PO-CH/NL/0677 PART A

2/3

psl/70A

MPW 10/11

Mr RIG Allen
Ms Life
Alex, Jonathan, Moira
Julie, Tony D

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?!

pyp

SECRET

From: Sir G.Littler
Date: 15 November 1987

CHANCELLOR

MEETINGS IN BRUSSELS

I attach some notes for the trilateral meeting, a check-list of the points which could be worth covering. I think the main thing is to flush out Stoltenberg on two points:

- will he move more on the fiscal front? According to Trichet (after the Franco-German Summit bilateral Friday) Stoltenberg personally is the main resistance, and is now under pressure from CDU colleagues as well as FDP, while Poehl also sees need for a move - genuinely and not just passing the buck.
- is he prepared to give real priority to holding exchange rates? I think in the ERM he wants to help; I am less sure from Tietmeyer whether he shares our perception of the dangers of further dollar decline as he should.

2. Two or three other disparate points you should know of:

- At Stoltenberg's request, Tietmeyer is drafting some points for representations to the US by the European G7 members (or three of us). Not very sensible at this stage, I think, and I would certainly advise against our now having yet another go at them.
- Trichet asked me about excluding Italy from the session on Monday morning. We quickly agreed: that there was no question of bringing them in at this late stage; that it might be sensible for him and me to speak to Sarcinelli

afterwards - not apologising but debriefing on what we would emphasise as an attempt to get at the Germans; and that we would draw the point to Ministers' attention.

- Eyskens is of course playing pre-election politics: you should know that his letter to EC colleagues was largely leaked to "De Standaard" the day he sent it, but seems not to have been picked up elsewhere.

3. On a quite separate issue you may recall that, from the Luxembourg European Council a couple of years ago, the Commission were asked to report back on the monetary area by the end of 1987. Several Monetary Committee members, including me, have urged that the report should simply state what has happened and been agreed on the lines of the Nyborg meeting - and a good and constructive report it would be, so we argued. We thought the Commission were accepting this until, only late last week, I was warned that the Commission are now proposing a much more ambitious report, to go straight to the European Council (presumably Copenhagen) looking forward to further steps towards monetary union over the years ahead. I am sure you will agree we could without this! I am told that the pressure comes not from Delors himself but from his staff. If you have chance to sound Delors, and he confirms what I have been told, you might like to try some dissuasion - I am sure Stoltenberg would be an ally in this.

(Geoffrey Littler)

SECRET

NOTES FOR TRILATERAL

Objectives

- Agree need to avoid further dollar collapse
- Agree action needed in Europe in light of changed situation (on merits and in interest of Community and world prospects)
- Restore G7 credibility and market confidence
- Agree conditions needed to restore credible "Louvre".

Avoiding dollar collapse

- Our UK analysis is that further dollar collapse would solve nothing but pose greatest threat of a world-wide loss of confidence and recession. Do others agree and what do we think is responsible US view?

Action in Europe

- Recent events have shifted balance of risk away from inflation towards fear of recession
- Germany has a key role - especially in view of low level of activity recently
- Action on fiscal as well as monetary front needed
- Irrespective of US action - although of course tactically may be advantages in holding for negotiation
- Action by others than Germany (? especially UK)

Confidence in G7

- Badly undermined - need to understand reasons: market doubts fostered by public rows suggesting (1) lack of will to cooperate, (2) lack of mutual confidence, (3) lack of adequate policy action must be at root.
- Must tackle all these three to win back credibility.

SECRET

Basis for renewed Louvre

- Do we want to renew - all of us?
- Do we want exchange rate stability as part of it - and immediately? Would an 'agreement' without explicit undertakings on exchange rate stability be sufficient?
- **Conditions for effective full agreement:**
    - Immediate or promised imminent policy actions: (by US - ?$30bn + for 1988 and more for 1989 in form which shows determination; by Germany some fiscal action with demonstration effect; for Japan a 1988 budget carrying forward stimulus to domestic demand); what about the NICs?

      supply side action

      + opening of markets
    - Undertakings to use interest rates with some cooperative flexibility to keep differentials

      foreign borrowing / actions of Japan (or rather on)
    - Genuine US commitment (and others) to intervene and be seen to do so

      "only Reagan & Baker comm..."
    - Assurance of public posture of responsible US authorities (this may be the most elusive point)
- Can we help presentation by deliberate analytical comment on recent events? And could we agree on substance of it?

Future Work

- ? Pressure on US (Stoltenberg may propose some joint demarche: I think unwise at this juncture, and wrong for UK after what we have already done)
- ? Further work in European group of deputies - ? better to include Italy if we do
- ? How quickly move towards G7 (? deputies: ? Ministers) when US budget question publicly settled.

SECRET

From: Sir G.Littler
Date: 17 November 1987

CHANCELLOR

c.c. Sir P.Middleton

BALLADUR AND STOLTENBERG

At Balladur's suggestion, Trichet asked me this morning to pass on to you the following information.

2. Balladur has written personally to Stoltenberg (he handed the letter to him as they left our meeting in Brussels yesterday) urging German fiscal action in the interests both of European equilibrium and of contributing to easing world imbalances. Specifically he has asked Stoltenberg to accelerate the planned DM 20 billion tax reductions on 1 January 1990 : to make a first cut of DM 5 billion at least on 1 January 1988 and the balance one year later.

3. No action suggested. Balladur simply wanted you as an ally to be aware privately of what line he had taken. My view is that we should support an approach on these lines, at least in the first instance. More generally, I do hope Stoltenberg will in the end go for tax reduction and and possible structural changes and not infrastructure capital expenditure which would be far less effective (and also mildly tiresome as an 'example' for us).

(Geoffrey Littler)

RM6.71

SECRET

PMP

FROM: MISS M P WALLACE
DATE: 17 November 1987

NOTE FOR THE RECORD

cc Sir G Littler

TELEPHONE CALL WITH MR STOLTENBERG

The Chancellor spoke briefly with Mr Stoltenberg on the telephone this morning.

2. The Chancellor said he was sorry he had not had an opportunity to speak to Mr Stoltenberg yesterday afternoon in Brussels. He agreed with Mr Stoltenberg that further substantive discussion could now wait until Saturday. They would then have to consider what could be achieved by measures in Europe, what contact there should be with Mr Baker, and what preparations should be made for a G7 meeting. Mr Stoltenberg accepted that it would be dangerous to wait too long, and said that if necessary he would overcome his reluctance to have a December meeting.

mpw.

MOIRA WALLACE

ps3

Pse update US Oct fig curly available, & prob. Canada's too. [illegible]

FROM: P SULLIVAN
DATE: 18 November 1987

MISS M WALLACE

cc: Mr Matthews
Miss O'Mara

CH/ US & Canada below. Japan still n.a.
MPW 25/11

INFLATION IN G7 COUNTRIES

Your minute to Mr Matthews of 18 November asked for the latest annual inflation rates in the G7 countries. The table below gives the rates for September and October (where available).

Increase of 0.3 percent. points between Sept & Oct in USA & Italy, as well as UK, and 0.5 percent points in Germany. AM

Consumer Price Inflation (12-month percentage change)

Percentages

	September	October
United States	4.3	~~n.a~~ 4.6
Japan	0.7	n.a
West Germany	0.4	0.9
France	3.2	3.2
United Kingdom	**4.2**	**4.5**
Italy	5.0	5.3
Canada	4.5	~~n.a~~ 4.4

Peter Sullivan

P SULLIVAN
IF2
EXT. 5548

Boards of Governors

INTERNATIONAL MONETARY FUND · INTERNATIONAL FINANCE CORPORATION · IFC · INTERNATIONAL DEVELOPMENT ASSOCIATION · IDA · INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT · WORLD BANK

Please let me have
a table showing latest
inflation rates (RPI/CPI)
in each G7 country.

N

RM6.70

UNCLASSIFIED

pwp

FROM: MISS M P WALLACE
DATE: 16 November 1987

MR S W MATTHEWS

cc Miss O'Mara

INFLATION IN G7 COUNTRIES

For this month's First Order the Chancellor would like to have a table showing the latest annual rate of inflation in each of the G7 countries. We would be grateful if you could provide this.

MPW

MOIRA WALLACE

UNCLASSIFIED

Before Tsy Questions, PSC Chancellor Lawson a table showing the latest annual rate of inflation in each of the G7 countries. M.

132205
MDLIAN 8337

UNCLASSIFIED
FM ROME
TO PRIORITY FCO
TELNO 620
OF 091615Z NOVEMBER 87
INFO SAVING WASHINGTON, BONN, PARIS, TOKYO, OTTAWA, UKREP BRUSSELS
INFO SAVING UKDEL IMF/IBRD, UKDEL OECD

THE ITALIAN ECONOMY, OCTOBER 1987

SUMMARY:

1. THE MAIN EVENTS IN OCTOBER WERE THE COLLAPSE OF THE STOCK MARKETS, THE FAILURE OF THE GOVERNMENT TO PUSH THROUGH THE FINANCE BILL, RISING INFLATION AND THE CONINUING UNREST IN PUBLIC SERVICES, PARTICULARLY THE TRANSPORT INDUSTRY.

DETAIL:

2. THE COLLAPSE OF INTERNATIONAL STOCK MARKETS HAS ALREADY BEEN WELL RECORDED AND THE MILAN STOCK EXCHANGE SUFFERED HEAVILY IN COMMON WITH ALL OTHERS. THE TWO POINTS WHICH ARE CAUSING MOST CONCERN IN MILAN ARE THAT THE FALL FROM 1 JANUARY HAS BEEN SPECTACULAR, INCLUDING SUBSTANTIAL LOSSES ON MANY LEADING COMPANIES SUCH AS FIAT, MONTEDISON AND GENERALI, AND THAT IN THE LAST FEW DAYS THE LARGE INSTITUTIONS HAVE BEEN SELLING HEAVILY. IN THE EARLY STAGES OF THE COLLAPSE SELLING WAS MAINLY BY SMALL INVESTORS WITH THE INSTITUTIONS APPARENTLY FOLLOWING ADVICE FROM ROMITI, FIAT'S GENERAL MANAGER NOT TO PANIC. THERE IS NO WAY OF ESTIMATING HOW FAR DOWN THE MARKET WILL GO.

3. AFTER A FAIRLY COOL RECEPTION IN THE SENATE LITTLE HAS GONE RIGHT FOR THE FINANCE BILL, AND CONSIDERATION WAS ABRUPTLY STOPPED AT THE END OF OCTOBER WHEN THE BILL WAS REFERRED BACK TO THE GOVERNMENT FOR A COMPLETE RE-DRAFT IN THE LIGHT OF INTERNATIONAL ECONOMIC CONDIDTIONS WHICH HAD CHANGED COMPLETELY. THE NEW TARGET IS TO PRODUCE A MEASURE WHICH WILL REDUCE THE PUBLIC SECTOR DEFICIT TO BELOW 100,000 BILLION LIRE AND AVOID INFLATIONARY PRESSURES, WITHOUT PROVOKING A GENERAL STRIKE AND COMPLETELY ALIENATING THE EMPLOYERS SIDE, AND TO PRODUCE IT WITHIN A FEW DAYS SO THAT IT CAN BE PRESENTED TO THE SENATE ON 10 NOVEMBER.

4. AFTER A PERIOD OF SEVERAL MONTHS AT ABOUT 4.2 PERCENT INFLATION NOW LOOKS SET TO RISE TO ABOUT 5.5 PERCENT BY THE END OF OCTOBER AND TO 6 PERCENT BY THE END OF THE YEAR.

132205
MDLIAN 8337

LABOUR AND SOCIAL AFFAIRS:

5. ON THE LABOUR SIDE THERE HAS BEEN A WAVE OF STRIKES IN THE TRANSPORT INDUSTRIES AFFECTING RAIL AND AIR SERVICES VERY BADLY AND TO A LESSER EXTENT BUS SERVICES. THE TROUBLE SHOWS EVERY SIGN OF CONTINUING AND IS BEING CAUSED MAINLY BY THE COMITATI DI BASE (COBAS), WHO ARE SEEKING BETTER PAY AND CONDITIONS FOR LIMITED GROUPS OF WORKERS, AND ALSO TRYING TO OBTAIN RECOGNITION OF THEIR RIGHT TO REPRESENT THEM. THEY ARE ALSO ACTIVE IN THE EDUCATION SERVICE.

6. THERE HAVE BEEN SEVERAL PROPOSALS FOR A LAW TO CONTROL STRIKES AND PROVIDE FOR THE SAFEGUARDING OF ESSENTIAL SERVICES BUT NONE HAS FOUND GENERAL FAVOUR INCLUDING ONE PUT FORWARD BY THE PRIME MINISTER GORIA WHICH HAS BEEN EFFECTIVELY VETOED BY THE SOCIALISTS. DISCUSSIONS ARE CONTINUING ON OPTIONS PUT FORWARD FROM WITHIN AND OUTSIDE GOVERNMENT.

BRIDGES

YYYY

DISTRIBUTION 164

MAIN 156

MONETARY	WED

SAVING 8

WASHINGTON	OTTAWA
BONN	UKREP BRUSSELS
PARIS	UKDEL IMF/IBRD WASHINGTON
TOKYO	UKDEL OECD

NNNN

PH1/182

SECRET

Rp

NOTE OF A MEETING IN No.11 DOWNING STREET
AT 11.45am ON WEDNESDAY 18 NOVEMBER

Present: Chancellor
Sir T Burns
Sir G Littler

PREPARATION FOR G7

The Chancellor felt that unless a G7 agreement had a currency dimension, it was questionable whether it was worth having; it might instead be better to rest simply on co-ordinated statements, without any meeting. But that would be highly undesirable and we should certainly continue to fight for agreement to the principle of a further period of currency stability; it was of lesser importance whether the existing rate was at the top, bottom or middle of the band.

2. The main issue was whether the US were prepared to enter into such an agreement. It was critical to get a firm commitment from them, one that went beyond simple platitudes. To get market credibility, the US must either to undertake foreign currency borrowing, or activate swap agreements. They would also have to be prepared to use interest rates to buttress an exchange rate agreement, though this would no doubt be very difficult to negotiate. But the US had to finance its current account deficit, and - providing it did not slide into recession - it was difficult to see how this could be done without an interest rise at some stage.

3. For the Germans, the Chancellor thought that although Stoltenberg was considering the possibility of doing something on tax, we should not cavil at increased public expenditure if the

difficulties of negotiating tax changes with the Laender proved too great. Sir T Burns agreed; but he pointed out that extra public expenditure would not be as effective as tax cuts in helping balance of payments adjustments (and would cause problems with the environmentalists). It also would be very useful if there was something that could be done to reduce savings incentives in Germany. The Chancellor commenteds that if the German economy was growing at its potential there might not be a current account surplus.

4. The Chancellor also thought a gesture was needed from the Germans on the monetary front. One possibility was for the Bundesbank to agree to do nothing to reduce the interest rate differential vis a vis the US.

5. For the French, Balladur would commit himself to his three year tax reductions; but, for EMS reasons, he could not do anything on interest rates. For the UK, the Chancellor was reluctant to show his hand on the Budget, beyond repeating the line he had already taken. So he would prefer to take a further ½% off interest rates if some concrete action was needed. Sir T Burns wondered whether any action from us was needed: there did not seem to be any need for us either to increase or decrease domestic demand. And we could point to a forecast of 3% GDP growth excluding North Sea oil.

6. On the timing, the Chancellor thought that waiting would not make any agreement easier. He thought we should aim for the first weekend in December, while recognising that it might have to be deferred beyond that.

ACSA

A C S ALLAN

Distribution:

Those present
Sir P Middleton

pmf

SECRET

From: Sir G.Littler
Date: 22 November 1987

CHANCELLOR

c.c. Mr Alex Allan
Sir P.Middleton
Sir T.Burns
Mr Peretz

WEEKEND MEETING IN BONN

I attach a detailed record of the discussion yesterday in Bonn - a valuable meeting in which a great deal of ground was covered. I am limiting the circulation of this minute. I shall also copy the attached note however to the Governor of the Bank of England and to Huw Evans.

Follow-up Action

2. I have noted the following:

- we are all trying to keep the fact of the Bonn meeting secret (no harm if it gets known, as we thought it did, that you paid a visit: we want to keep the G3 quiet);
- you will telephone (may have done so) Jim Baker: we want to get him thinking of 12/13 December, and also of a G5 for certain important elements of discussion before G7;
- for your diary: as well as 12/13 December for G5/G7 note also for G3(Eur) 11 a.m. Brussels on 7 December (I will be in touch with my colleagues about logistics);
- I am making arrangements for further talk among G3(Eur) deputies; I want to offer them a draft which I must take with me at 4.15 p.m. on Tuesday 24 November when I leave for Brussels.

SECRET

- I shall follow up at the Monetary Committee in Brussels on Wednesday the question of possible Community action or pressure jointly with the U.S. on Taiwan and Korea.

3. We want also to give thought to the idea of a Hong Kong move in connection with the G7 operation. I shall try to track Piers Jacobs who may still be in London for a day or two this week. I shall also discuss with Mr Peretz what further helpful work we could do.

(Geoffrey Littler)

SECRET

Note for the Record

MEETING WITH GERMAN AND FRENCH FINANCE MINISTERS

On Saturday 21 November 1987 a meeting was held at the private home of Herr Stoltenberg in Bad Godesberg from 5 p.m. to 8 p.m. between:

Stoltenberg (German Finance Minister) and Tietmeyer;
Balladur (French Finance Minister) and Trichet; and
the Chancellor of the Exchequer and Littler.

The meeting had been planned the previous Monday with the aim of concerting views on the conditions for renewed G5/G7 international cooperation. The United States authorities had managed only the day before the meeting at last to announce agreement in principle on a package of measures to reduce the U.S. fiscal deficit in the next two years.

2. Opening the discussion Stoltenberg suggested the need for a common understanding on the basic objective of cooperation. In his view a new agreement should cover all the elements present in the February Louvre Accord. In passing he had re-examined the text of that Accord: it seemed to him that Germany had met the commitments he had given in it; so too had the U.S. with their decision of the day before, assuming it was confirmed. But it must be recognised that recent developments meant that market and public expectations were now more demanding.

3. He had talked at length with both Poehl and Schlesinger of the Bundesbank, urging on them the importance of maintaining the necessary interest rate differentials and he was making progress with them. He recalled the October statement by Jim Baker (U.S. Treasury Secretary) about interest rates - not wanting a rise which could threaten recession merely to support the dollar's value. In his view it was vital that the U.S. should accept the need to raise their interest rates if that was necessary to support the dollar. Cooperation to restore stability of exchange rates was essential and willingness on all sides to use interest rates to this end was an integral part of it. Otherwise there could be no effective agreement.

4. The Chancellor said that Stoltenberg had indeed gone straight to the heart of the problem. As a preliminary comment on the question of public statements from the U.S. he feared that there was no way of preventing unhelpful views being expressed by such people as Sprinkel, Wallis, Yeutter and Verity. Baker was in principle more reliable: it would be very helpful if we could get public acceptance that only statements by Baker or the President himself were authoritative. He thought Baker wanted to be helpful, but Stoltenberg must recognise that Baker felt keenly that Germany had not met the contingent undertaking in the Louvre Accord to take stimulative action if German activity developed as sluggishly as it evidently had done in much of 1987.

5. On the main issue he whole-heartedly agreed. Markets were fragile and to re-create confidence would not be easy. A new collaborative effort to restore exchange rate stability was in the interests of all. He had told Baker that this was an essential element and a condition of having any new G7 agreement at all. He had indicated to Baker his own willingness to accept a lower range for the dollar than in the Louvre Accord, but had insisted that a new agreement could not be buttressed only by intervention; an agreement cooperatively to manage interest rate differentials would be vital and in this connection Baker must be prepared to see U.S. interest rates rise if that were necessary. He believed Baker would accept this - while adamant that there was no case for such a move immediately. He welcomed Stoltenberg's talks with Poehl and Schlesinger: willingness to act on interest rates by both Germany and the U.S. was the core of the problem.

6. Balladur expressed two concerns. First, were all ready to give exchange rate stability the priority he wanted? - in which case certain conclusions followed. Secondly, the consequences of the October crash included both slower U.S. and world growth and a damaging further loss of competitivity of Europe against virtually all the world except Japan which would harm already unsatisfactory European growth prospects.

7. These concerns led him to pose questions. Was the action just announced by the U.S. enough? What action should Europe now take? (Incidentally he saw Baker's refusal to contemplate a very early G7 meeting as a threat). And if stability of the dollar was not obtainable, what about the EMS? - would it not be necessary to adapt the system?

8. The Chancellor suggested re-phrasing Balladur's first question. The fact was that what the U.S. had announced was all that could now be expected from them on the fiscal front. The question should therefore now be: were the U.S. prepared to commit themselves to stability of exchange rates by willingness to use interest rates as required? The others accepted this.

9. Reverting to the Chancellor's comment on Baker's views about German performance, Stoltenberg said he thought there had been a misunderstanding. Baker had not appreciated - and others had not foreseen the scale of it - the damaging impact on the ERM countries of the change of exchange rates in 1986, which had cut both immediate growth and confidence. The German position had indeed shown signs of improvement in the summer, but prospects were now very uncertain again. All of this should underline the common interest in more stable exchange rates.

10. Focussing again on the importance of managing interest rate differentials, Stoltenberg said that he had not been happy with the way the Bundesbank had given wrong signals in early October, although that did not justify the attack by Baker which had been responsible for the real damage. Looking to the future, he thought that the U.S. deficit decisions, if carried through, must

have a good effect: but they were not enough on their own. We faced inevitably a worrying period with U.S. trade figures likely now to get worse for a while. This was what made the interest rate problem so crucial. The Chancellor and Balladur agreed.

11. As far as the Bundesbank was concerned, Stoltenberg said that Schlesinger and his supporters were having to rethink their position. Baker's public attack on them had not helped, but they were shaken by what had happened and were now more ready to listen to arguments from Poehl and himself. He thought they would be prepared to cooperate, within some limits. They could not accept a binding agreement to limit further action unconditionally. But they would probably be willing: to accept the principle of using interest rate differentials in the interest of exchange rate stability, subject to review from time to time or for some period ahead, and with a provision that if they wanted to make a move they would undertake to consult before doing so.

12. (Balladur at this point asked Stoltenberg whether it was true, as rumoured, that he and Baker had bilaterally agreed to a lower dollar/DM range than in the Louvre Accord. Stoltenberg recalled that he had talked with Baker on 'Black Monday' - after the unfortunate Baker statement of the previous Friday but before the Stock Market crash happened. The dollar at that moment was standing at about DM 1.77 and they had simply agreed to try to cooperate and avoid damaging public statements. That night - when the Stock Market news was clear - he had telephoned Baker seeking assurance that he still respected the Louvre commitment. Baker had shown reluctance but agreed to try to work around then current levels, which for his part Stoltenberg had accepted as the only practicable choice).

13. The Chancellor said that what Stoltenberg had said about the Bundesbank was important and helpful. He hoped it meant that there could be a clear statement of the need to use monetary policy instruments in support of exchange rate stability, reserving the right to make independent movements only after consultation. Stoltenberg confirmed this was his hope, but the language of an agreement would need careful drafting; he remarked in passing that Poehl had bitterly lamented the shortness of the G5 meeting in September which had denied him the opportunity of pursuing there points which in retrospect could have been valuable. Stoltenberg also offered that the Bundesbank were minded to consider a reduction of interest rates as part of a renewed Accord in which all played an appropriate part.

14. The Chancellor suggested that this pointed to a 3-part statement: general conduct of monetary policy supportive of stable exchange rates; reservation of right to make minor change after consultation; half per cent off rates immediately. The U.K. might well offer a matching half per cent reduction. Stoltenberg confirmed but emphasised the need for language reconciling the Bundesbank obligations to balance the pursuit of growth and of price stability. The Chancellor said he saw no conflict in giving priority to exchange rate stability and Balladur agreed.

15. Balladur reverted to the problem that any further revaluation of European currencies against all except the Yen would do great damage to the European economies. It was for him intolerable that the Bundesbank alone should have the power effectively to determine Europe's external competitiveness. Stoltenberg said soothingly that he took the point and that he hoped the Bundesbank would help. The trouble was that they were worried by threats to German price stability, although he believed that the dollar depreciation hitherto should help allay their fears - the Chancellor and Balladur strongly endorsed the last point. He would continue to work for a satisfactory formula. Balladur commented that we could not pursue Louvre-type cooperation unless all were prepared to forego some sovereignty.

16. The Chancellor moved on to the U.S. position, stressing again the need for both Germany and the U.S. to adopt supportive monetary action. He was prepared to accept Baker's argument that there was no need for an immediate increase in U.S. interest rates but a future need could by no means be ruled out and an agreement would need commitment by the U.S. to accept this. It was a question of priorities over which Baker's October statement had given the wrong answer.

17. Stoltenberg agreed, pointing out that the U.S. had to be able to attract funds to finance their external deficit in any case. The Chancellor endorsed this: if the dollar plummeted the problem of financing for the U.S. could be even worse and interest rates would have to be raised anyway. Stoltenberg said that it would be very helpful if the U.S. would seek some finance through borrowing in foreign currencies. The Chancellor agreed: the need for the U.S. to equip themselves with funds was clear. Borrowing in foreign currencies would be the best answer and we should all encourage that, although the memory of 'Carter Bonds' would be an uncomfortable hurdle. As one alternative, he wondered whether an announcement of extended swap arrangements might be a useful signal to the markets. Tietmeyer pointed out that big swap lines already existed (the U.S. had some $15 billion worth with Germany and Switzerland) but were not used. Trichet suggested using them could be a helpful signal. The Chancellor summed up that foreign bond borrowing would clearly be best, but we should not overlook other possibilities.

18. Balladur wanted to know more clearly: what procedure would be envisaged for interest rate consultation? what ranges for exchange rates should be adopted? and what fiscal action could be offered by Germany?

19. Stoltenberg said that more discussion was needed to get a formula on interest rates: some flexibility was essential; minor daily changes might be excluded; any major change would have to be the subject of consultation. Balladur asked would this be G5 or G7 and the Chancellor suggested leaving the point vague but trying in practice to use G5. Balladur asked whether the recent interest rate agreement between France and Germany would have been subject

to consultation with others under the system envisaged: others felt that a problem would only arise if moves were contemplated which might seem perverse, and Stoltenberg thought that one possibility might be that an objector could call for a meeting if he felt that the basic agreement was threatened.

20. On Balladur's second question, the others thought it would be unrealistic to look for a range above the going market rate - which incidentally might be a reason for wanting to avoid delay. Stoltenberg said that Poehl wanted a more flexible arrangement and the Chancellor said that Baker wanted a wider range. All of these points would need further discussion.

21. On Balladur's third question, Stoltenberg claimed that Germany had been pursuing an expansionary policy with very large staged tax reductions and that the public sector deficit was now deteriorating very fast - it could well be 3% of GDP in 1988. But further possibilities of action were being explored. He believed that it would not be possible to accelerate at all the planned 1990 tax reductions, mainly because of opposition by the Laender - he had talked to Laender finance directors recently and they had been totally opposed (given the impact on their own finances of any change of plans); he would be talking shortly to the political leaders, but frankly expected the same response. What he was now exploring was the possibility of offering from the Federal budget loans to Laender and private firms at subsidised rates to promote investment, and this could be on a large scale of DM 10/15 billion over two years. He also confirmed that he would postpone planned increases in indirect taxes. He then spoke bitterly about the cost of the Community Budget and the necessity of raising some more taxes soon to meet it. Nobody rose to the Community point.

22. The Chancellor commented that the investment financing seemed a little like the Japanese approach. Asked about timing, Stoltenberg thought he could well be ready to announce decisions in a couple of weeks. The Chancellor commented that straight tax reductions would be more relevant and welcome but the important thing was to be able to deliver anything offered.

23. Stoltenberg then asked what others were prepared to do for an agreement. The Chancellor said he would want to sustain the exchange rate and undertake to use monetary policy to that end. He hoped to reduce interest rates if the Bundesbank also moved. On the fiscal front he would not be able to announce anything new until his budget in March, but he would be prepared to tell his colleagues privately that he intended to reduce taxation further. But in any case the U.K. rate of growth was such that he did not expect to be pressed further. Balladur said he had already announced that, following FF 70 billion of tax reductions in the two years 1987 and 1988 he would seek another FF 45 billion in the following two years. He also wanted cooperation in monetary policy and with French interest rates far too high would be looking for an opportunity to reduce them, heavily dependent on the EMS situation and on further arrangements to make the system work better.

SECRET

24. On other countries, the Chancellor suggested we wanted three things from Japan, although we should leave the U.S. to take the lead and stand ready to back them up: undertakings and some movement in interest rates in parallel with what had been proposed for Germany; fiscal action in 1988 to carry forward what had been done in 1987; and greater opening of markets to imports. Also we should seek to get the Community to work jointly with the U.S. in bringing pressure to bear on Taiwan and South Korea to open up their heavily protected markets. Incidentally it was important as well that the U.S. reaffirm the commitment of the administration to resisting protectionist action. All of this was agreed.

25. Discussion then turned to future arrangements for meetings and their preparation, and the problems both of G5/G7 and within Europe of G3/G4 (brief reference to enquiries and pressure from Amato, Italian Finance Minister). It was agreed that there must be provision for a substantial G5 meeting - this being the forum in which the hard details of practical cooperation on exchange rates and interest rates would be worked out. This in turn made it desirable for European cooperation on such matters to be G3 and not G4. The Chancellor hopefully suggested that the acceptance of G5 as well as G7 meetings recently might ease the problem.

26. Stoltenberg suggested that G5 should meet on Saturday for a long evening, with G7 meeting the following day. He was happy to offer invitations to Bonn. The Chancellor said that he had a strong preference for Europe and would happily offer London - Baker might feel he preferred more 'neutral' ground than Bonn. Balladur said he had no preference.

27. It was thought that 12/13 December might be the best date to aim at. Earlier might be impracticable; later would risk not getting a meeting before Christmas. Baker did not want meetings of Deputies first. He might be playing tactics, but for now this should be accepted. It would be helpful however to get Baker committed to a December date as soon as possible. Stoltenberg and the Chancellor both intended to get in touch with Baker shortly in any case and would pursue this. Stoltenberg said that he had not told Baker of the present meeting and did not intend to: he would simply say he had had informal contacts with colleagues.

28. It was also agreed that further European discussion would be desirable, and two arrangements were made:

- the same group would find it useful to meet again soon and the morning of 7 December, before the ECOFIN lunch, could be a suitable time: it was agreed that deputies would explore logistics for a meeting at 11 a.m.
- the three deputies would meet to see whether they could prepare elements of a possible G5/G7 agreement and public statement (provisionally Littler to hand over a draft on 25 November in Brussels, and all three to meet Saturday 28 November, possibly in Paris).

(Geoffrey Littler)
H.M. Treasury, 22 November 1987.

1. Jonathan

2. Julie C
X & Y for diary in manuscript and square bracket

Alex

Alex
For you. I gave C/E his top copy on Sunday. Geoff

SECRET

From: Sir G.Littler
Date: 22 November 1987

PMP

CHANCELLOR

c.c. Mr Alex Allan
Sir P.Middleton
Sir T.Burns
Mr Peretz

WEEKEND MEETING IN BONN

I attach a detailed record of the discussion yesterday in Bonn - a valuable meeting in which a great deal of ground was covered. I am limiting the circulation of this minute. I shall also copy the attached note however to the Governor of the Bank of England and to Huw Evans.

Follow-up Action

2. I have noted the following:

- we are all trying to keep the fact of the Bonn meeting secret (no harm if it gets known, as we thought it did, that you paid a visit: we want to keep the G3 quiet);
- you will telephone (may have done so) Jim Baker: we want to get him thinking of 12/13 December, and also of a G5 for certain important elements of discussion before G7;

X

- for your diary: as well as 12/13 December for G5/G7 note also for G3(Eur) 11 a.m. Brussels on 7 December (I will be in touch with my colleagues about logistics);

Y

- I am making arrangements for further talk among G3(Eur) deputies; I want to offer them a draft which I must take with me at 4.15 p.m. on Tuesday 24 November when I leave for Brussels.

SECRET

- I shall follow up at the Monetary Committee in Brussels on Wednesday the question of possible Community action or pressure jointly with the U.S. on Taiwan and Korea.

3. We want also to give thought to the idea of a Hong Kong move in connection with the G7 operation. I shall try to track Piers Jacobs who may still be in London for a day or two this week. I shall also discuss with Mr Peretz what further helpful work we could do.

(Geoffrey Littler)

SECRET

Note for the Record

MEETING WITH GERMAN AND FRENCH FINANCE MINISTERS

On Saturday 21 November 1987 a meeting was held at the private home of Herr Stoltenberg in Bad Godesberg from 5 p.m. to 8 p.m. between:

Stoltenberg (German Finance Minister) and Tietmeyer;
Balladur (French Finance Minister) and Trichet; and
the Chancellor of the Exchequer and Littler.

The meeting had been planned the previous Monday with the aim of concerting views on the conditions for renewed G5/G7 international cooperation. The United States authorities had managed only the day before the meeting at last to announce agreement in principle on a package of measures to reduce the U.S. fiscal deficit in the next two years.

2. Opening the discussion Stoltenberg suggested the need for a common understanding on the basic objective of cooperation. In his view a new agreement should cover all the elements present in the February Louvre Accord. In passing he had re-examined the text of that Accord: it seemed to him that Germany had met the commitments he had given in it; so too had the U.S. with their decision of the day before, assuming it was confirmed. But it must be recognised that recent developments meant that market and public expectations were now more demanding.

3. He had talked at length with both Poehl and Schlesinger of the Bundesbank, urging on them the importance of maintaining the necessary interest rate differentials and he was making progress with them. He recalled the October statement by Jim Baker (U.S. Treasury Secretary) about interest rates - not wanting a rise which could threaten recession merely to support the dollar's value. In his view it was vital that the U.S. should accept the need to raise their interest rates if that was necessary to support the dollar. Cooperation to restore stability of exchange rates was essential and willingness on all sides to use interest rates to this end was an integral part of it. Otherwise there could be no effective agreement.

4. The Chancellor said that Stoltenberg had indeed gone straight to the heart of the problem. As a preliminary comment on the question of public statements from the U.S. he feared that there was no way of preventing unhelpful views being expressed by such people as Sprinkel, Wallis, Yeutter and Verity. Baker was in principle more reliable: it would be very helpful if we could get public acceptance that only statements by Baker or the President himself were authoritative. He thought Baker wanted to be helpful, but Stoltenberg must recognise that Baker felt keenly that Germany had not met the contingent undertaking in the Louvre Accord to take stimulative action if German activity developed as sluggishly as it evidently had done in much of 1987.

5. On the main issue he whole-heartedly agreed. Markets were fragile and to re-create confidence would not be easy. A new collaborative effort to restore exchange rate stability was in the interests of all. He had told Baker that this was an essential element and a condition of having any new G7 agreement at all. He had indicated to Baker his own willingness to accept a lower range for the dollar than in the Louvre Accord, but had insisted that a new agreement could not be buttressed only by intervention; an agreement cooperatively to manage interest rate differentials would be vital and in this connection Baker must be prepared to see U.S. interest rates rise if that were necessary. He believed Baker would accept this - while adamant that there was no case for such a move immediately. He welcomed Stoltenberg's talks with Poehl and Schlesinger: willingness to act on interest rates by both Germany and the U.S. was the core of the problem.

6. Balladur expressed two concerns. First, were all ready to give exchange rate stability the priority he wanted? - in which case certain conclusions followed. Secondly, the consequences of the October crash included both slower U.S. and world growth and a damaging further loss of competitivity of Europe against virtually all the world except Japan which would harm already unsatisfactory European growth prospects.

7. These concerns led him to pose questions. Was the action just announced by the U.S. enough? What action should Europe now take? (Incidentally he saw Baker's refusal to contemplate a very early G7 meeting as a threat). And if stability of the dollar was not obtainable, what about the EMS? - would it not be necessary to adapt the system?

8. The Chancellor suggested re-phrasing Balladur's first question. The fact was that what the U.S. had announced was all that could now be expected from them on the fiscal front. The question should therefore now be: were the U.S. prepared to commit themselves to stability of exchange rates by willingness to use interest rates as required? The others accepted this.

9. Reverting to the Chancellor's comment on Baker's views about German performance, Stoltenberg said he thought there had been a misunderstanding. Baker had not appreciated - and others had not foreseen the scale of it - the damaging impact on the ERM countries of the change of exchange rates in 1986, which had cut both immediate growth and confidence. The German position had indeed shown signs of improvement in the summer, but prospects were now very uncertain again. All of this should underline the common interest in more stable exchange rates.

10. Focussing again on the importance of managing interest rate differentials, Stoltenberg said that he had not been happy with the way the Bundesbank had given wrong signals in early October, although that did not justify the attack by Baker which had been responsible for the real damage. Looking to the future, he thought that the U.S. deficit decisions, if carried through, must

have a good effect: but they were not enough on their own. We faced inevitably a worrying period with U.S. trade figures likely now to get worse for a while. This was what made the interest rate problem so crucial. The Chancellor and Balladur agreed.

11. As far as the Bundesbank was concerned, Stoltenberg said that Schlesinger and his supporters were having to rethink their position. Baker's public attack on them had not helped, but they were shaken by what had happened and were now more ready to listen to arguments from Poehl and himself. He thought they would be prepared to cooperate, within some limits. They could not accept a binding agreement to limit further action unconditionally. But they would probably be willing: to accept the principle of using interest rate differentials in the interest of exchange rate stability, subject to review from time to time or for some period ahead, and with a provision that if they wanted to make a move they would undertake to consult before doing so.

12. (Balladur at this point asked Stoltenberg whether it was true, as rumoured, that he and Baker had bilaterally agreed to a lower dollar/DM range than in the Louvre Accord. Stoltenberg recalled that he had talked with Baker on 'Black Monday' - after the unfortunate Baker statement of the previous Friday but before the Stock Market crash happened. The dollar at that moment was standing at about DM 1.77 and they had simply agreed to try to cooperate and avoid damaging public statements. That night - when the Stock Market news was clear - he had telephoned Baker seeking assurance that he still respected the Louvre commitment. Baker had shown reluctance but agreed to try to work around then current levels, which for his part Stoltenberg had accepted as the only practicable choice).

13. The Chancellor said that what Stoltenberg had said about the Bundesbank was important and helpful. He hoped it meant that there could be a clear statement of the need to use monetary policy instruments in support of exchange rate stability, reserving the right to make independent movements only after consultation. Stoltenberg confirmed this was his hope, but the language of an agreement would need careful drafting; he remarked in passing that Poehl had bitterly lamented the shortness of the G5 meeting in September which had denied him the opportunity of pursuing there points which in retrospect could have been valuable. Stoltenberg also offered that the Bundesbank were minded to consider a reduction of interest rates as part of a renewed Accord in which all played an appropriate part.

14. The Chancellor suggested that this pointed to a 3-part statement: general conduct of monetary policy supportive of stable exchange rates; reservation of right to make minor change after consultation; half per cent off rates immediately. The U.K. might well offer a matching half per cent reduction. Stoltenberg confirmed but emphasised the need for language reconciling the Bundesbank obligations to balance the pursuit of growth and of price stability. The Chancellor said he saw no conflict in giving priority to exchange rate stability and Balladur agreed.

15. Balladur reverted to the problem that any further revaluation of European currencies against all except the Yen would do great damage to the European economies. It was for him intolerable that the Bundesbank alone should have the power effectively to determine Europe's external competitiveness. Stoltenberg said soothingly that he took the point and that he hoped the Bundesbank would help. The trouble was that they were worried by threats to German price stability, although he believed that the dollar depreciation hitherto should help allay their fears - the Chancellor and Balladur strongly endorsed the last point. He would continue to work for a satisfactory formula. Balladur commented that we could not pursue Louvre-type cooperation unless all were prepared to forego some sovereignty.

16. The Chancellor moved on to the U.S. position, stressing again the need for both Germany and the U.S. to adopt supportive monetary action. He was prepared to accept Baker's argument that there was no need for an immediate increase in U.S. interest rates but a future need could by no means be ruled out and an agreement would need commitment by the U.S. to accept this. It was a question of priorities over which Baker's October statement had given the wrong answer.

17. Stoltenberg agreed, pointing out that the U.S. had to be able to attract funds to finance their external deficit in any case. The Chancellor endorsed this: if the dollar plummeted the problem of financing for the U.S. could be even worse and interest rates would have to be raised anyway. Stoltenberg said that it would be very helpful if the U.S. would seek some finance through borrowing in foreign currencies. The Chancellor agreed: the need for the U.S. to equip themselves with funds was clear. Borrowing in foreign currencies would be the best answer and we should all encourage that, although the memory of 'Carter Bonds' would be an uncomfortable hurdle. As one alternative, he wondered whether an announcement of extended swap arrangements might be a useful signal to the markets, Tietmeyer pointed out that big swap lines already existed (the U.S. had some $15 billion worth with Germany and Switzerland) but were not used. Trichet suggested using them could be a helpful signal. The Chancellor summed up that foreign bond borrowing would clearly be best, but we should not overlook other possibilities.

18. Balladur wanted to know more clearly: what procedure would be envisaged for interest rate consultation? what ranges for exchange rates should be adopted? and what fiscal action could be offered by Germany?

19. Stoltenberg said that more discussion was needed to get a formula on interest rates: some flexibility was essential; minor daily changes might be excluded; any major change would have to be the subject of consultation. Balladur asked would this be G5 or G7 and the Chancellor suggested leaving the point vague but trying in practice to use G5. Balladur asked whether the recent interest rate agreement between France and Germany would have been subject

to consultation with others under the system envisaged: others felt that a problem would only arise if moves were contemplated which might seem perverse, and Stoltenberg thought that one possibility might be that an objector could call for a meeting if he felt that the basic agreement was threatened.

20. On Balladur's second question, the others thought it would be unrealistic to look for a range above the going market rate - which incidentally might be a reason for wanting to avoid delay. Stoltenberg said that Poehl wanted a more flexible arrangement and the Chancellor said that Baker wanted a wider range. All of these points would need further discussion.

21. On Balladur's third question, Stoltenberg claimed that Germany had been pursuing an expansionary policy with very large staged tax reductions and that the public sector deficit was now deteriorating very fast - it could well be 3% of GDP in 1988. But further possibilities of action were being explored. He believed that it would not be possible to accelerate at all the planned 1990 tax reductions, mainly because of opposition by the Laender - he had talked to Laender finance directors recently and they had been totally opposed (given the impact on their own finances of any change of plans); he would be talking shortly to the political leaders, but frankly expected the same response. What he was now exploring was the possibility of offering from the Federal budget loans to Laender and private firms at subsidised rates to promote investment, and this could be on a large scale of DM 10/15 billion over two years. He also confirmed that he would postpone planned increases in indirect taxes. He then spoke bitterly about the cost of the Community Budget and the necessity of raising some more taxes soon to meet it. Nobody rose to the Community point.

22. The Chancellor commented that the investment financing seemed a little like the Japanese approach. Asked about timing, Stoltenberg thought he could well be ready to announce decisions in a couple of weeks. The Chancellor commented that straight tax reductions would be more relevant and welcome but the important thing was to be able to deliver anything offered.

23. Stoltenberg then asked what others were prepared to do for an agreement. The Chancellor said he would want to sustain the exchange rate and undertake to use monetary policy to that end. He hoped to reduce interest rates if the Bundesbank also moved. On the fiscal front he would not be able to announce anything new until his budget in March, but he would be prepared to tell his colleagues privately that he intended to reduce taxation further. But in any case the U.K. rate of growth was such that he did not expect to be pressed further. Balladur said he had already announced that, following FF 70 billion of tax reductions in the two years 1987 and 1988 he would seek another FF 45 billion in the following two years. He also wanted cooperation in monetary policy and with French interest rates far too high would be looking for an opportunity to reduce them, heavily dependent on the EMS situation and on further arrangements to make the system work better.

SECRET

24. On other countries, the Chancellor suggested we wanted three things from Japan, although we should leave the U.S. to take the lead and stand ready to back them up: undertakings and some movement in interest rates in parallel with what had been proposed for Germany; fiscal action in 1988 to carry forward what had been done in 1987; and greater opening of markets to imports. Also we should seek to get the Community to work jointly with the U.S. in bringing pressure to bear on Taiwan and South Korea to open up their heavily protected markets. Incidentally it was important as well that the U.S. reaffirm the commitment of the administration to resisting protectionist action. All of this was agreed.

25. Discussion then turned to future arrangements for meetings and their preparation, and the problems both of G5/G7 and within Europe of G3/G4 (brief reference to enquiries and pressure from Amato, Italian Finance Minister). It was agreed that there must be provision for a substantial G5 meeting - this being the forum in which the hard details of practical cooperation on exchange rates and interest rates would be worked out. This in turn made it desirable for European cooperation on such matters to be G3 and not G4. The Chancellor hopefully suggested that the acceptance of G5 as well as G7 meetings recently might ease the problem.

26. Stoltenberg suggested that G5 should meet on Saturday for a long evening, with G7 meeting the following day. He was happy to offer invitations to Bonn. The Chancellor said that he had a strong preference for Europe and would happily offer London - Baker might feel he preferred more 'neutral' ground than Bonn. Balladur said he had no preference.

27. It was thought that 12/13 December might be the best date to aim at. Earlier might be impracticable; later would risk not getting a meeting before Christmas. Baker did not want meetings of Deputies first. He might be playing tactics, but for now this should be accepted. It would be helpful however to get Baker committed to a December date as soon as possible. Stoltenberg and the Chancellor both intended to get in touch with Baker shortly in any case and would pursue this. Stoltenberg said that he had not told Baker of the present meeting and did not intend to: he would simply say he had had informal contacts with colleagues.

28. It was also agreed that further European discussion would be desirable, and two arrangements were made:

- the same group would find it useful to meet again soon and the morning of 7 December, before the ECOFIN lunch, could be a suitable time: it was agreed that deputies would explore logistics for a meeting at 11 a.m.
- the three deputies would meet to see whether they could prepare elements of a possible G5/G7 agreement and public statement (provisionally Littler to hand over a draft on 25 November in Brussels, and all three to meet Saturday 28 November, possibly in Paris).

(Geoffrey Littler)
H.M. Treasury, 22 November 1987.

FOSS G5/G7 MEETING

psl/82A

UNCLASSIFIED

PMP

FROM: A C S ALLAN
DATE: 16 November 1987

MR S W MATTHEWS

1985 & 1987: "The burden of taxation will be reduced"

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Tyrie

PREPARATION FOR POSSIBLE G5/G7 MEETINGS

The Chancellor was grateful for your minute of 13 November.

2. He thought the points about international comparisons of Government borrowing were crucial. Not only does GGFD as a percentage of GDP ignore the important relationship to savings in each country, it also ignores sheer scale. This is important now that we are all in the same global market. If the US deficit doubles the financing problems in a world context are of a quite different order from that caused by (say) a doubling of the UK deficit, even if the percentage of GDP were the same in each case.

ACSA

A C S ALLAN

sw54

FROM: S W MATTHEWS
DATE: 13 November 1987

CHANCELLOR

cc: Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Tyrie

Ch
Figures on GGFD as % savings are quite interesting (X)

MATTHEWS TO CH/EX 13/11

PREPARATION FOR POSSIBLE G5/G7 MEETINGS

We have been putting together some material on the economic prospects and policies of the three largest economies in preparation for an eventual G7 meeting. Further refinement of the arguments and additional data are needed, but you may like to see the draft as it currently stands, as you will be seeing Balladur and Stoltenberg on Monday at the ECOFIN Council. It complements Sir Terence Burns' note "Post-stock market fall: the next steps" and our note on "World Economic Developments" dated 9 November which brought together the latest data on the world economy.

