principles.

Notwithstanding the impacts of lower oil and grain prices in 1986, the deficit for fiscal year 1986-87 is now estimated at $31.0 billion, $1.0 billion below the February 1987 budget projection, and $3.4 billion below the 1985-86 deficit of $34.4 billion. Program spending for fiscal year 1986-87 is estimated to be $89.4 billion, the target set out in the February 1986 budget and reconfirmed in the February 1987 budget. Revenues will be somewhat stronger than expected in the February 1987 budget, largely reflecting stronger corporate income tax collections in the first quarter of 1987 than anticipated. Financial requirements, excluding exchange fund transactions, in 1986-87 are estimated at $21.6 billion, $2.4 billion less than forecast at the time of the February 1987 budget, resulting from both the improvement in the deficit and increases in the net source of funds from non-budgetary transactions.

For 1987-88, the deficit forecast is unchanged from the February 1987 budget, although underlying the $29.3 billion deficit estimate is higher-than-anticipated statutory program spending, particularly in the areas of farm income support programs, unemployment insurance benefits, and public debt charges. These spending increases are offset by higher-than-anticipated revenue collections. Expected financial requirements for 1987-88 remain unchanged from the February 1987 budget forecast of $21.3 billion.

As indicated in Table 5.1, the pace of deficit decline is expected to slow temporarily in fiscal years 1988-89 and 1989-90. This reflects the ongoing impacts of lower oil and grain prices in 1987-88 and beyond, and the transition to the reformed corporate and personal income tax systems.

5. The Fiscal Principles

Introduction

This chapter reviews the outlook for expenditures, revenues and the deficit in the context of the four principles of responsible fiscal management that were set out in the Speech from the Throne in October 1986. The revenue track presented in this chapter embodies the impacts of the first stage of tax reform as discussed in Chapter 4. The expenditure track reflects the ongoing programs of the Government of Canada, updated for changes to the economic outlook as well as for the automatic impacts on federal expenditures of the first stage of tax reform.

The Fiscal Strategy

The government's medium-term fiscal strategy is guided by four principles:

- to reduce the growth of the public debt to no more than that of the economy over the medium term: that is, to stabilize the debt-to-GDP ratio;
- to achieve continuing, sizeable year-over-year reductions in the deficit;
- to achieve substantial year-over-year reductions in the government's financial requirements; and,
- to ensure that the greater part of the fiscal progress is achieved through effective expenditure restraint and good management.

These principles have been pursued aggressively since the fall of 1984. While much progress has been made, there have also been unforeseen developments, primarily originating from adverse international events, that have slowed fiscal progress from what had been planned. In particular, the dramatic fall in oil and grain prices in 1986 and the likelihood that these commodity prices will not recover to earlier levels over the remainder of the decade has meant a substantial loss in income for the Canadian economy relative to what was expected at the time of the February 1986 budget. This in turn has put upward pressure on the medium-term deficit track through the impacts of lower oil prices on corporate income tax revenues and of lower grain prices on certain statutory expenditures.

While actions were taken in 1986 to dampen the impacts of these developments on the 1986-87 deficit, attempts to offset fully the ongoing influences of lower oil and grain prices over the remainder of the decade, through either further large expenditure cuts or large revenue increases, were judged likely to be more

estimated to represent only 15.6 per cent of total personal, corporate and sales tax revenues, the lowest share in more than two decades. This further decline has resulted primarily from the impact of low commodity prices and increasingly aggressive tax avoidance activities.

In the absence of tax reform, increasing reliance on personal income taxes would have continued. The tax measures in the first stage of tax reform will lower the share of personal income taxes and increase the shares of both corporate income and sales taxes. The corporate tax share will increase from a low of 15.6 per cent in 1987-88 to 17.2 per cent by 1991-92. The second stage of tax reform will bring about further re-balancing of the shares of the main tax revenues as the federal sales tax is replaced by a broad-based multi-stage sales tax, and there are additional personal income tax reductions and the removal of the personal and corporate surtaxes.

Table 4.2

Structure of Main Federal Tax Revenues

Fiscal periods	Personal income tax	Corporate income tax	Federal sales tax	Total of personal, corporate and sales taxes
		(per cent)		
Historical				
1971-72 to 1975-76	57.6	22.9	19.5	100.0
1976-77 to 1980-81	59.4	23.3	17.3	100.0
1981-82 to 1985-86	64.6	19.0	16.4	100.0
Current Year Projection				
1987-88	65.1	15.6	19.4	100.0
Projection for Stage One of Tax Reform				
1991-92	62.9	17.2	19.9	100.0

Note: Details may not add due to rounding.

As indicated in Panel B of Table 4.1, the acceleration of the sales and excise tax payments will result in a one-time revenue increase of $1.6 billion in 1988-89, while the acceleration of source deductions and quarterly instalments will result in a one-time revenue increase of $1.1 billion in 1989-90. These management initiatives will also yield ongoing savings in the form of reduced public debt servicing costs.

The cumulative impact of the measures outlined in Table 4.1 on the deficit and net debt over the 1988-89 to 1991-92 period is negligible.

Re-balancing Federal Tax Revenue Shares

Table 4.2 traces the shares of the three main federal revenue sources since the early 1970s. A number of trends stand out. The relative importance of personal income taxes has increased markedly, while the shares of both the corporate income tax and sales tax have declined significantly. This shift in the balance of federal tax revenues reflected a combination of policy actions undertaken in the 1970s and early 1980s, and the uneven impact of economic conditions in the late 1970s and early 1980s on the composition and size of the underlying tax bases.

The share of sales tax revenues declined substantially in the mid-1970s due largely to reductions in sales tax rates and a narrowing of the sales tax base by the extension of exemptions. The decline in the corporate tax share in the second half of the 1970s largely reflected policy changes, both increasing use of preferences and rate reductions. The increase in the personal income tax share reflects movements in the other shares as well as the rising trend in personal income as a proportion of national income through the 1970s.

In addition to the ongoing impacts on tax shares from policy changes in the 1970s, the very disparate impacts of the 1981-1982 recession on the underlying tax bases further altered the balance of federal tax revenues in the 1980s. In particular, corporate profits were severely depressed by the recession, and corporate tax revenues fell correspondingly. Furthermore, the losses built up during the recession, combined with the loss-carryover provisions of the corporate tax system, continued to dampen the growth in corporate tax revenues during the recovery. As a result, the share of corporate taxes declined from 24.3 per cent of total personal, corporate and sales tax revenues in 1980-81 to 17.9 per cent by 1985-86. The recession also restrained the growth in consumer expenditures, thereby dampening the sales tax share. In contrast, growth in personal income tax revenues was also negatively affected by shifts in both the size and composition of the personal income base in the first half of the 1980s, but the impact was smaller than that on the other tax sources. As a result, the personal income tax share increased further.

Since 1984-85, strengthening growth in personal income and domestic sales subject to the federal sales tax, in conjunction with fiscal policy measures relating to personal income and federal sales tax rates, have increased the shares of these tax revenue sources. With the exception of 1984-85, the share of corporate income tax revenues continued to decline, so that for 1987-88 corporate income tax is

Related Actions to Ensure Responsible Fiscal Management

An important principle of tax reform is that the fiscal impact of the reform should be basically neutral. Because sales tax reform will be implemented in a second stage, responsible fiscal management requires raising additional revenues from the existing sales tax system. These revenue increases are outlined in Panel B of Table 4.1.

Until the new sales tax system can be put in place, the government is proposing a number of interim changes to the existing federal sales tax. These measures will alleviate some of the major competitive distortions that now exist and reduce opportunities for tax avoidance. Together with increased revenue resulting from corporate tax reform, the measures will raise additional revenues to finance personal income tax reform. The measures include:

- moving the point of tax from manufacturers to marketing companies where the marketing company is related to the manufacturer, to reduce opportunities for unfair tax avoidance;
- moving the point of tax for certain products to the wholesale level to reduce the competitive advantage of imported goods;
- extending the sales tax to most telecommunications services at a rate of 10 per cent (charges for residential telephone lines will be exempt) and increasing the rate of tax for cable television services from 8 per cent to 10 per cent; and,
- taxing paint and wallpaper at the general sales tax rate, rather than the lower rate that applies to construction materials.

In addition, the government will be increasing the current refundable sales tax credit from $50 to $70 per adult and from $25 to $35 per child. The higher credits will be reduced by 5 per cent of family net income in excess of $16,000.

On balance, these measures are estimated to increase revenues by $1.1 to $1.3 billion per annum.

The government is also proposing, as part of tax reform, a number of new measures directed at strengthening compliance and improving administration. As part of its efforts to administer the tax system more efficiently on behalf of all taxpayers, an examination of further opportunities to speed up collection of tax liabilities has been undertaken. As a result of that examination, the government is proposing additional measures that will complement the initiative to accelerate payroll source deductions for large employers announced in the February 1987 budget. These measures will not represent an increase in tax liabilities but only an acceleration in the time at which liabilities already owed to the government are remitted. They include an acceleration of federal sales and excise tax payments, a further acceleration of the remittance of personal payroll source deductions made by large employers, and an acceleration of quarterly personal income tax instalments.

Table 4.1

Fiscal Implications of Stage One of Tax Reform

A. Total Direct Revenue and Expenditure Impacts of the Personal and Corporate Tax Measures	1988-89	1989-90	1990-91	1991-92
		(millions of dollars)		
Revenue impacts				
Personal income tax				
Conversion of exemptions to credits and marginal tax rate reductions	−2,185	−5,910	−4,600	−4,905
Base-broadening and other measures	480	2,070	2,255	2,495
Net personal income tax reductions	−1,705	−3,840	−2,345	−2,410
Corporate income tax				
Tax rate reductions	−635	−1,545	−1,645	−1,665
Base-broadening measures	1,165	2,170	2,810	3,190
Net corporate income tax increases	530	625	1,165	1,525
Total net revenue reductions	−1,175	−3,215	−1,180	−885
Expenditure impacts				
Increased payments under Established Program Financing and Equalization	340	360	385	395
B. Related Revenue Measures				
Changes to the federal sales tax (FST) and the refundable sales tax credit				
Shift in federal sales tax to wholesale level for selected items and change in the treatment of marketing companies	295	310	315	330
10-per-cent tax on specified telecommunication and cable services	870	945	1,000	1,055
Tax at general rate on paint and wallpaper	60	60	65	65
Increase in refundable sales tax credit by $20 per adult and $10 per child	−120	−150	−155	−160
Net increase in FST revenues	1,105	1,165	1,225	1,290
Tax liability management				
Acceleration of source deductions and quarterly instalments of personal income tax		1,100		
Acceleration of sales and excise tax payments	1,600			
Total revenue increases resulting from tax liability management	1,600	1,100		
Total net revenue increases	+2,705	+2,265	+1,225	+1,290
Deficit implications of stage one of tax reform	−1,190	1,310	340	−10

would allocate more taxable income to lower-rate jurisdictions. The result of such shifts would be a further significant erosion of the government's corporate tax revenues.

The initiatives proposed under stage one of comprehensive tax reform will considerably improve the stability and predictability of federal tax revenues. The broadening of the tax bases and the elimination of selective tax preferences, together with the lowering of tax rates, closer convergence of the top personal and corporate statutory tax rates and general anti-avoidance rules will address the prospective erosion of tax bases that would undoubtedly have occurred in their absence.

Direct Revenue and Expenditure Impacts of the Personal and Corporate Tax Measures

Panel A of Table 4.1 presents the direct revenue and expenditure impacts of the personal and corporate tax measures in the first stage of tax reform.

The changes to the personal income tax system will lower statutory tax rates significantly, broaden the personal tax base by reducing tax preferences, improve the fairness of the tax system and relieve about 850,000 lower-income Canadians from federal personal income tax through the conversion of exemptions to credits. On balance, these proposals will result in a reduction in federal personal income tax liabilities for the vast majority of Canadians. Most of the personal income tax proposals will be fully implemented in the 1988 taxation year but the adjustment of the withholding tables on July 1, 1988 means that there will be large refund payments in fiscal year 1989-90. By 1991-92, the tax reform proposals will reduce personal income tax revenues by approximately $2 1/2 billion per annum.

Similarly, the changes to the corporate income tax system will reduce statutory corporate tax rates and broaden the corporate tax base by about 20 per cent. The variation in average effective corporate tax rates across industries will be reduced significantly. In total, the corporate tax changes will increase the corporate tax share of total federal revenues. Corporate tax revenues are about $500 to $600 million higher in fiscal years 1988-89 and 1989-90 as a result. As the measures become fully phased in, the increase in corporate tax revenue will grow to about $1.5 billion by 1991-92.

The total direct revenue impacts of the personal and corporate tax measures would, in the absence of other measures, result in an increase in the deficit of $1.2 billion in 1988-89 and $3.2 billion in 1989-90, as the tax measures are almost fully phased in over a two-year transition period. Beyond this transition period, the revenue effects of these tax changes will contribute to an increase in the deficit of about $1 billion per annum. As well, these measures will directly increase the deficit by an additional $350 to $400 million per year through higher expenditures under the equalization program and because of higher Established Programs Financing cash payments to the provinces due to changes in the value of tax points.

to adverse economic developments, such as large swings in commodity prices in the late 1970s and mid-1980s, and the substantial impacts of the 1981-1982 recession on income, tax bases and revenues.

In addition, however, decisions taken by governments have altered the tax structure in a way that, on balance, has led to a narrowing of tax bases and upward pressure on tax rates. The proliferation of selective tax preferences has ongoing implications for the predictability and stability of federal tax revenues:

- First, tax preferences directly reduce tax bases. To maintain revenue collections, tax rates must be raised. Moreover, since the government is not always able to anticipate accurately the use of these preferences, they directly impair the overall predictability of federal revenues and create uncertainty in fiscal planning.

- Second, the increasing use of tax preferences has substantially altered the relationship between taxes paid and income earned, both across and within sectors. Thus, even with a given aggregate level of income in the economy, changes in the composition of that income can have dramatic impacts on federal revenue collections. This is an important source of difficulty in predicting revenues. These types of compositional shifts were prevalent in the first half of the 1980s. For example, increasing proportions of transfer and investment income in total personal income – both of which are effectively taxed at lower rates than salary income – acted to reduce personal income tax collections over the period 1981 to 1984.

- Third, the interaction between high tax rates and narrow tax bases has encouraged increasingly aggressive tax avoidance activities which have further eroded tax bases. This is evident in the increased trading in corporate losses between taxable and non-taxable firms that has taken place in recent years.

If left unchecked, base erosion would have continued through the 1980s, putting upward pressure on tax rates to ensure ongoing progress in meeting fiscal objectives. While the government has attempted to address this problem through various tax initiatives in recent years, the prospect of further pressures arising from both domestic and international factors has become more serious.

For example, the sales tax base is highly vulnerable to erosion. The narrow base of the federal sales tax itself provides incentives for producers to seek tax-exempt status for their own goods. The breadth and variety of current exemptions from sales tax has prompted several court challenges seeking exempt status for goods that are now taxable. As well, the increasing tendency for businesses to restructure their operations through marketing companies in order to reduce sales tax liabilities, particularly in the light of recent jurisprudence, also puts the existing sales tax base at considerable risk.

In addition, reductions in statutory corporate tax rates in the United States and other countries mean that there is increased potential for real income-generating activities to shift abroad, as well as for changes in financial transactions that

4. The Fiscal Implications of Stage One of Comprehensive Tax Reform

Introduction

Events in the 1970s and 1980s have shown just how sensitive federal revenues can be to both economic developments and policy changes. Some of this sensitivity reflects the influence of economic factors on government revenues, such as swings in commodity prices and the 1981-1982 recession. In addition, however, discretionary changes to the tax system during the 1970s and early 1980s, and important tax developments abroad, have significantly increased the variability of the federal government's revenues. This variability has impaired the government's ability to undertake both its short- and medium-term fiscal planning. Indeed at times it has forced the government to make unintended mid-year corrections that can be disruptive to fiscal planning.

The experience of the 1980s has highlighted disturbing trends in the tax structure that have reduced the predictability and stability of federal revenues. In particular, developments have tended to weaken the relationship between what is earned as income and what is counted as income for tax purposes, as well as between what is counted as income for tax purposes and what is actually paid in tax. This problem has resulted from the proliferation of selective tax preferences, and their increased use by taxpayers to minimize their tax payable. While economic factors will always influence revenue collections, comprehensive tax reform will help reduce the variability and improve the predictability of federal tax revenues, enhancing the overall environment for fiscal planning.

The lower personal and corporate statutory tax rates, elimination of selective income tax preferences and broader income tax bases proposed in the first stage of comprehensive tax reform have three main fiscal implications. They will:

- reduce the variability of the federal government's revenues;
- affect the medium-term projections for the federal deficit; and,
- require related actions to ensure that the first stage of tax reform is consistent with the government's principles for responsible fiscal management.

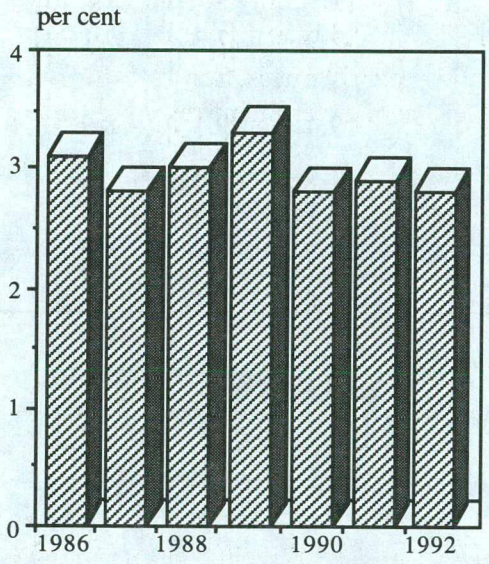
Improving Fiscal Stability with Stage One of Tax Reform

Over the past decade the flow of revenues from the tax system has become less stable and more difficult to predict. In part, these problems have been attributable

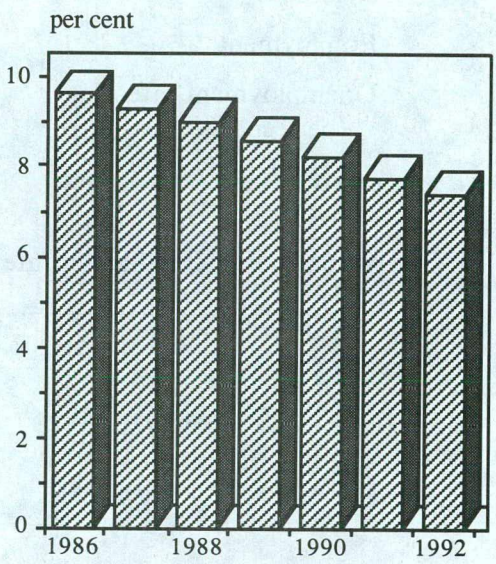
Chart 3.3

Canada's Medium-Term Economic Prospects: Key Indicators

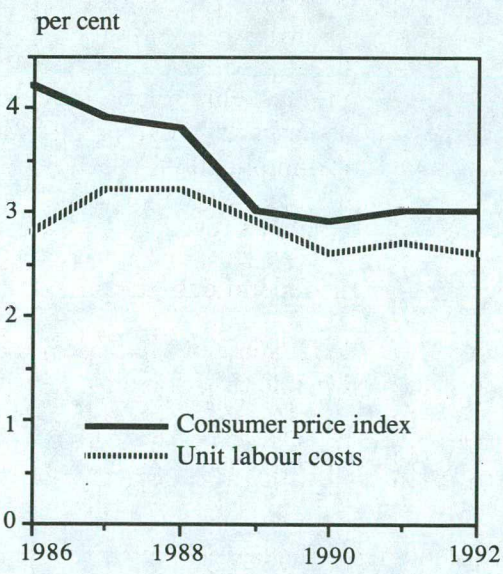
Growth Rate of Real GDP



Unemployment Rate



Inflation



Growth Rate of Real Private Business Non-Residential Investment

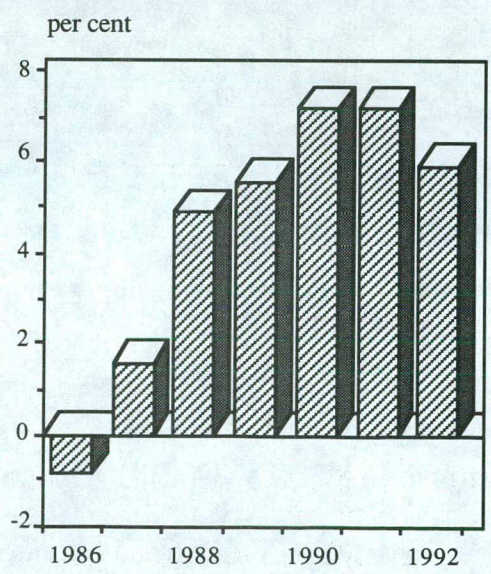


Table 3.3

Medium-Term Economic Outlook: Main Economic Indicators

	1986	1987	1988	Average 1989-1992
	(per cent change unless otherwise specified)			
Real GDP	3.1	2.8	3.0	3.0
Employment	2.9	2.3	2.1	2.2
Unemployment rate (per cent level, fourth quarter)	9.4	9.1	8.9	8.0
Inflation (CPI)	4.1	3.9	3.8	3.0
90-day commercial paper rate	9.2	7.8	7.6	7.2

actions, a balanced assessment of medium-term international economic prospects suggests that a moderately optimistic projection is the most likely.

Canada's Medium-Term Economic Prospects

The fundamentals of the Canadian economy are healthy. Although the Canadian economy is now in its fifth year of expansion, the typical domestic signs of a tiring recovery – rising inflation and costs, excessive inventories, and weakness in housing markets – are not present. With strong consumer confidence, firming investment spending and a stable policy environment, Canada's prospects are good for continuing, and relatively strong, output and employment growth. This should permit ongoing, gradual declines in the unemployment rate throughout the medium term.

Stage one of comprehensive tax reform will enhance the medium- to longer-term economic potential of the Canadian economy. The changes to the personal and corporate income tax systems will increase incentives to work and invest, and will improve the quality of the capital stock, thereby enhancing productivity. These beneficial impacts will, however, be realized only gradually.

The second stage of tax reform, which includes replacing the existing sales tax system while enhancing the refundable sales tax credit, eliminating the income surtaxes and further reducing personal income taxes, will complement and extend the stage one incentives to increased labour supply and saving. But the major economic impact of the second stage of comprehensive tax reform will be its strongly beneficial effects on the competitiveness of Canadian industry and the incentives for Canadian industry to invest. Comprehensive tax reform will lead to a more efficient allocation of resources in the Canadian economy, a more competitive economy in the global marketplace, and increased potential for growth and job creation in the 1990s.

The highlights of the Canadian medium-term projections are set out in Table 3.3 and Chart 3.3. Real GDP growth should average 3 per cent over the period 1989 to 1992, allowing the unemployment rate to fall below 8 per cent by the 1990s. The Canadian economy should continue to show a favourable performance on unit labour costs, and this should help to stabilize the underlying inflation rate around 3 per cent. A favourable global competitive position for Canadian corporations and some recovery in commodity prices should allow ongoing improvements in the current account and generate sufficient profit growth to finance substantial capital spending. In an environment of moderate international interest rates and good Canadian inflation performance, there would be scope for further declines in Canadian interest rates over the medium term.

will be affected by how the major current trade and fiscal imbalances evolve. While there are risks associated with the current international situation, there are also opportunities for the major industrial countries to implement policies in a co-ordinated fashion to better ensure a sustained expansion.

It is important to recognize that medium-term projections are not forecasts; rather, they represent views of possible economic outcomes that are consistent with the economic and policy assumptions embedded in them. Different, but perhaps equally plausible, assumptions can lead to quite different economic projections. Clearly, medium-term projections at present will be influenced by assumptions about government policy decisions in the United States, Germany, Japan and elsewhere.

The basic assumption about the international environment embedded in the medium-term projection is that the major international imbalances improve gradually, without significant disruptions to the international economic system. The depreciation of the U.S. dollar that has already taken place, combined with the improving growth in domestic demand in the main overseas OECD economies, is projected to lead to steady improvements in the U.S. trade position. While Gramm-Rudman-Hollings deficit targets will not likely be achieved, a substantial reduction in the U.S. deficit is expected in fiscal years 1987 and 1988, and the U.S. administration has committed itself to sizeable further declines in the deficit over the medium term. Furthermore, the G-7 countries have agreed to implement policies in a co-ordinated fashion that should further reduce current international imbalances.

The resulting improvement in trade and fiscal imbalances, and the positive perception of government policies, should contribute to an environment in which real interest rates will moderate. In this medium-term international projection, lower real interest rates will make the debt burdens of less developed countries easier to manage. Steady, moderate growth in the global economy should also set the stage for some firming of commodity prices.

If progress in reducing present international imbalances is not continued, the consequences for the international economy would be severe. For example, failure of the U.S. government to achieve substantial deficit reduction, weak domestic demand growth in overseas countries and lack of progress in re-balancing trade flows among the largest industrialized countries could well set the stage for an environment in which the U.S. dollar falls sharply, U.S. protectionism increases, international interest rates rise, and the risks of financial disruption arising from the international debt burdens of the developing countries increase.

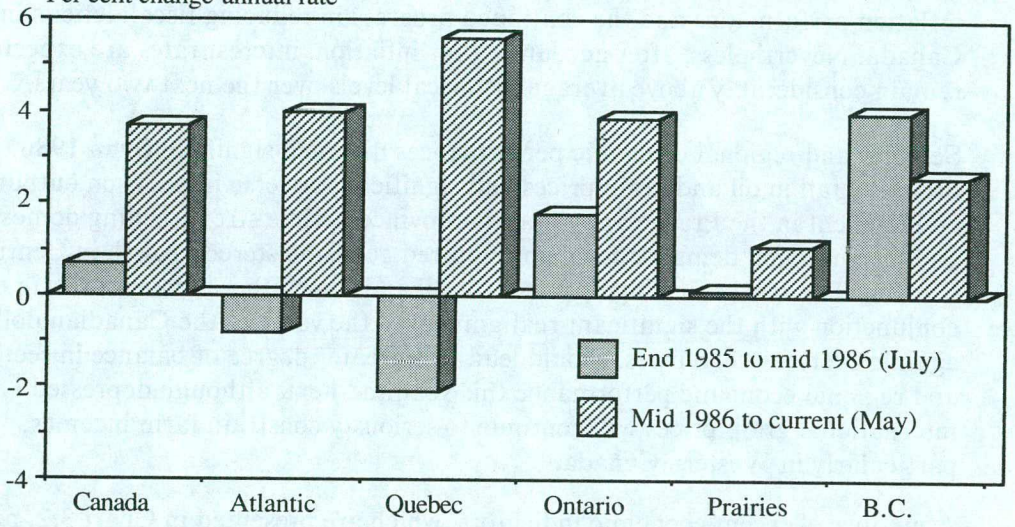
Such developments would threaten the prospects for sustained world economic growth. Recent signs of improvement in the U.S. trade and fiscal imbalances, however, coupled with strengthening domestic demand and declining real net trade surpluses in Japan and Germany, suggest that the required adjustments are under way. Success in pursuing co-ordinated policy measures is being influenced by the realization that failure to act could seriously threaten international economic prospects. In the light of recent economic developments and policy

Chart 3.2

Indicators of Recent Regional Economic Performance

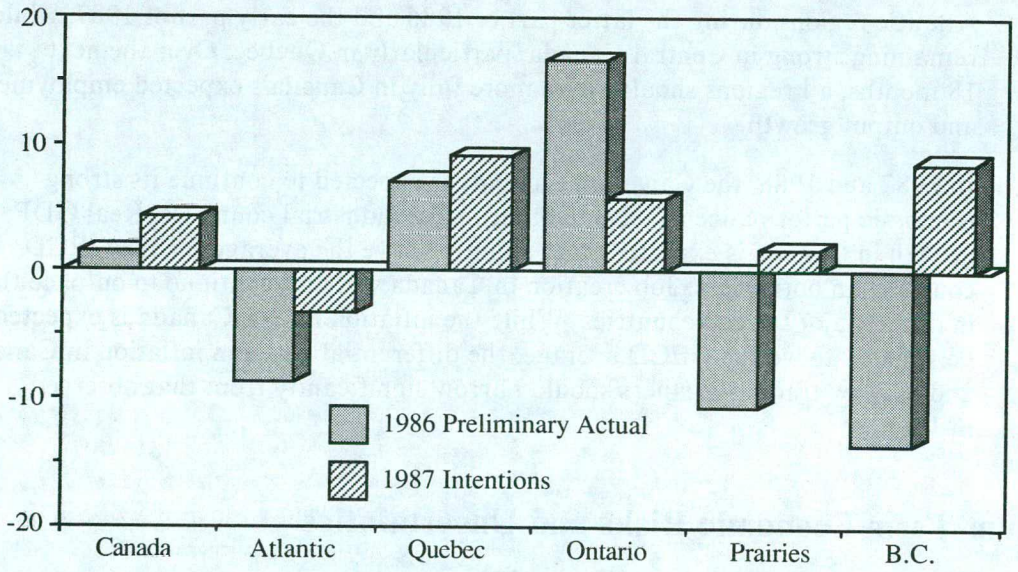
Regional Employment Growth Since December 1985

Per cent change-annual rate



Regional Growth in Business Capital Expenditure* (In Current Dollars)

Per cent



* Private and Public Investment Intentions Survey, Statistics Canada, March 1987.

favour of the United States in 1986, the Canadian rate of inflation is forecast to move below the U.S. inflation rate by 1988.

Interest rates are assumed to decline slightly from the levels prevailing in May 1987. The 90-day commercial paper rate is expected to average 7.8 per cent this year, the same level as forecast in the February 1987 budget, and then decline to 7.6 per cent in 1988. The yield on industrial bonds is expected to decline more significantly by 1988, in part due to anticipated developments in U.S. financial markets, but also reflecting the forecast improvement in relative Canadian inflation performance and the continued progress in reducing fiscal deficits in Canada. Nevertheless, after accounting for inflation, interest rates are expected to remain considerably above average historical levels over the next two years.

Sectoral and regional economic performances diverged significantly in 1986. The dramatic fall in oil and grain prices had significant adverse impacts on output and employment in the Prairie and Atlantic provinces, while strengthening domestic and international demands for manufactured goods bolstered growth in Central Canada. The recent firming of prices for oil and some other commodities, in conjunction with the significant realignment in the value of the Canadian dollar against overseas currencies, should lead to a greater degree of balance in sectoral and regional economic performance this year and next, although depressed international grain prices will continue to seriously constrain farm incomes, particularly in Western Canada.

A number of recent economic indicators, which are presented in Chart 3.2, point to a broadening of economic activity across regions and sectors. The P&PI Investment Intentions survey by Statistics Canada indicates greater balance in business spending plans across sectors and regions in 1987 than was observed in 1986. As well, employment growth improved substantially in the Western and Atlantic regions during the latter part of 1986 and the early part of 1987, while remaining strong in Central Canada, particularly in Quebec. Over the next 18 months, all regions should share more fully in Canada's expected employment and output growth.

In 1987 and 1988, the Canadian economy is expected to continue its strong economic performance relative to other major industrial countries. Real GDP growth in Canada is expected to be slightly above the average for the OECD countries in both years. Job creation in Canada will also continue to outpace that in other major OECD countries. While the inflation rate in Canada is expected to be slightly above the OECD average, the differential between inflation in Canada and our key trading partners should narrow significantly from that observed in 1986.

Medium-Term Economic Risks and Uncertainties

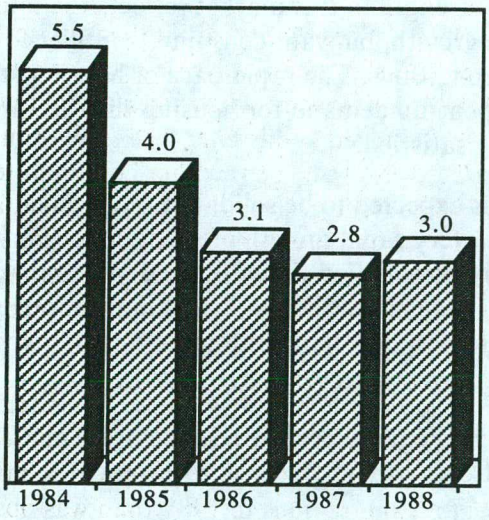
Canada's economic prospects into the early 1990s will be importantly influenced by both economic policies at home and by progress and stability in the international economic environment. The prospects for such progress and stability

Chart 3.1

Economic Performance and Prospects in Canada: 1984-1988

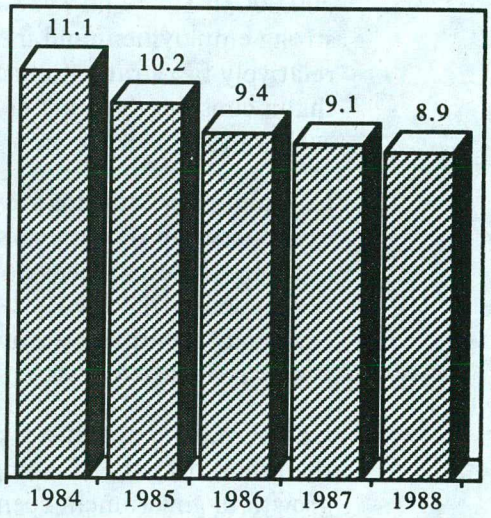
Growth Rate of Real GDP

per cent



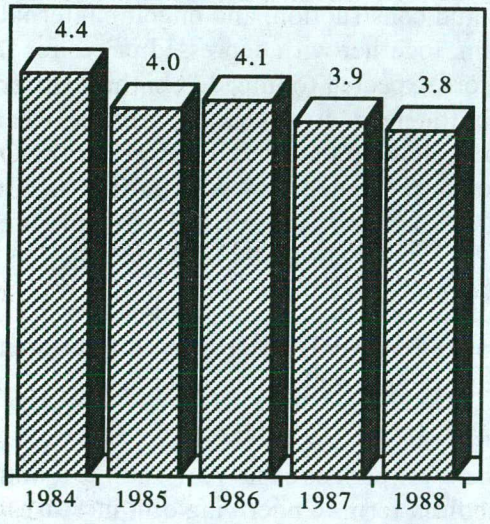
Unemployment Rate - Fourth Quarter

per cent



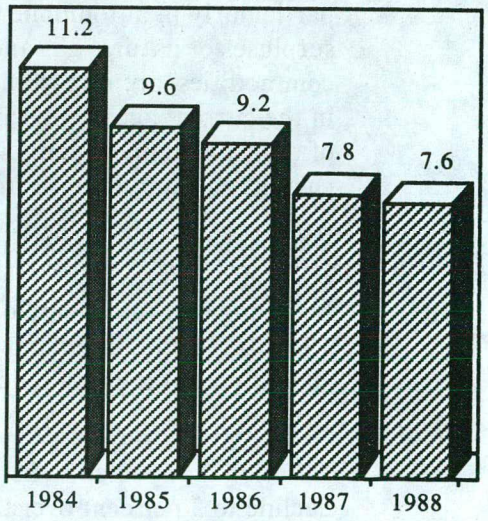
Inflation Rate (CPI)

per cent



90-Day Commercial Paper

per cent



Note: Figures for 1987 and 1988 are forecasts.

Output growth in the Canadian economy over the short term is expected to be led by non-energy investment and a rebound in inventories from the low levels of late 1986. The latest Private and Public Investment Intentions (P&PI) survey by Statistics Canada suggests that non-energy investment will rise 6.2 per cent this year, or about 3 per cent in real terms. The prospects for energy investment are expected to offset some of this strength. A rebound in inventory accumulation to more normal levels over this year and next will also be a significant contributor to real output growth.

Housing activity has been very strong recently, with monthly housing starts averaging 222,000 (at annual rates) since mid-1986. Activity in this market is anticipated to continue to be robust, with housing starts expected to average 200,000 in 1987 and 1988. The strength in this market reflects the impact of strong employment and income growth, buoyant consumer confidence and relatively favourable financial conditions. The rapid pace of housing starts means that a considerable part of the pent-up demand for housing that accumulated earlier in the 1980s is now being satisfied.

Consumer expenditure growth is expected to be solid, but more moderate than experienced in recent years. The very rapid growth of spending on consumer durables since 1983 has now largely satisfied the built-up demand that existed for these goods after the 1981-1982 recession. The pattern of domestic spending is expected to shift away from durables, especially automobiles, and move to other goods and services.

Government expenditures on final demand are expected to grow much more slowly than total output, reflecting actions by both levels of government to restrain growth in government spending.

Some improvement in the volume of net trade is forecast but the nominal current account deficit this year and next is expected to be similar to that recorded in 1986. Weakness in final domestic demand growth in the United States, particularly in automobile sales and construction, and ongoing international surpluses of natural gas and grain, together with depressed prices for these commodities, are important factors expected to impede a significant improvement in the current account position in the near term. The international competitiveness of the Canadian economy will be crucial in determining the pace at which the current account deficit is reduced over the next few years.

The pace of output growth this year and next is expected to generate an environment in which both job creation and labour force growth will continue to be strong and the unemployment rate will continue to decline. From the end of 1986 to the end of 1988, over 550,000 new jobs are expected to be created. This should permit a gradual decline of the unemployment rate to below 9 per cent by next year.

Inflation is expected to be just below 4 per cent this year and next, and then decline to 3 per cent over the medium term. Underlying cost increases should continue to be moderate, but some upward pressure on prices will come from indirect tax increases and housing. In contrast to the large inflation differential in

to be double the 1.6-per-cent increase in real GDP registered from the fourth quarter of 1985 to the fourth quarter of 1986.

Table 3.2

Canadian Economic Performance and Outlook: Main Economic Indicators, 1986 to 1988

	1986 (actual)	1987 (forecast)	1988 (forecast)
	(percentage change unless otherwise indicated)		
Expenditures (volumes)			
Gross domestic product (GDP)	3.1	2.8	3.0
Consumer expenditure	4.0	2.7	3.1
Residential investment	13.2	6.6	−3.9
Business non-residential investment	−0.8	1.6	4.9
Machinery and equipment	5.4	4.4	5.3
Non-residential construction	−7.7	−1.9	4.5
Government expenditure	0.5	1.8	1.0
Final domestic demand	3.1	2.6	2.4
Inventory change (billions of 1981 dollars)	3.8	1.5	2.9
Exports	3.1	2.9	2.5
Imports	5.1	0.7	1.7
Net exports (billions of 1981 dollars)	16.4	19.4	20.8
Current account balance (billions of current dollars)	−8.8	−7.6	−8.3
Housing starts (thousands of units)	200	209	192
Prices and costs			
CPI	4.1	3.9	3.8
GDP deflator	2.8	3.5	3.7
Average wage settlements	3.4	3.5	3.7
Labour market			
Labour force	1.8	1.9	1.8
Employment	2.9	2.3	2.1
Unemployment rate (per cent level, fourth quarter)	9.4	9.1	8.9
Incomes			
Personal income	6.9	6.2	6.0
Corporate profits	−4.9	10.2	16.6
Personal savings rate (per cent level)	11.3	10.5	9.5
Financial market assumptions			
90-day commercial paper rate (per cent level)			
Nominal	9.2	7.8	7.6
Real[1]	5.1	3.9	3.8
McLeod Young Weir average of long-term corporate bond rates (per cent level)			
Nominal	10.8	10.6	9.4

[1] Real interest rates are defined as the nominal rates minus the percentage change in the consumer price index.

