MT

PART 2

C

CONFIDENTIAL FILING

CONSULTATIONS WITH THE IMF
MEETINGS OF THE WORLD BANK
VISITS BY MR. CLAUSEN, PRESIDENT OF WORLD BANK
Visits by managing director of the IMF.
VISITS BY Mr CONABLE, PRESIDENT OF WORLD BANK

ECONOMIC POLICY

PART 1: JUNE 1979

PART 2: MARCH 1983

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~12.4.83~~		~~30.8.86~~					
~~13.4.83~~		~~19.9.86~~					
~~14.4.83~~		~~24.9.86~~					
~~5.5.83~~		~~25.9.86~~					
~~29.6.83~~		~~26.9.86~~					
~~26.9.83~~		~~28.9.86~~					
~~6.10.83~~		~~29.9.86~~					
~~14.12.83~~		~~13.10.86~~					
~~16.12.83~~		~~16.10.86~~					
~~17.1.84~~		29.9.86					
~~31.5.84~~		PT 2 ENDS					
~~3.12.84~~							
~~9.1.85~~							
~~25/4/85~~							
~~6.6.85~~							
~~15.10.85~~							
~~12.12.85~~							
~~31.1.86~~							
~~4.2.86~~							
~~10.4.86~~							
~~21.5.86~~							
~~24.7.86~~							
~~6.8.86~~							
~~19.8.86~~							

PREM 19/1712

Dd 533270 5M 2/78 8362633 JET

PART 2 ends:-

UKDel IMF Washington Tel No 303 29/9/86

PART 3 begins:-

NLW to HMT 3/10/86

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(86) 29th, item 2	24/07/1986
CC(85) 29th, item 2	15/10/1985
CC(85) 14th, item 2	25/04/1985
CC(83) 29th, item 1	06/10/1983
CC(83) 15th, item 1 (G7 & G5 meetings)	05/05/1983
CC(83) 15th, item 1 (IMF/IBRD meeting)	05/05/1983

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed __________ Date 15/09/2014

PREM Records Team

GRS 450 CONFIDENTIAL 1. ~~NW~~ 2 NBP.

CONFIDENTIAL
FM UKDEL IMF/IBRD WASHINGTON
TO ROUTINE FCO
TELNO 303
OF 291900Z SEPTEMBER 86
INFO ROUTINE UKDEL OECD, UKREP BRUSSELS, UKMIS GENEVA
INFO ROUTINE UKMIS NEW YORK

IMF: INTERIM COMMITTEE

1 A FAIRLY MUTED MEETING. THE LDCS EXPRESSED FEARS ABOUT THE ADEQUACY OF GROWTH IN THE MAJOR ECONOMIES AND CRITICISED VARIOUS ASPECTS OF THE DEBT STRATEGY. BUT THERE WERE NO THREATS, AND FUNARO OF BRAZIL DID NOT (AS HAD BEEN WIDELY FORECAST) ANNOUNCE A UNILATERAL LIMIT ON BRAZIL'S DEBT SERVICE PAYMENTS FOR 1987. THE G5, WITH THE EXCEPTION OF THE AMERICANS, AFTER THEIR EXHAUSTIVE DISCUSSIONS IN THE G5 AND G7 MEETINGS (SEE MY TELNO 295), WERE ALSO FAIRLY RESTRAINED ON WHAT THEY EXPECTED FROM EACH OTHER.

2 ON THE DECISIONS BEFORE THE INTERIM COMMITTEE THERE WERE NO SURPRISES. THE LIMITS ON ENLARGED ACCESS AND THE FUND'S SPECIAL FACILITIES WERE LEFT UNCHANGED FOR 1987 (THOUGH THE US STIPULATED THAT THEIR AGREEMENT WAS CONDITIONAL UPON (I) A REVIEW OF THE COMPENSATORY FINANCING FACILITY AND (II) A GO-SLOW ON THE NINTH QUOTA INCREASE). NO SDR ALLOCATION COULD BE AGREED. AS EXPECTED, THE JAPANESE OFFERED TO LEND SDR 3 BILLION TO THE FUND ''TO ENHANCE ITS ABILITY TO SUPPORT ADJUSTMENT EFFORTS''. THE COMMITTEE AGREED THE USE OF INDICATORS SHOULD CONTINUE TO BE DEVELOPED IN A PRAGMATIC AND FLEXIBLE FASHION.

3 BAKER'S MORNING SPEECH NOTED US COMMITMENT TO REDUCING THE BUDGET DEFICIT BUT OMITTED ANY MENTION OF THE NEED TO REDUCE PUBLIC EXPENDITURE IN THE US. HE LAID STRESS UPON THE LARGE SIZE - ON CURRENT EXCHANGE RATES AND LIKELY GROWTH ABROAD - OF THE US CURRENT ACCOUNT DEFICIT IN 1987 AND BEYOND. THIS WOULD BE ''POLITICALLY AND ECONOMICALLY UNACCEPTABLE''. EITHER THE DOLLAR WOULD HAVE TO FALL FURTHER OR THERE WOULD HAVE TO BE FASTER GROWTH OUTSIDE THE US. ON PROTECTIONISM, BAKER DESCRIBED THE US ADMINISTRATION AS FEELING BESIEGED BY PROTECTIONIST PRESSURES: THERE WOULD NOW BE A TEMPORARY BREATHING SPACE IN CONGRESS, BUT THESE PRESSURES WOULD BE IN FULL FLOOD AGAIN BY THE SPRING. HE WARNED THAT IF THE US WENT PROTECTIONIST, THAT WOULD BE THE END OF THE FREE TRADE SYSTEM.

4 ON DEBT, BAKER PAINTED A MODERATELY ENCOURAGING PICTURE OF PROGRESS WITH THE STRATEGY. HE EMPHASISED THAT THE COMMERCIAL BANKS MUST DO THEIR PART. ''THEY MUST STEP FORWARD'' AND IT WAS IMPORTANT THAT WE SAW A DEMONSTRATION OF THIS IN THE CASES OF MEXICO AND NIGERIA ''IN THE NEAR TERM''.

CONFIDENTIAL

/5.

5 THE CHANCELLOR'S SPEECH AND THE COMMITTEE'S COMMUNIQUE ARE BEING FAXED TODAY IN FULL.

6 FCO PLEASE PASS TO SHERIDAN (HMT), KENT (BOE) AND DRUMMUND (ERD).

LANKESTER

YYYY

ORWBAN 6671

MONETARY
ERD

INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

September 28, 1986

Dear Prime Minister,

I was deeply touched by the kind and generous letter which you sent on the occasion of my decision to leave my position as Managing Director of the International Monetary Fund. It has been a great honor for me to manage the Fund over the last eight years and I have found the experience both rewarding and uplifting, not least because of the challenging and difficult circumstances which we have all faced over that period. I hasten to add that any contribution that I have made to tackling these difficulties would not have been possible without the assistance and the backing of the membership. I would, therefore, like to take this opportunity to thank you personally for your own particular support and that of your Chancellor of the Exchequer, which was always forthcoming--and much appreciated--especially at the most critical moments. As you know, I have immense admiration for your qualities of leadership and the policies which you have been pursuing since you came to office and for the imprint that you have made as one of the world's great leaders.

Please accept my sincere best wishes for your continued success and happiness in the future.

Sincerely yours

Jacques de Larosière

J. de Larosiere

The Prime Minister
10 Downing Street
London, S.W.1, England

ZCZC
WBLNAN 93 9005 ORWBAN 6627
CONFIDENTIAL
DD 290800Z FCOLN
FM WASHI TO FCOLN
281600Z SEP
GRS 120

DP 1558 2

1 CP to see
2 Prime Minister

CONFIDENTIAL
FM WASHINGTON
TO DESKBY 290800Z FCO
TELNO 2466
OF 281600Z SEPTEMBER 86

PERSONAL FOR NIGEL WICKS, NO 10, FROM PPS/CHANCELLOR

IMF MANAGING DIRECTOR

1. THE CHANCELLOR DISCUSSED WITH STOLTENBERG WHETHER THERE WAS A GERMAN CANDIDATE. STOLTENBERG SAID POEHL WAS NOT INTERESTED. LAMBSDORFF'S NAME HAD BEEN MENTIONED, BUT THAT WAS IMPOSSIBLE BECAUSE OF THE CHARGES STILL OUTSTANDING AGAINST HIM. GERMANY WOULD THEREFORE SUPPORT RUDING.

2. AT THE G5 MEETING, THE CHANCELLOR PROPOSED THAT THE ISSUE SHOULD BE DISCUSSED BY EUROPEAN FINANCE MINISTERS AT A SPECIAL MEETING ON 13 OCTOBER IMMEDIATELY BEFORE THE ECOFIN IN LUXEMBOURG. THIS PROPOSAL WAS ACCEPTED BY ALL. INVITATIONS ARE BEING ISSUED HERE.

3. FCO FOR DISTRIBUTION TO NIGEL WICKS ONLY.

ACLAND

SRWAJG

(1)

PRIME MINISTER

MANAGING DIRECTOR OF THE IMF

Mr. Lubbers, the Dutch Prime Minister, may try again to telephone you over the weekend, to tell you how much importance he attaches to seeing Ruding appointed to the IMF post. He knows that his views have reached you and been passed on to the Chancellor, but nonetheless wants a personal word.

You will want to avoid committing yourself, since the Chancellor will have to judge the tactical situation at the IMF/IBRD meeting. But you can say that we are well aware of Ruding's qualities: we think he is a very strong candidate: and we don't favour giving the French another turn.

C.D.P

(C. D. POWELL)
26 September 1986

GRS 650

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No10 (by tube)

IMMEDIATE

ADVANCE COPY

RESTRICTED
FM UKDEL IMF/IBRD WASHINGTON
TO PRIORITY FCO
TELNO 295
OF 251500Z SEPTEMBER 86

IDA 8: MY TELNOS 291 AND 292

SUMMARY

DEPUTIES' MEETING CONCLUDED WITH AGREEMENT ON ALL MATTERS EXCEPT: (I) ADDITIONAL VOLUNTARY CONTRIBUTIONS TO REACH DOLLARS 12 BILLION OR MORE, AND (II) GAP-FILLING EXERCISE FOR DOLLARS 11.5 BILLION. THE DOOR WAS LEFT OPEN FOR FURTHER DISCUSSION IN THE COMING WEEK TO RESOLVE POINT (I).

2. MAIN QUESTIONS RESOLVED WERE: TERMS, EXCHANGE RATES, PROCEDURAL ISSUES, AND A TEXT REQUESTED BY THE US DEALING WITH IDA LENDING FOR AGRICULTURAL COMMODITIES.

TERMS

3. REVISED TERMS WERE AGREED AS IN PARA. 3 OF TELNO 292 BUT WITHOUT (REPEAT WITHOUT) THE UK PROPOSAL TO ESTABLISH THE SAME GRANT ELEMENT FOR EACH MATURITY. THIS WAS OPPOSED BY THE US AND CANADA, AND SINCE NO OTHERS STOOD BY US WE WERE FORCED TO DROP IT. (HOWEVER, IT COULD BE REVIVED WHEN THE ISSUE IS DEALT WITH IN DETAIL BY THE EXECUTIVE BOARD.) SUBSEQUENTLY, THE NEWS LEAKED OUT AND THE CHAIRMAN INDICATED THAT OBJECTIONS HAD BEEN MADE PRIVATELY BY SOME COUNTRIES (INDIA IN PARTICULAR). WE WILL EXPLAIN WHAT HAPPENED AND OUR OWN STANCE TO THE INDIANS IN THE MARGINS OF THE ANNUAL MEETINGS, BUT OF COURSE FOREWARNED THEM THAT THINGS MIGHT COME OUT IN THIS WAY (ODA MODEV 451 TO NEW DELHI).

SENT 30 SEP 1986

EXCHANGE RATES

4. AGREED AS IN PARA. 5 OF TELNO 292.

PROCEDURAL

5. THE FOLLOWING WERE AGREED.

(I) ADVANCE CONTRIBUTIONS: THE TRIGGER FOR THESE WILL BE CUT FROM 30 PERCENT OF NOTIFIED CONTRIBUTIONS TO 20 PERCENT, BUT IN ACCORDANCE WITH OUR WISHES IT WILL BE POSSIBLE TO RESTRICT ADVANCE CONTRIBUTIONS TO LESS THAN ONE THIRD OF THE TOTAL.

(II) NO CHANGE MADE IN THE PRO RATA CLAUSE.

(III) EFFECTIVENESS: STAFF CONFIRMED THAT A US QUALIFIED NOTIFICATION COULD BE ACCEPTED WITH LESS THAN ONE THIRD APPROPRIATION FOR THE FIRST YEAR.

(IV) PAYMENT METHODS: PAYMENT IN CASH IN ONE OR THREE INSTALLMENTS, AS AN ALTERNATIVE TO THE DEPOSITION OF PNS, AND ON A BASIS SATISFACTORY TO THE MANAGEMENT (I.E., AN APPROPRIATE CALCULATION OF PRESENT VALUE).

(V) VOTING RIGHTS: A COMMITTEE OF EDS TO BE ESTABLISHED TO EXAMINE THE VOTING RIGHT SYSTEM WITH A VIEW TO SIMPLIFYING IT, AND TO REPORT BACK TO THE DEPUTIES FOR THE 9TH REPLENISHMENT, OR IF POSSIBLE EARLIER. IN THIS CONTEXT, ITALY AND THE NETHERLANDS EXPRESSED A WISH TO GIVE MORE WEIGHT TO CURRENT THAN TO CUMULATIVE CONTRIBUTIONS: WE PUT ON RECORD THE REVERSE VIEW.

RESTRICTED

/AGRICULTURE

RESTRICTED

AGRICULTURE

6. TO HELP COUNTER CONGRESSIONAL FARM LOBBY OPPOSITION TO LENDING FOR QUOTE SURPLUS UNQUOTE AGRICULTURAL COMMODITIES, THE US REQUESTED WORDING ABOUT IDA LENDING IN THIS AREA WHICH WOULD REFLECT EXISTING MANAGEMENT POLICIES BUT HIGHLIGHT THE NEED TO ENSURE AN ADEQUATE RATE OF RETURN ON INVESTMENTS IN THE LIGHT OF WORLD MARKET CONDITIONS. IN SPITE OF CONSIDERABLE RESERVATIONS EXPRESSED BY MANY DEPUTIES ABOUT THE PRINCIPLE OF ADDING FURTHER RIDERS OF THIS SORT TO THE REPORT, AN ACCEPTABLE TEXT WAS AGREED.

COMMENT

7. THE PROGRESS MADE HIGHLIGHTS THE CASE FOR PRESSING FOR AN AGREEMENT ON IBRD SHARES IN THE NEXT FEW DAYS. EVEN DOLLARS 11.5 BILLION CANNOT BE MADE SECURE WITHOUT JAPANESE/US ACCORD, BECAUSE OF JAPANESE THREAT TO RETURN TO ITS 12 PERCENT SHARE IF THE DEAL FALLS THROUGH. OTHER ASPECTS OF THE PRESENT CONSENSUS COULD COME UNSTUCK WITH TWO MONTHS DELAY (WITH POSSIBLE RISKS ALSO OF PRESSURE TO INCREASE OUR CONTRIBUTION BY RECALCULATING THE EXCHANGE RATE) AND THE DANGER OF A COMMITMENT GAP WOULD BE SIGNIFICANTLY INCREASED. ADVICE IN PARA. 5 OF TELNO 191 THEREFORE STANDS.

8. FCO PLEASE ADVANCE TO ROTH (ODA), MISS C. BALFOUR (BANK OF ENGLAND), MAUD (FCO) AND WALSH (HMT).

LANKESTER

YYYY

ORWBAN 6582

MONETARY
ODA

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ADVANCE ADDRESSEES.

'ADVANCED AS REQUESTED'

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OCMIAN 4778
CONFIDENTIAL
DD 251700Z PARIS
FM FCOLN TO PARIS
251630Z SEP
GRS 146

CONFIDENTIAL
FM FCO
TO DESKBY 251700Z PARIS
TELNO 621
OF 251630Z SEPTEMBER 86
AND TO PRIORITY IMF/IBRD WASHINGTON

PLEASE PASS TODAY FOLLOWING MESSAGE TO FRENCH PRIME MINISTER'S OFFICE.
BEGINS
DEAR PRIME MINISTER
THANK YOU FOR YOUR LETTER OF 24 SEPTEMBER ABOUT THE SUCCESSION TO JACQUES DE LAROSIERE AS MANAGING DIRECTOR OF THE IMF.
AS YOU SAY, MR BALLADUR HAS ALREADY RAISED THIS QUESTION WITH THE CHANCELLOR OF THE EXCHEQUER. THEY, AND OTHER FINANCE MINISTERS, WILL NO DOUBT BE DISCUSSING IT IN WASHINGTON LATER THIS WEEK. MEANWHILE I HAVE, OF COURSE, PASSED ON YOUR VIEWS TO THE CHANCELLOR.
YOURS SINCERELY
MARGARET THATCHER
ENDS
ORIGINAL FOLLOWS BY BAG FOR YOU TO FORWARD.

HOWE

OCMIAN 4778
LIMITED
ERD.
PS
PS/MR CHALKER
PS/PUS
MR MAUD.

COPIES TO
PS/NO 10 DOWNING ST.
PS/CHANCELLOR.

ecl

10 DOWNING STREET

LONDON SW1A 2AA

cc FO
HMT

THE PRIME MINISTER

25 September 1986

Dear Prime Minister.

Thank you for your letter of 24 September about the succession to Jacques de Larosière as Managing Director of the IMF.

As you say, Mr. Balladur has already raised this question with the Chancellor of the Exchequer. They, and other Finance Ministers, will no doubt be discussing it in Washington later this week. Meanwhile I have, of course, passed on your views to the Chancellor.

Yours sincerely

Margaret Thatcher

His Excellency Monsieur Jacques Chirac

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

25 September 1986

Alex Allan sent me earlier today a draft reply from the Prime Minister to Monsieur Chirac about the choice of a successor to de Larosiere as Managing Director of the IMF.

I enclose a signed copy of the reply. I should be grateful if it could be telegraphed to Paris this afternoon for very early delivery.

I am copying this letter and enclosure to Alex Allan (HM Treasury).

Charles Powell

Colin Budd Esq
Foreign and Commonwealth Office.

RT8.42

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

25 September 1986

Charles Powell Esq
10 Downing Street
LONDON
SW1

Dear Charles

Thank you for your letter of 24 September enclosing a letter to the Prime Minister from Monsieur Chirac about the choice of a successor to de Larosiere as Managing Director of the IMF. We think there would be some advantage in the Prime Minister sending up a quick, but non-committal, reply today. I enclose a draft.

I am copying this letter and enclosure to Colin Budd (Foreign and Commonwealth Office).

Yours sincerely
Tony Kuczys

pp A C S ALLAN
Principal Private Secretary

RT8.43

DRAFT LETTER FROM PRIME MINISTER TO MONSIEUR CHIRAC

Thank you for your letter of 24 September about the succession to Jacques de Larosiere as Managing Director of the IMF.

As you say, Mr Balladur has already raised this question with the Chancellor of the Exchequer. They, and other Finance Ministers, will no doubt be discussing it in Washington later this week. Meanwhile I have, of course, passed on your views to the Chancellor.

MT

MARGARET THATCHER

IMF: ECONPOL Pt2

Prime Minister

You should be aware of this.

CDP 25/9.

CONFIDENTIAL

2 CDP

(2)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

25 September 1986

MANAGING DIRECTOR OF THE IMF

The Netherlands Prime Minister telephoned this morning. Since he was unable to speak to the Prime Minister I subsequently spoke to his office who said that he wanted to urge the Prime Minister strongly to support Mr. Ruding for the post of Managing Director of the IMF. I said that I would ensure that the Prime Minister and the Chancellor were informed of Mr. Lubbers' message. Clearly the matter would be discussed in Washington and it was helpful to be informed directly of the Netherlands Government's views before the Chancellor's departure.

I am copying this letter to Colin Budd (Foreign and Commonwealth Office).

CHARLES POWELL

Alex Allan, Esq.,
H.M. Treasury.

CONFIDENTIAL

(2)

Prime Minister

M. Chirac has written to you seeking support for M. Camdessus (Governor of the Bank of France) as successor to de Larosière

CDP 24/9.

MESSAGE DE MONSIEUR JACQUES CHIRAC

PREMIER MINISTRE

A

THE RT. HON. MARGARET THATCHER, M.P.,

PRIME MINISTER

I don't see why France should have this post yet again

Le 24 septembre 1986

"Madame le Premier Ministre,

Je tiens à vous mettre au courant d'un problème de personne dont l'importance ne vous échappera pas et que M. Balladur a déjà évoqué auprès du Chancelier de l'Echiquier.

Jacques de Larosière vient de nous faire part de son intention de quitter la direction générale du Fonds Monétaire International dans les mois qui viennent. Il considère en effet qu'il est de l'intérêt de l'institution de procéder à partir de maintenant au renouvellement du Directeur Général : à ses yeux l'ouverture de sa succession dans la dernière année de son mandat (de mai 1987 à mai 1988) risque de porter préjudice à l'efficacité de l'action du "Managing Director".

.../...

Le Fonds s'apprête en particulier à aborder à partir du début de 1987 la négociation quinquennale du relèvement des quotes-parts. M. de Larosière pense que cette négociation, qui durera au moins trois ans, devrait être engagée par l'homme qui aura la responsabilité future de l'institution.

Je sais que vous attachez beaucoup d'importance, comme moi, à cette fonction de responsable du Fonds Monétaire International, surtout dans la conjoncture présente. Il est essentiel de trouver un candidat de très haute qualité.

A cet égard, parcourant les noms possibles pour cette importante fonction, j'ai songé pour ma part à Michel Camdessus, le Gouverneur de la Banque de France, ancien Président du Comité monétaire européen, et ancien Président du Club de Paris, dont l'autorité internationale est grande, notamment auprès des pays en voie de développement, et qui me paraît avoir toutes les qualités nécessaires de rigueur, d'intelligence et de compétence.

J'ajoute qu'il me paraît avoir également les qualités humaines qu'il faut pour traiter les problèmes délicats qui se posent à cette grande institution internationale.

.../...

Je me suis assuré que Michel Camdessus était prêt à assumer ces très importantes responsabilités si un consensus était réuni sur son nom.

Je tenais absolument, avant la réunion de Washington où se retrouveront nos Ministres des Finances, à m'ouvrir auprès de vous de cette question qui me tient à coeur.

J'adresse le même message à M. Bettino Craxi et à M. Helmut Kohl.

Veuillez agréer, Madame le Premier Ministre, l'expression de ma haute considération, de mes respectueux hommages et de mon bien cordial souvenir.

signé : Jacques Chirac"./.

PRIME MINISTER

NEXT MANAGING DIRECTOR OF THE IMF

The Chancellor told me this evening that there would be discussion during the Bank/Fund meetings in the G5 and other meetings in Washington of Larosière's replacement. He would be grateful for your confirmation of the line he proposes to take. This was:

Tony Barber?

He saw no credible British candidate. Morse and McMahon were not right. Richardson was too old. There was no-one else.

So far there were three candidates being touted (all from Europe since the convention is that the Managing Director is always a European). They were:

> Dini, a Deputy Governor of the Bank of Italy - not favoured by anyone except the Italians.
>
> Camdessus, Governor of the Bank of France on whose behalf Chirac's office have already lobbied us. The Chancellor did not believe he was the right candidate and any rate a Frenchman should not succeed a Frenchman, especially since a Frenchman ran the other major international economic organisation, OECD. He is likely to be the candidate favoured by the developing countries (though note that the IMF Board votes by a weighted majority on the next Managing Director).
>
> Ruding, a Conservative Dutch Finance Minister, former Executive Director on the IMF Board, and Chairman of the Interim Committee. The Chancellor knows him well, believes that he would do a good job and would have the support of the Americans and the Germans and would not be blackballed by the LDC's.

The Chancellor would like to give early support to Ruding in the hope of getting a band-wagon running for him. He would try to enlist the Germans. This might cause a somewhat mucky row in the Community in view of the other two European candidates, but the Chancellor will try and avoid this. He takes the point that the Dutch have been over-represented in top international jobs, but feels that in this case Ruding is the best candidate.

Agree that the Chancellor should proceed in this way?

In addition, the Chancellor made the point that if Ruding became Managing Director, the Chairmanship of the Interim Committee would become vacant. There would be two candidates. Stoltenburg and himself. If Stoltenburg really wanted the job, which he doubted, the Chancellor would support him. If not, he would be ready to accept the nomination if he was drafted (as I would expect him to be).

I think that the Chancellor should be encouraged to take this job. Geoffrey Howe, and Dennis Healey before him, both did it well. It will mean some extra travelling for the Chancellor, and seeing foreign visitors here.

Agree that the Chancellor can accept the Chairmanship of the Interim Committee?

Yes MT

N.L.W.

Is there no possibility of Tony Barber? I do not think another Dutchman would be a good thing. What about Stoltenberg himself? MT

N L WICKS

24 September 1986

SL2AIX

Gie

ECh

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

24 September 1986

I enclose a copy of a letter to the Prime Minister from M. Chirac in which he seeks support for the choice of Michel Camdessus as successor to de Larosiere as Managing Director of the IMF. I should be grateful for a draft reply.

BF

I am copying this letter and enclosure to Colin Budd (Foreign and Commonwealth Office).

(Charles Powell)

Alex Allan, Esq.,
H.M. Treasury.

BM

AMBASSADE DE FRANCE

LONDRES

L'AMBASSADEUR

24th September, 1986

Dear Prime Minister,

I have just received this message addressed to you by Monsieur Jacques Chirac, Premier Ministre.

I enclose it herewith.

Yours sincerely,

J. Viot

Jacques Viot

The Rt. Hon. Margaret Thatcher, M.P.,
Prime Minister,
Downing Street,
LONDON S.W.1

MESSAGE DE MONSIEUR JACQUES CHIRAC
PREMIER MINISTRE

A

THE RT. HON. MARGARET THATCHER, M.P.,
PRIME MINISTER

Le 24 septembre 1986

"Madame le Premier Ministre,

Je tiens à vous mettre au courant d'un problème de personne dont l'importance ne vous échappera pas et que M. Balladur a déjà évoqué auprès du Chancelier de l'Echiquier.

Jacques de Larosière vient de nous faire part de son intention de quitter la direction générale du Fonds Monétaire International dans les mois qui viennent. Il considère en effet qu'il est de l'intérêt de l'institution de procéder à partir de maintenant au renouvellement du Directeur Général : à ses yeux l'ouverture de sa succession dans la dernière année de son mandat (de mai 1987 à mai 1988) risque de porter préjudice à l'efficacité de l'action du "Managing Director".

.../...

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Je sais que vous attachez beaucoup d'importance, comme moi, à cette fonction de responsable du Fonds Monétaire International, surtout dans la conjoncture présente. Il est essentiel de trouver un candidat de très haute qualité.

A cet égard, parcourant les noms possibles pour cette importante fonction, j'ai songé pour ma part à Michel Camdessus, le Gouverneur de la Banque de France, ancien Président du Comité monétaire européen, et ancien Président du Club de Paris, dont l'autorité internationale est grande, notamment auprès des pays en voie de développement, et qui me paraît avoir toutes les qualités nécessaires de rigueur, d'intelligence et de compétence.

J'ajoute qu'il me paraît avoir également les qualités humaines qu'il faut pour traiter les problèmes délicats qui se posent à cette grande institution internationale.

.../...

Je me suis assuré que Michel Camdessus était prêt à assumer ces très importantes responsabilités si un consensus était réuni sur son nom.

Je tenais absolument, avant la réunion de Washington où se retrouveront nos Ministres des Finances, à m'ouvrir auprès de vous de cette question qui me tient à coeur.

J'adresse le même message à M. Bettino Craxi et à M. Helmut Kohl.

Veuillez agréer, Madame le Premier Ministre, l'expression de ma haute considération, de mes respectueux hommages et de mon bien cordial souvenir.

signé : Jacques Chirac"./.

O.C

C DO
24/9.

cc PC

AMBASSADE DE FRANCE

LONDRES

L'AMBASSADEUR

24th September, 1986

Dear Prime Minister,

I have just received this message addressed to you by Monsieur Jacques Chirac, Premier Ministre.

I enclose it herewith.

Yours sincerely,

J. Viot

Jacques Viot

The Rt. Hon. Margaret Thatcher, M.P.,
Prime Minister,
Downing Street,
LONDON S.W.1

FILE CAJ

10 DOWNING STREET

From the Principal Private Secretary

24 September 1986

Thank you for your letter of 23 September about a personal letter from the Prime Minister to Jacques de Larosiere. I now attach a letter signed by the Prime Minister and would be grateful if the Chancellor of the Exchequer could hand this to Larosiere when he sees him on Friday morning.

N. L. WICKS

A. C. S. Allan, Esq.,
H. M. Treasury

SRW

SRW
AJA

cc HMT

10 DOWNING STREET

LONDON SW1A 2AA

THE PRIME MINISTER

24 September 1986

Dear Monsieur de Larosière

I am among your many admirers who feel a sense of loss at your decision to leave the International Monetary Fund, though I do fully understand your wish to spend more time with your family and your home.

You have presided over the Fund during a time of momentous strain for the world economy and under your stewardship the Fund has responded to the tasks before it. You have conducted the Fund's affairs with great energy, flair and enterprise so that under your management its reputation has increased still further. You can be very proud of all that you have accomplished during your time in Washington.

I wish you every success and happiness for the future. My best wishes go, too, to your wife and family.

Yours sincerely

Margaret Thatcher

Monsieur Jacques de Larosière de Champfeu

SRW

PRIME MINISTER

NEXT MANAGING DIRECTOR OF THE IMF

The Chancellor told me this evening that there would be discussion during the Bank/Fund meetings in the G5 and other meetings in Washington of Larosière's replacement. He would be grateful for your confirmation of the line he proposes to take. This was:
He saw no credible British candidate. Morse and McMahon were not right. Richardson was too old. There was no-one else.

So far there were three candidates being touted (all from Europe since the convention is that the Managing Director is always a European). They were:

Dini, a Deputy Governor of the Bank of Italy - not favoured by anyone except the Italians.

Camdessus, Governor of the Bank of France on whose behalf Chirac's office have already lobbied us. The Chancellor did not believe he was the right candidate and any rate a Frenchman should not succeed a Frenchman, especially since a Frenchman ran the other major international economic organisation, OECD. He is likely to be the candidate favoured by the developing countries (though note that the IMF Board votes by a weighted majority on the next Managing Director).

Ruding, a Conservative Dutch Finance Minister, former Executive Director on the IMF Board, and Chairman of the Interim Committee. The Chancellor knows him well, believes that he would do a good job and would have the support of the Americans and the Germans and would not be blackballed by the LDC's.

The Chancellor would like to give early support to Ruding in the hope of getting a band-wagon running for him. He would try to enlist the Germans. This might cause a somewhat mucky row in the Community in view of the other two European candidates, but the Chancellor will try and avoid this. He takes the point that the Dutch have been over-represented in top international jobs, but feels that in this case Ruding is the best candidate.

Agree that the Chancellor should proceed in this way?

In addition, the Chancellor made the point that if Ruding became Managing Director, the Chairmanship of the Interim Committee would become vacant. There would be two candidates. Stoltenburg and himself. If Stoltenburg really wanted the job, which he doubted, the Chancellor would support him. If not, he would be ready to accept the nomination if he was drafted (as I would expect him to be).

I think that the Chancellor should be encouraged to take this job. Geoffrey Howe, and Dennis Healey before him, both did it well. It will mean some extra travelling for the Chancellor, and seeing foreign visitors here.

Agree that the Chancellor can accept the Chairmanship of the Interim Committee?

N L WICKS
24 September 1986

SL2AIX

RA3.69

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

23 September 1986

Nigel Wicks Esq CBE
10 Downing Street
LONDON
SW1

Dear Nigel,

You asked me whether the Prime Minister should send a personal letter to Jacques de Larosiere. The Chancellor feels this would be welcome, and would be glad to hand it to Larosiere when he sees him on Friday morning. I attach a draft. The Chancellor will be leaving on Thursday afternoon.

Yours
Alex

A C S ALLAN
Principal Private Secretary

GRS 480

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FM UKDEL IMF/IBRD WASHINGTON
TO DESKBY 220800Z FCO
TELNO 287
OF 192300Z SEPTEMBER 86

PERSONAL FOR ADVANCE ADDRESSEES ONLY.
IMF: MANAGING DIRECTOR
SUMMARY.
1. LAROSIERE TO RESIGN AT END 1986. .
DETAIL.
2. AT A MEETING OF EXECUTIVE DIRECTORS THIS EVENING, LAROSIERE ANNOUNCED HIS INTENTION TO RESIGN WITH EFFECT FROM END -1986 OR AT THE LATEST VERY EARLY IN 1987.
3. EXPLAINING WHY HE WAS GOING EIGHTEEN MONTHS BEFORE HIS CONTRACT ENDS, HE SAID HIS REASONS WERE LARGELY PERSONAL. HIS SON AND DAUGHTER HAD RETURNED TO FRANCE. HIS WIFE WANTED TO BE WITH THEM AND SO HE FELT HE MUST GO TOO. BUT HE ALSO THOUGHT THAT THE TIME WAS RIPE FOR NEW LEADERSHIP: HE MENTIONED THE CHALLENGES THAT LAY AHEAD WITH THE NEGOTIATIONS ON THE NEXT QUOTA INCREASE AND THE EXPANDED ROLE OF MULTILATERAL SURVEILLANCE. FURTHERMORE, HE HAD SOME RESERVATIONS ABOUT GOING TO THE END OF HIS CONTRACT AND BECOMING A LAME DUCK MANAGING DIRECTOR.
4. HE WOULD ANNOUNCE HIS RESIGNATION IN HIS SPEECH AT THE ANNUAL MEETINGS BUT HE WISHED GOVERNORS TO BE WARNED IN ADVANCE SO THAT THEY COULD BEGIN CONSULTING ON THE SUCCESSION.
5. LAROSIERE SAID HE HOPED HIS DECISION COULD BE KEPT WITHIN THE CONFINES OF GOVERNMENTS UNTIL THE ANNOUNCEMENT (COMMENT: SOME HOPE).
COMMENT.
6. THIS IS SAD NEWS INDEED. I HAVE NO DOUBT THAT THE DECISION IS LARGELY FOR PERSONAL REASONS AND THAT HE CANNOT (REPEAT NOT) BE PERSUADED TO STAY. IF WE WISHED TO PUT FORWARD A BRITISH SUCCESSOR, WE WOULD CLEARLY NEED TO START LOBBYING AT NEXT WEEK'S MEETINGS.
7. FCO PLEASE ADVANCE TO PS/PRIME MINISTER, PS/CHANCELLOR, PS/GOVERNOR, SIR P. MIDDLETON, SIR G. LITTLER, H.P. EVANS AND CULPIN (TREASURY), AND LOEHNIS (BANK OF ENGLAND).

LANKESTER

(ADVANCED AS REQUESTED)

YYYY

ORWBAN 6462
MINIMAL
HD/ERD

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SAVINGRAM

BY BAG

FROM UKDEL IMF/IBRD WASHINGTON 160930

RESTRICTED

TO FCO SAVINGRAM NO 336 OF 15 SEPTEMBER 1986

IMF: WORLD ECONOMIC OUTLOOK

Summary

A rather gloomy review. Directors noted the apparent slowdown in growth in the industrial countries so far this year and the very difficult position continuing to face the ldcs not least because of the weakness of commodity prices. On the positive side however most Directors from the industrialised countries noted that the prospects for a "bounce back" in growth remained good as a result of recent falls in interest and inflation rates together with the beneficial effects of the oil price feeding through. The ldcs were more sceptical.