2. Following your discussion at lunch yesterday with the Canadian Finance Minister, we have been attempting to establish the nature of the constraints on additional fiscal measures by the Germans and have been in touch with our Embassy in Bonn.

3. Tax revenues in the Federal Republic are shared in agreed proportions with the Laender (and local government). Thus income tax is divided 42½ per cent Federal government, 42½ per cent Laender and 15 per cent local government; corporation tax 50/50 between Federal and Laender; VAT 65/35 between Federal and Laender; capital taxes, plus taxes on oil, tobacco and spirits accrue to the Federal government; taxes on beer, land and buildings, motor vehicles to the Laender and local government. Thus additional tax cuts, or bringing forward those already planned, need the agreement of the Laender as they will also lose revenue, which implies cutting expenditure as they have to balance their budgets. Given the composition of the Bundesrat (the upper house of parliament), the Laender are in a position to block the reform, if they wish.

4. The effective constraint thus appears to be whether there are means whereby the Federal government can if necessary compensate the Laender for their loss of revenue from additional tax cuts (e.g. giving them a higher share of tax revenues or increasing the German equivalent of the Rate Support Grant) - our Embassy in Bonn believe that some such measures are feasible. The secondary constraint of course is whether Stoltenberg is prepared to run a larger budget deficit, particularly as the loss of tax revenue is likely to fall largely on the Federal budget in the cases of income tax, corporation tax or VAT (and entirely on the Federal budget in the case of indirect taxes controlled by the Federal government alone).

5. If Stoltenberg is not prepared to run a larger budget deficit (despite pressures from his FDP coalition partners to do so), then the case for lower German interest rates to sustain the growth of demand (real or nominal), and to provide the counterpart of the US deficit cuts, is that much stronger.

SM.

S W MATTHEWS

POLICIES AND PROSPECTS IN THE THREE LARGEST COUNTRIES

This note looks at what policy changes are needed in the three largest countries in the light of recent developments on world equity markets and foreign exchange markets.

Recent economic developments

2. The latest data on the world economy were brought together in the "World Economic Developments" note dated 9 November. The figures below add some more detail on recent terms of trade movements and relative patterns of export/import volumes. There are clear signs of a reduction in trade imbalances only in the case of Japan (in part reflecting the recovery in oil prices):-

- US: Since end of 1986 relative volumes have improved: but terms of trade have deteriorated.

		Export Volume as Percentage of Import	Terms of Trade	Visible Trade Balance $bn
85	Q1	67	115	-29
	Q2	62	116	-33
	Q3	61	114	-35
	Q4	59	113	-43
86	Q1	58	116	-40
	Q2	58	120	-40
	Q3	56	121	-43
	Q4	56	118	-44
87	Q1	58	116	-44
	Q2	58	113	-43
	Q3	-	111*	-46**

* July

** Not seasonally adjusted.

- **Japan:** A large turn-round in relative volumes of imports and exports. But large improvement of terms of trade.

	Export Volume as Percentage of Import	Terms of Trade	Visible Trade Balance $bn
85 Q1	128	108	9
Q2	130	111	11
Q3 Plaza	131	112	12
Q4	130	124	16
86 Q1	123	130	17
Q2	111	163	21
Q3	111	173	24
Q4	108	173	22
87 Q1	114	165	26
Q2	104	165	25
Q3	100*	163*	23

* Average of July and August.

- **Germany:** Again a large turn-round in relative volumes of imports and exports. But improvement in terms of trade.

	Export Volume as Percentage of Import	Terms of Trade	Visible Trade Balance $bn
85 Q1	116	95	5
Q2	118	96	6
Q3	114	99	7
Q4	115	100	8
86 Q1	112	106	11
Q2	110	112	13
Q3	111	116	16
Q4	109	116	15
87 Q1	108	116	16
Q2	106	116	16
Q3	104*	117*	17

* Average of July and August.

3. International comparisons of fiscal policy stance generally focus on general government financial deficits; this is for instance the concept which the IMF and OECD forecast. On this basis the US budget deficit does not appear exceptionally high and some apologists for Reaganomics (e.g. Paul Craig Roberts in the Financial Times of 11 November) have made a certain amount of this point, ignoring in so doing the low overall level of saving in the US. Moreover, the figures are not strictly comparable. In the US, while central government is running a deficit, the state and local governments run surpluses so the general government budget deficit is less than the Federal deficit. These surpluses do not have to be placed in Federal government debt; indeed a substantial part is invested in equities and other assets as it arises from contributions to pension funds on behalf of employees. A better measure of the weight of financial deficits in different countries is provided by looking at the deficit in relation to aggregate national saving rather than GDP - see table 1 below.

X

Table 1: General Government Financial Deficit - as a percentage of gross private savings

	1980	1981	1982	1983	1984	1985	1986
US	7	5	22	23	18	17	21
Japan	16	14	13	13	10	3	3
Germany	15	19	17	12	9	6	5
France	-1	10	15	17	16	17	15
UK	19	16	13	19	19	15	15
Memorandum Items							
US Federal deficit as a percentage of gross private savings							
US	13	13	26	34	33	27	30
UK PSFD as a percentage of gross private savings							
UK	23	18	22	19	21	15	13

Guidelines for policy

4. The principal criteria for judging the appropriateness of the policies of the three largest countries and for recommending any changes in these policies should presumably be that they:

(a) reduce current account imbalances;

(b) help to stabilise exchange rates and avoid excessive dollar depreciation;

(c) help to maintain the momentum of growth in the world economy; and

(d) do not involve taking undue risks with inflation.

5. It is difficult to bring these factors together in a single indicator, but (as we have discussed in earlier work) forecast growth rates of domestic demand probably provide the most suitable benchmarks in current circumstances for judging policies. Starting from the assumptions that:

(i) subject to an inflation constraint, countries should aim for medium term growth in line with productive potential - perhaps a rather conservative ambition for Germany, but one that should involve no inflationary risks; and

(ii) reductions in current account imbalances, of say ¾ per cent of GNP per year should be sought over the next three years - a comparatively unambitious target, which would reduce current account imbalances as a proportion of GNP from about 3½ per cent now to about 1½ per cent in 1990;

we estimate that the growth rate of real domestic demand in each year 1988, 1989 and 1990 needs to be no more than 1½ per cent p.a. in the US and around 3½ per cent p.a. in Germany and approaching 5 per cent p.a. in Japan.

6. The arithmetic underlying this conclusion is set out below:

	US	Japan	Germany
1. Current account in 1987 (per cent of GNP)	-3½	3½	3¾
2. Target for 1990 current account (per cent of GNP)	-1½	1½	1½
3. Estimated effect per annum of terms of trade changes on current balance expressed as % of GNP	-¼	+½	+½
4. Required contribution per annum of net export volumes to growth of GNP	1	-1¼	-1¼
5. Estimated growth rate of productive potential, per cent per annum	2½	3½	2¼
6. Required growth rate of real domestic demand, per cent per annum	1½	4¾	3½

7. This figuring can obviously be only illustrative. There is for instance considerable uncertainty about the scale of the terms of trade changes that adjustments in trade volumes will have to outweigh in order to reduce imbalances in value terms. (The figures in row 3 of the table are derived from the last WEP which contained modest further dollar depreciation. If there are greater terms of trade movements induced by larger exchange rate changes, this would tend to increase the gap required between the growth rate of real domestic demand in the US on the one hand and Japan and Germany on the other, in order to achieve the same reduction in the nominal current balance as a proportion of GDP). Estimates of the growth of potential are also uncertain. We have revised our estimate down for Japan to reflect growth being led by domestic demand rather than exports. Although we have revised down our estimates for Germany compared with a year ago, they are still toward the upper end of the range.

8. In Washington the Japanese and Germans naturally emphasised the bull points about their economic growth, but even then the forecasts did not show sustained growth in real domestic demand of the required magnitude, while the US concern to avoid a recession led to aspirations for domestic demand growth faster than 1½ per cent p.a. The following points to make and background on the three largest countries attempt to point up the main policy implications of these considerations.

UNITED STATES

Points to make

(i) Deficit reduction in FY1987 an impressive achievement, but many one-off factors contributed (roughly $35 billion of the $73 billion fall in the deficit).

(ii) Need a package of measures to reduce Federal budget deficit by more than $23 billion in fiscal 1988. Minimum target should be to ensure deficit in FY1988 is no higher than in 1987 ($148 billion).

(iii) To demonstrate commitment of both Administration and Congress package should include tax increases, cuts in defence and non-defence spending. Must be no "fudges".

(iv) Desirable to agree and announce measures for fiscal 1989 too. Need assurance that deficit reduction will continue despite Presidential election campaigning. GRH-II deficit target for 1989 ($136 billion plus $10 billion leeway) not tough enough.

(v) Cuts in US budget deficit needed not just to restore confidence, but also to free resources to improve current account. Before fall in share prices US domestic demand expanding strongly and labour market conditions tightening. Consequence was bad trade figures. Some slowdown in growth of domestic demand essential to improve current account - faster growth outside US will not help much if US economy already fully employed.

(vi) Slowdown in growth now expected for 1988 will tend to increase baseline budget deficit. Quite wrong to argue that smaller cut than $23 billion now required, but do not necessarily have to make additional cuts to compensate for cyclical rise in deficit. In any event, lower interest rates will be a partial offset.

(vii) US monetary policy must strike delicate balance between support for financial markets and support for dollar. Right for moment to provide liquidity to financial markets, but any excess liquidity should be mopped up when possible. Exchange rate stability depends on a willingness to use interest rates - which is why recent statements by Baker are so damaging.

Background

1. Mr Dolphin's note of 30 October provided detailed analysis of developments on the US Federal budget deficit. The following table shows the important figuring.

Table 3: US Federal budget deficit ($ billion)

Fiscal years	1986	1987	1988	1989	1990
CBO baseline*			179	192	176
GRH-II targets			156**	136	100
HMT forecast	221***	148***	170	150	140
(% of GNP)	(5.3)	(3.4)	(3.6)	(3.0)	(2.7)

* i.e. deficits on the basis of unchanged policies

** CBO baseline less $23 billion

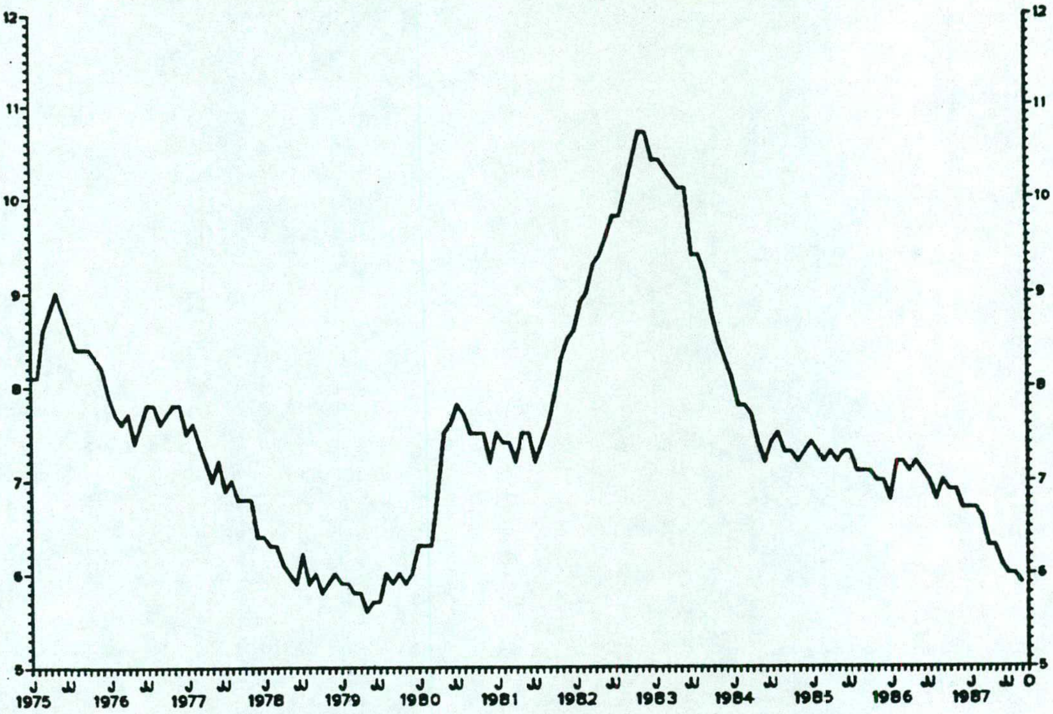
*** actual.

2. Our forecasts have been revised in the light of the prospect of weaker US growth and lower interest rates but are obviously tentative in view of present uncertainties. If a deficit reduction package of $23 billion is agreed for 1988 and only limited measures are enacted for 1989 we expect a small rise in the deficit this year followed by a similar sized fall next year. This is in line with most other assessments of deficit prospects.

3. The revised Gramm-Rudman-Hollings (GRH) targets are also shown in Table 3. There is no target for 1988, rather a requirement that a deficit-reduction package amounting to $23 billion is agreed. Otherwise, automatic spending cuts of the same magnitude will be enacted. In terms of reducing the deficit there is little to choose between an agreed package and automatic spending cuts. (In fact, the latter may be preferable because they can bring bigger medium-term deficit cuts.) But for market confidence it is vital that both the Administration and Congress are seen to be taking positive steps to reduce the deficit. This requires an

CHART 1

US - UNEMPLOYMENT AS % OF CIVILIAN LABOUR FORCE



US - HELP WANTED ADVERTISING (VACANCIES)

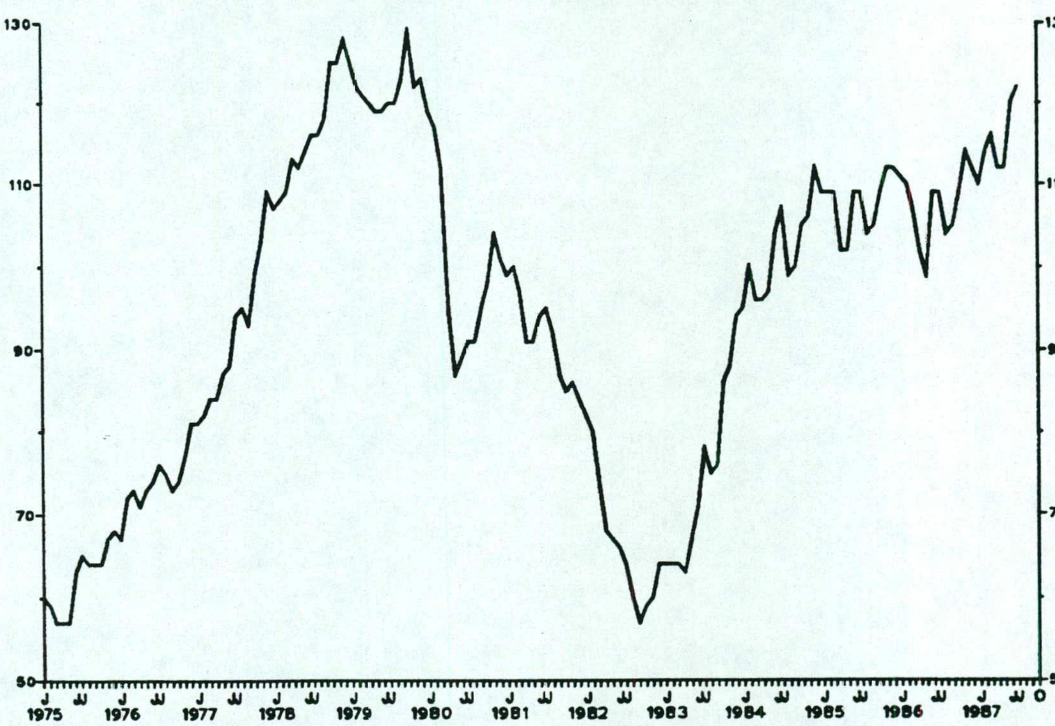
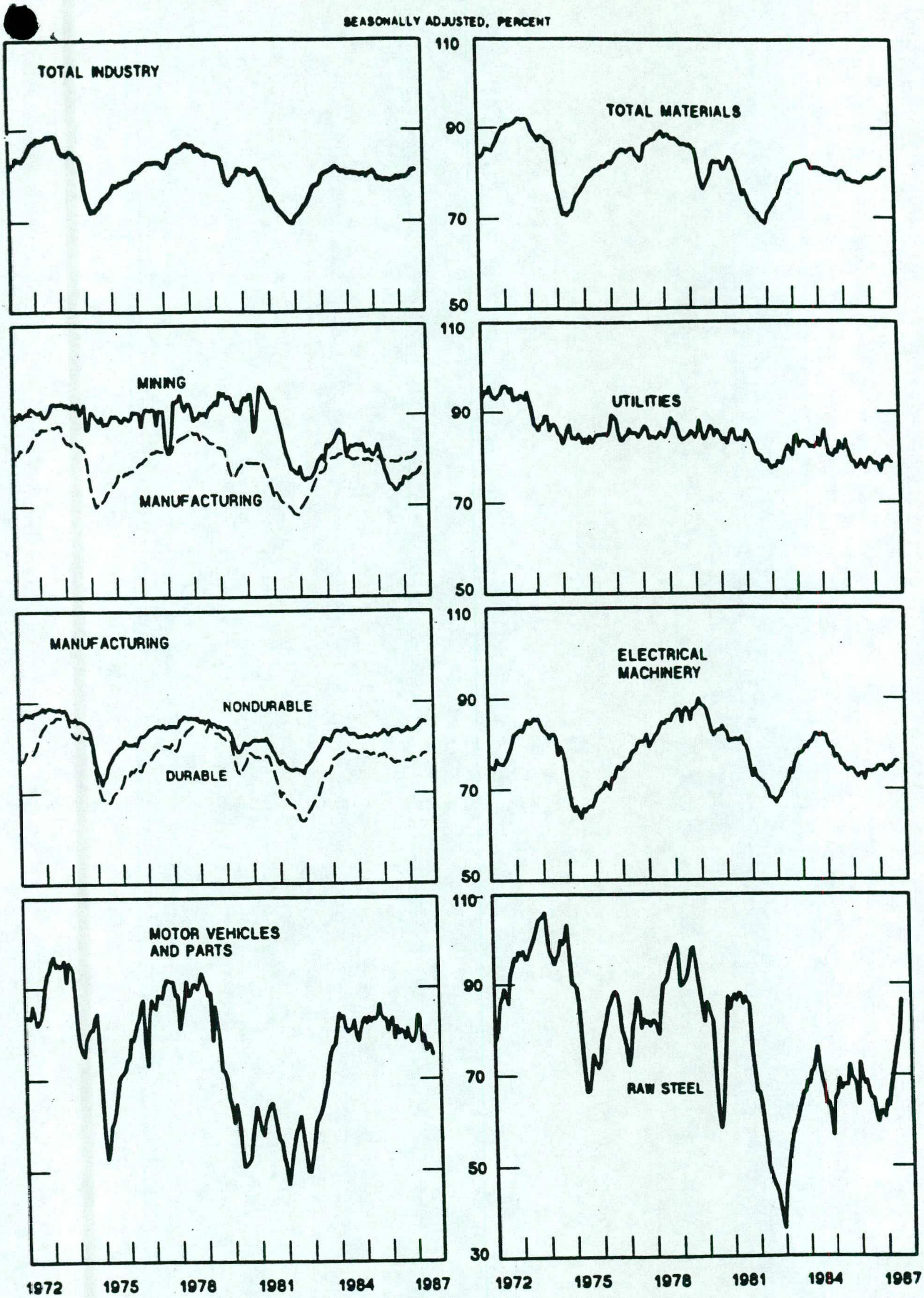


CHART 2.

CAPACITY UTILIZATION

SEPTEMBER DATA



Source: Federal Reserve Board

agreed package to cut the deficit by more than $23 billion. To demonstrate both sides' willingness to make cuts the package should include cuts in defence and non-defence expenditure and increases in taxes.

4. Before the sharp fall in equity prices, US domestic demand was growing strongly and unemployment in September was 5.9 per cent, a fall of 1.1 per cent over a year earlier, bringing the economy close to full employment. The unemployment rate is now almost as low as in mid-1979 and vacancies close to their previous peak (chart 1). However rates of capacity utilisation (on the Federal Reserve measure) are still below 1979 peaks in most industries (charts 2 and 3). There are reports of shortages of skilled labour in some regions (e.g. the Atlantic Seaboard), but capacity bottlenecks do not yet appear to be a serious problem.

5. The terrible trade figures for June, July and August provided further evidence that the US needed to switch resources from satisfying domestic demand into improving the trade account. In some respects therefore, the slowdown in US domestic demand growth that the falls in equity prices should produce is both welcome and necessary if the current deficit is to fall and inflation is to remain low.

6. One of the reasons for the strength of US domestic demand in the 1980's was the dramatic fall in the saving ratio. Some recovery in saving will be required if the US current account deficit is to be reduced and efforts to maintain the growth of consumers' expenditure to avoid a recession would be misplaced.

1980	7.1%	1984	6.1%	1987Q1	4.4%
1981	7.5%	1985	4.5%	Q2	3.0%
1982	6.8%	1986	4.3%	Q3	3.0%
1983	5.4%				

7. Some commentators are beginning to argue that the fall in stockmarkets will have such a large negative effect on growth in the US that it would be inappropriate to cut even $23 billion from the prospective deficit in fiscal 1988. This argument seems to take no account of the CBO's (and others') projection that the deficit will rise by $31 billion if no changes are made to policy, or of gains to confidence from cuts in the deficit.

8. Monetary policy in the US faces conflicting pressures. At present the Federal Reserve is willing to cut interest rates and provide liquidity to the financial markets and this is probably right. But inflationary pressures could still emerge, especially if the dollar's exchange rate falls sharply, or if the negative wealth effects from lower equity prices are less than some currently fear. At some point, therefore, the Federal Reserve will have to mop up any excess liquidity in the markets and, maybe, increase interest rates to support the dollar.

JAPAN

Points to make

(i) In order to reduce its current deficit, Japan should aim for growth in real domestic demand substantially faster than the growth in potential output of about 3½ per cent a year. Domestic demand ought to grow at approaching 5 per cent not just in 1988 but for several successive years. Ways of sustaining strong growth in domestic demand include fiscal and monetary policies, and structural reforms.

(ii) Inflationary pressures are very weak. Average earnings growth around 2½ per cent, i.e. below growth rate of productivity, especially when adjusted for Japan's terms of trade gains. The strength of the yen does not indicate lax monetary conditions. The fairly rapid growth in money supply is to some extent the result of financial deregulation.

(iii) The fall in share prices, and the consequent tightening in world monetary conditions, puts the onus on hard currency countries to reduce interest rates. At about 4 per cent, Japanese short rates are high in real terms.

(iv) Despite this year's 'package', fiscal policy still does not look particularly expansionary. The OECD provisional forecasts show the general government deficit to rise only slightly from 0.9 per cent of GNP in 1986 to 1.2 per cent in 1987, and to remain unchanged on present policies in 1988. The 1988 Budget should instead provide for a significant further stimulus to domestic demand.

(v) Other measures to strengthen Japanese domestic demand could include greater passing on to consumers of terms of trade gains, deregulation of land use, financial innovation to facilitate consumer credit etc.

Background

1. In 1987Q2, real GNP was 2½ per cent higher than a year before and real domestic demand 4 per cent higher. There are now some signs that the economy is picking up. Industrial production, about flat for eighteen months, rose sharply in the summer. The government has expressed confidence that the target of 3½ per cent growth in the financial year (ending next April) will still be met - though this would require growth to average more than 5 per cent over the final three quarters.

2. The 12-month rate of consumer price inflation remained negative during the first half of the year. It rose to 0.7 per cent in August. Wholesale prices in August were still lower than a year before. Average earnings in August were only 2¼ per cent higher than a year before - well below the increase in productivity. The GDP deflator was ½ per cent lower in 1987Q2 than in 1986Q2.

3. Neither the growth rates in broad monetary aggregates of over 10 per cent nor the price increases in certain asset markets are good evidence that monetary conditions are lax. Deregulation has contributed to the rapid rise in wholesale bank deposits. The spectacular rise in land values is confined to the commercial centres of the major cities, where regulations limit the amount of new land for development.

4. The central government deficit for FY1988 is expected to be 3.4 per cent of GNP, only a slight increase from 3.2 per cent in 1986-87. There is no official estimate for the general government deficit, but OECD and IMF estimates point to an increase of only ¼-½ per cent of GNP.

5. The guidelines for public expenditure for FY1988 allow for an increase of 1.8 per cent - but from the initial FY1987 budget. They seem to imply little change from the likely actual level of spending in FY1987, allowing for the increases subsequently announced in the May package. These guidelines suggest that as soon as the economy starts to pick up the Ministry of Finance will

seek to revert to its plans for budgetary consolidation. It does not seem to have got the message that several years of domestic demand growth of approaching 5 per cent p.a. are needed.

6. There is said to be concern that the public works programme and the housebuilding boom are leading to bottlenecks in construction. Chart 3 shows the number of new buildings started; this has risen quite sharply since mid-1985, but there was previously a long period of stagnation. The current rise is no steeper than the trend during the 1970's. Cost of building materials is not rising sharply. The real bottleneck is the availability of land, which is restricted by excessive regulations. Capacity utilisation in manufacturing is still relatively low (chart 4).

CHART 3. **JAPAN - BUILDINGS STARTED**

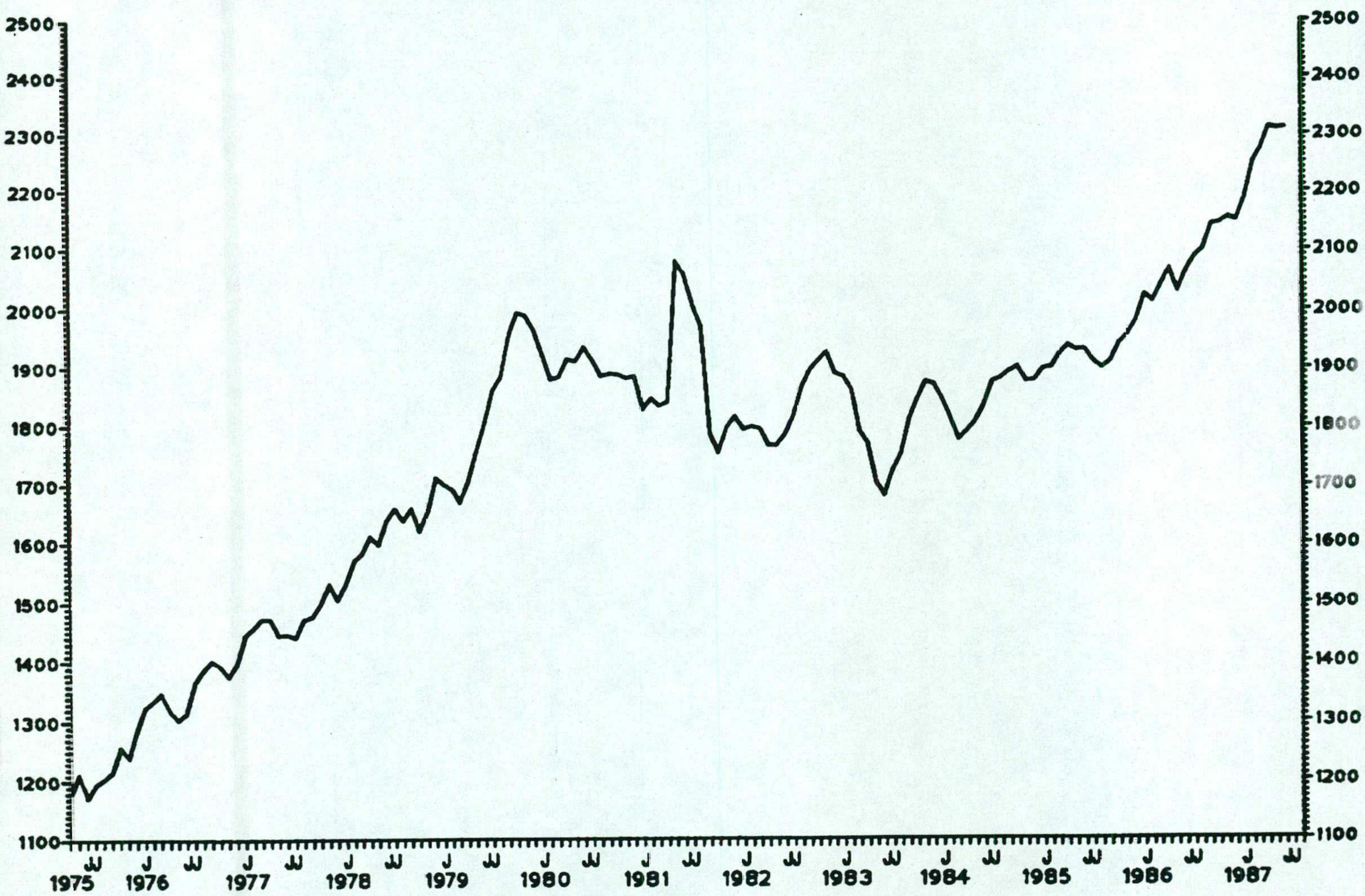
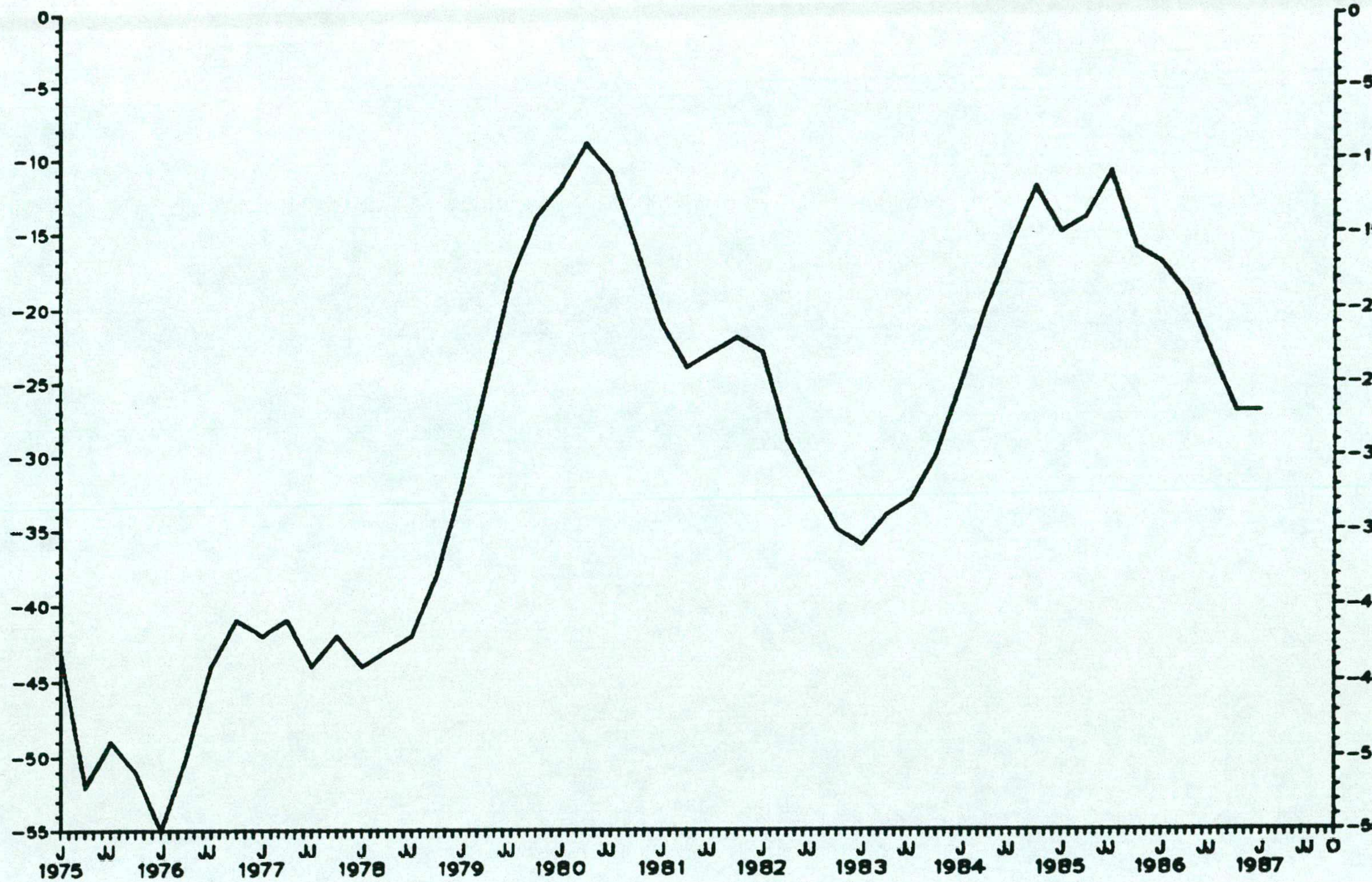


CHART 4. **JAPAN – CAPACITY UTILISATION IN MANUFACTURING**



GERMANY

Points to make

(i) There has been some rebound of the economy from virtual stagnation last winter, but it is weaker than German authorities are claiming, and strengthening of German economy over summer owes as much to exports as domestic demand.

(ii) Net export volumes are now making a negative contribution to German GNP growth, but import growth in volume terms has slowed since 1985.

(iii) Little sign of unexpected worsening of inflation. Once account taken of oil price effects, underlying inflation rate still very low and not rising.

(iv) No evidence of any need for tightening of monetary policy, despite CBM target overshoot. Bundesbank targets may be too restrictive in current circumstances.

(v) Rise in budget deficit this year reflects weak growth not discretionary measures. Tax cuts next year partly paid for by expenditure restraint and past fiscal drag, so net expansionary effect modest. Larger tax cuts likely to be needed if growth in domestic demand sufficient to produce a significant reduction in current balance is to be achieved.

(vi) Longer term structural weaknesses have resulted in deterioration in German growth performance and continuing high unemployment. Rigidities in economy perpetuated by Government's reluctance to cut industrial subsidies or reduce the protection given to German farmers.

Background

Monetary policy

1. CBM stock is substantially overshooting target range of 3-6 per cent for 1987. Bundesbank allowing overshoot at time of low interest rates owing to large weight that currency has in measure. Authorities fear however that other aggregates such as broad M3 are growing faster than warranted by medium term growth potential of economy at stable prices. However, Bundesbank assessment assumes stable velocity for CBM. In fact, velocity may have downward trend of ½-1 per cent per year; velocity also has historically fallen at times of substantial balance of payments surplus.

Fiscal policy

2. The German Government has had considerable success in reducing the deficit from 3.7 per cent of GNP in 1981 to 1.2 per cent in 1986 and expenditure from 49.7 per cent to 46.8 per cent over the same period.

3. The Federal government has presented its budget for 1988 to the Bundestag. This includes DM8½ billion of tax cuts from the second phase of the 1986-88 tax reform plus DM5½ billion brought forward from the proposed 1990 tax cut. These tax cuts are however against an unindexed base and thus are partially paid out of nominal as well as real fiscal drag. The 1988 tax reductions will also tend to reduce Lander expenditure owing to fall in tax yield on revenues shared between Federal and Lander governments.

4. The OECD's documentation for the forthcoming EPC meeting shows some modest increase in the general government deficit from 1.2 per cent in 1986 to 1.6 per cent in 1987. This 0.4 per cent rise is entirely accounted for by growth falling below potential - the OECD's calculations put the change in "built-in stabilisers" at 0.4 per cent.

5. The deficit is not forecast to widen significantly in 1988 despite the tax cuts as expenditure growth is restricted to 2.4 per cent. OECD put the GGFD in 1988 at 2.0 per cent of GNP. No tax cuts are proposed for 1989. A second round of personal sector tax cuts of DM 19.4 billion is proposed for 1990. It seems that these will not alter the budgetary stance significantly, since they are to be financed by reductions in subsidies, increases in consumption taxes, and changes in personal and company tax allowances, including the controversial withholding tax. The detailed figuring is set out in the table below.

Inflation prospects

6. The German 12-month inflation rate was negative throughout most of last year owing to the impact of the oil fall and the DM appreciation. The reassertion of positive inflation since April is entirely due to the oil price fall dropping out of the inflation figures. Underlying non-energy prices have been falling mildly throughout the year.

7. Most forecasts for 1988 point to a return in inflation to an underlying rate of 1½ per cent. This has been long anticipated with continuing downward pressure on inflation from terms of trade gains and slow domestic growth, the risks of any greater acceleration look pretty small.

THE GERMAN TAX PACKAGE: ESTIMATED EFFECTS ON REVENUES

Cuts to be made in 1988

	DM billion
Cut originally planned	9.0
Cut from 1990 brought forward	5.2
	14.2

Cuts planned for 1990

Original gross tax reduction	44.5
Less brought forward to 1988	5.2
Less planned offsetting rises in other taxes	19.4
Net tax cut in 1990	19.8

Current plans for additional revenue raising to finance 1990 package

Revenue gain from withholding tax	3½ - 4
Reductions in depreciation allowances under corporation tax	4½
Measures to broaden base of personal income tax	3½
Changes in regional policy and local taxes	6
Total so far agreed	17½ - 18
Government's original target	19.4

Pay

WORLD ECONOMIC DEVELOPMENTS

1. Real GDP overall, for both the major 5 and the major 7, grew rather faster during the first half of 1987 than it had done during the second half of 1986. Growth speeded up in North America and remained high in the UK. It slackened in France and remained very low in Germany.

	Percentage growth rates between:	
	1986Q2 - 1987Q2	1986Q4 - 1987Q2 (Annual rate)
US	2½	3¼
Japan	2 3/4	2½
Germany	3/4	¼
France	1 3/4	1
UK	3 3/4	3½
G5	2¼	2½
Italy	2½	4¼
Canada	3¼	6
G7	2¼	3

2. The 12-month rate of consumer price inflation continues to edge up - to 3 per cent in the G5 in September.

3. The average trade imbalances of the three largest countries over the latest 12 months have changed little this year (in nominal dollar terms) from the average monthly trade balance in 1986.

	$ billion, monthly averages		
	US	Japan	Germany
1986	-13.9	7.7	4.5
1987*	-13.5 (Aug)	8.3 (Sep)	4.7 (Sep)

* Average of 12 months to August or September.

4. Interest rates rose briefly in late September and early October, but have since come down again.

5. Share prices, despite the recent drop, remain higher in the US and Japan than on average in 1986.

PETER SULLIVAN DAVID SAVAGE

9 November 1987

WORLD ECON DEV

SECTION A: NOMINAL AND REAL GNP

1. The growth rate of <u>nominal GNP</u> in the G5 countries has slowed, to $4^3/4$ per cent over the year to the second quarter of 1987.

Table 1: GNP growth in the G5 countries*

		Nominal GNP	Real GNP	GNP Deflator
Annual percentage change				
1980		9.6	0.9	8.6
1981		9.8	1.6	8.1
1982		5.6	-0.4	6.0
1983		7.1	2.9	4.1
1984		8.6	4.9	3.5
1985		6.6	3.2	3.3
1986		5.6	2.7	2.8
Change from four quarters earlier (per cent)				
1986	Q1	6.3	3.0	3.2
	Q2	6.1	3.0	3.1
	Q3	5.4	2.4	3.0
	Q4	4.8	2.4	2.3
1987	Q1	5.0	2.5	2.4
	Q2	4.7	2.2	2.5
Indices (1980=100)				
1986	Q1	149.1	114.7	130.0
	Q2	151.2	115.6	130.8
	Q3	153.1	116.1	131.9
	Q4	154.3	116.7	132.2
1987	Q1	156.5	117.6	133.2
	Q2	158.4	118.1	134.1

* All G5 averages in the note are weighted by GDP in 1980.

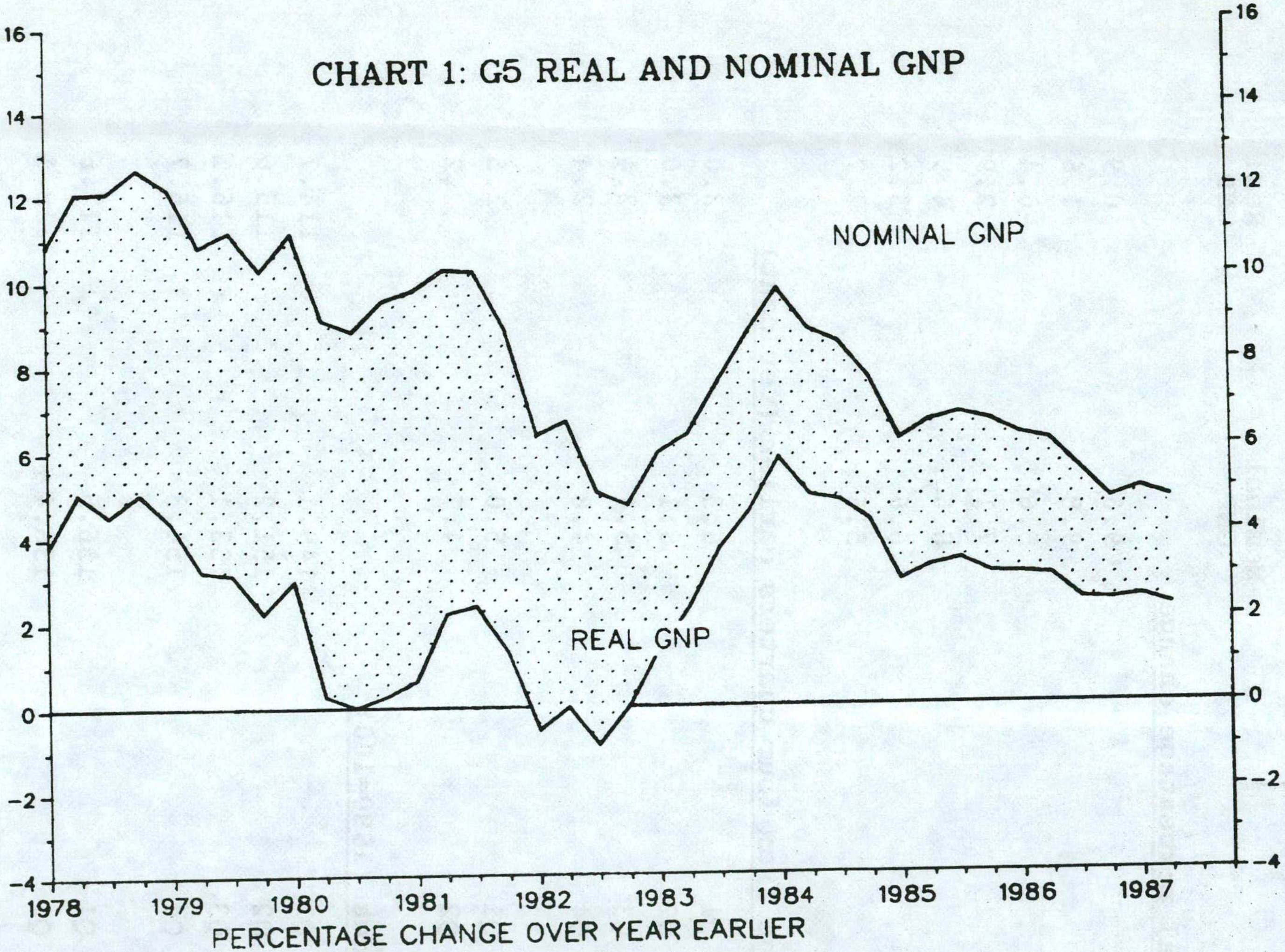


CHART 1: G5 REAL AND NOMINAL GNP
NOMINAL GNP
REAL GNP
16
14
12
10
8
6
4
2
0
-2
-4
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
PERCENTAGE CHANGE OVER YEAR EARLIER

2. Overall in G5, real GNP increased at a moderate rate in the first quarter. There were quite strong increases in the US, Japan and the UK, but little change in France and a fall in Germany (probably caused by bad weather). Growth in real domestic demand in G5, which had been slight in the fourth quarter, strengthened a little. Consumers' expenditure, public consumption and fixed investment were all weak.

3. GNP in the US rose more slowly in the second quarter than in the first. Stockbuilding fell as expected, but consumers' expenditure and investment increased from their low first-quarter levels.

4. German GNP recovered in the second quarter, but to a level little higher than that for the third quarter of last year.

5. Japanese GNP hardly changed in the second quarter, a reduction in the real foreign balance (exports falling and imports rising) offsetting a substantial rise in domestic demand.

