PO-CH/N40860
PART A

Chex Lawson

PART A

CONFIDENTIAL

(Circulate under cover and
notify REGISTRY of movement)

PO -CH /NL/ ~~0112~~ 0860

PART A

CHANCELLOR'S PAPERS ON THE MINISTERIAL MEETING OF THE ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD), 17-18 APRIL 1986, PARIS

PO -CH /NL/ ~~0112~~ 0860
PART A

Begins: 11/4/86
Ends: 16/4/86

DD: 25 years

5/9/95

RP2.90

RESTRICTED

FROM: P WYNN OWEN

DATE: 12 March 1986

MR DYER

MR FITCHEW o.r.

cc PS/Sir P Middleton
Sir G Littler
Mr Scholar
Mrs Lester

FIXTURE CLASH: THURSDAY 17 APRIL

We have spotted that the next Treasury First Order Questions clashes with the OECD meeting in Paris. I should be grateful if you could liaise as soon as possible on Mr Fitchew's return and provide advice to the Chancellor on what might be possible.

R.

P WYNN OWEN

RESTRICTED

b/f 20/3 pd

FROM: B O DYER
DATE: 13 March 1986

MR FITCHEW

cc PS/Sir P Middleton
Sir G Littler
Mr Scholar
Mr Wynn Owen
Mrs Lester

FIXTURE CLASH: THURSDAY 17 APRIL

Mr Wynn Owen's minute of 12 March records a clash of engagements on Thursday 17 April - Treasury First Order Questions and the OECD meeting in Paris; and asks that I liaise with you in providing advice to the Chancellor.

If it is considered desirable that the Chancellor attend the OECD meeting (and he concurs), I do not see that this need necessarily cause a great problem.

First, it would in no way set a precedent if the Chancellor were absent for Treasury First Order Questions in order to attend a Ministerial meeting overseas. This occured on a number of occasions when Sir Geoffrey Howe was Chancellor - eg on 13 May 1982 to attend an IMF meeting in Washington and on 9 December 1982 to attend a 'Group of Five' Finance Ministers meeting. And it was a very frequent occurence indeed when Roy Jenkins was Chancellor under a Labour Government.

Secondly, provided the Chancellor's arrival in Paris could be deferred until say around 7 pm, it may be possible for him to fulfil both engagements. Treasury First Order Questions ends at 3.15 pm and I have checked that on the day in question there is a flight from Heathrow at 4.30 pm arriving Paris at 6.30 pm (Continental time).

B. Dyer

B O DYER

PH/42

RESTRICTED

1- JK
2- [illegible]

FROM: P WYNN OWEN
DATE: 25 MARCH 1986

MR B O DYER

cc PS/Sir P Middleton
Sir G Littler
Mr Fitchew
Mr Scholar
Mrs Lester

OECD MINISTERIAL, 17 APRIL

The Chancellor has seen your minute of 25 March and is content to miss First Order Questions on 17 April to attend the first day of the OECD Ministerial.

2. I should be grateful for advice on whether this means all the other Treasury Ministers will need to attend First Order Questions and on how we should notify the Business Managers.

P WYNN OWEN

506/10

RESTRICTED

01-233 4749

FROM: B O DYER
DATE: 25 March 1986

CHANCELLOR

C/ Content to skip First Order for OECD?

Ro 25/3

cc PS/Sir P Middleton
Sir G Littler
Mr Fitchew
Mr Scholar
Mr Wynn Owen
Mrs Lester

OECD MINISTERIAL, 17 APRIL

Before taking a final decision on whether to skip 'First Order' on 17 April and attend the OECD Ministerial, you wished to know if there were any further clashes this year between Treasury Questions and overseas trips. Such a clash occuring again this year, currently, looks most unlikely.

2. Prior to the Summer recess, Treasury First Order Questions fall on Thursday 17 April, 15 May, 19 June and 17 July. Currently, there are no overseas trips registered in your diary (or, as far as I can discover, yet to be inserted) which clash with these dates, other than the OECD on 17 April.

3. In the period October to December 1986, the position is a little less clear; when our 'First Order' dates will depend on the length of this Session's spillover (I can only hazard a guess of 3 to 4 weeks). Nevertheless, the prospect of a clash looks very unlikely. According to your forward diary for this quarter, none of your overseas trips is scheduled for a Thursday, when the House might sit (Thursday being, traditionally, the Treasury's 'First Order' day).

4. For the record, Questions for our next 'First Order' on 17 April are being tabled today to appear on tomorrow's Order Paper. To accelerate their processing, it would be most helpful if we could have your decision on the OECD Ministerial before the Easter recess.

B. Dyer

B O DYER

RP6.24

RESTRICTED

FROM: P WYNN OWEN

DATE: 25 March 1986

MR DYER

cc PS/Sir P Middleton
Sir G Littler
Mr Fitchew
Mr Scholar
Mrs Lester

OECD MINISTERIAL, 17 APRIL

The Chancellor has seen and was grateful for Mr Fitchew's minute of 18 March. Before taking a final decision on this, he would like to know if there are any further clashes this year between Treasury Questions and overseas trips.

P WYNN OWEN

1492/011

RESTRICTED

From : G E Fitchew
Date : 18 March 1986

C/ Skip first order and go to OECD?

PS/CHANCELLOR

cc PS/Sir P Middleton
Sir G Littler
Mr Scholar
Mrs Lester
Mr Dyer

RO 20/3

Yes. ~~[illegible]~~

Before going this way, are there further clashes this year between Qns TSY & [illegible]? [illegible]

OECD MINISTERIAL, 17 APRIL

Your minute of 12 March draws attention to the clash which has now arisen between the next Treasury First Order Questions and the first day of the OECD Meeting in Paris and asks for advice on how to deal with it.

2. Mr Dyer's minute of 13 March (attached) sets out a number of instances on which the Chancellor's predecessors have missed First Order Questions in order to attend international meetings. In the light of this there are three possible ways of dealing with the clash :-

(a) the Chancellor to miss First Order Questions and to attend the whole of the first day of the OECD Meeting. This effectively begins at 10.30 am, so there would be no need to fly out the night before;

(b) the Chancellor to stay for First Order Questions, but leave for Paris immediately afterwards on the 16.30 flight. This would enable him to attend the Ministerial dinner at 8.30 pm and then stay on for as much of Friday's OECD discussion as seems necessary. The Chancellor's place during the first day's meeting until his arrival could be taken by Sir Geoffrey Littler;

(c) another Treasury Minister (the Chief Secretary or Economic Secretary) to attend the OECD Ministerial in the Chancellor's place.

MST not due to answer Questions

Comment and Recommendation

3. After consulting Mr Bayne in Paris, I think the choice really lies between (a) or (c). The Secretariat's present intention is

to complete the discussion on macro-economic issues and international finance on the first day, leaving only trade (and settlement of any outstanding points on the Communique). It would simply not be worth the Chancellor's while to go out simply for the dinner on the first day.