Canada continues to have an impressive record of job creation. The 2.9-per-cent expansion of employment in 1986 was the strongest rate of increase since 1980 and by far the fastest rate of employment growth among the major industrial countries. And there have been further strong gains to date in 1987. Indeed, from July 1986 to May 1987 employment expanded at a 3.7-per-cent annual pace. Canada also has one of the fastest growing labour forces among the major OECD countries. The labour force grew by 1.8 per cent in 1986. While this strong labour force growth has dampened somewhat the influence of job creation in reducing the unemployment rate, significant progress is nevertheless being made. The unemployment rate in May was 9.1 per cent, down from 10.0 per cent at the end of 1985 and a peak of 12.8 per cent during the 1981-1982 recession.

Inflation, as measured by the consumer price index, was close to 4 per cent in 1986 for the third consecutive year. The impact of substantial price declines for refined petroleum products was offset by increases in food prices, indirect taxes, and housing costs. Import prices were also significantly higher, reflecting the decline of more than 10 per cent in the trade-weighted value of the Canadian dollar against the currencies of our major trading partners from early 1985 to the end of 1986. Wage costs remained moderate, with wage settlements averaging 3.4 per cent in 1986, and the Canadian economy has experienced good productivity growth during the recovery.

Paralleling developments in the international economy, Canadian financial markets have recently shown considerable volatility. From recent peak levels reached just prior to the February 1986 budget, short-term Canadian interest rates had fallen roughly 4 percentage points by the end of 1986. The substantial strengthening of the Canadian dollar early in 1987 presented the opportunity for a further decline in Canadian rates of over 1 percentage point by March. However, since March, increases in U.S. interest rates have led to some upward pressure on short-term Canadian interest rates, with rates moving back to levels prevailing at the end of 1986.

Canada's Short-Term Economic Prospects

The updated economic outlook for 1987 is very similar to that presented in the February 1987 budget. Economic activity in Canada is expected to expand at a moderate pace over the year, with some declines in both inflation and the unemployment rate, and relatively stable conditions in financial markets. Recent output and employment data strongly confirm this view, and suggest that growth will be considerably stronger than was expected by many private sector forecasters in early 1987.

The short-term economic outlook for the Canadian economy is summarized in Table 3.2 and Chart 3.1. Real gross domestic product (GDP) is expected to grow by 2.8 per cent this year and by 3.0 per cent in 1988. While these average annual rates of growth are slightly less than that recorded in 1986, the pace of expansion through this year and next will be significantly stronger than last year. The average annual pace of growth from the end of 1986 to the end of 1988 is expected

For commodities, the expected international environment is one in which prices in aggregate are expected to rise slightly from their present, generally depressed, levels. Depressed international grain prices are expected to continue, reflecting the excessive subsidization of agriculture in a number of countries. There is substantial volatility in international oil prices at present. For forecasting purposes, the oil price is assumed to average about $18 (U.S.) per barrel in 1987 and 1988.

Recent Canadian Economic Developments

With a real output growth rate of 3.1 per cent in 1986, Canada was the fastest growing economy of the major OECD countries. Yet the pace of growth through the year was uneven, and certain sectors and regions were hard hit by adverse international developments.

The pattern of output growth during 1986 was heavily influenced by swings in inventory investment. A rapid buildup of inventories during the first half of the year was followed by a much smaller increase on average in the second half and a decumulation of inventory stocks in the final quarter of the year. While a strengthening profile of final domestic demand and the volume of net exports through the year acted to partly buffer the influence of the inventory swings on real output, the pace of total output growth slowed significantly in the second half of the year. However, with the adjustment to the unsustainably high inventory accumulation likely completed before the end of the year, the economy is poised for a return to higher growth. Monthly GDP data for the first quarter of 1987 indicate a sharp increase in economic growth.

The pattern of economic growth across sectors and regions also varied substantially in 1986, reflecting largely adverse international developments for two key commodities, oil and grain. Oil prices had fallen by more than 50 per cent from late 1985 to mid-1986, and export prices for natural gas had also declined substantially. In response, there was an early and substantial cutback in employment and investment by the petroleum sector. Similarly, world grain prices fell sharply, with price levels in 1986 at their lowest levels in 10 years, having declined more than 20 per cent from 1985 levels alone. This created substantial economic difficulties and uncertainty in the main grain-producing regions of the country. Besides impacting significantly on regional economic performance in 1986 and early 1987, these developments accounted for a sizeable proportion of the increase in Canada's current account deficit.

From a deficit of $0.6 billion in 1985, Canada's current account balance deteriorated significantly in 1986 to an $8.8 billion deficit. As noted above, sharp declines in international prices for oil, natural gas and grains, and continuing weakness in other primary product prices were important factors in this deterioration. Large currency realignments against overseas currencies also played a sizeable role by raising the price, and hence nominal value, of imports from overseas countries.

Table 3.1

International Economic Prospects in the Short Term

	1986	1987	1988
	(annual percentage changes unless otherwise specified)		
United States			
Real GNP	2.5	2.5	3.0
Final domestic demand	3.6	1.3	1.5
Volume of net exports (billions of 1982 dollars)	−147.8	−122.3	−68.5
CPI	1.9	3.5	4.2
Employment	2.3	2.0	1.6
Current account balance ($ billions)	−140.6	−148.8	−131.0
90-day commercial paper rate[1] (per cent level)	6.7	6.4	6.4
AAA corporate bond rate (per cent level)	9.0	8.8	8.6
Major Overseas OECD countries			
Real GNP/GDP			
Europe[2]	2.4	2.3	2.2
Japan	2.5	2.7	3.3
Inflation (CPI)			
Europe[2]	2.3	2.9	3.1
Japan	0.6	0.3	1.5
Oil price assumption			
West Texas Intermediate at Chicago (U.S. dollars per barrel)	15.50	17.70	17.70

[1] Annual average yield basis

[2] Weighted average of Germany, France, the United Kingdom and Italy

over lack of progress in reducing the U.S. trade and fiscal deficits. However, in volume terms the trade balance is improving and improvements in the nominal current account deficit should be forthcoming. As well, the fiscal deficit is also declining from its peak in fiscal year 1986 and continued progress is expected. The increase in the rate of inflation largely reflects the unwinding of the temporary effects of lower energy prices in 1986 and the once-and-for-all increase in import prices due to the large depreciation of the U.S. dollar. Underlying cost increases remain moderate. Furthermore, domestic demand growth in the United States is weak, so growing credit market pressures are not evident.

These factors suggest that the U.S. interest rate increases in recent months may be unwound. In the forecast it is assumed that U.S. short-term interest rates decline slightly from their May 1987 average levels by year-end, and then remain fairly flat through 1988.

was very low by recent standards because of the appreciations of their currencies relative to the U.S. dollar and the decline in the international price of oil.

The outlook for the international economy in 1987 and 1988 is set out in Table 3.1. Economic performance in the major European and Japanese economies is expected to be similar to 1986, although inflation will be somewhat higher. The trade surpluses in Japan and Germany are expected to show some decline later this year and through 1988. Further declines in real trade balances will reduce output growth. Without additional policy initiatives, growth in final domestic demand, particularly in Germany and Japan, will be moderate at best. As a result, there is some risk that the pace of final domestic demand growth in overseas countries will not be strong enough to offset the impact on their real output and employment growth prospects from the expected deterioration in their trade balances. A particular area of concern is that, with uncertainty in exchange markets, expectations by businesses of further currency appreciation against the U.S. dollar will constrain investment spending in Germany and Japan.

The growth of real output in the United States is expected to be 2.5 per cent in 1987, the same pace as recorded a year earlier. In 1988 growth of real GNP of 3 per cent is expected. Behind this pattern of modest improvement in real output growth is an expectation of a pronounced shift in the composition of output from domestic demand to trade. With the growth rate of real final domestic demand projected to be well under 2 per cent in both 1987 and 1988, a continuing improvement in the constant-dollar trade account is expected to be the primary source of economic growth. This trade improvement will emanate largely from the depreciation of the U.S. dollar on a trade-weighted basis since early 1985. The nominal value of the current account balance, however, is not expected to show significant improvement until 1988, reflecting the lags in the adjustment of trade volumes to the depreciation of the U.S. dollar.

The rate of inflation as measured by the consumer price index (CPI) fell dramatically in the United States in 1986, averaging 1.9 per cent for the year and reaching 1.1 per cent by year-end. Much of this decline was accounted for by the fall in energy prices. Excluding energy, the rate of inflation in 1986 was just below 4 per cent. In 1987 and 1988 inflation should average 4 per cent, although quarterly movements in U.S. inflation may be temporarily above 4 per cent as energy prices rise and import prices begin to reflect more fully the depreciation of the U.S. dollar. To date, import prices in the United States have shown only a partial response to the depreciation of the dollar.

Financial markets in the United States in recent months have reflected the general international uncertainty about trade and fiscal imbalances. Renewed downward pressure on the external value of the U.S. dollar has emerged since the beginning of 1987, particularly relative to the Japanese yen. In response to this pressure, and to the rising U.S. rate of inflation, interest rates moved up in the United States in March and April of this year.

Much of this financial market response may be an over-reaction to recent U.S. inflation performance and uncertainty over the prospects for the U.S. trade and fiscal imbalances. The dollar's weakness is in part related to the disappointment

3. The Economic Outlook, 1987 to 1992

Introduction

In the February 1987 budget, economic and fiscal forecasts were presented only for fiscal years 1986-87 and 1987-88. At the time, it was recognized that comprehensive tax reform would have important impacts on Canada's medium-term economic and fiscal prospects. This chapter presents economic projections to 1992 which reflect the proposals set out in the first stage of comprehensive tax reform.

International Economic Prospects in the Short Term

The prospects for the international and Canadian economies depend very much on how current world trade and fiscal imbalances evolve. The present massive trade deficit in the United States and large surpluses in Germany and Japan, combined with large government deficits in some countries such as the United States, are troubling. These imbalances, together with the increasing pressures on heavily indebted developing countries, present a serious challenge to sustaining healthy world economic growth.

Steps have been taken to address international imbalances in a co-ordinated fashion. The fiscal deficit in the United States is being reduced, although uncertainty about the pace of future declines remains. Some stimulus has been injected into overseas economies, particularly in Japan where more is promised.

In the absence of sufficient policy actions, large exchange rate realignments have been necessary and have occurred. However, relying solely on exchange rate shifts is neither satisfactory nor desirable to achieve the needed medium-term adjustments. Further policy changes are required to reduce credit demands by the U.S. government and to encourage stronger domestic demand growth in other nations.

Real output growth in Japan and the major European members of the Organization for Economic Co-operation and Development (OECD) averaged about 2.5 per cent in 1986. However, after three years of trade-led growth, the prime source of growth in 1986 shifted significantly from net exports to domestic spending in these countries. This pick-up in final domestic demand, particularly in Germany and Japan, was weaker than expected, however, and in combination with the decline in constant dollar trade surpluses, resulted in worse-than-expected overall real growth performance. Inflation in the major overseas OECD countries

Household savings will increase as a result of the higher after-tax returns to savings. As well, an improved current account balance will provide a further source of national savings.

Estimates of the overall loss in real output resulting from the distortions caused by the present federal sales tax, obtained from general equilibrium model analyses, range as high as 1.5 per cent of real GDP, or about $8 billion in today's dollars. These costs arise primarily from the taxation of business inputs and the federal sales tax bias against Canadian goods in export and domestic markets. A reformed national sales tax system, free of these biases and neutral in its impact on goods and services, could yield even more substantial long-term real output gains.

The structural gains from sales tax reform will be substantial. Following the implementation of a broad-based multi-stage sales tax, there would likely be a sizeable demand stimulus from the improvement in the net trade balance and the increase in investment spending to reflect higher desired capital stocks. This will increase real GDP growth and expand employment opportunities.

For obvious reasons, the shift from a narrowly-based federal sales tax to a broad-based multi-stage sales tax will have some impact on the prices of previously untaxed goods and services. This impact would be more substantial if existing provincial retail sales taxes were replaced by a national system at the same time. This one-time increase in the prices of goods and services which are not now subject to tax will be offset, to a certain degree, by price reductions resulting from the lowering of the tax rates on currently taxable commodities. As well, for many Canadians, the increased costs would be offset or more than offset by the refundable sales tax credit, the removal of the surtax on personal income, and further personal income tax cuts. After a brief period, price trends would return to normal. As such, the one-time price adjustment should not find its way into the determination of other costs, and would not increase export prices.

price, which represents only a portion of the final selling price, and subsequent mark-ups at the wholesale and retail levels vary from product to product and result in a wide diversity in effective tax rates. There are many examples in which the effective tax rates for similar products made by different manufacturers also vary widely. Second, the base for the federal sales tax is very narrow. For example, only about one-third of the value of consumer purchases is currently subject to the federal sales tax.

- This variability in the effective tax rates across sectors, and even across manufacturers within an industry, means that economic allocation decisions are being distorted by the influence of the sales tax system. The end result is an overall loss in the economic efficiency with which Canada's resources are allocated.

Sales tax reform that eliminates these distortions will improve the structure and performance of the Canadian economy. In addition to the structural gains from sales tax reform, the move to a broad-based multi-stage sales tax will also have appreciable short- to medium-term impacts on the overall economy. Growth rates of output and employment will increase in response to increased investment spending and a positive swing in Canada's trade balance. These impacts will arise because a broad-based multi-stage sales tax will remove the tax on business inputs, treat domestic and imported goods equally, and distribute the tax load more fairly across a broader range of goods and services.

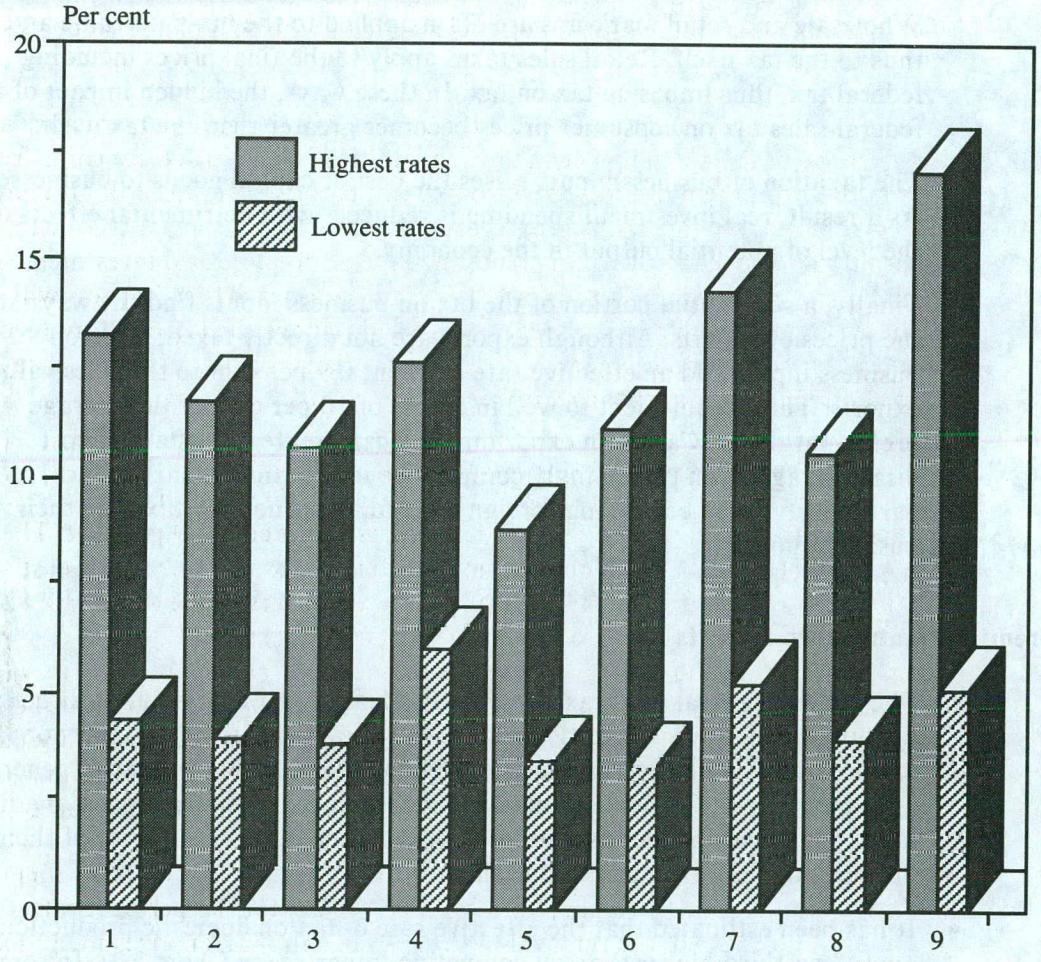
Reform of the sales tax system will enhance the competitive position of the Canadian economy. The elimination of the tax on business inputs would lower exporters' costs relative to their competitors' costs by about 0.9 per cent. The removal of the tax bias in favour of imports would improve the relative cost position of Canadian producers with respect to importers in the order of 2 to 3 per cent. For certain industries producing goods such as household furniture, jewellery, sporting equipment, toys and games and cosmetics, the benefits would be much larger. Depending on how trade prices are set in the various markets, the benefits would initially flow through either a better net trade performance or, more directly, into higher Canadian profits. This would lead to greater production opportunities, capacity expansion, job creation and higher national income.

Slightly more than one-third of the value of final expenditures on investment is now subject to federal sales tax at either the 8-per-cent or 12-per-cent rate. Therefore, the effect of the removal of the federal sales tax on investment goods and its replacement by a broad-based multi-stage sales tax would be roughly equivalent to a 4-per-cent reduction in the cost of capital. Over the longer term, the result could be an increase in the level of the desired capital stock of as much as 4 per cent. The resulting expansion of the capital stock will enhance Canada's output potential.

The proposed reforms will also generate additional savings to help finance this higher investment. Increased reliance on sales taxes and less on income taxation, accompanied by the elimination of the income surtaxes, will further increase the level of savings in the economy. Higher savings will flow from two main sources.

Chart 2.3

Effective Federal Sales Tax Rates on Selected Domestically Produced Commodities



1- Auto parts
2- Household textiles
3- Kitchen utensils
4- Household appliances
5- Electric light bulbs, lamps
6- Office and stationery supplies
7- Sporting equipment
8- Blankets, bedsheets and towels
9- Cosmetics

supplies, building materials and many types of non-production business machinery and equipment. The tax on these inputs becomes a cost for other goods and services that use such inputs in their production, and thus a hidden cost in the price of almost all goods and services in the economy, even though they may not be directly subject to the tax. Because the direct and indirect tax components of the final price are different for different goods and services, depending upon how they are produced and distributed, the tax distorts relative prices and leads to a misallocation of resources.

- Taxation at an early stage of production also results in the impact of the tax on final prices (for goods that are directly taxed) being compounded. Wholesale and retail mark-ups are often applied to the tax-paid value and thus to the tax itself. Retail sales taxes apply to the final prices including federal tax, thus imposing tax on tax. In these ways, the hidden impact of the federal sales tax on consumer prices becomes greater than the tax itself.

- The taxation of business inputs raises the cost of capital goods to businesses. As a result, real investment spending is reduced, with detrimental effects on the level of potential output in the economy.

- Finally, a substantial portion of the tax on business inputs finds its way into the prices of exports. Although exports are not directly taxed, taxes on business inputs add an effective rate of about 0.9 per cent to the sales value of exports. This is equivalent to well in excess of 10 per cent of the average profit margins of Canadian exporters, and can create a substantial cost disadvantage in an increasingly competitive international marketplace, particularly when competing foreign companies do not pay taxes on their business inputs.

Preferential Treatment to Imports

- The current federal sales tax not only disadvantages exports, but it directly favours imports over domestic production. The tax bears more lightly on imports than on domestically produced goods because importers are generally not taxed on distribution and marketing costs incurred in Canada. Canadian manufacturers who incur these costs and recover them in the price of their products do, however, pay tax on them.

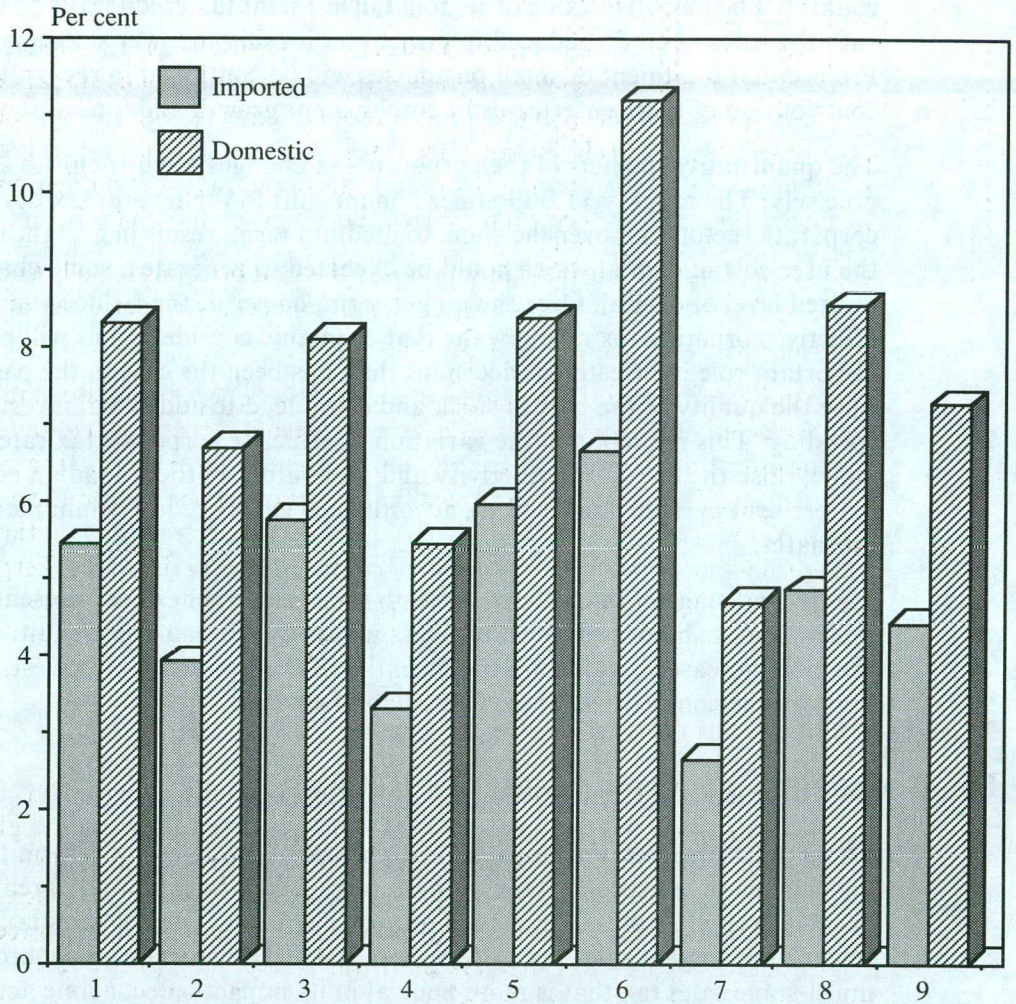
- It has been estimated that the effective rate of tax on domestic production is about one-third higher than on competing imports (see Chart 2.2). In some cases, the effective tax rate can be as much as 70 to 80 per cent higher: this is the case, for example, for household furniture, jewellery, sporting equipment, toys and games, and cosmetics.

Allocation Biases

- Effective federal sales tax rates across goods produced in the Canadian economy vary widely (see Chart 2.3). There are two main reasons for this dispersion. First, the federal sales tax applies to the manufacturer's selling

Chart 2.2

Effective Federal Sales Tax Rates on Selected Domestic and Imported Goods



1- Tires
2- Household furniture
3- Household appliances
4- Glassware and glass products
5- Televisions, radios, stereos
6- Office machines and equipment
7- Jewellery
8- Toys and game sets
9- Cosmetics

interest deduction, thus increasing the relative after-tax cost of borrowing and lowering the tax incentive for debt financing relative to equity.

To reflect Canadian priorities, certain corporate tax preferences will be retained. Research and development is essential to enhance Canada's longer-term competitiveness and to raise the economy's growth potential. Favourable tax treatment for R&D investments will continue to provide Canadians with one of the most favourable tax regimes for this type of investment of any industrial country. The incentive value of regional investment tax credits will be maintained, with the rates of credit reduced in direct relationship to lower statutory tax rates. Preferential treatment of small businesses will be continued in recognition of the contribution of these enterprises to employment growth and innovation.

The quantitative impacts of the corporate tax changes are difficult to assess precisely. The roughly $1 billion per annum shift in the federal tax burden to the corporate sector will, over the short to medium term, result in a slight increase in the user cost of capital which could be expected to generate a somewhat lower desired level of capital. Over the longer term, however, the reduced variation in effective corporate tax rates means that economic considerations will play a more important role in investment decisions than has been the case in the past. This will raise the quality of the capital stock and could lead to additional investment spending. This reduction in the variation of effective corporate tax rates could, alone, raise the level of productivity and real output in the Canadian economy by 0.3 per cent over the longer term, according to general equilibrium model estimates.

The second stage of tax reform, through the replacement of the present sales tax system and its hidden taxes on business inputs by a broad-based multi-stage sales tax, will increase significantly the incentives for corporations to invest, and will improve the competitiveness of Canadian businesses.

The Economic Impacts of Sales Tax Reform

The impacts on overall economic performance of the sales tax reform to be undertaken in the second stage of tax reform will be substantially greater than the economic impacts of the first stage of tax reform. The goal of sales tax reform is to replace the current sales tax system, with its many distortions, by a broad-based multi-stage sales tax that is more neutral in its impact on economic activity. A reformed sales tax system will interfere less with the efficient allocation of resources within the economy, and enhance Canada's international competitiveness.

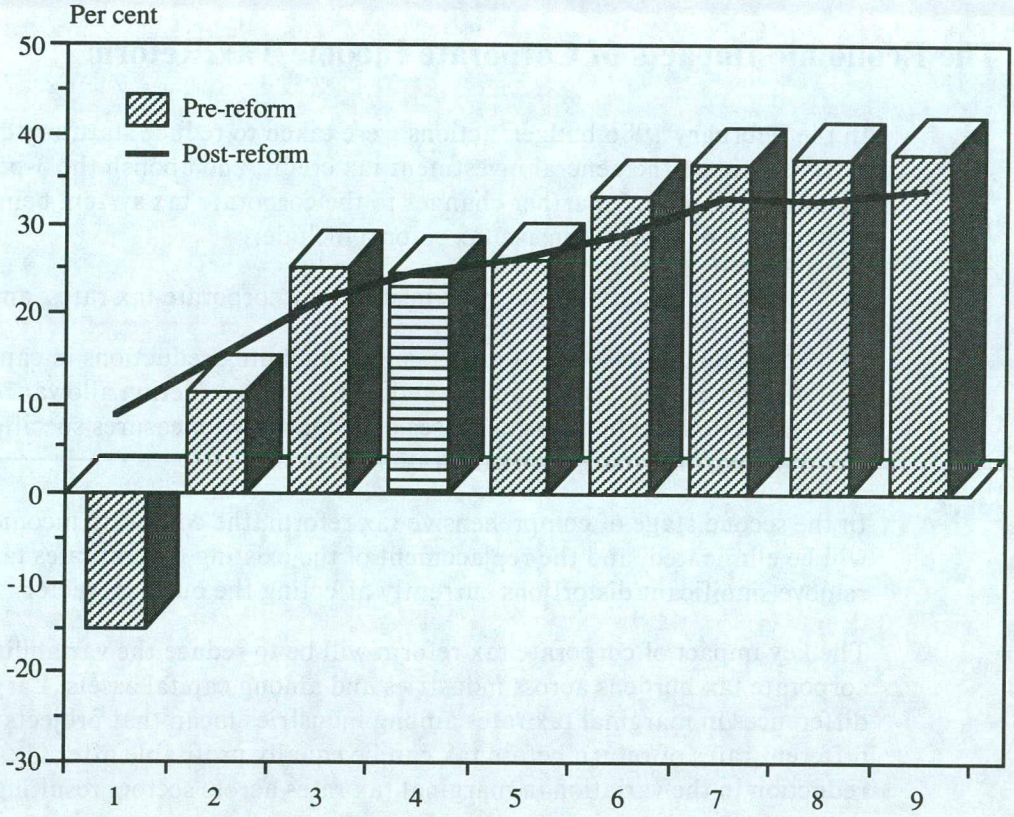
The main economic distortions in the present federal sales tax system are set out below.

Taxation of Business Inputs

- The taxation of business inputs rather than final sales has a number of serious adverse impacts on economic performance. Currently, about half of federal sales tax revenues comes from the taxation of business inputs such as office

Chart 2.1

Federal/Provincial Tax Rates on New Investment for Large Corporations, by Industry Group (1)



1 - Mining
2 - Oil and gas
3 - Agriculture, forestry and fishing
4 - All sectors (2)
5 - Manufacturing
6 - Services
7 - Construction
8 - Retail trade
9 - Wholesale trade

(1) Provincial tax rates are those in effect May 1, 1987. Values are based on the assumption that provinces parallel the base-broadening measures of tax reform but do not change rates.
(2) Total non-financial sector.

saving. Over all, tax reform could increase the personal savings rate by as much as 1 percentage point, or close to $4 billion in today's dollars.

A higher rate of domestic savings over the longer term should provide a larger, and less costly, pool of funds for investment activities. Increases in investment will expand the productive capacity of the Canadian economy, thereby raising productivity and enhancing competitiveness. As domestic savings move into better balance with domestic investment, the current account of the balance of payments should improve. Decreased reliance on foreign savings will act to raise national income.

The Economic Impacts of Corporate Income Tax Reform

In the February 1986 budget, actions were taken to reduce statutory corporate tax rates, eliminate the general investment tax credit, and abolish the 3-per-cent inventory allowance. Further changes to the corporate tax system being introduced in stage one of comprehensive tax reform include:

- further substantial reductions in statutory corporate tax rates; and,
- additional base broadening measures, including reductions in capital cost allowance rates, the elimination of the earned depletion allowance, restrictions on business expenses and significant measures specific to the finance, insurance and real estate industries.

In the second stage of comprehensive tax reform, the corporate income tax surtax will be eliminated, and the replacement of the existing federal sales tax system will remove significant distortions currently affecting the business sector.

The key impact of corporate tax reform will be to reduce the variability of corporate tax burdens across industries and among capital assets. Large differences in marginal tax rates among industries mean that projects earning very different rates of return before tax can be equally profitable after tax. The reduction in the variation in marginal tax rates across sectors resulting from corporate tax reform implies that the corporate tax system will have a less distortionary effect on new investment decisions (Chart 2.1).

Corporate tax reform will also reduce the relative tax disadvantage currently affecting labour-intensive industries and firms. This is achieved as current tax incentives to substitute capital for labour in the production process are reduced. Reducing tax-induced distortions in production technologies should promote economic efficiency.

The corporate tax system affects many business decisions. Another important effect of the current system of high statutory corporate tax rates is that it encourages businesses to finance the acquisition of assets by debt rather than equity. The experience of the 1980-1982 period provides a clear demonstration of how an economy can suffer from excessive corporate leverage. The lower corporate tax rates resulting from tax reform will reduce the tax value of the

of these benefits are necessarily imprecise because they will result from structural changes in the economy, and changed behaviour on the part of individuals which will occur only over a longer period of time. Notwithstanding the difficulty of measuring such impacts precisely, macro-economic and micro-economic analyses of the personal income tax reform proposals indicate that the potential benefits for the medium- to longer-term performance of the Canadian economy are likely to be substantial.

Labour Supply Incentives

One of the main features of personal income tax reform is the reduction in marginal tax rates for the majority of Canadians. This means that Canadians will keep more, and in many cases substantially more, of each additional dollar they earn. Greater after-tax earnings will provide an incentive for more Canadians to enter the labour force and, for those already employed, to work longer and more productively.

Economic models of labour supply behaviour suggest that the tax changes included in stage one of personal tax reform will lead to significantly higher labour supply, both through higher labour force participation rates and additional hours worked per employed person. Conventional model estimates indicate that labour supply could be increased permanently by at least 0.5 per cent. This estimate, however, is on the lower end of the range of possible impacts. Higher empirical estimates of the sensitivity of labour supply to increases in after-tax wages also exist that would suggest an increase in labour supply of 1 per cent or more. The second stage of tax reform will reinforce these incentives.

Longer-term economic potential is directly related to the growth of labour supply in the economy. While the timing of increases in the Canadian labour supply resulting from the incentive effects of tax reform will depend upon employment conditions and will likely be realized only over the longer term, such increases will have an important and positive impact on Canada's economic prospects. Canada's international competitiveness will be enhanced, the trade balance will improve and more jobs will be created. Increased employment will further raise domestic demand, thereby producing a virtuous circle of higher labour supply and greater employment opportunities.

Savings Incentives

Comprehensive tax reform will strengthen personal sector incentives to save. In the first stage of tax reform, the total impact on aggregate personal savings behaviour is likely to be negligible as the positive incentive effect of lower statutory personal income tax rates is largely offset by base broadening. As the personal income surtax is eliminated and personal income taxes are cut further in the second stage of tax reform, however, there will be an increase in the marginal after-tax return to saving that will provide a significant stimulus to personal sector

2. The Economic Benefits of Comprehensive Tax Reform

Introduction

Canada's tax system has become an obstacle to economic growth – tax incentives, not economic incentives, are determining too many economic decisions. It is damaging Canada's productive capacity, and putting future competitiveness and growth at risk. High personal marginal income tax rates, increasing complexity and a growing perception of unfairness are eroding incentives to greater work effort, saving and entrepreneurship so essential to a dynamic economy. These negative economic aspects of the personal and corporate income tax regimes are being exacerbated by reliance on a sales tax system that discriminates against domestic manufacturers and discourages domestic investment and exports.

The purpose of this chapter is to set out the longer-term economic benefits to be realized from comprehensive tax reform. Tax reform is designed to reduce the importance of selective tax preferences, to lower personal and corporate statutory tax rates in a consistent fashion, and to remove distortions generated by the existing sales tax system. Tax reform will proceed in two stages. The first stage focuses on a reform of the current personal and corporate tax systems. The second stage will eliminate the 3-per-cent income surtaxes, provide further personal income tax reductions and enhance the refundable sales tax credit, in conjunction with fundamental reform of the sales tax system.

The Economic Impacts of Personal Income Tax Reform

In the first stage, the central elements of personal income tax reform are:

- a reduction in marginal income tax rates and in the number of tax brackets;
- the elimination or restriction of many special tax preferences; and
- the conversion of most exemptions and deductions to tax credits.

In conjunction with sales tax reform, the personal income surtax will be eliminated and personal income taxes cut further in the second stage of tax reform.

The longer-term economic benefits of personal income tax reform will flow from the increased incentives for Canadians to work and to save. Quantitative estimates

income tax systems under stage one of comprehensive tax reform. To ensure that these changes do not hinder further progress in meeting the fiscal principles, interim changes to the existing federal sales tax are being proposed, along with initiatives to improve the management of the collection of tax liabilities. These measures are also described in Chapter 4.

Chapter 5 updates the 1986-87 and 1987-88 fiscal situations, and provides an overview of the medium-term fiscal outlook in terms of the government's fiscal principles. It is now estimated that the deficit for fiscal year 1986-87 will be $31.0 billion, $1 billion lower than forecast in the February 1987 budget. For fiscal year 1987-88, the deficit is forecast to be $29.3 billion, the same as in the February 1987 budget.

With the current five-year expenditure plan and moderate economic growth, the medium-term outlook is consistent with the government's principles of responsible fiscal management that have guided fiscal policy since November 1984 and were reiterated in the Speech from the Throne in October 1986. The federal deficit should fall to 3.4 per cent of gross domestic product (GDP) by 1991-92, a dramatic contrast to the 8.6-per-cent level that prevailed in 1984-85. The growth of public debt is projected to decline steadily, and the debt-to-GDP ratio is expected to stabilize by 1991-92.

1. Introduction and Overview

Since the fall of 1984, substantial progress has been made in addressing Canada's growing fiscal vulnerability in a substantive, responsible and persistent fashion. Important structural initiatives have also been undertaken to support economic renewal. But Canada's tax system has increasingly become an obstacle to a growing and vibrant economy over the longer term. Actions have been taken in successive budgets, and on other occasions, to address the shortcomings of the present tax system. Nevertheless, it has become evident that an extensive overhaul of the tax system is required if it is to contribute to economic renewal.

Comprehensive tax reform will improve the structure and performance of the Canadian economy. The economic benefits of the proposed reforms to the personal, corporate and sales tax systems are discussed in Chapter 2. Tax reform will encourage savings and investment, enhance productivity growth and improve Canada's international competitiveness. These benefits will not be realized overnight – the impact of these structural improvements on the way our economy functions will be felt in future years as more and more economic decisions are made within the environment of the new tax structure.

The international economic environment and medium-term prospects for the Canadian economy incorporating the impacts of the first stage of tax reform are set out in Chapter 3. The economic environment reflects both risks and opportunities. The outlook for 1987 has changed little from that presented in the February 1987 budget, with continued moderate growth of output and employment expected this year. Inflation is expected to remain moderate and the unemployment rate should continue to decline.

The medium-term outlook for the Canadian economy is for a sustained economic expansion. Beyond 1987, the main risks and uncertainties to the economic and fiscal outlook arise mainly from the large and persistent international imbalances. Co-ordinated action by the Group of Seven (G-7) countries to address these imbalances in a timely and concerted fashion is both a challenge and an opportunity to build a sounder world economy. Tax reform, Canada-U.S. trade negotiations, and the other structural initiatives the government has introduced, and is pursuing, will help to ensure that Canada is able to compete in an uncertain and increasingly competitive international environment.

Tax reform has an important bearing not only on Canada's economic prospects, but also on continued success in meeting the government's fiscal principles. Comprehensive tax reform will reduce the variability of federal revenues and thereby assist in fiscal planning. Chapter 4 sets out the impacts on government revenues and expenditures of the proposed changes to the personal and corporate

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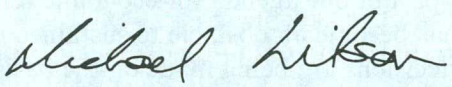
comprehensive tax reform. The fundamentals of the Canadian economy are sound and there are no domestic pressures or imbalances that suggest the current expansion cannot continue. With reasonable growth in the international economy, Canada can achieve sustained economic expansion in the years ahead and make further progress consistent with our four fiscal principles and restoring health to the nation's finances.

At the same time, there are risks and uncertainties that must be recognized, and challenges that must be met. These are addressed clearly in this document. The current international situation of large fiscal and trade imbalances poses substantial risks. These must be effectively addressed by co-ordinated policy actions in the industrial countries if the world expansion is to be sustained. I am encouraged that the Group of Seven countries have agreed on the need for such positive policies, and have committed themselves to take appropriate actions. Growing protectionism in the United States and elsewhere poses a serious threat to an open world trading system and prospects for stronger world growth. I believe that the bilateral Canada-U.S. trade negotiations now under way, and our participation in the Uruguay round of multilateral GATT trade negotiations, can contribute importantly to a lessening of the protectionist risks facing Canada.

Tax reform will also contribute to meeting these challenges. By improving our international competitiveness, and strengthening the structure of our domestic economy, we will better adapt and prosper in a changing and uncertain world environment. Tax reform will allow us to continue to build an even stronger foundation for sustained economic growth and steady improvement in the economic and social well-being of all Canadians.



The Honourable Michael H. Wilson
Minister of Finance

Preface

Since September 1984 the government has been working to achieve the goal of sustained economic growth and the creation of productive jobs for Canadians. Our *Agenda for Economic Renewal* set out the government's philosophy of economic management and the directions that we would take to create opportunities for Canadians and restore vitality to the economy.