6. French GNP grew at an annual rate of only 1½ per cent during the first half of the year. Stockbuilding was exceptionally high.

td6(b)

Table 2: GNP and Domestic Demand Growth in individual countries

	GNP*: US	Japan	Germany	France	UK	G5	Domestic demand growth**: US+	Japan	Germany	France	UK	G5
Annual percentage changes												
1983	3.6	3.2	1.8	0.7	3.4	2.9	5.2	1.8	2.3	-0.7	4.5	3.4
1984	6.8	5.0	3.0	1.4	2.6	4.9	8.9	3.8	1.9	0.4	2.8	5.5
1985	3.0	4.7	2.5	1.7	3.7	3.2	3.7	3.8	1.5	2.2	3.0	3.2
1986	2.9	2.5	2.4	2.1	3.3	2.7	4.0	4.1	3.7	3.9	3.7	3.9
Change from four quarters earlier (per cent)												
1986 Q1	3.6	3.0	1.7	2.2	2.9	3.0	4.8	3.3	1.8	3.0	2.9	3.8
Q2	3.3	2.5	3.3	2.4	2.4	3.0	4.3	4.6	5.2	5.3	3.2	4.5
Q3	2.6	2.4	2.1	1.8	3.2	2.4	3.9	4.5	3.5	3.8	3.7	4.0
Q4	2.2	2.0	2.4	2.1	4.5	2.4	2.8	3.8	4.1	3.3	5.2	3.4
1987 Q1	2.0	3.7	2.4	2.1	3.8	2.5	2.3	4.4	4.1	4.2	2.1	3.1
Q2	2.4	2.7	0.8	1.7	3.8	2.2	1.8	4.0	1.8	2.4	3.6	2.4
Indices (1980=100)												
1986 Q1	116.0	122.8	106.5	108.7	112.5	114.7	122.6	117.2	101.4	107.0	114.0	116.0
Q2	116.2	124.0	109.3	110.0	113.2	115.6	123.6	119.6	105.1	110.0	114.1	117.8
Q3	116.6	124.9	110.1	110.4	114.2	116.1	124.6	120.8	105.4	110.8	115.7	118.8
Q4	117.1	125.8	109.9	110.8	115.6	116.7	124.7	121.6	106.6	110.4	117.2	119.2
1987 Q1	118.4	127.3	109.1	111.0	116.8	117.6	125.4	122.4	105.6	111.5	116.4	119.6
Q2	119.0	127.3	110.2	111.8	117.5	118.1	125.9	124.4	106.9	112.7	118.2	120.7

* Expenditure measure of GNP/GDP at market prices except for UK (GDP (A) at market prices)

** Includes stockbuilding

CHART 2: GNP IN THE G5 COUNTRIES

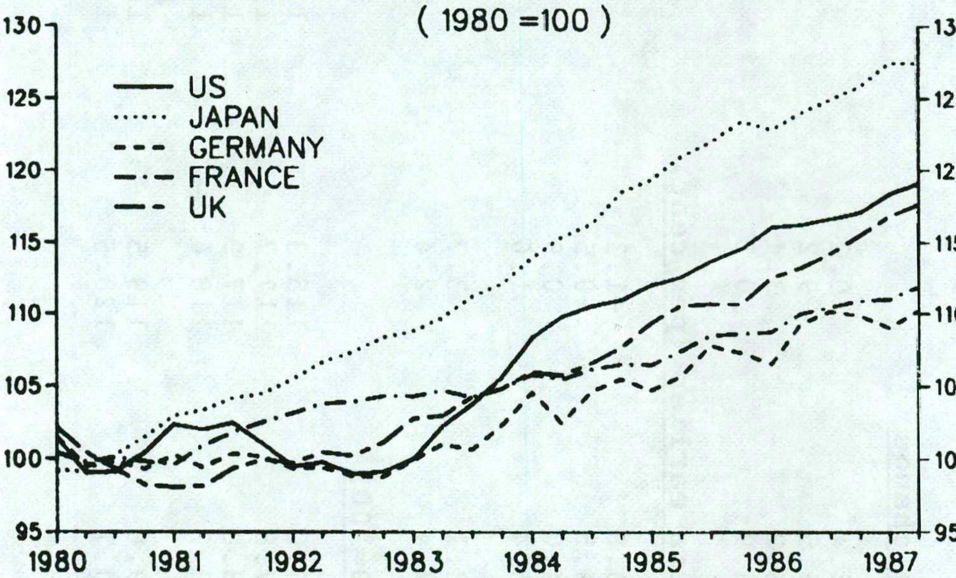
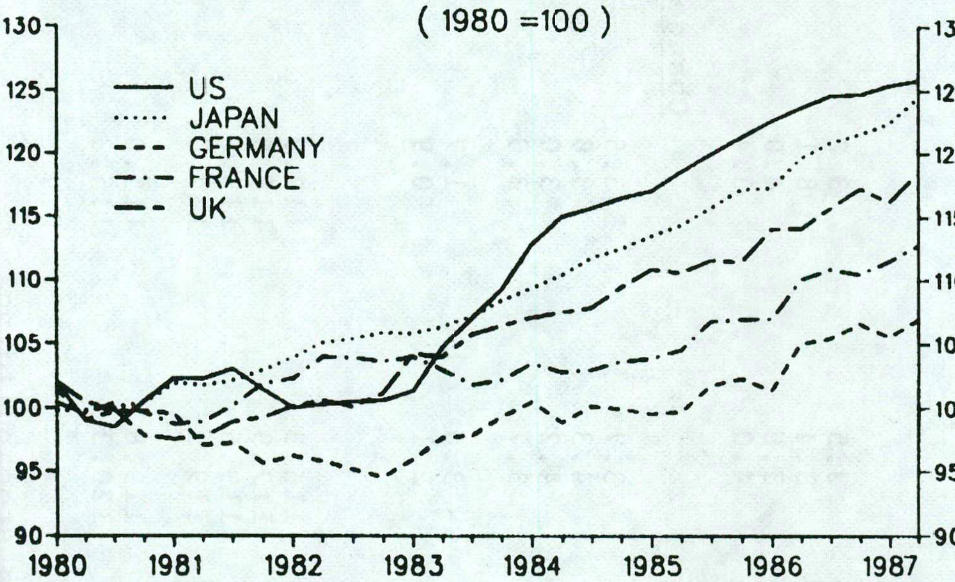


CHART 3: DOMESTIC DEMAND IN THE G5 COUNTRIES



td6(a)

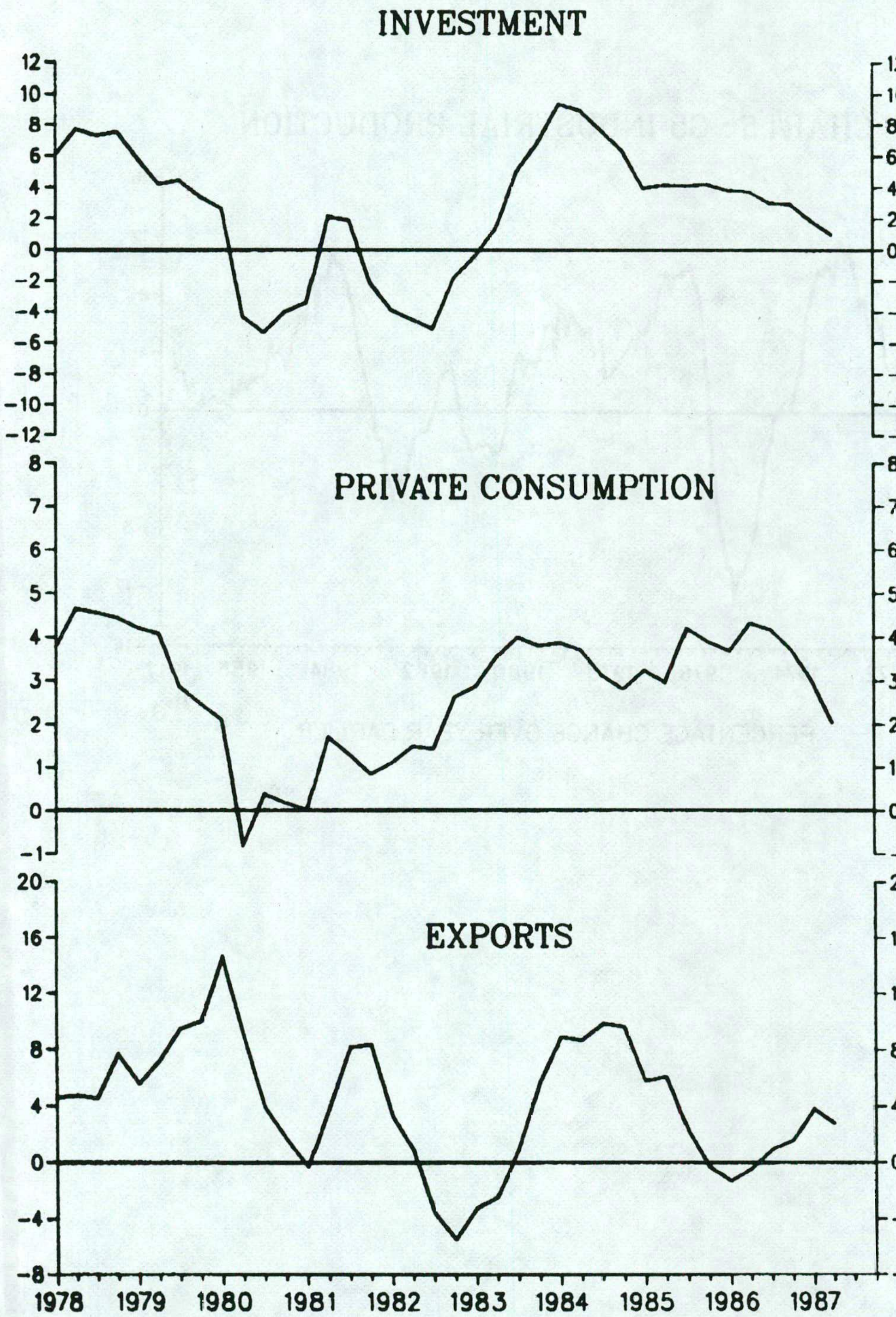
Table 3: Growth of real expenditure in the G5 countries

	Private Consumption	Investment	Government Expenditure	Domestic* Demand	Exports	Imports	Real GNP
			Annual percentage change				
1983	3.5	3.2	2.1	3.4	0.2	2.7	2.9
1984	3.4	8.1	3.0	5.5	9.2	12.8	4.9
1985	3.6	4.0	3.3	3.2	3.4	3.4	3.2
1986	4.0	3.4	5.0	3.9	0.2	6.8	2.7
			Change from four quarters earlier (per cent)				
1986 Q1	3.7	3.8	3.0	3.8	-1.3	2.9	3.0
Q2	4.3	3.8	3.6	4.5	-0.5	7.8	3.0
Q3	4.2	3.0	3.1	4.0	0.9	9.4	2.4
Q4	3.7	3.0	10.1+	3.4	1.6	7.2	2.4
1987 Q1	3.0	1.7	3.0	3.1	3.7	7.1	2.5
Q2	2.1	0.9	1.2	2.4	2.4	3.8	2.2
			Indices (1980=100)				
1986 Q1	116.3	112.9	116.1	116.0	115.3	122.6	114.7
Q2	117.9	114.3	117.1	117.8	117.7	130.5	115.6
Q3	119.5	115.2	118.4	118.8	117.9	133.3	116.1
Q4	119.5	117.0	128.0+	119.2	118.6	133.3	116.7
1987 Q1	119.8	115.0	119.6	119.6	119.5	131.4	117.6
Q2	120.3	115.3	118.6	120.7	120.5	135.4	118.1

* Including stockbuilding

\+ Inflated by Japanese Government's issue of commemorative medals.

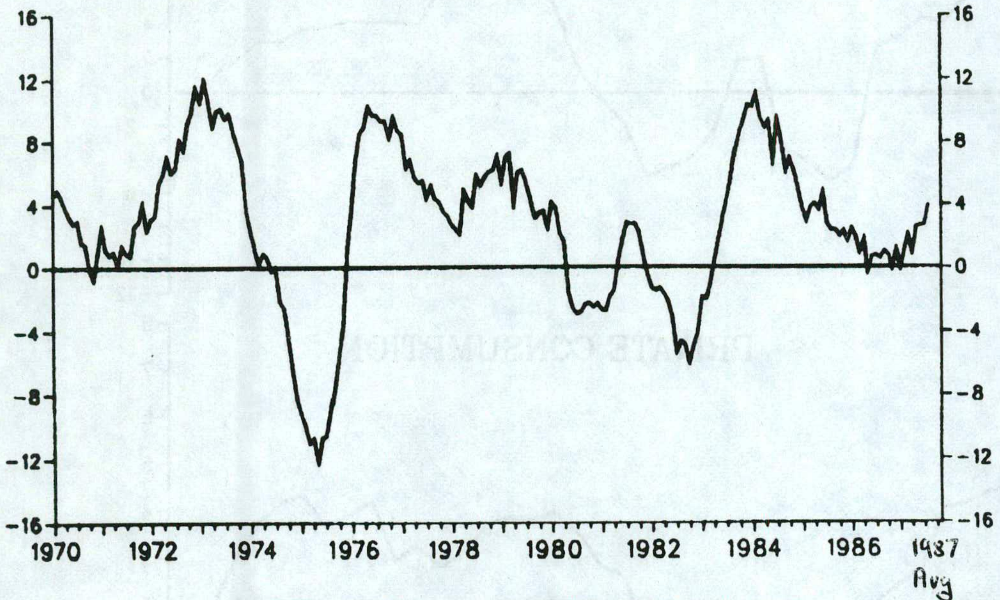
CHART 4: G5 EXPENDITURE GROWTH



PERCENTAGE CHANGE OVER YEAR EARLIER

7. Industrial production in the G5 countries (which increased only slightly during 1986) has picked up since last winter.

CHART 5 : G5 INDUSTRIAL PRODUCTION



PERCENTAGE CHANGE OVER YEAR EARLIER

Table 4: Industrial production in the G5 countries (change on year earlier)

		United States	Japan	Germany	France	United Kingdom	G5*
1983		5.9	3.5	0.8	0.4	3.6	3.7
1984		11.5	10.9	3.4	1.7	1.3	8.0
1985		1.7	4.5	5.4	0.7	4.7	3.0
1986		1.0	-0.3	2.1	0.7	2.0	1.0
1987	Q1	1.6	0.6	-0.9	1.0	2.8	1.0
	Q2	3.1	1.0	0.3	2.3	2.5	2.1
	Q3	4.7	-	-	-	-	-
1987	Jan	0.2	0.5	-1.9	-2.0	2.2	-0.1
	Feb	1.5	-0.2	0.0	2.0	2.9	1.0
	Mar	3.0	1.6	-0.9	3.0	3.3	2.0
	Apr	2.2	0.5	-0.9	-1.0	1.2	0.9
	May	3.2	-0.6	3.0	5.1	3.8	2.6
	Jun	3.9	3.1	-1.2	2.9	2.5	2.7
	Jul	4.6	3.9	-3.1	1.0	3.3	2.7
	Aug	4.7	5.4	2.4	1.5	3.6	4.0
	Sep	5.4	-	-0.6	-	-	-
Indices (1980=100)							
1987	Q1	116.9	122.6	105.0	101.3	112.1	113.9
	Q2	118.1	122.6	107.6	103.7	112.5	115.1
	Q3	120.7	-	106.4	-	-	-
1987	Jan	116.5	122.4	104.0	99.0	110.7	113.1
	Feb	117.1	121.6	106.0	102.0	112.6	114.0
	Mar	117.2	123.7	105.0	103.0	112.9	114.5
	Apr	117.3	122.0	108.0	102.0	112.3	114.5
	May	118.0	120.6	108.2	104.0	113.2	114.9
	Jun	118.9	125.3	106.7	105.0	111.9	115.9
	Jul	120.3	126.0	105.6	104.0	114.4	116.6
	Aug	120.6	125.7	110.6	104.0	115.3	117.6
	Sep	120.8	-	106.4	-	-	-

* Weighted by 1980 industrial output at 1980 exchange rates.

8. Unemployment rates have been about constant this year in Japan, Germany and France and have fallen in the US and UK (Tables 5 and 6). For the G5 as a whole the unemployment rate is ½ per cent lower than at the start of the year.

Table 5: OECD Standardized Unemployment rates (per cent of labour force, seasonally adjusted)

	US	Japan	Germany	France	UK	G5*
1984	7.4	2.7	7.1	9.7	11.7	7.0
1985	7.1	2.6	7.2	10.2	11.2	6.8
1986	6.9	2.8	6.9	10.4	11.1	6.7
1986 Q1	6.9	2.6	7.1	10.2	11.1	6.7
Q2	7.0	2.7	7.0	10.5	11.2	6.8
Q3	6.8	2.9	6.9	10.6	11.2	6.8
Q4	6.7	2.8	6.8	10.6	11.0	6.6
1987 Q1	6.6	2.9	6.8	10.9	10.7	6.6
Q2	6.1	3.0	6.9	11.0	10.3	6.4
Q3	5.9	-	-	-	-	-
1987 Jan	6.6	3.0	6.8	10.8	10.8	6.6
Feb	6.6	2.9	6.8	10.9	10.7	6.6
Mar	6.5	2.9	6.9	11.1	10.6	6.6
Apr	6.2	2.9	6.9	11.0	10.5	6.4
May	6.2	3.2	6.9	11.0	10.2	6.5
Jun	6.0	3.0	6.9	10.9	10.1	6.3
Jul	5.9	2.7	7.0	10.9	9.9	6.2
Aug	5.9	2.8	7.0	11.0	9.8	6.2
Sep	5.8	-	-	10.6	9.5	-

* Using 1980 labour force weights.

Table 6: Unemployment rates, national definitions*

(per cent of labour force, seasonally adjusted)

	US	JAPAN	GERMANY	FRANCE	UK
1984	7.5	2.7	9.1	9.9	11.1
1985	7.2	2.6	9.3	10.2	11.3
1986	7.0	2.8	9.0	10.5	11.4
1986 Q1	7.1	2.7	9.2	10.3	11.4
Q2	7.1	2.8	9.0	10.5	11.5
Q3	6.9	2.9	8.8	10.6	11.6
Q4	6.8	2.8	8.7	10.7	11.3
1987 Q1	6.7	2.9	8.8	11.1	11.0
Q2	6.2	3.1	8.9	11.1	10.7
Q3	5.8	-	-	-	-
1987 Apr	6.2	3.1	8.8	10.7	10.9
May	6.2	3.2	8.8	10.7	10.4
Jun	6.0	3.0	8.9	10.7	10.3
Jul	5.9	2.7	9.0	10.7	10.2
Aug	5.9	2.8	8.9	10.7	10.0
Sep	5.8	-	9.0	10.5	9.8

* Not comparable between countries

Source: OECD, DE.

SECTION B: PRICES AND LABOUR COSTS

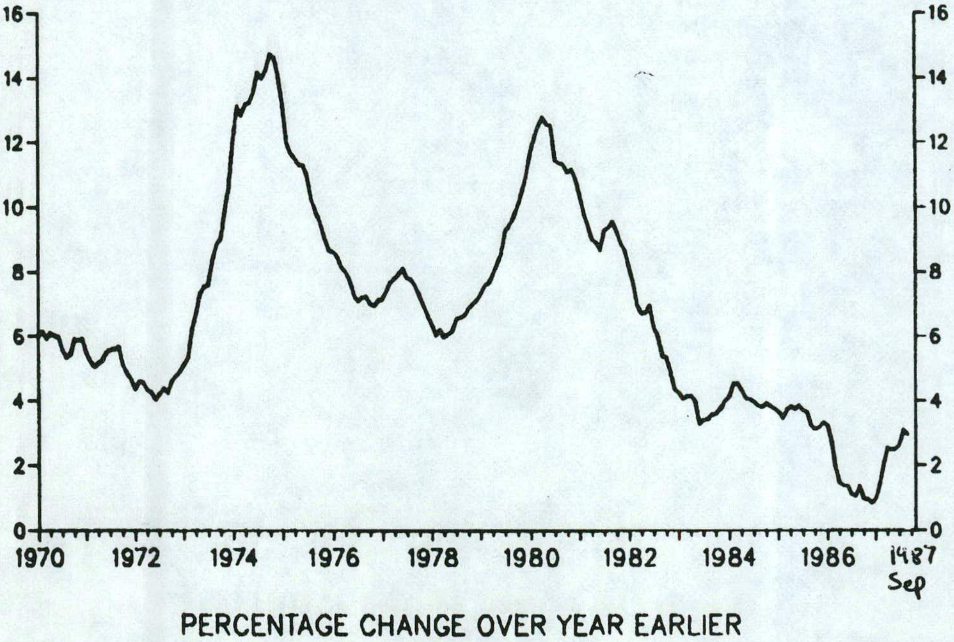
9. At the end of 1986, G5 consumer price inflation was at its lowest for over 20 years. It has picked up in all the major countries this year, but especially in the US.

Table 7: Consumer prices (percentage change on a year earlier)

	US	Japan	Germany	France	UK	G5
1983	3.2	1.8	3.3	9.4	4.6	3.8
1984	4.2	2.3	2.4	7.7	5.0	4.1
1985	3.6	2.0	2.2	5.8	6.1	3.5
1986	1.9	0.4	-0.2	2.5	3.4	1.5
1987 Jan	1.4	-1.5	-0.8	3.0	4.0	1.0
Feb	2.1	-1.4	-0.5	3.4	3.9	1.4
Mar	3.0	-0.8	-0.2	3.3	4.0	2.0
Apr	3.8	-0.2	0.1	3.5	4.2	2.5
May	3.8	-0.3	0.2	3.4	4.1	2.5
Jun	3.7	0.0	0.2	3.3	4.2	2.5
Jul	3.9	-0.4	0.7	3.4	4.4	2.6
Aug	4.4	0.7	0.8	3.5	4.4	3.1
Sep	4.3	0.7	0.4	3.2	4.2	2.9

Source: OECD

CHART 6: G5 CONSUMER PRICE INFLATION



PERCENTAGE CHANGE OVER YEAR EARLIER

10. Growth of unit labour costs has slowed in the major countries. This has been due partly to faster rises in productivity and partly to slower rises in earnings.

Table 8: Unit labour costs (manufacturing, in domestic currencies, percentage change on year earlier)

	US	Japan	Germany	France	UK	G5
1983	-2.4	-2.2	-0.5	7.6	0.0	-0.7
1984	-2.0	-3.9	1.0	4.7	2.5	-0.7
1985	0.1	2.4	0.3	2.9	3.9	0.3
1986	-0.5	2.5	3.3	2.3	4.1	1.4
1986 Q1	-0.6	1.4	1.6	2.8	6.2	1.1
Q2	-0.1	2.8	2.8	1.3	5.6	1.5
Q3	-0.3	3.4	4.4	3.1	3.0	1.8
Q4	-0.7	2.6	4.5	2.0	1.6	1.2
1987 Q1	-1.0	-0.2	5.5	0.6	1.0	0.5
Q2	-1.8	-0.5	0.6	-1.0	1.5	-0.8
Indices (1980=100)						
1986 Q1	108.6	96.6	110.8	148.1	126.3	112.9
Q2	108.7	96.2	111.7	145.5	125.8	113.6
Q3	108.4	97.0	113.5	146.6	125.3	113.0
Q4	108.6	97.6	115.0	148.3	126.1	113.7
1987 Q1	107.5	96.4	116.9	149.0	127.5	113.5
Q2	106.7	95.7	115.7	146.8	127.7	112.6

Source: IMF

11. Prices of metals and (until August) agricultural materials have been recovering this year, while food prices have hardly risen, in nominal SDRs (table 9 and chart 7). In real terms, commodity prices are still lower than at the beginning of 1986 (table 10 and chart 8).

Table 9: Nominal Commodity Prices (In nominal SDRs, 1980 = 100)

	Food	Agricultural Non-Food	Non-Ferrous Metals	Metal Ores	Oil
1983	94.1	104.5	95.3	103.3	116.2
1984	93.2	115.5	96.7	109.7	117.5
1985	85.2	99.8	91.1	105.4	113.5
1986	82.5	83.2	77.4	88.5	52.5
1986 Q1	89.1	87.9	82.1	93.6	80.4
Q2	86.3	84.1	78.5	89.4	46.0
Q3	77.9	79.0	74.6	85.5	38.5
Q4	76.6	82.0	74.5	85.6	45.2
1987 Q1	74.3	82.6	75.3	82.4	55.5
Q2	75.4	85.0	80.5	79.0	57.7

Source: United Nations

CHART 7 : ECONOMIST INDICES FOR 1987

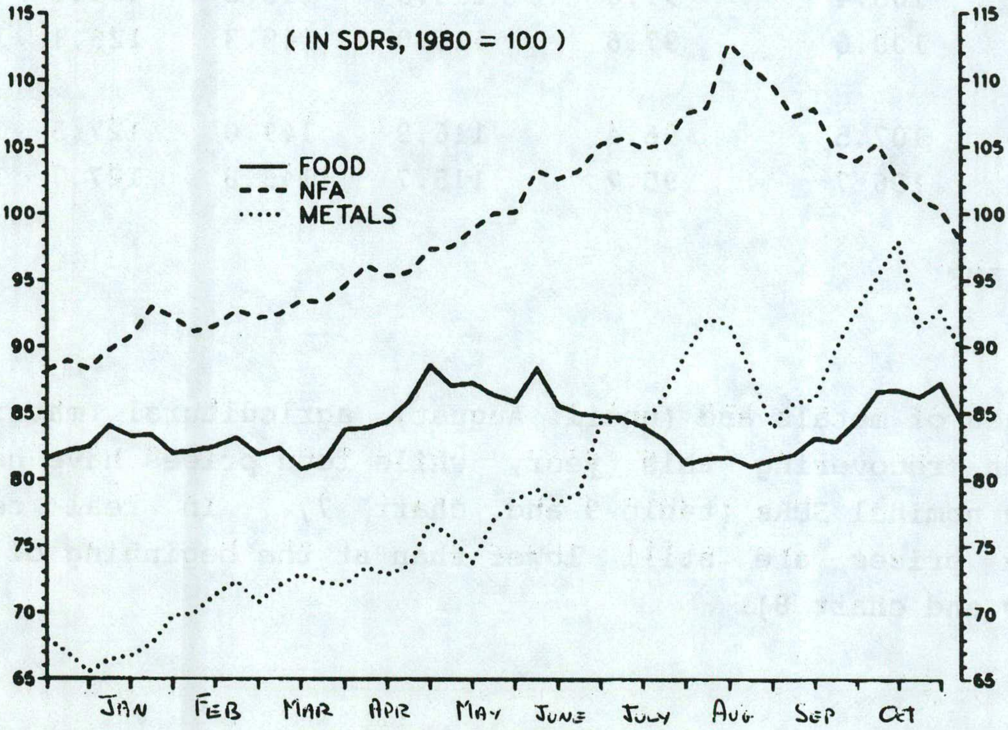
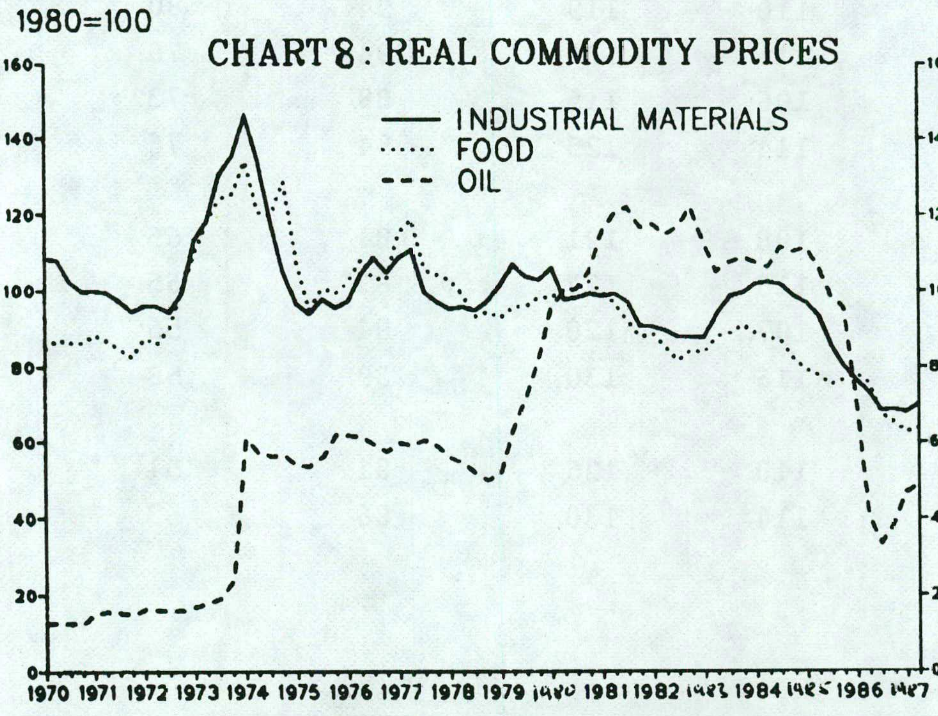


Table 10: Real Commodity Prices (1980 = 100)*

	Food	Agricultural Non-Food	Non-Ferrous Metals	Metal Ores	Oil
1983	87.6	97.3	88.7	96.2	108.2
1984	86.2	106.7	89.4	101.4	108.6
1985	76.9	90.2	82.3	95.3	102.6
1986	71.4	72.1	67.0	76.6	45.5
1986 Q1	77.8	76.8	71.7	81.7	70.2
Q2	75.5	73.5	68.6	78.2	40.2
Q3	67.3	68.2	64.5	73.8	33.3
Q4	65.1	69.7	63.3	72.8	38.4
1987 Q1	62.6	69.6	63.5	69.4	46.7
Q2	63.5	71.6	67.8	66.6	48.7

* Deflated by trade-weighted unit value indices for manufactured exports.

Source: United Nations



Deflated by manufacturers unit value index.
Comprises agricultural non-food, non-ferrous metal and metal ores

SECTION C: TRADE AND CURRENT BALANCES

13. Approximate figures for the volume of G5 exports to various trade blocs are shown in Table 11. (These are computed as exports at current prices deflated by total, not regional, unit value indices. The figures for total exports and exports to OECD include intra-G5 trade and are not seasonally adjusted).

14. The total volume of exports appears to have changed little over the course of last year. A fall in exports to non-OECD countries, especially oil producers, has offset a rise in exports to OECD countries.

Table 11: G5 Export Volumes (1980 = 100, not seasonally adjusted)

	Total	to OECD	to non-OECD	of which: OPEC	non-OPEC
1981	102	100	106	121	102
1982	99	98	100	125	92
1983	98	101	93	102	90
1984	107	114	95	88	97
1985	110	120	93	76	98
1986	111	125	86	61	94
1985 Q1	110	119	94	80	98
Q2	111	121	94	76	100
Q3	106	115	89	73	94
Q4	114	125	94	76	100
1986 Q1	108	121	84	65	90
Q2	113	127	87	65	93
Q3	107	120	84	56	93
Q4	116	130	89	58	99
1987 Q1	110	126	81	51	91
Q2	114	130	86	53	96

5. On 12-month moving averages, the trade imbalances of the three largest countries have changed little (in dollar terms) over the year so far. But current account imbalances have fallen slightly in relation to GNP (see chart 9).

Table 12: Visible Trade balances of US, Japan and Germany*
($ billion, monthly averages, not seasonally adjusted for the US).

	US	Japan	Germany
1984	-10.3	3.7	1.7
1985	-12.4	4.7	2.2
1986	-13.9	7.7	4.5
1987 Jan	-12.3 (-13.7)	9.6 (8.0)	4.8 (4.5)
Feb	-15.1 (-14.0)	9.2 (8.3)	6.1 (4.7)
Mar	-13.6 (-14.1)	8.4 (8.5)	4.8 (4.9)
Apr	-13.3 (-14.0)	8.2 (8.3)	5.3 (5.0)
May	-14.4 (-14.1)	8.1 (8.5)	6.0 (5.2)
Jun	-15.7 (-14.1)	6.9 (8.5)	4.6 (5.1)
Jul	-16.5 (-13.3)	7.7 (8.5)	5.6 (5.1)
Aug	-15.7 (-13.5)	6.8 (8.3)	4.9 (5.1)
Sep	-	8.2 (8.3)	6.4 (4.7)

* Averages of past 12 months in brackets.

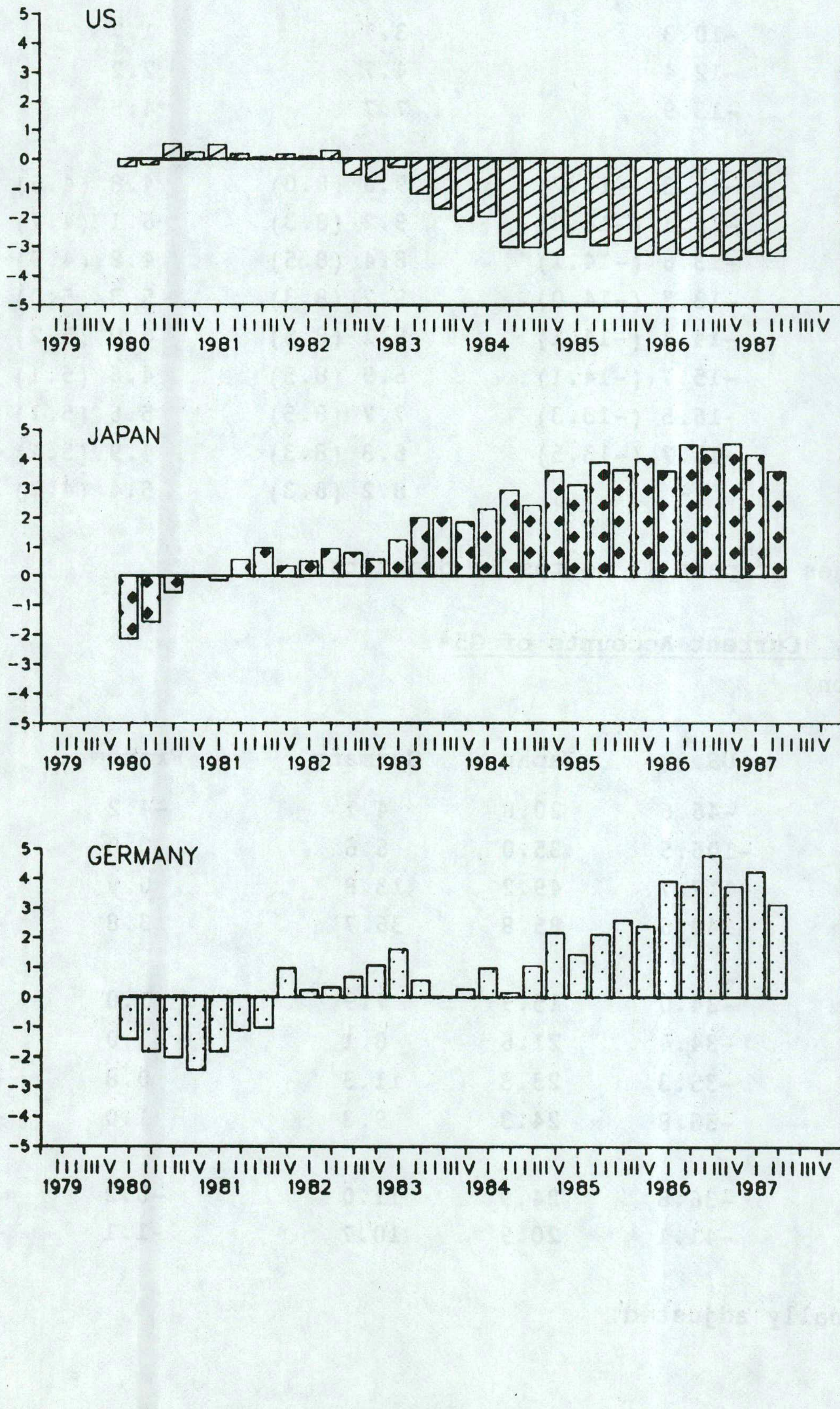
Table 13: Current Accounts of G5*
($ billion)

	US	Japan	Germany	France	UK
1983	-46.6	20.8	4.1	-4.2	5.0
1984	-106.5	35.0	6.6	0.0	2.1
1985	-117.7	49.2	13.8	0.9	4.6
1986	-140.6	85.8	36.7	3.8	-0.2
1986 1	-34.0	15.9	7.9	1.0	1.5
2	-34.4	21.6	8.1	1.0	0.2
3	-35.3	23.8	11.3	0.8	-1.1
4	-36.8	24.3	9.3	1.0	-0.8
1987 1	-36.8	24.9	11.0	-0.2	0.9
2	-41.1	20.9	10.7	-1.1	-0.9

* Seasonally adjusted.

CHART 9

CURRENT BALANCES (AS % OF NOMINAL GNP)



SECTION D: INTEREST RATES, MONEY SUPPLY AND EXCHANGE RATES

16. Short term rates in the United States and Germany rose quite sharply in late September and early October, but have since fallen back (chart 10).

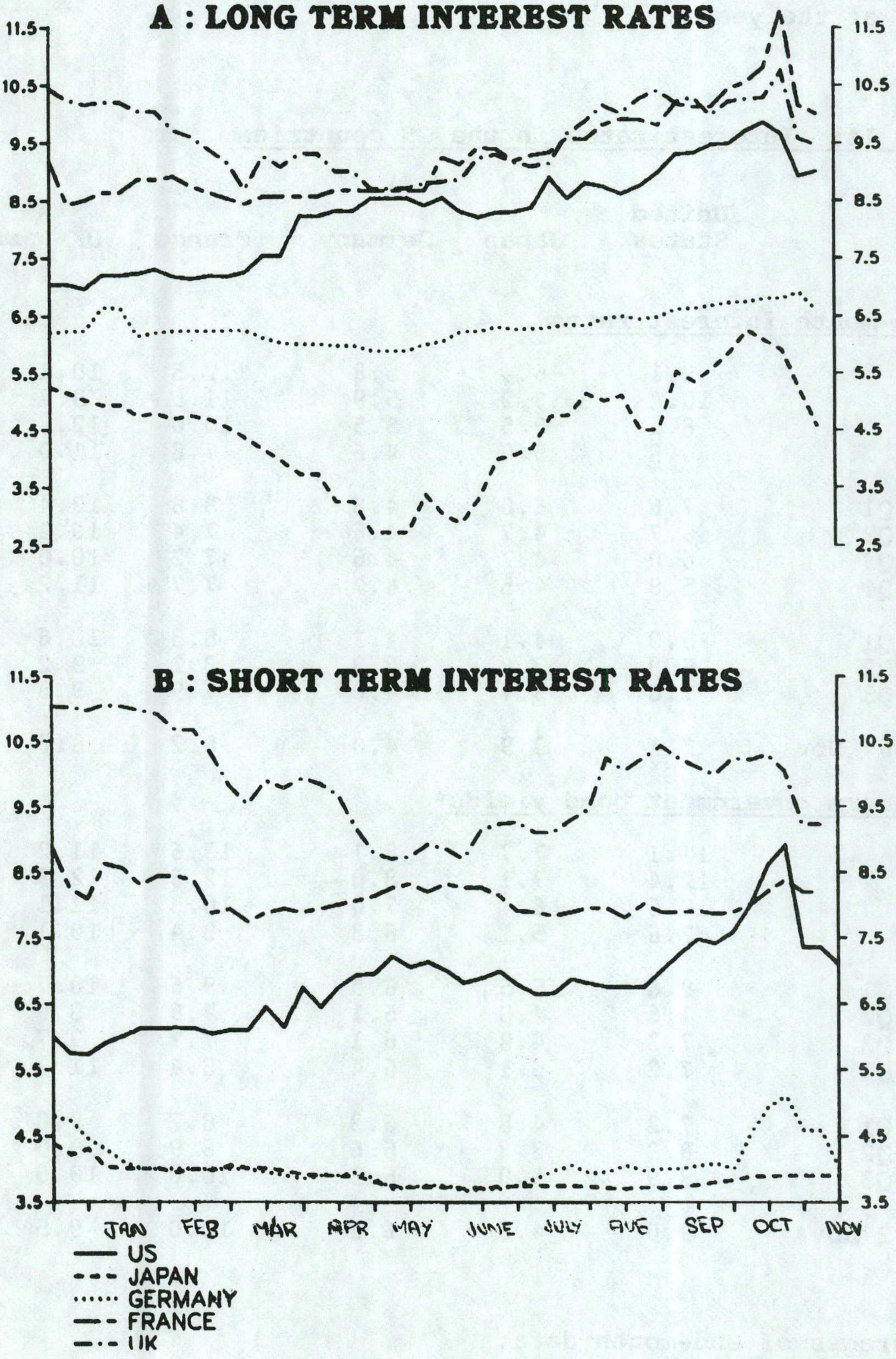
17. Long rates have risen markedly in the US and France since the start of the year.

Table 14: Interest rates in the G5 countries

	United States	Japan	Germany	France	UK	G5 weighted average
Three-month interest rates						
1983	9.1	6.4	5.8	12.5	10.1	8.6
1984	10.4	6.2	5.9	11.5	9.7	9.0
1985	8.1	6.5	5.5	10.0	12.3	8.0
1986	6.5	5.0	4.6	7.8	11.0	6.5
1986 Q1	7.6	6.0	4.6	8.8	12.4	7.5
Q2	6.7	4.7	4.6	7.4	10.2	6.4
Q3	6.0	4.7	4.6	7.2	10.0	6.1
Q4	5.8	4.5	4.7	7.7	11.2	6.1
1987 Q1	6.0	4.1	4.2	8.3	10.6	6.1
Q2	6.8	3.8	3.8	8.1	9.2	6.2
Q3	7.0	3.7	4.0	7.9	9.8	6.3
6 Nov	7.1	3.9	4.0	8.2	8.8	6.3
Long-term government bond yields*						
1983	11.1	7.7	8.1	13.6	11.2	10.3
1984	12.4	7.1	8.0	12.3	12.3	10.8
1985	10.6	6.4	7.0	10.8	11.1	9.4
1986	7.6	5.1	6.3	8.4	10.1	7.3
1986 Q1	8.6	5.5	6.5	9.6	10.7	8.0
Q2	7.6	4.8	6.1	7.9	8.9	7.0
Q3	7.3	4.8	6.1	7.7	9.7	6.9
Q4	7.2	5.1	6.4	8.4	11.1	7.2
1987 Q1	7.2	4.8	6.3	8.7	9.8	7.0
Q2	8.3	3.3	6.6	8.9	9.0	7.2
Q3	8.9	5.0	6.5	10.0	10.0	8.1
2 Nov	9.0	4.6	6.6	10.0	9.5	8.0

* Averages of end-month data.

CHART 10 : NOMINAL INTEREST RATES



18. In 'real terms', short term rates are generally lower than at the start of the year.

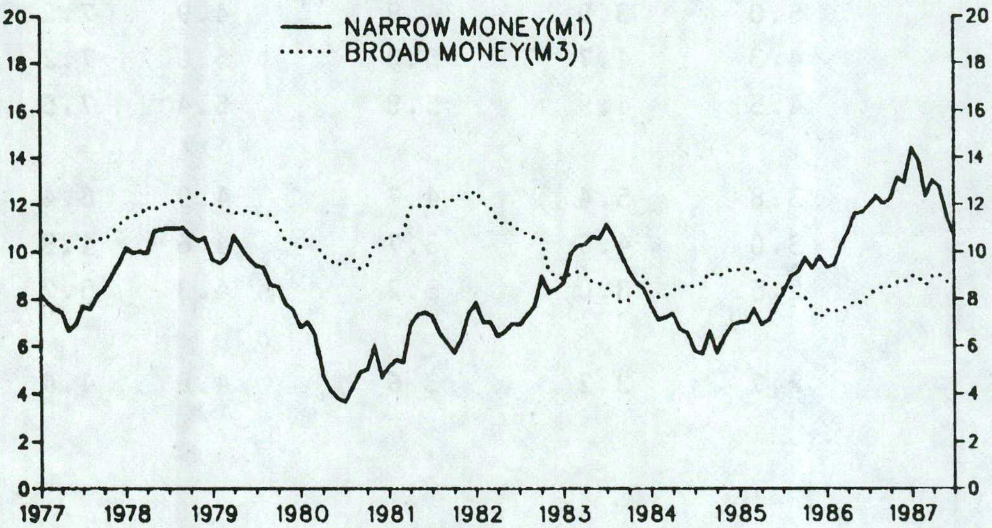
Table 15: Real Short-Term Interest Rates*
(in per cent)

	United States	Japan	Germany	France	UK	G5
1983	5.6	4.5	2.4	2.8	5.3	4.6
1984	5.9	3.8	3.4	3.5	4.5	4.8
1985	4.4	4.4	3.2	3.9	5.8	4.3
1986	4.5	4.5	4.9	5.1	7.2	4.9
1986 Q1	4.4	4.5	3.9	5.0	7.1	4.7
Q2	5.0	3.9	4.8	4.9	7.2	4.9
Q3	4.3	4.7	5.0	5.0	7.2	4.8
Q4	4.5	4.9	5.8	5.4	7.5	5.1
1987 Q1	3.8	5.4	4.7	4.9	6.4	4.6
Q2	3.0	4.0	3.7	4.6	4.8	3.6
Q3	2.5	3.0	3.2	4.3	5.2	3.2
6 Nov	2.7	3.2	3.6	4.8	4.4	3.3

* Three month money market rates deflated by change in consumer price index on year earlier.

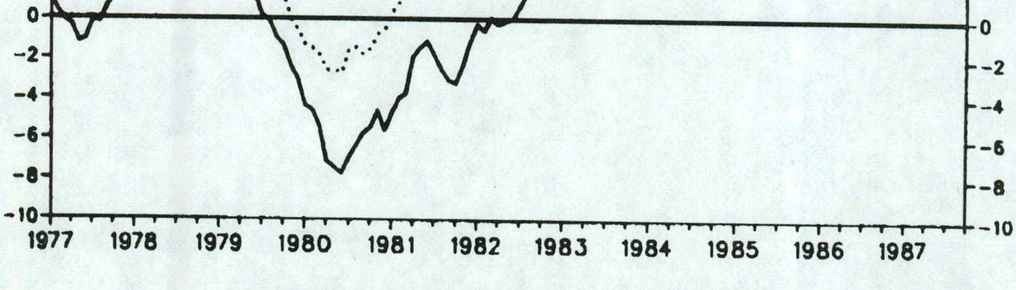
19. Growth in M1 accelerated sharply last year in the G5 countries but has slowed, particularly in the US, since the start of the year. This indicator is probably unreliable given the effects, especially in the US and UK, of innovations (such as the paying of market-related interest on sight deposits) on the demand for this aggregate. The nominal growth of broad aggregates (M2 or M3) has been slower than M1 (except in the UK), but faster than nominal GNP.

CHART 11: G5 MONEY SUPPLY



PERCENTAGE CHANGE OVER YEAR EARLIER

CHART 12: G5 REAL MONEY SUPPLY



PERCENTAGE CHANGE OVER YEAR EARLIER

Table 16: Narrow money growth (M1, seasonally adjusted, percentage change on a year earlier)

		US	Japan	Germany	France	UK	G5	UK MO
1980		6.2	2.6	2.3	8.8	4.1	5.1	8.5
1981		7.0	3.3	1.1	11.5	11.7	6.4	4.6
1982		6.6	5.8	3.6	11.8	17.1	7.4	0.9
1983		11.1	3.6	10.0	9.8	16.0	9.8	5.7
1984		7.0	2.8	3.2	10.4	14.0	6.6	5.6
1985		9.2	5.1	4.2	9.0	15.7	8.2	4.6
1986		13.4	6.9	8.3	7.6	22.2	11.5	4.0
1987	Jan	17.3	9.4	9.1	10.4	23.4	14.4	5.1
	Feb	16.6	11.2	9.0	6.8	22.0	13.8	4.1
	Mar	15.4	10.3	7.3	1.4	23.5	12.4	4.1
	Apr	15.8	10.8	8.3	3.6	23.1	13.0	4.8
	May	14.2	12.2	9.6	3.3	24.4	12.7	4.4
	Jun	11.9	11.0	8.7	5.0	24.1	11.4	4.2
	Jul	10.5	10.9	9.1	4.1	23.0	10.6	5.4
	Aug	9.3	11.5	10.5	-	24.6	-	4.7
	Sep	8.4	-	9.6	-	20.4	-	4.9

CHART 13

G5 BROAD AND NARROW MONEY-VELOCITY OF CIRCULATION

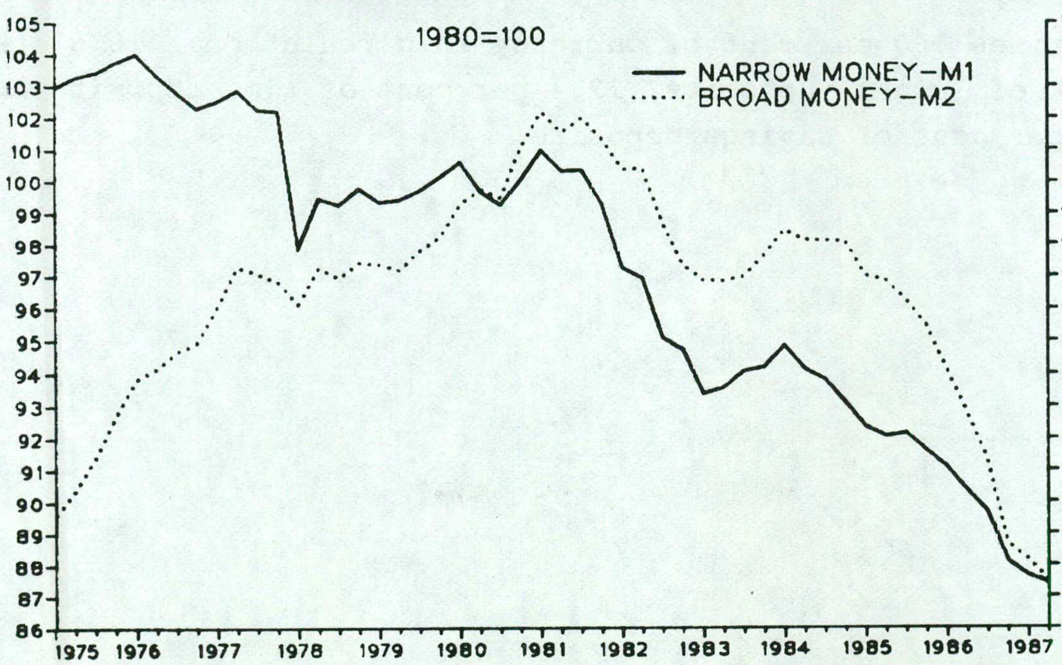


Table 17: Broad money growth (percentage change in seasonally adjusted measure on a year earlier)

	US M3	Japan M2+CDs	Germany M2	France M3	UK M3	G5	Germany CBM*
1980	9.2	9.2	8.9	11.2	15.0	9.9	4.8
1981	11.9	8.9	9.9	12.0	19.7	11.7	4.4
1982	10.9	9.2	6.5	11.5	21.2	10.8	4.9
1983	9.8	7.4	2.7	10.2	12.2	8.6	7.3
1984	10.1	7.8	3.3	9.8	9.3	8.6	4.8
1985	9.0	8.4	4.1	8.6	12.2	8.4	4.6
1986	8.1	8.6	4.0	5.1	18.1	8.1	6.4
1987 Jan	9.0	8.6	6.8	5.3	18.4	9.0	7.5
Feb	8.6	8.8	6.8	4.9	19.8	8.9	7.7
Mar	8.1	9.0	6.7	4.9	19.3	8.6	7.9
Apr	7.6	9.8	7.7	6.9	20.3	9.0	7.7
May	7.4	10.2	8.5	6.8	19.2	9.0	8.4
Jun	7.2	10.1	7.0	7.6	19.4	8.7	8.7
Jul	6.4	10.4	6.6	7.8	21.2	8.5	8.4
Aug	6.2	11.0	6.7	-	22.5	-	8.0
Sep	5.9	-	6.5	-	19.5	-	-
Target	5.5-8.5	10**		3-5			3-6

* Comprises 100 per cent of currency in circulation, 16.6 per cent of sight deposits, 12.4 per cent of time deposits and 8.1 per cent of savings deposits.