4. We would hope that in these circumstances the Chancellor would be prepared to miss First Order Questions and attend the whole of the first day and the Ministerial dinner. This will be the last major international meeting in the run-up to the Tokyo Summit. The Washington meetings, which precede it, will focus on debt and international monetary issues. The OECD agenda and the Communique emerging from it will be more narrowly concentrated on the macro-economic policy stance of the industrial countries and in particular of the Tokyo Seven. The outcome of the OECD discussion is therefore likely to be directly relevant to the Summit and it is desirable that the Chancellor should have the opportunity to influence the Communique. Depending on the outcome of the Washington meetings there is also a risk that the French could try to re-establish this link between trade negotiations and international monetary reform in the OECD. Finally, the OECD agenda also includes a number of items under the heading of Structural Policies (energy policy, labour markets, financial markets and agriculture) which are of interest to us.

5. Of the Chancellor's G5 colleagues, both Baker and the new French Minister are expected to be present for the first day and dinner only, (though Stoltenberg and Takeshita will not).

6. We should be grateful to have the Chancellor's reactions. If he wishes to keep the options open until more is known about the contents of the Order paper, we suggest that a contingency reservation should still be made on the Thursday morning breakfast flight to Paris.

G.E.F.

G E FITCHEW

67/031

B/f 16/4 pl ~~b/f 14/4~~
pmp

FROM: A M DOLPHIN
DATE: 11 April 1986

MR KUCZYS ✓

cc: Sir P Middleton
Sir G Littler
Mr Fitchew
Mr Mountfield
Mr Odling-Smee*
Mr Sedgwick*
Mr Culpin
Mrs Case*
Mr Kelly*
Mr Matthews
Mr Butt*
Mr Bush*
Mr Legg*
Mr Redley*
* communique only

OECD MINISTERIAL MEETING ON 17 - 18 APRIL

We have now received from the OECD copies of the draft communique C/MIN(86)3 and the BIAC submission to the Ministerial Meeting. Copies of these documents are attached.

A.M. Dolphin

A M DOLPHIN

b/5 16/4 for folder.

Covering CONFIDENTIAL

FROM: C J E LEGG

DATE: 15 April 1986

1. MR P DAVIS 15/4

2. CHANCELLOR

cc PS/CST
PS/EST
PS/FST
PS/MST
Sir P Middleton
Sir G Littler
Mr Lavelle
Mr Fitchew
Mr Mountfield o/r
Mr Sedgewick
Mr S Matthews
Mrs Case
Mr Dolphin
Mr Bush
Mr Westhead

OECD MINISTERIAL MEETING ON 17-18 APRIL

BRIEF ON TIED AID FINANCING

Attached is an interdepartmentally agreed brief on tied aid financing which is also being submitted to the Secretaries of State for Foreign Affairs and for Trade and Industry.

2. A meeting of expert officials (which Mrs Case will attend) is scheduled for 16 April at which the package of new discipline measures proposed by the OECD Secretary General will be discussed. So it is possible that by the time Ministers meet some compromises will have been reached.

3. It is possible that you will be informally approached by the Americans who will press for an increase in the minimum grant element to 40% (5% more than the EC mandate proposes). In which case you can say that 40% would be acceptable to the UK provided the increase is linked to the speedy introduction of differentiated discount factors (DDF). We are bound by the EC mandate, but will continue to try to persuade our EC partners to move nearer the US position.

LINE TO TAKE

C J E LEGG

CONFIDENTIAL

OECD MINISTERIAL 17-18 APRIL 1986

TIED AID CREDITS: BRIEF

REFERENCES: C/MIN(86)2: Improving the Dynamics of global growth (Para 33iv)

C/MIN(86)3: Draft Communique (Para 23 and Annex)

C/MIN(86)8: Transparency and Discipline in Tied Aid Financing

OBJECTIVES

(i) To secure agreement to a package of new discipline measures as close as possible to the EC mandate;

or (ii) failing that, to ensure that clear instructions are given by Ministers for a package to be agreed quickly by participants - say, by the end of July 1986.

LINE TO TAKE

(i) UK united with all other participants on need to secure now a durable agreement to increase transparency and discipline in tied aid financing. Task of this meeting should be to reach agreement. [If necessary, failing that, need to lay down guiding principles and strict timetable for speedy solution.]

(ii) Fully support EC mandate which offers realistic improvements in discipline and is a stronger package than that proposed by the chairman of the Consensus in his report (C/MIN(86)8 Annex). [The Secretary General's paper specifically seeks an answer on this point.]

(iii) Essential that increases in minimum grant element (m.g.e) be linked with introduction of differential discount factors (DDF). Otherwise, unfair advantages enjoyed by low interest rate countries under present standard (10%) discount factor will be further increased.

(iv) Oppose weakening the proposed discipline measures by allowing a lower m.g.e for partially untied aid financing.

(v) See some advantage in linking agreement on new discipline measures with agreement on CIRRs. But doubt whether work on individual CIRRs sufficiently advanced at this stage. Would not wish differences on CIRRs to prevent agreement on tied aid financing at this meeting. But willing to see subject remitted to Consensus group for speedy solution.

FALL BACK

(vi) Willing to consider with EC partners suggestions by others for specific modifications to the EC proposals, provided overall package represents a real increase in discipline, and that minimum grant element increases tied to introduction of DDF (see background note, para 9).

TACTICS

As far as possible you should try to keep discussion restricted to the EC mandate and ensure that all EC ministers remain wedded to it. The danger is that other, non-EC participants, notably the Swiss and Japanese will seek to remove DDFs from the package by trying to drive a wedge between the Germans and Dutch who were out-voted on this at ECOFIN, and other EC members.

It is just possible that the Community will need to revise its position in the course of the meeting. If so the brief will serve to point the directions in which the present mandate could be altered.

BACKGROUND

1. Over recent years there has been a significant growth in the use of "tied aid finance" for commercial purposes (ie the financing of export transactions using development aid funds, either as mixed credits (aid used in association with export credits) or less concessional tied aid loans). Most countries see tied aid financing as a serious and unwelcome distortion of international trade, but many, including the UK, have had to introduce arrangements to maintain their competitive position. The UK has consistently backed efforts in the OECD to improve transparency and discipline, but progress has been slow - mainly because of obstruction by France and Japan, who claim to regard mixed credits and aid loans with a low grant element as a legitimate form of aid and as a way of spreading benefits more widely.

2. At the OECD Council meeting on 12 April 1985, Ministers agreed as a first step to increase the minimum permissible grant element in tied aid financing from 20 to 25%, and to establish revised notification and consultation procedures. They instructed that further measures to strengthen transparency and discipline in the field of tied aid financing should be pursued expeditiously.

3. Progress towards these further measures has been slow. The US has pressed for an across the board increase in the m.g.e to 50%, but this has been resisted by other participants, notably France. Within EC there has been considerable disagreement, finally resolved at the informal ECOFIN on 5 April, when an EC mandate (Annex A) was agreed by QM: the Dutch and Germans were out-voted.