We set for ourselves the tasks of restoring responsibility to the management of the government's finances and reducing the size of government in the economy. Equally important, we began the job of creating a changed role for government in the economy, a role that would foster risk-taking and entrepreneurship, a role that would reward success rather than subsidize effort.

In the February 1987 budget, I released a document entitled *The Agenda for Economic Renewal: Principles and Progress* that showed the considerable progress that we have made in only 2 1/2 years. We have reduced the deficit substantially; we have cut in half the rate of growth of government debt; and as promised, we have accomplished this goal primarily through expenditure control and good management. Important structural initiatives in a wide range of areas have been undertaken to support and encourage a vibrant and dynamic economy.

Comprehensive tax reform is a major part of our agenda for economic renewal. The current tax system increasingly has become an obstacle to sustained economic growth. Too many private economic decisions are being made on the basis of tax incentives rather than economic incentives; incentives to work, save and invest are being eroded; our industries are being put at a disadvantage in both domestic and foreign markets. Comprehensive tax reform will address these distortions and inequities in a substantial way, strengthen incentives to save and work, and create a more efficient and a more competitive economy.

Comprehensive tax reform will be implemented in two stages. In the first stage, personal and corporate statutory tax rates will be reduced and the tax bases will be broadened. This will be followed in the second stage by the elimination of the personal and corporate income surtaxes, further personal income tax cuts and an enhancement of the refundable sales tax credit in conjunction with the replacement of the federal sales tax with a broad-based multi-stage sales tax. At this time, with important decisions still to be made about the specific sales tax option to be introduced and the timing of its implementation, it is not possible to integrate the second stage of comprehensive tax reform into our medium-term economic and fiscal projections.

In this document, therefore, I am providing detailed medium-term economic and fiscal projections that take into account the first of the two stages of

Tax Reform 1987

Economic & Fiscal Outlook

June 18, 1987

The Honourable
Michael H. Wilson
Minister of Finance

Canada

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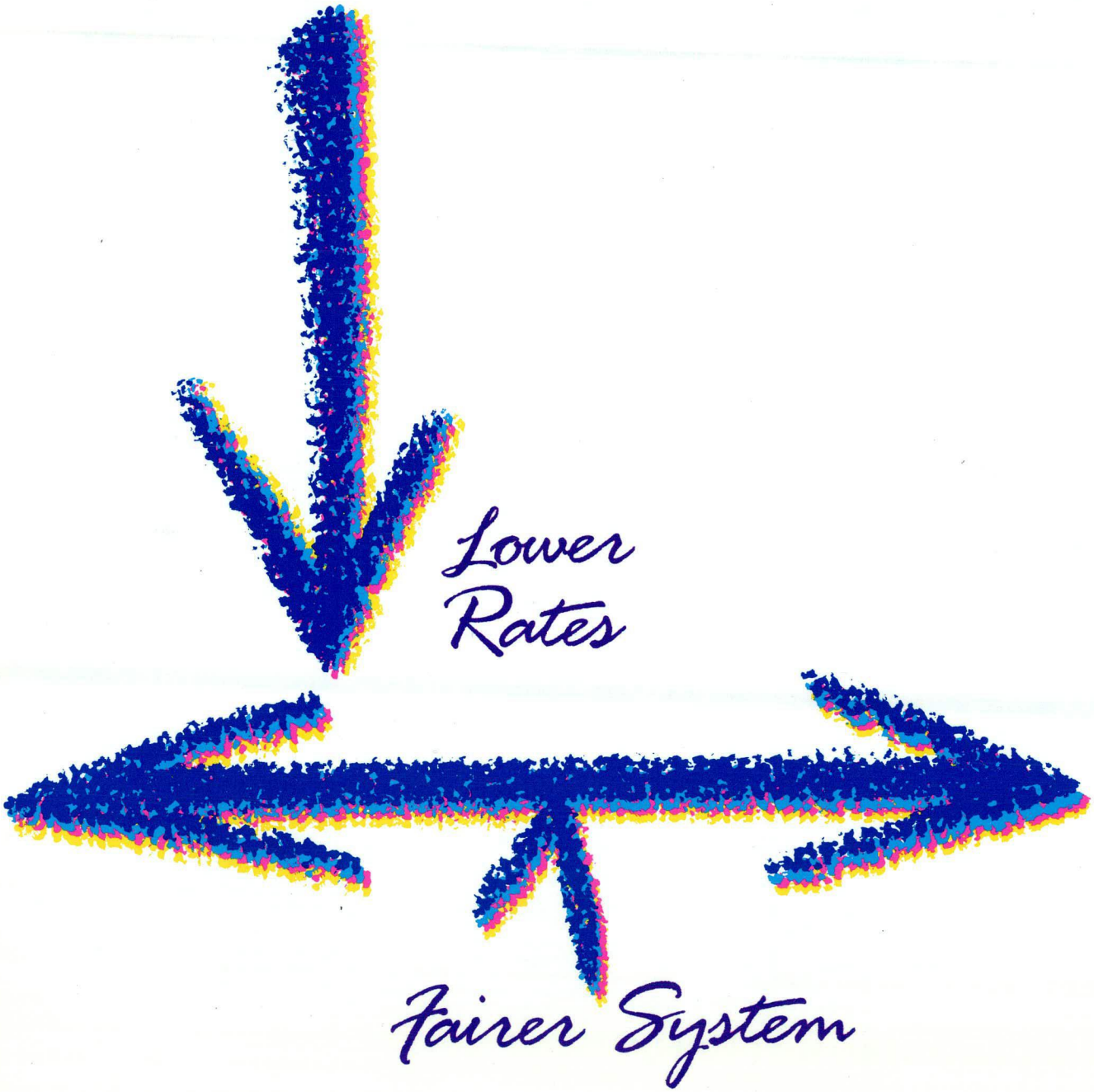
Michael H. Wilson
Minister of Finance



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CONFIDENTIAL

1. AESA
2. put into pp for mtg.

FROM: P D P BARNES
DATE: 31 July 1987

PS/CHANCELLOR

cc Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr H Evans
Mr Odling-Smee
Mr Matthews
Mr Peretz
Mr Savage
Ms Symes

POST-LOUVRE : NEXT STEPS

The Economic Secretary has seen Sir T Burns's minute to the Chancellor of 28 July.

2. The Economic Secretary thinks that an agreement, like the Louvre agreement, between a very small group of countries to restore stability after a period of massive exchange rate movements is obviously desirable and effective.

3. He also thinks that a longer term commitment by those countries to try to maintain stable rates is likely to be effective for as long as each country wants stability for its own rate.

4. However, he fears that an attempt to set up a complex system for countries to press each other to follow policies designed to maintain stable exchange rates will be:-

(i) bound to fail and

(ii) counterproductive, since it will encourage countries with difficut adjustment problems to put the onus of change on everyone else.

PB

P D P BARNES
Private Secretary

CONFIDENTIAL

Ch

Terry is keen for a meeting on Monday. AA

1. Alex
2. Ch

At your meeting on 14 July you asked for this paper by Friday ~~24~~ July, so if necessary you cd have a meeting this week. Unfortunately the paper has been delayed; and the slot we had held provisionally for a meeting on Thursday has been squeezed out. If, after reading* this, you feel you do want a meeting we will arrange it for next Monday, when we may not have a full cast, but PEM and Terry will be in. AWK

* not essential tonight (just Terry's view might)

CHANCELLOR OF THE EXCHEQUER

CONFIDENTIAL

[Club approach?]

FROM: SIR T BURNS
DATE: 28 JULY 1987

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr H Evans
Mr Odling-Smee
Mr S Matthews
Mr Peretz
Mr Savage
Ms Symes

POST-LOUVRE: NEXT STEPS

I attach a paper, drafted by IF2, which develops my earlier minute (3 April) on possible next steps in the search for a new framework for international financial co-operation. It has benefited from discussion with Sir Geoffrey Littler.

2. Whether by good luck or good management the Louvre agreement can be said to have held over the past five months despite universal scepticism at the time. A combination of intervention and monetary policy decisions by the G7 has brought some stability to exchange rates and reduced the risk of a dollar 'undershoot'.

3. One possibility now is to attempt to develop that experience into a longer-term scheme for bringing greater stability to exchange rates. There are two motives behind this ambition:

- the fear that there is an inbuilt tendency for substantial overshooting of exchange rates unless policy is directed at preventing it. Even if compatible policies were pursued there is a fear that we could still have substantial exchange rate swings unrelated to underlying factors;

- the costs imposed on the tradeable goods sector when it has to adjust to these swings, and the explicit desire of industry for greater exchange rate stability. In addition there must be a suspicion that uncertainty about exchange rates is an important factor in discouraging private sector investment.

4. For many years it was not possible to contemplate collective action to foster exchange rate stability; inflation rates were high and variable; there was an absence of any significant agreement about the part exchange rates played in international adjustment; and until recently the dollar was obviously severely misaligned.

5. From a UK point of view the past year or two has seen a coming together of two separate developments:

- the greater status given to Sterling in our assessment of monetary policy decisions. This has been a gradual process over many years but since early 1985 there has been a further push in this direction. There are signs of a similar approach emerging elsewhere with the exchange rate having a significant weight in interest rate decisions;

- the willingness of the G5 countries to take a collective view about the appropriate pattern of exchange rates. This began with the Plaza agreement and was further developed in the Louvre agreement.

6. The challenge now is to set out a scheme for formalising these developments. There are a number of requirements of any scheme that would help in establishing a longer-term framework:

- it should be seen as a further evolution from the present arrangements. Indeed with only a modest re-writing of history it might be possible to present it as an explicit description of what has been happening since February;

- it should not provide the private sector with a relatively easy way of exploiting the authorities. In my view those proposals which point to hard target zones together with automatic formulae for updating exchange rates fall into this category;

- it should encourage Governments to pursue compatible policies, particularly with regard to budget deficits;

- it should sustain a sensible overall anti-inflationary stance of monetary policy for the group as a whole;

- it should give us an opportunity to refocus the indicators exercise in a way that is constructive and manageable.

7. In practice there are two separate operations:

- to convince ourselves of where we want to go;

- and persuading others to move in that direction.

Once we are agreed on the line to take we can begin to work on the presentation to others. One approach is to draft a speech for Washington setting out your interpretation of the evolution of international financial co-operation and suggesting where it might lead. Another approach is to draft a paper along the same lines that Geoffrey Littler might discuss with other G5 Deputies in advance of the meeting.

8. If you have time on your hands during August I would recommend reading the attached article (top copy only) by Frenkel and Goldstein 'A Guide to Target Zones'. It is a useful compendium of arguments 'for' and 'against' various types of target zone schemes.

T BURNS

ENCS

CONFIDENTIAL

POST LOUVRE: NEXT STEPS

Note by IF2

This note considers how the Louvre Agreement might be taken forward. It begins with an outline of how we might formalise and bring together both Louvre-type exchange rate commitments and the indicators exercise envisaged in the Venice Summit Declaration. The proposed framework follows on from the Plaza and Louvre Agreements as an evolutionary step toward greater official management of the exchange rates of the major currencies. It also fits in with the development of our policy toward sterling's exchange rate. The subsequent sections of the paper spell out the detailed issues raised by the proposed framework and discuss more fully the rationale for it. In addition we propose a method of "global surveillance", i.e monitoring financial conditions in the G7 as a whole to guard against any damage to the inflation rate of the group.

2. A FRAMEWORK FOR INTERNATIONAL CO-OPERATION

2. The proposed framework has four elements:

(i) A reference point based on the current level of exchange rates is fixed for each currency and ranges around this point agreed. There would be provision for periodic revision of these ranges. (See Section 4).

(ii) These reference ranges would have "soft buffers", i.e. there would be no absolute requirement to keep an exchange rate within its range, but each country would

give significant weight to movements of its exchange rate in the operation of its monetary policy. There would be a presumption that in the first instance it would use monetary policy and intervention to try to prevent a movement of the exchange rate outside its reference range. But if market pressures were sustained there could be a need for fiscal policy measures, or some change in the reference range. (See Section 5).

(iii) Multilateral (e.g. G7) surveillance of each of the major countries' economies would monitor the movement of market exchange rates against their reference ranges. It would also examine a number of other indicators to assess the reasons for any exchange rate movement outside its reference range, to judge the medium-term sustainability of current policies and their international consistency, and to consider what remedial measures should be taken by which country. (See Section 6).

(iv) Procedures for monitoring monetary conditions in the G7 countries as an aggregate would be established, in order to stabilise the average inflation rate and avoid the risk of persistent inflationary or deflationary bias that might result if countries' monetary policies were based mainly on exchange rate objectives. (See Section 7.)

3. WHY DEVELOP THE LOUVRE AGREEMENT?

3. There is widespread agreement, reflected in the communiques of successive international meetings, that it would be desirable to reduce exchange rate fluctuations and to deter countries from

pursuing policies that contribute to exchange rate misalignments or other unsustainable outcomes. This agreement, however, conceals differences of view about how this is best achieved. Thus some have emphasised that greater exchange rate stability can be achieved only by the major countries pursuing mutually consistent fiscal and monetary policies and that they should be encouraged to do this through the "peer pressure" of multilateral (G7) surveillance. Others, while recognising the need for the fundamental determinants of exchange rates to be consistent, have argued that setting exchange rate targets (backed up by multilateral surveillance) can help provide the discipline to achieve this.

4. The Louvre Agreement can be seen as a pragmatic mixture of both approaches. Its most visible, and easily monitored element, was the agreement on exchange rates and this has largely been successful. After a period when it was tested by the markets and the authorities responded with large scale intervention and some widening of interest rate differentials, exchange rates have been relatively stable. Progress on the agreed changes in fiscal policy has been more uneven and while trade volumes are now adjusting in a reasonably satisfactory manner, current account imbalances in dollar terms are not yet on a decisively downward trend.

5. The G7 will presumably want therefore to discuss at its next meeting whether it still considers that exchange rates are broadly consistent with underlying fundamentals. It would be opportune at the same time to consider how the Louvre Agreement can be developed from an ad hoc arrangement to stabilise rates for a limited period into a new framework for international co-operation, which can accommodate changes in exchange rates where necessary.

6. One reason for wishing to do this is that the indicators exercise of the Tokyo and Venice Summit Declarations remains unfocused. The range of indicators to be examined is wide and, while this is appropriate in attempting to assess the medium term consistency and sustainability of the major countries' economic policies, it is too general to provide clear-cut policy implications. This might be remedied to some degree if it were possible to agree benchmarks against which outcomes or forecasts can be judged to determine whether remedial action is needed, but the US appear to envisage an excessively narrow focus on short term forecasts and real GNP growth as a performance indicator.

7. Although it may be possible to make technical and analytical improvements to the indicators exercise, the "peer pressure" of multilateral surveillance may provide only a weak discipline to pursue macroeconomic policies consistent with exchange rate stability. In any case, such policies may not be a sufficient condition for exchange rate stability. Foreign exchange markets respond quickly to all new information, discounting its future effects into current exchange rates. As a result, they tend to fluctuate like other asset prices. While forward markets etc, which enable traders to hedge, mean that this is not a serious problem in the short term, experience suggests that speculative bubbles and bandwagon effects may develop. Exchange rates may thus show much greater variability than the fundamentals justify, producing substantial shifts in relative prices leading to protectionist pressures and potentially serious costs of resource misallocation. Achieving greater credibility in the soundness and appropriateness of fiscal and monetary policies may help prevent this variability, but - as the Louvre Agreement demonstrates - there is a case for more direct official action to stabilise exchange rates.

8. Setting reference ranges and using monetary policy and intervention to help maintain exchange rates within these ranges may help to reduce exchange rate movements unrelated to fundamentals, but cannot substitute for getting the fundamentals right. Hence the need (envisaged in the proposal) for reference ranges to be accompanied by the development of the indicators exercise to help identify desirable changes in macroeconomic and other policies, as well as occasions when changes in reference ranges themselves may be necessary.

9. The proposed framework should contribute, not only to greater exchange rate stability, but also to the solution of current account imbalances. The main contribution of the framework could be to prevent new misalignments occurring (assuming that the reference ranges we begin with are in line with fundamentals). But what it cannot necessarily do is to force those domestic policy changes which would be most helpful from the point of view of the balance of payments disequilibria. Indeed the opposite could happen. For example, although it is not the likeliest situation, if the dollar were to come under upward pressure from markets over the next year or so. In that situation the policy responses in the US, Germany and Japan that were required to prevent such an exchange rate misalignment (easier policies in the US and tighter ones in Germany and Japan) would actually worsen the current account imbalances. In these circumstances, the case for intervention rather than relative interest rate changes would be stronger.

4. HOW TO SET REFERENCE RANGES

10. A sustainable and credible arrangement would focus on a range within which it would be reasonable to expect the spot rate could be maintained over a period ahead, perhaps 6-12 months, and should seek to avoid the emergence of significant misalignments over the medium term of 2-3 years.

Determination of the reference range

11. The range would be based on the contemporaneous exchange rates. This could be done in two ways. Following the Louvre Agreement, an inner band of some ±2.5% around these rates is indicated and an outer band of some ± 5% at which - if markets were still pressing in spite of the authorities' actions - it would be appropriate to take stock again.

12. The contemporaneous spot rate, or too narrow a rate around it, might quickly prove impossible to maintain if there were large shocks or if the effects of past policy changes and exogenous shocks had not fully worked through.

13. An alternative would be to specify reference ranges in terms of specific rates, e.g DM/$ 1.73-1.92. This need not involve explicit agreement on the (implicit) central rate. A future change in the reference range might be more easily agreed than a change in the central rate. An inner/outer band could also be expressed in this specific form, rather than in terms of percentage points.

14. Any reference range would be for political negotiation. To prevent the emergence of severe misalignments it should be forward looking, and set in a medium term framework. Projections based on a range of models and quantitative assessments could help in forming judgments about what range might be consistent with long run fundamentals.

How the reference range should be denominated

15. The Louvre Agreement expresses the central rates as national currencies against the dollar. The implicit cross rate for non-dollar currencies can move within twice as wide a band as any single currency against the dollar. Other possibilities include:

(i) **parity grid** which sets out the bilateral ranges for each country against the others. (These could be identical in percentage terms for each country, or - as in the EMS - wider for some countries than for others.) It may well be easier to ensure both parties take action when the band is violated, so enforcing greater symmetry than when rates are expressed only against the dollar.

(ii) **rates against the SDR** The heavier a currency's weight in the SDR basket, the larger the effective range against other currencies for a given percentage band against the SDR.

The choice depends on how many countries participate. The key rates are those of the G3 and we have a preference for bilateral rates, either against the dollar or a simple parity grid.

Width of reference range

16. Arguments in favour of wide ranges include:

(i) uncertainty about the appropriate central rate;

(ii) ranges should be able to cope with some shocks, otherwise realignments would be needed frequently;

(iii) when ranges came to be re-negotiated there would usually be no reason for the exchange rate to jump, and hence less risk of one-way speculation building up.

(iv) reduction in the risk of the arrangement breaking down.

17. Reducing misalignments does not mean trying to constrain other policies to prevent any misalignment: members will insist on a substantial measure of domestic autonomy. However, wide reference ranges recognise that (a) countries are often not able to agree fully on appropriate ranges and policies and (b) exchange rate ranges can put only limited pressure on countries to correct inappropriate fiscal and monetary policies. Wide reference ranges could be a less useful anchor for exchange rate expectations.

18. The Louvre Agreement represents something of a compromise, but also has very soft buffers. It has a relatively narrow band (some ± 2.5%) at whose edges limited concerted action is generally appropriate; and a wider band at the edges of which further consultations might be appropriate. A more formal arrangement might require somewhat wider ranges although perhaps still around a narrower intermediate band. If ranges were to be formally agreed for the G7 currencies, and not just the G3, then again there is a strong case for wider ranges requiring less frequent consultations: formal commitments from a larger number of participants would probably make such consultations more complicated, for example requiring meetings rather than telephone conversations.

Should ranges be publicly announced?

19. What matters most is what the authorities actually do, rather than their expressions of intent. Flexibility would be maintained if ranges - and accompanying agreements on procedures - were not publicly announced. A reaffirmation of the Louvre undertaking to foster stability of exchange rates would be a sufficient signal to the markets. Publicising the ranges could, at least in the short term, lead to destabilising speculation to test the authorities' commitment. Credibility would be damaged if the agreement broke down at an early stage.

20. It might be argued that announcing the agreed ranges at the outset would help anchor the markets' exchange rate expectations; encourage stabilising speculation (but only to the extent that markets believed both in the authorities' commitment and that the ranges were broadly in line with fundamentals); and make it easier to prick speculative bubbles. It would also help to keep pressure on participating governments to maintain their commitment. However, the more successful the agreement the faster the market would begin to work out the ranges for itself. This would be no bad thing: any eventual announcement of the ranges would be much more credible.

Who should participate?

21. Most proposals suggest either the G3 alone, or the G5/7. A development of the Louvre Agreement to go beyond understandings on intervention arrangements, and to focus on domestic policy adjustment over the longer term, might be best restricted to the G3 in the first instance. An advantage is that the necessary parity grid could be very simple, involving only three currencies. With smaller numbers it would be easier to reach agreements, and less risk of free riders.

5. HOW TO RESPOND TO MARKET PRESSURES OR SHOCKS

Hard or soft buffers?

22. Each country would be expected to give weight to the movements of the exchange rate relative to the reference range in its conduct of macroeconomic policy. There would be no absolute obligation to keep within the reference range. The appropriate response to pressures at either end of the range would depend on why those pressures occurred. Soft buffers would give the authorities time to assess the situation; to decide whether to push the rate back into the band or to adjust the range; and allow policy changes that take time to implement or to take effect. In practice, fiscal policy changes can be made less often and with greater difficulty than interest rate changes.

Monetary policy and intervention

23. Concerted **intervention**, whether according to 'rules' or by loose arrangements requiring close consultation between national authorities, would help to prevent speculative bubbles puffing up, although interest rate changes might be needed to reinforce the message. If there is large scale unsterilised intervention it will be especially important to monitor international monetary conditions so as to avoid excessive tightness or easiness. (See Section 7 on Financial Conditions in G7 as a whole.) It is worth noting the benefits from symmetric offsetting intervention in two countries at the same time. World money supply would be unchanged if unsterilised purchases of foreign currency in the country whose currency was tending to appreciate were matched by unsterilised sales of foreign currency in the country whose currency is tending to depreciate.

24. **Monetary policy** changes would be an appropriate response to exchange rate changes caused by relatively loose or tight monetary policy compared to other countries. Random deviations from the central rate could be met by appropriate deviations in monetary policy without systematically threatening the medium term credibility of domestic policy, although interest rates could become more volatile.

25. In contrast, co-ordinated monetary policy to stabilise exchange rates against persistent pressure at the edges of the range may lead to increasing divergences between domestic objectives and the monetary policy outcome. For instance, intervention and changing interest rates will both tend to make monetary targets more difficult to achieve.

Implications for fiscal policy

26. If interest rates and/or unsterilised intervention are used to defend the parity against persistent upward or downward pressure this may force a prolonged departure from the desired

policy mix. For example, if the authorities had met persistent downward pressure on the exchange rate by raising interest rates they might find themselves with weaker investment and current account positions than they would wish. Assuming that money GDP was growing at about the desired rate, the policy mix could be corrected by tightening fiscal policy and allowing interest rates to fall. This would improve the current account and worsen the capital account while leaving the exchange rate at the original level.

27. If, however, money GDP was growing too slowly, both the policy mix and the overall policy stance could be corrected by adjusting the reference range down and reducing interest rates without any change in fiscal policy. This case is discussed next.

Deciding whether to revise the reference range

28. A system that simply revised ranges to accommodate potentially undesirable or unsustainable policies would swiftly lose credibility as a means towards greater exchange rate stability and prevention of misalignments. General principles might be adjust reference ranges after permanent and desirable real shifts, such as oil price changes, or as a component of a policy change aimed at keeping money GDP on track. But the reference ranges would not be changed (or not be changed fully) in order to accommodate past inflation differentials.

29. It is impossible to divorce a sustainable exchange rate both from the consideration of sustainable national policies which determine the fundamentals. Consultations between countries will want to take account of a range of factors in judging whether a desired real exchange rate change should be accommodated by a change in the nominal reference range.

30. Supply shocks will generally indicate a change in the real rate. The obvious example for the UK is a fall in oil prices which requires a fall in the real exchange rate, and this can be taken through a drop in the nominal exchange rate without any significant impact on domestic inflation and money GDP growth. A change in the reference range might in practice be essential to maintain orderly markets and limit potential overshooting. However, in the short run other supply changes such as relative productivity growth can be hard to distinguish from short term fluctuations: there may then be a case for allowing the real economy, prices and wages to adjust.

31. Changes in the policy mix inevitably entail changes in the real exchange rate. The policy mix may be changed either to conform to longer term constraints, e.g a sustainable debt/GNP ratio or current account balance over the long run, or in response to shocks. There is no easy rule about whether a national government - or its international partners - should want the real exchange rate change to require a nominal realignment.

6. SURVEILLANCE AMONG G7 COUNTRIES

32. In its broadest terms, multilateral surveillance describes the process of monitoring economic developments within and between countries. In a G5/7 context, multilateral surveillance has increasingly developed by way of the "objective indicators" exercise. This is something of a mess. There is confusion between objectives and indicators. There are different views about how the world works and there is the desire of the Americans to use indicators as a stick to beat Germany and Japan. The exercise has come to mean little more than a collection of short term forecasts by the IMF, for use mainly by Ministers and Governors in a G5/7 context.

Focusing the indicators' exercise

33. In the past, we have asked that the indicators should:

(i) focus on the medium term;

(ii) use domestic demand rather than GNP, as the key to trade imbalances;

(iii) use Fund rather than national forecasts;

(iv) avoid forecasts of market sensitive variables like exchange rates and interest rates;

(v) develop ranges and margins of error;

(vi) focus on nominal incomes, rather than real magnitudes.

All of these should be attainable, with the exception of the last: we have made no progress in trying to persuade other countries to focus on nominal incomes.

34. For the indicators exercise to be more than forecasts, criteria need to be established against which forecasts can be measured. For example a country (like Japan) that needs to reorientate its economy away from exports needs to see its domestic demand growing substantially faster than total output in the medium term. It is reasonable to assume (as we do in the MTFS) that GNP grows at close to productive potential in the medium term. This and an assumed switch out of the balance of payments provides a possible "benchmark" for the growth of domestic demand in the medium term.

35. The 8 April G7 document on indicators defined seven indicators: growth, domestic demand, inflation, current account balances, budget performance, monetary conditions and exchange rates. Benchmarks could be set, in a medium term context, for some or all of the following six months:

Output : medium term sustainable growth. This is defined as productive potential with the possibility of an additional allowance, e.g for using up spare capacity or having to adjust in ways which reduce the growth rate for a period. Medium term can be defined as three years.

Domestic Demand : benchmark growth of output plus the resource shift into or out of the balance of payments consistent with the benchmark for the current account.

Inflation : government objectives for the medium term (MTFS assumption for UK).

Nominal Income : output plus inflation.

Current Account : a possible benchmark would be an assumption, for example, that 1989 current accounts would be half those in 1986, for Japan, Germany and the United States.

Fiscal Deficit : Government plans, e.g MTFS for UK (expressed both in terms which each country uses in practice - PSBR for the UK, Federal deficit for the US - and in terms which are comparable across countries, e.g the general government financial deficit).

Exchange rates and interest rates : no forecasts, no benchmarks.

Examples of medium term benchmarks are given in the attached tables Annex A that we have drawn up for each of the G5. These tables raise a number of questions.

Fiscal and monetary policies

36. Fiscal policy benchmarks appear in the tables, but monetary policy does not. This reflects partly the technical difficulties (e.g with monetary aggregates) experienced in setting monetary policy in a medium term framework; partly the reluctance of most countries to attempt to set out any numbers (e.g on interest rates) relevant to monetary policy in the future.

37. This asymmetry between the presentation of monetary and fiscal policies is a feature of the present indicator system. While this leaves the system of indicators incomplete, it has the advantage of flexibility, but the serious disadvantage of appearing to give excessive emphasis to fiscal policy in the determination of e.g domestic demand.

How defensible is the derivation of benchmarks?

Reasonably straightforward for **output** and **domestic demand**, (for possible misuse, see below). The **current account** benchmark is arbitrary: consistency with an external debt criterion, e.g a desirable path for a debt/income ratio; and/or desired savings/ investment balance could be used to define a better benchmark - at least in theory. A current account benchmark provides the arithmetical link between output and domestic demand, on the assumption of no change in the terms of trade.

An **inflation** benchmark is desirable if nominal income is excluded.

Fiscal deficits are already a feature of most countries' forward plans and commitments were made at Louvre. They should therefore be in this table.

Nominal income would be a substitute for output and inflation, but some countries would find difficult the concept of a benchmark for this variable.

Do we need all six benchmarks?

Not necessarily. In order to focus on interactions, the crucial benchmarks are domestic demand and the current account. To focus on consistency of policies fiscal deficits should be included.

How should the benchmarks be expressed?

The options here include: a set of central figures, as in the attached tables; a set of ranges; a series of qualitative statements ("current accounts to move towards balance"). The case for a set of quantified benchmarks is that it makes possible and necessary tests for consistency:

(i) within countries;

(ii) between countries.

Is there likely to be a problem of inconsistency?

The benchmarks for output, domestic demand and the current account are constructed so as to be consistent for each country. One measure of fiscal policy is specified for the future. Although monetary policy is not specified in any quantitative way, the plan/benchmark for fiscal policy would have (unstated) implications, for both monetary policy and exchange rates. Countries participating in these arrangements would want to make quantitative assessments (by themselves and/or the IMF) as an input into the design of any published benchmarks.

There may well be a separate problem about the consistency of IMF forecasts drawn up on the assumption of constant real or nominal exchange rates.

Who provides the numbers

The Fund would provide data and forecasts; any quantified benchmarks would have to be agreed between the Fund and G7 countries individually and collectively.

How would Ministers use these numbers?

(i) to compare fiscal policy commitments with recent developments and future prospects;

(ii) to compare the prospective growth of domestic demand with the benchmark?

(iii) to compare the prospective current account with the benchmark;

(iv) to ensure (via the IMF) that the forecasts and benchmarks were mutually consistent;

(v) to assist in reaching views on whether macro policy setting is appropriate.

Misuse of these numbers

The greatest danger is that the "benchmark" figures for output and domestic demand would be interpreted as targets to be aimed at year by year. But this already happens to some extent; the medium term presentation in the table makes it a little less likely; and divergencies of forecast from benchmark are not necessarily signals for fiscal policy changes.

7 . FINANCIAL CONDITIONS IN G7 AS A WHOLE

38. Most discussion in a G5/7 context is about individual major countries and the problems of imbalances between countries. But for policy decisions in individual countries must be informed by knowledge of the **overall** position in the G5/7 as a whole, and indeed in the world as a whole. The regular IMF and OECD forecasts fulfil part of this role. But it also needs to be a regular feature of G5/7 surveillance discussions.

39. There is a need regularly to assess whether policies, at the aggregate level of OECD as G7, are:

(i) consistent with steady, non-inflationary growth in demand and output, avoiding an inflationary or deflationary bias; and

(ii) if the overall policy stance is right, whether the balance between fixed and monetary policies is appropriate, e.g consistent with a reasonable level of interest rates.

40. Just as there is a regular assessment in the Treasury of monetary conditions, so a similarly wide ranging exercise could be undertaken (by the IMF staff) at the level of G7 as a whole. Amongst the indicators we would expect to see included in such an assessment are:

Nominal GDP*
Output*
Inflation*
Monetary aggregates
Nominal and real interest rates
Commodity prices
Gold price
Price/earnings ratios in stock markets
Property and land prices
Exchange rate for G7 as a whole
Indicators of fiscal stance: budget deficits* and debt/income ratios*

The aim would be to build up a picture of current developments, drawing on movements in commodity and asset prices often used as forward indicators.

The indicators with a * would include forecast values; there would be no attempt to forecast the others.

ANNEX A: INDICATORS AND BENCHMARKS

Notes on tables and definitions of variables

Output : real GNP/GDP at factor cost or market prices

Domestic demand : total final expenditure less exports, at constant market prices

Inflation : indicators currently show both CPI and GNP deflator. Latter fits in better with nominal income approach; CPI is more readily used by Ministers, more accurate, up to date etc. Figures in tables are deflators.

Nominal income : GNP/GDP at market prices

Current account : as per cent of GDP/GNP

Fiscal deficit : for compatibility across countries, general government financial deficit, as per cent of GNP, as currently used, is suitable. But government objectives are usually framed with a different definition in view: the benchmark could be the GGFD, consistent with the Government's objective.

Sources of Forecasts in tables : for UK, from MTFS and numbers underlying the MTFS. For other countries, latest Treasury WEP exercise.

FRANCE

Annual growth rates

	Data		Forecasts				Medium Term Benchmark
	1985	1986	1987	1988	1989	Av 1987-89	
OUTPUT	1¾	2¼	1½	2	2¾	2	2½
DOMESTIC DEMAND	2¼	4	2	2¼	2¾	2¼	2½
INFLATION	5¾	4½	3¼	2½	2	2½	2-3
NOMINAL INCOME	7	7	4¾	4¾	5	4¾	5
CURRENT ACCOUNT (1)	¼	½	0	-¼	-¼	-¼	½
FISCAL DEFICIT (1)	2½	3	2½	2½	2¼	2½	2 *

(1) As percentage of GDP

* Intended to be broadly in line with a pledge made at the time of the Louvre Agreement to reduce the central government deficit by 1 per cent of GDP by 1988, from an estimated 1986 outturn of 2.8 per cent.

U K

Annual growth rates

	Data		Forecasts*				Medium term
	1985	**1986**	**1987**	**1988**	**1989**	**Av 1987-89**	**Benchmark**
OUTPUT	3½	2¾	3	2½	2½	2½	2½*
DOMESTIC DEMAND	2¾	3¼	3½	2½	2¼	2¾	2½
INFLATION	6	3½	4½	4	3½	4	4*
NOMINAL INCOME	9	6½	7½	6¼	6¼	6½	6½*
CURRENT ACCOUNT (1)	1	0	-½	-½	0	-¼	0
FISCAL DEFICIT (1)	2¾	3	3	2	2½	2½	2½ **

(1) As percentage of GDP

* Projections from MTFS

** Consistent with PSBR for 1989-90 projected in MTFS

U S

Annual Growth rates

	Data		Forecasts:				Medium Term
	1985	1986	1987	1988	1989	Av 1987-89	Benchmark
OUTPUT	2¾	2½	2½	2¾	2½	2½	2½
DOMESTIC DEMAND	3½	3½	1½	1¾	1½	1¾	2
INFLATION	3½	2½	3	4	4½	3¾	3-4
NOMINAL INCOME	6½	5½	5½	6¾	7	6½	6
CURRENT ACCOUNT (1)	-3	-3½	-3½	-3	-2½	-2¾	1½
FISCAL DEFICIT (1)	3½	3½	2	2½	2½	2½	*

(1) As percentage of GNP

* The Gramm-Rudman-Hollings target for the Federal budget deficit in FY 1989 is $72 billion (1½ per cent of GNP);

the outturn for FY 1987 is estimated at $180 billion (4.2% of GDP)

JAPAN

Annual growth rates

	Data		Forecasts:				Medium Term Benchmark
	1985	1986	1987	1988	1989	Av 1987-89	
OUTPUT	4¾	2½	3	3½	3½	3½	4
DOMESTIC DEMAND	3¾	4	4½	4¾	4¾	4¾	5
INFLATION	1½	1¾	1½	¾	½	¾	1-2
NOMINAL INCOME	6½	4½	4½	4½	4	4½	5-6
CURRENT ACCOUNT (1)	3¾	4½	3½	3	2½	3	1½
FISCAL DEFICIT (1)	¾	1	1½	1½	1	1¼	*

(1) As percentage of GNP

* The target set in this February's Financial Reconstruction Plan is to reduce the issue of 'deficit-financing bonds' (roughly corresponding to the central government deficit on current account) from 1½ per cent of GNP in FY 1987 to zero by FY 1990.

GERMANY

Annual Growth Rates

	Data		Forecasts				Medium Term Benchmark
	1985	1986	1987	1988	1989	Av 1987-89	
OUTPUT	2½	2½	1½	2½	3	2½	3
DOMESTIC DEMAND	1½	3¾	3¼	3¾	4	3¾	4
INFLATION	2¼	3	2¼	1½	1½	1¾	1-2
NOMINAL INCOME	4¾	5½	3¾	4¼	4½	4¼	4-5
CURRENT ACCOUNT (1)	2¼	4	3½	2½	1¾	2½	2
FISCAL DEFICIT (1)	1	1¼	1½	1	1¼	1½	1½*

(1) As percentage of GDP

* Intended to be broadly in line with the draft 1988 Finance Plan, in which the borrowing requirement is projected at DM29 billion (about 1.4 per cent of GNP), compared with an estimated outturn of DM 22.3 billion (1.1 per cent) for 1987.

IP.C13/009

CONFIDENTIAL

NOTE OF A MEETING AT NO 10 DOWNING STREET AT 3.30PM ON MONDAY 3 AUGUST

Present:
Chancellor
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr H P Evans
Mr Odling-Smee
Mr Peretz
Mr Culpin

POST-LOUVE : NEXT STEPS

The Chancellor said he was most grateful for Sir T Burns' note of 20 July and for the paper by IF2. He thought that the wild gyrations in the dollar over the past 10 years had made a strong case for action to try to bring about more stable exchange rates. The gyrations had not reflected economic fundamentals and had produced harmful results; and it was now easier to think of a more managed approach when there was already greater convergence in inflation and in economic policy.

2. Sir T Burns agreed. It was impossible to find a rational explanation for all the movement in the dollar (or indeed in sterling); much had to be "froth" or "bubbles". He thought it was difficult to conclude other than that floating had operated much less well than expected: apart from producing erratic fluctuations, the great uncertainties permitted governments to pursue incompatible policies for longer.

3. Sir P Middleton said he agreed that there was undoubtedly some froth in the exchange rate movements. But he did not agree that we had arrived at convergence on inflation rates and

coordination of economic policies by accident: he was not convinced that, without floating rates, we could have secured this position. Sir T Burns doubted whether movements in the dollar had done much to lower world inflation rates, except perhaps via their generally deflationary effect on world activity.

4. The Chancellor commented that one of the reasons why floating had not been very successful was that the long-term stabilising speculators looked for by the theorists had not emerged. All the operators in the foreign exchange markets had very short-term horizons. And even if they believed that in the long-run, for example, the dollar might fall, that would not stop them chasing it up in the short-term if that was where they believed the market was going. He thought this short-termism could be turned to the authorities' advantage: if we could create the view that in the short-term exchange rates would remain stable, then that would tend to become self-validating.

5. There was some discussion about the sort of mechanisms we might look for. The Chancellor felt that one fault of Bretton Woods was that its margins were too narrow; this gave the markets a one-way bet, and left the authorities without sufficient tactical flexibility in intervention policy. He thought the plus and minus 5% bands implicit in the Louvre were more realistic. Sir G Littler was against declared numerical margins: one of the successes of the Louvre had been that the uncertainties about the exact limits of fluctuation had worked to the authorities' advantage. The Chancellor thought there were some demonstration effects from specifying what the margins were, but he agreed that it was undesirable to publish intervention points or describe our tactics in any detail. Sir T Burns felt that soft buffers were important: the more the authorities pinned themselves to particular targets, the more it gave the markets something to tilt at.

6. Mr Cassell commented that one of the problems of Bretton Woods had been that currencies had been fixed in terms of the

dollar. He thought in present circumstances a parity grid was more sensible. The Chancellor agreed. There was clearly a choice of how many currencies to include in the grid: the simplest would be just to have the dollar, Deutschmark and yen, with other currencies hanging off that.