20. The dollar has depreciated further recent weeks (particularly against the yen) after a period of stability (table 18). In effective terms on 5 November the dollar was 7 per cent below and the yen 9 per cent above their levels at the time of the Louvre Agreement in late February (table 19). Chart 16 shows the changes in the dollar since then, against the deutschemark and yen and in effective terms.

Table 18: Bilateral exchange rates since Louvre

	Yen/$	DM/$	FFr/$	$/£	$ Effective
Louvre - 20 Feb 1987	153.5	1.826	6.08	1.53	104.0
Averages of daily rates:					
March	157.5	1.835	6.11	1.59	103.3
April	142.9	1.811	6.03	1.63	101.0
May	140.6	1.789	5.98	1.67	100.4
Jun	144.4	1.818	6.07	1.63	101.7
Jul	150.2	1.847	6.15	1.61	103.3
Aug	147.6	1.857	6.20	1.60	103.3
Sep	143.1	1.812	6.05	1.65	100.8
Oct	143.3	1.801	6.01	1.66	100.6
Latest:					
5 Nov 1987	134.6	1.668	5.64	1.86	96.9

CHART 14: REAL AND NOMINAL EFFECTIVE EXCHANGE RATES

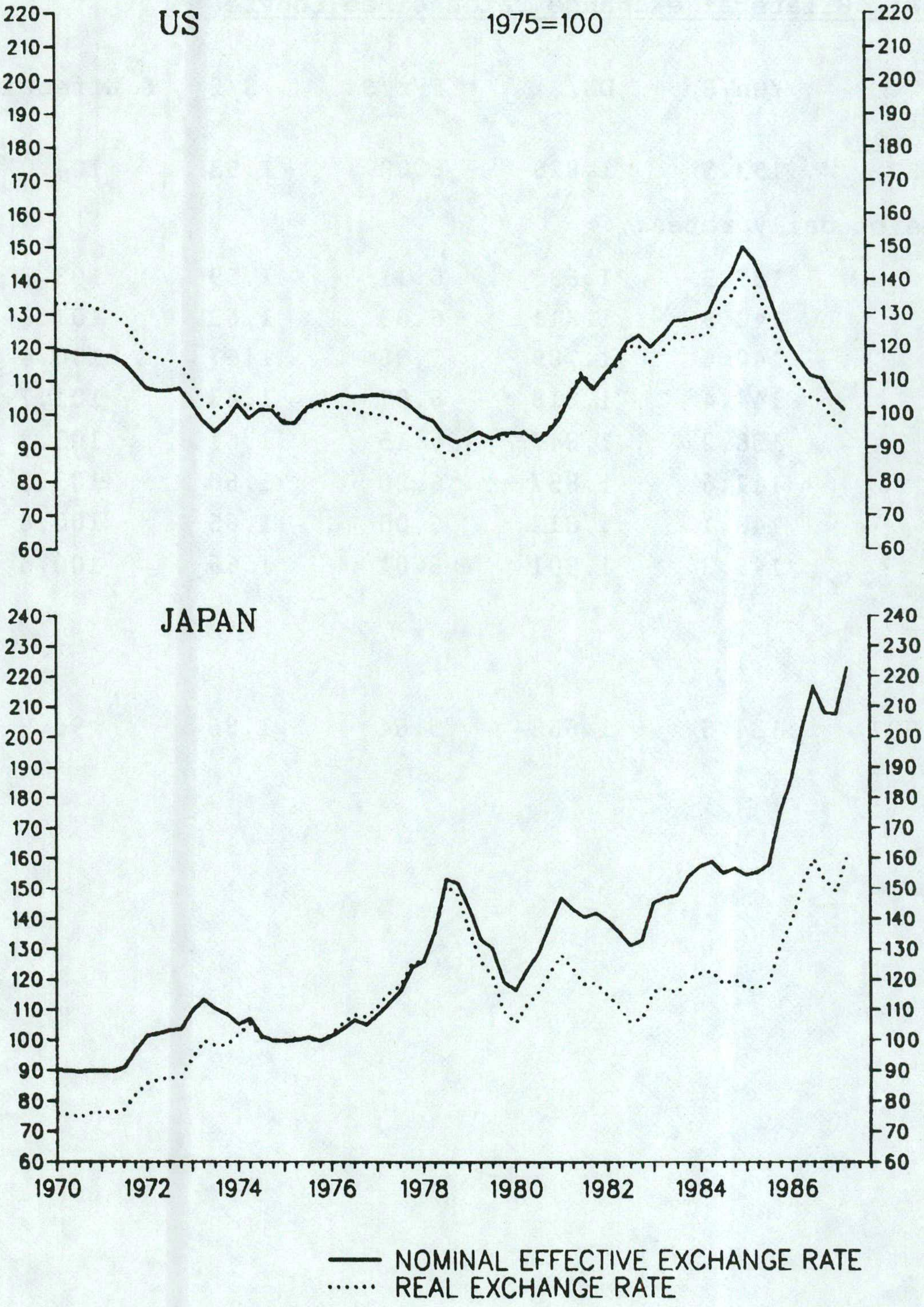


CHART 15:REAL AND NOMINAL EFFECTIVE EXCHANGE RATES

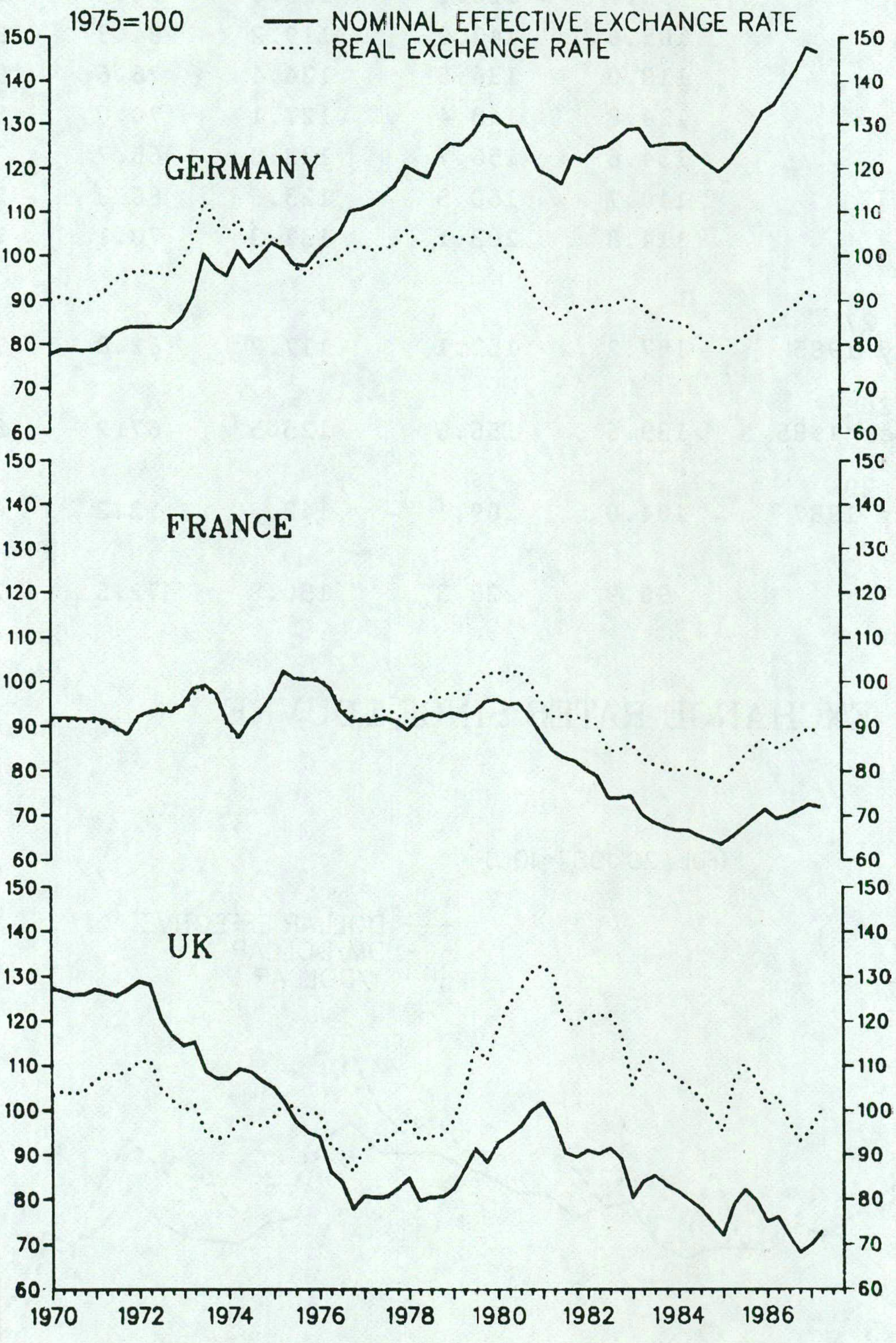
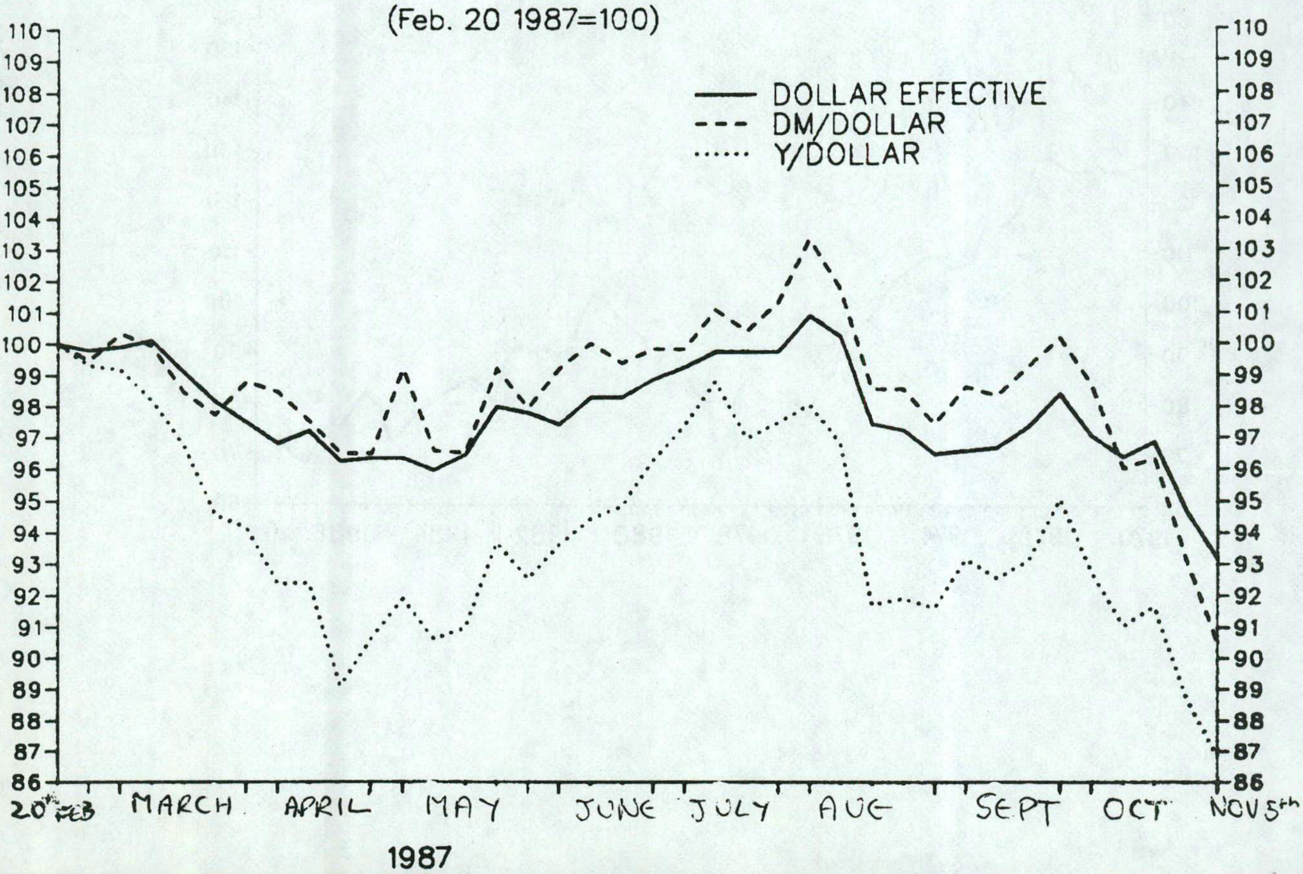


Table 19: Effective exchange rate movements (1975 = 100)

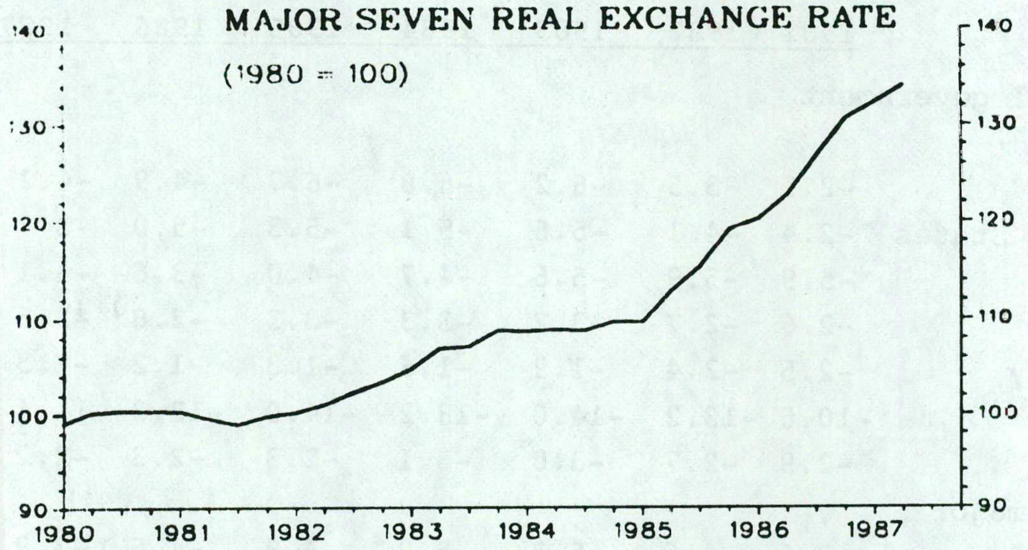
	United States	Japan	Germany	France	United Kingdom
1980	93.7	126.4	128.8	94.4	96.0
1981	105.6	142.9	119.2	84.3	94.8
1982	118.0	134.6	124.4	76.6	90.4
1983	124.8	148.4	127.1	70.0	83.2
1984	134.6	156.7	123.8	65.7	78.6
1985	140.7	160.5	123.6	66.3	78.2
1986	114.8	203.1	137.3	70.1	72.8
$ Peak - 27 February 1985	157.2	157.1	117.2	62.0	70.2
Plaza - 20 September 1985	139.6	156.6	125.5	67.2	82.0
Louvre - 20 February 1987	104.0	209.1	148.3	72.2	69.1
Latest - 3 Nov 1987	96.9	228.3	150.8	72.5	75.3

CHART 16 EXCHANGE RATES SINCE LOUVRE



21. As measured by the ratio, in common currency, of consumer prices in G7 to those in the rest of the world, the real exchange rate of G7 appears to have appreciated substantially since early 1985 (Chart 17). This reflects a tendency for developing countries in Asia and newly industrialised countries (such as Korea, Hong Kong, and Singapore) to link their currencies to the depreciating dollar.

CHART 17



SECTION E: BUDGET DEFICITS AND PUBLIC DEBT

22. Budget deficits have declined on average in the major countries since 1983. They are expected to remain about constant next year on present policies (rises in Japan and Germany offsetting falls in France and Italy.

Table 20: Central and general government financial balances

	1981	1982	1983	1984	1985	1986	1987	1988
Central government								
Canada	-2.1	-5.5	-6.2	-6.8	-6.7	-4.9	-4.1	-3.8
United States	-2.4	-4.1	-5.6	-5.1	-5.3	-5.0	-3.7	-3.7
Japan	-5.9	-5.9	-5.6	-4.7	-4.0	-3.6	-4.1	-4.6
France	-2.6	-2.7	-3.2	-3.3	-3.3	-2.8	-2.5	-2.1
Germany	-2.5	-2.4	-1.9	-1.6	-1.3	-1.2	-1.3	-1.5
Italy	-10.6	-13.2	-14.0	-13.2	-14.0	-12.3	-11.4	-10.1
UK	-2.9	-2.7	-3.0	-3.1	-2.3	-2.3	-2.2	-2.1
Seven major countries	-3.6	-4.6	-5.3	-5.0	-4.9	-4.5	-3.9	-3.9
General government								
Canada	-1.5	-5.8	-6.9	-6.4	-7.0	-5.5	-4.5	-4.1
United States	-1.0	-3.5	-3.8	-2.8	-3.3	-3.5	-2.3	-2.4
Japan	-3.5	-3.6	-3.7	-2.1	-0.8	-0.6	-1.2	-1.6
France	-1.9	-2.8	-3.2	-2.7	-2.9	-2.9	-2.6	-2.1
Germany	-3.7	-3.3	-2.5	-1.0	-1.1	-1.2	-1.5	-2.0
Italy	-11.5	-11.3	-10.7	-11.5	-12.2	-11.2	-10.4	-9.9
UK	-2.8	-2.3	-3.6	-3.8	-2.6	-2.8	-2.6	-2.5
Seven major countries	-2.7	-3.9	-4.1	-3.4	-3.3	-3.3	-2.6	-2.7

(a) Percentages of GNP or GDP

(b) IMF estimates and forecasts (Oct. 1987).

SECTION F: STOCK MARKETS

23. The drop in share prices followed very substantial rises in most countries since 1982 (charts 18 and 19). In the US, Japan and UK, share prices were still, on 4 November, higher than on average in 1986 (table 21).

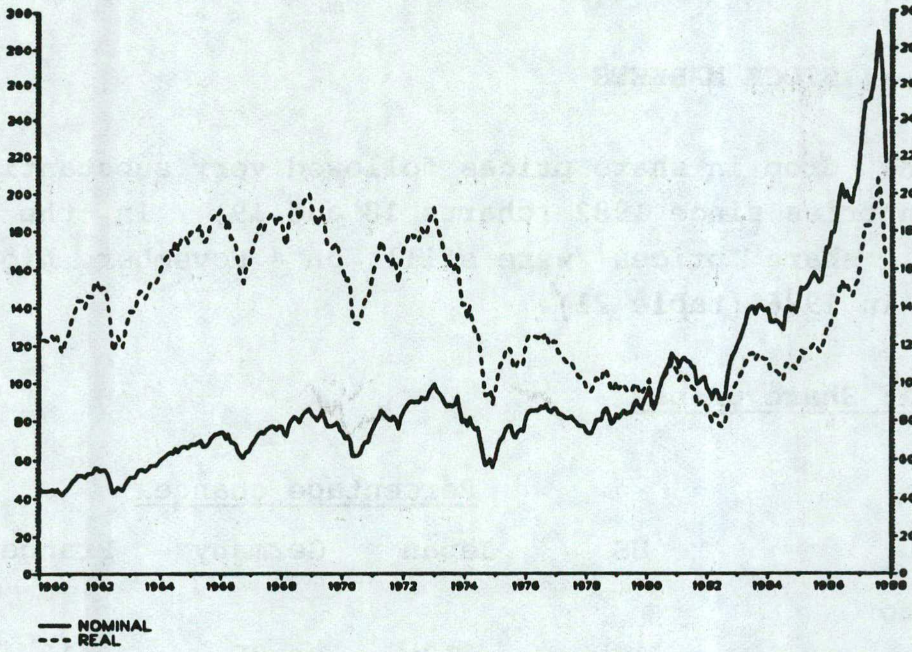
Table 21: Share prices

	Percentage changes				
	US	Japan	Germany	France	UK
Oct 15 to Nov 4	-17½	-12½	-25	-18	-31
Average 1987Q1-Q3 to Nov 4	-18	-6	-23	-27½	-24
Average 1986 to Nov 4	+9	+41	-25	-12½	+4½

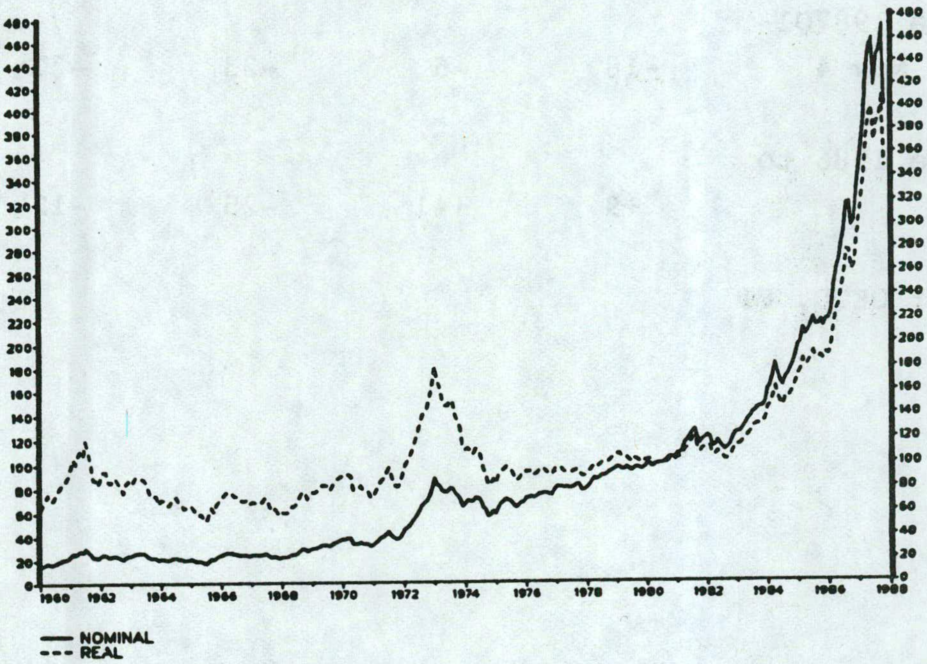
Source: OECD, FT

CHART 18

US SHARE PRICES



JAPANESE SHARE PRICES



U.K. SHARE PRICES

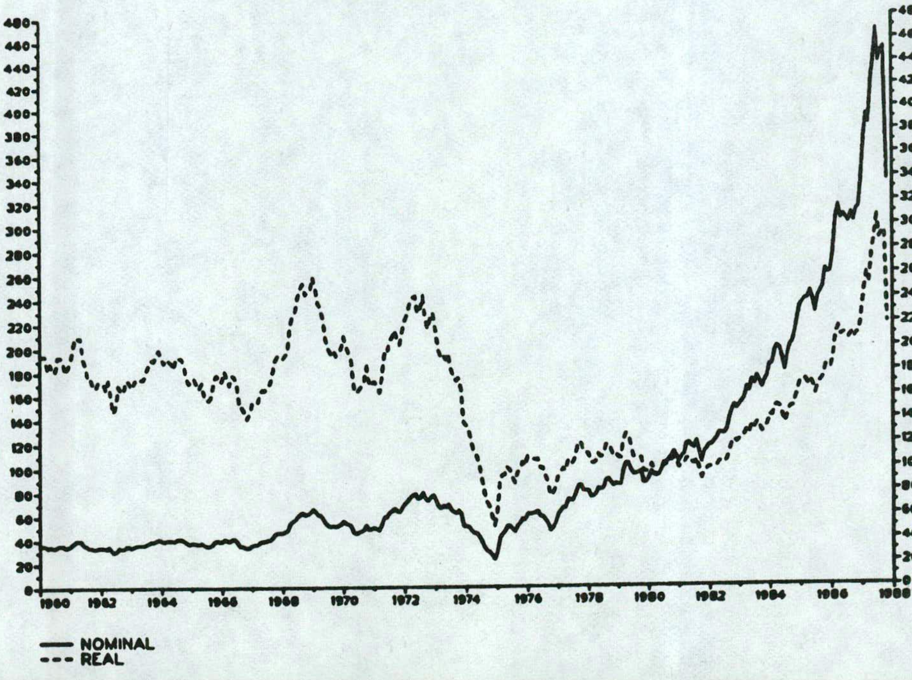
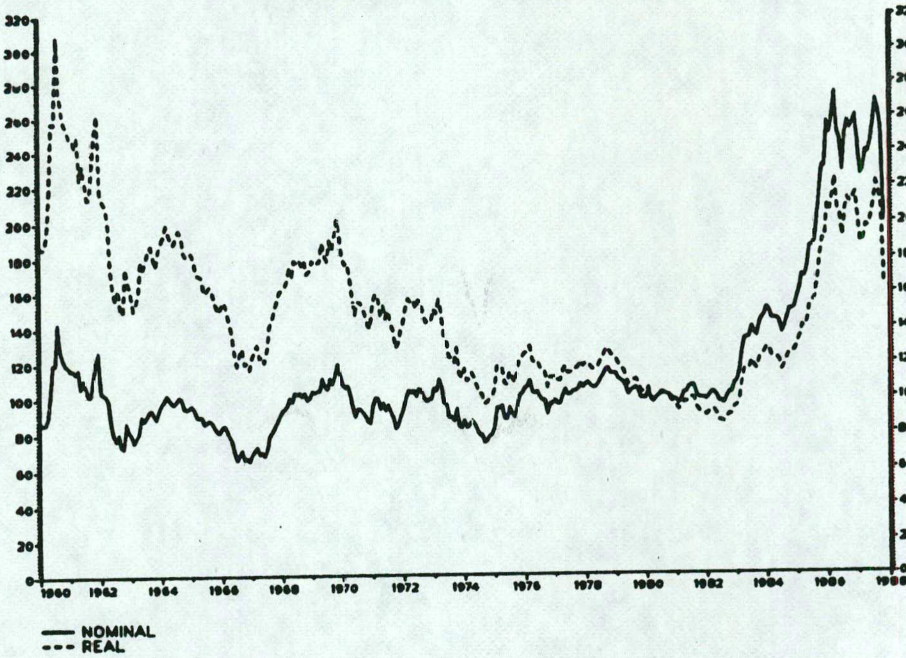
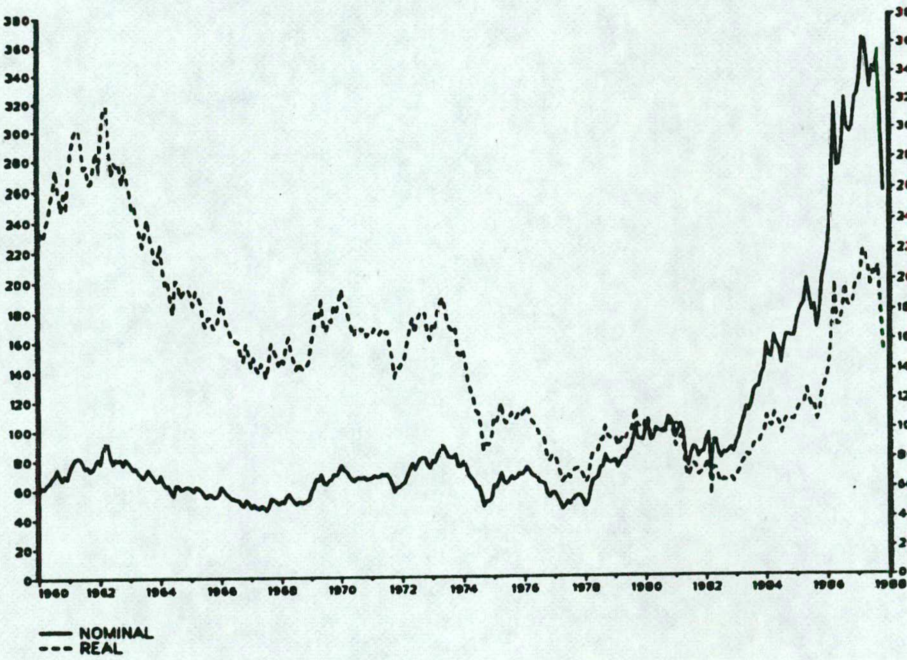


CHART 19

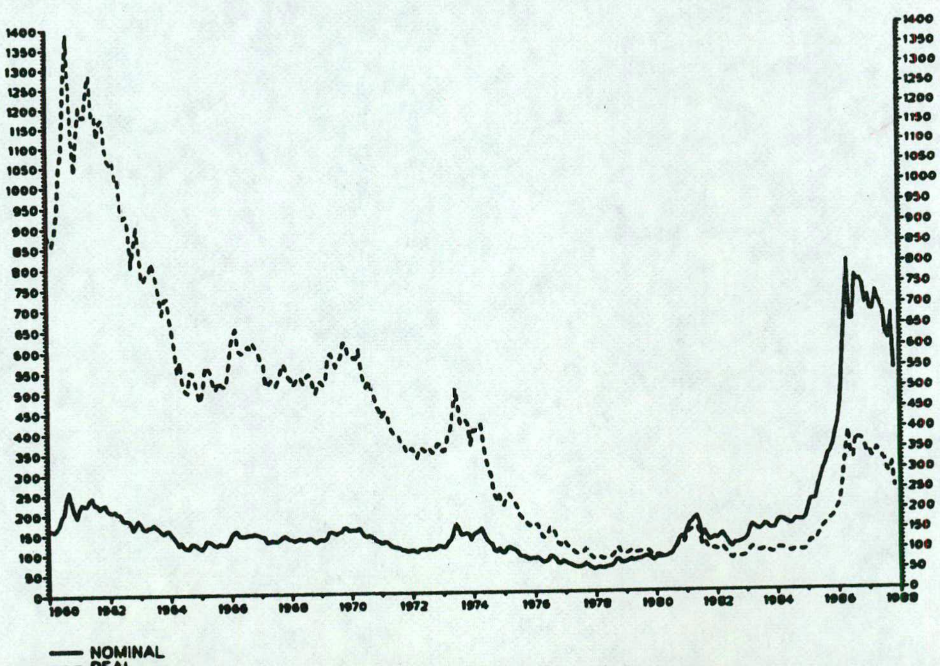
GERMAN SHARE PRICES



FRENCH SHARE PRICES



ITALIAN SHARE PRICES



SECRET

From: Sir G.Littler
Date: 20 November 1987

MR ALEX ALLAN

WEEKEND VISIT

You were putting together a dossier of figures, etc. Here are one or two additional contributions:

- Bonn telegram 868 gives the Embassy assessment of present influences on German economic management.
- A Sheet of key figures on current accounts, trade and reserves of Taiwan and Korea.
- (Optional) A recent Mulford speech on NICs - which covers Hong Kong and Singapore as well as Taiwan and Korea but does at least focus heavily on the latter two and does acknowledge that the former two are different! (There is of course a case for a move by Hong Kong, if it were not for politics and confidence: I wonder whether it could be thinkable to make it as a related part of a G7 package which included demands on Taiwan and Korea?)

2. I also attach a check-list of points for our discussion.

GL

(Geoffrey Littler)

CHECKLIST

1.6850

1.50/1.70

SECRET

CHECK-LIST OF POINTS

U.S. Action

- what are they likely to get and when?
- what minimum agreement could we welcome?
- what to say about follow-up, action by others, G7 plans?
- what if US action cannot command welcome? in that event action by others still needed (or even more)? and how to handle exchange rates?
- what if jittery markets during further delay and muddle?

German Action

- nature and timing of fiscal action?
- monetary undertaking necessary - in what form?

Supply side?

Action by others?

- do we want to press Japan? or leave that to US?
- UK position?
- need for all to accept flexible use of interest rates and differentials?
- action to influence NICs (Taiwan and Korea) - anything EC or individual countries can do to encourage?

EC/US demands

Conditions for a G7 Meeting?

- US fiscal action - how disappointed can we afford to be /Congress and still want to go forward?
- Likely US demands? No one in other Int. [illegible] (esp Germany)
- Crucial importance of exchange rate element - if not then better to refrain from meeting?

SECRET

Exchange rate element in G7 agreement

- US commitment crucial - actions and words and silence!
- ? limited US commitment inadequate, given history (e.g. not more than $ X million) interest rate commitment visibility of intervention.
- foreign currency borrowing? swaps? other ideas? (given need for demonstration to repair loss of confidence and especially to bolster evidence of US commitment)
- levels? skewed? breadth of ranges? other details? 10 per cent

G7 Logistics

- timing? (Miazawa alleged to be tied to Tokyo until 12 December!) 12/13
- venue? [illegible]
- preparation?
- draft statement? can we settle any points of shape and coverage? [short] [link policy & XR]

Conclusions of meeting

- tell Baker?
- more general publicity?
- what about Italians?
- any further work / contacts? GL to draft communiqué

BONN
TELEGRAM

G. From Mr Braithwaite (FCO)

CONFIDENTIAL
OO FCOLN
FM BONNN TO FCOLN
191430Z NOV
GRS

CONFIDENTIAL
DEDIP
PERSONAL
FM BONN
TO IMMEDIATE FCO
TELNO 868
OF 191430Z NOVEMBER 87

FOLLOWING PERSONAL FOR R Q BRAITHWAITE FROM PAULINE NEVILLE-JONES
PLEASE PASS FOLLOWING TO SIR G LITTLER, HM TREASURY

GERMAN MACRO-ECONOMIC MANAGEMENT

1. GERMAN REACTIONS TO EVENTS IN THE MARKETS HAVE BEEN AND REMAIN CHARACTERISTICALLY SLOW MOVING. THERE IS NOW LESS COMPLACENCY AROUND IN BONN THAN ON 19 OCTOBER. THIS HAS GIVEN WAY TO DEFENSIVENESS AND GENERALISED WORRY. IT HAS NOT HOWEVER SO FAR RESULTED IN A SUFFICIENT SENSE OF URGENCY TO CAUSE THE GERMAN AUTHORITIES TO DEPART FROM THE EXISTING LINES OF THEIR ECONOMIC POLICY. IT IS DIFFICULT TO SEE WHAT ON THE DOMESTIC SCENE - WHICH OCCUPIES CENTRE STAGE IN BONN IF NOT IN FRANKFURT - WILL CHANGE THIS IN THE FORESEEABLE FUTURE. VARIOUS FACTORS REINFORCE INERTIA:

- CONVICTION THAT THE FISCAL MEASURES ALREADY EMBARKED ON ARE THE RIGHT WAY FORWARD AND THAT TIMING SHOULD NOT BE TAMPERED WITH (THOUGH THIS DOES NOT PRECLUDE MINOR CHANGES E.G. POSTPONING INCREASES IN EXCISE TAXES):
- TEMPERAMENTAL DISINCLINATION TO TAKE SHORT TERM MEASURES (E.G. LOWERING INTEREST RATES FURTHER) RATIONALISED AS BEING EITHER INEFFECTIVE OR (CONTRADICTORILY) INDIRECTLY INFLATIONARY:
- A CERTAIN BLOODYMINDEDNESS ABOUT BEING LECTURED TO BY COUNTRIES THAT HAVE A LESS GOOD RECORD OVER TIME OF MAKING A SUCCESS OF THEIR ECONOMICS THAN THE FRG:
- DEEP-SEATED UNWILLINGNESS TO GET OUT IN FRONT INTERNATIONALLY MAINLY, THOUGH NOT EXCLUSIVELY, BECAUSE OF THE IMPACT THIS COULD HAVE ON THE AUTONOMY OF GERMAN DOMESTIC ECONOMIC POLICY MANAGEMENT.

2. THESE FACTORS ARE REINFORCED BY INSTITUTIONAL AND POLITICAL DIFFICULTIES. GERMAN POLICY MAKERS HAVE (CORRECTLY) PERCEIVED THAT THEIR POLITICAL AND ECONOMIC SET UP IS WELL GEARED TO NON-INTERFERENCE IN THE RUNNING OF THE ECONOMY BY GOVERNMENT. IT IS LIABLE HOWEVER TO WORK MUCH LESS WELL WHEN CHANGE LED BY GOVERNMENT IS NEEDED, WHETHER SHORT OR LONG RANGE (DEREGULATION OF THIS EXCESSIVELY REGULATED ECONOMY, REDUCTION OF SUBSIDIES ETC.). BOTH ARE REQUIRED AT THE MOMENT AND BOTH ARE BEING DUCKED DESPITE SLOWLY GROWING AWARENESS OF THE NEED FOR LIBERALISATION. SO FAR THE REACTION OF POLICY MAKERS HAS BEEN TO THROW UP THEIR HANDS IN A FATALISTIC FASHION ABOUT REFORM/CHANGE CITING THE UNDOUBTED DIFFICULTIES OF GETTING

- AGREEMENT INSIDE THE COALITION:
- AGREEMENT WITH THE LAENDER (WHICH ARE INESCAPABLY INVOLVED IN MOST DECISIONS INVOLVING MONEY AND MOST OF WHICH ARE WORRIED ABOUT THEIR TAX BASE):
- THE ACQUIESCENCE OF WELL ORGANISED INTEREST LOBBIES.

AN ADDITIONAL COMPLICATION IS THE SEEMINGLY POOR STATE OF COMMUNICATION BEWTWEEN THE BUNDESBANK AND RELEVANT FEDERAL MINISTERS: STOLTENBERG (DISTRACTED OVER SCHLESWIG-HOLSTEIN, THOUGH THINGS ARE CALMING DOWN ON THAT FRONT): BANGEMANN (HEART IN THE RIGHT PLACE BUT INEFFECTIVE - AS SHOWN BY HIS NEED TO SEND A LETTER TO STOLTENBERG ABOUT ECONOMIC POLICY): GENSCHER (BETTER AND LESS TRICKY THINGS TO GET OUT IN FRONT ON) AND KOHL (DOES NOT GIVE THE IMPRESSION OF BEING MUCH DISTURBED AND IS AT PRESENT TOURING AFRICA). OUR BUNDESBANK CONTACTS EXUDE FRUSTRATION OVER DISORGANISATION IN BONN AND A TENDENCY TOWARDS PERSECUTION COMPLEX OVER INFRINGEMENT OF THE BANK'S PREROGATIVES IN MONETARY POLICY. THEY DO NOT HOWEVER GIVE THE IMPRESSION THEY HAVE DONE EVERYTHING WITHIN THEIR POWER TO BRING WIDER, INTERNATIONAL, CONSIDERATIONS EFFECTIVELY TO BEAR IN THE DOMESTICALLY DOMINATED DEBATE IN THE CAPITAL. DIVISIONS ON POLICY WITHIN THE BUNDESBANK DO NOT ASSIST ITS PULLING POWER IN BONN. STALEMATE BETWEEN THE POEHL AND SCHLESINGER FACTIONS MEANS IN EFFECT THAT THE BUNDESBANK IS UNABLE TO GIVE A LEAD ON THE NATURE AND EXTENT OF SHORT TERM STIMULATORY MEASURES. INSTEAD, IT ACQUIESCES IN A FURTHER INCREASE IN THE PUBLIC SECTOR DEFICIT.

3. AS WE HAVE COMMENTED IN PREVIOUS REPORTING, AS THINGS STAND IT IS DIFFICULT TO SEE WHAT WILL CAUSE THE GERMANS TO SHIFT GEAR. USE OF THE 1967 STABILISATION LAW TO STIMULATE ECONOMIC ACTIVITY IS BEING

URGED /

URGED BY SOME, BUT IS REGARDED IN BONN AS BEING TOO DRASTIC AND DRAMATIC FOR CURRENT CONDITIONS. IRREFUTABLE PROOF OF A FURTHER SLOW DOWN IN THE GERMAN ECONOMY WOULD PROBABLY CHANGE THINKING. THERE IS A REAL DANGER OF SLOWDOWN: THE REACTION OF GERMAN BUSINESSMEN AND INDUSTRIALISTS TO TURMOIL INTERNATIONALLY COULD WELL BE TO REVISE INVESTMENT PLANS DOWNWARDS AND TO DRAW DOWN STOCKS. GERMAN CONSUMERS WILL ALSO BE PRONE TO INCREASE THEIR ALREADY HIGH PROPENSITY TO SAVE. BUT THIS WILL TAKE TIME TO SHOW UP IN THE FIGURES AND EVEN LONGER TO RESULT IN ACTION. ONE SENSES WITH SOME CONTACTS THAT THEY FEEL THAT MANAGEMENT - BY - CRISIS AT SOME UNSPECIFIED TIME IN THE FUTURE WILL IN PRACTICE BE THE GERMAN WAY FORWARD.

4. THE BEST POSSIBLE COUNTER TO GERMAN INSTITUTIONAL AND POLITICAL DIFFICULTIES AND TO THE PREVAILING ABSENCE OF WILL TO OVERCOME THEM WILL BE CONSTANT, PATIENT PLUGGING AWAY IN PRIVATE ON A STRATEGY FOR AND A GERMAN CONTRIBUTION TO INTERNATIONAL COOPERATION ON THE PART OF FOREIGN AUTHORITIES - BANK AND GOVERNMENT - WHICH THE GERMANS FEEL THEY HAVE SOME CAUSE TO RESPECT.

BULLARD

NO DISTRIBUTION
MR BRAITHWAITE

FIGURES ON TAIWAN + KOREA

35.3 lm.3273.27

[Tab]le 1: Current Accounts

	1980-85	1986	1987 Forecasts* US Treasury	Morgan Guaranty	IMF
Taiwan					
$ US billion	3.7	16.2	18.3	26	19.6
% of GDP	7.0	22.9	19.1	27	27.7
Korea					
$ US billion	- 2.8	4.6	7.5	12	6.9
% of GDP	- 4.3	4.9	6.4	10	6

* US Treasury forecasts from their internal paper on Asian NICs; Morgan Guaranty from "World Financial Markets" September/October 1987; IMF from Article IV consultations.

Table 2: Reserves

	1986	1987
Taiwan $ US billion	47.6	64.8 (about 34 months imports)
Korea $ US billion	8.6	9.0 (2-3 months imports)

Table 3: Exchange Rates

	1985	1986	1987Q1	1987Q2	Latest
Taiwan					
NT$/US $	40	38	35	33	30 (18 November)
RER*	95	89	89	93	96 (September)
Korea					
Won/US $	870	880	860	830	798 (18 November)
RER*	89	76	74	75	76 (September)

* Real effective rate, Morgan Guaranty using relative consumer prices (1980=100)

MULFORD ON NICs

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE ON DELIVERY
EXPECTED AT 9:05 A.M. PST
NOVEMBER 17, 1987

REMARKS BY
THE HONORABLE DAVID C. MULFORD
ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS
UNITED STATES DEPARTMENT OF THE TREASURY
BEFORE THE
ASIA/PACIFIC CAPITAL MARKETS CONFERENCE
HYATT ON UNION SQUARE
SAN FRANCISCO, CALIFORNIA

INTRODUCTION

Recent developments in the world economy have heightened awareness of global economic interdependence and of the continuing need for successful economic policy coordination. In the two years since the Plaza meeting, progress in establishing a framework and a process for policy coordination has been substantial. Indeed, one element in last month's market turbulence appears to have been the fear of a breakdown in the coordination process established among the major nations.

What followed in world stock markets provided a graphic demonstration of the interlinkages of world financial markets. The impact of market judgments is more powerful than many political leaders and economists had imagined. Global markets are here now; and prime time television coverage provides a constant reminder to individuals in all the industrial democracies that their economic future can be influenced by developments in financial markets on the other side of the world.

To those of us who work day to day in this field, the message is clear: economic policy coordination among the major trading nations must continue to be strengthened and the needed adjustment within and among nations accelerated. World attention is now more clearly focused than ever before on the coordination process that emerged from the Plaza Agreement, the Tokyo Summit, and the Louvre Accord. Though still in its infancy, it has produced important commitments and results among G-7 countries to strengthen global growth, to reduce trade imbalances, and to promote exchange rate stability. The United States and the other major nations need to do more to produce faster adjustment of world imbalances and we, in turn, need the cooperation of many other nations, debtors and creditors alike, in our global financial and trading system.

Today we look to Asia. Those of you attending this conference will focus these next two days on Asia's capital markets. These markets are an important part of the Asian scene. However, my task today, as keynote speaker, is to address the political and economic questions that stand out in Asia today. This presents a wide variety of potential issues, but so far as United States economic policy is concerned, there are two overriding areas of concern: one is, of course, our bilateral economic relationship with Japan, which I discussed in a speech last July to the Japan Society. The other is U.S. relations with the four Asian NICs, Korea, Taiwan, Hong Kong, and Singapore.

My remarks today will focus on the Asian NICs and, in particular, on Taiwan and Korea. As a group, the four now account for the fastest growing component in the overall trade deficit of the United States. The deterioration in this part of our deficit continues today, despite the very substantial adjustments by the United States and other major nations since the Plaza Accord in September 1985 which have produced clear signs of a turn for the better in most of our major trading relations. Korea and Taiwan also make a sizable contribution to global imbalances -- sufficient to warrant special mention this year in the Louvre and Venice Summit Communiques.

It is my judgment that the NICs have clearly emerged as major trading economies, but they have yet to demonstrate that they are responsible trading partners.

The question is: Will they soon shoulder their responsibilities in the world's trading system that is the source of their prosperity? Or will they continue to be increasingly directed toward export-led growth, powered by undervalued currencies that ensure increased penetration of the world's largest and most open market? And in the case of Taiwan and Korea: Will they elect to remain relatively closed economies with elaborate and pervasive investment, trade, and tariff barriers?

At this moment, these remain open and deeply concerning questions.

THE ASIAN NICS' CONTRIBUTION TO GLOBAL IMBALANCES

I would like to begin by highlighting the rapid expansion of the four NICs' share of world trade and the sizable contribution that they are making to global imbalances.

Since 1970, the four NICs have made enormous inroads in world markets. That year, the four accounted for only 3.1% of total world exports. By 1986, their share had more than doubled to 6.4%, as their aggressive export drive produced increasingly impressive results. Taiwan was out front, more than tripling its share of world exports from 0.6% in 1970 to 2.0% in 1986. Korea more than doubled its share to 1.4% and Hong Kong and Singapore also showed substantial gains.

I cite these percentages in part because it is often said that they are inconsequential in the overall picture of world trade. As mere figures they may appear to be so. But consider for a moment what they mean for the NICs' economies in both absolute and relative terms.

