PO-CH/NL/753

PART A

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Part A

PO/CH/NL/753
Pt. A

G7 MEETINGS

4-10-89

From: Huw Evans
Date: 5 September 1989

PUP

CHANCELLOR

cc

Sir Peter Middleton
Mr R I G Allen
Mrs M Brown

HIGH LEVEL GROUP

First reports of today's meeting from Nigel Wicks: chaotic, only UK and Netherlands against setting up/continuing of group, but - and this is good - it was agreed that the work of the group should be remitted to Antibes.

2. The task of the group, the Presidency argued, was to prepare a list of questions relevant to the proposed IGC, <u>not</u> to answer questions of substance.

3. We shall get a fuller report tomorrow.

HPE

H P EVANS

cc PS/Chancellor - 12/2
Mr Wicks
Mr Evans
Mr Allan
Mr Tarkowski
Mr Lazar

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TO: THE SECRETARIES
THE GROUP OF TEN
INTERFUND
PARIS

G10 MEETING OF MINISTERS AND GOVERNORS: 24 SEPTEMBER 1989

YOUR TELEX OF 23 AUGUST REFERS. THE DELEGATION OF THE UNITED KINGDOM TREASURY WILL COMPRISE:

1. RT HON N LAWSON MP, CHANCELLOR OF THE EXCHEQUER

2. N L WICKS CVO CBE

3. F CASSELL

4. C A ENOCH

5. A C S ALLAN

KIND REGARDS

MRS D C LESTER
HM TREASURY
LONDON

*
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Tony.
Pse. check with Mr Tarkowski whether "X" has been done.

CH/EXCHEQUER
REC. 23 AUG 1989
ACTION Mr WICKS
COPIES TO Mr EVANS
Mr ALLAN
Mr TARKOWSKI

89-08-23 11:46
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262405 TRSY G
INFUND 610712F

RT. HON. NIGEL LAWSON, PC MP
CHANCELLOR OF THE EXCHEQUER
H.M. TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG
UNITED KINGDOM

GROUP OF TEN
THE SECRETARIES

CONFIDENTIAL
AUGUST 23, 1989

NOTE FROM THE SECRETARIES

MR. OTTO STICH, CHAIRMAN OF THE G-10 MINISTERS AND GOVERNORS, HAS INFORMED THE SECRETARIAT THAT HE WISHES TO CONVENE A MEETING OF THE G-10 MINISTERS AND GOVERNORS ON SEPTEMBER 24, 1989, AT 8:00 A.M., IN THE EXECUTIVE BOARD ROOM OF THE IMF IN WASHINGTON D.C. THE MEETING IS EXPECTED TO LAST ONE AND HALF HOURS. AN AGENDA WILL BE CIRCULATED IN DUE COURSE.

X WE WOULD APPRECIATE YOUR COMMUNICATING TO US THE NAMES OF THE MEMBERS OF YOUR DELEGATION (INTERFUND PARIS, TELEX NO. 610712).

WITH KIND REGARDS,

THE SECRETARIES

*
262405 [redacted]
INFUND [redacted]

FROM: D I SPARKES
DATE: 18 SEPTEMBER 1989

MR EDMONDS (IF2)

cc Sir T Burns
Mr Sedgwick
Mr Hibberd
Mr Melliss

BF 25/9

INTERNATIONAL COMPARISONS OF GROSS FIXED CAPITAL FORMATION

... The Chancellor has seen the attached article by Gerald Lyons that appeared in this morning's Times. The table purports to show that over the period 1960 to 1987 Britain had the lowest level of capital formation as a proportion of GDP of all the G7 countries. The Chancellor would like to know how the table would look (a) if housing is excluded, and (b) if it were confined to business investment only. I would be grateful for advice.

D.C.S.

DUNCAN SPARKES

GILT-EDGED

A high risk policy for sterling

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The United Kingdom economy is set to experience a hard landing over the next year. Economic growth will slow substantially. The trend for underlying inflation will be upwards and the current account will remain in sizeable deficit. This economic scenario is unlikely to allow sterling to remain stable and a sharp fall in the currency is likely.

Financial markets have tended to focus on the positive aspects of the policy stance. In particular, high interest rates have slowed consumer spending and have led to a stagnation in the housing market. Now, mainly on account of the mortgage rate effect, retail price inflation has started to fall.

However, there are potential problems in the outlook for consumer spending and inflation. First, overall consumer spending has not slowed as quickly as wished, and the growth of earnings and the impact of National Insurance reductions could mean that spending rebounds in the run-up to Christmas. Second, underlying inflation has continued to pick up and with earnings growth rising, fears of a wage-price spiral remain.

Negative effects of policy are already being seen in other areas of the economy. High interest rates are adversely affecting UK output and investment intentions.

In the second quarter, for instance, manufacturing output growth was flat, while industrial production fell 1 per cent. Over this quarter, it was noticeable that there was a 2 per cent fall in the output of chemicals, textiles and clothing.

The latter industries are clearly being hit by a loss of cost competitiveness, associated with sterling's strength. A slowdown in manufacturing is not good for the economy. As domestic demand slows, what is needed is for output growth to be maintained, through production being switched to meet overseas demand.

Another major problem is that investment intentions have been reduced. For instance, according to the latest CBI survey in July, the balance of firms expecting to authorize more capital spending on plant and machinery over the next year fell to 3 per cent from 18 per cent in April. In the survey before the tightening in monetary policy took place last year, the corresponding figure was 32 per cent.

As in the early 1980s, it is more likely to be smaller companies that are adversely affected by a tight monetary policy stance. Unlike the larger companies, they tend not to be so well diversified internationally and are thus more exposed to a domestic slowdown. Also, they are more likely to borrow funds at the high level of domestic interest rates. Larger firms tend to be more cash-rich and borrow at lower rates in the international capital markets.

If investment is curtailed and smaller firms cut back on expansion plans, then this could emerge as a longer-term problem for the economy. The balance of growth in future years will not be as desirable as one would wish. Furthermore, it makes it more difficult to envisage a significant improvement in the current account outlook.

GROSS FIXED CAPITAL FORMATION (% of GDP)

	'60-87	'80-87
USA	18.2	17.9
Japan	31.4	29.0
Germany	22.8	20.5
France	22.8	20.5
UK	18.1	16.9
Italy	23.6	21.6
Canada	22.3	21.3

Source: OECD

The current deficit was exacerbated by the strength of domestic demand last year, but the poor underlying trend was clearly in evidence long before 1988. The underlying picture of a worsening deficit appears to be explained by structural problems in the economy, in particular the low level of past investment in the UK. As shown in the table, the latest comparable figures from the OECD show that over the period 1960-87, Britain had the lowest level of capital formation as a proportion of GDP amongst the G7 counties.

As Britain does not produce goods of the right-mix of product type to solve the current account deficit, increased investment is required in order to produce better quality goods. While importing investment goods is preferable to importing consumer goods, it begs the question why we can't produce them ourselves.

At present, exchange rate movements are being increasingly determined by capital flows, seeking out high-yielding currencies. However, currencies do eventually move in response to underlying fundamentals. On this basis, the fundamentals for sterling are not favourable. Eventually, sentiment towards sterling is likely to change.

It is difficult to envisage the Chancellor wanting to allow sterling to fall. A depreciation would add to inflationary pressures and may be damaging at this stage of the electoral cycle. Instead, it is more likely that interest rates would be kept high to support the currency. However, sterling has been supported solely by short-term capital funds. With a current account deficit of £14.6 billion last year, there was no evidence of net inflows of long-term capital. Last year, for instance, longer-term c[illegible]ital flows were leaving Brit[illegible]

Identified flows of direct and portfolio investment overseas exceeded inflows into Britain by £13 billion, and after taking into account valuation changes the net effect was an outflow of £20.5 billion. Thus short-funds attracted to the UK had to offset the current account deficit and the outflow of longer-term capital.

Even allowing for the balancing item this meant there was a substantial flow of short-term funds that was financing the current account deficit.

As European interest rates rise over the next few months these speculative funds are likely to be increasingly attracted overseas. Financial markets are likely to demand ever-higher British interest rates to support sterling. The problem though is that high domestic interest rates are not improving the underlying fundamentals in the economy. Eventually, sterling will come under downward pressure, with a negative impact for the economy and the gilt market.

Gerard Lyons
DKB International

Monday 18 September 1989

PERSONAL
Covering SECRET/CONFIDENTIAL/RESTRICTED

PLP

FROM: N L WICKS
DATE: 19 SEPTEMBER 1989
Ext : 4369

PRINCIPAL PRIVATE SECRETARY

cc Sir P Middleton*
Sir T Burns*
Mr Evans*
Mr Scholar*
Mr A C S Allan*
Mr Mountfield†
Mr Peretz°
Mr Walsh^
Mr Melliss§
Mr Pickering†¶

Mr Crockett - B/E*

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* Whole document
† Debt
° Markets
§ Surveillance
^ Money Laundering
¶ IMF Quotas

Ch X & Y, Important that there should be no public references or talk of [illegible] options [illegible] Lawson [illegible]

MEETING OF G7 DEPUTIES IN PARIS ON THURSDAY 14 AND FRIDAY 15 SEPTEMBER 1989

Attached are notes on the subjects covered at this meeting of G7D. Could recipients please keep knowledge of discussions on a strict need-to-know basis.

VMBrown

pp N L WICKS

PERSONAL

Re the Table, how far? Look if you exclude housing, & compare the business investment?

GILT-EDGED

A high risk policy for sterling

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Financial markets have tended to focus on the positive aspects of the policy stance. In particular, high interest rates have slowed consumer spending and have led to a stagnation in the housing market. Now, mainly on account of the mortgage rate effect, retail price inflation has started to fall.

However, there are potential problems in the outlook for consumer spending and inflation. First, overall consumer spending has not slowed as quickly as wished, and the growth of earnings and the impact of National Insurance reductions could mean that spending rebounds in the run-up to Christmas. Second, underlying inflation has continued to pick up and with earnings growth rising, fears of a wage-price spiral remain.

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The latter industries are clearly being hit by a loss of cost competitiveness, associated with sterling's strength. A slowdown in manufacturing is not good for the economy. As domestic demand slows, what is needed is for output-growth to be maintained, through production being switched to meet overseas demand.

Another major problem is that investment intentions have been reduced. For instance, according to the latest CBI survey in July, the balance of firms expecting to authorize more capital spending on plant and machinery over the next year fell to 3 per cent from 18 per cent in April. In the survey before the tightening in monetary policy took place last year, the corresponding figure was 32 per cent.

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Gerard Lyons
DKB International

Monday 18 September 1989

MEETING OF G7 DEPUTIES IN JEAN-CLAUDE TRICHET'S OFFICE AND IN THE RESTAURANT AT THE MINISTRY OF FINANCE RUE DE BERCY ON THURSDAY 14 AND FRIDAY 15 SEPTEMBER 1989

The meeting began at 12.30 pm after Trichet had welcomed Utsumi to the group in place of Gyohten.

Markets

Trichet argued that a decline in the dollar would be both compatible with the control of inflation in Europe and helpful in dealing with trade balance disequilibria. He suggested if it was agreed that some moderate decline in the dollar was appropriate, the discussion should concentrate not on theory, but on practical means for achieving that end.

2. Mulford thought that there was a real problem of credibility for the G7. He posed three questions: why was the dollar so strong? what should be done now about it? and what should be said in any G7 communique. His preference was to avoid any communique, but he doubted whether Ministers would be able to get away with that. He believed that some deterioration in the US trade figures was close, though he did not know whether that would be evidenced in Friday's figures or later. Trichet interjected at this point that there seemed to be an asymmetry in intervention policy. Governments were more ready to accumulate assets through intervention than to use them.

3. Utsumi agreed that the dollar was too strong. Japanese companies were now not so keen to shift production abroad. He thought a G7 communique was unavoidable. The Japanese authorities were most reluctant to see any reference to any target zone type arrangements.

4. Tietmeyer ascribed the strength of the dollar to expectations about US interest rates. In the early summer there had been expectations of a fall in US interest rates and the dollar had

weakened. There was now no such expectation and the dollar was stronger. He did not put as much emphasis on the uncertainty in Eastern Europe as an explanation of dollar strength, though uncertainty in the Far East over China and Hong Kong was in his view a factor. President Bush's good performance was also pushing up the dollar. But all this was surmise and there was no obvious explanation. He saw no likelihood of the Fed relaxing in the near future.

5. As regards action, intervention day after day undermined credibility. The steady decline in the Bundesbank reserves certainly had an effect on the market. If dollar strength was due to interest rate differentials, there were two options. First, the Fed could reduce interest rates, but he saw no likelihood of that in the immediate future. Second the FRG could increase interest rates again. He was not in favour of that. Yet if the dollar rose, that question would come up again: it would be argued that while Germany had no domestic source of inflation, it was importing inflation through deutschmark weakness. The Bundesbank would be happy with a change in the alignment of the franc in the EMS. This might be justified in economic terms. But he would not press for it. Even if there was a big realignment in the EMS, it would not change much the pattern of imbalances in Europe. The German trade balance could be ascribed, in large part, to their exports of investment goods and they were not price elastic.'

6. He saw advantage in a G7 communique. There would no doubt be something to say on the world economy and IMF matters. He had not made up his mind what it might say on exchange markets. He would be happy if a formula could be found which would push the dollar down a little.

7. <u>Dobson</u> said that there was a fog on prospects for the US economy. The economic fundamentals suggested it might weaken so a turning point might be near. This uncertainty suggested that Ministers should avoid fundamental decisions. In her view a communique was unavoidable. But it was important to avoid falling into the trap of giving the market the impression that it was the

G7's job to manage the dollar. Something should be said on the US's commitment to reduce their budget deficit. This prompted Mulford to ask what. Their commitment was already clear. Tietmeyer responded that there was increasingly concern about in-year growth of the deficit and the likelihood that it would increase if the economy slowed down.

8. Sarcinelli had no new views on the dollar, though interest rate expectations were certainly a factor. If interest rate differentials were to change, this should be done through the Fed reducing, rather than the Bundesbank increasing. He was not in favour of large interventions for long periods. He believed that a communique was unavoidable.

9. Wicks, picking up Tietmeyer's reference to Hong Kong and referring to Mulford's at the previous day's G10D, stressed the importance of avoiding public, or semi-public statements which could undermine confidence in Hong Kong. The fact was that confidence was recovering and it was important to sustain it. Both Tietmeyer and Mulford indicated their assent. Wicks then described the course of UK policy over the last few months, emphasising that it was now apparent to everyone that a significant slowdown had, as intended, taken place in the UK economy. He referred to the background of the substantial intervention undertaken by the UK in recent months. He reported the Chancellor's firm view that a communique was unnecessary with a warning to the market that one would not be forthcoming, as had happened in February.

10. Trichet then circulated some charts which drew attention to the lack of coherence between Bundesbank and US intervention, with the US intervening substantially recently as the dollar rose and the Bundesbank noticeable by its absence. Tietmeyer said that the US intervention had had little result. Trichet produced another chart which purported to show little correlation between changes in interest rate differentials and changes in the dollar/ deutschmark rate.

11. Mulford said that G7 Deputies seemed to agree that the dollar was too high and that some decline, though not a precipitous one, would be helpful. There was some agreement too that the fundamentals pointed to a lower dollar in due course. Ministers faced a difficult operational problem in deciding whether to have a G7 communique, and if so what to include in it. He suggested that against that background Ministers should agree to intervene strongly, over a 6-8 week period, and in very large sums. They would justify such intervention by statements in the communique that it reflected a general view of dollar overvaluation. He did not suggest that interest rate policies should be changed. The communique might also announce that G7 Deputies and Central Bank Governors Deputies should meet regularly to discuss macro-economic and exchange rate issues. This would, he thought, create an impression in the market of renewed co-operation. In answer to a question, Mulford said that Secretary Brady agreed with the suggestion regarding meetings of Deputies, but he had not discussed with him his proposal for intervention.

X

12. Wicks said that he was sure that the Chancellor would want to consider most carefully Mulford's suggestion for intervention. He was sure that he would agree with the proposal about Central Bank Governors.

13. Tietmeyer argued that the intervention would not succeed in its objective unless the Fed signalled an interest rate reduction. Care was needed to avoid action which pushed the dollar into a free fall. Mulford thought that Greenspan would resist cutting rates. Utsumi thought Mulford's suggestion about intervention worth thinking about, but suggested the agreement might last for only 3-4 weeks. He was opposed to meetings with Central Bank Deputies. That might raise awkward issues about who was in charge of policy. The Japanese Central Bankers were also talkative. If there were to be meetings of Central Bank Deputies, it should not be mentioned in the communique. Dobson had no problem with meetings with Central Bankers. Sarcinelli saw force in Utsumi's arguments about Central Bankers. Their attendance might also irritate G10. But he did not think that either his Minister of

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Central Bank Governor would oppose the proposal. He favoured Mulford's proposal regarding intervention.

14. Tietmeyer had reservations about inviting Central Bankers, but seemed ready to accept the possibility of totally informal talks. Trichet strongly supported the proposal for meetings with Central Bankers three or four times a year. He saw advantages in Mulford's suggestion for intervention, but warned that France would not participate in a loose operation which lacked coherence and credibility. There needed to be a clear understanding of action if the dollar moved either upward or downward. Wicks agreed with Trichet's point about the need for a credible operation. Tietmeyer repeated his doubts about intervention, though he saw advantages if the tactical situation was right. But that could be not judged in advance. Intervention would be useful if the dollar was already on the way down, for example following some bad news. He wondered whether Bundesbank reluctance might be overcome if they intervened as agents for the Fed, not on their own account.

15. Following further general discussion, the Deputies identified four options. First, there was the option outlined by Mulford. Second, the communique could try to create an expectation of a reduction in interest rate differentials, coupled with intervention to capitalise on the favourable market perceptions which might thereby result. Third, the present stance could be maintained where Central Banks intervened if circumstances seemed right. Fourth, there should be no communique, and the market should be allowed to run. If the dollar strengthened, the authorities should surprise the market by not intervening and only intervene when the market turned. Both Utsumi and Trichet expressed strong opposition to the fourth option. It could leave the dollar much higher, especially if the market interpreted it as the reintroduction of the policy of benign neglect. Tietmeyer expressed further hesitancy about the first option and thought that there was a low probability that Poehl would support it.

16. This part of the discussion concluded with the Deputies undertaking to report the discussion to their Ministers and let

Mulford know their views by Tuesday at the latest. He would prepare the first draft of a communique in case it was needed. The Deputies should meet at 6.00 pm on Friday in Mulford's office.

MEETING OF G7 DEPUTIES IN JEAN-CLAUDE TRICHET'S OFFICE AND IN THE RESTAURANT AT THE MINISTRY OF FINANCE RUE DE BERCY ON THURSDAY 14 AND FRIDAY 15 SEPTEMBER 1989

Money Laundering

In a brief discussion over lunch, Mulford explained the background to the decision to nominate the Deputy Secretary to the Treasury, John Robson, as the US representative on the Money Laundering Task Force. This reflected the political importance attached to the issue in Washington and the need to have a senior official in charge in the Treasury in order to resolve fights over turf. Tietmeyer believed that Hong Kong, Madrid and Vienna were important centres for laundering drug money. Hong Kong should have been invited to join the group. Wicks explained that the UK would represent Hong Kong at the meeting and would be ready to follow up the German points if they were made there.

MEETING OF G7 DEPUTIES IN JEAN-CLAUDE TRICHET'S OFFICE AND IN THE RESTAURANT AT THE MINISTRY OF FINANCE RUE DE BERCY ON THURSDAY 14 AND FRIDAY 15 SEPTEMBER 1989

Surveillance

The meeting had before it a paper circulated by Frenkel, to which was annexed a commentary on structural measures in each G7 country. Utsumi registered strong objections to G7D becoming involved in structural issues. That would only encourage other Ministers in Japan to seek to become involved in the G7 process. Other G7 Deputies reminded Utsumi that his predecessor, Gyohten, had agreed that the IMF should produce such a list.

2. Frenkel briefly described his paper. It was clear that monetary tightening earlier in the year had reduced the risk of inflation getting out of control, though risks still existed in the UK, Canada and the US. The IMF's assessment was that the current account imbalances would remain. That was, in their view, a cause for concern. The continued patience of the markets could not be relied upon. This was not to say that all imbalances were in themselves bad. But the size of the US, Japanese and German imbalances undoubtedly made them a cause for concern. The shortage of world savings clearly suggested that the policy response to the imbalances was not to reduce savings in, for example, Japan or Germany but to seek to increase them in the deficit countries. Structural policies were beneficial whatever their effect on the balance of payments. By making economies more flexible, they would reduce the degree of exchange rate adjustment necessary for improving current accounts.

3. Utsumi repeated his objections to G7 Ministers discussing structural issues. His Minister was not responsible for these matters. Dobson said that most Ministers were responsible for tax issues. Wicks pointed out that many Ministers of Finance could become involved in structural issues through their control of public expenditure policy. Sarcinelli said that arguments such as

that had overcome his initial view that G7 Ministers should not discuss structural issues.

4. After further discussion it was agreed that the Deputies should present three simple questions to Ministers on inflation, imbalances and structural reform. Deputies should ensure that Ministers had in their briefing pack the background paper by the IMF which was at Annex A of Frenkel's paper.

MEETING OF G7 DEPUTIES IN JEAN-CLAUDE TRICHET'S OFFICE AND IN THE RESTAURANT AT THE MINISTRY OF FINANCE RUE DE BERCY ON THURSDAY 14 AND FRIDAY 15 SEPTEMBER 1989

IMF Quotas

Mulford said that Secretary Brady intended to resolve the quota issue by the end of the year. But he would not be able to focus the Administration's attention on the matter until after 15 October when an important decision would be taken on the budget. It was already clear that there was a very substantial difference of opinion in the Administration on the case for a quota and on its timing. Those opposed to a quota argued that if the Administration committed themselves publicly to one by the end of 1989, legislation would have to be put up during the following year's election period. Even though the quota increase would not add to budget totals, the fact that it required authorisation would force difficult political discussion. Some in the Administration thought that this would cause problems for the Article 150 account which was used to finance various aid policies. Others argued that the Democrats would want an assurance that they would not be attacked in the 1990 election by the Republicans if they voted for the quota increase. Such an assurance could neither be made nor delivered.

2. Key players were likely to be Scowcroft, Baker, Darman and Brady. Secretary Baker was also arguing against the precedent of funding an institution which was in surplus. He believed that a quota increase would hurt the President, though he might change his mind when diplomatic representations had been made to him by friendly governments. G7 Foreign Ministries might wish to write to him with that in mind. His concern was the principle of a quota increase, not so much about its size. Indeed, some argued that if there was a quota, it should be larger rather than smaller. Secretary Baker also believed that the decision could be delayed until late in 1990. This would be an easier time, both for the legislative programme and for politics. By then the tax issue would have been faced. Darman had similar views.

Scowcroft's were unknown. Baker saw the case for moving Japan into second place. Camdessus would shortly see the main actors. A decision was expected some time in the period 15 October-10 November. After that it might be necessary to have a special meeting of the Interim Committee. Meanwhile it would be important to avoid a row at the Annual Meetings. A row would simply raise the political temperature unhelpfully.

3. Mulford went on to say that many were associating the quota increase with the IMF's growing arrears. That issue had to be resolved. The existing approach, based on support groups, would not work. Other approaches needed to be considered, including gold. Level of access also needed reconsideration. Asked by Tietmeyer to explain his reference to gold, Mulford said that one possibility was to sell gold to clear the arrears. It was always possible that Congress might mandate the US to press for such a policy as part of the quota legislation. Wicks suggested that the G7 Deputies ought to look at all the options to see whether they could agree a way forward.

4. Dobson asked whether the US's attitude on quotas was connected with their views on IDA 9. Mulford replied, "not yet", but the two issues could become linked; it would be impossible to pass legislation on both matters within the same year. Mulford concluded his presentation by saying that he agreed that Japan needed a special increase so that it went into second place.

5. Tietmeyer said that on the basis of Mulford's presentation, he assumed that there would be no real discussion at the Annual Meetings. The FRG still favoured an increase of some 50 per cent, though they would be ready to move up to, say, a 66 per cent increase if that was the consensus. They accepted that Japan should move to second or third place. They could live with Japan in second place and themselves in third place or with both Japan and themselves second equal. The clear priority was to improve Japan's position. His Government were ready to talk about the ranking issue in advance of decisions on quota size.

6. Sarcinelli reminded Deputies that Italy sought a doubling in the size of the Fund, but were ready to compromise in the range of 66-70 per cent. He agreed with Tietmeyer that Japan needed to move into second place and the rankings he had suggested.

7. Utsumi agreed that a special Interim Committee was likely later in the year. He too was not optimistic that the support group approach would be successful. He was ready to study other possibilities, especially for those countries which were not co-operating with the Fund. He saw no reason for making the solution of the arrears problem a precondition for a quota increase. On size, his personal view was that the quota increase might be around, say, 50 per cent. Regarding ranking, the Finance Ministry were increasingly under criticism in the DIET and in the Upper House, which was now outside LDP control, for failing to secure second place in the IMF. Against such a background, he could not guarantee that aid bills would pass unless Japan moved into second place. He could agree that Germany and Japan should share second place with the French and the United Kingdom sharing third.

8. Wicks said that the UK favoured a moderate increase in quota size of up to 25 per cent. It was not sensible, in their view, to discuss rankings until decisions on quota size were nearer and more was known about the US's position. But it was already clear that no normal distribution of quotas would bring the UK below its present second place. That was not to say that the Japanese case had gone unnoticed in London. But decisions on rankings were inevitably politically sensitive. Whatever was decided for Japan, it was difficult to make a case for the UK to fall below third place.

9. Trichet said that he was averse to selling gold for settling arrears. He agreed with Tietmeyer's solutions on quota rankings. This prompted Tietmeyer to intervene to say that his Government wished to reduce enlarged access. Since enlarged access was financed by borrowing, that would enable borrowing to be eliminated. Wicks argued that elimination was not necessary. Sarcinelli, Trichet, Utsumi and Dobson were all in favour of reducing borrowing, but not eliminating it.

10. Trichet undertook to report the outline of the discussion to G7 Ministers, but would probably not go into details regarding ranking. He would suggest that the Deputies considered arrears.

11. The discussion concluded at 23.00 hours.

MEETING OF G7 DEPUTIES IN JEAN-CLAUDE TRICHET'S OFFICE AND IN THE RESTAURANT AT THE MINISTRY OF FINANCE RUE DE BERCY ON THURSDAY 14 AND FRIDAY 15 SEPTEMBER 1989

The Debt Strategy and Problem Countries

Discussion resumed at 7.30 am.

2. Mulford said that with the Mexican term sheet out, it was time to take stock. The Philippines had been given disappointing terms by the banks and the country might be obliged to reopen the agreement reached. It was unfortunate, too, that some banks were refusing to go beyond the terms agreed for Mexico. Some bank advisory committees, though not the Mexican one, were proving inadequate to their task. They were staffed with too junior officials and were in effect no more than listening posts. G7 Deputies should keep in close touch with the details of each negotiation. G7 regulators too needed to keep in close touch. He would circulate information to the Deputies on a regular basis showing the state of play on each deal outstanding. The US would use the Annual Meetings to try to push forward the debt strategy, and particularly to make contact with the European Banks with whom the US Treasury felt cut off. To that end, the Treasury had considered various options - another meeting with G7 Deputies, US Treasury Secretary meeting European Chairmen, and meetings of G7 Deputies, Banks and particular countries. After consideration, Secretary Brady had decided to make an effort to meet the European Bank Chairmen one by one in the same way that he saw the US Chairmen.

3. Mulford then said that President Bush was very interested in a debt strategy. He was therefore going to give a small reception in the White House during the Annual Meetings, at 5.30 pm on Tuesday 26 September, to which would be invited leading bankers from all countries, G7 Ministers, Governors and Deputies. Utsumi, after commenting that this timing would raise acute difficulties for his Minister who was seeing 20 senators at that time, said

that those Japanese bankers not invited would be very angry. Regarding Mulford's comments on the Philippines, Japan was ready to put $600 million into that country's financing package when the time was right. He agreed that the terms negotiated by the country were not sufficiently generous.

4. Sarcinelli reported that Italian bankers felt some resentment over the US Treasury's tactics in the debt strategy. Tietmeyer reminded Mulford that it was not the German Government's practice to press the banks to enter into deals, but he was ~~already~~ ready to remind them to behave responsibly. After Mulford had indicated that the general impression in the US Administration was that the criticism of the Brady Plan by UK bankers was government inspired, Wicks explained why this was not the case.

5. Trichet then asked whether Morocco could qualify for Brady Terms. The Deputies agreed that it could qualify if it met the conditions. They noted that its economic performance, particularly regarding the exchange rate parity, had not been satisfactory recently.

6. Tietmeyer asserted that some IMF Executive Directors were reneging on the compromise agreement reached among the Deputies in the spring regarding Brady terms, in particular regarding the escrow account. The Italian and Canadian Executive Directors were the main culprits. The Japanese Executive Director had also been unhelpful in seeming to suggest that both the Fund and Bank should become well involved in debt and debt service reduction negotiations. The relevant G7 Deputies said they would speak to their EDs. [No criticism was made of the UK ED!]

7. Trichet reported that he was opposing, within the French Government, suggestions of highly concessional terms for Poland, including concessional interest rates, very long term rescheduling and extensive new trade credits. Too much generosity would destabilise the debt strategy. Fortunately, it seemed to be accepted that new credits and rescheduling should not take place until an IMF programme had been agreed. At some time it would be necessary to have a stand-up fight with the banks in order to

prevent them pre-empting the funds available. Tietmeyer agreed that the key was an IMF programme. His Government had a special bilateral problem involving the Jumbo Credit. This would be dealt with outside the Paris Club. Trichet feared that this would have a contagion effect. Tietmeyer responded that it was linked to German language negotiations. Germany would also make substantial amounts of new money available in due course - probably at a higher level than any other country. He believed that it would be necessary to find some new co-ordinating machinery, once an IMF programme had been agreed, to advise and encourage the Polish Government in their reform efforts. Sarcinelli discerned signs of friction between the European Commission, in their role as Chairmen of the Co-ordinating Group, and the IMF. Besides Poland, Ministers should discuss Yugoslavia and Hungary. The central issue was, in his view, whether the international financial community should be more understanding of those countries which were moving from a state controlled sector to a more market orientated approach.

8. Utsumi argued strongly against action which would spread contagion to other countries. Japan would not make their recycling money available to the Communist countries, except to Yugoslavia. Mulford observed bitterly that the prospect of IMF lending to Poland underlined the importance of establishing a new policy for arrears. Lending to countries like Poland could lead to the destruction of the IMF some 10 years out. Aid to such countries should be made through donor countries' budgets, not through the subterfuge of the Fund. Trichet, after welcoming the resolute passage in the Prime Minister's letter regarding Paris Club terms, said that he could not see how the UK could oppose EIB lending to Poland in view of the terms of that letter.

Eg La Amana?!

9. Mulford reported strong opposition in the US Administration to the proposed support group for Vietnam and for an IMF programme for that country. His Government would vote against it. Utsumi shared US views. The political situation had become more difficult since the breakdown of the Paris Conference on the future of Cambodia. Sarcinelli had an open mind. They would be willing to join the support group if Somalia gained support.

Wicks spoke according to his brief. Trichet thought that Vietnam had tremendous potential and urged membership of the support group. Tietmeyer reported German hesitations for the time being. Dobson said that Canada would participate if the support group met all the normal criteria.

10. Dobson then announced that she would be leaving the Canadian Ministry of Finance in October to return to the private sector.

11. The meeting concluded at 9.45 am.

PLP

FROM: JOHN GIEVE

DATE: 20 SEPTEMBER 1989

MR WICKS

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz

G7 STANCE ON THE DOLLAR

This note is a record of the discussions you have had with the Chancellor on this issue over the last few days.

Friday 15 September

2. You reported on the discussion of markets at the G7 Deputies' meeting in Paris on the lines of your note of 19 September and asked for the Chancellor's reaction to the four options set out in paragraph 15. The Chancellor said he was happy with the option outlined by Mulford. However, it was of the first importance that any such action should be properly prepared and agreed before the meeting of G7. In particular, it was very doubtful whether the Bundesbank would agree to this option. The worst outcome would be a long wrangle in G7 itself followed by a fudged communique and inevitable leaks of disagreement. Unless the communique was clearly going to say something definite about exchange markets, he would much prefer there to be no communique at all; but again the fact that there would be no communique would need to be announced before the G7 meeting. You agreed to report this reaction to Mulford and to discuss with other Deputies as appropriate.

Tuesday 19 September

3. In the morning, you reported to the Chancellor the results of your contacts with other Deputies. It seemed likely that the French and Italians would go along with Mulford's plan although this was not completely clear (and Carli was less of an

interventionist than his predecessor). Mulford had said that both Brady and Greenspan fully supported the option and so did the Japanese. Their plan was to exert maximum pressure on the Germans at the G7 meeting. You and the Chancellor agreed that this was not the right way to proceed and that Greenspan should speak to Pohl in advance. You agreed to relay this.

4. Last night, you rang to say that Mulford had accepted this advice and Greenspan was prepared to talk to Pohl. However, he wished to be able to say that the UK were fully behind the option (rather than that we would play if Pohl agreed). Mulford acknowledged, however, that if Pohl resolutely refused to play, the other participants would need to consider whether to go ahead without him.

5. I consulted the Chancellor who said that he would not commit himself in advance to join the Americans in an attempt to force the dollar down if the Bundesbank refused to play. However, Greenspan could say that we stood four-square behind the option in the sense that we fully supported the proposal that all G7 countries should join in the action. Clearly we would have to reconsider the position if Germany refused to agree. Even if they did agree, the [illegible] amounts and duration of intervention and target ranges would all need to be discussed at G7. I relayed this to you and you spoke to Mulford in those terms.

6. You and the Chancellor agreed that a communique was now inevitable and you said you would prepare a draft for the sensitive sections.

JC

JOHN GIEVE

pe43

FROM: P EDMONDS (IF2)
DATE: 21 September 1989
X5546

APS/CHANCELLOR

Thanks.

cc Sir T Burns o/r
Mr Sedgwick
Mr Hibberd
Mr Melliss
Mr Deane
Mr Hurst
Mr Hennebry

13

INTERNATIONAL COMPARISONS OF GROSS FIXED CAPITAL FORMATION

1. The Chancellor asked for tables showing gross fixed capital formation, gross non-residential fixed capital formation, and gross fixed capital formation by the business sector, as percentages of GDP, for each of the G7 countries. I attach tables showing averages for each country for 1960-87 and 1980-87. The source is the OECD Annual National Accounts database. The business sector includes corporate and quasi-corporate enterprises, including public sector corporations, but excludes unincorporated business (e.g. many farms), which cannot be separated out from the household sector.

2. Excluding residential investment moves the UK's investment GDP ratio above than that of the US over the whole period 1960-87, and equal to the US ratio for the 1980-87 period, but it is still below those of the other G7 countries in both periods.

3. The ratio of <u>business</u> investment to GDP in the UK is above the US and France, and probably Italy (Italian data incomplete) for both periods, but below Japan, Germany and ~~France~~.

Canada

INVESTMENT COMPARISONS

P.Edmonds

P EDMONDS

Gross Investment in the G7 Countries
(All figures percentage of GDP)

1960-1987

	GDFCF	GDFCF less residential	Business Investment	
US	18.2	13.5	9.0	
Japan	31.4	25.1	17.7	
Germany	22.8	16.1	19.4	
France	22.8	15.6	10.6	
Italy	24.5	17.6	7.0	(1970-84)
UK	18.1	14.4	10.9	
Canada	22.3	16.5	12.3	

1980-1987

	GDFCF	GDFCF less residential	Business Investment	
US	17.9	13.4	9.6	
Japan	29.1	23.4	15.6	
Germany	20.5	14.5	17.9	
France	20.5	14.3	9.6	
Italy	21.7	15.5	5.4	(1980-84)
UK	16.9	13.4	10.5	
Canada	21.3	15.6	12.5	

Source: OECD Annual National Accounts

ANX B CHANGE

DRAFT

STATEMENT OF THE GROUP OF SEVEN

1. The Finance Ministers and Central Bank Governors of Canada, France the Federal Republic of Germany, Italy, Japan, the United Kingdom and the United States met on 23 September 1989, in Washington for an exchange of views on current international economic and financial issues. The Managing Director of the IMF participated in the multilateral surveillance discussions.

2. The Ministers and Governors reviewed their economic policies and prospects. They noted that their economies were experiencing further solid growth this year and that the current expansion was expected to continue at a ~~substantial~~ healthy rate in 1990. There are signs that the rise in inflation has now ended, thanks to the tightening of monetary policy over the past year. Ministers and Governors agreed that monetary policy should continue to aim at a sustained reduction in inflation. Further progress is also being made in reducing large external imbalances although adjustment has slowed.

3. Ministers and Governors reaffirmed support for the economic policy coordination process and stressed the importance of continuing to implement the economic policies which have contributed to more than 7 years of sustained growth with low inflation. They note the continuing efforts of the United States to reduce the Federal budget deficit by implementing measures

aimed at achieving the Gramm-Rudman budget deficit targets. Japan and Germany will continue to undertake economic policies aimed at sustaining an adequate growth of domestic demand. Ministers and Governors reaffirmed the need to move ahead on structural reforms that will: increase national savings where there are impediments; open our economies to foreign goods and services; and improve efficiency by curbing subsidies and excessive regulations.

4. The Ministers and Governors agreed (G7 Min) that a rise of the dollar above current levels ~~could threaten~~ to undermine the adjustment ~~process; and that~~ (or) an excessive fall would ~~similarly~~ be counterproductive and damage growth prospects for the world economy. (In this context) ~~They~~ reiterated their commitment to cooperate closely on exchange markets.

5. The Ministers and Governors ~~expressed~~ reaffirmed their support for the strengthened debt strategy and recognised the substantial progress which has been achieved. They commended the Fund and the Bank for their prompt and effective response in developing the operational guidelines governing support for debt and debt service reduction. They also welcomed the progress by debtor nations and commercial banks in negotiating financial packages that incorporate debt and debt service reduction. The Ministers and Governors re-emphasised the central importance of sustained implementation by debtor countries of macro economic and structural policy reforms in order to achieve sustainable growth, viable balance of payments positions and restoration of normal access to private credit markets. [omits references to capital flight, inward investment, urging banks etc to cooperate]

6. [The Ministers and Governors reaffirmed the importance they attached to steady progress in the Uruguay round of trade negotiations. They expressed their determination to halt and reverse all protectionist tendencies and strengthen the open multilateral trading system. They urged all parties to fulfil their Punta del Este commitments on standstill and rollback. The Ministers and Governors called upon all participants, in developed and developing countries, to make the most constructive contribution possible to a successful outcome.]

SURVEILLANCE

M245

CONFIDENTIAL

FROM: C MELLISS (IF2)
DATE: 21 September 1989
X4700

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns*
Mr Wicks*
Mr Evans*
Mr A Allan*
Mr Peretz
Mr Riley
Mr Sedgwick*
Mr Gieve*
Mr O'Donnell*
Mr Hood*
Mr Hurst
Mr Edmonds
Mr Gibbs*
Mr Tyrie

* with attachment

G7 SURVEILLANCE DISCUSSIONS

1. I now attach a copy of Camdessus' paper for the G7 surveillance discussion on Saturday, annex B of my note of earlier today.

2. The paper gives a brief description of main developments in the world economy, Camdessus' own responses to the issues for discussion and the usual surveillance tables. The surveillance tables are the same as those recently seen by deputies: annex E applies.

3. Camdessus' remarks on the issues for discussion are generally uncontroversial. On the external balances the calls for 'an appropriate sharing of the burden of adjustment between surplus and deficit countries', without being specific what he has in mind for surplus countries. He endorses the need for some exchange rate adjustment and for US fiscal adjustment. You will want to emphasise the good fiscal position in the UK.

CLM

C MELLISS

CONFIDENTIAL

CONFIDENTIAL

FROM: C MELLISS (IF2)
DATE: 21 September 1989
X4700

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns*
Mr Wicks*
Mr Evans*
Mr A Allan*
Mr Peretz
Mr Riley
Mr Sedgwick*
Mr Gieve*
Mr O'Donnell*
Mr Hood*
Mr Hurst
Mr Edmonds
Mr Gibbs*
Mr Tyrie

* with all attachments

G7 SURVEILLANCE DISCUSSIONS

1. For the meeting on Saturday, surveillance and world economic issues will be discussed between 11am and about 5pm. Camdessus will be present. There will be two papers on the table:

A. the report by Deputies, including issues for discussion, and an annex by IMF staff dealing with structural policy issues in each country,

B. the report by Camdessus, including surveillance tables.

The first of these is attached as an annex. We have not yet received a copy of the second, and will prepare a separate note when it becomes available. The following briefing is attached:

C. notes on the Deputies' issues for discussion,

D. notes on the IMF annex on structural policies measures, including responses to the points on the UK and a reminder of the main areas where we press for reform in Germany and Japan (by Mr Edmonds and Mr Gibbs),

E. notes on the IMF surveillance tables as seen by the Deputies on 13th-14th September. (This may need to be updated when the Camdessus paper arrives.)

Brief No. 1 for the Annual meetings, on the World Economy, is also relevant, and I am sending you separately a copy of the draft IMF World Economic Outlook, to be published to coincide with the meetings.

2. Mr Peretz will be sending you separate material on exchange rates.

World Economy since Spring Meetings

3. Growth in the G7 countries has slowed down less than was expected in April. The major surprise has been the strength of activity in the first half of this year, especially in Germany - GDP rose by 4.6 per cent in the first half - and in Japan, where it was also 4½ per cent up on a year earlier. Even in the US, GDP continued to rise by over 3 per cent. For G7 countries as a whole the fastest rate of growth in the current upswing was in the first half of 1988, and growth has slowed down gradually since.

4. Capacity utilization therefore remains at very high levels in all G7 economies, although comparisons with previous cyclical peaks is made difficult by the structural change that has occurred. A recession seems unlikely, and a gradual reduction in growth towards the growth of productive potential is a central projection.

5. As annex E shows inflation has now moderated in most countries, and is expected by both the IMF and ourselves to fall back further through to the end of 1990, perhaps to about 4 per cent on average.

6. The projected soft landing would, if it occurs, represent a remarkably good performance by the world economy. There are a

number of factors, mostly on the supply side, which are providing more favourable conditions this time:

- growth has been sustained by investment and exports rather than consumption, and this has contributed to raising capacity;

- activity remains strongest in Germany and Japan, both low inflation countries;

- increased labour market flexibility has probably helped to prevent inflation rising further, especially in the US;

- supply conditions in commodity producing industries remain favourable;

- compared with previous upswings, the larger current account deficits have helped to reduce inflationary pressure;

- immigration into Germany is raising that country's productive potential.

External Balances

7. Recent months show some reductions in the visible trade balances of both US and Japan, but not Germany. There may have been some underlying improvement, but there is also evidence that a J curve effect has contributed. As annex C makes clear, the best policy is a clear need to raise government saving in US, Italy and Canada, both to lower inflation and to contribute to current account improvement. The US, supported by France, will wish to make more of the slow pace of adjustment (especially in Germany) and to warn of the dangers of the adjustment process going into reserve.

Structural Reform

8. The annex to the Deputies' Report may be welcomed, although you may want to point out that the OECD remains in the lead on this topic by virtue of its greater expertise and experience. The issue of trade policy, is only mentioned specifically in relation to the US and Japan. Brief No. 10 covers trade issues, and you are planning to speak on trade to the Development Committee. Japanese concerns about finance ministers being involved in structural reform issues should be overridden.

UK forecasts

9. The IMF surveillance tables include figures for national forecasts. For the UK these are the FSBR figures. Mr Sedgwick will be providing you with his latest assessment on the UK and world economic situation and prospects.

CLM

C MELLISS

(1)

ANNEX A

September 15, 1989

Deputies' Report to Ministers and Governors

ANX A REPORT BY DEPUTIES

The Deputies have conducted an assessment of economic developments in light of the short-term performance indicators and medium-term objectives and projections. Our principal conclusions are:

Performance indicators

Economic activity has remained robust. Output growth in the G-7 countries is expected to slow to a more sustainable pace during the period ahead, a tendency which has already been observed in the United Kingdom and in North America. The overall rate of resource utilization is expected to remain high in all countries, and the risk of a more significant slowdown is considered to be small.

External imbalances. Since the middle of 1988 progress in reducing current account imbalances has been inadequate, and the recent appreciation of the dollar has reduced the likelihood of significant further adjustment during the period ahead.

Inflation. There are signs that the inflationary pressures resulting from transitory factors in the first part of the year (rising energy and food prices, and indirect tax increases in Japan, Germany, and Italy) are now beginning to abate. However, the continuing high levels of capacity utilization in all countries suggest that inflation is likely to fall only slightly next year. The risks in the inflation outlook continue to warrant a cautious monetary stance.

Policies

The Deputies considered that additional policy measures continue to be required in both deficit and surplus countries to foster stability in financial markets, strengthen the basis for sustained non-inflationary growth, revive progress in reducing external imbalances to more sustainable levels, safeguard an open international trading system, and enhance the credibility of the policy coordination process.

In view of the high rate of capacity utilization in many deficit countries, including the United States, Italy, and Canada, additional action to reduce fiscal deficits is essential. Such action, together with some adjustment of exchange rates, would make room for an increase in net exports while sustaining the growth of investment, thus providing a solid basis for long-term growth. Structural measures to reduce the distortions that affect the level and the allocation of saving also would be helpful in these countries, as well as in the United Kingdom.

In countries with current account surpluses, policies should seek to sustain adequate growth of domestic demand. While medium-term fiscal

(2)

objectives and the current buoyancy of demand suggest that the case for an expansionary shift in fiscal policy may not be compelling at present, these countries should be prepared to take timely steps should the need arise. Prompt and decisive action in the area of structural policies will also be required.

The need to improve the performance of saving and investment in the industrial countries taken as a group suggests that the adjustment process should involve primarily a rise in national saving in the deficit countries rather than a decline in the surplus countries. The process of policy coordination would be considerably strengthened by efforts to roll back restrictive trade measures and to make decisive progress in the current round of multilateral trade negotiations.

Issues for Discussion

1. In view of the objective of sustained growth with low inflation, do Ministers and Governors consider the present stance and mix of fiscal and monetary policies to be appropriate?

2. What should be done to resume progress in reducing the external imbalances to sustainable levels? In this context, which measures should be taken to bring the exchange rate of the dollar into line with economic fundamentals?

3. A number of areas of priority for additional structural reform have been identified (see Annex prepared by the IMF). How is it possible to speed up structural reform efforts given the political interests that are often associated with specific distortions?

3

ANNEX

Structural Policy Measures

In response to the Deputies' request this annex includes, for each of the seven major industrial countries, a list of structural measures which could contribute to an improvement of economic performance. The annex was prepared by the IMF staff, partly on the basis of Article IV consultations with the authorities of the G-7 countries. The list of measures provided should be seen as preliminary and does not aim at being exhaustive.

To summarize, the most important measures that should now be considered in the structural area are: to reduce or eliminate rigidities and distortions in labor markets, including barriers to the intersectoral and interregional mobility of labor; to reduce industrial subsidies; to modify those feature of existing tax systems that affect the level and distort the allocation of private saving and investment; to intensify the reform of social security systems; to reform land regulations and those aspects of the distribution systems that add to domestic costs and inhibit market access; and, to reduce the widespread subsidies and restrictions that distort agricultural production and trade. While detailed trade measures are not specified separately for every country, it is clear that every effort should be made to counter protectionist pressures, to roll back existing restrictions and to move toward an early and successful conclusion of the Uruguay Round of multilateral trade negotiations.

X

Canada

1. Initiatives announced in the April 1989 budget

a. Sales tax reform

The new federal Goods and Service Tax is to replace the existing federal manufacturing sales tax at the beginning of 1991, and will be set at a rate of 9 percent. The existing federal sales tax is subject to various drawbacks: it applies to business inputs; favors imports over domestically produced goods; has a narrow base; and has become an unreliable source of revenue. The new sales tax should reduce these problems and produce significant efficiency gains. This initiative should be implemented as scheduled despite the strong opposition that has been voiced in recent months.

b. Reform of the unemployment insurance (UI) system

This reform aims to achieve budgetary savings, provide more training, and reduce disincentives to work. The Canadian UI system--in particular the extended regional benefits scheme--in the past has been criticized for hindering labor market flexibility, thereby contributing to large regional disparities in unemployment rates and a high natural rate of unemployment. While the latest initiative is welcome, additional steps should be taken in the period ahead to reduce further the disincentive effects of the UI system.

2. Status of financial reform

In recent years, competition and technological change have prompted Canadian financial institutions to diversify their services, thereby blurring the traditional distinctions between the various institutions. To address regulatory and supervisory problems caused by these developments, the Government has undertaken phased legislative reform. The first stage of reform, which principally involved the securities industry, has now been implemented. The second phase involves drawing up legislation to cover the chartered banks, trust and mortgage loan companies, and insurance companies, and the Government is committed to completing this phase as soon as practicable.

3. Other areas in which structural reforms would be desirable include the following:

a. At present corporate tax policy is used to promote investment in manufacturing, in small businesses, and in particular provinces. A more neutral approach would yield efficiency gains.

b. Government subsidies for agriculture, which have increased rapidly in the 1980s, should be scaled back.

c. Protection accorded to the clothing and textiles industries should be curbed or eliminated.