7. The Chancellor raised the question of how the new arrangements might be backed up. He did not think the present indicators exercise offered anything at all: sovereign states would always be unwilling to allow others to dictate their fiscal and monetary policies. But countries were prepared to commit themselves to exchange rate relationships, and that implied commitments on intervention and short-term interest rates. That was not to say that we should give up on pressures on countries to pursue sensible fiscal policies: that was quite rightly an important topic for discussion at the regular G5/G7 meetings. But it was important to separate out the mechanisms needed to run a more stable exchange rate system from the global surveillance implicit in the indicators exercise.

8. There was some discussion about whether we should have an anchor for the system, to stop it having an inflationary bias. The Chancellor saw two possibilities. The first was a separate agreement linked to commodity prices or some other numeraire; it was very difficult to see how this would work. The second, and potentially more promising, was simply to say that this was supposed to be an anti-inflationary club, and to qualify for membership, a country's inflation had to be low. Sir T Burns thought it would be helpful to compute average figures for the "club" and keep them in circulation, to demonstrate how the group in aggregate was performing.

9. The Chancellor thought the way to take this forward was for him to set out these ideas in his speech to the Interim Committee in Washington in September. Before that, he would inform his

G5 and G7 colleagues at the earlier meetings. He would want to present the proposals as an evolution of existing policy, tracing its history from Plaza through the Louvre. It would be important to bring out the separate and subordinate role of the indicators exercise. He would not want in the speech to cover details about ranges or intervention tactics etc: it was preferable to edge the consensus along gradually. But it would be important to work up our answer to all the obvious supplementaries. Sir T Burns agreed to prepare a draft speech for a further meeting in early September.

ACSA

A C S ALLAN
5 August 1987

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Those present
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Mr S Matthews
Mr Cropper

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ELAND HOUSE, STAG PLACE
LONDON SWIE 5DH
UNITED KINGDOM

SUBJECT: PROPOSED MEETING OF G-6 DEPUTIES

I WOULD LIKE TO CONVENE A MEETING OF THE G-6 (PRINCIPALS PLUS ONE) DURING THE TIME OF THE 1987 ANNUAL MEETINGS OF THE WORLD BANK AND IMF TO DISCUSS A VARIETY OF MDB ISSUES.

I PROPOSE WE MEET AT THE TREASURY ON FRIDAY, SEPTEMBER 25, IF PEOPLE WILL BE IN WASHINGTON BY THEN, OTHERWISE ON TUESDAY, SEPTEMBER 30, 1987. I SUGGEST THAT OUR AGENDA INCLUDE: (1) DEVELOPMENT COMMITTEE AND WORLD BANK ANNUAL MEETTING= (2) CAPITAL STRUCTURE OF THE WORLD BANK= (3) STATUS OF AFDF NEGOTIATIONS= AND (4) STATUS OF IDB NEGOTIATIONS. I WELCOME ANY ADDITIONAL SUGGESTIONS YOU MAY HAVE FOR THE PROPOSED AGENDA AND WOULD APPRECIATE A RESPONSE ON THE DATES SUGGESTED FOR THE MEETING AS SOON AS POSSIBLE. SINCERELY,

JAMES W. CONROW DEPUTY ASSISTANT SECRETARY (DEVELOPING NATIONS).

18/5424/WM

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PERSONAL

6th August, 1987.

Dear Nigel

I am enclosing a memorandum. I am sorry it was hastily drawn up and is so lengthy. I hope, however, to draft an even longer more carefully prepared dissertation covering many other points, including detailed practical suggestions, while I am on holiday. I will send it on to you shortly after my return.

Greatly daring, I am enclosing too a copy of my Hirsch Lecture delivered in 1985 based on speeches I made in 1984. I hope you will feel able to glance through it. Even though I have incorporated some of the material in the memorandum, I hope you might think it worthwhile.

With my warmest good wishes.

Yours

Harold

Encls.

MR 12/49

UNCLASSIFIED

FROM: J M G TAYLOR
DATE: 12 August 1987

SIR T BURNS

cc: PS/EST
Sir P Middleton
Sir G Littler
Mr Cassell
Mr H Evans
Mr Odling-Smee
Mr S Matthews
Mr Peretz

POST LOUVRE: NEXT STEPS

Lord Lever has sent the Chancellor a copy of his 1985 Hirsch lecture. The Chancellor has asked me to send this out, since it has some relevance to the work in hand for his September initiative. He has commented that although he does not buy it wholesale, it does contain some insights. He recognises that you and copy recipients will have seen this lecture at the time, but he thinks it is still worth looking at again.

J M G TAYLOR

HIRSCH LECTURE — JUNE 1985.

THE DOLLAR AND THE WORLD ECONOMY: THE CASE FOR CONCERTED MANAGEMENT

HAROLD LEVER (Lord Lever)

Conventional wisdom has been strained past breaking point in seeking to explain both the excessive weakness of the dollar in the mid-1970s and its excessive strength so far in the 1980s. In the 1970s there were loud criticisms from both Europe and the US that the dollar's weakness was due to misguided US government policies. It was repeatedly asserted that the dollar would cease being weak only if the US "put its house in order". Now, 7 or 8 years later, even more alarming policies are said to have produced the opposite situation - a dollar which is by common consent grossly overvalued. The paradox is that the US is now being told to do much the same thing as before, but this time in order to produce the opposite effect. Much of this advice, as is normal on these occasions, has a moralising overtone. In my view it is wise to defer the sermons until we have examined the actual market operations of the dollar more closely than is habitual.

In looking at recent history to discover the "mystery" of dollar movements, we must first highlight certain delusions which hold an undeserved sway, not only in the popular mind but also in what would normally be thought authoritative quarters, all over the world. These delusions are:

1) That the dollar's rise is an expression of the relative competence of countries and their governments. As the Japanese

yen has experienced deformities not very different from the other currencies it is difficult to see how this absurdity can be maintained.

2) That high US interest rates, whether resulting from the fiscal deficit or not, produced a surge of investment money from abroad between 1982 and 1984 which was responsible for the dollar's rise.

3) That speculators are responsible for the dollar's rise.

4) That the damage being caused by grossly misaligned exchange rates is unavoidable and that nothing can be done about it.

I will argue that the explanation for the dollar's movements is to be found in the supply/demand equation of dollars in the currency markets: that capital movements have become by far the dominant influence on the supply and demand for dollars: and that the movement of bank money is the most mobile aspect of capital movements. I will also argue that the movements in bank money arise from the normal and desirable functioning of the dollar as the world currency.

I will further argue that though the turnover in the currency markets is enormous, virtually all of it is self balancing froth. What matters is not the total dealings but the balance of supply and demand. I will argue that this balance would be manageable if we had concerted

intervention by central banks. Unfortunately, under our present unmanaged floating rate arrangements, it is capital movements and not fundamental economic factors which determine the parity of the dollar. I will point out that this leaves us with an unmistakable choice. We must either pursue co-operative action to provide some counterbalance to capital movements or accept the continued damage to the fundamental workings of the world economy.

Under floating exchange rates, the movement of the dollar parity at any given time will depend on the balance between the supply and demand of dollars at the existing parity. The main sources of supply and demand for dollars are:-

(i) the condition of the current account of the balance of payments,

(ii) movements of medium and long-term portfolio and investment funds,

(iii) speculative movements, and

(iv) banking movements.

When we examine the changes in these categories between the period of dollar weakness in the 1970s and its recent period of great strength, the most striking contrast is the extent to which the supply of dollars has been increased by the deterioration of the US current account balance. Yet instead of going down under the vast extra supply of dollars thus

created, the dollar has risen sharply. Clearly there must have been a sustained counterbalancing change elsewhere in the supply and demand equation for dollars even to maintain the previous parity level. Water does not run uphill even in currency markets. Something has tilted the supply/demand balance.

The first question must be: Has there been a great inflow of money converted from other currencies seeking to benefit from the high US interest rates? In markets, in which a year's interest can be lost in an adverse currency change of a few days, it is expectations of parity rather than interest rate differentials which dominate external currency movements. It is, therefore, on the face of it in the highest degree unlikely that any rise in the US interest rates, especially one associated with fiscal disorder, could prompt so great an inflow as to outweigh the growing trade deficit of the last two years. The existence of a surge in such investment funds has been asserted or assumed without proof in innumerable comments. In fact, the official figures show no major change in inward investment between 1982 and 1984. And, despite uncertainties in aspects of these figures, it can be safely asserted that there has been no change in foreign investment between 1982 and 1984 which could conceivably have outweighed the $100 billion increase in the current account deficit.

I now turn to speculative movements. They find expression in a

number of not readily identifiable ways. But, it is impossible to believe that they could autonomously be so perverse as to outweigh the adverse factors facing the dollar, including the sheer weight of dollars generated by the US trade deficit. Indeed why on earth should speculators have supposed that the dollar would go up when all expert comment suggested the contrary especially when, from the speculators point of view, the increased current account deficit was threatening the supply/ demand equation of dollars at its most vulnerable point? I must emphasise that I am not suggesting that speculation has not contributed to the dollar's deformities. Still less do I believe that speculative movements have helped to dampen the dollar's swings. The reverse is the case. Most speculators seek to win profits (or more commonly to avoid losses) by anticipating the continuation of a trend not its reversal. Far from fighting the dollar's downward trend in the late 1970s for example, speculators followed it and thereby added to the dollar's undervaluation. The same, in reverse, has happened in the 1980s. There is nothing exceptional in this behaviour. The only people who are surprised by it are those who accepted the academic case for floating rates in the 1960s and 1970s. This was based on seminar models which either ignored or assumed away the problems they would create. The key false assumption which was made was that any major deformity of a currency's parity caused, for example, by cyclical capital movements, would be corrected by the action of long-sighted speculators.

Outside the seminar it should have been obvious that anything resembling unmanaged floating rates would be dominated destructively and irrelevantly, by short-term and medium-term capital movements and by seasonal and cyclical trading and payments movements. Market traders and speculators behave in exactly the opposite way to the seminar assumptions. The reality of free money markets is that the overwhelming weight of speculative movement will (rightly from the trader's point of view) be concerned to follow an immediate trend not to oppose it. Nobody will sell the dollar on Monday in the opinion that it will be lower next year if he thinks he can sell at a higher price in the next hour, next day, next week or next month. Any experienced currency trader will tell you that speculators who take a long-term view usually end up in bankruptcy well before their "long-term view" has been proved true or false.

In my view, therefore, the recent strength of the dollar is partly to be explained by speculative transactions but these should be seen as 'piggy back' transactions, i.e. as riding on the back of other, more fundamental forces.

We must, therefore, consider banking movements. First, a little history. Before, during and after Bretton Woods, the role of the dollar in financing world trade increased. The American banking system, and linked to it the dollar operations of banks throughout the world, has taken on the lion's share of satisfying the world's needs for funds in

addition to the domestic needs of the US itself. So, in the years immediately following 1974, after the first oil shock, US banks with overseas banks who increasingly attached themselves to the dollar banking system poured out hundreds of billion of dollars in loans to finance the deficits of South American and other governments and to finance third party trade, i.e. trading transactions all over the world between countries other than the US itself. This lending seemed safe, profitable and was warmly encouraged by all the leading governments. By these means, the dollar performed its functions as the world currency. Without these vast credits the world recession after 1974 would have been calamitous. There were important errors by the governments and banks in the method of recycling the OPEC dollars, but there could be no doubt that the world economy was saved from great injury by the actions of the world banking system. It was a productive error.

This process injected enormous supplies of dollars into the market. Most of these dollars were subsequently changed for DMs, yen, Swiss francs and sterling, in the ordinary course of trade. They were, therefore, added to the existing overhang of dollars on the world market that stemmed from US overseas investment after the war. On this there had been a good deal of public comment - in fact, it helped to bring about the demise of the Bretton Woods system.

The world recovery in the 20 years after the war transformed the

dollar situation. The post war dollar shortage changed to an emerging glut. This was not caused by the trading surplus of the recovering countries but by the accumulation of dollars resulting from US overseas investment. The weight of this outflow made it inevitable that the ability of the US to deliver gold in exchange for foreign-held dollars, as provided by Bretton Woods, could not be maintained. By 1967 the gold option, though formally still extant, had in practice ceased to exist. The world then had for the first time to face head on the key question of capital movements for which Bretton Woods had given only a temporary and unclear answer.

At Bretton Woods and thereafter, everybody agreed that parities ought to reflect economic fundamentals, including long term direct investment. Everyone agreed that parities should not be decided or distorted by capital movements. Bretton Woods provided a satisfactory ~~problem~~ answer to this problem as long as there was a dollar shortage. The dollar shortage ended sooner than anybody expected and was replaced by what was then thought to be a dollar glut. It was not really much of a glut, but the revival of the European economies was accompanied by a revival of European nationalist self-assertion. It was resented that US citizens could buy into Europe and pay in dollars to do so. The immense benefits accruing to Europe from this were little considered. What we heard were the vigorous assertions of national pride which were in principle no different from those which now keep investment capital from many less

sophisticated developing countries, the folly of which the Europeans now join in deploring.

With the removal of the gold option, the countries in dollar surplus were greatly troubled by the question: what does a country do when capital movements produce more dollars than the central bank is willing to hold? Should it attempt to restrict the capital movements which brought this about? Should it let its parity rise to a point where the market will absorb or deter the unwanted dollars or should it on its own responsibility reluctantly and carrying the parity risk hold them without limit? For a time surplus countries alternated uneasily and resentfully between these choices. Gold worshippers to a man - some more noisily than others - they felt greatly frustrated by the closing of the gold option.

It was not only the surplus countries who chafed under the restraints and disciplines involved in maintaining a proclaimed but adjustable parity: countries not affected directly by the dollar glut saw in the situation the chance for them too to escape from these constraints in the belief that they would achieve greater freedom in formulating their own economic policies. They joined the surplus countries in seeking to break down the Bretton Woods arrangements. They all saw in this break down an ending of "the exorbitant privilege" which enabled the US to settle its payments deficits in its own currency. They all believed that the ending of the Bretton Woods arrangements would reduce the dominance of the dollar in

the world economy.

The US also became attracted to this attitude because they saw in the break down the opportunity of devaluing the dollar and thereby removing both their relatively small trading deficit and the formal obligation to deliver gold against dollars which embarrassingly they were no long able to fulfill. In short, all the great countries for different reasons were determined to replace a multilaterally agreed system for world currencies with a regression to unilateralist action in the mistaken belief that thereby they would not only painlessly solve their problems of trading balances but also the problems of capital movements.

The prospectus which sold an unmanaged floating rate was false at almost every relevant point. Unsurprisingly, its practice brutally disappointed the expectations of the world's leaders who accepted it. It has not removed trading inbalances, it has exaggerated them, especially those of the US. Above all, it has not produced parities which broadly reflect economic fundamentals but volatile parities grossly distorted up and down by capital movements.

In their regression to unilateralism none of these professing multilateralists were willing to see the problem of capital movements correctly. They were all agreed that it was neither feasible nor desirable to attempt to impose effective controls upon them. But they refused to see that in the new situation, the dollar in its role of world currency

had become a world responsibility. There had to be procedures agreed between the leading countries to discharge this responsibility - procedures which would ensure that benign and necessary capital movements could continue without disrupting parities. Instead of answering the problem our leaders sought to run away from it by moving to floating rates. In fact they had unwittingly decided to accept the chronically disrupted parities inevitable in the absence of some systematic multilateral management of the dollar in its world currency role.

In the period from 1974 to the end of 1978, the more or less continuous outflow of dollars on capital account was the underlying reason for the sustained weakness of the dollar. This weakness could have been avoided only by systematic central bank intervention, such as would have been provided if Bretton Woods had been brought up-to-date instead of being destroyed. But there was little comprehension of the true reasons for the dollar's decline and therefore little motivation to check it by multilateral action. Benign neglect became the order of the day, i.e. abdication of responsibility in the area of capital movements and their impact on parities. Such intellectual energy as our leaders were able to muster was devoted to mutual recrimination and sermonising with none left to see the problem straight or to tackle it. They were like car drivers involved in an accident, charging each other with careless driving when in truth the collision was caused because none of the cars involved possessed an effective braking system.

In late 1978 the US government in cooperation with other major countries was driven to mount the largest intervention package in history. Though only a fraction of this package was deployed, its announcement steadied the dollar. As the large speculative position began to be reversed, a breathing space was given to the dollar and in 1979 its value was more realistically maintained. So much for the parrot cry that intervention is always ineffective. With the new realism about the dollar, investment flows into the US started to grow: by 1981 they had reached $80 billion, and they continued thereafter at about the same level. These flows counterbalanced the outward dollar flows from the banks which continued apace until 1982.

The early 1980s saw the growth of anxieties about the wisdom the safety and desirability of some of the international financing which had earlier been undertaken. In particular, the banking crisis made its impact. The outflow of dollars from the banking system were sharply reduced. This, together with reduced US investment and profit taking from the closing and reversing of speculative bear positions, laid the foundation for the stronger dollar and put it on an upward trend.

It should here be noted that the nuge accumulated outflow from the earlier period had by this time mainly been converted into other currencies. But most of it still remained as obligations to US creditors denominated in dollars. Any recall by creditors would henceforth require debtors to

achieve repayment or service by converting their own currencies into dollars, a process which when it occurred would inevitably drive those currencies down and the dollar up.

Between 1982 and 1984 the inflow of foreign money into the dollar increased hardly at all. But the capital balance of the US in this period improved dramatically because of the sharp drop in US private lending overseas. According to the official figures, which are known to be incomplete and which understate the drop, bank lending fell from over 100 billion dollars in 1982 to virtually nothing in 1984, partly, but only partly, because of the debt crisis. This contrasts with a deterioration in the US current account of $90 billion.

It is this dramatic change in the US capital account which has been the lead factor in the sustained rise of the dollar parity. It has overwhelmed even the large increase in the supply of dollars caused by the astronomical increase in the US trade deficit. The upward trend, once established, in its turn attracted a speculative entourage which added further to the upward pressure on the dollar parity.

From all this we must now draw the following conclusions:

(1) Vast movements of dollar funds are an inevitable consequence of the dollar's role as world currency. Massive changes in the dollar banking system's posture are neither encouraged nor deterred by parity changes because the obligations to the banks are for the most part

continuously denominated in dollars. But changes in the US capital account trends, to which speculative movements and to a less volatile extent investment movements attach themselves, produce violent and unpredictable swings in parity levels. The dramatic turn around in bank money movements was triggered by the debt crisis but other factors played a part too. The mainspring, however, was sudden and belated realisation of the dangers in the overseas lending to which the banks had exposed themselves.

(2) In the absence of systematic and concerted intervention to balance these cyclical movements, the parity of the dollar in its relation to every major currency in the world will be deformed. It is cash on the table which talks in markets not rhetoric or analyses, especially as much of the latter is offered after the event.

(3) These movements will not be corrected by the action of speculators taking a long-term view.

The deformities of the dollar have already been damaging for economies throughout the world. They create major distortions in trade, investment flows, manufacturing patterns, in agricultural and commodity prices. As Paul Volcker rightly said in the first of these lectures in 1978 "When patterns of trade or capital become influenced by monetary fluctuations rather than lasting comparative advantage, the underlying rationale of a liberal trade and investment order is undercut. The instinctive political reaction in the face of seemingly capricious impacts on one industry or

another is to protect or subsidise domestic industry, or to impede the flow of capital."

The problem of capital movements the world's leaders have evaded for 20 years must now be squarely faced. What then are we to do? Professor McKinnon and others have suggested that the remedy would be to target US monetary policy on the exchange rate. Judgments on interest rates, etc. would have to be related not to the needs of the US domestic economy but to the need to repel or to attract foreign money. In my view such action cannot succeed in its objective but the major distortions which would result even from the attempt would cause further serious injury to the US and to the world economy.

Another course of action would be to seek to impose restrictions on the free movement of bank finance and investment capital. This is neither feasible nor desirable. Of course, a better regulatory system internationally for banks is quite another matter. This leaves the world's leaders with two choices. They can either accept the profoundly disruptive consequences of a dollar parity unrelated to relevant fundamentals or organise the concerted action required to broadly neutralise the impact of movements in banking money on parities. I here return to Paul Volcker's first lecture, "Money will not manage itself and certainly international money will not".

I accept that there is no immediate prospect other than to work

within the broad framework of the present floating arrangements. For the immediate future I would strongly support Paul Volcker's plea that there should be a firm understanding between the leading nations that they will strongly resist extremes of fluctuations by concerted intervention. I agree, too, with him that a sense that extreme fluctuations will be resisted and reversed could help to stabilise market expectations and thus reduce the risk of these fluctuations developing in the first place.

Though there is a case for greater harmonisation of the economic and financial policies of the leading countries, I do not believe that the kind of intervention for which I am calling should or can await further achievements in that direction. Indeed, greater currency stability is more a pre-condition of advance in this area, while harmonisation by itself will not eliminate the problem of capital movements. I am most definitely not calling for intervention to defend unrealistic parities. What I am calling for is intervention to counterbalance the mechanical deforming effect of those money movements which are not in themselves related to the fundamental economic factors which ought to govern parity but are produced by the normal functioning of the dollar as the world currency. Nor am I perfectionist in my approach. I would be satisfied to remedy the grosser distortions which arise from the patent defects in the present monetary arrangements. The concerted intervention that I am urging is the minimum necessary financial hygiene required for the functioning of the dollar as

the world currency.

The choice before us is not whether we have some other world currency but whether we have a better functioning of the dollar in that role. We must not allow the distant prospect of some other noble but purely notional goal to lose for us the more modest prizes offered by immediate reality. Most countries maintain an Exchange Equalisation Fund. What I am calling for is the systematic coordination of these Funds on the required scale to bring into being what in effect would be a world Exchange Equalisation Fund.

The Central Banks' operations should be based on the realities of today's money world and on a recognition of the dollar's unique role in it. This role was not an artificial construct of Bretton Woods or any formal procedures - it derived naturally from the strength stability and dynamism of the US economy and the unique size depth and openness of her money markets.

The central position of the US in the world economy and in the world's financial markets will mean that in the years ahead she will be a magnet for great quantities of world money and normally the world's biggest capital importer. But she will also be the world's biggest capital exporter thanks to the dynamism and world range of her entrepreneurs and bankers.

These two-way flows of capital - short-term, medium and long are a

desirable feature of the modern world economy - indeed they are necessary to its vigour and dynamics. But they will reflect and respond to events world-wide and to the rhythms and hazards of the world scene. These two-way flows will over a long period find a broadly desirable balance but not in the short or medium-run. There will be phases when they will be sharply out of balance. We have been in such a phase since 1981. Import of capital continues to be buoyant but export of capital has dried up, in large part, but by no means solely, due to the international banking crisis. These phases are an inevitable aspect of the US role in the world economy and especially of the functioning of the dollar as the world currency. If no counterbalancing action is available large capital surpluses and deficits will be created for the US and market action will automatically force the dollar up or down as the case may be. Large matching trading deficits or surpluses will result and because these derive not from the normal functionings of competitiveness and long-term comparative advantage but from monetary consequences of the fluctuations in the US capital account, they will be difficult to correct and will have capricious and disruptive impact on trade, capital direction employment and ultimately on political relationships.

The only way of avoiding these haphazard dislocations of the US and the world economy is by pursuing cooperative intervention in the exchange markets to balance the US capital account otherwise than solely by trade inbalances.

Bretton Woods broadly provided this kind of intervention but it was not adapted to world post-war recovery. Unlike Bretton Woods, the interventions I am advocating would allow parities to fluctuate, but within a range determined by market forces freed from dominance of an uncorrected capital inbalance. We will get a truer market sufficiently responding to fundamental economic factors not the false market of recent years reflecting mainly the phases of sharp disparity in inward and outward US capital flows.

Unlike Bretton Woods and most unilateral interventions the concerted Central Bank intervention would not be directed to maintaining an artificial or unrealistic parity but to creating the market conditions for a realistic one. There might at times be many billions involved in these interventions but any such sums would be trivial compared with the size of the world gross product which is being protected. This is now running at over 12 thousand billion dollars a year. They would be tiny even when compared with one year's normal growth in world gross product of around 400 billion dollars. And it is not only a year's growth that is being threatened by present currency instability.

Contrary to much misguided talk of "spending" billions on intervention or "pouring money down the drain" no money is spent, it is exchanged. If concerted intervention had begun in the early 1980s the Fed would now possess larger amounts of a range of currencies, while other central banks would own more dollars. We would have witnessed a productive re-arrangement

of the currency reserves of the Central Banks. That is why talk of an inflationary increase in the money supply is misguided too. No new money is created. When you sell dollars you acquire DM, yen and sterling. The effect on the global money supply is precisely zero. And it is time that Governments woke up to the fact that it is a global money supply with which we are dealing. When in the fraction of a second an electric impulse turns a yen or DM or pound into a dollar or vice-versa, calculations based on the amount of money held in a particular currency at a particular time are plainly absurd.

It will be argued that any cooperative intervention that is politically feasible could be and would be outweighed by market forces. The gross turnover of currency dealings should not dazzle or mislead us as to the size of the task that is involved in the currency correction system I am advocating. It is not the total buying or selling orders of the day that decides the parity, it is the balance between them. It is that margin of excess or shortfall in demand for the dollar at the existing parity which determines in which direction the parity will go. We are too little informed about the extent of that excess or shortfall at any given period nor is it easy to assess what margin produces what parity change. We can, however, be certain that the margin of excess or shortfall is a miniscule fraction of the total turnover, which overwhelmingly consists of self-balancing short term trading. Even the longer term movements have a substantial element of self-balance. In no period has it been beyond

the power of the central banks to cope. The ability to act is there but the willingness to act will only come when governments of the world achieve a correct understanding of the problem.

The options open are unmistakable. Governments must either permit their central banks to organise systematic intervention to balance the effect on parity of the movements of bank funds or they must allow these movements to continue to operate unchecked as the crucial determinant of dollar parity. The future path of the dollar has become unpredictable and also that of the US trading deficit which is affected by it. Equally the dollar parity will greatly affect the outcome of the world debt problem for which no coherent or convincing solution has yet been proposed. The dollar trading deficit must be corrected. This cannot be done without a correction of the dollar parity. Even with this, correction will be difficult and require a good deal of time. While it continues it distorts investment, production and employment in the US and promotes protectionist forces. Those countries whose export trade is temporarily benefitted by the deficit will find that the inevitable correction will result in serious future dislocation of the industrial structures their export boom is producing. A "soft landing" for the dollar parity is at best a hopeful outside chance. Without action on the lines I have advocated we run the most terrible risks of disruptive disorder in the dollar parity and thereby in the parities of every other major country's currency.

To sum up, the dollar's role as the world currency implies normal and desirable flows of bank finance which, under the present floating rate arrangements, must inevitably result in cycles of gross parity deformity. We must either find the means broadly to counterbalance the effect of these movements or we will continue to experience, at an accelerating pace and to an ever more dangerous degree, those trends that have already severely disrupted the progress of interdependent prosperity and which now threaten a major assault upon the central principles on which the successful post-war liberal trading experience was based.

5th June, 1985.

Hirsch Lecture — June 1985.

THE DOLLAR AND THE WORLD ECONOMY: THE CASE FOR CONCERTED MANAGEMENT

HAROLD LEVER (Lord Lever)

Conventional wisdom has been strained past breaking point in seeking to explain both the excessive weakness of the dollar in the mid-1970s and its excessive strength so far in the 1980s. In the 1970s there were loud criticisms from both Europe and the US that the dollar's weakness was due to misguided US government policies. It was repeatedly asserted that the dollar would cease being weak only if the US "put its house in order". Now, 7 or 8 years later, even more alarming policies are said to have produced the opposite situation - a dollar which is by common consent grossly overvalued. The paradox is that the US is now being told to do much the same thing as before, but this time in order to produce the opposite effect. Much of this advice, as is normal on these occasions, has a moralising overtone. In my view it is wise to defer the sermons until we have examined the actual market operations of the dollar more closely than is habitual.

In looking at recent history to discover the "mystery" of dollar movements, we must first highlight certain delusions which hold an undeserved sway, not only in the popular mind but also in what would normally be thought authoritative quarters, all over the world. These delusions are:

1) That the dollar's rise is an expression of the relative competence of countries and their governments. As the Japanese

yen has experienced deformities not very different from the other currencies it is difficult to see how this absurdity can be maintained.

2) That high US interest rates, whether resulting from the fiscal deficit or not, produced a surge of investment money from abroad between 1982 and 1984 which was responsible for the dollar's rise.

3) That speculators are responsible for the dollar's rise.

4) That the damage being caused by grossly misaligned exchange rates is unavoidable and that nothing can be done about it.

I will argue that the explanation for the dollar's movements is to be found in the supply/demand equation of dollars in the currency markets: that capital movements have become by far the dominant influence on the supply and demand for dollars: and that the movement of bank money is the most mobile aspect of capital movements. I will also argue that the movements in bank money arise from the normal and desirable functioning of the dollar as the world currency.

I will further argue that though the turnover in the currency markets is enormous, virtually all of it is self balancing froth. What matters is not the total dealings but the balance of supply and demand. I will argue that this balance would be manageable if we had concerted

intervention by central banks. Unfortunately, under our present unmanaged floating rate arrangements, it is capital movements and not fundamental economic factors which determine the parity of the dollar. I will point out that this leaves us with an unmistakable choice. We must either pursue co-operative action to provide some counterbalance to capital movements or accept the continued damage to the fundamental workings of the world economy.

Under floating exchange rates, the movement of the dollar parity at any given time will depend on the balance between the supply and demand of dollars at the existing parity. The main sources of supply and demand for dollars are:-

(i) the condition of the current account of the balance of payments,

(ii) movements of medium and long-term portfolio and investment funds,

(iii) speculative movements, and

(iv) banking movements.

When we examine the changes in these categories between the period of dollar weakness in the 1970s and its recent period of great strength, the most striking contrast is the extent to which the supply of dollars has been increased by the deterioration of the US current account balance. Yet instead of going down under the vast extra supply of dollars thus

created, the dollar has risen sharply. Clearly there must have been a sustained counterbalancing change elsewhere in the supply and demand equation for dollars even to maintain the previous parity level. Water does not run uphill even in currency markets. Something has tilted the supply/demand balance.

The first question must be: Has there been a great inflow of money converted from other currencies seeking to benefit from the high US interest rates? In markets, in which a year's interest can be lost in an adverse currency change of a few days, it is expectations of parity rather than interest rate differentials which dominate external currency movements. It is, therefore, on the face of it in the highest degree unlikely that any rise in the US interest rates, especially one associated with fiscal disorder, could prompt so great an inflow as to outweigh the growing trade deficit of the last two years. The existence of a surge in such investment funds has been asserted or assumed without proof in innumerable comments. In fact, the official figures show no major change in inward investment between 1982 and 1984. And, despite uncertainties in aspects of these figures, it can be safely asserted that there has been no change in foreign investment between 1982 and 1984 which could conceivably have outweighed the $100 billion increase in the current account deficit.

I now turn to speculative movements. They find expression in a

number of not readily identifiable ways. But, it is impossible to believe that they could autonomously be so perverse as to outweigh the adverse factors facing the dollar, including the sheer weight of dollars generated by the US trade deficit. Indeed why on earth should speculators have supposed that the dollar would go up when all expert comment suggested the contrary especially when, from the speculators point of view, the increased current account deficit was threatening the supply/ demand equation of dollars at its most vulnerable point? I must emphasise that I am not suggesting that speculation has not contributed to the dollar's deformities. Still less do I believe that speculative movements have helped to dampen the dollar's swings. The reverse is the case. Most speculators seek to win profits (or more commonly to avoid losses) by anticipating the continuation of a trend not its reversal. Far from fighting the dollar's downward trend in the late 1970s for example, speculators followed it and thereby added to the dollar's undervaluation. The same, in reverse, has happened in the 1980s. There is nothing exceptional in this behaviour. The only people who are surprised by it are those who accepted the academic case for floating rates in the 1960s and 1970s. This was based on seminar models which either ignored or assumed away the problems they would create. The key false assumption which was made was that any major deformity of a currency's parity caused, for example, by cyclical capital movements, would be corrected by the action of long-sighted speculators.

Outside the seminar it should have been obvious that anything resembling unmanaged floating rates would be dominated destructively and irrelevantly, by short-term and medium-term capital movements and by seasonal and cyclical trading and payments movements. Market traders and speculators behave in exactly the opposite way to the seminar assumptions. The reality of free money markets is that the overwhelming weight of speculative movement will (rightly from the trader's point of view) be concerned to follow an immediate trend not to oppose it. Nobody will sell the dollar on Monday in the opinion that it will be lower next year if he thinks he can sell at a higher price in the next hour, next day, next week or next month. Any experienced currency trader will tell you that speculators who take a long-term view usually end up in bankruptcy well before their "long-term view" has been proved true or false.

In my view, therefore, the recent strength of the dollar is partly to be explained by speculative transactions but these should be seen as 'piggy back' transactions, i.e. as riding on the back of other, more fundamental forces.

We must, therefore, consider banking movements. First, a little history. Before, during and after Bretton Woods, the role of the dollar in financing world trade increased. The American banking system, and linked to it the dollar operations of banks throughout the world, has taken on the lion's share of satisfying the world's needs for funds in

addition to the domestic needs of the US itself. So, in the years immediately following 1974, after the first oil shock, US banks with overseas banks who increasingly attached themselves to the dollar banking system poured out hundreds of billion of dollars in loans to finance the deficits of South American and other governments and to finance third party trade, i.e. trading transactions all over the world between countries other than the US itself. This lending seemed safe, profitable and was warmly encouraged by all the leading governments. By these means, the dollar performed its functions as the world currency. Without these vast credits the world recession after 1974 would have been calamitous. There were important errors by the governments and banks in the method of recycling the OPEC dollars, but there could be no doubt that the world economy was saved from great injury by the actions of the world banking system. It was a productive error.

This process injected enormous supplies of dollars into the market. Most of these dollars were subsequently changed for DMs, yen, Swiss francs and sterling, in the ordinary course of trade. They were, therefore, added to the existing overhang of dollars on the world market that stemmed from US overseas investment after the war. On this there had been a good deal of public comment - in fact, it helped to bring about the demise of the Bretton Woods system.

The world recovery in the 20 years after the war transformed the

dollar situation. The post war dollar shortage changed to an emerging glut. This was not caused by the trading surplus of the recovering countries but by the accumulation of dollars resulting from US overseas investment. The weight of this outflow made it inevitable that the ability of the US to deliver gold in exchange for foreign-held dollars, as provided by Bretton Woods, could not be maintained. By 1967 the gold option, though formally still extant, had in practice ceased to exist. The world then had for the first time to face head on the key question of capital movements for which Bretton Woods had given only a temporary and unclear answer.

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(2) In the absence of systematic and concerted intervention to balance these cyclical movements, the parity of the dollar in its relation to every major currency in the world will be deformed. It is cash on the table which talks in markets not rhetoric or analyses, especially as much of the latter is offered after the event.

(3) These movements will not be corrected by the action of speculators taking a long-term view.

The deformities of the dollar have already been damaging for economies throughout the world. They create major distortions in trade, investment flows, manufacturing patterns, in agricultural and commodity prices. As Paul Volcker rightly said in the first of these lectures in 1978 "When patterns of trade or capital become influenced by monetary fluctuations rather than lasting comparative advantage, the underlying rationale of a liberal trade and investment order is undercut. The instinctive political reaction in the face of seemingly capricious impacts on one industry or

another is to protect or subsidise domestic industry, or to impede the flow of capital."

The problem of capital movements the world's leaders have evaded for 20 years must now be squarely faced. What then are we to do? Professor McKinnon and others have suggested that the remedy would be to target US monetary policy on the exchange rate. Judgments on interest rates, etc. would have to be related not to the needs of the US domestic economy but to the need to repel or to attract foreign money. In my view such action cannot succeed in its objective but the major distortions which would result even from the attempt would cause further serious injury to the US and to the world economy.

Another course of action would be to seek to impose restrictions on the free movement of bank finance and investment capital. This is neither feasible nor desirable. Of course, a better regulatory system internationally for banks is quite another matter. This leaves the world's leaders with two choices. They can either accept the profoundly disruptive consequences of a dollar parity unrelated to relevant fundamentals or organise the concerted action required to broadly neutralise the impact of movements in banking money on parities. I here return to Paul Volcker's first lecture, "Money will not manage itself and certainly international money will not".

I accept that there is no immediate prospect other than to work

within the broad framework of the present floating arrangements. For the immediate future I would strongly support Paul Volcker's plea that there should be a firm understanding between the leading nations that they will strongly resist extremes of fluctuations by concerted intervention. I agree, too, with him that a sense that extreme fluctuations will be resisted and reversed could help to stabilise market expectations and thus reduce the risk of these fluctuations developing in the first place.

Though there is a case for greater harmonisation of the economic and financial policies of the leading countries, I do not believe that the kind of intervention for which I am calling should or can await further achievements in that direction. Indeed, greater currency stability is more a pre-condition of advance in this area, while harmonisation by itself will not eliminate the problem of capital movements. I am most definitely not calling for intervention to defend unrealistic parities. What I am calling for is intervention to counterbalance the mechanical deforming effect of those money movements which are not in themselves related to the fundamental economic factors which ought to govern parity but are produced by the normal functioning of the dollar as the world currency. Nor am I perfectionist in my approach. I would be satisfied to remedy the grosser distortions which arise from the patent defects in the present monetary arrangements. The concerted intervention that I am urging is the minimum necessary financial hygiene required for the functioning of the dollar as

the world currency.

The choice before us is not whether we have some other world currency but whether we have a better functioning of the dollar in that role. We must not allow the distant prospect of some other noble but purely notional goal to lose for us the more modest prizes offered by immediate reality. Most countries maintain an Exchange Equalisation Fund. What I am calling for is the systematic coordination of these Funds on the required scale to bring into being what in effect would be a world Exchange Equalisation Fund.

The Central Banks' operations should be based on the realities of today's money world and on a recognition of the dollar's unique role in it. This role was not an artificial construct of Bretton Woods or any formal procedures - it derived naturally from the strength stability and dynamism of the US economy and the unique size depth and openness of her money markets.

The central position of the US in the world economy and in the world's financial markets will mean that in the years ahead she will be a magnet for great quantities of world money and normally the world's biggest capital importer. But she will also be the world's biggest capital exporter thanks to the dynamism and world range of her entrepreneurs and bankers.

These two-way flows of capital - short-term, medium and long are a

desirable feature of the modern world economy - indeed they are necessary to its vigour and dynamics. But they will reflect and respond to events world-wide and to the rhythms and hazards of the world scene. These two-way flows will over a long period find a broadly desirable balance but not in the short or medium-run. There will be phases when they will be sharply out of balance. We have been in such a phase since 1981. Import of capital continues to be buoyant but export of capital has dried up, in large part, but by no means solely, due to the international banking crisis. These phases are an inevitable aspect of the US role in the world economy and especially of the functioning of the dollar as the world currency. If no counterbalancing action is available large capital surpluses and deficits will be created for the US and market action will automatically force the dollar up or down as the case may be. Large matching trading deficits or surpluses will result and because these derive not from the normal functionings of competitiveness and long-term comparative advantage but from monetary consequences of the fluctuations in the US capital account, they will be difficult to correct and will have capricious and disruptive impact on trade, capital direction employment and ultimately on political relationships.

The only way of avoiding these haphazard dislocations of the US and the world economy is by pursuing cooperative intervention in the exchange markets to balance the US capital account otherwise than solely by trade inbalances.