4. Although agreement within EC came too late for the last Consensus Meeting in March, it was apparent there that considerable differences remained. In his report to Ministers (C/MIN(86)8 Annex, paras 3-7), the Chairman of the OECD Consensus Group (Axel Wallen of Sweden) has, therefore, set

out a possible package of measures for discussion at the Ministerial and in the annex to the draft Communique the Secretary General has refined these further into a package of specific measures. These are broadly similar to the EC mandate but with the following additions:-

(i) a ban on export credit subsidies (as well as tied aid) to the richer (Category 1) countries;

(ii) a three stage increase in the m.g.e to 40%;

(iii) a lower m.g.e for partially untied aid financing (ie where procurement is permitted only in the donor and developing countries) - a sop to the Japanese;

(iv) linkage of the package on discipline to agreement on CIRRs.

5. The attitudes to these proposals fall into three camps:

(1) The US still favours a single large increase in the m.g.e, but would be likely to compromise around 40% for intermediate countries - compared with the 35 per cent proposed by the EC. In a recent letter to Sir G Littler and in their comments on the draft annex to the Communique the Americans have indicated that they will accept DDF provided the increase in the m.g.e is 40% rather than 35% and have stated their opposition to a lower m.g.e for partially untied aid.

(2) Japan is anxious to protect its Overseas Economic Co-operation Fund (OECF) loans which are partially untied and is strongly opposed, like other low interest rate countries (Switzerland, Netherlands and Germany), to the introduction of differential discount factors (DDF). The last two have, of course, already lost the argument on DDFs in the EC, and are now bound by the EC mandate.

(3) France, Belgium, Italy, the UK and the rest of the EC are willing to accept increases in the m.g.e only if linked with the introduction of DDFs.

6. The introduction of DDFs has become crucial to the whole discussion. The UK and others regard it as essential since, otherwise, a higher m.g.e would have little effect on countries with low interest rates. This is because the 'grant element' in a tied aid credit is normally not an explicit grant as such, but an implicit grant representing the value to the borrower of being able to borrow at the subsidised rate rather than a market rate. Formally, it is the difference between the present value of the debt service payments under a loan discounted at the 'market rate' and the loan value itself. A loan provided at the market rate would by definition have a zero grant element. But under OECD rules, a standard 10% discount rate is used as the 'market rate' when calculating grant elements in tied aid credits, irrespective of the currency in which the loan is made and the true market interest rate in that currency. As a result, the grant element so calculated does not reflect the actual subsidy cost to the donor country, ie the difference between the market interest rate in that currency and the subsidised interest rate on the tied aid loan, but the difference between the subsidised interest rate and the 10% notional rate. Thus for donors with low interest rate currencies the grant element calculated under existing OECD rules overstates the actual subsidy involved. For example, the Japanese, who under existing rules commonly offer OECF loans with a calculated subsidy around 40%, well above the current 25% m.g.e, would achieve a grant element of only 20% if DDF was applied. So an increase in the m.g.e to any level up to 40% without DDF would not bite on the bulk of their loans. Conversely, such an increase would have immediate and severe impact upon the UK, substantially restricting the amount of business that could be won per unit of ATP expenditure.

7. Given the wide range of views held by OECD participants, it is unlikely that the Ministerial will be able to agree a package of new discipline measures, though this remains the UK's primary objective. Instead, the problem may be remitted for further work by Consensus participants. Some participants (particularly the Swiss and Austrians) may argue for the DAC to take on the further work rather than the Consensus. This could lead to problems since EC does not have competence in the DAC and the Dutch and Germans would be free to argue against DDFs. In which case, it will be essential that the Communique gives as clear guidance as possible as to what the final package might contain and that a tight timetable is set. The aim should be to complete the further work by the end of July before the EC goes on summer leave, so that the package can be endorsed by participants early in the Autumn.

8. Discussion in the Ministerial is likely to concentrate on possible areas of compromise to achieve an agreed package. As indicated above, the UK is committed to the EC mandate. However, it may be necessary to indicate a willingness to consider compromise in the interests of a deal. The extent to which compromise on individual measures within the package would be acceptable to the UK is discussed below. But it is essential that any changes do not produce an overall package which lets major tied aid participants off the disciplinary hook and impacts to the UK's disadvantage. Our industry has already indicated that it will be closely watching the outcome of the meeting from this point of view. Any compromise which breaks the essential link between increasing the minimum grant element and the introduction of DDF would be unacceptable, as would a permanent or other significant concession to the Japanese on partially untied aid.

INDIVIDUAL MEASURES

9. (i) <u>Ban on Tied Aid Financing for the richer (Category 1) countries</u>. For tied aid financing this is acceptable to all countries, because it has no effect.

(Category 1 does not include middle and low income developing countries). It is included in the EC Mandate, but Wallen goes much further by proposing the elimination of all export credit subsidies to Category 1 countries (sub-para (a) of C/MIN(86)3 Annex). We take this to mean that official support for exports between rich countries would be confined to market-related CIRRs (see (vi) below) thus removing the option for matrix rates which have greater potential for subsidy. This has been a longstanding proposal by the Nordic countries. In principle, the UK is committed to the eventual elimination of export credit subsidies, but would prefer the first step to be confined to removing matrix rates for OECD markets. If necessary, elimination for all Category 1 markets could be accepted but other EC countries are anyway likely to resist.

(ii) <u>One step increase in m.g.e for the least developed countries (LLDCs) to 50%</u>. This also is accepted by all participants and is included in the EC Mandate and the draft Communique proposals (sub-para (b) of C/MIN(86)3 Annex). Again this will have very little effect since these countries receive hardly any mixed credits or less concessional loans.

(iii) <u>Phased increase in m.g.e for intermediate countries</u>. The EC Mandate suggests that this should be to 30% immediately and 35% after one year. The draft Communique (sub-para (b) of C/MIN(86)3 Annex) also suggests three yearly steps of 5% to 40%. The US will press for at least an increase to 40% at once or in stages. In return we should seek the immediate and full introduction of DDF or as a minimum an immediate, significant step towards DDF with full introduction before the 40% minimum grant element is reached.

(iv) <u>Lower m.g.e for partially untied aid</u> (sub-para (b) of C/MIN(86)3 Annex. This is a sop to the Japanese and is unlikely to be supported by other participants. The

Americans have already indicated their opposition to it. It is counter to recent moves to apply full discipline to such loans and would open up a means of circumventing this. In many cases there may be no competitive developing country source of the goods involved, meaning that the aid is effectively tied. It would give the Japanese an unjustifiable advantage, given that the overwhelming proportion of their tied and partially untied loans is the latter. We see no scope for compromise on this item, except, possibly, to allow for a very minor and short transitional adjustment if this were the only way to agree on the rapid implementation of a full DDF system and then only if all other countries were in agreement on this.

(v) Phased introduction of DDFs. This is included in both the EC Mandate and in the draft Communique (sub-para (c) of C/MIN(86)3 Annex). EC proposes introduction over two years, rather than three as suggested in the draft Communique. Our preference is for as quick an introduction of a full DDF as possible, anything less is likely to be to our disadvantage. No detailed consideration has yet been given to the form phasing of the DDF should take, but there are several possibilities, eg a phased broadening of the band of discount rates employed. Provided a substantially lower discount rate is introduced immediately for low interest rate currencies as a first short step to full differentiation we could agree. There also remains the question of how the appropriate discount factor for each currency should be derived and how frequently it should be changed. It is essential that the rates chosen should reflect the cost to the donor country, (ie the actual level of interest rates of the currency used). The draft Communique suggests that the DDFs should be the CIRR for the currency. This would not be entirely appropriate because the CIRR rate is by definition an approximation of the commercial rate for each currency whereas the cost of aid funds to the donor country should reflect the Government borrowing rates. A better alternative base (which is already used for the construction of CIRRs) would be five year government bond rates in each country but a solution based on CIRRs would be acceptable. It may be suggested, as a sop to the low interest rate currencies that the adoption of a DDF be constrained by a ceiling to ensure that high interest rate currencies do not benefit fully from DDF although we would want to push for as high a ceiling as possible. Whilst this would limit the advantage to the UK, it would succeed in the main objective of increasing discipline on the Japanese and might be accepted as a compromise.