France

1. Labor markets

A number of measures could be considered to increase labor productivity and the flexibility of labor markets. First, there could be a still greater and more broadly based emphasis on vocational training and general education. Vocational training should ideally be coordinated with official employment schemes and should develop into a general and nation-wide system, similar to that existing in Germany. Second, the wide array of often temporary labor market schemes could be simplified and streamlined to reduce uncertainty. Third, conditions for part-time employment need to be improved, partly by adapting regulatory conditions, but also through a review of pertinent tax and social security legislation and regulation. Fourth, profit sharing and participation could be promoted further to raise incentives and enhance the flexibility of wages.

2. Tax reform

The tax system is in need of rationalization and simplification, especially in the area of savings. In particular it would be desirable to "level playing field" to achieve a more efficient allocation of private saving. Also, efficient and least-distorting ways of raising direct taxes will have to be explored, as the role of indirect taxes will diminish as a result of fiscal harmonization within the EC. Finally, the variability of tax legislation needs to be reduced to produce a more stable tax environment.

3. <u>Modernization of the social security system</u>

The scope and structure of the social security system raises questions of efficiency and equity. Efforts to control expenditures need to be intensified. On the revenue side, a better balance needs to be found between sources of finance--away from taxation of labor income and toward a broader income base; this would help to reduce disincentives and to contain labor costs.

4. <u>Domestic and international competition</u>

Domestic competition needs to be strengthened mostly through policies aimed at facilitating entry, by removing (or at least reviewing) restrictive legislation and/or "corporatist" mechanisms. The balance between consumer protection and domestic competition could be reconsidered. International competition is still impaired by outright protection, including public procurement rules, and by subsidization. While the French authorities have started to dismantle protectionism, their timetable implies long delays, at least in some areas like automobiles, agricultural products, and textiles. A speedier implementation of measures to liberalize trade would be desirable.

<u>Federal Republic of Germany</u>

In recent years, the Germany authorities have made some progress on structural policies--first in facilitating youth and part-time employment and curtailing social transfers, and, later, in areas such as telecommunications, health insurance, and the design of a pension reform. In addition, the government's privatization program has been virtually completed, and a three-step tax reform has been enacted (the third step is to take effect in 1990) which contains important supply-side elements aimed at reducing disincentives in the tax system and cutting subsidies in the form of tax preferences. However, in some important areas (including subsidies and protection of certain industries) little or no progress has been made, and staff studies continue to show potential for large benefits from policy actions in the areas of competition, protection, subsidies and regulation. In particular, these studies suggest that, with appropriate macroeconomic support, actions in these areas would yield large gains in output, employment, and domestic demand, a substantial reduction in the price level and, at least in the first few years, a significant narrowing of the current account surplus.

The staff recommends action in the following areas:

1. In agriculture, there is a need for a more market-oriented pricing approach, rather than the policy of price support-cum-production control pursued by the German authorities in the framework of the Common Agricultural Policy of the EC.

2. In the coal sector, the present approach, based on subsidization, is inefficient and should be abolished. As in the case of agriculture, coal mining is effectively insulated from exchange rate changes and support is given to a relatively small industry at a high cost to the rest of the economy.

3. There would also be significant gains--in Germany and abroad--from a reduction of protection in areas such as iron and steel, shipbuilding, and clothing and textiles. It would be appropriate for Germany to play an active role in promoting free trade in these areas within the responsible EC and GATT forums.

4. In the labor market, changes are needed in the institutional framework governing hiring, firing, and wage determination so as to increase wage differentiation and improve labor market flexibility. The Employment Promotion Act (1985) contained important temporary measures to facilitate part-time and youth employment; these proved effective and they have recently been extended through 1993. But much more will be needed to bring the level of unemployment back into the range that prevailed before the 1980s.

5. The economy would benefit from liberalization of rules and regulations covering service industries (notably retail trade, financial services, transportation and energy distribution). The report of the Deregulation Commission is expected in the summer of 1990.

6. In addition to action in the above areas, further reform of the tax system is warranted to eliminate distortions facing businesses. The authorities envisage a reform of business taxes in the period through 1992.

Italy

1. Real sector

The relative underdevelopment of Southern Italy (Mezzogiorno), and its high unemployment rate, are major structural problems for which there are no easy solutions. The policies followed in the past, based on public investment and subsidies, have turned out to be inadequate. Although the issue clearly cannot be settled solely by economic measures, greater emphasis on tax and employment incentives could make a very positive contribution to regional development. The energy sector is also in need of structural reform: the energy plan, submitted by the Government to Parliament in 1988, targeted a reduction in energy dependence in general (and oil dependence in particular), and the strengthening of the electricity supply system. This plan should be approved without further delay. In this connection, a major role could be played by a transportation policy (for which a Plan had been approved in 1986, but never implemented) aimed at reducing road transportation in favor of railway transportation. Finally, ecological conditions in Italy are deteriorating rapidly with adverse consequences on the tourist industry; improvements in this area are highly recommended.

2. Fiscal sector

The following structural measures would help reduce Italy's large fiscal deficit. On the expenditure side: reform of the social security system involving an increase in retirement age (currently 55 years for women and 60 for men), a lowering of the accrual rate (the highest in the G-7 at 2 percent a year) and a reduction in the degree of indexation of charges; in the railway sector, significant increases in fares and a reduction in employment (which has been estimated to exceed several times the actual requirements in this area). Local finances could also be reformed to bring expenditure by local authorities more in line with their revenue raising capability. On the revenue side, reform of tax administration to reduce tax evasion would be desirable, including simplification of the current tax structure and enhancement of enforcing activities. An improvement of the quality of public services and promotion of labor productivity in the public sector through enhancement of labor mobility and productivity-related forms of compensation would be helpful. Finally, improvement in the management of public debt: to this end, the role of institutional investors (e.g., pension funds) could be enhanced; the reduction of debt through the sale of public sector assets could also be considered.

3. Monetary sector

Financial intermediaries are still relatively inefficiént and undersized and financial markets suffer from a lack of transparency. The following measures, which are awaiting Parliamentary approval, would be most appropriate: a change in the form of organization of public banks, allowing recapitalization partly through private participation; the provision of incentives for mergers leading to the creation of financial conglomerates; the introduction of regulation on takeover bids, closed-end investment funds and insider trading; and the introduction of an antitrust legislation. Financial regulation also needs to be adapted to the requirements of European integration, which will involve greater harmonization not only in the tax treatment of financial assets, but also in reserve requirements on bank deposits (at present averaging 21 percent in Italy, against 6 percent in Germany and 3 percent in France).

Japan

The importance of structural reforms is well recognized in the current Five-Year Economic Plan, which has fully incorporated the recommendations of the Mayekawa and other commissions. Progress in the implementation of these recommendations has been most evident in the areas

(8)

of tax and financial reform. The implementation of structural reforms in other areas, however, has been more limited. In particular, it would be appropriate to move forward in the areas of land management, agriculture, and the distribution system.

Land management in Japan presents a complex and politically difficult problem. Regulations covering the use and taxation of land have distorted the allocation of this scarce resource, and have restricted the supply of land for nonagricultural purposes. Rental laws, building codes, and zoning regulations have hindered urban renewal and development. Property and inheritance taxes are substantially lower for agricultural land than for residential land, thus providing a disincentive to redeveloping urban agricultural land for housing or business use. The Five-Year Economic Plan recognizes the need for the implementation of prompt and forceful measures to rationalize the use of land, but such measures are yet to be introduced.

Imports of agricultural goods remain subject to quotas and high tariffs. The lowering of administered prices for some commodities, as well as the decision to gradually abolish import quotas for beef, oranges, and other products are important first steps. But a much fuller agricultural reform is needed to promote international adjustment and harmony as well as to improve domestic resource allocation and consumer welfare. In addition to liberalization of agricultural imports, there is scope for stepping up the pace of deregulation of the agricultural sector more generally, in particular with respect to the marketing and distribution of rice.

Access to Japan's markets would be further enhanced by a streamlining of the distribution system. To be sure, the distribution sector is already undergoing significant adjustment in response to market forces, but this adjustment would be accelerated by the relaxation of government regulations, notably the Large-Scale Retail Store Law, that may be restricting competition. This Law has restricted the opening and expansion of large stores. It is necessary to relax the implementation of the Law by simplifying and shortening the process of approval of new stores as soon as possible and eventually to abolish the Law itself.

United Kingdom

1. Tax reform

The authorities have actively pursued tax reform in recent years. In particular, the number of tax brackets was reduced and both the basic rate and the top marginal rate were lowered. The lower marginal rates have reduced the incentive for tax evasion and avoidance and have improved the climate for enterprise. In the 1989 budget, a major reform of the system of employees' national insurance contributions was announced; the changes involved a simplification of the system, and further reduced the contribution payable at the lower earnings limit. These changes reduced discontinuities in marginal rates and disincentives to work, but reform of the system could be extended, for example to cover the structure of employers' contributions.

In recent years the tax treatment of savings and investment has been made more neutral. The 1989 budget introduced improvements in the taxation of life insurance and pensions, involving lower tax rates on a broader tax base. Nevertheless, distortions affecting the allocation of saving and investment remain. Tax incentives have been aimed at stimulating home and share ownership, business enterprises, private premises, and profit-related pay. As a result, a large proportion of capital income is exempt from tax. As regards housing, in the absence of a tax on imputed rent and a capital gains tax, the tax deductibility of mortgage interest represents an important distortion. The planned removal of local property taxes, which have tended to offset this distortion, makes reform of the taxation of owner-occupied housing more urgent.

Alex? Combin - ||

2. Labor markets

Labor market relations are in a state of transition owing partly to the legislative changes adopted in the mid-1980s. Positive changes in workplace practices in areas such as manning demarcation and work hours have--together with substantial labor shedding--boosted productivity in recent years, especially in manufacturing. However, the continued existence of labor market rigidities is suggested by wide disparities in regional unemployment rates.

The functioning of the labor market could be improved by proceeding with announced plans to further rationalize employment training schemes and preventing pre-entry closed shop arrangements. In addition, restrictive practices within self-regulating professions should be terminated. The 1988 Housing Act introduced reforms to increase the availability of housing, especially in the private rented sector. Acceleration of these reforms to phase out rent restrictions and protected tenancies on existing lettings would help improve labor mobility.

3. Trade practices

The authorities remain committed to the preservation and extension of an open trading system. However, a number of voluntary export restraint arrangements are maintained, including those operated under the EC framework. The Government should also move to increase competitiveness in the tender system in the areas of health and defense purchases.

United States

1. Private saving

Tax provisions that distort saving decisions include: the deductibility of interest on home equity loans, the proceeds of which are used for purposes other than home purchases; the deductibility of mortgage interest and property tax on owner-occupied homes; the taxation (and the deduction from the tax base) of nominal interest rather than interest in real terms; the taxation of capital gains based on nominal gains rather than on gains in real terms; and the double taxation of dividends.

In varying degrees these provisions affect both the overall level and allocation of private saving. There is some uncertainty about the effect that the removal of these distortions would have on the overall level of private saving. However, their elimination should lead to a more efficient allocation of savings, in particular between the accumulation of tangible assets (e.g., houses) and financial assets, with implications for the private saving/investment balance (and therefore the external current account). In addition, the elimination of some of those provisions (e.g., deductibility of mortgage interest or property tax on owner-occupied homes) would raise federal revenue and thus increase national saving.

2. Health care

Health care costs are rising rapidly, at least in part as a result of a range of impediments to the functioning of the price mechanism in this area. Policy should take these impediments into account. As a first step, the abolition of the exclusion from taxation of employer contributions to employee health care insurance programs might be considered as this exclusion is exacerbating the tendency for medical insurance to lead to excess demand for health care. More generally, the authorities need to reinforce their efforts aimed at finding a way of resolving the dilemma posed by the tradeoff between the risk spreading afforded by insurance and the need to establish appropriate incentives to restrain health care expenditures.

3. Trade policy

In the trade policy area, the United States should start dismantling the long-standing protection accorded to steel and to textiles and clothing. As regards sugar, the United States should comply with the recent GATT panel ruling promptly. It is also important to ensure that the Trade Act of 1988 is not implemented in a protectionist way. Of particular concern are the dangers associated with Super 301, including its tendency toward unilateralism, its emphasis on U.S. market share as a primary objective in negotiations, a possible proliferation of quantitative restraints, and the risk that designated countries might attempt to divert the sources of their imports in favor of the United States.

4. Agriculture

On agriculture, steps should be taken--for example, in the context of the 1990 Farm Bill--to continue the progress toward making the sector more market oriented.

INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

TO: ✓Mr. Cassell
Mr. Filosa
Mr. Grosche
Mr. Marcel
Mr. Massé
Mr. Warner
Mr. Yamazaki

DATE: September 20, 1989

FROM: The Managing Director

SUBJECT: Meeting of Ministers and Governors of Major Industrial Countries

The attached note and tables have been prepared as background for the forthcoming meeting of Ministers and Governors of the major industrial countries. I should be grateful if you would arrange to transmit this material to your authorities by confidential channels.

Attachment

ANX B REPORT BY CAMDESSUS

SECOND PERM SEC'S OFFICE OVERSEAS FINANCE SECTOR	
ACTION	Mr Pickering
	Mr Melliss
	Mr Peretz
cc	PPS
	Mr Evans
	Mr Scholar
	Mr Lazar

CONFIDENTIAL

September 20, 1989

World Economic Situation and Policy Issues

Note by Michel Camdessus

Managing Director, International Monetary Fund

This note and the attached indicator tables update the information provided in the note for the April meeting of Ministers and Governors of the major industrial countries in Washington.

1. Recent economic developments and short-term prospects

The expansion of the world economy is expected to be sustained this year and next, albeit at a more moderate pace than in the past two years. In most of the major industrial countries (with the notable exception of Germany) there are signs of some slowdown in the growth of output in the first half of 1989, as the tightening of monetary conditions during the past year has begun to take effect. For the seven major countries as a group, the Fund staff projects a moderation in the rate of growth of real GNP, from 4 1/2 percent in 1988 to 3 1/2 percent in 1989 and 3 percent in 1990. These projections are not very different from the official estimates prepared in early 1989 (Table A).

Since the middle of 1988 progress in reducing external imbalances has been mixed. Germany's (seasonally adjusted) current account surplus rose sharply in the first quarter of 1989, but fell back somewhat in the second quarter; Japan's surplus declined markedly in the second quarter, after having risen in the two previous quarters. The current account deficit of the United States in the first half of 1989 was approximately unchanged from its average level in 1988, while the deficit of the United Kingdom fell slightly in both the first and second quarters. The most recent data suggest that the trade imbalances of the United States and Japan narrowed in the last few months. However, these developments are insufficient to re-establish a trend toward lower imbalances, particularly since they appear to have reflected J-curve effects associated with the recent strengthening of the dollar. On the customary assumption of unchanged policies and real exchange rates, the staff expects the external imbalances of the major countries to remain large in relation to GNP in the next several years (Table C). The projections prepared by the authorities in early 1989 envisaged a gradual narrowing of the imbalances over the medium term.

Consumer prices in the seven major countries rose by about 4 1/2 percent in the first eight months of 1989 from the same period a year earlier, compared with an increase of 3 percent in 1988. The acceleration reflected higher food and oil prices as well as increases in indirect taxes in some countries, but high rates of capacity utilization and a tightening of labor markets also played a role. Although the Fund staff continues to expect inflation to slow next year, their projections for inflation are generally higher than those prepared by the authorities in January 1989 (Table 8).

Following a modest pick-up in the latter part of 1988, the rate of increase in non-oil commodity prices fell sharply during the first half of 1989 (Chart 1). This development can be attributed mainly to a weakening of prices for metals, minerals, and tropical beverages, notably coffee. The broad commodity price index (including oil) rose sharply from late in 1988 through May 1989 as oil prices recovered (Chart 2). Oil prices subsequently fell back significantly before recovering partially during the past month.

Exchange rate developments during the first eight and a half months of 1989 featured a considerable strengthening of the U.S. dollar, despite indications of a slowdown in the pace of external adjustment. The recent appreciation of the U.S. dollar began in December of last year and was halted in mid-June; from mid-June to early August the dollar depreciated sharply, but it rose again during August, recovering most of the loss experienced since mid-June. In the first half of September, the real effective value of the U.S. dollar was 11 1/4 percent above its level in December 1988 and almost 16 percent above its end-1987 trough. The appreciation of the dollar in nominal terms since the end of 1988 has been most pronounced against the yen and the pound sterling (about 18 percent), but it has also been significant against the deutsche mark, the franc and the lira (13, 11 1/2, and 9 3/4 percent, respectively). The U.S. dollar changed little vis-à-vis the Canadian dollar (Table III).

Nominal interest rate differentials in favor of dollar-denominated assets have remained positive vis-à-vis the yen and deutsche mark, but they narrowed significantly since March (Table IV). The composite indicator of short-term interest rates in the seven major countries rose by 230 basis points from the first quarter of 1988 to August 1989 (Table II). Over the same period the composite indicators of long-term interest rates increased by only 10 basis points; yield curves have continued to flatten everywhere and have become inverted in several countries. These developments suggest that temporary price disturbances have not had a major impact on long-term expectations about inflation.

As regards fiscal policies, in the United States the Administration's latest estimate of the federal deficit in FY 1989 (the year ending September 30, 1989) is $148 billion, compared with a Gramm-Rudman-Hollings (GRH) target of $136 billion, and down from $155 billion in FY 1988. According to the Administration's latest assessment, a number of bills to implement the April bipartisan budget agreement, which are now before Congress, would bring the projected deficit down to just below $110 billion (the GRH target of $100 billion plus a $10 billion cushion allowed before automatic spending cuts are triggered), but the margin for slippage is very small.

In Japan, the Fund staff projects that the surplus of the general government sector would increase by about 3/4 percentage point of GNP between 1988 and 1990, reflecting the strength of the economy. In Germany, the stance of fiscal policy in 1989 is estimated to be somewhat more restrictive than in 1988, owing mainly to additional revenues from new excise taxes; fiscal policy is expected to become stimulative next year, as the third phase of the 1986-90 income tax reduction and reform plan comes into effect. In the United Kingdom a sizable fiscal surplus is projected for the next few years. In Canada, substantial deficit-reduction measures (primarily on the revenue side) were announced in the April budget aimed at forestalling a near-term worsening of the fiscal position and bringing about a significant reduction of the deficit in the medium term. Relatively small changes in fiscal positions are expected for France and Italy in 1989-90 on the basis of current policies. The Italian government is currently considering major initiatives to reduce its large budget deficit.

There has been little change in the staff's output projections for the developing countries. After slowing from 4 1/4 percent in 1988 to 3 1/4 percent in 1989, the growth of real GDP is expected to recover to 4 percent in 1990. However, significant differences in performance among countries will persist. Most of the exporters of manufactures should continue to grow at a much faster rate than the other developing countries. However, the economic performance of the heavily indebted countries, especially in Africa and the Western Hemisphere, is likely to continue to be severely constrained by external financing difficulties and domestic problems, including very rapid inflation in certain countries. The aggregate current account surplus of the four Asian NIEs is projected to decline from $28 billion in 1988 to $25 billion in 1990.

Issues for Discussion

Recent developments have not altered significantly the appraisal of policy issues contained in the note submitted for the April meeting. The policy appraisal is therefore not repeated in detail here. Instead, the following comments respond to the questions for discussion listed in the Deputies' Report to Ministers and Governors.

(1) Regarding the appropriateness of the policy stance, Fund staff projections suggest that current policies are compatible with a continuation of growth close to the rate of expansion of potential, and with an abatement of recent inflationary pressures. However, a tighter stance of fiscal policy in the major deficit countries would greatly ease the task of monetary management, contribute to an increase in saving, investment and potential growth in all countries, and facilitate the external adjustment process. In the absence of a substantial fiscal adjustment (or a pronounced cyclical downturn) an easing of monetary ? in all cos?

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conditions would be unwarranted as it would involve the risk of a renewed pick-up in inflation.

(2) Further progress in reducing external imbalances requires an appropriate sharing of the burden of adjustment between surplus and deficit countries. In this context, I basically agree with the Deputies' assessment, including the need for some exchange rate adjustment. Of course, exchange rate changes should be accompanied by action in the deficit countries to restrain the growth of domestic demand--including action to cut fiscal deficits, where appropriate--to bring about a lasting improvement in the external position while safeguarding investment and price performance. Indeed, to set in motion this process, prompt and sizeable action by the United States in the fiscal area would be essential as it would free resources and allow U.S. interest rates to fall, thus creating the conditions for appropriate exchange rate adjustments. As part of the process, surplus countries should ensure that the growth of domestic demand is sustained at a pace consistent with external adjustment.

(3) Together with fiscal adjustment, bold implementation of the structural measures listed in the Annex to the Deputies' report should be viewed as essential. These measures should be adopted promptly in all countries to improve economic performance and to assist the process of international adjustment. I recognize the political difficulties involved in implementing these measures. But we all have a major stake in removing these deeply rooted impediments to growth and employment and strengthening the credibility of the policy coordination process. We must therefore use this process to help overcome opposition from domestic pressure groups to measures that are clearly in the general interest.

DATE :SEPTEMBER 20, 1989

TABLE I. PERFORMANCE INDICATORS FOR 1989-90 AND OUTTURN FOR 1988 AND FIRST HALF OF 1989 1/
(CHANGES IN PERCENT, UNLESS OTHERWISE NOTED)

	REAL GNP/GDP GROWTH			REAL TOTAL DOMESTIC DEMAND GROWTH			CONSUMER PRICE INFLATION			CURRENT ACCOUNT BALANCE ($ BILL.)			TRADE BALANCE ($ BILL.) 2/		
	1988	1989	1990	1988	1989	1990	1988	1989	1990	1988	1989	1990	1988	1989	1990
ANADA															
UTHORITIES' PROJECTIONS	4.2	2.3	2.1	5.1	2.7	1.2	4.0	3.8	3.5	-7.8	-10.6	-8.5	8.5	8.4	12.0
MF STAFF, SEPT. 1989	5.0	2.6	2.0	5.8	5.4	2.1	4.0	5.2	4.9	-8.4	-15.8	-16.5	8.0	4.8	5.1
UTTURN 1988, H1 1989	5.0	3.1		5.8	6.2		4.0	4.8**		-8.4	-13.1		8.0	6.3**	
ITED STATES															
UTHORITIES' PROJECTIONS	3.8	3.3	3.2	2.9	2.8	2.6	3.9	3.9	3.7	-135.0	-115.0	-110.0	-126.0	-100.0	-85.0
MF STAFF, SEPT. 1989	4.4	2.9	2.1	3.3	2.3	2.4	4.1	5.1	6.9	-126.5	-125.1	-138.7	-127.2	-113.5	-128.1
UTTURN 1988, H1 1989	4.4	3.2		3.3	2.6		4.1	5.0**		-126.5	-122.4		-127.2	-111.6**	
APAN															
UTHORITIES' PROJECTIONS 3/	4.9	4.0	3.7	6.7	4.7	4.2	0.7	2.0	1.5	78.0	71.0	66.2	93.0	88.0	84.2
MF STAFF, SEPT. 1989	5.7	4.9	4.7	7.7	5.2	4.6	0.7	2.2	1.6	79.6	72.0	89.7	95.0	91.9	105.9
UTTURN 1988, H1 1989	5.7	4.5*		7.7	5.8*		0.7	2.1**		79.6	73.2		95.0	91.1**	
ERMANY, FED. REP. OF															
UTHORITIES' PROJECTIONS	3.4	2.6	2.8	3.7	2.9	3.2	1.2	2.3	2.0	48.0	47.0	45.0	76.8	77.5	76.8
MF STAFF, SEPT. 1989	3.6	4.0	3.0	3.7	2.7	3.1	1.2	3.0	2.7	48.6	53.4	56.8	79.1	82.2	88.2
UTTURN 1988, H1 1989	3.6	4.7		3.7	2.9		1.2	2.9**		48.6	53.7		79.1	74.1**	
ANCE															
UTHORITIES' PROJECTIONS	3.4	2.8	2.9	3.8	2.7	2.8	2.7	2.5	2.3	-4.0	-4.5	-3.1	-6.0	-6.8	-4.1
MF STAFF, SEPT. 1989	3.5	3.4	3.0	3.6	3.6	3.0	2.7	3.5	3.0	-4.3	-5.5	-4.9	-5.6	-6.8	-6.8
UTTURN 1988, H1 1989	3.5	3.5		3.6	3.5		2.7	3.5**		-4.3	-4.8		-5.6	-7.0**	
ALY															
UTHORITIES' PROJECTIONS	3.6	3.0	3.1	4.2	3.5	3.4	4.8	4.0	3.3	-3.7	-5.2	-4.8	-2.6	-4.9	-5.2
MF STAFF, SEPT. 1989	3.9	3.2	2.9	4.3	3.7	3.4	5.0	6.6	5.1	-5.2	-8.1	-10.2	-0.6	-4.9	-7.6
UTTURN 1988, H1 1989	3.9	3.1*		4.3	4.4*		5.0	6.5**		-5.2	...		-0.6	-13.1**	
ITED KINGDOM															
UTHORITIES' PROJECTIONS 4/	4.3	2.3	1.9	6.5	2.5	1.4	6.5	5.5	3.3	-25.7	-25.4	-20.0	-36.0	-37.4	-36.4
MF STAFF, SEPT. 1989	4.2	3.0	2.7	6.2	3.6	1.1	4.9	7.9	5.5	-26.1	-30.6	-26.7	-36.6	-40.6	-36.7
UTTURN 1988, H1 1989	4.2	1.5		6.2	5.0*		4.9	8.0**		-26.1	-31.4		-36.6	-40.8**	
JOR INDUSTRIAL COUNTRIES															
UTHORITIES' PROJECTIONS	4.0	3.2	3.1	4.2	3.3	3.0	3.1	3.3	2.9	-50.2	-42.7	-35.2	7.7	24.8	42.3
MF STAFF, SEPT. 1989	4.5	3.5	3.0	4.6	3.4	3.0	3.1	4.4	3.8	-42.3	-59.6	-50.5	12.1	13.2	20.0
UTTURN 1988, H1 1989 5/	4.5	3.5		4.6	3.8		3.1	4.4		-42.3	...		12.1	-0.9	

THE AUTHORITIES' LATEST ESTIMATES WERE SUBMITTED IN EARLY 1989. ACTUAL DATA FOR THE FIRST HALF (H1) OF 1989 ARE INDICATED AS PERCENT CHANGES FROM A YEAR EARLIER; CURRENT ACCOUNT AND TRADE BALANCE DATA SHOW THE CUMULATIVE OUTCOME FOR THE FOUR QUARTERS TO Q2 1989 SEASONALLY ADJUSTED. * INDICATES DATA ARE AVAILABLE THROUGH Q1 1989; ** INDICATES DATA ARE AVAILABLE THROUGH JULY, 1989.

PROJECTIONS PROVIDED BY NATIONAL AUTHORITIES IN NATIONAL CURRENCY OR IN PERCENT OF GNP/GDP HAVE BEEN CONVERTED INTO U.S. DOLLARS USING NATIONALLY PROVIDED EXCHANGE RATES. FOR THE UNITED STATES, THE ESTIMATE FOR THE FOUR QUARTERS TO Q2 1989 IS ON A CENSUS BUREAU BASIS; THE CORRESPONDING FIGURE FOR 1988 IS $119.7 BILLION. FOR THE FED. REP. OF GERMANY THE ESTIMATE FOR THE TWELVE MONTHS TO JULY 1989 IS ON A TRADE RETURN BASIS; THE CORRESPONDING FIGURE FOR 1988 IS $73 BILLION. DATA FOR FRANCE ARE ON A TRADE RETURN BASIS.

DATA PERTAIN TO FISCAL YEARS ENDING MARCH 31 OF THE FOLLOWING YEAR.

CONSUMER PRICE FIGURES REFER TO THE RETAIL PRICE INDEX AND ARE ON A FOURTH-QUARTER TO FOURTH-QUARTER BASIS.

WEIGHTED AVERAGE OR SUM OF AVAILABLE DATA FOR INDIVIDUAL COUNTRIES.

DATE :SEPTEMBER 20, 1989

TABLE II. COMPOSITE INDICATORS FOR MAJOR SEVEN COUNTRIES -- LATEST INDICATORS
(PERCENT CHANGES AT ANNUAL RATES, UNLESS OTHERWISE NOTED)

	1987	1988				1989					
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	MAY	JUNE	JULY	AUG.
REAL GNP/GDP	5.8	5.8	1.3	4.6	3.0	5.7	...	...	...	...	...
INDUSTRIAL PRODUCTION	8.1	5.6	3.6	7.4	4.2	4.9	1.9	-7.7	15.5	...	...
CONSUMER PRICES	2.8	2.0	3.7	3.6	4.0	4.2	6.8	6.2	3.3	2.9	0.8
COMMODITY PRICES											
BROAD INDEX, 1980=100	76.1	72.4	75.6	76.7	74.8	80.5	82.8	82.9	82.8	80.8	79.9
PERCENT CHANGE	10.0	-18.0	18.9	6.1	-9.7	34.1	12.2	2.0	-2.4	-25.3	-12.1
NARROW INDEX, 1980=100	91.9	89.7	94.2	97.5	96.9	99.1	99.8	100.4	100.4	97.9	97.7
PERCENT CHANGE	30.9	-9.3	21.9	14.7	-2.3	9.3	2.8	24.7	0.7	-26.3	-2.3
MONETARY GROWTH											
M1	5.5	6.8	8.6	6.1	5.5	8.6	...	-6.7	...	...	...
M2	7.7	7.4	8.4	8.5	7.3	6.2	5.5	0.2	11.1	...	...
SHORT-TERM INTEREST RATES											
NOMINAL	6.3	6.0	6.2	7.0	7.6	8.3	8.4	8.4	8.4	8.3	8.3
REAL 1/	3.1	3.2	3.4	4.0	4.2	4.4	3.7	3.7	3.7	3.6	4.0
LONG-TERM INTEREST RATES											
NOMINAL	8.4	7.7	8.0	8.4	8.1	8.3	8.3	8.3	8.0	7.9	7.8
REAL 1/	5.2	4.9	5.2	5.4	4.7	4.4	3.6	3.6	3.3	3.2	3.4
EMPLOYMENT	1.1	2.2	2.8	2.1	1.1	11.2	...	...	...	...	...
UNEMPLOYMENT RATES	6.5	6.3	6.2	6.2	6.0	5.8	...	5.8	...	...	...

1/ NOMINAL INTEREST RATE LESS INCREASE IN CONSUMER PRICE INDEX FROM TWELVE MONTHS EARLIER.

DATE :SEPTEMBER 20, 1989

TABLE III. SPOT EXCHANGE RATES, AND NOMINAL AND REAL EFFECTIVE EXCHANGE RATES
(PERIOD AVERAGES)

	1980	1985	1987	1988	1988	1989				
					DEC.	MAY	JUNE	JULY	AUG.	SEP. 1-15
OT EXCHANGE RATES (CURRENCY UNITS PER U.S. DOLLAR EXCEPT AS NOTED)										
NADA	1.17	1.37	1.33	1.23	1.20	1.19	1.19	1.20	1.19	1.19
PAN	227	239	145	128	124	132	138	144	141	147
RMANY, FED. REP. OF	1.82	2.94	1.80	1.76	1.76	1.87	1.95	1.98	1.89	1.98
ANCE	4.23	8.99	6.01	5.96	6.00	6.32	6.62	6.72	6.42	6.68
ALY	856	1909	1296	1302	1295	1372	1418	1436	1371	1421
ITED KINGDOM (US$/POUND)	2.33	1.30	1.64	1.78	1.83	1.70	1.63	1.55	1.62	1.55
FECTIVE EXCHANGE RATES (INDICES, 1974-86=100)										
REAL TERMS 1/										
NADA	91.4	97.4	93.6	101.5	104.2	107.1	107.8	108.1	108.0	109.8
ITED STATES	85.7	124.6	87.3	82.6	81.3	84.7	88.0	90.3	87.7	90.4
PAN	93.1	92.9	115.1	121.2	124.0	121.9	117.7	113.1	112.1	109.7
RMANY, FED. REP. OF	105.0	94.1	108.5	107.7	107.5	105.9	105.9	106.5	107.5	105.9
ANCE	105.1	95.8	95.8	92.0	89.6	89.2	88.1	88.1	88.5	87.7
ALY	95.8	103.0	104.7	102.4	103.5	103.3	103.3	103.6	104.5	104.2
ITED KINGDOM	115.0	109.4	106.1	119.2	125.1	124.3	123.6	119.5	121.0	119.0
NOMINAL TERMS 2/										
NADA	92.5	94.8	85.4	90.3	92.2	94.8	95.9	96.3	95.8	97.4
ITED STATES	85.2	127.2	91.9	86.6	84.9	89.0	92.1	94.0	91.2	94.0
PAN	92.9	118.1	161.7	179.2	184.9	177.9	173.2	168.2	168.4	164.8
RMANY, FED. REP. OF	108.2	103.8	123.8	122.9	122.1	120.0	118.8	118.8	120.5	118.7
ANCE	112.5	79.2	86.0	84.2	82.9	82.2	81.1	81.0	82.2	81.5
ALY	99.8	66.9	70.7	68.1	68.0	67.3	67.3	67.5	68.5	68.3
ITED KINGDOM	109.3	89.1	82.6	87.0	88.8	86.4	85.4	82.5	83.8	82.4

/ BASED ON THE FUND'S CALCULATIONS OF RELATIVE NORMALIZED UNIT LABOR COSTS IN MANUFACTURING IN A COMMON CURRENCY.
/ BASED ON THE FUND'S MERM CALCULATIONS.

DATE :SEPTEMBER 20, 1989

TABLE IV. NOMINAL AND REAL SHORT-TERM INTEREST RATES 1/
(IN PERCENT, PERIOD AVERAGES)

	1986	1987	1988	1989 FEB.	MAR.	APR.	MAY	JUNE	JULY	AUG.	SEPT. 15
NOMINAL RATES											
CANADA	9.0	8.2	9.4	11.4	12.0	12.3	12.2	12.1	12.1	12.1	12.2
UNITED STATES	6.2	6.0	6.9	8.8	9.1	9.0	8.7	8.4	8.2	8.2	7.8
JAPAN	5.1	3.9	4.1	4.6	4.7	4.6	5.0	5.3	5.3	5.4	5.6
GERMANY, FED. REP. OF	4.6	4.0	4.3	6.4	6.6	6.4	7.0	7.0	7.0	7.0	7.4
FRANCE	7.7	8.2	7.9	9.2	9.1	8.7	8.9	8.9	9.1	9.0	9.3
ITALY	12.9	11.4	11.3	12.5	13.1	12.5	12.5	12.6	12.7	12.8	12.6
UNITED KINGDOM	10.9	9.7	10.3	13.0	13.0	13.1	13.1	14.2	13.9	13.8	13.9
REAL RATES 2/											
CANADA	4.8	3.8	5.4	6.8	7.5	7.7	7.3	6.8	6.7	7.0	7.0
UNITED STATES	4.3	2.3	2.9	4.0	4.3	3.8	3.4	3.1	3.1	3.4	3.0
JAPAN	4.5	3.8	3.4	3.6	3.6	2.2	2.1	2.2	2.1	2.6	2.8
GERMANY, FED. REP. OF	4.8	3.7	3.1	3.8	3.9	3.4	3.9	3.9	4.0	4.1	4.4
FRANCE	5.2	4.9	5.2	5.8	5.7	5.1	5.2	5.3	5.6	5.6	5.8
ITALY	6.7	6.8	6.3	6.2	6.8	5.8	5.7	5.6	5.7	6.1	5.9
UNITED KINGDOM	7.5	5.6	5.4	5.2	5.1	5.1	4.8	5.9	5.7	6.5	6.6

1/ INTEREST RATES ON THE FOLLOWING INSTRUMENTS: CANADA AND THE UNITED STATES, THREE-MONTH TREASURY BILLS; JAPAN, DISCOUNT RATE ON TWO-MONTH PRIVATE BILLS; FRANCE, THE FEDERAL REPUBLIC OF GERMANY, ITALY, AND THE UNITED KINGDOM, THREE-MONTH INTERBANK LOAN RATES.

2/ NOMINAL RATES LESS INCREASE IN CONSUMER PRICE INDEX FROM TWELVE MONTHS EARLIER; FOR THE MOST RECENT PERIOD, STAFF PROJECTIONS OF THE DEFLATOR ARE USED.

DATE :SEPTEMBER 20, 1989

A. OUTPUT AND DEMAND
(CHANGES, IN PERCENT, EXCEPT IF OTHERWISE NOTED)

NATIONAL AUTHORITIES ESTIMATES (IMF STAFF ESTIMATES)

	1988	1989	1990	1991	1992
REAL GNP/GDP					
CANADA	4.2 (5.0)	2.3 (2.6)	2.1 (2.0)	3.0 (3.0)	3.5 (3.3)
UNITED STATES	3.8 (4.4)	3.3 (2.9)	3.2 (2.1)	3.3 (2.6)	3.2 (2.6)
JAPAN	4.9 (5.7)	4.0 (4.9)	3.7 (4.7)	3.7 (4.2)	3.7 (4.2)
GERMANY, FED. REP. OF	3.4 (3.6)	2.6 (4.0)	2.8 (3.0)	2.5 (2.6)	2.5 (2.3)
FRANCE	3.4 (3.5)	2.8 (3.4)	2.9 (3.0)	2.9 (3.0)	3.0 (3.1)
ITALY	3.6 (3.9)	3.0 (3.2)	3.1 (2.9)	3.2 (3.0)	3.3 (3.0)
UNITED KINGDOM 1/	4.3 (4.2)	2.3 (3.0)	1.9 (2.7)	2.8 (2.7)	2.8 (2.7)
MAJOR INDUSTRIAL COUNTRIES	4.0 (4.5)	3.2 (3.5)	3.1 (3.0)	3.2 (3.1)	3.2 (3.1)
OTHER INDUSTRIAL COUNTRIES	(3.3)	(3.1)	(2.3)	(2.8)	(2.9)
DEVELOPING COUNTRIES	(4.2)	(3.2)	(4.0)	(4.9)	(5.4)
REAL TOTAL DOMESTIC DEMAND					
CANADA	5.1 (5.8)	2.7 (5.4)	1.2 (2.1)	2.2 (3.1)	3.6 (3.3)
UNITED STATES	2.9 (3.3)	2.8 (2.3)	2.6 (2.4)	2.9 (2.6)	2.9 (2.6)
JAPAN	6.7 (7.7)	4.7 (5.2)	4.2 (4.6)	4.2 (4.3)	4.2 (4.3)
GERMANY, FED. REP. OF	3.7 (3.7)	2.9 (2.7)	3.2 (3.1)	2.8 (2.6)	2.8 (2.3)
FRANCE	3.8 (3.6)	2.7 (3.6)	2.8 (3.0)	2.8 (3.0)	2.9 (3.0)
ITALY	4.2 (4.3)	3.5 (3.7)	3.4 (3.4)	3.4 (3.3)	3.4 (3.2)
UNITED KINGDOM	6.5 (6.2)	2.5 (3.6)	1.4 (1.1)	2.0 (2.2)	2.1 (2.4)
MAJOR INDUSTRIAL COUNTRIES	4.2 (4.6)	3.3 (3.4)	3.0 (3.0)	3.1 (3.1)	3.2 (3.1)
OTHER INDUSTRIAL COUNTRIES	(3.8)	(3.6)	(2.3)	(3.3)	(3.4)
CHANGES IN REAL FOREIGN BALANCE (IN PERCENT OF GNP/GDP)					
CANADA	-0.9 (-1.1)	-0.3 (-2.5)	0.8 (0)	0.9 (-0.1)	-0.1 (0)
UNITED STATES	1.0 (1.2)	0.5 (0.5)	0.5 (-0.3)	0.5 (0)	0.3 (0)
JAPAN	-1.6 (-2.0)	-0.7 (-0.3)	-0.5 (0.1)	-0.5 (-0.1)	-0.5 (-0.1)
GERMANY, FED. REP. OF	-0.3 (-0.1)	-0.3 (1.3)	-0.4 (-0.1)	-0.3 (0)	-0.3 (0)
FRANCE	-0.4 (-0.1)	0.1 (-0.2)	0.1 (0)	0.1 (0.1)	0.1 (0.1)
ITALY	-0.6 (-0.4)	-0.5 (-0.5)	-0.3 (-0.4)	-0.2 (-0.3)	-0.1 (-0.2)
UNITED KINGDOM	-4.5 (-2.0)	-0.2 (-0.6)	0.6 (1.6)	0.9 (0.5)	1.0 (0.3)
MAJOR INDUSTRIAL COUNTRIES	-0.2 (-0.1)	0 (0.1)	0.2 (0)	0.1 (0)	0 (0)
OTHER INDUSTRIAL COUNTRIES	(-0.6)	(-0.5)	(0)	(-0.5)	(-0.5)

1/ AVERAGE MEASURE OF GDP.

GENERAL NOTE: THE ESTIMATES SHOWN REFLECT DIFFERING NATIONAL PRACTICES. FOR CHARACTERIZATIONS OF NATIONAL ESTIMATES, SEE THE ATTACHED GENERAL AND TABLE-SPECIFIC NOTES. THE SAME DEGREE OF PRECISION IS APPLIED FOR ALL COUNTRIES SOLELY AS A MATTER OF CONVENIENCE. THE PROJECTIONS BY NATIONAL AUTHORITIES WERE SUBMITTED IN EARLY 1989.
THE IMF STAFF PROJECTIONS IN THIS AND THE FOLLOWING TABLES WERE FINALIZED ON SEPTEMBER 5, 1989 AND REFLECT THE FOLLOWING WORKING ASSUMPTIONS: OIL PRICES ARE ASSUMED TO AVERAGE $16.00 PER BARREL IN 1989, $16.35 IN 1990, AND TO REMAIN CONSTANT IN REAL TERMS THEREAFTER; EXCHANGE RATES ARE ASSUMED TO REMAIN UNCHANGED IN REAL TERMS FROM THE AVERAGE LEVEL PREVAILING IN THE FOUR WEEKS ENDING AUGUST 8, 1989; "PRESENT" ECONOMIC POLICIES OF THE NATIONAL AUTHORITIES ARE ASSUMED TO BE MAINTAINED. UNLESS OTHERWISE NOTED, IMF STAFF PROJECTIONS REFER TO CALENDAR YEARS.

DATE :SEPTEMBER 20, 1989

B. INFLATION
(CHANGES, IN PERCENT)

NATIONAL AUTHORITIES ESTIMATES (IMF STAFF ESTIMATES)

	1988	1989	1990	1991	1992
GNP/GDP DEFLATOR					
CANADA	4.1 (4.1)	3.3 (5.2)	3.1 (4.4)	2.8 (4.1)	3.0 (4.0)
UNITED STATES	3.4 (3.3)	4.0 (4.5)	3.6 (4.6)	3.2 (4.4)	2.7 (4.3)
JAPAN	0.5 (0.4)	1.2 (1.8)	1.0 (1.3)	1.0 (1.0)	1.0 (1.0)
GERMANY, FED. REP. OF	1.9 (1.5)	2.0 (2.5)	2.0 (2.5)	2.0 (2.3)	2.0 (2.3)
FRANCE	2.7 (3.1)	2.5 (3.2)	2.3 (2.8)	2.1 (2.5)	2.0 (2.5)
ITALY	5.0 (6.0)	4.3 (6.6)	3.6 (5.1)	3.6 (4.4)	3.6 (4.0)
UNITED KINGDOM	7.2 (6.7)	5.4 (7.5)	3.9 (5.7)	3.0 (4.5)	2.6 (4.0)
MAJOR INDUSTRIAL COUNTRIES	3.0 (2.9)	3.1 (4.0)	2.7 (3.6)	2.5 (3.3)	2.3 (3.2)
CONSUMER PRICES					
CANADA	4.0 (4.0)	3.8 (5.2)	3.5 (4.9)	3.2 (4.1)	3.2 (4.0)
UNITED STATES	3.9 (4.1)	3.9 (5.1)	3.7 (4.9)	3.2 (4.6)	2.7 (4.4)
JAPAN	0.7 (0.7)	2.0 (2.2)	1.5 (1.6)	1.5 (1.2)	1.5 (1.2)
GERMANY, FED. REP. OF	1.2 (1.2)	2.3 (3.0)	2.0 (2.7)	2.0 (2.3)	2.0 (2.3)
FRANCE	2.7 (2.7)	2.5 (3.5)	2.3 (3.0)	2.1 (2.6)	2.0 (2.5)
ITALY	4.8 (5.0)	4.0 (6.6)	3.3 (5.1)	3.3 (4.4)	3.3 (4.0)
UNITED KINGDOM	6.5 (4.9)	5.5 (7.9)	3.3 (5.5)	2.8 (4.5)	2.6 (4.0)
MAJOR INDUSTRIAL COUNTRIES	3.1 (3.1)	3.3 (4.4)	2.9 (3.8)	2.6 (3.4)	2.4 (3.2)

DATE :SEPTEMBER 20, 1989

C. CURRENT ACCOUNT AND TRADE BALANCES

	1988	1989	1990	1991	1992
	NATIONAL AUTHORITIES ESTIMATES (IMF STAFF ESTIMATES)				
CURRENT ACCOUNT (IN BILLIONS OF U.S. DOLLARS)					
CANADA	-8 (-8)	-11 (-16)	-9 (-17)	-4 (-20)	-4 (-22)
UNITED STATES	-135 (-127)	-115 (-125)	-110 (-139)	-95 (-158)	-85 (-169)
JAPAN 1/	78 (80)	71 (72)	66 (90)	62 (97)	60 (106)
GERMANY, FED. REP. OF	48 (49)	47 (53)	45 (57)	44 (60)	43 (65)
FRANCE	-4 (-4)	-5 (-5)	-3 (-5)	-2 (-4)	0 (-3)
ITALY	-4 (-5)	-5 (-8)	-5 (-10)	-4 (-12)	-3 (-13)
UNITED KINGDOM	-26 (-26)	-25 (-31)	-20 (-27)	-14 (-24)	-10 (-24)
MAJOR INDUSTRIAL COUNTRIES	-50 (-42)	-43 (-60)	-35 (-50)	-14 (-60)	0 (-62)
OTHER INDUSTRIAL COUNTRIES	(-12)	(-18)	(-19)	(-21)	(-25)
DEVELOPING COUNTRIES	(-9)	(-7)	(-16)	(-18)	(-17)
CURRENT ACCOUNT (IN PERCENT OF GNP/GDP)					
CANADA	-1.6 (-1.7)	-2.0 (-2.9)	-1.6 (-2.8)	-0.8 (-3.1)	-0.7 (-3.3)
UNITED STATES	-2.8 (-2.6)	-2.2 (-2.4)	-1.9 (-2.5)	-1.6 (-2.7)	-1.3 (-2.7)
JAPAN 1/	2.7 (2.8)	2.2 (2.5)	2.0 (2.9)	1.8 (2.9)	1.7 (2.9)
GERMANY, FED. REP. OF	4.0 (4.0)	3.7 (4.5)	3.4 (4.5)	3.2 (4.5)	2.9 (4.5)
FRANCE	-0.4 (-0.4)	-0.4 (-0.6)	-0.3 (-0.5)	-0.2 (-0.4)	0 (-0.3)
ITALY	-0.4 (-0.6)	-0.6 (-1.0)	-0.5 (-1.1)	-0.4 (-1.2)	-0.3 (-1.2)
UNITED KINGDOM	-3.2 (-3.2)	-2.9 (-3.7)	-2.2 (-3.1)	-1.4 (-2.5)	-1.0 (-2.4)
MAJOR INDUSTRIAL COUNTRIES	-0.4 (-0.4)	-0.3 (-0.5)	-0.3 (-0.4)	-0.1 (-0.4)	0 (-0.4)
OTHER INDUSTRIAL COUNTRIES	(-0.6)	(-0.9)	(-0.9)	(-0.9)	(-1.1)
DEVELOPING COUNTRIES	(-0.3)	(-0.2)	(-0.4)	(-0.4)	(-0.3)
TRADE BALANCE (IN PERCENT OF GNP/GDP)					
CANADA	1.8 (1.6)	1.6 (0.9)	2.2 (0.9)	2.9 (0.8)	2.6 (0.8)
UNITED STATES	-2.6 (-2.6)	-1.9 (-2.2)	-1.5 (-2.3)	-1.2 (-2.4)	-0.9 (-2.3)
JAPAN	3.2 (3.3)	2.8 (3.2)	2.5 (3.4)	2.4 (3.3)	2.2 (3.2)
GERMANY, FED. REP. OF	6.4 (6.5)	6.1 (6.9)	5.8 (7.0)	5.5 (7.0)	5.2 (7.0)
FRANCE	-0.6 (-0.6)	-0.6 (-0.7)	-0.4 (-0.7)	-0.3 (-0.6)	-0.1 (-0.6)
ITALY	-0.3 (-0.1)	-0.5 (-0.6)	-0.5 (-0.8)	-0.5 (-1.0)	-0.4 (-1.0)
UNITED KINGDOM	-4.5 (-4.5)	-4.3 (-4.9)	-4.0 (-4.2)	-3.4 (-3.8)	-3.0 (-3.5)
MAJOR INDUSTRIAL COUNTRIES	0.1 (0.1)	0.2 (0.1)	0.3 (0.2)	0.4 (0.1)	0.5 (0.1)
OTHER INDUSTRIAL COUNTRIES	(-1.0)	(-1.4)	(-1.3)	(-1.4)	(-1.5)
DEVELOPING COUNTRIES	(1.3)	(1.3)	(1.1)	(1.1)	(1.0)

1/ NATIONAL AUTHORITIES' ESTIMATES ARE ON A FISCAL YEAR BASIS.