2. On policies in the major countries, Directors noted the continuing uncertainty hanging over prospects for the US economy. They underlined therefore the importance of early and firm action to reduce the budget deficit. Most Directors felt that Germany and a fortiori Japan should also take measures to slow their pace of fiscal retrenchment.

Detail

3. On 12 September the Board concluded its discussion of the staff's latest forecasts for the world economy.

4. Directors noted the slowdown in growth in the industrialised countries so far in 1986. This partly reflected the negative results of the oil price fall feeding through before the positive effects were apparent. Most Directors from the industrialised countries supported the staff's view that this "growth pause" would prove temporary and that growth was likely to recover in the second half of the year and through 1987. The ldcs were more sceptical however and underlined the damaging effects that slower growth in the industrialised countries was having upon them.

5. Directors recognised that the position facing the ldcs remained very difficult. Ldc Directors expressed particular concern about the recurrent weakness of commodity prices. They welcomed therefore the staff's discussion of this problem and they expressed interest in further study.

6. Directors continued to support the broad stance of policies followed by industrial countries in recent years. Nonetheless they expressed concern about the size of the current account imbalances expected in the largest countries over the medium run. The substantial realignment of the major currencies was welcome but Directors doubted whether this alone would be sufficient to bring about sustainable current account positions. They emphasised therefore the need for appropriate fiscal and monetary policies. Directors stressed the need for the US authorities to press firmly ahead with their fiscal adjustment effort. In addition, most Directors thought that Japan and Germany should moderate the pace of fiscal adjustment in order to support domestic demand.

7. In response to these views Grosche (Germany) noted that, in contrast to the position in Japan, current exchange rates were already expected to lead to a substantial reduction in the current account surplus relative to GDP over the years ahead. The authorities would implement their fiscal policies flexibly. Indeed the draft 1987 budget showed a rise in net borrowing. In any case, growth in Germany both this year and next was expected to be robust. Fujino (Japan) was more vehement. He questioned the staff's forecasts for Japan and suggested various drafting changes before the WEO should be published, including deleting section IV of the paper (which contains the material on economic indicators). The Japanese current account surplus would fall and anyway it was misleading to express the surplus in dollars. Japanese growth would pick up. The rapidly rising debt burden made fiscal action difficult although the authorities would announce a fiscal package soon.

8. Dallara (US) expressed concern about the prospects for the US current account deficit which was likely to remain high despite the fall in the dollar. The administration remained committed to fiscal adjustment. Even so, other countries would also need to adopt appropriate policies if US adjustment was not to lead to an excessive slowdown in growth. In

particular, he was concerned about the slow growth through next year shown in the staff's forecasts for Germany and Japan. In this light, while he supported the authorities' overall fiscal objectives, he thought that both Germany and Japan had some room for flexibility in the short-term.

9. Turning to policies in the developing countries, Directors emphasied the very difficult situation which would require the maintenance of policies to reduce the reliance of the economy upon imports and foreign savings. The weakness of commodity markets underlined the importance of continued export diversification. While Directors recognised that import substitution might have a role to play in some developing countries, they said that these should be used in the light of comparative advantage and without reliance upon excessive protectionist barriers. On the other hand, Sengupta (India etc.) - the strongest, and quite often the only advocate in the Board of development through administrative controls - argued that tariffs and export subsidies could be economically efficient.

10. Several Directors referred to the forthcoming GATT discussions. The ldc Directors underlined the importance of the industralised countries giving ldc exports unrestricted access to their markets. Rye (Australia etc.) continued his campaign against agricultural protection which he argued was an important factor behind the weakness of agricultural prices.

11. Directors welcomed the material on economic indicators for the major countries included in the staff's report. Only a few Directors took the opportunity to make specific suggestions on the way in which this exercise might be extended. Both Wijnholds (Netherlands etc.) and de Groote (Belgium) felt that the exercise should be made more specific in its policy content. Wijnholds thought that the staff should work towards the setting of policy norms which could be used to trigger policy discussions if policy went off track.

UK Intervention

12. Foot spoke to your telnos 202 - 204.

13. He noted that there appeared to have been a slowdown in growth so far this year. Nonetheless he suggested that it was probably too early to read

very much into this. In part it seemed to reflect the fact that those who had lost from the oil price fall had adjusted their behaviour before those who had gained. In any case, he was confident that the recovery had not ended and that, subject to one key uncertainty, the conditions for continued growth appeared to be good. In support of this view, Foot noted that both inflation and interest rates had been significantly reduced during the course of this year. Indeed he questioned whether the staff had not been too pessimistic not only on the outlook for inflation in the UK but also more generally. A significant realignment of exchange rates had also taken place. Foot also wondered whether the staff had not been too pessimistic concerning recent trends in commodity prices. The ffgures in the staff report seemed to imply that commodity prices in the second quarter of this year had been rather weaker than would be implied by the Economist index or estimates of the UN index.

14. The main uncertainty that Foot identified was the outlook for the US economy. The prospects for continued large current account deficits was a source of concern. This emphasised the need to take resolute measures to reduce the fiscal deficit. Such action was particularly important as the financial markets seemed to have already discounted some fiscal action and there was a danger that interest rates might rise if the expected fiscal adjustment were not put in place.

15. Turning to the policies in the industrial countries, Foot said that he continued to support the strategy followed over recent years which had allowed recovery to be combined with a good inflation performance. Where inflation was low, there might be a case for bringing forward tax adjustments.

16. Continuing, Foot noted that the staff seemed to have some doubts that the private sector would take up the resources freed by the planned reduction in fiscal deficits in the major countries in the years ahead. It was important not to see this question out of perspective. One reason for the poor performance of the world economy in recent years might well be the crowding out of private sector activity by the public sector. In this light, the planned reduction in the demands of the public sector should help to contribute to the strengthening of the growth performance.

17. The situation facing the ldcs remained difficult Foot said. Additional borrowing should only be undertaken cautiously. It was important for the ldcs to reduce their reliance upon imported goods and capital in stimulating faster growth.

18. Foot welcomed the staff's material on economic indicators. He suggested that its usefulness could be increased if it included scenarios investigating the effects of different policy options.

19. Finally, on the GATT round, Foot noted the importance of resisting protectionist pressures. This would require the flexible attitude of all participants in the talks.

<u>Staff Replies and Other Points</u>

20. Hood (Director, Research Department), in personal remarks in his last WEO discussion before his retirement, underlined the uncertainties in the present situation and in particular the growing signs of disatisfaction with the operation of the international monetary system as evidenced by "economic warfare" on the trade front. Nonetheless there were positive signs and he stressed that the Fund had potentially a vital role.

21. Crockett (Deputy Director, Research Department) noted that there had been some positive developments since the forecast was completed and these would be taken into account in the update that the staff were currently preparing. The revision to the US Q2 GNP figures was not a major source of concern because final domestic demand was still growing strongly. The update would incorporate a $15 oil price for this year - the same as that used in the Spring exercise but higher than that in the papers for this meeting. The main effect of this change would be to improve the UK's balance of payments in the short term. The position of the OPEC countries would also improve somewhat.

22. Concerning the point Foot had raised on the recent developments in the commodity markets, Crockett accepted that the price index used by the staff had diverged significantly recently from the Economist index. The staff had been surprised by this but thought that this difference was unlikely to

make any significant difference to the forecasts as these were done for all the individual commodities and then aggregated.

23. There was a brief discussion of the arrangements for publishing the WEO. It was agreed that, as in previous years, it should be published in final form after the Annual Meetings. A shortened version would be given to the press at the time of the Interim Committee.

LANKESTER

MONETARY.

ERD.

Mr. Wicks

Your Ref

with compliments

GEOFFREY LITTLER

Treasury Chambers
Parliament Street
London SW1P 3AG
Tel: Direct Line 01-233
Switchboard 01-233-3000

THE TIMES - SATURDAY, 30 AUGUST, 1986

FOURTH LEADER

In the United States, a Miss Hart, who is a follower of the extremist politician Lyndon LaRouche, has been fined $500 for "disorderly conduct". What she was convicted of doing was "to present a slab of raw liver to an archbishop as a protest against what she said was his support for the International Monetary Fund".

We confess that we are as baffled by this story as we have ever been in our lives. There are no further details in the report we have seen, other than the lady's age, which can hardly be a material consideration, and we have quoted the words of the charge *verbatim*. But what can it mean?

In the first place, why should it be termed "disorderly conduct" (and of a nature grave enough to warrant arrest and a fine) to give an archbishop a piece of liver? Possibly, he was known not to like liver, even lightly grilled with sage and accompanied by a watercress salad (which is how we like it); but in that case he would merely have declined the gift, and could hardly have taken offence at it. (Even if he was a vegetarian the same would hold true.)

Besides, if the archbishop is anything like the archbishops we know, he would have accepted it as a gift even if he did not like the taste, and distributed it to the poor and hungry of his archdiocese, thus turning what was intended as an insult into a deed of mercy. But how could it have been intended as an insult? For note that Miss Hart *presented* the liver to him; there is no suggestion that she threw it at him, let alone hit him on the head with it.

And, that is only half of the mystery. The presentation of the liver, we are told, was by way of rebuke for his support of the International Monetary Fund. Now there is no reason why an archbishop should not admire the work of the IMF, though it is unlikely that he would have time to involve himself closely in its activities. But why should that bring down on him the wrath of a lady, to the extent that she would pause on her way to her rendezvous with history to pop into a butcher's?

Nor does theology help; if it was pig's liver, Jews and Mohammedans would be forbidden to touch it, but there are no Jewish or Muslim archbishops, and we know of nothing in the teaching of any of the sects of Christianity which takes any view at all of liver, much less a view so strong that it warrants prosecution.

We end as baffled as we began, and throw ourselves on our readers. To the sender of the most implausible solution to this mystery, provided its inner logic is without fault, we shall present a full pound of the best calves liver that money can buy. Archbishops, and directors of the International Monetary Fund, are eligible, and welcome to compete.

MJ2 CIA

cc Mr Norgrove

10 DOWNING STREET

From the Private Secretary

19 August 1986

Thank you for your letter of 18 August about the forthcoming visit to London by the new President of the World Bank. The Prime Minister has agreed to see Mr Conable and we have provisionally arranged a time of 1630 on Monday 20 October. I should stress that the later dates in November are very inconvenient for the Prime Minister since she will be making major speeches on 10 and 12 November and will be heavily involved in preparation on both the days Mr Conable will be here. No doubt you will give us briefing before his visit.

Tim Flesher

Colin Budd Esq
Foreign and Commonwealth Office

ECL

OLO

CE

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Foreign and Commonwealth Office

London SW1A 2AH

18 August 1986

Prime Minister:

Agree to see Barber Conable? The October dates are possible and better than November (between the Guildhall speech + the State Opening)

Monday morning is better than Tuesday

Dear Tim,

19/8

Visit to London by the new President of the World Bank

Barber Conable, who took over from Tom Clausen as President of the World Bank on 1 July, ~~has~~ asked to make an early visit to London to pay courtesy calls on Ministers. He has suggested either Monday 20 and Tuesday morning 21 October or Monday 10 and Tuesday morning 11 November. Later days in either of those weeks would be possible alternatives.

Conable has particularly asked if he might call on the Prime Minister on this occasion, as well as the Foreign Secretary and the Chancellor. The Prime Minister was good enough to receive Clausen in similar circumstances four years ago; and our relations with the World Bank are even more important to us now, given its enhanced role in dealing with the debt crisis following US Treasury Secretary Baker's initiative in Seoul last October. Conable's visit will afford us a good opportunity of underlining the Government's support for the Bank, and of rehearsing to him personally some of the policy points which the Chancellor will

/have

have made in his speech to the Annual Meeting in Washington next month. It is particularly welcome to have this opportunity of making our views known to him before he has been exposed to the Bank's internal pressures for too long. We therefore recommend that the Prime Minister should see Conable on this occasion. If that is agreed in principle, I should be glad to learn whether any of the dates which he has suggested would be convenient.

Yours sincerely,

Colin Budd

(C R Budd)
Private Secretary

T Flesher Esq
No 10 Downing St

PS The October dates are impossible for the Foreign Secretary.

SM4/102

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CDP 6/8

FROM: A W KUCZYS
DATE: 6 AUGUST 1986

MRS CASE

cc Sir G Littler
Mr Mountfield
Miss Cund

Mr Powell - No 10

MR Lankester - UKDEL

EGYPT/IMF

The Chancellor has seen the recent exchange of telegrams with Paris and Bonn, about the respective positions which the UK, France and Germany are taking over Egypt in the IMF. He has commented that there is no difference of substance between our position and that of, say, the Germans. It is the old story of our being honest and other countries less so.

AWK

A W KUCZYS

GRS 1350

CONFIDENTIAL

DW to all CAs

DW

CONFIDENTIAL
FROM UKDEL IMF/IBRD WASHINGTON
TO DESKBY 240800Z FCO
TELNO 232
OF 232300Z JULY 86
AND TO DESKBY 241500Z MEXICO CITY

MY TELNO 230
IMF: MEXICO

1. LAROSIERE BRIEFED EXECUTIVE DIRECTORS THIS MORNING. HE HANDED OVER THE LETTER OF INTENT (EBS/86/161) WHICH WE HAVE FAXED TO LONDON. HE DESCRIBED THE KEY ELEMENTS OF THE MEXICAN PROGRAM: TAX REFORM, PRICE INCREASES AND RESTRUCTURING IN THE PUBLIC SECTOR, REORIENTING OF PUBLIC EXPENDITURE IN FAVOUR OF CAPITAL SPENDING, TRADE LIBERALISATION, AND A FLEXIBLE EXCHANGE RATE POLICY. HE WENT OVER THE TWO INNOVATIVE FEATURES OF THE PROGRAM--THAT IS, THE OIL PRICE TRIGGER AND THE PROVISION FOR ADDITIONAL PUBLIC INVESTMENT IF RECOVERY FAILS TO MATERIALISE. THESE ARE SPELT OUT IN THE LETTER OF INTENT. IT SHOULD BE NOTED THAT FULL COMPENSATION IF THE OIL PRICE FALLS BELOW DOLLARS 9 PER BARREL RUNS FOR ONLY NINE MONTHS, IT IS PHASED OUT OVER THE SUCCEEDING THREE QUARTERS. LAROSIERE SAID THAT THE TOTAL COMPENSATION FOR WHICH MEXICO COULD BE ELIGIBLE IN THE EVENT OF THE PRICE FALLING AS LOW AS DOLLARS FIVE PER BARREL WAS DOLLARS 2.5 BILLION. HE WOULD EXPECT THE FUND TO CONTRIBUTE UP TO HALF OF THIS BY WAY OF ENLARGED ACCESS AND THE COMMERCIAL BANKS THE REMAINDER. AS MENTIONED IN TUR, LAROSIERE EXPECTS THE IBRD TO FINANCE THE EXTRA DOLLARS 500 MILLION OF ADDITIONAL PUBLIC INVESTMENT IF GROWTH DOES NOT MATERIALISE. THE LETTER OF INTENT SAYS THAT ''THIS FUNDING WOULD NEED TO BE COMMITTED IN ADVANCE AND NOT AT THE MOMENT OF THE TRIGGERING OF THE MECHANISM''. IT REMAINS TO BE SEEN WHETHER THE IBRD CAN AGREE TO THIS. I HAVE MY DOUBTS, PARTICULARLY SINCE THEY ARE ALREADY PLANNING ON LARGE NEW COMMITMENTS AND NET DISBURSEMENTS OF ABOUT DOLLARS 1 BILLION IN BOTH 1986 AND 1987. NONETHELESS, IT IS CLEAR (FROM WHAT PETRICIOLI SAID HERE YESTERDAY, AND FROM ORTIZ (IMF MEXICAN ALTERNATE DIRECTOR) WHO ALSO SPOKE AT THIS MORNING'S BRIEFING) THAT THE MEXICANS REGARD THIS AS AN IMPORTANT ELEMENT IN THE PROGRAM.

2. LAROSIERE SAID THAT HE HAD NO ILLUSION ABOUT THE DIFFICULTIES IN PERSUADING THE BANKS TO COME UP WITH THEIR SHARE OF THE FINANCING (DOLLARS 6 BILLION PLUS), BUT IT WAS CRITICAL THAT THEY SHOULD. IF THEY WANTED THE BAKER INITIATIVE TO TAKE OFF, NOW WAS THE TIME FOR THEM TO SHOW IT. HE POINTED OUT THAT COMMERCIAL BANK EXPOSURE TO MEXICO WAS ABOUT DOLLARS 70 BILLION, SO THE FINANCING ASSUMED FROM THEM WOULD ADD ABOUT 4 PER CENT PER ANNUM IN 1986 AND 1987 TO THEIR EXPOSURE. THIS WAS MORE THAN THE 2-3 PER CENT PER ANNUM ASSUMED IN THE BAKER-15 COUNTRIES TAKEN AS A WHOLE. BUT BANK LENDING TO COUNTRIES OTHER THAN MEXICO HAD BEEN MINIMAL AND THE BANKS WOULD BE RECEIVING SOME REPAYMENTS FROM THE MEXICAN PRIVATE SECTOR (ALMOST DOLLARS 1 BILLION IN 1986 AND 1987).

3. THE LETTER OF INTENT DOES NOT GIVE A COMPLETE PICTURE AND IT WILL NOT BE POSSIBLE TO PROPERLY ASSESS THE PROGRAM UNTIL WE HAVE THE FULL STAFF REPORT. IN PARTICULAR, IT INCLUDES LITTLE ON THE BALANCE OF PAYMENTS. HOWEVER, LAROSIERE DID READ OUT THE BALANCE OF PAYMENTS PROJECTIONS UNDERLYING THE PROGRAM ICH ARE AS FOLLOWS:

(LLARS BILLION

	1986	1987	AL 6-1987
OIL EXPORTS	5.6	6.0	
TOTAL IMPORTS	12.0	14.3	
CURRENT ACCOUNT DEFICIT	-3.5	-2.9	-6.4
PRIVATE CAPITAL ACCOUNT	-1.5	-1.3	-2.8
OF WHICH:			
DIRECT INVESTMENT	+0.6	+0.6	+1.2
EXTERNAL CREDIT	+1.8	+1.0	+2.8
DEBT AMORTISATION	-2.2	-1.3	-3.5
INTEREST RECEIPTS NOT REPATRIATED	-1.2	-1.2	-2.4
ERRORS AND OMISSIONS	-0.5	-0.4	-0.9
INCREASE IN NET RESERVES	-0.5	-0.9	-1.4
INCREASE IN GROSS RESERVES			-2.8
FINANCING GAP			12.0
FINANCED BY:			
IBRD/IDB			+2.7
IMF			+1.4
PARIS CLUB			+1.5
COMMODITY CREDIT CORPORATION			+0.7
MYRA INTEREST REBATE			+0.5
OTHER AND SHORT-TERM ITEMS			-0.8
COMMERCIAL BANKS			+6.0

4. OIL EXPORT PROJECTIONS BASED ON PRICE OF DOLLARS 9 PER BARREL OF MEXICAN CRUDE OIL MIX IN Q3 1986 AND DOLLARS 11 IN Q4 1986 AND 1987, AND EXPORT VOLUME OF 1.2 MBD IN H2 1986 ND .3 MBD IN 1987. IMPORT PROJECTION FOR 1987 IS BASED ON MINIMUM REGARDED AS CONSISTENT WITH GDP GROWTH OF -3.5 R CENT UND STAFF ARE ASSUMING GDP REDUCTION OF 4 PER CENT IN 986). DER PRIVATE CAPITAL ACCOUNT, EXTERNAL CREDIT IS MAINLY TRADE CREDIT, DEBT AMORTISATION INCLUDES REPAYMENT OF BANK CREDIT BY THE MEXICAN PRIVATE SECTOR (ESTIMATED AT DOLLARS 0.9 BILLION OVER THE TWO YEARS) AND AMORTISATION OF BONDS BOTH OF WHICH IT IS ASSUMED CANNOT BE RESCHEDULED. INTEREST RECEIPTS NOT REPATRIATED REFERS TO INTEREST RECEIVED ON MEXICAN ASSETS HELD BY THE PRIVATE SECTOR ABROAD WHICH ARE, STRICTLY SPEAKING, CURRENT RECEIPTS BUT WHICH IN PRACTICE ARE NOT AVAILABLE TO FINANCE IMPORTS. FUND STAFF THINK IT RIGHT THAT MEXICO SHOULD REPLENISH ITS RESERVES. FIGURE OF DOLLARS 1.4 BILLION FOR INCREASE IN NET RESERVES CORRESPONDS

CONFIDENTIAL /TO

TO PERFORMANCE CRITERION UNDER STAND-BY ARRANGEMENT (SEE TABLE 1 OF EBS/86/161). FIGURE OF DOLLARS 2.8 BILLION FOR INCREASE IN GROSS RESERVES INCLUDES DOLLARS 1.4 NET DRAWING FROM THE FUND (I.E. DOLLARS 1.7 BILLION PURCHASE UNDER STAND-BY ARRANGEMENT MINUS DOLLARS 0.3 BILLION OF REPURCHASES FALLING DUE). THE FIGURE OF DOLLARS 1.5 BILLION FOR PARIS CLUB IS, LAROSIERE FREELY ADMITTED, A COCKSHY. THE MYRA INTEREST REBATE IS THE REBATE UNDER LAST YEAR'S RESTRUCTURING AGREED WITH THE BANKS. ''OTHER AND SHORT-TERM ITEMS'' REFERS MAINLY TO CREDIT LINES AND OTHER SHORT-TERM DEBT WHICH THE MEXICANS SAY CANNOT BE RENEGOTIATED. IF YOU DEDUCT THE LATTER AND THE FUND NET DRAWING FROM TH+ DOLLARS 12 BILLION FINANCING GAP, THE RESULTANT FIGURE OF DOLLARS 10.1 BILLION CORRESPONDS TO THE PERFORMANCE CEILING FOR NET FOREIGN BORROWING IN THE LETTER OF INTENT.

5. ON THE FISCAL SIDE, IT SEEMS THAT THE MEXICANS ARE PROPOSING TO RAISE ADDITIONAL REVENUE AMOUNTING TO 1.3 PER CENT OF GDP (PARA. 7). THEY ARE PROPOSING TO CUT PUBLIC EXPENDITURE BY 0.5 PER CENT OF GDP, BUT WITHIN THIS TO RAISE CAPITAL OUTLAYS BY 0.5 PER CENT OF GDP (PARA. 9). IN ADDITION, THEY ARE PLANNING TO RAISE THE PRICES AND TARIFFS IN THE PUBLIC SECTOR TO YIELD 1.2 PER CENT OF GDP (PARA. 8). THIS SEEMS TO BE CONSISTENT WITH THE 3 PER CENT OF GDP EXTRA FISCAL EFFORT WHICH WE HAVE BEEN TOLD ABOUT PREVIOUSLY, BUT IT IS NOT CLEAR WHAT IT MEANS FOR THE PSBR IN 1987. THE CEILING ON THE LATTER IS TO BE AGREED SOMETIME BEFORE END-1986.

6. LAROSIERE SAID HE HOPED TO BRING ALL THIS TO THE BOARD IN EARLY SEPTEMBER, BUT HE WOULD NOT DO SO UNTIL THE CRITICAL MASS OF FINANCING WAS PRETTY MUCH TIED UP.

7. FCO PLEASE ADVANCE TO PS/CHANCELLOR, LITTLER, LAVELLE, MOUNTFIELD, AND MATTHEWS (TREASURY), PS/GOVERNOR, LOEHNIS, KENT AND CRAWFORD (BANK OF ENGLAND), AND FOWLER, BRAITHWAITE AND MAUD (FCO).

LANKESTER (ADVANCED AS REQUESTED)

MONETARY
MCAD
MAD

GRS 450

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Confidential

FM UKDEL IMF/IBRD, WASHINGTON
TO DESKBY 220800Z FCO
TELNO 153
OF 212300Z MAY 86
AND TO ROUTINE MEXICO CITY

Please file

IMF: MEXICO

WHEN I SAW LAROSIERE YESTERDAY ON ANOTHER MATTER, WE BRIEFLY DISCUSSED MEXICO. HIS MOOD WAS SOMBRE. HE SAID HE HAD SEEN MANCERA IN PHOENIX OVER THE WEEKEND AND (NOTWITHSTANDING MANCERA'S OPTIMISM ON AGREEMENT WITH THE FUND AS REPORTED IN MONDAY'S FINANCIAL TIMES) THEIR DISCUSSION HAD BEEN INCONCLUSIVE. LAROSIERE GAVE THE IMPRESSION OF BEING RATHER PESSIMISTIC ABOUT THE MEXICANS' WILLINGNESS TO DO MORE ON THE FISCAL SIDE. AT CURRENT OIL PRICES, IT WAS ESSENTIAL THAT THE PUBLIC DEFICIT BE REDUCED TO AT LEAST SOMETHING BELOW 10 PER CENT OF GDP TO JUSTIFY A FUND PROGRAMME. ANYTHING HIGHER THAN THIS WOULD BE TOO RISKY FOR THE FUND, DAMAGING TO THE MEXICAN ECONOMY AND WOULD LACK CREDIBILITY WITH THE COMMERCIAL BANKS.

2. LAROSIERE GAVE ME THE FUND STAFF'S LATEST FIGURING ON THE BUDGET. AS OF LAST NOVEMBER, THE MEXICANS WERE BUDGETING ON A PUBLIC DEFICIT AT 5.3 PER CENT OF GDP. THIS HAD INCREASED TO 9.3 PER CENT AS A DIRECT RESULT OF THE OIL PRICE COLLAPSE. IT HAD RISEN FURTHER TO 13.8 PER CENT LARGELY ON ACCOUNT OF HIGHER PUBLIC SECTOR INTEREST PAYMENTS DUE TO HIGHER INTEREST RATES IN MEXICO AND THE HIGHER PESO INTEREST COST OF FOREIGN LOANS. THE LATTER FIGURE HAD IN THEORY BEEN REDUCED TO ABOUT 12.3 PER CENT BY THE MEASURES ANNOUNCED BY SALINAS ON 23 APRIL (MEXICO TELNO 156). STAFF SIMULATIONS SHOWED THAT, EVEN IF ADDITIONAL EXTERNAL FINANCING WERE AVAILABLE TO COVER A 12.3 PER CENT DEFICIT, A DEFICIT OF THIS MAGNITUDE WOULD INCREASE THE RATE OF INFLATION TO AROUND 150 PER CENT. LAROSIERE POINTED OUT THAT THE LONGER THE MEXICANS DELAYED, THE RISING RATE OF INFLATION WOULD, BY INCREASING THE COST OF DEBT SERVICE, PUSH UP THE DEFICIT FURTHER.

3. FUND NEGOTIATING TEAM HAVE RETURNED FROM MEXICO WITH MEXICAN TEAM HEADED BY SUAREZ. ORTIZ (MY MEXICAN COLLEAGUE ON THE FUND BOARD) TELLS ME THAT THEY ARE TRYING TO PERSUADE THE FUND TO ACCEPT THE CONCEPT OF THE QUOTE OPERATIONAL DEFICIT UNQUOTE - I.E. THE DEFICIT MINUS THE INFLATION COMPONENT OF PUBLIC DEBT INTEREST PAYMENTS. THEY ESTIMATE THE INFLATION COMPONENT AT NEARLY 9 PER CENT OF GDP IN 1986, AND ACCORDINGLY ARGUE THAT THE INFLATION ADJUSTED DEFICIT IS VERY MODEST. I DOUBT WHETHER THE STAFF WILL ACCEPT THIS LINE OF REASONING SINCE THE HIGH ACTUAL DEFICIT STILL HAS TO BE FINANCED, AND PARTICULARLY WITH HIGH AND RISING INFLATION, THIS SEEMS UNLIKELY TO BE ACHIEVED WITHOUT RECOURSE TO THE BANKING SYSTEM UNLESS REAL INTEREST RATES ARE TO REMAIN UNCOMFORTABLY HIGH.

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4. ORTIZ SAYS THAT THE MEXICAN TEAM WILL NOT GIVE ANYTHING FURTHER ON THE BUDGET. HOWEVER, HE HAS ALL ALONG BEEN IN THE PESSIMISTS' CAMP AND HAS NOT (NOT) ALWAYS BEEN PROVED RIGHT - SEE E.G. MY TELNO 67.

5. FCO PLEASE ADVANCE TO MOUNTFIELD (HMT), KENT (BOE), RICHARDSON (ERD) AND WOOLVERTON (ODA).

LANKESTER

MONETARY DIST

MCAD.

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Pl. file

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CONFIDENTIAL
FROM UKDEL IMF/IBRD WASHINGTON
TO DESKBY 110800Z APRIL 86 FCO
TELNO 109
OF 102300Z APRIL 86
AND IMMEDIATE NEW YORK (FOR CHANCELLOR'S PARTY)
AND IMMEDIATE TO BONN, PARIS (AND FOR MOUNTFIELD) TOKYO AND UKMIS GENEVA (FOR MOUNTFIELD)

IMF: INTERIM COMMITTEE - INFORMAL SESSION

1 THE INFORMAL SESSIONS REVEALED LITTLE CHANGE FROM ALREADY FAMILIAR POSITIONS. AS IN THE PLENARY SESSION, DISCUSSION WAS LOW KEY. THE CHANCELLOR'S MAIN PRESENTATION ON EXCHANGE RATES AND SURVEILLANCE IS REPORTED IN FULL IN A SEPARATE TELEGRAM.

THE DEBT STRATEGY

2 IN HIS INTRODUCTION THE MANAGING DIRECTOR STRESSED THE NEED FOR SOUND POLICIES IN DEBTOR COUNTRIES AND NOTED SOME RECENT POSITIVE DEVELOPMENTS, FOR EXAMPLE AN EASING OF CONTROLS ON INWARD CAPITAL INVESTMENT AND SOME INNOVATIVE SCHEMES TO CONVERT DEBT INTO EQUITY, WHICH SHOWED PROMISE. FOR THE CREDITOR COUNTRIES HE WELCOMED THE REFERENCES IN THE G10 COMMUNIQUE TO THE NEED TO CO-OPERATE REGARDING RESUMPTION OF EXPORT CREDIT COVER TO COUNTRIES IMPLEMENTING APPROPRIATE ADJUSTMENT POLICIES. IF DEBTORS CONTINUED THEIR ADJUSTMENT EFFORT THEN NEW LENDING WOULD EVENTUALLY BE FORTHCOMING BUT THERE MIGHT BE A RECOGNITION LAG BEFORE THE BANKS WERE CONFIDENT ENOUGH TO INCREASE THEIR COMMITMENTS. IN THIS SITUATION A FUND PRESENCE COULD BE USEFUL, EITHER A FINANCIAL ONE OR IN SOME CASES ENHANCED SURVEILLANCE. THE RECENT FALL IN OIL PRICES WOULD RESULT IN MUCH LARGER FINANCING GAPS FOR SOME COUNTRIES AND THE FLEXIBILITY OF THE CASE-BY-CASE APPROACH WOULD BE ALL THE MORE IMPORTANT.

3 BAKER (US) ALSO STRESSED THE POSITIVE FEATURES OF THE CURRENT OUTLOOK. RECENT FALLS IN INTEREST RATES WOULD SAVE DEBTOR COUNTRIES DOLLARS 11 BILLION AND THE FALL IN OIL PRICES, BY STIMULATING WORLD RECOVERY WOULD INCREASE THEIR NON-OIL EXPORT REVENUES. HE NOTED THE WIDESPREAD SUPPORT FOR HIS SEOUL INITIATIVE AND SAID THAT THIS WAS NOT INVALIDATED BY THE RECENT FALL IN OIL PRICES. HOWEVER, HE ACKNOWLEDGED THAT FINANCING NEEDS WOULD BE INCREASED. POLICY REFORMS IN DEBTOR COUNTRIES WERE CRITICAL BUT WOULD TAKE TIME TO IMPLEMENT. THE DEBT CRISIS HAD EVOLVED OVER A LONG PERIOD AND WOULD TAKE A LONG TIME TO RESOLVE. NEVERTHELESS, BAKER WAS OPTIMISTIC ABOUT THE PROGRESS BEING MADE IN A NUMBER OF DEBTORS. AND THE MULTILATERAL INSTITUTIONS WERE PLAYING A HELPFUL ROLE. FUND PROGRAMMES EXISTED OR WERE IN PROSPECT IN 11 OF THE 15 HEAVILY INDEBTED COUNTRIES. AND THE IBRD WERE MOVING FORWARD AND DEVELOPING NEW PROCEDURES. THEIR INVOLVEMENT SHOULD BE MORE IN THE FORM OF STRUCTURAL ADJUSTMENT LOANS RATHER THAN PROJECT

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LENDING. IBRD INVOLVEMENT WITH PRIVATE CREDITORS WAS ALSO PROMISING. BAKER DISAGREED WITH THOSE WHO ARGUED FOR MORE FLEXIBILITY IN THE FUND'S LENDING POLICIES AND FOR AN EARLY GCI. ON THE LATTER, THE BANK COULD INCREASE ITS LENDING BY DOLLARS 2-2.5 BILLION PER ANNUM OVER THE NEXT FEW YEARS WITHOUT A GCI. AS FOR THE FUND IT SHOULD WORK WITH DEBTORS TO PROMOTE BETTER POLICIES RATHER THAN MAKE SPECIAL CONCESSIONS. ACCESS LIMITS WHICH SHOULD BE ASSESSED ON A CASE-BY-CASE BASIS ALREADY CONTAINED ADEQUATE FLEXIBILITY. AND THERE WAS NO NEED FOR A REVIEW OF THE CFF OR ITS ACCESS LIMITS. THERE WAS NO NEED TO ACCELERATE THE NEXT QUOTA REVIEW.

4 SILVA HERZOG (MEXICO) STRESSED THE SACRIFICES THAT DEBTOR COUNTRIES HAD HAD TO MAKE IN RECENT YEARS. DEBT SERVICING HAD BEEN AT THE EXPENSE OF GROWTH. THE EFFECT OF RECENT FURTHER FALLS IN DEBTOR COUNTRIES' TERMS OF TRADE WAS FOUR TIMES GREATER THAN THE BENEFITS ARISING FROM LOWER INTEREST RATES. THE BANKS REMAINED UNRECEPTIVE AND INDUSTRIAL COUNTRY GOVERNMENTS WERE NOT PULLING THEIR WEIGHT EITHER. EXPORT CREDIT COVER WAS SUSPENDED AT THE FIRST HINT OF RESCHEDULING AND CREDITOR GOVERNMENTS INSISTED ON A FUND PROGRAMME FOR A PARIS CLUB RESCHEDULING. AND THE REGULATORY ENVIRONMENT CONSTRAINED BANK LENDING. HERZOG AGREED WITH THE NEED FOR SOUND POLICIES IN DEBTOR COUNTRIES BUT THIS WOULD NOT ON ITS OWN BE SUFFICIENT TO STEM CAPITAL FLIGHT. THIS RELIED ON IMPROVED CONFIDENCE. FURTHER REDUCTIONS IN INTEREST RATES WOULD BE NEEDED TOGETHER WITH A REDUCTION IN SPREADS. AND A MORE FLEXIBLE REGULATORY ENVIRONMENT WOULD ALLOW THE BANKS TO CONSIDER INTEREST RATE CONCESSIONS WHICH MIGHT BE THE EASIEST SOLUTION TO PRESENT DIFFICULTIES. EXPORT CREDIT AGENCIES SHOULD MAINTAIN COVER TO COUNTRIES THAT WERE RESCHEDULING. THE PROBLEMS OF HIGHLY INDEBTED OIL PRODUCING COUNTRIES MERITED SPECIAL ANALYSIS. THE CASE-BY-CASE APPROACH HAD BEEN APPLIED IN FAR TOO STANDARD A FASHION ACROSS COUNTRIES.