(vi) <u>Link with CIRRs</u> (sub-para (d) of C/MIN(86)3 Annex). Commercial Interest Reference Rates are the market-related rates at which official support can be given in low interest rate currencies. The Consensus Group is currently examining the existing rates which have proved contentious not to say unworkable. This proposal suggests a link between resolution of tied aid credits and the CIRRs problem. This is necessary because acceptable CIRRs would have to form the basis of official support if matrix rates were no longer available for Category 1 markets (or, indeed, OECD markets alone) and are suggested as the basis for DDF rates. More generally, widening the package may improve the chances of a general settlement (eg the US has indicated that it would not continue discussions about CIRRs unless the EC is prepared to compromise on tied aid financing and the converse may also apply). In fact, insufficient work has been done on interest rates to enable Ministers to reach agreement at this stage (though the rates in Wallen's paper (C/MIN(86)8) are broadly acceptable to the UK with the important exceptions of the US dollar and, perhaps, the yen). However, linkage is in theory possible and could form part of a remit to officials to force a speedy overall settlement.

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Interest rates likely to
come down – though not
as fast as inflation, since
the sharp fall in oil & other
commodity prices this year will
produce an inflation rate below
underlying [illegible] inflation.

C/ Sir Geoff is staying with Ambassador Nick Bayne on:-

010 33 1 4 500 5517

He is out to dinner with Bayne, but should be obtainable there between 6 and 7 pm or any time after 10pm (UK time) tonight.

Robert's speaking note (Annex H) to follow in final form, as will a separate folder for the proposed Wilson bilateral.

I've tucked in the front of this folder various key pprs from last week which you might draw on in any drafting you do.

We leave No 11 at 7am. Robert and I will travel with you. Don't forget your passport.

RS 16/4

'68/011

FROM: S W MATTHEWS
DATE: 16 April 1986

CHANCELLOR

cc: Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lavelle
Mr Fitchew
Mr Mountfield
Mr Odling-Smee
Mr Sedgwick

Mr Richardson
(FCO)

OECD MINISTERIAL MEETINGS, 17 - 18 APRIL

This brief is an annotated guide to the agenda, papers and briefing for the OECD Ministerial Meeting.

2. The meeting agenda and a list of the papers (C/MIN(86)1) is at Flag A. You will probably need to consult only two of the papers:

a. The Secretary-General's note "Improving the dynamics of global growth", C/MIN(86)2. This is a comparatively short paper by OECD standards (22 pages) and sets out the Secretary-General's view of the current situation and prospects, considers their policy implications and concludes with questions for discussion. (Flag B).

b. The draft communique, C/MIN(86)3. (Flag C).

Oh!

Organisation of the meeting

3. The meetings will be Chaired by Mr Ozal, the Turkish Prime Minister. There are to be four main rounds of discussion, with macroeconomic policies and structural adjustment being taken on the first day, when you will be attending - plus perhaps tied-aid credits. Relations with developing countries and trade will be discussed on the second day, when the Foreign Secretary will be attending. Mr Clark, the Minister for Trade, will attend on both days.

4. The Secretary-General hopes the meetings will be more informal than in the past and that this will facilitate debate. Reading of prepared statements is to be discouraged and there is to be

no pre-negotiated speakers list, although it may be possible to come to some arrangements on the spot.

5. There are to be informal working lunches for Ministers on both days. The Secretary-General hopes that these will discuss the communique, with a view to identifying specific problems in it, but not engaging in detailed drafting, which would be left to officials. At the end of the afternoon on the first day, Ministers will, it is hoped, be able to approve the parts of the communique relating to that day's business. EPC, the Executive Committee in Special Session and OECD Ambassadors have all worked on the communique and for the most part it looks quite good. There is no need to initiate discussion or press for ammendments on any specific points in the communique. The main points we want to see in it are set out in the next paragraph. Mr Fitchew has a note setting out our detailed drafting suggestions.

UK objectives

in no order of importance!

6. Our main objectives (i.e. for the most part the points which we would wish to see reflected in the communique) are:

a. To reaffirm the commitment to sound fiscal and monetary policies as necessary conditions for sustainable, non-inflationary growth, and the need for structural measures to make markets work better in order to achieve higher levels of employment;

b. to maintain pressure on Japan to pursue policies to reduce its current account surplus;

c. to agree that the benefits of lower oil prices should be passed on to consumers to encourage private sector growth (except in a few countries where budget deficits are still very large and inflation high);

d. to open up the international discussion of agriculture as a structural adjustment problem, to be tackled by aligning prices paid to producers more closely with world prices;

e. to endorse the approach to developing countries' debt problems set out in last week's Interim and Development Committee communiques;

f. to agree in principle new rules for tied-aid credits, including their grant element and differentiated discount rates;

g. to give impetus to the new GATT round;

h. to encourage OECD's work on trade in services.

Macroeconomic policies

7. This is the first item on the agenda. Paragraphs 2 - 20 and questions 1 - 4 of the Secretary-General's note are relevant.

8. Discussion is likely to go over ground already trodden at the Interim Committee Meeting. OECD's latest forecast (on the basis of a $15 per barrel oil price) is similar to that of the IMF and thus slightly less optimistic than the FSBR forecast. Nonetheless, the outlook is a favourable one, although problems remain, notably the US Federal budget deficit, the Japanese current account surplus, structural rigidities in Europe etc. There may also be some debate on how far lower oil prices should be passed on to consumers.

9. The following pieces of briefing are attached:

i a short speaking note (Flag D);

ii the brief on the world economic outlook prepared for the Washington meetings (Flag E);

iii a few key facts and figures (Flag F); The "postcard" you asked for.

iv "answers" to the Secretary-General's questions (Flag G).

Structural policies

10. Paragraphs 21 - 29 and questions 5 - 7 of the Secretary-General's note are relevant. The Secretary-General has picked out three areas for discussion: energy, labour markets

and agriculture. He will also report progress on the structural adjustment study commissioned last year, which he is due to present to the 1987 OECD Ministerial Meeting.

11. I am attaching a speaking note by Mr Pickford which covers these issues. (Flag H). Current Flag H ~~not~~ final version – to follow from Robert

12. The Secretariat were slow to get down to work on the structural adjustment study. The approach that they are now proposing to adopt looks sensible, but ambitious and we will need to keep an eye on developments to ensure that the study comes up with relevant and concrete policy conclusions.

13. On labour markets the Secretary-General's note places a welcome emphasis on the need for increased flexibility (and for the better working of markets generally) as well as for moderation in the growth of real wages in order to reduce unemployment.

