PO-CH/NL/0856
PART A

Chex Lawson

PART A

**CONFIDENTIAL**

(Circulate under cover and notify REGISTRY of movement)

PO -CH /NL/0856

PART A

CHANCELLOR'S 1986 PAPERS ON THE INTERNATIONAL MONETARY FUND (IMF) INCLUDING PAPERS FOR THE SPRING AND AUTUMN WASHINGTON MEETINGS

PO -CH /NL/0856

PART A

Begins: 10/1/86

Ends: 8/4/86 (CONTINUED)

DD: 25 years

6/9/95

FROM: P G F DAVIS
DATE: 10 JANUARY 1986

1. SIR G LITTLER
2. CHANCELLOR

cc Mr Lavelle
Mr Fitchew
Mr Mountfield
Mr Denison

**VISIT TO UK OF WORLD BANK PRESIDENT, MR A W CLAUSEN, IN FEBRUARY OR MARCH**

ODA have been asked to advise the World Bank on a choice of dates for Mr Clausen's annual visit to the UK. Two options have been offered: 24-25 February and 2 days in the week beginning 10 March. It has been customary for the World Bank President on his annual visit to see the Chancellor briefly, as well as the Foreign Secretary, the Minister for Overseas Development and the Governor of the Bank of England. Last year, as you will recall, Budget preoccupations prevented your seeing Mr Clausen, and the position might be the same this year. But with the World Bank coming into greater prominence in the context of international debt, and as this will be Mr Clausen's last visit before he hands over to a successor, you may think it worth sparing him 15 or 20 minutes if that were possible. It would help to underline the UK's interest in how the World Bank develops to fill its enlarged role. This is on the assumption, of course, that the February dates, which appear to be the more suitable generally, are chosen.

P G F DAVIS
AEF1

X| If you can spare 15 mins on 24/25 Feb - yes. But no need for you to feel any obligation: you will be able to have a 'farewell talk' in Washington in April.

[illegible] 10/1

Ch/ 'x' shd be possible, tho' perhaps not v. desirable
[illegible]

I will have a farewell talk with Mr C in W'ton in April. [illegible]

FROM: P WYNN OWEN
DATE: 13 JANAURY 1986

**MR P G F DAVIS**

cc Sir Geoffrey Littler
Mr Lavelle
Mr Fitchew
Mr Mountfield
Mr Denison

**VISIT OF MR CLAUSEN**

The Chancellor has seen your minute of 10 January and has decided that he will have a farewell talk with Mr Clausen in Washington in April, but not before.

P WYNN OWEN

CHANCELLOR OF THE EXCHEQUER

Nigel.

Pl arrange for telex below to be sent to Mr Ruding, returning pps + a copy to me.

Thanks.

RS 6/2

Ian

Pl arrange. (Overseas Communications?) Telex not a FCO telegram.

Thanks Nigel

1489/031

From : G E Fitchew

Date : 4 February 1986

PS/CHANCELLOR

C.
OK?

Ro 5/2

cc Sir G Littler o/r
Mr Lavelle
Mr Mountfield
Mr Matthews
Mr Sheridan

**IMF INTERIM COMMITTEE : TELEX FROM MR RUDING**

Mr Ruding's telex of 23 January below seeks the agreement of members of the Interim Committee to Mr Khan, as Chairman of the Development Committee, being invited to take part in the discussions of the Interim Committee on the G10 and G24 reports.

2. I suggest the Chancellor sends a short courtesy reply agreeing to this.

3. I attach a draft letter.

G E FITCHEW

64/007

~~Draft~~ Telex to

H Onno Ruding

Chairman

Interim Committee

Interfund

Many thanks for your message of 23 January. I welcome your proposal that Chairman Khan should be invited to participate in our deliberations of the G10 and G24 Reports. I look forward to hearing from you in due course about our agenda and procedures.

Nigel Lawson

Chancellor of the Exchequer

Mr Sheridan 5565.

We spoke. I would be grateful if you would supply a draft.

SY 27/1.

Mr Matthews

M. [illegible] you draft a short courtesy reply agreeing G.K.?

24/1

CH/EXCHEQUER
REC. 24 JAN 1986
ACTION ~~[illegible]~~
COPIES TO SIR G. LITTLER
MR LAVELLE
MR FITCHEW
MR S. MATTHEWS

86-01-23 21:27
*
262405 TRSY G
FR
NIGEL LAWSON
CHANCELLOR OF THE EXCHEQUER
H.M. TREASURY
LONDON (ENGLAND)
BT
LAST WEEK I HAD USEFUL EXCHANGES OF VIEWS IN WASHINGTON WITH CHAIRMAN KHAN OF THE DEVELOPMENT COMMITTEE, THE MANAGING DIRECTOR OF THE FUND, THE PRESIDENT OF THE WORLD BANK, AND THEIR STAFFS, REGARDING PREPARATIONS FOR THE APRIL 1986 MEETINGS OF THE INTERIM COMMITTEE AND OF THE DEVELOPMENT COMMITTEE. IN THAT CONTEXT I FOLLOWED UP ON MY COMMITMENT IN PARAGRAPH 10 OF THE INTERIM COMMITTEE COMMUNIQUE IN SEOUL DATED OCTOBER 7, 1985, TO COMMUNICATE WITH THE CHAIRMAN OF THE DEVELOPMENT COMMITTEE WITH A VIEW TO SEEING TO WHAT EXTENT ARRANGEMENTS COULD BE MADE FOR COOPERATION ON MATTERS PERTAINING TO DEVELOPMENT IN THE REPORTS ON THE INTERNATIONAL MONETARY SYSTEM THAT HAVE BEEN PRESENTED BY THE GROUP OF 10 AND THE GROUP OF 24. IN THAT CONNECTION I WOULD LIKE TO PROPOSE TO THE MEMBERS OF THE INTERIM COMMITTEE THAT CHAIRMAN KHAN BE INVITED TO PARTICIPATE IN THE DELIBERATIONS OF THE INTERIM COMMITTEE ON THE G-10 AND G-24 REPORTS. I TRUST THAT THIS SUGGESTION MEETS WITH YOUR APPROVAL.
REGARDING THE PROVISIONAL AGENDA OF THE INTERIM COMMITTEE MEETING, AND ITS FORMAT AND PROCEDURES, I WILL COMMUNICATE WITH YOU WHEN THE EXECUTIVE BOARD'S PREPARATORY WORK FOR THE COMMITTEE WILL HAVE PROCEEDED FURTHER.
WITH BEST REGARDS,
H. ONNO RUDING
CHAIRMAN, INTERIM COMMITTEE
INTERFUND
23JAN86
*
262405 TRSY GMMMMM

x pl

FROM: P E DENISON

DATE: 21 February 1986

21/2

1. MR P G F DAVIS
2. CHANCELLOR

C/ Tim Lankester is already provisionally fixing a bilateral for you with Khan, given that you'll miss the Development Committee. But no need to refer to that here. Content with draft?

cc Economic Secretary
Sir P Middleton
Sir G Littler
Mr Lavelle
Mr Fitchew
Mr Mountfield
Mr Culpin
Mr S W Matthews
Mr Sheridan

**DEVELOPMENT COMMITTEE**

OK RO 26/2

We are sorry to trouble you at a particularly busy time, but there would be advantage in your sending a reply to the letter of 17 January from Mr Khan, Development Committee Chairman, about the arrangements for the Spring Meetings.

2. Mr Khan reports that he has been invited to attend the Interim Committee discussions of the G10 and G24 Reports on the International Monetary System, to speak on the issues of interest to the Development Committee. He said he would welcome any views and suggestions to include in his statement. We, and UKDEL IMF/IBRD, suggest that it would be helpful to support his general approach and suggest points that he might reinforce to counterbalance the advice he will undoubtedly receive from developing countries.

x 3. You have already written separately to Mr Ruding, the Chairman of the Interim Committee, agreeing that Mr Khan should participate.

4. The general arrangements Mr Khan has proposed for the conduct of the meetings seem satisfactory.

5. A draft letter to Mr Khan is attached.

P E DENISON

SP

R type final for C's sig!

**DRAFT LETTER FROM THE CHANCELLOR**

H E Ghulan Ishaq Khan
Chairman of the Development Committee
1818 H Street, NW
Washington DC 20433
USA

Thank you for your letter of 17 January about the Interim and Development Committee meetings in April.

2. The arrangements you propose for the Development Committee are satisfactory.

3. I certainly support your aim to advance the work done in Seoul and promote the transfer of real resources to developing countries for overcoming poverty and debt through growth.

4. I welcome too the joint approach to the G10 and G24 Reports and the opportunity you will have to take part in the Interim Committee's discussions. The Development Committee will not have met by then and will not have discussed the Reports but I hope it will be possible for you to reinforce a number of the themes that are important to us.

5. Support for the central role of the IMF is fundamental. This applies both to the healthy funtioning of the international monetary system and to the debt strategy. On the latter, there is growing agreement that the Fund will need to work in increasingly close conjunction with the World Bank. Improving the cooperation between the two institutions is therefore essential. You might usefully welcome the recently renewed growth in World Bank lending and look

forward to a continued expansion, especially in policy-based lending, as the Baker proposals take effect. It will be important to build on the initial impetus these proposals received at Seoul. I imagine you will want to recognise the importance of IDA in the transfer of resources to the developing countries. IDA Deputies may have held further discussions before the Interim Committee meeting, and it should be possible for you to note continuing progress towards the settlement of IDA8 with appropriate priority for the countries of Sub-Sahara Africa. It would be helpful too for you to note the critical need for the developing countries themselves to counter capital flight and to create the conditions likely to encourage non-debt-creating flows.

5. I hope you will also be able to commend the way the issues in the Reports are being addressed at the Spring Meetings. A full discussion in the Interim Committee, with your own contribution on behalf of the Development Committee, should help to focus attention on improving the operation of the present system through better policy coordination of the major countries and strengthened Fund surveillance.

**NIGEL LAWSON**

b/F 4/4 pl

CH/EXCHEQUER

REC. 26 MAR 1986

ACTION MR MOUNTFIELD

COPIES TO CST, EST

SIR P. MIDDLETON

SIR G. LITTLER

MR LAVELLE

MRS CASE

MR S. MATTHEWS.

26/3

THE WORLD BANK
Washington, D. C. 20433
U.S.A.

A. W. CLAUSEN
President

March 21, 1986

Dear Nigel:

I thought you would be interested in the attached table, which sets out the status of programs and associated financing for highly-indebted middle-income countries identified by Secretary Baker in the context of the 1985 Bank/IMF Annual Meetings. As the second column of the table shows, many of the countries that have accepted the need for adjustment already have financing programs in place which run through all or part of 1986; some programs extend into 1987. For several countries (Argentina, Mexico, Morocco, Ivory Coast), discussions of future financing programs are already under way or are scheduled to commence shortly. Public perception that little action is occurring in response to the Secretary's initiative does not therefore reflect the true situation.

The last columns of the table describe The World Bank's lending operations, and indicate a number of important developments: first, sizable increases in new loan commitments in 1985 as compared with 1982; second, a doubling of gross disbursements between 1982 and 1986; and third, the considerable proportion of our resources devoted to adjustment lending in many of these countries in 1986-1987.

While much still depends on what can be agreed with Mexico and Brazil, I would expect that World Bank lending to these 14 countries will exceed $6 billion this year, a little less than half of our total lending. More could have been accomplished, and indeed still may be. There has, however, been little progress with Nigeria, while Yugoslavia's decision-making process has thus far stifled structural change; and the political situation in the Philippines has postponed action on structural adjustment there.

Warm regards.

Sincerely,

The Right Honourable
Nigel Lawson, P.C., M.P.
Chancellor of the Exchequer
H. M. Treasury
Parliament Street
London SW1P 3AG
United Kingdom

Status of Programs for
Highly Indebted Countries
(as of March 18, 1986)

| | Commercial Bank Agreements | | | | | World Bank Lending and Disbursement Data | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | New Loans $ million | | Gross Disbursements | | | Estimated Share of Adjustment Lending (%) |
| Country | Time Period Already Covered | Amounts | Paris Club | IMF | World Bank Actions | 1982 | 1985 | 1982 | 1985 | 1986 (est.) | 1986 - 1987 1/ |
| ARGENTINA | August 1985 - May 1986 | Rescheduled: $13.9 billion New Money: $4.2 billion | Under discussion | Standby: Dec. 1984 - March 1986. Amount: SDR 1419m | The Bank's first loan in support of the adjustment process is the agriculture sector loan ($350m. - Board consideration in April), which would bring total FY86 lending to over $400m. Operations to support industrial sector, trade policy and energy sector reforms are foreseen as part of the 1986-87 financial support package. | -- | 240 | 83 | 144 | 350-450 | 64% |
| BOLIVIA | -- No substantive discussions underway -- | | | Currently considering possibility of a Standby Agreement and Compensating Finance Facility Agreement. | Government has undertaken reforms in exchange rate regime, trade and domestic price liberalization, but major problems with fiscal deficit continue. Bank is preparing a Rehabilitation Import Credit for Board presentation this fiscal year. | -- | -- | 19 | 11 | 10-25 | 50% |
| BRAZIL | 1986 | Tentative agreement reached on amounts due in 1985 and 1986 totaling $15.5 billion. | No agreement. | No agreement in place. | Bank will continue to support Brazilian reform efforts. Some $1.3 billion of Bank lending is programmed for FY86 primarily in support of agriculture, rural and urban development and power sectors. | 1090 | 1648 | 623 | 760 | 1175 | 23% |
| CHILE | 1985 - 1987<br>1985 - 1986 | Rescheduled: $5.7 billion New Money: $1.085 billion (including $150m IBRD guaranteed) | Period: Jan. 1985 - Dec. 1987 Amount: $170m. | EFF: Jan.85 - Dec. 1987 Amount: SDR 750m | Financial support for medium-term adjustment program arranged with close Bank involvement: Chile SAL I approved October 1985 ($250m), Highway Sector A-Loan ($140m) and Bank $150m. guarantee of total $300m. commercial bank cofinancing. Bank support of program also provided through Industrial Sector loan ($100m - July 85) and Small and Medium Scale Enterprise loan ($40m - August 85). SAL II expected to be appraised mid-1986. Total FY86 Bank lending approved is $456m. | -- | 541 | 32 | 231 | 365 | 62% |

1/ Loans already approved or under active discussion.

| Country | Commercial Bank Agreements: Time Period Already Covered | Commercial Bank Agreements: Amounts | Paris Club | IMF | World Bank Actions | World Bank Lending and Disbursement Data: New Loans $ million 1982 | New Loans 1985 | Gross Disbursements 1982 | Gross Disbursements 1985 | Gross Disbursements 1986 (est.) | Estimated Share of Adjustment Lending (%) 1986 - 1987 1/ |
|---|---|---|---|---|---|---|---|---|---|---|---|
| COTE D'IVOIRE | -- <br> 1985 | Discussions currently underway. Total amortization due 1986-1989 is $1.1 billion <br> New Money: $132m cofinanced with WB Hwy. Sector loan of $110m. | To be discussed following Fund Agreement | Fund currently discussing new Agreement to take effect commencing June 1986 (probably a 2-year standby for about SDR 100m). | Bank currently negotiating SAL III for $250m. to support medium-term adjustment program. | 158 | 207 | 223 | 70 | 140-195 | 39% |
| MOROCCO | -- | Discussions of rescheduling of 1985-1986 amounts currently underway. Total amortization due 1985-86 is $836 million. | Period: Jan. 85 - Feb. 1987. Amount: $2191m | Standby Agreement Sept. 85 - Feb. 1987 Amount: SDR 200m. SDR 10m drawn in Sept. 85; Subsequent drawings not made due to noncompliance with Fund targets. | Bank has made two Industrial and Trade Policy Adjustment (ITPA) loans in support of medium-term adjustment (ITPA I - $150m., Board - Jan. 1984, ITPA II - $200m. Board - July 1985). An Education Sector Reform loan ($150m) is scheduled for Board consideration in late March. A Public Enterprise Reform loan ($200m) is under consideration for FY87. Total Bank FY86 lending may be $550-600 million. | 166 | 381 | 134 | 307 | 370 | 40% |
| NIGERIA | Oct. 1983 - Dec. 1986 | $5.5 billion Debt rescheduling. $3 billion Trade Credits. New Money: $925 million. | No agreement | No agreement | Level of Bank support hinges on agreement on a sustainable medium-term adjustment program, and Government capacity to provide administrative approval of operations already negotiated. | 247 | 236 | 144 | 271 | 215 | 0% |
| PHILIPPINES | Through December 1985 | Continued coverage hinges on IMF review originally scheduled for Feb. 86. | Period: Jan. 85 - Dec. 1986. Amount: $800m. | IMF standby Oct. 1985 - June 1986 Amount: SDR 615m. | The Bank made two SALs to the Philippines in FY81 and FY83. Present program is supported by loans for agriculture and financial sector reforms. Future support would first focus on restructuring Government corporations. | 533 | 104 | 251 | 233 | 280 | 0% |
| YUGOSLAVIA | 1985 - 1986 | Amount: $3.6 billion. No new money. | Discussions to be scehduled in next 4-8 weeks. | IMF standby May 1985 - Dec. 86 Amount: SDR 300m. | Bank discussing SAL II with authorities for over a year. Although stabilization measures are in place, progress on medium-term structural adjustment is slow. | 136 | 253 | 330 | 295 | 310 | 33% |
| | | | | | Total | 3752 | 5414 | 2672 | 3949 | 5490-5695 | |

1/ Loans already approved or under active discussion.

| Country | Commercial Bank Agreements: Time Period Already Covered | Amounts | Paris Club | IMF | World Bank Actions | World Bank Lending and Disbursement Data: New Loans $ million 1982 | New Loans 1985 | Gross Disbursements 1982 | Gross Disbursements 1985 | Gross Disbursements 1986 (est.) | Estimated Share of Adjustment Lending (%) 1986 - 1987 1/ |
|---|---|---|---|---|---|---|---|---|---|---|---|
| COLOMBIA | 1986 - 1987 | No rescheduling. New money: $1 billion | No agreement | IMF has agreed to monitor targets | Bank supporting this adjustment effort with a Trade Policy and Export Diversification loan (June 85 - $300m); a Trade and Agriculture Sector loan is being processed - $250m for Board approval in April/May 1986. Total FY86 Bank lending about $700 million. | 297 | 703 | 277 | 586 | 600 | 25% |
| ECUADOR | 1985 - 1989<br>1986 | Rescheduled: $4.2 billion<br>New Money: $200 million | Period: 1985-1987 Amount: $392m | Standby Jan. 1985 - Mar. 1986 Amount: SDR 105m | Adjustment program supported by Agriculture Sector Loan (Oct. 85 - $100m). Industrial Finance project ($100m) and a Small-Scale Enterprise project ($30m) are also scheduled for Board consideration in FY86. | 152 | 106 | 41 | 40 | 65-100 | 36% |
| MEXICO | August 1985 - December 1999 | Rescheduled: $48.7 billion Debt rescheduling being sought by Mexico - no agreement yet. | No agreement | EFF: Dec. 82 - Dec. 85; due to partial non-compliance last two tranches not drawn. 1985 Emergency Facility: SDR 219m Standby currently under discussion. | Bank currently processing a Trade Policy loan in support of Government´s trade liberalization efforts ($500m). Total FY86 Bank lending, excluding the trade loan is expected to be about $1 billion including an earthquake reconstruction loan. | 540 | 928 | 408 | 840 | 1420 2/ | 30% 3/ |
| PERU | | No agreement | No agreement | No agreement | | 433 | 18 | 85 | 131 | 130 | 0% |
| URUGUAY | January 1985 - December 1989<br>1986 | Rescheduled: $2 billion<br>New Money: $45 million Hydropower Cofinancing | No agreement | Standby: Sept. 85 - Dec. 86 Amount: SDR 122m | Negotiations are about to conclude on voluntary cofinancing of $45m to match a Bank loan of $45m for a hydropower project; Bank loan approved Sept. 1985. This is the first voluntary lending to region since 1982; offering is oversubscribed. | --- | 49 | 22 | 30 | 60 | 65% |

1/ Loans already approved or under active discussion
2/ Incl. Trade Policy loan
3/ Incl. fast disbursing Emergency Reconstruction loan.

FROM: P WYNN OWEN
DATE: 26 March 1986

PWP

PS/CHIEF SECRETARY

cc PS/Economic Secretary
Sir G Littler
Mr F E R Butler
Mr Lavelle
Mr Mountfield
Mr Turnbull
Mr C D Butler
Mr Fitchew
Mr P Davies
Mrs Case
Mr Denison
Mr Lankester - UKDEL

**MIGA**

The Chancellor discussed Mr Mountfield's minute of 26 March to the Chief Secretary with the Foreign Secretary today.

2. He thinks the Foreign Secretary seems content with this solution, but notes we will, of course, need agreement in writing. The Chancellor thinks this is a sensible and satisfactory outcome.

R.

P WYNN OWEN

2569/32

CONFIDENTIAL

From: P MOUNTFIELD
Date: 26 March 1986

**CHIEF SECRETARY**

cc Chancellor
Economic Secretary
Sir G Littler
Mr F E R Butler
Mr Lavelle
Mr Turnbull
Mr C D Butler
Mr Fitchew
Mr P Davis
Mrs Case
Mr Denison

Mr Lankester - UKDEL

The For Sec: content with this solution, but we will need agreement on grounds. It is a sensible & satisfactory outcome.

To note. You may wish to change that the Foreign Sec agrees in full with points (a) to (e).

RO 26/3

**MIGA (MULTILATERAL INVESTMENT GUARANTEE AGENCY)**

This note records the agreement I reached last night - ad referendum on both sides - with Crispin Tickell. I understand that the Foreign Secretary may be briefed to mention it to the Chancellor when they meet later today. Subject to that, I hope you will endorse it. We then have a firm agreement so that the Chancellor can announce our decision during the Interim/Development Committee meetings next month.

The elements of the deal are:

(a) The costs of the UK subscription will be met 50/50 from the Reserve and from the agreed Aid Programme: at present exchange rates, around £1.5 million from each.

(b) ODA will take departmental responsibility for administering the UK interest.

(c) Treasury will allow three extra posts to ODA for this purpose (in practice I doubt if they will be needed after a year or so's setting-up phase).

(d) If ODA run into difficulty on their running-cost target by mid-year as a result, Treasury will agree the necessary increase.

(e) DTI and ECGD undertake to provide the necessary technical support (eg joint attendance at international meetings). I have agreed this with officials in both Departments.

2. The main problem is (a), but you told me you were prepared to settle on this basis. The other concessions are irritating but trivial. What matters is (b) - this operation belongs with ODA's other responsibilities for the World Bank family (of which MIGA is part) and for encouraging financial flows to Third World countries. Having this responsibility for promoting private-sector flows will be useful in changing ODA's excessively aid-orientated approach.

3. If you agree (and ODA confirm the Foreign Secretary's approval) we will arrange an exchange of Private Secretary letters to record the deal.

PM

**P MOUNTFIELD**

Top copy of 'X' PI

FROM: P G F DAVIS
DATE: 1 APRIL 1986

PS/CHANCELLOR

cc PS/Chief Secretary
Sir G Littler
Mr Lavelle
Mr Milligan
Miss Long

X1 **MR CLAUSEN'S LETTER OF 21 MARCH**

We shall append Mr Clausen's letter and the table attached to it on the status of programmes for highly indebted countries to the Chancellor's briefing for the Spring meetings. I attach a draft letter of acknowledgement.

2. It might be appropriate to mention in the reply that the Chancellor hopes to have a talk with Mr Clausen in Washington (Mr Wynn Owen's minute to me of 13 January).

P G F DAVIS
AEF1

CONFIDENTIAL

PS/Cx
PS/EST
Sir G. Littler
Mr Battle
Mr Lavelle
Mr Mountfield
Mr Turnbull
Mr C.D Butler
Mr Fitchew
Mr Milligan
Miss Long
Mr P.G.F. Davis

CHIEF SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

L V Appleyard Esq
Private Secretary to the
Secretary of State
Foreign Office
King Charles Street
London
SW1

1 April 1986

Dear Len,

**MIGA**

The Foreign Secretary and the Chancellor of the Exchequer discussed, on 26 March, the following solution to the question of departmental responsibility for UK membership of the Multilateral Investment Guarantee Agency, subject to agreement in writing:

a. ODA will take departmental responsibility for administering the UK interest in MIGA;

b. half of the cost of the UK subscription to MIGA will be met from the Reserve and half from the agreed Aid Programme;

c. Treasury will allow 3 extra posts to ODA for the work;

d. if ODA run into difficulty on their running costs target by mid-year as a result, Treasury will agree the necessary increase.

DTI and ECGD officials have agreed to provide the necessary technical support (e.g. joint attendance at international meetings).

The Chief Secretary would be grateful for formal agreement to this arrangement. He hopes that the way is now clear for an announcement to be made at the Spring Meetings that the UK is ready to sign the MIGA Convention, and, if appropriate, for us to sign there and then.

I am copying this to John Mogg (DTI), Mark Denham (ODA) and to Michael Stark (Cabinet Office).

Yours sincerely,

Jill

**JILL RUTTER**

CCI/1298

CONFIDENTIAL

R P

FROM: **JILL RUTTER**

DATE: **1 April 1986**

MR MOUNTFIELD

cc:
Chancellor
Economic Secretary
Sir G Littler
Mr F E R Butler
Mr Lavelle
Mr Turnbull
Mr C D Butler
Mr Fitchew
Mr P Davis
Mrs Case
Mr Denison
Mr Lankester - UKDEL

**MIGA (MULTILATERAL INVESTMENT GUARANTEE AGENCY)**

The Chief Secretary has seen your minute of 26 March. He understands that the Foreign Secretary is content with the agreement set out in your minute.

2 He is delighted that a deal has been done and has commented "well done".

Jill Rutter

**JILL RUTTER**
**Private Secretary**

CONFIDENTIAL

Pps p1

FROM: P G F DAVIS
DATE: 1 APRIL 1986

PS/CHIEF SECRETARY

cc PS/Chancellor
PS/Economic Secretary
Sir G Littler
Mr F E R Butler (or)
Mr Lavelle
Mr Mountfield (or)
Mr Turnbull
Mr C D Butler
Mr Fitchew
Mr Milligan
Miss Long

**MIGA**

Mr Wynn Owen's minute of 26 March recorded that the Foreign Secretary seemed content with the solution to the question of departmental responsibility for UK membership of the Multilateral Investment Guarantee Agency, which the Chancellor put to him in discussion, but that he wanted agreement in writing. I have spoken to the Chancellor's Office and to ODA, and I think the best way to clinch the matter would be for you to write to the FCO. I attach a draft letter which sticks closely to the wording in Mr Mountfield's submission to the Chief Secretary of 26 March.

2. It was envisaged that if departmental responsibility could be settled in time, the Chancellor would announce the UK's intention to sign the MIGA Convention when he attends the Spring Interim/Development Committee Meetings in Washington next week. It would be useful if the letter could give the Foreign Secretary the opportunity of assenting to this, and sound him out on the question of our actual signature, which conceivably should best be done at the same time: the Foreign Secretary may now have views on who should sign and when, and there is not much time for this to be settled. ODA are content for this matter to be handled in this way.

P G F DAVIS
AEF1

**DRAFT LETTER FROM PS/CHIEF SECRETARY TO PS/SECRETARY OF STATE FOR FOREIGN AND COMMONWEALTH AFFAIRS**

cc PS/Secretary of State for Trade and Industry
PS/Minister for Overseas Development
PS/Sir Robert Armstrong

**MIGA**

The Foreign Secretary and the Chancellor of the Exchequer discussed, on 26 March, the following solution to the question of departmental responsibility for UK membership of the Multilateral Investment Guarantee Agency, subject to agreement in writing:

a. ODA will take departmental responsibility for administering the UK interest in MIGA;

b. half of the cost of the UK subscription to MIGA will be met from the Reserve and half from the agreed Aid Programme;

c. Treasury will allow 3 extra posts to ODA for the work;

d. if ODA run into difficulty on their running costs target by mid-year as a result, Treasury will agree the necessary increase.

DTI and ECGD officials have agreed to provide the necessary technical support (eg joint attendance at international meetings).

2. The Chief Secretary would be grateful for formal agreement to this arrangement. He hopes that the way is now clear for an announcement to be made at the Spring Meetings that the UK is ready to sign the MIGA Convention, and, if appropriate, for us to sign there and then.

3. I am copying this to ...

RT8.49

cc PS/CST
Sir G Littler
Mr Lavelle
Mr Milligan
Miss Long
Mr Davis

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

~~b/f 4/4 (PL)~~

2 April 1986

Mr A W Clausen
President
The World Bank
Washington DC20433
USA

b/f 7/4

Dear Mr Clausen

In the Chancellor's absence from the office, I am writing to acknowledge your letter of 21 March and table of the Status of Programmes for Highly Indebted Countries. Mr Lawson looks forward to the opportunity of having a talk with you in Washington.

Yours sincerely

A W Kuczys

A W KUCZYS
Private Secretary

1492/041

From : A B Milligan

Date : 3 April 1986

PS/CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lavelle
Mr Fitchew
Mr Mountfield
Mr Culpin
Mr Davis
Mr Matthews
Miss Barber
Mr Pitcairn
Mr Sheridan
Mr Denison

Mr Reilly (FCO)
Mr Barnes (ODA)
Mr Ware (B/England)
Mr Lankester - UKDEL

**BRIEFING FOR IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS, 9-11 APRIL**

I attach two sets of the final briefing prepared for the forthcoming Spring meetings (see index attached). These have been approved by Sir G Littler and agreed with ODA, FCO and the Bank. A separate comprehensive speaking note for the Interim Committee is being submitted by Mr Fitchew.

Andrew Milligan

A B MILLIGAN

**INDEX TO INTERIM/DEVELOPMENT COMMITTEE BRIEFING**

| No. | Title |
|---|---|
| 1. | World Economic Outlook |
| 2. | Debt situation and strategy (covering Baker, bank provisions, export credits, CFF, Fund/Bank collaboration and Annex on Trust Fund) |
| 3. | SDR allocations |
| 4. | Consideration of issues in G10/G24 Reports on the international monetary system |
| | (a) Functioning of the Exchange Rate System |
| | (b) Surveillance |
| | (c) Management of International Liquidity and the Role of the SDR |
| 5. | World Bank Paper on the Major Debtors |
| 6. | Sub Saharan Africa |
| 7. | World Bank Issues (covering GCI, IDA8, IFC) |
| 8. | MIGA |
| 9. | Problem Countries |
| 10. | Follow Up Report on Task Force on Concessional Flows. |

C.

Two folders, though the second, as last year, is largely background bulky fund ppro.

Rachel asked me to remind you to use the US trip to discuss the job, IDT and speeches with Robert Culpin.

Worth reading all this folder; though some points are clearly more for Development Committee (DC) than Interim Committee (IC) there is clearly much overlap.

A few points:-

BILATERALS: should be possible hopefully with

- Baker
- Clausen
- Khan
- Herzog.

I doubt you'll have time for any more.

MIGA: The Foreign Sec returns on Sunday and we should hear early on Monday whether he has any difficulty with you telling the IC of UK joining and signing up for the UK.

CHANCELLOR OF THE EXCHEQUER

Either his office or this one (I don't think it matters which) will then have to minute No 10 on Monday notifying them of what is planned.

A note from AEF on current position will follow later today.

UK INITIATIVES: Besides MIGA, you'll see the briefs include 2 lines to take you'll want to play up:-

- internationalisation of reserves (Brief 4a, Point to make g)
- Surveillance - collection/exchange of data (Brief 4b)

Various other relevant bits and pieces to follow later today and Monday.

Mr Ross-Goobey has promised the New York redraft by 4pm today.

Rus 4/4.

1492/041

From : A B Milligan

Date : 3 April 1986

PS/CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lavelle
Mr Fitchew
Mr Mountfield
Mr Culpin
Mr Davis
Mr Matthews
Miss Barber
Mr Pitcairn
Mr Sheridan
Mr Denison

Mr Reilly (FCO)
Mr Barnes (ODA)
Mr Ware (B/England)
Mr Lankester - UKDEL

**BRIEFING FOR IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS, 9-11 APRIL**

I attach two one removed sets of the final briefing prepared for the forthcoming Spring meetings (see index attached). These have been approved by Sir G Littler and agreed with ODA, FCO and the Bank. A separate comprehensive speaking note for the Interim Committee is being submitted by Mr Fitchew this afternoon (Friday).

Andrew Milligan

A B MILLIGAN

FROM: P G F DAVIS
DATE: 4 APRIL 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir G Littler
Mr Lavelle
Mr Fitchew
Mr Mountfield
Mr Culpin
Miss Long

C/ To note. We await Foreign Sec's judgement on Monday.
RS 4/4

**MIGA**

ODA propose to advise the Foreign Secretary, when he returns from India on Sunday, that you should be given the power to sign the MIGA Convention while you are in Washington next week. This would go naturally with your announcement of our decision to become a founder member. A suitable opportunity might occur on Wednesday morning when I understand you will be seeing Mr Clausen (see Brief No 7, Background paragraph 10).

2. According to FCO the power required is a Queen's Full Power, which the Foreign Secretary will have to request. As there is no possibility of the formal Power being ready before you leave for Washington, the plan is to telegraph it to Washington with an assurance that the formal document will be deposited later. We understand that this is a well-established procedure. We should know on Monday whether the Foreign Secretary has agreed, as he is expected to, that this is the way to proceed.

3. At that point we expect the Foreign Secretary's office to let the Prime Minister's office know what is happening and confirm the arrangements for departmental responsibility which you discussed with the Foreign Secretary on 26 March.

4. ODA are preparing a Press Announcement for issue, if

appropriate, on Wednesday. They will clear it with us and the DTI. You will no doubt wish the matter to be covered in the Press arrangements in Washington.

Peter Davis

P G F DAVIS
AEF1

3057/005

From : G E Fitchew

Date : 4 April 1986

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lavelle
Mr Mountfield
Mr Culpin
Mr Davis
Mr Matthews
Miss Barber
Mr Pitcairn
Mr Sheridan
Mr Denison
Mr Milligan

Mr Reilly (FCO)
Mr Barnes (ODA)
Mr Ware (B/England)
Mr Lankester (UKDEL)

C/ Holes made for you to insert into your IMF folder.
But any feedback prior to our departure on Tuesday would be helpful.
R 4/4

**IMF INTERIM COMMITTEE MEETINGS : DRAFT SPEAKING NOTES**

I attach below a draft speech in fairly full note form on which you could draw at the morning formal session of the Interim Committee. This covers :-

- the World Economic Outlook;
- exchange rate regime and multilateral surveillance;
- debt.

2. The notes draw on, but are not everywhere identical with, the Line to Take sections in the individual briefs. In particular, the section on debt faces head-on (and rejects) the debtors' demands for interest rate concessions or other generalised debt relief. In the most recent discussions in the Executive Board the LDCs have started to work up a good head of steam in support of such schemes; and the Line to Take in the debt brief may be a little too bland and optimistic.

3. The speech, as it stands, will almost certainly be too long to deliver for the seven minutes allocated to you in the formal

session, though it would be possible for the full text to be read into the record and drawn on by Mr Culpin (though not released) for press briefing. I suggest that for delivery the section on exchange rates and multilateral surveillance could be largely omitted, since these topics will be discussed in the more informal afternoon session.

G E FITCHEW

4650

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

C

The Foreign Secretary would like to have a word with you today on the telephone about EMS.

Would you be content to speak to him just before your 3.15 meeting here?

D
7/4

233-4650
Sandra Philips

FROM: P WYNN OWEN
DATE: 7 April 1986

SIR G LITTLER

cc Mrs Lomax
Mr Culpin
Mr Kuczys
Mrs Lester

**TELEPHONE CONVERSATION WITH THE FOREIGN SECRETARY**

The Chancellor had a brief telephone conversation with the Foreign Secretary at 3.15pm today.

2. The Foreign Secretary said he was ringing about the ERM realignment, but he would also value a discreet word about related matters in the near future. The Chancellor agreed Diary Secretaries should fix this up.

3. The Foreign Secretary suggested the Chancellor should beware of rubbishing the weekend's events in any way when speaking to the Prime Minister. The Chancellor was fully aware of that point. The weekend had resulted in a perfectly reasonable outcome in the circumstances, though it was arguably wholly unnecessary.

4. The Foreign Secretary said he hoped the Chancellor might be able to make a concession on SDR allocations in Washington. The Chancellor said there was no need for this. Pressure for a IDA replenishment and the GCI for the IBRD, plus his signing up to MIGA, added up to sufficient positive signals. If the SDR point was conceded, those pressing for it would find that it did not add up to much in practice. There was no need to be out in front on that particular issue. The Foreign Secretary agreed MIGA was now all settled.

5. Robert Culshaw (PS/Foreign Secretary) later rang to confirm that the Foreign Secretary was content for the Chancellor both to announce and sign up to MIGA in Washington this Wednesday. Mr Culshaw will be writing to No 10 today to inform them of this outcome. He suggested Press Offices could liaise on handling.