5 PRESSED BY RUDING (CHAIRMAN) AS TO WHAT HE MEANT BY INTEREST RATE CONCESSIONS HERZOG REFERRED TO BELOW MARKET RATES OF INTEREST BUT CLEARLY DID NOT EXPECT THE BANKS TO CONCEDE THIS. WHAT HE SEEMED TO HAVE IN MIND WAS THE FINANCING IN SOME WAY OF THE DIFFERENCE BETWEEN MARKET RATES AND WHAT DEBTOR COUNTRIES COULD AFFORD. IN THE CASE OF OIL PRODUCING COUNTRIES HE SUGGESTED LONG-TERM BONDS LINKED TO THE PRICE OF OIL.

6 SOURROUILLE (ARGENTINA) MADE MANY OF THESE SAME POINTS INCLUDING THE NEED FOR INTEREST RATE CONCESSIONS AND BETTER TERMS OF TRADE. ANALYSIS OF DEBTOR COUNTRIES SHOULD BE FOCUSSED ON THE MEDIUM-TERM AND HOW TO GET THERE RATHER THAN ON SHORT-TERM FIRE FIGHTING. THE BAKER INITIATIVE WAS A STEP IN THE RIGHT DIRECTION BUT THE FINANCING INVOLVED WAS NOT ENOUGH. IF THE INTERIM COMMITTEE COULD NOT FIND A SOLUTION TO DEBTORS' PROBLEMS THEN A SEPARATE WORKING GROUP OF THE INTERIM AND DEVELOPMENT COMMITTEES SHOULD BE SET UP. FUNARO (BRAZIL) ALSO TOOK UP THIS POINT BUT STOLTENBERG (GERMANY) SAID THAT SUCH MATTERS SHOULD BE LEFT TO THE EXECUTIVE BOARD. RUDING AGREED.

7 NOUIOUA (ALGERIA) SAID THAT DEBTOR COUNTRIES NEEDED EXCEPTIONAL TREATMENT. ON INTEREST RATES, HE NOTED THAT EXPORT CREDIT AGENCIES OFTEN CHARGED HIGHER THAN MARKET RATES AND THAT THEIR RATES TENDED TO LAG BEHIND CHANGES IN MARKET RATES.

8 SINGH (INDIA) WARNED THAT BECAUSE OF BANKS' RELUCTANCE TO LEND TO HEAVILY INDEBTED COUNTRIES SOME MORE CREDIT-WORTHY COUNTRIES WERE BEING PRESSED TO TAKE ON MORE EXPENSIVE DEBT WHICH THEY COULD NOT AFFORD.

9 RUDING REMARKED ON THE CHANCELLOR'S HAVING SIGNED THE MIGA CONVENTION THAT MORNING AND RECOMMENDED THAT OTHER COUNTRIES FOLLOWED SUIT.

THE EXCHANGE RATE SYSTEM AND SURVEILLANCE

10 THE CHANCELLOR OPENED THIS SOMEWHAT MORE LIVELY DEBATE. (SEE MIFT). THOSE G10 MINISTERS WHO SPOKE RESTATED THE POSITIONS TAKEN AT THE G10 MEETING. BAKER STRESSED THAT THE SYSTEM COULD BE IMPROVED. IT SHOULD FEATURE SYMMETRY IN SURVEILLANCE - OF SURPLUS AND DEFICIT COUNTRIES, LARGE AND SMALL COVERING THE WHOLE RANGE OF POLICIES WHICH AFFECTED EXCHANGE RATES. THE SYSTEM SHOULD ALSO BE FLEXIBLE BUT THE PRESENT SYSTEM WAS ARGUABLY TOO FLEXIBLE. THIS SUGGESTED THE NEED FOR GREATER AUTOMATICITY. A FINAL REQUIREMENT WAS THE POLITICAL WILL TO TAKE THE NECESSARY ACTION WHEN REQUIRED.

11 PRESSED BY THE CHANCELLOR AS TO WHAT HE MEANT BY GREATER AUTOMATICITY, BAKER SAID HE DID NOT ENVISAGE ACTION BEING TRIGGERED BY, SAY, OBJECTIVE INDICATORS BUT BY PEER GROUP PRESSURE. HOWEVER, SUCH INDICATORS COULD BE A FOCUS FOR SUCH PRESSURE.

12 BAKER MADE NO MENTION OF AN INTERNATIONAL MONETARY CONFERENCE. HOWEVER, THIS PARTICULAR FLAG WAS TAKEN UP BY CAMDESSUS (FRANCE) WHO FORCEFULLY RESTATED FRENCH ARGUMENTS IN FAVOUR OF TARGET ZONES (AFTER A NOTICEABLE RECENT RETICENCE BY THE FRENCH ON THIS SUBJECT: THIS MAY INDICATE THAT BALLADUR HAS BEEN PERSUADED TO SUPPORT THEM). HE CITED THE EXAMPLE OF THE EMS WHICH, QUITE THE OPPOSITE OF PROVIDING A ONE WAY BET TO SPECULATORS (AS THE CHANCELLOR HAD SUGGESTED), HAD ACTUALLY REDUCED SPECULATION. IN CONTRAST THE PRESENT SYSTEM, WITH NO RULES FOR OPERATORS, PROVIDED AN INCENTIVE FOR SPECULATORS. BUT THE CHANCELLOR, STOLTENBERG AND SUMITA (JAPAN) WERE ALL CATEGORICALLY OPPOSED TO TARGET ZONES. STOLTENBERG AND ALSO RUDING SAID THAT THERE WERE OTHER EXPLANATIONS FOR THE SUCCESS OF THE EMS AND THAT IT COULD NOT AUTOMATICALLY BE EXTENDED BEYOND THE EEC. BAKER TOO SAID HE DID NOT SUPPORT TARGET ZONES. SINGH AND NEBBIA (ARGENTINA) BOTH SPOKE IN FAVOUR OF TARGET ZONES AS DID KHAN (CHAIRMAN OF THE DEVELOPMENT COMMITTEE, OBSERVING). THEY AGREED THAT THE EXCHANGE RATE SYSTEM SHOULD BE FLEXIBLE BUT THIS WAS NOT PRECLUDED BY TARGET ZONES. THEY ARGUED FOR SETTING UP A SPECIAL JOINT COMMITTEE OF IC/DC DEPUTIES TO LOOK INTO THE QUESTION OF THE EXCHANGE RATE SYSTEM. HOWEVER, THIS IDEA WAS EFFECTIVELY SQUASHED BY BAKER AND STOLTENBERG AND RUDING TOO (WHO STRESSED THE COMPARATIVE ADVANTAGE OF THE INTERIM COMMITTEE IN THIS AREA).

13 IN CONTRAST TO THE SHARPLY DIVERGENT VIEWS ON THE MERITS OF TARGET ZONES THE NEED FOR MORE EFFECTIVE SURVEILLANCE OF INDUSTRIAL COUNTRIES' POLICIES WAS UNANIMOUSLY AGREED. ALL AGREED THAT THE G5 PLAZA MEETING AND MORE RECENTLY THE CO-ORDINATED REDUCTION IN INTEREST RATES WAS A STEP IN THE RIGHT DIRECTION BUT G24 MINISTERS FELT SUCH SURVEILLANCE SHOULD BE FORMALISED WITH REFERENCE TO OBJECTIVE INDICATORS INCLUDING THE EXCHANGE RATE. THE MANAGING DIRECTOR, IN HIS INTRODUCTORY REMARKS, NOTED THE REFERENCE IN THE G10 COMMUNIQUE TO A STUDY BY THE EXECUTIVE BOARD OF HOW OBJECTIVE INDICATORS MIGHT FACILITATE THE SURVEILLANCE PROCESS AND THIS STUDY WAS DULY COMMISSIONED. BAKER SAW OBJECTIVE INDICATORS AS A WAY OF STIFFENING THE RESOLVE OF NATIONAL GOVERNMENTS TO SUBMIT TO INTERNATIONAL SURVEILLANCE BY MAKING PUBLIC KNOWLEDGE THEIR COMMITMENTS TO SELECTED INDICATORS AND THEIR SUCCESS OR FAILURE IN ACHIEVING THEM. HE ALSO SPOKE IN FAVOUR OF PUBLISHING A BRIEF STATEMENT FROM THE MD AT THE CONCLUSION OF IMPORTANT ARTICLE IV CONSULTATIONS. HOWEVER, NO ONE ELSE FAVOURED THIS IDEA. THE CHANCELLOR'S SPECIFIC SUGGESTIONS TO PUT MULTILATERAL SURVEILLANCE IN A MEDIUM-TERM FRAMEWORK WERE WELL RECEIVED. STOLTENBERG AND SUMITA, WHILE PREPARED TO GO ALONG WITH THE G10 LINE ON OBJECTIVE INDICATORS MADE CLEAR THAT AGREEMENT TO STUDY THEM WAS NOT A COMMITMENT TO IMPLEMENT THE FINDINGS OF ANY STUDY. STOLTENBERG REPEATED WHAT HE SAID AT THE G10 MEETING ABOUT SUCH A STUDY BEING A BACK DOOR TO TARGET ZONES AND SUMITA COULD ONLY SUPPORT THE STUDY AS AN ANALYTICAL TOOL. WHITELAW (AUSTRALIA) ALSO RAISED A NUMBER OF PRACTICAL OBJECTIONS.

14 G24 DIRECTORS URGED THAT THE EXECUTIVE BOARD COMPLETE A STUDY OF THE ROLE OF THE FUND BEFORE THE NEXT INTERIM COMMITTEE MEETING.

INTERNATIONAL LIQUIDITY AND THE ROLE OF THE SDR

15 THE FINAL INFORMAL SESSION DEGENERATED EVENTUALLY INTO A REVIEW OF THE PROS AND CONS OF AN SDR ALLOCATION. THERE WERE NO CHANGES IN PREVIOUSLY ESTABLISHED POSITIONS. BAKER, STOLTENBERG, SUMITA AND LEIGH-PEMBERTON ALL SAID THEY REMAINED UNCONVINCED THAT THE CASE FOR AN SDR ALLOCATION HAD BEEN PROVED. WILSON (CANADA) SAID HIS CONSTITUENCY WAS UNABLE TO REACH A CONSENSUS AS CANADA WAS NOT IN FAVOUR ALTHOUGH THE OTHER MEMBERS WERE.

16 BAKER IN PARTICULAR REMAINED FIRMLY OPPOSED. HE EMPHASISED THE CHANGES THAT HAD OCCURRED IN THE MONETARY SYSTEM SINCE THE INCEPTION OF THE SDR NOTABLY THE CHANGE TO FLOATING EXCHANGE RATES AND THE GREATLY INCREASED ROLE OF THE INTERNATIONAL CAPITAL MARKETS. ALTHOUGH HE RECOGNISED THERE WERE WEAKNESSES IN THE PRESENT SYSTEM, IT WAS IMPORTANT NOT TO UNDER-ESTIMATE ITS STRENGTHS. RENEWING SDR ALLOCATIONS MIGHT NOT INCREASE STABILITY IF IT REDUCED THE DISCIPLINE IMPOSED ON COUNTRIES BY THE NEED TO RETAIN CREDIT-WORTHINESS. THE US WAS WILLING TO EXAMINE WAYS TO INCREASE THE USEFULNESS OF THE SDR BUT WERE YET TO BE CONVINCED THAT ANY OF THE PROPOSALS WOULD IMPROVE THE FUNCTIONING OF THE INTERNATIONAL MONETARY SYSTEM. STOLTENBERG EMPHASISED THAT THE SDR WAS A MONETARY INSTRUMENT

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AND NOT A VEHICLE FOR THE TRANSFER OF RESOURCES FOR DEVELOPMENT. THIS WAS SUPPORTED BY OTHERS AND USEFULLY REFLECTED IN THE COMMUNIQUE. ALL THE OTHERS WHO SPOKE ARGUED IN FAVOUR OF RENEWED SDR ALLOCATIONS. GIVEN THE CONTINUING OPPOSITION OF SOME MEMBERS, THEY EMPHASISED THE POSSIBILITIES RAISED BY THE VARIOUS REFORM SCHEMES PUT FORWARD TO TARGET SDR ALLOCATIONS ON THE MOST NEEDY COUNTRIES AND ENCOURAGE LDCS TO RETAIN SDRS IN THEIR RESERVES RATHER THAN SPENDING THEM (RECONSTITUTION). SEVERAL ALSO PICKED UP A SUGGESTION MADE AT THE START OF THE MEETING BY LAROSIERE THAT FURTHER WORK SHOULD BE DONE TO CONSIDER WAYS TO IMPROVE THE ATTRACTIVENESS OF THE SDR AS HE FELT THAT PART OF THE RESISTANCE TO RENEWED ALLOCATIONS REFLECTED SOME OF THE INDUSTRIALISED COUNTRIES' UNWILLINESS TO HOLD ADDITIONAL SDRS IN THEIR RESERVES.

17 THE COMMUNIQUE ASKED THE FUND BOARD TO CONTINUE CONSIDERING THE ROLE OF THE SDR IN THE INTERNATIONAL MONETARY SYSTEM.

16 FCO PLEASE ADVANCE TO PS/CHANCELLOR AND LAVELLE, PS/SIR P MIDDLETON (HMT), PS/GOVERNOR (BANK OF ENGLAND), PS/SIR C TICKELL (ODA) AND MAUD (ERD).

LANKESTER

MONETARY
ERD

SUBJECT
cc Master

JL MJ

10 DOWNING STREET

From the Principal Private Secretary

4 February 1986

Dear Philip,

PRIME MINISTER'S MEETING WITH THE MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND

The Prime Minister had almost an hour's discussion with Monsieur de Larosiere, Managing Director of the IMF, on 3 February about the development of the world economy.

Larosiere said that management of the international debt situation had become more difficult, especially following the recent fall in oil prices. If the oil price fell below $18-19 a barrel, the international debt situation would, in his view, be very difficult to handle. The situation was as dangerous as in 1982. But now the IMF could not pump new money into the system; indeed, the Fund would, over the next few years, receive funds from its members. To that extent the system had lost its buffer. He agreed with Secretary Baker that the World Bank had to be given a greater role. But the Bank must not lower the quality of its lending. In any event, the World Bank finance would be relatively small. He concluded therefore that the commercial banks should make more finance available, for example increasing their nominal exposures to 3 per cent a year compared to the 14 per cent prospective increase in their capital base. Even this increased exposure might not suffice to safeguard the system if oil prices fell to an even lower level.

The Prime Minister commented that commercial banks would want to see the backing for their new loans. If they came to Government for support, the banks would be told that they were on their own. Larosiere commented that he was not suggesting that bank loans should be guaranteed by Governments. But imaginative action needed to be taken to prevent Mexico initiating a domino reaction from other debtor countries.

Larosiere noted a growing political fatigue in some debtor countries. Critics of the existing strategy were increasingly arguing that it was wrong for the developing countries to run trade surpluses and so effectively to transfer resources to the developed world. The Prime Minister agreed that it was distressing for debtor countries, even after taking firm economic action, to see

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the level of their debt increase because of increases in interest rates or falls in the oil price.

Larosiere said that the position of Mexico was crucial. The authorities there had assumed an oil price of $23 in setting their budgetary targets, but now the price has fallen to below $19. Mexico's problems were still probably manageable even with a $19 oil price, though the commercial banks would need to make more new money available. He feared that there were forces in Mexico pushing the country towards a Peruvian reaction. Everything should be done to encourage the goodwill of the Mexican Government.

Larosiere commented that in Brazil the problem was high inflation, stimulated largely by an uncontrolled fiscal position which was pre-empting resources into the public sector. Brazil had been able to sustain this fiscal expansion while resources remained unused as a result of the recession. But soon capacity constraints would make inflation even worse. Argentina had some success in reducing its inflation rate, though unfortunately this was now edging up. Again, the Fund was trying to persuade that country to restrain fiscal policy, with the aim of limiting the fiscal deficit to some 3 per cent of GDP.

The Prime Minister commented on Nigeria that her feeling was that the country still had not taken sufficiently strong measures. Larosiere replied that the Fund had not yet studied the recent budget, but his impression was that more needed to be done on the external side.

Larosiere said that the course of interest rates was crucial for the prospects of the large debtors and interest rates depended on the policy mix in the United States. The Prime Minister said that she believed that confidence in the dollar would remain. The United States was fundamentally a vigorous economy, with a long tradition of self-reliance and no prospect of a Socialist Government. And unlike Europe, it did not have enemies on its border. Larosiere emphasised that the United States had to introduce the proper domestic policies to deal with its internal and external deficit. The Prime Minister expressed her confidence in President Reagan's determination, though she accepted that the real test of the Gramm-Rudman Act would come in its second year of operation.

Concluding the discussion on the international economy, Larosiere said that if there were the right macro policies in the United States, the oil price was stabilised in some way, for example by moderation of production to prevent a slump in the oil price, banks were reasonably co-operative and export credit agencies did not cut back exposure, then the international debt problem would continue to be manageable. But if these conditions were not forthcoming, imaginative solutions would need to be sought, including the conversion of bank debt into equity, greater readiness by developing countries to accept foreign investment, and sales by the banks of debt at a discount.

Larosiere then asked for the Prime Minister's views on the possibility of "an understanding" with OPEC on oil prices. The Prime Minister emphasised that she was firmly against such an approach. The UK was a free economy and it was for the oil companies themselves to decide levels of output. There would need to be a "devastating" situation before the British Government could conceive of restrictions in oil production. Larosiere commented that he was not necessarily opposed to low oil prices, but disliked the speed of change in prices. The Prime Minister agreed, fearing a substantial increase in oil prices in, say, three years' time.

Commenting on the UK economy, Larosiere said that a fall in the oil price would reduce the scope for tax reductions. The UK fiscal position therefore had to be very restricted. The Prime Minister noted the difficulties in judging the tightness of monetary policy. Larosiere agreed that it was necessary to pay attention to many indicators in judging monetary conditions.

I am sending a copy of this letter to Colin Budd (Foreign and Commonwealth Office) and Michael Stark (Cabinet Office).

Yours sincerely
Nigel Wicks

N. L. Wicks

Philip Wynn Owen, Esq.,
H. M. Treasury.

1469/023

CONFIDENTIAL

From : G E Fitchew
Date : 31 January 1986

CHANCELLOR

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

INTERNATIONAL MONETARY FUND : VISIT OF M. DE LAROSIERE

You have agreed to see M. de Larosiere on Monday 3 February at 4 pm. He is visiting London to speak at the Annual Overseas Bankers' Dinner.. He will also be calling on the Prime Minister and the Governor. The main topics which he is likely to want to discuss with you are :-

(a) The outcome of the G5 meeting and the general world economic prospect. Mr Lankester has already briefed de Larosiere in broad terms about G5. But he will want to hear your own assessment both of the meeting and for the outlook on oil and interest rates;

(b) The UK economy. I am attaching at Annex A the IMF staff appraisal, which we have just received, following the Article IV Mission last December. Since their visit we have of course had the sharp fall in oil prices and adjustment of the exchange rate. You will recall that the IMF Staff were urging a tighter fiscal policy and a somewhat more flexible approach to the exchange rate. The Article IV discussion of the UK is to take place on 24 February.

(c) Debt and Baker Initiative. It would be helpful to have de Larosiere's views on the progress of the Baker initiative and on the likely first candidates. You may also like to sound him out on the Fund's approach to the cases of Brazil and Nigeria, both of which have been refusing to negotiate with the Fund on a standby arrangement (though there have been signs in the last few days that both are shifting their position a little). You might also get his reaction to S. Herzog's claim that Mexico is negotiating for a drawing from the Compensatory Financing Facility to help finance the shortfall in its oil earnings. (This would be a change in CFF practice; Oil is not excluded from the CFF, but there has been an understanding that OPEC members would not draw; and no major non-OPEC producer has drawn in respect of a shortfall on oil earnings. The main objection, however, is the doubt as to whether the oil price will recover before the 1990s).

(d) The April Meetings. What kind of discussion and outcome does de Larosiere envisage on the G10 and G24 reports? (At present the IMF plan appears to be to separate the exchange rate/surveillance nexus of issues from the rest of the two reports in the hope that the Interim Committee can reach conclusions on them in April. (This has some attractions if those who are pressing for "target zones" and/or an international monetary conference can be bought off with some strengthening of the IMF's surveillance procedures. If not, the Interim Committee may not be able to go further than a procedural solution, involving further work by the Executive Board in the run-up to the Autumn Annual Meetings).

(e) Other Fund Business. Libya, the Trust Fund and "arrears" cases.

2. I attach some short speaking notes on all these issues. Mr Lavelle will support you at the meeting.

G.E.F.

G E FITCHEW

[redacted]

POINTS TO MAKE

(a) G5 Meeting

(i) Tim Lankester and the press will have told you most of what happened at G5. Important to have confirmed the Plaza Agreement remained in force. Japanese very adroit last week in talking up the Yen, while reducing discount rate. G5 agreed we could not concert interest rate reductions, but that all of us should look for suitable windows to do so, as domestic situation allows. Hope Germans will follow Japanese lead. UK position will depend critically on what happens to the oil price and the exchange rate; can't take risks on inflation.

(ii) (if necessary). No conclusions reached on Italian and Canadian requests to be associated with G5 meetings in some way. All agreed to reflect further on the various options and implications of any new arrangements for other groupings, eg in particular Economic Summit and G10. But US has now supported Italian/Canadian requests and some accommodation with them will have to be found. Some signs that Italians not asking to participate at all G5 meetings, only in operational discussions. Strengthening G10 one possibility; but don't agree with Ruding that this could replace G5. Any views?

(b) World Economy

The world economy is now in a period of low inflation and fairly good growth. The steep fall in oil prices in recent weeks should produce a further fall in inflation and permit lower interest rates worldwide. We are now forecasting that inflation in the major industrialised countries wil fall to an average of 2½ per cent in 1986 (compared with 3½ per cent in 1985) and that the growth of real GNP will pick up to 3 per cent a year (from 2½ per cent in 1985).

(c) UK Economy and Article IV Consultations

Welcome encouragement IMF has given to our policies in recent years. (Any differences of view on detail, not on strategy). Most of sharp fall in oil price has taken place since December Article IV consultations. Exchange rate has fallen no further than would be expected, given fall in oil prices. Have therefore resisted further pressure on interest rates. But monetary policy remains tight; high real interest rates; outlook for further fall in inflation remains more or less unchanged; exchange rate effect offset by lower oil price. But will not take any risks. Fiscal policy also tight; PSBR down to 2¼% or less this year and public expenditure projections flat in real terms, even excluding asset sales. No decisions taken on budget or scope for tax cuts, given uncertainties over oil price. Have made clear need for prudence. Main worry on economy - unemployment and real wage increases.

(d) Baker Initiative and Debt

(i) Welcome Fund and Bank response to Baker proposals, in particular readiness to collaborate. What do you see as next steps? Important for Fund and Bank to reach agreements with two or three countries on Baker-type programmes before Spring meetings. Who are front-runners?

(ii) Position of oil exporting debtors (Mexico, Venezuela, Indonesia, Nigeria) now very worrying. $1 per barrel fall costs them $500m a year each. But was encouraged by Herzog's commitment to adjustment and privatisation when I saw him last week. Understand he has approached you for a CFF drawing to compensate for effect of oil price fall. What is your reaction? Dangers on this, since oil prices unlikely to recover much before 1990s. But would be sympathetic to fuller use of enlarged access facilities in upper credit tranches by oil exporters, provided there is proper adjustment. [Table below shows maxima available to oil exporters under enlarged access].

(iii) Also concern about political reluctance of some debtors (Brazil, Nigeria) to negotiate with Fund. Welcome line you took with commercial banks over Brazil. Our view remains that debtors must have Fund endorsement for their policies as pre-condition for Paris Club rescheduling. Have made this clear to Nigerians*. Clearly an SBA is best solution in both these cases. But Paul Volcker

---

* to be supplemented by record of Mr Lavelle's meeting with Nigerians. (Mr Lankester advises that de Larosiere needs to be reassured that our offer of a new line of credit to Nigeria was conditional on IMF endorsement).

suggested at G5 meeting that we might <u>in extremis</u> need to consider other forms of Fund endorsement, provided the adjustment programmes are right. What do you think?

(e) <u>G10/G24 Reports</u>

How do you see these being handled at Interim Committee? Hope we can avoid any commitment to an international monetary conference. Would be unlikely to lead anywhere on exchange rates (no consensus on "target zones"); and could cause difficulties both on debt and for the GATT MTNS.

(f) <u>Other IMF Issues</u>

Hope Fund can avoid embroilment over Libya. Our ED was instructed to vote that US action was taken purely on security grounds†.

Welcome new US proposals on Trust Fund. These now close to IMF's own proposals. Should be possible to reach a consensus.

Growth of arrears to IMF worrying. Progress on Zambia and Gambia, but Sudan gets worse. See no alternative to case-by-case financial packages** Will do what we can within limits of the aid programme.

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† to be updated on Monday in light of Friday's Board discussion.

** Glad we were able to help put together package for Zambia.

file

ECL

bc PC

10 DOWNING STREET

From the Private Secretary 12 December 1985

**INTERNATIONAL MONETARY FUND:
MANAGING DIRECTOR'S VISIT TO LONDON**

The Prime Minister has noted from UKDEL IMF/IBRD telegram number 231 that the IMF Managing Director will visit London on 3 February. The Prime Minister would like to see him and could manage a half hour meeting at 1500 that day.

I am copying this letter to Rachel Lomax (H.M. Treasury).

(Charles Powell)

P.F. Ricketts, Esq.,
Foreign and Commonwealth Office.

FC(84)3
11 DECEMBER 1984

COPY NO.

HER MAJESTY'S TREASURY

IMF: UNITED KINGDOM CONSULTATIONS 1984

Attached is a copy of the concluding remarks delivered by Mr Schmitt, Head of the IMF team, at the closing session of the Article IV consultations on Monday 10 December.

H M TREASURY

December 10, 1984

Concluding Remarks

1. The United Kingdom has been an early pioneer in the pursuit of policies that have become an international norm. It is now part of a broad consensus among the major countries that the control of inflation is a necessary condition for sustained economic growth. It is also generally accepted that this objective is to be achieved by monetary and fiscal restraint. The experience with such policies in the United Kingdom is therefore of keen interest to the international community which we represent.

2. The success you have had with your financial strategy has been considerable, but it has not been without stress. The growth in nominal GDP has been lowered progressively from over 15 percent in 1979-80 to less than 7 percent by the first half of 1984, and the split between price inflation and output gains has become more favorable. Price inflation has been brought down below 5 percent--but wage inflation remains at nearly 8 percent. Output growth reached 3 1/2 percent in 1983 and on a strike-adjusted basis in 1984 as well--but not without putting pressure on the external position. And unemployment has contined to increase and now stands at 13 percent of the labor force.

3. With inflation down to a much lower level, increasing concern is being expressed about unemployment. There are two views on the mix of factors that have brought it to its present level, and on the most effective

ways of ameliorating it. According to one view, a large part is attributable to a persistent deficiency in aggregate demand stemming from overly restrictive financial policies. According to the other view, the bulk of it is attributable to excessively high and rising real wage levels. We see greater risks in tilting towards expansion than in maintaining restraint.

4. We appreciate that it would be less difficult for you to sustain downward pressure on prices if unemployment had come down as you expected it to do a year ago. We also understand that any tilting is taking place within the scope of a broadly unchanged medium-term strategy. You continue to target a zero inflation rate, at least by 1993; by that time you expect the PSBR to have come down to 1 percent of GDP, a rate that would allow the public debt to rise in tandem with nominal GDP. We are nevertheless concerned about a policy stance this year and next that promises no better than to leave price inflation unchanged at just under 5 percent.

5. The expansion of your main monetary aggregates has thus far remained within the target ranges set for them at the beginning of the financial year. However, these target ranges have proved consistent with developments in domestic interest rates relative to those abroad that have depressed the exchange rate by as much as 10 percent in the twelve months to October 1984. There has been need on occasion, particularly in July, to adjust interest rates upward to minimize the inflationary threat from this quarter. There clearly is a limit to the extent to which the U.K. can decouple its real interest rates from those in the U.S. in current conditions of fairly mobile capital. To the extent it cannot, monetary expansion will only depress the exchange rate and drive up prices.

6. Though the main monetary targets may still be met this year, the PSBR is all but certain to exceed the level specified in the budget. The whole of the excess is due to spending overruns inasmuch as revenues are also higher than anticipated. However, any adverse effects on domestic interest rates from the higher borrowing requirement is likely to be small, linked as domestic rates are to those abroad, and the net stimulus to activity is therefore likely to have been appreciable. Within a given monetary environment, furthermore, the higher level of activity is likely to have held exchange rates up and prices down compared to where they would otherwise have been.

7. A progressive lowering of the PSBR was originally intended to minimize the effect of the anti-inflationary strategy on interest rates. Now that this effect appears to be much smaller than once thought, the urgency of reducing the borrowing requirement looks to be rather less strong than before. To bring it down this year and next increased reliance is therefore being placed on oil revenue and on asset sales neither of which have a major impact on demand or on monetary conditions. Making the necessary adjustments shows the PSBR rising in relation to GDP not only above the level budgeted for this year, but above the level registered the year before (see Table).

8. While such developments may not appear overly disquieting in the immediate present, they do store up dangers for the future. The danger of particular concern to us internationally is the demonstration effect on other countries which, like the U.K., may not individually have a signicant effect on world interest rates but collectively certainly do. Even

individually, acquiescence would have to delay the time when the growth of public debt in the U.K. can be scaled down to leave room for private debt to expand in a framework of non-inflationary growth. Any short-term gain will therefore come at a considerable long-term loss.

9. With a continued tight fiscal policy a degree of monetary ease might still be defensible if downward pressure on the exchange rate were to succeed in improving competitiveness. Improvements in competitiveness did occur after 1981 because extensive labor shedding raised productivity fast enough to absorb wage increases. These productivity increases dropped sharply in 1984, and as wages continued to rise, unit labor costs jumped by 6 1/2 percent, a rate well above the current rate of price inflation. As long as wages continue to rise more rapidly than prices, it will be difficult to improve competitiveness by exchange depreciation. Monetary ease will then be largely spent on rising prices rather than on increased output and employment.

10. It seems to us that the troublesome increases in real wages may in large part reflect a lag in the downward adjustment of inflationary expectations behind the fall in actual inflation. Wage contracts set nominal wages that, given price expectations, should produce a real wage that will clear the market. If actual prices turn out to be higher, real wages will be lower and employment temporarily higher than the equilibrium level; if actual prices are lower, real wages will rise and employment be reduced. A policy of continued financial restraint may well be best suited to narrowing the distance between them and to bringing unemployment down.

11. Seeking to correct a deficiency of aggregate demand may thus be counter-productive. A direct attack on real wages would seem to carry more promise. One feature in the functioning of labor markets deserves particular attention in this regard. In finding the market clearing wage, the effective supply seems often to be limited to those workers still employed. In such cases there is little scope for the real wage once set to be reduced, and no direct way therefore to re-employ those once out. There is need to reduce the barriers to entry not only for new entrants into the labor market, but for anyone seeking a job.

12. The functioning of labor markets has already improved in a number of ways in recent years. Thus the pay of young workers, relative to that of adults, seems to have been falling for some time now, suggesting that their share in total employment may now begin to increase. Similarly, the growth in employment in recent years seems to be accounted for entirely by women in part-time work where wage costs are not inflated by government or trade union policy. Much more needs to be done before such impediments to employment are reduced for adult full-time workers as well. There is no doubt, however, that supply-side measures will need to concentrate in this area before the benefits of an anti-inflationary policy can be fully realized.

13. We would also like to note the contribution to a more competitive economy that can be made by a continued liberalization of trade. Similarly, we hope that you will resist pressures that may develop to limit official development assistance unduly.

14. Because the U.K. was one of the first countries to initiate a coherent anti-inflationary policy, its problems as well as its successes are of keen interest to the world at large. You are clearly a vital component in the application of that policy on a global scale. We are gratified by the resolve you have shown in persevering with it even in difficult times. Any slippage from it could adversely affect expectations well beyond your own borders. We therefore continue to wish you well.

PSBR Actual and Adjusted

	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86
1. in billions of pounds sterling							
PSBR, actual	10.0	12.6	8.6	8.9	9.7	8.4	7.0
plus oil revenues	+ 2.4	+ 3.8	+ 6.4	+ 7.8	+ 8.9	+ 12.0	+ 12.0
less permanent income from oil	- 1.6	- 1.9	- 2.1	- 2.2	- 2.3	- 2.4	- 2.5
plus special asset sales 1/	+ 1.0	+ 0.4	- 0.1	+ 0.5	+ 1.1	+ 2.3	+ 2.5
PSBR, adjusted	11.8	14.9	12.8	15.0	17.4	20.3	19.0
2. in percent of GDP							
PSBR, actual	4.8	5.3	3.3	3.1	3.2	2.6	2.0
PSBR, adjusted	5.7	6.3	4.9	5.3	5.7	6.2	5.4

Source: H.M. Treasury

1/ Excluding sales of Council Houses

3 Feb 3.00

Prime Minister
Agree to see him?
CDP

Yes mo

GRS 200

CONFIDENTIAL

CONFIDENTIAL
FROM UKDEL IMF/IBRD, WASHINGTON
TO PRIORITY FCO
TELNO 231
OF 102200Z DECEMBER 85

IMF: MANAGING DIRECTOR'S ONE DAY VISIT TO LONDON - 3 FEBRUARY

1 THE MANAGING DIRECTOR IS ATTENDING AND SPEAKING AT THE ANNUAL BANQUET OF THE OVERSEAS BANKERS IN LONDON ON MONDAY, 3 FEBRUARY. HE HAS ASKED WHETHER, DURING THAT DAY, STARTING AROUND 9.30-10.00 AM AND FINISHING BY AROUND 5.30 PM IT WOULD BE POSSIBLE TO MEET AS MANY OF THE FOLLOWING AS ARE FREE TO SEE HIM: THE PRIME MINISTER, THE CHANCELLOR, THE GOVERNOR, SIR GEOFFREY LITTLER, SIR JEREMY MORSE AND LORD RICHARDSON. EXACTLY WHAT HE WISHES TO DISCUSS WILL NO DOUBT DEPEND UPON PROGRESS ON THE INTERNATIONAL DEBT FRONT BETWEEN NOW AND THEN. (WE SHALL BE ABLE TO ESTABLISH THIS BETTER NEARER THE TIME.)

2 I SAID THAT I WAS SURE HE WOULD BE WELCOME [illegible] DIARIES WERE FREE AND SHOULD BE GRATEFUL FOR ADVICE, IN DUE COURSE, OF WHAT MAY BE POSSIBLE.