In 1985, Taiwan's current account surplus stood at $9.2 billion, or an astonishing 15.5% of GNP. This year, its current account surplus is likely to top $19 billion, a staggering 20% of GNP. Taiwan has virtually no external debt and its reserves have more than tripled since the end of 1985. At more than $70 billion, Taiwan's reserves now equal its 1986 GNP and provide an unprecedented -- and unjustifiable -- three years of import coverage.

Korea is coming up hot on Taiwan's heels. Despite its Government's dire predictions about the impact of the labor strikes in August on its competitiveness, Korea's current account surplus will probably exceed $10 billion this year, a shift into the black of about $11 billion since its modest deficit in 1985. Korea's 1987 surplus will be equal to about 8% of its GNP, dwarfing in relative terms those expected for Japan and Germany, which in both cases will be around 4% of their respective GNPs.

Korea's export performance is largely responsible for its current account outlook. Its exports in the first three quarters of this year jumped nearly 36%. While Korea's new exports, automobiles and electronics, posted the most dramatic increases -- 90% and 49%, respectively -- the old workhorses of Korea's export-led economy, textiles and footwear, also posted impressive gains of 36% and 26%, despite the relatively protectionist climate for trade in those products.

Taking advantage of its surpluses, Korea has been reducing its external debt, in part through prepayments, by more than $8 billion from its peak of $47 billion in mid-1986. Moreover, apparently embarrassed by its new riches, Korea -- a country with a $2400 per capita income -- has begun a concessional foreign assistance program. One is tempted to assume that creating such a program is easier for Korea than adjusting its own economy to push for a higher standard of living for Koreans. Will this aid program be used, as we have seen elsewhere, to develop additional export markets?

The growth of the NICs as world traders would not have been possible without an open market in the United States. From 1970 to 1986, our share of their rapidly accelerating exports increased from 22% to 37%. The extent of Taiwan's dependence on the U.S. market is even more starkly highlighted by the fact that, in 1986, its exports to the United States accounted for 27% of its GNP, while Korea's 1986 exports to the United States equaled nearly 15% of its GNP. It is surprising to realize that these figures far exceed those for all our other trading partners, except Canada for which the figure was 19%. In short, the degree of dependence of these two economies on the U.S. market is disturbing to us and should be to them.

I wish that I could say that our share of the NICs' total imports showed similar expansion, but the relationship has not been reciprocal. Our share of their total imports declined sharply from 32% in 1970 to only 17% in 1986, hardly a partnership in the normal sense of the word. As a result, our aggregate trade with the four went from near balance in 1970 to a $3.6 billion deficit in 1980. Then, from 1980 to 1986, our deficit with the four grew a staggering 700%, reaching $28.8 billion in 1986. This amounted to 20% of the total U.S. trade deficit in 1986, compared with only 14% in 1980.

In 1987 our deficit with the NICs grew a further 29% in the first eight months to $23 billion. This performance follows the stream of lamentations among the NICs in 1986 that, because of the modest currency appreciation and trade and investment concessions that we had asked them to make, their export boom would come to an abrupt end. As I said at the beginning of my remarks, the U.S. trade deficit with the four Asian NICs is now the fastest growing component of our overall trade deficit and the deterioration continues. Korea and Taiwan account for the bulk of this growth, but recently Singapore has also contributed. It is true that the rate of increase in their aggregate surplus has slowed modestly in 1987, but to put the absolute figure of $23 billion into perspective, let us remember that it is second only to our deficit with Japan and exceeds our individual deficits with Germany and Canada.

ORIGINS OF THE IMBALANCES

Why have these trade imbalances grown to such proportions? Has the United States become less competitive during this period? The answer is unfortunately yes. But is this the only reason, or even the principal reason, for the deterioration in our trade balance? Here, the answer is clearly no, because the United States has already undertaken painful domestic adjustments that have laid the basis for the reduction in our trade deficit that has begun to materialize.

These adjustments include, first and foremost, the U.S. dollar's significant depreciation against the currencies of most of our G-7 partners, particularly against the yen and the German mark. Since the Plaza Accord, the dollar has depreciated some 44% against the yen and 41% against the German mark. Seen from the perspective of the Japanese and the Germans, the adjustment has been even greater, as the yen has appreciated 78% against the dollar and the mark, 71% against the dollar.

Moreover, we reduced our fiscal deficit in FY 1987 by $73 billion to $148 billion, or 3.4% of our GNP, down from 5.3% in FY 1986. This is the largest fiscal adjustment accomplished in recent years by any major industrialized nation. As you know, the Administration is committed to further deficit reduction in FY 1988 and is working closely with the Congress to achieve this goal.

These difficult adjustment efforts are strengthening U.S. competitiveness and, combined with initial steps to increase demand in some of the other G-7 countries, have already laid the basis for an improvement in U.S. external accounts, a point that, regrettably, the markets often seem to ignore. Our trade deficit in nominal value terms has leveled off. Moreover, our real trade deficit expressed in constant 1982 dollars has declined continuously for the past four quarters, except for the extraordinary third-quarter bulge in oil import volume.

Given these adjustments in the United States and elsewhere, we must look to other factors to explain the persistence of large global imbalances. One such factor for the U.S. figures has been the major LDC debtors' reduced ability to import since 1982. However, a key explanation, the one that I want to emphasize to you today, is the Asian NICs' own economic policies. The NICs' policies have been aimed at turning their economies into powerful export machines, able to penetrate foreign markets aggressively while -- in the case of Taiwan and Korea, although not in the case of Hong Kong and Singapore -- protecting their internal markets from foreign competition.

Policies in three major areas have enabled the NICs to develop their natural advantages as exporters. The first of these is exchange rate policy, which in my view has played the central role in the NICs' recent rise as trading powers. The NICs have actively used exchange rate policy to secure and maintain their current competitive advantage. It is clear, especially from the pattern of exchange rate movements since the Plaza Accord, that market forces have little, if anything, to do with exchange rate determination in any of the four.

- The Korean authorities administratively fix the won rate, obfuscating the process by the use of one or more baskets of currencies, ostensibly to guide their decisions through reference to market forces. Moreover, when followed closely, as we have done, over a period of time, it is clear that in practice this approach is manipulative. This judgment is shared by the IMF which, in July after extensive consultations with Korea, concluded that further appreciation of the won was called for. Korea also employs a broad range of capital controls to facilitate its exchange rate management.

  The result of these policies is that the won has become seriously undervalued. Despite the rapidly growing strength of its external accounts, Korea has allowed the won to appreciate against the U.S. dollar by only about 12% since the Plaza Accord, far short of the appreciation of the yen and the German mark, which total 78% and 71%, respectively. In addition, though it may seem hard to believe, the won is still 26% weaker against the U.S. dollar than it was in July 1980, when the dollar was at its weakest point before beginning its strong recovery of the early 1980

- The Taiwanese authorities intervene in Taipei's interbank market, often on a massive scale, to manipulate the NT dollar rate. They recently reimposed controls on foreign borrowing and forward foreign exchange transactions to facilitate their efforts to repress market pressures for further appreciation of the new Taiwan dollar. Although, at 36%, appreciation of the new Taiwan dollar against the U.S. dollar since the Plaza Accord exceeds that of the Korean won, it still lags by a substantial margin that of the Japanese yen and other major currencies.

- The Singaporan dollar has been relatively stable against the U.S. dollar, appreciating by a scant 7.5% since the Plaza Accord. Thus, it has continued to depreciate against the yen and other currencies, including those of Korea and Taiwan. This is clearly a major factor in the 65% growth of its trade surplus with the United States this year through August, compared with the same period in 1986.

z

- o Finally, Hong Kong's policy of a fixed link to the U.S. dollar has allowed it to post the greatest competitive gains, in terms of relative exchange rates, not only against the yen, but also against all the other NICs.

Second, trade policy has played a supporting role in the efforts of Korea and Taiwan to maximize exports and minimize imports of both goods and services. While Hong Kong and Singapore have trading systems that are among the most open in the world, Korea and Taiwan maintain import bans, restrictive licensing arrangements, tariff rates affording high levels of effective protection, and other less transparent administrative devices to limit imports.

Despite some tariff reductions and liberalization of licensing requirements, serious problems remain. Many of you here are all too aware of the difficulties of marketing financial services in Korea and Taiwan, but you may be less familiar with the kinds of problems that merchandise exports encounter.

Wine exports to Korea, an area in which this part of California possesses an obvious natural competitive advantage, is a highly pertinent illustration of these difficulties. With great fanfare, Korea announced last April that it would "liberalize" imports of still wine, effective October 1 of this year. However, a closer reading of the announcement revealed that the Government intended to allow imports only up to 10% of Korea's 1986 domestic consumption, until October 1, 1988, when the quota would be increased to 20%. Not until 1991 would the quantitative restriction be completely lifted. But the truly limited nature of this so-called liberalization is not apparent until you consider that the present tariff schedule is such that the lowest possible wholesale cost is fully three times the landed cost. Thus, foreign producers will have difficulty filling even the 10% quota.

Finally, macroeconomic and structural policies have also supported the NICs' drive for larger trade surpluses, particularly in Korea and Taiwan. For example, tax exemptions, operating subsidies, *ad hoc* financial bail-outs, directed credit and preferential interest rates, government assistance in obtaining inputs and marketing production, restrictions on new entrants into specific sectors, local source/origin requirements for government procurement, and lax protection for foreign patents and copyrights have all been employed at varying points as the authorities have targeted first one sector and then another for development as an export powerhouse.

THE NEED FOR STRUCTURAL ADJUSTMENT

What are we to conclude from the NICs' growing strength in world markets, particularly their increasing reliance upon the U.S. market, and from the causes of these developments? And what should the major industrial nations do about a situation that represents such a clear-cut problem for the urgently needed adjustment of world imbalances?

I am also asked with increasing frequency what the United States is doing about our severe trade imbalances with the NICs. Frustrated members of Congress have begun to devise what in my view are highly undesirable methods to target countries with protracted trade surpluses with the United States that engage in unfair trading practices. U.S. businessmen complain strongly about the predatory practices in foreign markets of Korean and Taiwanese companies that enjoy various forms of state support, including the competitive advantage of an undervalued currency. Meanwhile, the efforts of U.S. financial and business organizations to make direct investments in those growing markets, or even to gain access for their products and services, meet with numerous obstacles.

One of the unfortunate results of this build-up in frustration is that many now openly support protectionist measures aimed directly at the offending countries. The Administration continues to oppose the retaliatory approach embodied in proposals such as the Gephardt amendment because they would restrict rather than expand trade. Our aim is to open foreign markets, not to close the U.S. market.

The United States has engaged in talks on trade and financial services over a number of years with all four NICs, especially with Korea and Taiwan, and there have been modest accomplishments in a micro sense to achieve liberalization. However, in 1986, we concluded that a broader approach was required. The currency and other adjustments among the G-7 countries since the Plaza Accord had begun to reveal the magnitude of the competitive advantage that NICs were taking for themselves. It was clear to us that their present export-led growth strategy based on undervalued exchange rates and the current mix of other supporting policies was not sustainable. Nor was the continued accumulation and concentration of external surpluses in official hands in the long-term economic interests of the NICs, whose economies were becoming severely distorted.

The NICs are increasingly vulnerable as their export extravaganza continues. One way or another, the U.S. trade deficit will be reduced and, eventually, eliminated. All principal trading nations, not just the G-7 countries, will have to contribute to that end. This means that the Asian NICs' surpluses will be reduced in absolute terms. Merely stabilizing the surpluses at their current levels is an inadequate policy objective and an unattainable outcome. In fact, attempting to perpetuate such large external surpluses requires repressing the growth of consumption below levels that are reasonable, given the NICs' current per capita income levels and standards of living.

Moreover, the excessive accumulation of net foreign assets and reduction of net foreign liabilities, such as we are seeing in Taiwan and Korea, is a misguided use of their domestic savings. Indeed, one objective economic analysis recently published by the Institute for International Economics recommended modest current account deficits, rather than the sizable surpluses that they have pursued, as the most appropriate macroeconomic policy objective for the NICs. Given their stage of development and the efficiency with which they use capital, their savings would be better left in private hands to be invested in new housing, businesses, or directed more aggressively toward expanding education and building new economic and social infrastructure.

This means that the Asian NICs, especially Taiwan and Korea, can no longer sit by and act as if the problem of global imbalances has little to do with them. The mix of policies that the NICs have followed, whatever its previous merits, has now become inappropriate for them and unacceptable to other major nations. Unless they create sources of growth to replace their current excessive dependence upon exports, their future growth will be jeopardized and they will encounter adjustments more painful than those they are now being encouraged to make.

Accordingly, in July 1986, we initiated a dialogue with both Korea and Taiwan. We have sought to discuss not just currency issues, but rather the full range of macroeconomic policy and structural changes that we believe that they, as major trading nations, should undertake to improve prospects for reducing world imbalances and to enhance their own long-term development. Briefly, I will outline the approach that we have taken.

Exchange Rate Policy

First and foremost, we have urged the NICs to adopt an exchange rate policy that allows their currencies to reflect fully the underlying strength of their economies. This is essential, not just from the perspective of reducing trade tensions, but also to avoid making the inevitable task of structural adjustment more difficult as domestic producers develop a stronger and stronger vested interest in the undervalued exchange rate.

The independent economic analysis to which I referred a few moments ago concluded that, based on the NICs' exchange rates last April, a further 10-15% real effective appreciation of their currencies against those of their trading partners was called for. I would note that this implies substantial nominal appreciation not only against the U.S. dollar, but even more so against the Japanese yen and German mark, against which the NICs have continued to depreciate. The very substantial changes in the yen and the mark against the U.S. dollar and the modest impact that those currency changes have had to date on our bilateral trade balances with Japan and Germany suggest that the magnitude of the required nominal changes in the NICs' currencies is very large indeed.

The United States is not alone in believing that improved exchange rate policies in the NICs are essential. At the time of the Louvre Agreement, the Venice Economic Summit, and this year's Annual Meetings of the IMF and World Bank, the G-7 countries as a whole stressed the importance of such policies.

Trade Liberalization

Trade liberalization is another key area of structural reform that we have consistently and forcefully urged to open the NICs' domestic economies more to international competition. Hong Kong and Singapore are models in this regard, having long ago eliminated virtually all import restrictions and established low or zero tariff levels. Both Korea and Taiwan should follow suit by quickly rationalizing and reducing their tariff rates, eliminating remaining licensing requirements and bans, and abolishing the special taxes and other administrative procedures that they employ to limit imports.

I would point out that I do not include under the rubric of trade liberalization the ad hoc administrative and financial arrangements that Korea and Taiwan have adopted to avoid making the necessary fundamental structural changes. These measures include export quotas, special buying missions to the United States, and special financing arrangements to induce their importers to purchase U.S. goods. These voluntary measures are only short-term palliatives; they cannot be a substitute for genuine trade liberalization and, over the long haul, will only distort patterns of investment, production, and trade.

Finally, without diminishing the importance of open markets in achieving economic restructuring, trade liberalization cannot substitute for appropriate exchange rate action.

Macroeconomic Policies

We have also pointed out the need to strengthen domestic demand, both consumption and investment, as a key complement to exchange rate adjustment and trade liberalization, in order to continue economic growth at satisfactory rates in conditions of declining external demand. Growth of consumption in all of the NICs has lagged real GNP growth by substantial margins. Thus, credit allocation and interest rate policies, which have discouraged consumer and mortgage lending, should be modified. Ways also need to be found to reorient investment away from the export sector and toward production for the domestic market, as well as to boost overall investment levels, particularly in Taiwan where both public and private investment have actually declined in recent years.

THE ROLE OF CAPITAL MARKETS

This leads us logically to the vital role that capital markets can play in supporting structural adjustment and the reduction of global imbalances. Greater efficiency of domestic capital mobilization and allocation stimulates growth and can contribute to reducing external imbalances because all sectors -- including housing, consumer goods, and services -- are better able to command the necessary resources for expansion. This will allow for less reliance on exports for growth.

The Asian NICs need to assign a higher priority to developing their capital markets and integrating them into the world economy. There are promising signs of growing sophistication and efficiency in some of the NICs' financial markets, particularly their stock markets. Nonetheless, financial markets in many of the NICs remain underdeveloped. All too often, money markets are heavily regulated; deep and liquid markets for government and corporate instruments are lacking; and active participation by foreigners is discouraged or even prohibited.

Accomplishing change will require a comprehensive strategy. An example for such a strategy is offered by the approach the Japanese have followed since 1984 when -- against the backdrop of an undervalued currency and a burgeoning trade surplus with the United States -- they agreed in the Yen/Dollar Talks to open and liberalize their financial markets. Adapted to the NICs, this strategy could have three components.

The first would call for the development of domestic bond, stock, and money markets, free of unnecessary government guidance. While markets in Hong Kong and Singapore are largely free of interest rate restrictions and government-directed credit allocation, such interference remains the watchword in Korea and Taiwan.

Second, the NICs would open their markets, allowing some integration into the world economy so they are not left behind in the trend toward globalization. The U.S. economy has long benefited from following a policy of national treatment which accords foreign and domestic financial institutions the same treatment. We have strongly urged other countries to adopt this policy, not only to stem the tide of protectionism in the United States, but also to foster their own economic growth.

While national treatment in many markets has improved in recent years, full equality of competitive opportunity for foreign financial institutions is visibly lacking in Korea and Taiwan. Foreign firms are severely handicapped relative to their domestic counterparts by restrictions on local currency funding, on establishing viable networks of bank branches, and on their ability to expand effectively into other financial activities, such as ATM services, savings, trust, and securities business.

Such restrictions are not acceptable as a continuing basis for doing business. Their immediate removal would benefit both the domestic financial market and the adjustment process.

The third and last point is internationalization of currencies. Restrictions on the use of currencies abroad and by non-residents should be removed hand in hand with the elimination of excessive exchange rate management practices. Such restrictions isolate the home economy, and, worse, deprive it and others of potentially attractive borrowing and investment opportunities.

For the Asian NICs, complete internationalization of their currencies is a longer-term goal and progress toward it should be accelerated. Last April, the Korean Government announced that it would liberalize invisibles transactions, encourage the use of won in international trade, and allow establishment of won accounts by non-residents at home and abroad. Now it should follow through with a rapid timetable for these steps. Last summer, Taiwan eased controls on capital outflows. It should now also ease controls on inflows.

CONCLUSION

In conclusion, I believe the United States has presented the NICs with a strong case and a reasonable strategy for maintaining their development while contributing to a reduction in global imbalances. The NICs are important beneficiaries of the world's open trading system and, as major trading nations, they have a responsibility as well as a strong self-interest in maintaining its growth.

We are frankly concerned by the lack of responsiveness to our approach and by the meager results that have been forthcoming. This is particularly serious in exchange rate policy which, if there were a spirit of cooperation, could be adjusted quickly to respond to an obviously deteriorating situation.

I noticed that the program for this conference refers to the Asian NICs as the "Four Tigers." Although the NICs may be regarded as "tigers" because they are strong, ferocious traders, the analogy also has a darker side. Tigers live in the jungle and by the law of the jungle. They are a shrinking population. To survive, tigers -- and the NICs -- must adapt; and adaption will require cooperative, not predatory, behavior.

-oOo-

cc Mr R I G Allen
Mr A C S Allan

COVERING CONFIDENTIAL

PMP

V. useful discussion for G7. [illegible]

Chief Economic Adviser to the Treasury

cc SIR G LITTLER
MR EVANS
MR ODLING-SMEE
MR SEDGWICK
MR S DAVIES
MR S MATTHEWS

STOCK MARKET FALL

I attach a draft of a note I have been putting together, both as possible background to our discussions in advance of a G7 meeting; and to draw on at EPC next week. I would be grateful for any comments by this evening if possible.

VH

pp. T BURNS

Alex

Maybe the Chancellor would like to glance at this draft tomorrow on his travels. I ~~now~~ am planning to do some more work on it tomorrow but any comments welcome at this stage if possible.

[illegible]

CONFIDENTIAL

POST-STOCK MARKET FALL: THE NEXT STEPS

1. After events of past month, worth standing back and trying to assess implications of what has happened.

Discuss under a number of headings:

Summary of position we took in Washington at the end of September.

Chronology of events in October.

Change to environment post-crash.

Risks and dangers.

A possible agenda for a G7 meeting.

Situation pre-crash

2. At the meetings in Washington there was increased optimism about economic activity in the major industrial countries. Growth rates had picked up - particularly in US and Japan. As with UK, domestic demand growth possibly helped by rising prices of securities and property/land. Some worry about poor growth in Germany.

3. Inflation rate had picked up - but largely once for all effects of oil prices. One puzzling and worrying feature was movement of long-term interest rates. Also seen some strengthening of commodity prices but patchy. In general little in way of inflationary threat. The nagging worry was the persistence of trade imbalances of the US, Germany and Japan.

4. The US trade deficit had been slow to improve. Figures for August very bad - a merchandise trade deficit of $15.7 billion.

US trade deficit had deteriorated sharply between 1980 and 1986. There were a number of influences: poor underlying performance; the strength of domestic demand, partly due to fiscal policy; and the direct effects of the huge dollar appreciation between 1980 and 1985.

Over past two years fiscal stance has improved; and the dollar has fallen sharply. But little improvement in trade deficit; partly J-curve; partly because domestic demand has continued to grow relative to elsewhere. One possible factor keeping down savings ratios has been buoyant financial markets. Also length of lags. As result imports growing rapidly; and exporters taking opportunity to increase profit margins.

5. Following the Louvre agreement an effort had been made to stabilise the dollar and support it with policy changes. There were several reasons for a period of exchange rate stability:

- to give an opportunity for the lags to work through so that we could observe the underlying situation a little more clearly following the large dollar depreciation;

- to slow speed of depreciation that could lead to an undershoot of the dollar;

- to give the appreciating countries an opportunity to adjust their economies from emphasis on growth of external trade to growth of domestic demand;

- to avoid inflationary expectations in the US getting too firm a hold.

6. At the time of the Washington meetings it was possible to be optimistic about the exchange rate aspect of the agreement. A combination of intervention, adjustment of monetary policies and an unwillingness of the market to take on the authorities had all contributed to the period of stability. You set out your reasons for continuing the approach with some suggestions for building upon the experience since Louvre.

7. But some other aspects of the Louvre agreement were not working out as planned. Although the US budget deficit had fallen sharply in the current financial year, projections showed only modest improvement - if any - over the medium term. Japan had introduced a fiscal package but doubts about speed of opening up domestic markets to imports. And promised German fiscal action remained on a long fuse despite sluggish growth.

8. Some commentators argued that a dollar depreciation was necessary:

- the large projected trade deficits;

- the absence of private sector financing during 1987;

- the risk that slow growth of money supply in the US, and rising interest rates caused by action to defend the dollar, would lead to recession;

- the comparable risk that rapid monetary growth in Japan and Germany would lead to higher inflation

9. We took the line that the case for further depreciation had not been demonstrated:

- the effects of the previous depreciation had not worked through;

- it was not possible to have a rapid adjustment of the US current account deficit; patience was needed;

- the US appeared to be close to full capacity and further depreciation without bigger cuts in the budget deficit risked feeding through rapidly into faster inflation. Growth of imports and profit margins of exports further evidence;

- (privately) that a longer period of stability would advance the cause and credibility of managed floating;

- there was little risk of US recession; slow monetary growth had to be balanced against earlier exchange rate depreciation and buoyant financial markets that had both served to ease monetary conditions. Inflation was a bigger risk than recession;

- similarly there was little risk of burgeoning Japanese and German inflation; the delayed effects of exchange rate appreciation had tightened monetary conditions and this had to be offset against the faster growth of domestic monetary aggregates.

The ambition was not to keep the dollar fixed indefinitely but to lay the groundwork so that when a change was needed it would be "managed".

10. At the G7 Meeting in Washington the Louvre agreement was confirmed. Worries about tightening of monetary policy in Japan and Germany were raised but assurances given that this was not happening.

The Events of October

11. The chronology of the events of October/November are worth setting out as they are often mis-stated by those wishing to blame the Louvre accord for the stock market crash:

- despite assurances German monetary policy appeared to tighten - albeit marginally;

- Baker said he would rather see the dollar fall than be pushed into interest rate war and called on Germany to relax policy;

- stock market collapse; some strengthening of bond markets but initially exchange rates stable;

- attempts begin by US administration to speed up budget discussions;

- the US (and UK) moved to reduce interest rates as response to tightening of liquidity;

- the dollar began to fall;

- some interest rate response from Germany

- statement from Baker that US not going to risk recession to help dollar;

- further dollar weakness; equity markets drifting lower.

Change to Economic Environment Post-Crash

12. The sharp fall in equity prices combined with some easing of interest rates and a lower dollar will have significant effects on the economic outlook.

13. Domestic demand is likely to be adversely affected. Those countries with the biggest stock markets should be most affected. Furthermore the biggest negative effects are likely to be in countries who have been benefiting from previous strength of financial markets. Given the time lags it is difficult to be precise about effects but we could see

some increase in private sector savings ratios. Housing/land markets are likely to be adversely affected. Despite lower interest rates incomes in the financial community will be damaged. In most cases it was in the financial centres that property prices were particularly strong. This will also tend to work to dampen domestic demand.

14. The big unknown is the extent of the shock to business investment. There were signs of strengthening investment intentions. Some will now be put on ice until the dust is allowed to settle.

15. Commodity prices and long-term interest rates have fallen. This points to some easing of any inflationary threat. Projections of inflation rates are likely to be reduced.

16. The weaker dollar will cause problems for the export industries of the appreciating countries with knock-on effects to investment. Before the recent dollar fall there were increasing signs of gradual adjustment to the earlier dollar depreciation. A further round of adjustment will now begin. On past evidence the net effect in the G7 countries could be adverse; how adverse will depend on the extent to which the NICs stick to the dollar or adjust their parities.

17. The combined effects on US domestic demand are likely to be beneficial as far as the trade accounts are concerned. In addition the reduction of pressure on resources could mean that the effects of previous dollar depreciation become more evident.

Risks

18. The biggest risk we now face is of uncontrolled dollar depreciation. This would:

- further disrupt financial markets;

- cause major problems for appreciating countries;

- lead to worrying inflation rates in the US;

- eventually push up US interest rates and force authorities to act quickly on the budget deficit;

- risk further bout of protectionism.

19. This would all be extremely damaging as far as business confidence is concerned. The dangers of a major recession would become very real.

?

A Possible Package

20. You have argued that a credible package might be as follows:

- a lower US budget deficit with convincing adjustment in later year;

- measures to strengthen domestic demand in Germany/ Japan;

- agreement to stabilise the dollar at a lower rate and a commitment to action that would bring that about.

21. A lower US budget deficit is crucial to stabilisation of financial markets:

- the US are incapable of financing their deficit from internal savings; higher net domestic savings could emerge for a variety of reasons - none of them comfortable: higher inflation, higher interest rates, or a lower rate of investment.

x

- until earlier this year private sector capital flows made a significant contribution. They have now dried up. They will only re-emerge when the expected rate of return is high enough. The greater the expectation that the dollar will decline the more that will require higher interest rates.

That is why recent comments have been so damaging - it is a serious mistake to imagine that a lower dollar can avoid higher interest rates if no action is taken on the deficit:

- it is a mistake to think that a lower budget deficit will bring an unnecessary recession. That may happen anyway. But action to correct the deficit could boost confidence, restore the flow of overseas finance and avoid further financial markets disruption. If UK experience is anything to go by the net effect could be positive;

- it is difficult to see how an improvement in the current account will emerge without a correction of the budget deficit. A lower dollar will only exercise significant trade effects if there are the resources available for it to "work". A lower budget deficit (or higher interest rates) are the only mechanisms available to create that room apart from a recession caused by a blow to confidence.

22. Measures to strengthen domestic demand in Germany/Japan are necessary to smooth the path of adjustment to lower external demand resulting from lower US domestic demand and exchange rate appreciation:

  - domestic demand will be strengthened automatically from lower inflation but on its own that may not be enough;

  - it is up to each country whether this should be brought about by fiscal or monetary policy. Some of the burden is likely to fall on monetary policy if the third objective - a stabilisation of the dollar - is to be achieved;

- there is little in the way of inflation threat to either country. The weakness of commodity prices, coupled with the strength of their own currency, will both be exercising a powerful disinflationary force;

- given the progress on budget consolidation in recent years there can be little danger of bringing forward tax reductions that are planned for later years.

? Sclerosis

23. A reaffirmation of the objective of dollar stability would be very helpful. But difficult to make credible. Helpful because serious risk of dollar undershoot and world recession. Difficult because so many recent comments have seemed directed to undermining principles of co-operation. Some important principles:

- If dollar stability is wanted it requires a commitment to provide the means. Intervention can play a part. But most crucially it requires monetary action. There is no escape from the principle that exchange rate variations have to be given a large weight in the conduct of monetary policy. Already set out reasons for this. If cannot do this then no point in making commitment.

- And it must be supported by policy action to bring about necessary adjustment of trade imbalances, which has clear implications for growth of domestic demand.

24. In other words. If the third component is to be achieved it requires the first two - plus a willingness to give exchange rate weight in monetary policy.

Permanent Secretary
H M TREASURY

PPS

Sir P Middleton

Hughes the Chancellor would like to see this

RB
19/11

EPC PRESS STATEMENT

sw42

For Bonn Meeting Folder (Saturday)

FROM: S W MATTHEWS
DATE: 18 November 1987

SIR PETER MIDDLETON

cc: Sir T Burns
Sir G Littler
Mr Evans
Mr R I G Allen
Mr Savage

OECD: EPC, 16-17 NOVEMBER: PRESS STATEMENT

I am attaching a copy of the statement as finally issued at the Sprinkel's press conference.

2. Most of the questions put to Sprinkel by the press were about the US budget deficit, taxes, prospects for the US economy, the dollar etc. He replied much as in the EPC meeting. He avoided overt criticism of German policies, when asked about German views on the scope for additional tax cuts.

3. There were signs that some journalists had already seen the latest OECD forecasts. Philip Stephens (FT) and Peter Torday (WSJ) both picked up the statement in paragraph 5 that sustained exchange rate stability required greater compatibility of macroeconomic policies and performance than now prevails across member countries, and asked whether it meant that a new Louvre Accord was impossible and/or that the EPC meeting had achieved little. Sprinkel pointed out that the meeting was not designed or intended to renegotiate the Louvre Accord, and refused to comment further.

The Chancellor might wish to see this

SM.

S W MATTHEWS

4.

Press Statement by the Chairman of the EPC : 17.11.1987

1. The Economic Policy Committee met under my chairmanship on November 16 and 17, 1987. The Committee discussed the effect of recent financial market developments on the real economy, and the policies that are needed to maintain economic growth and price stability while at the same time ensuring a reduction in the large external imbalances. The following summarises the broad conclusions reached by the Committee.

2. It is not possible to identify any single cause for the stock market declines. Despite the improvements made in reducing sizeable imbalances, there is a rising concern that, unless further policy actions are taken, the present imbalances are likely to persist.

3. The loss of financial wealth from the sharp fall in stock prices may cause a slowdown in domestic demand growth but is unlikely to result in a recession. This effect is likely to be greater in the United States, where shares are more widely, and directly, held by individuals, than in most other OECD countries. Much depends, however, on the state of consumer and business confidence. The Committee unanimously agreed that the implementation of internationally consistent policies is the key to maintaining confidence and hence sustaining employment. Such policies should deal with the weakening of demand growth in the short-run, and address the more deep-rooted longer run problems. Elements of such policies, which emerged from the Committee's discussion, are the following.

4. There was broad agreement that the recent relaxation of monetary policies in most OECD countries was timely and important in avoiding disruptive events in the financial system, and thus contributed to the maintenance of confidence. Interest rates have generally fallen back to levels prevailing earlier this year because of monetary easing and a shift from stocks to bonds. Delegates agreed that monetary policy should accommodate the demand for additional liquidity and should sustain non-inflationary economic growth. Interest rates need not, in present circumstances, increase from present levels and could come down. At the same

time, the monetary authorities should remain vigilant against the development of damaging inflationary pressures in the longer term.

5. The conduct of macroeconomic policies in each Member country is linked, in varying degrees, to exchange rate considerations. While it is difficult to determine with confidence the appropriate level of exchange rates, the Committee was unanimous in agreeing that greater exchange rate stability is desirable. However, sustained exchange rate stability requires greater compatibility of macroeconomic policies and performance than now prevail across Member countries. Such policies must be conducive to non-inflationary growth and the reduction of imbalances.

6. In the Committee's view, U.S. fiscal policy has a major role to play in reducing international payments imbalances. In addition to the substantial decrease in FY 1987, Gramm-Rudman-Hollings will reduce the core fiscal deficit by $23 billion in FY 1988. It is hoped that further multi-year reductions can be agreed to by the Administration and Congress. Such an agreement is important for confidence in financial and foreign exchange markets.

7. Fiscal policies in other countries should be supportive of domestic demand without, however, putting at risk sound public finance over the medium term. In this regard, the Committee welcomed the fiscal policy adopted by the Japanese authorities to encourage domestic demand growth. A majority of the Committee thought that additional fiscal measures in Germany to support demand would be desirable in the current economic situation. The margin for manoeuvre on the fiscal front in most other countries was judged to be rather limited.

8. A major concern of the Committee was the threat of protectionist pressures. It was concerned that unilateral measures, such as the U.S. trade bill, might trigger retaliatory actions. In the Committee's view, such proliferation of protectionism would erode confidence and would be a recipe for a world-wide contraction of activity. Not only should protectionism be resisted, but freer international trade should be promoted. In this connection, the recent Canada-U.S. Free Trade Agreement and the intended achievement of a fully integrated European market were generally welcomed.

Free trade is one of the driving forces for prosperity. The Committee strongly hopes that the on-going GATT negotiations will be speeded up.

9. The Committee recognised the importance of structural considerations. Over the long run, durable improvement in economic performance can only be attained through a reduction of various rigidities and by enhancing adaptability and flexibility of our economies. Structural policies will help to ease the adjustment to a reduction of external imbalances. In particular, the Committee underscored the significance of structural reforms in Japan and Germany as a way of enhancing demand.

10. More generally, the Committee thought it encouraging that some significant progress has been made in improving the overall functioning of our economies and that all of the Member governments intend to continue pursuing these policies. The Committee noted, however, that progress has been uneven across different markets and countries. The most striking contrast is between the rapid and extensive deregulation of financial markets and the slow and limited progress achieved in the markets for labour, goods and non-financial services. In financial markets, the need for appropriate supervision was recognised; in other markets, stepped-up efforts to improve their functioning were thought necessary. In many cases, these latter efforts mean a reduction in the degree of government regulation, intervention or ownership. The Committee welcomed the general tendency towards a more efficient, and often smaller, public sector.

11. The Committee was in agreement that putting appropriate policies in place is the best way for OECD governments to contribute to the healthy development of many of the developing countries. In particular, the problems of highly indebted countries can be alleviated by sustained OECD growth, lower interest rates, improved access to OECD markets and additional financing. However, ultimately the problems of these developing countries can only be resolved through their own adoption of appropriate economic policies. Moreover, the Committee thought that the group of newly-industrialising countries in Asia, with their collective current account surplus now reaching $30 billion, should promptly adopt trade and exchange rate policies that reflect their increased importance in the world economy.

12. To conclude my remarks, the Committee believes there is no reason for being either complacent or alarmist. Appropriate economic policies can deal with the negative impact of the recent financial developments. Over the next several years, structural problems and macroeconomic imbalances will likely remain a challenge. The solution will require continued co-operation and co-ordination by Member countries.

FT 18-11-87

OECD nations expect growth to be hit by crash

BY PHILIP STEPHENS AND IAN DAVIDSON IN PARIS

WESTERN governments yesterday acknowledged that the slump in world equity prices may significantly damp economic growth next year and that further policy shifts in the largest economies were needed to preserve stability on financial markets.

In the first joint assessment of the impact of last month's stock market slide, senior officials from the 24 member governments of the Organisation for Economic Co-operation and Development said they had agreed that was no reason to be "either complacent or alarmist".

A statement released after two days of talks at the OECD's Economic Policy Committee underlined, however, the significant differences which remain on how best to respond. It acknowledged that, while all governments wanted to promote sustained exchange rate stability, that would require "greater compatability of macroeconomic policies and performance than now prevail."

To the obvious annoyance of the Bonn Government, the statement added that a majority had singled out West Germany as needing to take more action to stimulate its economy.

Tentative projections presented to the meeting by the OECD secretariat point to a slowing in the average economic growth rate of member countries from 2¾ per cent this year to 2¼ per cent in 1988 and 1¾ per cent in 1989. Growth in the US, which has a much higher proportion of individual shareholders than other industrial countries, could weaken most as a result of the stock market crash.

The estimates for West Germany, which were fiercely contested by the Bonn delegation, point to growth next year of just 1½ per cent and a further deceleration in 1989 to 1¼ per cent.

Mr Beryl Sprinkel, chairman of President Reagan's council of economic advisers, told a press conference after the meeting that Bonn had agreed to review the possibility of a looser fiscal policy if its economy slowed significantly

He added, however, that the West German delegation had made no specific promises. Clearly irritated by the degree of pressure applied by other governments, Mr Bernhard Molitor, a senior West German Economics Ministry official, said that he doubted whether it would be politically possible for his government to bring forward tax cuts due in 1990.

Against that background, the statement said that major imbalances in the world economy - the US trade deficit and parallel surpluses in Japan and West Germany - were likely to "remain a a challenge."

The confidential OECD projections point to some improvement in the US current account deficit in the next two years, but suggest that it will remain at unsustainably high levels. The deficit is forecast to fall from $156bn this year to $134bn in 1988 and to $111bn in 1989.

Mr Sprinkel, who chaired the economic policy committee meeting, insisted that it was not US policy to "talk down the dollar." Other senior officials at the talks added that Mr James Baker, the US Treasury Secretary, had also informed their governments that his remarks in a recent

Continued on Back Page

Continued from Page 1

OECD

newspaper interview had been misinterpreted.

The apparent reluctance of the US to fix any target for the dollar, however, was reflected in the statement's comment that "it is difficult to decide with confidence the appropriate level of exchange rates." Member countries did agree on the need to ensure that interest rates were set at levels low enough to ensure that there was sufficient liquidity in their financial systems. "Interest rates need not, in present circumstances, increase from present levels and could come down.

The statement, which was drafted by Mr Sprinkel and agreed with his colleagues after several hours of wrangling, emphasised the need for substantial reductions in the US budget deficit. Mr Sprinkel, however, rejected suggestions that the deficit had been the cause of the equity price collapse The more likely reasons were rising interest rates and speculation that the US Administration might raise taxes - a policy which President Reagan had again rejected this week.

Senior officials at the talks said that there had been no discussion on the possibility of an early meeting of the Group of Seven nations in the event of a deal this week between the White House and Congress to cut the deficit.

Informal contacts among the seven were continuing, however, and officials could prepare the ground for ministerial talks within days of any accord in Washington.

Japan, with a strongly growing economy in recent months, escaped relatively unscathed at this week's meeting, with the OECD predicting that its output would rise by 3½ per cent this year, by 3½ per cent in 1988 and by 3¼ per cent in 1989. The US economy is forecast to expand by 2¾ per cent this year before slowing to a 2¼ per cent growth rate in 1988 and 1½ per cent in 1989.

WSJ 18-11-87.

Slow-Growth Forecasts Lead OECD Panel To Press Germany on Stimulating Economy

By Peter Torday
Staff Reporter of The Wall Street Journal

PARIS – Industrial nations, facing predictions that the recent stock market crash could drive down their growth rates to the lowest levels since the 1981-1982 recession, stepped up pressure on West Germany to stimulate its powerful economy.

But West German officials, attending a twice-yearly meeting of the Economic Policy Committee of the 24-nation Organization for Economic Cooperation and Development, dismissed tentative OECD forecasts that German growth would slow to around 1.25% this year as too pessimistic.

Most other nations in the tightly integrated European economy believe slow German growth is holding back their own economic progress. And the U.S. wants to see a faster German expansion in return for its own efforts to cut its budget deficit.

Curbing Demand, Trade Surpluses

If a credible package to cut the U.S. budget deficit is enacted, it's expected to damp demand for imports and reduce the huge U.S. trade deficit, while faster growth in Germany should stimulate demand there for imports, curbing its large trade surplus.

A statement issued on behalf of the committee by Beryl Sprinkel, chairman of President Ronald Reagan's Council of Economic Advisers, said "a majority of the committee thought that additional fiscal measures in Germany to support demand would be desirable."

But it also said the loss of wealth resulting from the crash, which began on Wall Street Oct. 19, is unlikely to result in recession.

West German officials said Monday that they would allow their budget deficit to rise slightly but didn't offer any other measures. Mr. Sprinkel, who was chairman of the OECD meeting, said at a news conference that he believed Bonn would "take another look" if growth slowed further.

Mr. Sprinkel said he hoped the Reagan administration would strike an agreement with the U.S. Congress on multiyear reductions in the budget deficit but appeared on the defensive as he rejected suggestions that Americans would have to tighten their belts. "No, I don't believe we're going to have to suffer," he said. The U.S. official also said President Reagan is "dead set against" increases in tax rates as part of a budget package.

European and Japanese leaders publicly have urged the U.S. to increase taxes rather than resort to one-time revenue enhancements, such as asset sales, to restore confidence in financial markets.

Yesterday's statement, however, merely asserted that U.S. fiscal policy has a major role to play in restoring confidence and curbing global trade imbalances.

No Specific Prescriptions

Most economists and officials attribute the collapse in equity markets and the resulting turbulence on foreign exchanges to strains in the world economy caused by the U.S. trade and budget deficits. But the OECD committee's statement didn't offer specific policy prescriptions for underpinning market and business confidence after the crash, which it said couldn't be attributed to any single cause.

Instead the committee, which reviews tentative economic predictions by the OECD Secretariat and debates economic policy changes, said it didn't believe there was any reason to be either "complacent or alarmist."

The OECD talks and a meeting of European Community finance ministers Monday were the first major gatherings of economic officials since the market crash, and their conclusions appear equally tentative and general. The EC ministers said they would improve conditions for growth if there is a substantial U.S. budget deficit cut. Only the public warnings of British Prime Minister Margaret Thatcher and French President Francois Mitterrand raise the specter of world recession unless major nations act to underpin growth and restore market confidence.

Reduced Expectations

The tentative OECD forecasts presented to the committee are understood to show the crash could shave about 0.5% off U.S. growth, reducing it to around 2%. European growth, meanwhile, is expected to slow about 0.25%, to less than 2% this year.

Meanwhile, Mr. Sprinkel said the committee agreed that sustained currency stability requires the policies of member nations to be more compatible than they are now. His remarks strongly suggest that many officials believe there is little point in the seven leading industrial nations – the U.S., Japan, West Germany, Britain, France, Italy and Canada – reviving their Louvre accord to stabilize the dollar without major policy changes.

Some European monetary officials believe the U.S. still wants to see the dollar decline to avert a recession in the U.S., even though Mr. Sprinkel asserted that President Reagan made it clear "we don't have a policy of talking down the dollar." Other European officials point out the crash has curbed U.S. inflationary pressures sufficiently to allow a decline of several percentage points more before those pressures revive.

Mr. Sprinkel said the committee thought interest rates, which leading central banks brought down to counter the deflationary effect of the crash, might decline further. European monetary officials believe West German short-term rates could continue to ease if U.S. budget cuts are forthcoming, and U.K. officials have hinted at limited declines in Britain under similar circumstances.

OECD calls for cut in rates

By David Smith, Economics Correspondent

Times 18-11-87.

Senior officials from the leading industrial countries, meeting in Paris, said that there was scope for lower interest rates worldwide and for further action to boost growth in Germany.

The two-day meeting of the economic policy committee of the Organization for Economic Co-operation and Development concluded that the main central banks should continue to respond to the world financial crisis by providing liquidity.

In addition, fiscal policy moves by Germany were judged to be an appropriate response to the prospect of slower world growth, although the scope for such action in other countries was seen to be limited.

The OECD meeting, which could be seen as a rehearsal for the Group of Seven meeting which is expected to follow a budget accord in the US, did not call for Japanese fiscal action.

Japan is generally judged to have fulfilled her international obligations, but Germany — still growing sluggishly — is viewed as excessively cautious

The committee stressed the desirability of exchange rate stability, but also emphasized the importance of greater compatibility of economic policy and performance among the main economies

The OECD statement said: "Monetary policy should accommodate the demand for additional liquidity and should sustain non-inflationary growth. Interest rates need not increase from present levels and could come down."

The OECD has revised down its growth forecasts for the next 18 months

Forecasts presented by OECD economists suggested a half-point cut in the growth rate to 1.75 per cent. However, several members of the economic policy committee, including Sir Peter Middleton, the Treasury's representative, said that this was too pessimistic and that growth of 2 per cent was more likely.

NOTE OF A MTG.
18.11.87. G7

PH1/

SECRET

CHANCELLOR OF THE EXCHEQUER

NOTE OF A MEETING IN No.11 DOWNING STREET
AT 11.45am ON WEDNESDAY 18 NOVEMBER

Present: Chancellor
Sir T Burns
Sir G Littler

PREPARATION FOR G7

The Chancellor felt that unless a G7 agreement had a currency dimension, it was questionable whether it was worth having; it might instead be better to rest simply on co-ordinated statements, without any meeting. But that would be highly undesirable and we should certainly continue to fight for agreement to the principle of a further period of currency stability; it was of lesser importance whether the existing rate was at the top, bottom or middle of the band.

2. The main issue was whether the US were prepared to enter into such an agreement. It was critical to get a firm commitment from them, one that went beyond simple platitudes. To get market credibility, the US must either to undertake foreign currency borrowing, or activate swap agreements. They would also have to be prepared to use interest rates to buttress an exchange rate agreement, though this would no doubt be very difficult to negotiate. But the US had to finance its current account deficit, and - providing it did not slide into recession - it was difficult to see how this could be done without an interest rise at some stage.

3. For the Germans, the Chancellor thought that although Stoltenberg was considering the possibility of doing something on tax, we should not cavil at increased public expenditure if the

difficulties of negotiating tax changes with the Laender proved too great. Sir T Burns agreed; but he pointed out that extra public expenditure would not be as effective as tax cuts in helping balance of payments adjustments (and would cause problems with the environmentalists). It also would be very useful if there was something that could be done to reduce savings incentives in Germany. The Chancellor commenteds that if the German economy was growing at its potential there might not be a current account surplus.

4. The Chancellor also thought a gesture was needed from the Germans on the monetary front. One possibility was for the Bundesbank to agree to do nothing to reduce the interest rate differential vis a vis the US.

5. For the French, Balladur would commit himself to his three year tax reductions; but, for EMS reasons, he could not do anything on interest rates. For the UK, the Chancellor was reluctant to show his hand on the Budget, beyond repeating the line he had already taken. So he would prefer to take a further ½% off interest rates if some concrete action was needed. Sir T Burns wondered whether any action from us was needed: there did not seem to be any need for us either to increase or decrease domestic demand. And we could point to a forecast of 3% GDP growth excluding North Sea oil.

6. On the timing, the Chancellor thought that waiting would not make any agreement easier. He thought we should aim for the first weekend in December, while recognising that it might have to be deferred beyond that.

ACSA

A C S ALLAN

Distribution:

Those present
Sir P Middleton

Chief Economic Adviser to the Treasury

Mr Hudson

As promised

T

This is Terry's actual speaking note - a revised version of his notes on Post - Stock Market Fall: The Next Steps.

BURNS TO EPC 16.11.87

CONFIDENTIAL

Remarks to EPC Meeting 16 November 1987

Welcome opportunity to open discussion. It has been a tempestuous six weeks since IMF meetings. Look forward to discussion. As I have the privilege of speaking early in the discussion I want to set out the background to some of the issues.

1. Discuss under a number of headings:

   (i) The position as it appeared in Washington at the end of September.