Rp.

P WYNN OWEN

Foreign and Commonwealth Office

London SW1A 2AH

7 April 1986

C/ X does not surprise me. Y is what we need for the time being. RO 7/4

CH/EXCHEQUER
REC. -7 APR 1986
ACTION CST
COPIES TO

7/4

PS/Ch — Culpan LS arrange ballyhoo: let me see draft ASAP (via SL) point out that Lawson one of the prime movers for this, & has been one of the founder members, (etc etc).

Dear Jill,

Multilateral Investment Guarantee Agency (MIGA)

Thank you for your letter of 1 April. I confirm that we are content with the arrangements set out at (a) to (d) for the transfer of responsibility for MIGA from the Treasury to the ODA.

X I must reserve the Foreign Secretary's position on the question of contingent liabilities arising from membership of MIGA. It is to be hoped that the prospect of calls being made upon the guarantees provided by members is remote; but if such claims arose they could be for large sums, which could not be contained within FCO spending ceilings. This would have to be a matter for further discussion if and when it arose.

So far as technical support from DTI and ECGD officials is concerned, we understand that this will take the form of full and comprehensive back-up on all specialised aspects of investment guarantees, analagous to that which the Treasury and the Bank of England already provide to the ODA on certain aspects of multilateral banking. We envisage that this would involve a substantial input by DTI and ECGD officials on a continuing basis.

Y. We also see political advantage in an announcement being made at the Spring Meetings that the UK is ready to sign the MIGA Convention. It should indeed be possible for the Chancellor to sign when he calls on the President of the World Bank on the morning of Wednesday 9 April. Full Powers will be needed, and we shall have to telegraph them to Washington today or tomorrow. Formal Full Powers, approved by the Foreign Secretary and signed by The Queen, will be deposited later.

I am copying this letter to Philip Wynn Owen (Treasury) John Mogg (DTI), Martin Dinham (ODA), and Michael Stark (Cabinet Office).

Yours ever,

Robert Culshaw

(R N Culshaw)
Private Secretary

Miss J K Rutter
PS/Chief Secretary
HM Treasury

SECRET

10 DOWNING STREET

From the Private Secretary

CH/EXCHEQUER

| | |
|---|---|
| REC. | -7 APR 1986 |
| ACTION | SIR G. LITTLER |
| COPIES TO | CST, FST, MST, EST, |
| | SIR P. MIDDLETON |
| | Mr LAVELLE |
| | Mr CULPIN |

Mr MOUNTFIELD
Mr FITCHEW
Mr P. DAVIS.

7/4

7 April 1986

C/ See X (and XX in Shultz letter).

RP 7/4

I enclose a copy of a letter to the Prime Minister from Secretary Shultz about the idea of establishing a regional development fund for the states of the Middle East. The idea apparently emerged in the course of Mr. Peres' recent visit to Washington. Mr. Shultz invites the Prime Minister's reaction and advice. You will note that it is also intended to raise the matter in the margins of the IMF/IBRD Interim and Development Committees in Washington.

X

I should be grateful for a draft reply in due course.

I am copying this letter and enclosure to Rachel Lomax (H.M. Treasury), and to Martin Dinham (Mr. Raison's Office, Foreign and Commonwealth Office).

CHARLES POWELL

Robert Culshaw, Esq.,
Foreign and Commonwealth Office.

CCPC

EMBASSY OF THE UNITED STATES OF AMERICA
LONDON

April 7, 1986

Dear Prime Minister:

The Secretary of State has asked that we deliver the enclosed letter to you which was received by us telegraphically this morning.

Sincerely,

Raymond Seitz

R.G.H. Seitz
Charge d'Affaires, a.i.

Enclosure

The Rt. Honorable Margaret Thatcher, M.P.,
Prime Minister
Number 10 Downing Street,
London, SW1.

Dear Prime Minister:

During the course of Prime Minister Peres' visit to Washington, he discussed his concern, which we share, about economic deterioration in the region. We considered whether there are ways to reverse this negative trend caused by a decline in remittances, increased unemployment as workers return from the oil-producing states, and decreased financial assistance from those same states.

In this connection, a concept has emerged of establishing a regional development fund for the states of the Middle East. I believe that such a multilateral approach, which could foster an improved climate for peace, could have as the chief contributors the major industrialized countries as well as commercial banks. The assistance would focus on a regional approach to support development projects in Egypt, Jordan, Lebanon, Syria, the West Bank/Gaza and Israel.

We find this concept intriguing as a way of encouraging economic development and peace and stability in the region. I believe it is worthy of further study and consideration, and would value highly your own reaction and counsel on the concept. Secretary Baker, Deputy Secretary Whitehead and AID Administrator McPherson plan to raise this issue with Mr. Lawson in bilateral discussions at next week's meetings of the IMF/IBRD Interim and Development committees here in Washington.

XX

We will provide the Chancellor with additional details on the concept and our thinking at that time.

Sincerely,

(s/) George P. Shultz

The Rt. Honorable Margaret Thatcher, M.P.,
Prime Minister,
Number 10 Downing Street,
London, SW1.

~~PEUP~~

(keep intact for now)

CHANCELLOR OF THE EXCHEQUER

C/-

Two new notes here

ON TOP – Steven Matthews on key tables/ppr for G5 + G10.

BELOW – Useful Steering Brief from Pat Sheridan.

Folder now includes revised briefs as requested, apart from "postcard" of Brief on "Surveillance" points to make which Geoffrey Fitchew will provide in the US.

On Capital flows, look at ppr from Andy Milligan below standard brief 2.

The IMF ppr on functioning of Forex markets is now in your IMF folder 2.

Pl remember 1) Passport

2) DJ.

Rno 7/4

63/005

CONFIDENTIAL

FROM: S W MATTHEWS
DATE: 7 April 1986

1. SIR G LITTLER
2. CHANCELLOR

cc: EST.
Sir P Middleton
Sir T Burns
Mr Lavelle
Mr Fitchew
Mr Mountfield
Mr Culpin
Mr Sheridan

**G5 AND G10 SURVEILLANCE DISCUSSIONS**

For the G5 Surveillance Discussion, Mr de Larosiere has circulated short notes on the multilateral setting for economic policies in the G5 countries and on the implementation of the debt strategy. The analytical work underlying these notes was set out in the WEO document. Larosiere has also circulated a few tables which update the WEO projection using an oil price of $15 per barrel and real exchange rates at their early March levels (attached).

2. The notes on macroeconomic policies look forward to a significant correction of imbalances in the world economy, but raise the question whether sufficient has yet been done. The Managing Director's comments on the policies in the major countries look broadly acceptable:

- The US should not increase its money supply to push interest rates and its exchange rate down further, nor should Germany or Japan push their interest rates up;

- the US must ensure that its planned fiscal restraint is implemented;

- a somewhat less restrictive fiscal policy stance in Japan in 1986-87 would be appropriate.

2. With regard to the debt strategy, Larosiere has simply provided a check list of the latest state of play in the Baker 15 countries.

0

3. The IMF paper, "Policy interactions in industrial countries", sets out a baseline scenario to 1991. This is largely constructed on the basis of current policies except that in the US (where a "current services" budget would have had the public debt to GNP ratio continuing to rise steeply) it is assumed that action is taken to stabilise this ratio by the end of the decade. The paper then attempts to quantify a variant in which the US budget deficit is reduced in line with the Gramm-Rudman targets and examines the implications for growth etc in the US and other G10 countries.

4. This paper by the IMF staff represents a useful innovation, and is in line with the suggestion in the draft speaking notes for your speech at the Interim Committee that there is considerable advantage in setting multilateral surveillance in the context of a quantified medium-term analysis of prospects and policies. Nevertheless, the usual caveats apply. Such forecasts are subject to a margin of error and we cannot predict with certainty private sector reactions to government policy changes, making "fine tuning" of the world economy next to impossible. Secondly, the scenarios considered are at present only hypothetical and thus contain few immediate implications for policy: the US, for instance, has still actually to implement cuts in its budget deficit such as are assumed in the baseline scenario.

5. Nevertheless, the paper usefully illustrates the importance of the mix of fiscal and monetary policies adopted in the major countries for exchange rates and economic performance more generally. Possible specific points to make are suggested in brief 1 on the World Economic Outlook in the main set of briefing for the Interim and Development Committee meetings.

SM.

S W MATTHEWS

## Table 1. G-5: Developments in Output and Employment

(Percentage changes from preceding period at annual rates, except as indicated)

| | 1975-82 Average | 1983 | 1984 | 1985 1/ | 1986 2/ | 1987 2/ | 1986 2/ 1st half | 1986 2/ 2nd half 1/ | 1987 2/ 1st half | 1987 2/ 2nd half |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | Seasonally adjusted | | | |
| **Real GNP/GDP** | | | | | | | | | | |
| United States | 1.9 | 3.5 | 6.5 | 2.2 | 2.9 | 3.6 | 2.9 | 4.0 | 3.5 | 3.4 |
| Japan | 4.3 | 3.2 | 5.1 | 4.6 | 3.0 | 3.2 | 2.6 | 2.6 | 3.0 | 4.2 |
| France | 2.3 | 0.7 | 1.6 | 1.1 | 2.4 | 2.3 | 1.7 | 3.0 | 2.0 | 2.0 |
| Germany | 1.8 | 1.5 | 3.0 | 2.4 | 3.7 | 2.7 | 3.1 | 3.5 | 2.7 | 2.1 |
| United Kingdom 3/ | 1.1 | 3.3 | 2.5 | 3.3 | 2.8 | 2.1 | 3.9 | 1.2 | 2.9 | 2.0 |
| G-5 average 4/ | 2.3 | 2.8 | 4.8 | 2.6 | 3.0 | 3.1 | 2.8 | 3.3 | 3.1 | 3.1 |
| **Employment 5/** | | | | | | | | | | |
| United States | 1.7 | 1.3 | 4.1 | 2.0 | 2.3 | 2.2 | 2.8 | 2.0 | 2.3 | 2.2 |
| Japan | 0.9 | 1.7 | 0.6 | 0.8 | 0.5 | 0.6 | 0.4 | 0.6 | 0.5 | 0.8 |
| France | 0.1 | -0.5 | -1.0 | -0.3 | 0.2 | 0.5 | 0.2 | 0.4 | 0.6 | 0.5 |
| Germany | -0.1 | -1.7 | -- | 0.8 | 1.3 | 0.9 | 1.4 | 1.4 | 0.8 | 0.6 |
| United Kingdom | -0.8 | -1.2 | 1.7 | 1.1 | 1.0 | 0.9 | 1.0 | 0.9 | 0.9 | 0.8 |
| G-5 average 4/ | 0.9 | 0.5 | 2.1 | 1.3 | 1.5 | 1.4 | 1.7 | 1.4 | 1.4 | 1.4 |
| **Unemployment rate 5/ 6/** | | | | | | | | | | |
| United States | 7.5 | 9.6 | 7.5 | 7.2 | 6.9 | 6.5 | 7.0 | 6.9 | 6.7 | 6.5 |
| Japan | 2.1 | 2.6 | 2.7 | 2.6 | 3.0 | 3.1 | 2.9 | 3.0 | 3.2 | 3.1 |
| France | 6.0 | 8.6 | 10.1 | 10.8 | 11.0 | 11.0 | 11.0 | 11.1 | 11.1 | 11.0 |
| Germany | 4.3 | 8.2 | 8.1 | 8.2 | 7.7 | 7.6 | 8.0 | 7.7 | 7.6 | 7.6 |
| United Kingdom | 6.7 | 12.1 | 12.6 | 13.1 | 13.1 | 13.0 | 13.1 | 13.0 | 13.0 | 12.9 |
| G-5 average 4/ | 5.8 | 8.2 | 7.5 | 7.5 | 7.4 | 7.2 | 7.4 | 7.4 | 7.3 | 7.2 |

Sources: IMF, Data Fund; national sources; and IMF staff projections.

1/ Partially preliminary data and staff estimates.

2/ IMF staff projections based on an oil price of US$15 per barrel from Q2 1986 and real exchange rates kept constant at their early March 1986 levels.

3/ GDP at market prices, estimated on the basis of the average of expenditure, output, and income measures of GDP.

4/ Averages are GNP/GDP weighted.

5/ Data are not strictly comparable across countries.

6/ In percent of the labor force; period averages.

Table 2. G-5: Movements in Prices and Costs 1/

(Percentage changes from preceding period at annual rates)

| | 1975–82 Average | 1983 | 1984 | 1985 2/ | 1986 2/ | 1987 2/ | 1986 3/ 1st half | 1986 3/ 2nd half 2/ | 1987 3/ 1st half | 1987 3/ 2nd half |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | Seasonally adjusted | | | |
| **GNP/GDP deflator** | | | | | | | | | | |
| United States | 8.0 | 3.8 | 4.1 | 3.3 | 3.4 | 3.0 | 3.5 | 3.1 | 3.0 | 2.9 |
| Japan | 4.7 | 0.8 | 1.3 | 1.6 | 1.1 | 1.5 | 0.9 | 0.9 | 1.5 | 1.9 |
| France | 11.1 | 9.5 | 7.1 | 5.9 | 4.2 | 3.0 | 4.0 | 3.1 | 3.1 | 2.7 |
| Germany | 4.3 | 3.2 | 1.9 | 2.1 | 2.5 | 1.4 | 2.6 | 2.2 | 1.2 | 1.0 |
| United Kingdom | 15.0 | 5.1 | 4.2 | 6.1 | 3.7 | 3.9 | 3.0 | 2.0 | 4.8 | 4.3 |
| G-5 average 4/ | 7.9 | 4.0 | 3.6 | 3.4 | 3.0 | 2.6 | 2.9 | 2.5 | 2.7 | 2.6 |
| **Consumer prices** | | | | | | | | | | |
| United States | 8.8 | 3.2 | 4.3 | 3.5 | 3.1 | 3.1 | 2.9 | 3.4 | 3.1 | 3.0 |
| Japan | 6.5 | 1.9 | 2.3 | 2.1 | 0.5 | 1.3 | 0.2 | -0.4 | 1.7 | 2.1 |
| France | 11.1 | 9.6 | 7.4 | 5.8 | 2.2 | 2.1 | 1.1 | 1.9 | 2.3 | 2.0 |
| Germany | 4.7 | 3.3 | 2.4 | 2.2 | — | 1.0 | -0.3 | — | 1.2 | 1.7 |
| United Kingdom | 14.6 | 4.6 | 5.0 | 6.1 | 3.8 | 3.9 | 3.6 | 3.5 | 4.0 | 4.1 |
| G-5 average 4/ | 8.6 | 3.8 | 4.1 | 3.6 | 2.1 | 2.4 | 1.8 | 2.1 | 2.6 | 2.6 |
| **Unit labor costs in manufacturing** | | | | | | | | | | |
| United States | 7.4 | -2.8 | -1.3 | 1.7 | 1.4 | 0.8 | 2.1 | 1.1 | 0.8 | 0.5 |
| Japan | 4.4 | 0.4 | -4.5 | 1.4 | 3.0 | 0.6 | 4.8 | 2.3 | 0.5 | -0.8 |
| France | 10.6 | 7.6 | 1.9 | 1.4 | 0.7 | 0.2 | 1.6 | 0.3 | 0.2 | 0.2 |
| Germany | 3.9 | -1.0 | -0.8 | -0.5 | 1.6 | 0.6 | 2.5 | 1.7 | 0.6 | -0.5 |
| United Kingdom | 14.1 | 1.3 | 3.4 | 5.2 | 5.3 | 4.8 | 5.1 | 5.1 | 4.9 | 4.7 |
| G-5 average 4/ | 7.4 | -0.4 | -1.0 | 1.6 | 2.0 | 1.1 | 2.9 | 1.7 | 1.0 | 0.5 |

Sources: IMF, Data Fund; national sources, and IMF staff projection.

1/ In domestic currency terms.

2/ Partially preliminary data and staff estimates.

3/ IMF staff projections, based on an oil price of US$15 per barrel from Q2 1986 and real exchange rates kept constant at their early March 1986 levels.

2

Table 3. G-5: Monetary Aggregates: Recent Trends and Targets 1/

(Percentage changes, seasonally adjusted at annual rates)

| | | 1984 | | | 1985 | | | 1986 | Latest data | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Official Target 2/ | Outturn for the target period | Nominal GNP growth during target period | Official Target 2/ | Outturn for the target period | Nominal GNP growth during target period | Official Target 2/ | Month of last obser-vation | Increase over pre-vious 12 months 3/ | Increase over pre-vious 3 months 3/ | Increase relative to the base-period | Nominal GNP growth during target period 4/ |
| United States | M1 | 4-8 | 5.3 | 9 | 3-8 | 13.2 | 5.4 | 3-8 | Feb. 86 | 10.8 | 7.2 | 7.1 | 7.4 |
| | M2 | 6-9 | 7.9 | | 6-9 | 8.6 | | 6-9 | Feb. 86 | 6.4 | 4.2 | 4.1 | |
| | M3 | 6-9 | 10.3 | | 6-9 1/2 | 7.5 | | 6-9 | Feb. 86 | 6.8 | 7.5 | 7.6 | |
| Japan | M1 | ... | 4.3 | 7.2 | ... | ... | 6.0 | ... | Jan. 86 | 4.3 | 8.6 | ... | 5.4 5/ |
| | M2+CDs | 8 | 7.9 5/ | | 8 1/2 | 9.0 5/ | | 9 | Feb. 86 | 9.0 | 8.2 | 9.0 5/ | |
| France | M1R | ... | 7.8 | 8 | ... | ... | 7.1 | ... | Nov. 85 | 10.5 | 5.6 | ... | 6.6 |
| | M2R | 5 1/2-6 1/2 | 7.6 | | 4-6 | ... | | ... | Nov. 85 | 8.7 | 8.8 | ... | |
| | M3R | ... | 7.6 | | ... | ... | | 3-5 6/ | Nov. 85 | 7.5 | 7.6 | ... | |
| Germany | M1 | ... | 3.5 | | ... | 5.7 | 4.9 | | Feb. 86 | 6.4 | 6.1 | ... | 5.9 |
| | CBM | 4-6 | 4.6 | 4.7 | 3-5 | 4.5 | | 3 1/2-5 1/2 | Feb. 86 | 5.2 | 6.6 | 7.5 | |
| United Kingdom | M0 | 4-8 | 5.7 | | 3-7 | 3.5 | 9.5 | 2-6 | Feb. 86 | 3.5 | 4.6 | 3.5 7/ | 6.8 |
| | £M3 | 6-10 | 11.9 | 7.0 | 5-9 | 14.8 | | 11-15 | Feb. 86 | 14.8 | 6.8 | 14.8 7/ | |

Sources: National sources.

1/ M1 is the narrowly defined money supply, i.e., currency plus domestic demand deposits. M2 (and, sterling M3 for the United Kingdom) are money stocks broadly defined, which add to M1 domestic savings deposits (and, in the case of the United States, small time deposits, money market deposit accounts, money market mutual fund balances, and overnight RPs and Eurodollars; in the case of Japan, certificates of deposit). German CBM is "central bank money" defined as currency in circulation plus commercial banks' minimum required reserves held at the central bank against domestic liabilities, calculated at constant reserve ratios. M3 for the United States includes, in addition to M2, large time deposits, term RPs, and term Eurodollars. M0 (monetary base) for the United Kingdom consists of currency plus banks' operational balances at the Bank of England and till money.

2/ Target ranges for the United States and Germany are set for the fourth quarter of the target year over the fourth quarter of the previous year. In 1985, however, for the United States the target range for growth of M1 was rebased in July 1985 and was for the fourth quarter over the second quarter. In 1986, all monetary targets are set on a fourth quarter over fourth quarter basis. For Japan, the projection period is a rolling quarterly period with year-on-year growth rates. In 1984, the projection period in the table shows the fourth quarter of 1984 relative to the fourth quarter of 1983; in 1985, the fourth quarter of 1985 over the fourth quarter of 1984. For France the target range for 1984 and 1985 refers to the average growth of M2 held by residents (M2R) for the three months centered on December of the target year compared to the same period of the preceding year; for 1986 the target range refers to the growth of M3 in the three months ending in December over the same period of 1985. For the United Kingdom the period covered for 1984 is from February of 1984 to April of 1985 (an an annual rate); for 1985 and 1986 it is the rolling 12 month periods beginning with March and ending with March of the following year. Nominal GDP growth is for the respective financial years, i.e., April through March.

3/ Most recently available month relative to 12 months or 3 months earlier.

4/ Staff estimate.

5/ In Japan, figures for 1984 and 1985 represent fourth quarter over fourth quarter, and that for 1986 is first quarter 1986 over first quarter 1985.

6/ For 1986, the monetary target is expressed in terms of M3, and based on the average of the three months centered on November 1985.

7/ Falls within the target period listed for 1985.

~~38 6.25 7.25 58 95 76~~

(4)

LGFB(5)
US +1.5
Japan +3.3
France +0.8
Germany +0.2
UK -0.6

Table 4. G-5: Fiscal Developments

(In percent of GNP/GDP)

| | 1975-82 Average | 1983 | 1984 | 1985 1/ | 1986 1/ | 1987 1/ |
|---|---|---|---|---|---|---|
| General government expenditures 2/ | | | | | | |
| United States | 32.6 | 35.0 | 33.9 | 35.1 | 35.3 | 34.9 |
| Japan | 30.2 | 33.3 | 32.8 3/ | 32.1 | 32.2 | 32.4 |
| France | 43.6 | 49.2 | 49.7 | 49.4 | 48.7 | 48.3 |
| Germany | 48.8 | 48.7 | 48.4 | 47.7 | 46.5 | 46.2 |
| United Kingdom | 44.0 | 45.8 | 46.1 | 45.1 | 44.3 | 43.5 |
| General government financial balances 2/ | | | | | | |
| United States | -1.6 | -3.8 | -2.9 | -3.5 | -3.4 | -2.1 |
| Japan | -4.0 | -3.5 | -2.6 3/ | -1.6 | -1.5 | -1.5 |
| France | -1.3 | -3.1 | -2.8 | -2.5 | -2.5 | -2.5 |
| Germany | -3.3 | -2.5 | -1.9 | -1.1 | -0.8 | -0.6 |
| United Kingdom | -3.7 | -3.7 | -3.8 | -3.4 | -3.1 | -3.2 |
| Central government financial balances 4/ | | | | | | |
| United States | -2.6 | -5.3 | -4.6 | -5.0 | -4.6 | -3.2 |
| Japan | -5.4 | -5.7 | -5.4 3/ | -4.9 | -4.8 | -4.7 |
| France | -1.8 | -3.3 | -3.4 | -3.3 | -3.0 | -3.0 |
| Germany | -2.3 | -1.9 | -1.6 | -1.3 | -1.3 | -1.2 |
| United Kingdom | -2.7 | -3.2 | -3.2 | -2.8 | -2.7 | -2.9 |

US +2.7?
UK +0.7?

Sources: National sources; and IMF staff estimates. Figures are not comparable across countries.

1/ IMF staff estimates and projections.
2/ National accounts basis.
3/ IMF staff estimates.
4/ For France, the figures are on an accrual basis and exclude operations with the Fonds de Stabilisation des Changes and the social security system. For Germany, the figures are on an administrative basis and exclude social security. Figures for the Unitied States and the United Kingdom are on a national accounts basis and inlcude social security; for the U.K. special sales of assets are excluded. Figures for Japan include social security accounts and net lending operations of the central government.

NB: X Ask Lawsing what figs would be for Fr & Germany if social sec included

Table 5. G-5: Government Financial Balances and Private Savings 1/

(In percent of GNP/GDP, except as indicated)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 2/ | 1986 2/ | 1987 2/ |
|---|---|---|---|---|---|---|---|---|---|
| General government deficit (as percentage of gross private savings) 3/ | | | | | | | | | |
| United States | -2.6 | 7.2 | 5.4 | 19.9 | 21.8 | 15.7 | 20.2 | 19.8 | 12.1 |
| Japan | 16.6 | 15.8 | 14.0 | 13.4 | 13.1 | 9.6 | 5.9 | 5.6 | 5.4 |
| France | 3.4 | -1.4 | 9.9 | 15.4 | 17.5 | 15.5 | 14.0 | 12.8 | 12.3 |
| Germany | 12.8 | 15.0 | 19.3 | 17.1 | 12.6 | 9.8 | 5.7 | 3.8 | 3.1 |
| United Kingdom | 13.2 | 16.2 | 13.6 | 11.7 | 17.7 | 16.9 | 15.8 | 14.4 | 15.2 |
| Gross private savings less general government deficit | | | | | | | | | |
| United States | 18.2 | 16.2 | 17.1 | 14.1 | 13.8 | 15.5 | 13.9 | 13.8 | 15.2 |
| Japan | 23.8 | 23.5 | 23.7 | 23.4 | 23.2 | 24.5 | 25.8 | 25.9 | 25.7 |
| France | 19.5 | 18.6 | 16.3 | 14.9 | 14.5 | 15.2 | 15.7 | 17.1 | 17.6 |
| Germany | 17.4 | 16.4 | 15.4 | 15.9 | 17.0 | 17.8 | 18.3 | 18.6 | 19.5 |
| United Kingdom | 21.1 | 18.3 | 17.8 | 17.7 | 17.2 | 18.5 | 18.1 | 18.5 | 17.9 |
| Net private savings less general government deficit | | | | | | | | | |
| United States | 7.6 | 5.1 | 5.7 | 2.0 | 2.1 | 4.4 | 2.9 | 2.8 | 4.2 |
| Japan | 11.9 | 11.3 | 11.0 | 10.0 | 10.1 | 11.5 | 12.7 | 12.6 | 12.2 |
| France | 9.5 | 7.9 | 5.6 | 3.8 | 3.4 | 4.5 | 4.8 | 6.2 | 6.3 |
| Germany | 6.8 | 5.3 | 3.8 | 4.0 | 5.1 | 5.9 | 6.9 | 7.5 | 7.6 |
| United Kingdom | 6.1 | 4.5 | 4.2 | 5.3 | 4.7 | 5.8 | 5.4 | 5.8 | 5.2 |

Sources: National sources; and IMF staff estimates.
1/ Data are not fully comparable across countries.
2/ IMF staff estimates and projections.
3/ See Table 4 for deficit as percentage of GNP/GDP.
4/ IMF staff estimates.

5

6

Table 6. G-5: Current Account Balances 1/

| | 1975-82 Average | 1983 | 1984 | 1985 2/ | 1986 3/ | 1987 3/ |
|---|---|---|---|---|---|---|
| | | | (In billions of U.S. dollars) | | | |
| Current account balances | | | | | | |
| United States | -1.0 | -46.0 | -107.4 | -117.7 | -110.5 | -108.8 |
| Japan | 2.8 | 20.8 | 35.0 | 49.3 | 72.0 | 62.0 |
| France | -1.3 | -4.7 | -0.8 | 0.3 | 9.0 | 8.0 |
| Germany | -0.4 | 4.1 | 6.3 | 13.1 | 25.5 | 20.3 |
| United Kingdom | 2.9 | 4.7 | 1.1 | 3.8 | 3.8 | -0.7 |
| G-5 total | 3.0 | -21.1 | -65.8 | -51.2 | -0.2 | -19.2 |
| | | | (In percent of GNP/GDP) | | | |
| Current account balances | | | | | | |
| United States | -- | -1.4 | -2.8 | -3.0 | -2.6 | -2.4 |
| Japan | 0.4 | 1.8 | 2.8 | 3.7 | 3.9 | 3.2 |
| France | -0.2 | -0.9 | -0.2 | 0.1 | 1.3 | 1.1 |
| Germany | 0.1 | 0.6 | 1.0 | 2.1 | 2.9 | 2.2 |
| United Kingdom | 0.5 | 1.1 | 0.3 | 0.8 | 0.7 | -0.1 |
| G-5 average 4/ | 0.1 | -0.2 | -0.6 | -0.3 | 0.1 | -0.1 |

Memorandum items:

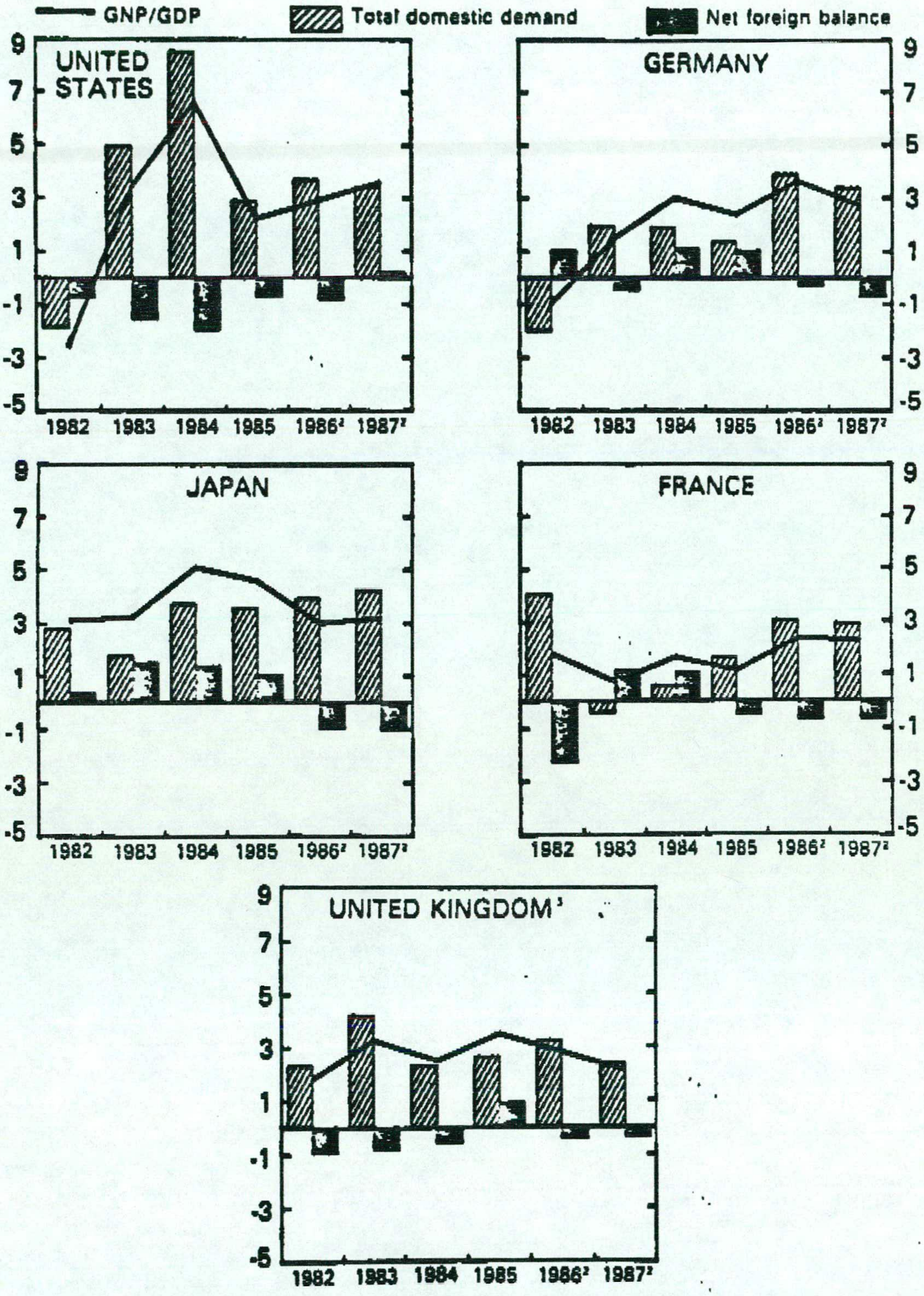
| | 1984 | | 1985 | | | |
|---|---|---|---|---|---|---|
| | 3rd qtr. | 4th qtr. | 1st qtr. | 2nd qtr. | 3rd qtr. | 4th qtr. |
| | | | (In billions of U.S. dollars) | | | |
| Trade balances 5/ | | | | | | |
| United States | -115.9 | -123.5 | -93.5 | -113.9 | -131.8 | -157.9 |
| Japan | 41.2 | 53.0 | 45.9 | 52.6 | 56.4 | 69.5 |
| France | 0.1 | -2.3 | -4.4 | -1.5 | -3.0 | -1.5 |
| Germany | 20.5 | 24.9 | 18.5 | 23.9 | 28.3 | 31.8 |
| United Kingdom | -8.4 | -6.4 | -5.6 | -0.6 | -2.5 | -1.3 |

Sources: IMF, Data Fund; national sources; and IMF staff estimates.
1/ Including official transfers.
2/ Partially preliminary figures.
3/ IMF staff projections based on an oil price of US$15 per barrel from Q2 1986 and real exchange rates kept constant at their early March 1986 levels.
4/ Average is GNP/GDP weighted.
5/ Seasonally adjusted at annual rates.

7

CHART 1

# CONTRIBUTIONS TO REAL GNP/GDP GROWTH[1]




Sources: IMF, *International Financial Statistics*, and staff projections.

[1]For total domestic demand and the net foreign balance, contribution to GNP/GDP growth in percentage points; for GNP/GDP, changes in percent compared to previous year.

[2]Staff projections.

[3]For the United Kingdom GDP at factor costs is estimated on the basis of the average of expenditure, output and income measures of GDP, while the contributions to growth are based solely on expenditure estimates.