3 FCO PLEASE ADVANCE TO PS/PRIME MINISTER, PS/CHANCELLOR, LITTLER AND FITCHEW FOR LANKESTER (HMT), PS/GOVERNOR, LOEHNIS AND WARE (BOE). PLEASE DISTRIBUTE TO ADDRESSEES ONLY.

FOOT

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NBPM
AT 17/6

PRIME MINISTER 6 June 1985

DEBT AND THE IMF

This paper by Vaubel has been prepared for my Committee. It is concise, incisive and, in my view, correct.

The essence is in the first 8 pages where it suggests that IMF conditionality should be a pre-condition of a loan and not a fragile promise of future performance.

This Vaubel type of pre-conditionality would require countries to have both monetary and fiscal control, together with free and open markets, before they qualify for multinational assistance.

AW

ALAN WALTERS

Roland Vaubel*

April 1985
First Draft

THE INTERNATIONAL ORGANISATIONS AND THE INTERNATIONAL DEBT PROBLEM: THE NEXT STEPS

1. The immediate reaction to the international debt crisis of 1982/83 has been a substantial expansion of subsidized public lending to the debtor countries. The most dramatic step was the increase in IMF quotas by more than 47 per cent. As a result, IMF lending adjusted for inflation is now four times larger than in 1970.[1)] The ratio of IMF lending to world exports is now more than 50 per cent larger than it was in 1970 or 1980.

   To many observers, this increase in IMF lending appeared to be necessary to ward off a collapse of the banking system. From an economic point of view, this was somewhat surprising; for the prevention of liquidity crises is normally considered the task of the national central banks. The latter are better suited for this purpose because they can act as a lender of last resort to specific banks in difficulty. They would not indiscriminately subsidize the whole banking system by granting concessionary loans to a group of its debtors.

1) IMF lending is defined as the stock of granted loans, regardless of whether they have been drawn or not. Holdings of SDRs are treated as undrawn loans. The figures have been deflated in terms of dollars by the U.S. GNP deflator. See Table 1 on the following page.

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* The author is professor of economics at the University of Mannheim, W. Germany. This analysis has been prepared for the committee on international economic policy constituted in London on November 30, 1984.

TABLE 1

[illegible] Lending

SDR b. outstanding at the end of	1955	1960	1965	1970	1975	1980	1984
Special Drawing Rights (net cumulative allocations)	-	-	-	3.4	9.3	17.4	21.4
Buffer Stock Facility	-	-	-	-	0	0	0.4
Compensatory Financing	-	-	0.1	0.1	0.7	2.8	7.5
Oil Facilities	-	-	-	-	4.8	1.9	-
Trust Fund Loans	-	-	-	-	-	1.3	2.8
Credit tranche drawings	0.1	0.4	2.9	2.9	1.8	2.6	14.1
Extended facility drawings	-	-	-	-	-	1.1	12.9
Undrawn balances under							
- Standby arrangements	0.1	0.4	0.3	0.2	1.0	2.3	3.6
- Extended arrangements	-	-	-	-	0.1	3.9	3.0
Total IMF Lending							
- in SDRs	0.2	0.8	3.3	6.6	17.7	33.3	65.7
- in 1975 US dollars	0.4	1.5	5.6	9.1	20.7	30.2	36.1
- relative to world exports	.002	.007	.020	.023	.026	.023	.035

Sources: IMF, International Financial Statistics, Supplement on Fund Accounts, Yearbook 1982, and February 1985 issue.

2. These quarrels are bygones. Now that the immediate crisis has been weathered, the perspective has shifted. The time for short-term crisis management is over. It is increasingly necessary to take a longer-term view. Two long-run dangers in particular have to be averted.

First, the handling of the debt crisis must not encourage the governments of debtor countries to become more imprudent in their economic policies. This is the "moral hazard problem".

Second, the experience of the debt crisis must not induce private lenders to stop exporting capital to the developing countries. This is the "capital flow problem".

If those problems are not solved, the debt crisis is likely to repeat itself. In what way can international organisations like the IMF and the World Bank be made to contribute to the solution of these problems?

THE MORAL HAZARD PROBLEM

3. If those who are in trouble because of their own fault, receive aid, subsidized loans or insurance payments as a result, they and all other potential recipients have less of an incentive to avoid such trouble. In insurance economics, this danger is called "moral hazard"; in the context of aid, it has aptly been dubbed "the Samaritan's dilemma"(Buchanan).

Is there any reason to believe that the debtor countries have (at least partly) been responsible for their defaults? There is no doubt that the causes of the debt crisis have partly been external to the debtor countries: the oil price increase of 1979, the appreciation of the dollar, the world recession, the deterioration of the debtor countries' terms of trade, the increase in real interest rates, etc. Most of these were the result of disinflationary monetary policy in the United States. But was it so improbable that U.S. inflation would be fought at some point? At the very least, prudent dollar debtors would have allowed for a considerable margin of risk.

This interpretation is supported by the fact that a sizable number of debtor countries - especially in Asia - managed to avoid default. The performance of the various debtor countries has differed very considerably. This can also be shown over a longer period: from 1960 to 1982, 14 out of (on average) 114 member countries accounted for 80 per cent of the reschedulings, and 42 countries received 78 per cent of the standby and extended credits from the IMF.[1] This is not the outcome one would expect if the trouble had been due to unfavourable random disturbances. A recent study by Donovan demonstrates that the defaults have to be attributed to the internal fiscal and monetary management of the debtor countries rather than to external shocks.[2]

Finally, there can be doubts whether the debtor countries have done everything in their power to meet their obligations once the crisis had developed. After all, they were not insolvent. For instance, they could have sold public property or mineral exploitation rights, or they could have offered such assets as collateral.

With regard to moral hazard, it is important to note that IMF lending is subsidized in several ways. Standby credits beyond 200 per cent of quota and extended facility credits beyond 140 per cent of quota, for example, are subject to periodic charges which are linked to the yield on certain U.S. government

1) See my "The Moral Hazard of IMF Lending", in: Allan H. Meltzer, ed., International Lending and the IMF. A conference in Memory of Wilson E. Schmidt, The Heritage Lectures, 21, Washington, D.C., 1983; reprinted in: The World Economy, Vol. 6, Nr. 3, London, September 1983; a German version "Wozu IWF-Kredite?" appeared in: Wirtschaftsdienst, Vol 64, Nr. 8, Hamburg 1984. The number of reschedulings and standby or extended credits, respectively, has been weighted in each case by the number of years to which the rescheduling or the credit applied.

2) Donal J. Donovan, Sources of External Servicing Difficulties, International Monetary Fund, December 1983, summarized in: Finance and Development, Dec. 1984.

securities. If a country uses its Special Drawing Rights, it has to pay a weighted average of treasury bill rates in the five major currencies. Since the typical IMF borrower represents a high credit risk, he would have to pay a higher interest rate in the international capital market. In the market, his risk premium may even rise to infinity, i.e., he may not be considered creditworthy at all. Since the borrower would not want loans from the IMF if he could get them more cheaply in the market, they are subsidized almost by definition.

Hence, a moral hazard problem is almost certain to exist.

4. The moral hazard problem can be reduced by attaching policy conditions to the loans. There are two relevant effects. On the one hand, acceptance of conditions can improve the creditworthiness of the debtor and thereby reduce the element of subsidization which the predetermined interest rate implies. On the other hand, policy conditions may prevent the debtor from wasting the money in order to ask for more. However, in recent years, the Fund's performance criteria have actually been fulfilled in only about 20 per cent of cases.[1)]

The present form of IMF conditionality, if effective, could prevent the borrowing governments from staying in trouble in order to get more money. But there is still the problem that the prospect of subsidized IMF credits reduces the cost of getting into trouble in the first place. It weakens the incentive to avoid imprudent economic policies. It strenghtens the incentive to declare default. To minimize this remaining type of moral hazard, it is necessary to reform IMF conditionality.

1) See the study by G. Bird, "The International Monetary Fund and Developing Countries: Retrospect and Prospect", De Economist, vol.131, 1983, pp. 161-195.

- 5 -

IMPROVING IMF CONDITIONALITY

5. At present, policy conditions are only formulated after the "needs test" has been passed. Moreover, they are negotiated on a case-by-case basis; they are not predictable. Obviously, IMF conditionality would be much more effective and efficient, if it did not operate ex post and ad hoc but ex ante and in accordance with general rules. The rules should be announced in advance, apply to all potential borrowers and concern their policies before and after the lending. The general ex ante conditions which the IMF (and any international public lender) could formulate might usefully relate to

i) the excess of monetary expansion over real economic growth,

ii) the budget deficit relative to GNP,

iii) the existence of minimum wages and price and interest controls,

iv) the extent of trade barriers and exchange controls, and/or

v) the expropriation of foreign and/or domestic investors.

6. General ex ante conditionality is practiced, for example, by national lenders of last resort, the central banks. Commercial banks have to satisfy certain preannounced conditions in order to be eligible for discounts credits. They would not even be admitted to the banking industry, if they did not comply with these rules.

Civil servants at the international lending institutions are interested in large budgets and the power to formulate policy conditions, but - like all political decision makers - they are more interested in case-by-case discretion than in the mere application of predetermined general rules. If conditionality is to be reformed, the initiative has to come from those who control them: from the national member governments.

It is important that the conditions should relate to policy instruments or easily controllable intermediate targets; for without controllability there can be no responsibility. In particular, the conditions should not focus on remote endogenous economic variables like the current account balance[1]; performance criteria with respect to hardly controllable variables are not only likely to be missed (as IMF experience shows), they are also unlikely to exert much influence on the conduct of economic policy.

7. One of the Fund's favourite policy conditions is devaluation. Thanks to the monetary and the portfolio-balance aaproach to the balance of payments, it is now widely recognized that devaluation increases the current account balance at most, if at all, temporarily, and that its only important lasting effect is a boost to the price level. Moreover, devaluation is not a necessary condition for a larger current account balance. If monetary policy is assigned to the exchange rate target, while fiscal policy is used to lower domestic absorption, net capital imports and the current account deficit can be reduced without recourse to devaluation and additional inflation. If exchange rate fixity meant inflation at home, it would be better, of course, to let the currency appreciate.

1) In the case of the current account, there is the additional problem that this target has no obvious normative significance. A current account deficit and the concomitant net capital imports, for example, may indicate high productivity and creditworthiness rather than a policy problem. Alternatively, where the current account deficit is a problem, it may be due to borrowing from the IMF (which is a form of official capital import and, therefore, tends to increase the deficit).

8. The debtor countries have asked for an additional allocation of Special Drawing Rights, but they are not likely to obtain it in the near future. The reason is that SDRs are unconditional liquidity: no policy conditions may be attached to their use - not even ex post and ad hoc.

Resistence to further increases in IMF lending is justified for several reasons. It is not only that the immediate threat to the banking system is over. There may, it is true, be also humanitarian grounds for additional public lending to these countries (even though the major debtors are among the richest developing countries). But there can be no doubt that the IMF is not the appropriate institution to distribute development aid. The IMF staff is not specialized in this field, and its lending operations take the form of money creation in the donor countries. To declare the IMF responsible for international aid is like assigning domestic social policy to the national central bank.

THE CAPITAL FLOW PROBLEM

9. One of the main consequences of the debt crisis is that (current and potential) private lenders have lost confidence in the creditworthiness of the developing countries. For the time being, some "fresh money" is still provided by the banks because the governments of the developing countries might otherwise repudiate their debt completely and cause several of the creditor banks to collapse. However, as the banks are gradually building up reserves and increasing their equity capital, the threat potential of the developing countries diminishes and their share in new international bank credits is likely to shrink even further.

In these circumstances, the developing countries have to find new sources of finance if they want to continue to import private capital from abroad. One possibility might be bond financing, for bonds can be sold to non-bank lenders that are much less sensitive to their debtors' defaults than the banks. However, as the experience of the 1930s has shown, the probability that the developing countries might also default on their bonds, is by no means negligible. Thus, the developing countries cannot sell a large amount of bonds, even if they offer very high real interest rates.

A more promising source of finance is direct and portfolio investment by foreigners. From the point of view of foreign investors, it possesses the advantage that the governments of the developing countries do not have to service it. Political risks remain - notably the risk of expropriation. But it is one thing to default on one's debt service, and quite another to violate the right of property by expropriating foreigners. It is therefore important to ask whether existing obstacles to direct and portfolio investment in developing countries can be reduced in an efficient way. One suggestion that has to be considered is the World Bank proposal of a "Multilateral Investment Guarantee Agency" (MIGA)[1].

MULTILATERAL INVESTMENT GUARANTEES

10. The World bank proposes the establishment of an international public agency which sells insurance cover against non-commercial risks to foreigners investing in developing countries. Non-commercial risks include currency transfer risk, expropriation risk, the risk of breach of legal commitments by the host government and the risk of war or "civil disturbance" (Art. 11). At least initially, the agency is to focus

1) Draft Outline of the Convention Establishing the Multilateral Investment Guarantee Agency, World Bank, Legal Department, Washington, D.C., October 1, 1984.

on new private direct investments that serve a developmental purpose and are authorized by the prospective host country (Art. 12-15).

The agency starts its operations when at least ten developing countries and five industrial countries have joined it and have paid ten per cent of their subscriptions to its capital. In addition to operations based on share capital and reserves (accumulated fees), members may sponsor investments for guarantee, incurring loss-sharing liability for them on a pro rata basis with other sponsoring members (Art. 25-27). The agency would also reinsure national or regional investment guarantee agencies and private political risk insurers (Art. 19-21).

All members of the World Bank and Switzerland may join the agency (and its sponsorship fund). In the agency's council, the developing countries and the industrial countries would each have 50 per cent of the votes (Art. 45). The President of the World Bank would be ex officio chairman of the agency's board of directors. He would have no vote except in the (likely) case of an equal division (Art 38). The president of the agency would be nominated by the chairman of the board and be appointed by the board.

Where the agency compensated an investor under the contract of guarantee, it would assume his legal rights to collect damages from the host country (Art. 18). Disputes with host countries would ultimately be settled by a tribunal in which an arbitrator appointed by the Secretary General of the International Center for the Settlement of Investment Disputes (ICSID) is likely to have the casting vote (Annex, Art. 4). The Secretary General of ICSID is Vice President of the World Bank.

11. What arguments are there in favour of a multilateral public agency that insures foreign direct investment in developing countries against political risk? Why not leave this task to the private political risk insurance market which has rapidly grown in recent years?

One possible answer, which is given by the World Bank staff[1], is that many investments are not and cannot be insured in the market: private insurers normally limit their cover to three years, shy away from large projects, and are reluctant to cover war risks. This answer will not do. As one of the major controversies in post-war economics (Pauly et al. v. Arrow) has shown without doubt, the cost of insurance can often exceed its benefits. The absence or unavailability of insurance cover for certain risks is no proof of market failure and hence no reason for governments to step in.

The only argument which may carry some force is that, ultimately, a multilateral public agency might develop economies of scale in its risk diversification which the private insurance market cannot achieve. Empirically, it is not clear that this argument applies, but it is conceivable. However, if economies of scale are the justification, the agency need not subsidize its product on a long-term average.

12. Subsidized public provision of political risk insurance is not only unnecessary it is also clearly detrimental; for it would reward the developing countries to the degree that their governments generate political risks. Exchange restrictions, expropriation and breaches of legal commitment are not natural desasters but acts of policy. A public insurance which subsidized political risk bearing,

1) Cf. Multilateral Investment Guarantee Agency: Questions and Answers, World Bank, Washington, D.C., July 3, 1984.

would weaken the politicians' incentives to reduce political risk. The probability of damage would increase. Once more, avoidable moral hazard would be created. 1)

Does the World Bank proposal provide for subsidies? The draft outline does not indicate how the insurance premiums and fees are to be determined; it merely states that

> "the terms and conditions of each contract of guarantee shall be determined by the Agency subject to such rules and regulations as the Board shall issue" (Art. 16)

and that

> "the President shall, pursuant to general policies to be established by the Board, determine premiums to be charged for guarantee and reinsurance operations and fees and charges for services rendered by the Agency (Art. 32).

According to Article 31,

> "the Agency shall carry out its activities... with a view to maintaining to the extent possible its ability to meet its financial obligations without resort to the callable portions of members' subscriptions".

The World Bank's Commentary to the Draft Outline interprets this statement as follows:

> "It is fully anticipated that the Agency will ultimately finance itself from its own revenues and will operate at no cost to its members" (p. 13).

1) For moral hazard to exist, it it not necessary that the insurance alters the behaviour of the insured. It is sufficient that the insurance increases the expected value of the damage. Unemployment insurance, for example, creates a moral hazard not only by altering the behaviour of the insured but also by affecting the behaviour of the trade unions.

The only type of subsidy which would not create moral hazard would be a subsidy paid by the host country itself. However, if this was the only aim, there would be no need for a public insurance agency;the developing countries could simply offer to pay part of the insurance premia which private political risk insurers demand.

But this commentary is not part of the draft convention. The agency must be obliged by its charter to avoid any subsidisation of political risk insurance - at least on a longer term average (to be defined in the Convention).

The Vice President of the World Bank has agreed that

> "the agency must become self-sustaining over the medium term. Administrative expenses and claims would have to be met through premium revenues and returns on invested reserves"[1)]

It ought to be noted, however, that this is not sufficient to avoid subsidisation on a longer term average. This is because, according to the draft outline, the member governments would not receive a market rate of return on their capital subscriptions, neither on the funds they have paid in nor for the liabilities they undertake. They would risk their taxpayers' money for nothing in return.

Even if the agency earned a market rate of return on its capital and allocated its net income to its reserves (Art. 33), member countries which chose to withdraw from the agency would not be entitled to (their) part of the accumulated earnings. Art. 56 merely states that

> "the Agency shall enter into an arrangement with such a state for the settlement of their respective claims and obligations".

Finally, if the agency is to operate without subsidies and on an equal footing with private political risk insurers, it must not be "exempt from all taxes and duties" (Art. 52).

1) Ibrahim F.I. Shibata, "Increasing private capital flows to LDCs. An examination of the proposed multilateral investment guarantee proposal", Finance and Development, December 1984, p. 8.

The convention has to be altered to exclude any form of subsidisation on a longer term average. Otherwise, the agency would reward mistaken policies in the host countries and obtain an unjustified competitive advantage over private insurance companies.

Is a Multilateral Investment Guarantee Agency likely to avoid subsidisation over a longer run? The World Bank Staff emphasizes that very few national investment guarantee schemes have made losses over a longer term.[1] What is less clear is whether this could also be said if the national agencies had to pay a market rate of return to the taxpayers and taxes to the government.

13. A multilateral insurance against political risks need not weaken the political incentive to reduce political risks. If properly designed, it may even strenghten this incentive. This would be the case if the agency could use sanctions against those member countries which expropriated direct investors from abroad without adequate compensation, which imposed exchange controls or which failed to honour their legal commitments. The following sanctions in particular would be easy to implement:

- if the host country does not fully compensate the investor (or, after subrogation, the insurance agency), its subscription to the agency's capital is used as a pledge;
- if the host country does not pay full compensation for damage, it is excluded from any further investment guarantees;
- if the host country does not pay full compensation, it is excluded from any further loans of the World Bank Group and the IMF.

1) Multilateral Investment Guarantee Agency: Questions and Answers, op. cit.

Article 55 of the draft outline states that

> "if a member fails to fulfill any of its obligations under this Convention, the Council may suspend its membership".

Since the draft convention does not oblige the host countries to avoid political risks or to always pay full compensation for them, it has to be clarified whether the draft would permit the first two sanctions. Moreover, deterrence would be more credible and effective, if the council were not merely permitted, but obliged to impose these sanctions. The third type of sanction (exclusion from World Bank and IMF loans) is not envisaged by the draft convention at all.

Perhaps it ought to be emphasized that the first and the third sanction could be introduced regardless of whether a multilateral investment guarantee agency is established. For the first sanction to become available the government of a developing country would merely have to be willing to deposit a pledge with a foreign public or private institution in order to increase foreign confidence in its own policies. Since the governments of developing countries have not chosen this route in the past, one may doubt that they would want to join a multilateral institution that could impose such sanctions.

15. The Multilateral Investment Guarantee Agency proposed by the World Bank would discriminate between direct investment by foreigners and direct investment by residents. Even if the agency's insurance cover was not subsidized, it would introduce an economic distortion.[1] The most probable effect of this distortion

1) It might be argued that some discrimination in favour of foreign investors is justified because their political risks are larger. In this case, however, nondiscrimination would imply that only the foreign investors' excess political risk be insured.

is that the additional capital imports would largely be offset by additional capital exports of LDC residents. As the experience of the last decade has shown, considerable offsetting of this type is likely, even if neither insurance discrimination nor free convertibility exists.

The World Bank staff has recognized this problem and suggested that "if MIGA members so desire, its operations might be extended to domestic investors in certain situations."[2] Will many members agree to such a solution?

15. International agencies, like all bureaucracies, are constantly in danger of succumbing to Parkinson's Law. Their staffs grow, unless limits are imposed from the outside. In the present case, no such limits are set. On the contrary, the draft convention defines MIGA's tasks very broadly: it should

> "carry out research and disseminate information on investment opportunities in developing countries ...and ..., upon request of a member, provide advice on improvement of the investment climate in its territory" (Art. 23).

Most of these services are already provided (free of charge) by other multilateral development institutions. Moreover, since it is very important that MIGA should offer its insurance services on strictly commercial terms, it might be advisable to prevent it from providing <u>any</u> free or partly subsidized services. Otherwise, the non-subsidisation principle would be difficult to enforce in MIGA's insurance activities.

1) Multilateral Investment Guarantee Agency: Questions and Answers, op. cit., p. 43.

If the establishment of a multilateral investment guarantee agency is to represent a shift of emphasis in the international development effort - a shift in response to the debt crisis rather than an attempt to devote more public resources to development policy - , then the staff of the new agency might be usefully recruited from the personnel of the World Bank Group which would shrink correspondingly.

It is true that, under certain conditions, a multilateral investment guarantee agency could serve "to improve the efficiency of worldwide resource allocation", as the World Bank suggests.[1] However, it seems doubtful that these conditions are satisfied by the World Bank's proposal.

1) Multilateral Investment Guarantee Agency: Questions and Answers, op. cit., p. 6.

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DESKBY 220800Z

FM UKDEL IMF/IBRD WASHINGTON 200127Z APR 85

TO IMMEDIATE FCO

TELNO 54 OF 19 APRIL 85

AND TO BRASILIA (FOR LADY YOUNG)

INFO UKDEL OECD, UKMIS NEW YORK, UKMIS GENEVA, DELHI, BONN, PARIS, ROME, TOKYO, OTTAWA.

MEETINGS OF THE INTERIM AND DEVELOPMENT COMMITTEES HELD IN WASHINGTON ON APRIL 17-19, 1985.

SUMMARY.

1. THE CHANCELLOR OF THE EXCHEQUER AND THE GOVERNOR OF THE BANK OF ENGLAND ATTENDED THE MEETINGS. THE MEETING'S NEW INFORMAL FORMAT MADE FOR BETTER DEBATE. CONCERN ABOUT LOWER UNITED STATES GROWTH DID NOT (REPEAT NOT) PROMPT CALLS FOR OTHER COUNTRIES' REFLATION. CASE-BY-CASE APPROACH TO DEBT GENERALLY ENDORSED. DEVELOPING COUNTRIES IN REALISTIC AND PRACTICAL MOOD. LITTLE PRESSURE FOR A TASK FORCE ON DEBT OR FOR POLITICAL DIALOGUE. DIFFICULT DISCUSSIONS ON TRADE WITH PERHAPS SOME HARDENING OF G24 POSITIONS AND INDIAN INTRANSIGENCE LEADING TO UNSATISFACTORY REFERENCE TO TRADE LIBERALISATION IN COMMUNIQUE. NO SPECIAL FOLLOW-UP MEETINGS CONTEMPLATED.

MO

DETAIL

FORMAT OF MEETINGS.

2. THE COMMITTEES MET FOR THE FIRST TIME WITH SHORTER PLENARIES AND WITH RESTRICTED INFORMAL SESSIONS. THIS NEW FORMAT WAS A QUALIFIED SUCCESS, WITH FINANCE MINISTERS EFFECTIVELY DOUBLING THEIR PRODUCTIVITY BY COMPLETING IN THE MORNING PLENARY SESSIONS WHAT HITHERTO HAD TAKEN A COMPLETE DAY. THE INFORMAL RESTRICTED SESSIONS DID NOT AVOID SET-PIECE INTERVENTIONS, BUT PROMPTED SOME LIMITED DEBATE AND FRANKER SPEAKING THAN USUAL.

THE WORLD ECONOMY

3. THERE WAS GENERAL AGREEMENT THAT THERE HAD BEEN PROGRESS IN RESTORING STABILITY AND GROWTH TO THE WORLD ECONOMY AFTER THE RECESSION OF THE EARLY 1980S AND THE TURBULENCE OF THE DEBT CRISIS. THE PUBLICATION DURING THE MEETINGS OF THE UNEXPECTEDLY LOW US GROWTH FIGURES FOR THE FIRST QUARTER --1.3 PER CENT AT AN ANNUAL RATE--REMINDED MINISTERS THAT SUSTAINED GROWTH COULD NOT BE TAKEN FOR GRANTED. BUT THE PROSPECT OF LOWER US GROWTH DID NOT BRING FORTH A CRY FOR FISCAL REFLATION IN OTHER COUNTRIES. RATHER, THE EMPHASIS WAS ON THE NEED FOR THE EUROPEANS TO IMPROVE THE EFFICIENCY OF THEIR ECONOMIES, FOR THE US TO REDOUBLE ITS EFFORTS TO REDUCE ITS BUDGET DEFICIT, AND FOR THE JAPANESE, AND OTHERS, TO OPEN UP MARKETS. THERE WAS HARDLY ANY DISCUSSION OF THE US PROPOSAL FOR A POSSIBLE INTERNATIONAL MONETARY CONFERENCE. THE INTERIM COMMITTEE AGREED TO REVIEW, AT ITS NEXT MEETING IN SEOUL, IMPROVEMENTS OF THE INTERNATIONAL MONETARY SYSTEM CURRENTLY UNDER STUDY.

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/DEBT

DEBT

4. THE MINISTERS, FROM BOTH DEVELOPED AND DEVELOPING COUNTRIES, ACKNOWLEDGED THAT DEBT PROBLEMS WOULD CAUSE TROUBLE FOR A LONG TIME TO COME. SOME COUNTRIES HAD ACHIEVED CONSIDERABLE PROGRESS THOUGH AT A POLITICAL AND SOCIAL COST. THERE WERE MANY TRIBUTES TO THE SUCCESS OF MEXICO AND TO HER FINANCE MINISTER SILVA HERZOG. THE DIFFICULTIES OF THE IMF PROGRAMS IN BRAZIL AND ARGENTINA, AND IN OTHER COUNTRIES, AS WELL AS THE CONTINUED PROBLEMS OF SUB-SAHARAN AFRICA--ON WHOSE EARLY RESOLUTION NO ONE WAS HOPEFUL--PROVIDED SOMBRE BACKGROUND TO THE DISCUSSION.

5. REPRESENTATIVES OF MANY DEBTOR COUNTRIES EMPHASISED, IN A WAY NOT DONE AT PREVIOUS MEETINGS, THAT INDIVIDUAL DEBTOR COUNTRIES HAD THE MAIN RESPONSIBILITY FOR RESOLVING THEIR OWN PROBLEMS, BUT CLEARLY THE SOCIAL AND POLITICAL COSTS INVOLVED WOULD BE MADE MORE TOLERABLE BY EXTRA RESOURCES FROM ABROAD. THEOUGH THERE WAS THE RITUAL SUPPORT FOR THE 70-PARAGRAPH LONG G24 COMMUNIQUE, MOST LATIN AMERICAN COUNTRIES DID NOT PUSH WITH ANY ENTHUSIASM FOR THE CARTAGENA CONSENSUS. THE FINANCE MINISTERS FROM ECUADOR AND MEXICO, AND THE CENTRAL BANK GOVERNOR FROM BRAZIL, IN IMPRESSIVE INTERVENTIONS, ALL SPOKE WITH MODERATION. BUT THEY CAUTIONED THAT THE IMPOSITION OF TOO HARSH AND FAST ADJUSTMENT WOULD BREAK THE SOCIAL AND POLITICAL FABRIC, AND DAMAGE DEVELOPING DEMOCRACIES IN LATIN AMERICA. THERE WAS NO (REPEAT NO) SUPPORT AMONG INDUSTRIALISED COUNTIRES FOR PROPOSALS FOR A TASK FORCE OR FOR ''POLITICAL DIALOGUE''.

6. MINISTERS, FROM BOTH DEVELOPED AND DEVELOPING COUNTRIES, ENDORSED THE ''CASE-BY-CASE'' APPROACH'' TO THE RESOLUTION OF THE DEBT CRISIS. THERE WAS NO SUPPORT FOR ''GLOBAL SOLUTIONS'' WHICH, AS THE CHANCELLOR OF THE EXCHEQUER AND THE US SECRETARY OF THE TREASURY POINTED OUT IN INFORM SESSION, WOULD POSE UNACCEPTABLE BURDENS ON TAXPAYERS IN THE DEVELOPED COUNTRIES. THERE WAS CONSENSUS, HOWEVER, THAT THE CASE-BY-CASE APPROACH WOULD HAVE TO EVOLVE, IN A PRACTICAL WAY, TO MEET THE NEEDS OF PARTICULAR DEBTORS, E.G. THROUGH MULTIYEAR RESCHEDULING ARRANGEMENTS (ON WHICH CAUTIOUS WORDS WERE INCLUDED WITHIN THE INTERIM COMMITTEE COMMUNIQUE), AND EARLIER EXTENSION OF EXPORT CREDIT COVER. DEVELOPING COUNTRIES WERE URGED TO REDUCE BARRIERS TO PRIVATE DIRECT INVESTMENT, A TASK WHICH, SAID THE CHANCELLOR, WAS AS IMPORTANT TO THE DEVELOPMENT OF A HEALTHY WORLD ECONOMY AS THE REDUCTION IN TRADE BARRIERS BY DEVELOPED COUNTRIES.

TRADE

7. THE DISCUSSION WAS NOTABLE ESSENTIALLY FOR A STANDOFF BETWEEN THE AMERICANS AND INDIANS, AS SELF-APPOINTED SPOKESMEN FOR THE DEVELOPING WORLD, ON HOW TO MOVE FORWARD ON MTNS. THIS MAY HAVE BETOKENED SOME HARDENING IN THE LDC POSITION. NO NEW POINTS WERE ADVANCE BY EITHER SIDE. THE EUROPEAN COMMUNITY PLAYED ALMOST NO ROLE, APART FROM A VERY BRIEF ITALIAN INTERVENTION AT THE OUTSET. THERE WAS A LONG HAGGLE ABOUT THE DRAFTING OF INNOCUOUS WORDS IN THE COMMUNIQUE.

/CHANCELLOR

CHANCELLOR OF THE EXCHEQUER'S INTERVENTIONS

8. IN HIS INTERVENTIONS AT THE INTERIM COMMITTEE, THE CHANCELLOR NOTED THAT, AFTER THE ILL-FOUNDED EXPANSION OF THE 1970S, THERE HAD BEEN A NEED FOR PAINFUL ADJUSTMENT IN MANY DEVELOPING COUNTRIES. SIGNIFICANT PROGRESS HAD BEEN MADE BUT FURTHER EFFORTS WERE NEEDED, FOR EXAMPLE TO ENCOURAGE A HIGHER LEVEL OF DOMESTIC SAVING AND TO ATTRACT FOREIGN SAVING IN THE FORM OF INWARD DIRECT AND PORTFOLIO INVESTMENT. PROBLEMS OF STRUCTURAL ADJUSTMENT WERE NOT CONFINED TO THE DEVELOPING COUNTRIES: THERE WERE RIGIDITIES AND INEFFICIENCIES IN INDUSTRIAL COUNTRIES TOO, AND THESE, AS WITH THE RECENT COAL STRIKE IN THE UK, HAD TO BE TACKLED WITH DETERMINATION. IT WAS CRUCIAL TO AVOID A FURTHER MOVE TOWARDS PROTECTIONSIM. IN THE IMMEDIATE FUTURE, THERE MIGHT BE SOME SLOW-DOWN IN WORLD GROWTH AS ADJUSTMENT CONTINUED AND THE US FISCAL POSITION WAS BROUGHT UNDER CONTROL. FISCAL STIMULATION IN OTHER COUNTRIES WAS NOT THE ANSWER. THE RESPONSE SHOULD BE TO REDUCE FINANCIAL IMBALANCES, AND HERE THE UNITED STATES HAD A SPECIAL RESPONSIBILITY FOR ITS FISCAL DEFICIT, TO TACKLE STRUCTURAL RIGIDITIES AND TO REASSERT THE OPENNESS OF INTERNATIONAL TRADE.

9. HE TOLD THE DEVELOPMENT COMMITTEE THAT OBSTACLES TO INTERNATIONAL CAPITAL FLOWS NEEDED TO BE REDUCED. DIRECT AND PORTFOLIO INVESTMENT HAD A LARGER ROLE TO PLAY. IN THAT CONTEXT, A MULTILATERAL INVESTMENT GUARANTEE AGENCY COULD BE HELPFUL. THE CHANCELLOR ENDORESED THE IDEAS ON EXPORT CREDIT COVER SET OUT IN THE PRESIDENT'S REPORT, NOTING ESPECIALLY THE NEED TO IDENTIFY WORTHWILE AND REMUNERATIVE PROJECTS AND THE WORLD BANK'S POTENTIAL CONTRIBUTION IN THIS PROCESS. IT WAS NOT REALISTIC TO LOOK FOR ANY SUBSTANTIAL EXPANSION OF OFFICIAL DEVELOPMENT ASSISTANCE: THE RESOURCES WHICH WERE AVAILABLE SHOULD BE USED EFFICIENTLY AND FOCUSSED ON THE AREAS OF GREATEST NEED. UNLESS POSITIVE MOVES WERE MADE TOWARDS TRADE LIBERALISATION, THERE WAS LIKELY TO BE AN INCREASING SLIDE INTO PROTECTIONISM. ON THE ROLE OF THE WORLD BANK, HE INDICTED THE UK'S WILLINGNESS TO CONSIDER WITH OTHER THE ISSUE OF GENERAL CAPITAL INCREASE, RECOGNISING HOWEVER THAT IMPORTANT QUESTIONS ABOUT ITS SIZE, PAID-IN ELEMENT, ETC REMAINED TO BE RESOLVED. HE WELCOMED THE SPECIAL FACILITY FOR AFRICA.

BANK AND FUND

10. THERE WAS GENERAL ENDORSEMENT OF THE WORK OF THE BANK AND FUND. THE UNITED STATES, SUPPORTED BY OURSELVES, THE WEST GERMANS AND JAPANESE OPPOSED AN ALLOCATION OF SDRS. THE FUND EXECUTIVE BOARD IS TO EXAMINE THE USE OF IMF TRUST FUND PROCEEDS AND THE STRENGTHENING OF FUND SURVEILLANCE. WEST GERMAN AND LATIN AMERICAN DOUBTS TONED DOWN REFERENCES IN THE COMMUNIQUE TO THE MULTILATERAL INVESTMENT GUARANTEE AGENCY TO NO MORE THAN QUOTE NOTED UNQUOTE. WE AND THE UNITED STATES JOINED IN PREVENTING THE FRENCH INSERTING TOO FORTHCOMING WORDS INTO THE DEVELOPMENT COMMITTEE COMMUNIQUE ABOUT A GENERAL CAPITAL INCREASE FOR THE WORLD BANK.