DATE :SEPTEMBER 20, 1989

D. FISCAL BALANCES

NATIONAL AUTHORITIES ESTIMATES (IMF STAFF ESTIMATES)

	1988	1989	1990	1991	1992
BUDGET BALANCE -- NATIONAL CONVENTIONS (IN PERCENT OF GNP/GDP) 1/					
CANADA	-3.5 (-3.7)	-4.7 (-3.7)	-4.0 (-2.8)	-3.3 (-2.4)	-2.7 (-1.8)
UNITED STATES	-3.2 (-3.2)	-3.2 (-3.0)	-1.7 (-2.6)	-1.1 (-2.7)	-0.4 (-2.3)
JAPAN	-2.4 (...)	-1.8 (...)	-2.4 (...)	-2.3 (...)	-1.9 (...)
GERMANY, FED. REP. OF	-2.5 (-2.5)	-2.0 (-1.8)	-2.3 (-2.2)	-2.0 (-1.8)	-1.9 (-1.6)
FRANCE	-2.0 (-2.0)	-1.7 (-1.7)	-1.4 (-1.5)	-1.1 (-1.3)	-0.8 (-1.2)
ITALY	-11.0 (-11.6)	-10.1 (-11.5)	-8.7 (-11.5)	-7.3 (-11.4)	-6.1 (-11.2)
UNITED KINGDOM	3.0 (3.0)	2.7 (3.0)	1.9 (2.8)	1.1 (2.0)	0.5 (1.0)
GENERAL GOVERNMENT BALANCE (IN PERCENT OF GNP/GDP) 2/					
CANADA	-3.1 (-3.4)	-4.0 (-3.9)	-3.9 (-2.9)	-3.2 (-2.4)	-2.4 (-1.7)
UNITED STATES	-2.1 (-2.0)	-2.1 (-2.0)	-0.5 (-1.8)	0.1 (-1.7)	0.8 (-1.3)
JAPAN 3/ 4/	... (...)	... (...)	... (...)	... (...)	... (...)
GERMANY, FED. REP. OF 3/	... (-2.0)	... (-0.2)	... (-0.9)	... (-0.8)	... (-0.7)
FRANCE	-1.6 (-1.4)	-1.6 (-1.4)	-1.3 (-1.4)	-1.0 (-1.1)	-0.7 (-1.0)
ITALY	-9.9 (-10.6)	-9.5 (-10.6)	-8.2 (-10.5)	-7.0 (-10.2)	-5.8 (-9.9)
UNITED KINGDOM	1.0 (0.9)	1.1 (1.9)	0.4 (2.0)	-0.1 (1.5)	-0.6 (0.5)
[illegible]OR INDUSTRIAL COUNTRIES	... (-1.7)	... (-1.3)	... (-1.2)	... (-1.0)	... (-0.9)

1/ CANADA; CENTRAL GOVERNMENT (FISCAL YEAR BASIS); UNITED STATES: FEDERAL GOVERNMENT (FISCAL YEAR BASIS); JAPAN: CENTRAL GOVERNMENT GENERAL ACCOUNT (FISCAL YEAR BASIS) -- REFLECTS BOND FINANCING OF GENERAL ACCOUNT; GERMANY: TERRITORIAL AUTHORITIES; FRANCE: CENTRAL GOVERNMENT; ITALY: CENTRAL GOVERNMENT; UNITED KINGDOM: PUBLIC SECTOR BORROWING REQUIREMENT (FINANCIAL YEAR BASIS).

2/ NATIONAL INCOME ACCOUNTS BASIS.

3/ THE JAPANESE AND GERMAN AUTHORITIES DO NOT FIND THIS CONCEPT MEANINGFUL.

4/ IMF STAFF ESTIMATES OF THE GENERAL GOVERNMENT BALANCE (FISCAL YEAR BASIS) FOR JAPAN ARE 1.6 PERCENT OF GNP IN 1988, AND 2.1 - 2.3 PERCENT OF GNP DURING 1989-92.

DATE :SEPTEMBER 20, 1989

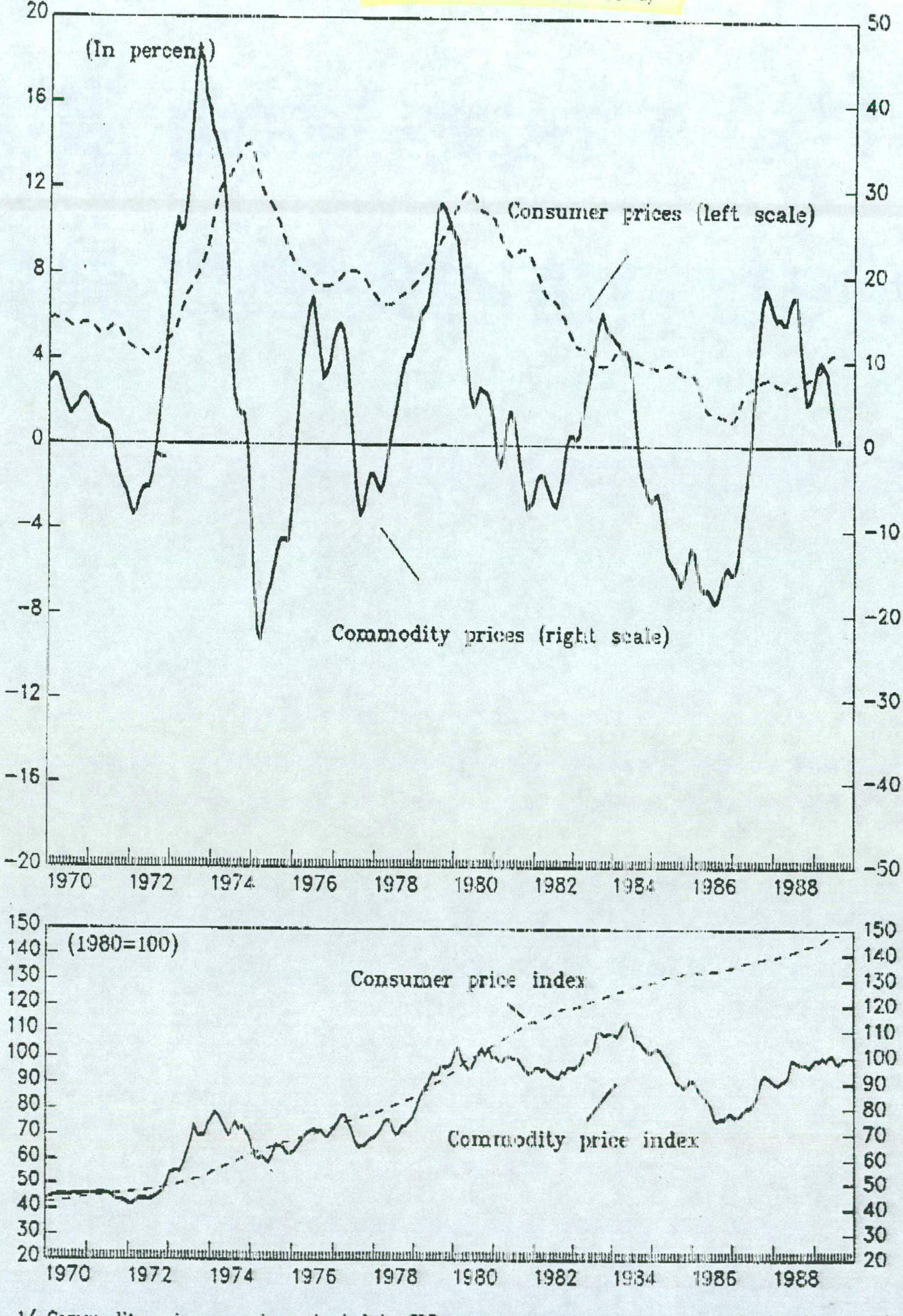
E. MONETARY CONDITIONS

NATIONAL AUTHORITIES ESTIMATES (IMF STAFF ESTIMATES)

	1988	1989	1990	1991	1992
ONETARY GROWTH RATES: TARGET OR FORECASTED AGGREGATE (IN PERCENT) 1/					
CANADA (M1)(M2)	4.4 (10.4)	2.9 (9.0)	6.7 (8.5)	8.9 (8.0)	7.5 (7.5)
UNITED STATES (M2)	5.3 (5.2)	3 - 7 (3 - 7)	2.5-6.5(3 - 7)	2 - 6 (2.5-6.5)	1.5-5.5(2 - 6)
(M3)	6.2	3.5-7.5	3 - 7	2.5-6.5	2 - 6
JAPAN (M2+CD)	10.7 (10.4)	9 (9 - 10)	8 (8 - 9)	8 (8 - 9)	8 (8 - 9)
GERMANY, FED. REP. OF (M3)	... (6.8)	... (5)	... (5)	... (5)	... (5)
FRANCE (M2)	4 (3.7)	4 - 6 (4)	5 (4)	5 (4)	5 (4)
ITALY (M2)	6 - 9 (8.6)	... (8.0)	... (7.5)	... (5.5-8.5)	... (5 - 8)
UNITED KINGDOM (M0)	1 - 5 (7.7)	1 - 5 (5.8)	0 - 4 (4.5)	0 - 4 (4.5)	-1 - 3 (4.0)
IORT-TERM INTEREST RATES -- NOMINAL					
CANADA	9.7	11.1	9.6	8.0	7.7
UNITED STATES	6.7	7.4	5.5	4.5	4.0
JAPAN	4.1	...	...	...	...
GERMANY, FED. REP. OF	...	...	...	...	...
FRANCE	7.9	8.0	7.0	6.3	5.5
ITALY	11.2	...	...	...	...
UNITED KINGDOM	...	...	...	...	...
ING-TERM INTEREST RATES -- NOMINAL					
CANADA	11.3	11.6	10.5	9.9	9.4
UNITED STATES	8.9	8.6	7.2	6.0	5.0
JAPAN	5.1	...	...	...	...
GERMANY, FED. REP. OF	...	...	...	...	...
FRANCE	9.0	9.0	8.5	8.0	7.5
ITALY	12.1	...	...	...	...
UNITED KINGDOM	...	...	...	...	...

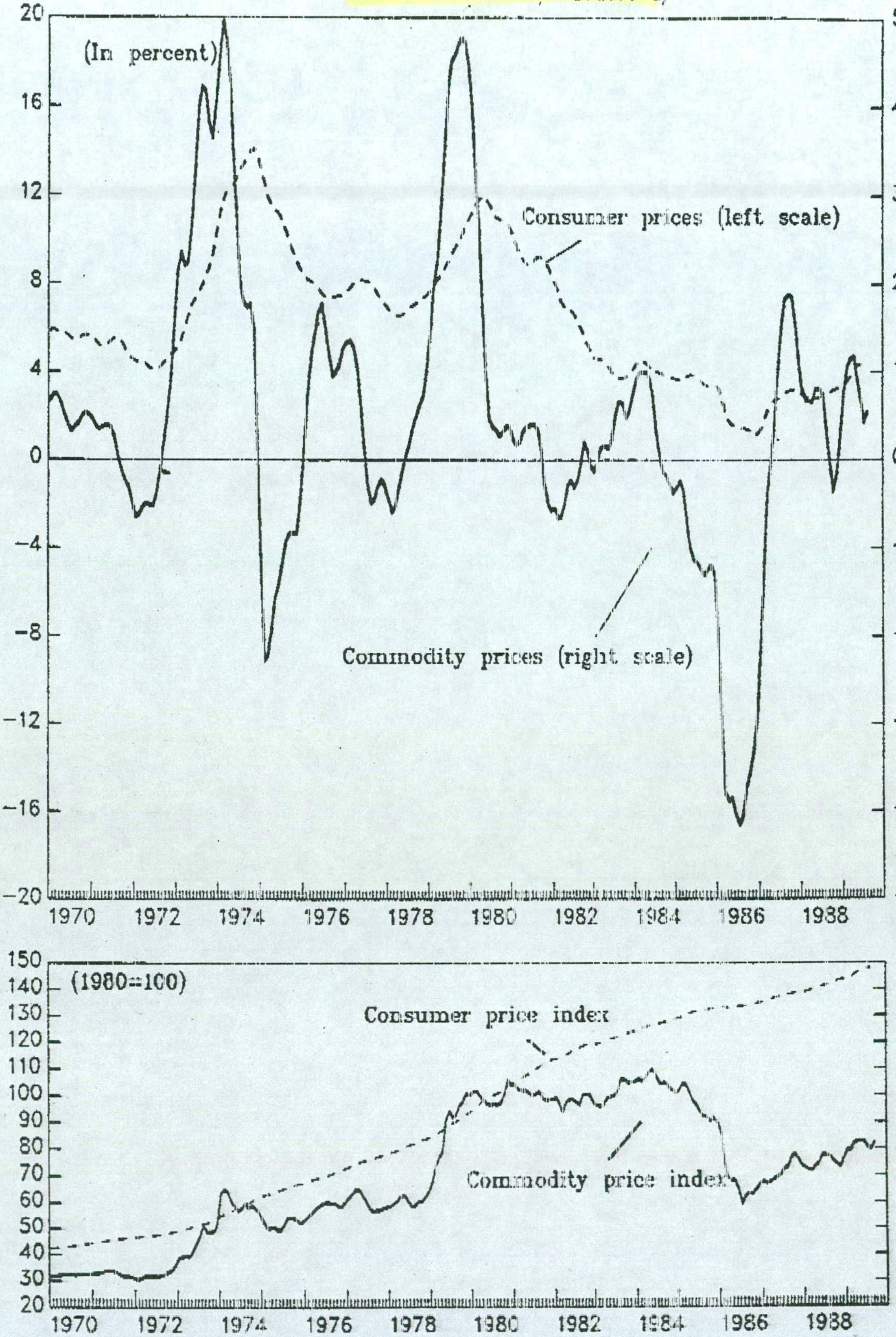
NATIONAL AUTHORITIES DATA FOR THE UNITED STATES AND THE FEDERAL REPUBLIC OF GERMANY AND IMF STAFF ESTIMATES FOR ALL COUNTRIES REFER TO THE RATE OF CHANGE DURING YEAR.

Chart 1. Inflation Rates for Non-oil Commodity Prices and G-7 Consumer Prices 1/



1/ Commodity prices are denominated in SDRs; consumer prices are measured in local currencies and are averaged using GNP weights. The top panel shows 3-month centered moving averages of 12-month inflation rates. Consumer prices are shown through August 1989. Commodity prices for September 1989 are estimates based on actual data for September 1-15.

Chart 2. Inflation Rates for Commodity Prices Including Oil and G-7 Consumer Prices 1/



1/ Commodity prices are denominated in SDRs; consumer prices are measured in local currencies and are averaged using GNP weights. The top panel shows 3-month centered moving averages of 12-month inflation rates. Consumer prices are shown through August 1989. Commodity prices for September 1989 are estimates based on actual data for September 1-15.

September 20, 1989

Notes to Economic Indicator Tables

The national authorities' estimates shown in Tables A-E were submitted early in 1989 and reflect a variety of national conventions, forecasting procedures, and working assumptions. The following notes clarify the main differences in the various estimates, first by providing a general characterization for each country, and second by listing some table-specific comments.

1. General characteristics

Canada

The estimates are on a calendar year basis. They were prepared in December 1988 and reflect the third quarter 1988 Income and Expenditure Accounts. The policy assumptions reflect status quo fiscal policies at both the federal and provincial level and do not provide for Stage II of the Tax Reform, the timing and exact form of which remain uncertain. The estimated impact of the Canada/U.S. Free Trade Agreement is reflected in the estimates. The exchange rate is assumed to average C$1.22 per U.S. dollar over the forecast period.

United States

The economic forecast was updated in early February 1989. Figures are on a calendar year basis. The Budget estimates were updated by the new Administration in February 1989 and pertain to fiscal years ending September 30 of the year indicated. For 1991-92, the economic indicators are objectives, not forecasts or projections.

Japan

The estimates pertain to fiscal years ending March 31 of the following year. The exchange rate assumption is ¥123 per dollar, the average rate prevailing from end-November to end-December 1988. With the exception of monetary conditions, data for FY 1988-89 are based on the FY 1988 and FY 1989 budgets, and the Economic Outlook for FY 1989.

Monetary growth for FY 1988-92, real total domestic demand, the change in the real foreign balance, the current account, and the trade balance for FY 1990-92 were prepared by the Fund staff on the basis of bilateral discussions with the Japanese authorities. These data are preliminary technical figures and not objectives or projections for each fiscal year. (See table-specific notes.)

Federal Republic of Germany

The estimates are on a calendar year basis. For 1988 they reflect the publication of the Federal Statistical Office of January 1989. The medium-term estimates have been prepared by the Fund staff on the basis of bilateral consultations with the German authorities. The estimates therefore do not represent officially announced projections. A new official forecast was prepared in May 1989 in the context of the medium-term fiscal plan covering the period 1989-93. The exchange rate is assumed to average DM 1.75 per dollar in 1989.

France

The estimates were prepared in early January 1989. They are based on the assumption of a constant exchange rate of FF 6 per dollar (the average exchange rate of July 1988). Oil prices are assumed to average $14 per barrel in 1988 and $15 per barrel in 1989.

Italy

The estimates are on a calendar year basis and were prepared on the basis of "Relazione Previsionale e Programmatica" published at the end of September 1988. The conversion factor is Lit 1300 per U.S. dollar throughout the projection period.

United Kingdom

The estimates for 1988-89 pertain to calendar years except for the GDP deflator, monetary growth and the budget indicators, which refer to financial years ending March 31 of the following year. For 1990-92 all estimates refer to financial years unless otherwise noted. Figures for the trade balance in 1989 and domestic demand, the real foreign balance, consumer prices, the current account and trade balance, and the general government balance for 1990-92 are Fund staff estimates prepared in consultation with the U.K. authorities. These figures are not official forecasts. Other data are based on the Budget Statement forecast presented on March 14, 1989. The estimates assume that the exchange rate will average $1.75.

Other industrial countries and developing countries

Estimates are based on Fund staff projections for the October 1989 World Economic Outlook.

2. Table-specific notes

Table A--Output and Demand

Real GNP/GDP. Estimates pertain to GNP for the United States, Japan, and the Federal Republic of Germany, and to GDP for other countries. For Japan, data for FY 1990-92 are based on a mechanical interpolation of average annual figures for the period covered by the Five-Year Economic Management Plan (May 1988) and should not be interpreted as objectives or projections for each fiscal year. For the United Kingdom the compromise measure of GDP is used.

Real total domestic demand. For Japan, data for FY 1990-92 are based on the average annual figures for GNP growth and the growth contribution of real total domestic demand assumed in the Five-Year Economic Management Plan. For the United Kingdom, the estimates for 1990-92 are Fund staff estimates generated so as to be consistent with the projected rate of growth of GDP and a gradual reduction of the current account deficit.

Change in real foreign balance. For the United States, data are calculated as the change in the share of the real net export balance in real GNP. For other countries, data are calculated as the difference between the growth rates of real GNP/GDP and real total domestic demand.

Table B--Inflation

GNP/GDP deflator. Estimates pertain to GNP for the United States, Japan, and the Federal Republic of Germany, and to GDP for other countries. For Japan, data for 1990-92 are based on a mechanical interpolation of the average annual figures for the period covered by the Five-Year Economic Management Plan and should not be interpreted as objectives or projections for each fiscal year. For the United Kingdom, the deflator is for GDP at market prices.

Consumer prices. For Japan, data for 1990-92 are based on a mechanical interpolation of the average annual figures for the period covered by the Five-Year Economic Management Plan and should not be interpreted as objectives or projections for each fiscal year. For the United Kingdom, figures refer to the retail price index and are on a fourth-quarter-to-fourth-quarter basis; the data for 1990-92 are Fund staff estimates based on the projected rate of change in the GDP deflator.

Table C--Current account and trade balance

For the United States, estimates of current account and trade balances from 1989 to 1992 are indicated as mid-points of the ranges projected by the authorities. For the current account these ranges are (in U.S.$ billion): 1989: -105 to -125; 1990: -100 to -120; 1991: -85 to -105; 1992: -75 to -95; for the trade balance the ranges are: 1989: -90 to -110; 1990: -75 to -95; 1991: -60 to -80; 1992: -50 to -70. For Japan, data for FY 1990-92 are illustrative Fund staff estimates consistent with the growth rates for real GNP and real total domestic demand as explained above. The exchange rate assumption is ¥123 per dollar. For the United Kingdom, the data for 1990-92 are Fund staff estimates.

Table D--Fiscal balances and monetary conditions

Budget balance--national conventions. The data for the United States, Japan, and the United Kingdom pertain to the fiscal or financial years of each country. For the United States, Japan, Canada, France, and

Italy, the data refer to federal or central government. For the United States, figures are on a unified budget basis. For the Federal Republic of Germany, the data refer to the Territorial Authorities. For Japan, the budget balance refers to the general account of the central government. Data for FY 1988-89 are based on the Budget for FY 1988 and FY 1989. Data for FY 1990-92, which are based on the Medium-Term Fiscal Projection of the National Budget submitted to the Diet in February 1989, are preliminary technical figures of the fiscal balance between total expenditure and revenue excluding bond issues, and not objectives or projections of government bond issues for each fiscal year. The medium-term fiscal objective at present is summarized in the Five-Year Economic Management Plan as follows: "The government will try to eliminate the dependence on deficit financing bonds by FY 1990 and to reduce the ratio of government bond issues to total expenditures during the time covered by the plan." For Italy, taking into account the estimates of the State Sector deficit available in early 1989 and the fact that the rate of growth should be higher than expected, the authorities estimate a State Sector deficit of around 11.5 percent of GDP in 1988. For the United Kingdom, the data refer to Public Sector Debt Reduction.

General government balance. Except as noted, estimates are on a national accounts basis. For the United States, Federal budget figures are on a unified basis while figures for state and local governments are on a national accounts basis. For the United Kingdom, the estimates refer to the general government financial surplus, adjusted for privatization proceeds; the estimates for 1990-92 are Fund staff estimates consistent with the projected changes in the PSDR.

Monetary growth. For Canada, the data are projections rather than targets. For the United States, the data are on a fourth-quarter-to-fourth-quarter basis. The growth rates of M2 and M3 in 1988 compare with target growth ranges of 4-8 percent for both aggregates. The target ranges for 1989 are tentative and those beyond have not been considered officially by the Federal Reserve. The figures shown are indicative of a trend toward lower ranges over time, consistent with the objective of promoting non-inflationary economic growth. For Japan, the data are based mainly on an extrapolation of the relationship between monetary growth and the change in nominal GNP observed between 1984 and 1987.

Interest rates. Short-term interest rates on the following instruments: Canada, 90-day commercial paper; United States, 91-day T-bills; Japan, the average of the discount rate on two-month private bills from April to December 1988; the Federal Republic of Germany, Frankfurt interbank offer rate for three-month funds; France, money market rate; Italy, gross rates on three-month Treasury Bills. Long-term interest rates on the following instruments: Canada, McLeod Young Weir bonds; United States, 10-year Treasury bonds; Japan, average of 10-year government bonds with longest remaining period to maturity, from April to December 1988; the Federal Republic of Germany, Federal bonds with 7 to 10 years to maturity; France, first-class bonds; Italy, gross average rate on bonds of industrial credit institutions.

ANNEX C

ANX C NOTES ON THE DEPUTIES ISSUES

SURVEILLANCE: DEPUTIES REPORT TO MINISTERS AND GOVERNORS: ISSUES FOR DISCUSSION

1. In view of the objective of sustained growth with low inflation, do Ministers and Governors consider the present stance and mix of fiscal and monetary policies to be appropriate?

Line to take

(i) Latest figures show that in most countries consumer and producer prices have eased slightly since early summer. Oil and other commodity prices have fallen back since the first quarter; oil prices are now about $2 pb below their peak in April and the IMF commodity price index is now over 2 per cent below its March peak. Underlying inflation has probably changed little in recent months.

(ii) Growth in Germany and Japan is proving exceptionally vigorous this year, and in US the slowdown is now less than expected. Capacity utilization remains at very high levels in all G7 countries.

(iii) Prompt action by monetary authorities has contributed to halting the rise in inflation. But real interest rates average only 4.0 per cent in the G7, compared with 1984-88 average of 4½ per cent. No danger that monetary tightening has been excessive, ~~but some danger of premature easing in the US, especially as consumption expenditure now seems stronger than originally thought. Risk that present stance of policy will fail to deliver a significant reduction in inflation, especially in US.~~

(iv) Mix of policies clearly inappropriate in Italy, and to a lesser extent Canada, with large fiscal deficits accompanied by highest nominal and real interest rates. US deficit also remains too high.

(v) Weakness of deutschemark, together with very strong growth and current account surplus may be indication both that overall stance of policy a little lax and mix inappropriate in Germany. Tighter monetary policy would reduce inflationary pressures domestically and help reduce external surplus through stronger deutschemark. Prospective easing of fiscal policy next year (equivalent to 1% GDP and part of medium term fiscal strategy) looks inappropriate without compensating tightening of monetary policy.

2. <u>What should be done to resume progress in reducing the external imbalances to sustainable levels? In this context, which measures should be taken to bring the exchange rate of the dollar into line with economic fundamentals?</u>

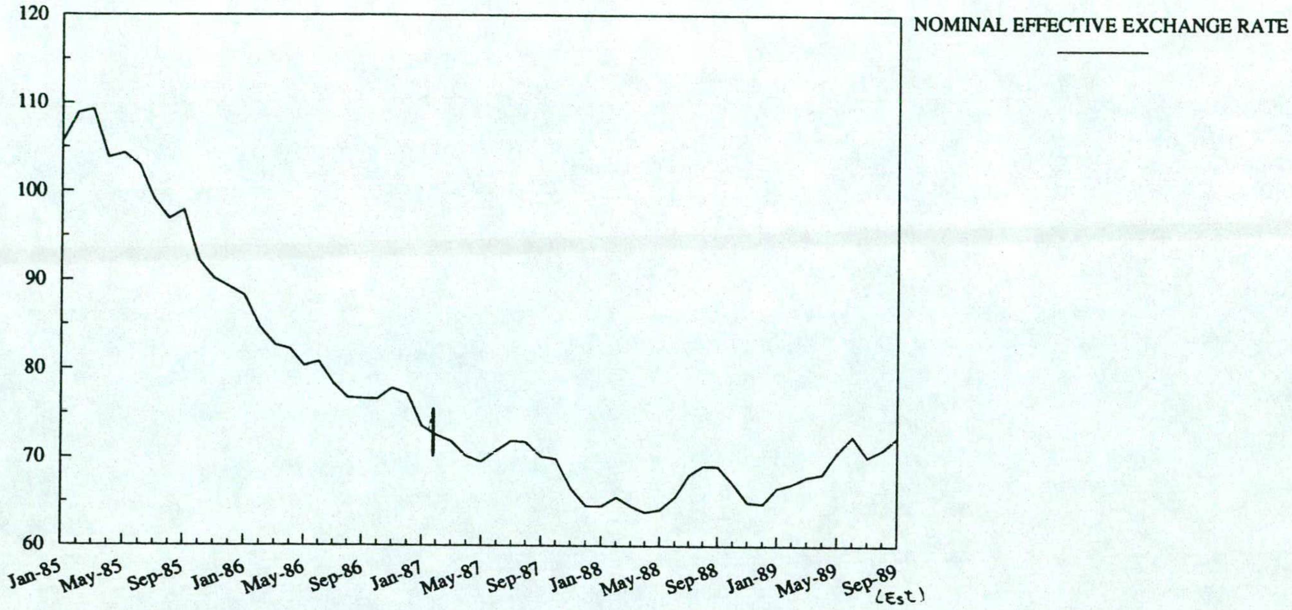
(i) No evidence that external surpluses and deficits are unsustainable, provided that appropriate policies in place.

(ii) Policies for reducing inflation and ensuring that current account deficits are sustainable at stable exchange rates are complementary. Reducing the growth of domestic demand where it is excessive both bears down on inflation and decreases domestic absorption. Current UK policy is an example of this. ~~Tighter US fiscal policy would meet this requirement. It might also permit some easing in interest rates, taking pressure off the dollar.~~

(iii) Recent dollar strength not fully understood. Credibility of US monetary policy, reductions in US trade deficit and political risks in Asia and E Europe may all have had some effect.

(iv) The dollar is now above its Louvre level against the DM and it is close to its Louvre level in effective terms - see chart below. Competitiveness, in terms of either relative unit labour costs or relative export prices is slightly worse than at the Louvre. So if anything the value of the dollar is somewhat above that justified by fundamentals. Therefore a case for some fall in the dollar - though not an excessive one.

USA:NOMINAL EFFECTIVE EXCHANGE RATE



3. <u>A number of areas of priority for additional structural reform have been identified (see Annex prepared by the IMF). How is it possible to speed up structural reform efforts given the political interests that are often associated with specific distortions?</u>

(i) For each country to decide how best to proceed. All G7 countries have had some success in structural reform. Need for progress recognized across political spectrum, a examples of Australia and New Zealand show. Need to point to wider benefits to consumers and society as a whole, and to show that those who oppose structural reform are often self - interested and benefit directly from the structural rigidity.

ANNEX D

G7 DEPUTIES REPORT TO MINISTERS: ANNEX ON STRUCTURAL REFORM

1. The annex to the Deputies' Report to Ministers, prepared by the IMF staff, lists for each G7 country some structural reforms which have been carried out and others which are desirable. The paper identifies as key priorities labour market rigidities, industrial subsidies, tax and social security reform, land and distribution systems, agriculture and trade policy. These priorities are in line with ours and can be endorsed.

2. This brief deals first with the section on the UK, including a number of points to make. It then deals with Germany and Japan. You may like to take the opportunity to emphasise the desirability of key reforms in Japan and Germany and some familiar points to make are listed. Finally the key points in the Deputies' Report on the other G7 countries are summarised.

UK

3. The UK section notes the extent of tax and labour market reform and the Government's commitment to free trade. It calls for reform of taxation of owner occupied housing, accelerated implementation of commitments on employment training and moves to increase competitive tendering in health and defence. It also notes that a number of VRAs remain in place.

ANX D NOTES ON THE IMF ANX

Points to make

(i) On reform of employers' national insurance contributions: the UK rates of employers' contributions are not high by international standards (they are higher in Japan, France and Germany). They have already been reduced for low-paid workers from 9 per cent to 5 or 7 per cent.

(ii) On reform (i.e. abolition) of mortgage interest tax relief: this relief serves to encourage home ownership, and withdrawing it suddenly would cause hardship. However, its nominal value has not risen since 1983, eligibility has been tightened, and the basic rate of income tax reduced. To have kept pace with house price increases since 1983, the ceiling would now have to be £70,000. Many mortgages now exceed the limit of relief, so for these people there is no additional incentive at the margin to borrow for house purchase in preference to other assets. Therefore distorting effects have been reduced.

(iii) On accelerating plans to rationalise training: these plans are advancing at a rapid rate. The programme for handing over control of occupational training to 100 or so private sector Training and Enterprise Councils is proceeding faster than originally planned. But we must safeguard the quality of training.

(iv) On reform of the professions: much progress has already been made, and reforms of the legal and medical professions are in progress. The UK is also working actively for mutual recognition of professional qualifications in the Single Market. We want to see this process largely completed by 1992, as a significant part of the preparation for Stage 1 of European Monetary Union.

(v) On Voluntary Export Restraints: the UK Government has withdrawn support from most inter-industry agreements. We will be arguing that the role of VERs in the developing common external trade policy should be further reduced. The UK is in the van of promoting liberal trade views in the EC. A liberal common external policy will encourage competitiveness among EC producers and benefit EC consumers.

(vi) On tendering in health and defence purchases: the principle of competitive tendering is being increasingly used in the UK: 50 per cent (by value) of defence contracts are now put out to tender. We welcome the opportunities created by a more international approach to procurement; this will help us improve value for money. The forthcoming reform of hospital finances will increase the scope for competitive tendering in the National Health Service.

Germany

4. German policies in the labour market, on pensions, telecoms, health insurance and tax reform are noted with approval by the staff. The lack of progress in reducing subsidies, protection and regulation in other areas is also noted. Most of the reforms which the UK has argued that Germany should undertake are included: reduced support and protection to agriculture, coal, iron and steel, and deregulation of services especially the retail trade, financial services and transport. The desirability of reducing support to aerospace is an omission. You can support the need for Germany to take these measures, noting that such reforms, as well as being desirable in their own right, could, as IMF studies suggest, aid current account adjustments.

Points to make

(i) Germany should reduce subsidies to agriculture. Overall transfer from tax payers and consumers to farmers, including CAP support, is DM30bn, representing 90% of value added in agriculture and 1½ per cent of GNP. Reform would increase imports, lower taxes as EC and national subsidies fall, lower food prices and raise real consumer incomes, and transfer resources from agriculture to more efficient uses elsewhere in the economy. If Germany wants to support its farmers for social and environmental reasons it should do so by carefully targetted subsidies - at a lower level than current national subsidies.

(ii) Germany should reduce large industrial subsidies to coal, aerospace, steel and shipbuilding.

In 1987 the subsidy to coal was about DM3.0bn. It takes the form of compensation to the principal coal users (steel and electricity) for the difference between domestic coal prices and world prices of coal and oil, so support is effectively open-ended. The German arrangements are guaranteed until 1995 at least. Important to secure reduced levels of subsidy and of production. German industry would benefit from cheaper imported coal.

Important to reduce subsidies to aircraft industry. Danger that support becomes institutionalised. Increasing German support may be used to bid up subsidies all round. Must resist protectionist arguments for support and press for progress in reducing subsidies. Federal support to aircraft mostly to Airbus, was about DM4½bn (£1½bn) in 1986. Although a significant proportion of the Airbus support was in the form of loans, some of these have since been written off. The government has agreed to underwrite Deutsche Airbus' loss as part of the agreement to return Daimler Benz to the private sector.

Can we say this?

Japan

5. Japan is acknowledged to have made good progress in tax and financial reform but little progress in other areas: reform is particularly needed in the areas of land taxation, agriculture and the distribution system. These are the priorities we have identified for Japan: you can agree with them and call for early progress. As with Germany, reform could aid current account adjustment.

Points to make

(i) Further structural reforms would promote efficiency in the Japanese economy and may, on balance, tend to reduce the current account surplus.

(ii) Japan should alter its taxation structure to free the market for land, to reduce tax distortions that keep land in agricultural use, and to reduce regulations on urban development and construction. Support prices for agricultural products and restrictions on food imports should both be reduced. Japan will need to move in these directions as part of its response to the GATT agreement in April. According to the OECD, government support accounted for 76 per cent of farming income in Japan in 1987, compared with 51 per cent in the EC and 41 per cent in the US. Yet Japanese agriculture accounted for only 3 per cent of GDP in 1986.

(iii) Reform of Japanese distribution is needed. Government should pursue more competitive policies with regard to manufacturer/wholesaler/retailer relationships, with the emphasis on deregulation. Welcome existing plans to improve working of the Large Retail Stores Law: we hope they will soon be fully effective and that further reforms will be proposed. Inefficiency is indicated in several ways:

- The number of retail stores per 1000 people in Japan is twice as great as in the UK or the US.

- The very high ratio of wholesale sales to retail sales of consumer goods: goods are being re-sold more often before they reach the consumer.

The Large Retail Stores Law protects small shopkeepers by allowing them to prevent or delay the establishment of large retail outlets: only ½ per cent of Japanese stores have a floorspace of more than 500 square metres. And retail price maintenance is widespread.

(iv) There has been some liberalisation of air transport services but further liberalisation would increase competition, increase consumer choice, reduce prices and reduce the current account surplus. For example:

- removal of restrictions on the number of services that can be operated, allowing the airlines more flexibility to respond to change in market demand.

- simplified arrangements for the approval of fare levels, allowing airlines to introduce more competitive fares.

- flexible arrangements for routeings.

Other G7 countries

6. The Report calls for Canada to move towards a more neutral treatment of investment by corporation tax reform and to reduce support and protection of textiles and agriculture.

7. On France, the annex calls for action to reduce labour market rigidities, reform tax treatment of saving reform social security with a view to containing expenditure. It draws particular attention to the use of subsidies and protection to insulate French industry from international competition.

8. Italy is asked to undertake tax and social security reform linked to reduction of the financial deficit.

9. The US is asked to consider tax reform to remove distortions of savings behaviour and reform of health care. In a useful passage, particular attention is directed at US trade policy: protection of steel and textiles should be dismantled and the 1988 Trade Act should not be implemented in a protectionist way. The dangers of Super 301 are highlighted.

ANNEX E

IMF SURVEILLANCE TABLES: WORLD ECONOMIC SITUATION

1. The attached table summarises the IMF and national forecasts for the G7 in aggregate and the G3 plus the UK individually. The IMF staff forecasts for 1989 have become slightly more optimistic compared with those presented to the spring meetings as data have become available. Those for 1990 are little changed. The national forecasts are those submitted in the spring, for the UK the FSBR forecasts. The current staff forecasts were seen by Deputies at their meeting on 13th-14th September and a previous staff forecast discussed by Deputies on 12th July.

2. Firm data for the first quarter National Accounts for France and Italy and provisional second quarter data for the US, Germany and Canada are now available. Data for Japan for the second quarter will be available this week.

3. The <u>IMF forecasts</u> are based on the conventional assumptions of no policy changes and of constant real exchange rates at their May 1989 levels. Thus, for example, US interest rates remain at their current level and the US federal deficit is on a constant services assumption, and not consistent with Gramm-Rudman targets. The world oil price is assumed to be about $16, compared with a current level of some $16-17.

4. Compared with the staff forecasts made for the spring meetings the main differences are on inflation in most countries and on GDP growth in Japan and Germany.

- The higher than expected oil prices, and higher consumer taxes in Germany and Japan have contributed to an upward revision of ½ per cent to consumer price inflation in 1989 for the G7 as a whole. The revision to the GNP deflator is much smaller.

- The staff forecasts of GNP growth in Japan for 1989 and 1990 have been revised up to 5 per cent and 4¾ per cent

ANX E IMF SURVEI-LLANCE TABLES

respectively. On this basis the Japanese economy would expand by over 15 per cent in the three years 1988 to 1990.

- On Germany the staff have revised up GDP growth this year from 2½ to 4 per cent. This is consistent with the data available for the first half of the year, and reflects strong investment and export growth.

5. The staff forecast shows a soft landing for the G7 economies, with growth falling gradually back towards productive potential and inflation moderating but only to 3.8 per cent in 1990 and 3.2 per cent by 1992. This compares with figures of 2 per cent and 2.8 per cent in 1986 and 1987. It is an assessment with which we broadly agree.

6. The main features of the staff forecast for G7 countries are:-

- G7 GNP growth slows gradually through this year. In 1990 it is forecast to be 3 per cent, still marginally above the estimated growth of productive potential.

- For most countries inflation is now thought to be around or a little past its peak. The IMF forecast, as in July, is for only a very small reduction in US inflation in 1990 from the 1989 figure of 5 per cent. There is disagreement about this among forecasters, although we concur with the staff forecast.

- Latest figures on commodity prices suggest some easing of pressure.

- Recent movements of the dollar have given rise to largely unexpected reductions in the current accounts of the US and Japan in the second quarter. This is reflected in the forecasts: the US deficit is now expected to be $125bn in 1989 and $139bn in 1990, about $15bn and $20bn less than forecast in March. The figure for 1990 is a little more pessimistic than other forecasts.

- <u>Fiscal balances</u> (general government deficits) show a reduction of about ½ percentage point between 1988 and 1989 for G7 as a whole. The general government deficit is now smaller than at any time since the mid-1970s.

7. This favourable outlook rests on continuing good supply performance, with inflation declining as capacity utilization remains high, and growth continuing above the usual assessment of productive potential. Some favourable supply side factors may be mentioned:-

(i) oil prices are unlikely to strengthen. A significant increase in Iraqi export capacity later this year, and a gradual rise in non-OPEC production could put downward pressure on prices next year. Supply of other commodities is also strong.

(ii) Immigration from all sources into Germany this year is expected to be up to ½ million, with similar increases in following years. This will add at least 1 per cent to labour supply and productive potential growth.

(iii) Growth in business investment in the G7 has averaged 8½ per cent since end 1986, and is expected to hold up well over the next two years. This has helped to increase capacity.

8. The Fund's <u>forecasts for the UK</u> are almost the same as those in March. The PSDR, which has been increased in both 1989-90 and 1990-91, is now above the corresponding FSBR projection. The projection for domestic demand in 1989 is higher than our own forecast. But there is great uncertainty about the data for this at present. The figures given for inflation show a fall from 7.7 per cent to ~~3.8~~ 5.5 per cent between the fourth quarters of 1989 and 1990. This is helpful, although the figure for 1989Q4 is too pessimistic. (These figures include MIPS: the RPI less MIPS was 5.7 per cent up on a year earlier in August, compared with 7.3 per cent for the inclusive figure.)

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		Real GDP Growth		Current Balance $bn (% of GDP)		Consumer Price Inflation	
		IMF	National	IMF	National	IMF	National
USA	1988	4.4	3.8	-127 (-2.6)	-135 (-2.8)	4.1	3.9
	89	2.9	3.3	-125 (-2.4)	-115 (-2.2)	5.1	3.9
	90	2.1	3.2	-139 (-2.5)	-110 (-1.9)	4.9	3.7
Japan	1988	5.7	4.9	80 (2.8)	78 (2.7)	0.7	0.7
	89	4.9	4.0	72 (2.4)	71 (2.2)	2.2	2.0
	90	4.7	3.7	90 (2.5)	66 (2.0)	1.6	1.5
Germany	1988	3.6	3.4	49 (4.0)	48 (4.0)	1.2	1.2
	89	4.0	2.6	53 (4.5)	47 (3.7)	3.0	2.3
	90	3.0	2.8	57 (4.5)	45 (3.4)	2.7	2.0
UK(1)	1988	4.2	4.3	-26 (-3.2)	-26 (-3.2)	6.5	6.5
	89	3.0	2.3	-31 (-3.4)	-25 (-2.9)	~~7.7~~ (7.9)	5.5
	90	2.7	1.9	-27 (-2.7)	-20 (-2.2)	~~3.8~~ 5.5	3.3
G7	1988	4.5	4.0	-42 (-0.4)	-50 (-0.4)	3.1	3.1
	89	3.5	3.2	-60 (-0.4)	-43 (-0.3)	4.4	3.3
	90	3.0	3.1	-51 (-0.4)	-35 (-0.3)	3.8	2.9

(1) For the UK the consumer price figures are for the fourth quarter of each year.

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EXCHANGE MARKETS

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SECRET

From : D L C Peretz (MG)
Date : 21 August 1989
x 4460

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Wicks
Mr Scholar
Mr Evans
Mr A Allan
Miss O'Mara o/r
Mr N Williams o/r

G7 : EXCHANGE MARKETS

It is uncertain how the G7 discussion on exchange markets will go. But in case there is detailed discussion, including discussion of intervention arrangements, you might find it useful to have the background material in this note, as well as in the attached standard MG1 Briefing Pack.

Appropriate Level for the Dollar

2. The dollar is now almost as high as it has been over the period since the Louvre. It is around 6% up against the deutschemark, and around 6% down against the yen since February 1987. Chart 2 attached shows two measures of the real dollar exchange rate : using relative unit of labour costs, and relative consumer prices. On both measures there has been a significant real appreciation since the second half of 1987 and 1988. There is of course no comparison with the overvaluation in 1984, but if one assumes that the average real level of the dollar in, say, the second half of 1987 was the desired level, then the dollar is today overvalued by perhaps 5-10%.

3. This all suggests that if there is discussion of the appropriate ranges for the dollar, as there was in February and December 1987, then its current level should probably be regarded as the top of the range - with perhaps the level reached in December 1987 (DM 1.64 and yen 127) regarded as the bottom.

S E C R E T

Intervention and Reserves

4. The following table sets out the amounts of intervention carried out so far in 1989 by the US, Japan and Germany.

Intervention 2nd Jan-20 Sept 1989 : $m equivalents

		Total
US	-9170 (against DM) -8902 (again yen)	- 18,612
Japan	-16,576 (against yen) - 100 (against DM)	- 16,676
Germany	- 3,574 (against DM)	- 3,574

The UK figure over the same period (as reported to other central banks) at -6,868 is around double the German figure.

5. One factor behind the Bundesbank's reluctance to intervene has clearly been a perception that the level of German foreign exchange reserves was getting low. Another factor is the Bundesbank's distaste for other central banks acquiring DM. The run down in German foreign exchange reserves has been as follows :-

German foreign exchange reserves, excluding
gold : $ billion, end period

1987		1988		1989		
Q1	Q4 (peak)	Q3 (low point)	Q4	Q1	June	August
43	58	31	34	42	40	42

(Note : the rise in reserves in Q1 1989 reflects a bunching of US official payments in respect of US troops in Germany, as well as intervention).

6. While a level of $40 billion of reserves, excluding gold, still seems substantial by the standard of other countries (see table in briefing pack), the Bundesbank is presumably worried that it has no ready mechanism to raise extra foreign currency for the reserves if they run too low. This is a function of its independence : it would not want to ask the German government to borrow foreign currency on its behalf. However, you should note that in addition to their foreign currency reserves the Bundesbank has gold reserves valued, at current market prices, $34.5 billion. Surely if necessary the Bundesbank could find a way of mobilising these - perhaps by building on existing central bank swap arrangements.

Intervention : Tactics, Amounts, etc

7. It is possible the discussion could move on to detailed consideration of intervention arrangements, as it did in February and December 1987. You might like to have to hand the secret annex agreed at the Louvre and the document prepared in December 1987 - both are attached. I suggest the key points for any discussion are :

- Tactics. If there is to be a concerted attack on the dollar by central banks, it is essential that it is done well. It is also essential that all parties should be seen to be co-operating willingly. Given the Bundesbank's recent attitude, commentators will certainly probe to see if the Germans are really behind the exercise. It would be most important for the Bundesbank to make it clear that it was, and to refrain from expressing doubts, even in semi-private.

- Amounts and shares. On the two previous occasions the agreement was to spend up to $15 billion, with the amounts divided equally between the US, Japan and Europe. In this case it would be an agreement to sell dollars, rather than to buy dollars. But otherwise it might be convenient to follow the previous practice on shares. The convention has been that of the European share, the Bundesbank undertakes half, with the other half shared out between EMS countries (including the UK) and Switzerland - implying a very modest UK share of the total.

- For us, it would also be important that the arrangements should allow purchases either of sterling or DM for dollars to count towards our share, with the choice between the two to be achieved by us. (So long as we are free to interpret the agreement in this way, it might however be better to avoid raising this point explicitly - given the likelihood of German objections).