14. On agriculture, the paper rightly points to the urgency of the need to tackle the problems of over-supply which have resulted from a combination of protection and technical progress. It points to the budgetary costs and trade tensions between OECD countries that this has engendered, but fails to mention the costs for consumers in industrialised countries and for producers in developing countries. It pulls its punches a bit on the need for lower prices for producers.

Tied-aid credits

15. I am attaching a brief prepared by AEF Division and agreed with other departments. (Flag I). Mrs Case is attending a meeting of officials at the OECD today to discuss this subject in preparation for the Ministerial Meeting. She will be briefing Sir G Littler on the outcome of the meeting. Although the subject may not come up on the first day, you may find it useful to draw on the briefing if bilaterial meetings are needed on the subject with other Ministers. The principal issue is to achieve greater discipline over the use of tied-aid credits by raising their minimum grant element and at the same time ensuring that it is appropriately calculated, i.e. on the basis of actual market interest rates rather

than the standard 10 per cent discount rate that has been used to date. The UK's main concern is to ensure that the discipline to be applied is effective and of equal rigour for all countries.

Relations with developing countries

16. Paragraphs 30 - 33 and questions 8 and 9 in the Secretary-General's note are relevant. Discussion is likely to cover much the same ground as at the Interim and Development Committee Meetings last week.

Trade policy

Eh?

17. Paragraphs 34 - 39 and questions 10 - 13 of the Secretary-General's paper are relevant. A brief by the FCO and DTI is attached. (Flag J). Our main concern is that the OECD should reiterate its commitment to a successful new GATT round, and must signal its willingness to deal seriously with issues such as agriculture and textiles which are of concern to the developing countries in order to get their acceptance for the inclusion of graduation and trade in services. We would also like to see the OECD give higher priority to work on liberalising trade in services between member countries. To focus this work and to give it the required sense of urgency Ministers could press the Secretary-General to report back to them on progress at next year's Ministerial Meeting.

What do?
Why don't we
Shultz'll do the
same?

Other matters

18. OECD budget. The US delegation to the OECD have informed the Secretary-General that their contribution to the 1986 budget will be about FF40 million short of their assessed amount. This is equivalent to about 5 per cent of the total OECD budget. It appears to be part of a US Administration policy to make unilateral cuts in contributions to all international organisations. The Foreign Secretary will be raising this matter with Mr Whitehead (Under Secretary of State) at the Ministerial. The FCO consider that it would be helpful, if the opportunity arises, for you also to raise the subject bilaterally with Treasury Secretary Baker. You could say that, unlike some other international organisations, OECD is a useful and relevant body, which serves both US and UK

interests well. The new Secretary-General is making good progress in improving the quality of OECD's work. If the US withholds an amount equivalent to 5 per cent of the total budget, this will reduce the effectiveness of OECD and make future budget negotiations difficult. A short background note is at Flag K.

19. Bilateral with Mr Wilson. Separate briefing is being provided for your meeting with the Canadian Finance Minister.

SM

S W MATTHEWS

68/010

D ✓ MACRO SPEAKING NOTE

OECD MINISTERIAL MEETING: SPEAKING NOTE FOR DISCUSSION OF MACROECONOMIC POLICIES

1. Thank Secretary-General for his compact but comprehensive note setting out the main issues for discussion. His paper rightly recognises achievements of medium-term strategy of prudent fiscal and monetary policies in attaining non-inflationary economic growth in industrial countries. And that developments over the past year (in particular the adjustment of exchange rates, fall in oil prices, and lower interest rates) have further improved the prospects for this year and next, and reduced the risks from imbalances in the world economy. But the Secretary-General is right to warn us against complacency.

2. OECD countries as a whole now into fourth year of growth: sixth in the case of the UK. But although output is at record levels, unemployment is unacceptably high, especially in Europe. I shall have more to say this afternoon about the need for structural policies to improve the working of markets, and in particular the labour market.

3. Another problem is that despite recent falls in interest rates, real rates remain high in the OECD area. To achieve a sustainable reduction we must reduce claim on aggregate savings made by public sector deficits in the industrialised countries as a whole. Significant reduction in US Federal budget deficit particularly important; US accounts for well over 40 per cent of total OECD budget deficit. Trust that Congress and Administration will achieve a compromise yielding a deficit in line with Gramm-Rudman-Hollings Act.

4. Persistent current account imbalances need to be tackled. Particularly if we are to avoid resurgence of protectionist pressures. Welcome series of Japanese packages to boost domestic demand and the appreciation of the yen since Plaza. Japan must not allow their effects on its current account to be diminished by industrial subsidies. Remain concerned that growth of domestic demand in Japan may be inadequate, with consumers' expenditure continuing to grow comparatively slowly. Appreciation of yen needed will be greater the less satisfactory is domestic demand.

5. Despite the problems of imbalances overall prospect for world economy created by low inflation is a good one. UK forecast for seven major industrial cognations (based on $15 per barrel oil price) has slightly faster growth and slightly lower inflation than that of the OECD Secretariat. But differences are relatively minor.

6. We must ensure that this outlook is sustained. This means sticking to existing monetary policy frameworks, and taking advantage of the favourable environment for nominal interest rate reductions created by lower inflation. Individual countries should be prepared to cut rates if domestic circumstances are right, and if no risk of producing exchange rate movements that would increase current account imbalances. Slightly concerned about emphasis that Secretary-General puts on reducing interest rates through coordinated action. Informal consultation between monetary authorities are clearly highly desirable, but circumstances only occassionally propitious for joint action.

65/014

OECD MINISTERIAL: KEY FIGURES

1. Comparison of forecasts (oil price - $15 a barrel)

		OECD*	FSBR**
Real GNP	1986	3¼	3½
	1987	3	4 (4)
Consumer prices	1986	3½	2½
	1987	2¾	1½ (1¾)

* Total OECD

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

2. OECD forecasts of current balances ($ billion)

	1985	1986	1987
United States	-119	-145	-130
Japan	49	80	75
Germany	13	30	20

3. Exchange rate and interest rate developments since last Ministerial

	April 9 1985	April 15 1986	Change
Exchange rates			
US $ index	148.7	119.2	-19.8%
Yen: $	255	179	-29.8%
D-mark: $	3.15	2.32	-26.3%
Three-month interest rates (per cent)			
US	8.6	6.5	-2.1
Japan	6.3	5.0	-1.3
Germany	6.2	4.5	-1.7
Government bond yields (per cent)			
US	11.7	7.2	-4.5
Japan	6.8	4.8	-2.0
Germany	7.4	5.9	-1.5

4. Fiscal policy indicators

United States:

Federal deficit in FY1986 likely to top $200 billion;
Gramm-Rudman deficit target for FY1987 is $144 billion;
Federal deficit in 1986 about 5 per cent of GNP;
General government deficit 3½ per cent of GNP;
US Federal deficit nearly 60 per cent of total OECD general government deficit;
US general government deficit just over 40 per cent of total OECD general government deficit.

Japan:

Central government deficit in FY1986 cut by ½ per cent to 3¼ per cent of GNP;
General government deficit in FY1986 likely to be ¾ per cent of GNP;
Discretionary expenditure held constant in nominal terms for fourth successive year.