/ASSESSMENT

ASSESSMENT

11. SO ALL IN ALL SOME REALISTIC DISCUSSION WHICH DID NOT HIDE THE MAGNITUDE OF THE DIFFICULTIES STILL FACING THE WORLD ECONOMY, ESPECIALLY ON THE DEBT FRONT. BUT GENERAL RECOGNITION, AT LEAST AMONG MOST PARTICIPANTS PRESENT AT THESE MEETINGS, THAT EXISTING APPROACHES, WITH APPROPRIATE DEVELOPMENT, OFFER THE ONLY VIABLE WAY OF MEETING THESE DIFFICULTIES.

12. THE COMMITTEE'S COMMUNIQUES ARE IN MIFTS.

13. FCO PLEASE ADVANCE TO PS/CHANNCELLOR, LITTLER AND LAVELLE (TREASURY), PS/GOVERNOR AND LOEHNIS (BANK OF ENGLAND), TICKELL (ODA), BRAITHWAITE AND TAIT (ERD).

WICKS

MONETARY
ERD

(ADVANCED AS REQUESTED)

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FM BANJUL 150345Z APR 85

TO PRIORITY FCO

TELEGRAM NUMBER 72 OF 15 APR

AND TO PRIORITY UKDEL IBRD/IMF WASHINGTON

YOUR TELNO 46: THE GAMBIA AND THE IMF

1. I CALLED ON PRESIDENT JAWARA TODAY AND SPOKE ALONG THE LINES OF YTUR.

2. PRESIDENT SAID HE WAS GRATEFUL TO THE PRIME MINISTER FOR RECEIVING HIM AND GIVING HIM SUCH A SYMPATHETIC HEARING. HE WAS ALSO GRATEFUL FOR OUR HELP AND ADVICE AND HE WOULD, AS A FIRST STEP INSTRUCT THE FINANCE MINISTER TO SUBMIT A REQUEST TO THE IMF FOR TECHNICAL ASSISTANCE IN PREPARING AN ECONOMIC REFORM PROGRAMME, WHICH HOPEFULLY WOULD LEAD TO A NEW PROGRAMME. HE WAS PARTICULARLY GRATEFUL FOR OUR CONDITIONAL OFFER TO CONVERT POUNDS ONE MILLION OF PROJECT AID INTO BALANCE OF PAYMENTS SUPPORT AND TO PRESS OTHER DONORS TO FOLLOW SUIT ONCE AN IMF PROGRAMME HAD BEEN AGREED. I EMPHASISED THAT THIS WAS DEPENDENT ON THE GAMBIA GIVING AN UNDERTAKING TO ACCEPT SUCH ECONOMIC REFORMS AS THE IMF STIPULATED.

3. THE PRESIDENT SAID THEY HAD BEEN GIVING THOUGHT TO WHAT OTHER MEASURES WERE AVAILABLE TO THEM. THE CABINET HAD AGREED THAT IF THE US GOVERNMENT PROVIDED 12,000 TONNES OF RICE AS FOOD AID, WHICH THE GAMBIA HAD REQUESTED, THE DOLLARS TWO MILLION SET ASIDE FOR RICE IMPORTS THIS YEAR WOULD BE USED INSTEAD TO PAY OFF PART OF THE IMF ARREARS. THIS CONFIRMS WHAT FINANCE MINISTER TOLD THE US AMBASSADOR. SISAY ALSO TOLD HENNEMEYER THAT ITALY HAS PROMISED TO MAKE A GRANT TO THE GAMBIA TO COVER THIS YEAR'S FERTILIZER IMPORTS AND IT HAS BEEN AGREED THAT THE FOREIGN EXCHANGE EARMARKED FOR FERTILIZER IMPORTS WOULD ALSO GO TOWARDS PAYING OFF THE IMF ARREARS.

GARNER

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SAVINGRAM

BY BAG

FROM UKDEL IMF/IBRD WASHINGTON 11040930

RESTRICTED

TO FCO SAVINGRAM NO 145 OF 11 APRIL 1985

IMF: 1985 WORLD ECONOMIC OUTLOOK

On 3 April, the Executive Board held its second discussion on the World Economic Outlook (EBS/85/47 - 50 and Supplements 1 - 11). The discussion was based (loosely) on the themes identified in the Managing Director's buff statement (85/63), taking the form of a seminar with Directors making unscripted interventions and with the staff also playing an active role.

Summary of Discussion

2. An interesting and thoughtful discussion, if sometimes a little lacking in focus. Many ideas emerged but few conclusions. The MD made two general points.

3. First, he said that while recovery in the world economy was likely to continue, it was only realistic to recognise that the pace might slow this year and next and perhaps into 1987. It was certainly true that the US current account deficit was unsustainable at the present rate, and would have to be reduced. This would need to be done by a combination of US budget deficit reduction, and removal of rigidities in other industrial countries. But for the immediate future, the net effect on activity was almost certainly to be negative, in the developed countries and elsewhere. There could be "rough terrain" to traverse; but there was no avoiding it if longer-term prospects were not to be jeopardised. (Comment: effectively, the MD seemed to be saying that in aggregate the world had

been growing faster than it really should have done - and for reasons other than lower inflation and lower nominal interest rates i.e. a substantial fiscal stimulus from the US - and things would now have to slow down).

4. Second, in response to comments from a number of LDC Directors, the MD elaborated on his view of the Fund's role in low income countries. These countries were not excluded per se from Fund assistance; and they would clearly need flows of concessional assistance for a long time. The Fund's role was to help them to meet reversible external shocks, and to help countries correct their domestic policies. Often it was difficult to know whether an external problem was reversible, or whether it reflected more deep-seated structural problems which the Fund was not well-equipped to tackle. Where the latter was the case, the Fund would have to be cautious, putting in programmes for relatively modest amounts while encouraging other donors to look at the problems and to increase their assistance. The answer was certainly not increased access, which would not address the fundamental problems.

Main Points of Interest

The US

5. Directors asked how long the inflow of capital into the United States could continue. Fujino noted that the US dollar was a reserve currency, and that the depth of the US financial markets was very great. This asymmetry between the US and other countries meant that the US could continue the current policy stance longer than would be possible elsewhere. De Maulde asked how long it would be before the debt export ratio in the US exceeded the levels that had been considered worrying in Brazil and Mexico. Hernandez-Cata (Division Chief, Western Hemisphere Department) felt that it would be five years at most. De Groote and other Directors emphasised the importance of looking at the stock of dollar denominated assets abroad. A depreciation of the dollar would reduce the

ratio of dollar assets to other assets, and, all other things being equal (which they would of course not be), result in a further capital inflow into the US to restore the previous ratio. Sengupta said that the crucial assumption being made was that the rest of the world just watched the present capital inflow and did nothing. If the dollar fell, and the fiscal deficit was not reduced, he wondered whether the US could contain the rate of inflation. Harmonisation of monetary and fiscal policies between countries was the only way to achieve the staff's baseline scenario.

6. Dallara observed that the current capital inflow did not reflect use of foreign savings per se, but rather a rundown of US assets abroad. He noted too the difficulties of making any very precise analysis in the presence of large errors and omissions. Hernandez-Cata agreed that there had been a substantial rundown of US assets abroad; however, if one assumed errors and omissions to be largely short-term capital inflows, there might well also have been substantial use of foreign savings. What really mattered was the US' net external position abroad.

7 Clark noted that many Directors had questioned the continuing willingness of investors to put money in the US. But, turning the question around, he wondered whether it was wise from the US' own point of view to be absorbing funds at a real interest rate which far exceeded the probable growth potential of the economy. One way out was clearly a big depreciation to write down the accumulated stock of debt. But this was only a partial answer. In the aftermath of such a depreciation, with perhaps a serious erosion of confidence in the United States, real interest rates (and perhaps to an even greater extent, nominal interest rates) might have to go higher.

8. Hernandez-Cata added that the US current account deficit would not be removed by any likely change in the relative cyclical position of the US vis-a-vis other countries; even if US growth slowed to be roughly

comparable with that abroad, there would still be a substantial deterioration of the external position. If one assumed that market psychology and perceptions remained constant, such deficits would have to be financed from savings and not from portfolio readjustments. This would require a very large fraction of world savings.

9. Hernandez-Cata said that he knew of no model of exchange rates which explained the movement of the dollar in 1983/84 and particularly the later part of 1984.

10. Nimatallah remarked that we should not wait until capital flows to the US dropped off sharply; the proper solution was a gradual reduction in the fiscal deficit, in which case the capital which had been freed would probably be invested in Europe.

11. Crockett (Deputy Director, Research Department) noted that a fall in the dollar would tend to push up the US prices and reduce US demand with the opposite effect elsewhere. In adition, there would be an external to production in the US which would offset the effect of the fall in demand in the US to some extent. However, much would depend on the US authorities' policy response. If they tightened monetary policy to reduce the inflationary effect of a dollar fall, this would further reduce the level of demand through an increase in interest rates, which might, via the inventory cycle, send the economy into a recession.

12. Hernandez-Cata then observed that a reduction in the US fiscal deficit might, by removing what could be seen as the last obstacle to sustainable growth in the US economy, have the paradoxical effect of increasing capital inflows, and the current account deficit.

Japan

13. Fujino made a spirited defense of the Japanese surplus, very much along the lines of his comments in the recent Japanese Article IV

discussion. Most of the deterioration of the US current account over the past four years had been due to the high dollar. The Japanese were making strenuous efforts to open their markets. To take a topical example, sales of cars in Japan would be much facilitated if foreign manufacturers expanded their dealing and service networks, as German suppliers were doing. He added that his brother-in-law owned both a Pontiac and a Volkswagen (which some people felt did not entirely clinch the argument). Dallara countered that the US still believed that market opening in Japan was necessary, and pointed to the sharp increase in the EEC trade deficit with Japan at a time when Japan's growth was considerably higher than that in Europe and the yen was appreciating against European currencies.

The Scope for Fiscal Relaxation

14. Grosche argued that relaxing fiscal policies in particular economies, such as Germany, would be extremely risky. It would impair confidence without guaranteeing results; such policies had proved very ineffective in the 1970s. In any case, the economic situation in Germany was relatively satisfactory apart for unemployment, and a boost in demand would be difficult to justify. In addition, Germany's room for manoeuvre was quite small, and there was still some way to go in reducing the fiscal deficit.

15. Polak said that he did not believe that international policy coordination should be based on agreement to reach certain growth rates. Growth rates were domestic objectives which had to be weighed against other domestic objectives such as inflation. So far, fiscal adjustment in Europe had not prevented reasonable growth, largely because of the demand effects of the US deficit. Political leaders had thus been able to avoid domestic criticism. However, there were questions about what would happen when the deficit and the dollar were corrected. In that case, the slack in the US might not be sufficiently offset by further expansion in Europe and Japan. Then, countries on both sides of the Atlantic and Pacific would

have to give up some of their preferred policy package for the good of the international system as a whole.

16. Lundstrom intervened to repeat his view that there was scope for a fiscal stimulus in certain countries (which he did not name but which clearly included Japan, Germany and the UK). Fujino said that he would have to decline "with characteristic oriental modesty" (and uncharacteristic oriental humour) this invitation. As Grosche had noted previously, fiscal stimuli had not worked in 1978 and would probably not work now. Jaafar, however, felt that there was scope for Japan to expand faster than other countries, and that the Fund followed the G7's views too much on this question.

17. The MD summed up this part of the discussion with the remarks noted in the summary above. Sengupta intervened to record his dismay at the course the discussion had taken, saying that in his view policy coordination was essential.

Savings and Interest Rates

18. Ortiz emphasised the difficulty of increasing domestic savings in many developing countries. For instance, raising public savings through tax increases reduced private disposable income and thence, in turn, private savings. Price increases in public enterprises had a similar effect. As for private savings, in the very poorest countries these were largely constrained by the level of income. In a closed economy, real positive interest rates would often not increase savings significantly, although they would improve resource allocation and increase the amount of savings channelled through the financial system. He added that increases in domestic interest rates could have serious effects on internal debt service and thereby worsen the fiscal position.

19. Crockett remarked that real positive interest rates were often necessary to bolster the external position by preventing capital flight.

Indeed, the staff had pointed out in their papers that this had been an important factor in developing countries' recent current account adjustment.

20. De Maulde said that his authorities attached great importance to increasing domestic savings in developing countries. In many ways, the remedies lay more in the province of the Bank than the Fund. One important factor was often the inadequacy of the institutional framework (e.g. the lack of banking services in rural areas).

Inflation

21. Discussion then moved to the question of hyper-inflation in Western Hemisphere countries. The MD observed that it was essential to avoid putting any new indexation systems in place.

22. Ortiz remarked that the staff's prescriptions often amounted to indexing exchange and interest rates, which pushed a greater weight of adjustment onto other prices in the economy. Beza (Deputy Director, Western Hemisphere Department) said that the staff would usually have been able to accept market determination of these rates; but the authorities were often not willing to allow this. Some form of indexation was the inevitable result.

23. Sengupta said that the quality of adjustment was the essential thing. He then made an impassioned plea for slower adjustment and more finance, suggesting that most standby arrangements should in fact be EFFs. Dallara emphasised the importance of reducing public consumption rather than public investment. Inflation could be reduced by trade liberalisation, and by eliminating the use of credit ceilings as a monetary tool.

Direct Investment

24. There was a very brief discussion of the role of direct investment in developing countries, which added nothing to the discussion in the Board last year.

WICKS.

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NBPM AT 9/1

Foreign and Commonwealth Office

London SW1A 2AH

9 January, 1985

AT
We agreed that there was no pressing need & some disadvantage in the Prime Minister seeing Mr Clausen this time
CDP 9/1

Dear Charles,

Visit of the President of the World Bank: 16-17 January 1985

Mr Clausen is planning to come to London on 16-17 January to lobby Ministers in favour of a UK contribution to the Bank's proposed Fund for Africa, about which the Presidents of Togo and Zambia recently wrote to the Prime Minister. Mr Clausen has said that he wishes particularly to see the Foreign Secretary but has enquired whether the Prime Minister would be free to see him.

In view of the pressures on our aid funds, we could only make a UK cash contribution to any Fund for Africa at the expense of our own bilateral aid, and particularly that to African countries. We have therefore told the Bank that it is unlikely we shall be able to contribute directly to any Fund. Nevertheless, we are discussing with them whether we can associate some of our existing bilateral aid to Africa with their programme.

Sir Geoffrey Howe has agreed to see Mr Clausen. He does not think it necessary, however, that the Prime Minister should try to find time to do so as well. But we thought you should be aware of Mr Clausen's request to call on the Prime Minister.

Yours ever,

Peter Ricketts

(P F Ricketts)
Private Secretary

C D Powell Esq
10 Downing Street

RESTRICTED

-9 JAN 1985

316.6

Prime Minister (2)

AT 17/12

Treasury Chambers, Parliament Street, SW1P 3AG
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Andrew Turnbull Esq
10 Downing Street
London SW1

14 December 1984

Dear Andrew

IMF: UK CONSULTATIONS 1984

I understand that when the Chancellor saw the Prime Minister this morning he undertook to show her a copy of the concluding remarks made by the head of the IMF team at the end of the UK Article IV consultations earlier this week. These, as you may recall, do not represent the final IMF staff conclusions at the end of the Article IV consultations, but merely the conclusions the visiting team reach before they return to Washington. A copy is attached.

Yours ever

David

D L C PERETZ

December 10, 1984

Concluding Remarks

1. The United Kingdom has been an early pioneer in the pursuit of policies that have become an international norm. It is now part of a broad consensus among the major countries that the control of inflation is a necessary condition for sustained economic growth. It is also generally accepted that this objective is to be achieved by monetary and fiscal restraint. The experience with such policies in the United Kingdom is therefore of keen interest to the international community which we represent.

2. The success you have had with your financial strategy has been considerable, but it has not been without stress. The growth in nominal GDP has been lowered progressively from over 15 percent in 1979-80 to less than 7 percent by the first half of 1984, and the split between price inflation and output gains has become more favorable. Price inflation has been brought down below 5 percent--but wage inflation remains at nearly 8 percent. Output growth reached 3 1/2 percent in 1983 and on a strike-adjusted basis in 1984 as well--but not without putting pressure on the external position. And unemployment has contined to increase and now stands at 13 percent of the labor force.

3. With inflation down to a much lower level, increasing concern is being expressed about unemployment. There are two views on the mix of factors that have brought it to its present level, and on the most effective

ways of ameliorating it. According to one view, a large part is attributable to a persistent deficiency in aggregate demand stemming from overly restrictive financial policies. According to the other view, the bulk of it is attributable to excessively high and rising real wage levels. We see greater risks in tilting towards expansion than in maintaining restraint.

4. We appreciate that it would be less difficult for you to sustain downward pressure on prices if unemployment had come down as you expected it to do a year ago. We also understand that any tilting is taking place within the scope of a broadly unchanged medium-term strategy. You continue to target a zero inflation rate, at least by 1993; by that time you expect the PSBR to have come down to 1 percent of GDP, a rate that would allow the public debt to rise in tandem with nominal GDP. We are nevertheless concerned about a policy stance this year and next that promises no better than to leave price inflation unchanged at just under 5 percent.

5. The expansion of your main monetary aggregates has thus far remained within the target ranges set for them at the beginning of the financial year. However, these target ranges have proved consistent with developments in domestic interest rates relative to those abroad that have depressed the exchange rate by as much as 10 percent in the twelve months to October 1984. There has been need on occasion, particularly in July, to adjust interest rates upward to minimize the inflationary threat from this quarter. There clearly is a limit to the extent to which the U.K. can decouple its real interest rates from those in the U.S. in current conditions of fairly mobile capital. To the extent it cannot, monetary expansion will only depress the exchange rate and drive up prices.

6. Though the main monetary targets may still be met this year, the PSBR is all but certain to exceed the level specified in the budget. The whole of the excess is due to spending overruns inasmuch as revenues are also higher than anticipated. However, any adverse effects on domestic interest rates from the higher borrowing requirement is likely to be small, linked as domestic rates are to those abroad, and the net stimulus to activity is therefore likely to have been appreciable. Within a given monetary environment, furthermore, the higher level of activity is likely to have held exchange rates up and prices down compared to where they would otherwise have been.

7. A progressive lowering of the PSBR was originally intended to minimize the effect of the anti-inflationary strategy on interest rates. Now that this effect appears to be much smaller than once thought, the urgency of reducing the borrowing requirement looks to be rather less strong than before. To bring it down this year and next increased reliance is therefore being placed on oil revenue and on asset sales neither of which have a major impact on demand or on monetary conditions. Making the necessary adjustments shows the PSBR rising in relation to GDP not only above the level budgeted for this year, but above the level registered the year before (see Table).

8. While such developments may not appear overly disquieting in the immediate present, they do store up dangers for the future. The danger of particular concern to us internationally is the demonstration effect on other countries which, like the U.K., may not individually have a signi-cant effect on world interest rates but collectively certainly do. Even

individually, acquiescence would have to delay the time when the growth of public debt in the U.K. can be scaled down to leave room for private debt to expand in a framework of non-inflationary growth. Any short-term gain will therefore come at a considerable long-term loss.

9. With a continued tight fiscal policy a degree of monetary ease might still be defensible if downward pressure on the exchange rate were to succeed in improving competitiveness. Improvements in competitiveness did occur after 1981 because extensive labor shedding raised productivity fast enough to absorb wage increases. These productivity increases dropped sharply in 1984, and as wages continued to rise, unit labor costs jumped by 6 1/2 percent, a rate well above the current rate of price inflation. As long as wages continue to rise more rapidly than prices, it will be difficult to improve competitiveness by exchange depreciation. Monetary ease will then be largely spent on rising prices rather than on increased output and employment.

10. It seems to us that the troublesome increases in real wages may in large part reflect a lag in the downward adjustment of inflationary expectations behind the fall in actual inflation. Wage contracts set nominal wages that, given price expectations, should produce a real wage that will clear the market. If actual prices turn out to be higher, real wages will be lower and employment temporarily higher than the equilibrium level; if actual prices are lower, real wages will rise and employment be reduced. A policy of continued financial restraint may well be best suited to narrowing the distance between them and to bringing unemployment down.

11. Seeking to correct a deficiency of aggregate demand may thus be counter-productive. A direct attack on real wages would seem to carry more promise. One feature in the functioning of labor markets deserves particular attention in this regard. In finding the market clearing wage, the effective supply seems often to be limited to those workers still employed. In such cases there is little scope for the real wage once set to be reduced, and no direct way therefore to re-employ those once out. There is need to reduce the barriers to entry not only for new entrants into the labor market, but for anyone seeking a job.

12. The functioning of labor markets has already improved in a number of ways in recent years. Thus the pay of young workers, relative to that of adults, seems to have been falling for some time now, suggesting that their share in total employment may now begin to increase. Similarly, the growth in employment in recent years seems to be accounted for entirely by women in part-time work where wage costs are not inflated by government or trade union policy. Much more needs to be done before such impediments to employment are reduced for adult full-time workers as well. There is no doubt, however, that supply-side measures will need to concentrate in this area before the benefits of an anti-inflationary policy can be fully realized.

13. We would also like to note the contribution to a more competitive economy that can be made by a continued liberalization of trade. Similarly, we hope that you will resist pressures that may develop to limit official development assistance unduly.

14. Because the U.K. was one of the first countries to initiate a coherent anti-inflationary policy, its problems as well as its successes are of keen interest to the world at large. You are clearly a vital component in the application of that policy on a global scale. We are gratified by the resolve you have shown in persevering with it even in difficult times. Any slippage from it could adversely affect expectations well beyond your own borders. We therefore continue to wish you well.

PSBR Actual and Adjusted

	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86
1. in billions of pounds sterling							
PSBR, actual	10.0	12.6	8.6	8.9	9.7	8.4	7.0
plus oil revenues	+ 2.4	+ 3.8	+ 6.4	+ 7.8	+ 8.9	+ 12.0	+ 12.0
less permanent income from oil	- 1.6	- 1.9	- 2.1	- 2.2	- 2.3	- 2.4	- 2.5
plus special asset sales 1/	+ 1.0	+ 0.4	- 0.1	+ 0.5	+ 1.1	+ 2.3	+ 2.5
PSBR, adjusted	11.8	14.9	12.8	15.0	17.4	20.3	19.0
2. in percent of GDP							
PSBR, actual	4.8	5.3	3.3	3.1	3.2	2.6	2.0
PSBR, adjusted	5.7	6.3	4.9	5.3	5.7	6.2	5.4

Source: H.M. Treasury

1/ Excluding sales of Council Houses

File with

IMF papers

'THE ROLE AND FUTURE OF THE INTERNATIONAL FINANCIAL INSTITUTIONS'

The Jane Hodge Memorial Lecture
delivered by

ROBIN LEIGH-PEMBERTON ESQ,
GOVERNOR OF THE BANK OF ENGLAND

at the University of Wales Institute of Science and Technology on Monday 3 December 1984

1984 JANE HODGE MEMORIAL LECTURE

Introduction

1 My title is "The Role and Future of the International Financial Institutions." Although it could be taken to cover a wide field, I propose to focus my remarks on the International Monetary Fund and the main arm of the World Bank group, the International Bank for Reconstruction and Development. Forty years ago, the Bretton Woods Conference established what have come to be called the Bretton Woods Institutions, and such anniversaries tend to stimulate introspection. More importantly, however, this is a particularly demanding time for the institutions; the criticisms directed at them from some quarters show no sign of abating; and the institutions have themselves begun to re-examine their roles.

2 The aim of this lecture is twofold. First, to stand back a little and look at some of the more important features of the IMF and Bank as they are today. Secondly, to think about their future in the light of the problems with which they have to deal. I may say at the outset that I believe the institutions have been responding constructively to difficult circumstances and the world as a whole has benefited from the vital part they have been playing. I appear before you tonight, therefore, in the role of champion rather than critic.

Origins

3 Although historically the two institutions both grew from the same determination to avoid the chaotic conditions of the inter-war years, and although Keynes referred to them at their birth as "lusty twins", I am sure he saw them as independent members of the same family, each with its own purposes and functions, and its own financial structure.

4 The World Bank was seen as an engine for long-term financing of post-war reconstruction and then development more generally. In the early years, this was largely directed towards specific projects to develop the economic infrastructure of the newly independent countries and was soon widened to cover productive investments in industry, agriculture and energy. In pursuit of these objectives, the Bank was given its own share capital against which it was empowered to borrow from the private capital markets.

5 In contrast, the IMF was placed at the centre of a new international monetary system in which members accepted the disciplines of fixed exchange rates, thereby surrendering some of their sovereignty. It had the task, in which it was notably successful, of constructing an

efficient multilateral payments system out of the morass of controls, bilateral arrangements, and multiple exchange rates inherited from the war years. Its lending function was to be a subsidiary one, supporting the system by financing countries experiencing temporary balance of payments disequilibria. The "fund" of its title was a pool of resources contributed by all members in the form of a quota subscription, and from which members could borrow in amounts directly related to their quota.

6 On the one hand, the Bank was to be a permanent long-term lender; on the other, the Fund was intended to revolve, drawing on countries in current account surplus to assist those in deficit to return to equilibrium. It was also assumed that countries in surplus and deficit would themselves alternate over time.

Subsequent Changes

7 The differences in concept remain important for a proper understanding of the institutions. But the original designs, thanks to the foresight of the drafters, have not prevented a good measure of evolution over the past forty years. In the Fund we have seen a change, accelerating in the last ten years, in the relative importance of its main functions. It is now a lender on a considerable scale, and with that function it has developed as a different kind of force for adjustment through the conditionality attached to its economic programmes. The shift in emphasis can be attributed partly to the breakdown of the par value system in the early 1970s, which came about for a variety of reasons - including the declining willingness of members, especially those in surplus, to accept restrictions on their exchange rate policies, and also the asymmetry of a system in which the key currency, the US dollar, was not subject to disciplines in the same way. But another underlying reason for the shift in the Fund's emphasis has been the changing composition of its membership. It now has nearly 150 members, compared with fewer than 50 when it was founded; and while short-term adjustment to restore equilibrium might have been appropriate for many of those early members, it sits less well on the newer members whose problems and external environment are less tractable and more likely to bring them repeatedly to the Fund for assistance. With the main industrial countries not currently borrowing from the Fund, the developing countries have now become the predominant users of Fund resources.

8 The Fund has responded by trying to tailor its lending to longer-term needs and also to the scale of the problems of indebted members

- with longer repayment periods and larger multiples of quota. This in turn, however, has caused a number of practical and what I might call "theological" problems, the most obvious of which is that subscribed resources have become inadequate. Thus the Fund has been forced to borrow large additional sums and has departed a long way (some would say too far) from first principles.

9 The Bank, too, has adapted - in its earlier years by forming the International Development Association as its soft lending arm, directing concessional aid to the poorest countries, and during the 1970s by further enlarging the range of its operations. Most recently, we have seen it step beyond its traditional functions into co-financing, to which I will return later and which is a laudable attempt to increase private capital flows. It has also taken special initiatives to speed up disbursements as a contribution to immediate financing needs. The most significant development has been the introduction of broader forms of lending aimed at encouraging structural and other types of adjustment, to which the Bank has begun to attach more general policy recommendations than was possible or appropriate in the case of its traditional project lending.

Present Position

10 Thus the two institutions have drawn closer together, reflecting joint recognition of the difficult world situation, and perhaps of the argument that short and long-term adjustment are two sides of the same coin. But the blurring of distinctions and the departure from convention also suggest the need to ask whether the trends are necessarily in the right direction.

11 The Fund will need to consider how far it can continue with large-scale lending - especially to those countries which have become prolonged users of its resources - and, if it cannot, how it can still ac as a force for adjustment. It must also explore different ways of exerting its influence, through more effective general surveillance to replace the powers it lost with the old par value system.

12 The Bank, having discovered that it cannot stand aloof from the adjustment process, has to determine how far it should change the direction of its lending towards the encouragement of adjustment; and how it can maintain or expand its overall contribution at a time when there may be considerable pressure on other sources of finance.

13 For both institutions, their increasingly complementary role makes co-ordination more than ever necessary.

THE IMF

14 In considering these questions in relation to the Fund I will look first at its financial constraints; then at the role it plays in member countries through adjustment programmes and associated conditionality; and finally at the prospects for its wider role in the international system.

Financial Constraints

15 Because the Fund has the character of a mutual organisation, it is not sufficient to say that debtors' needs are very great and that the Fund should do more for them. The creditors' view must also be considered. When a member in a strong balance of payments position provides resources to the Fund, he has two important principles in mind. First, the resultant claim on the Fund remains in his reserves and is firmly understood to be withdrawable at need. Secondly, he is reassured to know that under its Articles of Agreement the Fund is confined to being a short-term lender: it is a monetary institution, not an aid-giver in the development business. The Fund must therefore be sure that its own assets are good and will be repaid on time: hence the insistence by large creditors that its resources must revolve. To ignore their legitimate anxieties about the liquidity of their claims and the overall percentage of their reserves represented by Fund-related assets would risk damaging irreparably the consensus and mutual self-help embodied in the institution, and would make it more difficult to obtain resources in the future.

16 It is sometimes felt that the Fund is consequently subject to excessive influence from the major industrial nations. But their influence is not disproportionately high in relation either to their economic position in the world or to their financial contribution to the Fund. This influence is in any case not conferred by the Fund; it would be no less, indeed it would probably be greater, if the Fund did not exist.

Conditionality

17 Let me now turn to the concerns of borrowers. Despite the central role the Fund has played in the adjustment undertaken by many countries over the last few years, it has certainly not won universal praise in the process. On the contrary it has been accused of going beyond its charter in meddling with all the problems presented by international debt; while perhaps the loudest and most persistent criticism is that the policies it advocates are inimical to growth.

18 I can, I think, dispose quickly of the charge of meddling too far. The restoration of equilibrium in members' economies is the Fund's proper concern. We should recall the consensus, which grew in the wake of the second oil shock, that adjustment rather than financing was the appropriate response. Given also the increasing reluctance of commercial banks to finance current account deficits on anything like the scale they had done in the 1970s, deficit countries turned to the IMF (some, it must be admitted, later than was desirable) to provide them not only with balance of payments support but also to advise on and monitor recovery programmes which would restore international confidence. Without the Fund's presence and the adjustment it encouraged, the necessary restoration of creditworthiness in indebted countries would be considerably further away than it is today.

19 What, then, of the Fund's alleged bias against growth? The accusation of being indifferent to the sufferings of the populations of countries with Fund programmes is made too often for it to be ignored, though perhaps the role of scapegoat is not the least valuable of the parts the Fund plays. It is true that the most noticeable feature of programmes is the restrictions they place on certain key financial variables, but it does not follow that the Fund is opposed to economic growth. After all, a healthily growing economy which participates increasingly in international trade must benefit all Fund members. The essential distinction, however, is between sustainable and unsustainable growth. Demand has usually been excessive in those countries that have needed to adopt Fund programmes, and the position has become unsustainable. The Fund advises members to attempt to avoid such a situation in the first place or, at the very least, to take immediate corrective action. It is not the Fund's fault if that advice is not taken and, then, when a programme is eventually agreed, economic conditions are considerably worse and the remedies correspondingly more severe. Even then, these programmes do not ignore the need to improve supply-side factors by, for instance, encouraging realistic producer prices and an appropriate exchange rate. But because such measures take time to bite, it is nearly always necessary to reduce demand temporarily to bring the external deficit to a level that can be financed.

20 Of course, austerity measures are not without social cost. But runaway budget deficits and profligate borrowing also have grave social costs, such as high and accelerating inflation which causes most harm to those least able to avoid its effects. Also, in nearly all cases the measures traditionally associated with Fund programmes would eventually have to be adopted, whether or not under the auspices of the Fund. Unbalanced economies need to be righted again and lasting growth can occur only when this has been achieved.

21 There can of course be real tensions, particularly in present circumstances, between the constraints of short-term adjustment and longer-term requirements. The Fund is obliged, however, to focus on short-term balance of payments needs, and its advice therefore concentrates on short-term policies - the sort of policies which can be implemented quickly and whose effect will be prompt. Many members are in any case unwilling to make longer-term commitments themselves. But this does not mean that nothing is done to try to make these policies compatible with the long-term interests of a country. As long as the ultimate aims of the programme are not jeopardised, there are many ways to arrive at the same destination, and it is a major part of the Fund's task to explore them all fully with members.

Role as Catalyst: does the Fund need to lend?

22 The conditionality of Fund programmes also serves to reassure market lenders about the economic soundness of troubled borrowers. Indeed, that feature has meant far more to the major debtors than the amount of money they could get from the Fund, which is necessarily limited. Is there something wrong with the balance here? The fact that Fund lending is relatively small in relation to their needs seems to me more an indication of the scale of their indebtedness than of any inadequacy in the Fund's contribution which is, rightly, related to quotas that reflect relative economic strength. But does this mean that the Fund's role is closer to that of adviser and that it no longer needs to lend?

23 Perhaps in time the membership could arrive at new obligations which would make this workable. For the foreseeable future, however, I see two main reasons for the Fund to continue to lend. The first concerns conditionality. Unless the Fund actually lends to members they lack the incentive to seek the Fund's advice in the first place, or to accept the conditions and performance targets set out in its programmes, to which the draw-downs of its loans are related. The Fund could, perhaps, confine itself to reporting to the banks, but it would then be in an invidious position, policing an agreement between two third-parties, to only one of which (the member country) it had any formal relationship. Of course, where a country has adopted an adjustment programme which has begun to bear fruit to the point where its net borrowing needs, if any, can be met through normal market mechanisms, then, once the programme has come to an end, the IMF can revert to a less active role of surveillance, but one which can still provide reassurance for the country's banking creditors. An interesting example of this is the responsibility to be given to the Fund in the two-stage multi-year rescheduling agreement

between Mexico and the banks, where a report on the Fund's surveillance of the country's economy will be made available to the banks with the full co-operation of the Mexican authorities. I hope that the arrangement will prove successful, but I doubt that it could be of general application. The second reason why I believe the Fund should continue as a lender concerns the commercial banks. It is generally thought that until recently the banks were providing a larger share of countries' financing needs, and moving further away from trade and project finance, than was desirable. In the last two years or so, however, that position has changed, to the extent that there might have been no new bank lending at all to some of the major debtors if they had not been operating economic programmes agreed with the Fund. The condition for the banks' continuing involvement with a country has been a similar commitment on the part of the Fund. In some of the more difficult cases this symbiosis is likely to be necessary for some time to come.

24 Even when the case for continued Fund lending is accepted, there is another difficult judgment to make. Looking to the future, in due course I would like to see the scale of the Fund's operations come closer to what can be financed from quota resources and from the General Arrangements to Borrow - those long-established arrangements set up initially to provide additional resources to the Fund in the event that any of the major industrialised nations would turn to it for assistance, but which have now been enlarged and are partly available for other countries as well. Additional borrowing arranged more recently, some of which continues today to support the Fund's expanded lending, has been essential to meet exceptional circumstances, but it should not become a permanent feature. It would obviously be unwise to predict that there will never again be occasions when the Fund may need to be temporarily enlarged on the basis of extra borrowing - ideally from official sources (since any expansion in its lending can itself happen only with government agreement). But as a general aim it will be important to take the opportunity whenever possible to wind down facilities meant for exceptional circumstances. We must fight against the temptation to treat the exceptional as the normal.