DLCP

D L C PERETZ

Chart 1

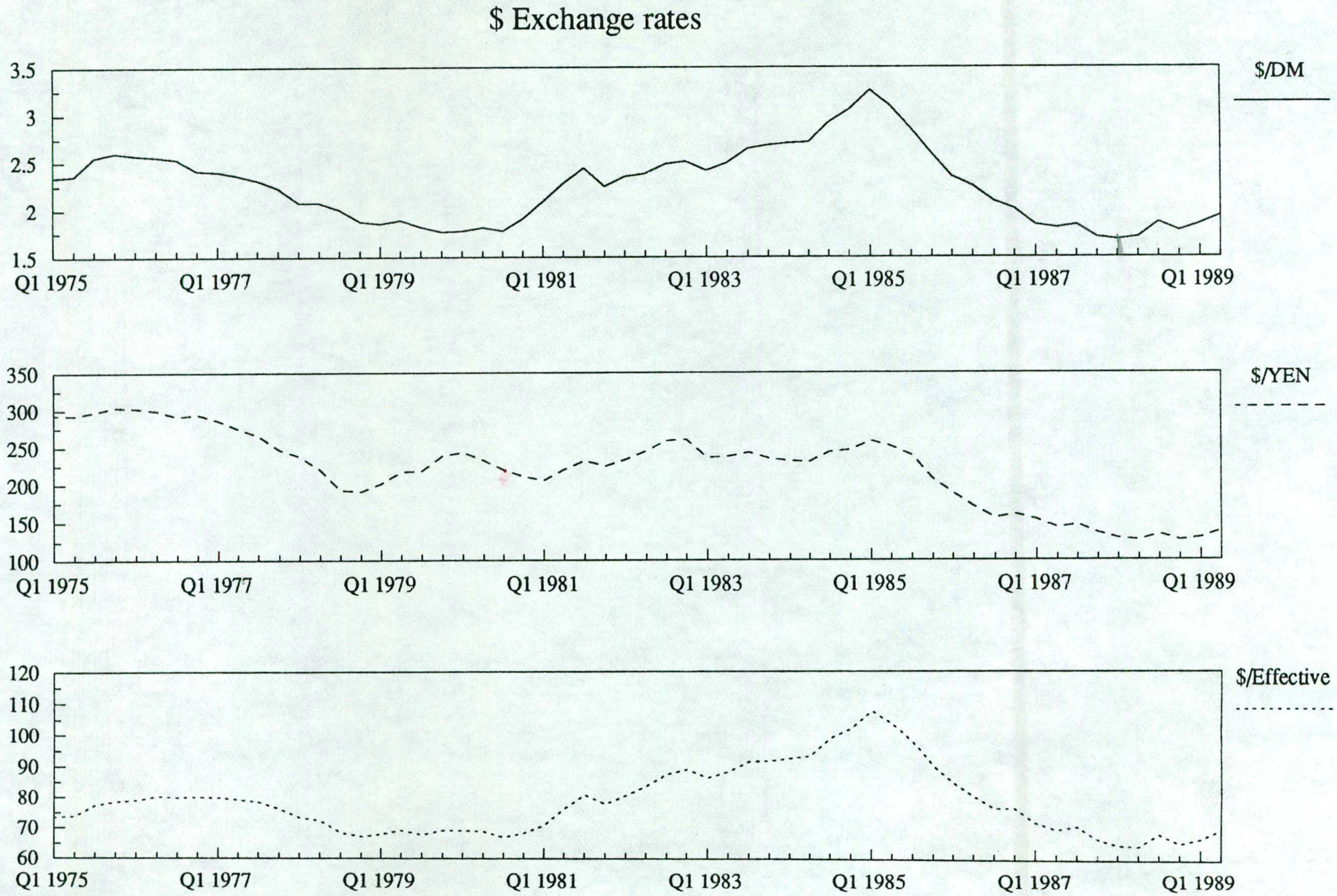

CHART 1
$ XCHANGE RATES

Chart 2

Real effective dollar exchange rate (1980=100)

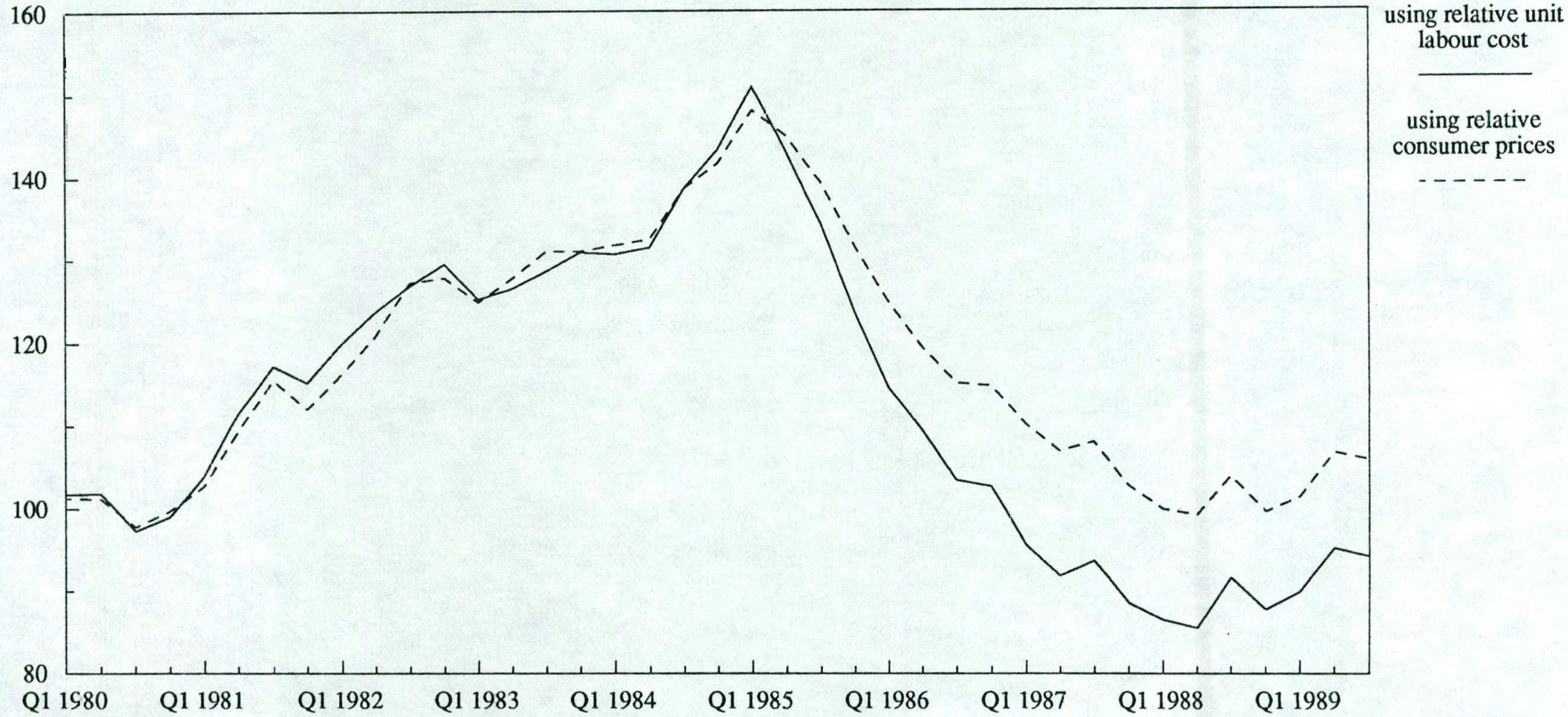

CHART 2 REAL $ XCHANGE RATE

ANNEX TO
LOUVRE ACCORD
FEBRUARY 1987

UNDERSTANDINGS ON INTERVENTION **SECRET**

1. BASIC STRATEGY

To promote greater exchange rate stability by seeking to maintain exchange rates around current levels for the time being. These understandings will be reviewed in a normal way at a meeting in early april in conjunction with the spring meeting of the Interim Committee. There would be no bias toward dollar purchases as opposed to dollar sales.

2. TACTICS

Participants will seek to avoid predictability in intervention activity. Intervention may occur when there is large and/or volatile movement of exchange rates, and would be expected as exchange rates deviate substantially from current levels. Levels and amounts of intervention would be discussed among participants on a day-to-day basis in light of market conditions.

3. SCALE

Total net intervention (dollar market only) would be maximum of $12 billion during the period until the next meeting. Daily amounts would vary, but would not ordinarily exceed $300 million for either the United States, Europe and Japan.

4. CURRENCY

As a general rule : for the United States, yen/$, DM/$; for others (except EMS interventions), dollars against national currency.

5. PROPORTIONATE SHARES

United States, Europe and Japan would have approximately equal shares over time. (Dollar sales or purchases offset through other EMS transactions would not be included in totals.) Participants would endeavour not to intervene in directions inconsistent with the basic purpose of the exercise without prior consultation.

6. VISIBILITY

Operations will be conducted without attempting to disguise them, and on occasion with the intention that they become known in the market. However, no official confirmation of intervention except in accordance with established subsequent publication policies.

7. LOCUS OF OPERATIONS

Presumption that each participant would have responsability for its own market and would not be expected to intervene in another market, although it could do so after consultation.

8. COORDINATION

Central banks continue to maintain close contacts on intervention operations pursuant to established channels. Finance ministries intensify their bilateral channels of communication.

ANX to LOUVRE ACCORD

Miss O'Mara asap

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.

INTER-VENT-ION

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.

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

SECRET

Proposed Intervention Approach

September 24, 1989

On the basis of Friday, September 22 closing rates of Y/$ 146.00 and DM/$ 1.9520, we propose the following approach starting with the Dollar's opening in Tokyo. In principle, this approach will be sustained for , subject to review.

(1) If the Dollar opens at the same level as last Friday's close, the United States, Germany and Japan should each be willing to sell at least $300 million per country. An additional amount may be used to bring about a decline.

(2) If the Dollar opens at a higher level than at last Friday's close, we will each be willing to sell at least $500 million. Additional amounts may be used as necessary.

(3) If the Dollar opens or moves to a substantially lower level than last Friday's close, no immediate intervention will be necessary.

(4) In considering tactics, it would be expected that an element of surprise could be useful and that continuous operations over extended periods would not necessarily be expected. Instead, substantial operations at opportune moments could be useful.

In all cases, the following guidelines should be observed:

(1) Close-of-day-trading rates in New York will serve as the new reference point for the next day using the same general framework as outlined above.

(2) The condition of other financial markets will be factored into consideration.

(3) Intervention activities will generally be conducted with an emphasis on market visibility.

(4) It is expected that the other European countries and Canada may engage in supporting operations consistent with this approach as appropriate.

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COVERING SECRET

FROM: I POLIN/P SMITH

DATE: 21 September 1989

X5556/4616

1. MR PERETZ 21/9

2. CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr Wicks
Mr Scholar
Mr Evans
Mr A Allan
Miss O'Mara o/r
Mr N P Williams o/r

MGI BRIEFING PACK

G7: EXCHANGE RATES, INTEREST RATES AND INTERVENTION

As background for this weekend's meetings, we attach;

i. graphs of movements in the £ERI, $/£, DM/£, yen/£, Yen/$ and DM/$ from the Louvre Accord to date. The last two graphs show the (<u>secret</u>) agreed G7 ranges;

ii. a table of movements in exchange rates from key dates;

iii. a table of long-term and short-term nominal and real interest rates in G7 countries;

iv. a table of recent UK base rate movements and the configuration of exchange rates at the time;

v. graph showing G7 short term nominal interest rates;

vi. facts sheets on the UK's official reserves and foreign currency debt;

vii. a table showing published changes in UK monthly official reserves (underlying and total) since the beginning of 1986;

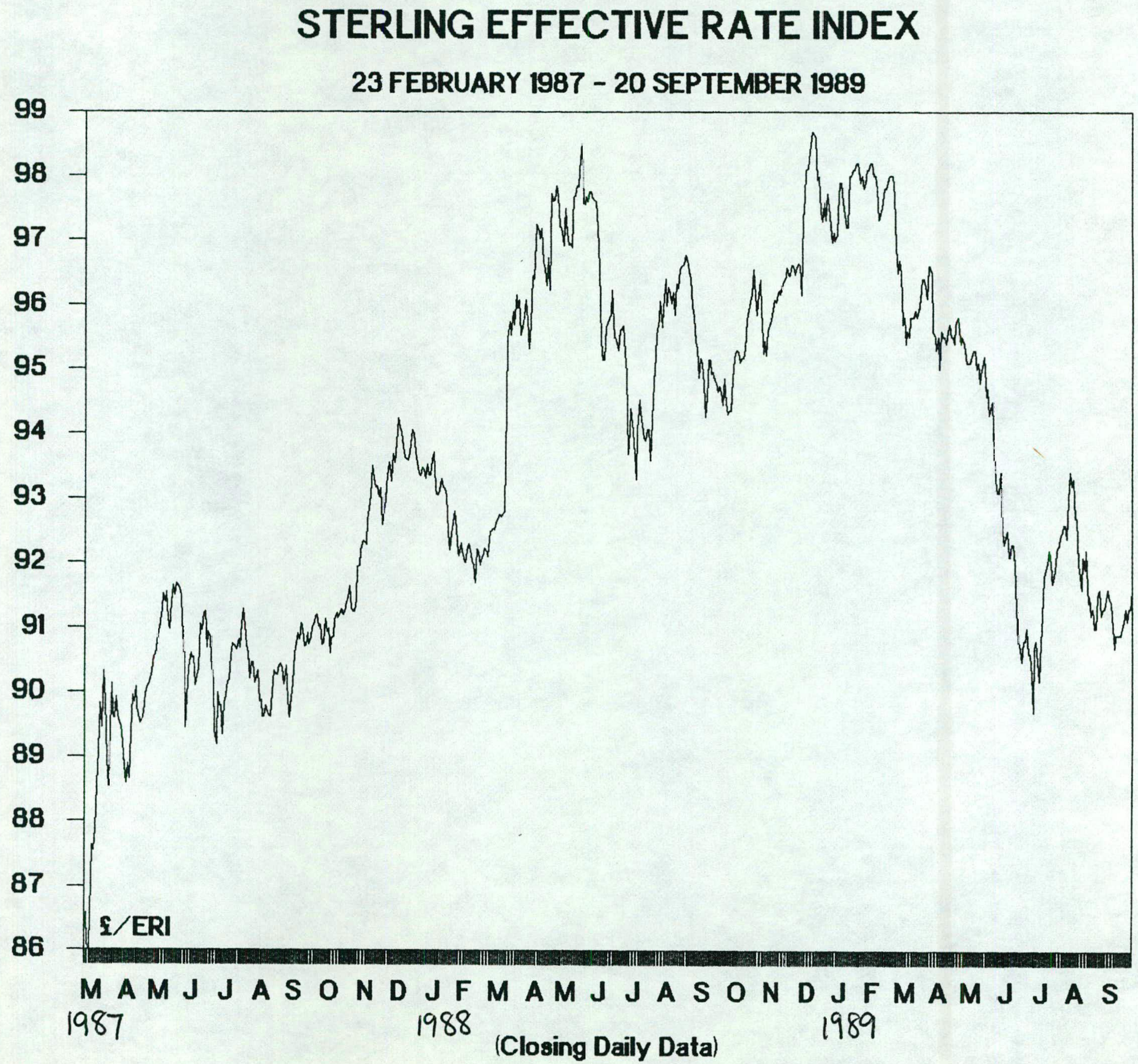
viii. a table using <u>unpublished</u> material showing the UK's net currency reserves at the end of August 1989;

ix. three summary tables showing <u>unpublished</u> G7 reported market intervention for 1987, 1988 and 1989 so far, together with monthly breakdowns;

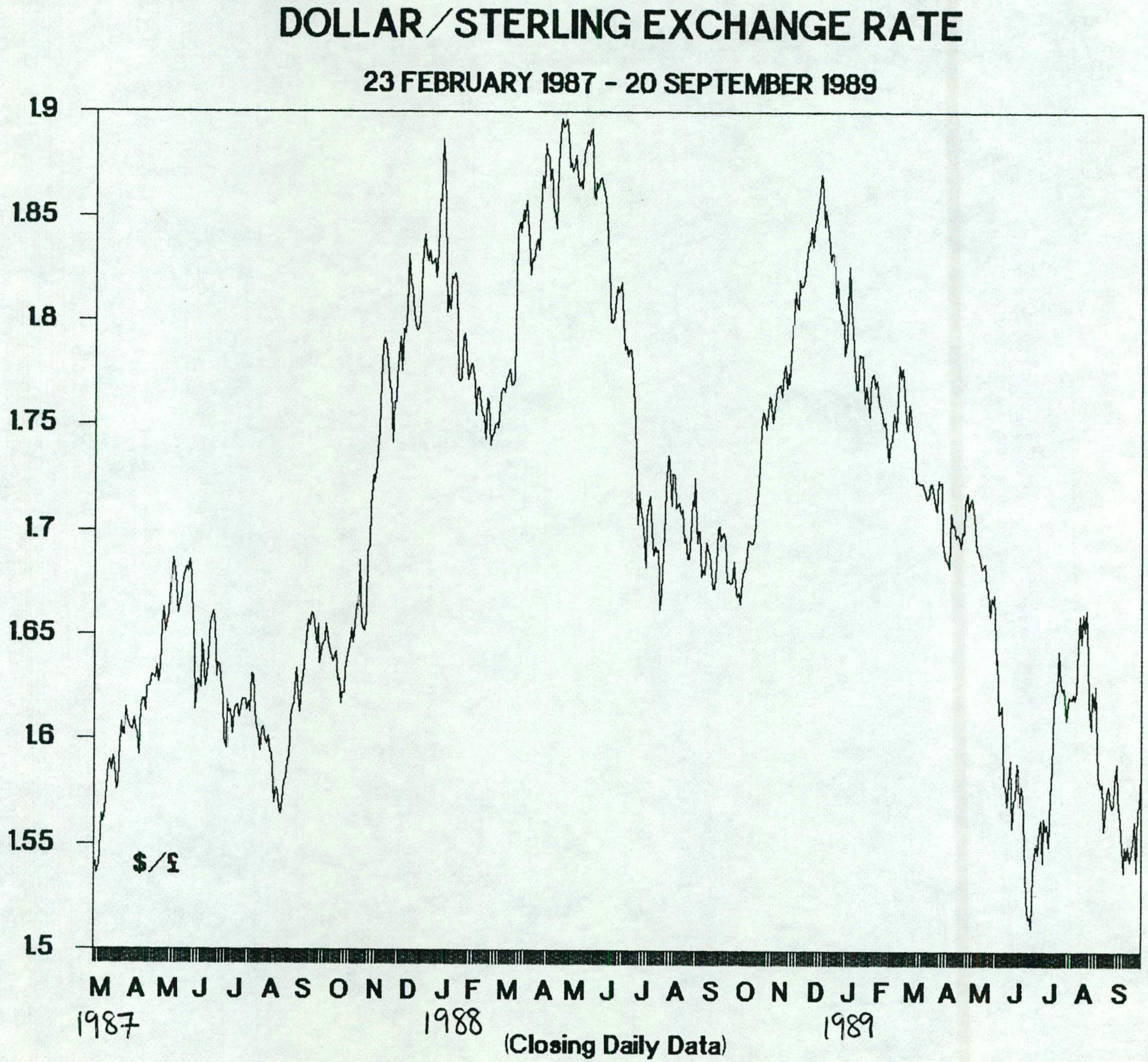
x. table showing levels of published G7 total reserves (minus gold) since the Louvre Accord to date.

Ian Polin Peter Smith

I POLIN/P SMITH



STERLING EFFECTIVE RATE INDEX
23 FEBRUARY 1987 - 20 SEPTEMBER 1989
99
98
97
96
95
94
93
92
91
90
89
88
87
86
£/ERI
M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S
1987
1988
1989
(Closing Daily Data)


DOLLAR/STERLING EXCHANGE RATE
23 FEBRUARY 1987 - 20 SEPTEMBER 1989
1.9
1.85
1.8
1.75
1.7
1.65
1.6
1.55
1.5
$/£
M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S
1987
1988
1989
(Closing Daily Data)

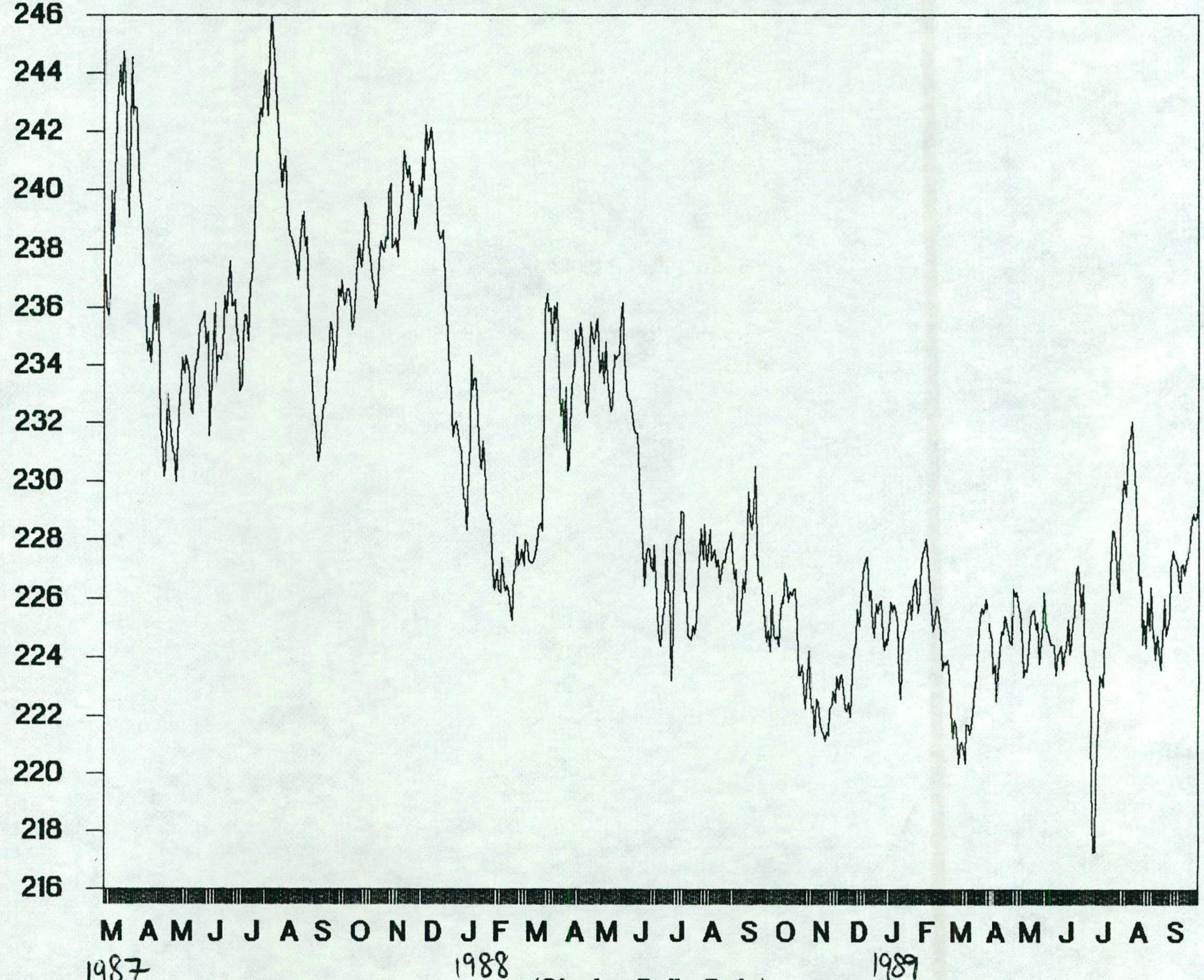
DEUTSCHEMARK/STERLING EXCHANGE RATE

23 FEBRUARY 1987 - 20 SEPTEMBER 1989

(Closing Daily Data)

YEN/STERLING EXCHANGE RATE

23 FEBRUARY 1987 - 20 SEPTEMBER 1989



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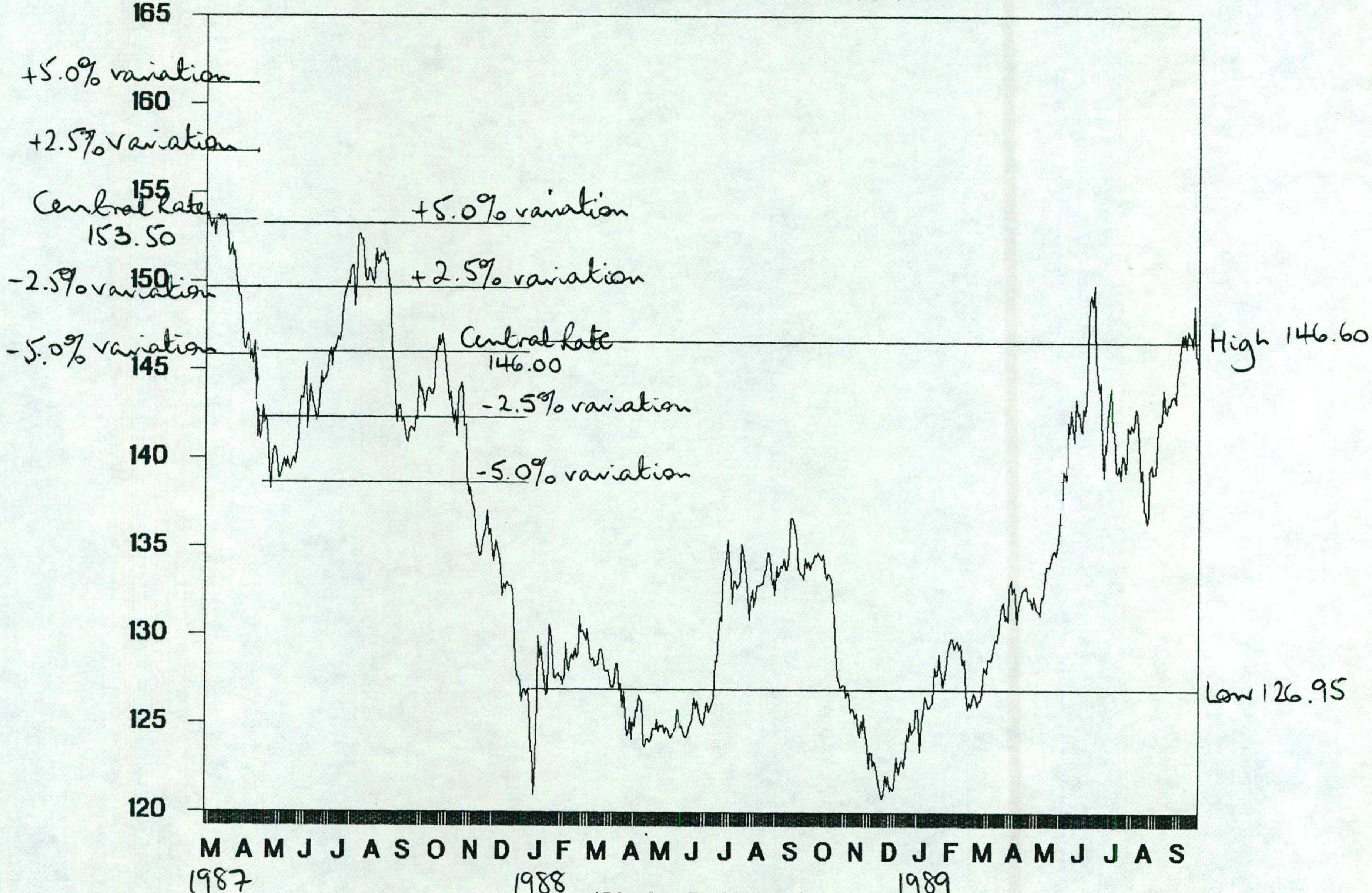
YEN/DOLLAR EXCHANGE RATE

23 FEBRUARY 1987 - 20 SEPTEMBER 1989



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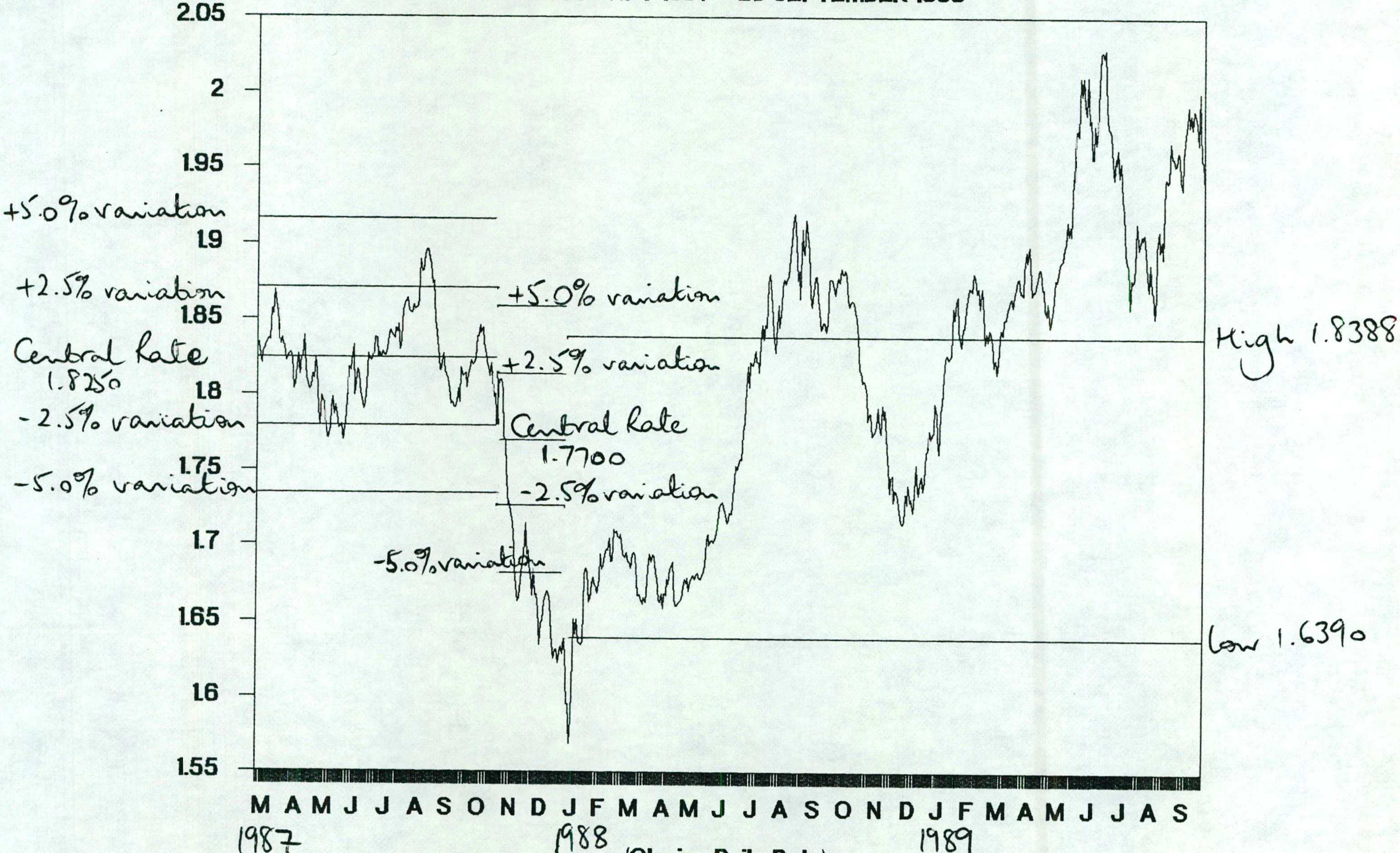
DEUTSCHEMARK/DOLLAR EXCHANGE RATE

23 FEBRUARY 1987 - 20 SEPTEMBER 1989



(Closing Daily Data)

(i) MOVEMENTS IN STERLING AND THE DOLLAR AGAINST OTHER MAJOR CURRENCIES

% change to Close 20 September 1989 since

	Closing Level 20.9.89	General Election 3.5.1979	All time £ low point against $ 26.02.85	Plaza Agreement 20.9.85	Paris Accord 20.02.87	Black Friday 16.10.87	G7 Statement 23.12.87	US Election 08.11.88	Budget 1989 14.3.89	G7 Washington 31.3.89
STERLING										
£ ERI	91.6	-14.4	0.8	-12.3	7.0	0.1	-1.8	-4.8	-4.7	-4.1
		107.0 *	90.9 *	104.4 *	85.6 *	91.5 *	93.3 *	96.2 *	96.1 *	95.5 *
$/£	1.5845	-23.7	53.0	15.9	3.7	-4.8	-13.0	-11.0	-8.0	-6.0
		2.0759 *	1.0357 *	1.3675 *	1.5283 *	1.6645 *	1.821 *	1.7797 *	1.7227 *	1.6855 *
DM/£	3.0700	-22.2	-15.0	-21.4	10.0	2.4	2.9	-3.1	-4.1	-4.1
		3.9450 *	3.6121 *	3.9063 *	2.7914 *	2.9969 *	2.9846 *	3.1686 *	3.2025 *	3.2008 *
Yen/£	229.31	-50.8	-15.7	-30.4	-2.3	-3.5	-0.8	2.6	2.7	2.5
		466.5 *	272.12 *	329.36 *	234.67 *	237.52 *	231.18 *	223.48 *	223.35 *	223.75 *
DOLLAR										
$ ERI	71.4	2.3	-36.9	-27.7	-1.6	2.6	10.9	7.7	5.6	3.8
		69.8 *	113.1 *	98.8 *	72.6 *	69.6 *	64.4 *	66.3 *	67.6 *	68.8 *
DM/$	1.9375	2.0	-44.1	-32.2	6.1	7.6	18.2	8.2	4.2	2.0
		1.9004 *	3.4665 *	2.8565 *	1.8265 *	1.8005 *	1.6390 *	1.7905 *	1.859 *	1.899 *
Yen/$	144.72	-35.6	-44.6	-39.9	-5.8	1.4	14.0	15.3	11.6	9.0
		224.70 *	261.15 *	240.85 *	153.55 *	142.70 *	126.95 *	125.57 *	129.65 *	132.75 *

(ii) Sterling all-time lows:

ERI	83.7	(8 October 1986)
$	1.036	(26 February 1985)
DM	2.7349	(28 January 1987)

(iii) Recent sterling trading highs:

ERI	98.7	(6 December 1988)
$	1.9065	(18 April 1988)
DM	3.2915	(1 February 1989)

(iv) Dollar all-time lows:

$ ERI	63.3	(30 October 1978)
DM	1.5620	(4 January 1988)
YEN	120.25	(4 January 1988)

(v) Recent dollar trading highs:

$ ERI	74.1	(15 June 1989)
DM	2.047	(15 June 1989)
Yen	151.75	(15 June 1989)

Note

Figures marked with '*' show level of closing exchange rate on which per cent change is based.

Open 144.5
now 142.9

Open 1.935
now 1.902

Open 1.5870
low 1.6180
now 1.61
Cross 3.062.

G7 nominal and real 3 month interest rates as at 20 September 1989

	Nominal	Relative to inflation(1)	Inflation
UK	13.9	6.2	7.3*
US	8.8	4.1	4.5*
JAPAN	5.7	2.7	2.9*
W GERMANY	7.5	4.4	3.0
FRANCE	9.3	5.6	3.5
ITALY	12.6	5.2	7.0
CANADA	12.4	6.6	5.4
G7 AVERAGE	8.9	4.4	4.7 (July)

All inflation rates July except * August.

G7 nominal and real 10 year bond yields as at close 19 September 1989

	Nominal	Relative to inflation(1)	Inflation
UK	10.2	2.7	7.3*
US	8.1	3.4	4.5*
JAPAN	5.3	2.3	2.9*
W GERMANY	6.9	3.8	3.0
FRANCE	8.6	4.9	3.5
ITALY	11.7	4.4	7.0
CANADA	9.5	3.8	5.4
G7 AVERAGE	7.9	3.4	4.7 (July)

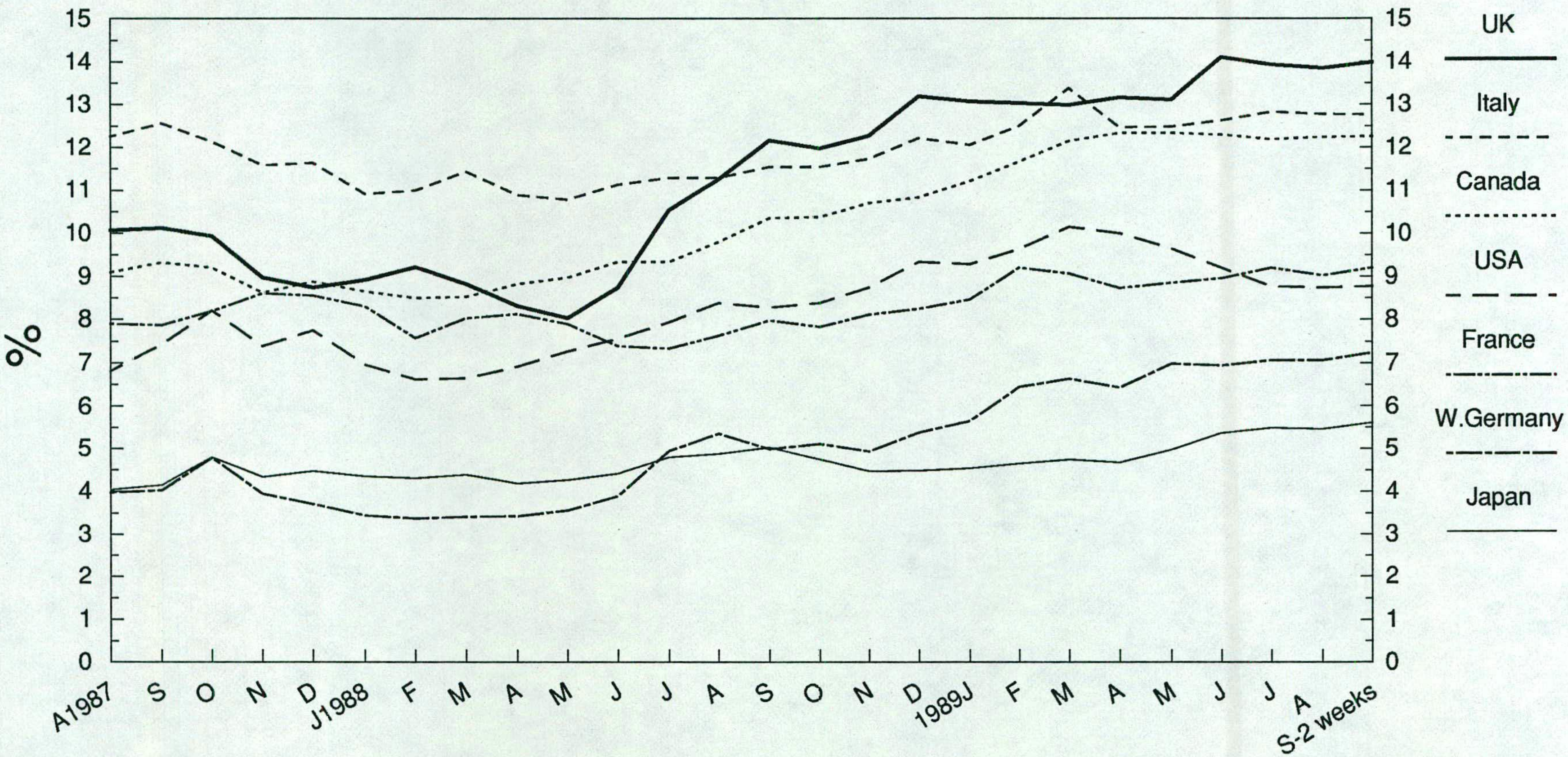
All inflation rates July except * August.

RECENT INTEREST RATE INCREASES WITH LONG RATES AND EXCHANGE RATES FOR COMPARISON

	Base Rates (1)	20 year gilt yields	DM/£	$/£	ERI
1987					
August 6	10	9.8	2.96	1.58	89.7
October 23	9 1/2	9.6	2.99	1.66	91.4
November 4	9	9.1	2.98	1.75	92.8
December 3	8 1/2	9.3	3.00	1.80	93.8
1988					
February 1	9	9.4	2.97	1.76	92.0
March 17	8 1/2	9.1	3.10	1.84	96.1
April 8	8	9.1	3.14	1.87	97.2
May 17	7 1/2	9.3	3.17	1.86	97.6
June 2	8	9.3	3.11	1.80	95.4
June 6	8 1/2	9.2	3.10	1.80	95.1
June 22	9	9.3	3.15	1.77	95.7
June 28	9 1/2	9.5	3.10	1.72	94.0
July 4	10	9.6	3.08	1.68	93.3
July 18	10 1/2	9.6	3.14	1.67	94.2
August 8	11	9.4	3.23	1.70	96.3
August 25	12	9.6	3.16	1.70	95.3
November 25	13	9.4	3.17	1.85	96.2
1989					
May 24	14	9.6	3.16	1.57	93.1
Sept	14	9.4	3.07	1.55	91.5

(1)Date when Bank announced change in dealing rates.Base rates usually moved next working day. All rates shown at day's close.

G7 3mth interest rates
monthly averages of weekly data



RESERVES AND OFFICIAL DEBT FACTSHEETS.

Previous reserve levels and changes

(i) **Reserves levels at key dates:**

$ million

End-period	Level of reserves
Labour	
End-December 1976 (Low)	4,129
End-March 1979 (High)	21,947
Conservative	
End-March 1985 (Low)	13,528
End-December 1988	51,685
End-January 1989 (High)	51,705
End-March 1989	46,931 (after revaluation)
End-August 1989	43,208

(ii) **Recent reserve changes:**

$ million

		Underlying change	Total change	Level of reserves at end period
1987	Year	+20,475	+19,513	44,326
1988	Year	+ 7,257	+ 4,480	51,685
1989	January	+ 330	+ 20	51,705
	February	+ 29	- 22	51,683
	March	- 1,196	- 1,227	50,456 (46,931)*
	April	+ 215	+ 325	47,256
	May	- 739	- 1,169	46,087
	June	- 2,236	- 2,422	43,665
	July	+ 67	- 34	43,631
	August	- 405	- 423	43,208

* after revaluation

Levels of total official debt at key dates

$ billion

End period	Level of total official debt
Labour	
End-March 1974 (low)	8.7
End-December 1977 (High)	25.5
Conservative	
End-May 1979 (High)	22.0
End-September 1984 (Low)	11.0
End-March 1989	15.2*

* Latest published figure from Financial Statistics, August 1989, Table 10.6.

PUBLISHED CHANGES IN UK OFFICIAL RESERVES 1986 - END AUGUST 1989

	Underlying Change	Total Change	$ million Spot Reserves at end Period
1986			
January	+ 132	+ 17	15,560
February	+ 112	+ 250	15,810
March	+ 278	+ 435	18,750*
April	+ 264	+ 237	18,987
May	+ 138	+ 179	19,166
June	+ 291	+ 22	19,188
July	- 4	- 105	19,083
August	- 141	- 159	18,924
September	- 372	+3502	22,426
October	- 668	- 434	21,992
November	+ 35	+ 14	22,006
December	+ 96	- 83	21,923
1986 Sub-Total	+ 161	+3875	
1987			
January	+ 72	+ 29	21,952
February	+ 287	+ 305	22,257
March	+1785	+1892	27,039*
April	+2912	+2768	29,807
May	+4760	+4872	34,679
June	- 230	- 315	34,364
July	+ 499	+ 551	34,915
August	- 457	- 550	34,365
September	+ 380	+ 443	34,808
October	+6699	+6591	41,399
November	+ 31	- 118	41,281
December	+3737	+3045	44,326
1987 Sub-Total	+20475	+19513	
1988			
January	+ 38	-1233	43,093
February	- 25	- 166	42,927
March	+2225	+1713	47,519*
April	+ 514	+ 338	47,857
May	+ 814	+ 676	48,533
June	+ 84	- 14	48,519
July	+ 910	+1307	49,826
August	+ 827	+ 813	50,639
September	- 143	-157	50,482
October	+1124	-434	50,048
November	+ 428	+ 992	51,040
December	+ 461	+ 645	51,685
1988 Sub-Total	+7257	+4480	
1989			
January	+ 330	+ 20	51,705
February	+ 29	- 22	51,683
March	-1196	-1227	46,931*
April	+ 215	+ 325	47,256
May	- 739	-1169	46,087
June	-2236	-2422	43,665
July	+ 67	- 34	43,631
August	- 405	- 423	43,208
1989 Sub-Total	-3935	-4952	

NOTE

(i)All changes and sub-totals do not include effect of annual revaluation changes.

SECRET

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TABLE : NET CURRENCY RESERVES : END AUGUST 1989

$ million

	Assets *	Liabilities	Net assets
US$	15075	9049 +	6026
DM	7085	1823	5262
DFLS	436	202	234
Yen	5416	202	5214
Sw fr	64	64	0
Canadian $	697	414 ++	283
ECU	4437	2575	1862
Others	2043 **	6	2037
	35253	14335	20918

Note: Liabilities valued on reserves valuation basis.

* assets include both spot and forward, and dollars pledged to EMCF.

\+ of which $1,806 million are long-term North American loans.

++ Long-term North American loans.

** includes +1920 Ffr,+119 Bfr ($ million equivalent).

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TABLE: 1989 (JANUARY 2nd to SEPTEMBER 20th CLOSE) SUMMARY OF TOTAL G7 REPORTED MARKET INTERVENTION+

$ million equivalent

	$	DM	Yen	FFr	ECU	Other Currencies	Total
US	-9,710 (agst DM) -8,902 (agst Yen)	-	-	-	-	-	-18,612
Germany	-3,574	-	-	-	-	+ 85 DKr	-3,489
Japan	-16,576 (agst Yen) - 100 (agst DM)	-		-	-	-	-16,676
France	- 945 (agst DM) - 30 (agst ECU) - 135	+ 1,268	+ 49	-	+240 - 62 (agst DM)	+ 30 SwFr	+ 415
Italy	+ 1,347 - 10 (agst ffr) - 689 (agst DM)	+7,044	-	+ 388	+1,313	+127 Dkr	+9,520
Canada	- 741 - 525 (agst DM) - 472 (agst Yen)	+ 763	+ 664	-	-	-	- 311
UK	- 505 (agst DM) -6,345	- 18	-	-	-	-	-6,868
	-47,912	+9,057	+ 713	+ 388	+1,491	+ 242	
						Grand Total	-36,021

+ on a done date basis

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TABLE: G7 REPORTED MARKET INTERVENTION[±] 1989

$ million equivalent

January 1989 to 20th September 1989	US	Germany	Japan	France	Italy	Canada	UK
1989							
Janury	-1880$ agst DM	-1356$	-	-190$ agst DM +88DM	-25$, -133$ agst DM +1752DM, +21FFr, +13Ecu	-33$, -185$ agst DM, +529DM	-205$ agst DM +125DM
February	-350$ agst DM	-309$	-	-60$ agst DM	-174$, -48$ agst DM +552 DM, -64 FFr, +34 Ecu	-638$, -25$ agst DM +48 DM, +71 Yen	-125$, -25$ agst DM -116 DM
March	-1419$ agst DM, -100$ agst Yen	-268$ +85 DKr	-	+256DM, +49 Yen -50$ agst DM, +30 SwFr, + 33 Ecu, -30$ agst Ecu, - 62 Ecu agst DM	+1259 DM, -16$ -76$ agst DM	+170$, +19 DM +38 Yen, -125$ agst DM -25$ agst Yen	-1205$, -75$ agst DM -27 DM
April	-220$ agst DM - 50$ agst Yen	-21$	-30$	+368DM, -30$ agst DM	+445 DM, -21$ agst DM	-8$, -20$ agst DM, +82 DM, +90 Yen	-550$, -35$ agst DM
May	-3550$ agst DM, -3185$ agst Yen	-949$	-5527$	+503DM, -380$ agst DM, +207 Ecu	+ 29FFr, -31$, -266$ agst DM, + 986 DM	+147 Yen, +45 DM, -145$ agst DM, -237$ agst Yen, -634$	-1355$, - 65$ agst DM
June	-1129$ agst DM, -3823$ agst Yen	-396$	-6570$ -100$ agst DM	-180$, -95$ agst DM	-101$, -67$ agst DM, -6 DM	-160$ agst Yen, -25$ agst DM, +290 Yen, +40 DM	-2560$
July	-230$ agst Yen	-	-1220$	+45$, +53 DM	+173$, +43 DM, +19Ffr +7 Dkr	+332$	-
August	-520$ agst Yen -400$ agst DM	-95$	-830$	-60$ agst DM	+1166$, -23$ agst DM -10$ agst Ffr, +1226 DM, +341 Ffr, +120 Dkr, +878 Ecu	+383$, -35$ agst Yen, +28 Yen	-475$, -50$ agst DM
September (1-20th close)	-994$ agst Yen -762$ agst DM	-180$	-2399$	-80$ agst DM	+355$, +787 DM, +42Ffr, +388 Ecu, -55$ agst DM	-313$, -15$ agst Yen	-75$, -50$ agst DM

SECRET

TABLE: 1988 (JANUARY TO DECEMBER) SUMMARY OF TOTAL G7 REPORTED MARKET INTERVENTION+

$ million equivalent

	$	**DM**	**Yen**	**FFr**	**ECU**	**Other Currencies**	**Total**
US	+2755 (agst Yen) -3,716 (agst DM)	-	-	-	-	-	- 961
Germany	-7,125 +175 (agst Yen)	-	-	-	-	-	-6,950
Japan	+5,311 -150 (agst DM)	-	-	-	-	-	+5,161
France	-3,005 -45 (agst DM) +20 (agst Yen)	+2,218	-	-	-	-	-812
Italy	-1,137 -254 (agst DM)	-525	-	+570	+99	-	-1,247
Canada	+8,299 +82 (agst Yen) -204 (agst DM)	+52	-79	-	-	-	+8,150
UK	+1,579 -230 (agst DM) +35 (agst Lira)	+1,620	-	+1,202	+1,356	+98 BFr	+5,660
	+2,390	+3,365	-79	+1,772	+1,455	+98	
						Grand Total	+9,001

+ on a done date basis

TABLE: G7 REPORTED MARKET INTERVENTION± 1988

$ million equivalent

January 1988 to December 1988	US	Germany	Japan	France	Italy	Canada	UK
1988							
January	+235$ agst Yen +480$ agst DM	+415$ +50$ agst Yen	+1060$	+610$, +3513DM +30$ agst DM	+366$,+795DM, +85ECU, +30$ agst DM	+1217$,+32Y,+91DM, +18$ agst Yen +37$ agst DM	+25$ agst DM
February	-	-	-	+356DM	-93$,-61DM -23Ffr	+840$, +116Y,+72DM	+35$ agst Lira
March	+318$ agst Yen		+379$	-90DM,+190$	-1236DM,-697$ -13Ffr	+1839$,-25$ agst Yen	+242$,+1004ECU +731DM,+951Ffr
April	+260$ agst Yen +240$ agst DM	+150$ +125$ agst Yen	+813$	+65$ +50$ agst DM +20$ agst Yen	-1650DM,-12Ffr -14ECU, -27$ +20$ agst DM	+809$ +48$ agst Yen +25$ agst DM -12 Yen	+540$
May	-	-7$	-	+98 DM	-372$ -294 DM +20 FFr	-372$	+670$ +100 FFr +100 ECU
June	-520$ agst DM	-1466$	-	-26$,-20$ agst DM	-91$,-20$ agst DM +678 DM, +68ECU	+2865$, -23$ agst DM	+125$,-50$ agst DM, +179 DM
July	-2410$ agst DM	-4169$	-150$ agst DM	-180$,-30$ agst DM	-312$,-187$ agst DM	-167$,-126$ agst DM	-150$ agst DM +575DM,+252ECU +98Bfr,+151FFr
August	-1806$ agst DM	-1976$	-	-731$,-175$ agst DM, +26DM	-366$,-91$ agst DM, +1139 DM -68FFr	-1448$ -140$ agst DM	-225$,-130$ agst DM, +66DM
September	-330$ agst DM -28$ agst Yen	-235$	-	-1364$, -146DM	-1350$, -6$ agst DM -220 DM -40 ECU +30FFr	+964$ -25$ agst DM	-363$,+80DM
October	+200$ agst Yen	-21$	+356$	-1006$,-1204DM	+1081$,+17DM +356 FFr	+1105$,-57DM -14 Yen	+200$,-112DM
November	+1570$ agst Yen + 530$ agst DM	+358$	+2653$	+100$ agst DM, - 83DM	+250DM,+724$,+236FFr	+809$,-54DM + 16$ agst Yen + 23$ agst DM -201 Yen	+315$,+75$ agst DM
December	+ 200$ agst Yen + 100$ agst DM	-174$	+ 50$	- 563$,-252DM	+ 57DM + 44ffr	-162$ + 25$ agst Yen	+ 75$,+101DM

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TABLE: 1987 SUMMARY OF TOTAL G7 REPORTED MARKET INTERVENTION+

$ million equivalent

	$	**DM**	**Yen**	**FFr**	**ECU**	**Other Currencies**	**Total**
US	+ 6,020 (agst Yen) + 2,378 (agst DM)	-	-	-	-	-	+ 8,398
Germany	+ 4,106 + 755 (agst Yen)	-	-	+ 3,308	-	+ 92 DKr + 2 I£	+ 8,263
Japan	+ 34,798 + 85 (agst DM)	-	-	-	-	-	+ 34,883
France	+ 6,597 + 710 (agst Yen) + 47 (agst DM)	- 10,041	-	-	-	-	- 2,687
Italy	+ 1,632 + 71 (agst Yen) + 106 (agst DM) + 34 (agst ECU)	- 1,211	-	-	+ 75	-	+ 707
Canada	+ 4,972 + 72 (agst DM) + 123 (agst Yen)	- 1,781	-	-	-	-	+ 3,386
UK	+ 26,999 + 200 (agst Yen) - 40 (agst DM)	+ 3,551	-	+ 658	+ 133	+ 38 Lira + 28 BFr	+ 31,567
	+ 89,665	- 9,482	-	+ 3,966	+ 208	+ 160	
						Grand Total	+ 84,517

+ on a done date basis

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TABLE: G7 REPORTED MARKET INTERVENTION± 1987

$ million equivalent

January 1987 to December 1987	US	Germany	Japan	France	Italy	Canada	UK
1987							
January	+50$ agst Yen	+566$, +21£ +3308ffr,+92DKr	+8649$	+189$,-4217DM	+394$,-628DM,-12ECU	+1445$	+181$
February	-	-	-	+661$,+2111DM	+493$,+1978DM	+291$	+174$,+30DM
March	+2395$ agst Yen -30$ agst DM	+200$ agst Yen	+8533$	+883$,+4084DM +250$ agst Yen	+37$,+612DM +27ECU	+1578$	+3630$ +100$ agst Yen +225DM
April	+1530$ agst Yen +99$ agst DM	+555$ agst Yen, +327$	+7398$ +50$ agst DM	+4525$,-970DM +460$ agst Yen	+1067$,+26ECU -1290DM, +71$ agst Yen	-1781DM	+5525$,+100$agst Yen +156DM
May	+20$ agst Yen +273$ agst DM	+269$	+35$ agst DM	-918DM	+169$,-1572DM	-553$	+6715$
June	+103$ agst Yen +415$ agst DM	+150$	+80$	+70$ agst DM -480DM	-47$,-855DM +25$ agst DM	+579$	-85$
July	-	-	-	+81DM	-953$,-455DM	+77$	+487$,+517DM
August	-681$ agst DM +105$ agst Yen	-133$	+959$	-714$,-40DM -267$ agst DM	-2102$,-870DM	+712$,-50$ agst DM	-526$,-150$agstDM
September	+235$ agst Yen	+216$	+670$	+20$ agst DM, -1138DM	+233$,+1844DM	+353$ +20$ agst Yen	+1603$,+35$ agst DM +664DM
October	+65$ agst Yen +395$ agst DM	+760$	+2012$	+338$,-6284DM, +60$ agst DM	+890$,+724DM, +10$ agst DM +34ECU	+138$ +38$ agst DM	+5818$,+50$ agst DM +1128DM
November	+428$ agst Yen +788$ agst DM	+812$	+3074$	-2270DM	+992$,-374DM	-21$,+17$ agst DM	-
December	+1089$ agst Yen +1119$ agst DM	+1139$	+3423$	+715$ +164$ agst DM	+459$,-325DM +71$ agst DM	+373$,+67$agst DM, +103$ agst Yen +34$ agst ECU	+3477$,+25$ agst DM +831DM, +658Ffr, +133ECU, +38Lira +28Bfr

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LEVELS OF PUBLISHED G7 TOTAL RESERVES (MINUS GOLD*) 1987 Q1 TO DATE

$ billion equivalent

	US	GERMANY	JAPAN	FRANCE	ITALY	CANADA	UK
End-period							
1987 Q1	36	43	69	32	24	5	20
Q2	33	44	69	30	24	5	27
Q3	34	42	71	31	18	5	28
Q4	36	58	80	30	31	7	37
1988 Q1	32	52	84	29	30	12	40
Q2	30	46	87	29	27	15	41
Q3	37	31	90	26	29	14	42
Q4	37	34	97	22	34	15	44
1989 Q1	39	42	98	23	38	15	40
April	39	44	99	23	40	15	40
May	44	40	95	21	39	15	39
June	50	40	89	26	39	15	37
July	52	42	88	26	42	15	37
August		42		26			36

* at national valuation

Notes

(1) Figures for total G7 published reserves supplied by the Bank

(2) Figures for gold at National valuation, taken from International Financial Statistics, published by IMF, September 1989 edition.