Bretton Woods broadly provided this kind of intervention but it was not adapted to world post-war recovery. Unlike Bretton Woods, the interventions I am advocating would allow parities to fluctuate, but within a range determined by market forces freed from dominance of an uncorrected capital inbalance. We will get a truer market sufficiently responding to fundamental economic factors not the false market of recent years reflecting mainly the phases of sharp disparity in inward and outward US capital flows.

Unlike Bretton Woods and most unilateral interventions the concerted Central Bank intervention would not be directed to maintaining an artificial or unrealistic parity but to creating the market conditions for a realistic one. There might at times be many billions involved in these interventions but any such sums would be trivial compared with the size of the world gross product which is being protected. This is now running at over 12 thousand billion dollars a year. They would be tiny even when compared with one year's normal growth in world gross product, ~~now~~ of around 400 billion dollars. And it is not only a year's growth that is being threatened by present currency instability.

Contrary to much misguided talk of "spending" billions on intervention or "pouring money down the drain" no money is spent, it is exchanged. If concerted intervention had begun in the early 1980s the Fed would now possess larger amounts of a range of currencies, while other central banks would own more dollars. We would have witnessed a productive re-arrangement

of the currency reserves of the Central Banks. That is why talk of an inflationary increase in the money supply is misguided too. No new money is created. When you sell dollars you acquire DM, yen and sterling. The effect on the global money supply is precisely zero. And it is time that Governments woke up to the fact that it is a global money supply with which we are dealing. When in the fraction of a second an electric impulse turns a yen or DM or pound into a dollar or vice-versa, calculations based on the amount of money held in a particular currency at a particular time are plainly absurd.

It will be argued that any cooperative intervention that is politically feasible could be and would be outweighed by market forces. The gross turnover of currency dealings should not dazzle or mislead us as to the size of the task that is involved in the currency correction system I am advocating. It is not the total buying or selling orders of the day that decides the parity, it is the balance between them. It is that margin of excess or shortfall in demand for the dollar at the existing parity which determines in which direction the parity will go. We are too little informed about the extent of that excess or shortfall at any given period nor is it easy to assess what margin produces what parity change. We can, however, be certain that the margin of excess or shortfall is a miniscule fraction of the total turnover, which overwhelmingly consists of self-balancing short term trading. Even the longer term movements have a substantial element of self-balance. In no period has it been beyond

the power of the central banks to cope. The ability to act is there but the willingness to act will only come when governments of the world achieve a correct understanding of the problem.

The options open are unmistakable. Governments must either permit their central banks to organise systematic intervention to balance the effect on parity of the movements of bank funds or they must allow these movements to continue to operate unchecked as the crucial determinant of dollar parity. The future path of the dollar has become unpredictable and also that of the US trading deficit which is affected by it. Equally the dollar parity will greatly affect the outcome of the world debt problem for which no coherent or convincing solution has yet been proposed. The dollar trading deficit must be corrected. This cannot be done without a correction of the dollar parity. Even with this, correction will be difficult and require a good deal of time. While it continues it distorts investment, production and employment in the US and promotes protectionist forces. Those countries whose export trade is temporarily benefitted by the deficit will find that the inevitable correction will result in serious future dislocation of the industrial structures their export boom is producing. A "soft landing" for the dollar parity is at best a hopeful outside chance. Without action on the lines I have advocated we run the most terrible risks of disruptive disorder in the dollar parity and thereby in the parities of every other major country's currency.

To sum up, the dollar's role as the world currency implies normal and desirable flows of bank finance which, under the present floating rate arrangements, must inevitably result in cycles of gross parity deformity. We must either find the means broadly to counterbalance the effect of these movements or we will continue to experience, at an accelerating pace and to an ever more dangerous degree, those trends that have already severely disrupted the progress of interdependent prosperity and which now threaten a major assault upon the central principles on which the successful post-war liberal trading experience was based.

5th June, 1985.

WILSON LETTER

Minister of Finance | Ministre des Finances

CANADA

Be put with pps. re Washington

CH/EXCHEQUER
REC. 17 SEP 1987
ACTION SIR G. LITTLER
COPIES TO EST
MR LAVELLE
MR H.P. EVANS
MR WALSH
AUG AOUT 26 1987

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C.

Dear Michel:

Thank you for your letter of July 30 requesting that Canada provide performance indicators in preparation for next month's G-7 multilateral surveillance exercise. International economic policy cooperation and coordination are essential if we are to successfully resolve the major imbalances within the world economy.

You have my full support in undertaking this initiative and in seeking economic indicators from all the G-7 participants. I am pleased to supply the information you have requested. As I have stated in the past, I attach particular importance to the role of the Fund in gathering and analyzing economic data from the G-7 participants and in advising ministers on the nature of the outlook during our periodic G-7 meetings. The Fund is uniquely placed to fulfill this function. Its independence and professionalism are beyond dispute. In addition, I believe the Fund can play a particularly important role in pointing out the implications of our discussions for other IMF member countries not individually represented at the table. I will be looking to you, at our September 25 meeting, to present candid views and recommendations.

Enclosed with this letter is a table providing projections for the main Canadian economic indicators, in a format similar to that used for last year's multilateral surveillance exercise. As well, attached is a summary table which provides additional detail that may be of interest. The projections are those which I presented to the Canadian Parliament on June 18, 1987 in conjunction with my tax reform package. Developments in the two months since then have been broadly consistent with these projections. As well, a brief note covering recent economic developments is attached. As additional information, I am enclosing a copy of the documentation on the forecasts that I tabled in Parliament in June.

.../2

Ottawa, Canada K1A 0G5

The projections in the main table have been done for the period through to 1990, as you requested. In the second table they have been extended for an additional three years to 1993. While multi-year forecasts are highly speculative and must be interpreted with caution, I believe it is important that international policy cooperation efforts be focussed on a medium-term framework. I am pleased that the Fund is taking this broader perspective.

To be fully successful, the multilateral surveillance effort requires an ongoing dialogue among the participants. This is essential if the underlying assumptions behind the indicators are to be understood and if the numbers are to be correctly interpreted. In this light, I would encourage you and your staff to discuss these indicators freely with my Department. We would be delighted to supply any additional information you may feel would be useful. I suggest that the Fund staff contact Mr. Scott Clark, Assistant Deputy Minister of Finance responsible for Fiscal Policy and Economic Analysis, in this regard. His telephone number is 613-992-3246.

Given their interest in these matters, I have sent a copy of this letter to other members of the G-7.

I look forward to our discussions in late September.

Yours sincerely,

Original Signed by
MICHAEL H. WILSON
a signé l'original

Michael H. Wilson

c.c.: Mr. James Baker
The Honourable Gerhard Stoltenberg
His Excellency Kiichi Miyazawa
The Right Honourable Nigel Lawson, M.P.
Monsieur Edouard Balladur
On. Antonio Gava

Date of Projection: Published in June 1987*

CANADA: ECONOMIC INDICATORS

(in per cent except where otherwise indicated)

	Averages or Year-on-Year Changes					End of Year Fourth Quarter or through the year changes		
	86	87	88	89	90	86Q4	87Q4	88Q4
1. Growth of demand and output								
In nominal terms: GDP	6.1	6.4	6.7	6.8	5.9	4.6	7.1	6.7
Total Domestic Demand	7.4	5.9	6.7	6.7	5.6	4.3	6.6	7.0
In real terms: GDP	3.1	2.8	3.0	3.3	2.8	3.0	3.3	4.0
Total Domestic Demand	3.5	2.0	2.8	3.4	2.6	-.01	3.0	3.1
2. Balance of payments ($ billions in national currency except if otherwise noted)								
Current account	-8.8	-7.6	-8.3	-8.2	-6.7	-9.1	-6.9	-9.0
Of which:								
Merchandise Exports (fob)	121	124	133	143	155	124	127	136
Merchandise Imports (fob)	110	111	118	127	137	113	113	122
Trade Balance	10	13	14	16	18	11	14	14
Volume of Merchandise Exports (change in per cent)	2.6	3.3	2.8	3.7	3.8	3.2	0.6	2.5
Volume of Merchandise Imports (change in per cent)	6.0	0.3	1.5	3.8	3.6	3.9	-2.9	4.1
Capital account, excluding reserve changes	9	16	11	8	7	6	10	7
3. Labour market indicators								
Unemployment rate	9.6	9.3	9.0	8.6	8.2	9.4	9.1	8.9
Growth of employment	2.9	2.3	2.1	2.3	2.3	1.8	2.8	1.9
4. Inflation rates								
GDP deflator	2.8	3.5	3.7	3.3	3.0	3.0	3.3	4.0
Consumer prices	4.1	3.9	3.8	3.0	2.9	4.3	3.6	3.8
Unit labour costs 1/	2.8	3.2	3.2	2.9	2.6	4.0	2.3	4.0
5. Monetary growth return: targeted or forecast aggregate (M1) 2/	4.9	11.0	7.0	6.2	6.1	5.4	9.2	7.0
6. Fiscal balance 3/								
Central (Federal) government								
In national currency ($ bills.)	-24.8	-25.7	-20.0	-22.6	-17.4	-26.5	-27.2	-23.0
In per cent of GDP	-4.9	-4.8	-3.5	-3.7	-2.7	-5.2	-5.0	-3.9
7. Change in level of gross reserves ($ Millions)	662	3950	-116	393	-247	-1203	-1	118

* Canadian Income and Expenditure Accounts data for 1986 have since been revised. The tables show the data available at the time the forecast was prepared.

	Averages or Year-on-Year Changes					Fourth Quarter or through the year changes		
	86	87	88	89	90	86Q4	87Q4	88Q4
8. Interest rates 4/								
Short-term 5/ -- nominal	9.2	7.8	7.6	7.7	7.3	8.4	7.8	7.6
-- real 6/	5.0	3.9	3.7	4.7	4.4	4.1	4.2	3.8
Long-term 7/ -- nominal	10.8	10.6	9.4	8.7	8.5	10.9	10.0	9.2
-- real 6/	6.7	6.7	5.6	5.7	5.6	6.6	6.4	5.4
9. Exchange rates 4/								
National currency per U.S. dollar nominal	1.389	1.341	1.344	1.340	1.341	1.385	1.342	1.344
Trade weighted or effective 8/ 9/ nominal	86.8	87.6	86.9	86.7	86.5	86.5	86.9	86.9
10. Savings and investment ratios (in per cent of GDP								
Savings 10/	10.9	10.7	10.2	10.7	10.5	10.6	11.0	10.4
Investment 10/	20.1	19.8	19.9	20.3	20.7	19.3	19.9	20.0
11. World Oil Price (WTI at Chicago - $U.S./bbl)	15.49	17.68	17.68	18.75	20.29	15.83	17.00	18.10

1/ Commercial sector
2/ There are no official targets for monetary aggregates
3/ Canadian Income and Expenditure Accounts
4/ Historical data and assumptions
5/ 90-day commerical paper rate
6/ Real rate equals nominal rate minus annual change in the CPI
7/ McLeod Young Weir bond rate
8/ Units per Canadian dollar, 1981=100
9/ 1977-81 Trade weights
10/ Savings = gross private savings = personal savings + undistributed corporate profits
Investment = government + private capital formation + inventory accumulation

JUNE 1987 FORECAST

	1986	1987	1988	1989	1990	1991	1992	1993
GROSS DOMESTIC EXPENDITURES								
VALUE	6.06	6.44	6.72	6.77	5.90	6.08	5.96	5.35
PRICE	2.84	3.54	3.66	3.33	2.98	3.09	3.10	2.79
VOLUME	3.14	2.79	2.95	3.32	2.84	2.90	2.77	2.49
EXPENDITURE DETAILS-VOLUMES								
CONSUMER EXPENDITURE	3.98	2.72	3.13	3.28	2.19	2.70	2.67	2.57
RESIDENTIAL CONSTRUCTION INV.	13.18	6.60	-3.93	4.34	1.77	1.00	0.92	1.98
NON-RESIDENTIAL CONSTRUCTION INV.	-7.65	-1.92	4.49	2.16	6.50	8.31	6.77	5.46
MACHINERY AND EQUIPMENT INV.	5.44	4.42	5.29	8.14	7.66	6.44	5.35	5.55
GOVERNMENT INV.	-4.52	0.68	-0.77	-1.29	0.10	0.75	0.17	0.62
GOVT. G AND S EXPENDITURES	0.54	1.81	1.04	1.16	1.22	1.50	1.31	1.52
FINAL DOMESTIC DEMAND	3.13	2.63	2.41	3.18	2.61	2.95	2.74	2.75
EXPORTS	3.13	2.94	2.50	3.62	3.92	3.63	3.23	2.42
IMPORTS	5.10	0.72	1.75	3.79	3.42	3.43	3.38	3.68
NET EXPORTS	-8.53	18.10	6.86	2.69	6.71	4.71	2.44	-4.45
FINAL DEMAND	2.59	3.27	2.62	3.16	2.81	3.04	2.72	2.38
INVENTORY CHANGE -$M	3817.00	1506.70	2901.37	3709.92	3959.34	3456.22	3780.04	4398.96
PRICE AND COSTS								
RAW MATERIALS	-12.70	-3.22	3.28	4.64	5.40	5.11	4.28	3.80
CONSUMER PRICE INDEX	4.17	3.93	3.84	2.97	2.89	3.00	3.00	2.62
TERMS OF TRADE	-3.36	-0.53	-0.69	0.30	0.32	0.64	0.66	1.03
HOURLY COMPENSATION	2.83	3.91	3.88	3.87	3.18	3.51	3.57	2.95
UNIT LABOUR COST.*	2.53	2.79	2.81	2.69	2.37	2.53	2.44	1.96
LABOUR MARKET								
LABOUR FORCE	1.82	1.93	1.78	1.85	1.82	1.70	1.55	1.52
PARTICIPATION RATE - %LEVEL	65.68	66.19	66.66	67.22	67.76	68.24	68.64	69.05
EMPLOYMENT	2.86	2.27	2.12	2.31	2.27	2.17	1.89	1.72
HOURS	-0.01	-0.59	-0.22	-0.16	-0.23	-0.23	-0.24	-0.21
PRODUCTIVITY	0.28	1.10	1.03	1.15	0.79	0.95	1.11	0.97
UNEMPLOYMENT RATE -%LEVEL	9.59	9.30	9.00	8.59	8.19	7.76	7.44	7.26
FINANCIAL MARKETS								
90-DAY COMMERCIAL PAPER RATE -%LEVEL	9.16	7.80	7.57	7.65	7.30	7.03	6.74	6.36
MYW BOND RATE -%LEVEL	10.82	10.60	9.41	8.71	8.50	8.39	8.31	8.19
TSE DIVIDEND-PRICE RATIO -%LEVEL	3.02	2.91	2.86	2.75	2.60	2.60	2.58	2.54
EXCHANGE RATE - $CDN / $US	1.389	1.341	1.344	1.340	1.341	1.336	1.321	1.298
MONEY SUPPLY - M1	4.87	10.99	7.01	6.19	6.07	6.27	6.30	5.65
OTHER INDICATORS								
TOTAL BALANCE - $M	-27336.	-26157.	-21414.	-24658.	-20148.	-16568.	-12615.	-10522.
FEDERAL BALANCE - $M	-24777.	-25715.	-20029.	-22616.	-17368.	-13409.	-8998.	-6985.
P-L-H BALANCE - $M	-5662.	-2799.	-3216.	-3500.	-3819.	-3654.	-3408.	-2801.
PERSONAL INCOME	6.92	6.16	5.99	6.22	5.39	5.74	5.89	5.04
REAL PERSONAL DISPOSABLE INCOME	1.28	1.59	1.90	3.82	1.69	2.18	2.34	2.12
CORPORATE PROFITS BEFORE TAXES	-4.91	10.17	16.56	10.03	10.01	6.88	8.05	6.36
HOUSING STARTS - THOUSANDS	198.25	209.13	191.71	195.95	195.86	191.30	189.50	187.51
PERSONAL SAVINGS RATE -%LEVEL	11.28	10.47	9.52	10.01	9.60	9.19	8.92	8.55
CURRENT ACCOUNT BALANCE - $M	-8806.	-7590.	-8304.	-8195.	-6733.	-4578.	-2120.	-1842.

* Economy-wide measure

Recent Economic Developments in Canada

Issue

Although growth slowed in the second half, the Canadian economy still grew at a 3.3 per cent rate in 1986, the highest growth rate of the seven major OECD nations. In the first half of 1987 the Canadian economy performed very strongly in terms of both output and employment expansion. Real GDP grew at an annual rate of 6.3 per cent in the first quarter, stronger than was forecast in the June 1987 White Paper and much stronger than virtually all private sector forecasters were expecting. Final domestic demand grew at a 6.1 per cent rate, with strong increases in consumer spending, residential construction and business non-residential investment. More recent monthly data and the revised Private and Public Investment Intentions survey indicate that these components are continuing to grow strongly. Available monthly real GDP data suggest that growth in production in the second quarter was almost as strong as recorded in the first quarter.

Highlights

- The increase in consumer spending in the first quarter was led by a strong increase in automobile purchases, although services also increased significantly. While the growth of disposable income in the first quarter was weaker than forecast, and the consumption increase was financed by a sharp decline in the personal savings rate, this does not indicate any fundamental weakness in the household sector. The slowdown in disposable income growth in the first quarter was exaggerated by the fall in farm income connected with a temporary decline in payments from the Western Grain Stabilization Fund. Employment growth increased in the second quarter. Thus labour income, the largest component of personal income, should increase strongly.

° The financial position of the household sector appears quite secure. Measures of financial strength, such as the ratio of net financial wealth to disposable income, are at high levels by recent standards and are rising. The confidence engendered by the declining rate of unemployment is contributing to a willingness by households to spend. This mood of optimism is evident in survey measures of consumer confidence.

° Monthly data show that the strong spending behaviour carried over into the second quarter. Auto sales, for example, exceeded the level reached in the first quarter. The strength in housing continues to foster gains in sales of furniture, appliances and other housing-related goods.

° Housing construction has picked up in recent months, hitting a level of 262 thousand starts (annual rate) in July after 254 thousand in the second quarter and 200 thousand in all of 1986. Housing has benefitted from the lower interest rates in the last year. Although rates have moved up from the March trough, they remain far below the rates experienced in the first quarter of 1986.

° Business non-residential investment is also exhibiting strength. Spending has rebounded strongly from the weakness in mid-1986. In the first quarter of 1987, investment was up 14.7 per cent at an annual rate, with machinery and equipment spending up 22.1 per cent. Evidence indicates that the remainder of the year will see continued gains in investment. Profits have registered four consecutive large quarterly gains, albeit from depressed levels in 1986. Capacity utilization rates have increased since the middle of 1986. The Statistics Canada mid-year Public and

Private Investment survey points to an increase of 8 - 9 per cent in real business spending in 1987, with the increases widespread across regions and industries.

° Inventory accumulation has slowed considerably in recent quarters compared to the first half of 1986. Inventory stocks are generally quite lean at present which should mean continued production gains in the coming months.

° The current account balance improved from a deficit of $11.7 billion at an annual rate in the fourth quarter of 1986 to $8.9 billion in the first quarter of 1987. The improvement reflected a gain in real net exports as well as an improvement in the terms of trade.

° Employment growth increased to a 3.3 per cent annual pace in the first seven months of 1987, and has been widespread both in terms of industry and region. The unemployment rate has dropped from 9.6 per cent at the beginning of 1987 to 8.9 per cent in June, the lowest rate since February 1982, before rising slightly to 9.1 per cent in July.

° Perhaps the most disappointing aspect of recent economic performance has been inflation. The 12-month increase in the CPI was 4.7 per cent in July, with energy prices registering large increases in recent months.

° With the higher inflation in recent months, interest rates have also drifted upward. The 90-day commercial paper rate for example currently stands at approximately 9 per cent as opposed to 7 3/4 per cent on average in the first half of 1987.

SECRET 1. Together 2. prep.

From: Sir Geoffrey Littler
Date: September 28, 1987

MR. ALLEN

cc: Governor
Mr. A. Loehnis
Sir P. Middleton
Sir T. Burns
Mr. D. Peretz
Mr. H. Evans
Mr. C.W. Kelly

MEETINGS OF G5 AND G7

I attach fairly detailed records of the two meetings at Ministerial level held in Washington on Saturday 26 September, together with the communique eventually issued from the G7.

2. Following various bilateral contacts among Ministers, as well as the meeting of Deputies the night before, it was tacitly agreed that no new cooperative action or measures should be announced, but the Louvre agreement should simply be declared to continue. There was therefore no discussion in detail of intervention arrangements, or of other modalities of cooperation.

3. On the main issue of the Louvre agreement, the meeting was in fact very harmonious throughout.

Geoffrey Littler

Attachments

SECRET

NOTE FOR THE RECORD

MEETING OF GROUP OF FIVE

A meeting of the Group of Five was held in the United States Treasury on Saturday, 26 September from 9.50am until just after mid-day. Those present were the customary trio (Finance Minister, Central Bank Governor, Senior Official) from each country, plus two interpreters (one for the French Minister and one for the Japanese Governor).

Exchange Rates

2. Baker (United States), opening the meeting as Chairman, said that he wanted the Louvre Agreement to continue. Comparing exchange rates now with what they had been at the time of the last G5 meeting in April, there had been very little change, and the variations in between the two dates had been within an acceptable range. This was a pretty good record of stability, although he noted that it had been achieved only with some large-scale intervention and some tightening of US interest rates - measures on which it would be difficult to rely in facing any future pressure. He must warn that, if the United States faced a choice between exchange rate stability and economic growth, they would choose to keep steady growth and avoid recession. He was not satisfied that all countries had done all that was necessary in their own policies. Publicly, he would like at this stage a general recommitment to the Louvre Agreement. Privately, he felt that all colleagues should reflect seriously on what additional action they could take and be ready, not later than the beginning of the new year, to declare and implement policy measures.

3. On the United States position, he claimed good progress in meeting undertakings given in the Louvre Agreement. The extent of the reduction of the fiscal deficit in the current year had been much greater than originally hoped: in April he had himself spoken of a reduction from $220 billion to $180 billion - it now seemed likely that the result would be $155 billion. This was the largest reduction of a deficit in a single year, in terms of proportion of GDP, to be found in the experience of any major country in recent years. He acknowledged that he had benefitted from a once-for-all boost of revenue as a result of capital gains tax reforms, but said this had made only a modest contribution.

4. As far as the coming year was concerned, the proposed revision of Gramm-Rudman - which he very much hoped the President would now endorse - would point to a deficit in fiscal 88 of around $150 - $155 billion, maintaining momentum and giving a further reduction in the deficit as a proportion of GDP.

5. The economy was growing reasonably well. At the beginning of the year he had forecast a rise in the rate of inflation to 5 per cent, following the exceptional low figure of just over 1 per cent last year. Latest estimates suggested that they would stay safely within 5 per cent. Two months from now they would pass the record for the longest ever peace-time expansion of the economy.

6. The resistance by the Administration to protectionist pressure in Congress and elsewhere was continuing. The President had exercised his veto on proposed measures in the textile field. The Omnibus Trade Bill now under consideration was going through an enormously complicated committee procedure in Congress. The Administration were trying to secure improvements: some elements of the present proposals were in themselves very welcome. But at the end of the day, he thought the balance of the Bill would be unacceptable and there would be a good chance of the President exercising and sustaining his veto again.

7. Miyazawa (Japan) said that, consistently with undertakings in the Louvre Agreement, Japan had announced on 29 May some income tax reductions and massive increases in expenditure; the supplementary budget had been passed on 24 July for immediate implementation, and the tax changes on 19 September would result in $11 billion equivalent of tax cuts in the current year and a further $5 billion of cuts in local taxes next year, as well as the elimination of tax concessions on smaller savings.

8. The sharp appreciation of the yen in 1986 had slowed down total growth, with a 4 per cent rise in domestic demand being offset by a 1.6 per cent fall in external demand. Currently the economy seemed to be rebounding, with domestic demand remaining buoyant: retail sales were up more than 5 per cent on one year ago and new housing starts were over 20 per cent higher. Corporate profits were rising again, particularly during the most recent quarter.

9. The structure of the Japanese economy was changing, away from dependence on exports and towards satisfaction of higher domestic demand, with substantial relocation overseas by some Japanese manufacturers. There could already be seen a sharp reduction in the Japanese trade surplus in dollar terms and he was expecting this to continue.

10. Looking ahead on the fiscal front, he expected continuation of a stance which would encourage a high level of domestic demand. It appeared - although the exposition was confused - that future budgets might aim to start from the basis of the current year total of main and supplementary budgets, instead of going back each time to the main budget. He claimed to have achieved a useful commitment to future expenditure in the "infrastructure fund", explaining that the government could expect to receive over the next three years some 14 trillion yen from sales of NTT shares: 9 trillion yen would go towards reduction of the outstanding national debt, but 5 trillion would go to the new fund for expenditure.

11. On the money market, the Bank of Japan had been resisting some pressure from the market to react to what they saw as an excessive previous fall in rates. Overall he hoped that Japan could now resume non-inflationary growth and reduce its external imbalances, but he felt that continued exchange rate stability was an important condition for this, and he therefore strongly endorsed the continuation of the Louvre Agreement.

12. Baker asked whether the Japanese budget for 1988 would be as good as that for 1987 and Miyazawa assured him that it would, since it would carry forward expansionary measures of expenditure and tax cuts. There was then a series of complicated exchanges as Sumita (Governor of the Bank of Japan) was questioned about Japanese interest rates and policy towards them. What appeared to emerge was that stories of a recent rise of one half per cent in Japanese interest rates were incorrect. There had been no movement in official rates and only a very small increase in some market rates. On the other hand the Bank of Japan had given very strong guidance to deter what they saw as excessive lending for property which had contributed to a rapid rise in land prices. On the direct challenge by Larosiere and others that quantitative control would surely tend to tighten the market and raise interest rates, it appeared that the Japanese authorities expected their market to be more obedient, particularly because there had been widespread public criticism of property speculators. Sumita appeared to give an assurance that the authorities would seek to avoid any increase in interest rates (his interventions were peculiarly difficult throughout: his Japanese interpreter seemed to have only modest command of both the subject and the English language! - in marked contrast to the French interpreter).

13. Before concluding the discussion on Japan, Baker took the opportunity of suggesting that a favourable impact on land prices could be helped if local rice fields ceased to be protected. The Chancellor, paying tribute to the measures taken by the Japanese authorities and to the resilience of Japanese industry, said that he had shared the concern of others over press reports of increases in Japanese interest rates. What had just been said was a very helpful clarification. He hoped that this clarification could be given wider publicity.

14. On the UK economy, the Chancellor said that growth was currently at a faster rate than in any of the other countries represented at this meeting. He thought the outturn for 1987 compared with 1986 could well be a 4 per cent real increase. This was in spite of a decline in activity in the oil sector and, incidentally, in spite of the United Kingdom having the highest interest rates of any country represented here. Healthy growth should continue, although he could not expect the present high pace to last through 1988. The inflation rate was likely to be in the 4 - 5 per cent range over the coming year, but he hoped it would come down thereafter. The target for the PSBR this year was 1 per cent of GDP after allowing for asset sales. In fact it was likely to turn out well below that level. A current account deficit for the current year of around one half per cent of GDP could readily be financed.

15. He strongly supported the continuation of the Louvre Agreement, which should be reaffirmed in clear terms. It had been far more successful than markets, press, and even some participants had expected at the outset.

16. One remark by Baker had caused him some concern: the reference to choice between exchange rate stability and economic growth. He thought this was dangerous talk. There was no sign of the United States plunging into recession. If there was a danger, it was rather that inflation in the US might rise a little more than was comfortable. He very much hoped that Japan and Germany would not raise interest rates, but it was surely wrong to rule out any further rise in US interest rates if the need was demonstrated in the event. If we were serious about maintaining the Louvre Agreement, the operation of monetary policies must be consistent with that Agreement.

17. Baker commented that he did not disagree with what the Chancellor had said, but measures taken and results achieved in the United States had been bigger than those of other countries since our last meeting. If other countries took unilateral decisions on interest rates or other matters they could not expect the United States to take it calmly. Greenspan added that he felt that the interest rate structure in the US was a potential threat to the vigour of the economy, which meant that there was not a great deal of room for increases in rates without doing damage. He was disappointed that the differential between the US and Japan in long-term rates had narrowed by as much as 100 basis points in recent weeks.

18. Stoltenberg (Germany) said that his assessment of the Louvre Agreement was entirely positive. It should be reaffirmed with a strong public message.

19. As far as Germany was concerned, a major process of adjustment to the new exchange rate structure was still taking place, and this largely explained the period of weakness in growth in Germany, to some extent shared in other parts of Europe. Without the exchange rate stability since the Louvre Agreement, this could have been very much worse. However, after the setback around the turn of the year, some recovery was now being seen and he expected this to gain strength as we moved into 1988. He was satisfied that correction of trade balances was taking place in real terms and beginning to be seen in nominal terms.

20. On German commitments under the Louvre Agreement, he noted that increased tax reductions for 1988 had now been legislated, in spite of some domestic argument. He was moving towards decisions on changes thereafter. Overall, the cumulative scale of tax reduction would be very large, amounting to nearly 2.5 per cent of GNP, and that would exhaust room for manoeuvre on the fiscal front. In passing, he noted that the budget deficit was currently increasing, from 2.5 per cent in 1986 to 3 per cent or more in the current year, largely as a reflection of the period of slower growth.

21. He thought it might be useful to review policies some time early in 1988. It would certainly be his hope to continue the Louvre Agreement. Without exchange rate stability, he frankly could not see a coherent strategy to maintain growth. It would be right in a few months to discuss again possibilities of action and the various factors affecting future prospects. But the burden of maintaining growth could not rest simply on fiscal policy.

22. In brief exchanges mainly between Baker, Stoltenberg and the Chancellor, there was a general sense that a further meeting early in 1988 could be helpful but that it was important to give no hint of such a meeting now.

23. Balladur (France) said that he had secured a substantial reduction of the budget deficit, down to 2 per cent of GDP. Inflation was down to only a little over 3 per cent this year, and he hoped 2 per cent next year. The rate of growth was inadequate, but he saw no room for fostering an increase through fiscal relaxation. Investment seemed to be picking up and indeed on OECD figures France would have the highest investment rate among OECD countries for the 3-year period 1986-1988. A massive program of privatisation was going well: 140 billion francs by the end of this year and another 40 billion francs early in 1988. The proceeds were effectively being used to pay off debt.

24. He was very pleased with the success of the Louvre Agreement, although not satisfied that all the commitments made in it had yet been fully carried out. On the problem of conflict between economic growth and exchange rate stability, he shared the Chancellor's worries, because he believed that instability in exchange rates itself undermined growth prospects.

25. He liked the idea of a meeting early in 1988, to be kept secret now, and suggested we might plan now two or three particular subjects to be considered. His own suggestions would be: interest rate policies and the possibility of avoiding increases; new engagements to promote stronger growth; increased cooperation among central banks, perhaps reactivating swap facilities. The Chancellor partly agreed: he thought there might also be something on intervention and its visibility which was important; but he counselled against seeking stability of interest rates, in the sense suggested by Balladur, because one might positively need changes to help maintain stable exchange rates. However, he did think it was possible and would be desirable to attempt an assessment of the overall level of interest rates among the major countries, to determine whether there was a case for the general level to rise or not. The value of this could, for example, be that if the judgement were that no general rise of rates should take place, that would imply that any attempt to widen differentials should involve symmetrical movement. Balladur commented that he was certainly not seeking rigidity of interest rates, but in his view real rates were too high and should not in general be allowed to rise further.

26. Poehl (Bundesbank) cautioned that there were real market pressures tending to edge interest rates up, and in the last resort it was wrong to fight such pressures. Any public statement about holding interest rates steady could have a bad effect on markets. Balladur repeated that we could never achieve satisfactory growth rates with the present high level of real interest rates. What we therefore had to do was to convince markets that we would fight inflation and, on the back of better expectations, seek to get interest rates down.

27. The Chancellor said that we must be vigilant over any risk of renewed inflation, but needed to keep that in perspective. The rise in inflation rates during the present year had been fully foreseen and had a perfectly good explanation in the year following the exceptionally low rates recorded in 1986.

28. Greenspan pointed to the unusual phenomenon that there really was no evidence of accelerating inflation in the major countries, and yet interest rates were reflecting growing market pessimism on future inflation. The fact was that markets were expecting events for which there was absolutely no evidence. It was probably a case of delayed understanding. He very much agreed with the analysis the Chancellor had made: we must try to communicate a better understanding and hope that the markets would soon catch up with the real prospects.

29. Larosiere, agreeing with the remarks just made, thought that one troublesome element was the continuing market suspicion and uncertainty over the future dollar exchange rate. It would be helpful in this respect to show that we were serious in reaffirming the Louvre Agreement. He also suggested that, when markets were tending to move long-term rates up as had happened recently, it was necessary for the authorities to be very careful not to validate market anxieties by allowing short-term rates to rise.

30. In brief concluding exchanges on this part of the agenda, it was agreed that the idea of a meeting early in 1988 would not be canvessed in the wider G7 meeting. As far as others were concerned, let there be an assumption that the next meeting would in the normal way be next April.

Debt Questions

31. At about 11.40am Baker introduced a brief discussion of debt strategy, mainly in relation to middle-income debtors. Everybody agreed that the case-by-case strategy must continue, resting on the broad principles which had been followed hitherto. It was in particular agreed that adjustment of economic and financial policies by debtor countries remained crucial and that standards of conditionality should not be allowed to slip.

32. As regards debts to commercial banks, there was general support for the "menu" approach in the context of voluntary negotiations between commercial banks and debtor governments.

33. Miyazawa wondered whether there could be a role for some international agency to help ease marginal banks out of their involvement and thus simplify negotiations. Challenged by Baker as to who would pay, he said that he was simply thinking of an agency such as the IFC which could assist with information and coordination, and did not have in mind any official financing.

34. Baker referred briefly to his own talks with the Brazilian Finance Minister and the current position of Brazil. Trichet (France) confirmed the conditions recently agreed by the Paris Club. There followed some suggestions, particularly from Baker, that commercial banks should be pursuaded to defer any agreement with Brazil in respect of 1988 maturities until an IMF agreement had been reached. There was some sympathy with the idea that such a move by commercial banks could add to the pressure on Brazil to reach such an agreement, although the point was also made that what the banks would be asked to do by Brazil was no more than re-financing interest payments immediately due. However, the Chancellor insisted that, just as governments should not incur moral hazard by persuading banks to lend, so they should also not fall into the trap of persuading them not to lend. The decision was one for judgement by the commercial banks themselves. This proposition was widely accepted.

35. Finally, on Argentina, Baker reported that notwithstanding the shift of power in recent elections, his belief was that Argentina would not try for an outright confrontation, but would try to maintain relations with the IMF and negotiate for the best terms possible.

Envoi

36. As the meeting broke up shortly after mid-day, Baker announced that President Reagan had just agreed to sign the legislation which effectively sets a new Gramm-Rudman target and this was unanimously welcomed as an important and helpful contribution towards reassuring markets.

Geoffrey Littler
27 September, 1987

SECRET

NOTE FOR THE RECORD

MEETING OF GROUP OF SEVEN

A meeting of the Group of Seven was held in the United States Treasury on Saturday 26 September, beginning with an informal lunch without collective discussion and then running at the meeting-table from about 1.45pm until 4.30pm. Those present were the customary trio (Finance Minister, Central Bank Governor, Senior Official) from each country, plus two interpreters (one for the French Minister and one for the Japanese Governor). The Canadian senior official was Stanley Hartt, not Dr. Wendy Dobson who acts normally as Deputy. The IMF Managing Director, Michel Camdessus, attended for the first part of the meeting only.

Surveillance

2. Camdessus was invited to open the discussion. He said he would not go in detail through the paper and figures he had circulated, but would simply highlight some of the achievements on the one hand and the uncertainties and problems on the other, which struck him as being important.

3. Under the heading of achievements, he pointed first to the scissors effect of the changing relationships between domestic demand growth and growth in total GNP, which were now shifting in the right directions. The reduction in the US fiscal deficit this year was turning out much larger than had been generally expected. There had been important advances in structural policies, including Canadian liberalisation of financial markets, French privatisation, French and Italian reductions of exchange controls.

4. Particularly important were the remarkable results achieved in foreign exchange markets, in terms of the degree of stability which had been maintained since the spring. There had indeed been a cost in intervention, and also in the need to adjust interest rates, but the management of the market had been conducted very well. In passing he wanted to convey the appreciation which had been expressed at the Executive Board by the whole IMF membership.

5. Under uncertainties and problems he began with the three main external imbalances which remained at an unsustainably high level. Even after allowing for J-curve effects, he doubted whether enough had been done. Prospects for the US fiscal deficit were still worrying (Baker interposed the news that the President had just signed the Debt Ceiling Bill, which Camdessus had not known and warmly welcomed). Activity in Germany and Japan was not strong enough to help with the scale of changes needed in the US external imbalance. The burden of adjustment could not be left to the US alone, and indeed needed cooperation and adjustment by many surplus countries.

6. He noted that there had been some slightly better figures from Germany recently, but he could not yet be confident, especially given the tendency in recent years for Germany to suffer a sluggish first half of each calendar year. The substantial measures taken by Japan seemed to be having effect, but it would be extremely important that the effects carry through and grow into 1988.

7. There were renewed worries in the markets about inflation, particularly in the United States and Japan. We must not risk loose monetary policies, but overriding importance should be given to keeping exchange rate stability.

8. He then suggested that there might usefully be discussion of the particular questions posed in his circulated paper.

9. Focussing on questions about the US, Baker said that, in signing the new legislation, the President was acutely conscious that he was putting himself at risk of having to cut the defence budget more than he wanted or accept tax increases. The determination of the US to preserve the momentum of deficit reduction should be clear. He thought it was also clear that they remained firm in resisting protectionism. On monetary policies, he agreed that we must not through imprudence lose important ground which had been gained, but he saw no evidence to justify the fears of renewed inflation to which the Managing Director had referred.

10. Miyazawa spoke of the Japanese intention to keep up the momentum of domestic demand in the coming years. He said there had been a change in attitudes in the new era since the Louvre agreement. Sumita spoke of the importance of maintaining price stability, but appeared to endorse a suggestion from the Managing Director that, while interest rates could perhaps not be reduced, it would be wrong to raise them.

11. The Chancellor took up the question on structural policies. He noted that the UK had during the last eight years introduced three pieces of legislation successively improving labour markets, mainly by giving the unions back to their members; and further measures were in preparation. The United Kingdom had taken a lead in pressing for agricultural reform - he only wished he could find more support from Germany and other colleagues present. And the UK record on privatisation was outstanding.

12. He did not share the apparent worries of the Managing Director about immediate inflationary pressures, especially as regards Japan. Inflation rates in Japan were consistently very low. Asset prices had indeed shown remarkable increases, but that was a rather special problem and not a major threat to price stability in general.

13. On interest rates, he noted that the UK had the second highest short-term rates of those around the table. This reflected the determination of the authorities to keep firm pressure against inflation. Interest rates must be handled flexibly if they were to be used - as they should be - both to help support exchange rate stability and to combat inflation. He thought the group should look at the general level of interest rates across the countries represented in the group as a whole. On that basis, his judgement would be that there was no need for a rise in the general level: world inflation was higher this year than last, but for special reasons, and looking at other potential warning signs, such as unit labour costs or commodity prices, he really saw no evidence of a significant resurgence of inflation in prospect. This being the case, it seemed to him that changes in interest rates within the group should be broadly symmetrical. Where there were market worries based on false expectations of renewed inflation, the authorities should try to educate and shape market sentiment.

14. He also picked up the reference by the Managing Director to the unsustainability of present levels of current account imbalances. He said that the argument must not be taken too far. There was no chance of the United States and Japan eliminating their imbalances in three or four years, as the Managing Director had said, but this was not necessarily a problem. The position of Japan as a major net saver in the world implied a current account surplus, and he recalled the history of the United Kingdom position a hundred years ago.