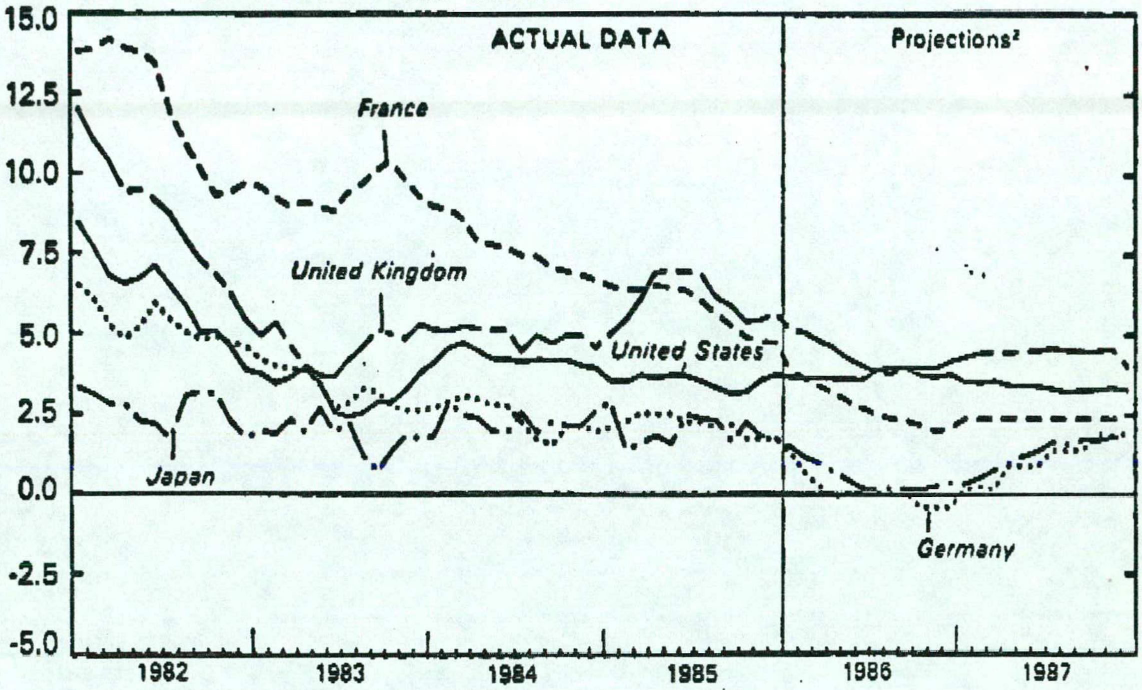
(8)

CHART 2

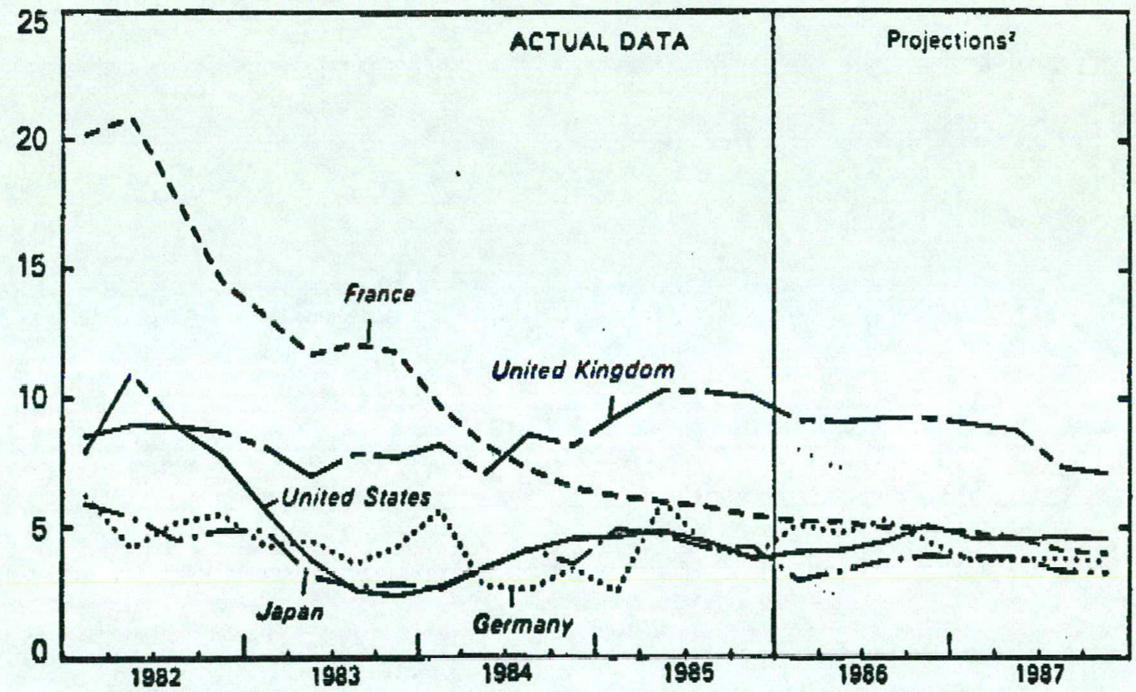
# PRICE AND COST DEVELOPMENTS[1]

(Percentage change over corresponding period of the previous year)

CONSUMER PRICE DEVELOPMENTS




HOURLY COMPENSATION IN MANUFACTURING



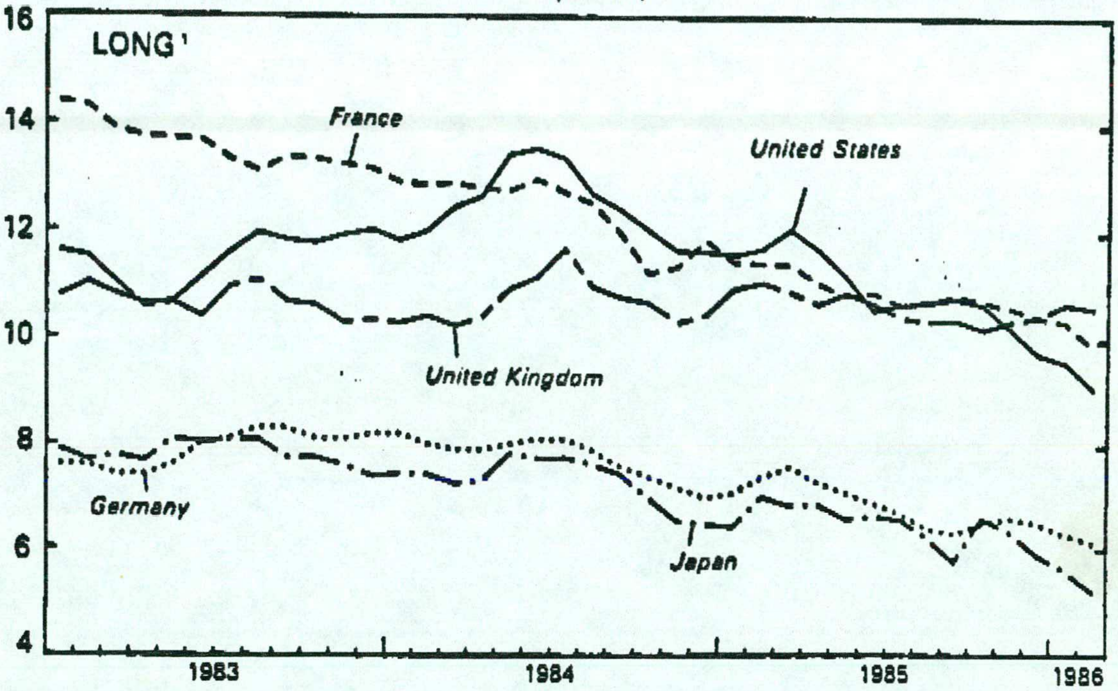

Sources: IMF, *International Financial Statistics*; and staff estimates.
[1] In domestic currency terms.
[2] Staff projections (quarterly basis).

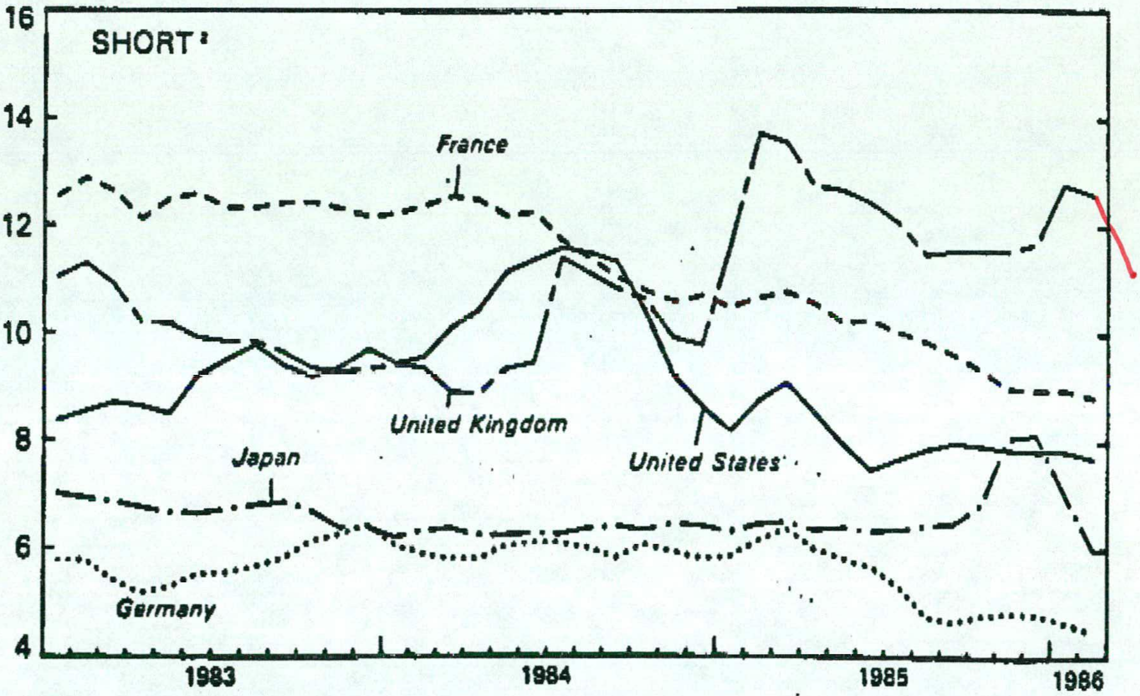
(9)

CHART 3

## NOMINAL LONG- AND SHORT-TERM INTEREST RATES

(In percent)




Source: IMF, *International Financial Statistics*.

[1]Government bonds.

[2]Interest rates on money market instruments of about 90 days' maturity; for Japan, discount rate on 2 month (private) bills.

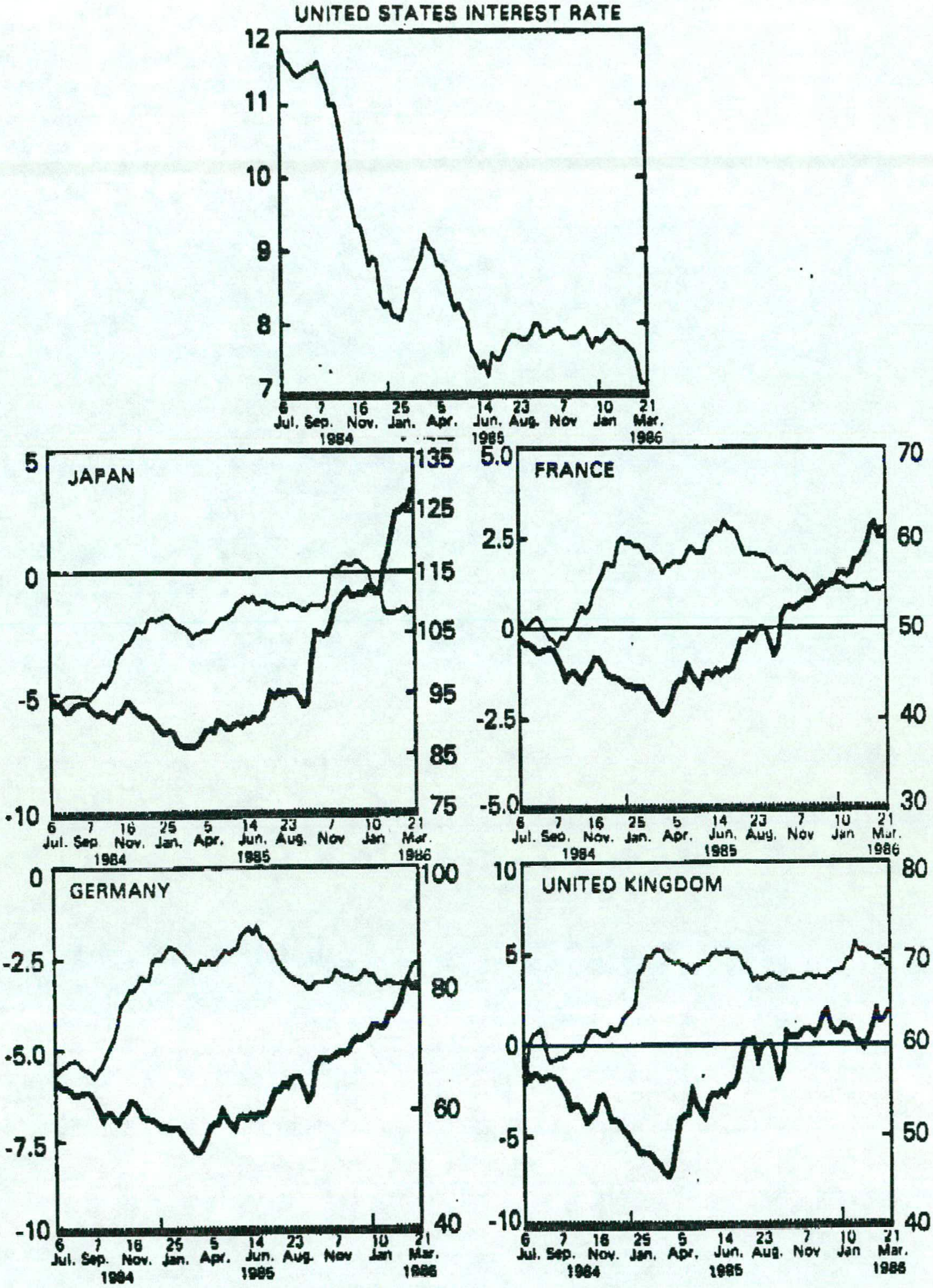
(10)

CHART 4

# EXCHANGE RATES AND SHORT-TERM INTEREST RATE DEVELOPMENTS

*Short-term interest rates*[1] *(Left scale)* in percent per annum

*Exchange rates (Right scale) (1980 = 100)*[2]




Source: IMF, Treasurer's Department.

[1] Weekly averages of interest rates on money market instruments of about 90 days' maturity; for Japan, discount rate on 2-month private bills.

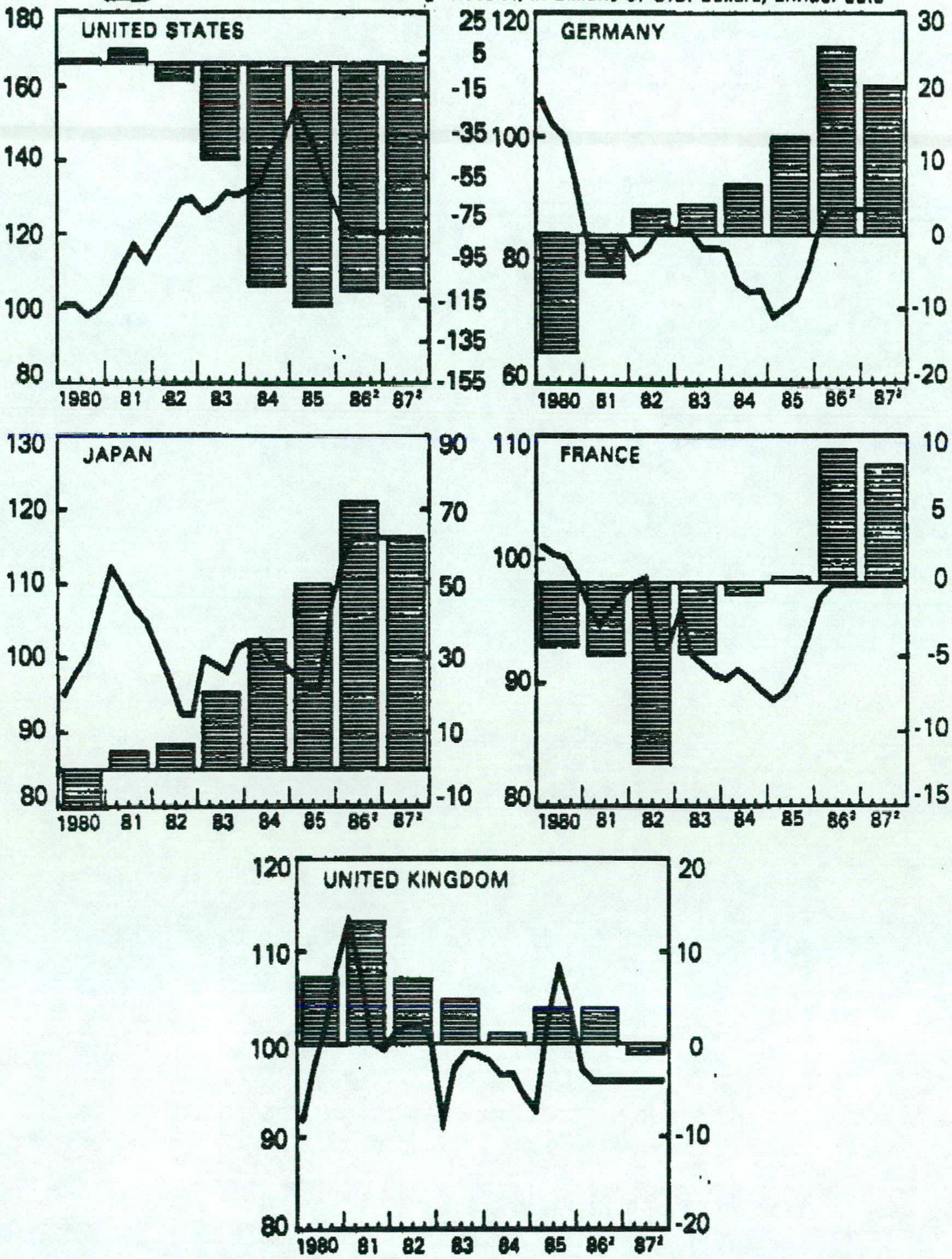
[2] An increase (decrease) in the exchange rate index indicates an appreciation (depreciation) of the respective currencies in terms of the U.S. dollar.

CHART 5

## CURRENT ACCOUNT BALANCES AND REAL EXCHANGE RATE DEVELOPMENTS[1]

*Real effective exchange rate (Left scale); 1980 = 100; quarterly data*[2]

*Current account balance (Right scale); in billions of U.S. dollars; annual data*




Sources: IMF, *International Financial Statistics;* and staff estimates.

[1]Based on normalized unit labor costs in manufacturing.

[2]Staff projections based on the assumption that the real exchange rate of early March, 1986 will remain constant through 1987.

64/018

FROM: P T SHERIDAN
DATE: 7 April 1986

1. SIR G LITTLER
2. PS/CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Mr Lavelle
Mr Fitchew
Mr Mountfield
Mr Culpin
Mr Davis
Mr Matthews
Miss Barber
Mr Pitcairn
Mr Milligan
Mr Denison

Mr Reilly (FCO)
Mr Barnes (ODA)
Mr Ware (B/England)
Mr Lankester - UKDEL

**IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS, 9 - 11 APRIL**

A full set of briefing for the Interim and Development Committee meetings was sent to you under cover of Mr Milligan's note of 3 April. Mr Fitchew in his note of 4 April submitted to you separately draft speaking notes for the Interim Committee. This note briefly indicates how the briefing relates to the agenda items at the various meetings.

Schedule of meetings

2. The main meetings will be the Interim Committee on 9 - 10 April and the Development Committee on 10 - 11 April but these will be preceded by G5 and G10 meetings.

G5

3. G5 Ministers, 3 - 6 pm, 8 April at US Treasury Department (hosted by Baker). A meeting in the surveillance series and to coordinate positions for meetings in the following days. Larosiere's surveillance note (which up dates some of the tables in the WEO General Survey) will be a key element of discussion. Brief 1 on the WEO is particularly relevant.

G10

4. G10 Ministers, 7 - 10 pm in the IMF Executive Board room (Chaired by Ruding). It will be preceded by an informal supper 6pm in the IMF Executive Dining Room. Emphasis will be on the G10/G24 Reports and the evolving debt strategy (briefs 4 and 2) refer. The IMF staff paper "Interactions between the G10 Economies", could also be discussed.

Interim Committee

5. The Interim Committee (agenda attached) commences at 9.30 am on Wednesday 9 April. On the Wednesday morning the Committee will consider in plenary session the questions of the World Economic Outlook, including the debt situation and SDR allocations. Ruding has asked speakers to limit their oral remarks to seven minutes. At the informal sessions on Wednesday afternoon and Thursday morning there will be a discussion of the debt strategy and consideration of the issues in the G10 and G24 Reports on the international monetary system. The Chairman of the Development Committee, Ishaq Khan, has been invited to participate in the deliberations on the G10 and G24 Reports.

6. We expect, as usual, the papers for the Interim Committee agenda to consist primarily of Larosiere's summings up of recent Board meetings (copies of these documents have already been sent to you).

World Economic Outlook

7. The principal paper here is likely to be the MD's summing of the Board discussion (buff 86/59). It identifies four principal topics - general outlook, policies in industrial countries, policies in developing countries and international coordination. Brief 1 (WEO) refers. Prospects for the world economy are now better in most respects than they were last Spring or at the time of the Seoul meetings. The risks to growth are also diminished since last year but uncertainty over the oil price will clearly be a matter of concern to the major oil exporting debtors.

Debt

8. Larosiere's summing up (86/50) of the Board discussion is the main paper. Brief 2 (debt) refers. Substantial progress has been made through the case-by-case strategy since 1982. This has been re-inforced by the Baker initiative on which there are already signs of progress.

SDR allocations

9. The MD's summing up (86/62) records the Board's discussion. Brief 3 (SDR allocations) underlines our opposition to allocations. There is no consensus on an allocation (positions have not changed since last Autumn) and discussion is likely to be very brief.

International Monetary System

10. Under this heading the G10 and G24 Reports will be discussed. There are three subjects - functioning of the exchange rate system, surveillance and management of international liquidity (including the SDR). On this topic Larosiere has produced a full report for the Interim Committee together with his summings up on surveillance and target zones. Briefs 4(a) to (c) refer. 4(a) underlines that we do not believe that any major change in the exchange rate regimes or institutions is desirable or practical and that we are not persuaded of the need for an international monetary conference. 4(b) stresses that we believe the way forward now is to improve policy coordination between major countries and to strengthen the role of the Fund both in multilateral surveillance and in bilateral consultations. We see considerable advantage in putting multilateral surveillance in the context of a quantified medium-term analysis of prospects and policies. 4(c) stresses that changes in the international monetary system since the early 1970s have fundamentally altered the rationale of the SDR.

Development Committee

Not for you, but you might glance through

11. The Development Committee (agenda attached) commences at 3.00 pm on Thursday 10 April. The agenda consists of two principal items and reports on three subsidary items:

a. Growth in the major debtors - including the World Bank lending programme and the implications for the GCI

b. Resource problems of Sub Sahara Africa

c. Progress reports on
  - IDA 8
  - Task Force on Concessional Flows
  - MIGA

The whole range of issues is covered in the President's Report. Separate IBRD papers cover (a) the major debtors (including the implications for GCI) (b) Sub Saharan Africa, and (c) a follow up report on concessional flows. The documentation is bulky and so is not attached here. Copies are, of course, available in Washington.

12. For the President's Report, briefs 5 to 10 are all relevant. For the paper on major debtors, brief 2 (debt situation and strategy) is relevant for general objectives but brief 5 specifically summarises the IBRD paper and examines its conclusions on the required level of financial flows and the impact on World Bank lending and resources. Brief 7 on World Bank Issues and the GCI also refers.

13. The IBRD paper on Sub Saharan Africa is a useful contribution but not likely to carry as much weight as the Bank papers on Africa in 1981 and 1984. Its scope is limited and it concentrates on financing and discusses only the 29 IDA eligible countries. Brief 6 examines the report.

14. On the progress reports there are accompanying background briefs - IDA 8 (brief 7), MIGA (brief 8) and Task Force on Congressional Flows (brief 10). There are also background notes on twelve problem countries (brief 9).

P T Sheridan

P T SHERIDAN

ICMS/Doc/86/1

March 6, 1986

INTERNATIONAL MONETARY FUND

INTERIM COMMITTEE OF THE BOARD OF GOVERNORS
ON THE INTERNATIONAL MONETARY SYSTEM

There follows the provisional agenda for the Twenty-Sixth Meeting of the Interim Committee, which is to be convened at 9:30 a.m. on Wednesday, April 9, 1986, in the Meeting Hall at the Fund's headquarters in Washington, D.C.

## PROVISIONAL AGENDA

1. Adoption of Agenda

2. Approval of Minutes of Twenty-Fifth Meeting (October 6, 1985)

3. World Economic Outlook

4. Debt situation and strategy

5. The question of allocation of SDRs

6. Consideration of issues in the reports by the Group of Ten and the Group of Twenty-Four on the international monetary system
   (a) Functioning of the exchange rate system
   (b) Surveillance
   (c) Management of international liquidity and the role of the SDR

7. Other business

8. Press communiqué

Notes

(1) The Chairman invites members of the Committee to address the world economic outlook, including the debt situation, as well as the question of allocation of SDRs in a plenary session on Wednesday morning, April 9. He proposes that consideration of the debt strategy and of issues in the reports by the Group of Ten and the Group of Twenty-Four on the international monetary system take place in informal sessions on Wednesday afternoon and on Thursday morning. The press communiqué would be finalized in a plenary session on Thursday morning which is expected to conclude by about noon on that day.

(2) Pursuant to the commitment of the Chairman of the Interim Committee in the Committee's Seoul communiqué (October 7, 1985) to communicate with the Chairman of the Development Committee on arrangements for cooperation on matters pertaining to development in the G-10 and G-24 reports, Chairman Ishaq Khan has been invited to participate in the deliberations of the Interim Committee on the reports.

DRAFT
1.23.86

## NOTICE OF MEETING

The twenty-eighth meeting of the Development Committee will be held on Thursday and Friday, April 10 and 11, 1986, commencing on April 10 at 3.00 p.m. in the Meeting Hall of the International Monetary Fund, 700 Nineteenth Street, N.W., Washington, D.C.

## PROVISIONAL AGENDA

1. Achievement of sustained growth in the middle-income countries encountering debt-service difficulties and its impact on the World Bank's overall lending program and its future resource requirements.

2. The resource problems of Sub-Saharan Africa

Progress Reports:

- Eighth replenishment of IDA. Oral report by the Chairman of IDA Deputies (para.7 of the communique)

- Follow-up on the conclusions reached by the Task Force on Concessional Flows (para.6) */

- Report on the Convention establishing the Multilateral Investment Guarantee Agency (MIGA) (para.12) */

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Notes:

1. The first item on the draft agenda relates to the Development Committee's request to the World Bank management to prepare for consideration at the April 1986 meeting of the Committee a report focused on how sustained growth can best be achieved in these countries (para.3 of the communique) and the resource requirements of the World Bank (para.5 of the communique).

2. The second item relates to the Committee's request to the World Bank management to prepare a study focused on the resource problems of Sub-Saharan Africa for discussion at the next Committee meeting (para.10).

3. The Director General of GATT may respond to the invitation to keep the Committee informed about further developments on the preparations for the proposed round of multilateral trade negotiations (para.11).

4. Progress Reports on the items marked */ will be made in the World Bank President's Report to the Development Committee.

5. Pursuant to para.13 of the Development Committee's communique of the October 1985 meeting, it is understood that the Chairman of the Interim Committee will propose that the Chairman of the Development Committee be invited to participate in the deliberations of the Interim Committee on the G-10 and G-24 reports.

PW

C/ IMF review of forex system also at Sack now.

RO 7/4

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

C

As last year, key background ppro for the IMF meeting, which you might have by you both this Saturday and next week. Useful index below.

If you have time Sir Geoff suggests you read:-

1(a) Chairman on "World Economic Outlook";

1(b) " on "Debt situation + strategy".

Probably not worth bothering with the rest, though the Lavelle report is a good quarry.

RO 4/4

1492/043

**ADDITIONAL BACKGROUND PAPERS FOR THE IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS**

1. Chairman's summing up of the IMF Board discussions on

   a) World Economic Outlook

   b) Debt situation and strategy

   c) Allocation of SDRs.

2. Report by the Managing Director on the Functioning of the International Monetary System

3. G24 Communique of 25 March

4. Lavelle Group report.

5. Review and Assessment of the System of floating Exchange Rates

## Table 1. G-5: Developments in Output and Employment

(Percentage changes from preceding period at annual rates, except as indicated)

| | 1975–82 Average | 1983 | 1984 | 1985 1/ | 1986 2/ | 1987 2/ | 1986 2/ 1st half | 1986 2/ 2nd half 1/ | 1987 2/ 1st half | 1987 2/ 2nd half |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | Seasonally adjusted | | | |
| **Real GNP/GDP** | | | | | | | | | | |
| United States | 1.9 | 3.5 | 6.5 | 2.2 | 2.9 | 3.6 | 2.9 | 4.0 | 3.5 | 3.4 |
| Japan | 4.3 | 3.2 | 5.1 | 4.6 | 3.0 | 3.2 | 2.6 | 2.6 | 3.0 | 4.2 |
| France | 2.3 | 0.7 | 1.6 | 1.1 | 2.4 | 2.3 | 1.7 | 3.0 | 2.0 | 2.0 |
| Germany | 1.8 | 1.5 | 3.0 | 2.4 | 3.7 | 2.7 | 3.1 | 3.5 | 2.7 | 2.1 |
| United Kingdom 3/ | 1.1 | 3.3 | 2.5 | 3.3 | 2.8 | 2.1 | 3.9 | 1.2 | 2.9 | 2.0 |
| G-5 average 4/ | 2.3 | 2.8 | 4.8 | 2.6 | 3.0 | 3.1 | 2.8 | 3.3 | 3.1 | 3.1 |
| **Employment 5/** | | | | | | | | | | |
| United States | 1.7 | 1.3 | 4.1 | 2.0 | 2.3 | 2.2 | 2.8 | 2.0 | 2.3 | 2.2 |
| Japan | 0.9 | 1.7 | 0.6 | 0.8 | 0.5 | 0.6 | 0.4 | 0.6 | 0.5 | 0.8 |
| France | 0.1 | -0.5 | -1.0 | -0.3 | 0.2 | 0.5 | 0.2 | 0.4 | 0.6 | 0.5 |
| Germany | -0.1 | -1.7 | -- | 0.8 | 1.3 | 0.9 | 1.4 | 1.4 | 0.8 | 0.6 |
| United Kingdom | -0.8 | -1.2 | 1.7 | 1.1 | 1.0 | 0.9 | 1.0 | 0.9 | 0.9 | 0.8 |
| G-5 average 4/ | 0.9 | 0.5 | 2.1 | 1.3 | 1.5 | 1.4 | 1.7 | 1.4 | 1.4 | 1.4 |
| **Unemployment rate 5/ 6/** | | | | | | | | | | |
| United States | 7.5 | 9.6 | 7.5 | 7.2 | 6.9 | 6.5 | 7.0 | 6.9 | 6.7 | 6.5 |
| Japan | 2.1 | 2.6 | 2.7 | 2.6 | 3.0 | 3.1 | 2.9 | 3.0 | 3.2 | 3.1 |
| France | 6.0 | 8.6 | 10.1 | 10.8 | 11.0 | 11.0 | 11.0 | 11.1 | 11.1 | 11.0 |
| Germany | 4.3 | 8.2 | 8.1 | 8.2 | 7.7 | 7.6 | 8.0 | 7.7 | 7.6 | 7.6 |
| United Kingdom | 6.7 | 12.1 | 12.6 | 13.1 | 13.1 | 13.0 | 13.1 | 13.0 | 13.0 | 12.9 |
| G-5 average 4/ | 5.8 | 8.2 | 7.5 | 7.5 | 7.4 | 7.2 | 7.4 | 7.4 | 7.3 | 7.2 |

Sources: IMF, Data Fund; national sources; and IMF staff projections.

1/ Partially preliminary data and staff estimates.

2/ IMF staff projections based on an oil price of US$15 per barrel from Q2 1986 and real exchange rates kept constant at their early March 1986 levels.

3/ GDP at market prices, estimated on the basis of the average of expenditure, output, and income measures of GDP.

4/ Averages are GNP/GDP weighted.

5/ Data are not strictly comparable across countries.

6/ In percent of the labor force; period averages.

Table 2. G-5: Movements in Prices and Costs 1/

(Percentage changes from preceding period at annual rates)

| | 1975-82 Average | 1983 | 1984 | 1985 2/ | 1986 2/ | 1987 2/ | 1986 3/ 1st half | 1986 3/ 2nd half 2/ | 1987 3/ 1st half | 1987 3/ 2nd half |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | Seasonally adjusted | | | |
| GNP/GDP deflator | | | | | | | | | | |
| United States | 8.0 | 3.8 | 4.1 | 3.3 | 3.4 | 3.0 | 3.5 | 3.1 | 3.0 | 2.9 |
| Japan | 4.7 | 0.8 | 1.3 | 1.6 | 1.1 | 1.5 | 0.9 | 0.9 | 1.5 | 1.9 |
| France | 11.1 | 9.5 | 7.1 | 5.9 | 4.2 | 3.0 | 4.0 | 3.1 | 3.1 | 2.7 |
| Germany | 4.3 | 3.2 | 1.9 | 2.1 | 2.5 | 1.4 | 2.6 | 2.2 | 1.2 | 1.0 |
| United Kingdom | 15.0 | 5.1 | 4.2 | 6.1 | 3.7 | 3.9 | 3.0 | 2.0 | 4.8 | 4.3 |
| G-5 average 4/ | 7.9 | 4.0 | 3.6 | 3.4 | 3.0 | 2.6 | 2.9 | 2.5 | 2.7 | 2.6 |
| Consumer prices | | | | | | | | | | |
| United States | 8.8 | 3.2 | 4.3 | 3.5 | 3.1 | 3.1 | 2.9 | 3.4 | 3.1 | 3.0 |
| Japan | 6.5 | 1.9 | 2.3 | 2.1 | 0.5 | 1.3 | 0.2 | -0.4 | 1.7 | 2.1 |
| France | 11.1 | 9.6 | 7.4 | 5.8 | 2.2 | 2.1 | 1.1 | 1.9 | 2.3 | 2.0 |
| Germany | 4.7 | 3.3 | 2.4 | 2.2 | -- | 1.0 | -0.3 | -- | 1.2 | 1.7 |
| United Kingdom | 14.6 | 4.6 | 5.0 | 6.1 | 3.8 | 3.9 | 3.6 | 3.5 | 4.0 | 4.1 |
| G-5 average 4/ | 8.6 | 3.8 | 4.1 | 3.6 | 2.1 | 2.4 | 1.8 | 2.1 | 2.6 | 2.6 |
| Unit labor costs in manufacturing | | | | | | | | | | |
| United States | 7.4 | -2.8 | -1.3 | 1.7 | 1.4 | 0.8 | 2.1 | 1.1 | 0.8 | 0.5 |
| Japan | 4.4 | 0.4 | -4.5 | 1.4 | 3.0 | 0.6 | 4.8 | 2.3 | 0.5 | -0.8 |
| France | 10.6 | 7.6 | 1.9 | 1.4 | 0.7 | 0.2 | 1.6 | 0.3 | 0.2 | 0.2 |
| Germany | 3.9 | -1.0 | -0.8 | -0.5 | 1.6 | 0.6 | 2.5 | 1.7 | 0.6 | -0.5 |
| United Kingdom | 14.1 | 1.3 | 3.4 | 5.2 | 5.3 | 4.8 | 5.1 | 5.1 | 4.9 | 4.7 |
| G-5 average 4/ | 7.4 | -0.4 | -1.0 | 1.6 | 2.0 | 1.1 | 2.9 | 1.7 | 1.0 | 0.5 |

Sources: IMF, Data Fund; national sources, and IMF staff projection.

1/ In domestic currency terms.

2/ Partially preliminary data and staff estimates.

3/ IMF staff projections, based on an oil price of US$15 per barrel from Q2 1986 and real exchange rates kept constant at their early March 1986 levels.

## Table 3. G-5: Monetary Aggregates: Recent Trends and Targets 1/

(Percentage changes, seasonally adjusted at annual rates)

| | | 1984 | | | 1985 | | | 1986 | Latest data | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Official Target 2/ | Outturn for the target period | Nominal GNP growth during target period | Official Target 2/ | Outturn for the target period | Nominal GNP growth during target period | Official Target 2/ | Month of last observation | Increase over previous 12 months 3/ | Increase over previous 3 months 3/ | Increase relative to the base-period | Nominal GNP growth during target period 4/ |
| United States | M1 | 4-8 | 5.3 | 9 | 3-8 | 13.2 | 5.4 | 3-8 | Feb. 86 | 10.8 | 7.2 | 7.1 | 7.4 |
| | M2 | 6-9 | 7.9 | | 6-9 | 8.6 | | 6-9 | Feb. 86 | 6.4 | 4.2 | 4.1 | |
| | M3 | 6-9 | 10.3 | | 6-9 1/2 | 7.5 | | 6-9 | Feb. 86 | 6.8 | 7.5 | 7.4 | |
| Japan | M1 | ... | 4.3 | 7.2 | ... | ... | 6.0 | ... | Jan. 86 | 4.3 | 8.6 | ... | 5.4 5/ |
| | M2+CDs | 8 | 7.9 5/ | | 8 1/2 | 9.0 5/ | | 9 | Feb. 86 | 9.0 | 8.2 | 9.0 5/ | |
| France | M1R | ... | 7.8 | 8 | ... | ... | 7.1 | ... | Nov. 85 | 10.5 | 5.6 | ... | 6.6 |
| | M2R | 5 1/2-6 1/2 | 7.6 | | 4-6 | ... | | ... | Nov. 85 | 8.7 | 8.8 | ... | |
| | M3R | ... | 7.6 | | ... | ... | | 3-5 6/ | Nov. 85 | 7.5 | 7.6 | ... | |
| Germany | M1 | ... | 3.5 | | ... | 5.7 | 4.9 | | Feb. 86 | 6.4 | 6.1 | ... | 5.9 |
| | CBM | 4-6 | 4.6 | 4.7 | 3-5 | 4.5 | | 3 1/2-5 1/2 | Feb. 86 | 5.2 | 6.6 | 7.5 | |
| United Kingdom | M0 | 4-8 | 5.7 | | 3-7 | 3.5 | 9.5 | 2-6 | Feb. 86 | 3.5 | 4.6 | 3.5 7/ | 6.8 |
| | LM3 | 6-10 | 11.9 | 7.0 | 5-9 | 14.8 | | 11-15 | Feb. 86 | 14.8 | 6.8 | 14.8 7/ | |

Sources: National sources.

1/ M1 is the narrowly defined money supply, i.e., currency plus domestic demand deposits. M2 (and, sterling M3 for the United Kingdom) are money stocks broadly defined, which add to M1 domestic savings deposits (and, in the case of the United States, small time deposits, money market deposit accounts, money market mutual fund balances, and overnight RPs and Eurodollars; in the case of Japan, certificates of deposit). German CBM is "central bank money" defined as currency in circulation plus commercial banks' minimum required reserves held at the central bank against domestic liabilities, calculated at constant reserve ratios. M3 for the United States includes, in addition to M2, large time deposits, term RPs, and term Eurodollars. M0 (monetary base) for the United Kingdom consists of currency plus banks' operational balances at the Bank of England and till money.