25 Yet in present circumstances and in many countries the timescale necessary for adjustment to take place is likely to be more protracted than in the past. Even in the most obdurate cases - where it is clearly sensible that aid and other forms of development assistance should provide the bulk of a country's needs - it would be very difficult for the Fund to cut itself off completely. Provided genuine attempts are being made by the country to achieve a sustainable solution to its problems, the Fund should continue to make resources available, on however a limited scale, to support those attempts.

Long-term problems, however, usually require long-term strategies and the involvement of the World Bank in these cases will also be essential.

Surveillance

26 I now turn to the Fund's more general influence, under the heading of surveillance. Now that the major countries are no longer obliged to maintain fixed (but adjustable) exchange rates, the Fund has lost much of its influence over their policies, which was in any case never very strong on those countries in balance of payments surplus. Another weakness is that the multilateral payments system has become distorted by the reintroduction of restrictive devices which had earlier been largely eliminated by the Fund.

27 It is therefore encouraging that, following the Williamsburg Summit, the search is now on for ways in which the Fund can more effectively discharge its duty to help maintain systemic order. As a result of decisions taken at Williamsburg, the Group of Ten countries are making a study of the ways in which the international monetary system might be improved.

28 We should not allow our expectations to run too high - for instance, by looking for a rapid return to a structured fixed exchange rate system. What I would hope to see, however, is general agreement that we should build on the existing annual consultations which the Fund holds with its members individually and begin to set these into a wider frame, involving particularly those countries whose currencies are components of the Special Drawing Right, or SDR, with a view to assessing the effects of one country's policies on others. Behind that concept is a growing recognition of the need for greater co-ordination and complementarity between the policies of major nations in wider areas than simply exchange rate adjustment as envisaged at Bretton Woods. It is also clearly desirable that this surveillance should be more symmetrical and applicable to all members than the present arrangements allow. To make this truly effective would imply some surrender of sovereignty, but that might not mean less freedom if it also reduced the adverse effects of policy decisions in other countries.

29 To the extent that such new procedures eliminated misunderstandings and mutually damaging policies, they would be helpful. My hope, also, would be that through this new multilateral surveillance, together with its periodic assessments of the world economic outlook, the Fund would be in a better position to promote consensus views on macro-economic issues for the benefit of the whole membership. It would, however, be foolish to hope that more effective surveillance could fully override political realities.

International Liquidity and the SDR

30 Another problem which has to be faced in time is the Fund's surveillance of international liquidity. Despite a system of floating exchange rates, where theory suggests that the possession and growth of reserves should be less important, it is clear that in practice - and for various reasons - countries set considerable store by an adequate and indeed rising stock of reserves. World reserves largely comprise foreign exchange holdings, some 70% of which are in US dollars. The major source of supply is, therefore, the external deficits of the United States, and there is no mechanism to ensure that the "correct" volume is supplied, even if it could be measured. We saw the dangers of such haphazard arrangements in the 1970s: a rapid expansion of international liquidity as a counterpart to large US external deficits prompted many countries to embark on what were in retrospect excessively expansionary policies; and, subsequently, the scope for obtaining reserves to spend expanded greatly through the ready availability of funds on the international markets. While such borrowings fulfilled a useful function in channelling capital between surplus and deficit countries, they have made it far more difficult to control official international liquidity. Perhaps ironically, during the same period many governments have been strengthening their control of domestic liquidity through changes in monetary policy. But stronger control of official international liquidity would require national governments to surrender a further degree of sovereignty to the Fund, and we have a long road still to travel before that comes in reach.

31 However long that road proves to be, a greater measure of international control of the supply of reserves remains a desirable objective. It would mean that the world would acquire the reserves it needed rather than those which appeared as the result of the policies of the major reserve centre. Moreover, if there were to be a weakening of the principal component of the current system,or indeed the development of a shortage of dollars (unlikely though that might seem at the moment), weaknesses in the structure could rapidly be exposed. The appropriate response at that stage cannot be stated in advance. But one potential remedy could be a resumption of regular issues of SDRs linked to a substitution exercise in which reserve currencies would be deliberately replaced by SDRs. The IMF could by these means begin to exercise the greater surveillance over international liquidity which is lacking under current arrangements.

32 In the meantime it would be prudent to continue attempts to make the SDR more attractive. As an official reserve asset it still has some way to develop - for example in its liquidity and transferability - if it is to match other reserve assets. As an international unit of account it has lived up even less to earlier expectations. A few years ago commercial banks began taking deposits denominated in SDR, but there was no great enthusiasm as the banks could find few SDR-based assets in which to invest. Perhaps if the Fund itself had borrowed in private markets, as was contemplated at that time, the private use of the SDR might have expanded in the same way that the ECU seems to have benefited from borrowing by institutions of the European Community. The ECU has also come into demand as a hedge against a fall in the US dollar, which the SDR is to only a limited extent. When the composition of the SDR basket was revised in 1980, the dollar weight was set as high as 42% - and currency movements have since increased this figure to no less than 54%. The problem will require some thought in future reviews of the SDR basket.

THE WORLD BANK

33 Let me now turn to the World Bank. The IBRD's contribution to world finance is illustrated by the fact that its outstanding loans amount to some $40 bn. It is less reassuring to look at the latest year, 1983, when the non-oil developing countries ran current account deficits totalling $50 bn. In that year the IBRD's gross disbursements of $8 bn were in fact less than those of the Fund (at $10 bn); and if we press the analysis further by offsetting repayments and interest costs of earlier loans, the Bank's contribution to the developing world was then only about $2 1/2 bn - with another $2 bn provided by the International Development Association. While we may expect some reduction in overall financing needs in the future, we cannot ignore the likelihood that commercial bank lending and other sources of official finance will continue to be restrained, including the probability that Fund finance will be reduced as the current exceptional situation returns to some normality. It seems right, therefore, to look to the Bank, and to think there may be a case for enlarging the scale of its lending.

34 If we now look at the Bank's functions, the case becomes stronger. I have already referred to its prime function as a long-term lender for specific projects, which accounts for the bulk of its operations and which I would not wish to see changed. There have, however, been other developments whose importance we need to assess and which also indicate that the Bank may have a wider role ahead of it.

35 One important function which I believe needs encouragement is that of catalyst, in order to make the most efficient use of the Bank's available resources and to respond to the call for greater private capital flows. Here I refer to the part the Bank can play in co-ordinating aid donors and agencies; the role of its other arm, the International Finance Corporation, in encouraging private equity and portfolio investment; and the efforts of the Bank to associate private lenders with its own operations. The Bank has long tried to gear up its lending by inviting other sources of finance - such as governments, export credit agencies and commercial banks - to join in supporting its projects. But despite the reassurance which is given by the Bank's acknowledged expertise in the preparation and monitoring of projects, this co-financing, as it is called, has not appealed to the commercial banks as strongly as was hoped. Commendable efforts are now being made to improve techniques, for instance by direct World Bank participation in loan syndications. It is an area which will be even more important in the future, and attempts to refine techniques and to improve communication should be continued. In this regard, the idea has emerged of establishing a banking subsidiary - a World Bank bank - which would be closer to the market place than its parent. Despite a number of technical and legal difficulties, the suggestion merits further consideration.

Broader Policy-based Loans

36 The other recent development to which I wish to draw particular attention is the introduction of new forms of lending associated with broader policy changes. In my view, these are an important adjunct to the Bank's more traditional operations, as well as a useful complement to the Fund's efforts to encourage adjustment, as they are designed to deal with institutional, structural and management rigidities which have often proved to be as important a hindrance to development as any lack of investment itself. They finance a transitional period during which old institutions and practices can be reformed or replaced, and in so doing help to create a sounder base for economic development more generally. An example of this is the series of structural adjustment loans to Turkey, in which World Bank finance helped to accelerate trade liberalisation, improve the system of export incentives, facilitate the mobilisation of domestic resources, restrain growth of public expenditure and improve the efficiency of State enterprises. The loans were put in train relatively quickly thanks to the fast-disbursing nature of structural adjustment lending. As each tranche in the series was disbursed, it was subject to economic monitoring and conditionality which had not been so important on project loans.

Policy conditions

37 Policy conditions are not a new concept for the Bank. But the form they took in the past was applied in piecemeal fashion mainly through policy covenants attached to project lending. These have not proved easy to monitor or to enforce. The long lead times needed to prepare projects and arrange co-financing have inevitably raised the costs of delaying or suspending a project in the light of adverse policy or institutional developments. Even now, the Bank's newer "conditionality" is not always as precise and well-monitored as it might be. In this context loans which make the release of funds dependent on explicit measures are more valuable than those which rely on general exhortations and are not drawn down in tranches.

38 With this new emphasis, some would say that the balance has already swung too far away from traditional project finance. What is important, however, is not so much to aim for a specific balance in aggregate but rather to achieve an appropriate mix of instruments for individual countries, in order to assist the process of adjustment; and to fit these into a more co-ordinated medium-term framework for country lending. This is not to argue for a large switch away from project lending as the mainstay of the Bank's operations. Broader policy-based lending should rather be seen as a complement to, and not a substitute for, traditional lending.

Financial Constraints

39 Given the importance of such lending, and if we also accept the continuing need for project finance and for sufficient World Bank input to induce other flows of finance, we have to consider the financial and operating constraints on the Bank. It is no surprise that these are rather different from those affecting the Fund. Nevertheless, they do exist and by examining them we can identify a number of problems to which the Bank should address itself in the period ahead.

40 First, the lending side. The Bank has to observe a statutory one-to-one gearing ratio between subscribed capital and reserves on the one hand and outstanding loans on the other. Thus, if lending continues to grow faster than capital, the Bank's ability to take on additional loans will disappear. Although we have not yet reached this point, we could soon be worryingly close to it. Continued growth in loan commitments would seriously erode the headroom presently available and would require the Executive Board to focus quickly on expanding the institution's lending capacity. The Bank may be able to sustain its current rate of lending for another year or two without needing a capital increase. But without further growth the

net flow of funds to developing countries - loan disbursements less repayments - would decline more steeply than currently projected, and the Bank might well find itself a net taker of funds from developing countries as a whole in two or three years' time. That would do little to enhance the World Bank's policy leverage. The message is, therefore, quite simple: an enhanced role requires general agreement on the need for an expansion of the Bank's lending authority - and sooner rather than later.

Gearing ratio

41 It would, of course, be possible to increase the Bank's lending if its gearing ratio were increased and it borrowed more on the markets. There are, however, inherent risks which in my judgment outweigh the advantages. The main attraction of this option, as canvassed by the Brandt Commission, is that it is apparently cost-free to the major shareholders. On the other hand, the Bank's statutory one-to-one ratio is uniquely conservative and represents one of the main pillars of its high credit rating. While we cannot be certain that a change in the gearing ratio would diminish its creditworthiness, it could be interpreted by the markets as a breach of faith and as a reduction in shareholder confidence and support. If so, the change could carry unfortunate implications for the Bank's market access and borrowing costs, which would in turn rebound on the volume and price of its lending. Ultimately, of course, it is the shareholders whose capital would be called in the event of a serious collapse of investor confidence. I thus regard the 'cost-free' aspects of this proposal with some suspicion.

Funding strategy

42 A substantial capital increase, on the other hand, would enlarge the Bank's lending authority without raising any such doubts, though it would not, of course, increase its ability to borrow from the markets. The continued success of its funding strategy rests on its access to as wide a range of markets as possible, and its ability to avoid saturating any one of them. The Bank has in fact successfully maintained a margin of 'excess capacity' by diversifying its borrowings across an ever wider range of currencies, markets and instruments. It is a process we support and which has been continuing as rapidly as considerations of cost and prudence allow. The Bank still relies, however, on the permission of member governments to borrow in their currencies, and this permission has not always been forthcoming.

43 One particular problem which the Bank faces, in common with other multilateral development agencies, is its relations with its shareholding governments, of which the industrial countries provide the major part of its capital backing. Among these countries there can be shifts in attitude, or doubts about the relative merits of multilateral as opposed to bilateral aid; and it is understandable that governments should often share the view of exporters in their country that bilateral aid ought to be distributed in a manner which benefits them as well as the recipient. Probably the wisest answer is that there should be room for both types of aid in major countries' budgets. Nevertheless, it is arguable that the channelling of aid through multilateral bodies may offer the best chance of avoiding wasteful duplication and of achieving greater efficiency all round. By allowing for international competitive bidding in procurement, multilateral bodies such as the Bank are best placed to ensure the efficient allocation of scarce aid resources. (And it is worth mentioning, parenthetically, that the UK's procurement record for contracts funded by multilateral aid has been relatively strong in recent years.)

44 However, questions are occasionally raised by governments and others about the efficiency of the multilateral development banks, and it will be vitally important for these agencies to prove their capabilities and to instil greater confidence. For the World Bank, the way ahead is to improve the functions I have been describing and to ensure, in particular, that its contribution to structural and other adjustment needs is based on sound conditionality. The solution here is in fact in the hands of the shareholders, who, I am tempted to suggest, should also consider redressing the relationships between the Bank's staff and its Executive Board. Some of the governments' doubts would be allayed if the role of the Executive Board could be enhanced to enable it to transmit shareholders' views more authoritatively.

Fund/Bank Co-operation

45 My last theme is the question of co-operation between the Fund and the Bank. Since so many countries' short-term difficulties are plainly the result of structural problems, it is sensible for them to look to the Fund and Bank for coherent policy advice as well as for financial assistance. The Fund will have to take account of the Bank's more prominent part in encouraging and monitoring adjustment efforts, and the Bank will need to rely on the Fund's advice in areas which lie within that body's competence - for example on exchange rates and credit policies. Both have a common interest in such subjects as appropriate external debt management policies in borrowing countries, and closer liaison between them could only be helpful.

46 The need for greater co-operation is now widely accepted and real attempts are being made to bring it about. It will not be easy, however, and there are obvious limitations to the process. As I have already explained, the institutions have separate identities, and it would be wrong to push them so close together as to compromise their distinct responsibilities or to dilute the purity of analysis and advice they now bring to their individual spheres of activity. This would be in nobody's interests, least of all those of borrowing countries.

47 Yet there is certainly room for something to be done. Fundamentally, we are talking about making the institutions more aware of and sensitive to each other's work. In practical terms it is not difficult to think of measures to promote the process of further co-operation: for example, more staff interchange to familiarise personnel with the workings of their sister institution; more joint staff missions; improved cross-fertilisation of research work; amalgamation of support services (such as the provision of debt statistics); and attendance at Bank Board Meetings of senior officials from the Fund (and vice versa) where general discussion of a country's economic performance is likely to be of relevance to both bodies. Modest organisational reforms will not resolve all the problems, of course, but if they improve lines of communication it should be possible to avoid the requirements of one institution running directly counter to, and thereby impeding assistance from, the other.

Conclusions

48 In conclusion, the main points I want to leave with you are these. First, the Fund is still, I believe, the only international institution which can provide the expertise, together with lubricating finance, to help economies return to equilibrium. In that context conditionality is essential, primarily as a helpful discipline to borrowers but also as a form of reassurance to other Fund members, on whose continuing commitment the existence of the Fund depends. Over time it would be helpful to confidence if Fund surveillance could be extended effectively to the whole membership, one consequence at least being the opportunity to eliminate some of the restrictive practices which have developed since the end of fixed exchange rates. Secondly, I think that the World Bank's role in assisting structural adjustment in developing economies should assume greater importance. To ensure this, without prejudice to project lending, a general capital increase is likely to be necessary in the fairly near future. Thirdly, the Fund and Bank need to work more closely together on questions related to developing countries, though we have to recognise that they cannot between them provide all the finance that economies in difficulty are likely to need.

49 Finally, I think that both Fund and Bank have stood up remarkably well to the challenges of recent years; and both deserve our gratitude for the constructive flexibility with which they have responded to the problems thrown up by world recession. The greatest mistake would be to risk throwing away what we already have. That is why I believe it right to work through existing institutions and to speak in terms of controlled evolution rather than of fundamental reform. But I also believe, especially at a time when the institutions are playing a more vital role than ever, in the need to maintain and reinforce our support. We need a strong IMF not only because of the demands placed upon it at present but also because, as in the recent past, it should be ready and able to meet contingencies. We shall also need it as a fulcrum of the next phase of evolution in the international monetary system, whatever that may be. We need a strong World Bank because clearly it will be called upon to continue its long-term financing of development in the years ahead, and also because in its newer role I see it sharing the IMF's task of encouraging adjustment and pursuing those very necessary efforts into the medium-term and beyond. I have no doubt that these "lusty twins" have at least another 40 years of beneficent life in them.

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TO IMMEDIATE FCO

TELEGRAM NUMBER 1730 OF 31 MAY 1984

SECRETARY OF STATE'S VISIT: BREAKFAST WITH VOLCKER

1. AT BREAKFAST TODAY, DISCUSSION BETWEEN THE SECRETARY OF STATE AND CHAIRMAN VOLCKER FOCUSSED ON INTERNATIONAL DEBT AND PROSPECTS FOR THE US ECONOMY.

2. ON DEBT, VOLCKER SAID THAT HE HOPED THE LONDON SUMMIT WOULD ENDORSE MULTI-YEAR RESCHEDULINGS. HE WAS ESPECIALLY ANXIOUS TO MAKE SUCH AN ARRANGEMENT FOR MEXICO, TO SPAN THE NEXT FOUR OR FIVE YEARS, AND HE WOULD BE PROMOTING THE IDEA AT THE PHILADELPHIA BANKING CONFERENCE. (MEXICO WOULD NOT, HE THOUGHT, NEED NEW MONEY IN 1985.) MORE GENERALLY, VOLCKER SAID HE WAS CONCERNED ABOUT THE PROPOSED BOGOTA MEETING OF LATIN AMERICAN DEBTORS, FOR WHICH ARGENTINA SEEMED TO HAVE BEEN A MOVING SPIRIT. ARGENTINA WAS ALSO A WORRY IN ITSELF: HE DID NOT RULE OUT THAT THEY MIGHT REFUSE TO AGREE AN IMF PROGRAMME. HIS BROAD STRATEGY WAS TO TRY TO ISOLATE ARGENTINA, BY CONSOLIDATING THE PROGRESS WHICH HAD BEEN MADE IN MEXICO AND BRAZIL AND IF POSSIBLE BY PERSUADING VENEZUELA TO CO-OPERATE WITH THE IMF. AT THE SAME TIME, EVERY EFFORT SHOULD BE MADE TO KEEP ARGENTINA IN PLAY THROUGH CONTINUING NEGOTIATIONS WITH THE FUND AND THE COMMERCIAL BANKS. THIS STRATEGY DID, HOWEVER, INVOLVE CONSIDERABLE DIFFICULTIES OF TIMING. AGREEMENT OF A MULTI-YEAR RESCHEDULING FOR MEXICO WOULD TAKE SOME WEEKS. MEANWHILE, THE END OF JUNE WOULD BE A CRITICAL DATE FOR ARGENTINA. THE US BANKS WERE LESS WELL PLACED NOW TO WITHSTAND THE CONSEQUENCES OF LOAN QUALIFICATION THAN THEY HAD BEEN AT THE END OF MARCH. IN RESPONSE TO A COMMENT BY THE SECRETARY OF STATE ON RISING INTEREST RATES, VOLCKER ACCEPTED THAT RECENT INCREASES HAD PROVIDED AMMUNITION TO THE LATIN AMERICANS: THERE WAS QUOTE AN ETERNITY UNQUOTE BEFORE THE PRESIDENTIAL ELECTION. VOLCKER INDICATED THAT HE WAS ATTRACTED BY THE IDEA OF INTEREST RATE CAPPING BUT STRESSED THAT ANY COSTS WOULD HAVE TO BE BORNE BY THE BANKS. FINALLY, VOLCKER SAID HE DID NOT THINK DEVELOPMENTS IN THE GULF WOULD SERIOUSLY AFFECT MANAGEMENT OF INTERNATIONAL DEBT PROBLEMS: ON SOME READINGS, THEY MIGHT BENEFIT THE OIL DEBTORS WITHOUT HURTING THE NON-OIL DEBTORS.

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3. ON THE US ECONOMY, VOLCKER THOUGHT THAT IT WAS IN SOME WAYS DOING TOO WELL. BUT THERE WAS SOMETHING RATHER PERVERSE ABOUT THE WAY GOOD NEWS ON GROWTH LED TO FALLS IN THE FINANCIAL MARKETS. HE WAS CONCERNED ABOUT THE TRADE DEFICIT AND SURPRISED THAT IT HAD PROVED SUSTAINABLE FOR SO LONG. ON FISCAL POLICY, VOLCKER THOUGHT THAT THE FINANCIAL MARKETS HAD ALREADY DISCOUNTED THE EFFECTS OF THE QUOTE DOWN PAYMENT UNQUOTE PACKAGE. FOR THE FUTURE, HE DID NOT WHOLLY SHARE THE GENERAL EXPECTATION THAT THE ADMINISTRATION WOULD MAKE A SERIOUS ASSAULT ON THE DEFICIT SOON AFTER THE ELECTION. THEY MIGHT BE SIDETRACKED, IN PARTICULAR BY REFORM OF THE TAX CODE. ON INTEREST RATES, VOLCKER SAID THAT THE RECENT RISE HAD NOT, FORMALLY, RESULTED FROM ACTION BY THE AUTHORITIES. IT HAD BEEN A MARKET RESPONSE TO OVERALL CREDIT DEMAND AND RISING INFLATIONARY EXPECTATIONS.

4. FCO PLEASE ADVANCE TO PS/CHANCELLOR, LITTLER, LAVELLE (FOR WICKS) (HMT), PS/GOVERNOR, LOEHNIS (BANK) AND TAIT (ERD)

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TO IMMEDIATE IMF WASHINGTON
TELNO.MISC 16 OF 17 FEBRUARY.

FOR NIGEL WICKS, UK DELEGATE TO THE IMF.

FOLLOWING HAS BEEN PASSED TO DIRECTOR, FISCAL AFFAIRS DEPARTMENT, IMF AND TO MR DANNEMANN, BUREAU OF STATISTICS, IMF.

FROM R.G. WARD, CENTRAL STATISTICAL OFFICE.

IMF OCCASIONAL PAPER NO.24: 'GOVERNMENT EMPLOYMENT AND PAY - SOME INTERNATIONAL COMPARISONS'.

THIS RECENTLY PUBLISHED PAPER HAS BEEN GIVEN WIDE PUBLICITY IN THE BRITISH PRESS OVER THE PAST TWO WEEKS. IT IS A GREAT PITY THAT THE IMF GAVE NO INDICATION OF ITS INTENT TO PUBLISH AS THE PAPER IS SERIOUSLY FLAWED, PARTICULARLY IN RELATION TO ITS TREATMENT OF THE FIGURES FOR THE UNITED KINGDOM. THE PUBLICATION OF ERRONEOUS CONCLUSIONS, BASED IN ONE INSTANCE ON DATA WHICH CAN ONLY BE DESCRIBED AS FICTITIOUS HAS CAUSED SOME EMBARRASSMENT TO H.M GOVERNMENT ,TO WHICH EFFICIENT MONITORING OF THE PUBLIC SERVICE HAS BEEN A PRIME OBJECTIVE.

THE MAIN CRITICISMS OF THE PAPER ARE AS FOLLOWS:

FIRST, THERE WAS A LARGE ARITHMETIC ERROR IN THE U.K FIGURES QUOTED. IN THE MANPOWER FIGURES WE SUPPLIED WE COULD NOT SHOW SEPARATELY A FIGURE FOR 'ADMINISTRATION'. THE FIGURE OF 0.78 PER 100 POPULATION IN TABLE 30 SEEMS TO HAVE BEEN INVENTED BY THE PAPER'S AUTHORS, AND THEIR CONCLUSION (ON PAGE 24) THAT OF THE COUNTRIES IN OECD THE UNITED KINGDOM IS THE MOST OVERBURDENED WITH ADMINISTRATION IS A (FOLLOWING WORDS UNDERLINED) COMPLETE FABRICATION.

SECOND, ALTHOUGH IN THE FUNCTIONAL EQUATIONS FOR CENTRAL GOVERNMENT, STAFF IN HEALTH, EDUCATION AND THE POLICE WERE AUGMENTED BY LOCAL AUTHORITIES STAFF THIS ADJUSTMENT DOES NOT ADEQUATELY COPE WITH THE VARYING INSTITUTIONAL ARRANGEMENTS FOR PROVIDING THESE SERVICES. IN SOME COUNTRIES WHERE THESE SERVICES ARE FINANCED INDIRECTLY THROUGH SUBSIDIES AND TRANSFER PAYMENTS, THE STAFF EMPLOYED IN PROVIDING NATIONAL HEALTH OR EDUCATIONAL SERVICES ARE CONSIDERED PART OF THE PRIVATE SECTOR. FURTHERMORE, IN THE ANALYSIS LEADING UP TO TABLE 16 OF THE PAPER NO COVERAGE ADJUSTMENTS AT ALL WERE MADE. IN THE UNITED KINGDOM, OVER HALF OF ALL CENTRAL GOVERNMENT EMPLOYEES WORK IN THE NATIONAL HEALTH SERVICE, AND THIS IS THEREFORE THE MAIN REASON WHY THE IGEM INDEX IS SO HIGH FOR THE UNITED KINGDOM. TO GIVE THE IMPRESSION THAT A HIGH IGEM INDEX REFLECTED EXCESSIVE BUREAUCRACY WAS QUITE MISLEADING.

FINALLY, ALTHOUGH THERE SEEMS TO HAVE EMERGED SOME SIGNIFICANT 'T'-STATISTICS FOR THE REGRESSION CO-EFFICIENTS, THE OVERALL CORRELATION IS QUITE LOW, WITH CONSEQUENTLY WIDE MARGINS OF ERROR IN THE 'PREDICTED VALUES' AND THE IGEM INDEX NUMBERS. LEAGUE TABLES BASED ON THE LATTER ARE FAR FROM THE PRECISE INDICATORS WHICH THE PRESENTATION MAKES THEM APPEAR TO BE. PERHAPS THE MOST STRAIGHTFORWARD WAY OF DEMONSTRATING THIS IS BY COMPARING THE PREDICTED VALUES FOR CENTRAL GOVENRMENT IN TOTAL WITH THE SUM OF THE FUNCTIONAL SECTORS. IN TABLE 16 PREDICTED EMPLOYMENT FOR THE U.K CENTRAL GOVERNMENT IS SHOWN AS 1,173,000. THE COVERAGE OF CENTRAL GOVERNMENT IN THE U.K IS EQUIVALENT TO ALL THE FUNCTIONAL SECTORS OTHER THAN EDUCATION AND POLICE. SUMMING THE PREDICTED VALUES SHOWN IN TABLE 33 (INCLUDING AN ESTIMATE FOR 'OTHER', NOT SHOWN: INCIDENTALLY, THE PREDICTED VALUES ARE CLEARLY RATES PER 100 INHABITANTS AND NOT THOUSANDS OF EMPLOYEES AS THE TABLES STATES) PRODUCES A TOTAL OF 1,800,000 EMPLOYEES, SOME 53 PER CENT HIGHER. ONE DOES NOT EXPECT TO FIND EXACT MATCHING, BUT A DISCREPANCY OF THIS ORDER DESTROYS THE CREDIBILITY OF THE WHOLE PROCEDURE.

THE ABSENCE OF THE MORE OBVIOUS CHECKS DOES NOT GIVE ANY GREAT CONFIDENCE IN THE UNCHECKABLE PARTS OF THE PAPER, IN PARTICULAR THE ESTIMATION OF THE EQUATIONS.

I MUST ASK THEREFORE FOR THE IMF TO ISSUE AN IMMEDIATE RETRACTION OF THE CONCLUSIONS OF THE PAPER. THE RITUAL CLAIM MADE IN THE INTRODUCTION THAT THE CONCLUSIONS ARE THOSE OF THE AUTHORS AND NOT OF THE IMF HAS NOT PREVENTED THEM BEING PRESENTED IN THE PRESS AS HAVING THE AUTHORITY OF THE FUND. AS BOTH THE PRIME MINISTER AND THE CHANCELLOR OF THE EXCHEQUER HAVE BEEN MADE AWARE OF OUR CONSIDERED VIEWS OF YOUR PAPER I WOULD APPRECIATE AN EARLY RESPONSE.

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Prime Minister
A clean bill of health from the IMF.
AT 14/12

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

14 December 1983

Andrew Turnbull Esq
10 Downing Street

Dear Andrew,

IMF 1983 ARTICLE IV CONSULTATIONS

The IMF concluded earlier this week their annual review of the UK economy - the so-called Article IV Consultations. You may like to see the attached transcript of the closing remarks delivered by Patrick de Fontenay (Head of the Fund team) at the final plenary session on 12 December.

As you know, after the visit a report is prepared by the staff, but not published, and the consultation process is completed by a discussion in the Fund's Executive Board. The assessment is thus provisional at this stage. But as they stand the Chancellor regards the Fund's conclusions, and the supporting analysis, as broadly satisfactory.

On this occasion the Fund seem to have had two main objectives. First, while impressed with the performance of the economy in terms of prices, competitiveness and output - the increasingly favourable split in nominal GDP between growth in output and inflation is one way they put it - they wanted to be satisfied they could track these developments back to the underlying policy stance. Secondly, they decided this year to give their analysis a medium term perspective, and in particular to test the objectives for public expenditure, tax reform and labour legislation against that time frame. On both counts, they appear to have come away broadly content with what they learnt.

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Although the press are told of these annual IMF visits, we do not normally say anything publicly after them. The Chancellor thinks it right to preserve this tradition. We have, however, established with de Fontenay that in the event of any erroneous press speculation, or disclosure in Washington, it would be reasonable for us to confirm informally that the Fund staff endorsed the general stance of Government economic policy.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

December 12, 1983

INTERNATIONAL MONETARY FUND

United Kingdom - 1983 Article IV Consultation

Preliminary Conclusions of the Mission

Our preliminary conclusions will not come as a surprise to you. As you noted at our first meeting, previous Fund missions have endorsed the general thrust of the Government's economic policies and the improved performance of the economy, in terms of prices, output and employment, appears to have vindicated those policies. We had to satisfy ourselves, however, that the current recovery in economic activity actually resulted from the policies which the Fund had supported in the past and not from a change in the policy stance. On this point we are now generally reassured.

Some slippage from fiscal and monetary objectives did occur toward the end of last year and earlier this year but corrective action has been taken. By the next fiscal year, both the PSBR and public expenditure should be back in line with the MTFS guidelines. Monetary aggregates are back around the top of the target range. We note that if greater weight were to be given now to the behavior of Mo it would signal a somewhat easier policy stance than the other indicators but we have not yet been able to form a judgment as to the significance and interpretation of that particular aggregate. Most countries have found it necessary to widen the array of intermediate targets and supplementary indicators used to monitor monetary policy. This leaves a greater role for judgment in interpreting often conflicting evidence, and therefore increases the margin for error. Perhaps this is inevitable given the pace of financial innovation and the changes in savings patterns. But too much agnosticism can carry risks as well. For this country, the steadily declining growth rate of nominal GDP in recent years, with an increasingly favorable split between growth in output and inflation, suggests that both judgments and policies have been broadly appropriate. Nevertheless, current monetary developments need to be watched in order to ensure that the deceleration in monetary expansion implied by the targets for next year takes place smoothly.

Exchange rate policy has remained flexible. While we recognize that exchange rate developments can prove a useful supplementary indicator of monetary conditions, they should not lead to policy reactions in all circumstances: this has not been the case. Changes in the nominal exchange rate have contributed, together with a better relative cost performance, to an improvement in competitiveness in 1981 and 1982. The deceleration in production costs, like the improvement in profitability, is not as broadly based as one would wish, however, as it applies to a smaller number of firms. Further progress in restraining domestic costs remains desirable. Otherwise the current recovery could be in jeopardy as there are clearly limits to the extent the exchange rate can compensate for a deterioration in the external current balance without resulting in unacceptable inflationary pressures.

We have tried on this occasion to look beyond 1984, a year for which prospects remain favorable, to see what further actions seem called for to leave the economy in a stronger position for the time when it will face a decline in oil production and exports. Another reason for adopting a somewhat longer time horizon, is our conviction that appropriate macroeconomic policies are not enough to ensure a better performance of the British economy. Actions are needed to enhance its competitiveness, efficiency, and flexibility. The type of measures needed take time to design and implement, and their effects are likely to come through only with a lag. The earlier the reform process can be started, the better. There is of course a very wide range of measures which appear useful and desirable, some of which, like privatization, have already been set in motion. We shall focus here on three areas only: public expenditure, tax reform, and the labor market.

It has always been the stated intention of this Government to reduce the relative size of the public sector. Considerations of efficiency and of the magnitude of the tax burden have been prominent. We believe there are others which can best be discussed in the framework of the MTFS. We were pleased to read that the Chancellor had said that the MTFS was alive and well. Indeed, we hope that its horizon can be extended and an LTFS might even be envisaged.

In that framework, reducing the size of the public sector should mean reducing public expenditure in order to reduce both taxes and borrowing. Tax reductions are desirable in the context of the tax reform we discuss next and because of the need to stimulate saving formation and avoid a possible tax-push to incomes and prices. In other words, reducing the PSBR by raising taxes is not an attractive option in the medium-term. In this context, the current proposals on "rate-capping" for local authorities are an important and commendable initiative. At the same time, the goal of reducing the PSBR, particularly now when the economy is on a cyclical upswing, seems equally desirable in order to avoid upward pressure on interest and exchange rates. For the recovery to be sustainable investment must not be crowded out and competitiveness must be enhanced. From a longer term perspective, if this country is to make up for its lagging growth performance relative to other industrial countries, it must devote a larger share of resources to investment and a smaller share to both public and private consumption.

We believe that these are some of the considerations which should guide public expenditure plans. The goal of keeping public expenditure constant in real terms over the next three years is no doubt not an easy one to achieve. If adhered to, it should allow some reduction in both taxes and public borrowing, though perhaps more modest than one would wish. It may also be possible, in public discussions of these issues, to move away from the notion that asset sales are an offset to public expenditure.

We would hope that early action can be initiated on some of the reforms of the demand determined programs, such as turning to the private sector for the provision of certain supplementary health and pension benefits, so as to ensure that the present spending targets are not exceeded and that they can be extended in a more ambitious direction in the subsequent period. Although the margin of uncertainty as regards long-term capital requirements is considerable, it seems clear that they are higher than the present investment ratio can provide and that a shift of resources out of the public sector is required to stimulate private savings and investment. We do not see foreign borrowing as an attractive option given the prospect that the current account position will soon begin to be adversely affected by the progressive reduction of North Sea oil production.

Turning to tax reform, we would include under that heading both the desirability of cutting certain taxes and tax reform proper. Reductions in payroll taxes and higher tax threshholds which would encourage employment and reduce the "poverty trap" should, in our view, be high on a list of priorities. We also very much support the ongoing reassessment of the various forms of investment allowances and other financial incentives to enterprises, which produce distortions between sectors and tend to encourage firms to substitute capital for labor, and hope that this reassessment will lead to a simpler and more neutral system of corporate taxation.