15. Finally, he drew attention to the interesting lag in reactions of volume and value of trade in Germany and Japan after the Plaza agreement and, he thought, in the United States in rather slower time. Greenspan endorsed this comment. He said that one reason for the slow reaction in the United States trade position since early 1985 was that huge profit margins had been built into trade at the currency levels then prevailing, so that the first phase of exchange rate correction did not significantly affect trade volumes. Effects were now being seen, and following what the Chancellor had said he would look for changes in nominal dollar values around the turn of this year.

16. Stoltenberg said that a key factor in the temporary slow-down of growth in Germany had been the impact of the exchange rate adjustment - which was still continuing. Against this background, the Louvre agreement had been of vital importance. He spoke of difficulties facing Germany, with a rising public sector deficit at the present time, troublesome moves by trade unions to reduce working time, and the continuing problems of adjustment to the higher value of the currency. He argued that the marginal changes in figures in Germany did not constitute a serious recession, that recent experience had been more promising, and that he was determined to pursue his programme of tax reductions.

17. Wilson said that Canada was pursuing a strategy of reducing the overall fiscal deficit, although he had problems in the inability to control provincial deficits. He aimed at a deficit of no more than 2½ per cent of GNP by 1990. Privatisation was continuing, along with further liberalisation of markets, and a substantial programme of reduction of subsidies. Such subsidies as remained - and there were strong political pressures to keep them - were in several areas of regional development and in relation to some grains and oil seeds. The process of change would inevitably slow down as the next elections approached, but the direction would remain consistent (Camdessus asked whether the strength of Canadian growth currently did not give opportunity for a renewed attack on the deficit: Wilson answered that it might do so in an academic sense, but not in the real world of politics).

18. He shared some of the concern of Camdessus over current account imbalances stretching out into the future. We could not carry too far the reliance on "unnatural" measures such as interventions and interest rate movements, and in any case recourse to high interest rates was damaging to the world economy.

19. Amato observed that Italy was emerging from a period of several months of a caretaker government, which had allowed some problems to fester. Domestic demand growth had risen rather faster than was prudent. The recovery of oil prices had not helped. When an effective government was restored in August, there were pressures which had to be resisted. Initial measures had been taken to reduce domestic demand - widely criticised as being too late, although he thought that a mere 15 days after the installation of the government was not too bad a record.

20. For 1988 he foresaw a continuation of higher growth than the IMF were forecasting, but basically with the same shading off during the year. Inflation should remain under control, but a bit above what had previously been expected - perhaps 4.8 per cent in 1987 and 4.5 per cent by the end of 1988.

21. The public sector deficit would probably remain at the same nominal amount (109000 billion lira) in 1988 as in 1987, but representing a fall in proportion of GDP from 11.2 per cent to 10.4 per cent. Interest payments on borrowing were a very heavy burden. He had in mind a kind of Italian Gramm-Rudman with the objective of reducing the deficit by 1991 to zero, excluding interest payments. He mentioned in passing that he had been able to use a popular switch from direct to indirect taxation in order to raise revenue.

22. The Italian government was pursuing liberalisation. He thought that an important psychological switch had been achieved. Whereas formerly people were able to do only what was specifically permitted, they were moving towards being able to do everything except what was specifically forbidden (although many people said that still too much was forbidden!).

23. He closed with a brief reference to agriculture and the community budget, saying that there was a growing realisation in the community that the existing system was unbearable, and that survival of the community as an effective institution required change.

24. Balladur outlined French policies over the two-year period between the last legislative elections and the forthcoming presidential elections. He had reduced the budget deficit by cutting expenditure by some 110 billion francs, using only 70 billion francs for tax reduction, partly to reduce personal taxes and partly to lower VAT towards what was likely to be an ultimate community scale. Over the next three years he would pursue a similar strategy, aiming for further 90 billion franc reduction in expenditure, half of which would be used to reduce the deficit and the other half to secure other reductions in VAT.

25. The record on inflation was very successful, with a total increase of only 8 per cent over the three-year period 1986-1988 - which put France third in the league after the two champions (Japan and Germany).

26. Progress was being made in reducing labour rigidities, although much remained to be done, particularly on the social security and local government budgets. Subsidies were being produced as a means of cutting expenditure. He agreed that something needed to be done in agriculture, but insisted that it must be comprehensive and take into account the fact that a common market in agriculture remained a primary goal of community policy.

27. He believed interest rates were too high - partly as a result of lack of conviction in markets about the inflation prospects, partly because of world increases, especially in the United States. He welcomed the assurances Sumita had given about Japanese interest rates.

28. Baker concluded this part of the discussion by suggesting that the process of surveillance could be very helpful if we persisted in improving it, while recognising the political difficulties. He hoped that all would cooperate, and that those who were slow or deficient in providing numbers would come into line. He expected Deputies to report progress by early 1988. At this point, Baker thanked Camdessus, who left the meeting.

World Bank: General Capital Increase

29. Baker confirmed that the US position was now that a GCI was appropriate, that negotiations should be concluded speedily, that they should not be disrupted by quarrels over shares. He would need to consult Congress before settling the US position, in respect of the total amount of the increase (for which he thought the staff proposals of $40 - 80 billion were the right ball-park) and the paid-up proportion.

IMF Structural Adjustment Facility

30. Baker said that this was a useful idea for recycling surpluses, but the United States could not contribute to everything which was proposed while continuing to cut its public sector deficit.

31. Stoltenberg said that Germany had a positive reaction to the proposal, although he felt that doubling rather than tripling should be the aim. They had not yet settled how their contribution could be made. Subsidies in particular presented difficulties. But they looked forward to continuing discussion. He thought that, as regards the sharing of burdens, the criterion of surplus or deficit was irrelevant. If it was not the case that all members would participate, then the arrangements would have to be voluntary, and that could be difficult to settle quickly.

32. Balladur noted that France was not a surplus country, but was nevertheless ready to accept a tripling of the facility and, in the sense of doing its duty, to offer a substantial contribution, as he had already publicly indicated. He recalled that the group had received a mandate from the Venice Summit to settle this matter by the end of the year. It was important to give a sense of direction at the present meetings.

33. The Chancellor noted that the United Kingdom was not a surplus country either. He recalled that there had been two proposals on which the Venice Summit had sought progress by the end of the year - the tripling of the Structural Adjustment Facility and his own proposals for the very poorest and heavily indebted countries, mainly in Sub-Saharan Africa. He thought that the Managing Director shared his own view that these two proposals should be seen in parallel. There was no question that the countries we were discussing here could return to creditworthiness on commercial markets within any foreseeable future. Indeed they would not be able to service their bilateral debts, so that creditors would sooner or later face a budget burden anyway. Creditors should take on that burden now and take the opportunity of linking a concession on interest rates with proper adjustment policies.

34. As regards the structural adjustment facility, he expressed a positive United Kingdom reaction, saying that the UK would certainly pay a fair share of grant for subsidy and could be ready to contribute capital in principle, although there were problems about the modalities of this. He awaited more precise proposals from the Managing Director.

35. Baker again made it clear that the United States would not be prepared to contribute at this stage, and added that it would be extremely counter-productive if pressure for a contribution were added to the lists of demands on Congress before the end of the year. Miyazawa said that Japan would happily join in, if the framework were satisfactory. He suggested that, given the large scale of the proposed expansion, sales of IMF gold should be considered as a means of financing, say, half the proposed expansion.

36. Wilson noted that none of the countries present had surpluses on domestic budgets, but one way or another support must be given to these poorest countries. Canada would do its share. Use of the proposed facility could be a valuable way of avoiding the necessity of rescheduling World Bank lending. (Baker quickly made a plea against what he saw as yet another initiative at this juncture).

37. Amato said that Italy was in much the same position as France in offering support in principle, but they preferred to wait for clarification of detailed proposals before giving specific answers on an Italian contribution. Baker accepted that all creditor countries should make an effort - including the United States but it was important not to let surplus countries off the hook. They had huge amounts of funds to recycle. If France was offering $500 million, how much would and should Japan offer?

38. After some desultory exchanges, it was agreed that the Managing Director should be encouraged to develop his proposals in further detail.

IMF Quotas

39. With no discussion it was quickly agreed that there was no urgency in pursuing the increase in IMF quotas. On the other hand, enlarged access should continue without any change. (No word was mentioned by United States or others about possible token reductions in cumulative limits, etc.).

Communique

40. Baker then tabled the communique which had been prepared by Deputies the previous evening. The Chancellor offered the suggestion of a much shorter communique, the text of which was also circulated, but after a pause for reading a consensus emerged in favour of the longer version. The meeting then considered the communique paragraph by paragraph, making a few amendments, and reaching unanimous agreement.

41. The agreed text of the communique, as published, is attached.

Geoffrey Littler
28 September, 1987

G-7 POLICY LINKS MAY PROVE TOO WEAK TO LAST CHANCELLOR NRMV 12/2

BY PETER TORDAY

WASHINGTON, SEPT 16 - A PLAN TO FORGE CLOSER LINKS BETWEEN THE ECONOMIC POLICIES OF TOP INDUSTRIAL NATIONS MAY BE IN DANGER OF STALLING ALMOST BEFORE IT GETS UNDERWAY.

BUT THE VERY FACT IT IS TAKING PLACE, ACCORDING TO U.S. TREASURY SECRETARY JAMES BAKER, REPRESENTS A GENUINE IMPROVEMENT OVER INTERNATIONAL COOPERATION IN THE PAST.

THE INTERNATIONAL MONETARY FUND SAID IN ITS ANNUAL REPORT ON WEDNESDAY THAT IT WILL PLAY A KEY ROLE IN THE PLAN.

16-SEP-2210 SEC622 MONM

CONTINUED ON - NRMW

P

G-7 POLICY =2 WASHINGTON NRMW

THE SCHEME CALLS FOR NATIONS TO ATTEMPT TO ENSURE THAT THEIR ECONOMIES, MEASURED BY MAJOR INDICATORS OF ECONOMIC PERFORMANCE, TO LIVE UP TO EXPECTATIONS.

BUT STATEMENTS BY WASHINGTON, TOKYO AND BONN SUGGEST THEY ARE LIKELY TO IGNORE THE IMF'S ADVICE AND MAY DIFFER SHARPLY OVER POLICIES AT HIGH-LEVEL TALKS NEXT WEEK.

THE IMF SAID THE HUGE TRADE IMBALANCES BETWEEN THE U.S. AND WEST GERMANY AND JAPAN WAS STILL AN ISSUE OF SERIOUS CONCERN. IT URGED STIMULUS BY BONN AND TOKYO AND BUDGET DEFICIT CUTS BY WASHINGTON TO HEAD OFF CURRENCY INSTABILITY, PROTECTIONISM, INFLATION AND TO FOSTER BALANCED WORLD GROWTH.

16-SEP-2214 SEC627 MONM

CONTINUED FROM - NRMV

CONTINUED ON - NRNX

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G-7 POLICY =3 WASHINGTON NRNX

SUCH A POLICY PRESCRIPTION HAS ALREADY BEEN AGREED TO BY THE THREE NATIONS. BUT JAPAN SAYS IT HAS DONE ENOUGH, WEST GERMANY MAINTAINS IT IS DOING ALL IT CAN AND WASHINGTON INSISTS IT HAS ACHIEVED MAJOR DEFICIT REDUCTION THIS YEAR, AND STILL THE U.S. TRADE DEFICIT RUNS AT RECORD LEVELS.

AS A RESULT, SOME U.S. OFFICIALS WONDER PRIVATELY IF THE LOUVRE AGREEMENT TO MAINTAIN A STABLE DOLLAR CAN SURVIVE THESE CONTRADICTIONS.

NONETHELESS, BAKER SAID THIS WEEK "WE ARE A HECK OF A LOT BETTER OFF TODAY THAN WE WERE A YEAR AND A HALF AGO, WHEN - I CAN PROMISE YOU - WE DIDN'T HAVE MEANINGFUL MEETINGS."

16-SEP-2242 SEC659 MONN

CONTINUED FROM - NRMW

CONTINUED ON - NRNY

P

G-7 POLICY =4 WASHINGTON NRNY

"WE HAD A LITTLE 'TOUR DE TABLE' EVERYBODY RECITED WHAT THEIR ECONOMIES' PROSPECTS WERE, BUT THERE WASN'T ANY SERIOUS DISCUSSION OF EFFORTS AT COORDINATION," HE SAID.

MONETARY OFFICIALS SAY THE IMF IS DUE TO PRESENT DETAILED FORECASTS OF ECONOMIC INDICATORS AND ANALYSIS OF THE ECONOMIES OF THE SEVEN LEADING INDUSTRIAL NATIONS -- THE U.S., JAPAN, WEST GERMANY, BRITAIN, FRANCE, ITALY AND CANADA -- AT A MEETING OF THEIR FINANCE MINISTERS HERE LATE NEXT WEEK.

INDICATORS ARE EXPECTED TO INCLUDE GROWTH, TRADE BALANCES, INFLATION, EXCHANGE RATES AND MONETARY CONDITIONS.

BUT AS THE IMF SAYS "ONE SHOULD NOT EXPECT TOO MUCH FROM

16-SEP-2243 SEC661 MONN

CONTINUED FROM - NRNX

CONTINUED ON - NRNZ

P

NRNZ

THE DEVELOPMENT OF INDICATORS."

G-7 POLICY =5 WASHINGTON NRAA

IT ADDS "NOR SHOULD MOVEMENTS IN INDICATORS BE EXPECTED EXPECTED TO TRIGGER AUTOMATIC ACTION."

A U.S. OFFICIAL, WHO ASKED NOT TO BE NAMED, ADMITTED THE PLAN HAD FEW TEETH. THE G-7 "HAVE NOT COMMITTED THEMSELVES TO VERY MUCH, EXCEPT TO GO THROUGH A PROCESS. IT'S ANOTHER OBSERVATION OF WHETHER PERFORMANCE MEASURES UP TO EXPECTATIONS," THE OFFICIAL SAID.

BAKER SUGGESTED STRONGLY THIS WEEK, HOWEVER, THAT THE NEW G-7 PLAN WOULD BE USED TO OBTAIN COMMITMENTS FROM BONN TO SPEED UP ITS ECONOMIC GROWTH.

16-SEP-2245 SEC663 MONN
CONTINUED FROM - NRNZ
CONTINUED ON - NRAB
P

G-7 POLICY =6 WASHINGTON NRAB

BAKER SAID: "WE DID HAVE ASSURANCES FROM THE FEDERAL REPUBLIC OF GERMANY AT AN OECD MEETING IN PARIS IN APRIL THAT IF THEIR GROWTH DID NOT MEASURE UP TO EXPECTATIONS THEY WOULD BE PLEASED TO LOOK AT ADDITIONAL MEASURES AND PROSPECTS." HE ADDED THE PROCESS "DID PICK UP THE DECLINE IN GERMAN GROWTH".

WESTERN MONETARY OFFICIALS HAVE ALSO SAID SEVERAL OTHER NATIONS, WITH THE EXCEPTION OF JAPAN, WERE TAKING UP THE U.S. CASE.

WEST GERMAN OFFICIALS, REACTING TO BAKER'S REMARKS, WARNED AGAINST ATTACHING TOO MUCH IMPORTANCE TO THE INDICATOR PLAN.

16-SEP-2247 SEC666 MONN
CONTINUED FROM - NRAA
CONTINUED ON - NRAD
P

G-7 POLICY =7 WASHINGTON NRAD

THE IMF FORECASTS ONLY 1.5 PCT GERMAN GROWTH THIS YEAR, A FIGURE UNDERSCORING THE U.S. ARGUMENT NOT ENOUGH IS BEING DONE TO CUT BONN'S TRADE SURPLUS WITH MORE DOMESTIC DEMAND.

JAPAN, WHICH THE IMF PREDICTS WILL GROW 3.2 PCT THIS YEAR AND 3.4 PCT IN 1988 DOES NOT WANT TO DRAW ATTENTION TO ITSELF.

IT ARGUES IT HAS ALREADY DONE ENOUGH TO BOLSTER DOMESTIC DEMAND, AND HENCE MAKE ITS GROWTH LESS DEPENDENT ON MASSIVE WAVES OF EXPORTS.

BOTH GERMAN AND JAPANESE OFFICIALS HAVE DRAWN ATTENTION TO THE FACT THAT THE U.S. ADMINISTRATION HAS NOT BEEN ABLE TO STRIKE A BUDGET DEFICIT AGREEMENT WITH CONGRESS.

16-SEP-2249 SEC669 MONN
CONTINUED FROM - NRAB
CONTINUED ON - NRAE
P

G-7 POLICY =8 WASHINGTON NRAE

EVEN THOUGH THE U.S. REAPED A WINDFALL BUDGET SAVING OF ABOUT 60 BILLION DLRS THIS YEAR DUE TO TAX REFORM, NO MEASURES ARE IN PLACE TO ENSURE THAT THE TREND WILL CONTINUE. THUS A PROCESS ORIGINALLY CONCEIVED BY FORMER FEDERAL RESERVE BOARD CHAIRMAN PAUL VOLCKER IN THE EARLY 1970S, AND REJECTED THEN, MAY HAVE TO STRUGGLE TO SURVIVE TODAY. VOLCKER, THEN A SENIOR TREASURY OFFICIAL, PROPOSED THE PLAN IN ORDER TO HELP REFORM THE CURRENCY SYSTEM. WHEN AT THE FED, VOLCKER SUGGESTED A SIMILAR IDEA TO BAKER, WHO IS ALSO CONCERNED ABOUT WILD EXCHANGE RATE SWINGS. "IN THE LONG RUN, WE MUST LOOK FOR WAYS TO ADD DISCIPLINE TO THE EXCHANGE RATE SYSTEM," BAKER SAID.

16-SEP-2251 SEC671 MONN
CONTINUED FROM - NRAD
REUTER
P

SECRET

From: Sir G.Littler
Date: 15 September 1987

MR ALEX ALLAN

G5

I mentioned to the Chancellor over the weekend the idea that the IMF Managing Director might next week be invited only to the G7 for the "surveillance" discussion, and not to the G5. When I rang Mulford last night, I found he was still hesitating over this. In the light of the Chancellor's reaction I urged him to keep Camdessus (and indeed "surveillance") away from the G5 and I think with this encouragement Mulford and Baker will now do so.

(Geoffrey Littler)

PUP

FROM: HUW EVANS
DATE: 7 SEPTEMBER 1987

SIR GEOFFREY LITTLER

cc PS/Chancellor
PS/Economic Secretary
PS/Sir P Middleton
PS/Sir T Burns
Mr Lavelle
Mr Peretz
Mr Matthews
Mr Walsh
Mr Batt
Mr Savage

HMT RESPONSIBILITY FOR G5/7/10

This minute clarifies the responsibility within the Treasury for briefing for the meetings of various groups of Ministers and their Deputies:

G5 and G7: Mr Matthews IF2, together with MG on exchange rate agreements such as the Louvre accord.

G10: Mr Walsh IF1, in consultation with IF2.

2. The reason for this division of responsibilities is that G5 and G7 discussions tend to centre on exchange rates, economic developments, and economic policy co-ordination; whereas (substantive) G10 discussions involve issues such as the GAB, more closely related to the responsibilities of IF1 for international financial institutions.

HPE

H P EVANS

MESSAGE REFERENCE: 11797 FROM TELEX1 AT D/30
RECEIVED 3-SEP-87 0:47:04. PRINTED 3-SEP-87 0:51:16

PMP

263907 ODMLDN G

FCO Monetary Distribution Please

9FID FY95 1-1 1DT80 30 09/02/87 20:46

UIN

US TREAS WSH
MSG WM822
FM DEPT OF TRSY WASHDC
TO IAN BUIST
UNDER SECREATARY
OVERSEAS DEVELOMENT ADMINISTRATION
LONDON
SUBJECT: MEETING OF THE G-6 DEPUTIES

14

THERE IS AGREEMENT AMONG US FOR A MEETING OF THE G-6 DEPUTIES DURING THE TIME OF THE 1987 BANK/FUND ANNUAL MEETING. THERE IS NO CONSENSUS YET ON WHETHER THE DATE OF THE MEETING SHOULD BE SEPTEMBER 25TH OR 30TH. THE BRITISH HAVE A STRONG PREFERENCE FOR MEETING ON SEPTEMBER 25TH. MY OWN PREFERENCE IS FOR THIS DATE AS WELL. I THEREFORE, RECOMMEND THAT WE HOLD OUR MEETING ON THURSDAY SEPTEMBER 25TH AT 2:00P.M. AT THE U.S. TREASURY.

SEVERAL DEPUTIES HAVE MADE ADDITIONS TO THE AGENDA I PROPOSED. OUR REVISED AGENDA, WHICH INCLUDES ALL ADDITIONS, IS AS FOLLOWS:

1. DEVELEPMENT COMMITTEE AND WORLD BANK ANNUAL MEETING.
2. CAPITAL STRUCTURE OF THE WORLD BANK.
3. STATUS OF AFDF NEGOTIATIONS.
4. STATUS OF IDB NEGOTIATIONS.
5. MANDATE AND MEMBERSHIP OF THE TASK FORCE TO STUDY THE ASIAN DEVELOPMENT BANK'S ROLE IN THE 90'S= AND REQUESTS FOR SCI'S.
6. STATUS OF IFAD NEGOTIATIONS ON THE FUTURE FINANCIAL BASIS OF THE INSTITUTION.

SINCERELY,
JAMES W. CONROW
DEPUTY ASSISTANT SECRETARY
(DEVELOPING NATIONS)

11/6693/WM
WNNN
263907 ODMLDN

INTERNAL/OTHER ORGANISATIONS/GOVERNMENT DEPTS

7

MONETARY

~~SENMAN~~ ..... Distribution Mr. J. CAINES E/9
Mr. Rolt IFID E423
Mr. Corby .. E429 Mr J. FAINT,
.. Crabtree .. E427 UK DEL IBRD/IMF
.. Bond .. E431 WASHINGTON
Miss V. LIPE, ~~Treasury~~, ~~Parliament St.~~
Mr. R. WARE, ~~Bank of England~~, ~~Threadneedle St.~~

Mr J Richardson
ESD FCO

4 SEP 87 15: 42

GERMAN MINISTRY SAYS NO SPECIAL G-5 MEETING NRCU

BONN, SEPT 3 - THE GROUP OF FIVE LEADING INDUSTRIAL NATIONS HAVE NOT TAKEN A DECISION TO CHANGE THE LOUVRE CURRENCY STABILIZATION ACCORD, A SPOKESMAN FOR THE WEST GERMAN FINANCE MINISTRY TOLD REUTERS IN ANSWER TO ENQUIRES.

HE ADDED THERE WAS NO SPECIAL G-5 MEETING PLANNED IN THE NEAR FUTURE.

"I CAN FLATLY DENY THAT THERE HAS BEEN A CHANGE IN THE LOUVRE ACCORD OR THAT THE G-5 PLANS TO HOLD A SPECIAL MEETING THIS WEEKEND OR SOON," HE SAID.

03-SEP-1657 MON438 MONO

MORE

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REUTER MONITOR 1359

DOLLAR EASES ON RUMORS OF G-5 MEETING NRCG

NEW YORK, SEPT 3 - THE DOLLAR EASED TO THE LOWS OF THE DAY ON VAGUE MARKET RUMORS THAT REPRESENTATIVES OF THE GROUP OF FIVE NATIONS WOULD MEET THIS WEEKEND TO FORGE AN AGREEMENT TO LOWER THE DOLLAR'S TARGET RANGE, DEALERS SAID.

OFFICIALS WERE NOT IMMEDIATELY AVAILABLE TO COMMENT ON THE RUMORS. DEALERS SAID THE RUMORS MAY HAVE SPREAD BECAUSE SEVERAL TOP POLICYMAKERS WILL BE ATTENDING A REGULAR MEETING OF THE BANK FOR INTERNATIONAL SETTLEMENTS IN BASLE, SWITZERLAND, ON MONDAY. THE DOLLAR HIT A LOW OF 1.7900 MARKS AND 140.75 YEN THIS MORNING, AGAINST YESTERDAY'S CLOSE AT 1.7960/70 AND 140.90/00. IT WAS LAST QUOTED AT 1.7910/17 MARKS AND 140.80/90

03-SEP-1630 SEC257 MONN

CONTINUED ON - NRCH

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REUTER MONITOR 1359

RA7.96

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

1 October 1987

David Norgrove Esq
10 Downing Street
LONDON
SW1

Dear David

SPEECHES IN WASHINGTON

... I attach a copy of the Chancellor's speech to the Annual
... Meetings in Washington yesterday. I also attach a copy of Secretary Baker's speech, which set out his - similar - ideas
... on the development of the Louvre accord. Finally, I attach a copy of the short but punchy speech by Mr Douglas, the New Zealand Finance Minister.

Yours
Alex

A C S ALLAN
Principal Private Secretary

CH's SPEECH TO ANNUAL MEETINGS

BOARDS OF GOVERNORS • 1987 ANNUAL MEETINGS • WASHINGTON, D.C.

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

Press Release No. 44

September 30, 1987

J

HOLD FOR RELEASE
UNTIL DELIVERY

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

I welcome the progress that we have made at these meetings on a number of issues of great importance. We have reaffirmed the Louvre agreement. There is now full support for an early and substantial general capital increase for the World Bank. And there is increasing recognition that within the general debt strategy, special action is required to help the very poorest and most heavily indebted countries, particularly in sub-Saharan Africa.

At the meetings of the Interim and Development Committees this April, I put forward a three-point proposal for assisting these countries, provided they pursue appropriate adjustment policies: the conversion of aid loans into outright grants; longer repayment and grace periods on Paris Club reschedulings; and reductions in the rates of interest on those reschedulings.

The Managing Director of the International Monetary Fund and the President of the World Bank have put forward complementary proposals for helping the poorest countries by concessional interest rates, including a substantial increase in the size of the Fund's structural adjustment facility (SAF). I support these proposals, and believe that heavy indebtedness should be a major factor in determining the allocation of funds under any enlargement of the SAF.

It is of the first importance that we make a real effort to reach agreement on all these proposals at the earliest possible date.

The U.K. Economy

I now turn to the experience of my own country during the past year. Since the sharp fall in the oil price in 1986, the growth rate of the U.K. economy, so far from slowing down as was expected, has actually picked up. At the same time, the growth rate for the major industrial

countries as a whole has been below expectations. At first sight, this seems paradoxical. The industrial countries in aggregate were significant beneficiaries from lower oil prices, whereas the United Kingdom, as a major oil producer and exporter, stood to lose significantly.

What has happened is that the U.K. economy has adjusted more smoothly to the fall in oil prices than many thought possible. The latest Fund forecast puts U.K. growth at 3.4 percent this year--the fastest growth of all the major industrial countries. And U.K. manufacturing productivity, currently rising at about 6 percent, has continued to exceed expectations, thus containing the growth of unit labor costs.

The United Kingdom's strong growth performance has not been brought about by any fiscal stimulus. The public sector borrowing requirement has in fact been reduced to less than 1 percent of GDP. We have been able to bring down tax rates by maintaining a declining path for public expenditure as a proportion of GDP. Nor has there been any relaxation of monetary policy. Interest rates have been held at levels necessary to maintain sound anti-inflationary conditions. In short, it is the enterprise economy that has done the trick. One consequence of this improved performance has been a significant drop in unemployment, which has fallen by 400,000 over the last 14 months.

The strong growth of U.K. output and demand has caused some to suggest that the U.K. economy is in danger of overheating, while others are forecasting a slowdown. Some manage to combine both predictions. But while, as in most countries, inflation is a bit higher than last year when the impact of falling oil prices was greatest, there has been no significant change in underlying inflationary pressure.

The United Kingdom is now well into its seventh year of steady growth at 3 percent a year. During that period there have been minor fluctuations, and after the slight spurt this year, I would expect something closer to the 3 percent average rate next year.

The Background to the Louvre

I now turn to the evolution of exchange rate policy.

For the first 25 years after World War II, exchange rate stability was achieved through the Bretton Woods system. This formed a cornerstone of the postwar economic order, not least as a force for financial discipline. But it began to break down in the late 1960s, and by the early 1970s it had collapsed altogether. Thereafter, with countries pursuing divergent economic policies, and many suffering from high and volatile inflation, a system of floating exchange rates was virtually inescapable. Indeed, many at the time believed this new flexibility to be desirable.

With hindsight, some of the arguments for free floating seem much less compelling. And the belief that markets would provide a stabilizing influence, through the operations of medium-term speculators, has not been borne out.

In particular, we have seen wild gyrations in the dollar that have clearly not been a reflection of economic fundamentals, which are essentially slow moving. Few could seriously argue that two deutsche mark to the dollar was "correct" in 1979, and again at the end of 1986, and yet that three deutsche mark to the dollar was "correct" in 1985. Moreover, these gyrations have damaged growth in world trade. Businesses have had to divert scarce management time and skills to coping with currency fluctuations, rather than improving company performance. And the major uncertainties about exchange rate movements inhibited risk taking and required a switching of resources at a pace that was wholly unrealistic.

The explanation for these gyrations in the dollar derives in large part from the nature of the foreign exchange markets. We now have global 24-hour markets in which turnover has increased dramatically, with only a small part of that related to commercial transactions. This presents particularly acute problems for the dollar, which still dominates the world's money markets. In 1986, on the London foreign exchange market, 97 percent of all transactions were in dollars.

Of course, all financial markets have a certain amount of speculative froth. But to function well they need some players to take a longer view, and so provide a stabilizing influence. In foreign exchange markets, they have been conspicuous by their absence.

This means that once the dollar starts to move in one direction, it can continue in the same direction for months and even years, even if there is a general consensus that the rate is out of line. This is what happened in 1984 and early 1985. Almost everybody agreed that the dollar was overvalued, and that, in the long run, it was bound to fall. But they continued to buy dollars in the belief that, in the short run, it would move even higher--which is, of course, what consequently occurred.

The result is that trends have been greatly magnified. Capital movements have generated fluctuations in the dollar; but equally, fluctuations in the dollar have themselves generated further capital movements. This is how exchange rates have often acquired a momentum of their own, which has not been reversed until they have reached extreme levels of over- or undervaluation.

Background to Plaza

It was a growing concern about this process that led to a small group of us to meet in the Plaza Hotel in September 1985. We shared three perceptions:

- first, that the gyrations in exchange rates had proved damaging;
- second, that the immediate problem was that the dollar was much too high; and
- third, that the time was right for the authorities of the major countries to give the markets a clear lead.

The Plaza agreement marked an important step toward a more managed system. In private, we discussed the scale of fall we saw as desirable, and although no figures were given in public, everyone was aware that we were looking for substantial changes. We agreed to cooperate to bring that about. And that agreement played an important role in securing a continuing fall in the dollar over the succeeding 15 months.

The Louvre

The Louvre accord earlier this year marked another important step forward--Plaza II, as I called it at the time to emphasize the continuity. By then the broad objectives agreed at Plaza had been achieved. The yen and the deutsche mark had appreciated by as much as 50 percent or so against the dollar.

We agreed that, given the policies being followed, the dollar was by then broadly in line with economic fundamentals and that the interests of the world economy would best be served by a period of stability, to allow time for the major economies to adjust to the exchange rate changes that had occurred. We were not, of course, thinking in terms of rigid exchange rates, but we did discuss the scale of fluctuation, around the then current levels, which we would not wish to see exceeded. Figures were agreed in private, but not, of course, revealed in public.

In spite of widespread skepticism when it was first concluded seven months ago, the agreement has proved a success.

Managed Floating

The move to managed floating has been made possible by two fundamental changes:

- First, we have at last returned to a world of low inflation. The average inflation rate for the major seven economies has fallen from 12 percent in 1980 to about 3 percent today. In the process, inflation differentials have been narrowed considerably.

- Second, there is now a clear consensus among the major countries about the approach to economic policy. And we all agree on the need for a greater reliance on market mechanisms within the framework of a firm monetary and fiscal policy.

We have been able to make this regime work because:

- We have chosen the right time to give a lead to the markets. In this sense we have been working with, rather than against, the grain of the markets.

- We have been prepared to commit ourselves publicly to appropriate and consistent domestic policies.

- In particular, we have all been prepared in practice to give significant weight to exchange rates in the conduct of monetary policy.

- We have been prepared to back up our agreement with coordinated intervention, sometimes on a substantial scale.

- We have deliberately not revealed details of our arrangements. And we have worked within margins of a size sufficient to allow us the necessary tactical room for maneuver.

A Regime for the Future

I believe that we can and should use the experience we have gained to build a more permanent regime of managed floating. I do not see the past two years simply as a temporary phase. Our objectives should be clear: to maintain the maximum stability of key exchange rates, and to manage any changes that may be necessary in an orderly way.

Let me make it clear that I am not suggesting that we can or should return to Bretton Woods. That system was undermined by its rigidity; the margins were too narrow; it required a predictable and mechanical response from the authorities that made them an easy target; necessary realignments were postponed too long, and consequently, when they came, they were inevitably large.

For the future, it is important, therefore, that we continue to keep an adequate degree of flexibility in terms of the width of the bands within which currencies are able to fluctuate. And, if and when the time comes to adjust one of the rates, that adjustment should be made by moving the midpoint within the confines of the existing range. This means that the markets are not given a one way bet, and the authorities retain tactical flexibility.

As I have already emphasized, what made the Plaza and Louvre agreements possible was that the countries participating were, and remain, in effect, members of an anti-inflationary club, with a clear

commitment to taking whatever steps are necessary to curb their own inflation. It is vital that that commitment continues, individually and collectively. A resurgence of inflation in any individual country would make it difficult for that country to remain within the club.

At the same time, we must also ensure that there is no persistent inflationary (or for that matter deflationary) bias for the group as a whole. This can be helped by:

- the development of indicators for the group as a whole; these will be mainly financial but special attention should also be given to the trend of world commodity prices;

- a nominal framework for policy, in terms either of a path for GDP growth for the group as a whole, or one for the average inflation rate; and

- a medium-term perspective when setting out the path and in gauging actual performance. We should not become involved in an exercise in short-term fine tuning.

In recent meetings we have put a lot of effort into developing performance indicators for individual countries. I have to say that I have considerable doubts whether we can usefully take that exercise much further. I believe it would be far more useful to devote our efforts to monitoring the performance of the group as a whole, so that we can ensure that we maintain the correct noninflationary policy stance.

Current Account Imbalances

Some fears have been expressed that the Louvre agreement will be undermined by the persistence of current account imbalances between the major countries. I do not believe this need be so.

What we are seeing is not altogether surprising. It is the familiar J-curve effect, and although the imbalances remain large, trade volumes are adjusting.

In any case, there is no law that dictates that the current accounts of the major industrial countries should always be in balance. We have an integrated world economy and we encourage the free flow of capital and goods. Clearly there are limits to the accumulated external liabilities or assets that can be sustained without creating major anxieties for capital markets. But investment opportunities and savings propensities inevitably differ from country to country and it is natural for this to produce substantial, and often sustained, capital account flows. These flows necessarily have their counterparts in current account surpluses and deficits.

The present combination of deficits and surpluses has emerged over several years during which the growth of domestic demand in the Federal Republic of Germany and Japan has been consistently below the growth of output, while in the United States it has been consistently above. The process of unwinding the imbalances requires a reversal of the differences between domestic demand and output in those countries. This is bound to take time to complete, but--and this is important--it has now begun.

It would be a serious mistake to seek a shortcut by a further dollar depreciation. It was undoubtedly necessary to correct the huge misalignment of the dollar in 1985. But there is no case for going to the opposite extreme of an artificially low dollar. The benefits to the current account would be small compared to the damage to U.S. inflation and the dislocation to the world economy. The main lesson from recent years is that we should avoid exchange rate misalignments, not encourage them.

Conclusion

In conclusion, I believe that external stability should now complement the internal financial stability that we have already achieved. It will remedy a major weakness in the world financial order and provide a sounder basis for the prosperity we all seek.

BAKER SPEECH

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-20

TEXT AS PREPARED
EMBARGOED FOR RELEASE UPON DELIVERY
EXPECTED AT 11:30 A.M. E.D.T.

Remarks by
Secretary of the Treasury
James A. Baker, III
at the Joint Meetings of the
World Bank and the International Monetary Fund
Washington, D.C.
September 30, 1987

Chairman Abdul Karim, President Conable, Managing Director Camdessus, fellow Governors and distinguished guests:

Two hundred years ago, the representatives of the thirteen American states gathered in Philadelphia to establish a common Constitution founded on individual rights and responsibilities. In much the same vein, we, as representatives of the global community, share similar needs and responsibilities that transcend our particular borders and require a strengthened framework for cooperation for the good of us all.

Our tasks are three-fold and inter-related: to build on the progress already achieved in strengthening the process of economic policy coordination; to achieve higher, sustainable growth among the developing nations; and to improve our international financial institutions.

Strong leadership from the Fund and the Bank in accomplishing these tasks is vital. A reorganized World Bank under the able leadership of President Barber Conable stands ready to expand its role in assisting the developing nations, while in a short period Michel Camdessus has demonstrated his broad capacities in guiding the IMF as its new Managing Director.

Improved International Policy Coordination

The current process of economic policy coordination evolved gradually over the last two years along a steady path, pointing toward greater stability and predictability in our international monetary arrangements. It had its roots in a broad consensus that volatile exchange rates were contributing to large trade imbalances, distorted investment, and a growing protectionist threat.

The September 1985 Plaza Agreement represented a major turning point in our efforts to promote a sound world economy. Too often in the past, the major industrial countries had reviewed the performance of their individual economies with little consideration of the interaction among them. At the Plaza, we revitalized the G-5 by agreeing on the direction that national policies should take, and by entering into new arrangements to facilitate exchange rate adjustments to reflect more fully underlying economic fundamentals.

The success of the new efforts created a momentum to move further along this course. At the Tokyo Summit, the Heads of State and Government agreed on a framework for a political mechanism for conducting multilateral surveillance of their economies utilizing economic indicators. Further, a new group was formed, the Group of Seven (G-7), that was symmetrical with the Summit structure. This brought to bear on the coordination process the necessary political leadership at the Heads of State and Government level. It also created a direct link between the formation of domestic policies and the international coordination process.

The Louvre Accord represented another milestone. We agreed upon a strengthened coordination process involving use of medium-term objectives and performance indicators. Furthermore, we made specific national policy commitments, and agreed to cooperate closely to foster exchange rate stability.

In April 1987, we initiated the new coordination process at a G-7 meeting in Washington, where we expanded and refined the Louvre Accord. At the Venice Summit, the Heads of State and Government endorsed these agreements, signaling full support by their governments at the highest levels. This past weekend, the G-7 reaffirmed their commitments to the policy directions set forth at the Louvre, including continued cooperation to foster stability of exchange rates.

The process is now firmly in place. Commitments are being met and progress is being achieved in addressing global economic problems.

In fiscal 1987, the U.S. budget deficit has been reduced by over $60 billion, a decline of 1.7 percent of GNP. Over the past four years, in fact, the U.S. has reduced its deficit by 2.7 percent of GNP -- the largest deficit reduction of any of the major industrial countries over a comparable period.

Our other economic signals also remain upbeat. The current expansion is on the verge of becoming the longest peacetime expansion in U.S. history -- an expansion that has taken place without a resurgence of inflation. Unemployment is down and jobs are up. Our trade deficit, although still large in nominal terms, has begun to decline in volume terms.

Other major industrial countries have also recognized their obligations. Japan is implementing a major stimulus package and domestic demand is strengthening, which should help to reduce its trade surplus. Germany has accelerated its tax reform efforts and agreed to reconsider domestic policies if growth falters.