   (ii) Change to environment post-crash.

   (iii) Risks, dangers and a policy agenda.

Situation pre-crash

2. At the meetings in Washington I sensed some increased optimism about economic activity in the major industrial countries. Compared to last Spring when we last met growth rates looked a little better - particularly in US and Japan - although worries about poor growth in Germany and France had been reinforced by developments during the year.

3. Inflation rate had picked up - but this was largely the once-for-all effects of oil prices. One puzzling and worrying feature was the extent of the increase in long-term interest rates. Also seen some modest strengthening of commodity prices. But in general I doubt if there was much in way of an inflationary threat. The nagging worry was the persistence of trade imbalances of the US, Germany and Japan; and the poor prospect of further reduction in the US fiscal deficit.

It was recognised that there were a number of influences behind the large US trade deficit: poor underlying performance; the strength of domestic demand, partly due to fiscal policy; and the direct effects of the huge dollar appreciation between 1980 and 1985.

However, there was concern that over past two years fiscal stance has improved; and the dollar has fallen sharply. But little improvement in trade deficit. A number of reasons: partly time lags; partly J-curve; partly because domestic demand has continued to grow at the same rate as elsewhere.

4. Following the Louvre agreement an effort had been made to stabilise the dollar and support it with policy changes.

5. At the time of the Washington meetings it was possible to be optimistic about the exchange rate aspect of the agreement. A combination of intervention, adjustment of monetary policies and an unwillingness of the market to take on the authorities had all contributed to the period of stability.

6. But some other aspects of the Louvre agreement were not working out as planned. Although the US budget deficit had fallen sharply in the current financial year, projections showed only modest improvement - if any - over the medium term. Japan had introduced a fiscal package but there remained doubts about speed of opening up domestic markets to imports. And promised German fiscal action remained on a long fuse despite sluggish and disappointing growth.

7. At the G7 Meeting in Washington the Louvre agreement was confirmed. Worries about tightening of monetary policy in Japan and Germany were raised but assurances given that this was not happening.

The Events of October

8. The chronology of events following the Washington meetings is worth setting out:

1. - despite assurances German monetary policy appeared to tighten - albeit marginally;

2. - Secretary Baker was reported as saying he would rather see the dollar fall than be pushed into interest rate war and called on Germany to relax policy;

3. - stock market collapse; some strengthening of bond markets but initially exchange rates stable;

4. - attempts begin by US administration to speed up budget discussions;

4. - the US (and UK) moved to reduce interest rates as response to tightening of liquidity;

5. - the dollar began to fall;

6. - some interest rate response from Germany

8. - Secretary Baker was reported as saying that US not going to risk recession to help dollar;

9. - further dollar weakness.

Change to Economic Environment Post-Crash

9. The sharp fall in equity prices combined with some easing of interest rates - both short and long term - and a lower dollar will have significant effects on the economic outlook. On previous experience it will take some months before these effects show themselves eg in order books and in lower inflation.

10. Agree that domestic demand is likely to be adversely affected. Those countries with the biggest stock markets - and particularly the largest domestic holdings of equities - should be most affected. Furthermore the biggest negative effects are likely to be in countries who have been benefiting from previous strength of financial markets. Given the time lags it is difficult to be precise about effects but we could see some increase in private sector savings ratios. Housing/land markets are likely to be adversely affected - although given their recent strength this may not be a bad thing in itself. In most cases it was in the financial centres that property prices were particularly strong; and despite lower interest rates incomes in the financial community will suffer. This will also tend to work to dampen domestic demand.

11. The big unknown is the extent of the shock to business investment. There were signs of strengthening investment intentions. Some will now be put on ice until the dust is allowed to settle.

12. Commodity prices and long-term interest rates have fallen. This points to some easing of any inflationary threat. Projections of inflation rates are likely to be reduced.

13. The weaker dollar will cause problems for the export industries of the appreciating countries with knock-on effects to investment. Before the recent dollar fall there were increasing signs of gradual adjustment to the earlier dollar depreciation. A further round of adjustment will now begin. On past evidence the net effect in the G7 countries could be adverse; how adverse will depend on the extent to which the NICs and the developing countries stick to the dollar or adjust their parities.

14. The combined effects of these changes on US domestic demand are likely to be beneficial as far as the US trade accounts are concerned. In addition the reduction of pressure on resources could mean that the effects of dollar depreciation become more evident. On the other hand the effects of lower equity prices on demand in Germany and Japan - albeit smaller than in the US case - will work in the opposite direction. But on balance the events of the past 6 weeks should lead to some improvement of trade imbalances.

Risks

15. So there are some clear silver linings to the storm clouds. But there is a further acute anxiety. We now face the serious risk of uncontrolled dollar depreciation. Some would appear to welcome this; just as they did the extraordinary appreciation up to 1985. But there could be some difficult side-effects. It could mean:

- further disruption to financial markets;

- major problems for appreciating countries who are having to adjust from emphasis on growth of external trade to growth of domestic demand. In turn, this would reduce world trade and offset some of the gain to US exports;

- worrying inflation rates in the US - and the consequence in time of a more serious recession ;

- eventual pushing up of US interest rates;

- risk of further bout of protectionism;

- and almost certainly involve some undershooting of the dollar which would have to be unwound with great difficulty later.

16. This would all be extremely damaging as far as inflation in the US and business confidence world wide is concerned.

17. I continue to be astonished at extent to which commentators see the resolution of policy imbalances through the simple answer of currency depreciation. It is certainly possible to deflate domestic demand through higher inflation and hence reduced real money balances. But can we really look with equanimity at the possibility of the largest industrial country solving its trade problems through this mechanism?

A Policy Agenda

18. My final remarks are under the heading of the policy agenda. I don't want to get into the "packaging" business of precisely who does what - but it is worthwhile to discuss a number of themes that are currently on the policy agenda:

19. First <u>a lower US budget deficit</u>: this is crucial surely to stabilisation of financial markets. Big issue. Sure lot of discussion. Four points:

1. - the US seems to be incapable of financing its Federal deficit from internal savings. When savings patterns are so different between countries it makes no sense to make crude comparisons of Budget deficits. Higher net domestic savings could emerge in the US for a variety of reasons - but none of them are comfortable: higher inflation, lower equity prices, higher interest rates, or a lower rate of investment;

2. - until earlier this year net private sector capital flows made a significant contribution to financing. For the time being they seem to have dried up. Maybe they will only re-emerge when the expected rate of return is

high enough. But the greater the expectation that the dollar will decline the more that will require higher interest rates. In my view it is a serious mistake to imagine that a lower dollar can avoid higher interest rates if no action is taken on the deficit;

3. - I have few worries that a lower budget deficit will increase the risks of recession. Action to correct the deficit could boost confidence, restore the flow of overseas finance and avoid further financial markets disruption. If UK experience is anything to go by the net effect could be positive;

4. - it is difficult to see how an improvement in the current account will emerge without a correction of the budget deficit. A lower dollar will only exercise significant trade effects if there are the resources available for it to "work". A lower budget deficit (or higher interest rates) are important mechanisms to create that room.

20. Second item on the policy is a further strengthening of domestic demand in Germany and Japan. This is necessary to smooth the path of adjustment to lower external demand resulting from lower US domestic demand and exchange rate appreciation. Again make four points:

1. - domestic demand will be strengthened automatically from lower inflation but on its own that is likely to be slow and insufficient;

2. - it is up to each country whether this should be brought about by fiscal or monetary policy. But given level of world real interest rates my bias would be towards monetary policy;

3. - there is little in the way of inflation threat to Japan or Germany. The weakness of commodity prices, coupled with the strength of their own currencies, will

both be exercising a powerful disinflationary force; the volume of evidence has changed further in recent weeks;

4. - given the progress on budget consolidation in recent years there can be little danger of bringing forward tax reductions that are planned for later years.

21. The third item on the policy agenda is a reaffirmation of the objective of dollar stability. Given the serious risk of dollar undershoot I mentioned earlier this remains an important issue. Like to mention one or two important principles of co-operation:

- the first is that if dollar stability is wanted it requires a commitment to provide the means. Intervention can play a part. But most crucially it requires monetary action. There is no escape from the principle that exchange rate variations have to be given a large weight in the conduct of monetary policy. For example, at present slow monetary growth in the US has to be balanced against earlier exchange rate depreciation. There is no simple trade-off but I have no doubt that given the wide swings in exchange rates it would be a mistake for authorities to give exclusive weight to domestic monetary aggregates.

- the second principle is that any agreement must be supported by policy action to bring about necessary adjustment of trade imbalances, which has clear implications for growth of domestic demand relative to the growth of productive potential. I remain concerned that judged in this way the US has to settle for a rather slower growth of domestic demand than it has experienced recently; and Germany and Japan need to be rather more ambitious.

22. Chairman. That concludes my remarks, and I look forward to the ensuing discussion.

1. Tonight
2 prep.

SECRET

From: Sir G.Littler
Date: 26 November 1987

MR ALEX ALLAN

G7

Following our conversation yesterday evening I have talked this morning with both Tietmeyer and Trichet (I cannot get Sarcinelli because he is locked in the Franco-Italian Summit meetings).

2. Trichet: I gave him an account yesterday of the talk the Chancellor had with Baker. He was very grateful because he and Balladur had not had contact with U.S. opposite numbers. When I spoke to him this morning he had not had a chance to talk to Balladur (who is in Italy), but he was quite sure that Balladur would dislike the idea of Anchorage, would want the G7 to focus on exchange rate stability after Congress has settled the budget, and not be used merely to help get Congressional approval, and would indeed continue to see no merit in an agreement lacking any satisfactory exchange rate undertaking.

3. Tietmeyer: Stoltenberg had a similar conversation to the Chancellor's with Baker, except that he had not pressed the point on "current levels" (having said he could accept more flexibility) and the interest rate point had apparently not been raised. Stoltenberg had not reacted immediately over timing and venue but had said he would reflect and contact Baker on Monday - what he had in mind was to wait for a report of the meeting Tietmeyer and Trichet and I are to have in Paris on Saturday.

(Geoffrey Littler)

NRES

GERMANY TO DECIDE =4 BONN

STOLTENBERG SAID WEST GERMANY HAD FULFILLED ITS ORIGINAL LOUVRE ACCORD COMMITMENTS BY EXPANDING TAX CUTS PLANNED FOR NEXT YEAR.

"THE BUNDESBANK HAS ALSO UNDERSCORED ITS PREPAREDNESS TO COOPERATE VIA A FLEXIBLE MONETARY POLICY," HE SAID. THIS WAS REFLECTED MOST RECENTLY IN REDUCTIONS IN SHORT TERM WEST GERMAN INTEREST RATES, HE ADDED.

STOLTENBERG NOTED THAT INDEPENDENT EXPERTS HAD THIS WEEK FORECAST WEST GERMAN GROWTH OF 1-1/2 PCT IN 1988, BELOW THE TWO TO 2-1/2 PCT INCREASE THE GOVERNMENT HAD FORECAST BEFORE THE OCTOBER 19 MARKET CRASH.

25-NOV-1045 MON548 MONF CONTINUED ON - NRET
CONTINUED FROM - NRER
P REUTER MONITOR 1121

NRET

GERMANY TO DECIDE =5 BONN

STOLTENBERG ADDED THAT IT WAS TOO EARLY TO MAKE CONCRETE FORECASTS ABOUT FUTURE ECONOMIC DEVELOPMENTS BECAUSE OF A NUMBER OF UNCERTAINTIES. ON MONDAY HE HAD SAID THE EXPERTS' FORECAST MAY BE TOO PESSIMISTIC.

HOWEVER, STOLTENBERG SAID THAT FOLLOWING THE U.S. BUDGET AGREEMENT IT NOW SEEMED THAT THE MOST IMPORTANT CONDITION FOR OVERCOMING CURRENT MARKET TURBULENCE COULD BE ACHIEVED.

STOLTENBERG SAID THERE WERE ARGUMENTS FOR AND AGAINST A MORE EXPANSIVE FINANCIAL POLICY. SOME POLITICIANS HAD URGED BONN TO ACCEPT HIGHER BUDGET DEFICITS, WHILE THE INDEPENDENT COUNCIL OF ECONOMIC ADVISERS TO THE GOVERNMENT HAD WARNED AGAINST THIS.

25-NOV-1046 MON551 MONF CONTINUED ON - NREU
CONTINUED FROM - NRES
P REUTER MONITOR 1121

NREU

GERMANY TO DECIDE =6 BONN

HOWEVER, STOLTENBERG ADDED THAT BECAUSE OF THE GOVERNMENT'S PREVIOUS SUCCESS IN BRINGING DOWN GOVERNMENT BORROWING AND IN LIGHT OF LOW LEVELS OF INFLATION, "WE ARE TREADING THIS NARROW PATH ON A SOUND FOOTING".

HE ALSO REPEATED HIS ASSERTION THAT FUTURE WAGE NEGOTIATIONS SHOULD SEEK TO BOOST EMPLOYEES' DISPOSABLE INCOMES RATHER THAN INCREASE COSTS BY CUTTING WORKING HOURS.

25-NOV-1051 MON556 MONF REUTER
CONTINUED FROM - NRET
P REUTER MONITOR 1121

CHANCELLOR
RM: 12/2

pmp

A, B, C

LAWSON SAYS G-7 DOLLAR STABILIZATION PACT NEEDED NRDQ

LONDON, NOV 24 - LEADING INDUSTRIALISED COUNTRIES MUST COORDINATE POLICIES AND STRIVE FOR A CURRENCY STABILISATION PACT WHICH TAKES THE DOLLAR'S RECENT FALLS INTO ACCOUNT, BRITISH CHANCELLOR OF THE EXCHEQUER NIGEL LAWSON SAID.

"THE ALTERNATIVE, A SHARP FURTHER FALL IN THE DOLLAR, IS NOT MERELY WHOLLY UNNECESSARY -- IT WOULD BE HARMFUL TO ALL CONCERNED," LAWSON SAID IN A SPEECH PREPARED FOR DELIVERY TO THE AMERICAN CHAMBER OF COMMERCE (ACC).

HE TOLD THE ACC THAT "THERE WOULD BE LITTLE POINT IN HOLDING A G-7 MEETING AT ALL UNLESS ALL THOSE INVOLVED WERE PREPARED TO CONTRIBUTE WHOLEHEARTEDLY TO THE STABILIZATION OF THE DOLLAR."

24-NOV-1430 MON449 MONF

CONTINUED ON - NRDR

P

REUTER MONITOR 1336

LAWSON SAYS =2 LONDON NRDR

"SUCCESS IN RESTORING STABILITY WILL DEPEND BOTH ON THE PURSUIT OF THE RIGHT POLICIES BY DEFICIT AND SURPLUS COUNTRIES ALIKE AND ON THEIR DETERMINATION TO GIVE THE NECESSARY PRIORITY TO MAINTAINING STABILITY, NOT SIMPLY BY INTERVENTION, WHOSE ROLE ... IS INEVITABLY LIMITED, BUT EVEN MORE BY THE MAINTENANCE OF APPROPRIATE INTEREST RATE DIFFERENTIALS," LAWSON SAID.

THAT WOULD MEAN U.S. INTEREST RATES BEING SET AT LEVELS WHICH COULD SUPPORT THE DOLLAR AND FINANCE THE BUDGET DEFICIT, HE ADDED. "THAT MAY WELL NOT MEAN HIGHER (U.S.) INTEREST RATES NOW, BUT IT DOES IMPLY THE READINESS TO ACT IF AND WHEN THE NEED ARISES," LAWSON SAID.

24-NOV-1431 MON453 MONF

CONTINUED FROM - NRDQ CONTINUED ON - NRDS

P

REUTER MONITOR 1336

LAWSON SAYS =3 LONDON NRDS

LAWSON SAID THAT "BY THE SAME TOKEN, SURPLUS COUNTRIES, AND IN PARTICULAR WEST GERMANY, WILL HAVE TO GIVE MORE ATTENTION TO WORLD INTEREST RATE DIFFERENTIALS, AND MONETARY CONDITIONS IN THE INDUSTRIALIZED WORLD AS A WHOLE, IN SETTING THEIR RATES."

"INTERNATIONAL CO-OPERATION IS THE ONLY SURE WAY TO KEEP THE WORLD ECONOMY ON AN EVEN KEEL," HE SAID.

"THE PROBLEMS OF THE WORLD ECONOMY ... ARE UNLIKELY TO BE SOLVED IF COUNTRIES GIVE OVERRIDING WEIGHT TO DOMESTIC INDICATORS OF MONETARY POLICY TO THE EXCLUSION OF EXTERNAL INDICATORS." LAWSON REPEATED THE PROMISE THAT BRITAIN "WILL PLAY ITS FULL PART (IN ANY FUTURE COMMON STRATEGY)."

24-NOV-1431 MON456 MONF

CONTINUED FROM - NRDR MORE

P

REUTER MONITOR 1336

LAWSON SAYS =4 LONDON
NRDW
LAWSON SAID HE WARMLY WELCOMES THE U.S. BUDGET ACCORD BETWEEN WHITE HOUSE AND CONGRESSIONAL NEGOTIATORS, BUT THAT CONGRESS MUST APPROVE THE PACKAGE OF SPENDING CUTS AND TAX INCREASES AS SOON AS POSSIBLE. "THEN THE FIRST MAJOR HURDLE (TOWARDS STABILISATION) WILL HAVE BEEN OVERCOME."

"THE SECOND HURDLE IS THE NEED FOR THE TWO BIG SURPLUS COUNTRIES -- JAPAN AND MORE PARTICULARLY WEST GERMANY -- TO COMMIT THEMSELVES TO FURTHER ACTION TO IMPROVE THEIR ECONOMIC MOMENTUM. IN THE CASE OF JAPAN, TO OPEN ITS MARKETS MORE FULLY TO IMPORTS," HE SAID.

24-NOV-1432 MON461 MONF

P MORE

REUTER MONITOR 1336

LAWSON SAYS =5 LONDON
NRDX
THE THIRD HURDLE, ACCORDING TO LAWSON, IS "THE NEED, GIVEN APPROPRIATE ECONOMIC POLICIES, INCLUDING THE RESOLUTE AVOIDANCE OF PROTECTIONISM, TO AGREE ON CONCERTED ACTION DESIGNED TO ENSURE A FURTHER PERIOD OF EXCHANGE RATE STABILITY, ALBEIT ONE THAT TAKES INTO ACCOUNT THE DECLINE IN THE DOLLAR THAT HAS OCCURRED SO FAR."

HE SAID NEWLY INDUSTRIALIZED COUNTRIES "WILL HAVE TO BE PREVAILED UPON TO PLAY THEIR PART - TAIWAN AND SOUTH KOREA IN PARTICULAR, WHO REGARD OPEN MARKETS ABROAD AS THEIR RIGHT, YET ENGAGE IN WIDESPREAD PROTECTION AT HOME AGAINST IMPORTS FROM DEVELOPED COUNTRIES."

24-NOV-1434 MON465 MONF

P MORE

REUTER MONITOR 1336

LAWSON SAYS =6 LONDON
NRDY
LAWSON SAID THE BRITISH ECONOMY WAS PARTICULARLY WELL PLACED TO RIDE OUT THE ECONOMIC STORM.

"WE HAVE THE ADVANTAGE THAT OUR ELECTION IS BEHIND US, NOT IN FRONT OF US, AND HAS RESULTED IN THE RETURN, WITH A LARGE MAJORITY, OF A GOVERNMENT WHOSE COMMITMENT TO SOUND FINANCE AND BUSINESS SUCCESS IS NOT IN DOUBT," HE SAID.

"ON THE (BRITISH) ECONOMIC FRONT, THE PUBLIC FINANCES ARE EXCEPTIONALLY STRONG, AND THE ECONOMY ITSELF IS IN ROBUST HEALTH, WITH BUSINESS CONFIDENCE HIGH, AND INVESTMENT INTENTIONS UNIMPAIRED (BY THE STOCK MARKET CRASH)," LAWSON SAID.

24-NOV-1434 MON468 MONF
CONTINUED FROM - NRDU
P REUTER

REUTER MONITOR 1336

a
This crossed with
my passing on
your comment
— but doesn't look
to have altered so
your comments still
applied - AA

pwp
~~pmp~~

SECRET

From: Sir G.Littler
Date: 27 November 1987

MR ALEX ALLAN

c.c. Sir P.Middleton
Sir T.Burns

G7 MEETING

Sir P Middleton and Sir T Burns and I discussed late this morning the notes I sent to you earlier. We thought we could make a few improvements, although basically we all agreed on the framework of my first draft. Here is the revised version. Subject to any comments from the Chancellor I shall draw on this material in my talks in Paris tomorrow.

Carter Bonds

2. I was unable last night to quote details from memory. The bonds were issued in 1978-79, with five year maturity:

- $5.2 billion equivalent in DM through the Bundesbank;
- $1.2 billion equivalent in Swiss Franc through the Swiss National Bank;
- ? we think a few Yen also but cannot immediately track down the details.

We think - I am checking - that they were redeemed as planned and thus emerged in the end as a rather successful coup!

(Geoffrey Littler)

SECRET

Starting-Point: In U.K. view the prime purpose of a G7 meeting should be to re-establish cooperation in stabilising the dollar exchange rate.

Two questions: If we cannot be confident of co-operation of any effective kind, do we still want / accept a meeting? And what are the possible / minimum acceptable terms of co-operation?

<u>If no effective exchange rate co-operation</u>

Other possible advantages of a meeting:

- ? to help Baker get Congress (and President) to implement the proposed package, by enabling him to show what he has won from other countries: but this could be high-risk, since Congress and President could not be guaranteed; and even if it worked it is such an inadequate objective and outcome that press and markets would surely be disappointed.
- ? pressure on Germany and Japan to take action : but we are fairly sure now that they will both take some action on the fiscal front anyway (Germany may announce before 12/13 December) and this is also expected by markets, therefore only advantages of meeting are: to let Baker take some of the 'credit', and to seek presentation of 'cooperative measures' (which could just possibly be used by some Ministers to help them get domestic agreement); these do not seem to be strong arguments.
- ? to concert action vis-a-vis NICs : but this does not need a G7 meeting, which in any case would not guarantee any results on the subject.

- ? reassuring messages generally : without more substance a joke.

Possible disadvantages of a meeting:

- ? any outcome which does not restore cooperation on exchange rate management or offer some significant new element will be seen as (and will in reality be) a retreat from Louvre and therefore disappointing.
- a G7 meeting will be treated by media and markets as a major event - expectations will focus on what it does for exchange rate prospects - a failure to satisfy such expectations could have disastrous effects on confidence.

The conclusion is that, while Baker may - for short-term domestic reasons - see advantage in a G7 meeting which offers nothing on exchange rates, there is no advantage for others. And a meeting of this kind could have a worse impact on markets than no meeting at all.

Possible elements of exchange rate cooperation

The two central problems are:

- the financial one: how is a substantial continuing U.S. deficit for some time to come going to be financed?
- the psychological one: how to assure U.S. commitment?

Ideally we need some combination of statements and actions, perhaps including as many as possible of the following:

1. "Exchange rate stability continues to have an important role to play in fostering adjustment and minimising the risks of further changes which could undermine business confidence and increase dangers of recession."

2. "It is realistic and acceptable to build around [recent/current/existing] exchange rate levels - as far as the G7 currencies are concerned."

3. "The Ministers and Governors intend to resume their cooperation in doing so."

4. "In the interests of [restoring greater stability of exchange rates / minimising any threat of disruptive further exchange rate movements] the Ministers and Governors will cooperate in their conduct of monetary policies as well as in foreign exchange intervention."

5. "The Ministers and Governors recognised the importance of monetary policy in helping to support exchange rate stability and foster the flows of funds needed to finance imbalances. In this connection they noted with satisfaction the monetary action they have taken in recent weeks.

6. "They emphasised the importance of maintaining appropriate interest rate differentials between their markets. They undertook to cooperate in this [and to consult each other regularly about actual and desirable interest rate developments]."

7. "In order to strengthen the resources available both for any necessary intervention and more widely to contribute to the necessary financing of imbalances they have agreed to [enlarge and] activate the network of currency swaps between their authorities."

8. "The process of adjustment of imbalances is bound to take a considerable time and meanwhile the substantial external United States deficit has to be financed. The bulk of the financing should be provided spontaneously by private capital flows, although it is important that the authorities contribute to a climate of confidence and of appropriate interest rates which will encourage such flows."

9. "Nevertheless there could well be a gap from time to time between the finance required and the private flow. To meet this, the United States Government intends to undertake a programme of issuing bonds denominated in foreign currencies. The authorities of the other six countries have in turn undertaken to facilitate access to their markets for such bonds."

10. [It would also be possible to link foreign currency borrowing by the United States to intervention by others - which also contributes to financing the United States external deficit].

cc. Mr A. Allan

SECRET

From: Sir G.Littler
Date: 27 November 1987

CHANCELLOR

c.c. Sir P.Middleton
Sir T.Burns

G7 MEETING

I attach some notes on:

- whether or not we want a meeting if there is nothing to satisfy us on the exchange rate problem;
- elements which might be sought on exchange rates in a public statement

2. I have not attempted to list permutations of the elements and grade them. It seems to me that 'borrowing' would be a big enough novelty, and in substance sufficiently important, for us to trade against it some explicit undertakings on the exchange rate itself. 'Swaps' cannot be as strong, because they are seen as bolstering reserves, rather than financing. Stolt not keen, for reason Ch. doesn't understand v keen on f.c. borrowing

3. I have incidentally spoken this morning to Sarcinelli - the Italians have had no separate contact with the US - personally he agreed with both my objections to Anchorage and my doubts about rushing into a meeting before Congress is settled and without any clear expectation of US cooperation on exchange rates. He said that at yesterday's Franco-Italian Summit they had agreed firmly on the need for restoring exchange rate stability as a G7 priority.

(Geoffrey Littler)

SECRET

Starting-Point: In U.K. view the prime purpose of a G7 meeting should be to re-establish cooperation in stabilising the dollar exchange rate.

Two questions: If we cannot be confident of co-operation of any effective kind, do we still want / accept a meeting? And what are the possible / minimum acceptable terms of co-operation?

If no effective exchange rate co-operation

Other possible advantages of a meeting:

- ? to help Baker get Congress (and President) to implement the proposed package, by enabling him to show what he has won from other countries: but this could be high-risk, since Congress and President could not be guaranteed; and even if it worked it is such an inadequate objective and outcome that press and markets would surely be disappointed.
- ? pressure on Germany and Japan to take action : but we are fairly sure now that they will both take some action on the fiscal front anyway (Germany may announce before 12/13 December) and this is also expected by markets, therefore only advantages of meeting are: to let Baker take some of the 'credit', and to seek presentation of 'cooperative measures' - all pretty feeble.
- ? to concert action vis-a-vis NICs : but this does not need a G7 meeting, which in any case would not guarantee any results on the subject.
- ? reassuring messages generally : without more substance a joke.

- ? absence of meeting would, given expectation of one, be seen as evidence of disagreement among 7 [illegible] bad for markets. But meeting with unimpressive results would be even worse — see below

Possible disadvantages of a meeting:

- ? any outcome which does not restore cooperation on exchange rate management or offer some significant new element will be seen as (and will in reality be) a retreat from Louvre and therefore disappointing.
- a G7 meeting will be treated by media and markets as a major event - expectations will focus on what it does for exchange rate prospects - a failure to satisfy such expectations could have disastrous effects on confidence.

The conclusion is that, while Baker may - for short-term domestic reasons - see advantage in a G7 meeting which offers nothing on exchange rates, there is no advantage for others. And a meeting of this kind could have a worse impact on markets than no meeting at all.

Possible elements of exchange rate cooperation

The two central problems are:

- the financial one: how is a substantial continuing U.S. deficit for some time to come going to be financed?
- the psychological one: how to assure U.S. commitment?

Ideally we need some combination of statements and actions, perhaps including as many as possible of the following:

? as fallback

Redo 1 & 2 as

1. "~~Exchange rate stability continues to have an important role to play in~~ fostering adjustment and minimising the risks of further changes which could undermine business confidence and increase dangers of recession."

"Current G7 XR [broadly] in line with economic fundamentals, and they believe that a period of XR stability will promote the best climate for [illegible]

2. ~~"It is realistic and acceptable to build around [recent/current/existing] exchange rate levels - as far as the G7 currencies are concerned."~~

3. "The Ministers and Governors [~~intend to resume their~~] cooperat~~ion~~e in [~~doing so~~] securing this."

4. "In the interests of [restoring greater stability of exchange rates / minimising any threat of disruptive further exchange rate movements] the Ministers and Governors will cooperate in their conduct of monetary policies, ensuring that they should act to support ER stability, as well as in foreign exchange intervention."

5. "The Ministers and Governors recognised the importance of monetary policy in helping to support exchange rate stability and foster the flows of funds needed to finance imbalances. In this connection they noted again with satisfaction the monetary action they have taken in recent weeks. They emphasised the importance of maintaining appropriate interest rate differentials between their markets. They undertook to cooperate in this and to consult each other regularly about actual and desirable interest rate developments."

6. "In order to strengthen the resources available both for any necessary intervention and more widely to contribute to the necessary financing of imbalances - they have agreed to [enlarge and] activate the network of currency swaps between their authorities."

SECRET

7. "Recognising that the process of adjustment of imbalances is bound to take a considerable time and that meanwhile the substantial external United States deficit has to be financed, the United States Government intends to undertake a programme of issuing bonds denominated in foreign currencies for this purpose. The authorities of the other six countries have undertaken to facilitate access to their markets for such bonds."

Pmg

DAY-BY-DAY . . .

	Date	UK Times	P & D Forecast	Market Indication as at 4.12.87	Last
Monday 7 December					
UK Retail Sales	Oct (final)	11.30	**132·9 (+0·8%)**	n/a	131 8 (−0 5%)
UK Credit business	Oct	11.30	**+£3·0bn**	n/a	+£3 2bn
Wednesday 9 December					
OECD Meeting, Paris.					
*OPEC Meeting, Vienna.					
G7-Deputy finance ministers meeting, Paris.					
Thursday 10 December					
CBI/FT Survey of distributive trades					
*US Merchandise trade	Oct	13.30	**−$15·0bn**	−$14 7bn	−$14 1bn
Friday 11 December					
*UK RPI	Nov	11.30	**+0·3%**	+0·3%	+0 5%
US PPI	Nov	13.30	**+0·4%**	+0 2%	−0 2%
US Retail sales	Nov	13.30	**Flat**	−0 4%	−0 1%

*See Feature Indicators.

Feature Indicators . . .

Wednesday 9 December – OPEC Meeting, Vienna.

OPEC's December meeting takes place in Vienna against a background of deteriorating fundementals and strong political pressures. Iran, with an agressive attitude towards higher nominal prices and cuts in production are at odds with the 'Saudi-camp' and its wishes to keep prices at $18/bl to stimulate demand.

Stronger than planned output in 1987 has led to higher inventories by year end. This leads us to calculate that the requirement for the first quarter of 1988 will be 16.9mbl/d.

Despite these limitations, we expect some form of agreement to arise as the fear of a repeat of the 1986 collapse lingers in participants minds. It is most likely that a new pattern of ceilings will emerge, along with a benchmark price of $18/bl; although that may be difficult to defend in current circumstances.

Thursday 10 December (13.30) – US Merchandise trade (October)
Our forecast: $15bn deficit.

$ bn (nsa)	Jun	Jul	Aug	Sep	Oct
Exports	21 1	21 0	20 2	21 0	
Imports	36 8	37 5	35 9	35 1	
of wh oil	4 0	4 6	4 7	3 9	
Balance	−15 7	−16 5	−15 7	−14 1	

Seasonal factors tend to boost imports sharply in October and information already available on oil purchases does suggest some deterioration in this area. On the other hand, the trend improvement in dollar competitiveness and the continued strength of manufacturing employment both point to an underlying improvement in the non-oil deficit in the fourth quarter.

Friday 11 December (11.30) – UK Retail prices (Nov)
Our forecast: index 103.2, +0.3% mom, 4.0% yoy

	Aug	Sep	Oct	Nov
Index	102 1	102 4	102 9	
MOM %	+0 3	+0 3	+0 5	
YOY %	4 4	4 2	4 5	

Retail price inflation in November is unlikely to be affected by another rise in the prices of food, drink and tobacco ahead of Christmas. Mortgage rate cuts come through in December and in the absence of any other significant pressures a 0.3% rise on the month; in line with recent trends is expected. The feed through of the November 1986 mortgage rate increase brings the year on year rate down to 4%.

Ch

Latest P&D calendar – G7 mtg!!

We to see X!

AM

Yes

Others [illegible] of them.

(This is the only Baker meeting [illegible] has to attend ostensibly because its existence [illegible] known!)

023313
MDHIAN 9010

CONFIDENTIAL
FM TOKYO
TO IMMEDIATE FCO
TELNO 980
OF 040600Z DEC 87
AND TO IMMEDIATE HM TREASURY, BANK OF ENGLAND, WASHINGTON,
AND TO IMMEDIATE PARIS, BONN , ROME, OTTAWA

JAPANESE ATTITUDES TO G5/G7

1. THE JAPANESE AUTHORITIES BELIEVE THAT THERE IS NO POINT IN HOLDING A G5/G7 MEETING UNTIL THE US IS ABLE TO PRODUCE MORE CONVINCING EVIDENCE, FIRST THAT THE US PROPOSALS TO CUT THE DEFICIT WILL WORK, AND SECONDLY THAT THEY WILL INDEED GO AHEAD WITHOUT SIGNIFICANT AMENDMENT BY CONGRESS. THE NEED, ABOVE ALL, IS TO ENSURE THAT A MEETING CAN SIGNAL TO THE MARKETS THE END OF THE CURRENT PERIOD OF UNCERTAINTY.

2. AT THE SAME TIME, HOWEVER, THE JAPANESE REMAIN EXTREMELY CONFUSED ABOUT THE US ATTITUDE TO THE DOLLAR, AND WOULD INEVITABLY BE ATTRACTED BY THE PROSPECT OF A MEETING WHICH CLARIFIED THE POSITION , IDEALLY WITH SOME SORT OF REAFFIRMATION OF THE LOUVRE ACCORD.

3. THE BANK OF JAPAN HAS BEEN PARTICULARLY ACTIVE THIS WEEK IN SUPPLYING FUNDS TO THE MONEY MARKETS. THIS HAS BEEN INTERPRETED BY SOME OBSERVERS HERE AS INDICATING THAT THE BOJ IS TRYING TO GUIDE MARKET RATES DOWNWARDS AS PART OF AN INTERNATIONALLY COORDINATED EFFORT ALONGSIDE ACTION TAKEN IN EUROPE IN ADVANCE OF A G7 MEETING. THE BANK OF JAPAN TELL US THAT THEIR MAIN MOTIVE HAS BEEN TO EASE THE VERY SEVERE SEASONAL CASH SHORTAGES WHICH ARE LIKELY TO PERSIST DURING DECEMBER, AND WHICH WOULD OTHERWISE PROMPT DISRUPTIVE INCREASES IN SHORT-TERM INTEREST RATES: BUT THEY ARE QUITE PLEASED AT THE INTERPRETATION OF THEIR ACTIONS BY COMMENTATORS.

WHITEHEAD

YYYY

023313
MDHIAN 9010

DISTRIBUTION 181

MAIN 181

FINANCIAL FED
ERD [-]

NNNN

Ch
Passed those on the Ecs
AA

(I have a copy if you want to phone comments)

PUP

WB spoke ✓

SECRET

Ch
Peter & Terry hadn't seen this in draft, but are content.
AA

From: Sir G.Littler
Date: 27 November 1987

CHANCELLOR

c.c. Sir P.Middleton
Sir T.Burns

G7 MEETING

I attach some notes on:

- whether or not we want a meeting if there is nothing to satisfy us on the exchange rate problem;
- elements which might be sought on exchange rates in a public statement

2. I have not attempted to list permutations of the elements and grade them. It seems to me that 'borrowing' would be a big enough novelty, and in substance sufficiently important, for us to trade against it some explicit undertakings on the exchange rate itself. 'Swaps' cannot be as strong, because they are seen as bolstering reserves, rather than financing.

Also, S'bg not keen on swaps, for reasons he will ...

3. I have incidentally spoken this morning to Sarcinelli - the Italians have had no separate contact with the US - personally he agreed with both my objections to Anchorage and my doubts about rushing into a meeting before Congress is settled and without any clear expectation of US cooperation on exchange rates. He said that at yesterday's Franco-Italian Summit they had agreed firmly on the need for restoring exchange rate stability as a G7 priority.

(Geoffrey Littler)

SECRET

Starting-Point: In U.K. view the prime purpose of a G7 meeting should be to re-establish cooperation in stabilising the dollar exchange rate.

Two questions: If we cannot be confident of co-operation of any effective kind, do we still want / accept a meeting? And what are the possible / minimum acceptable terms of co-operation?

<u>**If no effective exchange rate co-operation**</u>

Other possible advantages of a meeting:

- ? to help Baker get Congress (and President) to implement the proposed package, by enabling him to show what he has won from other countries: but this could be high-risk, since Congress and President could not be guaranteed; and even if it worked it is such an inadequate objective and outcome that press and markets would surely be disappointed.
- ? pressure on Germany and Japan to take action : but we are fairly sure now that they will both take some action on the fiscal front anyway (Germany may announce before 12/13 December) and this is also expected by markets, therefore only advantages of meeting are: to let Baker take some of the 'credit', and to seek presentation of 'cooperative measures' - all pretty feeble.
- ? to concert action vis-a-vis NICs : but this does not need a G7 meeting, which in any case would not guarantee any results on the subject.
- ? reassuring messages generally : without more substance a joke.

? absence of mtg but agreed expectation of one - so seen as evidence of disagreement & this v. bad news for markets. But ~~[illegible]~~ mtg with unimpressive result cd be even worse - see over/later

maybe better to get it over quickly

There is a negative argument missed here: if we do not have a meeting, that itself will be bad for confidence - why no meeting? can't agree on anything - given build-up & expectations that there will be a meeting. And if it's going to be a mouse, ...

SECRET

Possible disadvantages of a meeting:

- ? any outcome which does not restore cooperation on exchange rate management or offer some significant new element will be seen as (and will in reality be) a retreat from Louvre and therefore disappointing.
- a G7 meeting will be treated by media and markets as a major event - expectations will focus on what it does for exchange rate prospects - a failure to satisfy such expectations could have disastrous effects on confidence.

The conclusion is that, while Baker may - for short-term domestic reasons - see advantage in a G7 meeting which offers nothing on exchange rates, there is no advantage for others. And a meeting of this kind could have a worse impact on markets than no meeting at all.

Possible elements of exchange rate cooperation

The two central problems are:

- the financial one: how is a substantial continuing U.S. deficit for some time to come going to be financed?
- the psychological one: how to assure U.S. commitment?

Ideally we need some combination of statements and actions, perhaps including as many as possible of the following:

~~a. Prevent XRs [illegible] [illegible] [illegible]~~

pattern of

1. "Exchange rate stability ~~continues to have an important role to play in fostering~~ would providing the best climate adjustment and minimising the risks of further changes which could undermine business confidence and increase dangers of recession."

feeble? (ie better to omit)

Current G7 XRs are in line with economic fundamentals, & they [illegible] [illegible] that

2. "It is realistic and acceptable to build around [recent/current/existing] exchange rate levels - as far as the G7 currencies are concerned."

3. "The Ministers and Governors intend to resume their cooperation in ~~doing so~~." strengthening this.

4. "In the interests of [restoring greater stability of exchange rates / minimising any threat of disruptive further exchange rate movements] the Ministers and Governors will cooperate in their conduct of monetary policies (ensuring that they are such as to support XR stability, as well as in foreign exchange intervention."

5. "The Ministers and Governors recognised the importance of monetary policy in helping to support exchange rate stability and foster the flows of funds needed to finance imbalances. In this connection they noted again with satisfaction the monetary action they have taken in recent weeks. They emphasised the importance of maintaining appropriate interest rate differentials between their markets. They undertook to cooperate in this and to consult each other regularly about actual and desirable interest rate developments."

6. "In order to strengthen the resources available both for any necessary intervention and more widely to contribute to the necessary financing of imbalances - they have agreed to [enlarge and] activate the network of currency swaps between their authorities."

SECRET

7. "Recognising that the process of adjustment of imbalances is bound to take a considerable time and that meanwhile the substantial external United States deficit has to be financed, the United States Government intends to undertake a programme of issuing bonds denominated in foreign currencies for this purpose. The authorities of the other six countries have undertaken to facilitate access to their markets for such bonds."

Mr Alex Allan (Spare) - Top handed in at No. 11 yesterday evening GL 30/11

pup

SECRET

From: Sir G.Littler
Date: 29 November 1987

CHANCELLOR

c.c. Sir P.Middleton
Sir T.Burns
Mr Peretz

MEETING OF G3(EUR) DEPUTIES

I met Tietmeyer and Trichet for nearly four hours on Saturday 28 November in the latter's office in Paris, then stayed on with Trichet for forty minutes or so after Tietmeyer had left. We covered a lot of ground as reported below. I am copying this minute to the Governor, Anthony Loehnis and Eddie George.

2. I think there are two points on which to focus immediately. First, should you try to contact Stoltenberg (before he speaks to Baker tomorrow afternoon) to reinforce your worries about the proposed Anchorage meeting - I fear that he may let Baker talk him into it without thinking through the prospects clearly enough; (in general I felt that Tietmeyer was reflecting too great a readiness for a meeting and too little ambition over what a meeting needs to get from the U.S. if it is to be valuable). Secondly, whether German action on interest rates this week should affect our action and timing.

Early Action by Germany

3. Tietmeyer warned of two probable early German decisions:
- the Bundesbank are likely on Thursday 3 December to decide and announce a half per cent discount rate cut;
- the Bundesrat are likely to settle about Wednesday the new fiscal measures (on the lines sketched by Stoltenberg for us last week-end) and announce them quickly.

He said that by going ahead quickly they could take advantage of the momentum of internal discussion and avoid any appearance of acting under direct U.S. pressure. Kohl would then at Copenhagen tell Mrs Thatcher to stop her public criticism of Germany.

4. Trichet was inclined at first to complain that this would be throwing away Germany's cards before the negotiation with the U.S. I disagreed, suggesting that Baker must be confident already of some German action, that what was proposed would not be useable as a negotiating card to get U.S. commitments on exchange rates anyway, and that on the whole it would be better to give Baker clear German decisions now to use as arguments in Congress, rather than have them extracted at a G7 meeting which we wanted to focus on exchange rates. (Tietmeyer more or less denied that they had actually told Baker what they are planning, but Trichet and I later agreed that his manner had been shifty and we were convinced that they have told Baker already).

5. Reverting later in our discussion to interest rates, Trichet began to speculate with some enthusiasm whether a joint European move this week might have a good effect. Tietmeyer was cautious about a French move lest it upset the fragile equilibrium in Europe. Trichet thought that France might well do one quarter and asked about the U.K. I said we had wanted to wait for a G7 meeting; I hesitated over a joint move, although we would have to consider the likely or actual impact on us of a German move, which could make it difficult for us not to move a half fairly quickly. Later I agreed with Trichet that we would let each other know of any developments and of decisions if and when taken.

G7 Meeting - Timing and Venue

6. My attempts to get a common line against Anchorage were not fruitful. All agreed it was an appalling idea and that New York would be better and an European venue best. My problem was:

- Tietmeyer saw and accepted all the arguments but plainly felt that Stoltenberg would want to feel free to accept Baker's proposal for venue and timing if they reached an agreement bilaterally on the objective;
- Trichet said that Balladur would accept any arrangements which offered a way to stopping the dollar's decline - my arguments impressed him more than Tietmeyer.

7. I pressed strongly doubts about venue, timing and nature of the Baker proposal. My main argument was that European interest in having a meeting at all was to secure exchange rate stability and as much U.S. commitment to it as we could get; plainly this was not Baker's immediate objective - he wanted to use a meeting to help him with Congress. Against this background, I disliked the idea of meeting before Congress had finished its work because Baker would at that stage be especially antagonistic over any exchange rate commitment, arguing that it would damage the prospects of Congressional agreement on the fiscal package.

8. My last comment to Tietmeyer as he left was to urge that we must not allow ourselves to be conned into a G7 meeting designed to suit Baker's interests without being satisfied that it could serve our interests too. He said he had this very much in mind. But after he had gone Trichet told me that Balladur distrusted Stoltenberg's negotiations with Baker!

Exchange Rates

9. We began our discussion by talking about the purpose of a G7 meeting and confirmed that for all three of us the essential point was to try to get an understanding on exchange rates. This was also the position of Japan (Tietmeyer had spoken with Gyohten the previous day). It was also the Italian position - although we reckoned that Italy and Canada would attend any meeting for any purpose for the sake of being there. It was not the U.S. aim.

10. Trichet said that Balladur totally rejected the idea of a "more flexible agreement". In his view the Louvre Accord had been damaged because the U.S. and the Bundesbank had not felt bound to it as they should have - a new agreement must be more binding. It was also his very strong view that the dollar was under-valued: by perhaps 10-15% already at the Louvre rates and 20% or so now. This hit European trade. A still lower dollar would be a disaster for the franc and the future of the EMS.

11. Tietmeyer agreed that the dollar was under-valued but not by a very large margin. He thought that DM 1.7 - DM 1.75 could be justified, although 1.8 - 2.0 would be better. The important thing was to avoid a further decline. A new G7 agreement should aim at this, although it was important not to have it appear only as an exchange rate agreement - wider policies should be stressed. We must avoid anything resembling a 'target zone system' and there must not be too much specification or rigidity over rates. We should build on the right basic economic policies plus three elements: a strong common statement; intervention to give the right signals; and agreements on monetary policies.

12. I said I thought the dollar was a bit under-valued in a long-term framework, but perhaps some undershooting was inevitable in this direction to correct the damage of massive overshooting in the other. Our worry was not the precise level now, but the risks we saw in a further uncontrolled decline - in our view no solution to the imbalance problem and the worst threat to world economic prospects. I would happily trade something on flexibility and on level in return for what seemed to me to be the most important elements in an agreement: real U.S. commitment, in whatever form; a clear agreement to use monetary policies and interest rates to support it; and I would like to add some understanding about how the inevitable continuing U.S. external deficit meanwhile is to be financed.

13. In further exchanges on substance, Trichet pleaded for some arrangement which would set DM 1.64 as a floor for the dollar, but neither Tietmeyer nor I felt that this had a chance of acceptance. We then turned to the 'draft'.

Draft of G7 Statement

14. I attach a revised draft statement as it emerged from our discussion of the earlier draft I had given Tietmeyer and Trichet a few days before. The first 8 paragraphs of this are quite close to my earlier draft except for extensive shortening (by omission mainly of historical and analytical comment). The square brackets reflect:

- I assumed and the French want the IMF Managing Director present at G7 (but not G5); Stoltenberg does not want him even at G7 - this affects paras 1 and 5.

- Tietmeyer was hesitant about including other passages in paragraphs 4 and 5.

15. Paragraph 9 is basically a Tietmeyer draft (the phrase in square brackets being a suggestion worked out by me and Trichet which Tietmeyer undertook to consider). Tietmeyer and Trichet were both very sceptical about the chances of getting Baker to agree to other elements of my draft; and Tietmeyer refused on behalf of the Bundesbank to say publicly anything about the use of monetary policies to support the exchange rate. I said this left a thin draft and we must work for somethin more. It was agreed to regard my own 'draft of elements' (also attached for ease of reference) as a quarry for possible drafting material, either to strengthen the public statement or for private understandings.

Other points

16. Larosiere and Poehl have had some talk with Greenspan - with dispiriting results. Greenspan seemed to be taking the view that, given the helpful anti-inflationary effect of the stock market collapse, there was room for a decline of U.S. interest rates and the dollar.