2/ Target ranges for the United States and Germany are set for the fourth quarter of the target year over the fourth quarter of the previous year. In 1985, however, for the United States the target range for growth of M1 was rebased in July 1985 and was for the fourth quarter over the second quarter. In 1986, all monetary targets are set on a fourth quarter over fourth quarter basis. For Japan, the projection period is a rolling quarterly period with year-on-year growth rates. In 1984, the projection period in the table shows the fourth quarter of 1984 relative to the fourth quarter of 1983; in 1985, the fourth quarter of 1985 over the fourth quarter of 1984. For France the target range for 1984 and 1985 refers to the average growth of M2 held by residents (M2R) for the three months centered on December of the target year compared to the same period of the preceding year; for 1986 the target range refers to the growth of M3 in the three months ending in December over the same period of 1985. For the United Kingdom the period covered for 1984 is from February of 1984 to April of 1985 (an an annual rate); for 1985 and 1986 it is the rolling 12 month periods beginning with March and ending with March of the following year. Nominal GDP growth is for the respective financial years, i.e., April through March.

3/ Most recently available month relative to 12 months or 3 months earlier.

4/ Staff estimate.

5/ In Japan, figures for 1984 and 1985 represent fourth quarter over fourth quarter, and that for 1986 is first quarter 1986 over first quarter 1985.

6/ For 1986, the monetary target is expressed in terms of M3, and based on the average of the three months centered on November 1985.

7/ Falls within the target period listed for 1985.

Table 4. G-5: Fiscal Developments

(In percent of GNP/GDP)

| | 1975-82 Average | 1983 | 1984 | 1985 1/ | 1986 1/ | 1987 1/ |
|---|---|---|---|---|---|---|
| General government expenditures 2/ | | | | | | |
| United States | 32.6 | 35.0 | 33.9 | 35.1 | 35.3 | 34.9 |
| Japan | 30.2 | 33.3 | 32.8 3/ | 32.1 | 32.2 | 32.4 |
| France | 43.6 | 49.2 | 49.7 | 49.4 | 48.7 | 48.3 |
| Germany | 48.8 | 48.7 | 48.4 | 47.7 | 46.5 | 46.2 |
| United Kingdom | 44.0 | 45.8 | 46.1 | 45.1 | 44.3 | 43.5 |
| General government financial balances 2/ | | | | | | |
| United States | -1.6 | -3.8 | -2.9 | -3.5 | -3.4 | -2.1 |
| Japan | -4.0 | -3.5 | -2.6 3/ | -1.6 | -1.5 | -1.5 |
| France | -1.3 | -3.1 | -2.8 | -2.5 | -2.5 | -2.5 |
| Germany | -3.3 | -2.5 | -1.9 | -1.1 | -0.8 | -0.6 |
| United Kingdom | -3.7 | -3.7 | -3.8 | -3.4 | -3.1 | -3.2 |
| Central government financial balances 4/ | | | | | | |
| United States | -2.6 | -5.3 | -4.6 | -5.0 | -4.6 | -3.2 |
| Japan | -5.4 | -5.7 | -5.4 3/ | -4.9 | -4.8 | -4.7 |
| France | -1.8 | -3.3 | -3.4 | -3.3 | -3.0 | -3.0 |
| Germany | -2.3 | -1.9 | -1.6 | -1.3 | -1.3 | -1.2 |
| United Kingdom | -2.7 | -3.2 | -3.2 | -2.8 | -2.7 | -2.9 |

Sources: National sources; and IMF staff estimates. Figures are not comparable across countries.

1/ IMF staff estimates and projections.

2/ National accounts basis.

3/ IMF staff estimates.

4/ For France, the figures are on an accrual basis and exclude operations with the Fonds de Stabilisation des Changes and the social security system. For Germany, the figures are on an administrative basis and exclude social security. Figures for the Unitied States and the United Kingdom are on a national accounts basis and inlcude social security; for the U.K. special sales of assets are excluded. Figures for Japan include social security accounts and net lending operations of the central government.

Table 5. G-5: Government Financial Balances and Private Savings 1/

(In percent of GNP/GDP, except as indicated)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 2/ | 1986 2/ | 1987 2/ |
|---|---|---|---|---|---|---|---|---|---|
| General government deficit (as percentage of gross private savings) 3/ | | | | | | | | | |
| United States | -2.6 | 7.2 | 5.4 | 19.9 | 21.8 | 15.7 | 20.2 | 19.8 | 12.1 |
| Japan | 16.6 | 15.8 | 14.0 | 13.4 | 13.1 | 9.6 | 5.9 | 5.6 | 5.4 |
| France | 3.4 | -1.4 | 9.9 | 15.4 | 17.5 | 15.5 | 14.0 | 12.8 | 12.3 |
| Germany | 12.8 | 15.0 | 19.3 | 17.1 | 12.6 | 9.8 | 5.7 | 3.8 | 3.1 |
| United Kingdom | 13.2 | 16.2 | 13.6 | 11.7 | 17.7 | 16.9 | 15.8 | 14.4 | 15.2 |
| Gross private savings less general government deficit | | | | | | | | | |
| United States | 18.2 | 16.2 | 17.1 | 14.1 | 13.8 | 15.5 | 13.9 | 13.8 | 15.2 |
| Japan | 23.8 | 23.5 | 23.7 | 23.4 | 23.2 | 24.5 | 25.8 | 25.9 | 25.7 |
| France | 19.5 | 18.6 | 16.3 | 14.9 | 14.5 | 15.2 | 15.7 | 17.1 | 17.6 |
| Germany | 17.4 | 16.4 | 15.4 | 15.9 | 17.0 | 17.8 | 18.3 | 18.6 | 19.5 |
| United Kingdom | 21.1 | 18.3 | 17.8 | 17.7 | 17.2 | 18.5 | 18.1 | 18.5 | 17.9 |
| Net private savings less general government deficit | | | | | | | | | |
| United States | 7.6 | 5.1 | 5.7 | 2.0 | 2.1 | 4.4 | 2.9 | 2.8 | 4.2 |
| Japan | 11.9 | 11.3 | 11.0 | 10.0 | 10.1 | 11.5 | 12.7 | 12.6 | 12.2 |
| France | 9.5 | 7.9 | 5.6 | 3.8 | 3.4 | 4.5 | 4.8 | 6.2 | 6.3 |
| Germany | 6.8 | 5.3 | 3.8 | 4.0 | 5.1 | 5.9 | 6.9 | 7.5 | 7.6 |
| United Kingdom | 6.1 | 4.5 | 4.2 | 5.3 | 4.7 | 5.8 | 5.4 | 5.8 | 5.2 |

Sources: National sources; and IMF staff estimates.

1/ Data are not fully comparable across countries.
2/ IMF staff estimates and projections.
3/ See Table 4 for deficit as percentage of GNP/GDP.
4/ IMF staff estimates.

Table 6. G-5: Current Account Balances 1/

| | 1975-82 Average | 1983 | 1984 | 1985 2/ | 1986 3/ | 1987 3/ |
|---|---|---|---|---|---|---|
| | (In billions of U.S. dollars) | | | | | |
| Current account balances | | | | | | |
| United States | -1.0 | -46.0 | -107.4 | -117.7 | -110.5 | -108.8 |
| Japan | 2.8 | 20.8 | 35.0 | 49.3 | 72.0 | 62.0 |
| France | -1.3 | -4.7 | -0.8 | 0.3 | 9.0 | 8.0 |
| Germany | -0.4 | 4.1 | 6.3 | 13.1 | 25.5 | 20.3 |
| United Kingdom | 2.9 | 4.7 | 1.1 | 3.8 | 3.8 | -0.7 |
| G-5 total | 3.0 | -21.1 | -65.8 | -51.2 | -0.2 | -19.2 |
| | (In percent of GNP/GDP) | | | | | |
| Current account balances | | | | | | |
| United States | -- | -1.4 | -2.8 | -3.0 | -2.6 | -2.4 |
| Japan | 0.4 | 1.8 | 2.8 | 3.7 | 3.9 | 3.2 |
| France | -0.2 | -0.9 | -0.2 | 0.1 | 1.3 | 1.1 |
| Germany | 0.1 | 0.6 | 1.0 | 2.1 | 2.9 | 2.2 |
| United Kingdom | 0.5 | 1.1 | 0.3 | 0.8 | 0.7 | -0.1 |
| G-5 average 4/ | 0.1 | -0.2 | -0.6 | -0.3 | 0.1 | -0.1 |

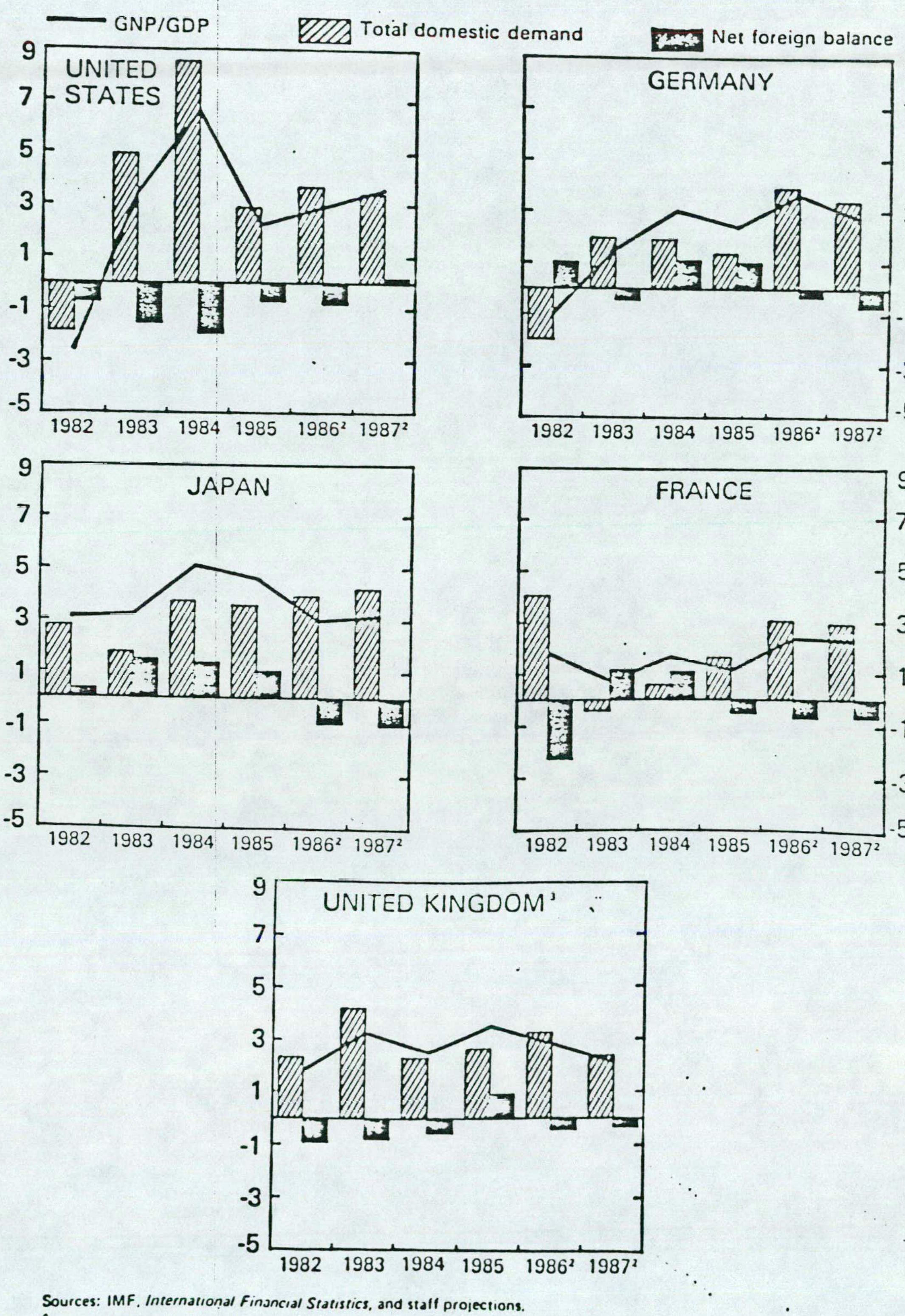
Memorandum items:

| | 1984 3rd qtr. | 1984 4th qtr. | 1985 1st qtr. | 1985 2nd qtr. | 1985 3rd qtr. | 1985 4th qtr. |
|---|---|---|---|---|---|---|
| | (In billions of U.S. dollars) | | | | | |
| Trade balances 5/ | | | | | | |
| United States | -115.9 | -123.5 | -93.5 | -113.9 | -131.8 | -157.9 |
| Japan | 41.2 | 53.0 | 45.9 | 52.6 | 56.4 | 69.5 |
| France | 0.1 | -2.3 | -4.4 | -1.5 | -3.0 | -1.5 |
| Germany | 20.5 | 24.9 | 18.5 | 23.9 | 28.3 | 31.8 |
| United Kingdom | -8.4 | -6.4 | -5.6 | -0.6 | -2.5 | -1.3 |

Sources: IMF, Data Fund; national sources; and IMF staff estimates.
1/ Including official transfers.
2/ Partially preliminary figures.
3/ IMF staff projections based on an oil price of US$15 per barrel from Q2 1986 and real exchange rates kept constant at their early March 1986 levels.
4/ Average is GNP/GDP weighted.
5/ Seasonally adjusted at annual rates.

CHART 1

## CONTRIBUTIONS TO REAL GNP/GDP GROWTH[1]




Sources: IMF, *International Financial Statistics*, and staff projections.

[1]For total domestic demand and the net foreign balance, contribution to GNP/GDP growth in percentage points; for GNP/GDP, changes in percent compared to previous year.

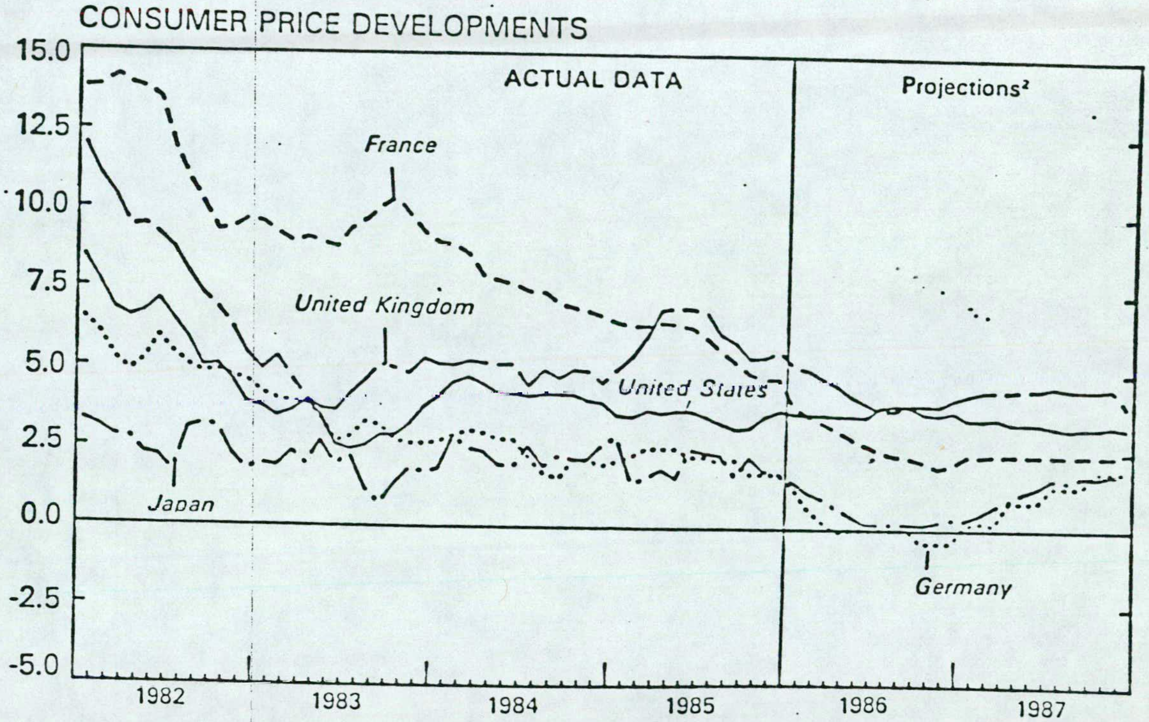
[2]Staff projections.

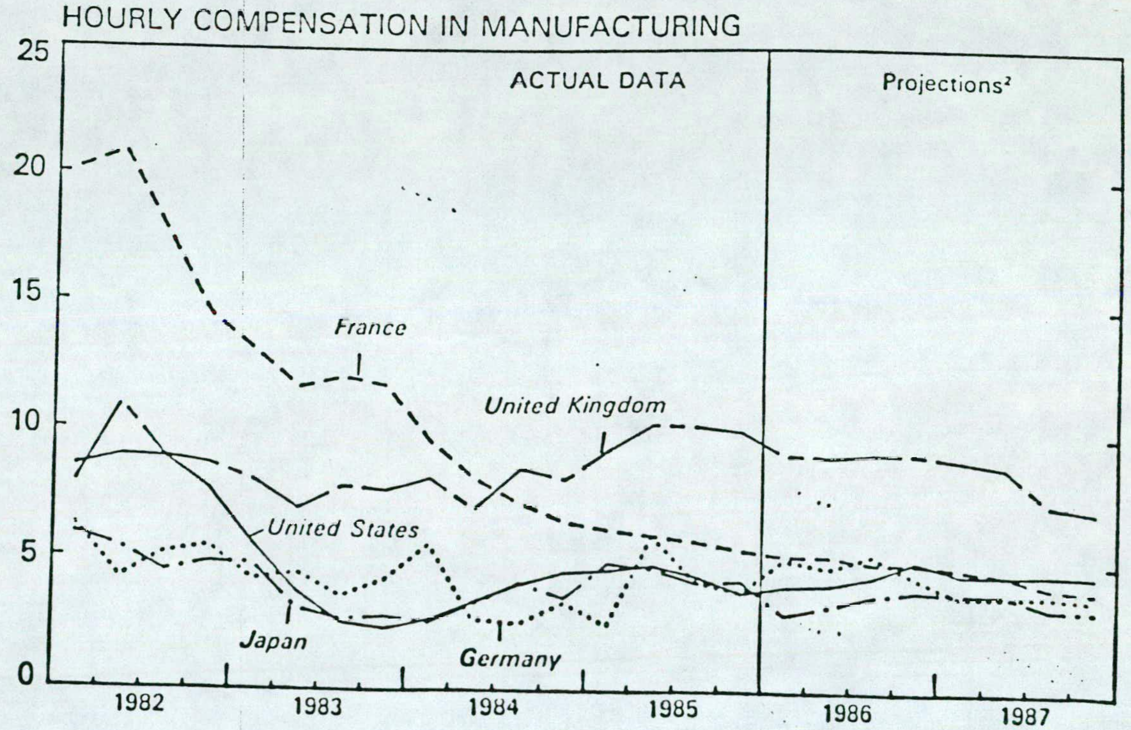
[3]For the United Kingdom GDP at factor costs is estimated on the basis of the average of expenditure, output and income measures of GDP, while the contributions to growth are based solely on expenditure estimates.

CHART 2

# PRICE AND COST DEVELOPMENTS[1]

(Percentage change over corresponding period of the previous year)



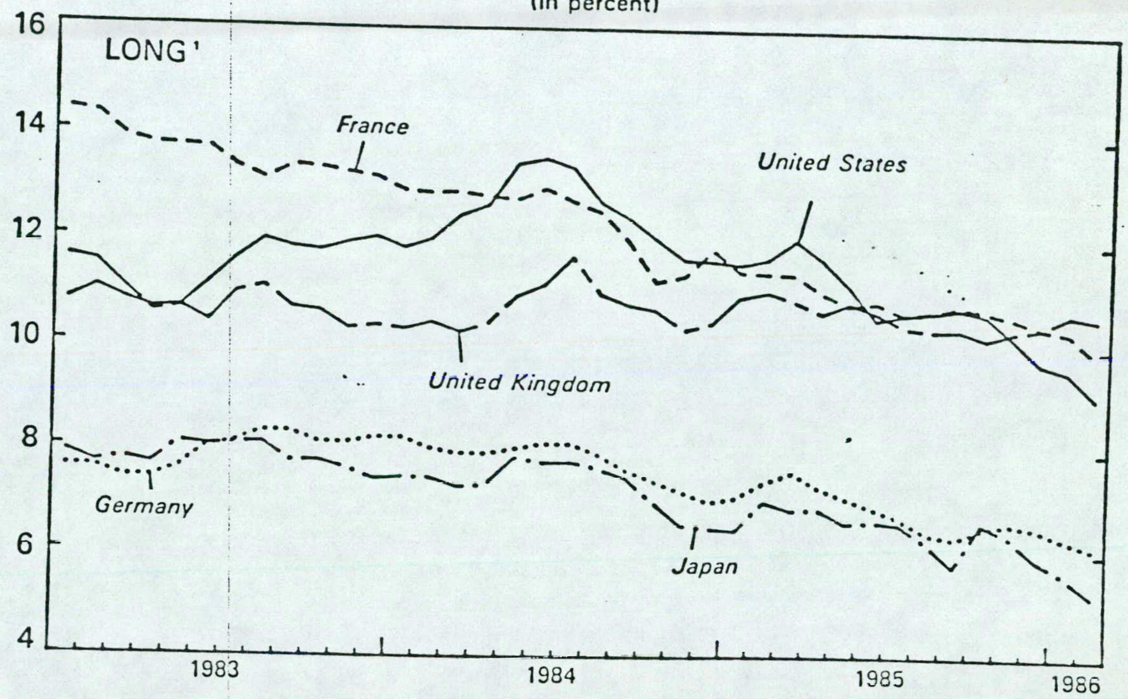



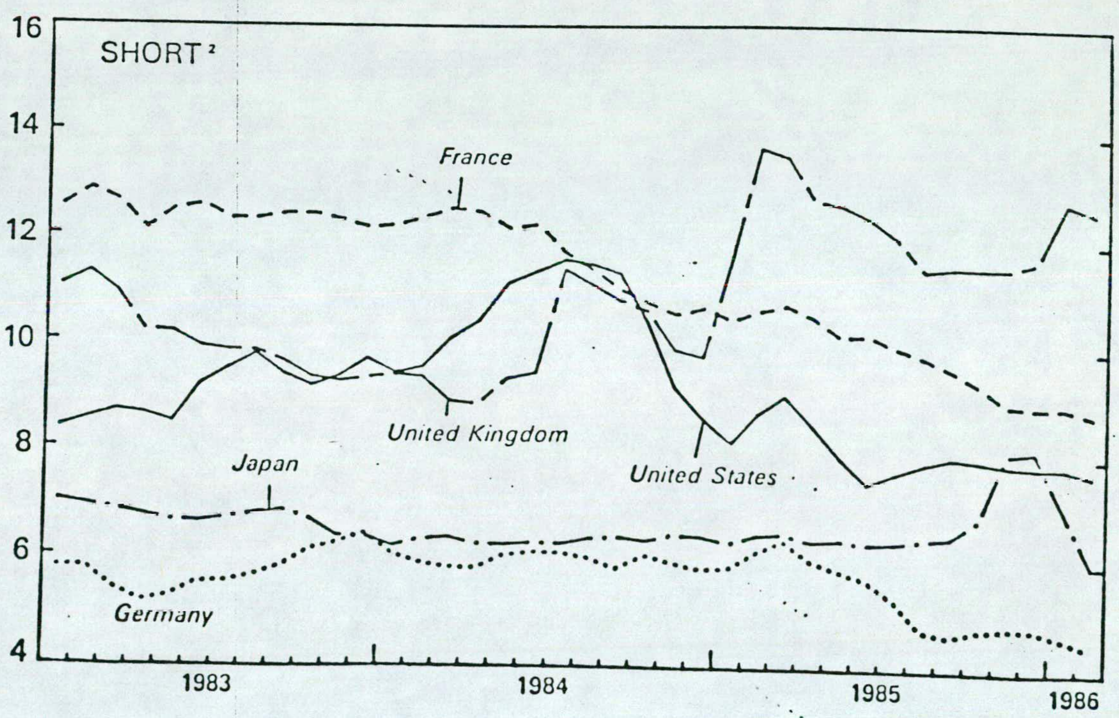

Sources: IMF, *International Financial Statistics;* and staff estimates.
[1] In domestic currency terms.
[2] Staff projections (quarterly basis).

CHART 3

# NOMINAL LONG- AND SHORT-TERM INTEREST RATES

(In percent)



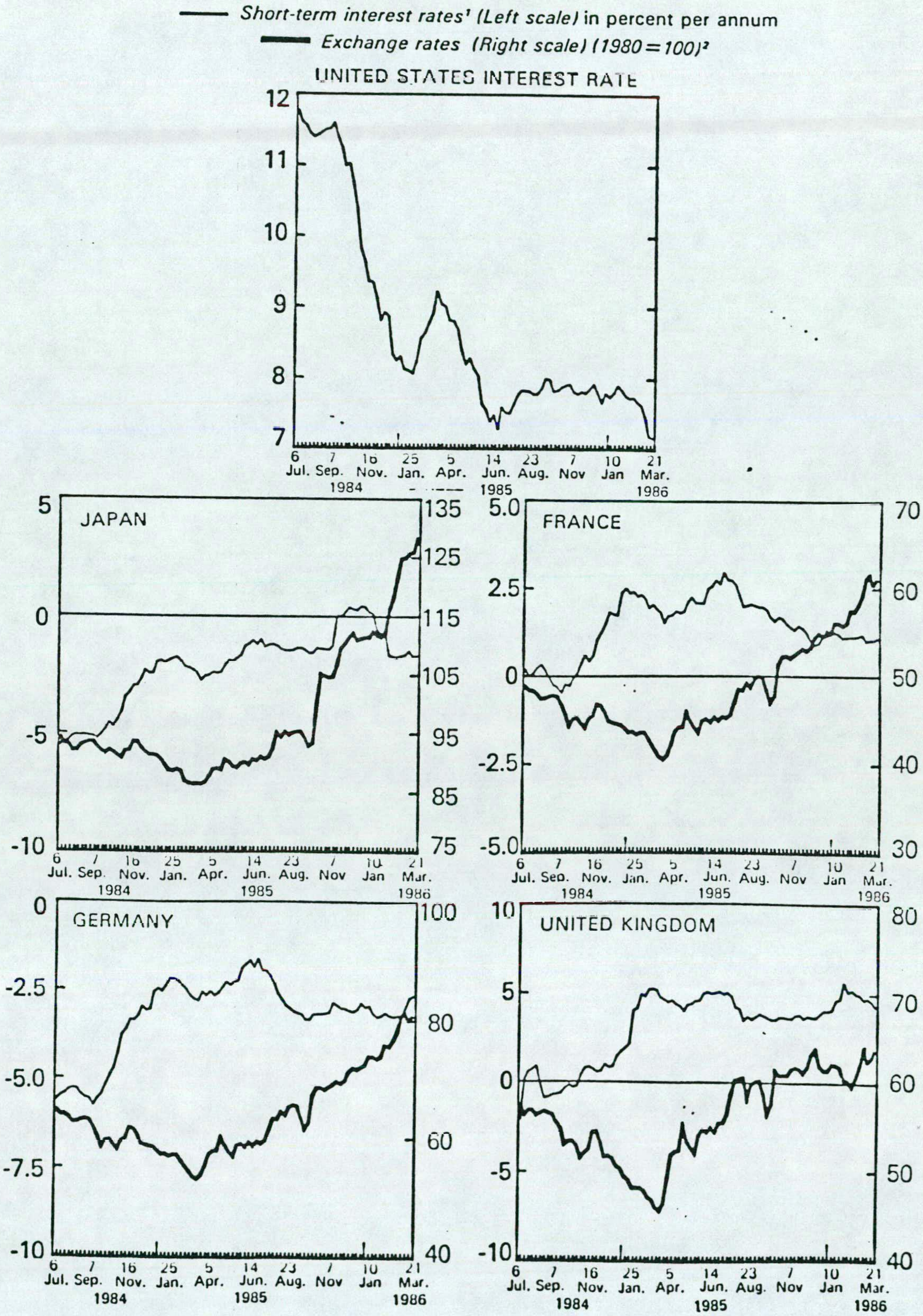

Source: IMF, *International Financial Statistics.*

[1] Government bonds.

[2] Interest rates on money market instruments of about 90 days' maturity; for Japan, discount rate on 2 month (private) bills.

CHART 4

## EXCHANGE RATES AND SHORT-TERM INTEREST RATE DEVELOPMENTS



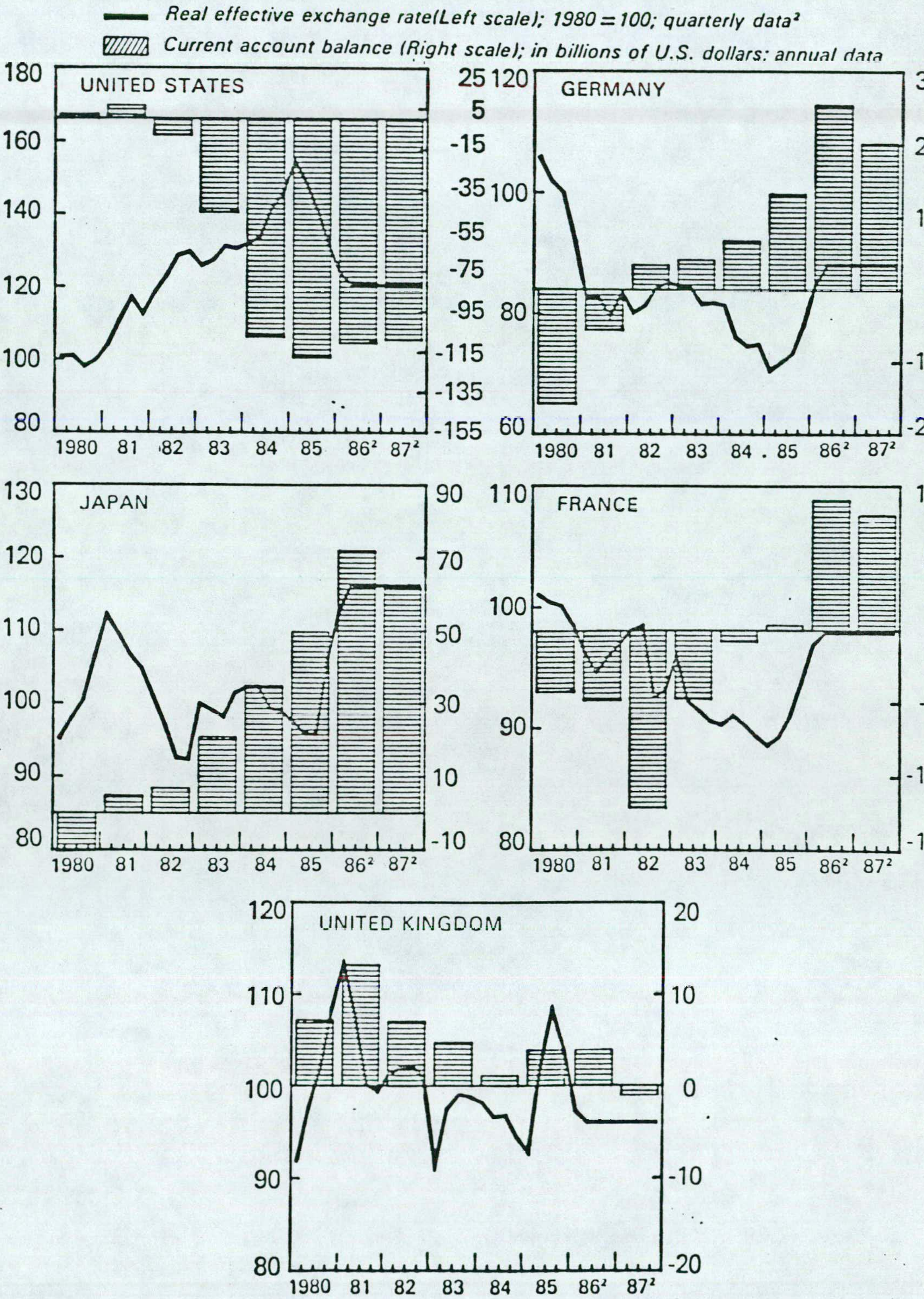

Source: IMF, Treasurer's Department.

[1]Weekly averages of interest rates on money market instruments of about 90 days' maturity; for Japan, discount rate on 2-month private bills.

[2]An increase (decrease) in the exchange rate index indicates an appreciation (depreciation) of the respective currencies in terms of the U.S. dollar.

CHART 5

# CURRENT ACCOUNT BALANCES AND REAL EXCHANGE RATE DEVELOPMENTS[1]




Sources: IMF, *International Financial Statistics;* and staff estimates.

[1]Based on normalized unit labor costs in manufacturing.

[2]Staff projections based on the assumption that the real exchange rate of early March, 1986 will remain constant through 1987.

# INDEX TO INTERIM/DEVELOPMENT COMMITTEE BRIEFING

| No. | Title |
|---|---|
| 1. | World Economic Outlook |
| 2. | Debt situation and strategy (covering Baker, bank provisions, export credits, CFF, Fund/Bank collaboration and Annex on Trust Fund) |
| 3. | SDR allocations |
| 4. | Consideration of issues in G10/G24 Reports on the international monetary system |
| | (a) Functioning of the Exchange Rate System |
| | (b) Surveillance |
| | (c) Management of International Liquidity and the Role of the SDR |
| 5. | World Bank Paper on the Major Debtors |
| 6. | Sub Saharan Africa |
| 7. | World Bank Issues (covering GCI, IDA8, IFC) |
| 8. | MIGA |
| 9. | Problem Countries |
| 10. | Follow Up Report on Task Force on Concessinal Flows. |
| 11. | Unitary Tax (for Baker bilateral) |

CONFIDENTIAL

Brief no 1 (Revised)

HM TREASURY

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS

9-11 APRIL 1986

## World Economic Outlook

### OBJECTIVES

1. To point out success of medium-term policies geared to achieving lower inflation and providing basis for sustained growth of output. Welcome move over past year to more sustainable pattern of exchange rates worldwide; together with planned changes in fiscal policy should help reduce imbalances.

2. Emphasise overall beneficial effects for world economy of lower oil prices, as suggested in our FSBR forecast, although effects on heavily indebted oil exporters qualify this to some degree.

3. Encourage US to implement measures to reduce fiscal deficit. Stress that Japan should ensure that growth of domestic demand is adequate to achieve reduction in its current account surplus.

4. Express agreement with staff recommendations that developing countries need to persist with structural adjustment policies.

5. Welcome staff paper for G10 looking at medium-term scenarios and policy coordination.

### POINTS TO MAKE

(a) World economy now in fourth year of recovery and inflation still falling. Prospects for 1986 and 1987 have been improved by lower oil prices and recent cuts in interest rates in most major countries. Our FSBR forecast suggests GNP growth in major seven around 3½ per cent in 1986, with consumer price inflation falling to 2½ per cent.

(b) Risks to growth diminished by developments since last WEO exercise: lower dollar, lower interest rates (especially long rates), lower oil price.

(c) Need to ensure that lower oil prices not just a temporary bonus. Stick to existing medium-term monetary framework. Lower inflation should allow fall in nominal interest rates within given monetary targets. Concerted action might be appropriate sometimes, but individual countries should be prepared to cut rates if domestic circumstances justify it, and if no risk of change producing exchange rate movements which would worsen problem of imbalances.

(d) To reduce real interest rates worldwide desirable to reduce claim on aggregate savings made by public sector deficits in OECD area as a whole. Reduction in US Federal deficit particularly important.

(e) Welcome Gramm-Rudman-Hollings and acceptance in United States of need for reduced deficit. Hope that Administration and Congress will be able to agree significant reduction of deficit in FY1987.

(f) Important that growth of domestic demand in Japan sufficient to start to reduce current account surplus. Cuts in interest rates an appropriate means if does not involve reversing recent exchange rate movements. But other measures needed too. Government's FY1986 budget looks too restrictive in this context.

(g) Current prospect for German economy in 1986 encouraging, but government may need to reassess policy stance later in year, if outlook then for marked slowdown in growth or continuing large current account surpluses.

(h) Structural policies in Europe need to be geared to increasing labour market flexibility. Dichotomy between real wage growth in US and Europe important in explaining divergent employment performance.

(i) Developing countries also need to implement structural adjustment policies designed to increase role of market forces in their economies.