As regards labor markets, we can also be brief. Generally, we endorse the conclusions of the Chancellor's recent memorandum to the National Economic Development Council on "Changing Employment Patterns". The Government can provide opportunities for training and encourage labor mobility, but beyond that we would agree that it cannot determine where and when new jobs occur. The scope to influence the choice between the level of earnings and the level of employment is also limited. Nevertheless, tax and employment protection legislation which discourages hiring could be changed. Labor legislation can also provide an environment in which labor markets respond more readily to supply and demand changes in the whole economy and to the special circumstances of individual companies and plants. Important changes have already been made in that area. Anything that can be done to reverse the continued upward trend of real wage costs should over time contribute to a better labor market situation and reduce the social and financial costs of unemployment.

Finally, we have for the first time examined in some detail the U.K.'s trade and trade adjustment policies. Like most other countries, the U.K. has not been able to resist all the pressures for protection resulting from loss of competitiveness and the recession, as well as actions taken by some trading partners. It would seem in accordance with the general principles of the Government's economic policies to aim at greater transparency in that area and at progressive trade liberalization. The gains to be reaped from freer trade in terms of lower inflation and greater efficiency would argue strongly for the dismantling of trade barriers and the phasing out of assistance to uncompetitive sectors.

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THE NEW YORK TIMES, SUNDAY, OCTOBER 2, 1983

The I.M.F.'s Perilous Plan for Growth

Critics fear the fund's austerity drive will kill recovery and drive poor nations further into slump.

This article was reported by Jeffrey Madrick and William Wolman and written by Mr. Wolman.

THE official tone at the International Monetary Fund's annual conference in Washington last week was guardedly optimistic. The forecasts framing the discussion called for an economic recovery in the industrial nations modest enough to allow interest rates to subside but rapid enough to enable the nations of the third world to begin working down their mountainous debt. "The recovery is growing strongly and the adjustment process is working very fast," declared Jacques de Larosiere, the I.M.F.'s managing director, with considerable confidence.

The conference focused on replenishing the resources of the I.M.F. and other world lending agencies. Officials clearly felt threatened by the balky United States Congress, which has yet to vote an increase in the American contribution to the fund. But the general view at the meeting was that once Congress comes through — which most expect — the I.M.F.'s slow-growth game plan for dealing with the world financial crisis, adopted at last year's meeting in Toronto, would work.

There is, however, a counterculture viewpoint — which surfaced frequently in the corridors of the I.M.F. meeting last week — that does not share even such guarded optimism about the future of the world economy. A number of economists and bankers, from a broad political and ideological spectrum, believe that the grand design that succeeded in containing last year's international banking crisis has little chance of putting the world economy back on a path of sustained recovery.

These somewhat iconoclastic pessimists include a Nobel Prize-winning economics professor, a leading Canadian economist of Keynesian pursuasion, a well-known American economist of monetarist bent and a heavy sprinkling of eclectic European and American bankers and financiers of no particular ideological stripe. Their views — which do not coincide on all matters — reflect the deepest fears of a growing number of economists and financiers. Alexandre Swoboda, director of the International Center for Studies of Money and Banking in Geneva, is one of the latter. "All may be fine in the world for the next six months or so," he said last week as he attended the I.M.F. meeting in Washington, "but then something is going to come undone."

IF these economists are basically correct, the great economic policy trap of the 1980's could prove to be the exact opposite of the one that entangled the world in the 1970's. During the last decade, policy makers and forecasters throughout the industrial and developing world repeatedly underestimated the devastating impact of inflation on the world economy, and paid the price in repeated recessions and slow growth.

Now, according to the counterculture view, these same policy makers and forecasters may be locked into a course that not only underestimates the power of the deflationary forces at work but also imposes severe austerity policies that could make the collapse of prices and economies inevitable. These austerity policies are the core of the I.M.F. game plan.

Many mainstream economists, of course, claim that another era of chronic policy errors can be avoided. "I am confident," said Mr. de Larosiere in a speech before the world's bankers last week, "that the spirit of cooperation that has sustained the fund over the recent difficult period can be strengthened so that we can meet the challenges ahead."

Given this general attitude, there was little evidence of fresh thinking at last week's meeting of the I.M.F., and no sign that the world's finance ministers and central bankers were making any serious provisions to deal with the weaknesses, or downside risks, that lurk in many corners of the international economy.

According to Sylvia Ostry, special adviser to the Privy Council in Canada and former chief economist for the Organization of Economic Cooperation and Development, "all the risks are now on the downside." In her activist approach to tax and spending policies, Mrs. Ostry is an economic Keynesian.

Said Nicolas Krul, a noted Swiss investment banker who shares some of her views: "The real objective of the I.M.F. conference is to keep serious worries

Continued

from surfacing."

The counterculture does not speak with one voice, but its basic message is clear: The world's financial problems — however ominous — must be faced openly by international agencies and major banks if they are to be resolved fairly and with as little political pain as possible. To the group, that means three things:

- Banks will have to give up hope of ever collecting all of the billions of dollars owed them by third-world nations.
- Governments in the industrial nations will have to shoulder more of the burden by pumping more money into the developing world's empty coffers.
- Political and financial leaders must shake off their obsession with inflation and adopt policies that are designed to sustain growth, not restrict it, even though inflation might rise somewhat in the process.

Policies that are quite the opposite, however, are now in place. The banks, reluctant to write down bad third-world debts, are rolling over old debts and making very few new loans to developing nations. On top of this, the I.M.F. has imposed stringent austerity programs on 46 developing countries — a quid pro quo for financial assistance — that in some instances have intensified local depressions that rival the worst periods of the 1930's. And the fear of renewed inflation has so intimidated industrial world leaders that their primary policy initiative has been to hold down growth.

TO many analysts, weak economic growth is not the worry. "If there are serious signs of a slowdown, the Federal Reserve can easily lower interest rates," said Barry Bosworth of Washington's Brookings Institution. But his Brookings colleague, Robert Solomon, an international economist, argues that weakness is very much the problem. The industrial world's "insistence on restrictive policies will make it impossible for the developing world to generate the export growth it needs to resolve the debt crisis," he said.

The only real source of world import growth and the one truly bright spot in the world economy is the United States, where a consumer-led recovery has been generated by record government deficits and a sharp fall in the savings rate. But to the counterculture thinkers, that recovery — which is expected to slow in the fourth quarter of this year — is a shaky foundation for world growth. The great concern is that there is no sign yet that rapid United States growth has provided much impetus to a self-sustaining takeoff in the rest of the world economy. The main problems are the shrinking American role in the world economy, and a United States policy mix that has created high interest rates and an overvalued dollar.

Traditionally, it is the American locomotive that pulls the rest of the economy along. "But the U.S. ability to pull up the rest of the world is much less than it once was," said Mrs. Ostry. "Every 1 percent rise in the U.S. economy will produce only a one-quarter percent rise in the rest of the O.E.C.D."

Moreover, according to A. Gary Shilling, a Wall Street economic consultant who heads his own firm, for the first time in post World War II history, weakness in the rest of the world could pull the United States recovery down as the thrust of domestic consumption and government spending peters out.

Europe is only now showing signs of strength amid its worst levels of unemployment since the Depression. Japan's growth is significantly below normal, and dependent on an export surge that for now is feeding the consumer boom in the United States.

The slow-growth attitude of world policymakers was reflected in Bonn's decision last month to raise its discount rate soon after the first signs of economic strength. Japan, concerned that its budget deficit is already too high, plans to provide no further fiscal stimulus to its economy. And its monetary policy remains constrained as it tries to bolster the yen against the rising dollar. The O.E.C.D.'s July forecast predicted growth in the U.S. and Canada next year of nearly 5 percent. But growth in Japan will be 3.5 percent, far below its historical average. And in Europe there will not be enough growth, says the organization, to prevent unemployment from rising above current record-high levels.

Outside the industrial world, the picture is far worse. Mr. de Larosière points out that 1983 will be the third year in a row in which economic growth per capita has stagnated in the third world. In Brazil, the real gross domestic product has already declined as rapidly as it did between 1928 and 1931. And the outlook suggests that it will drop still further. Production is off at a similar rate in Chile and real wages in Mexico have fallen sharply.

This combination of depression in the third world and slow growth in the West and Japan, is the central paradox in the I.M.F.'s strategy. What export earnings these countries can generate — and it will be modest at best — will be funneled into the repayment of their debt. Brazil's interest on its external debt, for instance, came to 79 percent of export sales in 1982. "Even if they can afford it," said George Soros, a New York money manager who runs the firm that bear his name, "it will just increase dangerous political tensions. There will probably come a point where they just won't be willing to pay."

In some sense at least, the industrial countries chose the slow-growth track upon which they are running. By contrast, the third world has been given virtually no choice but to pull in its belt. Forty-six developing nations are now operating under tough I.M.F. programs designed both to fend off immediate crises and to speed the borrower's return to the private credit markets.

But so far, there is little evidence that the programs are having the intended effect. Net new credits have been minimal in 1983. Data Resources Inc. reports that, based on data from the Bank for International Settlements, net new lending to developing countries in the first quarter of 1983 came to only $2 billion at an annual rate. D.R.I. estimates that the same rate continued into the second quarter. By contrast, new loans in the first half of 1982 grew at a $50 billion annual rate.

"There is no way the major banks can get out of this situation without writing down some of the debt," said Fritz Leutwiler, president of the Bank for International Settlements, at a speech at last week's conference. Wassily Leontief, who has won the Nobel prize in economics and is a professor at New York University, says: "The third world must have transfers of income in order to grow." He believes the transfers must come out of the coffers of government if not the hide of the banks.

The fundamental problem is that the balance of payments correction that Mr. de Larosière is trying to bring about in the third world has been achieved so far mostly by cutbacks in third world imports. To meet future financial obligations — with tighter world credit conditions — the developing countries must grow at a steady pace. But the combination of their existing debt burden and the new I.M.F. restraint programs may make this impossible.

IN Brazil, for example, said John Williamson of Washington's Institute for International Economics, the I.M.F. has demanded that wages be indexed to 80 percent of inflation, down from 100 percent. More important, the fund wants Brazil to bring its budget deficit to 7 percent of gross domestic product by next year, rather than the last year's 17 percent rate.

The attendant drop in demand would put a burden on Brazil's private sector that economists familiar with the country believe would be politically intolerable. "Brazil may promise to meet I.M.F. conditions," say Larry Sjaastad, a University of Chicago economist and specialist in Latin America, "but there is no way they can do it."

Compounding the problem, according to the counterculture analysis, is what some call the self-interest of the private banking system. On the one hand, the banks are earning huge fees in turning over existing loans, said Alan Meltzer, a monetarist economist

Continued

The I.M.F.'s Perilous Plan

from Carnegie-Mellon University. On the other hand, the private banking system as a whole is trying to reduce its overall exposure. Regional banks, for example, have reduced their inter-bank lending drastically to certain third world countries. Swiss and West German banks, sometimes at the prodding of their depositors, have also pulled back.

Yet, even if the industrialized world were headed for rapid and sustained economic growth — which would allow it easily to absorb growing exports from the developing world — some analysts say the third world would still need a rapid expansion of private credit from the West to get growth going.

Rimmer de Vries, chief international economist for Morgan Guaranty, estimates that new extension of private credit must grow by a sizable 7 percent a year — about $25 billion — for the developing countries to meet their debt repayment schedules.

It is already becoming clear that the I.M.F. will need more money from governments to meet its commitments than it expected just days ago. According to reports from the Washington meeting, Karl Otto Poehl, president of the West German Central Bank, estimated that the I.M.F. would need an emergency loan of $6 billion to $7 billion, in addition to the $8 billion it is waiting for from the United States and $6 billion expected from several other countries.

According to the counterculturists, the ultimate irony in I.M.F. thinking is that, even if its program could work in a few isolated countries, it is doomed to failure when applied so sweepingly to the entire third world. It is one thing to tell a single country to reduce imports drastically and expand exports. It is another to demand it of a whole region. Everybody can't sell more than they buy.

"The I.M.F. is telling everyone to export more; it forgets that somebody must import more," said Mr. Sjaastad from Chicago. The Shadow Open Market Committee, an unofficial group of economists that makes alternative policy proposals to actions taken by the Federal Reserve, made the same point recently.

Another bone the counterculture analysts pick with their mainstream colleagues is over the prospects for worsening inflation. "World leaders are still fighting inflation," said Mrs. Ostry, who formerly served as chairman of Canada's Economic Council in Ottawa. But, she adds, "outside of the financial marketplace, there is little evidence of inflation or inflationary expectations."

World wages, even in the expanding United States, have been particularly restrained. And volitile commodity prices, while rising substantially, have performed tamely for this point in a recovery. The Economist's index of world industrial commodities is up 17 percent since last year's trough, but it is still 25 percent below its 1980 peak. The moderation in prices contrasts sharply with the inflation premium built into high worldwide interest rates.

For any economist trying to figure out how the third world can move into a period of sustained growth, the most visible problems are high United States interest rates, and the consequent overvalued dollar. Those severely constrain, most analysts say, the ability of America's trading partners to pursue expansionary policies.

First, such countries feel they must keep their interest rates close to United States rates to protect their currencies and prevent huge capital outflows. Second, imports grow more expensive as currencies weaken and so countries worry about the inflationary consequences of stimulus.

"Expansion means more imports," says Mr. Swoboda, the Geneva economist. "And a country whose currency is weak and falling fears that the rising prices of those imports will trigger more inflation than real growth."

Some imbalances go beyond the problems of a strong dollar. The OPEC oil shock and a decade of slow growth have produced giant excess capacity in many basic industries. In a world dominated by slow growth policies, only the most dynamic economies, the United States, Japan and some countries in southeast Asia, have managed to create new industries to offset some of this decline.

Europe, for example, makes only 5 percent of the computer chips it uses. "The big problem in Europe is structural," says Karl Vak, head of an Austrian Central Savings and Commercial Bank. The great fear in Europe, said Mr. Swoboda, is that industrial backwardness means that economic stimulus will only lead to increased inflation or increased imports, not production or jobs.

Finally, the harsh contraction of imports by the third world, economists say, has cut back a vibrant source of export growth for the entire world. A reduced export market in the third world is not an enormous threat to the industrial nations of the O.E.C.D. because only 7 percent or so of their exports are sent in that direction. But the third world and the oil countries represent the fastest growing markets for the O.E.C.D. nations and in this sense, any slowdown in market growth, could retard growth prospects.

What the capital markets fear — and policymakers, too, at the I.M.F. and elsewhere — is that the world's slow growth crisis will ultimately be resolved by a great injection of reserves by the world's central banks that would, in turn, feed inflation. According to this scenario, central bankers will eventually supply massive reserves to help their banks expand credit, swallow bad debts, or ultimately, to avoid a major bank failure "A lot of people here are acting as if it will all be papered over," said Mr. Swoboda.

So far, however, it's clear that Western governments, especially the United States, are being especially parsimonious in doling out loans to the third world. The battle in Congress could still go against the I.M.F. quota, some Washington observers say. And in sharp and ironic contrast to the fear of too much credit flowing to the third world, the I.M.F.'s restrictive policies are forcing billions of dollars of income to flee from these third world countries to safer and more lucrative havens in the industrial world.

Moreover, the private banking community is actively trying to reduce its exposure to third world lenders and seems to have taken the view that it will expand credits only under official auspices, as in the new $6.5 billion commitment to Brazil worked out with the I.M.F.'s de Larosiere and Federal Reserve Chairman Paul A. Volcker at last week's conference.

These are not conditions that generate inflation, say the counterculture analysts. "You've got to understand," said Carnegie-Mellon Professor Meltzer, "these austerity programs are killing the debtor countries. They are being made to pay back laons that were never put to productive use."

According to Chicago's Mr. Sjaastad, between 1971 and 1982, debt service to the third world adjusted for the United States inflation rate grew by 17 percent a year. A study by the Amex Bank in London, a subsidiary of the American Express Company, reveals that since 1978, developing countries repaid $126 billion in interest payments of the total $140 billion lent to them. The small margin of $14 billion is all they had to spend on consumption and investment. And if no new credits are made in 1983, reports the bank, even that small margin will be wiped out.

ALL of which convinces the counterculture group that the potential for a worsening of the financial crisis in 1984 is large. "The issue is whether we have a controlled solution or an uncontrolled one," says Mr. Krul, who is the head of the Gulf & Occidental Investment Company, S.A., in Geneva. "An uncontrolled one could be disasterous."

Mr. Krul reflects the view of many analysts who believe that the banks and the governments of the industrial nations must eventually assume some of the developing countries' debt, at the same time forcing the banks to write down and restructure their debt.

"To some extent, the debt must be socialized among the world's countries," he said. One way frequently proposed to do this would be to have the central banks guarantee or even take over private loans, but at a value discounted to reflect more closely true economic value. George Soros, the New York investment manager, holds to this view. "The banks won't do it on their own," he said.

To Professor Leontief, the risks are even more stark. "Either we save the third world and the banks now, or we create political turmoil now, save the banks later, and give up entirely on the countries," he said.

Underlying the more sanguine views that prevailed at the I.M.F., is the comforting assumption that what are called "spontaneous" forces of recovery will somehow save the day and produce the environment necessary over the next year or two to wring excess debt out of the debtor nations.

But beneath this, say some counterculture analysts, lies a more cynical attitude, particularly among private bankers: Wring all you can from the third world now and if a new crisis comes, the Government will at last bail you out.

Such an ad hoc and painful road to the future should be avoided, say the these economists and bankers. An explicit, open arrangement among nations is needed. As Mr. Krul put it: "Solving the problem will require more international cooperation than at any other time since the end of World War II." ■

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IMF/IBRD ANNUAL MEETINGS 1983

1. THE 1983 ANNUAL MEETINGS, AND THE ASSOCIATED DISCUSSIONS IN G10, THE IDA (DEPUTIES), AND THE INTERIM AND DEVELOPMENT COMMITTEES, TOOK PLACE AT A TIME WHEN THERE IS FIRM EVIDENCE THAT THE WORLD ECONOMIC RECOVERY IS FULLY LAUNCHED. DESPITE EARLIER FOREBODINGS OF COLLAPSE THE INTERNATIONAL FINANCIAL SYSTEM IS STILL INTACT, AND WIDESCALE DEBT DEFAULT HAS BEEN AVOIDED, THANKS TO ECONOMIC ADJUSTMENT IN THE DEBTOR COUNTRIES, FINANCIAL SUPPORT FROM GOVERNMENTS, BANK RESCHEDULINGS, AND IMF SUPPORT.

2. DESPITE THOSE HELPFUL DEVELOPMENTS, IT IS CLEAR THAT THE WORLD ECONOMY IS STILL UNDER GREAT STRAIN. ECONOMIC RECOVERY IN THE DEVELOPED WORLD HAS NOT YET MUCH BENEFITED THE DEVELOPING WORLD, INTEREST RATES ARE STILL HIGH AND THE DEBT PROBLEMS IN SOME MAJOR COUNTRIES, PARTICULARLY BRAZIL, ARE NOT YET RESOLVED.

3. THIS WORLD PICTURE SUGGESTED TWO BROAD TASKS FOR THE GOVERNORS FROM THE OVER 140 MEMBER COUNTRIES ATTENDING THE ANNUAL MEETINGS. THE FIRST WAS TO AGREE THE POLICIES FOR SUSTAINING WORLD ECONOMIC RECOVERY. THE SECOND, AND MORE IMMEDIATE TASK, WAS TO BUTTRESS THE IMF'S ABILITY TO RESPOND TO COUNTRY DEBT CRISES, AND IN PARTICULAR TO AGREE THE SCALE OF FUTURE IMF LENDING TO COUNTRIES, THE SO-CALLED ''ACCESS'' QUESTION ON WHICH WE HAD TABLED AN IMPORTANT PROPOSAL IN THE IMF BOARD IN JULY.

4. US ATTITUDES COMPLICATED BOTH TASKS. DESPITE SECRETARY REGAN'S STRONG DEFENCE OF US BUDGETARY POLICIES AT THE MEETINGS., FEW ACCEPT HIS ARGUMENT THAT HIGH US BUDGET DEFICITS ARE NOT A CAUSE OF THE HIGH INTEREST RATES, WHICH ADD TO DEVELOPING COUNTRIES' DEBT BURDENS AND INHIBIT RECOVERY IN THE DEVELOPED COUNTRIES. BUT WHATEVER THE US ADMINISTRATION'S VIEWS ON INTEREST RATES, THE US POLITICAL PROCESS, IN PARTICULAR THE LACK OF AGREEMENT BETWEEN EXECUTIVE AND LEGISLATURE ON WHETHER THE DEFICIT SHOULD BE REDUCED BY TAX INCREASES OR SPENDING REDUCTIONS, IS LIKLEY TO POSTPONE ANY REAL ATTEMPT TO RESOLVED THIS ISSUE UNTIL AFTER THE PRESIDENTIAL ELECTION. THE US POLITICAL PROCESS ALSO COMPLICATES THE SECOND TASK OF BUTTRESSING THE IMF. THE IMF QUOTA BILL, IMPLEMENTING THE US CONTRIBUTION TO THE EIGHTH QUOTA REVIEW, IS STUCK IN CONGRESS WITH AN UNCERTAIN FUTURE THOUGH ITS PROSPECTS SHOULD HAVE BEEN MUCH IMPROVED BY PRESIDENT REAGAN'S STRONG SUPPORT FOR THE BILL IN HIS SPEECH TO THE OPENING SESSION OF THE ANNUAL MEETINGS. BUDGETARY RESTRAINT, CONGRESSIONAL ATTITUDES, AND THE ADMINISTRATION'S PHILOSOPHICAL STANCE ALSO MAKES THE US UNWILLING PARTNERS IN THE REPLENISHMENT OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA) AND THE SELECTIVE CAPITAL INCREASE (SCI) FOR THE WORLD BANK, WHICH WERE THE MAIN SUBJECTS BEFORE THE DEVELOPMENT COMMITTEE.

5. THE UNITED STATES' ECONOMIC IMPORTANCE -- OVER 20 PER CENT OF WORLD GNP -- AND ITS 20 PER CENT VOTING SHARE, SUFFICIENT TO BLOCK IMPORTANT DECISIONS, IN BOTH THE IMF AND WORLD BANK, PUTS IT AT CENTRE STAGE IN INTERNATIONAL, ECONOMIC DISCUSSIONS. AND THE PRESENT STANCE OF US POLICY MAKES THAT COUNTRY THE UNIVERSAL WHIPPING BOY AT MEETINGS SUCH AS THIS. THIS POSED A DIFFICULT TACTICAL DECISION FOR THE UK. WE DID NOT WISH TO DISSOCIATE OURSELVES FROM ONE OF OUR MAJOR ALLIES. BUT AT THE SAME TIME WE DID NOT WANT TO ASSOCIATE OURSELVES WITH CLEARLY UNREALISTIC US POSITIONS.

6. ON THE WORLD ECONOMIC OUTLOOK, THERE WAS GENERAL AGREEMENT AMONG THE DEVELOPED COUNTRIES THAT RECOVERY WAS MORE VIGOROUS THAN EXPECTED, ESPECIALLY IN THE US. THERE WAS SOME CONCERN THAT THE RECOVERY WAS STILL INSUFFICIENTLY BROAD-BASED, EITHER IN TERMS OF ITS GEOGRAPHICAL SPREAD OR THE ECONOMIC SECTORS, OTHER THAN CONSUMERS, WHICH WERE BENEFITING. THE DEVELOPING COUNTRIES UNIVERSALLY THOUGHT THE RECOVERY WEAK, BENEFITING ONLY A FEW MAJOR COUNTRIES. DESPITE THESE DISAGREEMENTS, THERE WAS GENERAL AGREEMENT THAT GOVERNMENTS SHOULD CONTINUE PRESENT POLICIES OF CONTROLLING MONEY SUPPLY GROWTH, REDUCING FISCAL DEFICITS AND REMOVING SUPPLY SIDE RIGIDITIES SO THAT MARKET FORCES COULD OPERATE. OPPOSITION TO PROTECTIONISM WAS REFLECTED IN STRONG STATEMENTS IN THE G10 AND INTERIM COMMITTEE COMMUNIQUES. THE HUGE US BUDGET DEFICIT WAS GENERALLY CRITICISED. ON FUTURE PROSPECTS, THERE WAS MUCH MORE CONFIDENCE AROUND THAN AT LAST YEAR'S MEETINGS IN OTTAWA.

7. ON IMF ISSUES, THERE WAS NO OBVIOUS PROGRESS IN SECURING G10 COUNTRIES' AGREEMENT TO THE IMF MANAGING DIRECTOR'S INITIATIVE TO BORROW DOLLARS 3 BILLION. BUT THE INTERIM COMMITTEE COMMUNIQUE HELPFULLY ENDORSED THE MD'S EFFORTS AND CALLED FOR A SUCCESSFUL CONCLUSION TO HIS NEGOTIATIONS WITHOUT DELAY. IT REMAINS TO BE SEEN WHETHER THIS WILL MOVE THE EUROPEAN CENTRAL BANKERS, ESPECIALLY THE FRG'S GOVERNOR POEHL.

8. THE TOUGH, UNCOMPRISING SPEECH OF MR REGAN, US TREASURY SECRETARY, TO THE INTERIM COMMITTEE, TOGETHER WITH THE DISCLOSURE IN THE NEWSPAPERS OF HIS HARD NEGOTIATING POSITION, DID NOT BODE WELL FOR AGREEMENT ON NEW ACCESS LIMITS TO FUND RESOURCES. BUT AFTER TWO ''MINISTERS' ONLY SESSIONS'', THE INTERIM COMMITTEE AGREED THE PROPOSAL, TABLED BY OURSELVES IN JULY, FOR A ''TWO-TIER'' SYSTEM OF ACCESS, LASTING FOR ONE YEAR ONLY, WHICH BRIDGES THE US POSITION AND THE VIEWS OF OTHER G10 COUNTRIES AND THE MORE MODERATE LDCS. BUT AMID SCENES OF SOME DRAMA DURING THE LAST STAGES OF COMMUNIQUE DRAFTING, DR SINGH (GOVERNOR, RESERVE BANK OF INDIA) WHO HAD RESERVED HIS GOVERNMENT'S POSITION IN THE LAST CLOSED MINISTERIAL SESSION, REPORTED THAT HIS GOVERNMENT COULD NOT AGREE WITH THE TWO TIER SYSTEM PROPOSED. HE WAS QUICKLY SUPPORTED BY THE CHINESE CENTRAL BANK GOVERNOR (MR LU) THE ALGERIAN CONSTITUENCY (WHO ALSO REPRESENT THE IRANIANS) AND, WE THINK, AN AFRICAN CONSTITUENCY LED BY THE FINANCE MINISTER OF ZIMBABWE, MR CHIDZERO. AFTER DISCUSSION, IT WAS AGREED THAT THE COMMUNIQUE SHOULD STAND BUT WITH THE RESERVE THAT A FEW MEMBERS OF THE COMMITTEE DID NOT AGREE WITH ALL THE CONCLUSIONS ON ACCESS LIMITS. IT REMAINS TO BE SEEN WHETHER

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THE AGREEMENT WILL HOLD WHEN THE EXECUTIVE BOARD TAKES THE FINAL DECISION. IT WILL NEED ONLY ONE OR TWO BACKSLIDERS TO JOIN WITH THE INDIANS AND THEIR SUPPORTERS TO FRUSTRATE THE NECESSARY 85 PER CENT MAJORITY. A GOOD OUTCOME FROM OUR VIEW POINT, IF IT CAN BE MAINTAINED, THOUGH AS MY FRENCH COLLEAGUE OBSERVED, THE LDCS WILL NO DOUBT MAKE POLITICAL CAPITAL FROM THE FACT THAT OPPOSITION BY THE REPRESENTATIVES OF HALF THE WORLD'S POPULATION WILL NOT BE SUFFICIENT TO SECURE THE 15% OF THE VOTES IN THE EXECUTIVE BOARD NECESSARY TO BLOCK THE PROPOSAL.

9. THE TONE OF THE DEVELOPMENT COMMITTEE, UNDER THE CRISP CHAIRMANSHIP OF KHAN, WAS MODERATE WITH LDCS MAKING THEIR CASE IN BALANCED TERMS. THE CHANCELLOR, IN A WELL-RECEIVED SPEECH, ARGUED THAT DEBTOR COUNTRY PROBLEMS COULD ONLY BE SOLVED BY A WELL-JUDGED MIXTURE OF EXTERNAL FINANCE AND DOMESTIC REFORM. HE CAUTIONED GOVERNMENTS AGAINST EXCESSIVE INTERVENTION AND HE URGED THE DEVELOPING COUNTRIES TO DO MORE TO CREATE A HOSPITABLE CLIMATE FOR INWARD INVESTMENT, A POINT WHICH WAS EMPHASISED IN THE COMMUNIQUE. ON THE SCI, THERE SEEMS TO BE GROWING AGREEMENT FOR AN INCREASE AROUND DOLLARS 8 BN, THOUGH THE US ARE STILL STICKING AT DOLLARS 3 BN. DESPITE PRESSURE FROM MANY COUNTRIES, INCLUDING THE UK, THE US ARE STILL RESOLUTELY OPPOSED TO AN IDA 7 ABOVE DOLLARS 9BN. MOST OTHER DEVELOPED COUNTRIES COULD ACCEPT UP TO DOLLARS 12 BN, COMPARED WITH THE MANAGEMENT'S BID FOR DOLLARS 16BN.

10. PRESIDENT REAGAN, IN AN IMPRESSIVE SPEECH, EMPHASISED THE CONNECTION BETWEEN ECONOMIC PROGRESS AND PERSONAL FREEDOM. HE URGED GOVERNMENTS NOT TO OVERSPEND, OVERTAX OR OVER-REGULATE. HE DEFENDED US BUDGETARY POLICY, POINTING OUT THAT PART OF THE BUDGET DEFICIT REFLECTED THE US'S DETERMINATION TO PROVIDE MILITARY STRENGTH AND POLITICAL SECURITY TO ENSURE THE PEACE OF THE WORLD. HE REFERRED TO HIS ''UNBREAKABLE COMMITMENT'' TO INCREASE FUNDING FOR THE IMF AND HE CRITICISED CONGRESS FOR ''PARTISAN WRANGLING AND POLITICAL POSTURING'' ON THE IMF QUOTA LEGISLATION. SECRETARY REGAN GAVE A ROSY ACCOUNT OF US ECONOMIC PROSPECTS. HE REPEATED US SUPPORT FOR THE IMF PROVIDED IT KEPT TO ITS TRADITIONAL ROLE OF SHORT-TERM LENDER AND DID NOT BECOME A DEVELOPMENT INSTITITUION. HIS ENDORSEMENT OF THE WORLD BANK GAVE NO SIGN OF US MOVEMENT ON IDA 7 OR THE SCI.

11. THE CHANCELLOR OF THE EXCHEQUER SAID THAT THE BRITISH GOVERNMENT'S ADJUSTMENT STRATEGY, ADOPTED FOUR YEARS AGO, WAS SHOWING GOOD RESULTS. INFLATION WAS DOWN TO AROUND 5% AND THE ECONOMY HAS BEEN GROWING AT AN AVERAGE ANNUAL RATE OF AROUND 2 AND A HALF - 3% SINCE THE TROUGH OF THE RECESSION IN THE FIRST HALF OF 1981, DESPITE UNFAVOURABLE WORLD TRADE CONDITIONS. THE CHANCELLOR DREW SIX SPECIFIC CONCLUSIONS FROM THE UK EXPERIENCE: THE STRATEGY WORKS, PERSEVERANCE IS NECESSARY, MONETARY AND FISCAL POLICY HAVE TO OPERATE IN HARMONY, A SOUND FINANCIAL STRATEGY IS ESSENTIAL, MARKET ORIENTATED POLICIES HELP RECOVERY, AND PAINFUL ADJUSTMENT PROGRAMMES ARE POLITICALLY POSSIBLE IF THEY WERE EXPLAINED TO THE PEOPLE. THESE CONCLUSIONS WERE BOTH RELEVANT AND ENCOURAGING FOR OTHER COUNTRIES. ON INTERNATIONAL DEBT, THE CHANCELLOR SUGGESTED THAT BORROWERS AND LENDERS SHOULD THINK IN TERMS OF TRYING TO

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RESHAPE MATURITIES. HE CALLED FOR CHANGE IN LDC ATTITUDES TOWARD PRIVATE INVESTMENT AND SUGGESTED THAT INCREASED ATTENTION SHOULD BE GIVEN TO STRENGTHENING THE ROLE OF THE WORLD BANK AND TO MEANS OF ASSOCIATION BETWEEN IT AND PRIVATE INVESTMENT. HE THEN REFERRED TO OUR POSITION ON IMF AND IDA ISSUES AND CONCLUDED BY WARNING AGAINST THE TEMPTATION OF BLAMING INTERNATIONAL FINANCIAL DISORDER ON THE SYSTEM RATHER THAN ON THE CONDUCT OF DOMESTIC POLICIES.

12. MR STOLTENBERG, THE FRG MINISTER OF FINANCE, GAVE AN ORTHODOX STATEMENT OF GERMAN ECONOMIC POLICY. HE HINTED THAT THE FRG'S AGREEMENT TO THE IMF QUOTA INCREASE WOULD NOT BE FORTHCOMING UNLESS OTHER MEMBERS WITH LARGE QUOTAS ALSO AGREED. MR DELORS, FRENCH MINISTER OF FINANCE, EMPHASISED THE FRENCH GOVERNMENT'S DETERMINATION TO CONQUER INFLATION AND STRENGTHEN THE BALANCE OF PAYMENTS. HE CALLED FOR A STRONGER ROLE FOR THE WORLD BANK AND THE IMF AND INCREASED PRIORITY IN AID FOR SUB-SAHARAN AFRICA. HE REPEATED, THOUGH IN MUTED TERMS, PRESIDENT MITTERAND'S CALL FOR AN INTERNATIONAL MONETARY CONFERENCE. MR MAYEKAWA, THE JAPANESE CENTRAL BANK GOVERNOR DEFENCED THE JAPANESE HIGH CURRENT ACCOUNT SURPLUS AND SUGGESTED THAT THE LOW VALUATION OF THE YEN DID NOT REFLECT ECONOMIC FUNDAMENTALS. HE SAID JAPAN WAS OPENING UP MARKETS TO IMPORTS. LIKE THE CHANCELLOR, HE CALLED ON THE PRIVATE BANKS TO TALK A LONGER PERSPECTIVE IN THEIR LENDING POLICIES.

13. THE IMF MANAGING DIRECTOR CALLED FOR A REDUCTION IN THE US BUDGET DEFICIT, A CONTINUED FIGHT AGAINST INFLATION, STRUCTURAL REFORMS, PARTICULARLY IN LABOUR MARKETS, AND RESISTANCE TO PROTECTIONISM. HE DEFENDED THE FUND'S ROLE IN REQUIRING THE LDCS TO MAKE A RAPID ECONOMIC AJDUSTMENT. THE PRESIDENT OF THE WORLD BANK GAVE A LONG REVIEW OF THE BANK'S WORK AND CALLED FOR ACTION ON IDA 7, THE SCI, CAPITAL INCREASE FOR THE INTERNATIONAL FINANCE CORPORATION, AND PRIORITY FOR SUB-SAHARAN AFRICAN.