WORLD
BACKGROUND

WORLD ECONOMIC DEVELOPMENTS

Activity

1. There are signs that the pace of growth is slowing in North America but activity remains buoyant in Japan, Germany and France.

2. Figures for the second quarter of 1989 show **GNP** growth on a year earlier of 3.1 per cent in the **US**, and 4.9 per cent in **Germany. GNP** growth in **Japan** was 4.5 in the year to 1989 Q1.

3. The growth rate of **industrial production** has slowed this year in the US but remains strong elsewhere.

4. **Capacity utilisation** rates are still close to or above past peaks in all the G7 countries except Japan, but fell in Q2 in the UK, US and France.

Inflation

5. There is evidence of some easing of **inflationary pressure** in the major economies:-

- The 12-month rate of G7 **consumer price inflation** rose further from 4.0 per cent in February to 4.8 per cent in May (the highest rate since April 1984), but was 4.7 per cent in July;
- **Producer prices** have risen sharply in the US and Japan so far this year but fell in July. The 12-month rate of G7 producer price inflation increased from 2.5 per cent in November to about 5.3 per cent in May but has now fallen back;
- The **Oil** price measured in SDRs has changed little over the summer, staying at about 5 per barrel below its April peak.

Policy

6. Short term **interest rates** have fallen since April in the US but have risen in Japan and Germany.

External Position

7. The US **current account deficit** has changed little over the last three quarters, but the Japanese and German **current account surpluses** both fell in Q2.

8. The **US dollar** has appreciated by 13 per cent in effective terms so far this year.

SAMANTHA BECKETT
EXT 5548

IF2 DIVISION
20 SEPTEMBER 1989

CONTENTS

NOTE : All data in this note are from OECD sources unless otherwise stated.

SECTION A: ACTIVITY IN THE G7

Growth of **real output** in the G7 has moderated from its very rapid rate at the end of 1987 and beginning of 1988, but remains above the estimated rate of growth of productive potential.

Table 1: GDP/GNP growth in the G7 countries

	Nominal GNP	Real GNP	GNP Deflator
Annual percentage change			
1984	9.2	4.8	4.2
1985	7.1	3.3	3.7
1986	6.1	2.6	3.4
1987	6.5	3.4	3.0
1988	7.8	4.5	3.2
Change from four quarters earlier (per cent)			
1987 Q1	5.5	2.4	3.1
Q2	5.9	2.8	3.1
Q3	6.8	3.9	2.8
Q4	7.8	4.7	3.0
1988 Q1	8.1	5.3	2.7
Q2	7.7	4.6	2.9
Q3	7.9	4.4	3.3
Q4	7.5	3.6	3.7
1989 Q1	7.9	3.6	4.1
Indices (1980=100)			
1987 Q1	163.5	117.6	139.0
Q2	166.5	118.8	140.2
Q3	170.0	120.5	141.1
Q4	173.6	122.1	142.2
1988 Q1	176.8	123.8	142.8
Q2	179.4	124.3	144.3
Q3	183.5	125.8	145.9
Q4	186.6	126.6	147.4
1989 Q1	190.7	128.3	148.6

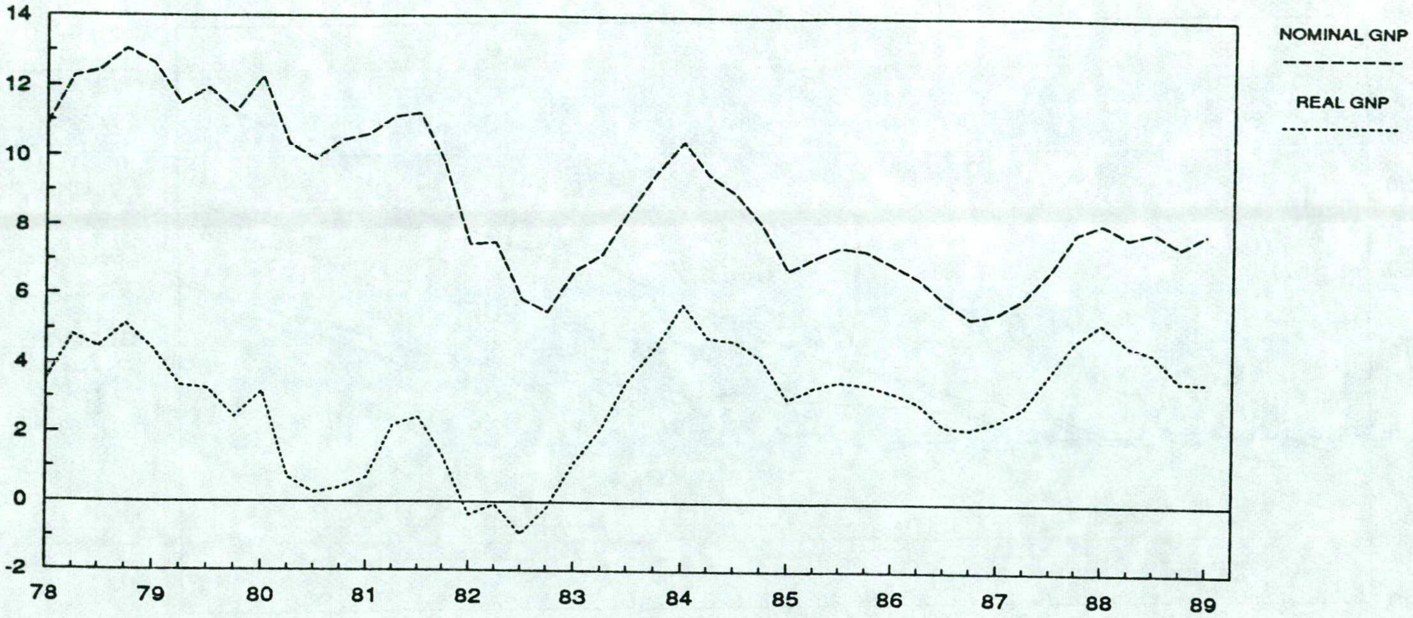
2. Table 2 shows that all the major countries shared in the vigorous expansion of 1988, but while growth slowed in 1989 in the US and UK it has not slowed in Germany.

Table 2 : GNP and Domestic Demand Growth in Indivdual Countries

		GDP/GNP* US	Japan	Germany	France	UK	G7***	Domestic Demand** US	Japan	Germany	France	UK	G7***
Annual percentage changes													
1984		6.8	5.1	3.3	1.3	1.7	4.8	8.9	3.8	2.0	0.4	2.6	5.4
1985		3.4	4.9	1.9	1.9	4.0	3.3	3.9	3.9	0.8	2.5	2.8	3.3
1986		2.7	2.5	2.3	2.3	3.2	2.6	3.5	4.1	3.5	4.1	4.2	3.7
1987		3.7	4.4	1.8	1.9	4.5	3.4	3.2	5.1	3.1	3.0	5.2	3.8
1988		4.4	5.8	3.6	3.4	4.3	4.5	3.2	7.8	3.6	3.8	7.3	4.6
Change from four quarters earlier (per cent)													
1987	Q3	4.3	4.6	1.5	2.0	5.0	3.9	3.5	5.0	2.9	2.2	5.7	4.0
	Q4	5.4	5.7	2.4	2.6	5.1	4.7	4.6	7.0	3.3	3.7	7.0	5.1
1988	Q1	5.1	7.0	4.4	4.0	5.5	5.3	3.9	9.1	4.6	3.5	8.7	5.4
	Q2	4.9	5.7	3.4	3.2	4.5	4.6	3.6	8.1	3.3	3.5	6.7	4.7
	Q3	4.4	5.7	3.6	3.5	4.0	4.4	3.1	8.0	3.5	4.2	6.9	4.7
	Q4	3.4	4.8	3.1	3.1	3.4	3.6	2.4	6.1	3.2	4.1	6.9	3.9
1989	Q1	3.3	4.5	4.4	3.0	2.3	3.6	2.7	5.8	2.8	3.2	6.0	3.9
	Q2	3.1		4.9		1.5		2.5		2.9		4.8	
Indices (1980=100)													
1987	Q3	121.5	131.2	111.3	112.9	119.1	120.5	128.2	127.1	107.6	113.6	123.8	122.4
	Q4	123.5	133.5	112.3	114.0	121.4	122.1	129.9	130.4	109.0	114.8	126.4	124.4
1988	Q1	124.7	136.7	113.7	115.3	122.6	123.8	130.1	133.8	110.2	115.8	127.8	125.6
	Q2	125.8	135.6	113.7	115.6	123.3	124.3	131.0	134.7	110.1	116.8	128.5	126.3
	Q3	126.8	138.7	115.3	116.8	123.8	125.8	132.2	137.3	111.4	118.5	132.3	128.1
	Q4	127.7	139.9	115.8	117.5	125.5	126.6	133.0	138.4	112.4	119.5	135.1	129.3
1989	Q1	128.8	142.9	118.8	118.8	125.4	128.3	133.6	141.7	113.3	119.6	135.6	130.5
	Q2	128.6		119.3		125.1		134.3		113.2		134.7	

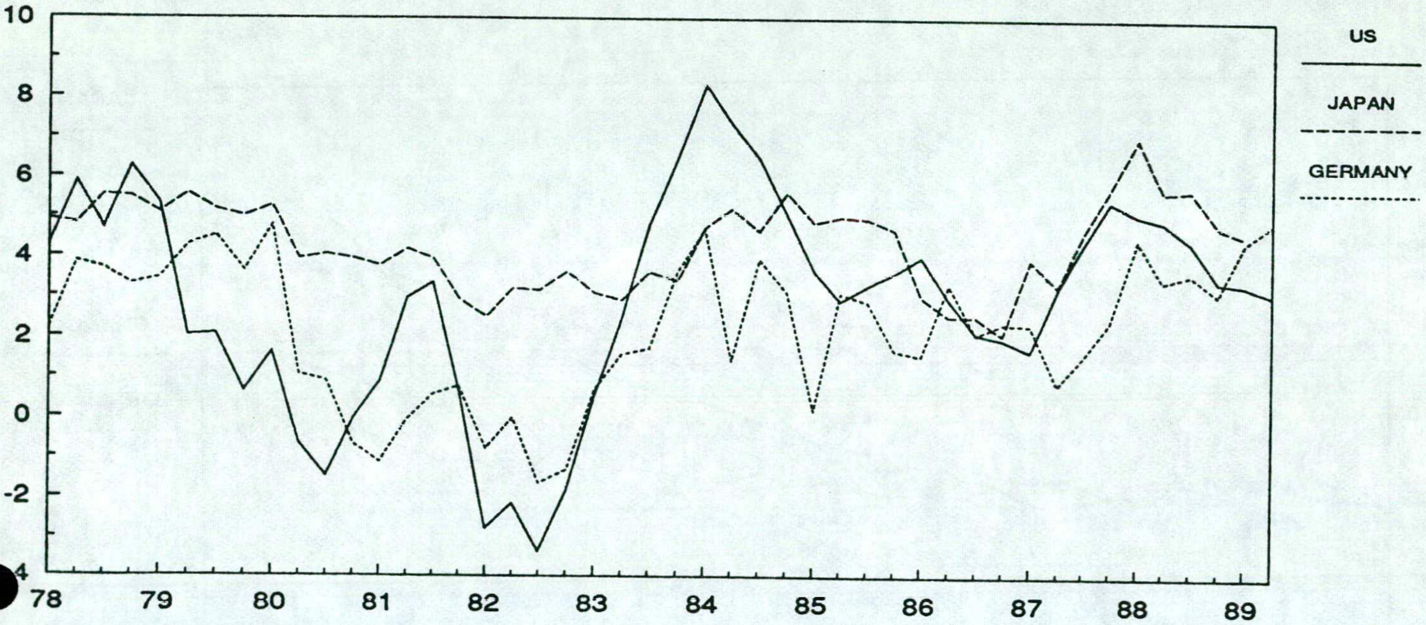
* Expenditure measure of GNP/GDP at market prices except for UK (HMT compromise measure of GDP at factor cost).
** Includes stockbuilding.
*** Weighted by GNP/domestic demand and exchange rates in 1980.

CHART 1 : G7 REAL AND NOMINAL GNP



PERCENTAGE CHANGE OVER YEAR EARLIER

G3 REAL GNP



PERCENTAGE CHANGE ON YEAR EARLIER

CHART 2 : REAL GNP

(1980 = 100)

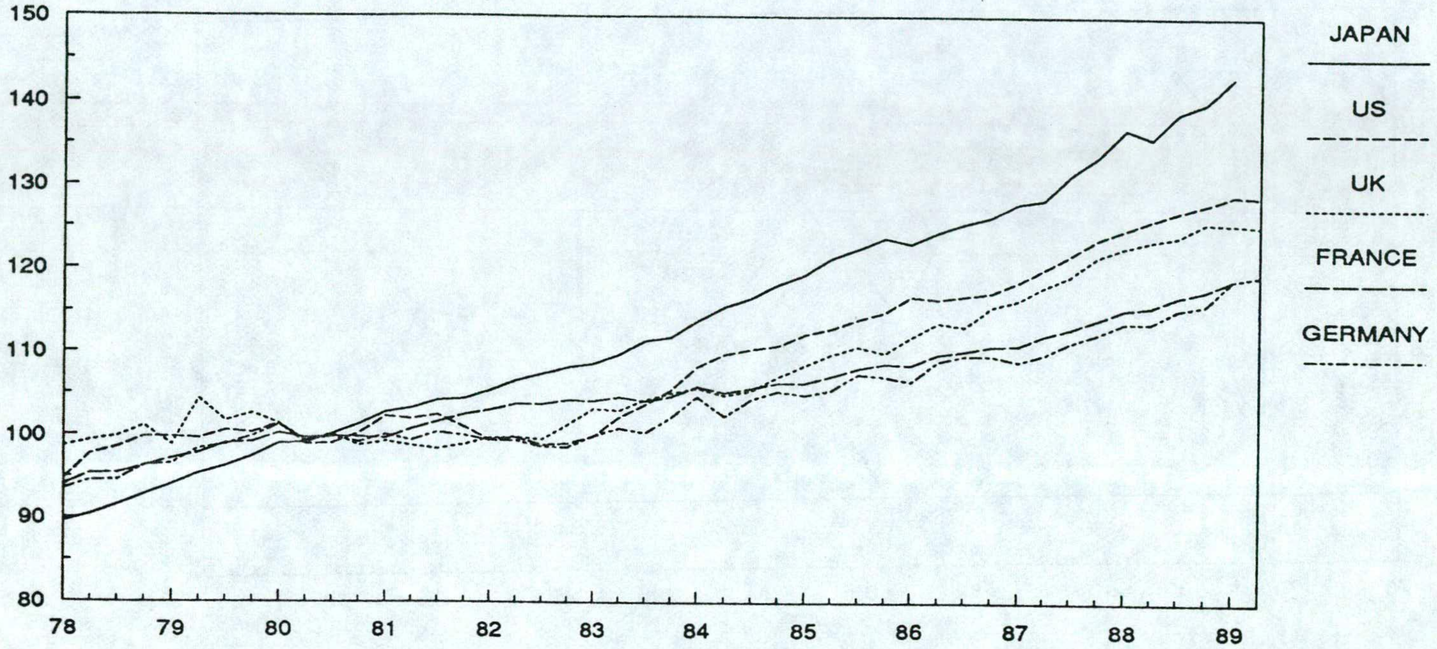


CHART 3 : REAL DOMESTIC DEMAND

(1980 = 100)

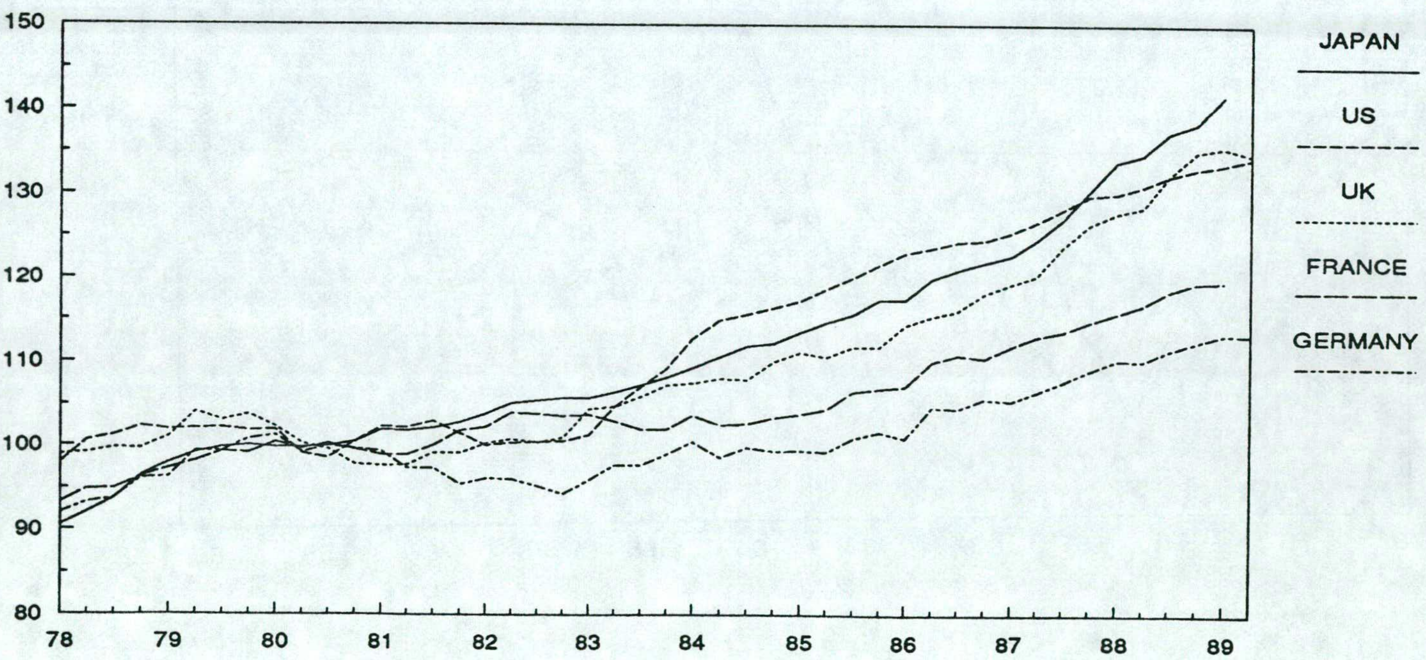


Table 3: Growth of real expenditure in the G7 countries*

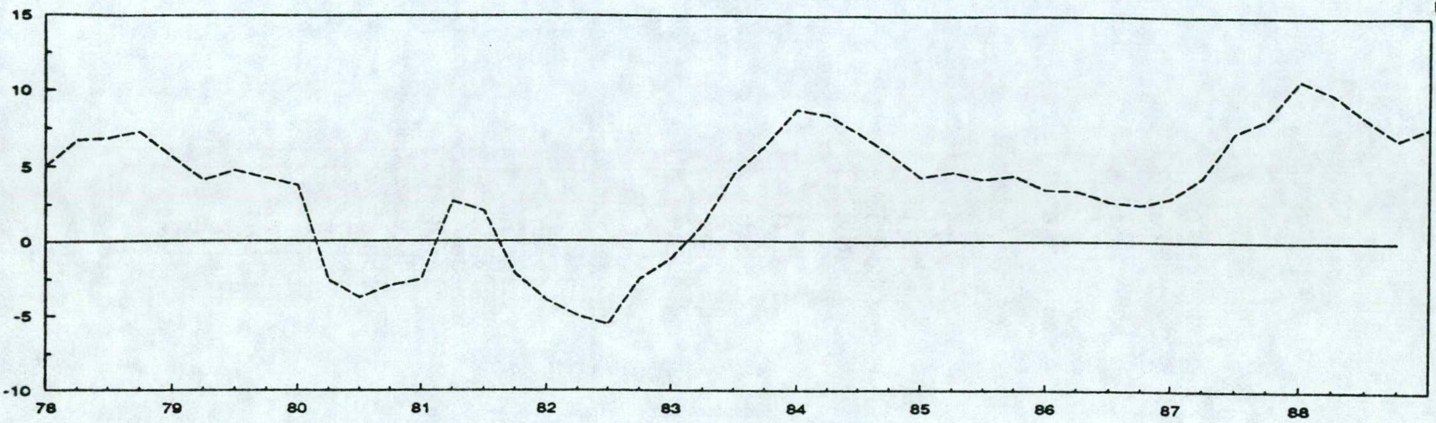
		Private Consumption	Investment	Government Expenditure	Domestic Demand**	Exports	Imports	Real GNP
		Annual percentage change						
1984		3.3	7.5	3.0	5.4	9.7	12.9	4.8
1985		3.6	4.4	4.7	3.3	3.7	3.4	3.3
1986		3.8	3.0	3.5	3.7	2.0	7.1	2.6
1987		3.4	5.6	2.1	3.8	5.8	7.6	3.4
1988		3.9	8.9	1.3	4.6	9.0	9.8	4.5
		Change from four quarters earlier (per cent)						
1987	Q1	3.3	3.0	3.3	3.1	3.2	6.7	2.4
	Q2	3.3	4.3	2.0	3.1	3.7	5.1	2.8
	Q3	3.4	7.2	2.2	4.0	6.9	7.5	3.9
	Q4	3.7	8.2	0.9	5.1	9.3	10.8	4.7
1988	Q1	4.5	10.9	1.0	5.4	10.3	11.1	5.3
	Q2	3.6	9.9	1.5	4.7	10.1	10.0	4.6
	Q3	3.6	8.3	0.5	4.7	8.4	9.6	4.4
	Q4	3.7	6.8	2.0	3.9	7.4	8.5	3.6
1989	Q1	3.0	7.4	1.9	3.9	9.3	10.4	3.6
		Indices (1980=100)						
1987	Q1	119.8	115.3	118.9	119.1	123.6	131.8	117.6
	Q2	121.4	118.3	119.4	120.7	125.8	136.2	118.8
	Q3	122.8	121.9	120.3	122.4	130.1	141.0	120.5
	Q4	123.5	124.6	121.2	124.5	133.3	145.8	122.1
1988	Q1	125.2	127.9	120.1	125.6	136.3	146.4	123.8
	Q2	125.8	130.1	121.2	126.3	138.4	149.9	124.3
	Q3	127.2	131.9	120.9	128.1	141.1	154.5	125.8
	Q4	128.1	133.1	123.6	129.3	143.2	158.2	126.6
1989	Q1	129.0	137.3	122.4	130.5	149.0	161.6	128.3

* Weighted by expenditure and exchange rates in 1980.

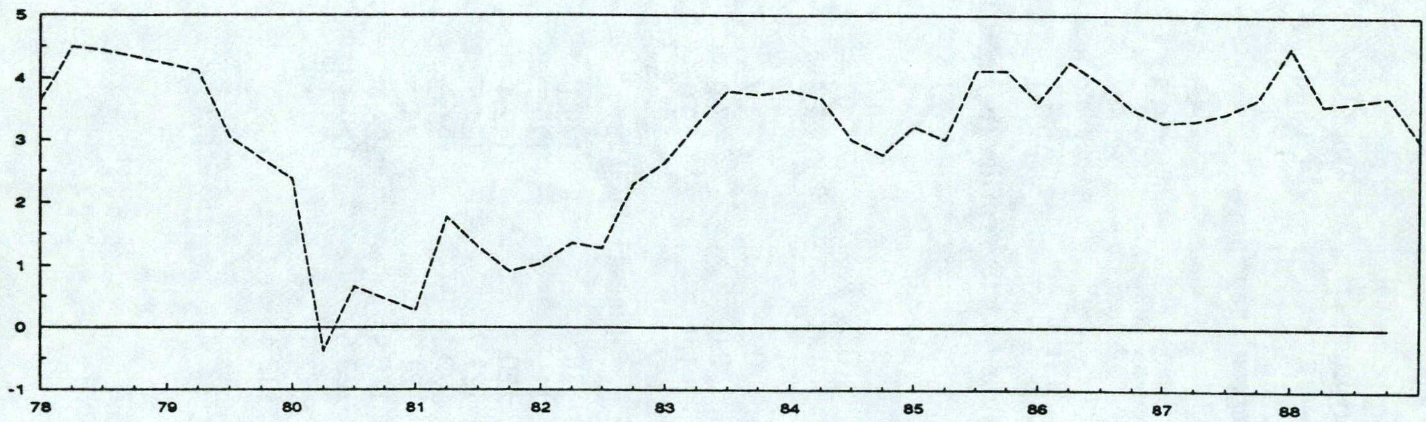
** Including stockbuilding.

CHART 4 : G7 EXPENDITURE GROWTH

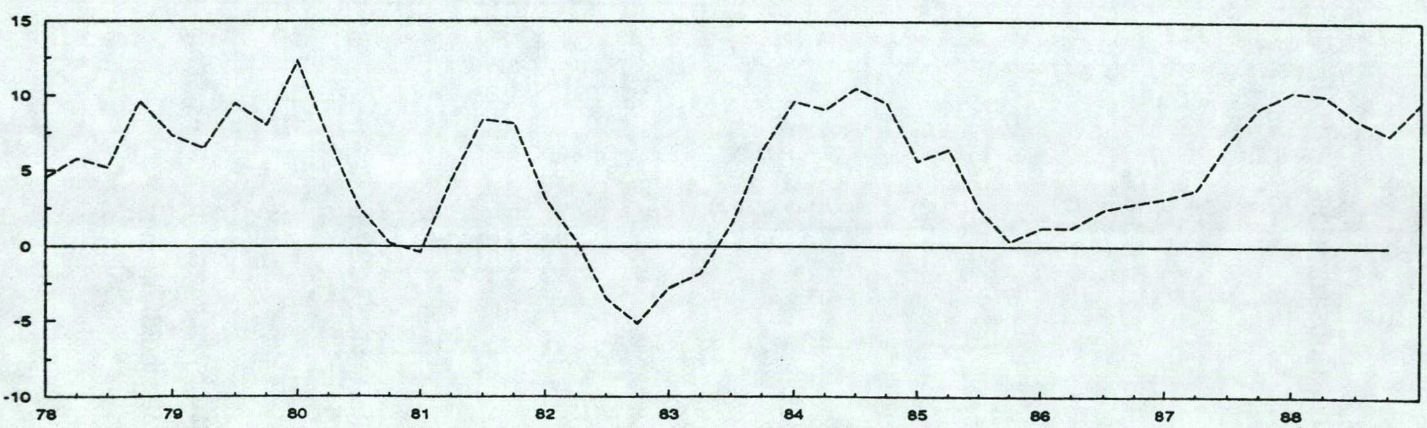
TOTAL INVESTMENT



PRIVATE CONSUMPTION



EXPORTS



PERCENTAGE CHANGE OVER YEAR EARLIER

3. Figures for the second quarter of 1989 show **US GNP** growth on a year earlier at 3.1 percent, continuing the slowdown from the rapid growth in 1988. The estimate of growth for 1988 has been revised upwards to 4.4 per cent on a drought adjusted basis. The effect of the drought is estimated to have been 0.4 per cent.

4. In **Germany**, real GNP growth was exceptionally strong in 1989Q2 at 4.9 per cent. **Japan** grew by 4.5 per cent in Q1, following 5.7 per cent for **1988** as a whole.

5. **G7 Investment** and **export** growth was strong throughout 1988. **Business investment** has been particularly buoyant, as Table 4 shows, but the OECD forecasts for 1989 are for a slowdown in all countries.

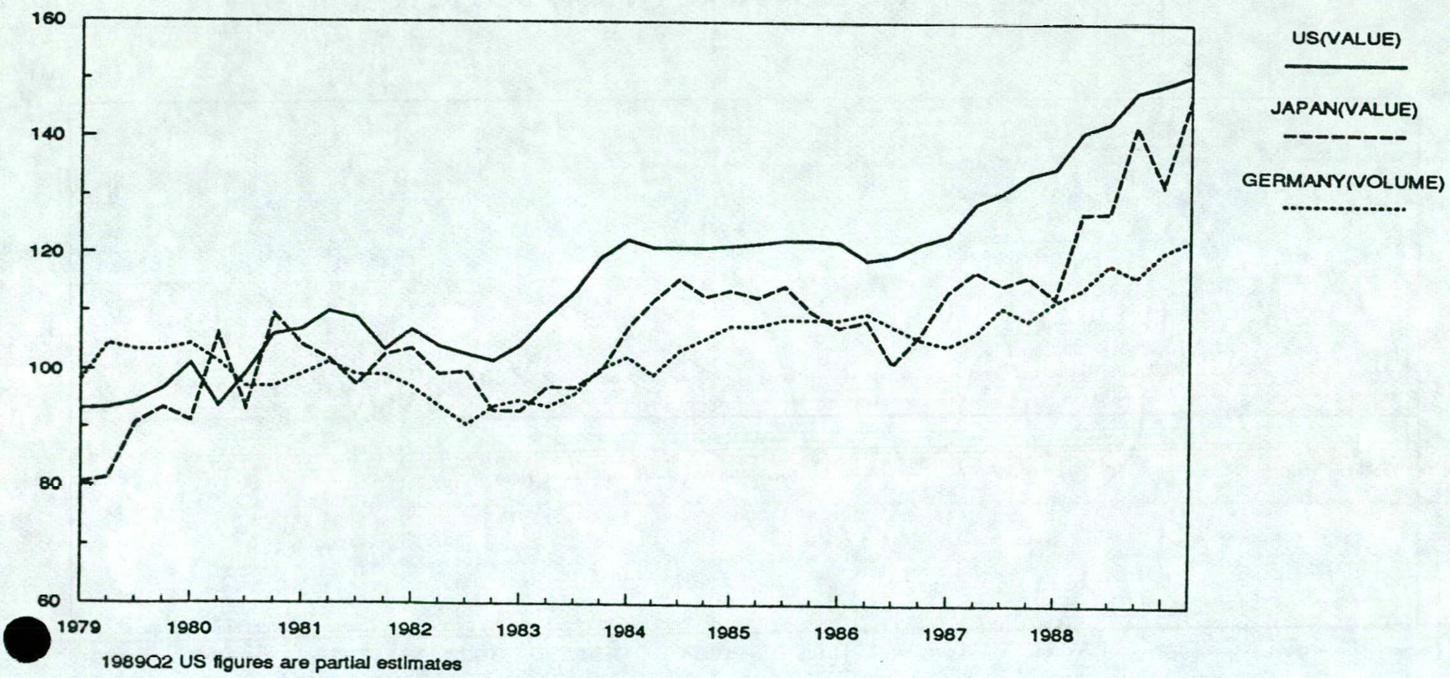
Table 4: Growth in Business Investment*

	United States	Japan	Germany	France	United Kingdom	G7
1986	-4.5	5.8	4.3	5.0	0.3	0.6
1987	2.8	8.0	4.4	4.8	14.4	5.8
1988	9.5	15.9	7.2	9.2	17.2	11.3

* OECD estimates of non residential private fixed investment.

6. **Net new orders** in manufacturing continue to rise in the US and Germany and are estimated to have surpassed their previous 1988Q4 peak.

CHART 5 : NET NEW ORDERS IN MANUFACTURING
(1980=100)



1989Q2 US figures are partial estimates

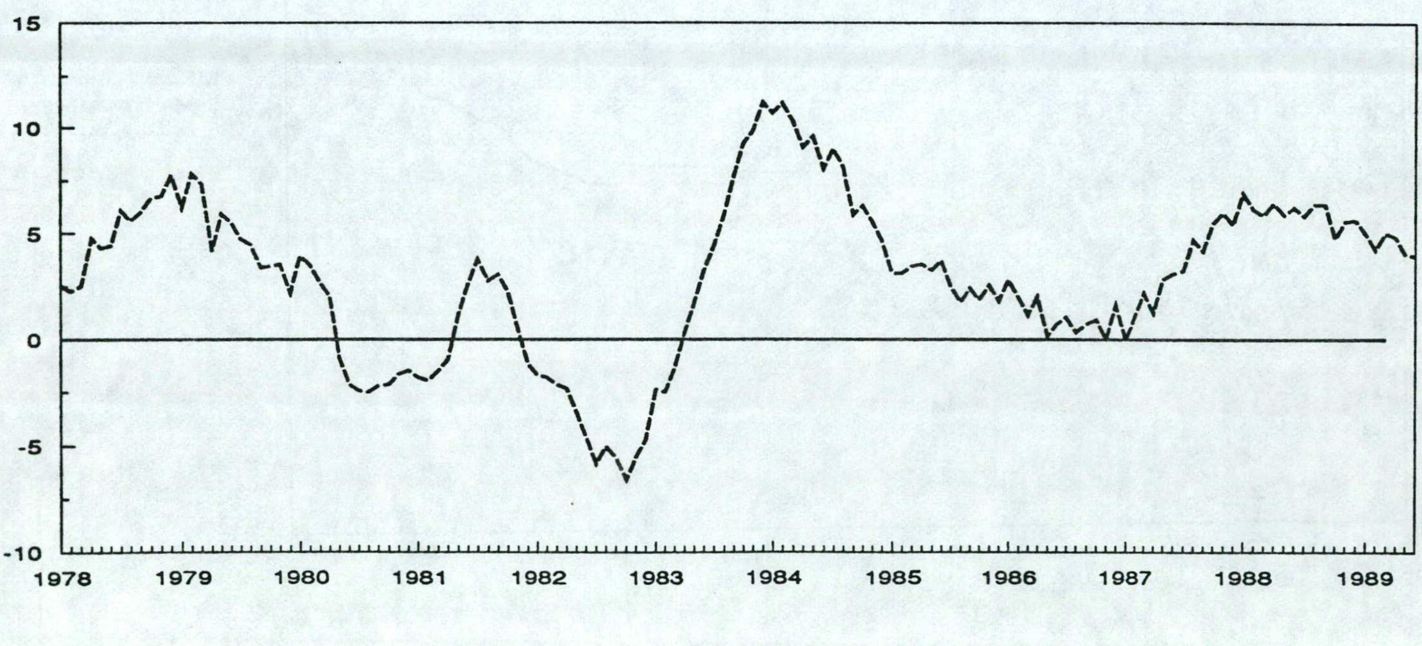
7. The growth rate of **industrial production** has slowed in the US through this year but remains strong in Japan. In Germany and France, though recent data has been volatile, it is at least as strong as last year.

Table 5: Industrial production in the G7 countries (percentage change on a year earlier)

		US	Japan	Germany	France	UK	G7
1984		11.2	9.3	3.0	1.7	0.2	8.2
1985		1.9	3.7	5.0	0.5	5.3	2.8
1986		1.1	-0.2	1.8	1.1	2.2	1.1
1987		3.8	3.4	0.3	2.1	3.5	3.3
1988		5.7	9.3	3.7	4.3	3.5	6.0
1988	Q1	6.0	10.0	3.2	3.9	3.9	6.3
	Q2	6.0	10.6	2.4	3.2	4.1	6.2
	Q3	5.7	9.1	4.7	5.8	3.9	6.2
	Q4	5.0	7.5	4.5	4.1	2.3	5.3
1989	Q1	4.6	7.5	4.7	4.7	1.3	4.8
	Q2	4.1	6.8	4.6	5.6	-1.1	4.3+
1989	Jan	4.8	8.6	5.0	5.7	1.2	5.0
	Feb	4.5	4.1	4.2	4.8	2.1	4.3
	Mar	4.4	9.7	4.9	3.8	0.6	5.0
	Apr	4.7	5.8	7.3	7.6	0.6	4.8
	May	4.1	7.4	2.2	4.7	-1.9	4.0
	Jun	3.6	7.2	4.4	4.6	-1.8	4.0+
	Jul	2.7	6.3	9.3+			

+ Partly OECD estimate.

CHART 6 : G7 INDUSTRIAL PRODUCTION



PERCENTAGE CHANGE OVER YEAR EARLIER

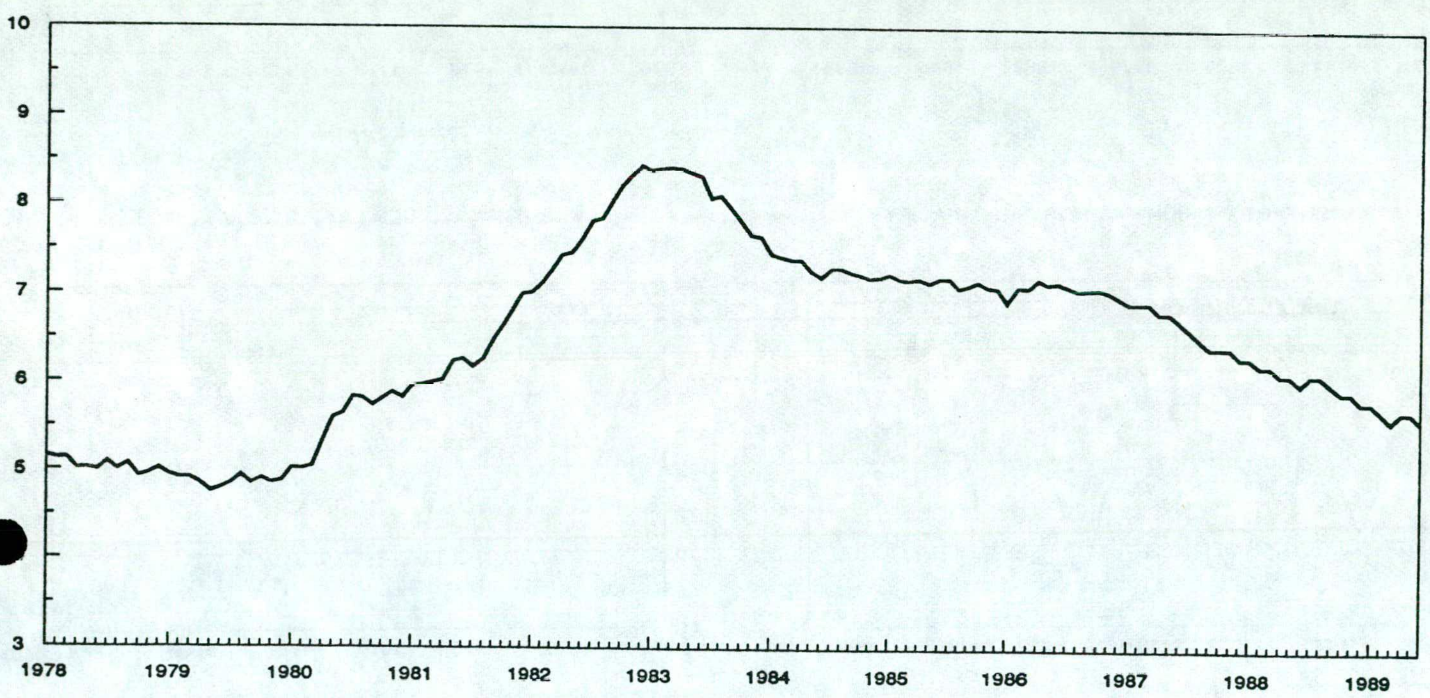
8. Unemployment rates in the US and Germany are generally at or a little below their January levels.

Table 6: OECD Standardized Unemployment rates (per cent of labour force, seasonally adjusted)

		US	Japan	Germany	France	UK	G7
1984		7.4	2.7	7.1	9.7	11.7	7.2
1985		7.1	2.6	7.2	10.2	11.2	7.1
1986		6.9	2.8	6.4	10.4	11.2	7.0
1987		6.1	2.9	6.2	10.5	10.2	6.6
1988		5.4	2.5	6.1	10.1	8.3	6.1
1989	Q2	5.4	2.5	6.2	10.1	8.6	6.1
	Q3	5.4	2.5	6.2	10.2	8.0	6.1
	Q4	5.3	2.4	6.0	10.1	7.5	6.0
1989	Q1	5.1	2.3	5.6	10.1	7.0	5.7
	Q2	5.2	2.2	5.6	10.0	6.6	5.7
1988	Oct	5.3	2.5	6.1	10.1	7.7	5.9
	Nov	5.3	2.4	6.0	10.0	7.6	5.9
	Dec	5.3	2.3	5.9	10.1	7.3	5.8
1989	Jan	5.4	2.3	5.7	10.1	7.1	5.8
	Feb	5.1	2.3	5.6	10.1	7.0	5.7
	Mar	4.9	2.3	5.5	10.1	6.9	5.6
	Apr	5.2	2.4	5.6	10.1	6.6	5.7
	May	5.1	2.4	5.6	10.0	6.6	5.7
	Jun	5.2	2.2	5.6	10.0	6.5	5.6
	Jul	5.2	2.3		10.1	6.4	

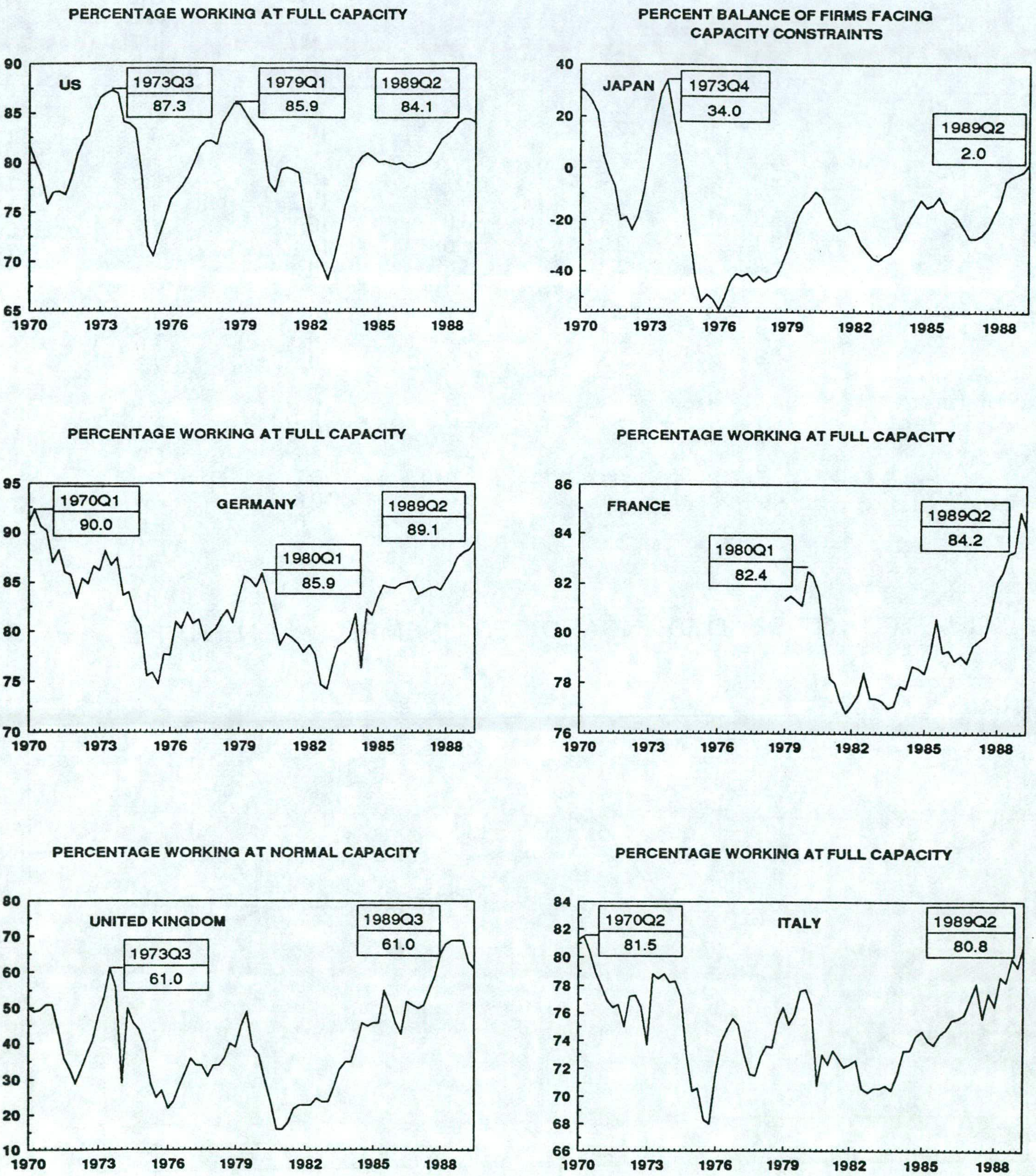
Source: OECD

CHART 7 : G7 OECD STANDARDISED UNEMPLOYMENT RATE



9. In the second quarter of 1989 **capacity utilisation rates** in manufacturing fell sharply in the UK and also fell in the US and France but generally remained close to their recent peaks, rising further in Germany and Italy.