5. Employment and real earnings 1975-1985

	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

66/032

E

Qs FOR DISCUSSION

OECD MINISTERIAL

Draft answers to questions for discussion

1a. Fiscal policy can make an important contribution to domestic and international balance. It must support monetary policy in establishing a stable financial environment. This will help secure balance in the domestic economy and make room for reductions in real interest rates.

Differing fiscal policies among the major countries - in particular the expansion of the Federal deficit in the US since 1980 when Japan and Germany were both reducing their government deficits (as a proportion of GNP) - helped produce enormous capital flows and exchange rate changes, contributing to the present current account imbalances. More consistent fiscal policies are needed to reduce these imbalances.

1b. General agreement that in countries where the public debt to GNP ratio is rising, while inflation persists, budget deficits should be reduced. But wrong to draw up over-precise rules for fiscal policy based on the size of public debt or public debt to GNP ratios. Other factors need to be taken into account, notably need to reduce international imbalances.

1c. In the 1960's and 1970's share of public expenditure in GNP grew too fast. Welcome general recognition of need to reduce its share. Even where deficit reductions are not required, progress in controlling government expenditure is welcome because it creates room for tax cuts to reduce the "wedge" between what consumers pay and what producers receive. Improvements in the composition of public expenditure and the structure of taxation can also contribute to improved economic performance. Revenue-neutral tax reform desirable if it reduces distortions.

2. Governments should take advantage of the improved prospects for inflation to cut nominal interest rates within existing monetary frameworks. Individual countries should be prepared to cut rates if domestic circumstances are right and if there is no risk of producing exchange rate movements that would increase current account imbalances. Consultation between countries should help reduce these risks.

A number of countries face difficulties in interpreting domestic monetary conditions because behaviour of monetary aggregates has been changed by financial innovation, liberalisation of financial markets, etc. In these circumstances it is appropriate to consider a range of monetary indicators.

Cuts in real interest rates are likely to require a reduction in the claim on aggregate savings made by public sector deficits in the OECD countries as a whole.

3. In general, the pattern of exchange rates has improved markedly over the last year, though further adjustment, of the yen in particular, likely to be necessary.

Greater convergence of economic performance and closer consultation obviously have important roles to play in improving the stability of exchange rates, especially if combined with a greater recognition of the implications of domestic policies for the international economic environment. Chancellor said at Interim Committee Meeting that he would "like to see multilateral surveillance ... put in the context of quantified, published medium-term analysis of prospects and policies".

In the right circumstances, recent experience has shown that concerted intervention can also play a useful, though limited, role.

4. The fall in oil prices will reduce inflation over next couple of years and provide a boost to growth in most industrialised countries.

For these benefits to be sustained governments must respond appropriately. On monetary policy, should maintain the current stance and take advantage of lower inflation to reduce nominal interest rates.

On fiscal policy, it may be appropriate for some governments to take advantage of opportunity to reduce deficits by raising excise taxes on oil, in addition to allowing tax revenues to rise through fiscal drag due to faster growth of real incomes. But in countries where the fiscal position is sound it may be appropriate to pass on some or all of the benefits of lower oil prices to consumers. In countries like Japan and Germany where much progress has been made in reducing government deficits, it may be appropriate to cut taxes so as to maintain an unchanged nominal government deficit.

For Lunch

Tied Aid Credit

It emerged yesterday at meeting of officials that the positions of US and EC are closer than we feared. The problem is that Japan and Switzerland are totally opposed to the introduction of "differential discount factors" (as low interest rate countries they would lose a competitive advantage – exactly the point on which EC had to outvote Germany and Netherlands).

If we could get Japan and Switzerland in, but not otherwise, US would drop their insistence on 40% minimum grant element and join EC figure of 35%.

Baker will try to put pressure on Japan, by threat to make this a Summit issue if no agreement of principle now. – Good tactic, I think, and worth supporting.

Need is to secure now agreement in principle now – all details of precise timing, staging, choice of reference rates could then be settled by officials in the Consensus Group.

See also on Communique attached

- notes
- annotated draft
- annotated US amendments

J ✓

OECD MINISTERIAL: 17/18 APRIL 1986

TRADE ISSUES

Note Alan Clark will be present throughout. RO 16/4

POINTS TO MAKE

New GATT Round

1. Agree major priority to resist protectionism. Crucial that new round be launched at September GATT Ministerial. OECD should reiterate firm commitment.

- GATT Ministerial will take final decisions on agenda: EC has stated clearly that there should be no preconditions as to whether specific items should be included or excluded.

- But increased liberalisation by more advanced developing countries must be major developed country objective.

- And if we are to get NICs/LDCs to accept inclusion of graduation and trade in services, must signal willingness to deal seriously with eg tropical products, agriculture, textiles.

2. MFA correctly identified by Secretary-General as major issue: must be renewed during 1986. EC has made it clear that new MFA should contain elements of liberalisation.

- Must recognise that future of MFA will be under discussion in new Round. NICs will not give up special treatment while they suffer discrimination under MFA.

Standstill and Rollback

3. Rollback exercise has proved value of multilateral action: easier for one country to pursue open trading policies if all its trade partners follow suit. Important message for new round.

- Rollback measures too modest to have serious macro-economic impact. But important in confidence-building terms. Specific rollback exercise must not be concluded on too gloomy a note. Most substantial move to dismantle trade barriers for some years.

4. OECD Ministerial should reaffirm importance of increased trade liberalisation, if not further rollback, which should be pursued vigorously in context of new round.

- Developing countries will, however, see willingness to give fresh commitment to standstill - no new multilateral measures - as earnest of our good faith in negotiations.

5. Right to safeguard action part of GATT.

- But must not camouflage new protectionist actions under guise of 'dealing with unfair trade': standstill must mean standstill.

OECD's role

6. OECD invaluable forum of like-minded where subjects in new round can be explored and prepared before being introduced into negotiations in Geneva.

- OECD Trade Committee has done useful work on services: should intensify this, and explore further eg how OECD Codes of Liberalisation could be strengthened in order to contribute to GATT negotiations.

- Completion of mandate on agriculture also important: encouraged by reference to 'multilaterally negotiated reduction in protection' in preliminary conclusions.

- OECD could also do useful work on graduation, although it should avoid appearing as rich man's club in doing so.

Japan

7. Better balance of rights and obligations among developed countries also important.

- Particularly, as draft communique notes, increased imports into Japan.

- Welcome direction of Japanese policy indicated by Maekawa report on restructuring of economy, and recent fiscal measures. But still await specific action (c.f EC 10 March statement - attached) Trading partners will judge effectiveness of Japanese <u>words</u> by impact on trade figures.
- So far Action Programme has had little effect. Trade imbalance continues to widen. Will not build confidence in open trading system in approach to new GATT round.

BACKGROUND

New GATT Round

1. Preparatory Committee continues to make steady, if unspectacular progress in considering agenda: hard-liners continuing to balk at inclusion of services.

- Must conclude report by mid-July to September GATT Ministerial.

- EC to discuss sensible Commission strategy paper on new round at 21/22 April Foreign Affairs Council.