**BACKGROUND**

6. IMF staff's forecast for 1986 and 1987 less optimistic than our own FSBR forecast, though part of difference explained by different oil price assumption (IMF - $20 a barrel, FSBR - $15 a barrel):

| | | IMF | FSBR* |
|---|---|---|---|
| Real GNP** | 1986 | 2.9 | 3½ |
| | 1987 | 2.9 | 4 (4) |
| Consumer prices** | 1986 | 3.1 | 2½ |
| | 1987 | 3.2 | 1½ (1¾) |
| World trade at constant prices | 1986 | 3.7 | 5½ |
| | 1987 | 3.9 | 5½ (5¼) |

* published figures are for 1987H1, unpublished figures for whole of 1987 are given in brackets

** major seven.

7. IMF staff have updated forecast for G5 countries assuming oil price of $15 per barrel and taking account of exchange rate developments during February, when yen and D-mark appreciated 7 per cent against dollar. IMF forecasts of consumer price inflation in G5 now similar to our FSBR forecast. Forecast of real GNP growth in G5 as a whole has been revised upwards marginally in 1986 and 1987, but IMF staff forecast still less optimistic than FSBR forecast. Changes in exchange rate assumptions have important effects on prospects in individual countries: main upward revision to growth forecast is for US, while Japan now expected to grow by only 3.2 per cent in 1987, compared with 3.7 per cent in main WEO forecast. IMF forecasts of UK economy now similar to FSBR forecasts:

| | | IMF | FSBR |
|---|---|---|---|
| Real GNP growth | 1986 | 2.8 | 3 |
| | 1987 H1 | 2.9 | 2½ |
| Consumer prices | 1986 | 3.8 | 3½* |
| | 1987 H1 | 4.0 | 3½** |

* Q4 on Q4

** Q2 on Q2

8. Recent exchange rate and interest rate developments are set out below:

| | September 20 | April 1 | Change |
|---|---|---|---|
| Exchange rates | | | |
| US $ index | 139.6 | 118.9 | -14.8 |
| Yen: $ | 240.9 | 177.7 | -26.2% |
| D-mark: $ | 2.86 | 2.33 | -19.5% |
| Three-month interest rates (per cent) | | | |
| US | 8.0 | 7.1 | -0.9 |
| Japan | 6.3 | 5.3 | -1.0 |
| Germany | 4.7 | 4.5 | -0.2 |
| Government bond yields (per cent) | | | |
| US | 10.3 | 7.4 | -2.9 |
| Japan | 6.2 | 4.6 | -1.6 |
| Germany | 6.6 | 5.5 | -1.1 |

9. In United States Federal deficit for FY1986 now expected to total just under $210 billion following implementation of maximum $11.7 billion expenditure cuts required this year under the Gramm-Rudman-Hollings Balanced Budget Act. President's budget proposals for FY1987 incorporate no tax increase, a real increase of 8 per cent in defence expenditure and cuts in non-defence expenditure, and meet deficit target of $144 billion. Congress has rejected these proposals and is now formulating an alternative budget.

10. In 1986 US general government deficit estimated about 42 per cent of total OECD general government deficit. Federal deficit larger than general deficit because state and local governments have been running overall surpluses, only part of which are planned automatically in Federal Government debt. Federal deficit likely to be around 5 per cent of GNP in 1986, nearly 60 per cent of the total OECD general government deficit.

11. The Japanese budget for FY1986, which begins in April, was officially described as "austere". Central government deficit is to be cut by about ½ per cent of GNP to 3¼ per cent of GNP, implying a general government deficit of ¾ per cent of GNP. Discretionary expenditure to be held constant in nominal terms for the fourth successive year. Another package of measures to boost domestic demand is expected to be announced in April. Previous packages, however, have mostly involved bringing forward expenditure already planned.

12. In Germany the first phase of the income tax cuts planned for 1986 and 1988 was implemented in January this year. So far, Stoltenberg has refused to consider bringing forward to 1987 the second phase. These cuts are sufficient only to compensate for past fiscal drag and do not reduce the real tax burden. Income tax cut planned for 1988 equivalent to 0.7 per cent of GNP, and would be achieved while making further reductions in the budget deficit as a per cent of GNP.

13. Developments in employment and real earnings in the US and Europe over the period 1975-85 are shown below.

| | **Change in total civilian employment (millions)** | **Change in real hourly earnings in manufacturing (per cent, over whole period)** |
|---|---|---|
| United States | 21½ | -1½ |
| OECD-Europe | ½ | +12½ |

H M TREASURY

1492/040

CONFIDENTIAL

Brief No. 2: (REVISED)

HM TREASURY

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS

9-11 APRIL 1986

Debt situation and strategy

A. OBJECTIVES

(a) Continue to endorse the case by case debt approach with its mix of adjustment and finance;

(b) Convince doubters that the Baker initiative will succeed, and progress is being made to attain its objectives;

(c) Reaffirm central role of Fund in debt strategy and encourage closer co-operation with IBRD;

(d) Reaffirm that policy reforms by debtors are essential to promote long term growth;

(e) Seek endorsement of IBRD's proposals for higher level of lending, and firmer US commitment to negotiate an increase in IBRD resources (see brief no. 7);

(f) Keep debt issues separate from a possible international monetary reform conference; (see brief no. 4);

(g) Make it clear that banks must rely on own judgement; no question of weaker supervision of government guarantees. Encourage UK banks to strengthen provision against debt risks.

B. LINE TO TAKE

(a) Baker initiative to strengthen case by case approach is working and beginning to show results;

(b) Progress is already being made. The set of principles in Baker initiative have been widely endorsed by all parties (IFIs, banks, debtors) as the foundation [illegible] build on. Fund and Bank are working closely together, eg agreement on use of Trust Fund resources for low income debtors (see annex 1). Bank has agreed to increase proportion of non-project lending to 30 per cent. Bank management is proposing a higher level of lending (see briefs nos. 5 and 7). Bank is making good progress with middle income debtors on agreeing possible programmes (see annex 2). Increasing number of countries are committing themselves to medium term structural reforms to adjust their economies and improve their growth potential; this is showing up in a recovery in direct investment and a slowdown in capital flight; the Fund Staff estimate that capital outflows from debtor countries fell from $36 billion in 1982 to $15 billion in 1985, and will decline further in 1986 and 1987.

(c) International environment now much more favourable to majority of debtors, eg : lower interest rates (LIBOR has fallen from 10-7½ per cent in the last 2 years, benefitting the Baker 15 by $6--7½ billion); a lower US dollar (25 per cent below its 1985 peak) and prospects for continued steady industrialised country growth, which have been improved by oil price fall;

(d) Recognise oil price fall will cause major difficulties for some oil exporting major debtors [particularly if oil price remains as low as $10]. Countries in this position will need both more adjustment and more finance. Appropriate that they should be able to make full use of IMF enlarged access facility (and if needs be, exceptional access) in support of credible adjustment programmes. Do not favour "reverse oil facility". No case for proliferation of new Fund facilities when existing facilities not used to the full. [If necessary] Use of CFF by oil producers not appropriate in present circumstances, as price fall is not a temporary and reversible shift for which facility was designed.

(e) In sum, as Fund WEO and debt papers show, sustainable growth for debtors is a realistic prospect, provided three essential requirements in the debt strategy are met :-

- continued adjustment by debtors;

- sustained non-inflationary growth and roll-back of protectionism in industrial countries;

- sustained financial flows to debtors, though "packages" put together by IMF and IBRD.

Recognise still a long way to go before debt/export ratios begin to decline significantly.

(f) IMF must retain central co-ordinating role, acting as an adviser in the design of effective programmes and a catalyst in the assembly of financing from private and public sources, as well as committing its own resources in support of soundly based adjustment programmes where appropriate. Commercial banks must make their own judgement on how much to lend. Desirable from all points of view that they should strengthen balance sheets. Not appropriate that the stance of supervision should be eased to encourage increased bank flows. IBRD role is also vital. UK supports IBRD proposals for higher lending level. This will soon need to be supported by increased IBRD resources; hence UK support for commitment to early negotiations on GCI. Substantial replenishment of IDA crucial; UK can support an outcome around \$12 billion provided burden-sharing arrangements are equitable. Industrial countries will continue to play their part through Paris Club rescheduling, and flexible resumption of export credit cover to countries undertaking necessary level of adjustment.

(g) Increased direct private investment in debtor countries both by domestic and foreign investors abroad should be regarded as essential component of debt strategy. Main responsibility for creating right environment to attract direct investment must rest with debtor countries themselves. In this context welcome agreement which has been reached on MIGA. Glad to be able to announce that the UK now in a position to sign MIGA and will do so shortly;

(h) But a good deal more can be done by the international institutions to encourage direct investment. Specifically :-

(i) in the co-ordination of export credit cover. World Bank can advise export credit agencies, which are the high priority projects in a debtor country's adjustment programme, to which export credit cover could most profitably be directed;

(ii) World Bank should, in collaboration with IFC, deploy more of their policy-based lending and technical assistance to encourage reform of financial markets and privatisation;

(iii) Both World Bank and IFC should make full use of existing instruments to gear up finance provided by private direct investors, whether foreign or resident. In case of IBRD this could be through expanded use of financial intermediaries;

(iv) encouragement to portfolio investment through IFC's newly-approved "Emergency Markets Growth Fund".

## C. BACKGROUND

1. The debt strategy has achieved considerable success since 1982, with an impressive turnaround in the overall current account deificts of the indebted developing countries (in 1985 one third of the 1982 level). During the last year external pressures intensified on many debtors, with weaker commodity prices, slower export market growth and a marked cutback in bank lending. Hence the debt service ratio of the Baker 15 heavily indebted countries has only fallen marginally (42.7 per cent 1983-85 cf 43.2 per cent 1981-82 and their external debt in relation to exports of goods and services has risen from 231 per cent in 1981-82 to

280 per cent in 1983-85.

2. The outlook remains uncertain. On the one hand there have been certain positive developments ie Baker, Plaza Agreement and Gramm-Rudman. Conversely the recent oil price falls have exacerbated the problems facing a minority of debtors and once more raised the real threat of a Mexican/Nigerian default. The Fund's medium-term scenarios, assuming oil at $15pb, project 3.3 per cent pa GDP growth rate in 1987-91 for the countries with recent debt servicing difficulties, and 4.0 per cent for all capital importing developing countries. A faster than expected cut in the US fiscal deficit and hence lower interest rates, would raise growth in both cases by over ½ per cent pa. Growth oriented adjustment policies, supported by stronger expansion in the industrialised countries could raise LDC growth rates by a further 1 per cent or so. Conversely increased lending (a 2 per cent pa raise in private and 3 per cent rise in official exposure 1987-91) would marginally raise GDP growth in LDCs but lead to a much more moderate decline in debt/export ratio and higher current account deficits and debt service ratio (see brief no. 5 for IBRD scenarios).

**BAKER**

3. The Baker initiative launched last October stressed 3 essential elements of the debt strategy :

(i) the implementation by debtor countries of policies to promote adjustment and structural reform;

(ii) a continued central role for the FUnd and an enhanced role for multilateral development banks (MDBs);

(iii) increased lending by commercial banks - an additional $20 billion over 3 years to 15 countries was suggested.

Baker should be seen as an evolutionary step in the case by case strategy, not as a plan for a series of pre-announced IFI/Banks/ debtors programmes. The US proposals have been widely welcomed, although the Cartagena Group have argued that it provides insufficient funds to guarantee debt repayments and stimulate growth, and called for below market interest rates and weaker IMF conditionality.

4. Some commentators have claimed the initiative has already failed, as no set of co-ordinated programmes has been introduced for the Baker 15. Such criticism is misplaced, misunderstanding the nature of proposals and under-estimating the work already in hand. Many of the large debtors are implementing credible reforms, eg Argentina, or approaching the IBRD and IDB for major policy based loans. For domestic reasons such countries have been unwilling to be identified as Baker guinea pigs. Work is in hand on reforms to streamline MDB assessment of projects and boost their disbursements.

5. Nevertheless a number of problems remain : the precise relationship between the IFIs and banks; whether commercial bank flows will in practice resume at the level indicated and if so; the implications for banks' capital adequacy.

6. It is for the banks themselves to decide on their participation. It is not for Governments either to coerce the banks or to remove commercial disciplines by providing guarantees for any schemes of burden sharing or by easing supervision in order to encourage increased bank flows. Both supervisors and banks share a common interest in further strengthening the financial system by strengthening balance sheets against bad debts. However, it needs also to be recognised that stronger balance sheets may make it harder to secure the participation of the banks involved. The same will be true of banks who have made write offs or otherwise reduced their exposure.

7. If the role of commercial banks is to diminish in relative importance over time, more stable financial flows are required, of longer maturity and more closely linked to specific trade flows or investment, eg direct investment, equity flows and export credit. The main responsibility for encouraging investment flows

rests with the debtor countries themselves. But there are a number of measures IFIs are taking and could take to encourage progress. The most obvious of these is the establishment of MIGA, which UK is now in a position to sign. But a number of other measures are noted in point (h) of the Line to Take above.

8. One aspect of financial flows the Fund has emphasised is the need for more flexibility by export credit agencies to ensure policies align closely with progress in debtor country adjustment. ECAs have of late allowed for prompter restoration of cover, and the UK's DX facility represents a relaxation of the former very restrictive stance. In some cases exporters may be slow to react in taking up any new credit. As export credit pledges have generally been unsatisfactory, we agree with the Fund proposal that in suitable circumstances indications of cover policy attitudes could be given for countries undertaking adjustment programmes.

**COMPENSATORY FINANCING FACILITY**

9. When the debt strategy was discussed on 24-25 March in the Executive Board, there were calls for a sharp easing on the terms of the CFF (ie less conditionality, more money) to help a variety of countries including oil producers. The criteria for a CFF drawing are : (a) the shortfall is temporary; (b) it is attributable to circumstances beyond the member's control; (c) the member is co-operating with the Fund. When the issue of the CFF oil producers was last discussed in 1983, it was agreed that OPEC membership in itself did not create a general presumption against a member's eligibility to the CFF; and that any requests should be considered on a case by case basis. This discussion was, however, constrained by the need to secure the third tranche of SAMA borrowing.

10. The US and Germans are now firmly against any access to the CFF by oil producers. When the Chancellor met Larosiere in January, he also expressed strong doubts about a CFF for oil producers. If the "beyond the control" criteria is looked at in a longer term perspective, the recent price collapse can be

seen, as part, as the result of OPEC increasing prices in 1973 and 1979 to unsustainable levels. The problem is to determine how far the increase in oil prices reflected market forces and what role was played by OPEC restricting supply. Getting a general agreement on a hypothetical counterfactual would be virtually impossible and the IMF would be unable to prove conclusively that the fall in oil prices resulted from OPEC policies. The "beyond the control" criteria is therefore one that gives no clear results. This makes it difficult to challenge the 1983 view that CFF drawing should be considered on a case by case basis.

11. However, it can be argued more persuasively that the fall in the oil price is not of the temporary and reversible character for which the CFF is designed. Accordingly, for oil producers, the accent needs to be more on adjustment than financing. This points to using the enlarged access policy under an SBA - flexibly where necessary in the case of exceptional adjustment - rather than a drawing under the CFF. (For similar reasons, the idea of a "reverse oil facility" being argued by Spain is inappropriate).

**CONCLUSIONS**

12. A successful continuation of the debt strategy will thus depend :-

(a) on the outcome of IMF/IBRD current negotiations with the major debtors, particularly Mexico's follow on programme where negotiations are in the balance - (Argentina, Brazil (and possibly Nigeria?) will begin serious negotiations later in the year. See brief no. 9 on problem countries);

(b) to a considerable extent on forthcoming World Bank issues, ie the endorsement of a new higher level of lending, firmer US commitment to a GCI, and the outcome on IDA VIII replenishment (see brief no. 7 on IBRD issues and brief no. 5 on IBRD role towards major debtors); and

Annex 1

**Trust Fund**

On 26 March, the IMF Executive Board approved the staff proposals for the use of the Trust Fund reflows (the World Bank Board on 17 March had already agreed to the ideas in principle).

The staff proposals represented in essence the modified US ideas which had evolved since Baker unveiled them in Seoul last October. The loans (SDR 2.7bn), to be known as the 'Structural Adjustment Facility', provide for three year 'policy frameworks' for the 60 IDA eligible countries. The joint policy framework agreed with the Fund and Bank is intended to permit wide ranging structural change in the economy, especially price liberalization, reform of parastatals etc. In each case, the World Bank Board would be 'expected to review' the joint policy framework.

Each potential recipient will be eligible to borrow up to 47 per cent of its quota - 20 per cent in the first year and 13.5 per cent in each of the following two years. the loans will carry an interest rate of ½ per cent, repayable in semi-annual instalments after 5½ years. Because India and China have agreed not to use the facility, about 80 per cent of the money will go to sub Saharan Africa.

The UK strongly supported the proposals as closely reflecting the remit of the Seoul Interim Comittee and as offering the best hope for effective use of the Trust Fund resources. In particular, the joint policy framework agreed with the Fund and Bank, while avoiding cross conditionality, would increase the effectiveness of both institutions. The programmes should also help catalyse other resources by giving donors and creditors confidence in a country's policies. Regular reviews would allow programmes to be adjusted flexibly to changing circumstances.

The Africans and Latin Americans had expressed reservations about the extra conditionality being required under the Structural Adjustment Facility and the threat of cross conditionality in the policy frameworks. However, despite these doubts, they were prepared to go along with the staff proposals. Nonetheless, a majority of Executive Directors underlined that they saw an IDA8 replenishment of at least $12bn as an essential counterpart to the new facility.

(c) on policies in industrial countries and the IFIs to expand non-debt creating financial flows.

HM TREASURY

ANNEX

25 MAR 1986

MR MOUNTFIELD
CST, EST
SIR P. MIDDLETON
SIR G. LITTLER
MR LAVELLE
MRS CASE
MR S. MATTHEWS.

THE WORLD BANK
Washington, D. C. 20433
U.S.A.

A. W. CLAUSEN
President

March 21, 1986

Dear Nigel:

I thought you would be interested in the attached table, which sets out the status of programs and associated financing for highly-indebted middle-income countries identified by Secretary Baker in the context of the 1985 Bank/IMF Annual Meetings. As the second column of the table shows, many of the countries that have accepted the need for adjustment already have financing programs in place which run through all or part of 1986; some programs extend into 1987. For several countries (Argentina, Mexico, Morocco, Ivory Coast), discussions of future financing programs are already under way or are scheduled to commence shortly. Public perception that little action is occurring in response to the Secretary's initiative does not therefore reflect the true situation.

The last columns of the table describe The World Bank's lending operations, and indicate a number of important developments: first, sizable increases in new loan commitments in 1985 as compared with 1982; second, a doubling of gross disbursements between 1982 and 1986; and third, the considerable proportion of our resources devoted to adjustment lending in many of these countries in 1986-1987.

While much still depends on what can be agreed with Mexico and Brazil, I would expect that World Bank lending to these 14 countries will exceed $6 billion this year, a little less than half of our total lending. More could have been accomplished, and indeed still may be. There has, however, been little progress with Nigeria, while Yugoslavia's decision-making process has thus far stifled structural change; and the political situation in the Philippines has postponed action on structural adjustment there.

Warm regards.

Sincerely,

Tom

The Right Honourable
Nigel Lawson, P.C., M.P.
Chancellor of the Exchequer
H. M. Treasury
Parliament Street
London SW1P 3AG
United Kingdom

Status of Programs for
Highly Indebted Countries
(as of March 18, 1986)

| Country | Commercial Bank Agreements: Time Period Already Covered | Commercial Bank Agreements: Amounts | Paris Club | IMF | World Bank Actions | World Bank Lending and Disbursement Data: New Loans $ million 1982 | New Loans $ million 1985 | Gross Disbursements 1982 | Gross Disbursements 1985 | Gross Disbursements 1986 (est.) | Estimated Share of Adjustment Lending (%) 1986 - 1987 1/ |
|---|---|---|---|---|---|---|---|---|---|---|---|
| ARGENTINA | August 1985 - May 1986 | Rescheduled: $13.9 billion New Money: $4.2 billion | Under discussion | Standby: Dec. 1984 - March 1986. Amount: SDR 1419m | The Bank's first loan in support of the adjustment process is the agriculture sector loan ($350m. - Board consideration in April), which would bring total FY86 lending to over $400m. Operations to support industrial sector, trade policy and energy sector reforms are foreseen as part of the 1986-87 financial support package. | -- | 240 | 83 | 144 | 350-450 | 64% |
| BOLIVIA | -- No substantive discussions underway -- | | | Currently considering possibility of a Standby Agreement and Compensating Finance Facility Agreement. | Government has undertaken reforms in exchange rate regime, trade and domestic price liberalization, but major problems with fiscal deficit continue. Bank is preparing a Rehabilitation Import Credit for Board presentation this fiscal year. | -- | -- | 19 | 11 | 10-25 | 50% |
| BRAZIL | 1986 | Tentative agreement reached on amounts due in 1985 and 1986 totaling $15.5 billion. | No agreement. | No agreement in place. | Bank will continue to support Brazilian reform efforts. Some $1.3 billion of Bank lending is programmed for FY86 primarily in support of agriculture, rural and urban development and power sectors. | 1090 | 1648 | 623 | 760 | 1175 | 23% |
| CHILE | 1985 - 1987<br>1985 - 1986 | Rescheduled: $5.7 billion New Money: $1.085 billion (including $150m IBRD guaranteed) | Period: Jan. 1985 - Dec. 1987 Amount: $170m. | EFF: Jan.85 - Dec. 1987 Amount: SDR 750m | Financial support for medium-term adjustment program arranged with close Bank involvement: Chile SAL I approved October 1985 ($250m), Highway Sector A-Loan ($140m) and Bank $150m. guarantee of total $300m. commercial bank cofinancing. Bank support of program also provided through Industrial Sector loan ($100m - July 85) and Small and Medium Scale Enterprise loan ($40m - August 85). SAL II expected to be appraised mid-1986. Total FY86 Bank lending approved is $456m. | -- | 541 | 32 | 231 | 365 | 62% |

1/ Loans already approved or under active discussion.

World Bank Lending and Disbursements . . .

| Country | Commercial Bank Agreements: Time Period Already Covered | Commercial Bank Agreements: Amounts | Paris Club | IMF | World Bank Actions | New Loans $ million 1982 | New Loans $ million 1985 | Gross Disbursements 1982 | Gross Disbursements 1985 | Gross Disbursements 1986 (est.) | Estimated Shar[illegible] Adjustment Lending [illegible] 1986 - 1987 1/ |
|---|---|---|---|---|---|---|---|---|---|---|---|
| COTE D'IVOIRE | --<br>1985 | Discussions currently underway. Total amortization due 1986-1989 is $1.1 billion<br>New Money: $132m cofinanced with WB Hwy. Sector loan of $110m. | To be discussed following Fund Agreement | Fund currently discussing new Agreement to take effect commencing June 1986 (probably a 2-year standby for about SDR 100m). | Bank currently negotiating SAL III for $250m. to support medium-term adjustment program. | 158 | 207 | 223 | 70 | 140-195 | 39% |
| MOROCCO | -- | Discussions of rescheduling of 1985-1986 amounts currently underway. Total amortization due 1985-86 is $836 million. | Period: Jan. 85 - Feb. 1987. Amount: $2191m | Standby Agreement Sept. 85 - Feb. 1987 Amount: SDR 200m. SDR 10m drawn in Sept. 85; Subsequent drawings not made due to noncompliance with Fund targets. | Bank has made two Industrial and Trade Policy Adjustment (ITPA) loans in support of medium-term adjustment (ITPA I - $150m., Board - Jan. 1984, ITPA II - $200m. Board - July 1985). An Education Sector Reform loan ($150m) is scheduled for Board consideration in late March. A Public Enterprise Reform loan ($200m) is under consideration for FY87. Total Bank FY86 lending may be $550-600 million. | 166 | 381 | 134 | 307 | 370 | 40% |
| NIGERIA | Oct. 1983 - Dec. 1986 | $5.5 billion Debt rescheduling. $3 billion Trade Credits.<br>New Money: $925 million. | No agreement | No agreement | Level of Bank support hinges on agreement on a sustainable medium-term adjustment program, and Government capacity to provide administrative approval of operations already negotiated. | 247 | 236 | 144 | 271 | 215 | 0% |
| PHILIPPINES | Through December 1985 | Continued coverage hinges on IMF review originally scheduled for Feb. 86. | Period: Jan. 85 - Dec. 1986. Amount: $800m. | IMF standby Oct. 1985 - June 1986 Amount: SDR 615m. | The Bank made two SALs to the Philippines in FY81 and FY83. Present program is supported by loans for agriculture and financial sector reforms. Future support would first focus on restructuring Government corporations. | 533 | 104 | 251 | 233 | 280 | 0% |
| YUGOSLAVIA | 1985 - 1986 | Amount: $3.6 billion. No new money. | Discussions to be scheduled in next 4-8 weeks. | IMF standby May 1985 - Dec. 86 Amount: SDR 300m. | Bank discussing SAL II with authorities for over a year. Although stabilization measures are in place, progress on medium-term structural adjustment is slow. | 136 | 253 | 330 | 295 | 310 | 33% |
| | | | | | Total | 3752 | 5414 | 2672 | 3949 | 5490-5695 | |

1/ Loans already approved or under active discussion.

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

March 27, 1986 - 86/61
Revised: 3/28/86

The Chairman's Summing Up at the Conclusion of the Discussion on Special Disbursement Account
Executive Board Meeting 86/56 - March 26, 1986

Most Directors wished the new facility to be called the Structural Adjustment Facility and found the general thrust of the staff paper to be acceptable, the staff having on the whole fairly reflected in its paper the spirit of the Board's February discussion.

1. Eligibility

Members eligible to use the facility will be the low-income countries that are currently eligible to receive IDA loans. Later changes in the list of IDA countries will not have an automatic effect on their eligibility, but will be a matter for decision by the Board. Commitments made will be honored, even if a particular member were to cease to be eligible in the course of a three-year arrangement.

2. Qualification

The resources shall be made available to eligible countries that are facing protracted balance of payments problems and that enter into annual arrangements with the Fund in support of a medium-term program of structural adjustment. In the assessment of a protracted balance of payments problem, the member's situation will be reviewed against a wide range of indicators, including, as a number of Directors suggested, the recent and the prospective behavior of the current account, reserves, indebtedness, arrears, and growth performance. The assessment should be made on a case-by-case basis, and avoid the mechanical application of statistical indicators. In addition, there will be the assessment of balance of payments need at the time of approval of annual arrangements.

3. Policy framework paper and collaboration with the World Bank

It was agreed, although with a certain reluctance by some Directors, that it would be useful to prepare a policy framework paper which will describe the major economic problems and challenges facing a country; the objectives of a three-year medium-term program; the priorities and the broad thrust of macroeconomic and structural adjustment policies; and references to the likely external financing requirements and, as far as possible, the available sources of such financing.

The framework paper is to be developed in close collaboration with the authorities--who are after all responsible for policy formulation--and the staffs of the Fund and the World Bank, who will work closely on these matters, including through joint missions. It is the expectation of the Fund that these framework papers will be reviewed by the Boards of the two institutions at an early stage before commitments are made on use of the resources of the structural adjustment facility by eligible countries.

The policy framework paper will have to be updated as the program is implemented and normally reviewed by the two Boards, at the time of presentation of the second and the third annual programs, as far as the Fund is concerned.

The suggestions by Mr. Foot would go a long way toward making the procedures as practical and as flexible as possible. I will take two illustrative cases. When discussions on the formulation of medium-term structural policies with a member country are well advanced, as they are in a number of cases, it may well be possible to present a medium-term framework paper and the program for the first year of an arrangement to the Board at the same time. In such cases the Board of the Bank would be expected to take up the policy framework paper first which would be followed by appropriate agreements on structural adjustment or sectoral loans. Quite often, when the two institutions are already collaborating deeply on medium-term structural policies in some countries, the joint mission could be extremely short; the essence of the work could even perhaps be conducted at headquarters. The modalities must be kept flexible, not with the intention of bringing the jointness of the operation into question, but to avoid unnecessary delays and to reduce costs and travel.

In the second case mentioned by Mr. Foot, of a country that was less advanced in the formulation of medium-term structural policies, a separate set of talks would probably have to be conducted with the country by the two staffs in order to arrive at a common understanding that would lead to a framework paper for review by the two Boards. Later on, the Fund would take up the specific program according to its own schedule and procedures, as hopefully would the World Bank.

These procedures will have to be introduced at the outset, as Mr. Massé said, in an experimental fashion with considerable pragmatism and with a view to avoiding rigidities, complications, and undue delays. Of course, each institution will have to be very vigilant to help the other. For instance, to take again the case of a country that has had a series of Fund-supported programs, so that the Fund is well acquainted with its medium-term structural problems and is ready to move quickly forward with a framework paper and a first program. The jointness of the operation, as Mr. Foot indicated, would necessitate prior review by the World Bank of the framework paper; the Board of the Bank must be able to have an input based on its review of the country's framework paper. In such a case, the Fund would hope that the World Bank Board would act in a way that would not delay action by the Fund. The deeper and closer the collaboration, the more each institution will have to be receptive to the schedule, procedures, and constraints of the other, and in particular of the one that happens to be the most advanced in its work.

While closer Fund/Bank collaboration is of the essence, it is fair to say that Directors have stressed that the competence, mandate, and expertise of each of the two institutions must be respected. The Fund would pay particular attention to what it was most well equipped to look at: macroeconomic developments and policies, fiscal policies, monetary policies, exchange rates, exchange systems, tax reforms, and price realignments, but in conjunction with the World Bank, which has particular expertise and competence in development and sectoral policies, investment priorities, microeconomic reforms, and the like.

Cooperation is of the essence, but it will be conducted in a manner that will not give rise to cross conditionality. I also want to stress that these framework paper procedures will apply only in the case of the structural adjustment facility. There is no intention to set a precedent and extend them to other facilities and arrangements or to countries not using the structural adjustment facility. I have taken note of Mr. Dallara's clear reaffirmation of this point.

4. Conditionality

The first annual program will have to be described in a written document from the authorities to the management, which will contain a request for a commitment of resources from the structural adjustment facility for a three-year period.

The document will describe in general terms the policies to be followed over the medium term, making reference to the policy framework paper, and will delineate more precisely the objectives of the authorities and the policies they will implement during the first year. Subsequent documents will review and update the medium-term policy plans and describe, also in specific terms, the policies to be implemented during the subsequent one-year periods.

We have no intention of overloading this conditionality with prior measures, but it needs to be understood that, especially in some cases where there is much to be done and where performance has been somewhat unsatisfactory, an annual program can be credible and can work only if the country is ready to take some measures that will be consistent with the unfolding of the program.

The question takes on added importance beyond the first year. As there will be no performance criteria governing disbursements and no phasing within a year, it will be necessary to make sure, after the first year, to capture correctly the progress that has been made under the structural program. The whole exercise is designed precisely to help a country to move toward that progress.

If after the first year, the Fund believes that the program has not worked and that corrective policies are necessary to make the second year consistent, at least with the general architecture of the medium-term framework, stock will have to be taken of those observations in the negotiation with the member country of the second program year.

Benchmarks or indicators will have to be constructed in a flexible way; they will not necessarily all be quantified and will essentially be devised to help monitor progress in policy implementation and in reaching the objectives of the program that have been described in the authorities' document. I want to make it very clear that these benchmarks or indicators will not be associated with disbursements.

Deviations from benchmarks will of course be noted, and an effort will be made to understand why they have happened. If the reasons are such that they could derail the direction of a program, policy adjustments may well be necessary, and they will be taken up in discussions leading to the arrangement in support of the next annual program.

5. Disbursements

Upon endorsement of the overall policy framework and approval of the program for the first year, the Fund will disburse to the member an amount of resources equivalent to 20 percent of the member's quota in the Fund and will make a commitment to the member to disburse additional resources in two additional tranches on approval of subsequent programs. Given the flexibility inherent in the procedure, an initial calculation has been made of each of the two additional tranches, at the equivalent of 13 1/2 percent of the member's quota. These amounts will be recalculated as the program unfolds; in light of the resources available to the facility, the amounts may be enlarged under the procedures described in EBS/86/53. Because of the uncertainties associated with Trust Fund reflows, commitments will have to be made contingent on the availability of resources.

* * * * *

I will end with three remarks, on flexibility, additionality, and on the protection of low-income contries which are not resorting to the facility. Flexibility has been mentioned throughout the discussion. I think it is fair to say that all Directors stressed that the procedures that will be utilized relating to policy framework papers and the annual programs should be applied flexibly in order to avoid undue delays. There was strong emphasis on the need to make the resources available quickly and also to avoid excessive burdens on the Board, on the staff, and on the authorities.

On additionality, there is no doubt that the rather complex meshing of the assistance by the two institutions will entail additional work and complications. But there are two fundamental advantages to be derived: first, the World Bank can and should provide the expertise to orient programs toward medium-term growth; and second, the resources of the structural adjustment facility should be augmented by other resources stemming from the World Bank, other multilateral sources, and bilateral donors. A number of Directors said that that additionality would only materialize if the eighth replenishment of IDA was to be pitched at the highest level of the range; otherwise, the matching of resources with those of the structural adjustment facility, would be somewhat cosmetic, without true additionality.

Finally, I wish to stress that Executive Directors reaffirmed their great appreciation to China and to India for having offered to forgo use of the facility: not because they are not low-income countries or have no need--they are low-income countries and they have needs--but as a gesture of international solidarity in favor of countries that are in even more dire straits. But China and India also want it to be absolutely clear that the arrangements on which decisions are being taken for use of Trust Fund reflows will not affect adversely the availability of concessional development finance to low-income countries that are not utilizing those reflows under the structural adjustment facility. The Board has unanimously reaffirmed that principle, which is contained in the Seoul communiqué of the Interim Committee, and which must now be implemented.

1937/9

FROM: A B MILLIGAN

DATE: 7 April 1986

MR WYNN OWEN

cc Sir G Littler
Mr Fitchew
Mr Mounfield
Mr Matthews

**BRIEFING FOR IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS**

1. The Chancellor asked for figures to support the statement in the brief on debt situation and strategy that capital flight was slowing down (paragraph b of the line to take).

2. I attach an extract from the IMF's latest World Economic Outlook, which substantiates this statement. The Fund estimate that capital flight from the capital importing countries has declined from over $36 billion in 1982 to $15 billion in 1985; further reductions are expected in 1986-87. These figures have been included in the revised version of the draft brief, copy attached.

3. I also attach an extract from the Financial Times of 4 April 1986 which you requested, reporting on capital flight from Latin America. This was based on the February issue of Morgan Guaranty's 'World Financial Markets' copy attached. Table 9 page 6 indicates that total capital flight from the 10 major Latin American debtors in 1983-85 was almost $31 billion. Over half this sum was from Mexico alone. Morgan Guaranty conclude (page 3) that no reversal of this outflow, as opposed to a slowdown, is in sight for the major Latin American debtors.

4. Lastly I attach (top copy only) the IMF paper on 'Review and Assessment of the System of Meeting Exchange Rates' which the Chancellor requested.

Andrew Milligan

A B MILLIGAN

capital exporting subgroup among them. For the non-fuel exporting countries, positive import growth is projected for 1986-87, although at a modest rate of about 4 percent. Any faster growth of imports by these countries would lead to increases in current account deficits and imply an increased ability and/or willingness on their part to step up borrowing from commercial sources. The chief exceptions are the coffee exporters (other than Brazil) which, because of the very rapid increase in their export earnings, are expected to increase their imports by some 12 percent in 1986.

## 2. Financing and debt

### a. External financing

The external financing situation of most capital importing developing countries remained as tight in 1985 as it had been in 1984, and current account deficits were limited accordingly. Nevertheless, there were some encouraging signs that countries may have completed the main part of the adjustment to the reduced levels of borrowing from private creditors. These signs included the levelling out of payments arrears outstanding, the continued, albeit modest, rebuilding of official reserves, the successful conclusion of a number of rescheduling arrangements, and the reduction in the net use of Fund credit. Nevertheless, external financing constraints remain severe and are likely to continue to be so for many countries until such time as their creditworthiness is re-established.

Four developments that characterized the payments position of capital importing developing countries in 1981-84 continued to be important in 1985. First, the deficit on goods, services, and private transfers, which had been reduced by almost two thirds from 1981 to 1984, remained at approximately its new lower level in 1985. It was thus largely covered by two relatively stable sources of finance: non-debt-creating flows and long-term borrowing from official creditors. Much of the reduction in deficits after 1981 was, of course, in response to the loss of access to private sources of credit. Net borrowing from private creditors fell from $73 1/2 billion in 1981 to less than $14 billion in 1984.

A second important trend in recent years has been the curbing of capital flight. The outflow of residents' capital from the capital importing countries (defined as net asset transactions plus recorded errors and omissions) has declined from $36 1/2 billion in 1982 to $15 billion in 1985. Still lower capital outflows are expected in 1986-87. The reduction in capital outflows had a number of causes. Some countries have introduced adjustment measures that have increased the attractiveness of domestic financial assets as compared with foreign assets--e.g., through increases in domestic interest rates and devaluation of over-valued currencies that ought to have a lasting effect on capital flight. Other countries, however, have delayed the adoption of appropriate adjustment policies, or have allowed slippages to occur in the implementation of an orderly adjustment strategy. Perhaps a more important factor in reducing capital flight has been the reduced level of capital inflows, which, because of the resulting shortages of foreign exchange, has restricted the ability of residents to purchase foreign assets.