CHART 8: CAPACITY UTILISATION IN MANUFACTURING



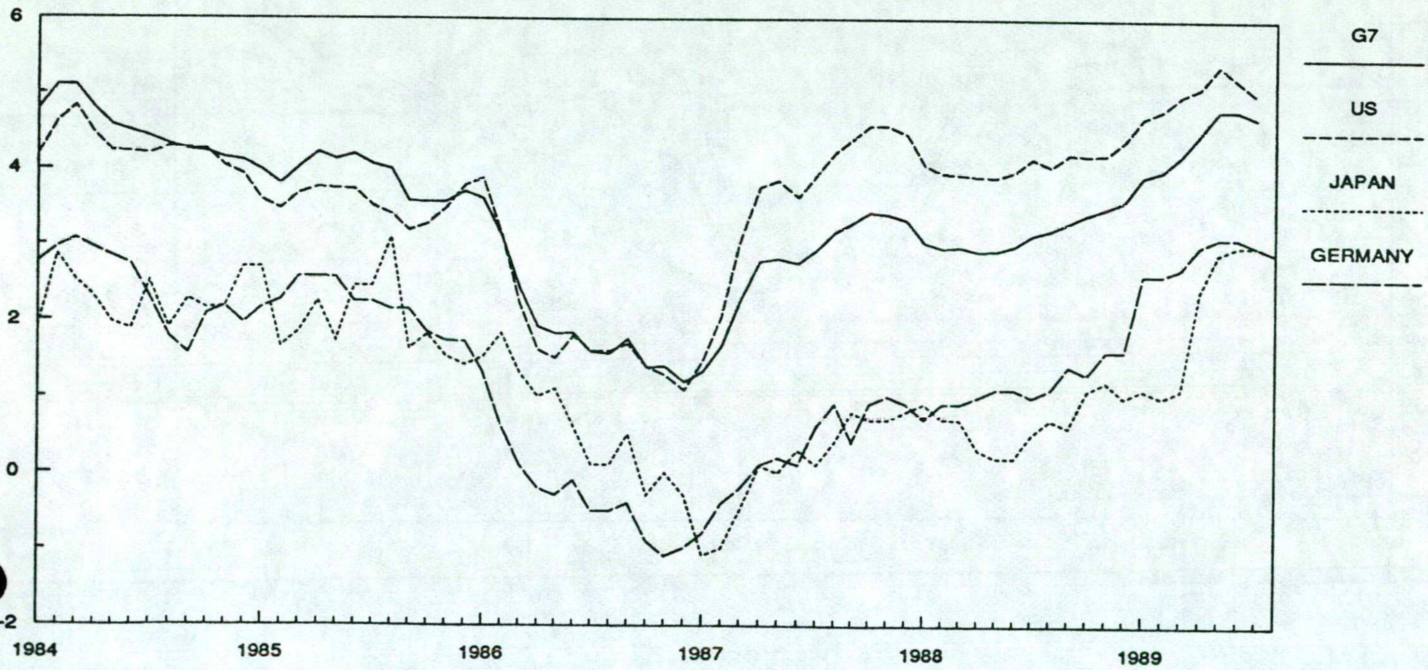
SECTION B: PRICES AND LABOUR COSTS

10 The 12-month **consumer price inflation** rate has risen in all the G7 countries since mid-1988, but may now have stabilised. The average for the G7 countries, unchanged at 3 per cent during the first half of 1988 was 4.7 per cent in July 1989.

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

		US	Japan	Germany	France	UK	UK (excludes mips)	G7
1984		4.3	2.3	2.4	7.4	5.0	4.4	4.4
1985		3.5	2.0	2.2	5.8	6.1	5.2	3.8
1986		1.9	0.6	-0.2	2.7	3.4	3.6	2.0
1987		3.6	0.1	0.2	3.1	4.2	3.7	2.7
1988		4.1	0.7	1.2	2.6	4.9	4.6	3.2
1988	Aug	4.0	0.7	1.2	2.8	5.7	5.0	3.2
	Sep	4.2	0.6	1.4	3.0	5.9	5.2	3.3
	Oct	4.2	1.1	1.3	3.0	6.4	5.1	3.4
	Nov	4.2	1.2	1.6	3.0	6.4	5.1	3.5
	Dec	4.4	1.0	1.6	3.1	6.8	5.1	3.6
1989	Jan	4.7	1.1	2.6	3.3	7.5	5.5	3.9
	Feb	4.8	1.0	2.6	3.4	7.8	5.7	4.0
	Mar	5.0	1.1	2.7	3.4	7.9	5.7	4.2
	Apr	5.1	2.4	3.0	3.6	8.0	5.9	4.5
	May	5.4	2.9	3.1	3.7	8.3	6.0	4.8
	Jun	5.2	3.0	3.1	3.6	8.3	5.9	4.8
	Jul	5.0	3.0	3.0	3.5	8.2	5.8	4.7
	Aug	4.5		2.9		7.3	5.7	

CHART 9 : CONSUMER PRICES
(PERCENTAGE CHANGE ON A YEAR EARLIER)



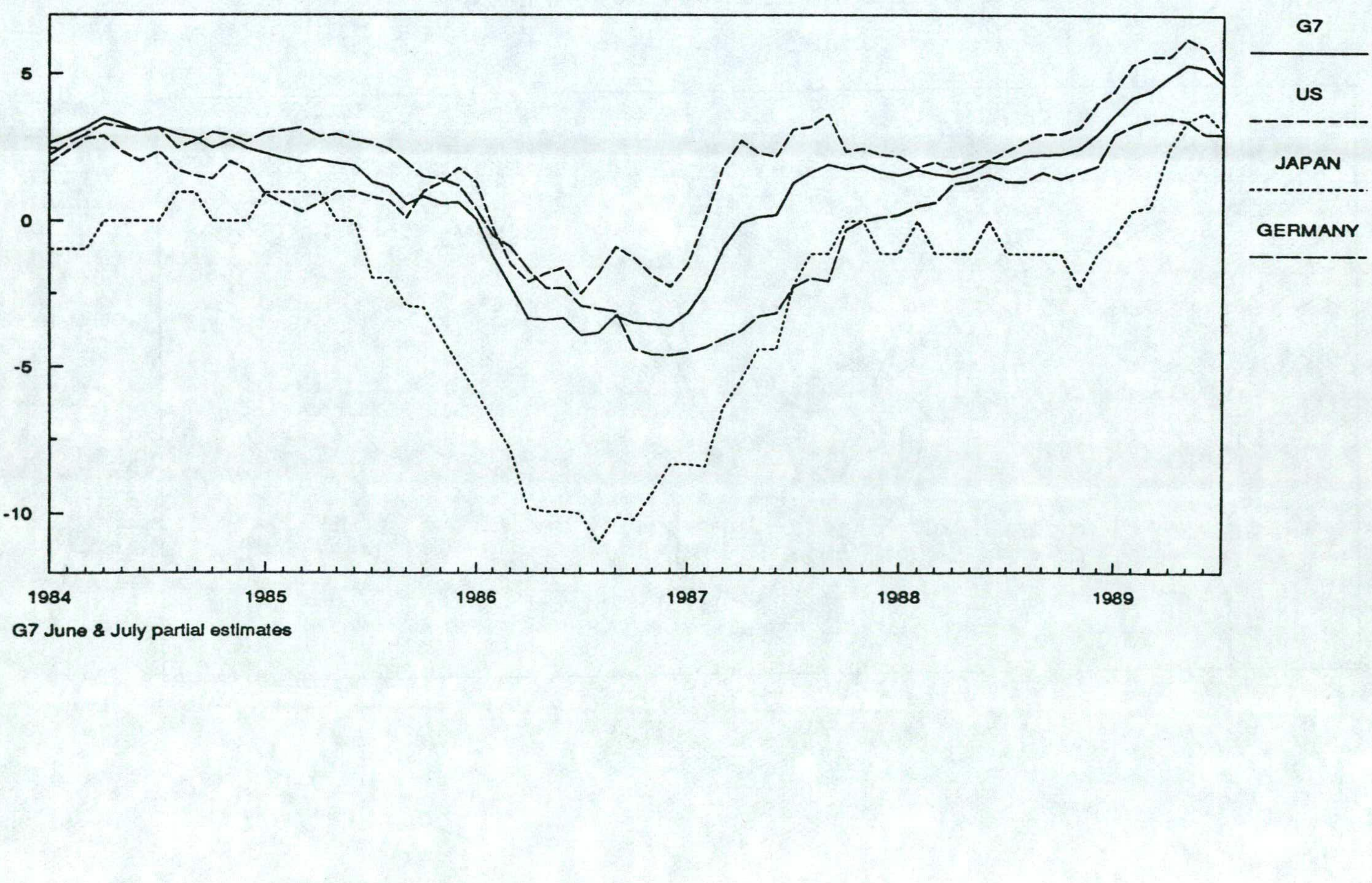
11. The 12-month rate of **producer price inflation** rose markedly between November 1988 and mid year, particularly in the US, Japan and Germany. But figures for June and July show that this upward trend has now stopped.

Table 8: Producer/wholesale prices (percentage change on a year earlier)

		US	Japan	Germany	France+	UK	G7
1984		2.1	-0.1	2.9	8.8	6.1	2.9
1985		0.8	-1.2	2.4	4.4	5.5	1.5
1986		-1.4	-9.1	-2.5	-2.5	4.3	-2.9
1987		2.1	-3.8	-2.5	0.0	3.9	0.3
1988		2.5	-1.0	1.3	5.2	4.5	2.1
1988	Sep	3.0	-1.1	1.7	6.7	5.0	2.3
	Oct	3.0	-1.1	1.5	7.2	4.8	2.3
	Nov	3.2	-2.3	1.7	7.7	4.9	2.5
	Dec	4.0	-1.1	1.9	8.2	4.9	3.0
1989	Jan	4.4	-0.6	2.9	8.6	5.2	3.6
	Feb	5.3	0.3	3.2	8.9	5.2	4.2
	Mar	5.6	0.5	3.4	9.0	5.2	4.4
	Apr	5.6	2.5	3.5	9.0	5.0	4.9
	May	6.2	3.4	3.4	8.9	5.1	5.3
	Jun	5.9	3.7	3.0		5.0	5.2 ++
	Jul	5.0	3.1	3.0		4.8	4.7 ++

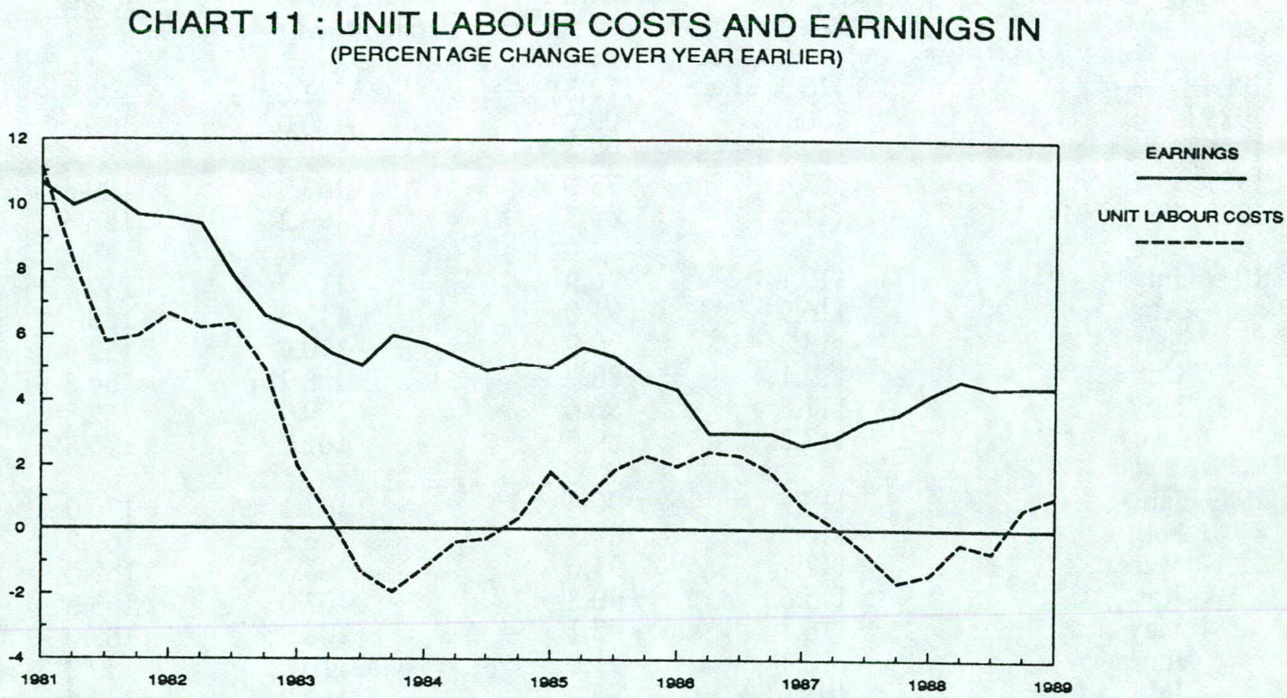
\+ Monthly figures estimated from quarterly data.
++ Partly estimated

CHART 10 : PRODUCER/WHOLESALE PRICES
(PERCENTAGE CHANGE ON A YEAR EARLIER)



G7 June & July partial estimates

12. The growth rate of **earnings** in manufacturing in the G7 countries has picked up to close to 5 per cent in 1989Q2.



Source: OECD,IMF

Earning figures are hourly except for Japan monthly. French and Italian figures for total industry.

13. **Unit labour costs** in manufacturing continued to rise on average in Q2 in the G7 countries, after falling for most of 1988.

Table 9: Unit labour costs (manufacturing, in domestic currencies, percentage change on year earlier)

		US	Japan	Germany	France	UK*	G7
1984		-2.0	-3.9	1.1	6.9	2.8	-0.4
1985		0.3	-1.1	1.8	6.6	5.9	1.7
1986		0.4	3.1	4.4	1.6	4.4	2.1
1987		-1.2	-2.5	2.5	-0.8	1.4	-0.4
1988		0.3	-3.4	-0.4	-2.3	2.8	-0.5
1988	Q1	-0.5	-5.6	-0.6	-2.7	2.3	-1.4
	Q2	0.3	-3.5	0.6	-2.5	4.5	-0.4
	Q3	0.4	-2.9	-2.2	-2.1	2.3	-0.7
	Q4	1.1	-1.5	0.7	-2.0	2.6	0.7
1989	Q1	1.0	-1.4	0.6	-0.3	2.9	1.0
	Q2					3.6	

* Unit wage costs

Source: IMF (except UK CSO)

14. On the Economist Index (in SDRs) non-oil **commodity prices** have on average fallen 10 per cent since January. **Oil** prices have changed little since May.

Table 10: Economist SDR Commodity Price Indices (1985=100)

			All items (excl. oil)	Food	Non Food Agriculturals	Metals	Oil (Brent)
1984			110.3	112.3	111.6	106.2	n/a
1985			100.0	100.0	100.0	100.0	100.0
1986			89.8	92.4	89.9	85.4	46.9
1987			87.4	73.0	103.3	100.6	52.8
1988			111.4	85.7	109.2	156.6	41.7
1988	Jul		119.1	96.9	117.7	157.6	42.3
	Aug		116.9	91.0	113.5	163.1	42.8
	Sep		113.3	90.9	110.9	152.9	38.1
	Oct		112.1	88.7	108.2	154.8	34.8
	Nov		111.8	86.6	100.9	162.8	35.4
	Dec		117.2	89.5	101.7	175.5	41.0
1989	Jan		119.9	90.4	107.1	179.0	46.4
	Feb		116.3	89.3	106.2	169.2	47.0
	Mar		117.7	91.6	108.0	169.0	52.8
	Apr		115.6	90.8	107.0	163.8	57.1
	May		116.3	92.1	108.5	163.0	54.2
	Jun		112.4	91.0	110.8	150.0	52.8
	Jul		108.1	86.2	112.0	142.5	53.1
	Aug		107.8	81.6	111.0	150.5	51.0
	Sep	12	107.9	82.2	112.6	148.1	54.4
% change on a year earlier			-6.1	-10.8	0.5	-4.7	+38.1

CHART 12 : ECONOMIST COMMODITY PRICE INDICES
(SDR's 1985 = 100)

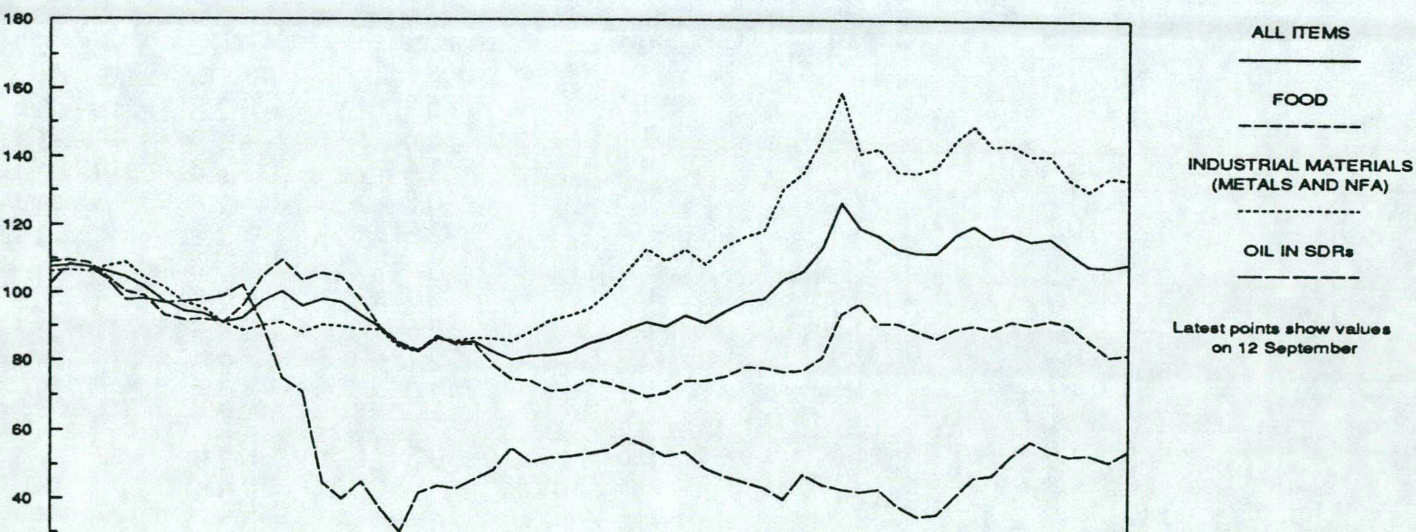
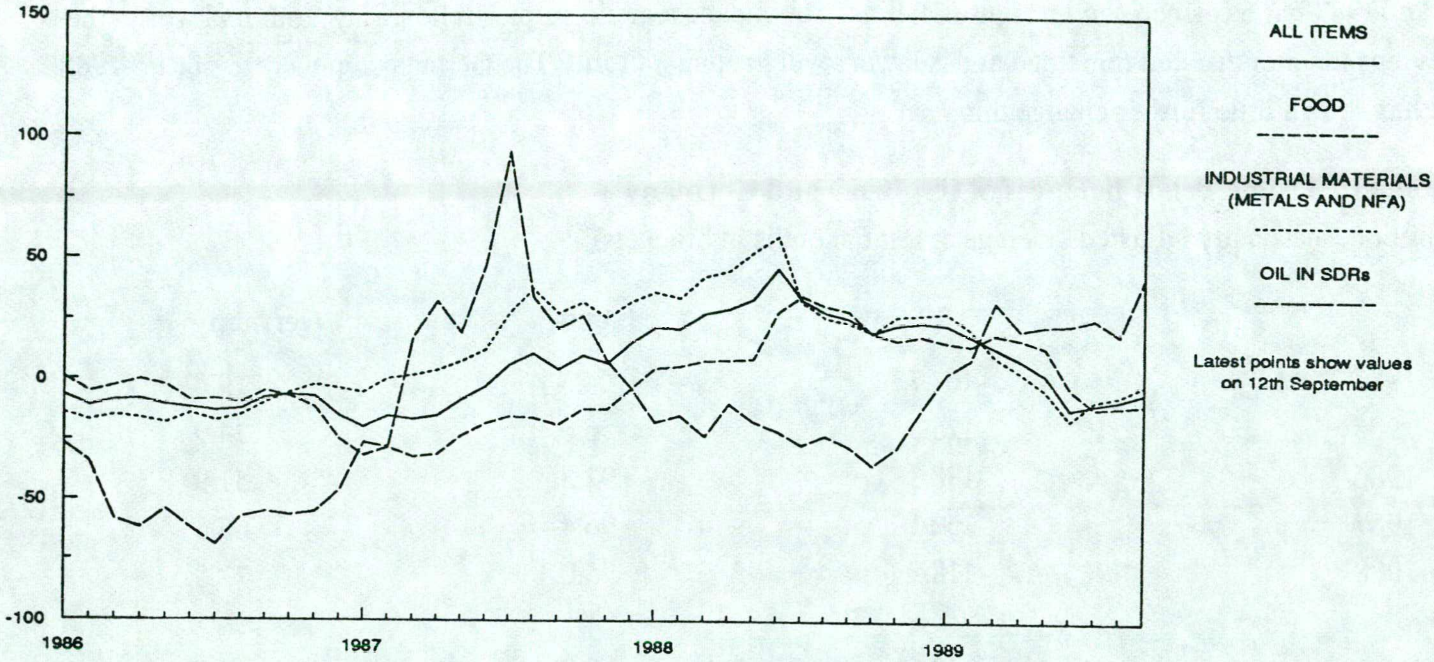
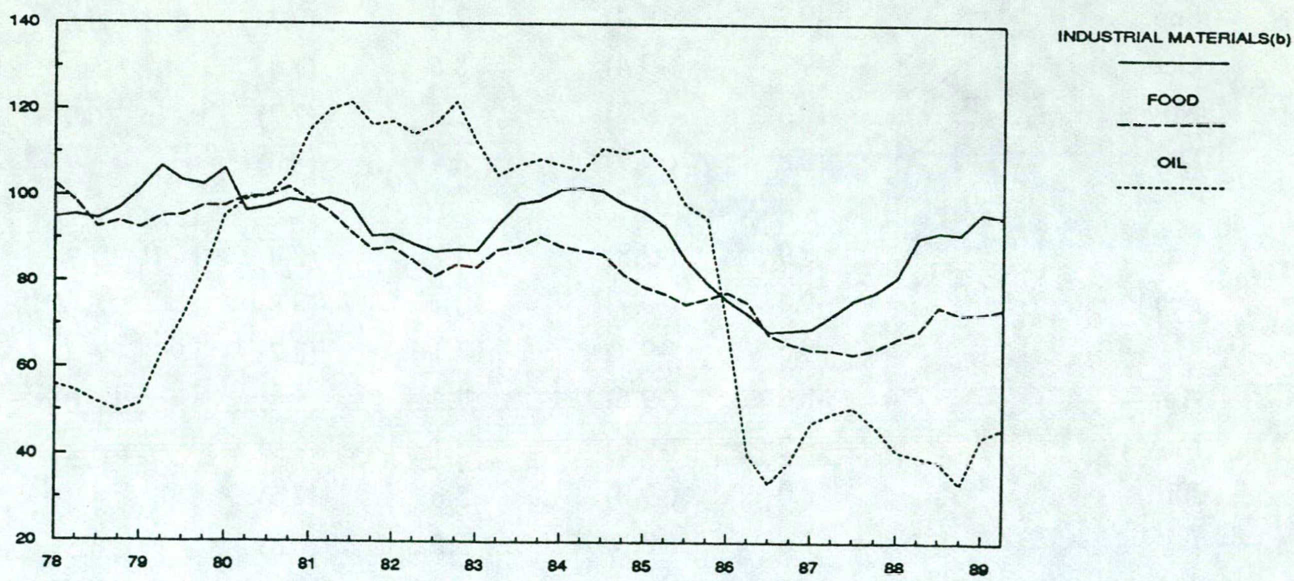


CHART 13 : ECONOMIST COMMODITY PRICE INDICES
(PERCENTAGE CHANGE ON YEAR EARLIER)



15. **Real** prices of industrial materials and food have recovered since 1986, but are still below their peaks of 1983-84. Real oil prices have recovered from their low in the fourth quarter of 1988.

CHART 14 : LEVELS OF REAL COMMODITY PRICES(a)
(1980=100)



(a) DEFLATED BY MANUFACTURERS UNIT VALUE INDEX
(b) COMPRISES AGRICULTURAL NON-FOOD, NON-FERROUS METAL AND METAL ORES

Includes some estimates for 1989Q2

SECTION C: TRADE AND CURRENT BALANCES

16. In dollar terms, the monthly **trade deficit** of the US was little changed in mid-1988 from its peak at the end of 1987 but has since shown signs of falling. The Japanese trade surplus fell in May from its level in the previous ten months, and remained at this lower level in June and July.The German surplus rose during 1988 but has shown little further change this year.

Table 11: Visible Trade balances of US, Japan and Germany*

($ billion, seasonally adjusted, average of last 6 months in brackets)

		US		Japan		Germany	
1984		-101.7		44.3		19.0	
1985		-126.5		56.0		24.9	
1986		-138.3		92.8		51.9	
1987		-152.1		96.4		65.5	
1988		-118.5		95.0		72.8	
1988	Mar	-9.6	(-11.5)	8.3	(8.0)	4.2	(5.5)
	Apr	-9.3	(-10.7)	7.7	(8.0)	6.6	(5.8)
	May	-8.7	(-10.2)	6.8	(7.9)	5.7	(5.8)
	Jun	-10.6	(-10.0)	6.4	(7.6)	8.1	(6.0)
	Jul	-8.5	(-9.7)	7.3	(7.4)	6.7	(6.0)
	Aug	-10.1	(-9.5)	7.7	(7.4)	5.9	(6.2)
	Sep	-9.2	(-9.4)	7.8	(7.3)	5.5	(6.4)
	Oct	-9.2	(-9.4)	8.6	(7.4)	5.2	(6.2)
	Nov	-10.5	(-9.7)	8.5	(7.7)	6.9	(6.4)
	Dec	-10.8	(-9.7)	8.4	(8.0)	6.2	(6.1)
1989	Jan	-8.9	(-9.8)	9.2	(8.4)	7.3	(6.2)
	Feb	-9.4	(-9.7)	10.1	(8.8)	6.6	(6.3)
	Mar	-9.5	(-9.7)	7.1	(8.7)	6.4	(6.4)
	Apr	-8.3	(-9.6)	7.4	(8.4)	6.0	(6.6)
	May	-10.2	(-9.5)	5.1	(7.9)	5.2	(6.3)
	Jun	-8.0	(-9.0)	5.8	(7.5)	6.4	(6.3)
	Jul	-7.6	(-8.8)	5.5	(6.8)	6.3	(6.1)

* fob/cif for US and Germany, fob/fob for Japan.

Source: Country data.

17. As a percentage of GNP, the US **current account** deficit declined in the fourth quarter of 1988 to its lowest level since 1984, and has changed little since then. The Japanese surplus fell sharply 1989Q2 after having been a roughly constant percentage of GNP in the last four quarters. The German surplus rose sharply in the first quarter of 1989 to its highest ever level as a percentage of GNP, but fell back in 1989Q2 to closer to its 1988 average level.

Table 12: Current Accounts
($ billion, percentage of GNP in brackets)

		US		Japan		Germany	
1984		-107.0	(-2.8)	35.0	(2.8)	9.8	(1.6)
1985		-115.1	(-2.9)	49.2	(3.7)	16.5	(2.6)
1986		-138.8	(-3.3)	85.8	(4.4)	39.2	(4.4)
1987		-154.0	(-3.4)	87.0	(3.6)	45.2	(4.0)
1988		-126.5	(-2.6)	79.5	(2.8)	48.5	(4.0)
1986	Q1	-32.5	(-3.1)	15.6	(3.6)	8.7	(4.3)
	Q2	-33.7	(-3.2)	21.4	(4.5)	8.4	(3.9)
	Q3	-35.5	(-3.3)	23.7	(4.4)	12.4	(5.2)
	Q4	-37.1	(-3.4)	24.2	(4.6)	10.8	(4.3)
1987	Q1	-37.6	(-3.4)	24.6	(4.5)	11.8	(4.4)
	Q2	-40.9	(-3.6)	21.5	(3.6)	11.4	(4.1)
	Q3	-42.0	(-3.7)	20.1	(3.4)	11.1	(4.0)
	Q4	-33.5	(-2.9)	20.7	(3.2)	10.5	(3.5)
1988	Q1	-32.0	(-2.7)	22.3	(3.1)	9.9	(3.2)
	Q2	-33.5	(-2.8)	17.1	(2.4)	14.8	(4.8)
	Q3	-32.3	(-2.6)	18.1	(2.6)	12.2	(4.3)
	Q4	-28.7	(-2.3)	21.3	(2.9)	11.3	(3.7)
1989	Q1	-30.4	(-2.4)	20.9	(2.8)	16.3	(5.4)
	Q2	-31.0	(-2.4)	12.5		13.7	(4.7)

Source: Country data.

SECTION D: INTEREST RATES, MONEY SUPPLY AND ASSET PRICES

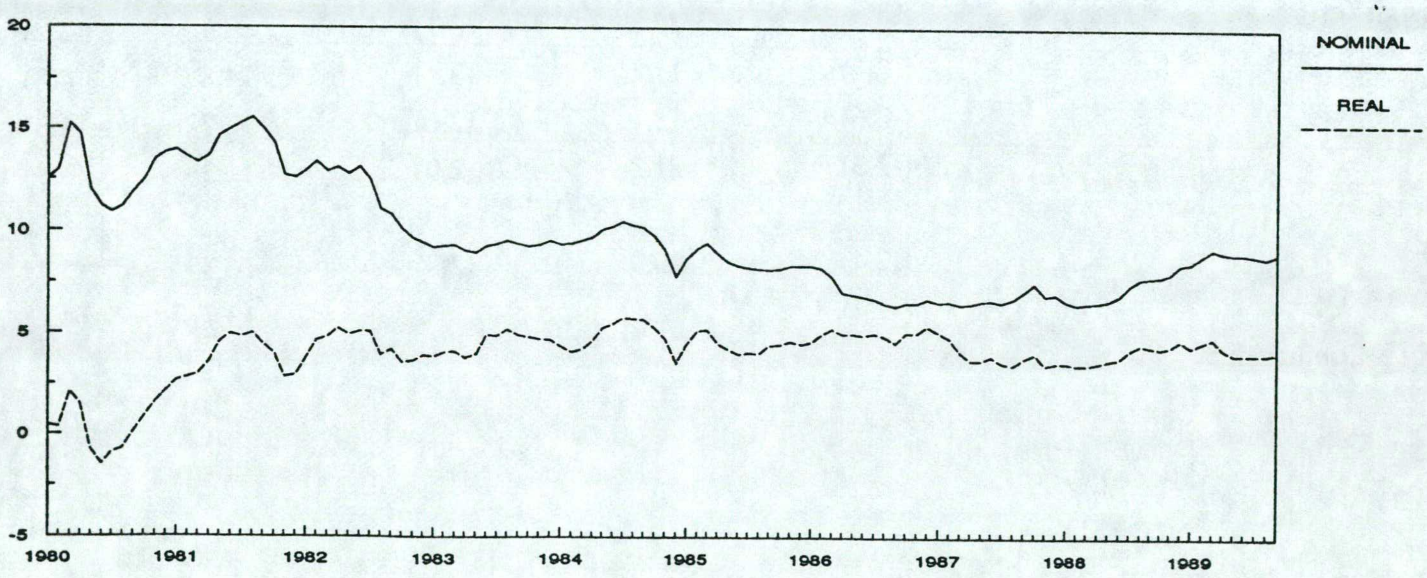
18. **Short term interest rates** have fallen in the US since April but have risen in Japan and Germany. On September 12 average G7 rates were 1 percentage point above their average for the last five years.

Table 13: Three-month interest rates in the G7 countries

		United States	Japan	Germany	France	UK	G7 weighted average
1984		10.4	6.5	6.0	11.7	9.9	9.7
1985		8.0	6.6	5.4	9.9	12.2	8.5
1986		6.5	5.1	4.6	7.7	10.9	7.1
1987		6.9	4.2	4.0	8.3	9.7	6.8
1988		7.7	4.5	4.3	7.9	10.3	7.3
Average 1984-1988		7.9	5.4	4.9	9.1	10.6	7.9
1988	Jun	7.5	4.4	3.9	7.4	8.9	6.9
	Jul	7.9	4.7	4.9	7.4	10.5	7.4
	Aug	8.4	4.8	5.3	7.7	11.4	7.8
	Sep	8.2	5.0	5.0	8.0	12.1	7.8
	Oct	8.4	4.7	5.1	8.0	12.1	7.8
	Nov	8.8	4.4	4.9	8.1	12.3	8.0
	Dec	9.3	4.5	5.3	8.3	13.2	8.4
1989	Jan	9.3	4.6	5.7	8.5	13.1	8.5
	Feb	9.6	4.7	6.5	9.2	13.0	8.9
	Mar	10.1	4.8	6.6	9.1	13.0	9.2
	Apr	10.0	4.7	6.4	8.7	13.2	9.0
	May	9.6	5.0	7.0	8.9	13.1	9.0
	Jun	9.2	5.4	7.0	9.0	14.1	9.0
	Jul	8.8	5.5	7.1	9.2	13.9	8.9
	Aug	8.7	5.5	7.1	9.0	13.9	8.8
	Sep 20	8.8	5.7	7.5	9.3	13.9	9.0

Source: Bank of England.

CHART 15 : G7 INTEREST RATES



Latest points show values on 20 September

19. **Average Real short term** rates in the G7 peaked in the first quarter and have now fallen back to below their average level for the years 1984-1988.

Table 14: Real Short-Term Interest Rates*

		US	Japan	Germany	France	UK	G7
1984		5.8	4.1	3.4	4.0	4.7	5.0
1985		4.4	4.5	3.3	3.9	5.8	4.5
1986		4.5	4.5	4.8	4.9	7.3	5.0
1987		3.1	4.1	3.8	5.0	5.3	4.0
1988		3.5	3.8	3.0	5.2	5.2	4.0
Average 1984-1988		4.3	4.2	3.7	4.6	5.6	4.5
1988	Q3	3.9	4.2	3.8	4.8	5.6	4.3
	Q4	4.3	3.4	3.5	5.0	5.6	4.4
1989	Jan	4.4	3.4	3.0	5.0	5.2	4.4
	Feb	4.6	3.6	3.8	5.6	4.9	4.6
	Mar	4.9	3.6	3.8	5.5	4.7	4.8
	Apr	4.7	2.2	3.3	5.0	4.8	4.3
	May	4.0	2.0	3.8	5.0	4.4	4.0
	Jun	3.6	2.4	3.7	5.1	5.4	4.0
	Jul	3.6	2.4	3.9	5.5	5.3	4.0
	Aug	3.6	2.4	3.9	5.3	5.2	4.0
	Sep 20	3.6	2.6	4.4	5.6	5.3	4.1

* Three month money market rates deflated by change in consumer price index. August and September figures based on July consumer price inflation.

20. **US Long term** fell 1 percentage point between April and June. Elsewhere rates have changed little through this year.

Table 15: 10-year government bond yields in the G7 countries

		US	Japan	Germany	France	UK	G7
1984		12.4	7.1	8.0	12.4	11.3	11.1
1985		10.6	6.5	7.0	10.9	11.1	9.7
1986		7.7	5.1	6.3	8.4	10.1	7.5
1987		8.4	4.5	6.3	9.4	9.6	7.9
1988		9.0	4.9	6.5	9.1	9.7	8.2
1988	Q3	9.3	5.5	6.7	9.1	10.0	8.5
	Q4	9.2	4.9	6.4	8.8	9.9	8.3
1989	Jan	9.3	4.9	6.6	8.6	10.0	8.3
	Feb	9.4	4.9	6.8	9.0	9.7	8.4
	Mar	9.6	5.1	6.9	9.1	9.9	8.6
	Apr	9.4	5.2	6.9	8.9	10.2	8.5
	May	9.0	5.3	7.0	8.8	10.1	8.4
	Jun	8.4	5.3	6.8	8.7	10.6	8.0
	Jul	8.2	5.2	6.7	8.6	10.2	8.0
	Aug	8.3	5.1	6.7	8.4	9.9	8.0
	Sep 18	8.2	5.4	6.9	8.6	10.2	8.1

Source: Bank of England, OECD.

21. Growth in M3 has slowed in the US so far in 1989 as it has in Germany.

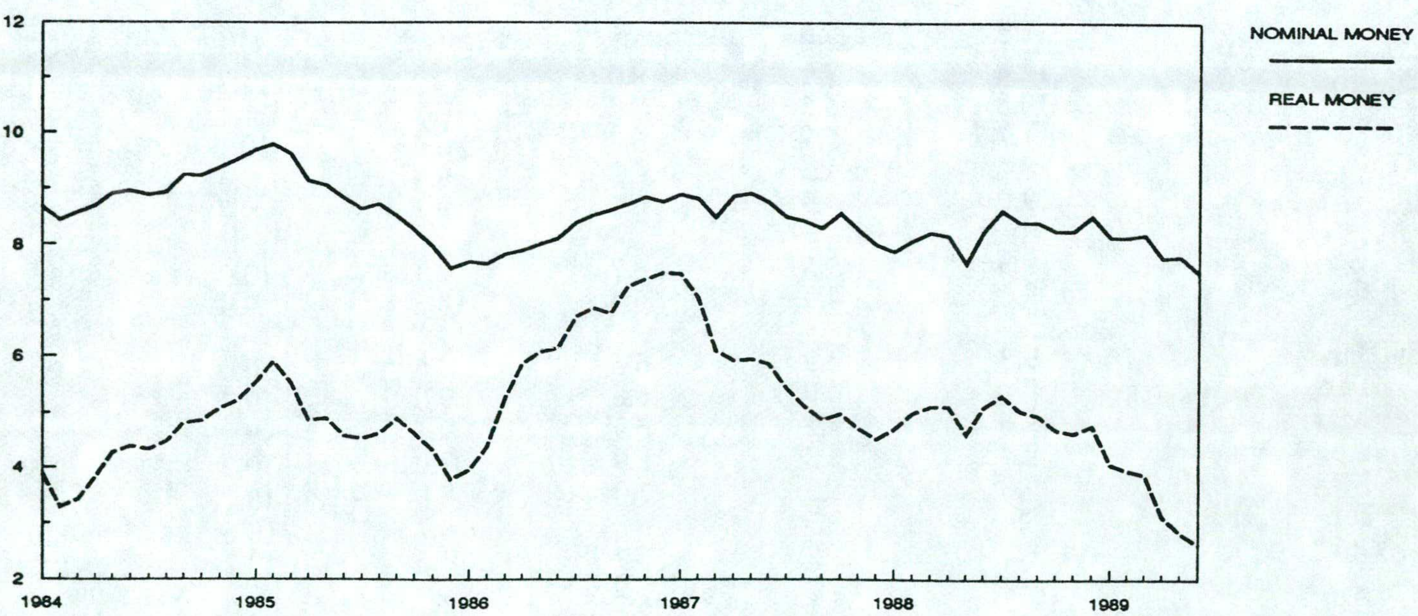
Table 16: M3 growth (seasonally adjusted, percentage change on a year earlier)

		US	Japan (M2+CDS)	Germany	France	UK (M4)	G7
1984		10.1	7.8	3.7	9.9	13.1	9.0
1985		9.1	8.4	4.7	8.7	13.4	8.8
1986		8.3	8.7	5.8	5.3	15.4	8.3
1987		6.9	10.4	7.1	7.4	15.3	8.6
1988		6.2	11.2	6.2	7.5	16.9	8.2
1988	Q1	5.8	12.0	6.0	8.2	16.2	8.1
	Q2	6.2	11.4	6.4	7.0	16.1	8.0
	Q3	6.7	10.9	5.8	7.6	17.8	8.5
	Q4	6.2	10.5	6.8	7.1	17.5	8.3
1989	Jan	5.9	10.0	6.9	6.7	18.1	8.1
	Feb	5.3	10.4	6.7	7.6	18.5	8.1
	Mar	5.2	10.4	6.9	7.6	18.4	8.2
	Apr	4.7	10.2	6.2	6.8	18.2	7.8
	May	5.2	9.4	5.3	7.0	18.5	7.8
	Jun	4.2	9.9	5.2	7.7	19.1	7.5++
	Jul		9.8				
		Year to 1989Q4	Year to 1989Q1	Year to 1989Q4			
	Target	$3\frac{1}{2}$-$7\frac{1}{2}$	9-10	5(4.4)*			

* Bracketed figure for Germany gives M3 growth between June and 1988Q4, the target base, at an annual rate.

++ Partly estimated.

CHART 15: BROAD MONEY GROWTH IN THE G7
(PERCENTAGE CHANGE OVER YEAR EARLIER)



22. **Share prices** have risen steadily so far this year, and are now above pre-crash levels in all the major economies.

Table 17: Share prices

			US St.& Poor	Japan Tokyo SE New	Germany Commer -bank	France CAC Gen.	UK FT. All Share
1986			262	1323	1999	362	779
1987			330	1954	1760	399	1025
1988			307	2132	1452	337	932
1987	15	Oct*	344	2159	1903	366	1190
	Nov		280	1851	1366	314	828
1988	Aug		303	2195	1476	353	954
	Sep		307	2126	1529	363	919
	Oct		319	2122	1601	383	958
	Nov		312	2218	1591	393	949
	Dec		319	2301	1620	399	915
1989	Jan		330	2435	1677	436	976
	Feb		340	2470	1657	444	1059
	Mar		338	2422	1648	440	1077
	Apr		348	2464	1686	460	1067
	May		361	2523	1703	466	1100
	Jun		370	2475	1800	483	1102
	Jul		380	2527	1878	489	1149
	Aug		397	2631	1965	511	1196
	Sep	19	396	2619	2009	542	1198
Percentage changes							
15 Oct 1987-19 Sep 1989			15	21	6	48	1
19 Sep 1988-19 Sep 1989			28.4	21.7	28.4	47.7	31.3

*15 October was the day preceding the collapse.

SECTION E: EXCHANGE RATES

23. The dollar's effective rate has appreciated by 13 per cent since December, and is now at the level of the time of the Louvre.

Table 18: Exchange rates

		Bilateral rates Yen/$	DM/$	$/£	Effective rates $	(1985=100) Yen	DM
$ Peak - 26 Feb 1985		261.0	3.43	1.05	113.1	99.3	96.9
Plaza - 20 Sep 1985		240.1	2.84	1.37	98.8	110.4	101.6
Louvre - 20 Feb 1987		153.5	1.83	1.53	72.6	126.9	116.1
G7 Communique 23 Dec 1987		126.8	1.64	1.82	64.4	144.4	116.8
1988	Sep	133.7	1.87	1.68	69.1	145.0	113.6
	Oct	134.5	1.82	1.74	67.1	149.1	113.8
	Nov	128.9	1.75	1.81	65.0	152.9	114.3
	Dec	123.1	1.76	1.83	64.8	152.3	113.9
1989	Jan	127.4	1.84	1.77	66.7	150.9	112.6
	Feb	127.6	1.85	1.75	67.0	151.1	112.4
	Mar	130.4	1.87	1.71	67.9	148.8	112.6
	Apr	132.0	1.87	1.70	68.2	147.1	112.8
	May	138.0	1.95	1.63	70.6	143.9	112.1
	Jun	144.1	1.98	1.55	72.4	139.3	112.4
	Jul	140.4	1.89	1.63	70.0	139.5	113.3
	Aug	141.2	1.93	1.60	70.6	139.8	112.6
	Sep 15	148.7	2.00	1.54	73.1	135.4	112.0

Source: Financial Times.