Standstill and Rollback

2. Successive OECD Ministerials have reaffirmed commitments to this exercise.

- EC accelerated all remaining Tokyo Round tariff cuts in December 1985 (US and Canada unable to do so), but has been less successful in agreeing on liberalisation of quantitative restrictions. (UK was willing to do so, provided that other EC partners were).

- General consensus in OECD that formal rollback exercise should now end: further concessions should form part of new GATT round.

- But OECD Ministerial will give renewed commitment to standstill of protectionist measures (which US find difficult to reconcile with their stated intention to eliminate others' unfair trading practices).

Japan

3. Maekawa Commission report to Nakasone addresses danger of export-led Japanese growth and consequent trade surpluses and need for more flexible financial/fiscal policies, stimulation of domestic demand, structural reform.

- But early action to implement unlikely: and very few specific proposals in new package of Japanese economic measures announced on 8 April to deal with more flexible management of monetary policy/stimulation of domestic demand.
- Implementation of 1985 Import Action Programme also very disappointing in key areas (e.g standards, testing, tariff reductions).
- Latest OECD forecasts indicate increase in Japanese current account surplus from \$35 billion (1984) to \$49 billion (1985), \$80 billion (1986) to \$75 billion (1987): EC Commission calculate falling oil price will add \$10 billion to 1986 surplus.

K

OECD BUDGET: US CONTRIBUTION

Line to take

(i) OECD is useful and relevant body, which serves both US and UK interests well. Under new Secretary-General good progress being made towards improving quality of OECD's work. If US withholds amount equivalent to 5 per cent of total budget will reduce effectiveness of OECD and make future budget negotiations difficult.

(ii) (If necessary). US have accepted an obligation to pay assessed share of budget, though obviously nothing other countries can do to force Americans to pay.

Background

1. Contributions to the OECD budget are based on a formula that takes account of countries' GNP and population. Under this formula the US would have contributed over 40 per cent of the total budget in 1986, but a special rule limits the contribution of any one country to 25 per cent. (In practice, of course, the rule affects only the US contribution). For 1986 the US budget contribution was assessed at around Fr 200 million (about $30 million). The US delegation have informed the Secretary-General that their contribution will fall Fr 40 million short of this amount.

2. The OECD is just one of several international organisations that is facing a cut in its US contribution - the UN and NATO are two of the others. Like NATO, but unlike the UN, the OECD has actively promoted policies that are in the US interest.

STRUCTURAL ADJUSTMENT

Said in this meeting last year that way to improve real economic prospects - and in particular employment prospects - is not to change ~~the~~ macro-economic policies, which we discussed this morning, and which are delivering the right results, but "to look to the supply side - in the correct sense of that much-abused term".

Welcomed then the emphasis OECD is now putting on <u>structural adjustment</u>. Fact that we are devoting separate session to it is a proper measure of its importance.

All about letting ~~free~~ markets work more efficiently. Difficult, slow, piecemeal process.

~~Rigidities in the lab mkt~~
But I have no doubt that mkt rigidities in general, & rigidities in the lab market in particular, are

MOM
Tack
?Cut

~~Some countries have built-in bias to free market solutions, but attitude by no means universal. In Europe the counterview - state control, public ownership, and government regulation - is all too prevalent.~~ Biggest single reason why European unemployment is so high.

<u>**Domestic**</u>

In UK, good progress in freeing <u>financial</u> markets from controls: abolished all controls on foreign exchange - one of freest capital markets in the world - paved way for revolution in securities market culminating in Big Bang.

<u>Labour</u> market more difficult. History of strikes and days lost through industrial action. Employers conditioned to expect union bloody mindedness and to believe people are trouble to employ.

But progress

- Abolished pay controls

- Legislated to control closed shop and picketing.

Expenditure of this sort and size cannot make sense.

- For the <u>developed</u> countries, ~~ridiculous~~ absurd to spend large amounts of taxpayers' money to encourage farmers to produce food no one wants to buy.

- Too much going into agriculture at expense of rest of our economies. Frustrates consumers' choice. Inefficient.

- Damaging, too, for <u>developing</u> countries. Reduces both amounts and prices of their agricultural exports. Especially damaging to debtor nations.

- Best way to help them increase their earnings would be to reduce agricultural protectionism.

In short, agricultural subsidies on present scale represent cruellest possible misallocation of resources.

And need to dispose of surpluses is causing friction and escalation of export subsidies and special deals.

Have to roll this back. Agree with Sec-Gen ~~Need an agricultural trade war about as much as a hole in the head.~~

UK doing its part. Think can claim to have been in vanguard of those advocating budget discipline in European Community. ~~Glad to say~~ We now have in place a financial guideline on agricultural spending.

Accepted quotas on milk production at great political cost. ~~in the UK.~~

~~Between 1977-78 and 1985-86,~~ Average level of the Community's ~~common~~ support prices, ~~expressed~~ in national currencies, fell by ~~in real terms in every year except one.~~ Down 3½ per cent in real terms last year, after 4 per cent the year before.

to go, especially in making our labour markets work better. Most European countries have been hampered by sclerotic markets, certainly compared with the freer environment in North America. ~~It is of the first importance that the OECD should continue to give attention to these problems, as a matter of the highest priority.~~ Interestingly Britain Shares Germany. As he knows, I have embarked on a committed programme in the UK which we can ...

Last year's report on costs and benefits of protection was important in creating favourable climate for a new GATT round. Secretariat study on structural adjustment can play similar role. ~~Free market message must not be obscured by too much detail on individual sectors.~~ Look forward to discussing report this time next year, and hope it will have a marked impact on policy debate - and policy actions.

International

Must extend not only to domestic policies and markets but also to international level. It is here that we face the single greatest danger - the threat of protectionism and trade warfare.

Trend and — clear major ... great element of move to ... disc. rate system

But Right that we should focus ~~particularly~~ on agriculture.

Mr ... NZ

Almost universally protected - and on a massive scale

- European Community spending over 20 billion ecus through Community Budget, this year.

- Probably as much again through national budgets.

- US spending $21 billion this year.

- OECD calculates value of subsidies in Japan ... ~~a third of all agricultural output in Japan is subsidised.~~ equiv. to 1/3 of all agric. output

- ~~Contributes to Japan's massive current account surplus - one of the principal imbalances we address at every one of these international meetings.~~

- To encourage strike ballots;

- To restrict excessive union immunities.

As a result general improvement in industrial relations.

- Number of dismissals for non-union membership has fallen dramatically.

- A number of major employers have terminated closed shop arrangments;

- Dramatic reduction in number of strikes: in 1985, number of recorded disputes lowest for nearly 50 years.

It takes time for these changes to have anything like their full effect. But slowly but surely, we are changing perceptions. Something I welcome wholeheartedly.

Perhaps greatest success is in rolling back limits of state intervention. Nowhere is this better seen than in our privatisation programme - being copied with enthusiasm in many OECD countries. [French Minister for Finance, Economy and Privatisation].

Returning control of companies, and indeed whole industries, to the private sector has an immediate pay-off to the economy. We have seen it already in the performance of privatised companies. Freed from government control, managements can respond as they see fit to changing opportunities in the market-place. The result is a more efficient industry, prospering from a more competitive environment.