A third development is that the rate of growth of external debt has slowed substantially. This deceleration occurred because cuts in deficits on goods, services and private transfers left deficits at levels that could more nearly be financed with non-debt-creating flows. Furthermore, as just noted, domestic adjustment in many countries, by helping to limit capital flight, reduced the need to borrow to finance outflows of residents' capital. Consequently, the rate of growth of total debt has fallen sharply: from 16 1/2 percent in 1981 to 4 1/2 percent in 1985 in terms of U.S. dollars. (The 1985 figure would have been even lower if the depreciation of the dollar had not caused the value of existing debt in non-dollar currencies to rise.) In 1986-87 the value of outstanding debt is expected to continue to rise at 4-4 1/2 percent.

Fourth, progress in strengthening the balance between external assets and liabilities, as well as in improving the maturity structure of external debt, has continued to be made. Reserves have increased in value by more than one quarter since the end of 1982, and the reserves/imports ratio, at 22 percent in 1985, is now at its highest level since 1979. The accumulation of arrears, which had been a record $10 1/2 billion in 1982, declined to $1 1/2 billion in 1984. In 1985, there was a small net repayment of arrears, i.e., a reduction in the oustandings, for the first time since 1979.

Part of the reduction in arrears was attributable to the successful conclusion of a series of annual and multi-year rescheduling agreements (MYRAs) (Table 13). MYRAs have the merit of stabilizing the debt repayments schedule over the medium term for countries that are seen to be pursuing appropriate medium-term adjustment policies. Consequently, MYRAs are in some respects more closely related to the voluntary arrangements for the early refinancing of debt that were common in the late 1970s than to the "distress" arrangements for annual debt reschedulings that became common in the first half of the 1980s. More generally, rescheduling arrangements have, for many countries, become an increasingly accepted method of refinancing outstanding debt for countries which have encountered debt servicing difficulties and are not yet ready to resume borrowing on a spontaneous basis. The sum forecast for debt rescheduling in 1986-87 does not, therefore, necessarily indicate a persistence of debt servicing problems at the same intensity as in 1983-84.

Reference ........................................

Financial Times Friday April [illegible]

# Argentine and Mexican debts 'largely due to capital flight'

BY PETER MONTAGNON, EUROMARKETS CORRESPONDENT

ARGENTINA and Mexico would be virtually free of their crippling foreign debt burden if they had not suffered from chronic capital flight over the past 10 years, according to a new study by Morgan Guaranty Trust of the US.

The study, published in the bank's monthly review of World Financial Markets, offers one of the first detailed assessments of the relationship between capital flight and the build-up of foreign debt.

It says that Argentina would have just $1bn (£680m) in foreign debt today instead of $50bn if there had been no capital flight. Mexico's debt would be an entirely manageable $12bn instead of $97bn.

The figures take into account the continuing drain on the balance of payments of servicing debt incurred to finance capital flight which in Mexico's case totalled $53bn in the past 10 years while that of Argentina totalled $26bn.

Morgan Guaranty warns that its figures, which are widely disputed in a number of countries covered by its study, provide only a rough estimate because of the lack of reliable data, but it says that with few exceptions the totals are more likely to underestimate the true extent of capital flight rather than exaggerate it.

The figures are reached by adding together recorded inflows of capital through net foreign investment and foreign borrowing and subtracting from this total the current account balance of payments deficit as well as increases in official reserves and recorded foreign assets of the debtor's domestic banking system. The residue is capital flight in the broadest sense of the term.

On this basis Venezuela also suffered heavily from capital flight over the past 10 years with a total of $30bn, while Brazil, the largest debtor in Latin America, lost only $10bn.

A further conclusion of the study is that capital flight is not just a problem for Latin America. Capital flight from South Africa totalled $17bn over the past 10 years and the country would have just $1bn in foreign debt instead of $24bn if it had not taken place. South Korea and Malaysia both lost $12bn, Nigeria and India $10bn and the Philippines $9bn.

Not all this money was stashed away in secret bank accounts by rich individuals. Morgan says it is using an "expensive" definition of the meaning of the term capital flight. It includes perfectly legitimate activities such as the acquisition of foreign-currency working balances by local enterprises engaged in international trade and trade credit extended directly by local exporters to their foreign customers.

CODE 18-77

BRIEF no 3:

HM TREASURY

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS

SDR allocations

## A. Objective

To avoid resumption of SDR allocation since case on grounds of long term global need not made out.

## B. Points to make

(a) Not persuaded of case for an allocation. There is no overall shortage of global liquidity. Current reserve levels are close to the 1970s average in relation to trade and external debt. Value of ratio of non gold reserves to imports at end 1985 (20.7 per cent) nearly equal to its average value of ratio over the period 1974-84 (21.1 per cent). Ratio for developing countries of 30.4 per cent in 1985 was second highest in 1980s (although we recognise that this reflects not only accumulation of reserves but also import compression as LDCs adjust).

(b) Acknowledge there are difficulties faced by countries which have not followed sound policies in securing level of reserves they desire. These reflect a lack of creditworthiness, which must be restored, rather than a global shortage of reserves. In such circumstances, there can be no evading the requirement for prudent adjustment policies. Nonetheless, we expect demand for international liquidity to grow roughly in line with trade. Operation of international capital markets should supply liquidity requirements although in some cases countries will face continuing limitations to their access to capital markets despite having implemented adjustment measures. It is partly this problem that Baker initiative addressed. In any case, it would not be solved by SDR allocations.

(c) Developments in the international monetary system have altered SDR's rationale. It now has a safety net role. If international capital markets provide inadequate to supply countries' needs, SDR could have a role to play, as G10 report recognised. No sign of this at present.

## Background

1. The SDR is a composite currency unit defined in terms of 5 international currencies (dollar, DM, yen, franc and sterling). So far SDR 21.4bn has been issued in proportion to Fund quotas. (SDR 9 bn during 1970-72; SDR 12 bn during 1979-81).

2. The IMF's Articles require SDR allocations to be justified by long term global need to supplement existing reserves. Judgement of reserves adquacy is inevitably contentious, but the UK has consistently rejected the case for allocations in recent years.

3. Because recent Board discussion of allocations have reiterated wellworn arguments and been unproductive, it was decided this time that it was desirable to clarify the potential role of the SDR in the international monetary system before considering allocations (see brief 4(c)). In their paper the IMF staff suggested a relatively modest allocation (2 bn p.a. for 5 years beginning in 1987). When Executive Board discussed the subject again on 25 March, there was, as expected, little change in basic positions. The US, Germany, Japan, UK and Australia (controlling 40 per cent of the votes) remained opposed to an allocation. The Canadians also said they no longer favoured an allocation although they would not oppose one if others favoured it. Other Directors maintained their previous position in favour of an allocation, arguing that it would improve the quantity and quality of developing countries' reserves. Since an allocation needs 85 per cent majority, the MD is not in a position to report a consensus in favour to Interim Comittee.

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OLD VERSION

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**Brief no 4(a)** Revised.

**HM TREASURY**

**IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS**

**9-11 APRIL 1986**

**Functioning of the Exchange Rate System**

**A. Objectives**

1. (a) To avoid any commitment to target zones and to get wider acceptance that they are impractical at least for the moment.

   (b) To get agreement that the best way forward is through strengthened surveillance (multilateral and bilateral) in G10 and IMF.

   (c) To avoid any public commitment to an international monetary conference.

   (d) To keep debt problems separate from discussions of the international monetary system.

**B. Points to make**

2. (a) Volatility of exchange rates reflects various external shocks of the 1970s inflation differentials and massive capital flows. Only the flexibility of the floating rate system would have coped with these problems and allowed countries to adjust flexibly to recent oil price falls.

   (b) Misalignment of currencies not a fault of flexible exchange rate system but the underlying economic imbalances eg fiscal policies, savings rates. Greater stability can only be achieved by removing such imbalances and convergence of economic policies.

   This whole dynamics [illegible] of Fx [illegible]

   (c) Priority must be to correct existing misalignments in system. Plaza agreement made considerable progress in doing so, though may not yet be complete. (Yen in particular still needs to appreciate.) But progress made of Plaza now needs to be underpinned by action to correct underlying economic imbalances, particularly US budget deficit.



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(d) Plaza not a shift towards a system of target zones nor would such an agreement have been possible at Plaza. But represents major countries' readiness to intervene in exceptional circumstances where it is agreed that a major misalignment needs correction.

(e) Not persuaded target zones are feasible, nor is it clear when they would be feasible. Considerable risk that zones would provide a one way bet to speculators, especially when further exchange rate adjustment was needed, and thus could be destabilising.

(f) Functioning of present system best improved by better policy co-ordination between major countries and strengthened IMF surveillance, building on progress at Plaza. Will have more detailed proposals to make on this. But this does not require nor do we all need major changes in institutions or exchange rates regime.

(g) One subject which should be studied in the surveillance exercise is the pattern of international capital flows and demand for foreign exchange reserves (both private and official), and the influences on them, given their impact on exchange rates. Understandable and natural that bulk of reserves (both official and private) now predominantly held in dollars. But one-way demand from rest of world (notably from Japan) to hold claims on the US must have contributed to recent exchange rate misalignment. A gradual and long term shift towards more diversified foreign exchange reserves holdings and a more balanced pattern of capital flows could help, albeit in a small way:

- reduce risks of future misalignment and variability;
- promote greater symmetry in the international adjustment process (by making it less easy for reserve currency countries to finance continuing deficits);
- enable Central Banks to conduct intervention operations more flexibly.

Am emphatically not suggesting any major overnight shift in pattern of reserve holdings; nor any artificial incentives. But important that the major surplus countries, whose currencies are or have potential to be reserve currencies (Germany and notably Japan) should remove any obstacles to internationalisation of their currencies; ensure that a sufficient range of attractive liquid assets exists; and accommodate other Central Banks wishing to increase their reserves holdings of these currencies.

(h) To sum up, do not believe that any major change in exchange rate regimes or institutions is desirable or practical. Accordingly, not persuaded of need for international monetary conference; dangerous and destabilising to up such a conference in absence of agreement on agenda or direction of reform. Priority is further work in Executive Board to strengthen procedures for surveillance and policy coordination.

**Defensive**

(i) Soft target zones? - their existence could not be kept secret, and thus destabilising (see (e) above).

(j) **Studies on target zones**? - no objection to Executive Board discussion of Fund studies with MD reporting back to Annual Meetings. No decision needed at this stage to follow up such work. Existing fora should be used - unpersuaded of need for G24 proposal for joint Ministerial Sub Committee of the Interim/Development Committees.

(k) **European Monetary System** is an example of a target zones? No-EMS works satisfactorily as Europe is a cohesive, political and economic grouping and the system is centered on 1 currency, DM. It is not a paradigim for greater fixity of exchange rates at the global level between the US, Japan and Europe, as the potential for destabilising flows is greater.

## C. Background

3. In 1985 the G10 Deputies' Report, endorsed by Ministers in Tokyo, concluded that the basic structure of the present international monetary system remains valid and requires no major institutional change. In 1985 G24 also produced a parallel report on these issues. The Reports were considered procedurally in Seoul and remitted to the Executive Board for further study. Since then in his State of Union message in January President Reagan invited Secretary Baker to report back to him by the end of the year on "whether the nations of the world should convene to discuss the role and relationship of our currencies". We understand that Baker continues to have an open mind on these issues and that he is unlikely to put forward any firm proposes at the meetings. At a recent lunch with businessman, he played down the importance of the monetary conference idea, noting that the President had not given him a deadline for his review. Nonetheless, because the

administration in the face of continuing protectionist pressures, need to show that they are continuing to look for progress in this area, it is possible that Baker may float some ideas, such as improved surveillance, for further consideration. (There are indeed solid US domestic reasons to explain the initiative - to help resist protectionist pressures and to take the initiative away from Congressmen Kemp and Bradley, who are due to hold another international monetary seminar at the end of June - this time in Europe. Nonetheless, the effect of the Reagan proposal is virtually to rule out any chance of discussions on international monetary reform/target zones for the time being).

4. The IMF Executive Board has discussed staff papers on the floating rate system reviewing the operation of managed floating rates over the last 14 years, and examining the arguments for and against target zones in greater depth. Discussion focussed on three proposals for reforming or strengthening the system: hard or soft target zones for the major currencies (favoured by G24); better co-ordination of the major industrial economies through a system of objective economic indicators (G24); and strengthened multilateral and bilateral surveillance of the major economies by the IMF (G10 and G24).

5. The papers, whilst not drawing any conclusions, agreed with the G10 and G24 reports that the floating rate system has been imperfect and its operation should be improved; that the main focus of attention should be the management of the major world currencies, and that IMF surveillance of the major economies should be strengthened.

6. Despite Reagan's proposal for a conference and a number of other developments (eg the Plaza Agreement), our view is that the majority line in the G10 Report remains valid ie the basic structure of the present system is sound and requires no major institutional change. In the Board we stressed the resilience of the currency system in the face of (continuing) external shocks (eg oil price uncertainty); the risk that target zones would incite rather than dampen destabilising speculation; the need to give priority to reducing current exchange rate misalignments and the domestic imbalances underlying them, and the impossibility of agreeing on and operating target zones, while misalignments persist.

how do you 'implement' target zones?

7. On objective indicators, we argued that setting mutually consistent targets for the five (or ten) majors is certainly impractical in current circumstances - even more so than fixing target zones. We tried to avoid the accusation of refusing to

accept any of the disciplines which we insist the IMF imposes on the debtors, but governments which need to borrow from the Fund simply have to accept a stronger degree of discipline than those who do not. We agreed that a mutually consistent set of forecasts, exchanges of data etc covering the major G10 economies could contribute usefully to improved surveillance (which has been a major theme since the Versailles summit).

8. In Board discussion there was no sign of consensus for major reforms to the system. Apart from ourselves, Germany and Japan remain opposed. Twelve Directors, mainly those representing ldc constituencies, favoured the introduction of target zones in one form or another. The French remain in favour but for the moment are not running the idea hard. They may be biding their time in the belief that the USA is effectively committed to an international monetary conference. In the Board, the US was non committal noting the US commitment to improving the functioning of the international monetary system and referring to the State of the Union Address. There was little enthusiasim for target zones but an implied preference for strengthening the surveillance process. The Managing Director noted in his summing up (copy attached) that there was broad agreement on the weaknesses of the present system and the need to seek to improve its operation. A return to fixed exchange rates was impossible and the flexibility of the present system had been valuable. The staff will undertake further work on the way exchange rate variability has affected different groups of countries and the extent to which the success of the EMS could be regarded as a paradigm for global reform. The most likely outcome at the Interim Committee is a compromise proposal that the IMF Executive Board should conduct a study of the conditions under which target zones might be feasible. We could, if necessary, accept this, on a without prejudice basis.

HM TREASURY

but define what is weak & how it would work

 L3

February 19, 1986 - 86/31

The Chairman's Concluding Remarks Following the Discussion on Review and Assessment of the System of Floating Exchange Rates and Target Zones
Executive Board Meeting 86/26 - February 12, 1986

1. General points

There is clearly widespread concern among Executive Directors about the way in which the exchange rate system has operated in recent years. In this connection, I wish to make several points.

First, there was broad agreement that, in present circumstances, a return to a fixed exchange rate system would be impracticable and undesirable. Given the magnitude of the external shocks that the world economy has suffered over the past ten years or so, and given the size, the openness and the integration of capital markets, Directors considered that an element of flexibility in the working of the exchange rate system has been--and remains--essential, as it has helped to preserve an open trading system. Its flexibility has contributed to the absorption of shocks by the system.

Second, it was widely recognized that the floating system has not functioned without substantial problems. Massive balance of payments imbalances have developed, there has been excessive short-term exchange rate volatility, and, perhaps more important, significant and persistent misalignments in exchange rates have appeared. These problems have entailed substantial costs in terms of market uncertainty, misallocation of resources, and protectionist pressures. A number of Directors considered that these costs have been particularly acute for developing countries--which have greater difficulty than industrial countries in utilizing hedging mechanisms--and for small, open countries, which are more vulnerable to external shocks stemming from exchange rate volatility and/or misalignment. The staff was asked to study further the possible differences in the impact of exchange rate variability and misalignment on the various groups of members.

Third, a number of Directors considered that the payments imbalances, exchange rate volatility, and exchange rate misalignments were not due directly to the floating rate regime itself; rather they were the reflection of the divergent and sometimes incompatible economic policies of the major industrial countries. However, a large number of Directors recognized that the way in which the floating regime had operated has some systemic implications. Indeed, the system had not helped to promote discipline and coordination in the setting of economic and financial policies in the major industrial countries. Moreover, the system had not--as had been hoped by some before the launching of the system--fully protected monetary policy autonomy. In sum, there was a clearer recognition that exchange rates do count, and that a more "active approach" toward improving the system was called for. The Plaza Agreement of September 22, 1985 and President Reagan's recent statement on currencies in his State of the Union Address are manifestations of the need for that approach.

## 2. Improving the functioning of the system

In the light of those general points, the question naturally arises what is to be done to improve the functioning of the system? A number of interesting views were expressed.

Directors generally agreed that the potential improvements in the exchange rate system rely heavily on the extent to which individual major industrial countries in particular will show the political will to increase policy discipline and pursue more internationally consistent policies. In other words, the basic questions are whether the international consequences of domestic policies will be taken more fully into account by the interested authorities when they formulate and implement those policies, and how the exchange rate system can enhance such mutual consistency.

The practical suggestions that have been presented and analyzed by the staff have to be looked at in the light of the objective of improving the functioning of the exchange rate system in order to achieve better policy coordination and consistency.

Twelve Directors said that they have an open mind on or a favorable attitude toward some form of target zones. The basic idea behind that line of thought is that target zones would introduce an automatic or quasi-automatic mechanism which would enhance the discipline in the system. There were some nuances of opinion among those who held that basic view. But several Directors were interested in a target zone system that would have the following characteristics: it would consist of a version of "soft" targets, at least at the start; it would give at least an indication of the direction of appropriate exchange rate movements, if not a precise pattern; it should trigger discussions in the event of emerging misalignments or other problems; it should provide a framework for regular discussions among major countries with a view to preventing problems; and the exchange rate indicator would be only one element of a broader set of criteria to be utilized in assessing the position of economic policies of different countries. Some Directors felt that an expanded version of the EMS was worth considering.

Other Directors were skeptical about, or had reservations on the idea of, setting a pattern of exchange rates and using that pattern as an operational mechanism. They made in particular the following points. First, it would be very difficult, if not impossible, to reach an agreement on a pattern of equilibrium exchange rates. Second, such a system could in some circumstances facilitate or foster destabilizing speculation. Third, and perhaps more important, concentrating on one indicator, the exchange rate, as a guide for policy adjustments, and using only monetary policy--the most flexible instrument--to maintain a predetermined pattern of exchange rates, could together result in inappropriate policy responses in some circumstances; monetary policy could become excessively subservient to the attainment of external policy objectives, and the system could then encourage inflation or deflation.

Whatever the mechanism, most Directors agreed that, without sound and consistent economic policies, a target zone system would not be an appropriate tool in itself, and could send misleading signals.

Most--if not all--Directors considered that the September 22, 1985 Plaza Agreement was a favorable--although belated in the view of several--development, as it was a manifestation of closer convergence of economic policies and had encouraged a more rational pattern of exchange rate developments. Most Directors also agreed that improved cooperation among the largest players in the exchange rate markets--especially the major industrial countries--was crucial for the successful working of any exchange rate regime. Most Directors further agreed that the appropriateness of exchange rates should be one, but only one, of the elements involved in the exercise of multilateral surveillance.

I come now to the possible role of objective indicators in the conduct of surveillance. A number of Directors stressed what they felt were the imperfections of the peer pressure mechanism and of the present surveillance procedures. They urged the Fund to adopt a negotiated set of broad objective indicators that could trigger policy discussions or even policy actions. But many Directors were skeptical or had reservations--indeed, some of them had strong reservations--about the mechanical use of such indicators, because of the complexity and possible shortcomings of such an exercise. In any event, several of them doubted whether it would be practicable to attain a consensus on such a complex array of indicators. But all agreed that the efficiency of surveillance should be reinforced, and I expect that to be the major theme of next week's discussion on surveillance.

In concluding I would note 11 precepts that were mentioned during the discussion. (1) The existence of a broad political will to take appropriate actions is a prerequisite for the successful working of any exchange rate system. The needed political will would be fostered by an appreciation by policymakers of how their own actions can affect the exchange rate system and in turn their own economies. (2) The major currency centers must maintain stable, anti-inflationary, sound and balanced economic policies if any exchange rate system is to work. (3) Surveillance must be reinforced and should encompass a wide range of indicators, including exchange rates. (4) The Fund must play a central role in the operation of and surveillance over the exchange rate system. (5) Directors should build on the strengths of the present system and correct its imperfections. (6) Whatever system is devised, it must have sufficient flexibility. (7) Directors should not overemphasize the significance of the differences in the various possible approaches to obtaining improvements in the exchange system; they should concentrate on the basic substantive objectives of those improvements. (8) The Fund should study more deeply the merits and limits of the EMS system as an aid in assessing possible improvements in the overall exchange rate system. (9) The improvements should aim, in particular, at avoiding the major misalignments that have marred the present system in recent years. (10) In discussing these matters we should not have in mind ideal, textbook situations and solutions. Instead, we should consider proposals and actions that are realistic and which are based on an understanding of how the markets function and are likely to react to changes in the exchange rate system. (11) We should do nothing that might encourage trade and payments restrictions.

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**BRIEF NO. 4B**

HM TREASURY

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS

9-11 APRIL 1986

**Surveillance**

## A. Objectives

(a) To seek a strengthening of surveillance (multilateral and bilateral) and improved policy co-ordination along the lines of the G10 Deputies report, as the only practical way forward to improve the working of the floating rate system;

(b) To make specific proposals for the improvement of multilateral surveillance through quantified analysis of medium-term prospects and policies.

(c) To leave the way open for the G5 to continue as a forum for surveillance (with the participation of the IMF Managing Director).

## B. Points to Make

(a) Pre-conditions for greater exchange rate stability are sustained action by major currency countries to remove the domestic economic imbalances, which underlie current exchange rate misalignments and variability; and, over the medium-term, greater consistency and coherence between major industrial countries' policies and objectives. Policy commitments entered into in Plaza Agreement a good first step. Need to build on this approach.

(b) Way forward now is to improve policy co-ordination between major countries and strengthen role of the Fund both in multilateral surveillance and in annual Article IV consultations along the lines set out in last year's G10 Report.

(c) As regards multilateral surveillance, build on the G10 Report's recommendation that there should be a separate chapter in the WEO, analysing G10 policies and their interaction. This should first be discussed by IMF Executive Board. The Managing Director's summary and report of that discussion could then be the basis for policy reviews by the G10 at Ministerial level. [We should not rule out more informal meetings of smaller groups of industrial countries, which the Managing Director would attend, the results of which could be fed into the wider G10 exercise].

(d) Multilateral surveillance should not be confined to exchange rates, but should cover domestic policies (fiscal and monetary), which affect the exchange rate and external viability more generally. Considerable advantage in putting multilateral surveillance in context of a medium-term analysis of prospects and policies. Nearly all major industrial countries now set their national monetary and fiscal policy in a medium-term framework. Time now ripe to try to do so internationally with the aim of bringing greater stability to financial markets.

(e) More precisely, multilateral surveillance might take the following sequence :-

(a) an analysis by IMF Staff of medium-term prospects and policies, as foreseen by each country, supplemented as necessary by quantification, eg projections of money GDP, real GDP, monetary aggregates, real interest rates, saving and investment, fiscal deficits and the external variables; (The paper produced on the G10 economies for this meeting is a good first step).

(b) the identification of potential inconsistences and conflicts and of alternative policies in one or more countries to help reduce such inconsistencies;

(c) discussion at Ministerial level of possible policy commitments, covering at least fiscal and monetary policies aimed at agreeing a set of medium-term objectives and policies consistent with a more stable world economy.

(f) Must emphasise that a large element of judgement and flexibility would have to be exercised in this process. Not practical to think of objective indicators which would act as automatic triggers for policy adjustment. Exact nature of policy commitments to be entered into and amount of publicity to be given to them will/ require discussion. Would probably be best to start in a relatively modest way - with unquantified and general commitments similar to those in the Plaza Agreement annexes. As credibility of the process grows, more precise commitments and clearer publicity might be possible.

(g) Stronger multilateral surveillance needs to be complemented by stronger bilateral surveillance both for G10 countries and the rest of the world. In particular, as the G10 Report proposes, there should be :-

- greater willingness to use supplemental surveillance in between Article IV reviews;

- fuller involvement of Finance Ministers and their senior officials in Article IV consultations;

- an obligation on member countries to respond within a fixed time period to policy recommendations emerging from the Article IV consultations and from the Executive Board's discussion.

Doubtful, however, about desirability of publishing outcome of Article IV discussions. This could compromise confidential relationship between Fund and Members.

(h) Next Steps. Further work now needed by the Executive Board with help from IMF Staff to work up more detailed proposals (including an annual timetable) for improving multilateral and bilateral surveillance along the lines suggested. Agree this work should include consideration of amendments to the 1977 and 1979 guidelines on surveillance.

**Background**

3. The IMF's surveillance function derives from its responsibility, expressed in Article IV for oversight of the international monetary system. It is conducted in accordance with guidelines drawn up in 1979 to take account of the general move to floating rates. Practice has evolved with time, with Article IV consultations and WEO central to the process. As a result, surveillance has increasingly focussed on underlying imbalances in the domestic economy and on fiscal and monetary policy rather than simply on the exchange rate and balance of payments.

4. The experience of the last few years - large exchange rate misalignments and increased variability together with corresponding fiscal and current account imbalances - have led to a general consensus that surveillance - particularly multilateral - should be strengthened. Proposals to this end feature in both the G10 and G24 Reports. The G10 Report, in particular, proposes a separate chapter in the IMF's WEO analysing G10 economic policies and their interactions; regular G10 Ministerial policy reviews based on the WEO analysis and strengthened Article IV procedures, in particular the use of in-year supplementary surveillance report as necessary. Staff papers for the Board's discussion on surveillance covered all these points as well as more detailed questions about the mechanics of the surveillance procedure.

5. Effective surveillance must look at national policies in a multilateral setting, and requires an assessment of the external repercussions of members' policies. The G10 Report's proposal for an assessment of G10 policy interactions, leading up to regular G10 Ministerial policy reviews, therefore represents a useful step towards a wider awareness of economic linkages between major countries. We have also supported a strengthening of the impact of existing bilateral (Article IV) surveillance procedures through, for exxample, strengthening both the analytical basis of surveillance and the influence of the consultation process through a more active follow-up after board discussions and supplemental surveillance as necessary, rather than through a wider coverage of those consultations.

6. The G24 go further in pressing for a system of "objective indicators" to be introduced. They seem to have in mind macro-economic performance targets for the main industrial countries analogous to those in Fund stand-by programmes, failure to adhere which would trigger off "supplementary surveillance" examinations of the major economies. In addition to the general wish to reduce economic instability, the G24 are mainly motivated by resentment that the industrial countries (particularly the USA) are not subject to the same constraints as developing countries, many of which have had to accept Fund conditionality under stand-by arrangements.

7. There are certainly strong objections to published "objective indicators", which would be regarded as automatic triggers in the way the G24 apparently envisage. In a situation in which target zones for exchange rates cannot be agreed, it would clearly be out of the question to agree on quantified and binding targets for a much larger number of monetary and fiscal variables. But we accept that a mutually consistent set of forecasts, exchanges of data, etc. covering the major G10 economies can contribute usefully to improve surveillance. This would enable the major

players to focus on the interactions between their economies and identify potential conflicts. The IMF Staff have indeed produced a detailed working paper for the Spring World Economic Outlook on "Interactions between the G10 Economies". The Points to Make set out our own proposals for improving the surveillance process by setting it in a quantified medium-term framework.

**Views of Other Countries**

8. In the Board all Directors agreed that surveillance needed to be strengthened. To be effective it had to encompass domestic as well as exchange rate policies and in this regard several Directors felt that the existing guidelines were drawn too narrowly. Therefore, while acknowledging that this had not prevented a broadening of surveillance procedures over the past few years, and that at bottom the effectiveness of surveillance would not be enhanced just by revising the guidelines, most Directors were of the view that some amendment of the 1977 document would be needed in due course if only to bring them into line with current practice.

9. On objective indicators, the G5, Canadian, Dutch and Australian chairs expressed objections to varying degrees. The US, however, appeared sympathetic to the development of a more systematic and quantified framework for multilateral surveillance and may therefore be responsive to our own proposals. Most Directors supported the idea of a separate WEO chapter on the interactions/repercussions in G10 countries and that the Chairman's summing up of the relevant Board discussion could provide a basis for the discussion by G10 Ministers. There was considerable support for the MD's participation in G5 meetings including, among G5 members, the French, Germans and, to a lesser extent, the US. On greater publicity on Article IV consultations, the Executive Board remains overwhelmingly opposed, with only the US in favour of a brief statement from the MD after each Article IV discussion of a major country.

10. At the G10 Deputies on 14 March the Dutch said that Minister Ruding would want both the G10 and Interim Committee

to discuss "consistency indicators"; and that he will want to propose follow-up studies of this subject in the IMF before the Annual Meetings in the autumn. Ruding sees this primarily as a procedural device to ensure that future work on exchange rate and surveillance issues should remain firmly within the IMF and G10, so that any take-over bid from the Tokyo Summit or elsewhere can be resisted. We should support him on this.

**HM TREASURY**

BRIEF 4(C) Revised

HM TREASURY
IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE
9-11 APRIL 1986

**Management of International Liquidity and the Role of the SDR**

**Objectives**

(a) To emphasize link between balance of payments adjustment mechanisms and global need for liquidity. Need to take these in their logical order. Only if changes to exchange rate regime were agreed, would it be appropriate to take decisions on the need for changes in supply of liquidity. Until then, right to keep SDR alive but not to over promote it.

(b) To recognise that even under the present exchange rate system the SDR could have a role to play in contributing to the stability of the system in certain contingencies but to argue that no long term global liquidity shortage at present.

(c) To reject arguments for conditional SDRs and for SDR aid link.

**Points to make**

2(a) Role of SDR has changed since its inception. It was conceived in a fixed exchange rate system when international capital markets were undeveloped with the objective of alleviating a shortage of international liquidity.

(b) Developments in the international monetary system in the 1970s - notably suspension of gold convertibility, growth of international credit markets, increases in private sector holdings of foreign exchange and the development of a multi-currency reserve system - have altered its original rationale.

(c) The growth of international credit market means that a country can, if it wishes, increase its gross reserves by external borrowing. Attaining and retaining the creditworthiness to do this has thus become a discipline requiring countries to follow prudent policies. Difficulties faced by countries which have not followed sound policies reflect a lack of creditworthiness, which must be restored, rather than a global shortage of reserves. In such circumstances, there can be no evading the requirement for prudent adjustment policies. New allocation of SDRs not a solution.

(d) Recognise that the present system of liquidity creation can produce 'Bandwagon' effects, but this underlines the need for the approach outlined in the G10 Report with its stress on the importance of stable policies. Efforts best directed towards making system work better through better coordinated policies, improved surveillance and central bank supervision together with better information.

(e) In line with G10 Report we see a safety net role for future contingencies for the SDR.

**Defensive points**

(i) SDR allocation would increase share of owned reserves. Can be argued that cases exist where present system may compel more abrupt balance of payments adjustment than might have been desirable or feasible with more "owned" reserves. But these are exception rather than rule, and not a symptom of a global shortage of liquidity. Abruptness of adjustment may reflect fact that it was initially delayed too long.

(ii) SDR-aid link. SDR designed to supplement international liquidity, not supplement development finance. Distribution of increased aid on basis of developing countries' IMF quotas not the most appropriate distribution on developmental grounds - tends to favour richer ldcs.

(iii) Conditional SDRs (French and Belgian proposals). Will be considered in future IMF work on SDR, but problems of targetting according to need likely to be formidable. Would not have full advantages for recipient of owned reserves and would undermine quality of SDR, since it would depend even more heavily on ability of ldcs to service it. Ldcs might also use it as an opportunity to secure a relaxation of Fund conditionality. Such skewed allocations always raise questions about possible need to amend Articles.

(iv) Indian proposals. Implications of these ideas far from worked out yet. For example, IMF under its Articles not able to borrow SDRs directly from its members. Therefore, a scheme such as Indian would require borrowing to be done indirectly. Moreover such a proposal unlikely to enhance SDR as an asset. However, MD has promised future staff work on those ideas. We must await them.

**Background**

3. The G10 Report put the SDR on the back burner. Questions about the future of the SDR are inextricably bound up with discussion of the exchange rate system. Any moves towards greater fixity in the latter inevitably raise the question of the adequacy of reserves. We would argue that the major countries - those most likely to need to intervene - already have adequate reserves or would have no difficulty in borrowing them. Nonetheless there can be presentational (apart from cost) disadvantages in borrowing. One weakness of the IMF staff's argument in favour of an SDR allocation has been their failure to distinguish between borrowing to augment reserves and borrowing to finance consumption. In some cases it may be difficult to distinguish which motive is dominant, but experience with SDRs suggests that those most keen to create them are most likely to use them and that this inevitably detracts from their role as owned reserves (although such use has to be paid for).

4. An assessment of the role of the SDR in promoting stability of the international monetary system needs to draw on recent experience of the operation of international credit markets. The main influence determining the volume of world liquidity remains the stance of monetary policy of the major countries. Nonetheless banks can have powerful effect on distribution of liquidity. There is no automatic or graded constraint on reserve creation and changes in a country's ability to borrow can sometimes come too abruptly. Private markets can thus on occasion be an unreliable source of liquidity, giving rise to periods of borrowing that is excessive in relation to the countries' capacity to service its debts followed by periods of sharply curtailed access to external finance.

5. The question of owned and borrowed reserves is a complex one. The argument that the owned reserve nature of SDRs could enhance the quality of reserves and hence the stability of the internationally monetary system will have attractions to some in the light of present international debt problems. The unreliable provision of liquidity by private markets also lay behind the G10 Deputies' conclusion that the SDR could provide a safety net for future contingencies, including the possibility of private markets being unable to meet a legitimate long-term global reserve need. It is for this reason principally that we believe that it would be prudent to maintain the SDR as an additional option for coping with certain types of acute, but unforseen, difficulties. Nonetheless, the fact that LDC's generally spend their SDR allocations rather than holding them, or

use them to settle transactions (when receiving as well as paying), is an important qualification to the view that SDRs would improve the quality of reserves.

6. The Executive Board itself has come up with little in the way of new ideas. There were repetitive discussions with most Directors reiterating positions well worn at previous discussions on the question of an SDR allocation. LDC directors confined themselves to arguing for an SDR allocation as a way of improving the liquidity position facing LDCs - many of whom were unable to borrow on the international capital markets. The Indians argued for an SDR allocation following which the OECD block would lend their allocations to the LDCs for perhaps 3 years. It is clear, however, that they have not fully worked out the implications of their proposals. The French and Belgians also reverted to earlier ideas of theirs that the SDR allocations might be more accurately targetted upon developing countries. The MD said the staff would discuss such proposals in their future work.

7. We have argued that the SDR is not at all well suited for such distributional schemes. It is wrong to confuse SDR as element in reserves with SDR as development finance (hence the need to avoid the SDR aid link). For the same reasons we are not keen on any conditional variety of allocation (which detracts from the nature of the SDR as owned reserve). Skewed schemes would either involve a change in Articles or, if they involved the voluntary passing back of allocations to Fund for use in programmes, would have to be structured so that did not involve direct lending to LDCs which EEA would not be empowered to do.

**HM Treasury**

Brief no 5:

## HM TREASURY
## IMF/IBRD AND DEVELOPMENT COMMITTEE MEETINGS
## 9-11 APRIL 1986
### World Bank paper on the major debtors

(See brief no 2 on debt situation and strategy for general objectives, line to take and background and brief no 7 on World Bank issues and the GCI. This brief summarises the IBRD paper on achieving sustained growth in major debtors and examines its conclusions on the required level of financial flows and the impact on World Bank lending and resources.)

### A. OBJECTIVES

1. Continue to promote the World Bank's role in the debt strategy.

2. Reaffirm UK commitment to increasing IBRD resources.

### B. LINE TO TAKE

(a) Welcome useful World Bank paper analysing debt problems of major debtors.

(b) Endorse increasing importance of World Bank's role in general debt strategy, and need for close collaboration with Fund, and improved co-ordination with regional development banks particularly in light of Baker strategy.

(c) Agree that a significant expansion in lending to countries pursuing effective policies is needed to solve debt situation, together with healthy recovery in world economy and vigorous pursuit of appropriate adjustment policies. Baker initiative will help mobilise such additional flows. We think net capital inflows on scale suggested in IBRD paper may be too high; they would certainly require strong policies by debtors to reassure creditors and attract necessary funds.

(d) Welcome the IBRD's preparatory work on the projections of their lending programme. Ready to enter into early discussions on the size, timing and paid in element of a GCI.

(e) Support greater willingness to share reports on progress of adjustment with commercial banks.