CHART 17 : EXCHANGE RATES SINCE LOUVRE

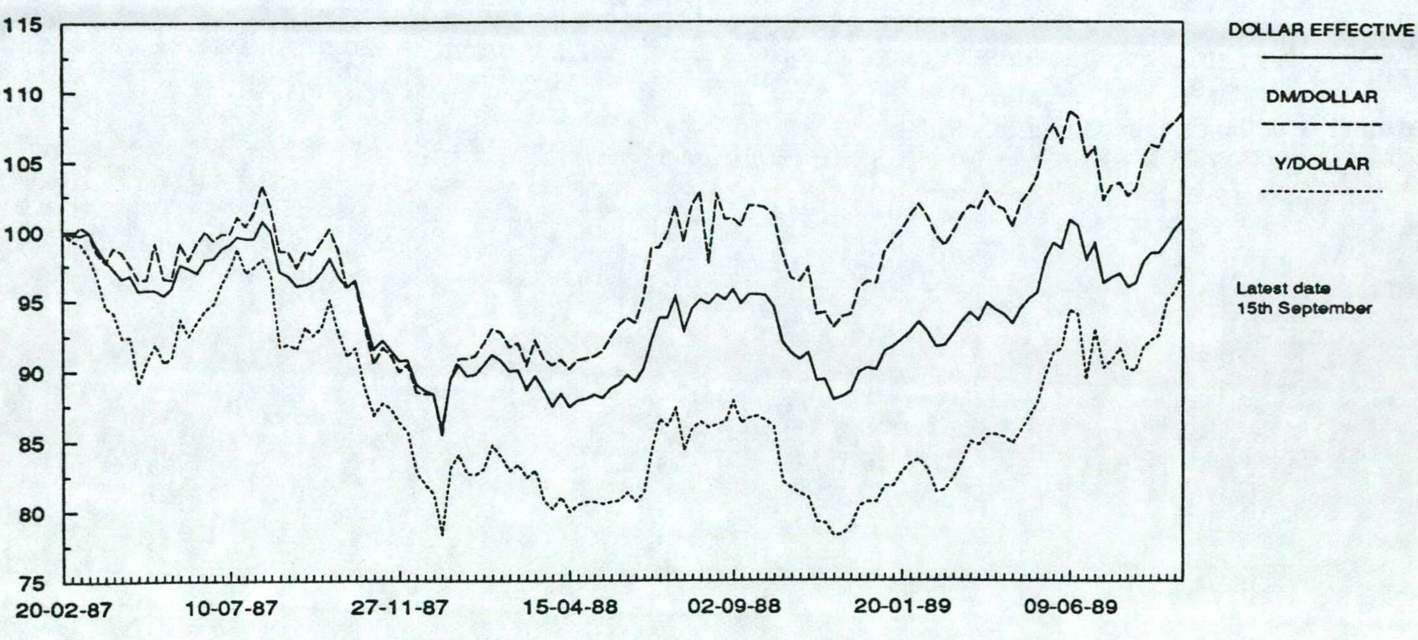
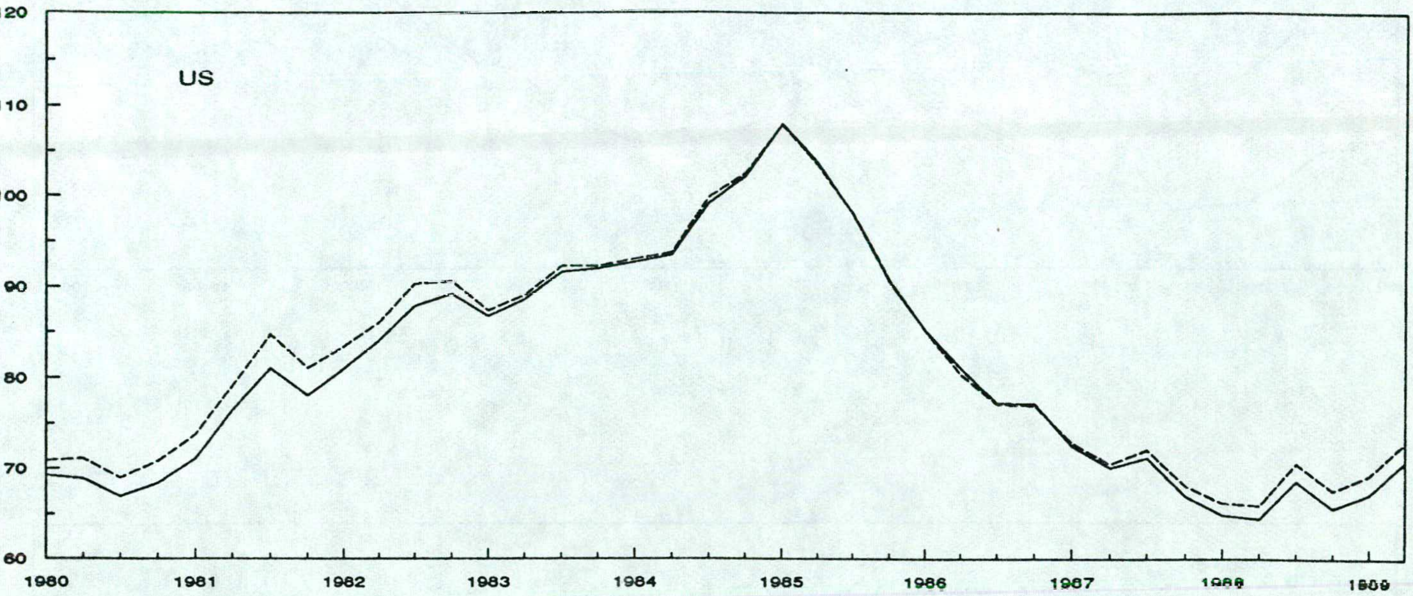
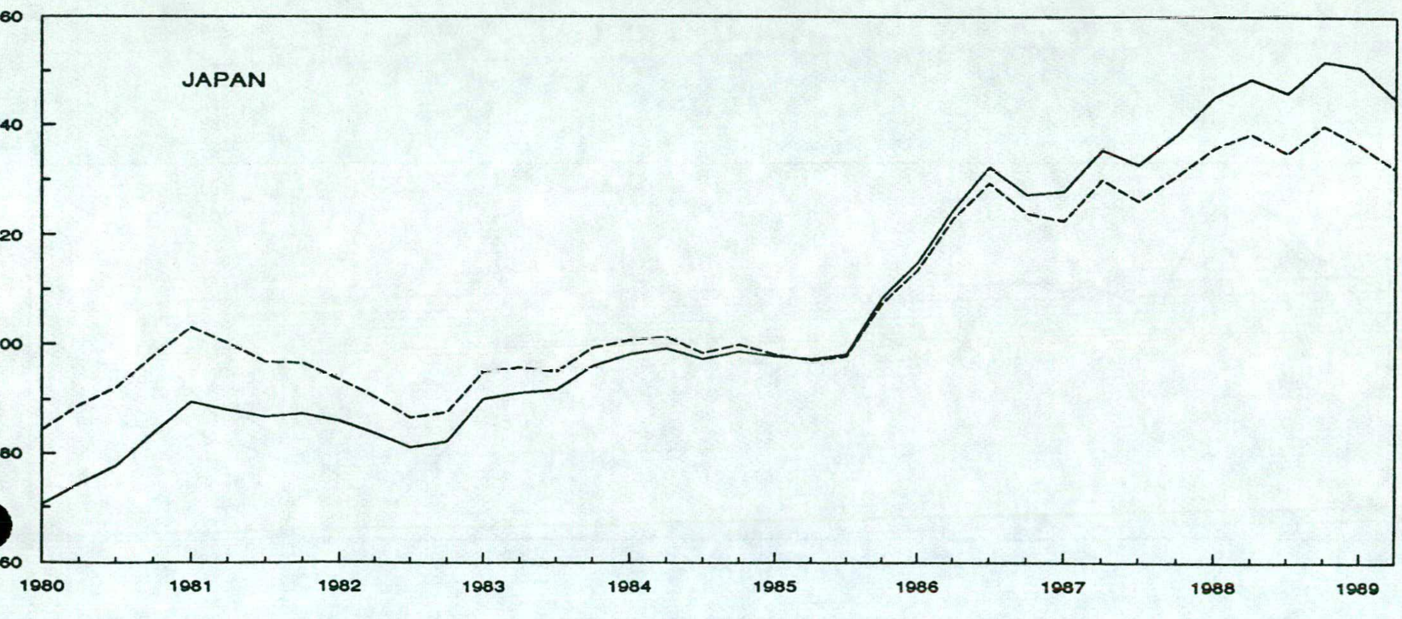


CHART 18 : REAL AND NOMINAL EFFECTIVE EXCHANGE RATES

(1985=100)



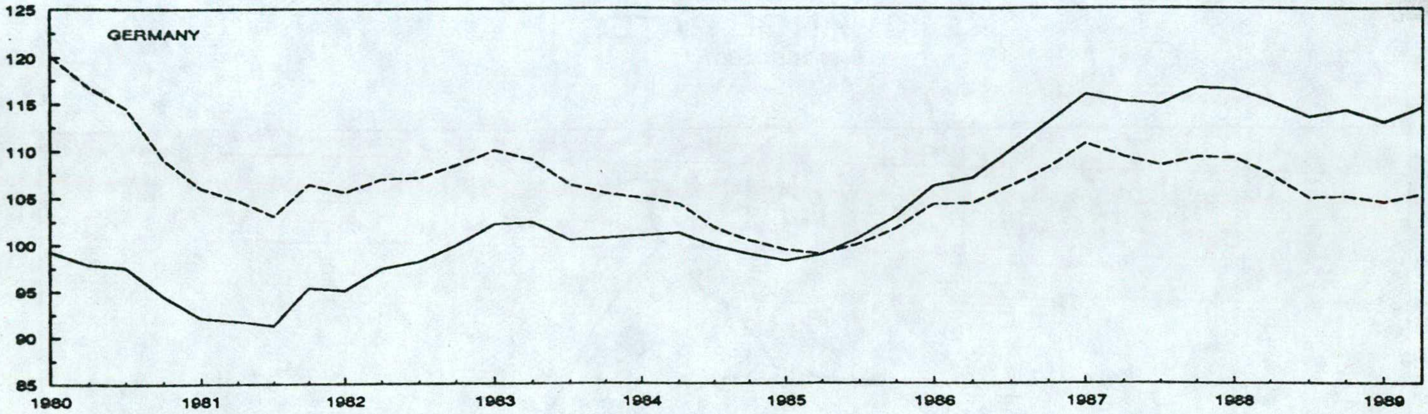


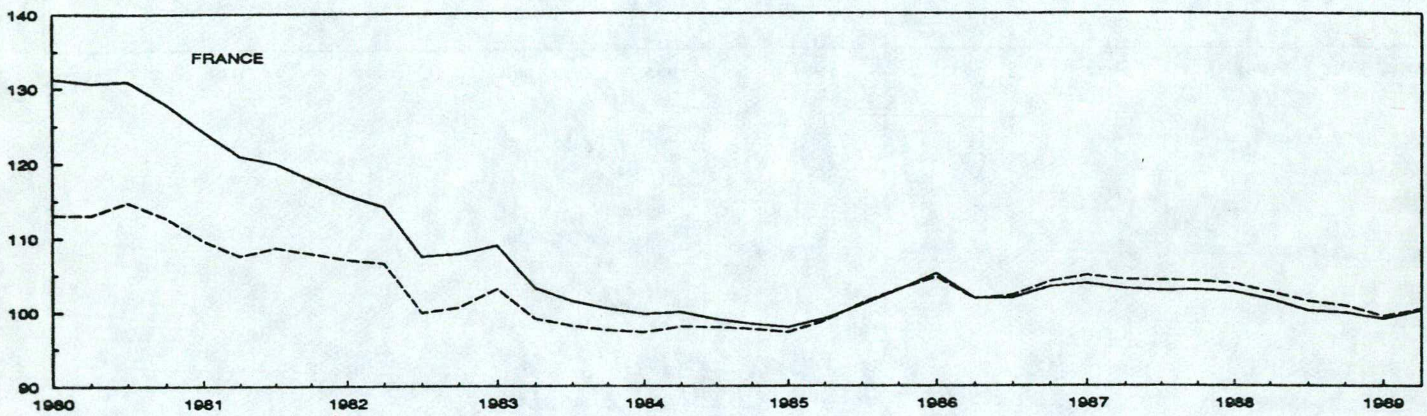
___ NOMINAL EFFECTIVE EXCHANGE RATE

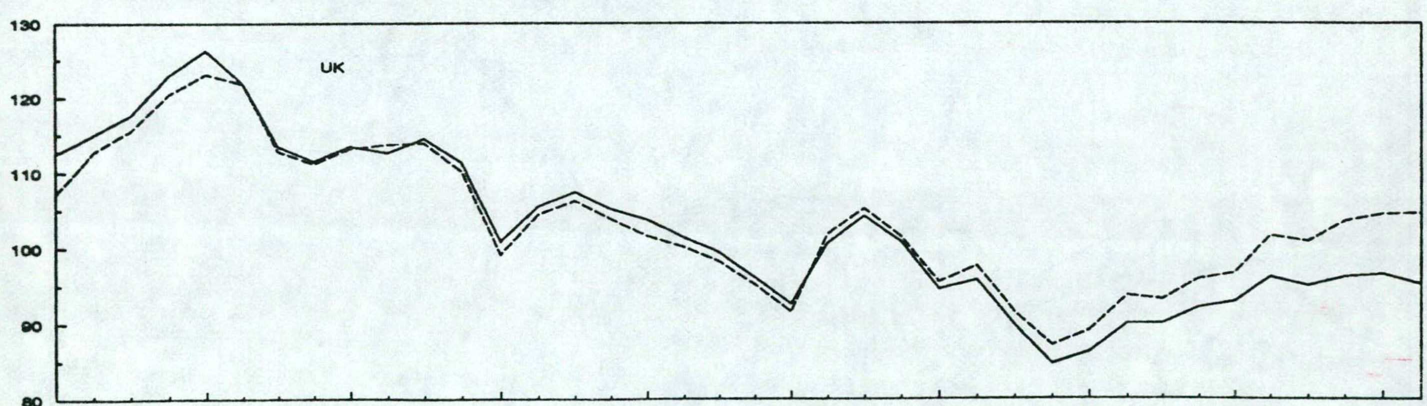
---- REAL EFFECTIVE EXCHANGE RATE

CHART 19 : REAL AND NOMINAL EFFECTIVE EXCHANGE RATES

(1985=100)



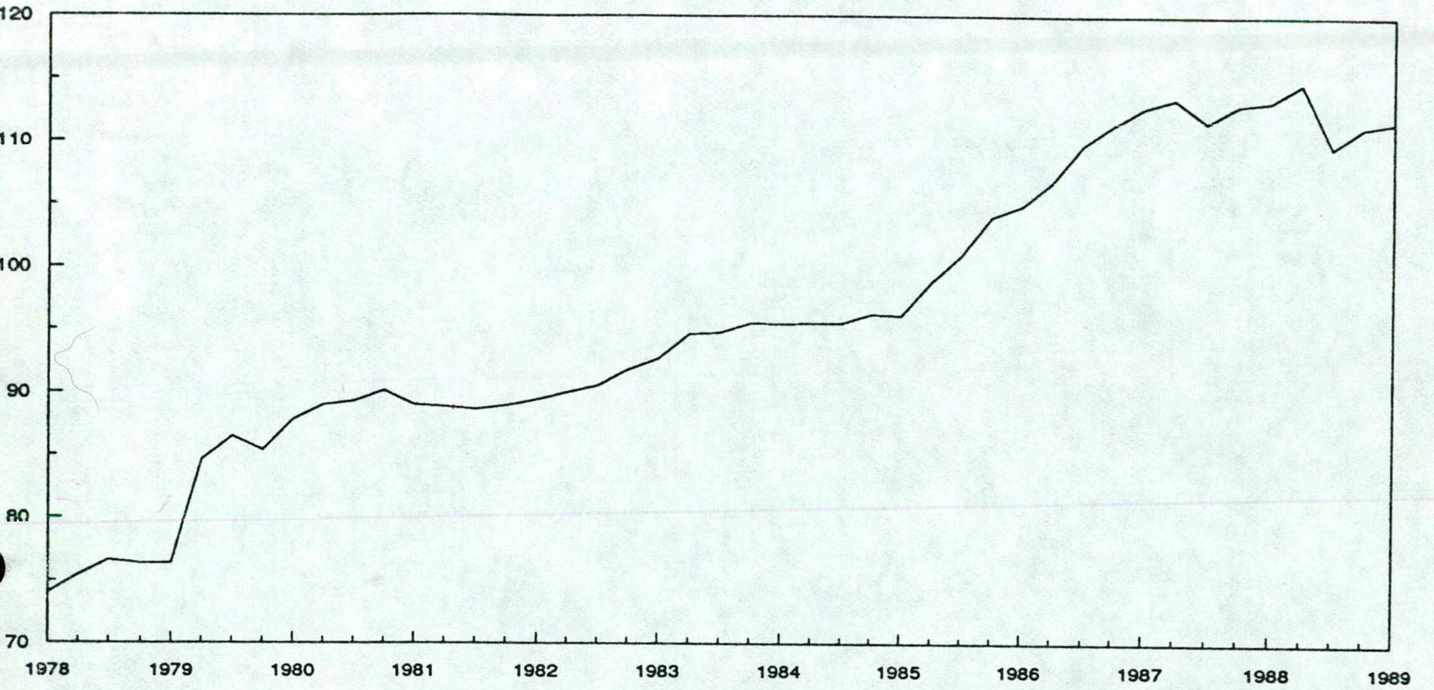




—— NOMINAL EFFECTIVE EXCHANGE RATE
--- REAL EFFECTIVE EXCHANGE RATE

24. As measured by the ratio, in common currency, of consumer prices in the G7 to those in the rest of the world, the real exchange rate of the G7 appreciated substantially between early 1985 and early 1987 but ...een broadly stable since.

CHART 20 : MAJOR 7 REAL EXCHANGE RATE
1985 = 100



PCD

September 23, 1989

STATEMENT OF THE GROUP OF SEVEN

The Finance Ministers and Central Bank Governors of Canada, France, the Federal Republic of Germany, Italy, Japan, the United Kingdom, and the United States met on September 23, 1989, in Washington for an exchange of views on current international economic and financial issues. The Managing Director of the IMF participated in the multilateral surveillance discussions.

The Ministers and Governors reviewed their economic policies and prospects. They noted that their economies were experiencing further solid growth this year and that the current expansion was expected to continue in the coming year. Moreover, inflation remains contained thanks to the implementation of appropriate policies, but vigilance is still required, particularly in those countries where inflationary pressures persist. Some further progress is also being made in reducing large external imbalances although adjustment has slowed. The Ministers and Governors considered the rise in recent months of the dollar inconsistent with longer run economic fundamentals. They agreed that a rise of the dollar above current levels or an excessive decline could adversely affect prospects for the world economy. In this context, they agreed to cooperate closely in exchange markets.

The Ministers and Governors reaffirmed support for the economic policy coordination process and stressed the importance of continuing to implement the economic policies which have produced 7 years of sustained growth with relatively low inflation. They encouraged the ongoing efforts of the United States to reduce the Federal budget deficit by implementing measures that will achieve the Gramm-Rudman-Hollings budget deficit targets. They also encouraged further deficit reduction in Canada and Italy, as well as the efforts of those countries and of the U.K. to reduce inflation. France will continue to promote savings so as to facilitate investment. The surplus countries, Japan and Germany, will continue to undertake economic policies aimed at promoting non-inflationary growth with a sufficient margin in the medium term between domestic demand and output growth to reduce substantially their large external imbalances. All need to implement reforms promoting economic efficiency, open their economies to foreign goods and services, curb subsidies and excessive regulations, and to take appropriate measures to foster savings where they are inadequate.

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The Ministers and Governors reaffirmed the importance they attach to an early and successful conclusion of the Uruguay Round of trade negotiations. They expressed their determination to resist protectionism and to strengthen the open multilateral trading system.

The Ministers and Governors discussed the historic events now in progress in some of the countries of Eastern Europe, especially in Poland and Hungary, and expressed their strong support for plans to create more open and market-based economies. They urge the Polish Government to reach an early agreement with the IMF on a strong and sustainable program and they stand ready to support such a program through bilateral and multilateral actions, including Paris Club rescheduling.

The Ministers and Governors expressed their support for the strengthened debt strategy and recognized the substantial progress which has been achieved. They commended the Fund and the Bank for their prompt and effective response in developing the operational guidelines governing their support for debt and debt service reduction.

The Ministers and Governors reaffirmed the key role of commercial banks in resolving debt problems. They further agreed that diversified financial support from the banks is needed to support sound economic reform programs through a broad array of new lending and debt/debt service reduction mechanisms. They also noted that they had reviewed, in a manner consistent with maintaining the safety and soundness of the financial system, their regulatory, tax and accounting practices with a view to eliminating unnecessary obstacles to debt/debt service reduction transactions and that this review had helped to clarify procedures to facilitate such transactions.

The Ministers and Governors reemphasized the central importance of sustained implementation by debtor countries of macroeconomic and structural policy reforms in order to achieve sustainable growth, viable balance of payments positions, and restoration of normal access to private credit markets. They noted that complementary efforts to reverse capital flight and attract foreign investment were particularly important elements of Fund and Bank programs for countries seeking to gain access to support for debt and debt service reduction.

The Ministers and Governors also reviewed other issues to be discussed in the forthcoming meetings of the Fund and the Bank. The Ministers and Governors recalled that the Executive Board of the IMF has been urged to complete its work on the 9th Review of Quotas with a view to a decision on this matter by the Board of Governors before the end of the year.

MEETING OF THE G7 IN THE BLAIR HOUSE, WASHINGTON ON SATURDAY 23 SEPTEMBER 1989

The meeting began at 11.10.

2. G7 Ministers, Governors and Deputies were present. The Managing Director of the IMF was present for the discussion on surveillance.

3. After Brady had described the agenda, the Chancellor suggested that Eastern Europe, particularly Poland, should be added to the agenda. Waigel gave support and the topic was put on the agenda. Brady then invited the Managing Director to give his presentation on surveillance.

Surveillance

4. Camdessus described the conjunctural picture in the terms of his note circulated to the Group. He then drew attention to six more fundamental issues. First, the Group should give a clear signal of stability and cooperation. Second, it should address the problem of savings, which clearly had implications for fiscal policy. Third, there should be efforts to reduce the external imbalances, partly as a result of buoyant Japanese tourism abroad. The present stalemate undermined the credibility of the coordination process. Fourth, there had been good news on inflation since the last meeting. Fifth, structural rigidities in economies needed further action. Sixth, the trend towards non-tariff barriers needed to be arrested where the developing countries seemed to be performing better than the industrial countries.

5. Brady described the fiscal policy in the United States. Discussions were at a crossroads. He would not want to bet on whether there would be a sequester or not. But the process was forcing cuts out.

6. Hashimoto described the economic situation in Japan as one of strong expansion with private consumption and investment both doing well. In the last quarter, the external balance had declined somewhat. The price situation was satisfactory, though there was some concern about tightening in the labour market. There was no case for increasing fiscal demand. Structural adjustment was a matter for the countries themselves and could not be discussed among Finance Ministers.

7. Wilson said that fiscal policy was the key to current account adjustment. He still saw a trend towards higher inflation and therefore was not as sanguine as the Managing Director. Camdessus intervened to say that he did not disagree. His comment had simply intended to indicate that the prospects for inflation were better than at the G7's last meeting. Then all the figures had pointed in the wrong direction. This was not now the case.

8. Beregovoy described the recent French budgetary changes. They were now reaping the benefits of economic growth. There was some social tension about the distribution of the results of growth. Savings were inadequate and the French Government would be taking measures to stimulate them. He then asked the Managing Director three questions: did he feel that the adjustment process was still progressing, was static, or had gone into reverse? what was his estimate of the trends of oil prices? what did he think was a satisfactory level for the dollar? France would refuse to import inflation and would therefore adjust its monetary policy to that end.

9. Waigel thought the overall economic situation favourable, but not without risks. The Brady Plan had provided an excellent environment for the developing countries. The expansionary budgetary policy in Germany would not, in his view, cause problems. He expected price stability to continue. Consumer prices would be kept below 3 per cent; if not, he would not live up to President Poehl's expectations! The German trade surplus had nothing to do with import restrictions or a vigorous export policy. Its origin lay in the competitiveness of German industry and the demand situation in Europe. His Government had a

substantial programme of structural reform, including labour market, privatisation, telecommunication and the post office. He was thinking of reforming the corporate tax sector.

10. Carli said that Italy had both the highest saving and dissaving rate. His objective was to reduce the dissaving rate - and his budget next week would take a substantial step in that direction. It would reduce old authorisations to spend next year as well as transfers to local authorities. Subsidies to firms would be reduced both because Italian industry did not need subsidies to compete and because this was in conformity with the principles of EMU. Charges for services would be introduced. Control would be exerted over post office savings so that those savings were no longer used to finance projects which the market would not touch. There would also be changes to energy taxation.

11. The Chancellor described the situation in the UK. Our position was the opposite of the Italians'. We too were saving and dissaving - but in the opposite direction to the Italians. It was clear monetary policy had to remain tight and interest rates high for some time to come. There were great political pressures for extra public expenditure, made harder to resist because of the Government's budget surplus. He would like to see an increase in the net savings ratio, but not by an even higher budget surplus. That suggested that personal savings should increase. But the unsolved question was how this should be done. Tax incentives simply shifted savings between different instruments. High interest rates would help. But there were also cultural reasons explaining differences in saving rates between countries. A feature of the UK scene was that two-thirds of householders owned their own houses, and that did not help savings. The programme for structural reform had to be pressed forward. He disagreed with Hashimoto's argument that structural reforms were not a matter for Finance Ministers' discussions. Finance Ministers had to be interested in these issues.

12. Turning to the Deputies' three questions, the Chancellor gave the following answers.

Q1. In view of the objective of sustained growth with low inflation, do Ministers and Governors consider the present stance and mix of fiscal and monetary policies to be appropriate?

The situation differed from country to country. Fiscal and monetary policy were not substitutable. Fiscal deficit should be eliminated so that the state did not make demands on the savings of the people. But fiscal policy was not something for fine tuning. Monetary policy had to bear the overwhelming burden of short-term economic management once budget balance had been achieved.

Q2. What should be done to resume progress in reducing the external imbalances to sustainable levels? In this context, which measures should be taken to bring the exchange rate of the dollar into line with economic fundamentals?

No-one knew what the sustainable level was. Policy should not have too many objectives. It should be confined to keeping inflation down and ensuring a good structural reform programme. He saw no particular reason for concern about current account balances, though there would be dangers if they got too far out of line. The exchange rate had an important role to play in monetary policy. He would therefore not assign it a role in influencing the current account.

Q3. A number of areas of priority for additional structural reform have been identified by the IMF staff. How is it possible to speed up structural reform efforts given the political interests that are often associated with specific distortions?

Germany and Japan still had substantial structural impediments, including widespread subsidisation of industry and agriculture. There should be action to reduce such impediments. He had no need to spell out what needed to be done in the case of Japan because the Prime Minister had done so in her recent speech. It was much better to concentrate discussion on structural reform rather than on current account imbalances which were a distraction.

13. Brady asked the Managing Director for his views on Poland and on quotas before he left the discussion.

Poland

14. Camdessus said that the Fund's negotiator, Russo, had been impressed by the new Polish Government's determination to implement a strong macroeconomic and supply side reform. The fear was that the romantic Polish approach would not recognise the magnitude of the task before them. Their economy did not allow for the checks on economic activity normal in market economies, such as a strong Central Bank. Even so, they were determined to go ahead with a rapid programme of deregulation. He hoped that sometime in November the Fund would agree a letter of intention with the prospect of a programme next year. That programme would be strong, but it also needed to be realistic. There would be problems for financing the balance of payments in the first year, and governments would need to consider how to help. The Banks would need to be made unhappy since so far they had benefited.

Quotas

15. Camdessus said that three questions arose regarding the IMF quota: what did its members want the Fund to do? what was the likely level of demand on the Fund? and what should be its liquidity? On the first question, he thought that the Fund should be sufficiently endowed to maintain its present policies and be ready to deal with unexpected shocks, such as had occurred in 1974 when oil prices had risen and in 1982 when the debt crisis had erupted. Neither of those shocks had been foreseen. Certainly present liquidity was high, but it would change very quickly. He could, he thought, accept an increase in quotas by two-thirds per cent provided it was coupled with some borrowing.

16. The Managing Director at this point left the discussion.

Exchange Markets

17. Brady said that policy coordination and exchange market intervention could not be divorced. A renewed commitment to policy coordination required strong intervention by the three major countries. Hashimoto agreed. Larosiere thought that there was a strong perception that the coordination process was faltering. One reason for that perception was the evident failure to reduce the imbalances. People were focusing attention increasingly on intervention policy. They had noticed that there had been much less intervention by the European countries than by Japan and the USA. He agreed that intervention should be carried out in a concerted fashion. It would not deal with all the problems - fiscal policy had a role to play.

18. Waigel repeated that the imbalances were not a global problem. They needed to be examined on a country by country basis. There was no trade balance problem now between the US and Germany. It was a European phenomenon. Intervention was not a panacea. Poehl did not know whether it was right to say that the markets thought cooperation had broken down. If that was the case, it was because G7 had created wrong expectations, for example over ranges and their ability to defend certain levels. The result had been that when the DM1.90 barrier had been broken, the impression had been given to the market that coordination had broken down. There had been quite substantial interventions since the dollar had begun to rise. These had been fairly distributed. But intervention would only help if it was done in an efficient and professional way. It needed to be supported by other measures in the monetary policy field.

19. He agreed that the significance of balance of payments deficits had changed. A system had not been invented which permitted the abolition of deficits. But it did permit goods and capital to free flow. There was a lot to be happy about - the longest upswing with low inflation for a very long time.

20. The Chancellor agreed with a lot that had been said. Cooperation and exchange rate stability had contributed to this

long period of prosperity. But the markets now had doubts about cooperation. It would be foolish to give up after having spent so much capital. Intervention was an outward and visible sign of the viability of the cooperative process. Nor could it be forgotten that the mere fact that the present G7 meeting had heightened the profile. A regular publication of communiques simply made life harder for Ministers. The old G5 managed to avoid communiques. The Group had managed to avoid a communique in February, partly because they had announced in advance that one would not be produced. They should work on the presumption that one would not be issued unless there was a clear need for it.

21. Wilson thought it was impossible to control markets, though they could be influenced. Unmanageable expectations should not be expected. The perception was in the markets that cooperation was slipping. It was importance to act in a coordinated way. The communique should not raise expectations. Participants' statements would be important. Of overriding importance was policy - particularly implementation of Gramm/Rudman/Hollings and consistent monetary policy.

22. Ciampi suggested that analysis had shown that intervention was more successful in 1987 when they were concerted than recently. Concerted intervention gave the comforting impression that the major countries agreed on major economic policies.

23. Summing up the discussion Brady said that it was agreed to have a coordinated intervention operation at this time.

24. The morning session concluded at 13.15.

25. The meeting resumed at 14.45.

Debt Strategy

26. Brady said that so far the Mexican negotiation had been successful: there had been some capital reflight, Mexican reserves were up, interest rates had been reduced from 56 per cent to 33 per cent, and the privatisation programme was proceeding. At the same time the shares of the money centre banks had risen in value both compared to the index and regional bank shares. Banks were strengthening their balance sheets and secondary prices of third world debt had strengthened. There had been agreement on a Philippines package and packages for Morocco and Costa Rica were under discussion. The need now was to maintain the momentum and to demonstrate that the initiative was simply not a US strategy. That was why he attached importance to an agreement with Morocco, which was not regarded as an area of particular US interest. Some banks were arguing that the initiative had killed the chance of new money. That would have happened in any event. It was important to maintain the sense of strategy; otherwise achievements would unravel. The United States put a lot of pressure on its banks to participate in the strategy, and to keep new money flowing into the countries. If the US Treasury had not become involved in the Mexican deal, there would not have been a deal. The communique needed to be strengthened in respect of the banks' role.

27. Hashimoto explained recent Japanese lending initiatives and the changes to Japanese tax law as they affected provisioning. He had some sympathy with Japanese banks who were arguing that it was difficult to provide new money at the same time as reducing debt and debt service.

28. Beregovoy agreed with Brady's analysis. Four messages should be given publicly. First, the developing countries had to be told that they would be eligible for debt relief if they took courageous action. Second, the commercial banks had to be told that they had a role to play. It was a pity that they had not followed what was required when the Philippines deal had been

negotiated. The banks were not forced to choose one option, but three. Third, the IFIs should be told to be active, fast and imaginative. Finally, G7 countries should emphasise that the debt strategy had to succeed. Enormous importance was attached to it in Africa, for example in Morocco, Gabon, Nigeria and the Ivory Coast. Action had to be followed through in the case of the Philippines. The French Government would shortly make an announcement of even better tax incentives for banks participating in debt reduction.

29. Wilson agreed that there had been real progress. But there were concerns, for example on transfer of risk. He congratulated the Japanese on their contribution. The Canadian banks were not interested in putting new money into Mexico. They had found negotiating that deal a frustrating process. Regulatory and tax provisions offered no real obstacles to debt reduction. He was particularly concerned that it was not immediately apparent that the Brady Plan was making a fundamental change in the policies of the debtor countries. Expectations had to be kept in line with reality. There was a concern about the absence of front end loading of money. Options had to be kept as flexible as possible. Financing gaps should not be filled with more foreign debt. The banks concern about slowness of the that the process needed to be met. Brady intervened to say that many of the banks had deliberately tried to play the Mexican negotiations slow.

30. Waigel said that it was now up to the banks and the developing countries to work out agreements among themselves. That was the best way to prevent a transfer of risk. He agreed that eligibility for Brady terms should be on a case by case basis. The guidelines for the initiative had reflected an agreed compromise. That must be respected by all G7 countries. Brady, said that even before the US initiative, it was clear that new money would not be on the table. Their initiative had assumed that new money would come from debt reduction, privatisation and the return of flight capital. The strategy attempted to sail between the Scylla of involving the IFIs too much and the Charybolis of saddling the banks with unperforming loans.

31. The Chancellor commended Brady for the ingenuity he had shown in devising his scheme. It had operated for only a short time. The real problem was that most countries were not pursuing sufficiently strong policies. Creditor governments could not make them do that. They could only provide inducements. He agreed with Waigel that the rules should not be changed after such a short time. The strengthened debt strategy as agreed in the Boards had the full support of the British Government which was providing generous tax relief. He had welcomed the increase in banks' provisions to 47 per cent. The British banks were not conspicuously enthusiastic about the Brady Plan, but were nonetheless in the act. They too were not keen about the new money option, but there were other options for them to choose. The UK did not have state owned banks and the Government would not tell the commercial banks what to do. Even if they did, they would not take any notice. The banks had to take their own decisions. He understood that the US were impatient for progress, but he could not see that the pace could be forced. It was a tribute to the Secretary that he had got so far in such a short time.

32. Brady retorted that he was not impatient, but unless there was action, the problems would remain. The Chancellor reminded him that much had been done through the Paris Club for many countries. Too often countries were softer towards the clearing banks than they were towards creditor governments. Perhaps the countries should take a tougher line with the banks, though this could not be said publicly. Mulford said that so far the only deal struck had been with Mexico. Progress was stalled on, for example, the Moroccan and Chilean deals because the banks were unwilling to price them. There was also concern that there would be insufficient money for enhancements in the case of the Mexican deal. Trichet reminded the G7 of the scale of Paris Club rescheduling since 1983. That rescheduling had covered both principal and interest. If governments' contribution through new export credit to debtor countries was taken into account, governments had undoubtedly been more generous than banks. Mulford observed that although the Morgan Bank had now provided complete provisions against some debt, they had said that this

actually might increase the prospects of their lending new money. The Chancellor said that we should not take much notice of what the banks said. They should be left to get on with it. Brady thought that unless a solution was found, there would be chaos or demands for a world solution to the debt problems.

33. Carli warned that there were risks in pressing the banks to intervene. He recalled the 1979 and 1980 Summits when banks had been invited to extend new credits to developing countries which were nearly insolvent. That had simply made the 1982 debt crisis worse. Financing development was not a proper function for commercial banks. Referring to the Somalia Support Group, he said that if G7 countries could not give an indication of their support for that country, it would be better to wind the group up. Brady replied that the US could not give any indication of support. But they were not saying yes, nor were they saying no.

IMF Quotas

34. Brady reported that there was no support for a quota increase in Congress. The Democrats were arguing that if the US Administration needed money for quotas, they should raise taxes. It was also clear that the Fund liquidity position did not require a quota increase in the immediate future. The state of the US Budget discussions made it clear that there would be no progress before 15 October, though he still stood by his commitment for a decision by the end of the year. Waigel said that his Government supported a substantial quota increase so that the Fund could rely on its own resources. Beregovoy wondered whether the Ministers should raise this issue when they saw President Bush on Tuesday. The Chancellor said that the Ministers had to accept Brady's account of his political difficulties. He wondered how urgent a Fund quota increase was. He recalled that the last quota increase had been 47 per cent, but this was in the wake of the debt crisis. The position was quite different now. Fund liquidity was now stronger than both before and after the 1983 quota increase. It was very difficult to say that a quota increase was necessary, even on the reduced scale of two-thirds increase suggested by the Managing Director. The UK's proposal was therefore for a moderate increase - up to 25 per cent. The UK were ready to defer consideration of the issue if this helped the US. Certainly the timing of discussions at the end of the year would be very difficult. It might be better to take decisions at the next Spring or Annual Meetings.

35. Greenspan saw no pressing need for an early decision. Fund liquidity had on occasions slipped down to some 40 per cent without any great crisis arising. He thought that the US Budget problems could be solved before a quota increase needed to be addressed.

36. Beregovoy believed that the Managing Director had made out a good case for a quota increase in the morning's discussions. The Fund would undoubtedly be short of liquidity in 1990 or 1991. France was willing to compromise on size, even if this meant not giving the Managing Director all he wanted.

37. Trichet then referred briefly to the discussions among G7 Deputies which had covered the decision making process, the size of the quota increase and ranking. On the latter point there had not been a consensus, though some had expressed support for a ranking which put the US in first place, Japan and Germany in second place and the UK and France in third.

38. Hashimoto said that there was strong pressure in the Diet for a higher ranking for Japan. Unless their position was adjusted to a more appropriate level, it would be difficult to secure authorisation for a new quota bill. He could go along with the rankings suggested by Trichet. Brady said that the US was more than ready to go along with Trichet's suggestion. The Chancellor recalled that Trichet had said there had been no consensus in the G7 Deputies. The quota rankings he had suggested raised grave technical and political difficulties. Brady intervened again to emphasise that his point was that he was happy with the Japanese in second place. The Chancellor said that when agreement had been reached on a general quota increase, it would be possible for Japan to move into second place through a special quota increase. But he saw no case for doing anything more. Certainly anything more would be most difficult to defend politically.

39. Waigel saw no need for a debate about rankings at that stage. If there was to be a debate, he would want to take up some of the points made by the Chancellor.

40. Wilson intervened at that point to urge support for the support group for Guyana. Unless there was more G7 support for the support group process, that approach would fail. The Deputies should look at the future of support groups. Mulford said that they should look at the issue of arrears as well. He said that the Deputies had concluded that support group procedures were not working well and were unlikely to work for countries with large arrears. The issue should be looked at in a fundamental way as part of the consideration of a quota increase. Tietmeyer objected that there was no formal link between arrears and quotas.

Poland

41. The Chancellor said that recent events in Poland were among the most important political developments since the Second World War. They were an open avowal of the failure of the Communist system and the beginning of the break-up of the Communist empire. Western governments should do all they sensibly could to help the Poles move towards democratic politics and a market economy. Similar considerations were applying to Hungary, which was seeing the same process but in a rather different way.

42. Waigel gave the Chancellor strong support. The policies of Erhard had won over the policies of Marx. The Paris Summit had already made important statements. There needed to be as flexible as possible rescheduling in the Paris Club. Poland now required expertise as much as economy. One possibility was the despatch of a small group of experts drawn from several countries to help the Poles. Germany would need to come to terms soon on their jumbo loan. Hungary was another case in point.

43. Hashimoto gave strong support to the Chancellor's sentiments. Japan was willing to give support to Poland, though it would be different in nature from the support to other indebted countries. Some Japanese firms had already indicated an interest in building plants in the country.

44. Beregovoy agreed fully with everything that had been said. Debt needed to be rescheduled in accordance with Polish capabilities to pay. It always needed to be borne in mind that Communist governments could evolve as the Polish situation changed. The same process was happening in Hungary. It was worth too to keep an eye on events in the German Democratic Republic.

45. Greenspan thought it important to decide at an early stage the appropriate amount of assistance and its form. The Polish economic structure was bizarre. The USSR had the same problems, but on a much larger scale. Many Eastern European economies were collapsing as the African socialist economies had collapsed. It was important to avoid putting any form of assistance into the

countries which forced the USSR back into its old Stalanist role. Too much aid could be a mistake. He agreed the need for a conceptual advisory group. There were great problems in, for example, the USSR in dealing with the 200 billion rouble overhang because of the lack of proper security markets.

46. Carli observed that the Polish and Hungarian experience was an experiment without precedents. One great problem was the lack of personnel who understood the working of markets. Another was that the basic philosophy of some Solidarity supporters did not have much sympathy with the principles of market economy. To that extent they were rather like the Catholic Communists in Italy. The first problem was to provide food. The IMF experts might not have sufficient experience with Poland's particular problems. It would therefore be important not to superimpose the West's convictions on the country. This prompted Greenspan to say that governments must not support the socialist part of the Polish reform programme. But if the Poles refused to take the West's advice, the West would have to accept the position. Poland either had to go forward to a market economy or back into Stalinism.

47. The meeting then proceeded to the consideration of the draft communique, a final version of which is attached.

48. The meeting concluded at 18.30 hours.

PLD

FROM: N L WICKS
DATE: 28 SEPTEMBER 1989
Ext : 4369

PRINCIPAL PRIVATE SECRETARY

cc EST
Sir P Middleton
Sir T Burns
Mr Evans
Mr Scholar
Mr A C S Allan
Mr Mountfield(Poland)
Mr Peretz (Markets)
Mr Pickering (Quotas)
Mrs Chaplin

Mr Cassell (UKDel)

Mr Crockett (B/E)

G7 DEPUTIES' MEETINGS, WASHINGTON 22 AND 27 SEPTEMBER 1989

I attach records of the meetings of G7 Deputies held on Friday 22 and Wednesday 27 September. Please could recipients ensure that the text is circulated on a strict need to know basis.

N.L.W.

N L WICKS

MEETING OF G7 DEPUTIES IN DAVID MULFORD'S OFFICE IN THE US TREASURY ON FRIDAY 22 SEPTEMBER 1989

The meeting began at 17.30 hours.

IMF Quotas

2. Mulford reported that there had been intensive discussions recently with Conable about the IDA replenishment. There had also been meetings on the Hill about the US GCI contribution and outstanding requirements to other multilateral development banks, which he said stood at $400 million. Congressman Obey, who had a lot of influence, was refusing to sanction the bills until the banks had taken a hit. He was also expressing opposition to further money for the IMF. There was, however, support on the Hill for IDA 9. Many saw it as political suicide to table both the Quota Bill and IDA 9 in the same year. Against this background, one possible solution was to link the decision on quotas to developments in Fund resources, for example, by stipulating that the Fund quota would be agreed and paid if liquidity ratios went down to a certain level. Tietmeyer, Trichet and Wicks all expressed doubts about such a proposal.

Markets

3. Mulford hoped the Ministers and Governors at their meeting the following day could decide to cooperate closely. He saw the makings of a consensus, though he knew that Tietmeyer had reservations. Tietmeyer said that his, and especially the Bundesbank view, was that interest differentials, not scale of intervention were the deciding factor. As long as there was no change in expectations, intervention would have no lasting effect.

4. Deputies then agreed that their Ministers and Governors should discuss the issue the following day. They then proceeded to prepare the first draft of a communique.

MEETING OF G7 DEPUTIES IN THE SHERATON HOTEL, WASHINGTON ON WEDNESDAY 27 SEPTEMBER 1989

The meeting began at 07.30.

Poland and the Paris Club

2. Trichet said that there seemed to be three options for dealing with Polish 1989 and early 1990 maturities: leave arrears to accrue, a formal rescheduling, or dealing with outstanding arrears on an interim basis by an exchange of letters.

3. In a general discussion the Deputies appeared to favour the exchange of letters. They undertook to reflect further and let Trichet know whether this was indeed their view. [*Could Mr Mountfield please provide me with a draft of a telex informing Trichet of our position*.] An important point to decide would be the period covered by the collective exchange of letters. It was suggested that the exchange should simply say that the arrangements covered the period only to, say, the end of January.

4. In further discussion, Trichet identified three further issues: what could be said now on new credit? what could be said when the rescheduling deal was agreed? and what could be said when Poland was restored to full creditworthiness. He suggested that countries should be clear and specific in making their position known to the Poles on these scores.

Arrears

5. Mulford undertook to prepare a full paper on future arrears strategy. In a general tour de table Deputies expressed some doubt whether the present support group approach could work for the larger arrears cases, whatever its effect on the smaller cases. Dobson said that the strategy already allowed for rescheduling of IMF monies, a technique which might be necessary in some of the substantial arrears cases. Other Deputies

indicated their strong dissent with her understanding that the existing approach allowed for rescheduling.

Vietnam

6. In a brief tour de table, Mulford explained the USA were still opposed to joining a support group for Vietnam or supporting a standby arrangement in the Board. Wicks spoke according to his brief. Trichet pressed for a more forthcoming position. Mulford undertook to put the matter on the agenda for one of the Treasury Secretary's breakfast meeting with Secretary Baker. [Could IF please ask the FCO to instruct the Embassy in Washington to keep track of State Department thinking here so that we are warned of any change.]

7. It was agreed that the next meeting should be in London on Monday 20 November, beginning at 9.00 am.

PERSONAL
Covering SECRET/CONFIDENTIAL

~~1 John~~
~~2 Bruce~~
~~3. Dominic~~

FROM: N L WICKS
DATE: 28 SEPTEMBER 1989
Ext : 4369

PRINCIPAL PRIVATE SECRETARY

cc EST*
Sir P Middleton*
Sir T Burns*
Mr Evans*
Mr Scholar*
Mr A C S Allan*
Mr Mountfield†
Mr Peretz°
Mr Melliss§
Mr Pickering†¶
Mrs Chaplin

Mr Cassell (UKDel)*

Mr Crockett (B/E)*

* Whole document
† Debt
° Markets
§ Surveillance
¶ IMF Quotas

G5/G7 MEETINGS, WASHINGTON, 23 SEPTEMBER 1989

I attach the record of the discussions at G5/G7 on Saturday 23 September. Please could recipients ensure that the text is circulated on a strict need-to-know basis.

N.L.W.

N L WICKS

MEETING OF THE G5 IN THE US TREASURY ON SATURDAY 23 SEPTEMBER 1989

The meeting began at 09.25 with the Ministers, Governors and Deputies of the G5 countries present.

2. Secretary Brady said that the world economy functioned best if markets believed that economic policy coordination was alive and well. Progress had been made in that direction in the last few years. But many, not only press commentators, were saying that the international policy coordination process had broken down. The key issue was intervention policy. Coherence of G5 intervention policies was tangible evidence that the coordination process was working. His feeling was that the dollar was higher than economic fundamentals dictated because of the flight of money into US dollars as a result of the uncertainties in the Soviet Union and China. While he would not argue that intervention always worked, there was a strong case for the G5 countries taking a further stand in the market after this meeting.

3. Greenspan observed that the G5 economies were doing well. Economic coordination was a crucial element in that process since it created the aura of stability in the international system. But the authorities needed to be cautious about hammering the exchange markets through intervention, lest unanticipated secondary effects should be created. This pointed to an appropriate and measured response.

4. Hashimoto thought that the dollar would weaken in the long run, although short-run sentiment was making it strong. Dollar strength gave Japanese firms problems of price competitiveness, for example for those firms importing intermediate goods or transferring plant abroad. So, a high dollar was an impediment to the adjustment of external balances. Japan therefore agreed that there should be coordinated intervention after the meeting.

5. Waigel thought that the results of the coordination process had been tremendous. The draft G7 communique and the IMF Report were pointing in the right direction. However, Ministers should

be clear where the imbalances came from. [This is a reference to the reductions in Germany's trade balance with the US.] He was sceptical, too, about intervention - that dealt only with symptoms, not causes. The communique should do no more than reaffirm what already had been decided. To go further would create undesirable speculation, for example that a system of target ranges had been created with all the uncertainties referred to by Greenspan.

6. Poehl recalled that massive dollar sales over the last few months they had not prevented the strengthening of the dollar, but had merely financed capital movements on terms favourable to currency traders. He was sceptical about the benefits of sterilised intervention, though he did not exclude use of the technique to influence expectations. If, and it was a big if, G5 really wanted the dollar to fall, they should use other instruments. Another reason for his reluctance to intervene was the size of other central banks' deutschmark holdings - some DM40 billion in the US, DM25 billion in Italy and total of DM120 billion in all the central banks. If these deutschmarks were suddenly unloaded, there would be enormous problems for German monetary policy. Nor should it be forgotten that the Bundesbank's reserves were limited. They now stood at some $45 billion, which was already at working balance level. These considerations led him to believe that it was reasonable for Japan and the EMS countries to consider a further rise in interest rates, perhaps coupled with some intervention. Such an increase was necessary both to stabilise the exchange rates and to put brakes on the too strong growth of real demand and the consequent prospect of inflationary pressures. If the theoretical possibility of a realignment was excluded, high interest rates were the only alternative. He could tell the meeting, in the strictest confidence, that the Bundesbank had more or less decided to raise interest rates at its next Council meeting.

7. Secretary Brady intervened to draw attention to the lack of balance between US and Japanese intervention and German intervention in the last three months: the US had put in $8 billion, the Japanese $10 billion, while Germany had only

intervened by $500-600million. That is what gave the markets the impression of a lack of coordination.

8. The Chancellor said that despite the problems, the world economy was in good shape. G7 cooperation had helped produce that outcome as well as a period of exchange rate stability. That was one reason why investment had been particularly strong in the last year or so. It was important to maintain the reality of cooperation between the G7 countries. Intervention had become a symbol of G5/G7 cooperation. As Poehl had indicated it could influence market expectations. He recalled the Group's meeting in February when Japan was not participating in intervention. That had produced concern from the Germans and since then Japan had participated. If any of the big three countries were not intervening or appeared half-hearted, the market was given an impression of disarray. Market expectations were now for a continued rise in the dollar. No-one wanted that. So expectations needed to be influenced in one direction. He understood Greenspan's concern about side effects. But he recalled the adverse side effects in the autumn of 1987 when there had been open disagreement between Germany and the USA. Financial markets' attention was now on the G5/G7 meeting. If nothing new emerged, market expectations would be affected adversely. He could support a communique broadly on the lines proposed by the Deputies. Bundesbank interest rates were their own concern. He would not dream of criticising what they did. But the reality of G7 cooperation was another matter. Poehl interjected to say that he agreed with all that the Chancellor had said.

9. Beregovoy agreed with the Chancellor. Cooperation had overcome difficulties in the past, like those at the time of the October 1987 crash or the public disagreements in the autumn of that year. Both public opinion and market operators were wondering whether the will to cooperate still existed. Intervention expressed the will to cooperate in monetary matters. It had a useful role in helping deal with imbalances. He agreed with Poehl that each country had to conduct monetary policy taking account of the consequences for its own country. But it needed to be realised, too, that interest rate changes affected the wider

world. After all, inflation had slowed down in Germany. Perhaps a better course might be for interest rates to rise in Japan and to fall in the US. The German approach of raising interest rates contradicted with their plans to lower tax rates.

10. Waigel countered with a statement of determination to continue with the tax reforms. On interest rates, Finance Ministers were never pleased when an independent Central Bank raised interest rates. That would cost him dear next year. But it would be a useful signal for the next round of collective bargaining.

11. Hashimoto interjected that in Japan the key to economic policy was the continuing strengthening of domestic demand. Sumita recalled Poehl's statement that without interest rate changes, intervention had its limits. The French Minister had suggested that the Japanese should increase their interest rates. At the end of May the official discount rate had been increased and thereafter market interest rates had increased. This was partly because of the strong domestic economy, but mainly because the strength of the dollar had persuaded market operators in Japan that Japanese interest rates would rise again. The market interest rate increases would not impede the strength of domestic economy.

12. Greenspan wondered whether a decline in the dollar would help the US trade account. Such a decline, brought about by lower interest rates, would increase imports because of higher domestic demand; and that might cancel out any beneficial trade effects from the fall in the dollar. He believed that monetary policy alone could have little effect on reducing trade imbalances. Nevertheless, he recognised that the US trade deficit was a problem. Some downward movement of the dollar would help, and concerted intervention to that end would be useful.

13. Poehl suggested that the whole question of trade balances needed to be reconsidered. The pattern of surpluses between the major countries had changed. Germany now had virtually no surplus with the US, but their surpluses with Europe had grown. So

Germany's trade imbalance problem was a European problem, if it was a problem at all in view of the ease in which deficits could be financed.

14. The Chancellor agreed that too much attention should not be focused on the current account imbalances. It was clear that they could be sustained and financed for much longer than had been expected. The UK experience had taught him to be sceptical about conventional wisdom on the relationship between fiscal deficits and trade surpluses. The language suggested in the draft communique in square brackets [referring to a fall in the holding helping to reduce trade imbalances] would cause him acute difficulty if it carried the implication that current account problems could be solved by devaluations - in the UK devaluation would simply cause an outburst of inflation.

15. Larosiere said that the fundamental issue of the US fiscal deficit was receiving less attention now because of the view that the Gramm/Rudman/Hollings process was working. He was not so sure. Countries in Europe too with overheating problems should give a firm impression that they were ready to use fiscal policy if need be.

16. Brady reported that progress was being made in deficit reduction. Discussion nowadays in Congress centred not on spending of money but on where savings were to be achieved to finance new expenditure - and the Defence Department was increasingly seen as the bank in this respect. He did not know whether there would be a sequester. Changing the direction of the US deficit was like turning a battleship.

17. Hashimoto disagreed with Poehl's remarks on the German trade deficit. Imbalances needed to be looked at on a multilateral, not bilateral basis. Markets' attention was focusing on today's meeting and it should give a message of cooperation. He fully agreed with the Chancellor's views.

18. Beregovoy reiterated the need to cooperate. But such cooperation had to be credible. If the only outcome of the day's

discussions was higher German interest rates, that might cause unhelpful disturbances.

19. Brady commented that three-cornered intervention was agreed. Poehl said that the Bundesbank would participate, but there were limits. Moreover, the techniques of intervention should be improved. The market should be taken by surprise. That did not mean spending $100-200 million each day. He did not approve of the use of concerted interest rate moves to influence exchange rates. But he thought that there was a case for increases in interest rates in Japan and Europe. Brady then suggested that the intervention should take place on Monday. Poehl thought that Tuesday would be better for operational reasons. Greenspan emphasised the importance of action on Monday. Poehl responded that it all depended on how the market reacted that day. But if intervention was thought to be useful then, the Bundesbank would participate on a substantial basis. But they could not repeat the operation every day. Lawson supported Brady. If there was no intervention after the meeting, the dollar would rise. Greenspan agreed that 24 hours of conjecture would be bad. Poehl then suggested that the experts should get together tomorrow to agree tactics. Hashimoto pointed out that Tokyo markets opened on Sunday evening Washington time. So the operation needed to be effective by then. Waigel emphasised the importance in public statements of not going beyond the communique. Brady agreed. It would be helpful if there was an air of mystery around the Group's deliberations.

20. The meeting ended at 10.50.

est.jo/ghaskins/03.25.9.89

ECONOMIC SECRETARY TO THE TREASURY

FROM: GINA HASKINS
DATE: 26 September 1989

MR A C S ALLAN 107/3

cc: Mr Evans

CFMM 1989

The Economic Secretary would like to thank you very much for all the work you did on the two speeches he gave at the CFMM in Jamaica last week, as well as your contribution to the briefing for his meeting with Michael Manley and helpful advice throughout the Conference.