These efforts are having their intended impact. Growth prospects are improving. Trade imbalances are showing signs of coming down, and exchange rates have been more stable.

This progress does not mean that we could or should stop seeking further improvements. Imbalances remain large and growth in Europe remains weak. We must follow through on earlier commitments and take additional steps as needed. At the recent G-7 meeting, we committed to do just that. In the United States, we recognize the need to continue our deficit reduction efforts in the U.S. in fiscal year 1988 and beyond. The President's decision this past weekend to sign the recent Gramm-Rudman-Hollings legislation will reinforce progress in reducing the budget deficit. Germany, Japan, and other surplus countries must also do their part by following policies which will enhance economic growth without inflation.

And it is critical that each of us works to preserve an open trading system. The imposition of protectionist measures at this time could undermine the progress we have made so far. The U.S. Administration remains resolute in its opposition to protectionist trade legislation. As President Reagan made absolutely clear yesterday, he will veto any protectionist legislation. Others must commit to fair trade policies that will buttress public support for an open trading system.

We have agreed that we should be concerned about the predictability and stability of exchange rates. Our coordination process utilizing indicators takes this into consideration. It is equally important that the policies resulting from the coordination process not be inflationary. It would be unfortunate if our efforts to foster exchange rate stability among currencies led to <u>stable</u> currency relationships -- but in a context of <u>inflationary</u> economic policies that reduced the real value of all currencies.

Accordingly, the United States is prepared to consider utilizing, as an additional indicator in the coordination process, the relationship among our currencies and a basket of commodities, including gold. This could be helpful as an early-warning signal of potential price trends.

We are proposing consideration of a commodity price indicator as an analytical tool and an improvement to our indicator process, to be used in conjunction with the other measures of economic performance -- such as growth, external imbalances, and exchange rates -- in reaching judgments about policies and performance.

Coordination is a step-by-step process, and we should be willing to consider additional refinements as we move forward.

The major industrial economies are not the only ones with an obligation to the world economy. It is time that South Korea, Taiwan, Hong Kong, and Singapore also help preserve the open world trading system. It is critical that they open their markets where restrictions remain and allow their currencies to reflect underlying economic fundamentals.

The International Debt Strategy

I would like to turn now to our cooperative efforts to address international debt problems. The "Program for Sustained Growth" that we have pursued since Seoul remains the only viable, mutually acceptable approach to debt problems.

Its basic principles remain as important and valid today as when initially proposed. The first is the central importance of economic growth. Second, in order to promote growth, market-oriented policy reforms within the debtor nations are critical. Third, to support these reforms, additional capital is needed in the form of equity, debt, and the repatriation of flight capital. And fourth, each case should be dealt with on its own merits.

Considerable progress has been made under this approach. The debtor nations have made substantial efforts to restructure their economies along more market-oriented lines. As a result, for the 15 major debtors as a whole, GDP growth is now in the range of 3.7 percent, the best in six years. Export earnings are projected to recover strongly in 1987-88, while imports this year are expected to be the highest since 1982. Capital flight has been reversed in several countries, and interest-to-export ratios are expected to fall to 27 percent this year compared to 31 percent in 1981.

The IMF and World Bank have provided sound policy advice, made $16 billion in new loan commitments since Seoul, and catalyzed financial support by other creditors. Over the same period, official creditors have rescheduled more than $17 billion in outstanding debt, including both principal and interest. And the commercial banks have committed nearly $10 billion in new loans, restructured approximately $110 billion in outstanding debt, reduced spreads and provided longer grace periods and maturities.

Nevertheless, problems remain. Reductions in commodity prices and export earnings in 1985-86 have worsened debt-to-export ratios for some. The recent firming of interest rates and continued strong protectionist pressures are both matters of serious concern.

The debt strategy provides a flexible, case-by-case framework for responding to individual debtor's needs and changes in the global environment. We should not be attracted by generalized debt relief schemes: They do not really offer significant short-term relief, and they pose major long-term risks to the debtors. They also ignore the reality that many debtors have inherently strong economies with unlimited potential. Their course into the 21st century must be built upon increasing their trade and financial linkages with the rest of the world, not undermining them.

We all need to do more to enhance the progress already made under the current strategy. To strengthen it further, we should further develop the "menu approach," strengthen the IMF's ability to promote growth, and initiate negotiations on a World Bank General Capital Increase (GCI).

The "Menu" Approach

Last spring, I suggested the development of a "menu" of financial options to facilitate commercial bank financing packages.

Permit me to elaborate today on the types of instruments that should be considered, where appropriate, for such "menus."

- Trade and project loans can channel more funds to the private sector, encouraging imports and providing banks with more easily identifiable returns.

- On-lending provisions also help to provide funds for productive use by private sector borrowers.

- New money bonds could have some of the characteristics of a senior claim, and therefore may be more attractive to banks in new money packages or to reduce the stock of debt.

- Notes or bonds which are convertible into local equity can help reduce debt service burdens and provide a boost to domestic production.

- Exit bonds can permit banks with smaller exposures to "exit" from future new money obligations, helping to streamline financing procedures.

- Debt/equity swaps help reduce both debt and debt-service burdens, while improving the debt/equity mix in foreign obligations.

- Conversion of debt paper to local currency for use by charitable organizations can provide some limited benefit.

- Limited voluntary interest capitalization may also be appropriate in certain selective cases, particularly for small debtors.

- Finally, general balance of payments loans will, of course, continue to be an essential component of virtually all new money packages.

More can be done to develop "menu" options -- by the debtors themselves, by commercial banks, by the international institutions, and by creditor governments. For example, we are now trying to identify possible regulatory impediments which might lie in the path of "menu" items. The Federal Reserve Board recently announced measures that will facilitate greater use of debt/equity swaps. Additional steps in this and possibly other areas are under consideration.

IMF Policies and Facilities

The IMF has played a central role in the debt strategy, and we must ensure that it will be able to continue this role as long as debt problems persist. In fulfilling this role, the Fund must remain faithful to its mandate as a monetary institution providing sound policy advice and temporary balance of payments financing. To do this, the Fund will need to adapt its policies to the changing circumstances and needs of its members.

In particular, the Fund must give greater attention in its programs to measures needed to promote long-run growth, as well as to correct short-run imbalances. And the Fund should work to see that comprehensive, growth-oriented programs are not blown off course by unforeseen developments beyond a country's control. Toward these ends, I propose the following package of changes in Fund facilities and policies.

First, I propose the creation of a new External Contingency Facility. It would help cushion the adverse effects on stand-by programs of external, unforeseen developments such as weaker commodity prices, lower export volumes, natural disasters, and sustained higher interest rates. Modification in economic policies will also often be required, but we hope this facility will catalyze additional lending by other creditors as well. Since such a new facility would compensate, among other things, for shortfalls in export earnings, it would of course replace the existing Compensatory Financing Facility (CFF). Like the CFF, it would be funded out of existing resources.

This new facility should be complemented by other changes which reinforce the growth orientation in Fund programs. Therefore, to help give debtors both the scope and impetus to focus on measures to promote growth and to correct payments imbalances, I propose that programs of 18 months or longer should involve semiannual -- rather than quarterly -- performance criteria and disbursements. Quarterly monitoring would still be needed to detect problems at an early stage, but debtors could avoid excessive focus on the short-run. This would be coupled with greater use of structural reforms as performance criteria in Fund programs, to complement the Fund's macroeconomic and exchange rate emphasis. Such areas as market-oriented pricing, privatization and reform of public enterprises, and trade and foreign investment liberalization would be covered, with careful coordination with the World Bank.

With the overall strengthening of performance that should result from these changes, the commercial banks should be able to rely more on overall program quality than on rigid linkages to Fund disbursements. In place of a preoccupation with mechanical formulas, the banks should focus on the appropriate policies to restore growth and creditworthiness and to maintain flexibility with regard to financing flows.

World Bank's Resources and Policies

Two years ago, I called upon the World Bank to play a greater role in the debt strategy, supporting structural reforms that are essential to achieve sustained economic growth and helping to catalyze private financing.

After carefully reviewing President Conable's plans for lending by the Bank and the need for a capital expansion in order to ensure that the Bank can fulfill this role, I believe that the time is now right to begin negotiations on a General Capital Increase.

However, I want to stress that the GCI is in no way intended to be a substitute for continued private flows. All must do their part -- the multilateral institutions, private creditors, and the developing countries themselves -- to support a return to creditworthiness and sustained growth.

I also believe the World Bank must play a more active role in the investment area. The development of loans based on investment policy reforms, for example, can provide needed encouragement to foreign direct and portfolio investment. Cofinancing of World Bank project loans can help encourage enhanced flows of foreign capital to support new production, including both commercial bank loans under the "menu" approach as well as other flows from private sector pension, insurance, or mutual funds.

The World Bank can also strengthen its advisory role in debt/equity swaps. Additional efforts to assist in the development of debtors' domestic capital markets and to provide financial advice -- for example in hedging interest and exchange rate risk -- should also be encouraged.

Low-Income Countries

Let me turn now to low-income countries. Many of these countries are now pursuing difficult economic reforms whose success requires persistent efforts at home and strong support abroad. A number of recent initiatives are designed to provide this support.

The first evolved from a U.S. initiative at Seoul two years ago. It resulted in the establishment of the IMF's Structural Adjustment Facility (SAF), and supplied a basis for enhanced cooperation between the World Bank and the IMF through the development of Policy Framework Papers.

Managing Director Camdessus has proposed expanding the SAF to provide additional funds for low-income countries with protracted payments problems. We welcome this proposal and believe that the best source of new funding for this purpose is the surplus countries.

To support these efforts, more must also be done to strengthen the effectiveness of program design and the policy coordination process. I therefore call on the Bank and the Fund to undertake joint missions, and to form a joint committee of the two Executive Boards, to review Policy Framework Papers. IDA loans should also be integrated into Policy Frameworks as closely as loans from the SAF.

The IDA VIII replenishment is another essential component. We expect Congress to take up the IDA VIII legislation in October. It has full Administration backing and we are committed to getting legislation before the end of the year.

Finally, as agreed at Venice, we continue to support on a case-by-case basis the provision of longer grace periods and maturities in official Paris Club reschedulings for the most needy low-income debtor nations.

Conclusion

We stand today at a particularly important juncture in international economic relations. We have accomplished much in recent years, but major tasks are still before us. The policy agenda remains a challenging one, and more than ever demands a unity of purpose among a diversity of interests.

The framers of the U.S. Constitution recognized 200 years ago that each state would benefit if the United States were strong and prosperous. Like them, we must put aside narrow parochial interests for the general good of the international commonwealth of nations. In so doing, we can forge a growing global economy and stable monetary system that enhances the well-being of each of us.

We have made a beginning, a good beginning. Now, we must continue our patient efforts to promote economic liberty, improve the global economy, and strengthen the framework for international cooperation. With your support, I am confident that we will be successful in this important endeavor.

Thank you.

DOUGLAS SPEECH

BOARDS OF GOVERNORS • 1987 ANNUAL MEETINGS • WASHINGTON, D.C.

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

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Press Release No. 26

September 29, 1987

V.g. will Sh a copy for N PM's information.

Statement by the Hon. R. O. DOUGLAS,
Minister of Finance and Governor of
the Fund for NEW ZEALAND,
at the Joint Annual Discussion

One of the catchphrases of this and most of the recent Joint Annual Meetings of the World Bank and the Fund is the need for adjustment. In New Zealand, we have in fact spent the last three years pursuing in a resolute and wide-ranging manner the kinds of adjustment reforms recommended by the Bank and the Fund. We have gone from being one of the more highly regulated economies in the OECD to one of the least regulated.

We have floated the New Zealand dollar, introduced a firm, anti-inflationary monetary policy, and removed exchange controls. In our traditional manufacturing sector, we are moving with speed to remove all import licensing at the same time as reducing tariffs across the board. In the public sector, we have established nine new government corporations with output equal to 12½ percent of GDP which were previously run as government departments in a noncommercial way. We are proceeding with a program of selling shares in a number of other government-owned enterprises. In the labor market, we have taken steps to overhaul the wage bargaining and industrial relations systems which had remained virtually unchanged since the turn of the century. Major tax reform has been undertaken with a flattening of marginal tax rates and the introduction of a broad-based consumption tax at a flat rate of 10 percent.

In our most important export industry - pastoral agriculture - we have virtually removed all government subsidies, concessional tax treatments, and soft lending. New Zealand therefore strongly endorses President Reagan's call for the removal of distortions in trade in agriculture. As President Reagan said, this would be a major step toward raising living standards, especially in developing countries, and increasing growth in world trade. Such reforms would achieve far more than any amount of concessional lending. Most delegates, I believe, recognize that agricultural reform is both desirable and necessary. The real question is whether there is sufficient political courage to introduce the required changes.

Members are generally agreed about what needs to be done to ensure higher economic growth and employment levels on a worldwide basis. The key ingredient of this process is the political will and effective management of structural adjustment.

I want to share with you some of the lessons we in New Zealand have learned in implementing our reforms. First, change must be made in quantum leaps. It must be comprehensive and wide ranging. Piecemeal reform can undermine the process of change.

Second, reforms must be implemented in the form of packages where there are offsetting costs and benefits for the community as a whole. There must be a sense of fairness, where all groups are seen to share the burden and benefits of adjustment.

At the same time, there must be careful attention to the pace of change. There are considerable lags between the implementation of policy changes and the achievement of positive outcomes. Insufficient momentum risks deferring the benefits of adjustments and thereby increasing the costs. This in turn risks eroding the constituency for the overall strategy.

Public education is important. It must be made clear why past approaches have failed, why there must be change, and what the benefits of change will be. Vested interest groups have in the past captured the policy process for their own benefit at the expense of the consumer. As we move to reverse this situation, we must learn to ignore the cries of the vested interest groups and talk directly to the general public about the benefits that will flow to them.

Fourth, change must be harmonized in different areas so that they are all mutually reinforcing. Improvements in fiscal and monetary policy, liberalization of markets, and the reduction of excessive debt levels must all be put in place at the same time.

Finally, we should all remember that the price for refusing to change will be a lot higher for all of us than the price of changing.

Chancellor's Office 12/2

A B C G

GS

NO PLANS FOR EARLY G-7 MEETING - JAPAN OFFICIAL

NRFK

TOKYO, OCT 29 - THE GROUP OF SEVEN MAJOR NATIONS HAVE NO PLANS TO HOLD AN EARLY MEETING, DESPITE THE RECENT FALL OF THE DOLLAR AND THE STEEP DROP IN GLOBAL STOCK PRICES, A SENIOR FINANCE MINISTRY OFFICIAL SAID.

"THERE ISN'T SUCH A PLAN AT ALL," THE OFFICIAL, WHO DECLINED TO BE IDENTIFIED, TOLD REUTERS.

THERE HAS BEEN SPECULATION IN THE CURRENCY MARKET THAT THE RECENT SUDDEN FALL OF THE DOLLAR MIGHT CONVINCE THE GROUP OF SEVEN TO MEET TO DISCUSS THE SITUATION.

THE G-7 COMPRISES BRITAIN, CANADA, FRANCE, ITALY, JAPAN, THE U.S. AND WEST GERMANY.

29-OCT-0116 MON045 MONF

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REUTER

REUTER MONITOR 0823

S E C R E T

PWP

From : D L C Peretz
Date : 26 October 1987

PPS

cc PS/EST
Sir P Middleton
Sir T Burns
Mr Cassell
Mr H P Evans
Mr C W Kelly

INTERNATIONAL MEETINGS

The Chancellor asked for an agenda for his meeting tomorrow.

2. We have on the table the proposals in Balladur's letter of 23 October, including the idea of an early meeting of G5 deputies. Meetings of G5/G7 deputies have already been arranged for 9/10 December to take forward work on surveillance/indicators.

Substance

3. What could usefully be discussed at an early meeting? Drawing on Balladur's ideas, the possibilities seem to be :-

i) Compare notes and take stock of situation. Worthwhile but hardly in itself worth a meeting. Could be done by telephone contact.

ii) Analyse causes of recent market events. Again, could be useful - though might be easier to do later on with benefit of a little more perspective;

iii) Are there any specific proposals for action on equity markets that could usefully be discussed internationally? (More likely to be useful to discuss broader action - see below - to restore confidence).

? NO

iv) Scope for fiscal action. Would be a further occasion for pressing US to raise taxes (that is clearly the symbolic action the markets are now looking for). Any

scope for further fiscal relaxation by Japan/Germany, to avert risk of world recession?

v) Interest rate action. We have moved on short-term rates. Could Germans/Japanese now do same? Do they have any inhibitions on getting long rates down? Should all Governments agree to limit demands on bond markets for a while?

vi) Louvre accord. Why is the Fed so reluctant to intervene? A US Government foreign currency borrowing might be a useful element in a stabilisation package. So might an agreement to strengthen the central bank swap network, and to increase cross holdings of the major 5 (SDR) currencies (as proposed by Balladur). Would it help to try to speed up medium-term development of Louvre - eg moving to published bands, either before or after a further dollar realignment. (Probably not).

vii) Surveillance/indicators exercise. IMF Staff will have done work for 9/10 December meetings. Subject best left until then.

Procedure

4. i) If there is to be a G5 meeting, presumably sensible to have preparatory deputies meeting first?

ii) Do we agree that a G5 or G7 meeting would be counter-productive, unless there is something of substance to say?

iii) If we agree that a meeting of deputies would be useful, how soon should it be? Sir G Littler is on holiday until the EC Monetary Committee meeting in Madrid on 30 October. Trichet is, I understand, in the US and will not be back until 28 October. I understand from my contact in the Tresor that Trichet may have in mind the idea of proposing a meeting of deputies this coming

weekend. If so I suppose it could be held in Madrid, since that is where Geoffrey Littler, Trichet, and Tietmeyer will be. If not, the sensible way forward would seem to be for those three deputies to discuss possible dates on Friday, and put an agreed proposal to their US and Japanese colleagues.

D L C PERETZ

U.S. TREASURY'S BAKER MEETS WEST GERMAN MINISTER NRIJ

WASHINGTON, OCT 19 - U.S. TREASURY SECRETARY JAMES BAKER MET WEST GERMAN FINANCE MINISTER GERHARD STOLTENBERG AND BUNDESBANK PRESIDENT KARL OTTO POEHL TODAY IN WEST GERMANY AND AGREED TO SUPPORT THE LOUVRE PACT, THE TREASURY DEPARTMENT SAID.

THE TREASURY DESCRIBED THE MEETING AS "A VERY POSITIVE, PRIVATE MEETING IN FRANKFURT, WEST GERMANY WHICH HAD BEEN AGREED UPON LAST WEEK. "THE PARTIES AGREED TO CONTINUE ECONOMIC COOPERATION UNDER THE LOUVRE AGREEMENT AND ITS FLEXIBLE APPLICATION INCLUDING COOPERATION ON EXCHANGE RATE STABILITY AND MONETARY POLICIES," THE TREASURY SAID.

19-OCT-2051 SEC691 MONH

CONTINUED ON - NRIK

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QUOTES-SEE AAQA 1921

U.S. TREASURY'S BAKER =2 WASHINGTON NRIK

THE TREASURY SAID BAKER AND STOLTENBERG "ARE CONSULTING WITH THEIR G-7 COLLEAGUES AND ARE CONFIDENT THAT THIS WILL ENABLE THEM TO FOSTER EXCHANGE RATE STABILITY AROUND CURRENT LEVELS."

THE LOUVRE PACT IS AN AGREEMENT BETWEEN THE GROUP OF SEVEN LEADING INDUSTRIAL COUNTRIES INCLUDING THE UNITED STATES AND WEST GERMANY TO PROMOTE CURRENCY STABILITY.

BAKER WAS SCHEDULED TO VISIT SCANDINAVIA AND BELGIUM THIS WEEK AND THE DEPARTMENT EARLIER REFUSED TO RELEASE DETAILS OF HIS TRAVEL ITINERARY, CITING SECURITY CONSIDERATIONS.

19-OCT-2052 SEC693 MONH

CONTINUED FROM - NRIJ

REUTER

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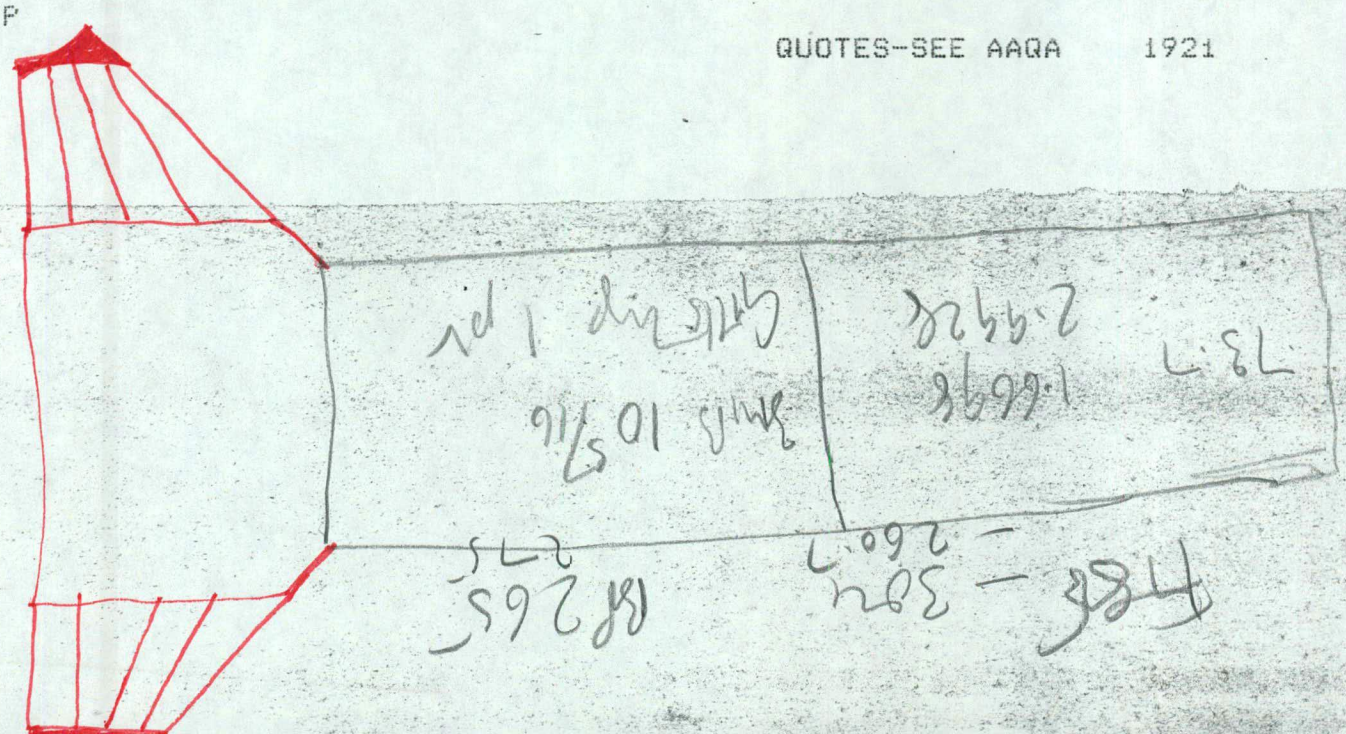
QUOTES-SEE AAQA 1921



Chancellor 12/12

(A) (B) (C) M. Kelly 10/12

LOUVRE ACCORD STILL IN EFFECT, JAPAN OFFICIAL SAYS NRMB

BY KUNIO INOUE

TOKYO, OCT 19 - THE GROUP OF SEVEN (G-7) INDUSTRIAL NATIONS STILL COMPLY WITH LAST FEBRUARY'S LOUVRE ACCORD TO STABILIZE CURRENCIES, A SENIOR BANK OF JAPAN OFFICIAL SAID.

AND U.S. TREASURY SECRETARY JAMES BAKER'S REMARKS AT THE WEEKEND INDICATING THE NEED TO REVISE IT DO NOT HERALD A LOWER RANGE FOR THE DOLLAR, OTHER SENIOR OFFICIALS FROM THE BANK OF JAPAN AND FINANCE MINISTRY AGREED IN INTERVIEWS.

"THE EXCHANGE MARKET IS APPARENTLY REACTING TOO MUCH, AND ANYONE WHO SOLD THE DOLLAR ON THE BAKER COMMENT WILL REGRET IT LATER ON," THE BANK OF JAPAN OFFICIAL TOLD REUTERS.

19-OCT-0851 MON262 MONA

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CONTINUED ON - NRMC

DEAL - SEE AADA 0918

LOUVRE ACCORD =2 TOKYO

THE BANK OFFICIAL SAID BAKER DID NOT MEAN TO TALK THE DOLLAR DOWN. A LOWER DOLLAR WOULD HARM THE U.S. ECONOMY, HE NOTED. NRMC

A FINANCE MINISTRY OFFICIAL WHO WAS DIRECTLY INVOLVED IN MONETARY TALKS WITH OTHER NATIONS ALSO SAID THE U.S. WOULD NEVER ATTEMPT TO LOWER THE REFERENCE RANGE FOR THE DOLLAR AGAINST THE MARK OR THE YEN.

THE MARKET ASSUMES THE DOLLAR REFERENCE RANGE TO BE BETWEEN 140-150 YEN AND BETWEEN 1.70 AND 1.90 MARKS.

THE DOLLAR CLOSED IN TOKYO TODAY AT 1.7730/35 MARKS AND 141.35 YEN.

19-OCT-0916 MON313 MONA

CONTINUED FROM - NRMB

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CONTINUED ON - NRMD

DEAL - SEE AADA 0918

LOUVRE ACCORD =3 TOKYO

"BEHIND BAKER'S REMARK WAS U.S. FRUSTRATION OVER HIGHER INTEREST RATES ABROAD, ESPECIALLY IN WEST GERMANY, BUT THIS DOES NOT REPRESENT ITS READINESS TO SCRAP THE BASIC FRAMEWORK OF THE LOUVRE ACCORD," THE FINANCE MINISTRY OFFICIAL SAID. NRMD

HE SAID THAT ON THE CONTRARY BAKER WANTED TO AVOID ANY FURTHER RISE IN U.S. INTEREST RATES BECAUSE IT WOULD NOT ONLY HURT THE U.S. ECONOMY BUT AGGRAVATE THE THIRD WORLD DEBT PROBLEM.

HIGHER U.S. INTEREST RATES WOULD MERELY RAISE THEIR INTEREST PAYMENT BURDEN AND DEPRESS U.S. STOCK AND BOND MARKETS FURTHER, THE MONETARY OFFICIALS SAID.

19-OCT-0921 MON328 MONA

CONTINUED FROM - NRMC

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CONTINUED ON - NRME

LOUVRE ACCORD =4 TOKYO NRME

BOTH THE MINISTRY AND CENTRAL BANK OFFICIALS, WHO DECLINED TO BE NAMED, NOTED THE U.S. NO LONGER WANTS TO SEE A FURTHER DECLINE OF THE DOLLAR BECAUSE THAT COULD ALSO FAN INFLATIONARY EXPECTATIONS IN THE U.S.

"THAT'S WHY BAKER DID NOT FAIL TO ADD THAT THE LOUVRE AGREEMENT IS STILL OPERATIVE," THE SENIOR MINISTRY OFFICIAL SAID.

BAKER SAID IN A U.S. TELEVISION INTERVIEW ON SUNDAY THAT WASHINGTON WOULD REEXAMINE THE LOUVRE ACCORD BECAUSE OF WEST GERMANY'S INCREASE IN SHORT-TERM INTEREST RATES.

19-OCT-0922 MON331 MONA
CONTINUED FROM - NRMD
CONTINUED ON - NRNB
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LOUVRE ACCORD =5 TOKYO NRNB

THE MARKET AT FIRST INTERPRETED THIS AS INDICATING THE U.S. WOULD BE READY TO SCRAP THE LOUVRE ACCORD AND LET THE DOLLAR DECLINE FURTHER UNLESS SURPLUS COUNTRIES, NOTABLY WEST GERMANY, TRY HARDER TO STIMULATE THEIR ECONOMIES AS PLEDGED IN THE ACCORD, FOREIGN EXCHANGE DEALERS SAID.

BUT THE MARKET ON REFLECTION ALSO NOTED BAKER'S ADDITIONAL STATEMENT THAT "THE LOUVRE AGREEMENT IS STILL OPERATIVE," AND THIS CAUSED SOME DOLLAR SHORT-COVERING IN TOKYO TODAY, THE DEALERS SAID.

UNCERTAINTY, HOWEVER, REMAINED THE FLAVOUR OF THE DAY IN TOKYO CURRENCY MARKETS.

19-OCT-0930 MON348 MONB
CONTINUED FROM - NRME
CONTINUED ON - NRNC
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LOUVRE ACCORD =6 TOKYO NRNC

THE JAPANESE MONETARY OFFICIALS SAID BAKER'S UNDISGUISED PRESSURE ON WEST GERMANY TO REFRAIN FROM GUIDING INTEREST RATES HIGHER MAY BE PART OF A PROCESS OF MULTILATERAL SURVEILLANCE, OR INTERNATIONAL ECONOMIC POLICY COORDINATION.

THE G-7, COMPRISING THE U.S., JAPAN, WEST GERMANY, BRITAIN, FRANCE, ITALY AND CANADA, HAVE AGREED TO MONITOR EACH OTHER'S ECONOMIC POLICIES AND FROM TIME TO TIME APPLY "PEER PRESSURE" TO PERSUADE OTHERS TO CHANGE THEIR POLICIES TO A DESIRED COURSE, THEY NOTED. "WITHOUT SUCH A BASIC AGREEMENT OF MULTILATERAL SURVEILLANCE, BAKER WOULD NEVER HAVE CRITICIZED THE WEST GERMAN POLICY SO OPENLY," THE MINISTRY OFFICIAL SAID.

AAMM 0947 KING ACCEPTS RESIGNATION OF BELGIAN COALITION - BELGA NEWS AGENCY SAYS
MORE
P

CONFIDENTIAL

FROM: HUW EVANS
DATE: 3 NOVEMBER 1987

SIR GEOFFREY LITTLER

cc Mr J Taylor

G5/7 CONTACTS

The Chancellor's office has not yet fixed anything up with Balladur. The Chancellor's preference is for a bilateral with Balladur, here, over lunch, next week, followed (but not immediately) by a trilateral with Stoltenberg - the discussions to take in both exchange rate/macro policy issues and EC finance.

2. The Chancellor's office would welcome your assessment of the position vis-a-vis other European Finance Ministers.

HPE

H P EVANS

PPS Chancellor A B C Ci
12/2 M
POs

NRJO

LAWSON IN FAVOUR OF PRODUCTIVE G7 MEETING

LONDON, OCT 30 - U.K. CHANCELLOR OF THE EXCHEQUER NIGEL LAWSON SAID HE WOULD BE IN FAVOUR OF A MEETING OF LEADING INDUSTRIALISED NATIONS TO DISCUSS FALLING STOCK EXCHANGES AND THE WEAK U.S. DOLLAR IF HE SAID IT WAS IMPORTANT A SENSIBLE PACKAGE BE PREPARED BEFOREHAND.

"THERE WOULD BE NO POINT IN HAVING A MEETING WHICH PRODUCED AN UNIMPRESSIVE RESULT," HE SAID IN A BBC RADIO INTERVIEW. "I THINK THAT WOULD BE WORSE THAN USELESS."

30-OCT-0826 MON936 MONG

CONTINUED ON - NRJP

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NRJP

LAWSON IN =2 LONDON

LAWSON SAID IT WOULD BE "WHOLLY COUNTER-PRODUCTIVE AND WHOLLY DAMAGING" FOR THE GROUP OF SEVEN NATIONS TO HOLD A MEETING WITHOUT REACHING AGREEMENT.

BUT HE STRESSED THE LEADING NATIONS ARE IN CONSTANT COMMUNICATION WITH EACH OTHER. "THERE IS A LOT OF WORK GOING ON IN ORDER TO GET A SENSIBLE PACKAGE," HE SAID.

LAWSON SAID THE U.S. WOULD HAVE TO CONTRIBUTE THE KEYSTONE OF ANY PACKAGE WITH SIGNIFICANT BUDGET DEFICIT CUTS, ALMOST CERTAINLY INVOLVING SOME TAX INCREASES.

"WE WILL CHIP IN OUR CONTRIBUTION," HE ADDED WITHOUT ELABORATING.

30-OCT-0837 MON956 MONG

CONTINUED FROM - NRJO

CONTINUED ON - NRJQ

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NRJQ

LAWSON IN =3 LONDON

"ONCE WE HAVE GOT THE OUTLINES OF A PACKAGE TOGETHER, THEN I THINK IT IS SENSIBLE TO HAVE A MEETING," HE SAID.

LAWSON SAID HE THOUGHT HE HAD BEEN RIGHT TO GO AHEAD WITH THE 7.2 BILLION STG PRIVATISATION OF THE GOVERNMENT'S SHAREHOLDING IN BRITISH PETROLEUM CO PLC <BP.L> BUT SAID HE HAD LEARNED FROM THE EPISODE.

ONE HAD BEEN THAT THE CITY OF LONDON IS MUCH MORE SECURE AND RELIABLE THAN OTHER FINANCIAL CENTRES, HE SAID. THE CITY HAD BEEN ABLE TO TAKE THE BP UNDERWRITING LOSS WITHOUT ANY PROBLEMS.

"THE PROBLEMS CAME FROM FINANCIAL CENTRES OVERSEAS," HE ADDED.

30-OCT-0859 MON000 MONG

CONTINUED FROM - NRJP

CONTINUED ON - NRJR

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NRJR

LAWSON IN =4 LONDON

U.S. INSTITUTIONS HAD AGREED TO UNDERWRITE 40 PCT OF THE ISSUE AND FACED WITH A TOTAL POTENTIAL LOSS OF SOME 400 MLN DLRS, HAD PRESSED LAWSON TO POSTPONE THE ISSUE UNTIL MARKET CONDITIONS IMPROVED.

LAWSON SAID HE WOULD BE IN FAVOUR OF A MEETING OF LEADING INDUSTRIALISED NATIONS TO DISCUSS FALLING STOCK EXCHANGES AND THE WORLD ECONOMY

BUT HE SAID IT WAS IMPORTANT A SENSIBLE PACKAGE BE PREPARED BEFOREHAND.

"THERE WOULD BE NO POINT IN HAVING A MEETING WHICH PRODUCED AN UNIMPRESSIVE RESULT," HE SAID IN A BBC RADIO INTERVIEW. "I THINK THAT WOULD BE WORSE THAN USELESS."

30-OCT-0826 MON936 MONG

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CONTINUED ON - NRJP

LAWSON IN =2 LONDON NRJF

LAWSON SAID IT WOULD BE "WHOLLY COUNTER-PRODUCTIVE AND WHOLLY DAMAGING" FOR THE GROUP OF SEVEN NATIONS TO HOLD A MEETING WITHOUT REACHING AGREEMENT.

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30-OCT-0837 MON956 MONG

CONTINUED FROM - NRJO

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CONTINUED ON - NRJQ

LAWSON IN =3 LONDON NRJQ

"ONCE WE HAVE GOT THE OUTLINES OF A PACKAGE TOGETHER, THEN I THINK IT IS SENSIBLE TO HAVE A MEETING," HE SAID.

LAWSON SAID HE THOUGHT HE HAD BEEN RIGHT TO GO AHEAD WITH THE 7.2 BILLION STG PRIVATISATION OF THE GOVERNMENT'S SHAREHOLDING IN BRITISH PETROLEUM CO PLC <BP.L> BUT SAID HE HAD LEARNED FROM THE EPISODE.

ONE HAD BEEN THAT THE CITY OF LONDON IS MUCH MORE SECURE AND RELIABLE THAN OTHER FINANCIAL CENTRES, HE SAID. THE CITY HAD BEEN ABLE TO TAKE THE BP UNDERWRITING LOSS WITHOUT ANY PROBLEMS.

"THE PROBLEMS CAME FROM FINANCIAL CENTRES OVERSEAS," HE ADDED.

30-OCT-0859 MON000 MONG

CONTINUED FROM - NRJP

P

CONTINUED ON - NRJR

LAWSON IN =4 LONDON NRJR

U.S. INSTITUTIONS HAD AGREED TO UNDERWRITE 40 PCT OF THE ISSUE AND FACED WITH A TOTAL POTENTIAL LOSS OF SOME 400 MLN DLRS, HAD PRESSED LAWSON TO POSTPONE THE ISSUE UNTIL MARKET CONDITIONS IMPROVED.

"IT WILL CERTAINLY BE SOMETHING THAT I SHALL HAVE TO RE-CONSIDER WHEN I CONSIDER WHETHER INDEED IN FUTURE PRIVATISATIONS WE DO WANT TO HAVE OVERSEAS UNDERWRITING," HE SAID, REITERATING DOUBTS HE FIRST EXPRESSED YESTERDAY.

30-OCT-0900 MON009 MONG

CONTINUED FROM - NRJQ

P

NRGF

G-7 HAS STEPPED UP COOPERATION, MIYAZAWA SAYS

TOKYO, OCT 30 - MEMBERS OF THE GROUP OF SEVEN (G-7) MAJOR NATIONS HAVE STEPPED UP THEIR COOPERATION IN DEFENDING THE DOLLAR AND ARE PREPARED TO CONTINJE TO INTERVENE HEAVILY IF NECESSARY, FINANCE MINISTER KIICHI MIYAZAWA SAID.

HE TOLD A PRESS CONFERENCE CENTRAL BANKS OF MAJOR NATIONS INTERVENED TO SUPPORT THE DOLLAR IN TOKYO, LONDON, FRANKFURT, ZURICH, BRUSSELS AND NEW YORK FROM THURSDAY TO EARLY FRIDAY.

HE ALSO SAID THERE WAS NO PLAN NOW TO CALL AN EARLY G-7 MEETING AS THE G-7 COUNTRIES HAVE ALREADY REAFFIRMED THEIR COMMITMENT TO THE LOUVRE ACCORD. "I HAVE NO INTENTION OF CALLING FOR A G-7 MEETING MYSELF AT THE MOMENT," HE SAID.

CONTINUED ON - NRGG

30-OCT-0221 MON556 MONB

REUTER MONITOR 0852

P

NRGG

G-7 HAS STEPPED UP =2 TOKYO

IF THE G-7 MEETS, IT MUST COME UP WITH SPECIFIC MEASURES TO HELP THE WORLD ECONOMY, MIYAZAWA SAID.

HE ALSO SAID HE EXPECTS THE YEN EXCHANGE RATE TO STABILIZE SOON.

COMMENTING ON REPORTS THAT FRENCH MONETARY AUTHORITIES SOLD DOLLARS AGAINST MARKS OVERNIGHT, MIYAZAWA SAID THAT DID NOT RUN COUNTER TO THE G-7'S EFFORTS TO SUPPORT THE U.S. CURRENCY. HE SAID THE FRENCH ACTION WAS AIMED PRIMARILY AT HELPING STABILIZE THE EUROPEAN MONETARY SYSTEM.

HE SAID HE WAS NOT TOO WORRRIED ABOUT THE TOKYO STOCK MARKET TURMOIL BECAUSE THE ECONOMY HERE IS FIRMLY RECOVERING.

REUTER

30-OCT-0234 MON565 MONB

REUTER MONITOR 0852

CONTINUED FROM - NRGF

P

NRGK

...REET RANGES FOR DOLLAR

...SAKI MIYAZAWA DENIED

G-7 HAS STEPPED UP COOPERATION, MIYAZAWA SAYS NRGF

TOKYO, OCT 30 - MEMBERS OF THE GROUP OF SEVEN (G-7) MAJOR NATIONS HAVE STEPPED UP THEIR COOPERATION IN DEFENDING THE DOLLAR AND ARE PREPARED TO CONTINUE TO INTERVENE HEAVILY IF NECESSARY, FINANCE MINISTER KIICHI MIYAZAWA SAID.