## C. BACKGROUND

Summary of paper

The paper sets out the World Bank's views on the issues facing the major debtors and on the amounts of finance that it expects will be necessary to enable faster growth in the debtors and to reduce their debt servicing burdens over the medium term. Its' analytical framework and presentation of the problem and debt strategy is generally conventional and unexceptionable: restoring growth and creditworthiness by improving domestic policies in indebted developing countries, and ensuring a strong and sustained recovery in industrial countries. The need for collaborative action by industrial and developing countries to liberalise international trade is stressed. The paper perhaps over-emphasises the progress that has been made to date; although current account deficits have been reduced to almost nothing, the main way of doing this has been through measures which compress imports , increase protection and work against structural reform. It corrrectly notes the almost complete drying up of commercial bank finance since 1985 for major debtors which emphasises again the need for sound structural adjustment policies.

2. The paper's medium term scenarios illustrat the size of the net capital inflows required by major debtors over the next decade:

Net capital inflows to highly indebted middle income countries

| **($bn, average pa)** | **Assuming Industrial countries 3.2% pa growth** | **Assuming Industrial countries 2.3% pa growth** |
|---|---|---|
| 1986-90 | 14 | 21 |
| 1991-95 | 8 | 27 |
| 1986-95 | 11 | 24 |

3. Such financing needs are higher than those suggested by other forecasters, particularly the IMF, and are up to 50 per cent higher than the flows indicated in the Baker initiative. The differences can be partly explained by different, and debatable, assumptions that are made to derive the required flows. The most important is the assumed need to meet growth targets of 4.1 per cent pa, to allow

for 1 per cent growth in per capita consumption. The lower Fund forecasts assume faster action by debtors to restore BOP equilibrium and internal financial balance.

4. The paper, unlike its IMF counterpart, does not examine in any detail where such flows might came from. Surprisingly there is very little reference at all to the Baker intiative and its proposals for concerted commercial bank, multilateral development bank lending, or to the role direct and portfolio investment and export credit agencies will play to fill the gap.

5. The final part of the report reviews the future involvement of the IBRD towards middle income debtors. The suggested joint role of the IBRD and the IMF is in line with UK thinking and Baker, but insufficient background is given on the financial needs of the World Bank, particularly the timing and amount of a GCI. This is inevitable given current uncertainties.

6. In discussing the role of the World Bank, the paper correctly notes that all parties concerned - the debtors, international community, commercial bank and other private sources of capital, and international financial institutions - have a part to play in achieving growth and the restoration of credit worthiness through economic adjustment programmes supported by adequate capital flows. The programmes, which are the responsibility of the governments of the countries concerned, should cover 3-5 years, involve close collaboration between the Bank and Fund on their respective interests; be flexible, subject to regular reviews and should be monitored closely by the Bank and Fund.

7. Projections of the Bank lending programme have been revised upwards since Seoul. The Upper end of the range discussed then (a programme rising to $20 billion a year by FY90) is closer to the mid point of the new range ($21.5 billion by FY90). The lending programme discussed at Seoul would have required a $53 billion GCI. This figure would be increased by a higher lending programme but other factors (exchange rate movements, future decisions on, say, the valuation of capital or lending terms) might work other way. No new figure is quoted for the GCI, but $53 billion would be sufficient to cover lending at the top end of the range. The timing of the GCI is uncertain until the growth in the lending programme is realised. The bank expect to need agreement in principle in the calendar year 1987 (possibly early in the year if lending reaches middle or top of range) as actual subscriptions should begin in FY88. (See brief no 7 on IBRD issues).

8. Finally, the paper notes that the World Bank has an important catalytic role in mobilising additional capital flows from other sources, although commercial bank participation should continue to be based on their own independent lending decisions. The World Bank can work with export agencies to help focus new flows to maximum effect.

9. Brief no 9 summarises recent economic developments in the major debtors.

**HM TREASURY**

Brief no 6

HM TREASURY

# IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS

## 9-11 APRIL 1986

## Sub Saharan Africa

### A. OBJECTIVES

(a) Welcome the report but draw attention to weaknesses.

(b) Avoid commitment to increased bilateral aid.

(c) Promote consensus for adequate increase in IDA.

(d) Support coordination but head off IBRD from excessive ambitions on adjustment and debt.

(e) Welcome Trust Fund agreement.

### B. LINE TO TAKE

(a) Report is helpful contribution to decision-making. Even more useful if it had included the whole of sub-Saharan Africa, considered in detail how to extricate the most seriously indebted countries, discussed where growth may now come from, and drawn conclusions about priorities in public investment planning.

(b) Structural adjustment: congratulate countries taking worthwhile measures, but much still to be done. Support for structural adjustment a basic element of our approach to aid for Africa. Need more thorough review than report offers of achievements so far. Bank should also consider guiding countries in mobilising domestic savings and stimulating private investment.

(c) Increased aid: sub-Saharan Africa will need continued support. We have given nearly £2 billion in aid to Africa over last ten years and intend to go on giving Africa a large share of money available.

(d) How to increase aid: Britain among leaders in converting aid loans to grants. Little more scope for doing more ourselves, but hope others can follow suit.

(e) IDA: Support sub-Saharan Africa as priority for IDA. Donor consensus essential for IDA 8 volume; support $12 billion replenishment (if satisfactory shares and exchange rates are agreed). IMF Trust Fund reflows proposal important for IDA recipients.

(f) Donor coordination: we try not to encourage countries into low priority or premature investments, and hope other donors will take similar care over economic and technical appraisal.

(g) Agree aid and debt should be looked at as related elements of an adjustment programme. But existing official debt rescheduling process works well. Closer Paris Club/Consultative Group cooperation could be helpful, but such fora risk growing unwieldy. Case for better behind scenes co-ordination.

(h) Cannot support using aid to refinance commercial debt.

(i) Welcome details of proposed monitoring secretariats.

**BACKGROUND**

1. The burden of the report and memorandum is that while many African countries are pursuing structural reforms to a greater or lesser extent, there is not a corresponding political will among donors to support them with more and better organised aid and debt relief. The Bank estimates that US$2.5 billion more a year in concessional flows and debt relief is needed to restore African imports per capita to the levels of 1980-82.

2. The main points of the report's summary and conclusions are as follows:

- Many African governments are making significant progress with structural adjustment; but they still have much to do to correct the accumulated distortions of the past.
- Declining imports and investment threaten to undermine structural adjustment in low income Africa.
- Africa will need at least $11 billion a year in concessional flows during 1986 to 1990. Allowing for known and expected aid commitments, there is a gap of $2.5 billion.
- Multilateral agencies might come up with $1 billion of this (if IDA 8 is $12 billion and Africa gets much of expected IMF Trust Fund reflows).

That leaves $1.5 billion to come from new bilateral aid and debt relief, equivalent to and increase of 30 per cent in bilateral aid compared with 1984. No donor should be a net recipient from an African country undertaking reforms.

- Donors could increase bilateral aid by means of new debt cancellations allowing export credit agencies to refinance on softer terms wider participation in debt rescheduling and larger aid budgets.

- Donors should act more in concert, in particular by not financing projects outside adjustment programmes agreed by African governments, bringing decisions on aid and debt together in the consultative groups, discussing financial packages among major donors before aid coordination meetings, giving medium-term indications of intended aid, establishing secretariats to monitor economic reform and the implementation of governments' and donors' agreements, and giving the multilateral agencies (especially the Band and Fund) a larger role in orchestrating donor assistance, both in designing adjustment programmes and coordinating finance.

Mr Clausen's covering memorandum repeats the argument and recommends the above mentioned ways in which donors could act more in concert.

3. The paper is likely to be a major item at both the Development Committee and at the UNGA Special Session on the critical economic situation in Africa (27-31 May). But it is not likely to carry as much weight as the Bank papers on Africa of 1981 and 1984. Its scope is limited; it concentrates on financing and discusses only the 29 IDA-eligible countries. This means it excludes Angola, Botswana, Cameroon, Congo, Gabon, Ivory Coast, Nigeria, Swaziland and Zimbabwe, many of which are worthy of donors' attention if the opportunities for gorwth in Africa are to be exploited. The paper could have said more about several questions, the following among others: The special problems of the seriously indebted countries; The sources of growth, given the Bank's justifiable pessimism about exports; and Priorities in African public spending and planning.

4. As the sub-saharan region recovers from drought, food supply prospects have improved, with some countries (notably Zimbabwe) now showing a food surplus. Although the reform effort in some countries continues to be tentative or non-existent, others are currently implementing major programmes of genuine structural reform (eg Ghana and, more recently, Zambia), whilst others continue to

maintain a dialogue with the IMF. However, the increasing incidence of arrears to the Fund (eg Liberia and Samalia) is a worrying trend.

HM TREASURY

CONFIDENTIAL

**Brief no 7: (Revise)**

**HM TREASURY**
**IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS**
**9-11 APRIL 1986**

**World Bank Issues**

## A. OBJECTIVES

1. Demonstrate our continued support for the World Bank Group by stating our willingness to work towards a substantial General Capital Increase and by indicating our willingness to participate in a generally agreed IDA8 Replenishment of up to $12 billion provided the exchange rate has been satsifactory settled and the burden sharing is equitable.

2. Chancellor to see Tom Clausen for a farewell meeting in the margins, if an opportunity arises.

## B. LINE TO TAKE

**IBRD General Capital Increase**

(a) Ready to enter into early discussions on the size, timing and paid-in element (if any) of a General Capital Increase.

**IDA 8**

(b) IDA volume must command support of all donors. Willing to play our part in a replenishment of up to $12 billion, provided this total is generally agreed, and to maintain our 6.7 per cent share, subject to the public expenditure cost, which might be affected by factors such as the applicable exchange rate. We expect other donors to maintain their IDA 7 shares.

(c) Minimum India/China allocation should be IDA 7 nominal level, and they should receive a fair share of any IDA 8 volume in excess of $9 billion.

(d) Support use of IMF Trust Fund reflows in conjunction with some IDA funds, to those IDA eligible countries facing persistent debt problems which are willing to undertake adjustment measures.

**International Finance Corporation**

[If raised in margins]

(e) Strongly support IFC. Reduced UK shareholding simply a reflection of our changed position in IBRD. Share re-allocation a matter for IFC Management, but we expect our unwanted shares to be rapidly allocated to others with general G5 agreement.

## C. BACKGROUND

**IBRD General Capital Increase**

1. The World Bank's capital base is the crucial element in its lending capacity. There is general agreement among shareholders that a General Capital Increase is needed if the Bank is to play a leading part in resource transfers, particularly under the Baker initiative, and if the Bank is to obviate negative net transfers in the 1990s. The actual size and timing of a General Capital Increase derives however from the Bank's current and future lending plans. Under the latter, put forward in the Development Committee paper relating to growth in Middle-Income countries and the impact on World Bank's resources (Paper R86-40), Bank Management suggests subscriptions to a $53 billion General Capital Increase to commence in Fiscal Year 1988 (see brief no 5 on major debtors).

2. The Bank's current lending has yet to reach the Sustainable Lending Level (SLL), ie the maximum level of Bank lending which can be sustained indefinitely with its existing capital base. If agreement is reached later this year on a new valuation of the Bank's capital, the SLL would be raised but this could be eroded by easier Bank lending terms and accelerated disbursement.

3. At an Executive Board meeting on 18 March, all shareholders, except the United States, reaffirmed the urgency of addressing the need for a General Capital Increase. The United States' view, has been that "if increased demand for quality IBRD lending demonstrates the need for increased capital resources, the US would be prepared to look seriously at the timing and scope of a GCI" (Baker's speech in Seoul). This means that Bank lending in FY86 and FY87 has to rise by over $2 billion above the low FY85 level of $11.4 billion. It is likely Baker will argue in Washington that consideration of a GCI is still premature, because the US have already agreed to interpret the SLL in a sufficiently flexible fashion to cope with likely lending in FY87, and agreement on a GCI would remove a bargaining chip with the debtors and banks. The US Administration is also known to want to avoid

a simultaneous submission to the US Congress covering both IDA 8 and a World Bank CGI.

4. We have made clear at previous IMF/IBRD gatherings our intention to participate in a CGI when the time comes. But there are political advantages now in giving a more definite signal by joining any general call by other major shareholders for early discussions on a General Capital Increase. There can, of course be no progress on the issue without the agreement of the United States, and we must therefore defer to the proof-of-need argument (which we ourselves support); but share-holders can meanwhile discuss issues such as size, timing and any paid-in element, including the release of national currency contributions. (The issue of whether the aid programme should be increased to cover the cost of UK contributions (£90 million under a 5 per cent paid-in GCI of $53 billion) is still to be settled in the appropriate Public Expenditure Survey.)

**<u>IDA 8</u>**

5. The IDA Deputies are due to meet in Washington on 7-8 April. (Supplementary briefing will be provided before the Development Committee meeting). Burden-sharing is the main item. The UK's 6.7 per cent share (of IDA 7) stands up well under the various burden-sharing criteria, (though we could come under pressure to raise this marginally because it is slightly less than our 6.82 per cent share of IBRD's capital subscribed by IDA donors) and we therefore intend to retain the same share and to pres main donors to do likewise. It is vital that FRG and Japan retain their high share; there are no financial grounds for the latter to reduce. The same high 18.7 per cent share of $12 billion will cost them very little more than their contribution under the $9 billion IDA7! But they ha e a case in the disproportion between their IBRD capital share and their IDA share, especially by comparison with Germany. We would indicate readiness to join others in considering ways of improving Japan's share position in IBRD (and IFC) if that will lay the question to rest for both IDA8 and IA9.

7. We should aim at avoiding the UK taking up any other marginal reductions in the shares of other donors. Potential candidates for marginal increases are the French, who should contribute at least the same as the UK, donors who have rising

aid programmes, (eg Italy), and Saudi Arabia which is to have single constituency representation in the Bank Board. We cannot rule our coming under pressure for a very small increase in the UK share as part of a general gap filling exercise to achieve a near 100 per cent subscription list; this would need to be referred to Ministers.

8. Bank Management can be expected to renew their pressure for a $12 billion target and will probably seek a UK statement in support as the only donor, apart from the United States, which has not so far declared itself. Their views are not expected to be announced at the next IDA meeting. We want to avoid getting into a position where the US puts down less than 255 per cent of $12 billion, and we are then pressed, with others, to subscribe at 6.7 per ent of $12 billion so as to maximise the total. We can use the formula in the line to take ((b) above) which has been agreed with ODA.

9. The United States formal position has been that they are working for a formal replenishment in the range $9-12 billion, subject to satisfaction on lending terms, allocation and IMF Trust Fund linkage. The latest indications are that the prospects of the US signing up to a £12 billion IDA 8 remain poor. Secretary Baker is said to be personally sympathetic to a replenishment up to $12 billion, but it is doubtful whether he will be willing to press the case in the face of the likely opposition. Congress has not yet focused on IDA 8, but the evidence of their current attitude to appropriations for IDA 7 is discouraging. The atmosphere might improve next year if the Democrats win control of the Senate in this autumn's elections, and thus year's budgetary and appropriations round is agreed on by all parties relatively pointlessly and without Gramm-Rudman cuts.

**World Bank President**

10. Mr Tom Clausen will be retiring in June at the end of his 5 year term. Mr Barber Conable has been nominated as his successor. When Mr Clausen was in London recently, just before the Budget, he asked for a meeting with the Chancellor but it was not possible to arrange it. He met the Economic Secretary. However, the Chancellor noted that he would have an opportunity for a farewell meeting with Mr Clausen at the April meetings. It may therefore be appropriate to arrange a short meeting.

HM TREASURY

Brief no 8

HM TREASURY

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS
9-11 APRIL 1986

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MULTILATERAL INVESTMENT GUARANTEE AGENCY

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A. **Objectives**

To maintain the impetus for establishing the MIGA by reaffirming UK support and announcing UK's intention to sign the convention.

B. **Points to Make**

(a) The UK fully supports the MIGA's objectives in promoting development by supporting private direct investment in the LDCs. We welcomed the scheme approved at Seoul and we are glad that countries are beginning to sign.

(b) Pleased to announce that the UK is now signing the Convention.

(c) Glad to be among the founder members. We will be playing our part in the Preparatory Committee to be held when enough countries have signed.

(d) We urge other countries to support this initiative and sign the Convention to help bring the MIGA into effect.

C. **Background**

1. Within the World Bank, arrangements have been agreed for setting up a multilateral scheme of investment insurance, to be operated by the Multilateral Investment Guarantee Agency (MIGA). It will be based in Washington. The Convention to establish the MIGA was opened for signature at the World Bank Annual Meeting in Seoul last autumn.

2. The MIGA's purpose is to promote development in the LDCs by helping to create conditions favourable to private direct investment. It will offer insurance to investors in the form of guarantees against non-commercial risks, including war and civil disturbance, expropriation of assets and restrictions on remittances; and will provide information, advice and technical assistance to help improve the investment climate.

3. The World Bank President will be, ex officio, Chairman of its Board of Directors. Member countries will each nominate their own Governor and will be represented on the Board by an Executive Director, most of whom will represent constituencies of several countries.

4. The MIGA will aim to finance its day-to-day operations out of premium income, but the governments of member countries (as shareholders) will contribute to the underlying share capital of 1 billion SDRs. The UK share will be $52.6 million (4.8 per cent) of which only $5.26 million (10 per cent) will actually be paid in cash. The balance (10 per cent deposited in promissory notes and 80 per cent callable capital) will remain on call - indefinitely, unless things go badly wrong.

5. The MIGA does not come into effect until the Convention has been signed by at least 5 developed countries and 15 developing countries whose combined subscriptions total more than one-third of the capital. Eleven countries have already signed the Convention: nine developing countries and two developed countries (the Netherlands and Italy) as follows, in order of signing.

| | |
|---|---|
| Ecuador | 11 October 1985 |
| Korea | 11 October 1985 |
| Turkey | 11 October 1985 |
| Senegal | 30 October 1985 |
| Sierra Leone | 4 December 1985 |
| St Lucia | 13 January 1986 |
| Grenada | 31 January 1986 |
| Netherlands | 3 February 1986 |
| Jordan | 5 February 1986 |
| Italy | 19 February 1986 |
| Vanuatu | 7 March 1986 |

World Bank staff appear to be assuming that enough countries will have signed by May or June for the Preparatory Committee to be held.

6. Given the size of the US shareholding (20.5 per cent) their participation may be crucial in bringing the MIGA into effect. The administration have pushed strongly for the authorisation of contribution to MIGA, and have submitted a budget request. Congress is broadly favourable in principle but there is considerable reluctance to sanction a new multilateral aid agency in the present fiscal climate. There are reports that US signature in June/July may be possible.

7. There is interdepartmental agreement on UK support for the MIGA. ODA will take responsiblity for the UK interest, consulting other departments as necessary. By signing the Convention now the UK will be among the founder members and to take part in the Preparatory Committee which will work out the detailed operating procedures. But it will still be necessary to take primary legislation before we can finally ratify the agreement.

**HM TREASURY**

109/16b



Brief no 9.

HM TREASURY

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS

9-11 APRIL 1986

**Problem Countries**

This is a background brief summarising recent economic developments in and the IMF's relations with the following major debtors and Commonwealth countries:

Argentina
Brazil
Gambia
Indonesia
Jamaica
Mexico
Nigeria
Phillipines
Poland
Tanzania
Yugoslavia
Zambia

# ARGENTINA

## Line to Take

Commend cooperation with Fund and success of economic reform package in reducing inflation, but stress worries about lack of control over public sector expenditure. Such slippages underline the need for rigorous implementation of tight fiscal policy if progress is to be sustained.

## Background

1. External debt at end-1985 was $50 billion, equal to 40 per cent GNP; DSR (long and medium term) 58 per cent. In seeking to reschedule some Paris Club debt due this year the Argentines have unilaterally declared a moratorium on interest and principle. Paris Club have protested at moratorium but will look favourably on efforts to reschedule, subject to new IMF programme being in place. Talks with commercial banks to raise some $1-2 billion needed in 1986 are expected to begin in April.

2. Second drawing of Fund programme was cancelled after failure to agree end-1985 fiscal targets. The (reduced) SBA of SDR 1.2 billion has been extended from end-March to end-May; drawings remain a trigger for tranches of the $4.2 billion commercial bank new money facility. Discussions on a new Fund facility are under way.

# BRAZIL

## Line to take

(a) Commend improvement in external account since 1983, which has restored confidence in potential of economy and offers hope of eventual return to normal market borrowing.

(b) Welcome bold measures introduced recently to combat inflation (cruzado plan), including replacement of currency and ambitious de-indexation measures; though still unclear whether supporting fiscal measures are adequate.

(c) Urge elimination of Paris Club arrears

## Background

1. Total debt biggest in LA: $100 bn at end-1985 (40 per cent of GNP); DSR 77 per cent (before rescheduling). Bank's advisory committee has agreed in principle to (i) a rescheduling of $6 bn of 1985 public sector maturities over 7 years, (ii) a rollover of 49 bn of 1986 public sector maturities to March 1987 and (iii) a rollover of $15 1/2 bn of short-term facilities to March 1987.

2. Official creditors have not received any princpal or interest payments from Brazil since January 1985. Paris Club maintain position that formal IMF programme is prerequisite for official MYRA.

3. Negotiations on new SBA broke down in 1985, with Brazilians questioning need for continued Fund involvement. To encourage banks to support the commercial bank rescheduling, Finance Minister Funaro sent a letter to de Larosiere promising closer co-operation with Fund in future, but no immediate prospect of agreement with IMF until after November elections.

# THE GAMBIA

## Line to take

1. Urge the Gambians to adopt a wide ranging adjustment programme which can win the support of the IMF and creditors.

## Fund Programme

2. The Gambia adopted an economic recovery programme in September 1985 after detailed and prolonged discussions with the IBRD and IMF. This was endorsed by a donor conference hosted by the UK in London. Although much of the programme has been implemented, an IMF Mission in February found serious lapses in the fiscal and monetary guidelines previously agreed with the Fund. The authorities had also been hesitant in carrying out exchange rate and producer price adjustments. This led to a breakdown in discussions on a possible Fund standby.

3. The Gambia's arrears to the Fund (SDR 9 million at end March, just over 50 per cent of quota) will need to be cleared by bridging finance before any programme can be agreed. Unfortunately the prospects of clearing the arrears and filling the $50 million financing gap have been upset by the failure to agree a programme and the authorities disappointing procurement of groundnuts, the major export, associated with exchange rate uncertainty before the recent devaluation.

4. The Fund believe that a lack of political will and widespread incompetence have lain at the root of The Gambia's difficulties. The President has now made himself personally responsible for economic reform though and is seeking urgent US and UK technical expertise to help overcome management problems. Before leaving, the IMF Mission outlined a number of objectives - including tighter monetary and fiscal policies - which must be met before discussions on an SBA can resume. Nogotiations on a World Bank Structural Adjustment Credit (with the UK as cofinancier - partly financed by the Special African Facility) are advanced though failure to agree a Fund programme may put in jeopardy its final agreement. It is hoped further discussions with the IMF can resume in May.

## INDONESIA

### Line to Take

Welcome authorities' fine record of prudent and successful economic management in recent years, and early recognition of need for further adjustment in 1986 in the face of the fall in oil prices. Stress need for further development of non-oil sector where growth has been rather lower than anticipated.

### Sensitivities

1. Avoid discussing recent oil price falls - Indonesians sore at UK's failure to co-operate with OPEC on production cuts - or collapse of tin rescue plan for which Indonesia was primarily responsible.

### Background

2. Adjustment measures implemented since early 1983, without IMF programme, have had remarkable success in reducing current account deficit and inflation and raising growth.

3. The economy now faces fresh problems in adjusting to lower oil prices, but authorities are well prepared for this: healthy reserves of $10.7 billion and undrawn commercial credits of nearly $2.5 billion at end 1985 provide a substantial cushion. At present, Indonesia is compensating for the fall in oil prices by producing above its quota of 1.2 mbd, but with oil prices remaining weak, the government is now considering further retrenchment. Economic growth is estimated to have fallen to around 1.5 per cent in 1985-86, well below the target of 5 per cent and the 4 per cent pa necessary to absorb the increase in the labour force.

5. Balance of payments projections by the IMF, the Bank and the FCO all indicate a sustainable scenario should oil prices fall to an average of $20 pb (at quota) in 1986. Problems become increasingly pressing below this level. Indonesia may be forced to negotiate a greater level of new commercial credits this year. So far her creditworthiness has held up well despite the fall in oil prices but the decision not to participate in the ITC rescue package may result in some re-appraisal.

# JAMAICA

**Line to take**

Urge Jamaican authorities to adopt a more realistic medium-term programme based on a flexible exchange rate policy.

**Background**

2. Debt: $3.5 billion at end-1985; 195 per cent of GNP; DSR 26 per cent.

3. Status of Fund programme. The SDR 115 mm SBA, in abeyance since September, was reactivated on 3 March. The agreed modifications entail maintenance of the present exchange rate (J$5.5 to US$ 1) while achieving the original balance of payments objectives for end-March through tougher monetary and fiscal measures and elimination of all arrears. Previous missed drawings were made available when relaxed end-January criteria were met (a drawing of SDR 26.6 mn has been approved). The UK criticised in the Board discussion the way previous missed drawings within the SBA were made available by meeting such relaxed targets. It argued that the agreed modifications do not form an adequate basis for sustainable adjustment and may weaken the IMF's authority.

4. New policies for the remaining 14 months of the SBA are being discusssed by a "new look" mission, comprising the IMF, IBRD and US AID. Report is due by end-March.

# MEXICO

## Line to Take

(a) Acknowledge difficulties created by falling oil revenues, but encourage authorities to agree measures for new Fund programme as soon as possible.

(b) Endorse the non-confrontational approach adopted by Mexico in discussions with creditors.

## Background

1. Debt: $97 billion at end-1985; 55 per cent of GNP; DSR 51 per cent. Mexico's domestic and external finances have been severely affected by falling oil revenues. The latest indication is that external finance of about $6 billion will be needed for 1986. No formal proposals have yet been made although bilateral negotiations with international financial institutions, governments and banks are continuing.

2. The three-year EFF for SDR 3.4 billion, approved in December 1982, broke down in mid-1985 after two years of exceptional performance, particularly on the external account. Negotiations on a replacement SBA for about SDR 0.9 billion are continuing and hopefully will be completed shortly. In response to last September's earthquakes, the IMF approved emergency assistance of SDR 291 million (25 per cent off quota) in January.

OLD VERSION



# NIGERIA

## Line to Take

Encourage Nigerian authorities urgently to agree a Fund programme, even more essential in wake of falling oil prices.

## Background

1. With oil at $15 pb, Nigeria's exports in 1986 will be maximum of $7.5 billion. Debt service payments without relief are some $5.5 billion, making substantial default inevitable in the absence of a settlement with the IMF and creditors. Debt rescheduling with new money from a Fund programme and other sources would enable a basic minimum import level.

2. Paris Club line on rescheduling officially guaranteed debt is that Nigeria must first reach agreement on a Fund programme. This could be couched with gestures of support from major debtors, eg UK offer of new credit would then become operative.

3. Commercial bank creditors been showing increasing signs of frustration in the absence of an initiative from the Nigerians on debt restructuring. On 27 March a Nigerian delegaion led by the Minister of Finance met with 20 creditor banks and requested a rescheduling. The Nigerians originally intended to request a MYRA for 3-4 years, but in the end requested, and were granted subject to the views of other creditor ban s, a 90 day standstill on principal repayments of public debt with an original maturity of over 12 months. Although the banks remain committed to linkage between rescheduling and the IMF, some have indicated a willingness to proceed with something less than a formal SBA. Progress on the rescheduling of short-term trade arrears continues to be slow.

4. Following a national debate which showed widespread hostility to the Fund, the Nigerian authorities announced on 12 December 1985 that they would not be seeking an IMF programme. Although the subsequent budget indicated the Nigerians accepted the need for 'IMF type-policies' the major barriers to agreement remain the need for a rapid and sizeable depreciation of the Naira and trade liberalisation.

# PHILIPPINES

## Line to take

1. Encourage generally pragamatic and reformist approach of new regime, which provides opportunity to implement fully adjustment measures previously advocated by IMF and IBRD.

2. Strongly discourage any suggestions of selective debt repudiation or interest payment moratorium as this would forfeit sympathy from external creditors and have damaging repercussions for Philippines.

## Background

1. Performance under the IMF programme agreed in 1984 has been patchy: slow growth and a fall in exports, but much lower inflation and a smaller current account deficit. Massive election spending by the Marcos regime is likely to lead to the breakdown of the programme, but the recovery in reserves after the election has meant no immediate external liquidity crisis. The Minister of Finance, Ongpin, hopes to have an outline of a new budget by the time of the Interim Committee and to begin negotiations for a new Fund programme shortly afterwards.

2. The new government intends to free the economy from the excessive and corrupt controls of the past regime. However, the change of regime has aroused new aspirations and the government may have to take some unpopular decisions before long against a background of growth in the economy.

3. Several Ministers have recently advocated repudiation of foreign debt applied in a questionable manner under the Marcos regime and suggested a waiver of interest on external debt for a limited period. Such statements may indicate a lack of experience or co-ordination within Mrs Aquino's cabinet.

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# POLAND

## Line to Take

(a) Pleased that Paris Club agreed minute covering this year has been initialled. Western governments have been generous; it is now up to other creditors and to Poles' own efforts on trade balance to close remaining financing gap.

(b) UK supports Poland's membership of the IMF, and is pleased that negotiations seem to be nearing completion.

## Background

1. Outstanding convertible-currency debt at end-1985 totalled $29.6 billion ($18 billion due to Western governments and $7 billion to Western banks). Current account surplus this year, and any 'spontaneous' new credit, seems unlikely to cover more than one third of debt service of $5.8 billion due before rescheduling. At the beginning of March Western governments initialled an agreement with the Poles rescheduling $1.9 billion of debt service due this year. The Poles have asked Western banks to provide rescheduling or new money equivalent to $1.1 billion. The banks have only offered a 75 per cent rescheduling of principal due $600 million), although they are due to meet the Poles again in the near future and may increase their offer marginally. Depending on the Poles success in rescheduling from other creditors, eg CMEA, Middle East, they may face a financing gap of $500 million-$1.2 billion this year unless the banks are much more forthcoming.

2. Poland has accepted the proposed Fund quota of SDR 690 million and, barring any further problems, could become a member by mid-year. No constituency yet appears willing to accept the Poles; the UK would not be eligible as it is a single member constituency.

CONFIDENTIAL

# TANZANIA

**Line to take**

1. Urge authorities to reach early agreement with the IMF, which will unlock substantial complementary concessional flows needed to revive economy.

**Background**

2. Tanzania is locked into a cycle of poor economic performance, deteriorating infrastructure, growing parallel markets and hand to mouth management of official payments at a grossly overvalued exchange rate. Good harvests, partial import liberalisation and decontrol of maize produced economic recovery in 1985: but the temporary balance of payments relief from higher coffee prices and on oil credit from Iran may tempt the authorities to defer radical adjustment. Many officials and some Ministers are convinced of the need for policy reforms and major devaluation but political interests are firmly against them.

3. Bop charcterised by established and sizeable trade and current account deficits. Lower net capital inflows have given rise to overall balance of payments deficits in 1984 and 1985 (proj). Authorities resorted to running up arrears to finance the gap. The end-1984 stock of medium and long term debt was $3.0bn (expected to have risen to £3.2bn by end-1985) and the DSR 54 per cent in 1985 despite the high proportion of concessional borrowing. There is a large pipeline of commercial arrears.

4. At Executive Board on 20 March, EDs left with no assurance that the Tanzanians have really moved on adjustment measures. Same sticking points remain; devaluation and the level of producer prices. Tanzania is in arrears to the fund (SDR 19.0 mn 17 January 1986) and when the Executive Board reviews the position not later than 24 April, a declaration of ineligibility looks inevitable.

# YUGOSLAVIA

**Line to take**

(i) Pleased commercial bank MYRA now in effect.

(ii) Strongly support aims of medium-term economic stabilisation and reform programme which should be pursued vigorously.

(iii) No consensus among creditor governments that official block MYRA justified, given continuing economic uncertainties and problem of appropriate conditionality in absence of follow-on SBA. UK not alone in this view. UK willingness to consider more limited serial MYRA would require continuing Yugoslav relations with IMF and more enhanced monitoring than that argreed by banks.

**Background**

1. Total convertible-currency foreign debt is $19 bn. A two-stage commercial bank MYRA (100 per cent of $3.6 bn principal due 1985-88) was signed in December 1985. Stage Two of the MYRA ($1.3 bn for 1987-88) is not due until March 1987, when enhanced monitoring should be in operation.

2. **Official creditors** have rescheduled 90 per cent of $0.9 billion principal due 1 January 1985 - 15 May 1986. Yugoslavs now seeking a block MYRA for $1.4 billion of principal due up to end-1988. Negotiations to begin in Geneva and Paris on 14 and 16 April. Governments concerned about authorities' ability to fulfil undertakings, given poor economic performance in 1985, breach of SBA criteria, change of government this May and lack of new Fund programme. Yugoslavs have been warned not to regard MYRA as automatic or on same conditionality as bank MYRA.

3. **IMF programmes** almost continuously since 1979. Current 12-month SBA expires 15 May 1986. Yugoslavia temporarily in breach of performance criteria in January after refusal to raise interest rates in line with positive real rate formula; rates belatedly raised 1 February. No further Fund programme envisaged; Yugoslavs opposed, and Fund staff believe continued involvement would be counter-productive. Mid-1986 to mid-1991 staff will carry out twice-yearly enhanced monitoring for bank MYRA.

## ZAMBIA

**Line to take**

1. Stress that continued commitment to adjustment will be necessary over the medium term.

**Debt Negotiations**

2. (a) A Paris Club (4 March) agreed to reschedule 100 per cent of principal and interest due in 1986 and unpaid at end-December 1985. A request to the London Club is expected shortly.

(b) Zambia is some US$40 mn in arrears on its oil facility. The consortium met and offered to re-open letters of credit to finance the next shipment if Zambia paid off a percentage of its arrears. Due to the extreme shortage of foreign exchange this was not possible, and the banks have agreed to meet again. The shortfall on the oil facility is claimed to have arisen because foreign exchange reserves had been used to support the foreign currency auction due to administrative delays in the receipt of the expected World Bank funds.

**Fund Programme**

3. An SBA (SDR 229.8 mn over two years) and CFF (SDR 68.7 mn) were approved on 21 February 1986. This was made possible by: (a) Zambia's introduction of various economic reforms including the key measure of a foreign exchange auction (October 1985) plus related trade liberalisation measures; and (b) the elimination of arrears of SDR 120 mn to the Fund, through the use of bridging finance.

4. Zambia will be watched very closely over the coming months to see if it really has broken out of the catch 22 problem.

HM TREASURY

Brief no 10

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS
9 - 11 APRIL 1986

**Follow up Report on Task Force on Concessional Flows**

A. **Objectives**

1. To show British aid policy and record in a favourable light (aid quality, effectiveness, co-operation with other donors and voluntary agencies) and, as far as possible, to limit criticism of our position (aid volume and UN targets).

B. **LINE TO TAKE**

**Aid volume and targets**

2. Britain aid programme is substantial. Aid allocations for next 3 financial years have been increased and in 1986-87 we shall spend some £1.2 billion.

**Defensive**

3. Aid cannot be exempt from Government's overall policy to control public expenditure. It is vital for developed countries to pursue policies that promote sustained non-inflationary growth in the world economy. This strategy will benefit both developed and developing countries.

4. Progress towards UN 0.7 per cent target must depend upon developments in our economy and other calls on our resources.

**Aid Quality and effectiveness**

5. Quality of aid is as important as quantity. Our bilateral aid is concentrated on the poorer developing countries. 80 per cent goes to countries with an income per head of $800 or less. Almost all new aid is provided on grant terms.

6. We give high priority to improving donor policies and procedures; promoting more effective dialogue with recipients and co-ordination with other donors; and encouraging developing countries to undertake difficult but necessary institutional and policy reforms.

7. The Government co-operates closely with British voluntary agencies. Since 1982-83 we have doubled resources for the joint funding of small development projects aimed at the poorest people. We also maintain an active volunteer programme.

C. **Background**

8. The Task Force was set up in May 1982, as a result of an initiative by the Nordic countries, Canada and Holland. It comparised individuals from 18 countries drawn from both industralised and developing countries.

9. The Task Force presented its final report, which has now been published, to the Development Committee in Seoul in October 1985. Sec M86-165 is a progress report to cover the 6 months since October. It adds very little to the debate but proposes four topics for further reports: aid volume and targets, the role of voluntary agencies, on analysis of 1985 aid volume, and public support for aid in donor countries. Although we would prefer to discourage any further work (especially an aid volume and targets) we can accept the future programme if, as we expect, that is the general consensus.

10. In 1984 our aid represented 0.33 per cent of GNP, compared with an average for DAC donors of 0.36 per cent.

11. The Task Force attached some importance to public awareness of aid issues within the developed countries. At present the UK provides only very modest support for such development education, preferring in a time of financial constraints to concentrate available funds on direct aid activities.