2. He would like you to pass on his special thanks to all the Treasury officials involved in providing the comprehensive briefing, and in ensuring that his visit to Jamaica went so smoothly.

Ms Lester cc Mr Pickering
Mr Tarkowski

Many thanks from me too for all your hard work.

AA
3/10

Gina Haskins

GINA HASKINS
PRIVATE SECRETARY

Mr Allan
Are Chancellor's Office sending a similar note? (Mr Barr put in a lot of work on the Annual mtgs. briefing, as did others in IMT & elsewhere)

cwl 4/10

PERSONAL
Covering SECRET/CONFIDENTIAL

P4

FROM: N L WICKS
DATE: 28 SEPTEMBER 1989
Ext : 4369

PRINCIPAL PRIVATE SECRETARY

cc EST*
Sir P Middleton*
Sir T Burns*
Mr Evans*
Mr Scholar*
Mr A C S Allan*
Mr Mountfield†
Mr Peretz°
Mr Melliss§
Mr Pickering†¶
Mrs Chaplin

Mr Cassell (UKDel)*

Mr Crockett (B/E)*

* Whole document
† Debt
° Markets
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G5/G7 MEETINGS, WASHINGTON, 23 SEPTEMBER 1989

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20. The meeting ended at 10.50.

MEETING OF THE G7 IN THE BLAIR HOUSE, WASHINGTON ON SATURDAY 23 SEPTEMBER 1989

The meeting began at 11.10.

2. G7 Ministers, Governors and Deputies were present. The Managing Director of the IMF was present for the discussion on surveillance.

3. After Brady had described the agenda, the Chancellor suggested that Eastern Europe, particularly Poland, should be added to the agenda. Waigel gave support and the topic was put on the agenda. Brady then invited the Managing Director to give his presentation on surveillance.

Surveillance

4. Camdessus described the conjunctural picture in the terms of his note circulated to the Group. He then drew attention to six more fundamental issues. First, the Group should give a clear signal of stability and cooperation. Second, it should address the problem of savings, which clearly had implications for fiscal policy. Third, there should be efforts to reduce the external imbalances, partly as a result of buoyant Japanese tourism abroad. The present stalemate undermined the credibility of the coordination process. Fourth, there had been good news on inflation since the last meeting. Fifth, structural rigidities in economies needed further action. Sixth, the trend towards non-tariff barriers needed to be arrested where the developing countries seemed to be performing better than the industrial countries.

5. Brady described the fiscal policy in the United States. Discussions were at a crossroads. He would not want to bet on whether there would be a sequester or not. But the process was forcing cuts out.

6. Hashimoto described the economic situation in Japan as one of strong expansion with private consumption and investment both doing well. In the last quarter, the external balance had declined somewhat. The price situation was satisfactory, though there was some concern about tightening in the labour market. There was no case for increasing fiscal demand. Structural adjustment was a matter for the countries themselves and could not be discussed among Finance Ministers.

7. Wilson said that fiscal policy was the key to current account adjustment. He still saw a trend towards higher inflation and therefore was not as sanguine as the Managing Director. Camdessus intervened to say that he did not disagree. His comment had simply intended to indicate that the prospects for inflation were better than at the G7's last meeting. Then all the figures had pointed in the wrong direction. This was not now the case.

8. Beregovoy described the recent French budgetary changes. They were now reaping the benefits of economic growth. There was some social tension about the distribution of the results of growth. Savings were inadequate and the French Government would be taking measures to stimulate them. He then asked the Managing Director three questions: did he feel that the adjustment process was still progressing, was static, or had gone into reverse? what was his estimate of the trends of oil prices? what did he think was a satisfactory level for the dollar? France would refuse to import inflation and would therefore adjust its monetary policy to that end.

9. Waigel thought the overall economic situation favourable, but not without risks. The Brady Plan had provided an excellent environment for the developing countries. The expansionary budgetary policy in Germany would not, in his view, cause problems. He expected price stability to continue. Consumer prices would be kept below 3 per cent; if not, he would not live up to President Poehl's expectations! The German trade surplus had nothing to do with import restrictions or a vigorous export policy. Its origin lay in the competitiveness of German industry and the demand situation in Europe. His Government had a

substantial programme of structural reform, including labour market, privatisation, telecommunication and the post office. He was thinking of reforming the corporate tax sector.

10. Carli said that Italy had both the highest saving and dissaving rate. His objective was to reduce the dissaving rate - and his budget next week would take a substantial step in that direction. It would reduce old authorisations to spend next year as well as transfers to local authorities. Subsidies to firms would be reduced both because Italian industry did not need subsidies to compete and because this was in conformity with the principles of EMU. Charges for services would be introduced. Control would be exerted over post office savings so that those savings were no longer used to finance projects which the market would not touch. There would also be changes to energy taxation.

11. The Chancellor described the situation in the UK. Our position was the opposite of the Italians'. We too were saving and dissaving - but in the opposite direction to the Italians. It was clear monetary policy had to remain tight and interest rates high for some time to come. There were great political pressures for extra public expenditure, made harder to resist because of the Government's budget surplus. He would like to see an increase in the net savings ratio, but not by an even higher budget surplus. That suggested that personal savings should increase. But the unsolved question was how this should be done. Tax incentives simply shifted savings between different instruments. High interest rates would help. But there were also cultural reasons explaining differences in saving rates between countries. A feature of the UK scene was that two-thirds of householders owned their own houses, and that did not help savings. The programme for structural reform had to be pressed forward. He disagreed with Hashimoto's argument that structural reforms were not a matter for Finance Ministers' discussions. Finance Ministers had to be interested in these issues.

12. Turning to the Deputies' three questions, the Chancellor gave the following answers.

Q1. In view of the objective of sustained growth with low inflation, do Ministers and Governors consider the present stance and mix of fiscal and monetary policies to be appropriate?

The situation differed from country to country. Fiscal and monetary policy were not substitutable. Fiscal deficit should be eliminated so that the state did not make demands on the savings of the people. But fiscal policy was not something for fine tuning. Monetary policy had to bear the overwhelming burden of short-term economic management once budget balance had been achieved.

Q2. What should be done to resume progress in reducing the external imbalances to sustainable levels? In this context, which measures should be taken to bring the exchange rate of the dollar into line with economic fundamentals?

No-one knew what the sustainable level was. Policy should not have too many objectives. It should be confined to keeping inflation down and ensuring a good structural reform programme. He saw no particular reason for concern about current account balances, though there would be dangers if they got too far out of line. The exchange rate had an important role to play in monetary policy. He would therefore not assign it a role in influencing the current account.

Q3. A number of areas of priority for additional structural reform have been identified by the IMF staff. How is it possible to speed up structural reform efforts given the political interests that are often associated with specific distortions?

Germany and Japan still had substantial structural impediments, including widespread subsidisation of industry and agriculture. There should be action to reduce such impediments. He had no need to spell out what needed to be done in the case of Japan because the Prime Minister had done so in her recent speech. It was much better to concentrate discussion on structural reform rather than on current account imbalances which were a distraction.

13. Brady asked the Managing Director for his views on Poland and on quotas before he left the discussion.

Poland

14. Camdessus said that the Fund's negotiator, Russo, had been impressed by the new Polish Government's determination to implement a strong macroeconomic and supply side reform. The fear was that the romantic Polish approach would not recognise the magnitude of the task before them. Their economy did not allow for the checks on economic activity normal in market economies, such as a strong Central Bank. Even so, they were determined to go ahead with a rapid programme of deregulation. He hoped that sometime in November the Fund would agree a letter of intention with the prospect of a programme next year. That programme would be strong, but it also needed to be realistic. There would be problems for financing the balance of payments in the first year, and governments would need to consider how to help. The Banks would need to be made unhappy since so far they had benefited.

Quotas

15. Camdessus said that three questions arose regarding the IMF quota: what did its members want the Fund to do? what was the likely level of demand on the Fund? and what should be its liquidity? On the first question, he thought that the Fund should be sufficiently endowed to maintain its present policies and be ready to deal with unexpected shocks, such as had occurred in 1974 when oil prices had risen and in 1982 when the debt crisis had erupted. Neither of those shocks had been foreseen. Certainly present liquidity was high, but it would change very quickly. He could, he thought, accept an increase in quotas by two-thirds per cent provided it was coupled with some borrowing.

16. The Managing Director at this point left the discussion.

Exchange Markets

17. Brady said that policy coordination and exchange market intervention could not be divorced. A renewed commitment to policy coordination required strong intervention by the three major countries. Hashimoto agreed. Larosiere thought that there was a strong perception that the coordination process was faltering. One reason for that perception was the evident failure to reduce the imbalances. People were focusing attention increasingly on intervention policy. They had noticed that there had been much less intervention by the European countries than by Japan and the USA. He agreed that intervention should be carried out in a concerted fashion. It would not deal with all the problems - fiscal policy had a role to play.

18. Waigel repeated that the imbalances were not a global problem. They needed to be examined on a country by country basis. There was no trade balance problem now between the US and Germany. It was a European phenomenon. Intervention was not a panacea. Poehl did not know whether it was right to say that the markets thought cooperation had broken down. If that was the case, it was because G7 had created wrong expectations, for example over ranges and their ability to defend certain levels. The result had been that when the DM1.90 barrier had been broken, the impression had been given to the market that coordination had broken down. There had been quite substantial interventions since the dollar had begun to rise. These had been fairly distributed. But intervention would only help if it was done in an efficient and professional way. It needed to be supported by other measures in the monetary policy field.

19. He agreed that the significance of balance of payments deficits had changed. A system had not been invented which permitted the abolition of deficits. But it did permit goods and capital to free flow. There was a lot to be happy about - the longest upswing with low inflation for a very long time.

20. The Chancellor agreed with a lot that had been said. Cooperation and exchange rate stability had contributed to this

long period of prosperity. But the markets now had doubts about cooperation. It would be foolish to give up after having spent so much capital. Intervention was an outward and visible sign of the viability of the cooperative process. Nor could it be forgotten that the mere fact that the present G7 meeting had heightened the profile. A regular publication of communiques simply made life harder for Ministers. The old G5 managed to avoid communiques. The Group had managed to avoid a communique in February, partly because they had announced in advance that one would not be produced. They should work on the presumption that one would not be issued unless there was a clear need for it.

21. Wilson thought it was impossible to control markets, though they could be influenced. Unmanageable expectations should not be expected. The perception was in the markets that cooperation was slipping. It was importance to act in a coordinated way. The communique should not raise expectations. Participants' statements would be important. Of overriding importance was policy - particularly implementation of Gramm/Rudman/Hollings and consistent monetary policy.

22. Ciampi suggested that analysis had shown that intervention was more successful in 1987 when they were concerted than recently. Concerted intervention gave the comforting impression that the major countries agreed on major economic policies.

23. Summing up the discussion Brady said that it was agreed to have a coordinated intervention operation at this time.

24. The morning session concluded at 13.15.

25. The meeting resumed at 14.45.

Debt Strategy

26. Brady said that so far the Mexican negotiation had been successful: there had been some capital reflight, Mexican reserves were up, interest rates had been reduced from 56 per cent to 33 per cent, and the privatisation programme was proceeding. At the same time the shares of the money centre banks had risen in value both compared to the index and regional bank shares. Banks were strengthening their balance sheets and secondary prices of third world debt had strengthened. There had been agreement on a Philippines package and packages for Morocco and Costa Rica were under discussion. The need now was to maintain the momentum and to demonstrate that the initiative was simply not a US strategy. That was why he attached importance to an agreement with Morocco, which was not regarded as an area of particular US interest. Some banks were arguing that the initiative had killed the chance of new money. That would have happened in any event. It was important to maintain the sense of strategy; otherwise achievements would unravel. The United States put a lot of pressure on its banks to participate in the strategy, and to keep new money flowing into the countries. If the US Treasury had not become involved in the Mexican deal, there would not have been a deal. The communique needed to be strengthened in respect of the banks' role.

27. Hashimoto explained recent Japanese lending initiatives and the changes to Japanese tax law as they affected provisioning. He had some sympathy with Japanese banks who were arguing that it was difficult to provide new money at the same time as reducing debt and debt service.

28. Beregovoy agreed with Brady's analysis. Four messages should be given publicly. First, the developing countries had to be told that they would be eligible for debt relief if they took courageous action. Second, the commercial banks had to be told that they had a role to play. It was a pity that they had not followed what was required when the Philippines deal had been

negotiated. The banks were not forced to choose one option, but three. Third, the IFIs should be told to be active, fast and imaginative. Finally, G7 countries should emphasise that the debt strategy had to succeed. Enormous importance was attached to it in Africa, for example in Morocco, Gabon, Nigeria and the Ivory Coast. Action had to be followed through in the case of the Philippines. The French Government would shortly make an announcement of even better tax incentives for banks participating in debt reduction.

29. Wilson agreed that there had been real progress. But there were concerns, for example on transfer of risk. He congratulated the Japanese on their contribution. The Canadian banks were not interested in putting new money into Mexico. They had found negotiating that deal a frustrating process. Regulatory and tax provisions offered no real obstacles to debt reduction. He was particularly concerned that it was not immediately apparent that the Brady Plan was making a fundamental change in the policies of the debtor countries. Expectations had to be kept in line with reality. There was a concern about the absence of front end loading of money. Options had to be kept as flexible as possible. Financing gaps should not be filled with more foreign debt. The banks concern about slowness of the that the process needed to be met. Brady intervened to say that many of the banks had deliberately tried to play the Mexican negotiations slow.

30. Waigel said that it was now up to the banks and the developing countries to work out agreements among themselves. That was the best way to prevent a transfer of risk. He agreed that eligibility for Brady terms should be on a case by case basis. The guidelines for the initiative had reflected an agreed compromise. That must be respected by all G7 countries. Brady, said that even before the US initiative, it was clear that new money would not be on the table. Their initiative had assumed that new money would come from debt reduction, privatisation and the return of flight capital. The strategy attempted to sail between the Scylla of involving the IFIs too much and the Charybolis of saddling the banks with unperforming loans.

31. The Chancellor commended Brady for the ingenuity he had shown in devising his scheme. It had operated for only a short time. The real problem was that most countries were not pursuing sufficiently strong policies. Creditor governments could not make them do that. They could only provide inducements. He agreed with Waigel that the rules should not be changed after such a short time. The strengthened debt strategy as agreed in the Boards had the full support of the British Government which was providing generous tax relief. He had welcomed the increase in banks' provisions to 47 per cent. The British banks were not conspicuously enthusiastic about the Brady Plan, but were nonetheless in the act. They too were not keen about the new money option, but there were other options for them to choose. The UK did not have state owned banks and the Government would not tell the commercial banks what to do. Even if they did, they would not take any notice. The banks had to take their own decisions. He understood that the US were impatient for progress, but he could not see that the pace could be forced. It was a tribute to the Secretary that he had got so far in such a short time.

32. Brady retorted that he was not impatient, but unless there was action, the problems would remain. The Chancellor reminded him that much had been done through the Paris Club for many countries. Too often countries were softer towards the clearing banks than they were towards creditor governments. Perhaps the countries should take a tougher line with the banks, though this could not be said publicly. Mulford said that so far the only deal struck had been with Mexico. Progress was stalled on, for example, the Moroccan and Chilean deals because the banks were unwilling to price them. There was also concern that there would be insufficient money for enhancements in the case of the Mexican deal. Trichet reminded the G7 of the scale of Paris Club rescheduling since 1983. That rescheduling had covered both principal and interest. If governments' contribution through new export credit to debtor countries was taken into account, governments had undoubtedly been more generous than banks. Mulford observed that although the Morgan Bank had now provided complete provisions against some debt, they had said that this

actually might increase the prospects of their lending new money. The Chancellor said that we should not take much notice of what the banks said. They should be left to get on with it. Brady thought that unless a solution was found, there would be chaos or demands for a world solution to the debt problems.

33. Carli warned that there were risks in pressing the banks to intervene. He recalled the 1979 and 1980 Summits when banks had been invited to extend new credits to developing countries which were nearly insolvent. That had simply made the 1982 debt crisis worse. Financing development was not a proper function for commercial banks. Referring to the Somalia Support Group, he said that if G7 countries could not give an indication of their support for that country, it would be better to wind the group up. Brady replied that the US could not give any indication of support. But they were not saying yes, nor were they saying no.

IMF Quotas

34. Brady reported that there was no support for a quota increase in Congress. The Democrats were arguing that if the US Administration needed money for quotas, they should raise taxes. It was also clear that the Fund liquidity position did not require a quota increase in the immediate future. The state of the US Budget discussions made it clear that there would be no progress before 15 October, though he still stood by his commitment for a decision by the end of the year. Waigel said that his Government supported a substantial quota increase so that the Fund could rely on its own resources. Beregovoy wondered whether the Ministers should raise this issue when they saw President Bush on Tuesday. The Chancellor said that the Ministers had to accept Brady's account of his political difficulties. He wondered how urgent a Fund quota increase was. He recalled that the last quota increase had been 47 per cent, but this was in the wake of the debt crisis. The position was quite different now. Fund liquidity was now stronger than both before and after the 1983 quota increase. It was very difficult to say that a quota increase was necessary, even on the reduced scale of two-thirds increase suggested by the Managing Director. The UK's proposal was therefore for a moderate increase - up to 25 per cent. The UK were ready to defer consideration of the issue if this helped the US. Certainly the timing of discussions at the end of the year would be very difficult. It might be better to take decisions at the next Spring or Annual Meetings.

35. Greenspan saw no pressing need for an early decision. Fund liquidity had on occasions slipped down to some 40 per cent without any great crisis arising. He thought that the US Budget problems could be solved before a quota increase needed to be addressed.

36. Beregovoy believed that the Managing Director had made out a good case for a quota increase in the morning's discussions. The Fund would undoubtedly be short of liquidity in 1990 or 1991. France was willing to compromise on size, even if this meant not giving the Managing Director all he wanted.

37. Trichet then referred briefly to the discussions among G7 Deputies which had covered the decision making process, the size of the quota increase and ranking. On the latter point there had not been a consensus, though some had expressed support for a ranking which put the US in first place, Japan and Germany in second place and the UK and France in third.

38. Hashimoto said that there was strong pressure in the Diet for a higher ranking for Japan. Unless their position was adjusted to a more appropriate level, it would be difficult to secure authorisation for a new quota bill. He could go along with the rankings suggested by Trichet. Brady said that the US was more than ready to go along with Trichet's suggestion. The Chancellor recalled that Trichet had said there had been no consensus in the G7 Deputies. The quota rankings he had suggested raised grave technical and political difficulties. Brady intervened again to emphasise that his point was that he was happy with the Japanese in second place. The Chancellor said that when agreement had been reached on a general quota increase, it would be possible for Japan to move into second place through a special quota increase. But he saw no case for doing anything more. Certainly anything more would be most difficult to defend politically.

39. Waigel saw no need for a debate about rankings at that stage. If there was to be a debate, he would want to take up some of the points made by the Chancellor.

40. Wilson intervened at that point to urge support for the support group for Guyana. Unless there was more G7 support for the support group process, that approach would fail. The Deputies should look at the future of support groups. Mulford said that they should look at the issue of arrears as well. He said that the Deputies had concluded that support group procedures were not working well and were unlikely to work for countries with large arrears. The issue should be looked at in a fundamental way as part of the consideration of a quota increase. Tietmeyer objected that there was no formal link between arrears and quotas.

Poland

41. The Chancellor said that recent events in Poland were among the most important political developments since the Second World War. They were an open avowal of the failure of the Communist system and the beginning of the break-up of the Communist empire. Western governments should do all they sensibly could to help the Poles move towards democratic politics and a market economy. Similar considerations were applying to Hungary, which was seeing the same process but in a rather different way.

42. Waigel gave the Chancellor strong support. The policies of Erhard had won over the policies of Marx. The Paris Summit had already made important statements. There needed to be as flexible as possible rescheduling in the Paris Club. Poland now required expertise as much as economy. One possibility was the despatch of a small group of experts drawn from several countries to help the Poles. Germany would need to come to terms soon on their jumbo loan. Hungary was another case in point.

43. Hashimoto gave strong support to the Chancellor's sentiments. Japan was willing to give support to Poland, though it would be different in nature from the support to other indebted countries. Some Japanese firms had already indicated an interest in building plants in the country.

44. Beregovoy agreed fully with everything that had been said. Debt needed to be rescheduled in accordance with Polish capabilities to pay. It always needed to be borne in mind that Communist governments could evolve as the Polish situation changed. The same process was happening in Hungary. It was worth too to keep an eye on events in the German Democratic Republic.

45. Greenspan thought it important to decide at an early stage the appropriate amount of assistance and its form. The Polish economic structure was bizarre. The USSR had the same problems, but on a much larger scale. Many Eastern European economies were collapsing as the African socialist economies had collapsed. It was important to avoid putting any form of assistance into the

countries which forced the USSR back into its old Stalanist role. Too much aid could be a mistake. He agreed the need for a conceptual advisory group. There were great problems in, for example, the USSR in dealing with the 200 billion rouble overhang because of the lack of proper security markets.

46. Carli observed that the Polish and Hungarian experience was an experiment without precedents. One great problem was the lack of personnel who understood the working of markets. Another was that the basic philosophy of some Solidarity supporters did not have much sympathy with the principles of market economy. To that extent they were rather like the Catholic Communists in Italy. The first problem was to provide food. The IMF experts might not have sufficient experience with Poland's particular problems. It would therefore be important not to superimpose the West's convictions on the country. This prompted Greenspan to say that governments must not support the socialist part of the Polish reform programme. But if the Poles refused to take the West's advice, the West would have to accept the position. Poland either had to go forward to a market economy or back into Stalinism.

47. The meeting then proceeded to the consideration of the draft communique, a final version of which is attached.

48. The meeting concluded at 18.30 hours.

sh10

PUP

FROM: STEPHEN HANKS (IF2)
DATE: 5th October 1989
X 5375

PS/CHANCELLOR 12/2

cc Sir T Burns
Mr Allan
Mr Sedgwick
Mr Melliss
Mr O'Donnell
Miss O'Mara
Mr Owen
Mr Hurst

G7 INTEREST RATES

Attached to this note is a fair copy of the interest rate tables which we supplied you with earlier today.

Stephen Hanks
STEPHEN HANKS

MARKET INTEREST RATES[1]

	G7	UK	US	J	G	Fr	It	Can
Oct 3	7.9	11.9	8.4	4.9	5.3	7.8	11.4	10.6
Oct	7.8	12.1	8.4	4.7	5.1	8.0	11.0	10.4
Nov	8.0	12.3	8.8	4.4	4.9	8.1	11.2	10.8
Dec	8.4	13.2	9.3	4.5	5.3	8.5	12.2	10.8
1989								
Jan	8.5	13.1	9.3	4.6	5.7	8.5	12.1	11.2
Feb	8.9	13.0	9.6	4.7	6.5	9.2	12.5	11.7
Mar	9.2	13.0	10.1	4.8	6.6	9.1	13.4	12.2
Apr	9.0	13.2	10.0	4.7	6.4	8.7	12.5	12.3
May	9.0	13.1	9.7	5.0	7.0	8.9	12.5	12.3
Jun	9.0	14.1	9.2	5.4	7.0	9.0	12.6	12.3
Jul	8.9	13.9	8.8	5.5	7.1	9.2	12.8	12.2
Aug	8.8	13.9	8.8	5.5	7.1	9.0	12.8	12.2
Sept	9.0	14.0	8.8	5.7	7.4	9.2	12.7	12.3
Oct 5	9.3	14.8	9.0	5.7	8.1	9.7	12.8	12.3
Change since								
1 year	1.4	2.9	0.6	0.8	2.8	1.9	1.4	1.9
1 Jan	0.8	1.6	-0.2	1.2	2.5	1.1	1.0	1.3

1 Three month market rates

OFFICIAL INTEREST RATES[1]

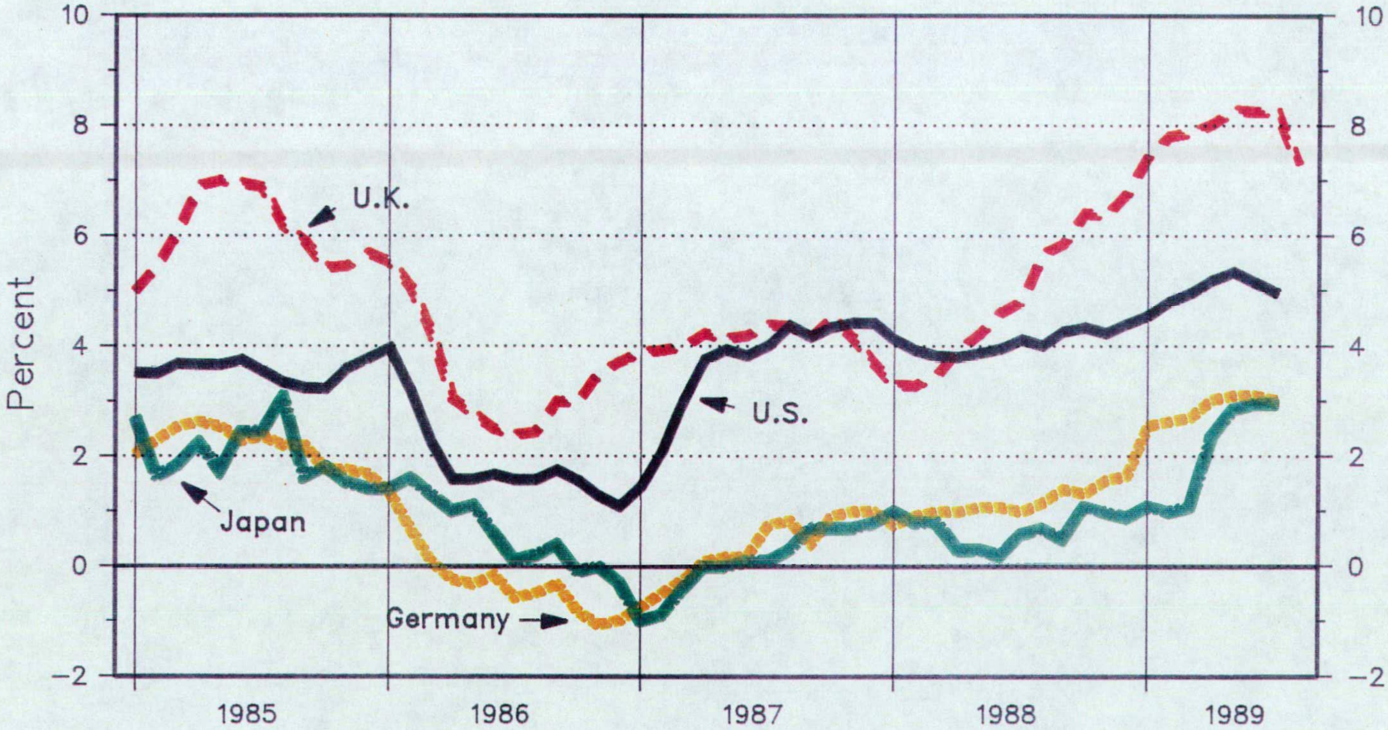
	US	Japan	Germany	France	Italy	Canada	UK
Oct 5	8.38	2½	5	7	12½	10.56	12
Oct	8.30	"	"	7.1	"	10.51	"
Nov	8.35	"	"	7¼	"	10.84	12.5
Dec	8.76	"	5.2	7¾	"	11.17	13
1989							
Jan	9.12	2½	5.8	8	12½	11.54	13
Feb	9.36	"	6	8¼	12½	11.70	"
Mar	9.85	"	6	"	13½	12.40	"
Apr	9.84	"	6.2	"	"	12.61	"
May	9.81	2½	6½	"	"	12.40	13.3
Jun	9.53	3¼	"	8¼	"	12.31	14
Jul	9.32	"	7	8¾	"	12.32	"
Aug	8.99	"	"	"	"	12.39	"
Sep	9.00	"	"	"	"	12.44	"
Oct 5	9.00	3¼	8	9½	13½	12.48	15
Change							
on 1 yr	0.62	¾	3	2½	1	1.9	3
on 1 Jan	0.14	¾	2½	1¾	1	0.94	2

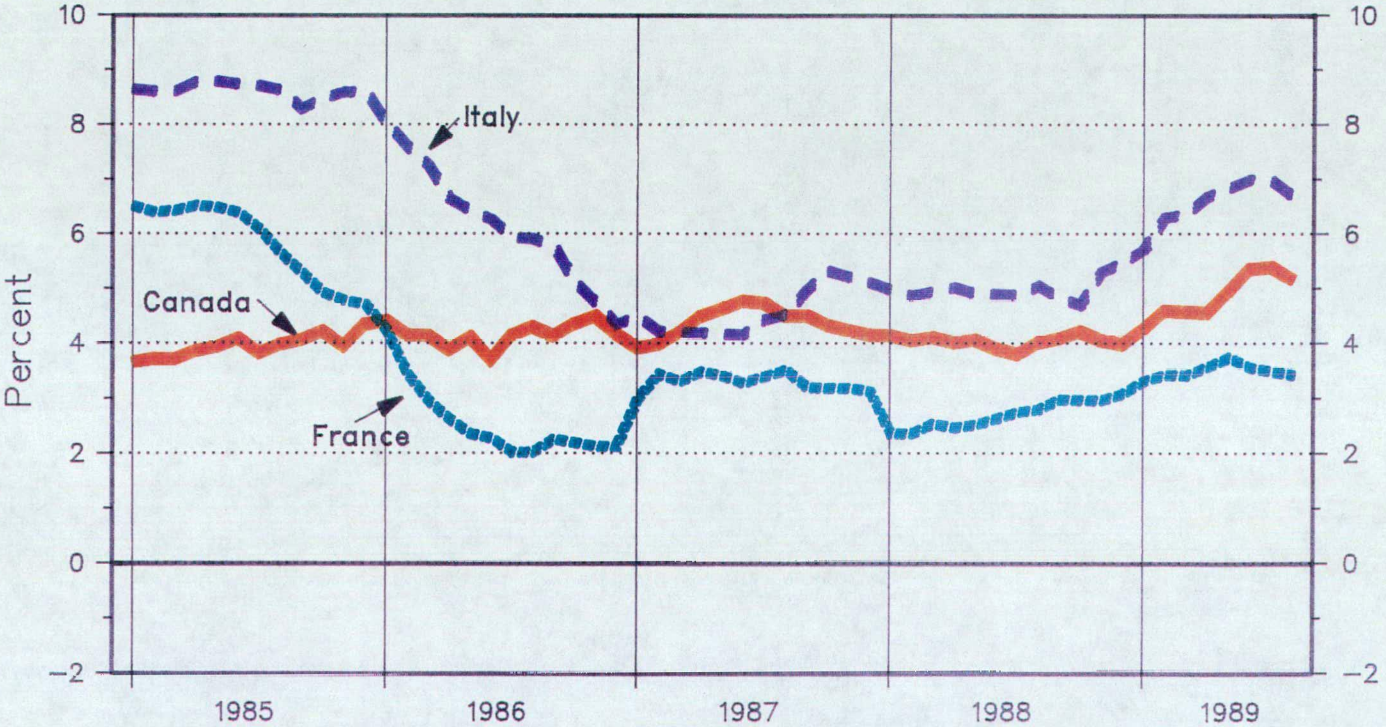
1 Defined as follows: US Fed funds rate, Bank of Japan discount rate, German Lombard rate, Bank of France intervention rate, Bank of Italy discount rate, Canadian Bank rate, UK base rate.

CHART E

Consumer Price Inflation

(Yr/Yr*)





*For each month; rise from 12 months earlier.
Actual data.

OASIA/IMI 9/19/89

CHART B

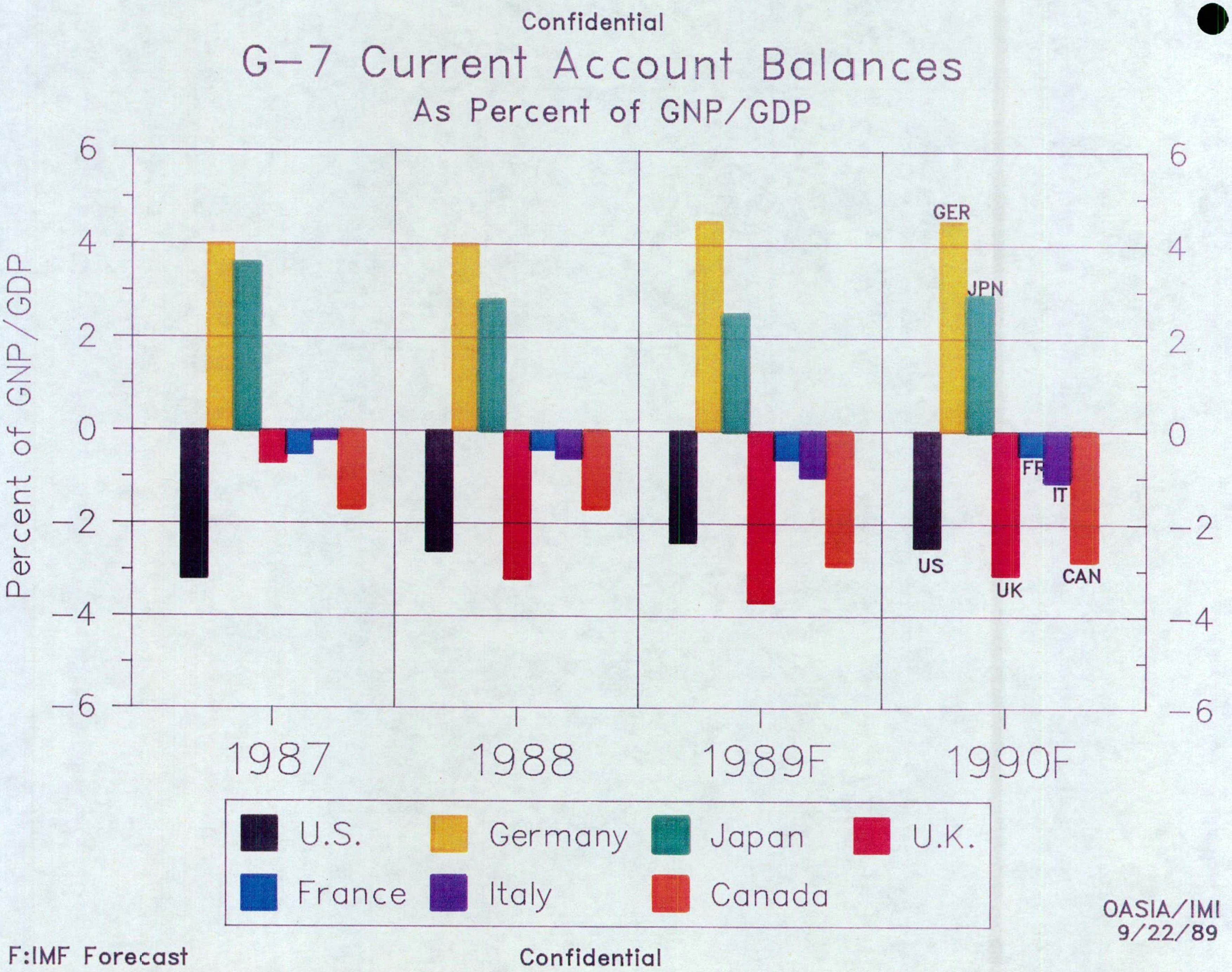

Confidential
G-7 Current Account Balances
As Percent of GNP/GDP
Percent of GNP/GDP
6
4
2
0
-2
-4
-6
GER
JPN
FR
IT
US
UK
CAN
1987
1988
1989F
1990F
U.S.
Germany
Japan
U.K.
France
Italy
Canada
OASIA/IMI
9/22/89
F:IMF Forecast
Confidential

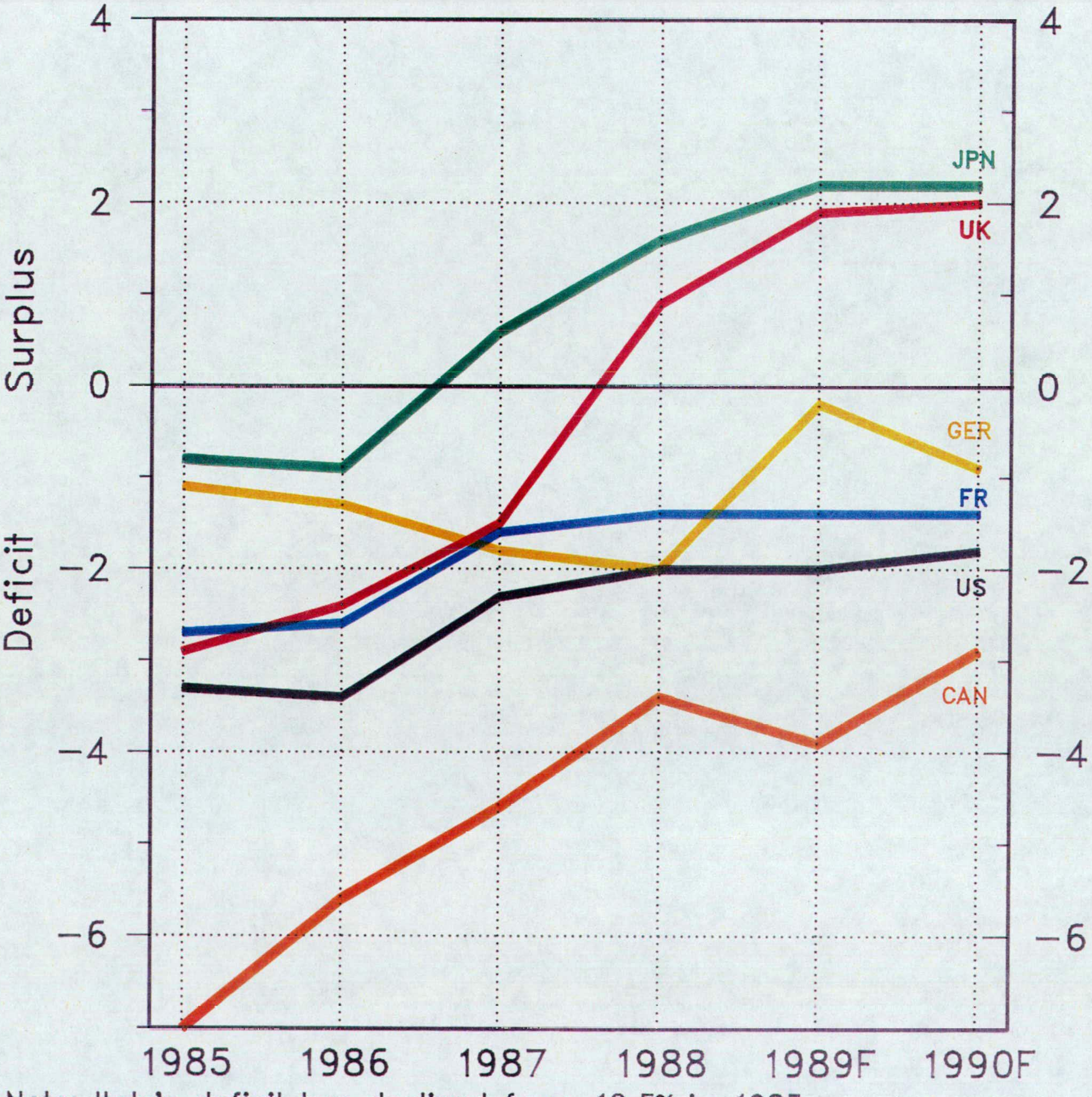
CHART D

Confidential

Fiscal Balances

General Government

(as percent of GNP/GDP)



Note: Italy's deficit has declined from 12.5% in 1985
to 10.6% in 1988

F:IMF Forecast

OASIA/IMI
9/22/89

Confidential

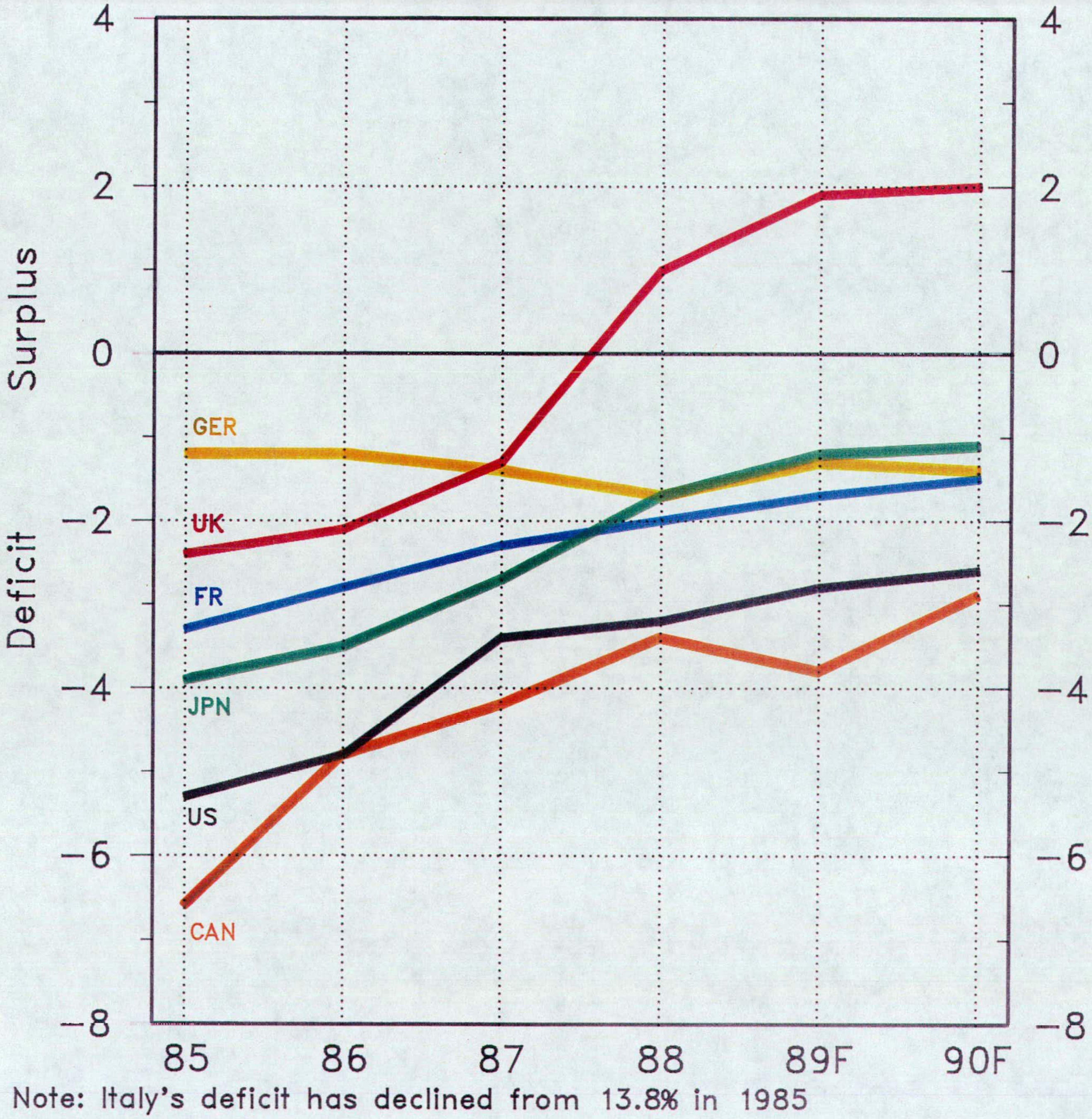
CHART C

Confidential

Fiscal Balances

Central Government

(as percent of GNP/GDP)



Note: Italy's deficit has declined from 13.8% in 1985 to 11.6% in 1988

F:IMF Forecast

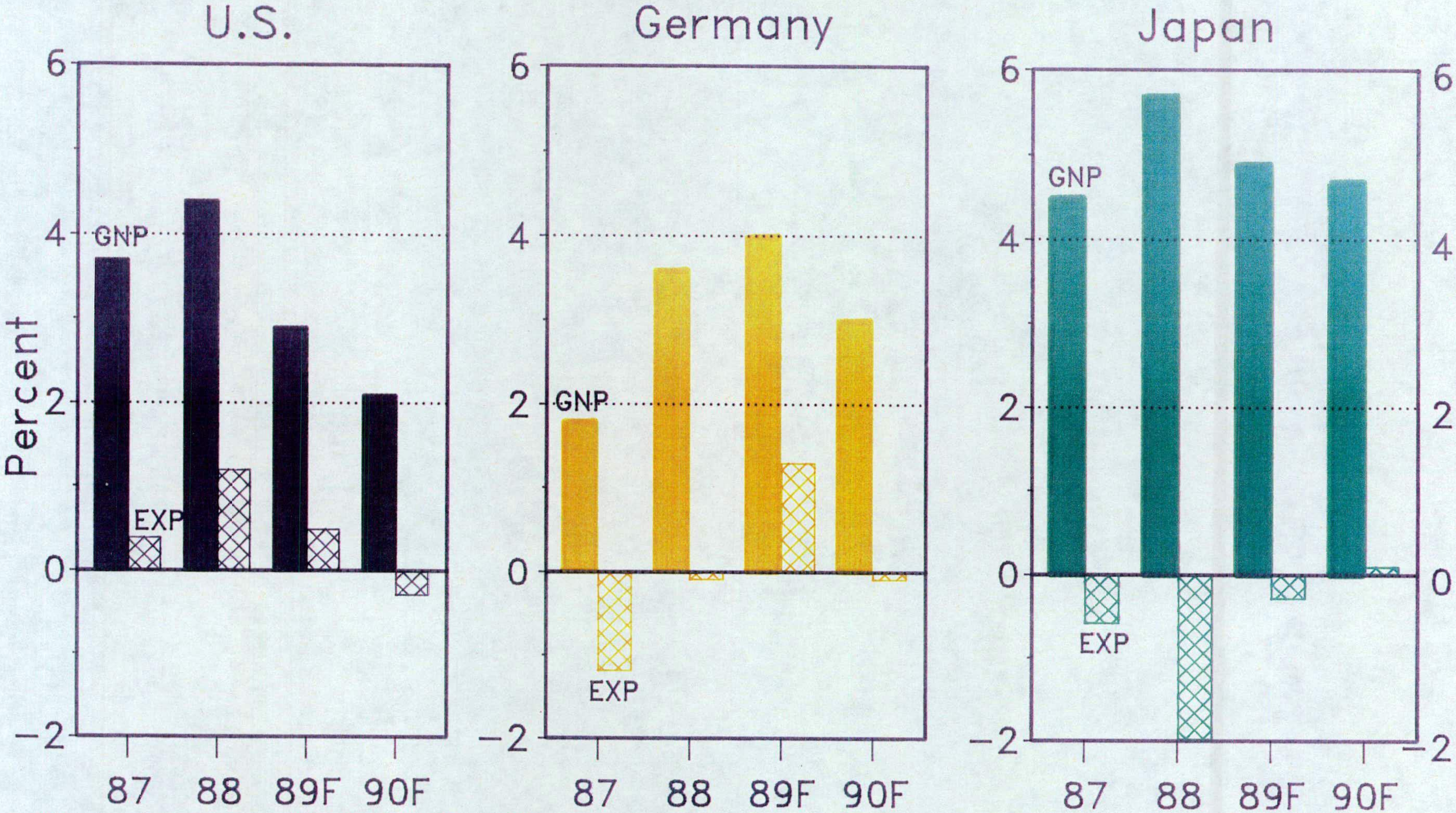
OASIA/IMI
9/22/89

Confidential

CHART A

Confidential

GNP and Contribution of Net Exports to GNP*



*Annual Average Real GNP Growth; net export growth as % of GNP.

OASIA/IMI 9/21/89

F:IMF Forecast

Confidential

SOMMET·TORONTO·SUMMIT

Mr Greive ←

It would be much appreciated if you would send a minute to David Barr, copied to Huw, me, Craig Pickering, T Tarkowski, M Lazar and A Kilpatrick, passing on Ch's thanks for work on briefing (not something I ever thought of doing I'm afraid).

AA

4/10.

chex.jp/jg/63 **UNCLASSIFIED**

PLT

FROM: JOHN GIEVE

DATE: 4 OCTOBER 1989

MR BARR (IF1)

cc Sir T Burns
Mr Wicks
Mr H P Evans
Mr Peretz
Mr A Allan
Mr Mountfield
Mr Bottrill
Mr Pickering
Mr Tarkowski
Mr Lazar
Mr N P Williams
Ms Ryding
Mr Kilpatrick

G7 ANNUAL IMF/IBRD MEETINGS

The Chancellor has asked me to pass on his thanks to all those who prepared briefing for the G7 and annual IMF/IBRD meetings. He noted that this year, in particular, there were a number of developments close to the meetings which required extra work and he found the briefing excellent and useful.

JG

Chx

I hope you don't mind

my taking your name in vain

JOHN GIEVE

UNCLASSIFIED

COMMUNIQUE

PLP

FROM: N L WICKS
DATE: 21 SEPTEMBER 1989
Ext : 4369

CHANCELLOR OF THE EXCHEQUER

cc EST
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Evans
Mr Odling-Smee
Mr A C S Allan
Mr Peretz
Mr Melliss
Mr Lazar

Mr Crockett - B/E

G7: DRAFT COMMUNIQUÉ

Mulford has circulated the draft of a G7 communiqué (Annex A) which he proposes should be discussed at the G7 Deputies' meeting tomorrow afternoon at 5.30 pm in Washington.

2. His draft is shorter and rather better than might have been expected. But there are some changes which we should seek. These are set out in the addition at Annex B. You will see that our draft includes a paragraph on trade. This would be useful, but not essential.

N.L.W.

N L WICKS