17. I had an earful from both Tietmeyer and Trichet about how damaging to German and French opinion, and they thought to the financial situation generally, was the Financial Times report of their interview of the Prime Minister. I reminded them of your warning last weekend and said again that there was to my knowledge no change of policy. They find it difficult to believe, however, that this interview was not planned and timed deliberately.

18. After Tietmeyer had gone, Trichet talked at length about the franc. He asked whether I could give him any reassurance on sterling, because the franc could not stay with the DM if sterling changed (after reading the Prime Minister's interview the French had spent a long time talking among themselves about its meaning and especially whether it presaged a change of policy which would put pressure on the franc). I told him that we wanted to stay as we are and indeed had demonstrated this by action both ways over recent months. I did not foresee pressures which would throw us off course: a sudden oil price collapse could still upset us, but I thought it unlikely; a large further dollar fall might well be uncomfortable (although we appeared to have some cushion in the sense that we had faced more upward than downward pressure at the present levels); we would aim to keep firm control of our own financial development and I saw no risk from that. He wondered whether we would not face pressure from industry to devalue; I said there were indeed some industries which suffered from a low dollar, but it was interesting to see how widely and positively accepted by industry our de facto linkage with the DM was. I said that a worry of my own about sterling had been that any devaluation of the franc and others in the ERM against the DM could affect us - he vehemently assured me that it was out of the question until after the election, unless by the intolerable force majeure of another big dollar drop.

(Geoffrey Littler)

SECRET

DRAFT: STATEMENT OF THE GROUP OF SEVEN

1. The Finance Ministers and Central Bank Governors of seven major industrial countries met today [in the framework of the surveillance procedures agreed upon at the Venice Summit by their Heads of State or Government]. They expressed their conviction that the continuing development of effective cooperation between them can and must play an important role in promoting a healthy and prosperous world economy and a stable world monetary system.

2. The Ministers and Governors emphasised that their basic objectives remain unchanged. The major imbalances which grew up in the early part of the decade must be corrected. That correction must be gradual and will inevitably take time if it is to be achieved without either rekindling inflation or undermining confidence and provoking recession.

3. The policies set out in the Louvre Accord are being - and will continue to be - implemented and are gradually showing the intended effects. In particular the balance between domestic demand and output in the United States and in Japan and the Federal Republic of Germany has swung round as was required and in volume terms their trade imbalances are clearly diminishing.

4. The sharp falls in share prices since mid-October may have some effect on economic prospects [in the directions of marginally reducing inflationary pressures and promoting somewhat higher savings and reduced domestic demand]. The authorities in the major countries have responded appropriately by monetary measures.

5. The Ministers and Governors discussed together [and with the Managing Director of the International Monetary Fund] the outlook for the economies of their individual countries and for the world economy as a whole, in the light of recent events. [There could well be a modest slow-down of the rate of growth of activity, for their countries as a group, but they believe that, with carefully sustained and cooperative policies, the rate of growth should remain substantial.] The likely impact of recent developments has suggested both the need and the opportunity for further action to reinforce the broad strategy of cooperative policies set out in the Louvre Accord.

6. Accordingly the Ministers and Governors have welcomed and endorsed the actions taken and proposed by each of their governments as follows:

> [Individual country passages, which should take credit for past "Louvre-type" actions as well as proposals, e.g. in particular show the continuity of U.S. attack on deficit]

7. The Ministers and Governors strongly rejected the false remedies to solve present difficulties which are sometimes advocated. In particular, protectionism constitutes a direct and serious threat to world prosperity and equilibrium, and would have harmful consequences for those countries that resorted to it. The Ministers and Governors reaffirmed their determination to fight protectionism, and to promote an open world trading system.

8. The reduction of world trading imbalances does not depend only on the seven countries whose Ministers and Governors issue this statement. They will be seeking appropriate cooperation from all other countries and international institutions. They again and in particular draw attention to the very large and still growing trade and current account surpluses of Taiwan and South Korea. The exports of those countries have benefitted greatly from relatively open markets in major industrial countries while their own markets continue to be extensively protected against imports. And their currencies have appreciated over the last two years only very modestly against the dollar, whilst falling in value against other major currencies.

9. The Ministers and Governors agreed that excessive fluctuations of exchange rates and a further decline of the dollar would both damage growth prospects in their countries and in the world economy and interrupt further progress in reducing international imbalances. They reemphasise their common interest in more stable exchange rates among their currencies. Therefore they will continue to cooperate closely [in economic and monetary policies] to foster stability of exchange rates.

SECRET

1. "Exchange rate stability continues to have an important role to play in fostering adjustment and minimising the risks of further changes which could undermine business confidence and increase dangers of recession."

2. "It is realistic and acceptable to build around [recent/current/existing] exchange rate levels - as far as the G7 currencies are concerned."

3. "The Ministers and Governors intend to resume their cooperation in doing so."

4. "In the interests of [restoring greater stability of exchange rates / minimising any threat of disruptive further exchange rate movements] the Ministers and Governors will cooperate in their conduct of monetary policies as well as in foreign exchange intervention."

5. "The Ministers and Governors recognised the importance of monetary policy in helping to support exchange rate stability and foster the flows of funds needed to finance imbalances. In this connection they noted with satisfaction the monetary action they have taken in recent weeks.

6. "They emphasised the importance of maintaining appropriate interest rate differentials between their markets. They undertook to cooperate in this [and to consult each other regularly about actual and desirable interest rate developments]."

7. "In order to strengthen the resources available both for any necessary intervention and more widely to contribute to the necessary financing of imbalances they have agreed to [enlarge and] activate the network of currency swaps between their authorities."

8. "The process of adjustment of imbalances is bound to take a considerable time and meanwhile the substantial external United States deficit has to be financed. The bulk of the financing should be provided spontaneously by private capital flows, although it is important that the authorities contribute to a climate of confidence and of appropriate interest rates which will encourage such flows."

9. "Nevertheless there could well be a gap from time to time between the finance required and the private flow. To meet this, the United States Government intends to undertake a programme of issuing bonds denominated in foreign currencies. The authorities of the other six countries have in turn undertaken to facilitate access to their markets for such bonds."

10. [It would also be possible to link foreign currency borrowing by the United States to intervention by others - which also contributes to financing the United States external deficit].

Pup.

SECRET

From: Sir G.Littler
Date: 1 December 1987

CHANCELLOR

c.c. Sir P.Middleton
Sir T.Burns
Mr Peretz

TALK WITH TIETMEYER

Tietmeyer was only able to ring through around 4 p.m. our time, and then told me the following:

- Poehl and Schlesinger have not been persuaded to move on interest rates on Thursday - which probably rules out the cut previously expected : this is not a case of willing to move but preferring to wait for a G7 meeting; it is rather that Poehl and Schlesinger have yet to be persuaded to fire what they tend to regard as their last shot!
- the Bundesrat likely to settle a fiscal package tomorrow and essentially on the lines previously sketched for us by both Stoltenberg and Tietmeyer - no acceleration of tax reductions; the one novelty (to me) and quite a big political hurdle in Germany is a 'deregulation' proposal to allow shops to open late one evening a week!
- Stoltenberg spoke again to Baker yesterday - nothing on a meeting (that Tietmeyer would vouchsafe) - but he told Baker firmly that there must be a clear public statement of resistance to a further decline of the dollar.

GL

(Geoffrey Littler)

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Ch

Geoff now tells me Tietmeyer was wrong on interest rates. Trichet rang him to say Poehl had rung Larosière (? & Governor) to say will be doing 1/2 % on Thursday (& French will do 1/4 %).

AA

c
Tietmeyer info

SECRET

From: Sir G.Littler
Date: 1 December 1987

CHANCELLOR

c.c. Sir P.Middleton
Sir T.Burns
Mr Peretz

TALK WITH TIETMEYER

Tietmeyer was only able to ring through around 4 p.m. our time, and then told me the following:

- Poehl and Schlesinger have not been persuaded to move on interest rates on Thursday - which probably rules out the cut previously expected : this is not a case of willing to move but preferring to wait for a G7 meeting; it is rather that Poehl and Schlesinger have yet to be persuaded to fire what they tend to regard as their last shot!
- the Bundesrat likely to settle a fiscal package tomorrow and essentially on the lines previously sketched for us by both Stoltenberg and Tietmeyer - no acceleration of tax reductions; the one novelty (to me) and quite a big political hurdle in Germany is a 'deregulation' proposal to allow shops to open late one evening a week!
- Stoltenberg spoke again to Baker yesterday - nothing on a meeting (that Tietmeyer would vouchsafe) - but he told Baker firmly that there must be a clear public statement of resistance to a further decline of the dollar.

GL

(Geoffrey Littler)

From : D L C Peretz
Date : 1 December 1987

PPS

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr H P Evans
Miss O'Mara
Mr Holgate
Mr Cropper

GERMAN INTEREST RATES

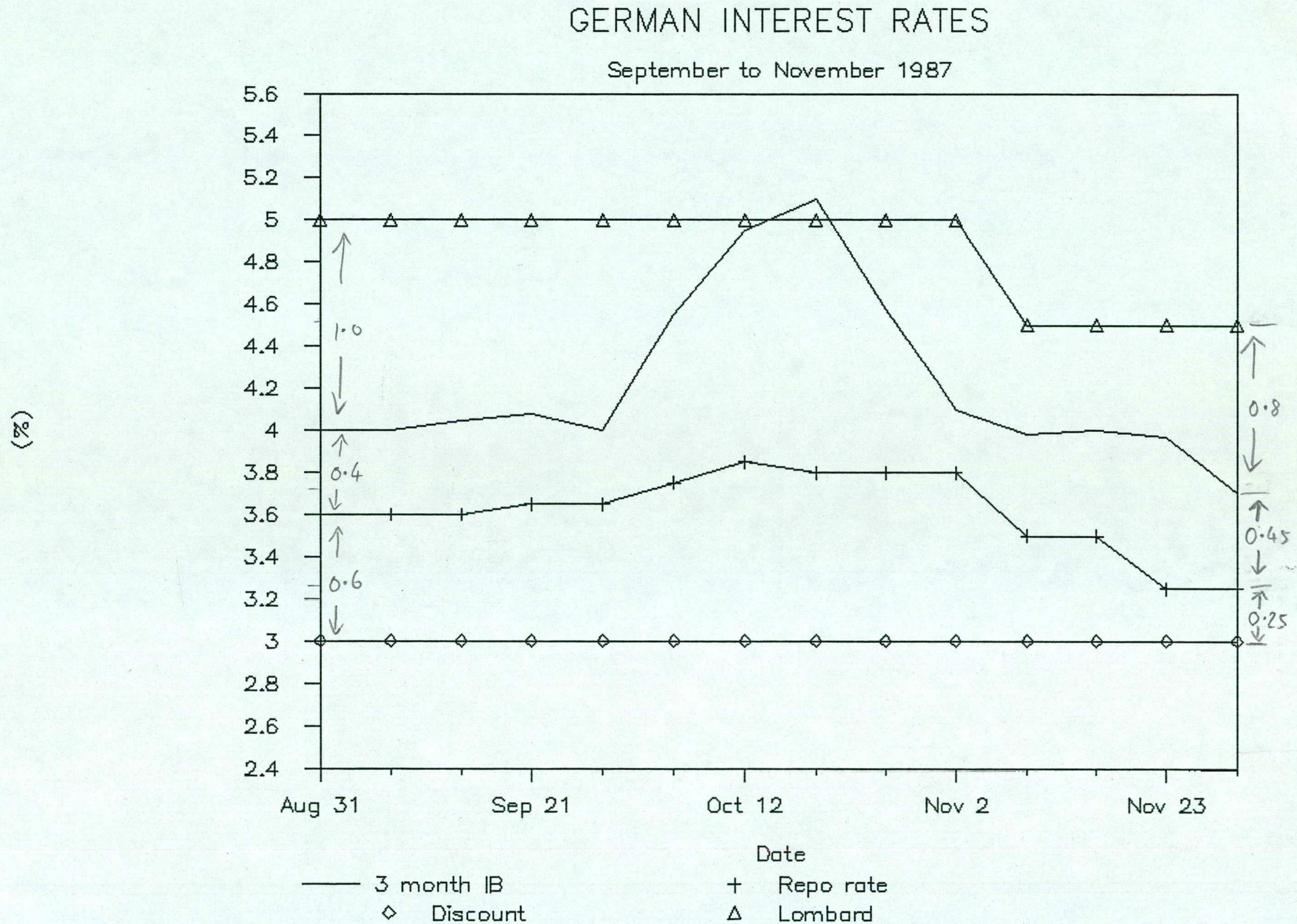
As promised, I attach a graph of movements in key German short-term interest rates over the last 3 months.

2. The key operational rate is the Bundesbank's repo rate. The Lombard rate is meant to represent something of a ceiling on short-term interest rates, though you will see that 3 month market rates rose briefly above it in early October.

3. The discount rate sets a floor to short-term interest rates. It is clear that the repo rate cannot be reduced much further without a reduction in the discount rate, and I guess the main significance of a cut in the discount rate is that it would be seen as paving the way for a cut in the repo rate, and hence in market rates. It is, of course, possible though that a further cut in the repo rate would be announced at the same time as a cut in the discount rate.

DLCP

D L C PERETZ


GERMAN INTEREST RATES
September to November 1987
5.6
5.4
5.2
5
4.8
4.6
4.4
4.2
4
3.8
3.6
3.4
3.2
3
2.8
2.6
2.4
(%)
1·0
0·4
0·6
0·8
0·45
0·25
Aug 31
Sep 21
Oct 12
Nov 2
Nov 23
Date
3 month IB
Repo rate
Discount
Lombard

pmp

CHANCELLOR OF THE EXCHEQUER

Ch

If you are forced to go to Anchorage, only practicable flights are

Saturday

Leave London 8-30 am; arrive Anchorage 12·35 pm – ie in time for lunch.

Sunday

3 options:

Depart	Arrive London (Monday)
10·35 am	8·25 am
11·20 am	9·04 am
12·55 pm	12·05 pm.

AA.

ROUGH GREAT CIRCLE DISTANCES.

(nautical miles)

	ANCHORAGE	LONDON	BONN	NEW YORK
LONDON	4000	—	300	3100
WASHINGTON	3000	3200	3500	100
BONN	4100	300	—	3400
PARIS	4100	200	200	3200
TOKYO	3100	5400	5300	6000
ROME	4700	800	500	3800
OTTOWA.	2700	3000	3200	300
	25700	12900	12800	19800

Ch

This is pretty rough

(cotton on globe lent by Tony Galsworthy)

but gives general picture.

AA

CHANCELLOR OF THE EXCHEQUER

pwp

Keep carefully

NB (1) Do not take this bundle apart without Alex's approval

(2) Master bundle is with Alex, this is spare — & includes a few additional ones including SECRET Annex on intervention on 23/12/87 plus indicators paper in April But not Louvre Annex.

pp

December 1987

STATEMENT OF THE GROUP OF SEVEN

1. The Finance Ministers and Central Bank Governors of seven major industrial countries have conducted close consultations in recent weeks on their economic policies and prospects in light of developments in financial markets. They reaffirmed their conviction that the basic objectives and economic policy directions agreed in the Louvre Accord remain valid and provide for a positive development of the world economy. They will continue to carry forward their economic policy coordination efforts in 1988 under the arrangements endorsed at the Venice Summit.

2. The Ministers and Governors reemphasized their view that the major external imbalances in the world economy must be corrected. The policies which have been implemented this year are gradually showing the intended effects. In particular, the balance between domestic demand and output in the United States and in Japan and the Federal Republic of Germany has shifted in a direction which promotes external adjustment and in volume terms their trade imbalances are diminishing. The greater stability of exchange rates achieved for much of the past year, following the earlier substantial exchange rate changes, contributed to this adjustment. The marked exchange rate changes over the past few weeks, however, stress the need to strengthen underlying economic fundamentals and to continue policy cooperation.

3. Developments in stock markets since mid October may have some adverse effect on prospects for economic growth for the industrialized countries as a group. The Ministers and Governors believe, however, that with sound economic policies and effective coordination the rate of growth should be substantial. To this end they agreed that appropriate policies for strengthening non-inflationary growth in their countries are necessary.

4. Accordingly, the Ministers and Governors agreed to intensify their economic policy coordination efforts. Their common efforts are directed towards reducing external imbalances. In particular, the United States has secured Congressional action to implement the agreement between the President and the bipartisan Congressional Leadership on a two-year package of additional budget savings that will reinforce progress in reducing the budget deficit. Japan has implemented a major stimulus program to strengthen domestic demand and will see to it that in the FY 1988 budget the expenditure for general public works will not be less than that for the FY 1987 budget including the July supplemental. The Federal Republic of

Germany is supplementing the previously announced increase in tax reductions in 1988 with new measures to increase investment and will not seek to offset the budget revenue losses arising from recent developments. There have also been coordinated reductions in interest rates in Europe which should contribute to the expansion of domestic demand and reduce trade imbalances. The specific policy intentions and undertakings by each country are set forth in the annex to this statement.

5. The Ministers and Governors are of the view that the recent monetary policy decisions and the reduction of interest rates in some countries were appropriate and will contribute to a restoration of stability to financial markets. They agreed that monetary policies should continue to be directed towards providing adequate monetary conditions to achieve strong economic growth in the context of price stability as well as to foster financial market stability.

6. The Ministers and Governors strongly rejected protectionist measures as a means of dealing with present imbalances. Protectionism constitutes a direct and serious danger to world prosperity and equilibrium and would have harmful consequences for those countries which resort to it. They reaffirmed their determination to fight protectionism and to promote an open world trading system.

7. The Ministers and Governors believe that the reduction of world trading imbalances requires cooperative action by other countries, particularly those with surpluses. They expressed particularly serious concern that some newly industrialized economies have failed to take adequate action to deal with large and growing trade surpluses which are exacerbating global imbalances and fostering protectionist pressures. They urged the newly industrialized economies to implement without delay trade and exchange rate policies that will facilitate the reduction of excessive trade surpluses and allow their currencies to fully reflect the strong competitive position of their economies.

8. The Ministers and Governors agreed that either excessive fluctuation of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that becomes destabilizing to the adjustment process, could be counter-productive by damaging growth prospects in the world economy. They reemphasized their common interest in more stable exchange rates among their currencies and agreed to continue to cooperate closely in monitoring and implementing policies to strengthen underlying economic fundamentals to foster stability of exchange rates. In addition, they agreed to cooperate closely on exchange markets. The Ministers and Governors stressed the need for consistent and mutually supportive policies and believe that the measures being taken

will accelerate progress towards the increased, more balanced economic growth, and sustainable external positions necessary for greater exchange rate stability.

--

Annex

Policy Intentions and Undertakings

The Government of Canada's fiscal strategy has succeeded in achieving a drop in the rate of growth of its spending and substantial, on-going declines in the budget deficit. Marked progress has been made in slowing the growth of debt, and towards the medium term objective of stabilizing the debt-to-GDP ratio. Fiscal restraint has been accompanied by impressive growth of domestic demand, output and employment. Major structural initiatives directed at enhancing competitiveness and the underlying potential of the economy have been undertaken, particularly tax reform and the negotiation of a free trade agreement with the United States. Monetary policy remains geared to non-inflationary growth in a climate of orderly exchange markets.

The Government of France has fully met its commitment to reduce its fiscal deficit and tax burden. The fiscal deficit will be reduced by 0.8% of GNP from 1986 to 1988. Over the same period of time, tax cuts will amount to 1.3% of GNP. A further reduction of 45 billion french francs in the fiscal deficit and an additional 45 billion french francs in tax cuts are scheduled in a 1989-1991 three year program which constitutes the long term strategy of the government and will be implemented in the yearly budgets. The privatization program decided upon in early 1987 is being carried out, and its initial objectives have even been surpassed. The full implementation of the program will be resumed as soon as market conditions permit.

The French Government will continue to pursue its adjustment and liberalization policies. New measures to sustain household savings, develop financial markets and improve the competitiveness of firms have been taken. Additional steps will be taken in the same direction in 1988.

The Government of the Federal Republic of Germany has increased the amount of the tax reductions for 1988 and beyond to about 14 billion DM, and will not seek to offset the budget revenue losses arising from recent developments. In addition, the necessary decisions have been taken for the structural tax reform with a further net tax reduction of 20 billion DM from 1990 onward.

In order to strengthen private and public investment, the Federal Government will provide special loans for the next 3 years of about 21 billion DM under preferential conditions. Moreover, it will accelerate investment in telecommunication infrastructure and take initiatives for further deregulation of markets.

The Bundesbank has reduced short-term interest rates substantially during the last few weeks. Monetary policy will

16.12.87 20:25

continue to maintain appropriate conditions for sustained non-inflationary growth.

The Government of Italy has taken restrictive measures in 1987 to halt the deterioration of the balance of payments due to a higher rate of domestic demand in Italy than in other industrial countries. For 1988 the objective embodied in the Finance Bill is to maintain a relatively high level of growth and to keep the average inflation rate constant, while making progress in correcting the public sector imbalance.

In the medium-term, to alleviate unemployment the Italian authorities intend to achieve satisfactory rates of growth while maintaining the balance of payments current account near equilibrium, to stabilize the debt/GDP ratio, and to devote more resources to the financing of productive as well as infra-structural investments, thus improving the quality of public services.

The Government of Japan noted that the Japanese economy is in a vigorous expansionary phase, led by domestic demand growth. The Government will steadfastly continue implementing the 6 trillion-yen-plus package decided on last May, and will see to it that in the FY 1988 budget the expenditure for general public works will not be less than that for the FY 1987 budget including the July supplemental.

The Bank of Japan will follow appropriate and flexible monetary policy supportive of non-inflationary growth and exchange rate stability.

The United Kingdom Government, in the context of the British economy's continued vigorous growth of output and domestic demand, coupled with sound public finances, will continue to strive to reduce inflation by pursuing a prudent monetary policy, while increasing its capacity for non-inflationary growth by further measures designed to free the operation of markets and increase the efficient use of resources, including tax reduction and tax reform. Public expenditure will continue to increase less rapidly than the growth of the economy as a whole, and the government will continue to work for the dismantling of barriers to trade both within the European Community and in the context of the Uruguay round of the GATT.

The United States Government has secured Congressional action to implement the agreement between the President and the bipartisan Leadership of the Congress on a two-year package of budget savings to reduce the U.S. budget deficit. This agreement provides for total budget savings, through a combination of spending restraint and increased taxes, in fiscal 1988 and 1989 of approximately $76 billion.

The budget agreement is part of an ongoing process of deficit reduction provided for under the revised Gramm-Rudman-Hollings legislation. It will reinforce the progress already achieved in reducing the deficit (including a fiscal 1987 cut of $73 billion or 1.9 percent of GNP) that has brought the deficit down to 3.4 percent of GNP from a peak of 6.3 percent.

The Administration will also continue to oppose steadfastly protectionist trade measures, while working for legislation authorizing negotiations to foster a more open and fair system for the international exchange of goods, services and investment.

SECRET

December 1987

UNDERSTANDINGS ON INTERVENTION AND CONSULTATIONS

1. The participants would hold regular consultations on financial market conditions. On the basis of these consultations, they would make ad hoc decisions on exchange market intervention at levels which the participants consider appropriate under present circumstances. Intervention should be considered if the dollar on the one hand had a tendency to fall below present levels and on the other hand if it approached levels prevailing at the time of the April Meeting of the Group of Seven in Washington.

2. The United States, Japan and Germany/Europe would be prepared to undertake intervention up to a total of $15 billion defined in terms of net purchases/sales of dollars against yen and -- according to the following understanding - against DM/other European currencies, with approximately equal shares over time up to $5 billion each. As a general rule the European share of $5 billion should be provided by Germany in DM on the one hand and the other European countries (EMS-countries in the exchange rate mechanism, plus United Kingdom, Switzerland and Austria) on the other hand in equal parts. If these other European countries intervene by a higher amount, the total European share will be increased correspondingly.

3. If intervention in the view of the participants is useful they will consult on the appropriate daily amounts of such intervention and their respective shares, taking into account market developments and the respective shares of the countries mentioned in para 2. It is understood that for all intervention by European countries the situation in the European Monetary System will be considered.

4. With regard to the currency of intervention, the general rules would be:

   - For the United States, equal priority to DM/dollar and yen/dollar, depending on market pressure;

   - For Europe, priority to DM/dollar, supplemented by European currencies against dollar;

   - For Japan, priority to yen/dollar;

   - Intervention in dollar/yen by the Deutsche Bundesbank and dollar/DM by the Bank of Japan will be subject to consultation between those two central banks and the U.S. authorities. This consultation should take place when either the DM/dollar rate or the yen/dollar rate is under pressure.

16.12.87 20:27

SECRET

5. Central banks would continue to maintain close contacts on intervention operations pursuant to established channels. Finance ministries would continue to discuss matters of mutual interest through their bilateral channels of communication.

6. This agreement would enter into effect when adopted by the participants in connection with the December G-7 statement and remain in force until the early 1988 meeting. In the event that the $15 billion of resources are exhausted prior to that meeting, participants would immediately consult.

16.12.87 20:28

September 26, 1987

Statement of the Group of Seven

1. The Finance Ministers and Central Bank Governors of seven major industrial countries met today. The Managing Director of the IMF also participated in the meeting. This continues the economic policy coordination process agreed by their Heads of State or Government at the 1986 Tokyo Summit and strengthened at the 1987 Venice Summit meetings. The Ministers and Governors are convinced that this process, including the use of economic indicators, provides an important and effective means of promoting a healthy and prosperous world economy and stable monetary system.

2. The Ministers and Governors reviewed together the events, policy developments, and evolution of foreign exchange markets since the Louvre Agreement and the April G-7 meeting in Washington. They were pleased with the exchange rate stability which has been achieved and which has benefitted their policies and performance.

3. In the Louvre Agreement the Ministers and Governors set out the policies which they intended individually to pursue, and undertook to monitor them together and as necessary intensify or adapt them. They note that some important decisions have been taken in individual countries which were envisaged in the February statement, and that generally the evolution of policies has been along the lines intended.

4. Some important favorable results are beginning to be seen. The substantial reduction in fiscal 1987 in the United States federal budget deficit is a very positive step, as is the continued determination in resisting protectionist pressures, and they particularly welcomed the announcement today by the President of the United States of his decision to sign legislation which will reinforce progress in reducing the budget deficit. The major program of additional expenditures and income tax cuts in Japan is being rapidly implemented. In Germany the reductions in income taxes from January 1988 will be greater than previously planned and the legislation for them has already been enacted. There have been reductions in external imbalances in real terms, although they remain high. Growth in domestic demand in surplus countries is picking up, but it is important that it improves further in some countries.

5. The Ministers and Governors note that the large trade surpluses of some newly industrialized economies continue to be an important factor contributing to external imbalances. They repeat their view expressed on earlier occasions that these economies should reflect their growing importance and responsibilities by reducing trade barriers and pursuing policies that allow their currencies to reflect more fully underlying economic fundamentals.

6. The Ministers and Governors commit themselves to take further appropriate actions as necessary to achieve the agreed goals set forth in the Louvre Agreement. They will particularly intensify their efforts to liberalize markets, implement tax reforms and pursue other structural changes to strengthen the vitality of their economies, to foster a high rate of sustained non-inflationary growth and to reduce external imbalances. They reaffirmed their determination to fight protectionism, and to promote an open world trading system.

7. The Ministers and Governors reaffirmed their intentions to carry forward their economic policy coordination efforts. During the coming year the developments of their economies will be monitored closely under the strengthened surveillance arrangements outlined in the Venice Summit. In light of the progress achieved to date in laying the basis for a reduction of imbalances, and the prospects for further progress, Ministers and Governors reaffirmed that currencies are within ranges broadly consistent with underlying economic fundamentals. They recommitted themselves to continue to cooperate closely to foster the stability of exchange rates around current levels.

CHANCELLOR 12/2

CHANCELLOR - INTERVIEW ON G7 STATEMENT

Transcript from: BBC Radio 4, Today, 23 December 1987

INTERVIEWER: (JOHN HUMPHREYS) .... the financial world has been waiting for G7 to get together and do something, G7 are the 7 big industrial countries. And now they have met and made a statement and the question is whether, after labouring so long and so mightily, they have brought forth a mouse? One of the G7 countries is Britain and on the line to answer that question is the Chancellor Nigel Lawson. Good morning, you've said you're worried about the declining $ but you've not really said have you what you're going to do to stop it declining more?

CHANCELLOR: I think that if anything the $ now is under valued. But the question of what further changes may take place with the $ in the short run will depend a great deal on the determination of the United States to maintain the value of its currency. But what this statement does show is the high degree of international co-operation which exists at the present time.

INTERVIEWER: Well does it, in what sense are you going to co-operate to do something about the $ or is it all in the hands of the United States now?

CHANCELLOR: No there is in the first place a whole list of the measures that we have taken as a result of our co-operation and common analysis of the situation. The reduction in the American budget deficit, which we all identified as necessary, and that has now been agreed by the Congress after a rather laborious process and signed by the President. And that was what we were waiting for before putting out this statement. Again on the other side of the Atlantic there has been a concerted reduction of interest rates including in the United Kingdom and throughout all the major European countries. And there is, as I say, a common response to this stock market collapse and indeed to the inbalances that lie behind it. And I think a response which began long before the stock market collapsed. It was because we identified the problems in the world economy that we started to have these meetings and have this concerted action.

INTERVIEWER: Are you satisfied that the $s not going to drop any more then, that it has been held at this level?

CHANCELLOR: No I think that - and my own views are similar - own personal view - that the $ taking any medium term view is undervalued at the present time. Whether it'll fall further or not I don't know. I think that there is a common will, and I think that will includes the United States, to try and secure that it doesn't fall any further. The question is how determined is the United States and that will be no doubt seen in the coming weeks and months. But it has fallen a very, very long way.

INTERVIEWER: Do you think the United States is determined enough because there is a feeling isn't there that Washington is quite happy to see the $ drop even more?

CHANCELLOR: No , no, if Washington had been happy to see the $ drop even more it would not have, the United States, would not have signed this statement which states quite clearly that they don't want to see the $ fall any further. And I think that it is there in Government departments, certainly in concert with other countries to back that by action. And I think in particular they will sooner or later have to be prepared to raise their interest rates.

INTERVIEWER: And so is that in effect a warning from you and the rest of G7, or the G6 if you like, that they've really got to do something about interest rates?

CHANCELLOR: No it's not a question of got to do something about interest rates. They've got to have an economic policy that all hangs together and makes sense. I think that the reduction in the budget deficit, it may well be that it could go further, but the reduction in the budget deficit is very welcome, it's very desirable. There are already signs that American exports are doing very much better in the world market and I think you will see a change in the trade figures in the United States over the next few months, a change for the better. And I think that that is on the mend. But in order to allow the exchange rate changes that have already taken place to have its full effect they're going to have to cut back to some extent on their growth of domestic demand. And I believe that that may need higher interest rates and they may need higher interest rates too in order to finance their deficits so long as they persist and that they're not going to go away overnight. But I think the fact that the United States has joined in this - and indeed is a leading participant - in this agreement, this communiquè which we've all agreed on. I think that's a healthy sign and a sign, as I said, that international co-operation is very much alive and well.

INTERVIEWER: You mentioned their trade figures, our trade figures are out today as well aren't they and they're apparently not really very good. Are you worried about the deterioration in Britain's balance of payments because we still regard it as being terribly important?

CHANCELLOR: No, we're running - I think this a circuit of the track if you like - we're running a a small, it's very small in relation to the size of the economy, a very small current account deficit which I forecast some time ago. Which is not surprising given that the British economy is growing so much faster than the rest of the world and that inevitably means it's a harder job for our exporters to export to the rest of the wolrd than it is for other countries who export to Britain growing as fast as it is. But our exports too are doing very well. And of course we have massive overseas assets which enable us to finance this very small deficit without any difficulty.

G-7 CALLS =5 WASHINGTON NRCE

"IT WAS FELT IMPORTANT BY ALL THAT THERE BE NOT ONLY A STATEMENT REGARDING A FURTHER DECLINE OF THE DOLLAR BEING COUNTERPRODUCTIVE, BUT THAT A RISE TO THAT LEVEL WITH RESPECT TO WHICH WE HAVE SOME UNDERSTANDING, BUT OBVIOUSLY DON'T WANT TO DISCUSS PUBLICLY, WOULD ALSO BE COUNTERPRODUCTIVE," HE SAID.

AN APPENDIX TO THE COMMUNIQUE LISTED THE POLICY INTENTIONS AND UNDERTAKINGS OF EACH OF THE SEVEN COUNTRIES BUT WAS MOSTLY AN ENUMERATION OF PAST ACCOMPLISHMENTS RATHER THAN PROSPECTIVE ACTIONS.

9 EX 12/2

23-DEC-0316 MON063 MONL

CONTINUED FROM - NRCD CONTINUED ON - NRCF

P

REUTER MONITOR 0524

G-7 CALLS =6 WASHINGTON NRCF

-- THE UNITED STATES PLEDGED TO RESIST PROTECTIONISM BUT MADE NO NEW COMMITMENTS TO CUT ITS BUDGET DEFICIT BEYOND THE 76 BILLION DLRS OF SAVINGS FOR FISCAL 1988 AND 1989 CONTAINED IN THE BILLS THAT PRESIDENT REAGAN SIGNED INTO LAW ON TUESDAY.

-- WEST GERMANY LISTED THE STIMULATIVE MONETARY AND FISCAL STEPS IT HAS TAKEN IN RECENT WEEKS AND SAID "MONETARY POLICY WILL CONTINUE TO MAINTAIN APPROPRIATE CONDITIONS FOR SUSTAINED NON-INFLATIONARY ECONOMIC GROWTH."

-- JAPAN PROMISED TO CONTINUE TO IMPLEMENT STEADFASTLY THE SIX TRILLION YEN STIMULUS PACKAGE AGREED LAST MAY AND WILL SEE TO IT THAT PUBLIC WORKS SPENDING WILL NOT FALL IN FISCAL 1988.

23-DEC-0320 MON066 MONL

CONTINUED FROM - NRCE CONTINUED ON - NRCW

P

REUTER MONITOR 0524

G-7 CALLS =7 WASHINGTON NRCW

THE BANK OF JAPAN WILL FOLLOW APPROPRIATE AND FLEXIBLE MONETARY POLICIES TO SUPPORT NON-INFLATIONARY ECONOMIC GROWTH.

-- BRITAIN PLEDGED TO KEEP STRIVING TO REDUCE INFLATION, LIBERALISE MARKETS AND CUT TAXES, WHILE PUBLIC SPENDING WILL CONTINUE TO GROW LESS RAPIDLY THAN THE ECONOMY AS A WHOLE.

-- FRANCE, WHICH SAID IT HAS FULLY MET ITS COMMITMENT TO REDUCE ITS FISCAL DEFICIT AND TAX BURDEN, WILL RESUME ITS PRIVATIZATION PROGRAM AS SOON AS MARKET CONDITIONS PERMIT.

IT ALSO PROMISED ADDITIONAL MEASURES IN 1988 TO SUSTAIN HOUSEHOLD SAVINGS, DEVELOP FINANCIAL MARKETS AND IMPROVE THE COMPETITIVENESS OF FIRMS.

23-DEC-0320 MON067 MONM

CONTINUED FROM - NRCF CONTINUED ON - NRCX

P

REUTER MONITOR 0524

G-7 CALLS =8 WASHINGTON NRCX

-- ITALY SAID IT WOULD STRIVE FOR SATISFACTORY ECONOMIC GROWTH IN THE MEDIUM TERM WHILE MAINTAINING THE CURRENT ACCOUNT MORE OR LESS IN BALANCE. IT WILL DEVOTE MORE RESOURCES TO FINANCING PRODUCTIVE INVESTMENT AND INFRASTRUCTURE.

-- CANADA REPORTED MARKED PROGRESS TOWARD ITS OBJECTIVE OF STABILIZING THE DEBT-TO-GDP RATIO AND SAID ITS MONETARY POLICY REMAINS GEARED TO ACHIEVING NON-INFLATIONARY GROWTH.

THE G-7 SAID THE MEASURES TAKEN THIS YEAR ARE GRADUALLY WORKING TO ADJUST THE BALANCE BETWEEN DOMESTIC DEMAND AND OUTPUT IN THE U.S., WEST GERMANY AND JAPAN. IN PARTICULAR TRADE IMBALANCES IN VOLUME TERMS ARE DIMINISHING.

23-DEC-0321 MON068 MONM

CONTINUED FROM - NRCW CONTINUED ON - NRCY

P

REUTER MONITOR 0524

G-7 CALLS =9 WASHINGTON NRCY

IN AGREEING THAT MONETARY POLICY SHOULD CONTINUE TO BE DIRECTED TOWARD ACHIEVING NON-INFLATIONARY ECONOMIC GROWTH, THE G-7 SAID RECENT INTEREST RATE CUTS IN CERTAIN COUNTRIES "WERE APPROPRIATE AND WILL CONTRIBUTE TO A RESTORATION OF STABILITY TO FINANCIAL MARKETS."

NEGOTIATIONS ON THE POLICY ACTIONS THAT LED TO THE G-7 COMMUNIQUE BEGAN SOON AFTER THE STOCK MARKET CRASH IN MID-OCTOBER, WHICH THE COMMUNIQUE SAID MAY HAVE SOME ADVERSE EFFECT ON ECONOMIC GROWTH PROSPECTS FOR THE GROUP AS A WHOLE.

IT NEVERTHELESS SAID "SUBSTANTIAL" GROWTH CAN BE ACHIEVED IF THE COUNTRIES COORDINATE THEIR POLICIES EFFECTIVELY.

23-DEC-0321 MON069 MONM

CONTINUED FROM - NRCX REUTER

P

REUTER MONITOR 0524

NREK

SUMITA SEES NO NEED TO HOLD G-7 MEETING NOW

TOKYO, DEC 23 - BANK OF JAPAN GOVERNOR SATOSHI SUMITA SAID HE SAW NO NEED TO HOLD A MEETING OF THE GROUP OF SEVEN (G-7) NOW.

HE ALSO TOLD A PRESS CONFERENCE THAT HE EXPECTED THE G-7 STATEMENT TO HAVE A CALMING EFFECT ON THE FOREIGN EXCHANGE MARKET, NOTING THAT THE DOLLAR BOUNCED BACK FROM BELOW 126 YEN THIS MORNING.

AFTER DROPPING TO 125.95 YEN THIS MORNING, THE DOLLAR RECOVERED TO A MIDDAY 126.30 YEN. IT OPENED HERE EARLIER TODAY AT 126.65 YEN.

23-DEC-0620 MON154 MONN REUTER

REUTER MONITOR 0524

P

FRANCE WELCOMES G-7 JOINT STATEMENT

PARIS, DEC 23 - FRANCE WELCOMES THE JOINT STATEMENT BY GROUP OF SEVEN FINANCE MINISTERS ON CURRENCY STABILISATION AND BELIEVES IT REPRESENTS A MORE PRECISE COMMITMENT TO PREVENTING A FURTHER DOLLAR FALL THAN THE FEBRUARY LOUVRE ACCORD, FRENCH FINANCE MINISTRY SOURCES SAID. NRFF

THEY POINTED TO A HARDENING OF LANGUAGE IN THE LATEST STATEMENT, REPLACING THE LOUVRE COMMITMENT TO STABILISE THE DOLLAR AT "AROUND" CURRENT LEVELS WITH A FIRM PLEDGE TO PREVENT ANY FURTHER FALL IN THE U.S. CURRENCY.

"IT IS A GOOD AGREEMENT," ONE SOURCE SAID.

23-DEC-0722 MON194 MONO

P

CONTINUED ON - NRFG

REUTER MONITOR 0524

FRANCE WELCOMES =2 PARIS

BUT, THE SOURCES SAID THE STATEMENT WAS NOT INTENDED TO COVER LONGER-TERM PROPOSALS PUT FORWARD BY FRENCH FINANCE MINISTER EDOUARD BALLADUR. NRFG

BALLADUR HAS SET OUT A LIST OF PROPOSALS FOR CONSIDERATION BY THE G-7, INCLUDING THE ESTABLISHMENT OF A PERMANENT SECRETARIAT TO MONITOR THE LOUVRE ACCORD, AND CLOSER HARMONISATION OF WORLD MARKETS TO HELP PREVENT THE VIOLENT FLUCTUATIONS OF RECENT WEEKS.

FRANCE BELIEVES IT WAS IMPORTANT TO ISSUE THE STATEMENT NOW TO SEND A SIGNAL TO THE MARKETS, RATHER THAN WAIT FOR ANY EVENTUAL FULL MEETING OF THE G-7 MINISTERS, THEY ADDED.

23-DEC-0725 MON198 MONO

CONTINUED FROM - NRFF

P

REUTER

REUTER MONITOR 0524

G-7 STATEMENT RAISES MORE QUESTIONS THAN ANSWERS NREL
BY ALAN WHEATLEY

WASHINGTON, DEC 23 - THE ABSENCE OF FRESH POLICY PROMISES TO REDRESS GLOBAL ECONOMIC IMBALANCES MAKES IT ONLY A MATTER OF TIME BEFORE THE FOREIGN EXCHANGE MARKET CHALLENGES THE GROUP OF SEVEN'S RENEWED RESOLVE TO DEFEND THE DOLLAR, DEALERS AND ECONOMISTS SAID.

"IT SEEMS TO ME THAT THEY DECLARED VICTORY AND WENT HOME," STEVE CERIER, FOREIGN EXCHANGE ANALYST AT MCCARTHY CRISANTI AND MAFFEI INC, SAID OF THE G-7 COMMUNIQUE, WHICH MAINLY HAILED ADJUSTMENTS ALREADY SET IN TRAIN. "ONE BAD TRADE NUMBER COULD JUST DEMOLISH THIS COMMUNIQUE COMPLETELY."

23-DEC-0622 MON155 MONN

CONTINUED ON - NREM

P

REUTER MONITOR 0524

G-7 STATEMENT =2 WASHINGTON NREM

INDEED, BY SPELLING OUT THAT CENTRAL BANKS WILL NOT TOLERATE A DESTABILIZING RISE IN THE DOLLAR, THE G-7 COULD PERPETUATE BEARISH SENTIMENT TOWARD THE CURRENCY, SOME DEALERS SAID. "IF THEY'RE THREATENING US WITH THE RISKS OF A HIGHER DOLLAR, WHO'S GOING TO BUY?" ONE NEW YORK TRADER SAID.

THE G-7 MAY BE SIMPLY ACKNOWLEDGING THAT GLOBAL TRADE IMBALANCES WILL REMAIN SO HUGE IN THE FORESEEABLE FUTURE THAT THE DOLLAR MUST NOT BE ALLOWED TO BOUNCE BACK SHARPLY FROM ITS 2-3/4 YEAR DECLINE, ANALYSTS SAID. YET IF THAT IS THE CASE, WHY WERE THERE NO CONCRETE PROMISES IN THE COMMUNIQUE OF FURTHER ACTION TO GET TO GRIPS WITH THE PROBLEMS, THEY ASKED.

23-DEC-0623 MON157 MONN

CONTINUED FROM - NREL

CONTINUED ON - NREN

P

REUTER MONITOR 0524

G-7 STATEMENT =3 WASHINGTON NREN

THE MEMBERS OF THE G-7 - THE U.S., JAPAN, WEST GERMANY, BRITAIN, FRANCE, CANADA AND ITALY - RE-EMPHASISED THEIR COMMON INTEREST IN STABLE EXCHANGE RATES.

THIS REPRESENTS A CHANGE IN POLICY BY THE U.S., WHICH SACRIFICED THE DOLLAR AFTER OCTOBER'S STOCK MARKET CRASH RATHER THAN KEEP INTEREST RATES HIGH AND RISK A RECESSION.

BUT THE G-7 COMMUNIQUE ENDORSED MONETARY POLICIES THAT AIM TO ACHIEVE STRONG ECONOMIC GROWTH, SUGGESTING THAT WASHINGTON IS STILL NOT WILLING TO RAISE INTEREST RATES IF NEED BE. A REAGAN ADMINISTRATION OFFICIAL WHO BRIEFED REPORTERS REFUSED TO DISCUSS THE MONETARY POLICY IMPLICATIONS OF THE NEW ACCORD.

23-DEC-0624 MON158 MONN

CONTINUED FROM - NREM

G-7 STATEMENT =4 WASHINGTON
"WHAT HAVE THEY DONE TO CHANGE THE RISK/REWARD RATIO FOR A GUY LIKE ME OF SELLING THE DOLLAR?" THE NEW YORK DEALER ASKED. HE DISMISSED THE G-7 COMMUNIQUE AS FLUFF.

THE U.S. MADE NO NEW COMMITMENTS TO REDUCE ITS BUDGET DEFICIT BEYOND THE 76 BILLION DLRS IN SAVINGS CONTAINED IN THE LEGISLATION THAT PRESIDENT REAGAN SIGNED ON TUESDAY, SAVINGS THAT ECONOMISTS EXPECT WILL SIMPLY STOP THE DEFICIT FROM RISING IN FISCAL 1988 AND 1989 FROM 148 BILLION DLRS IN 1987.

AND WEST GERMANY MADE NO NEW PLEDGES EVEN THOUGH IT HAS JUST SCALED DOWN ITS ESTIMATE OF GROWTH IN 1988 TO BETWEEN 1.5 AND TWO PCT FROM A PREVIOUS RANGE OF 2.25 TO 2.5 PCT.

23-DEC-0626 MON160 MONN

CONTINUED ON - NREP

CONTINUED FROM - NREN

P

REUTER MONITOR 0524

NREP

G-7 STATEMENT =5 WASHINGTON
REAGAN ADMINISTRATION OFFICIALS ARE CONFIDENT THAT THE NEW AGREEMENT WILL WORK BECAUSE THEY SAY SIGNIFICANT POLICY ADJUSTMENTS HAVE BEEN MADE THIS YEAR AND THE DOLLAR IS NOW AT MUCH LOWER AND, THEREFORE, MORE SUSTAINABLE LEVELS.

BUT CHARLES TAYLOR, AN ECONOMIST WITH PRUDENTIAL-BACHE IN WASHINGTON, SAID NOT ENOUGH HAS BEEN DONE TO ADDRESS THE FUNDAMENTAL IMBALANCES OF THE WORLD ECONOMY AND THIS BODES ILL FOR THE NEW PACT.

"I SEE NO REASON TO BELIEVE IT WILL STICK BETTER THAN THE LOUVRE ACCORD," HE SAID, REFERRING TO THE LAST MAJOR G-7 INITIATIVE SIGNED AT THE FRENCH FINANCE MINISTRY IN FEBRUARY.

23-DEC-0627 MON161 MONN

CONTINUED ON - NREQ

CONTINUED FROM - NREO

P

REUTER MONITOR 0524

NREQ

G-7 STATEMENT =6 WASHINGTON
THE G-7'S ATTEMPT TO PUT A FLOOR UNDER THE DOLLAR AROUND CURRENT LEVELS OF 126 YEN AND 1.62 MARKS MAY INHIBIT RECKLESS SPECULATION, BUT IT WILL BE VERY DIFFICULT TO GET PEOPLE TO BUY DOLLARS UNLESS THE U.S. ECONOMY STARTS TO GROW MORE SLOWLY, TAYLOR SAID.

BECAUSE OF THE ECONOMY'S RESILIENCE, IMPORT VOLUMES HAVE REMAINED HIGH AND THE TRADE GAP WIDE, HE EXPLAINED.

CERIER AT MCCARTHY CRISANTI SAID THE ONLY EFFECTIVE WAY TO REDUCE THE TRADE DEFICIT IS VIA A RECESSION THAT CURBS IMPORT DEMAND, BUT THE G-7 (ESPECIALLY THE U.S. IN AN ELECTION YEAR) IS UNWILLING FOR NOW TO CONTEMPLATE SUCH DRASTIC MEDICINE.