12. The Task Force comissioned a group of consultants, led by Professor Cassen of the Institute of Development Studies to study aid effectiveness. This report is to be published in April. They concluded that most aid is effective, but that a substantial proportion is not. This proportion is probably equal to the failure rate in public investment in industrial countries or in private sector investment.

**HM TREASURY**

FROM: P H LINFORD

INLAND REVENUE
POLICY DIVISION
SOMERSET HOUSE

27 March 1986

PS/CHANCELLOR

UNITARY TAXATION : CHANCELLOR'S NEW YORK VISIT

1. You asked for a short brief for the Chancellor to speak to Baker about unitary taxation. This is attached.

2. Mr Fawcett has provided separate briefing to Mr Pratt for the question and answer session after the Chancellor's speech.

P H LINFORD

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cc PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir G Littler
Mr Lavelle
Mr Fitchew
Mr Culpin
Miss Sinclair
Mr J G Graham
Mr Evans (IDT)
Mr Cropper
Mr Scholar
Mr H Davies
Mr Snoxell (FCO)
Mr R I G Allen (Washington)

Sir L Airey
Mr Battishill
Mr Taylor Thompson
Mr J H Roberts
Mr Cleave
Mr J Hall
Mr Fawcett
Mr Linford
Miss Hill
PS/IR

CHANCELLOR'S NEW YORK VISIT - 8-10 APRIL

UNITARY TAX

1. **UK Objectives**

a. Maintain pressure for federal legislation to be enacted by Congress and brought into effect before 31 December 1986.

b. Achieve some amendment of published federal legislation.

c. Negotiate treaty amendment to protect UK from worldwide unitary taxation (whether or not federal legislation passed by Congress).

2. **Points to make**

a. Welcome introduction of federal legislation, but important that momentum is maintained - particularly as it now appears unlikely that there will be a solution in California.

b. Although federal legislation is significant step forward it is important to get it right if it is to enjoy to confidence of foreign governments and multinational businesses.

c. As it stands the legislation has certain shortcomings. Hope it will be amended to reflect internationally expressed concerns. In particular -

i. States should have <u>no</u> powers to revert to use of worldwide unitary taxation as a sanction, and

ii. Water's edge definition should be based on the permanent establishment concept.

d.   Treaty negotiations should be pursued as soon as it is possible (see 3.c.).

e.   Grateful for recent US action in court cases (see 3.d.).

3.   **Background**

a.   In statement on 8 November 1985 the US Administration said it would:

i.   introduce federal legislation,

ii.  enter into negotiations to amend double taxation agreements, and

iii.  make representations in appropriate court cases.

The UK agreed not to trigger retaliatory legislation before 31 December 1986.

b.   Federal legislation was published 18 December and introduced in both Senate and House.  Hearings possible on 16 May.  Baker has written to Packwood and Rostenkowski urging prompt and favourable consideration of the Bill.  A UK Government Note commenting on the Bill has been submitted to US Treasury.

c.   There were talks between officials in December about possible treaty negotiations but US Treasury do not want these to start until after hearings on the federal legislation because this could affect the Bill's chances.

d.   The US Administration has filed an amicus brief in the Alcan/ICI case.

e.   Schultz has written to Governors of States using worldwide unitary taxation urging repeal of state laws.  However, Bills in California appear to have become inextricably entangled with the anti-apartheid issue and progress there is now thought to be extremely unlikely.

Brief No 11

HM TREASURY

IMF/IBRD INTERIM AND DEVELOPMENT COMMITTEE MEETINGS

9-11 APRIL 1986

## Trade and Debt

**A Objectives**

To ensure that the forthcoming GATT round is not used as a pretext by countries (eg Brazil and Mexico) to delay dismantling protectionist measures in the context of restructuring required by IBRD programmes.

**B Points to Make**

(a) The GATT round may not reach a conclusion for some years. It would be wrong to hold up necessary reforms which are of great and urgent importance to the economies concerned until the subjects are reached in GATT negotiations.

(b) Implementing "Baker" adjustment/growth measures must not be delayed by attitudes struck by Mexico and Brazil towards quid pro quos they seek within GATT.

(c) [If pressed: prepared to look at any specific proposals the IBRD want to put forward for breaking the log jam. But "credits" for the new round would be difficult if only because the benefits of removing non-tariff measures can't be quantified accurately.]

**C Background**

1. Mexico and Brazil are already showing reluctance to accept trade liberalisation measures under IBRD programmes because this prejudices their position in the GATT negotiations. To break the deadlock, the IBRD has suggested granting "credits"

for protection dismantled now, to be cancelled by concessions by trading partners in the GATT round.

2. Such reluctance could create an impossible position. The last (Tokyo) GATT round took almost 10 years to complete. Restructuring (of which dismantling trade protection is a vital part) could be delayed indefinitely before the appropriate quid pro quo emerged.

2. But the "credit" proposal provides no easy solution. The protective regimes consist largely of non-tariff measures. Redeemable "credits" depend on being able to quantify the benefit to trading partners of removing the barriers. It is impossible to quantify the effect of non-tariff measures with any precision. And even allowing for special dispensations exempting developing countries from the full rigours of GATT, many of the measures are not GATT-legitimate (eg quantity restraints) in the first place. So their removal would not warrant a "credit".

3. Arguably, opening markets to satisfy the requirements of structural adjustment lending is simply a condition of the loan, necessary in its own right to improve the prospects of the economy concerned. Further trading concessions by developed countries would in effect be paying for the trade liberalisation a second time.

4. The IBRD may want to put forward specific proposals. They have only outlined the position so far.

HM TREASURY

LP5.37

SECRET

FROM: P WYNN OWEN
DATE: 7 April 1986

SIR G LITTLER

cc PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Mr Lavelle
Mr Fitchew
Mr Mountfield
Mr S. Matthews

**MEXICO: IMPACT OF FALLING OIL PRICES**

The Chancellor has said he will be surprised if there is not an attempted "bounce" (along gapology lines) by Baker, Volcker and de Larosiere at Washington this week. He thinks we need to have our response ready for when the hat is passed round.

2. I should be grateful for a note by close today.

Ro

P WYNN OWEN

C. Thanks + farewell.
IDA 8.
GCI.
Major Debtors
+ end on upbeat MIGA.

CHANCELLOR

cc: Mr. Governor
Sir G. Littler
Sir C. Tickell
Mr. Manning

Rs 8/4

MEETING WITH MR. CLAUSEN

1. This is essentially a courtesy call to say goodbye.

2. Clausen has, of course, not been a great success. Contrary to original expectations, he has been a weak manager. His political skills have been pedestrian. And he has been inadequate intellectually. But this is not the time to dwell on his shortcomings but rather to thank him for what he has done. In particular:

- he has certainly tried very hard to maintain the Bank's momentum in the face of a hostile US political environment here (that is until very recently) and the debt crisis;

- he has worked especially hard for Africa. He successfully negotiated the $1.5 billion Special Facility for Africa, to which we are contributing £75 million in special joint financing;

- MIGA, which he turned from a long-standing proposal into something which is nearly ready to go;

- he leaves the Bank in good financial shape and he has at least helped to reorient it into a more market-oriented development institution;

- the Bank is responding well to the Baker debt initiative (though the driving force behind this has been Stern, the Senior Vice President);

- he (and Larosiere) have established much better cooperation between Bank and Fund. This will now be strengthened further as a result of the decisions on the Trust Fund.

3. You were, of course, unable to see Clausen when he visited London in mid-March because this was just before the Budget. He had some good discussions with the Foreign Secretary, the Governor, the Economic Secretary, and Mr. Raison: and he was very pleased, in particular, with what he heard from us on IDA replenishment. Whereas previously our official position had been somewhat ambivalent on how large a replenishment we would be prepared to go for, both the Foreign Secretary and Mr. Raison told him that we would go to $12 billion on the basis of our existing 6.7 per cent share, provided the sterling/dollar exchange rate remains at around its present level.

4. The following are issues which Clausen has said he wishes to cover. There is nothing else for you to raise.

(i) IDA 8.

The IDA Deputies have been meeting over the past 24 hours. The Americans have now said that in view of their success on the Trust Fund, they are prepared to negotiate in the range of $10.5 billion to $12 billion. But however willing the Administration is, it does not seem at all likely that the Congress will be prepared to go along with a replenishment as high as $12 billion. On the other hand, with our acceptance of a $12 billion replenishment, albeit with the exchange rate proviso, the Americans are now pretty isolated and there will be increasing pressure on them in the months ahead--particularly since they have now achieved their aims on the Trust Fund which they said was a necessary precondition if they were to take a more favourable stance on IDA.

5. At the IDA Deputies Meeting, most of the discussion has been about shares. The Japanese are reluctant to maintain the 18.7 per cent share which they have had in IDA 7 and have said they are only prepared to contemplate such a figure if they can have some assurance that they will be able to "harmonise" their share of IBRD capital with their IDA share. Many donors have expressed sympathy for the idea of an increase in Japan's share in IBRD in the context of the General Capital Increase, but pointed to the practical difficulties. The Americans have said that, in the context of a capital increase, they would like to change the Articles of Agreement to maintain their veto over further changes in the Articles with only a 15 per cent blocking vote (instead of the present 20 per cent). This at least offers the Japanese the signal of American willingness to reduce their share percentage in the IBRD (and it is hard to see where else extra shares for Japan could come from).

6. The other issue discussed by the IDA Deputies has been terms of IDA lending. On this the Americans have retreated from their earlier proposals to impose an interest charge tout court by agreeing instead to look at a "repricing mechanism", under which interest rates would be imposed on new IDA credits after a reasonable number of years unless borrowers met certain criteria (yet to be determined).

7. I think the IDA share issue, and possibly the total amount too, will need to be sorted out at the Tokyo Summit.

(ii) General Capital Increase

We support a GCI, though the precise amount will need to be discussed over the coming months. Bank Management are now proposing a figure of $53 billion which would, at current exchange rates and on certain other assumptions, allow the lending program to increase from its current level of $12-13 billion to $21.5 billion in 1991. Apart from the size of lending program to be sorted out, there are several issues which will have to be addressed in the coming months--valuation of Bank capital, the paid-in element, and lending terms amongst others. We need to try to avoid painting the Americans into a corner in the Development Committee (because Baker will want to avoid language which commits him unequivocally), but we will nonetheless want to work for a firm decision on the GCI at the Spring meetings in twelve months' time.

(iii) Major Debtors

For all the rather negative press comments on progress since Seoul, in fact the Bank has been working very hard with the major debtors to try to put together "adjustment-with-growth" programs. The Board approved a major policy reform loan to Argentina last week. A big trade policy loan to Mexico is under negotiation. You might ask Clausen how he sees the prospects. You might also suggest that the Bank should be doing more to make the public aware of progress to date.

MIGA

8. You will be signing the Convention immediately after your meeting with Clausen. He should be duly delighted, particularly since he was told in London that we still had a number of problems to sort out before we could sign. We are the third Part I country to sign--after Holland and Italy.

TL

TL T.P. Lankester
April 8, 1986

Chancellor / PS

REPORT FROM THE CHAIRMAN OF THE DEPUTIES
TO THE MINISTERS AND GOVERNORS OF THE GROUP OF TEN

Washington, April 8, 1986

1. Your Deputies met in Paris on March 13 and 14 to review the items on the agenda of the Interim Committee, focusing their attention on two main issues: (i) the conclusions and policy proposals contained in the Reports prepared by the Group of Ten and by the Group of Twenty-Four on the functioning of the international monetary system, and (ii) the debt situation and strategy. In this review, the Deputies took account of recent developments in exchange and oil markets as well as of the relevant discussions held in the IMF Executive Board.

## I. The functioning of the international monetary system

### (a) Exchange rates and surveillance

2. The Deputies noted that since the publication of their Report substantial adjustment has been achieved in the exchange rates of the main currencies, partly as a consequence of improved convergence of economic performances, effectively supplemented by concerted interventions in foreign exchange markets, in particular following the Plaza agreement of last September. However, large international payments imbalances remain. The fall in oil prices, while on the whole improving the outlook for growth and inflation, entails sizeable changes in countries' relative positions and renewed structural adjustment problems in the world economy. Protectionist pressures have not disappeared. And the ongoing adjustment in exchange rates has been accompanied by excessive volatility, while its effects will require some time to become fully manifest.

3. Given these circumstances and developments, the Deputies emphasized the need to achieve greater stability in exchange

rates and to avoid excessive swings, which they believe requires further progress in the reduction of divergences in national policies and continued cooperation to promote their consistency. There was also the recognition that, in the context of greater policy coordination, concerted intervention in exchange markets can play a useful supporting role. At the same time, the Deputies noted that the differential impact of the recent oil price drop on countries provides a powerful reminder of the need for flexible exchange rate arrangements for the main currencies.

4. The Deputies unanimously stressed the key role of surveillance in improving policy convergence and consistency internationally, and they reaffirmed the need to strengthen it along the lines indicated in their Report, placing emphasis on the need to improve the multilateral aspects of surveillance. There was consensus for maintaining surveillance firmly within the framework of the IMF, and a number of Deputies considered it important that a greater role in the implementation of multilateral surveillance could be played by the Group of Ten on the basis of a separate chapter in the IMF World Economic Outlook paper setting out the international repercussions of national policies of G-10 countries and their interaction in the determination of exchange rate developments and international adjustment. The usefulness of pursuing policy coordination and surveillance in smaller groups was also acknowledged. Mention was made of the desirability that the Managing Director attend all important meetings dealing with multilateral surveillance. The Deputies did not attach high priority to a revision of the 1977 and 1979 decisions on surveillance and were generally of the view that there is room for increasing the influence and effectiveness of surveillance within the existing framework.

5. The Deputies agreed that more effective surveillance requires strong political will to cooperate and to find workable compromises between national interests. In the view of most Deputies, stronger cooperation and policy consistency can only be the result of conviction and mutual understanding, to be

achieved mainly through peer pressure. Some Deputies, however, were of the opinion that it would be appropriate to make the surveillance procedures more binding, especially for countries which have a large impact on the world economy. All Deputies recognized the difficulties involved in reaching a consensus on the impact of national policies on exchange rates, and stressed the need to maintain a pragmatic judgmental approach. On the issue of the publicity to be given to the conclusions of the surveillance process, views were divided: a majority of Deputies considered that it was essential to preserve the confidential character of the relationships between the IMF and its members and more broadly of international policy advice in sensitive policy areas. The proposal that the Managing Director make a public statement on his own responsibility at the conclusion of Article IV consultations continued to find little support. On other aspects of surveillance, a number of Deputies were of the view that greater use should be made of the supplemental surveillance procedure. Some Deputies, however, were concerned over what they feel is this procedure's excessive emphasis on exchange rates as the sole or main trigger for consultations.

6. The Deputies reviewed the assessment made in their Report of the possibility of a target zone arrangement for the key currencies, noting that such an arrangement had been strongly advocated by the Group of Twenty-Four. They found that their opinions on this subject had not changed. Most Deputies still consider that a target zone arrangement would not be viable. In their view the imperfect knowledge of exchange rate determinants would make it very difficult to agree on an initial pattern of rates and on their desirable evolution over time. If the arrangement was too rigid, it would inevitably be tested, thus triggering speculative capital flows and placing strains on domestic monetary policies. If, on the other hand, it was too 'soft', it would not serve the purpose of providing an anchor for expectations.

7. Other Deputies, while agreeing that a target zone arrangement would not be feasible at present, in view of the opposition of the main countries involved and of the policy divergences which still exist among them, considered that the matter should be kept under review. They stressed the important role that exchange rates can play as indicators of policy consistency and, while not seeing a target zone arrangement as an end in itself, they believed that it would place a more effective constraint on national policies, thus offering a framework and a standard for strengthened surveillance. Once existing imbalances and divergences in national policies were removed, such a constraint could be an effective tool in keeping the system on track and preventing similar imbalances and divergences from recurring. For these reasons they considered that the IMF should devote further study to the technical and operational aspects of target zones, notably as regards the identification of desirable exchange rate paths and the underlying concepts of equilibrium, the main technical features of possible arrangements, and the tools and techniques for ensuring their cohesion.

8. The Deputies agreed that it might be useful to develop a set of indicators for the assessment of convergence and policy consistency both domestically and internationally, as they believed that internationally consistent exchange rates require consistent domestic policies and policy-mixes. While some Deputies envisaged such indicators providing close guidance for policies or serving as triggers for consultations and policy reviews, other Deputies stressed the subsidiary role of indicators, which must be used in conjunction with other elements in forming policy judgments, and cautioned against using them mechanically or inflexibly, as seems to be advocated in the G-24 Report. Concern was expressed in this regard lest indicators be used to bring the notion of target zones in through the back door, and strong opposition was voiced by some Deputies against formally incorporating any indicator system in the surveillance decisions. The Deputies recommended that the

Fund Staff be asked to prepare a study on the various possible indicators and on their potential use in the surveillance process.

9. The Deputies considered, in conclusion, that the thrust of the G-10 Report's analysis on exchange rates and surveillance remains valid and that it is important for the Interim Committee to give a signal that further progress will be made in implementing the Report's recommendations. They also considered it important to keep the discussion of these matters within the framework of the IMF, including the Group of Ten and the Interim Committee. For this reason, while not favoring the setting of a precise calendar for future steps, the Deputies stressed the need for indications and guidance to be provided to the Interim Committee to make possible policy decisions at the Fall meeting.

(b) Issues relating to the SDR

10. The Deputies noted that the G-24 Report called for a resumption of SDR allocations on a substantial scale and for linking them to development finance. They also noted that, in a recent document, the Fund Staff has concluded that in present circumstances an SDR allocation is warranted.

11. They stressed that issues relating to the transfer of resources should be kept separate from those relating to the functioning of the international monetary system. The discussion on SDR matters showed that positions have not changed since last summer and that the required broad support for a new SDR allocation does not exist. The Deputies continue to hold the view that the reserve nature of the SDR is not consistent with its use for resource transfer purposes and therefore oppose any link between SDR allocations and development finance. A number of Deputies still believe that a convincing case for an SDR allocation has not been made. In support of their position they noted that interest rates are coming down and that there is no scarcity of liquidity for creditworthy countries. They also

argued that an SDR allocation would not significantly alleviate the debtors' problems while it might retard adjustment. They reiterated the role of the SDR as an instrument for meeting long-term global liquidity needs and their willingness to preserve it in the system as a safety net to meet unforeseen circumstances.

12. Other Deputies felt on the contrary that there was a case for resuming SDR allocations, although views on procedures and on size differed. Some of them referred to the debt problem as an indicator of a need for liquidity or at least of its uneven distribution. Some Deputies also noted that increasing the share of owned reserves through steady, modest SDR allocations would not impair discipline and would enhance the stability of the system. A reconsideration of the Belgian proposal for conditional use of SDRs was advocated. The French proposal for direct lending of SDRs by industrial countries to debtor countries was also recalled, but it was open to question whether it would contribute to adjustment by the debtor countries.

13. Some Deputies noted that a large share of the cumulative SDR allocations of developing countries had been used to finance balance-of-payments deficits rather than to build up reserves: they suggested that in connection with possible new allocations thought should be given to reintroducing a reconstitution obligation. Such a measure would diminish the potential inflationary impact of allocations and perhaps help to reduce opposition to allocations. Some other Deputies, however, warned that reconstitution would reduce the attractiveness of SDRs, which in their view was already insufficient compared to that of other reserve assets.

## II. Debt strategy and problems of developing countries

14. In reviewing the foreign debt situation, the Deputies noted that the decline in the dollar and in interest rates in

major financial centers has brought direct relief to indebted countries. As for oil prices, the Deputies agreed that on balance the outlook for growth and inflation in the world economy has improved following the price fall. However, it will take some time before the improvement materializes. Moreover, the situation of a number of net oil exporters, including some large debtors, has deteriorated. In general, the Deputies emphasized the enduring nature of the debt problem of many developing countries and stressed that its orderly resolution will continue to require determined action and cooperation by all the parties involved in the years ahead.

15. The Deputies expressed strong support for the Baker initiative and reaffirmed its validity as a framework for strengthening the debt strategy. They stressed that recent developments, which have further differentiated debtors' conditions, have made the appropriateness of the case-by-case approach more evident than ever. In reviewing the implementation of the Baker initiative, the Deputies noted a number of positive developments. Some large debtor countries, such as Brazil and Argentina, have made significant progress in the pursuit of market liberalization, deindexation, privatization and the encouragement of private investment. In addition, IMF programs are again operative in several countries, while a number of others have approached the IMF and the World Bank for conditional loans and negotiations are proceeding.

16. The Deputies, however, felt that progress in certain areas had not been as rapid as desirable. They all placed emphasis on the need to strengthen the process of internal adjustment in debtor countries by reinforcing sound fiscal and monetary policies with structural reforms. This was seen as an essential condition for restoring sustained growth as well as for attracting foreign investment and checking capital flight. Particular stress was laid on this latter question, since commercial banks are reluctant to increase their exposure to indebted countries where capital flight is substantial. In this

context some Deputies noted that while commercial banks have expressed general support for the broad outlines of the Baker plan, no actual procedures have yet been established and no agreement has been reached on a framework for providing new money. The positive contribution to the creation of a favorable investment climate that would be made by early acceptance of the MIGA convention was also noted.

17. All Deputies stressed the crucial role of the IMF and of its stabilization programs in the implementation of the debt strategy. Such programs are required to establish the sound and stable macroeconomic and financial environment which is a prerequisite for more lasting structural reforms. For this reason the Deputies were concerned over recent attempts by some countries to dispense with Fund assistance in their adjustment policies and reiterated that countries should be encouraged to seek Fund assistance or Fund advice in the context of the enhanced surveillance procedure. To this end, some Deputies remarked that it might be useful for the Fund to try to present its policies in a way apt to minimize the political costs for the governments of the countries involved.

18. The majority of the Deputies spoke against the creation of new facilities to meet the additional financing needs of oil-exporting developing countries. It was noted that the proposal for an 'oil facility in reverse' had not been mentioned in the latest G-24 Communique, owing to divergent views on the matter within the Group. Regarding the G-24 proposals for resource transfers to alleviate the debt problem, the Deputies unanimously opposed an interest rate facility, which in their view would constitute an indiscriminate use of scarce resources, would not foster adjustment, and would create a dangerous precedent for orderly relationships between creditors and debtors. The possibility of enlarging access to the Compensatory Financing Facility for the benefit of oil exporters was also discussed, and the danger was noted that this could spur similar requests by exporters of other products whose prices are

declining. The discussion brought out that the most acceptable way to meet the additional financing needs of some indebted oil exporters would be a sparing recourse to the exceptional condition clause provided for under enlarged access to IMF resources. Some Deputies suggested that the activation of the GAB might need to be considered in this connection, in that despite its present comfortable level the Fund's liquidity situation could become a limiting factor since a number of countries with relatively large quotas might be eligible.

19. There was unanimous support for strengthening the role of the World Bank and of the other multilateral development institutions. The majority of the Deputies expressed the view that a general increase in the capital of the World Bank is necessary and that an early agreement on this increase is required. While acknowledging that the Bank's resources are not under immediate pressure, they advocate a capital increase as a needed signal to developing countries and commercial banks that additional resources will be available in support of structural adjustment and as a means to assure the World Bank a solid basis for its expanded lending programs. Other Deputies, however, were concerned lest the prospect of an early large capital increase retard adjustment efforts in debtor countries and remove an incentive for the World Bank itself to make the most efficient use of its resources.

20. On IMF/IBRD collaboration, some Deputies were satisfied with the progress that is being made, pointing to the necessarily informal character of such collaboration and noting that the results of improved contacts and exchange of information will be visible after some time. Other Deputies consider that while cross-conditionality should be avoided, there is a need for the two institutions to work together more closely in the design and implementation of their policies, including the possibility of joint programs. In the view of these Deputies, progress in the required direction has been rather slow.

21. All Deputies agreed on the need for action to improve the situation of the poorest countries. An essential element of such action is an early replenishment of IDA, which, in the opinion of most Deputies, should amount to some 12 billion dollars. The US proposal that IDA resources be used in conjunction with Trust Fund repayments was favored by most Deputies, who however linked their support to an early and adequate replenishment of IDA. This was seen as necessary to ensure that the resources of the Trust Fund may become available at an early date and that the conditionality that would attach to Trust Fund loans could be accepted by developing countries.

22. The Deputies recognized the important role of the industrial countries in the debt strategy, which is to maintain an economic environment conducive to sustainable non-inflationary growth and lower interest rates while ensuring adequate access to their domestic markets. The Deputies emphasized the direct contribution of industrial countries in the provision of finance to indebted developing countries, recalling that within the Paris Club framework rescheduling operations for more than 30 billion dollars have been concluded in the last three years.

23. The specific issue of the export credit policies was also discussed. The Deputies were in agreement on the need to harmonize these policies with respect to indebted countries and to show flexibility towards countries that are meeting the Baker plan criteria. However, it was stressed that countries must remain free to assess the merits of individual cases, and that re-establishing export credit cover can only be done on a case-by-case basis for those countries that are pursuing effective policies leading to structural adjustment.

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April 8, 1986

Mr. T. Lankester
British Embassy
3100 Massachusetts Avenue, N.W.
Washington, D.C. 20008

Dear Mr. Lankester:

I am enclosing a draft copy of Dennis Weatherstone's remarks for the Economic Club dinner this Thursday, at his suggestion. Since Dennis has been out of town, you may take this draft as an indication of the general drift of his speech, but not of its literal expression!

In case I have not reached you by phone before you receive this, we are assuming that Dennis will speak first and the Chancellor second, as we understand you prefer.

Please let me know if we can help further.

Sincerely,

Laura White Dillon

DRAFT 4.8.86 LWD

Remarks of Dennis Weatherstone, Chairman of the Executive Committee, J.P. Morgan & Co. Incorporated, before the Economic Club of New York, April 10, 1986.

Years ago, when I was more directly involved in the minute-to-minute movements of the financial markets than I am today, I got hooked on screen-scanning. I still switch on the screen first thing in the morning to see what's happening in the markets. And there's always one key price, or one key issue, that gives what you might call the pitch of the markets.

At different times in the past, gold, or the dollar, or even what happened in Vietnam have set that pitch. For the past few months, of course, it's been the price of oil. The spectacular fall of oil prices -- and the prospect of continued price volatility -- still call the tune for stock, bond, and foreign exchange markets around the globe.

The foreign exchange markets have an enduring fascination for me, and I'll return to them in a minute. But first I'd like to make just a few observations about oil developments.

As you all know, the collapse of oil prices will cause serious strains in important areas: among oil companies and oil-service firms, in states such as Texas and Oklahoma, in oil-producing countries like Mexico that are heavily indebted, and on some financial institutions. But by nature I am an optimist --

like my fellow speaker Nigel Lawson, if his comments on oil in his recent budget speech are any indication. I prefer to look ahead to the long-term benefits this price break has the potential to bring, in terms of economic growth here in the U.S. and abroad.

I say "potential" for a reason. Just how great the benefits turn out to be depends heavily, it seems to me, on how industrial countries respond to the opportunity presented by the oil-price fall. Make no mistake: the opportunity is an extraordinary one. The disinflationary impact of low oil prices creates a chance for industrial countries -- especially Japan and Germany -- to stimulate economic growth without risking a new bout of inflation.

This growth would go a long way toward correcting the trade and current account imbalances that still plague us -- despite the dollar's dramatic fall of more than 30% against both the yen and the mark since last year. The expansion of demand in the industrial world would also provide a major boost to developing countries. For these countries, exporting more to industrialized nations, in order to restore their own growth, is a political and economic necessity.

At the risk of denying my optimistic nature, let me emphasize that lower oil prices alone may do surprisingly little to stimulate growth if the key industrial countries do not adopt more expansionary policies. In Germany, France, and Japan, for example, we expect lower oil prices to add just 1.5% to economic growth for

1986 and 1987 combined. Without this boost, prospects for growth in these countries would be distinctly unpromising.

That may seem like the long way round to get to the foreign exchange markets. But I think there are some intriguing connections between what's happening in the oil markets and what has happened in the currency markets -- beyond the obvious effect of oil pushing the yen and the mark up against the dollar.

To begin with, the markets for both oil and the dollar are seeking trading ranges, albeit from very different starting points.

Until January, the price of oil for a decade had been set by a cartel. Another way of putting this is to say that oil producers, through more-or-less coordinated management of oil supply, managed the price of oil. The trouble was that the price got managed away from underlying economic realities: the gap between world demand for oil on the one hand and producers' desired output on the other got wider and wider. The center couldn't hold. Now the freewheeling forces of supply and demand are forcing a correction, and we don't yet know where -- or when -- the oil price will settle into a trading range.

What's happened in the exchange markets is roughly the opposite. For years, the major central banks -- especially U.S. authorities -- pretty much stayed out of the exchange-rate-management business, letting prices fall where the markets pushed them. Market forces by last year had pushed the dollar to lofty levels, contributing to record current account imbalances among the industrial countries.

Then in September we had the G-5 meeting here at the Plaza, when policymakers of the major industrial countries agreed that their exchange rates were out of sync with economic fundamentals. In an historic change of policy, they let it be known that they wanted an orderly depreciation of the dollar, and that they were prepared to intervene in concert to support that view in the foreign exchange markets. And down came the dollar.

Now I would hardly suggest that the G-5 constitutes a cartel like the OPEC of the past. But it is obviously true that, if there is a time to every purpose under heaven, now is apparently the time for more concerted management of exchange rates -- even, paradoxically, as it is the time for <u>less</u> concerted management of oil prices.

(OR: delete previous paragraph and add these sentences at the beginning of the following paragraph: Subsequently, President Reagan in his State of the Union message called upon Secretary Baker to reexamine the merits of proposed reforms of the international monetary system. One of these proposed reforms concerns target zones.)

In fact, it seems clear to me that the exchange markets have already begun to think about future rate developments in terms of target zones. We at Morgan have done a bit of brainstorming about what the entry levels for such zones might be, and I assume we are not alone in having conducted such an exercise. This doesn't mean we either expect or would want to see formal target zones. It has simply proved a useful analytical tool for understanding and anticipating the movement of exchange rates in the current environment.

But let's entertain the question: Should we move all the way to a regime of formal target zones for exchange rates? I think not -- unless the move is the means to an end, rather than the end itself.

Let's suppose that the G-5 countries could agree on the "right" exchange rates for their currencies -- the rates that would be consistent with acceptable trade flows, price levels, and economic growth. Even if they agreed, getting the market to trade at those rates would not be easy. I don't think anyone believes today that intervention alone could force the markets to maintain rates at a particular level. At the very least, the markets would have to be convinced that intervention signalled changes in economic policy that would be consistent with these "right" rates. Otherwise, the effort would be similar to OPEC's trying to maintain a price that contradicted the basic trend of supply and demand: it might work for a while, but the fundamentals would catch the system up in the end.

The point is that exchange rates depend on the whole international policy framework. The dollar decline of the past year at heart reflects market views that the U.S. policy mix has been changing, or at least is likely to change, in a more appropriate direction. The G-5 statement last September was useful and constructive. But it was constructive mainly because it signalled a new interest on the part of the five nations to work together, perhaps on more than just exchange rate intervention. It gave the markets a nudge at the right time at what I might call the margin of doubt. It confirmed the market's inkling about the dollar's basic trend.

Given the dollar's sharp descent, it's remarkable that its decline has been more or less orderly. We're now at the exchange rate levels that we thought a year ago would constitute a "hard landing" scenario, but the hard landing has actually been rather soft. I think this has been achieved precisely because the two factors I've just been talking about have worked together rather neatly. First, the fundamentals are shifting. In particular, there is more optimism that the U.S. budget deficit is on the way down. And second, the authorities have moved with the tide rather than against it and are happy with what has happened so far.

Now the question is, Where do we go from here?

I would argue that any move towards formal target zones would be a mistake. Formal target zones carry the risk of boxing the industrial world into a tight corner. The reason is this. Without further, coordinated policy changes, the dollar depreciation we have seen so far will not be enough to solve our most obvious problem: massive trade imbalances.

The dollar has not fallen enough to even out the enormous U.S. trade deficit and the corresponding surpluses in Japan and Europe. If there were no changes in fiscal and monetary policy here or abroad, the U.S. trade and current account deficits would remain more than $100 billion a year. The external debt of the United States would continue to mount. And, eventually, holders of dollars would begin to lose confidence in the currency. If that happened, we could be faced with a rapid depreciation of the dollar -- one that could be halted, if at all, only by a sharp increase in U.S. interest rates. In other words, we would have our crash landing.

In the United States, as I said, there is increased political commitment to substantial, phased reduction in the budget deficit. In Japan and Germany, however, there is stiff resistance to substantial policy changes that would increase domestic demand. But if those policy changes are not made, establishing target zones -- still less maintaining them -- would run into severe problems. The bottom line, ironically, is that formal target zones would work only if they were not necessary.

Now everyone knows that economic policymaking depends at least as much on politics as on economics. Is there an argument that target zones would be an adroit means of making fiscal policy changes politically possible? I think there is such an argument, but whether it is a practical one is another matter.

Germany, for instance, opposed formal target zones, even though it participates in the European Monetary System of more or less fixed exchange rate parities. The difference is that, within Europe, Germany is the leader; its EMS partners effectively must accommodate their actions to German policies. In a global system of target zones, the Germans with reason might expect greater pressure to set just the kind of more expansionary fiscal and monetary policies that they have resisted so far. Germany apparently is not eager to subject itself to such increased pressure. I should add that Germany is not alone in taking this stance: the United States has shown similar reluctance to allow external constraints to shape its domestic policies.

Nonetheless, we must recognize that the U.S. trade deficit is not just a U.S. problem, but a world problem. Further massive dollar devaluation would cure our huge trade imbalances, but that remedy would be hard on everyone -- especially Europe and Japan.

The fact remains that continued, substantial dollar depreciation -- in spite of its threat of renewed U.S. inflation -- would be the least painful way out of trade difficulties for this country if other countries refuse to budge. A constructive solution requires action by the surplus countries as well as by the U.S. As I mentioned at the outset, low oil prices offer a rare opportunity for such action. I hope that the current round of international economic gatherings, culminating in the Tokyo Summit, will focus attention on the need for coordination of fiscal and monetary policies among the major countries.

If our economic leaders recognize that more convergent policies are in their mutual interest, they will also recognize the political consequences of appearing to change course. It is here, and only here, that I can see a possible role for target zones, although not necessarily around today's rates. It might just be possible for the announcement of target zones to allow Japan and Germany to swallow their recent rhetoric and boost demand -- all in the interest of "exchange rate stability and world economic cooperation," of course!

The target zone question has presented itself in particularly pointed form recently to my fellow speaker. I am referring, of course, to the debate on British participation in the European Monetary System of more or less fixed exchange rates. Here, too, both timing and political considerations are of great importance. I can't resist a brief digression to contribute my tuppence to the debate.

If Britain decides to go ahead, when should it do so? Obviously, it makes sense to go in at a sustainable level -- one that not only clears the foreign exchange market but also stands a reasonable chance of producing the desired outcome for trade, prices, and economic growth. I think the current Deutsche mark/sterling rate of 3.40 to 3.50 is pretty close to such a level. This apparently was not the received wisdom last weekend! But unless British entry were to take place in the context of another substantial realignment, I still think that soon would be a better time than most.

The question of when to enter is important, but it is clearly secondary to the question, why enter at all? The usual answer is that it would provide protection against exchange rate instability with Britain's major trading partners.

Now avoiding instability within the EMS in effect means aligning policies with those of Germany, the leader of the system -- especially policies directed at controlling the medium-term inflation rate.

<u>If</u> the British government wished to commit itself to substantially reduce the medium-term inflation rate -- down to the

level of 1% that the Bundesbank seems to shoot for -- its actions might cause less pain to the British economy inside the EMS than outside of it. This is precisely because overshooting the exchange rate -- the thing that helped strangle the economy six or seven years ago -- would be avoided.

Nevertheless, the Chancellor's recent Budget, and the absence of a move last weekend, betrays a certain lack of enthusiasm for the EMS course. From the political standpoint, especially with an election looming ahead, the extra unemployment that would be needed to lower the inflation rate significantly would be difficult to accept -- even within the EMS. Perhaps the Chancellor will elaborate on this issue -- but I for one am not surprised by the lack of ardor in Britain's response to its EMS suitors.

Despite all the caveats I've been uttering about the limitations of target zones, my own preference is for more of the kind of exchange rate management that we saw at the Plaza and have witnessed since then. My point is simply that attempts to manage exchange rates quickly focuses attention on complementary fiscal and monetary policy intitiatives. My fondest hope for the upcoming Tokyo Summit is that it will issue a joint communique that reads something like this -- with apologies to the finance ministry staffs:

Quote: "Formalized target zones have little to offer for exchange rate management or global economic betterment. By contrast, on an informal basis, illustrative zones -- without target status -- could illuminate the interrelationships among the whole range of official policies and encourage appropriate policy changes."

End of quote -- end of speech!