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30-OCT-0221 MON556 MONB

P

CONTINUED ON - NRGG

REUTER MONITOR 0852

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30-OCT-0234 MON565 MONB

CONTINUED FROM - NRGF

REUTER

P

REUTER MONITOR 0852

MIYAZAWA DENIES G-7 LOWERED RANGES FOR DOLLAR NRGK

TOKYO, OCT 30 - FINANCE MINISTER KIICHI MIYAZAWA DENIED THAT THE GROUP OF SEVEN (G-7) HAS LOWERED THE PERMISSIBLE RANGES FOR THE DOLLAR.

THE G-7 REMAINS COMMITTED TO HOLDING THE DOLLAR STABLE AS SPELT OUT IN THE LOUVRE ACCORD, HE TOLD A PRESS CONFERENCE. BUT HE ADDED THAT THE ACCORD DID NOT HAVE SPECIFIC RANGES FOR THE DOLLAR.

CURRENCY DEALERS HAVE SPECULATED IN RECENT DAYS THAT THE G-7 IS PREPARED TO ALLOW THE DOLLAR TO FALL TO HELP REDUCE THE HUGE U.S. TRADE DEFICIT.

30-OCT-0230 MON564 MONC

REUTER

P

REUTER MONITOR 0852

prep

SECRET

From: Sir G.Littler
Date: 12 November 1987

MR ALEX ALLAN

c.c. Sir P.Middleton
Sir T.Burns

POSSIBLE G7 COMMUNIQUE

Your minute of yesterday.

2. I attach a quick draft - more as a trial run of some ideas than a genuine draft. I assume our basis will be some useful action but by no means enough on its own to restore confidence. One hard point in those circumstances, as the Chancellor noted, is exchange rate stability (last paragraph of draft). The other point which strikes me as a hard one (to negotiate as well as to decide) is whether and how far we should explain recent weeks: my first thought is that we must say something, and it might be turned to advantage if we could agree this is in G7.

(Geoffrey Littler)

Ok
One question is whether it is possible/desirable to claim credit for $ depreciation:
- became apparent that in light of slow progress on adjustment of trade balances and, particularly, in the light of the impact of the agents market falls that some depreciation of the dollar was appropriate. So did not stand in the way of modest dollar depreciation, Lloyd contented to cooperate a intervention so as to ensure orderly transition. Now reached level - Is this credible?! AA

SECRET

DRAFT : STATEMENT OF THE GROUP OF SEVEN

1. The Finance Ministers and Central Bank Governors of seven major industrial countries met today. They expressed their conviction - fortified by recent events - that the development of effective cooperation between them can and must play an important role in promoting a healthy and prosperous world economy and a stable monetary system.

2. The Ministers and Governors wished to emphasise that [their] broad objectives [remain what they have been] over the past two years. The major imbalances which grew up in the early part of the decade need to be corrected. But that correction must be gradual and will inevitably take time - time for the necessary adjustments to take place in world patterns of trade, demand and output without precipitate measures which could rekindle inflation or undermine confidence and seriously depress world activity.

3. To this end it is vital that the right directions of policy be clearly established - this was [done] in the Louvre Accord [and indeed initiated at the earlier Plaza meeting]. It is also vital that those directions of policy be pursued consistently and with determination [- this has been and remains the expressed intention of the Ministers and Governors and they reasserted it today].

This agreement was successfully implemented, and exchange rates remained broadly stable up till mid October.

4. At their meetings at the Louvre in February and again in Washington in April of this year the Ministers and Governors also concluded and reaffirmed their judgment that a period of stability of exchange rates would assist the necessary process of adjustment, and they not only agreed to cooperate to foster it but carried out that agreement with considerable success. In their more recent meeting in Washington in September they were able to note that some important favourable results were beginning to be seen, but recognised the need for further action and committed themselves to take such action.

5. During recent weeks markets have experienced some sudden and substantial changes of perception. On the one hand values of equities on all major markets, which in most cases had seen unexpectedly rapid and substantial rises in the previous year, suffered a sharp reversal. On the other hand, perhaps impatient with the apparent slowness of progress and evidently affected by uncertainty and lack of confidence in the determination of the authorities, foreign exchange markets experienced very heavy downward pressures on the dollar.

It also provide the circumstances in which the decline in the value of the dollar can be expected to have a more favourable impact on US trade volumes: the slackening of domestic demand will free resources both export & import substitution; and the inflationary dangers are much reduced.

6. These changes are likely of themselves to have an effect on future developments which, albeit not large, has some importance and needs to be taken into account. The reduction of asset values could well promote a tendency to higher savings and marginally reduced domestic demand: this could make a positive contribution in countries with very buoyant demand or with inadequate savings to finance deficits; it is obviously less helpful in the case of surplus countries. The decline in the value of the dollar should ultimately give a further stimulus to improvement of the volume balance of trade of the United States and of the surplus countries whose currencies have appreciated in value, although the well-known J-curve effect may make thhe nominal figures worse for a period.

7. Overall, and other things being equal, the impact of these changes would be likely to act as a slight brake on the rate of growth of world activity and a slight lowering of inflationary risks. They suggest both need and opportunity for some modest further action - action entirely consistent with the directions of policy foreseen and announced at earlier meetings.

[8. Country passages, stressing the continuity of US attack on deficit, the substantial scale of measures cumulatively being taken in Germany and Japan, the importance of tackling the problem of imbalances at both ends. And something surely about Taiwan and Korea]

SECRET

9. The Ministers and Governors have reexamined together the role of exchange rates between their currencies. They are fully conscious that there is no absolutely correct set of rates. But they share two views of particular importance at the present time:

- first, the most worrying threat of recent events has been the threat of uncontrolled dollar depreciation: the nature of the threat is that it would further disrupt financial markets, undermine confidence and activity in the appreciating currency countries, lead to inflationary pressures in the United States eventually pushing up their interest rates, and provoke further demands for protectionism: the damage to business confidence would make the danger of a major recession very real;

- secondly, provided exchange rates are at appropriate levels, if exchange rates are in the right ball park, a degree of sustained stability in them will positively encourage international business and investment decisions and give time for and support the gradual process of adjustment. The Ministers and Governors believe that, in the changed circumstances and with the modest decline of the dollar, these conditions now hold.

10. The Ministers and Governors believe that their policies and the actions outlined above - and further future actions which they will take as and when necessary in the same direction - provide an appropriate and adequate strategy for resolving the problems of imbalances on a basis which minimises the dangers of inflation on the one hand and recession on the other.

11. The Ministers and Governors discussed further the actions already taken by some of them during very recent weeks to adjust interest rates in the light of the need for continued confidence and the restoration of stability in both internal and external markets. They recognised the need to take careful account of the differentials between their markets as well as of the impact on domestic monetary conditions. They will consult regularly about actual and desirable interest rate developments in their markets.

12. For the reasons given above, the Ministers and Governors also believe that stability of exchange rates between their currencies - and above all the avoidance of further extensive changes in them - should be an important supporting influence. They have committed themselves to a renewed effort to foster this stability and have reviewed their techniques for doing so in the light of experience. [For the time being they will operate around exchange rates at very recent levels]. [They have agreed for the time being simply to monitor in close consultation the immediate evolution of markets which may need a short period of settling down in the light of the policies and actions they have announced in this statement - whether at slightly higher or lower levels. They will then concert action to maintain stability around those levels].

^ something about equipping with necessary resources.

SECRET

FROM: A C S ALLAN
DATE: 11 November 1987

SIR G LITTLER

cc Sir P Middleton
Sir T Burns

POSSIBLE G7 COMMUNIQUE

The Chancellor would be most grateful if you could prepare a quick draft of the sort of G7 Communique we might wish to see. The hardest point will be what we would want said about exchange rate stability.

2. The Chancellor would be grateful for a first draft by tomorrow (Thursday) night if possible.

ACSA

A C S ALLAN

PRP

With the compliments of
THE BRITISH EMBASSY
ECONOMIC DEPARTMENT

Mary Barry

9 November 1987

WASHINGTON, D.C.

This is the actual statement which was put out after Baker/Stoltenberg 19.10.87 meeting.

C PPS
Mr. Peretz
Mr. Kelly
Ms. Goodman

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

10/19/87

TREASURY STATEMENT

Today, Secretary of the Treasury, James A. Baker, III, Finance Minister Gerhard Stoltenberg and Bundesbank President, Karl Otto Poehl, had a very positive, private meeting in Frankfurt, Germany which had been agreed upon early last week.

The parties agreed to continue economic cooperation under the Louvre Agreement and its flexible application including cooperation on exchange rate stability and monetary policies.

They are consulting with their G-7 colleagues and are confident that this will enable them to foster exchange rate stability around current levels.

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B-1173

Chancellor's Office 12/2

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B
C

STOLTENBERG AGAIN URGES CAUTION ON G-7 MEETING
KARLSRUHE, WEST GERMANY, NOV 13 - NRLM
GERHARD STOLTENBERG AGAIN URGED CAUTION ABOUT A MEETING OF LEADING INDUSTRIAL NATIONS TO DISCUSS ECONOMIC POLICIES.
ASKED ABOUT THE PROSPECTS FOR SUCH A MEETING, STOLTENBERG TOLD REPORTERS DURING A FRANCO-GERMAN SUMMIT MEETING HERE, "THERE IS NO SENSE IN FORMALLY DISCUSSING THE MARKET SITUATION EVERY DAY AND GIVING PROGNOSES."
STOLTENBERG HAD ON WEDNESDAY RULED OUT ANY MEETING OF THE GROUP OF SEVEN (G-7) LEADING INDUSTRIAL DEMOCRACIES BEFORE THE UNITED STATES AGREED MEASURES TO CUT ITS BUDGET DEFICIT.

13-NOV-1305 MON714 MONR

P

CONTINUED ON - NRMB

DEALING - SEE AADA 1438

STOLTENBERG AGAIN =2 KARLSRUHE
NRMB
STOLTENBERG ALSO SAID THAT THE IMPROVEMENT IN THE FINANCIAL MARKET SITUATION OVER THE PAST FEW DAYS WAS A RESULT OF THE FACT THAT PROBLEMS HAD BEEN DISCUSSED IN A HARMONIOUS WAY.
"WE HAVE TO CONTINUE THIS WAY. WE MUST EMBARK ON A CONFIDENCE BUILDING PROCESS", HE SAID. THE WEST GERMAN FINANCE MINISTRY HAS OFTEN STRESSED THAT LEADING OFFICIALS FROM THE G-7 COUNTRIES ARE IN CONSTANT CONTACT EACH OTHER BY TELEPHONE, OR IN OTHER WAYS APART FROM FORMAL G-7 SESSIONS.
STOLTENBERG ALSO WELCOMED U.S. PRESIDENT REAGAN'S ASSERTION THIS WEEK THAT HE DID NOT WANT TO LET THE DOLLAR CONTINUE FALLING AS "AN IMPORTANT DECLARATION FOR THE EUROPEANS".
13-NOV-1326 MON745 MONA
CONTINUED FROM - NRLM
P

CONTINUED ON - NRMC

DEALING - SEE AADA 1438

STOLTENBERG AGAIN =3 KARLSRUHE
NRMC
EARLIER ON FRIDAY, FRANCE AND WEST GERMANY AGREED TO SET UP A JOINT ECONOMIC AND FINANCE COMMITTEE TO IMPROVE POLICY COORDINATION BETWEEN THE TWO COUNTRIES.
STOLTENBERG SAID HE WELCOMED THE OPPORTUNITY TO FORMALISE DISCUSSIONS WITH THE FRENCH ON ECONOMIC AND FINANCIAL POLICY.

13-NOV-1326 MON746 MONA
CONTINUED FROM - NRMB
P

REUTER

DEALING - SEE AADA 1438

A
B

CANADA'S WILSON SEES NO RUSH FOR G-7 MEETING

LONDON, NOV 13 - CANADA'S FINANCE MINISTER MICHAEL WILSON SAID HE SAW NO NEED TO RUSH IN CALLING A MEETING OF THE GROUP OF SEVEN (G-7) LEADING INDUSTRIAL NATIONS TO DISCUSS GLOBAL ECONOMIC PROBLEMS. NRJV

WILSON WAS ANSWERING QUESTIONS AT A PRESS CONFERENCE HERE BEFORE LEAVING FOR EUROPEAN COUNTRIES. "NOW, THERE IS SOME SENSE OF URGENCY BUT I THINK WE SHOULD GET IT RIGHT," HE TOLD REPORTERS.

13-NOV-1231 MON638 MONQ

P

CONTINUED ON - NRJW

DEALING - SEE AADA 1438

CANADA'S WILSON =2 LONDON

HE SAID HIS TALKS WITH OFFICIALS, CENTRAL BANKERS AND FINANCIAL MARKET PARTICIPANTS IN FRANCE, WEST GERMANY, SWITZERLAND AND THE U.K. HAD BEEN BILATERAL AND CONFIDENTIAL. NRJW

"AS WE APPROACH A POSSIBLE G-7 MEETING, IT'S IMPORTANT WE KEEP THOSE DISCUSSIONS ON THAT BASIS," HE SAID.

WILSON NOTED THAT A PACT TO REDUCE THE U.S. BUDGET DEFICIT, CURRENTLY UNDER NEGOTIATION IN WASHINGTON, WOULD PROVIDE A BASIS FOR ANY G-7 TALKS.

"THE NEGOTIATIONS WHICH ARE UNDER WAY ARE VERY IMPORTANT AND FORM A KEYSTONE TO ELEMENTS OF A G-7 MEETING WHICH I WOULD EXPECT WOULD OCCUR SOME TIME IN THE FUTURE," HE SAID.

13-NOV-1246 MON674 MONQ

CONTINUED FROM - NRJV

P

CONTINUED ON - NRLH

DEALING - SEE AADA 1438

CANADA'S WILSON =3 LONDON

ASKED WHAT CONTRIBUTION G-7 COUNTRIES OUTSIDE THE U.S. MIGHT OFFER IN TERMS OF EXPANDING THEIR DOMESTIC ECONOMIES AS PART OF A FUTURE FURTHER G-7 PACT, WILSON SAID, "NO COUNTRIES ARE PREPARED TO COME FORWARD WITH SPECIFIC COMMITMENTS UNTIL THEY SEE WHAT THE RESULT (OF THE BUDGET NEGOTIATIONS) MIGHT BE." NRLH

WILSON SAID HE WOULD BE VERY SURPRISED IF THE U.S. DID NOT PRODUCE A SATISFACTORY AGREEMENT. "THEY UNDERSTAND THE IMPORTANCE OF ACHIEVING AN AGREEMENT IN EXCESS OF THE 23 BILLION DLRS," HE ADDED.

THE GRAMM-RUDMAN BALANCED BUDGET LEGISLATION STIPULATES A MINIMUM 23 BILLION DLR CUT IN THE BUDGET FOR FISCAL 1988.

13-NOV-1300 MON705 MONR

CONTINUED FROM - NRJW

P

CONTINUED ON - NRLI

DEALING - SEE AADA 1438

CANADA'S WILSON =4 LONDON

NRLI

WILSON SAID IT WAS IMPORTANT THAT PROPER PREPARATION SHOULD TAKE PLACE BEFORE A G-7 MEETING AND THAT PARTICIPANTS SHOULD BE AWARE OF WHAT MEASURES WERE NEEDED TO INJECT A DEGREE OF CONFIDENCE AND RESTORE STABILITY TO WORLD FINANCIAL MARKETS.

WILSON HAS BEEN MEETING EUROPEAN OFFICIALS PARTLY TO EXPLAIN THE RECENT U.S./CANADIAN FREE TRADE PACT. HE MET U.K. CHANCELLOR OF THE EXCHEQUER NIGEL LAWSON ON THURSDAY.

HE SAID THAT DURING HIS VISIT TO EUROPE, PLANNED BEFORE THE TURMOIL WHICH STRUCK GLOBAL FINANCIAL MARKETS AFTER THE SHARE CRASH OF OCTOBER 19, PEOPLE HAD NOT EXPRESSED ANY MAJOR CONCERNS ABOUT A RECESSION.

13-NOV-1308 MON719 MONR

CONTINUED FROM - NRLH

P

CONTINUED ON - NRLJ

DEALING - SEE AADA 1438

CANADA'S WILSON =5 LONDON

NRLJ

"THERE'S NO SENSE OF IMPENDING DOOM OR ANYTHING LIKE THAT," HE SAID.

ASKED IF HE THOUGHT A FURTHER REDUCTION IN WORLD INTEREST RATES WAS APPROPRIATE, WILSON REPLIED, "AT THIS POINT I BELIEVE WE SHOULD BE MARKING TIME ON THE INTEREST RATE SIDE."

HE NOTED THAT MANY COUNTRIES HAD ALREADY REDUCED THEIR INTEREST RATES IN RESPONSE TO THE RECENT GLOBAL FINANCIAL CRISIS, THUS INJECTING A GOOD DEGREE OF LIQUIDITY INTO THEIR ECONOMIES.

"I THINK AT PRESENT WE'RE IN A FINE-TUNING PERIOD," HE SAID, CAUTIONING AGAINST FURTHER HURRIED MAJOR MOVES.

13-NOV-1313 MON726 MONR

CONTINUED FROM - NRLI

P

CONTINUED ON - NRLW

DEALING - SEE AADA 1438

NRLW

CANADA'S WILSON =6 LONDON

WILSON SAID ANY FOLLOW-UP TO THE FEBRUARY LOUVRE ACCORD ON CURRENCY STABILITY AND ECONOMIC COORDINATION SHOULD FOCUS ON FISCAL AND STRUCTURAL ADJUSTMENT MOVES AS WELL AS ON EXCHANGE RATES AND MONETARY POLICY.

HE SAID THE COMMITMENTS MADE TO ECONOMIC POLICY COORDINATION IN THE LOUVRE PACT, ALTHOUGH THEY HAD NOT BEEN 100 PCT FULFILLED, "HAVE IN LARGE PART BEEN FULFILLED AND THE DIRECTION IS CLEARLY THERE".

A GREAT DEAL WOULD DEPEND ON THE LONGER TERM IMPACT OF THE OCTOBER 19 GLOBAL EQUITY MARKET CRASH ON THE REAL ECONOMIES OF THE WORLD, HE ADDED.

13-NOV-1322 MON738 MONA

CONTINUED ON - NRLX

CONTINUED FROM - NRLJ

P

DEALING - SEE AADA 1438

NRLX

CANADA'S WILSON =7 LONDON

COUNTRIES WOULD NEED TO CAREFULLY MONITOR ECONOMIC INDICATORS TO ENABLE THEM TO ASSESS THE EXTENT OF THE DAMAGE, WILSON ADDED. "IT DEPENDS ON WHAT THE TEA LEAVES ARE GOING TO SHOW," HE SAID.

13-NOV-1336 MON766 MONA

REUTER

CONTINUED FROM - NRLW

P

DEALING - SEE AADA 1438

Copy. Chief, M.Dath, Littler, IDT

12/2

CANADA SAYS G-7 MEET WOULD HAVE TO FOCUS ON POLICY NRBY

BONN, NOV 12 - CANADIAN FINANCE MINISTER MICHAEL WILSON SAID HE WOULD WELCOME A MEETING OF GROUP OF SEVEN (G-7) INDUSTRIAL NATIONS, BUT THAT ANY SUCH TALKS WOULD HAVE TO BE WELL PREPARED AND FOCUS ON APPROPRIATE POLICY COMMITMENTS.

SPEAKING AFTER A MEETING WITH WEST GERMAN FINANCE MINISTER GERHARD STOLTENBERG, WILSON ALSO TOLD JOURNALISTS THAT THE RESULTS OF CURRENT U.S. TALKS TO REDUCE WASHINGTON'S BUDGET DEFICIT WOULD BE THE KEY TO HOLDING ANY MEETING.

HE DECLINED TO COMMENT ON WHAT POLICY DECISIONS BONN MIGHT OFFER AT A G-7 MEETING, BUT SAID ANY CUTS IN THE U.S. BUDGET DEFICIT WOULD HAVE TO BE COMPLEMENTED BY OTHER NATIONS.

12-NOV-1109 MON092 MONK

CONTINUED ON - NRBZ

P

CANADA SAYS =2 BONN NRBZ

WILSON SAID: "MY PREFERENCE WOULD BE TO HAVE A (G-7) MEETING, BUT ONLY IF IT IS SUCCESSFUL ... AND CAN CONTRIBUTE TO MARKETPLACE STABILITY." A MEETING NOT PROPERLY PREPARED OR EXECUTED COULD BE MORE DAMAGING THAN NOT HOLDING TALKS AT ALL.

"WE CAN FOCUS ON FOREIGN EXCHANGE RATES AND MAKE APPROPRIATE COMMITMENTS ON EXCHANGE RATES, BUT IF WE DON'T HAVE THE RIGHT POLICY PRESCRIPTION, IT IS DIFFICULT TO FOLLOW THROUGH WITH EXCHANGE RATE STABILITY," WILSON SAID.

"A FUTURE MEETING WOULD HAVE TO FOCUS ON APPROPRIATE POLICY DIRECTIONS," HE SAID, ADDING THIS WAS AN IMPORTANT CHANGE IN EMPHASIS WHICH WOULD HAVE TO BE CONVEYED TO FINANCIAL MARKETS.

12-NOV-1117 MON108 MONK

CONTINUED FROM - NRBY

CONTINUED ON - NRCA

P

CANADA SAYS =3 BONN NRCA

WILSON SAID THERE HAD BEEN SOME SHORTFALLS IN POLICY EXECUTION SINCE THE SIGNING OF LAST FEBRUARY'S LOUVRE ACCORD, WHERE LEADING INDUSTRIAL NATIONS PLEDGED TO ADAPT POLICIES IN A BID TO PROMOTE CURRENCY STABILITY.

HE ACKNOWLEDGED THE U.S. HAD MADE SHARP CUTS IN THE BUDGET DEFICIT BUT SAID FINANCIAL MARKETS WERE NOW FOCUSING KEENLY ON FUTURE MOVES. "THE NEGOTIATIONS BETWEEN THE ADMINISTRATION AND CONGRESS ARE IMPORTANT AND ...THE KEYSTONE TO ANY G-7 MEETING."

WILSON ADDED THAT FINANCIAL MARKETS WOULD BE DISAPPOINTED IF THE U.S. DID NOT COME UP WITH DEFICIT CUTS GOING BEYOND THE 23 BILLION DLRS CONTAINED IN THE GRAMM-RUDMAN ACT.

12-NOV-1131 MON147 MONK

CONTINUED FROM - NRBZ

CONTINUED ON - NRDP

P

CANADA SAYS =4 BONN NRDP

WILSON HAS HELD TALKS WITH FRENCH FINANCE MINISTER EDOUARD BALLADUR AND SEES U.K. CHANCELLOR OF THE EXCHEQUER NIGEL LAWSON LATER TODAY.

HE HAD ALSO MET BUNDESBANK PRESIDENT KARL OTTO POEHL AND SAID LAST WEEK'S BUNDESBANK INTEREST RATES CUTS WERE USEFUL. ON GERMAN ECONOMIC POLICY, WILSON SAID BONN HAD TO TAKE INTO ACCOUNT DOMESTIC CONSIDERATIONS. EARLY IMPLEMENTATION OF TAX CUTS, URGED BY FOREIGN GOVERNMENTS, HAVE BEEN OPPOSED IN GERMANY ESPECIALLY BY SOME REGIONAL AUTHORITIES.

HOWEVER, ECONOMICS MINISTER MARTIN BANGEMANN HAS THIS WEEK PRESSED FOR SOME SORT OF ACTION FROM BONN TO SUPPORT GROWTH.

12-NOV-1217 MON215 MONM

CONTINUED FROM - NRCA
CONTINUED ON - NRDQ

P

REUTER MONITOR 1128

CANADA SAYS =5 BONN NRDQ

WITHOUT WANTING TO COMMENT SPECIFICALLY ON WHAT POLICY DECISIONS BONN SHOULD TAKE, WILSON SAID: "IF THERE IS TO BE A MEANINGFUL REDUCTION IN THE U.S. BUDGET DEFICIT, THEN IT IS IMPORTANT TO HAVE OFFSETS FROM OTHER COUNTRIES TO PICK UP THE POSSIBLE SLACK THERE MIGHT BE IN ECONOMIC ACTIVITY."

WILSON SAID SIGNS OF A RECESSION IN THE UNITED STATES COULD BEAR ON THE TIMING OF ANY G-7 MEETING. GOVERNMENTS WOULD NOT WANT TO MAKE POLICY COMMITMENTS WHICH MIGHT BE PREMATURE.

WILSON SAID HE WAS CAREFULLY MONITORING KEY U.S. INDICATORS FOR ANY SIGNS OF A RECESSION, BUT IT MIGHT BE SOME THREE TO SIX MONTHS BEFORE THE PICTURE BECAME CLEAR.

12-NOV-1218 MON216 MONM

CONTINUED FROM - NRDP
CONTINUED ON - NRDR

P

REUTER MONITOR 1128

CANADA SAYS =6 BONN NRDR

HE DECLINED TO MAKE SPECIFIC COMMENTS ON THE DOLLAR'S RATE BUT ACKNOWLEDGED THAT THE DOLLAR REPRESENTED THE MAIN UNCERTAINTY ON THE FINANCIAL MARKETS.

HOWEVER, HE ADDED: "THE DOLLAR IS A SYMPTOM. WE SHOULD NOT BE TOTALLY PREOCCUPIED BY THE SYMPTOMS OF THE PROBLEM BUT LOOK AT THE CAUSES AND DEAL WITH THE CAUSES AS WELL."

ASKED IF HE WOULD BE STAYING AROUND IN EUROPE JUST IN CASE A G-7 MEETING WERE CALLED, WILSON JOKED "I THINK ILL RUN OUT OF SHIRTS BEFORE WE HAVE A G7- MEETING.

12-NOV-1219 MON218 MONM

CONTINUED FROM - NRDQ

REUTER

P

REUTER MONITOR 1128

CONTINGENCY PLANNING FOR G7 IN LONDON

Plan for just Sunday (or just Saturday)? Any bilaterals the evening before? G5 in morning, followed by G7 lunch and afternoon session?

2. All delegations to arrange own accommodation (help required?). Police escorts from airport?

3. All meetings at No.11 (as opposed to country retreat, or hotel)?

- Formal meetings in State Room?
- Lunch where? (Couldn't really fit 21 people in Soane dining room).
- Other refreshments?
- All aides etc. in Treasury. (With office handling communications between the two)?
- Any special security arrangements?

4. Do we need to lay on any press facilities? Press conference in the Treasury at the end? Should we provide room in Treasury during meetings or make them stand in street? And any help with telephones etc?

5. Who pays?!

FT INTERVIEW

TUESDAY, NOVEMBER 10, 1987

pr

FINANCIAL TIMES

Lawson hopes for swift move on G7 accord

BY PHILIP STEPHENS, ECONOMICS CORRESPONDENT

THE Group of Seven leading industrial nations could meet to reaffirm last February's Louvre accord within a week or so of any deal in Washington which secured a credible cut in the US budget deficit, Mr Nigel Lawson, the Chancellor, said yesterday.

Further reductions in British interest rates would be a "distinct possibility" as part of a package to give new life to international co-operation, he said. The Government would be much more reluctant, however, to loosen significantly its fiscal policy if the recent turmoil on financial markets had a more damaging impact on Britain's economy that at present seemed likely.

In an interview with the Financial Times, the Chancellor appeared optimistic that the seven - the US, Japan, West Germany, France, Britain, Italy and Canada - would secure a new accord to promote currency stability.

Comments last week by Mr James Baker, US Treasury Secretary, suggesting that Washington was prepared to see the dollar fall were aimed primarily at assuaging domestic concerns about the possibility of a recession. The US Administration would want to see February's agreement "re-instated" once it had secured a budget package, he said.

The Chancellor added that Thursday's move by the West German Bundesbank to lower its official interest rates had met his earlier criticism that the West German central bank had been too inflexible in its monetary policy.

He gave a clear hint, however, that West Germany would face pressure to push interest rates lower still in the event of a meeting of the Group of Seven.

Mr Lawson, who has kept in close contact with Mr Baker over the past week, appeared optimistic that the Administration would secure a deal with Congress to reduce the deficit. He repeated, however, that the $23bn reduction envisaged in the Gramm-Rudman-Hollings law should represent only the start of the "bidding". There was also a tremendous symbolic importance attached to the need for some element of tax increases in the package.

Once a deal was agreed in Washington, there would have to be some informal consultations between governments, but he hoped that it would be not much more than a week before a formal meeting of finance ministers and central bankers was held.

Turning to Britain's prospects, he said he remained confident that the economy would weather the recent storm on financial markets.

If the effects, however, were more damaging than expected, the main flexibility in government policy would be seen in lower interest rates rather than in a much higher public sector borrowing requirement.

Although the precise figure for next year's PSBR will not be set until the Budget, Mr Lawson said that he would be "very reluctant indeed" to see it any higher than the 1 per cent of national income set as a guideline in the Medium Term Financial Strategy. For this year the PSBR is forecast at £1bn or about 0.25 per cent of national income.

The Chancellor also underlined his commitment to seek to hold sterling stable against the D-Mark, but made clear that this involved not only keeping the rate below DM 3.00 but also not allowing it to fall significantly. If costs in Britain's industry rose faster than elsewhere he would not be prepared to "bail it out" through a lower exchange rate.

A stable exchange rate had two clear advantages - it provided a useful anti-inflation discipline and it allowed business and industry to know exactly where it stood, Mr Lawson said. In that context the D-Mark rate was particularly important, although the Government could not fix an exact point from which the rate could never fluctuate.

He acknowledged that full British membership of the European Monetary System would have advantages. Primarily it would give a greater guarantee of continuity of policy over a number of years in much the same way as the MTFS had done.

Mr Lawson said that the recent BP issue would be followed by a full review of the Government's privatisation programme - a review which had been planned before the stock market fall. The Government had already secured its planned privatisation receipts of £5bn for 1988-89 so no large-scale asset sales were planned in that year. However, if state industries such as British Steel were ready for flotation in that year, overshooting the £5bn target would not be an obstacle.

Finally, the Chancellor said he had no plans at present for a Green Paper on the taxation of savings and investment. Such a consultation document has been promised before the Government embarks on any major overhaul of the tax treatment of pension funds.

Details, Page 9; Money markets, Page 37; Stock market report, Page 39; Wall Street and Bourses, Pages 40 and 41; Dollar sinks, Back Page

Ch

This was FT interview Gordon Brown quoted @ Tsy questions.

(This was interview where all 3 tapercorders broke down, so no transcript of what yr said is available)

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TUESDAY, NOVEMBER 10, 1987

FINANCIAL TIMES

Lawson hopes to see deal on US budget agreed this month

BY MALCOLM RUTHERFORD

MR NIGEL LAWSON, the Chancellor of the Exchequer, hopes that the US Administration can have a package of measures to reduce the US budget deficit that it can put to Congress by November 15. A meeting of the Group of Seven, the world's major industrial democracies, might follow within seven days of the package being approved.

The G-7 meeting would be designed essentially to review and update the Louvre agreement of February which was intended to introduce a period of exchange-rate stability.

The Chancellor said in an interview with the Financial Times yesterday that he believed that the reason for the February accord still obtained. That was primarily to stop the wild gyrations of the dollar on the foreign exchange markets. However, "a very clear commitment by the US" to the principles of the agreement was a "sine qua non" of its reaffirmation.

Mr Lawson declined to comment on what he thought the dollar exchange rate should be in advance of a G-7 meeting.

He made clear that there were two main parties involved in current arguments: the Germans and the Americans. He said he believed Mr James Baker, the US Treasury Secretary, was trying very hard to achieve the package and appreciated the international dimension of the problem in a way that not all Americans do.

The Chancellor added that his strictures on the US in his Mansion House speech last week were not aimed at the US Administration, and certainly not at President Reagan, but at the US Congress and the US political processes in general. He thought there was no particular divide between the US Federal Reserve and the US Treasury, but that with the recent departure of Mr Paul Volcker as chairman of the Fed it was inevitably Mr Baker who was in the driving seat.

It was essential that any US package should include some "tax element, if only as an earnest of how seriously the problem was being taken." It was also important that the effects of the package should extend well into a second year and have a long-reaching structural impact.

Since the current US fiscal year started on October 1, it was bound to be what was planned for the second year that mattered. The US had, in any case, done quite well in reducing the budget deficit in fiscal 1987 It was what came next that was causing concern.

In West Germany Mr Lawson said he believed the Bundesbank was divided over monetary policy. One section thought that policy should be governed solely by what was happening to central bank money which had been expanding very fast. That was why there had been a tendency to raise short-term interest rates, which Mr Baker had criticised.

Another section believed that wider considerations should also be taken into account, including exchange rates.

Dr Gerhard Stoltenberg, the West German Finance Minister, was allied with the latter section and Mr Lawson left no doubt that he himself was close to Dr Stoltenberg.

The Chancellor said the first half-point cut in British interest rates, after the stock market fall last month, had been decided upon for wholly domestic reasons. The second, announced last week, was determined after consultation with his international partners, but Mr Lawson said that he would have gone ahead in any case.

Further decisions on interest rates will be taken as and when appropriate, but Mr Lawson said that interest rate cuts could be part of the G-7 package if it comes.

Going back to the Louvre Agreement, the Chancellor claimed that although it was essentially about exchange rates, there had been an understanding that the partners would have to accept "interest-rate consequences".

Mr Lawson thought the Germans had been unduly alarmed by talk of a worldwide resurgence of inflation, and had acted accordingly. That danger was now over, although West Germany might have a large role to play in any discussion of the G-7.

The Chancellor gave no intimation that Britain was ready to become a full member of the European Monetary System as a consequence of any international agreement - or of the lack of it. We are going for "the bigger prize", he said. which was to stop the "wild gyrations of the dollar"

He claimed that he was not convinced that full membership would give Britain greater influence over the policy of the Bundesbank. He wondered out loud how the Bundesbank could be influenced but added that it would be an attraction if it the influence could come from Britain.

Mr Lawson then said that the "greater, stronger case" for joining the EMS was the same as the case for the British Medium Term Financial Strategy (MTFS) when it was first set out shortly after Mrs Thatcher became Prime Minister and Mr Lawson was Financial Secretary at the Treasury. "It would give a greater guarantee of stability and continuity."

The Chancellor expressed little doubt, however, that the pound could continue to be held at the present level of around DM 3, despite the differential between British and West German inflation. It had stayed at that level since the budget in March and there were two reasons why it was desirable that it should go on doing so.

One was that it provided a "useful anti-inflationary discipline". The other was that business and industry wanted to know where they stood. Citing a recent CBI survey, he said that business was now more interested in stable exchange rates than in interest rates.

Asked what would happen if the Americans failed to give a firm commitment to the exchange rate in domestic policy, Mr Lawson argued that Britain could live with it. "We did live with it for years - huge sterling-dollar fluctuations." The Japanese had adjusted to big swings as well, but the Germans had more problems. However, it would still be better for everyone if a breakdown could be avoided.

It was too early to say what effect the stock market fall and the dollar weakness would have on third world debt, but the Chancellor noted that Brazil - the biggest debtor of all - had been moving closer to a deal with the Internation Monetary Fund.

On domestic policy Mr Lawson notably declined to say that he would react to any threat of recession by significantly increasing the public sector borrowing requirement. There would be "flexibility", he said, but he would be "very reluctant indeed" to see borrowing rise above the one per cent of gross domestic product set down in the MTFS and reaffirmed in last week's Autumn Statement. Current borrowing is estimated at one quarter per cent of GDP.

As for the fate of the BP issue, which was caught up in the stock market fall, the Chancellor said that there was due to be a breathing space in the series of privatisations in any case. He had always planned to take stock of the exercise, tap the brains of advisers and examine the lessons of the privatisation programme to date.

Mr Lawson added, however, that he would be wary of admitting something like clause eight in the BP contract with the underwriters again. That was the clause that enabled the underwriters to appeal to the Bank of England on the grounds that market conditions had materially changed.

The Chancellor said that he had no worries that the target of £5bn a year proceeds from privatisation would fail to be met. There were no immediate future candidates, but if something new came up - like steel - he would not stand in the way.

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TREASURY QUESTIONS 10 MARCH 1988

Interest Rates

9. **Mr. Duffy:** To ask the Chancellor of the Exchequer if he will make a statement on the present level of interest rates.

Mr. Lawson: Bank base rates are currently 9 per cent.

Mr. Duffy: In view of the present balances on trade and external payments, and the serious extent to which both will be aggravated by this week's predictable surge of sterling, how does the Chancellor explain last month's hike in interest rates—or was he overruled?

Mr. Lawson: I am not sure what the hon. Gentleman means by the predictable rise in sterling; I was not aware that he had predicted it. We remain committed to maintaining a policy of exchange rate stability. That was agreed by the Group of Seven Finance Ministers and central bank governors in the communiqué of 23 December last year. While stability certainly does not mean immobility, any further significant rise in the exchange rate against the deutschmark would be unlikely to be sustainable. (certainly) (in my opinion)

Mr. Tim Smith: Does my right hon. Friend agree that amid all the speculation about the likely next movement of interest rates and the sterling exchange rate, what really matters is keeping a continuous downward pressure on inflation? That is likely to be far more valuable to British industry than any minor damage done by a 3 per cent. rise in the exchange rate.

Mr. Lawson: My hon. Friend is right. The battle against inflation is at the core of the Government's policy. That is why it is necessary, as I have said time and time again in the House, to maintain interest rates at whatever level is necessary to keep downward pressure on inflation.

Mr. Robert Sheldon: Will the Chancellor bear in mind the words of the president of the CBI, who said yesterday that allowing the exchange rate to develop in this way would produce a serious threat to British industry? Is he aware that most of us thought we understood his policy, which was stability? It does not seem to be stability now. Can he explain it?

Mr. Lawson: I was certainly aware of what the president of the CBI said, and I fully understand why he said it. It is also right to remind the right hon. Gentleman that he said something else, too. He said that it was very much the responsibility of business and industry to contain their costs.

Mr. John Townend: In view of Britain's trade balance and the lower level of oil prices does my right hon. Friend consider that the present strength of sterling is due to our very high interest rates or mainly to overseas confidence in the Government's ability to manage the economy?

Mr. Lawson: It is clear that confidence throughout the world in the British Government's management of the economy is a major factor in the strength of the pound.

Mr. Gordon Brown: Do not the combination of the high pound, high interest rates, and high and worsening trade deficits emphasise the economic and social case for a Budget that puts investment before tax cuts? Does he recall the statement that he made on the question of exchange rate stability and the statement he made to the *Financial Times* on 10 November to the effect that the pound should not rise above Dm3? Has he changed his mind or has the Prime Minister changed it for him?

Mr. Lawson: I never quoted any particular figure and if the *Financial Times* quoted one attributed to me it was wholly wrong. The hon. Gentleman should recognise that the policies that we have been pursuing have made this country's economy stronger than it has ever been before, with living standards at record levels, low inflation, output at record levels, exports at record levels—a far better performance than most of our major competitors.

Mr. Gow: If the Opposition Front Bench are correct in saying that high interest rates discourage investment, how is it that we have seen a more prolonged period of sustained investment in this country despite moderately high interest rates? Will my right hon. Friend confirm that he will persevere with his monetary policy until we achieve our declared manifesto aim of stable prices?

Mr. Lawson: I can certainly confirm what my hon. Friend has asked me to confirm. I can certainly give that assurance. He is right to point out that the policies that we have been pursuing for nearly nine years, and which have brought unprecedented success, were condemned and criticised every inch of the way by the Opposition.