23-DEC-0628 MON163 MONN

CONTINUED ON - NRER

CONTINUED FROM - NREP

P

REUTER MONITOR 0524

NRER

G-7 STATEMENT =7 WASHINGTON
"THEY'RE IN A MESS AND THEY HAVEN'T INCREASED THE MARKETS' CONFIDENCE THAT THEY KNOW HOW TO GET OUT OF IT," HE SAID.

IF THE U.S. IS UNWILLING TO RAISE INTEREST RATES TO LEVELS THAT WILL RENEW INFLOWS OF PRIVATE CAPITAL, CENTRAL BANKS WILL HAVE TO CONTINUE TO FINANCE THE U.S. DEFICITS, ECONOMISTS SAY.

JAPANESE FINANCE MINISTER KIICHI MIYAZAWA SAID ON WEDNESDAY THAT STRONGER CENTRAL BANK INTERVENTION CAN BE EXPECTED AS PART OF THE NEW G-7 ACCORD.

BUT CENTRAL BANKS HAVE ALREADY BOUGHT MORE THAN 100 BILLION DLRS THIS YEAR, BEGGING THE ISSUE OF JUST HOW MANY MORE DOLLARS THEY CAN ABSORB WITHOUT REKINDLING INFLATION.

23-DEC-0629 MON164 MONN

CONTINUED ON - NRES

CONTINUED FROM - NREQ

P

REUTER MONITOR 0524

G-7 STATEMENT =8 WASHINGTON NRES

FEARS THAT DOMESTIC MONEY SUPPLY GROWTH WAS GETTING OUT OF HAND BECAUSE OF DOLLAR-SUPPORT INTERVENTION WAS A MAJOR FACTOR BEHIND THE BUNDESBANK INTEREST-RATE INCREASES IN SUMMER WHICH CONTRIBUTED GREATLY TO THE COLLAPSE OF THE LOUVRE ACCORD.

MOREOVER, AS CHRIS BOURDAIN OF BANKAMERICA IN NEW YORK SAID, "INTERVENTION ONLY WORKS WHEN THE MARKET IS OVERBOUGHT OR OVERSOLD." HE EXPECTS THE DOLLAR TO HEAD LOWER IN 1988.

THE CHRISTMAS LULL MAY GIVE THE DOLLAR A RESPITE, BUT UNTIL THE U.S. TRADE BALANCE STARTS TO SHOW A SUSTAINED IMPROVEMENT, DEALERS SAY THEY WILL ONLY BE TOO HAPPY IN THE NEW YEAR TO PICK UP THE GAUNTLET THAT THE G-7 HAS THROWN DOWN.

23-DEC-0633 MON169 MONN

CONTINUED FROM - NRER REUTER

P

G-7 CALLS FURTHER DOLLAR FALL COUNTERPRODUCTIVE NRBZ

WASHINGTON, DEC 22 - THE GROUP OF SEVEN (G-7) MAJOR INDUSTRIAL NATIONS SAID A FURTHER DECLINE OF THE DOLLAR OR A DESTABILIZING RISE IN THE CURRENCY COULD BE COUNTERPRODUCTIVE BY DAMAGING PROSPECTS FOR WORLD ECONOMIC GROWTH.

"THE (G-7) AGREED THAT EITHER EXCESSIVE FLUCTUATION OF EXCHANGE RATES, A FURTHER DECLINE OF THE DOLLAR, OR A RISE IN THE DOLLAR TO AN EXTENT THAT BECOMES DESTABILIZING TO THE ADJUSTMENT PROCESS, COULD BE COUNTERPRODUCTIVE BY DAMAGING GROWTH PROSPECTS IN THE WORLD ECONOMY," ACCORDING TO A G-7 STATEMENT ISSUED SIMULTANEOUSLY HERE AND IN THE OTHER SIX CAPITALS.

23-DEC-0300 MON028 MONL

CONTINUED ON - NRCA

P

REUTER MONITOR 0524

G-7 CALLS =2 WASHINGTON NRCB

THE G-7, WHICH GROUPS THE UNITED STATES, JAPAN, WEST GERMANY, BRITAIN, FRANCE AND CANADA, SAID THE BASIC OBJECTIVES AND ECONOMIC POLICY DIRECTIONS SET FORTH IN THEIR LOUVRE ACCORD OF LAST FEBRUARY REMAIN VALID AND PROVIDE FOR A POSITIVE DEVELOPMENT OF THE WORLD ECONOMY.

"THE MARKED EXCHANGE RATE CHANGES OVER THE PAST FEW WEEKS, HOWEVER, STRESS THE NEED TO STRENGTHEN UNDERLYING ECONOMIC FUNDAMENTALS AND TO CONTINUE POLICY COOPERATION," IT SAID.

THE STATEMENT SAID FINANCE MINISTERS AND CENTRAL BANK GOVERNORS AGREED TO INTENSIFY ECONOMIC POLICY COORDINATION BUT DID NOT SPELL OUT IN MUCH DETAIL THE NEW MEASURES TO BE TAKEN.

23-DEC-0301 MON032 MONL

CONTINUED FROM - NRCA CONTINUED ON - NRCC

P

REUTER MONITOR 0524

G-7 CALLS =3 WASHINGTON NRCC

THE G-7 ALSO AGREED THAT MONETARY POLICIES SHOULD CONTINUE TO BE GEARED TOWARD ACHIEVING STRONG NON-INFLATIONARY ECONOMIC GROWTH AS WELL AS FOSTERING FINANCIAL MARKET STABILITY.

THE GROUP BELIEVES THAT, WITH SOUND ECONOMIC POLICIES AND EFFECTIVE COORDINATION, ECONOMIC GROWTH SHOULD BE SUBSTANTIAL.

ON THE DOLLAR, THE G-7 NATIONS RE-EMPHASISED THEIR "COMMON INTEREST" IN MORE STABLE CURRENCY RATES AND AGREED TO COOPERATE CLOSELY ON THE FOREIGN EXCHANGE MARKETS.

A SENIOR REAGAN ADMINISTRATION OFFICIAL SAID THERE WAS AN EXPLICIT AGREEMENT AMONG SOME MEMBERS OF THE G-7 AS TO WHAT WOULD CONSTITUTE A DESTABILIZING RISE IN THE DOLLAR.

23-DEC-0304 MON044 MONL

CONTINUED FROM - NRCB CONTINUED ON - NRCD

P

REUTER MONITOR 0524

G-7 CALLS =4 WASHINGTON NRCD

THE OFFICIAL, WHO BRIEFED REPORTERS ON CONDITION HE NOT BE NAMED, DECLINED TO SAY WHICH NATIONS REACHED THAT AGREEMENT, WHAT LEVELS THEY HAVE IN MIND, OR WHAT COMMITMENTS MAY HAVE BEEN MADE TO INTERVENE IN THE FOREIGN EXCHANGE MARKET.

THE U.S. HAS BOUGHT DOLLARS PERIODICALLY THIS YEAR BUT ALSO SOLD DOLLARS IN MARCH AND AUGUST WHEN IT THREATENED TO RISE ABOVE 1.90 MARKS, DEALERS RECALLED.

ASKED WHETHER THE G-7 HAD ALSO AGREED ON THE BOTTOM OF THE DOLLAR'S RANGE, THE OFFICIAL REFUSED TO ACKNOWLEDGE THAT THERE WAS A RANGE AND REFERRED REPORTERS REPEATEDLY TO THE SECTION OF THE COMMUNIQUE OPPOSING ANY FURTHER DECLINE IN THE DOLLAR.

23-DEC-0315 MON061 MONL

CHANCELLOR 12/12

A, B, C;
PO's

G-7 STATEMENT IMPORTANT FOR EUROPE - STOLTENBERG NRGN

BONN, DEC 23 - WEST GERMAN FINANCE MINISTER GERHARD STOLTENBERG SAID THE OVERNIGHT JOINT STATEMENT BY THE GROUP OF SEVEN (G-7) NATIONS REAFFIRMING CURRENCY STABILITY WAS PARTICULARLY IMPORTANT FOR EUROPE.

"THIS COOPERATION IS ABOVE ALL OF GREAT SIGNIFICANCE FOR THE EUROPEAN STATES," STOLTENBERG SAID IN A STATEMENT RELEASED BY THE FINANCE MINISTRY.

HE ADDED THAT G-7 COOPERATION HAD PROVEN ITSELF ADMIRABLY WITHIN THE EUROPEAN MONETARY SYSTEM (EMS) DURING THE RECENT TURBULENCE ON GLOBAL FINANCIAL MARKETS. IN ADDITION, THE EMS ITSELF HAD BECOME A STABILISING FACTOR FOR THE MARKETS.

23-DEC-1016 MON430 MONQ

P

CONTINUED ON - NRGO

REUTER MONITOR 0803

G-7 STATEMENT IMPORTANT =2 BONN NRGO

STOLTENBERG'S STATEMENT, WHICH SUMMARISED THE G-7 STATEMENT REPORTED BY REUTERS FROM WASHINGTON, SAID THE RENEWED G-7 COOPERATION WOULD ALSO BE OF GREAT IMPORTANCE FOR CONTROLLING THE INTERNATIONAL DEBT CRISIS.

STOLTENBERG REPEATED THE G-7 CALL ON NEWLY INDUSTRIALISED ASIAN COUNTRIES TO PARTICIPATE IN THE ECONOMIC AND CURRENCY COOPERATION ALREADY EXISTING AMONG THE WORLD'S LEADING INDUSTRIALISED STATES TO REDRESS GLOBAL ECONOMIC IMBALANCES.

23-DEC-1029 MON449 MONQ

CONTINUED FROM - NRGN

P

REUTER

REUTER MONITOR 0803

CHANCELLOR 12/2

A.B.C.
PO'S

BANGEMANN WELCOMES G-7 ANTI-PROTECTIONIST VOWS NRGT

BONN, DEC 23 - WEST GERMAN ECONOMICS MINISTER MARTIN BANGEMANN WELCOMED THE STATEMENT BY THE GROUP OF SEVEN (G-7) LEADING NATIONS AND IN PARTICULAR THEIR DETERMINATION TO STOP PROTECTIONIST TRADE POLICIES.

A STATEMENT ISSUED BY BANGEMANN'S MINISTRY SAID: "THE MINISTER STRESSED, ABOVE ALL, THE VIEW THAT PROTECTIONIST MEASURES MUST BE DECIDEDLY REJECTED AS A MEANS OF COMBATTING TRADE IMBALANCES."

TO THIS EXTENT, WEST GERMANY WOULD CONSTRUCTIVELY SUPPORT NEGOTIATIONS AT THE GATT (GENERAL AGREEMENT ON TARIFFS AND TRADE) ON FREE INTERNATIONAL TRADE.

23-DEC-1048 MON471 MONR

CONTINUED ON - NRGU

P

REUTER MONITOR 0803

BANGEMANN WELCOMES =2 BONN NRGU

"THE WEST GERMAN GOVERNMENT WILL DO ALL IT CAN TO SPEED UP PROGRESS AT THE GENEVA (GATT) NEGOTIATIONS," BANGEMANN'S STATEMENT SAID.

WEST GERMANY WOULD URGE THE EUROPEAN COMMUNITY TO MAKE ITSELF A GOOD EXAMPLE OF AN OPEN MARKET, HE ADDED.

WEST GERMANY IS DUE TO TAKE OVER THE ROTATING EC PRESIDENCY ON JANUARY 1, 1988.

"ONLY IN A FREE GLOBAL ECONOMIC SYSTEM CAN ECONOMIC PROBLEMS BE SOLVED IN THE FUTURE IN A SATISFACTORY WAY," BANGEMANN SAID.

AAMM 1118 STOLTENBERG, BANGEMANN SEE DOLLAR UNDERVALUED, RISE POSSIBLE -FINANCE MINISTRY REUTER

P

REUTER MONITOR 0803

A,B,C, Miss O'Mara all PO's.

SUMITA SAYS CURRENCY MARKETS NEED G-7 REASSURANCE NRLZ

TOKYO, DEC 22 - BANK OF JAPAN GOVERNOR SATOSHI SUMITA SAID IT WOULD BE MEANINGFUL TO REASSURE THE MARKETS OF THE COMMITMENT BY THE GROUP OF SEVEN (G-7) INDUSTRIAL COUNTRIES TO COORDINATE POLICIES TO PREVENT THE FURTHER DECLINE OF THE DOLLAR, A JAPANESE NEWSPAPER REPORTED.

THE NIKKAN KOGYO SHIMBUN SAID SUMITA'S REMARKS INDICATED THE G-7 WAS LIKELY TO ISSUE SUCH A STATEMENT AFTER THE U.S. CONGRESS PASSES LEGISLATION CUTTING THE U.S. BUDGET DEFICIT.

THE DAILY QUOTED THE CENTRAL BANK GOVERNOR AS SAYING IN AN INTERVIEW THAT PASSAGE OF SUCH LEGISLATION WOULD HELP CALM THE CURRENCY MARKETS.

22-DEC-0148 MON749 MONK

P REUTER

COMMODITIES - INFO 0933

SECRET

From: Sir G.Littler
Date: 2 December 1987

CHANCELLOR

c.c. Sir P.Middleton
Sir T.Burns

MESSAGE TO G7 COLLEAGUES

Here is now a further version, agreed with Sir P,Middleton and Sir T.Burns.

2. A possible extra thought we mentioned this morning might take some such form as the following, but all three of us think are on reflection against including this:

> "In thinking about a possible early meeting, we need to weigh the risks we could face if markets reacted with disappointment to the outcome. Lack of an early meeting may itself be damaging, but we would have one course open to us which could help: actions are being taken - we could each make statements nationally which welcomed such actions and made a point of showing their positive value internationally, and we would leave the possibility of further joint action still as a future possibility."

(Geoffrey Littler)

SECRET

DRAFT MESSAGE TO BAKER

Copied: Stoltenberg, Balladur, Miyazawa, Amato, Wilson.

I thought it might be helpful if I shared with you and our G7 colleagues my thoughts on what we need as the basis for a successful G7 agreement.

We can all welcome the actions taken and proposed in relation to economic fundamentals: in particular the United States action on the fiscal deficit and the action which I believe Gerhardt and Kiichi will be aiming to take in their budgets for 1988. These joint moves should reinforce each other. We must get them properly understood as important moves in the direction of better equilibrium which do not add to risks of either recession or inflation. We must also make it clear that we all intend to persevere with whatever further measures may become necessary later.

But this alone will not be enough. I am convinced we must address the two basic and linked problems of exchange rates and the financing of the United States fiscal and current account deficits.

With the best will in the world - on the part of all of us - the United States are bound for some time to run substantial though diminishing deficits. And these deficits, even allowing for some improvement in domestic savings following the Stock Market fall, mean the United States still has to attract large net capital inflows from other countries.

Official intervention has in effect financed the major part of your external deficit this year. Though intervention has an important role to play, it obviously cannot be the sole or major source of external funds. Ideally, we all want spontaneous private flows to meet this need.

I believe it is unrealistic to hope to restore sufficient private capital flows to the U.S. as long as the market harbours expectations of dollar depreciation, which could be self-fulfilling.

Unless we can cooperate to prevent it, I see a real risk of further dollar depreciation spiralling out of control. All experience suggests that markets overshoot badly - waiting for the moment when sentiment turns to belief that future movements can only be upwards. Enormous damage could be done in this process - and it could hit us all quite quickly. I cannot see how the United States could avoid inflationary consequences - while the markets would inevitably drive up your interest rates. I am sure, too, that this would open the door to much greater risks of recession - in all our countries.

This is why I think it vital that - in order to put the United States in a more secure funding situation - we should restore the expectation of dollar stability. We need to do so openly and convincingly, and to equip ourselves to demonstrate that the unavoidable further deficits can be financed. It will not be enough to rely on vague statements of hopes and intentions.

We need clear agreements. In particular:

- we must emphasise that the current levels of our G7 exchange rates (some NICs are different) reflect fundamentals in the sense that they are consistent with the eventual adjustment of the major imbalances, given the policies we have put in place and intend to continue;
- we must all be prepared to commit ourselves to use monetary policy to encourage the needed capital flows at these exchange rates: this may not be easy and may require compromises with other domestic objectives at first, but would become easier once we recreate the expectation of stability;
- we need to demonstrate that we have resources for official funding which will still be needed from time to time if the market tests our resolution;
- the United States could make a major contribution to confidence and directly to the funding of your deficits if you undertook some sizeable borrowing in foreign currencies: this would also minimise the risks of a rise in United States interest rates. I am sure we would all be ready to help on both the substance and the presentation of this.

I repeat: we cannot afford to be vague; and none of us can afford an uncontrolled further dollar decline, because of the damage it would quickly do in both recession risks and inflation risks.

Thanks. OK as revised. X (or even an agreed communiqué ~~[illegible]~~ without a meeting!) is an idea we can broach on the telephone. N.

SECRET

From: Sir G.Littler
Date: 2 December 1987

CHANCELLOR

c.c. Sir P.Middleton
Sir T.Burns

MESSAGE TO G7 COLLEAGUES

Here is now a further version, agreed with Sir P,Middleton and Sir T.Burns.

2. A possible extra thought we mentioned this morning might take some such form as the following, but all three of us think are on reflection against including this:

X

> "In thinking about a possible early meeting, we need to weigh the risks we could face if markets reacted with disappointment to the outcome. Lack of an early meeting may itself be damaging, but we would have one course open to us which could help: actions are being taken - we could each make statements nationally which welcomed such actions and made a point of showing their positive value internationally, and we would leave the possibility of further joint action still as a future possibility."

(Geoffrey Littler)

Please type for Ch's signature. addressed to Baker. (James, the US Treasury man)

SECRET

~~**DRAFT MESSAGE TO BAKER**~~

~~Copied: Stoltenberg, Balladur, Miyazawa, Amato, Wilson.~~

I thought it might be helpful if I ~~shared with~~ write to you and ~~our~~ other G7 colleagues ~~my thoughts on what~~ to spell out what I believe we need as the basis for a successful G7 agreement.

We can, of course, all welcome the actions taken and proposed ~~in relation to~~ on economic fundamentals: in particular the promised United States action on the fiscal deficit and the action which ~~I believe~~ Germany has announced for its 1988 Budget. I believe Japan will similarly aim to take appropriate fiscal action in 1988. ~~Gerhardt and Kiichi will be aiming to take in their budgets for 1988.~~ These joint moves should reinforce each other. We must get them properly understood as important moves ~~in the direction of better equilibrium~~ to help correct imbalances, and ones which do not add to risks of either recession or inflation. We must also make it clear that we all intend to persevere with whatever further measures may become necessary later.

But this alone will not be enough. I am convinced we must address the two basic and linked problems of exchange rates and the financing of the United States fiscal and current account deficits.

With the best will in the world - on the part of all of us - the United States ~~are~~ is bound for some time to run substantial though diminishing deficits. And these deficits, even allowing for some improvement in domestic savings following the Stock Market fall, mean the United States still has to attract large net capital inflows from other countries.

SECRET

Official intervention has in effect financed the major part of ~~your~~ the United States' external deficit this year. Though intervention has an important role to play, it obviously cannot be the sole or major source of external funds. ~~Ideally, we all want s~~Spontaneous private flows have ~~to~~ meet this need.

I believe it is unrealistic to hope to restore sufficient private capital flows to the U.S. as long as the market harbours expectations of dollar depreciation, which could be self-fulfilling.

Unless we can cooperate to prevent it, I see a real risk of further dollar depreciation spiralling out of control. All experience suggests that financial markets, left to their own devices, overshoot badly, ~~- waiting for the moment when~~ until such time as sentiment turns and the ~~to~~ belief forms that future movements can only be upwards. Enormous damage could be done in this process. ~~- and it could hit us all quite quickly.~~ I cannot see how the United States could avoid serious inflationary consequences, ~~- while the~~ and sooner or later the markets would inevitably drive up ~~your~~ US interest rates. I am sure, too, that this would open the door to much greater risks of recession - in all our countries.

This is why I think it is vital that ~~- in order to put the United States in a more secure funding situation -~~ we should restore the expectation of dollar stability. We need to do ~~so~~ this openly and convincingly, and to equip ourselves with the necessary ~~ammunition~~ means ~~to demonstrate that the unavoidable further deficits can be financed~~ to do so. It will not be enough to rely on vague statements of hopes and intentions.

SECRET

We need clear agreements. In particular:

- we must ~~emphasise~~ spell out our view that the current levels of ~~our~~ G7 exchange rates ~~(some NICs are different)~~ do reflect economic fundamentals, in the sense that they are consistent with the eventual adjustment of the major imbalances, given the policies we have put in place and intend to continue;
- we must all be prepared to commit ourselves to use monetary policy to encourage the needed capital flows at these exchange rates: this may not be easy and may require compromises with other domestic objectives at first, but would become much easier once we recreate the expectation of stability;
- we need to demonstrate that we have resources for official funding which will still be needed from time to time if the market tests our resolution;
- the United States could make a major contribution to confidence ~~and directly to the funding of your~~ its ~~deficits~~ if ~~you~~ it undertook some sizeable borrowing in foreign currencies: this would also minimise the risks of a rise in United States interest rates. I am sure we would all be ready to help on both the substance and the presentation of this.

~~I repeat:~~ We cannot afford to be vague; and none of us can ~~afford~~ responsibly allow an uncontrolled further dollar decline, ~~because of~~ given the damage it would quickly do in terms of both recession risks and of inflation risks.

I am sending a copy of this letter to our other G7 colleagues.

NIGEL LAWSON

SECRET

From: Sir G.Littler
Date: 1 December 1987

CHANCELLOR

c.c. Sir P.Middleton
Sir T.Burns

POSSIBLE MESSAGE TO G7 COLLEAGUES

Here is a revised version, incorporating your ms comments and one or two points Sir T. Burns suggested (I have marked these in pencil on the top copy only).

2. It occurred to us to wonder whether G7 or G5. I do not feel strongly, but on balance I recommend G7 - influenced by the embarrassment for you if it got known to the other two that there was a document by you not shared with them!

(Geoffrey Littler)

~~Ch~~
~~PRM's comments on~~
~~separate copy below.~~
~~AA~~

SECRET

DRAFT MESSAGE TO BAKER

Copied: Stoltenberg, Balladur, Miyazawa, Amato, Wilson.

I thought it might be helpful if I shared with you and our G7 colleagues my thoughts on what we need as the basis for a successful G7 agreement.

I take for granted the need for actions taken and proposed in relation to the economic fundamentals, in particular your own action on the fiscal deficit (we have all welcomed your success in getting a set of two-year proposals agreed so far) and the action which I believe Gerhardt and Kiichi will be aiming to take in their budgets for 1988. These joint moves should reinforce each other and we must get them properly understood as important moves in the direction of better equilibrium which do not add to risks of either recession or inflation. We must also make it clear that we all intend to persevere with whatever further corrective measures may become necessary later.

But this alone will not be enough. I am convinced we must address the two basic and linked problems of our exchange rates and the financing of your two deficits which is still going to be required.

With the best will in the world - on the part of all of us - you are bound to run a very substantial deficit on current account, even though we hope diminishing, for quite some time. That has to be financed by net capital inflows from abroad.

Ideally, we all want spontaneous private flows to meet this need. We had this - perhaps too much of it - during the period of the very strong dollar, on the back of vigorous U.S. growth, profitable investment opportunities, high interest rates and hopes of further dollar appreciation. Once the dollar began to fall, as we all agreed it had to, however, this capital flow became more reluctant and the dollar exchange rate fell sharply. Although we managed jointly to stabilise the dollar for most of this year, we have to recognise that we did not immediately recreate the confidence for private capital flows to resume - and if we did achieve that for a time in the late summer we have lost it again. Indeed official intervention has in effect financed the major part of your 1987 external and internal deficits.

The combined fiscal and other actions we now expect to see taken should help reduce the scale of the underlying imbalance. And the stock market collapse may increase your domestic savings rate. But a large gap will remain to be filled.

X Omission

I believe it is unrealistic to hope to restore private capital flows to the U.S. as long as the market harbours expectations of dollar depreciation: even a large interest rate differential might be only partially effective. And to rely on a lower dollar to do the trick could mean waiting until the dollar fell a very long way indeed.

I see a real risk of further dollar depreciation spiralling out of control. All experience suggests that the markets could overshoot badly - waiting for the moment when sentiment turns to belief that future movements can only be upwards. I fear that enormous damage would be done in the process - and it could hit us all quite quickly. I cannot see how in that situation you could avoid inflationary consequences - while the markets would inevitably drive up your interest rates. I am sure, too, that this would open the door to much greater risks of recession - a recession that would hurt us all.

This is why I think it vital that we should restore expectations of dollar stability, that we should do so openly and convincingly, and that we should equip ourselves to demonstrate that your unavoidable further deficits can be financed.

There is no point in relying on vague statements of hopes and intentions. My prescription would include:

- we must emphasise that the current levels of our G7 exchange rates (some NICs are different) reflect fundamentals in the sense that they are consistent with the eventual adjustment of the major imbalances, especially your current account deficit - given the policies we have put in place and intend to continue;
- we must all be prepared to commit ourselves to use monetary policies to encourage the needed capital flows - which may not be easy and may require compromises at first, but should become easier if we can recreate some expectation of stability;

- we need to demonstrate that we have resources for official funding at need; but we do not want to rely excessively on this source of capital flows;
- you could make a major contribution by undertaking some sizeable borrowing in foreign currencies, which would give the huge advantage of covering part of the financing need with minimal adverse impact on your own interest rates. I am sure we would all be ready to help on both the substance and the presentation of this.

I repeat: we cannot afford to be vague; and none of us - including the United States - can afford an uncontrolled further dollar decline, because of the damage it would quickly do in both recession risks and inflation risks.

SECRET

From: Sir G.Littler
Date: 1 December 1987

SIR TERENCE BURNS

c.c. Sir P.Middleton
Mr Alex Allan

POSSIBLE MESSAGE TO G7 COLLEAGUES

Thank you for your notes. I have had a shot at a possible draft message from the Chancellor to G7 colleagues. I have used your material fairly closely, except that I have omitted the opening link between budget deficit, savings and current deficit - knowing how much the U.S. dislike that analysis.

2. Any further thoughts?

(Geoffrey Littler)

Ch

This is early draft - but any comment of substance / structure to feed in now?

AA

Meanwhile, I would like to see PM's comments and others in

a few comments - next draft. I will look again @ next stage.

SECRET

DRAFT MESSAGE TO BAKER

Copied: Stoltenberg, Balladur, Amato, Miyazawa, Wilson.

~~I think we and all our G7 colleagues share a wish to re-establish public and effective cooperation. But ~~a~~ any G7 meeting ~~now~~ is bound to be looked at very critically by press and markets - to such an extent that we could risk doing grave damage by a meeting which ~~somehow~~ failed to pass that test. At the same time failure to hold a meeting soon might also do damage if it were read as showing that we could not agree.~~

~~Against this background~~ I thought it might be helpful if I shared with you and ~~others in advance my own~~ our G7 colleagues my thoughts on what we need as ~~a~~ the basis ~~of~~ for a successful G7 agreement ~~an agreement.~~

I take for granted the need for actions directed at the economic fundamentals, in particular your own action on the fiscal deficit (we have all welcomed your success in getting a set of two-year proposals agreed so far) and the action which I believe Gerhardt and Kiichi will be aiming to take in their budgets for 1988. These joint moves must reinforce each other and should be - and be seen to be - moves in the direction of better equilibrium without adding to risks of either recession or inflation. We must also make it clear that we all intend to persevere with whatever further corrective measures may become necessary later.

But this alone will not be enough. I am convinced we must address the two basic and linked problems of our exchange rates and the financing of your two deficits which is still going to be required.

With the best will in the world - on the part of all of us - you are bound to run a very substantial deficit on current account, even though we hope diminishing, for quite some time. ~~It~~ They has to be financed by ~~some forms of~~ net capital inflows from abroad.

Ideally, we all want spontaneous private flows to meet this need. We had this - perhaps too much of it - during the period of the very strong dollar, on the back of vigorous U.S. growth, profitable investment opportunities, high interest rates and hopes of further dollar appreciation. Once the dollar began to fall, as we all agreed it ~~must,~~ had to, however, this capital flow became more reluctant and the dollar exchange rate fell sharply. Although we managed jointly to stabilise the dollar for most of this year, we have to recognise that we did not immediately recreate the confidence for private capital flows to resume - and if we did achieve that for a time in the late summer we have lost it again. Indeed official intervention has in effect financed the major part of your 1987 external and internal deficits.

SECRET

The combined fiscal and other actions we now expect to see taken should help reduce the scale of the underlying imbalance. And the stock market collapse ~~will possibly~~ may ~~add to~~ increase your domestic savings rate (although it may also add a little ~~back~~ to your budget deficit for cyclical reasons). But a large gap will remain to be filled.

I believe it is unrealistic to hope to restore private capital flows to the U.S. as long as the market harbours expectations of dollar depreciation: ~~- unless this was offset by~~ even a large interest rate differential ~~. And to~~ might be only partially effective. And to rely on a lower dollar to do the trick could mean waiting until the dollar fell a very long way, indeed.

I see a real risk of ~~our losing control of~~ further dollar depreciation spiralling out of control. All experience suggests that the markets could overshoot badly - waiting for the moment when sentiment turns to belief that future movements can only be upwards. I fear that enormous damage would be done in the process - and or could hit us all quite quickly. I cannot see how in that situation you could avoid inflationary ~~effects and~~ consequences - while markets would ~~carry~~ inevitably drive up your interest rates ~~up~~. I am sure, too, that ~~that we~~ this would ~~have~~ opened the door to much greater risks of recession - a recession that would hurt us all.

1978 experience

NBL

Re

This is why I think it vital that we should restore expectations of dollar stability, that we should do so openly and convincingly, and that we should equip ourselves to demonstrate that your unavoidable further deficits can be financed.

SECRET

There is no point in relying on vague statements of hopes and intentions. My prescription would include:

- we must emphasise that the current levels of our G7 exchange rates (some NICs are different) reflect fundamentals in the sense that they are consistent with the eventual adjustment of the major imbalances, especially your current account deficit;
- we must all be prepared to use monetary policies to encourage the needed capital flows - which may not be easy and may require compromises at first, but should become easier if we can recreate some expectation of stability;
- we need to demonstrate that we have resources for official funding at need; but we do not want to rely excessively on this source of capital flows;
- ~~ideally, as you know, I believe~~ you could make a major contribution by undertaking some sizable borrowing in foreign currencies, which ~~- we would all be ready to help in substance and presentation I am sure - and it~~ would give the huge advantage of covering part of the financing need with minimal adverse impact on your own interest rates. I am sure we would all be ready to help with the substance and presentation of this.

I repeat: we cannot afford to be vague; and none of us - including ~~you~~ the United States - can afford an uncontrolled further dollar decline, because of the damage it would quickly do in both recession risks and inflation risks.

pp

SECRET

From: Sir G.Littler
Date: 2 December 1987

CHANCELLOR

c.c. Sir P.Middleton
Sir T.Burns

MESSAGE TO G7 COLLEAGUES

Here is now a further version, agreed with Sir P,Middleton and Sir T.Burns.

2. A possible extra thought we mentioned this morning might take some such form as the following, but all three of us think are on reflection against including this:

> "In thinking about a possible early meeting, we need to weigh the risks we could face if markets reacted with disappointment to the outcome. Lack of an early meeting may itself be damaging, but we would have one course open to us which could help: actions are being taken - we could each make statements nationally which welcomed such actions and made a point of showing their positive value internationally, and we would leave the possibility of further joint action still as a future possibility."

(Geoffrey Littler)

SECRET

DRAFT MESSAGE TO BAKER

Copied: Stoltenberg, Balladur, Miyazawa, Amato, Wilson.

I thought it might be helpful if I shared with you and our G7 colleagues my thoughts on what we need as the basis for a successful G7 agreement.

We can all welcome the actions taken and proposed in relation to economic fundamentals: in particular the United States action on the fiscal deficit and the action which I believe Gerhardt and Kiichi will be aiming to take in their budgets for 1988. These joint moves should reinforce each other. We must get them properly understood as important moves in the ~~direction~~ correction of ~~better equilibrium~~ imbalances which do not add to risks of either recession or inflation. We must also make it clear that we all intend to persevere with whatever further measures may become necessary later.

we're not really in equilibrium at the moment: could 'better' be deleted?

But this alone will not be enough. I am convinced we must address the two basic and linked problems of exchange rates and the financing of the United States fiscal and current account deficits.

With the best will in the world - on the part of all of us - the United States ~~are~~ is bound for some time to run substantial though diminishing deficits. And these deficits, even allowing for some improvement in domestic savings following the Stock Market fall, mean the United States still has to attract large net capital inflows from other countries.

plural or singular?

SECRET

Official intervention has in effect financed the major part of your external deficit this year. Though intervention has an important role to play, it obviously cannot be the sole or major source of external funds. Ideally, we all want spontaneous private flows to meet this need.

I believe it is unrealistic to hope to restore sufficient private capital flows to the U.S. as long as the market harbours expectations of dollar depreciation, which could be self-fulfilling.

Unless we can cooperate to prevent it, I see a real risk of further dollar depreciation spiralling out of control. All experience suggests that financial markets overshoot badly until ~~- waiting for the moment when~~ sentiment turns to the belief that future movements can only be upwards. Enormous damage could be done in this process ~~-~~ which ~~and it~~ could hit us all quite quickly. I cannot see how the United States could avoid inflationary consequences ~~-~~ while the markets would inevitably drive up your interest rates. I am sure, too, that this would open the door to much greater risks of recession ~~-~~ in all our countries.

there are a lot of hyphens in this section; as a result it doesn't read easily

This is why I think it vital that - in order to put the United States in a more secure funding situation - we should restore the expectation of dollar stability. We need to do so openly and convincingly, and to equip ourselves to demonstrate that the unavoidable further deficits can be financed. It will not be enough to rely on vague statements of hopes and intentions.

SECRET

We need clear agreements. In particular:

- we must emphasise that the current levels of our G7 exchange rates (some NICs are different) reflect fundamentals in the sense that they are consistent with the eventual adjustment of the major imbalances, given the policies we have put in place and intend to continue;
- we must all be prepared to commit ourselves to use monetary policy to encourage the needed capital flows at these exchange rates: this may not be easy and may require compromises with other domestic objectives at first, but would become easier once we recreate the expectation of stability;
- we need to demonstrate that we have resources for official funding which will still be needed from time to time if the market tests our resolution;
- the United States could make a major contribution to confidence and directly to the funding of its ~~your~~ deficits if you undertook some sizeable borrowing in foreign currencies: this would also minimise the risks of a rise in United States interest rates. I am sure we would all be ready to help on both the substance and the presentation of this.

I repeat: we cannot afford to be vague; and none of us can afford an uncontrolled further dollar decline, because of the damage it would quickly do in both recession risks and inflation risks.

pp

SECRET

From: Sir G.Littler
Date: 1 December 1987

CHANCELLOR

c.c. Sir P.Middleton
Sir T.Burns

POSSIBLE MESSAGE TO G7 COLLEAGUES

Here is a revised version, incorporating your ms comments and one or two points Sir T. Burns suggested (I have marked these in pencil on the top copy only).

2. It occurred to us to wonder whether G7 or G5. I do not feel strongly, but on balance I recommend G7 - influenced by the embarrassment for you if it got known to the other two that there was a <u>document</u> by you not shared with them!

GL

(Geoffrey Littler)

SECRET

DRAFT MESSAGE TO BAKER

Copied: Stoltenberg, Balladur, Miyazawa, Amato, Wilson.

I thought it might be helpful if I shared with you and our G7 colleagues my thoughts on what we need as the basis for a successful G7 agreement.

I take for granted the need for actions taken and proposed in relation to the economic fundamentals, in particular your own action on the fiscal deficit (we have all welcomed your success in getting a set of two-year proposals agreed so far) and the action which I believe Gerhardt and Kiichi will be aiming to take in their budgets for 1988. These joint moves should reinforce each other and we must get them properly understood as important moves in the direction of better equilibrium which do not add to risks of either recession or inflation. We must also make it clear that we all intend to persevere with whatever further corrective measures may become necessary later.

But this alone will not be enough. I am convinced we must address the two basic and linked problems of our exchange rates and the financing of your two deficits which is still going to be required.

With the best will in the world - on the part of all of us - you are bound to run a very substantial deficit on current account, even though we hope diminishing, for quite some time. That has to be financed by net capital inflows from abroad.

Ideally, we all want spontaneous private flows to meet this need. We had this - perhaps too much of it - during the period of the very strong dollar, on the back of vigorous U.S. growth, profitable investment opportunities, high interest rates and hopes of further dollar appreciation. Once the dollar began to fall, as we all agreed it had to, however, this capital flow became more reluctant and the dollar exchange rate fell sharply. Although we managed jointly to stabilise the dollar for most of this year, we have to recognise that we did not immediately recreate the confidence for private capital flows to resume - and if we did achieve that for a time in the late summer we have lost it again. Indeed official intervention has in effect financed the major part of your 1987 external and internal deficits.

The combined fiscal and other actions we now expect to see taken should help reduce the scale of the underlying imbalance. And the stock market collapse may increase your domestic savings rate. But a large gap will remain to be filled.

I believe it is unrealistic to hope to restore private capital flows to the U.S. as long as the market harbours expectations of dollar depreciation: even a large interest rate differential might be only partially effective. And to rely on a lower dollar to do the trick could mean waiting until the dollar fell a very long way indeed.

I see a real risk of further dollar depreciation spiralling out of control. All experience suggests that the markets could overshoot badly - waiting for the moment when sentiment turns to belief that future movements can only be upwards. I fear that enormous damage would be done in the process - and it could hit us all quite quickly. I cannot see how in that situation you could avoid inflationary consequences - while the markets would inevitably drive up your interest rates. I am sure, too, that this would open the door to much greater risks of recession - a recession that would hurt us all.

This is why I think it vital that we should restore expectations of dollar stability, that we should do so openly and convincingly, and that we should equip ourselves to demonstrate that your unavoidable further deficits can be financed.

There is no point in relying on vague statements of hopes and intentions. My prescription would include:

- we must emphasise that the current levels of our G7 exchange rates (some NICs are different) reflect fundamentals in the sense that they are consistent with the eventual adjustment of the major imbalances, especially your current account deficit - given the policies we have put in place and intend to continue;
- we must all be prepared to commit ourselves to use monetary policies to encourage the needed capital flows - which may not be easy and may require compromises at first, but should become easier if we can recreate some expectation of stability;

- we need to demonstrate that we have resources for official funding at need; but we do not want to rely excessively on this source of capital flows;
- you could make a major contribution by undertaking some sizeable borrowing in foreign currencies, which would give the huge advantage of covering part of the financing need with minimal adverse impact on your own interest rates. I am sure we would all be ready to help on both the substance and the presentation of this.

I repeat: we cannot afford to be vague; and none of us - including the United States - can afford an uncontrolled further dollar decline, because of the damage it would quickly do in both recession risks and inflation risks.

CHANCELLOR 12/2

pmp

WEST GERMAN OFFICIAL SEES RATE CUT OVER 1/4 POINT NRMC

BONN, DEC 1 - A SENIOR WEST GERMAN GOVERNMENT OFFICIAL SAID THE BUNDESBANK WOULD NOT BE SATISFIED WITH ANY CUT OF ONLY A QUARTER OR EIGHTH PERCENTAGE POINT IN ITS DISCOUNT RATE FROM THREE PCT.

THE OFFICIAL, WHO DECLINED TO BE IDENTIFIED, SAID, "THE BUNDESBANK IS NOT SATISFIED WITH QUARTERS AND EIGHTHS." BANKERS IN FRANKFURT SAY THE CENTRAL BANK IS LIKELY TO CUT THE RATE BY HALF A POINT TO 2.5 PCT AT ITS MEETING ON THURSDAY AFTER IT CUT ITS KEY INTERVENTION RATE LAST WEEK.

THE OFFICIAL SAID, "I WOULD NOT BE AT ALL SURPRISED IF A SIGNAL DOWN WAS GIVEN."

01-DEC-2003 SEC991 MONR

CONTINUED ON - NRMD

P MMS - SEE EMMS 0814

NRMD

WEST GERMAN OFFICIAL =2 BONN

THE OFFICIAL ALSO CONFIRMED THAT THE GOVERNMENT WOULD DECIDE ON WEDNESDAY ON A PROGRAM TO PROMOTE INVESTMENT WORTH 21 BILLION MARKS.

HE SAID ABOUT 15 BILLION MARKS OF CHEAP CREDIT WOULD BE AIMED AT LOCAL AUTHORITIES FOR SPENDING MAINLY ON ENVIRONMENTAL PROJECTS AND ABOUT SIX BILLION MARKS TO SMALL AND MEDIUM-SIZED BUSINESSES.

01-DEC-2003 SEC992 MONR REUTER

CONTINUED FROM - NRMC

P MMS - SEE EMMS 0814

KOHL ASKS STOLTENBERG TO ASSESS NEW MONETARY ACCORD NRHL

BONN, DEC 2 - WEST GERMAN CHANCELLOR HELMUT KOHL HAS ASKED FINANCE MINISTER GERHARD STOLTENBERG TO TEST WHETHER A NEW INTERNATIONAL MONETARY AGREEMENT IS POSSIBLE, THE FINANCE MINISTRY SAID.

OFFICIAL SOURCES SAID THIS MEANT KOHL WAS GIVING THE GO-AHEAD FOR BONN'S PARTICIPATION IN A NEW MEETING OF THE GROUP OF SEVEN (G-7) COUNTRIES.

02-DEC-0931 MON080 MONI MORE

P MMS - SEE EMMS 0814

NRHM

KOHL ASKS =2 BONN

THE SPOKESMAN FOR THE FINANCE MINISTRY SAID: "THE CHANCELLOR HAS EXPRESSLY ASKED THE FINANCE MINISTER, IN THE URGENT INTERESTS OF THE FEDERAL REPUBLIC, TO PURSUE (HIS) GOOD INTERNATIONAL CONTACTS AND TO ASSESS WHETHER THE CONDITIONS EXIST FOR A NEW ACCORD."

THE GOVERNMENT HAS ALWAYS SAID IT IS NOT AGAINST HOLDING A G-7 MEETING, BUT HAS STRESSED THAT A MEETING MUST BE WELL PREPARED.

KOHL ASKS STOLTENBERG TO ASSESS NEW MONETARY ACCORD NRHL

BONN, DEC 2 - WEST GERMAN CHANCELLOR HELMUT KOHL HAS ASKED FINANCE MINISTER GERHARD STOLTENBERG TO TEST WHETHER A NEW INTERNATIONAL MONETARY AGREEMENT IS POSSIBLE, THE FINANCE MINISTRY SAID.

OFFICIAL SOURCES SAID THIS MEANT KOHL WAS GIVING THE GO-AHEAD FOR BONN'S PARTICIPATION IN A NEW MEETING OF THE GROUP OF SEVEN (G-7) COUNTRIES.

02-DEC-0931 MON080 MONI

CONTINUED ON - NRHM

P

MMS - SEE EMMS 0814

KOHL ASKS =2 BONN NRHM

THE SPOKESMAN FOR THE FINANCE MINISTRY SAID: "THE CHANCELLOR HAS EXPRESSLY ASKED THE FINANCE MINISTER, IN THE URGENT INTERESTS OF THE FEDERAL REPUBLIC, TO PURSUE (HIS) GOOD INTERNATIONAL CONTACTS AND TO ASSESS WHETHER THE CONDITIONS EXIST FOR A NEW ACCORD."

THE GOVERNMENT HAS ALWAYS SAID IT IS NOT AGAINST HOLDING A G-7 MEETING, BUT HAS STRESSED THAT A MEETING MUST BE WELL PREPARED.

02-DEC-0936 MON088 MONI

CONTINUED FROM - NRHL

CONTINUED ON - NRHN

P

MMS - SEE EMMS 0814

KOHL ASKS =3 BONN NRHN

THE BONN GOVERNMENT HAS BEEN PREPARING FOR ITS CONTRIBUTION FOR ANY G-7 MEETING, WHICH WOULD ALSO BE ATTENDED BY THE UNITED STATES, JAPAN, BRITAIN, FRANCE, CANADA AND ITALY, BUT WORKING OUT A PACKAGE OF ECONOMIC MEASURES AIMED AT BOOSTING GROWTH.

THE FINANCE MINISTRY SPOKESMAN SAID THAT EARLIER ON WEDNESDAY THE PARTNERS IN THE THREE-PARTY COALITION GOVERNMENT HAD APPROVED THE MEASURES AGREED YESTERDAY BY STOLTENBERG AND OTHER SENIOR GOVERNMENT MINISTERS.

THE PACKAGE INCLUDES PLANS TO PROMOTE ADDITIONAL INVESTMENTS WORTH 21 BILLION MARKS OVER THREE YEARS.

02-DEC-0940 MON096 MONI

CONTINUED FROM - NRHM

MORE

P

MMS - SEE EMMS 0814

prep

KOHL ASKS STOLTENBERG TO ASSESS NEW MONETARY ACCORD NRHL

BONN, DEC 2 - WEST GERMAN CHANCELLOR HELMUT KOHL HAS ASKED FINANCE MINISTER GERHARD STOLTENBERG TO TEST WHETHER A NEW INTERNATIONAL MONETARY AGREEMENT IS POSSIBLE, THE FINANCE MINISTRY SAID.

OFFICIAL SOURCES SAID THIS MEANT KOHL WAS GIVING THE GO-AHEAD FOR BONN'S PARTICIPATION IN A NEW MEETING OF THE GROUP OF SEVEN (G-7) COUNTRIES.

02-DEC-0931 MON080 MONI

CONTINUED ON - NRHM

P

MMS - SEE EMMS 0814

NRHM

KOHL ASKS =2 BONN

THE SPOKESMAN FOR THE FINANCE MINISTRY SAID: "THE CHANCELLOR HAS EXPRESSLY ASKED THE FINANCE MINISTER, IN THE URGENT INTERESTS OF THE FEDERAL REPUBLIC, TO PURSUE (HIS) GOOD INTERNATIONAL CONTACTS AND TO ASSESS WHETHER THE CONDITIONS EXIST FOR A NEW ACCORD."

THE GOVERNMENT HAS ALWAYS SAID IT IS NOT AGAINST HOLDING A G-7 MEETING, BUT HAS STRESSED THAT A MEETING MUST BE WELL PREPARED.

02-DEC-0936 MON088 MONI

CONTINUED FROM - NRHL

CONTINUED ON - NRHN

P

MMS - SEE EMMS 0814

NRHN

KOHL ASKS =3 BONN

THE BONN GOVERNMENT HAS BEEN PREPARING FOR ITS CONTRIBUTION FOR ANY G-7 MEETING, WHICH WOULD ALSO BE ATTENDED BY THE UNITED STATES, JAPAN, BRITAIN, FRANCE, CANADA AND ITALY, BUT WORKING OUT A PACKAGE OF ECONOMIC MEASURES AIMED AT BOOSTING GROWTH.

THE FINANCE MINISTRY SPOKESMAN SAID THAT EARLIER ON WEDNESDAY THE PARTNERS IN THE THREE-PARTY COALITION GOVERNMENT HAD APPROVED THE MEASURES AGREED YESTERDAY BY STOLTENBERG AND OTHER SENIOR GOVERNMENT MINISTERS.

THE PACKAGE INCLUDES PLANS TO PROMOTE ADDITIONAL INVESTMENTS WORTH 21 BILLION MARKS OVER THREE YEARS.

02-DEC-0940 MON096 MONI

CONTINUED FROM - NRHM

MORE

P

MMS - SEE EMMS 0814