We have already returned to the private sector 20 per cent of the state-owned industry we inherited in 1979. By the end of next year I expect that to have risen to some 40 per cent.

So we in the UK have made a big start. But we have a long way today.

- affecting two major world economies.

US DEFICIT

- Over 40% of OECD total budget deficit.
- Frankly acknowledged
- Look for progress.

JAPANESE SURPLUS

- $80 billion this year.
- growth, so far from accelerating, likely to slow down.

Secretary Baker pointed out the Japanese imbalance will require either further domestic growth or further exchange rate changes.

- Will need both.

Share view of M. Balladur that Plaza important step forward in exchange rate cooperation, resulting in a better pattern of exchange rates

- If we are not over ambitious, can build on Plaza
- And in that context further exchange rate moves in the direction agreed then.

Remember that was in September, before oil price collapse, of which Japan greatest beneficiary.

Japan also needs to facilitate greater international use of yen.

/Still

- Still does not bear weight

  importance of Japanese economy warrants.

Also important to recognise that subsidies to assist firms and industries hit by higher yen would be perverse and unacceptable.

Finally - a word on trade.

- Open markets.

/Developing countries/

- Avoidance of protectionism.

Warn about an agricultural trade war.

- On the brink.
- Those concerned must step back from it.

FROM: ROBERT CULPIN
DATE: 16 APRIL 1986

CHANCELLOR

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Lavelle
Mr Fitchew
Mr Odling-Smee
Mr Sedgwick
Mr Butt
Mr Matthews Miss O'Mara
Mr Pickford

OECD

Here is a speaking note on "structural adjustment" as requested. It is about the right length.

2. I have concocted it between briefings on the Lombard speech. We can edit it on the plane.

3. If copy recipients spot anything badly wrongly, please will they let me know, through your private office, in Paris?

RC

ROBERT CULPIN

CHANCELLOR OF THE EXCHEQUER
HONI SOIT QUI MAL Y PENSE

RP

C.

Robert's speaking note on structural issues for the afternoon OECD session.

Holes in it for insertion into your folder.

RO 16/4

STRUCTURAL ADJUSTMENT

Said in this meeting last year that way to improve real economic prospects - and in particular employment prospects - is not to change ~~the~~ macro-economic policies, which we discussed this morning, and which are delivering the right results, but "to look to the supply side - in the correct sense of that much-abused term".

Welcomed then the emphasis OECD is now putting on structural adjustment. Fact that we are devoting separate session to it is a proper measure of its importance.

All about letting free markets work more efficiently. Difficult, slow, piecemeal process.

Some countries have built-in bias to free market solutions, but attitude by no means universal. In Europe the counterview - state control, public ownership, and government regulation - is all too prevalent. Biggest single reason why European unemployment is so high. — see Page

Domestic

In UK, good progress in freeing financial markets from controls: abolished all controls on foreign exchange - one of freest capital markets in the world - paved way for revolution in securities market culminating in Big Bang.

Labour market more difficult. History of strikes and days lost through industrial action. Employers conditioned to expect union bloody mindedness and to believe people are trouble to employ.

But progress

- Abolished pay controls

- Legislated to control closed shop and picketing.

- To encourage strike ballots;

- To restrict excessive union immunities.

As a result general improvement in industrial relations.

- Number of dismissals for non-union membership has fallen dramatically.

- A number of major employers have terminated closed shop arrangments;

- Dramatic reduction in number of strikes: in 1985, number of recorded disputes lowest for nearly 50 years.

It takes time for these changes to have anything like their full effect. But slowly but surely, we are changing perceptions. Something I welcome wholeheartedly.

Perhaps greatest success is in rolling back limits of state intervention. Nowhere is this better seen than in our privatisation programme - being copied with enthusiasm in many OECD countries. [French Minister for Finance, Economy and Privatisation].

Returning control of companies, and indeed whole industries, to the private sector has an immediate pay-off to the economy. We have seen it already in the performance of privatised companies. Freed from government control, managements can respond as they see fit to changing opportunities in the market-place. The result is a more efficient industry, prospering from a more competitive environment.

We have already returned to the private sector 20 per cent of the state-owned industry we inherited in 1979. By the end of next year I expect that to have risen to some 40 per cent.

So we in the UK have made a big start. But we have a long way to go, especially in making our labour markets work better. Most European countries have been hampered by sclerotic markets, certainly compared with the freer environment in North America. It is of the first importance that the OECD should continue to give attention to these problems, as a matter of the highest priority.

Last year's report on costs and benefits of protection was important in creating favourable climate for a new GATT round. Secretariat study on structural adjustment can play similar role. Free market message must not be obscured by too much detail on individual sectors. Look forward to discussing report this time next year, and hope it will have a marked impact on policy debate - and policy actions.

International

Must extend not only to domestic policies and markets but also to international level. It is here that we face the single greatest danger - the threat of protectionism and trade warfare.

Right that we should focus particularly on agriculture.

Almost universally protected - and on a massive scale

- European Community spending over 20 billion ecus through Community Budget, this year.
- Probably as much again through national budgets.
- US spending $21 billion this year.
- Check OECD calculates a third of all agricultural output in Japan is subsidised.
- Contributes to Japan's massive current account surplus - one of the principal imbalances we address at every one of these international meetings.

Expenditure of this sort and size cannot make sense.

- For the developed countries, ridiculous to spend large amounts of taxpayers' money to encourage farmers to produce food no one wants to buy.

- Too much going into agriculture at expense of rest of our economies. Frustrates consumers' choice. Inefficient.

- primary producers, many of them

  Damaging, too, for developing countries. Reduces both amounts and prices of their agricultural exports. Especially damaging to deb~~a~~tor nations.

- Best way to help them increase their earnings would be to reduce agricultural protectionism.

In short, agricultural subsidies on present scale represent cruellest possible misallocation of resources.

And need to dispose of surpluses is causing friction and escalation of export subsidies and special deals.

Have to roll this back. Need an agricultural trade war about as much as a hole in the head.

UK doing its part. Think can claim to have been in vanguard of those advocating budget discipline in European Community. ~~Glad to say~~ W we now have in place a financial guideline on agricultural spending.

Accepted quotas on milk production at great political cost in the UK.

Between 1977-78 and 1985-86, average level of the Community's common support prices, ~~expressed~~ in national currencies, fell in real terms in every year except one. Down 3½ per cent in real terms last year, 4 per cent the year before.

Government will go on supporting reductions in price supports, and direct curbs on production where necessary, in order to apply to agriculture the financial and economic disciplines which we believe to be essential. Moving CAP in right direction.

Prospects would be improved by parallel action in all developed countries.

Only sure way to end imbalance between supply and demand is to make sure agricultural prices reflect market realities. Part and parcel of letting free markets work. Makes no more sense to manipulate prices for food than for other commodities [such as tin].

Message from this meeting should be clear: ~~signal of~~ determination to get governments out of the business of excessive agrucultural support. Best way forward would clearly be to reduce subsidies by mutual agreement, improve access to markets and liberalise agricultural trade. Should be major priority for new GATT round. Signal should go out loud and clear today.