CONCLUSION

14. MORE WAS ACHIEVED AT THE MEETINGS THAN MANY EXPECTED. THERE WAS FIRM ENDORSEMENT OF THE POLICIES FOR SUSTAINING THE ECONOMIC RECOVERY. THOUGH THE IMF MANAGING DIRECTOR'S DOLLARS 2 BILLION FUNDING INITIATIVE WAS NOT ADVANCED, PRESIDENT REAGAN'S UNEQUIVOCAL STATEMENT SHOULD HAVE IMPROVED THE PROSPECTS FOR THE US IMF BILL. THE CHANCELLOR'S PROPOSAL, ON ACCESS LIMITS, WAS AGREED AND BRIDGED US, EUROPEAN AND MODERATE LDC POSITIONS. IT REMAINS TO BE SEEN WHETHER THE AGREEMENT WILL STICK IN THE EXECUTIVE BOARD AND WHETHER RESIDUAL LDCS' BITTERNESS WILL ''UNCTADIFY'' FUTURE MEETINGS OF THE INTERIM COMMITTEE. THERE WAS GENERAL ENDORSEMENT OF THE WORLD BANK AND THERE ARE GOOD PROSPECTS OF AGREEMENT TO AN SCI OF AROUND DOLLARS 8BN. THERE WAS NO PROGRESS IN PERSUADING US TO CONTEMPLATE AN IDA 17 ABOVE DOLLARS 9 BILLION.

15. ALL IN ALL, MOST DELEGATES WILL LEAVE WASHINGTON WITH SOME CONFIDENCE IN THE CONTINUING WORLD ECONOMIC RECOVERY AND THE POTENTIAL FOR DEALING WITH THE MANY DEBT PROBLEMS WHICH STILL REMAIN. AS THE CHANCELLOR SAID IN HIS SPEECH TO THE ANNUAL MEETINGS, ''WE ARE NOT YET OUT OF THE WOOD, BUT WE ARE MOVING FORWARD AGAIN''.

17. SPEECHES AND COMMUNIQUES ARE BEING SENT BY BAG TO LONDON AND RECORDS OF THE INTERIM AND DEVELOPMENT COMMITTEES ARE BEING SENT BY SAVINGRAM.

WICKS

THIS TELEGRAM WAS NOT ADVANCED

MONETARY
ODA

X ref

MR. ~~COLES~~ AA 28/9.

cc: Head of Chancery

Please find attached a summary of President Reagan's speech to the 1983 IMF/IBRD Annual Meetings on Tuesday, September 27. A copy of the full speech is also attached.

Myles. A. Wickstead /.

M.A. Wickstead
UKDEL IMF/IBRD
September 28, 1983

X ref

MR. ~~COLES~~ AA 28/9.

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September 28, 1983

President Reagan's speech to the IMF/IBRD Annual Meetings
27 September 1983

Summary

The President began by acknowledging the leading role of the World Bank and its Affiliates, and the International Monetary Fund, in the quest for global economic, social and human improvement. The institutions were established in the wake of a period of totalitarian violence and suppression of individual rights, and were based on the principle of the supremacy of human rights. Now, as then, prosperity, security and freedom were inextricably linked. The unparalleled economic development and improvement in the human condition of the post-war years resulted from a belief in these principles.

2 In the 1970s, too many countries (including the US) forgot these principles, and permitted governments to overspend, overtax, and over-regulate. Solid foundations have to be re-built. Though countries are interdependent, sound domestic policies must be in place before the international economic system could expand and improve. The US had made real progress; inflation and interest rates had fallen dramatically, and GNP was expanding. The US still faced deficits, but this was caused in part by their determination to provide the military strength and political security to ensure peace in the world. The world economy was already showing signs of picking up as the US economy picked up. The 1980s could - and should - be an era of transition towards sustained, non-inflationary world growth.

3 The IMF was the lynchpin of the international financial system, and the US Administration would continue to support it. He had an unbreakable commitment to increased funding, and he urged Congress to pass the IMF Quota legislation speedily; failure to do so could lead to a major disruption of the entire world trading and financial systems. The US strongly supported the World Bank, and in particular he had proposed legislation to meet US commitments to IDA, which was important in helping people in the poorest countries to raise their standards of living.

4 Bank and Fund financing could only be a complement to, and not a substitute for, sound domestic policies. The dangers of protectionism must be avoided at all costs; it was a problem creator, not a problem solver. Open markets and free trade were essential pre-requisites for mutual economic prosperity. It was his personal belief that such a system could function only where independent states respected the freedom and independence of its individual citizens; their economic progress must be consistent with their personal dignity, their independence, and ultimately their freedom.

September 28, 1983

BOARDS OF GOVERNORS • 1983 ANNUAL MEETINGS • WASHINGTON, D.C.

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL MONETARY FUND

Press Release No. 3

September 27, 1983

Remarks by the Hon. RONALD REAGAN,
PRESIDENT OF THE UNITED STATES, at the 1983
Annual Meetings of the Boards of Governors of
the Bank, IFC and IDA and the Fund

On behalf of my fellow Americans, I am delighted to welcome you to the United States and to our nation's capital, and I am honored to have this opportunity to speak again to your distinguished members.

I say honored because I believe your institutions, the World Bank and affiliates, and the International Monetary Fund, serve noble purposes. There can be no higher mission than to improve the human condition and to offer opportunities for fulfillment in our individual lives and the life of our national and world communities. You are the leaders of the world community in bringing a better life to the diverse and often tragically poor people of our planet. You have worked tirelessly to preserve the framework for international economic cooperation and to generate confidence and competition in the world economy.

The unending quest for economic, social and human improvement is the basic drive that inspires and unites all of us. In 1945, when your great institutions were established, the civilized world had been brought to its knees by a wave of totalitarian violence that inflicted suffering, sacrifice, and the suppression of human rights on millions of innocent people.

Security, freedom and prosperity were very much on the minds of the citizens of the world in 1945. They should be on our minds today. The institutions you represent could not have been born, could not have flourished--and may I add, will not survive--in a world dominated by a system of cruelty that disregards individual rights and the value of human life in its ruthless drive for power. No state can be regarded as pre-eminent over the rights of individuals. Individual rights are supreme.

In this civilization we have labored so faithfully to resurrect, preserve, and enhance, let us be ever mindful: it is not just development and prosperity, but ultimately our peace and freedom that are always at stake. Too often, the demands of prosperity and security are viewed as competitors when, in fact, they are complementary, natural, and necessary allies. We cannot prosper unless we are secure, and we cannot be secure unless we are free.

The goals of the great international, political and economic institutions--the United Nations where I spoke yesterday, and the World Bank, its affiliates, and the IMF you represent here today--were to be reached by trusting in a shared and enduring truth: the keys to personal fulfillment, national development, human progress and world peace are freedom and responsibility for individuals, and cooperation among nations. When I addressed the delegates of the United Nations yesterday, I reminded them: you have the right to dream great dreams, to seek a better world for your people. And all of us have the responsibility to work for that better world. As caring, peaceful peoples, think what a powerful force for good we could be.

Today, I come before your distinguished assembly in that same spirit--a messenger for prosperity and security through the principles of freedom, responsibility, and cooperation.

When our nations trusted in these great principles in the postwar years, the civilized world enjoyed unparalleled economic development and improvement in the human condition. We witnessed a virtual explosion of world output and trade, and the arrival of many free, self-determined, independent nation states as new members of the international system.

And, as I said when I last spoke to you, the societies that achieved the most spectacular, broad-based economic progress in the shortest period of time have not been the biggest in size, nor the richest in resources and certainly not the most rigidly controlled. What has united them all was their belief in the magic of the marketplace. Millions of individuals making their own decisions in the marketplace will always allocate resources better than any centralized government planning process.

Trust the people, this is the crucial lesson of history. Because only when the human spirit is allowed to worship, invent, create, and produce, only when individuals are given a personal stake in deciding their destiny and benefiting from their own risks--only then do societies become dynamic, prosperous, progressive and free.

In the turbulent decade of the 1970s, too many of us--the United States included--forgot the principles that produced the basis for our mutual economic progress. We permitted our governments to overspend, overtax, and overregulate us toward soaring inflation and record interest rates. Now we see more clearly again. We are working and cooperating to bring our individual economies and the world economy back to more solid foundations of low inflation, personal incentives for saving and investment, higher productivity, and greater opportunities for our people.

Our first task was to get our own financial and economic houses in order. Our countries are interdependent, but without a foundation of sound domestic policies, the international economic system cannot expand and improve. Merely providing additional official development assistance will not produce progress. This is true for all countries, developed and developing, without exception. As the 1983 development report of the World Bank notes, "International actions can greatly improve the external environment confronting developing countries, but cannot supplant the efforts that the developing countries must make themselves."

I believe the United States is making real progress. Since we took office, we have reduced the rate of growth in our Federal Government's spending by nearly 40 percent; we have cut inflation dramatically, from 12.4 percent to 2.6 percent for the last 12 months; the prime interest rate has been cut nearly in half, from 21 1/2 percent to 11 percent. Figures released last week reveal our gross national product grew at an annual rate of almost 10 percent in the second quarter and about 7 percent in the third.

In the United States, we still face large projected deficits which concern us because deficit federal spending and borrowing drain capital that could otherwise be invested for stronger economic growth. But as Secretary Regan correctly pointed out, in the Interim Committee on Sunday, the deficit is coming down as a result of economic growth. Revenues are higher than anticipated, and we expect continued improvement. We will continue to work for greater restraint in federal spending, but we will not risk sabotaging our economic expansion in a short-sighted attempt to reduce deficits by raising taxes. What tax increases would actually reduce is economic growth--by discouraging savings, investment and consumption.

One other point about the United States deficit: let me make clear that it is caused in part by our determination to provide the military strength and political security to ensure peace in the world. Our commitment to military security is matched by our resolve to negotiate a verifiable nuclear arms reduction treaty. Only then can we safely reduce military expenditures and their drain on our resources. As I mentioned at the outset, there can be no lasting prosperity without security and freedom.

Turning more directly to economic development, all signs point to a world economic recovery gaining momentum. As early as last February, the Conference Board predicted that economic growth rates in the United States and six major industrial countries spell economic recovery in any language. Since then, industrial production in the OECD countries has been moving up. Your own IMF economists are predicting growth in the world economy of at least 3 percent next year. This is the brightest outlook in several years.

As the U.S. economy picks up steam, our imports rise with it. When you consider that half of all non-OPEC developing country manufactured goods exported to the industrial countries come to the United States, it is clear what a strong stimulus our imports provide for economic expansion abroad. And as other economies prosper, our exports, in turn, increase. We all gain. Many nations are moving steadily forward toward self-sustaining growth, and like us, they are doing it by relying again on the marketplace. This period of adjustment has not been easy for us; in fact, it has been very painful, but it is the one way that does work, and it is beginning to pay dividends.

Economic recovery is spreading its wings and taking flight. We all know those wings have not spread far enough, and I would add, recovery alone is not good enough. Our challenge is far greater: lasting, worldwide economic expansion. Together, we must make the 1980s an historic era of transition toward sustained, noninflationary world growth. I have every confidence that we can--and with our combined leadership and cooperation--we will.

The IMF is the linchpin of the international financial system. Among official institutions, it serves as a counselor, coaxing the world economy toward renewed growth and stability. At various times in its history, the IMF has provided important temporary balance of payments assistance to its member nations--including my own. At times, it must play the "Dutch uncle," talking frankly, telling those of us in government things we need to hear, but would rather not. We know how significant the IMF's role has been in assisting troubled debtor countries, many of which are making courageous strides to regain financial health. We warmly applaud the efforts of Mr. de Larosière and his staff.

My Administration is committed to do what is legitimately needed to help ensure that the IMF continues as the cornerstone of the international financial system. Let me make something very plain: I have an unbreakable commitment to increased funding for the IMF. But the U.S. Congress so far has failed to act to pass the enabling legislation. I urge the Congress to be mindful of its responsibility, and to meet the pledge of our government.

The IMF quota legislation has been pending for several months, and I do not appreciate the partisan wrangling and political posturing that have been associated with this issue during recent weeks. I urge members of both political parties to lay aside their differences, to abandon harsh rhetoric and unreasonable demands, and to get on with the task in a spirit of true bipartisanship. The stakes are great. This legislation is not only crucial to the recovery of America's trading partners abroad and to the stability of the entire international financial system, it is also necessary to a sustained recovery in the United States.

The sum we are requesting will not increase our budget deficit, and it will be returned with interest as loans are repaid to the IMF. What's more, it will keep the wheels of world commerce turning and create jobs.

Exports account for one out of eight manufacturing jobs in the United States. Forty percent of our agricultural products are exported. I am afraid that, even today, too few in the Congress realize the United States is interdependent with both the developed and developing world.

Examine the record: the United States has been a dependable partner, reaching out to help developing countries who are laboring under excessive debt burdens. These major debtor countries have already undertaken difficult measures in a concerted effort to get their economic houses in order. Most of them are working closely with the IMF to overcome economic hardships. They continue to demonstrate a commendable willingness to make necessary adjustments. That is why I can state that our participation in the IMF quota increase is not a government bailout of these debtor countries or of the banks which are sharing the burden. On the contrary, IMF plans to assist financially troubled countries call for the banks to put up more new money than the IMF itself.

This is by nature a cooperative enterprise. If the Congress does not approve our participation, the inevitable consequence would be a withdrawal by other industrial countries from doing their share. At the end of this road could be a major disruption of the entire world trading and financial systems--an economic nightmare that could plague generations to come. No one can afford to make light of the responsibility we all share.

We strongly support the World Bank; in fact, the United States remains its largest single contributor. We recognize its key role in stimulating world development and the vital assistance it provides to developing nations. Here again, I have proposed legislation to the Congress to meet our commitment for funding the World Bank, and especially the International Development Association. It is important that these funds be available to help the people in the poorest countries raise their standards of living. Tomorrow, Secretary Regan will be discussing both the Fund and the Bank in more detail. Because our investment in the World Bank's operations is so large, we feel a special responsibility to provide constructive suggestions to make it more effective.

Let me simply underscore again a fundamental point, and I say this as the spokesman for a compassionate, caring people. The heart of America is good and her heart is true. We have provided more concessional assistance to developing nations than any other country--more than $130 billion over the last three decades.

Whether the question at hand be Bank project financing or Fund balance of payments assistance, it must be considered a complement to, not a substitute for, sound policies at home. If policies are sound, financing can be beneficial. If policies are irresponsible, all the aid in the world will be no more than money down the drain.

As we work together for recovery, we must be on guard against storm clouds of protectionist pressures building on the horizon. At the recent economic summit in Williamsburg, my fellow leaders and I renewed our commitment to an open and expanding world trading system. The Williamsburg Declaration reads, "We commit ourselves to halt protectionism, and as recovery proceeds, to reverse it by dismantling trade barriers."

Whether such words will prove to be empty promises, or symbols of a powerful commitment, depends on the real day-to-day actions which each of our governments take. Everyone is against protectionism in the abstract. That is easy. It is another matter to make the hard, courageous choices when it is your industry or your business that appears to be hurt by foreign competition. I know. We in the United States deal with the problem of protectionism every day of the year.

We are far from perfect, but the United States offers the most free and open economy in the world. We import far more goods than any nation on earth. There is more foreign investment here than anywhere else, and access to our commercial and capital markets is relatively free.

Protectionism is not a problem solver, but a problem creator. Protectionism invites retaliation. It means you will buy less from your trading partners, they will buy less from you, the world economic pie will shrink and the danger of political turmoil will increase.

You know I have made this analogy before, but we and our trading partners are in the same boat. If one partner shoots a hole in the bottom of the boat, does it make sense for the other partner to shoot another hole in the boat? Some people say yes and call it getting tough. I call it getting wet--all over.

We must plug the holes in the boat of open markets and free trade and set sail again in the direction of prosperity. No one should mistake our determination to use our full power and influence to prevent anyone from destroying the boat and sinking us all.

I firmly believe that we can and must go forward together, hand in hand, not looking for easy villains to explain our problems, but resolved to pursue the proven path on which these institutions embarked almost four decades ago--a path of economic progress and political independence for all countries and for all people.

In closing, let me share with you a very deep personal belief I hold. We are all sovereign nations and, therefore, free to choose our own way as long as we do not transgress upon the sovereign rights of one another. But we cannot really be free as independent states unless we respect the freedom and independence of each of our own individual citizens. In improving their lot, which is the only reason you and I hold high offices in our lands, we cannot forget that how we help them progress economically must be consistent with this highest objective of all--their personal dignity, their independence and ultimately their freedom. That is what this job of ours is all about.

PX

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MR SCHOLAR

The Prime Minister should be warned that, notwithstanding the 48½% increase in quotas and the massive increase in the general agreement to borrow, which come into effect shortly, the IMF still finds itself "short" of the funding it reckons it needs in 1983. It looks likely that it will ask for some £6-8 billion. (Some part of this is due to the IMF's assumption that Saudi Arabia would maintain the high level of funding it provided in the previous two years; that assumption is now discredited.)

It is highly likely that, in addition to this call for additional reserves from the central banks, the IMF will ask for some additional medium term facilities, even for this present year. I doubt, however, whether they will wish to make borrowing through the markets like the World Bank does.

<u>The IMF has caused the banking and debt crisis</u>. It is conventional wisdom to argue that only the IMF can solve the present debt/banking crisis. Yet I believe that the IMF, and its burgeoning funds, are largely responsible for the present crisis. (I am glad to see that Enoch Powell has argued on very similar lines.) Indeed I regard the quota increase that is going through this year of 48½%, together with the expansion of the GAV, as the basis for yet another debt and banking crisis in the future.

The large expansion in loans to foreign governments during 1979/1982 was associated with the sharp increase in IMF lending authority that occurred during that period. In 1978 the IMF quotas were raised 34% and in 1980 were raised a further 50%. (Indeed over longer term historical perspective, IMF total liquidity since 1960 has increased by 4½times world exports.)

Bankers act perfectly rationally when they make increasing loans to foreign governments. They evaluate the risk premium and guage the ability and willingness of the IMF to render financial support. They also take into account the IMF's role as a debt collection agency.

/The IMF in its turn

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The IMF in its turn provides subsidised loans at below market rates of interest, to the borrowing government. The presence of the IMF also acts as an implicit loan guarantee to the private banks. Thus the bankers do not rationally take account of risks. The costs of rescheduling, moratoriums and defaults are borne by those countries that pursue prudent policies. They provide subsidies for the profligate countries and the owners of the banks.

I do not think it is politically feasible to reduce the size of the IMF. But it is possible to contain it.

ALAN WALTERS
12 July 1983

CONFIDENTIAL

Prime Minister
Mr de la Rosière didn't mention any of this at his meeting with the Chancellor (see record attached) MCS 29/6

PRIME MINISTER

IMF

Demonstrating the principle that rescheduling begets more rescheduling, the IMF is very likely to be asking for a considerable increase in its funding (over and above the 48½% increase in quotas and the three-fold increase in the GAB) during the next two weeks or so. Jacques de Larosiere is now making his rounds. The issue of new funds is likely to be discussed at the Paris meeting of the "deputies" on 8 July. The 48½% quota increase of last January has yet to be ratified and come into operation. But it now seems likely that the pressures of the American banks will ensure that Congress does ratify it, although with several attached clauses which would inhibit lending to countries, mostly Communist, which incur the ire of Congress. We do not know how this issue will be resolved, but I suspect that it is likely that some form of words will be found which is acceptable to the IMF and to Congress. The GAB, however, constitutes an increase from 6.4 billion SDRs to 17 billion SDRs. This is already agreed and does not need ratification.

The preliminary discussions of the new additional funding suggest that West Germany, Britain and Japan should be asked to contribute more than 1 billion SDRs each. Similarly, small countries such as Switzerland and the Netherlands should be asked to contribute between 250 million and 400 million. France, which has pursued such disastrous policies, will only be asked for a minimum sum of, say, 100-200 million SDRs. It is unlikely that the IMF will dare to approach the United States yet again; Congress, and perhaps even the Administration, would not put up with yet another draft of what is widely seen as a subsidy to American and international banks.

There is also another very important change involved in the new IMF proposals. As you know, the IMF has been concerned with short term finance for balance of payments adjustments. Now it is proposed that the IMF engage in intermediate financing, probably for about a seven year period. This is a substantial change of function. The IMF will need much greater funds if the money is to be tied up for long periods, and it marks a significant departure from the original concept of the function of the Fund. In fact the Fund will become a multinational aid agency - like the World Bank, the Asian Development Bank, the Inter-American Development Bank, etc.

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/In my view

In my view this would be wrong. But in any case we should think very hard before we tie up any more funds in multilateral aid agencies. We should not allow this metamorphosis without considerable thought for what it implies.

In my view, an extension of IMF assistance would:

a. demonstrate there are rewards to profligacy and unsound policies (viz France with her low contribution and perhaps even future borrowings, not to mention Brazil, Argentina, etc with their subsidised IMF credits);

b. designed to save the equity holders of American and various other international bank corporations, who have committed grave errors and wish the taxpayer to bail them out;

c. extend politically directed funding: the IMF staff have become more overtly politicised, thus ensuring that larger fractions of international capital flows are directed by political rather than commercial motives;

d. enhance the power of an international bureaucracy and increases the likelihood of a determined take-over by "global negotiations";

e. increase the strain on world capital markets at a time when the United States deficit is putting an unprecedented burden on financial flows;

f. raise the rewards for blackmail, such as we see now in the case of Brazil.

The penultimate point (e) is particularly relevant to the argument that the IMF should be <u>allowed to borrow in international capital markets</u>. I do not know whether de Larosiere will press this point. But if he does, I think we should oppose it since, although marginally better than a quota increase, it will provide the same strain on the system and, in effect, the same order of magnitude of the subsidy for profligacy.

I believe it is likely that the Foreign Secretary and perhaps even the Chancellor may find good arguments for supporting this additional increase in IMF resources. The pressure to be a good international financial statesman is considerable. It will be argued that it is in the UK's interests to make these substantial contributions, but I have yet to see that argument demonstrated. I can only see it doing most harm.

ALAN WALTERS
29 June 1983

7/6 cc HMT

10 DOWNING STREET

From the Private Secretary

31 May 1983

I attach a copy of a letter from the President of the World Bank which awaited the Prime Minister on her arrival at Williamsburg on Saturday.

I should be grateful if you would let me have a draft reply for the Prime Minister's signature, if possible by Tuesday 7 June.

I am sending a copy of this letter and its enclosure to John Kerr (HM Treasury).

See MCS note on Clausens letter no reply required now

M. C. SCHOLAR

Chris Greenwood, Esq.,
Foreign and Commonwealth Office.

in box.

THE WORLD BANK

R.F. Have you original letter?

R I.

Office of the President

5-20-83

This is a copy of Mr. Clausen's letter. The original was given to your Washington Embassy to hold for the arrival of the addressee at the time of the Williamsburg Summit meetings.

Helen Higgins

Helen Higgins
Secretary to Mr. A. W. Clausen

(4)

Prime Minister

This arrived at Williamsburg.

No need to reply to what I am ~~We will let you have a~~ assured is ~~Draft reply~~. a thank-you letter.

MCS 31/5

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

A. W. CLAUSEN
President

May 20, 1983

Dear Madam Prime Minister:

I am writing to thank you for taking the time to see me during my visit last month to the United Kingdom. I was glad to be able to discuss with you some of the problems we face in the Bank and in IDA. I welcome the emphasis which you place on effective use of aid and the need for appropriate economic policies on the part of recipient countries. That has been the consistent approach of The World Bank, with each of its loans strictly supervised and monitored throughout its life. IDA is dependent, of course, on grant money from Governments, but the Bank, which raises its funds on the financial markets, is very proud of its unique record of never having suffered a financial loss and of the quality of its projects.

I should like to repeat the plea I made to you that the present difficulties in the financing of IDA might once again be tackled in the same spirit as that which led, under your leadership, to the breaking of the deadlock in IDA financing a year ago.

Sincerely,

A. W. Clausen

The Rt. Hon. Mrs. Margaret Thatcher, P.C., M.P.
Prime Minister
10 Downing Street
London, S.W.1, England

2

CONFIDENTIAL

Prime Minister

To note

MLS 4/5

RECORD OF A DISCUSSION BETWEEN THE CHANCELLOR OF THE EXCHEQUER AND THE IMF MANAGING DIRECTOR AT 6.00 PM ON APRIL 28, 1983

Present: Chancellor	M. de Larosiere
Governor	Mr. Carter
Mr. Loehnis	
Mr. Kerr	

MT

G5

The Chancellor expressed warm appreciation of M. de Larosière's paper for discussion at the G5 meeting on April 29. The process of mutual surveillance, to which the meeting on April 29 would contribute, was one to which he attached considerable importance, and he hoped that the Managing Director would be prepared to pursue his analysis pretty firmly. M. de Larosière said that he had welcomed the support which the Chancellor had given in the two previous such discussions. He hoped that the Chancellor would again stress the relationship between high budgetary deficits and high interest rates. In the previous discussions, some of the other participants had been reluctant to press the obvious lesson on the Americans: the French understandably felt debarred by their own domestic circumstances from preaching to the United States, but he hoped that Dr. Stoltenberg would weigh in more strongly on this occasion than he and his predecessor had done in the past.

Argentina

The Chancellor explained the political difficulties for the United Kingdom Government of selling the line that "business as usual" should prevail in financial relations. This difficulty was enhanced by reports of Argentine arms purchases. And it was still further increased by the fact that the Argentines were demonstrably following a different rule, since discriminatory restrictions on UK banks and companies remained in force. Such discrimination was in breach of the understanding on which the IMF loan had been concluded. If it persisted, the July drawing on the loan should surely be blocked.

M. de Larosière agreed that the discriminatory restrictions persisted, and represented a breach of a key Fund principle. The Argentine authorities were committed to removing all such restrictions by July. If they did not, there could be no July drawing. He would see an Argentine representative on May 2, and would explain this to him forcefully.

The Governor said that he was currently in touch with the Argentines through Mr. McNamar in the US Treasury. The message for Buenos Aires, which would come best from the Managing Director, should be that all discrimination against banks and commercial companies must cease and that if it did not cease, not only would the flow of IMF funds stop, but so would flows from commercial banks. The problem in Buenos Aires was with the Airforce officers: the Army and Navy officers apparently recognised that discriminatory measures would have to be lifted.

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/M. de Larosiere

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M. de Larosière said that Central Bank and Finance Ministry spokesmen in Buenos Aires had told IMF representatives that the issue was political, and outwith their control: they had advised that it be pursued by diplomacy behind the scenes, and without any public denunciations. They had also warned that it was far from certain that the restrictions would be lifted. However, he intended to take a very firm line: if restrictions remained in force, the July drawing would not take place.

SDRs

M. de Larosière said that the Fund staff paper for discussion in the Board in July would be an objective analysis, with no specific proposal. He hoped that the analysis would cover all the points which the Chancellor had raised in his Development Committee speech. The first step was certainly to establish the facts. He was, however, inclined to think that there could be a case for a new SDR issue. Did the Chancellor rule one out? The Chancellor said that he had an open mind. Our own studies had been inconclusive, and we awaited the Fund paper with considerable interest. M. de Larosière said that there would probably be two discussions in the Executive Board--in July and in September: depending on how they went, he hoped to be in a position to put a proposition to the Interim Committee in late September.

Hungary

M. de Larosière said that the Hungarian Vice-Premier had sent him a personal letter describing current debate in Budapest on the timing of a further move towards economic liberalisation. The move sounded highly desirable, but the suggestion was that it could only be made quickly if the current IMF programme, which would run out at the beginning of 1983, were replaced or subsumed by a further programme covering a further two years, and involving a larger stand-by. The Hungarians were, in fact, observing the targets laid down in the current programme and hoped for a current account surplus of $500 million in this calendar year. They would be talking to the Fund in July: and the proposed new programme might be considered by the Board in September.

The Chancellor said that he did not exclude the idea of a further programme. It would certainly be good to encourage more liberalisation in Hungary. The Governor noted that the Hungarians were suffering from a leakage of some $30 million per month through Western commercial banks failing to renew lines of credit. Perhaps this played a part in the Hungarian motives in seeking a new Fund programme. What would happen if the programme were not agreed? The Managing Director said that the Hungarians maintained that in that event further liberalisation would have to wait until 1986 or 1987. But it could not be excluded that hard-liners in Budapest would ensure that it did not happen at all. Whittome was very keen to extend further Fund support: the Managing Director would maintain an open mind, at least until after the July discussions.

JOK.

J.O. Kerr
April 29, 1983
Washington DC

CONFIDENTIAL

RECORD OF DISCUSSION BETWEEN THE MINISTER FOR OVERSEAS DEVELOPMENT AND THE IBRD PRESIDENT AT 12.15 PM ON THURSDAY 14 APRIL 1983

Present:

Minister	Mr A W Clausen
Sir William Ryrie	Mr Munir Benjenk
Mr Browning	
Mr Hurrell	
Mr Barnes	
Mr Power	

1. Mr Raison said the UK attached importance to IDA - it was money well spent. Mr Clausen was pleased to hear this. However, it was imperative for the Association's future that the US Administration secured the $245 million supplementary for FY 83, since a final tranche of around $1 billion from the United States would provide a useful springboard for IDA 7.

2. US Treasury Secretary Regan had recently testified in strong terms before the Congress, but the main opposition was likely to remain unmoved; the political scene was complicated as the Democrats saw no good reason to help the Republicans. The IDA and IMF legislation was now being taken separately and it was right that the Administration should give priority to the latter. Action by the US President was necessary to secure the additional funds for IDA, and Mr Clausen hoped that Mrs Thatcher would raise the matter informally with Mr Reagan at the Williamsburg Summit. Mr Clausen confirmed to Sir William Ryrie that the issue would be unresolved at the end of May.

3. Mr Raison remarked that the Bank Management's $16-18 billion target for IDA 7 would be extremely difficult to achieve; the UK share would have to come down. Mr Clausen noted that this was the UK Government's position. He agreed it would not be easy to raise the sums he had in mind, but believed there was a consensus among the smaller donors, notably the Nordics, Italy and the Netherlands, for an IDA 7 of around $15-16 billion. Bank Management was obliged to act as the advocate for the needy countries in pitching as high a figure as possible; and donor countries had, after all, supported China's access to IDA 7 funds, bringing in another billion people as claimants.

4. On the Bank's activities, Mr Raison hoped for further involvement by private capital, but Mr Clausen thought the omens were not good, although the US economy was on the upturn. Mr Benjenk thought it important to watch the interaction of the recession in developing countries on the pace of recovery in developed countries, instancing the cancellation in the recent past of 25% of contracts by Latin American countries. Mr Clausen added that the Bank was entering into policy dialogue with borrowers to encourage them to liberalise trade.

/5.

5. The meeting concluded with a reference to the Bank's structural adjustment loans. Mr Raison enquired whether a limit was imposed for this form of lending and Mr Clausen replied that the Executive Board had recently agreed to raise the 10% limit.

The meeting adjourned at 12.55 pm for an official lunch.

E T Barnes
UN Dept (B)
Overseas Development Administration

18 April 1983

Distribution:

Mr Coles, No 10
Mr Holmes, FCO
Mr Power, P/S Mr Raison
Sir William Ryrie
Mr Browning
Mr Hurrell
Mr Frost
Mr L V Appleyard, ERD
Mr R J Bonney, Treasury
Mr R R Langley, Bank of England
Mr D F Smith, UK Del IMF/IBRD, Washington

Mr Coles A.J.C. 15/4.

RECORD OF DISCUSSION BETWEEN THE CHANCELLOR AND THE IBRD PRESIDENT AT 3PM ON 13 APRIL AT NO 11 DOWNING STREET

Present:

Chancellor	Mr A W Clausen
Mr Littler	Mr Munir Benjenk
Mr Carey	
Mr Wicks	
Mr Beastall	
Mr Kerr	

Mr Clausen thanked the Chancellor both for the first class arrangements made for his visit to London, and for the UK's continuing support of IBRD, and in particular of IDA. He congratulated the Chancellor on the agreement on the IMF eighth quota increase reached at the Interim Committee meeting in February: the implementation of that agreement must be regarded as the highest priority. But next in line should be IDA; and he very much hoped that the UK, and indeed all the EC participants, would press President Reagan at Williamsburg to make good the US's commitment to IDA 6, and to make a reasonable contribution to IDA 7. He recognised that there was virtually no domestic US lobby for IDA, and that going high-profile in IDA's defence would carry a political price for the President. But it was one which the needs of the developing world, and the US's own interests - given that 40 per cent of their exports of goods and services were to the developing world - required him to pay. It was very disappointing that he had so far kept his head down, despite the urging of Mr Shultz.

2. The Chancellor referred to the EC demarche to the US on 1 March, and agreed that it would be in order to discuss IDA at Williamsburg. But pressure on the President would have to be discreet and off-stage: any public hectoring would be wholly counter-productive. It was perhaps a pity that the original Regan plan to take the IDA 6 supplementary appropriation and the IMF eighth quota increase in tandem through Congress

had come unstuck: the omens for the quota increase now looked good, but the $245 million supplementary appropriation for IDA 6 seemed much more problematic. Mr Clausen said that IDA would be in considerable difficulty if it were to fail.

3. Mr Clausen then referred to IBRD lending levels and capital requirements. Some modest increase - say $2 billion-in the 1982/86 $60 billion five year lending programme seemed likely to be necessary: the issue would come up at the Development Committee meeting later this month. Also for preliminary discussion then would be the question of a selective IBRD capital increase. An increase commensurate to the outcome of the IMF eighth quota review would be of some $20 billion, but this would be much too ambitious. It might however be sensible to aim to reach agreement in the autumn on a selective increase of some $3 billion, reserving the balance for the next general capital increase, which was due in late 1986 (and which it might be sensible to advance to early 1986. It would be helpful if the Development Committee could signal a willingness to contemplate this acceleration).

4. The Chancellor said that he would be prepared to consider these proposals. No doubt a paper would be circulated before the Development Committee meeting. It would be good if discussion in the Development Committee could be made rather less stylised: the atmosphere in the Interim Committee in February had been good, perhaps partly because the agenda had been carefully prepared, with a small number of issues, all clearly identified and understood, for discussion and decision. Mr Clausen thought that the Development Committee should perhaps spend more time on debt and trade issues, and Mr Benjenk thought that relations between developed and developing countries were now much less confrontational than in the recent past, and that the restricted nature of the Development Committee made it an ideal forum to discuss such issues. The Chancellor said that he saw no objection to the discussion of debt and trade issues in the Development Committee, but that he would not wish such discussion to result in the creation of new machinery duplicating work better done elsewhere.

JOK.

J O. KERR

13/iv/83

RESTRICTED

DISTRIBUTION:

PS/Chief Secretary
Mr Middleton
Mr Burns
Mr Littler
Mr Unwin
Mr Wicks
Mr Beastall
Mr Bottrill
Mr Bonney
Mr Ridley

Mr Coles: No 10
Mr Holmes: FCO
Mr Power: ODA
PS/Governor: Bank of England
Mr Taylor: Washington

SUBJECT
cc Master

File
Suf
cc AW,

10 DOWNING STREET

From the Private Secretary

13 April 1983

Dear John,

CALL UPON THE PRIME MINISTER BY MR. CLAUSEN, PRESIDENT OF THE IBRD

Mr. A. W. Clausen called upon the Prime Minister this morning. He was accompanied by Mr. Benjinck. Mr. Alan Walters was also present.

Mr. Clausen said that in the present world-wide economic malaise, what was needed was sound sustainable growth. To achieve this it would be important to secure growth in the developing countries, which were important markets for the developed countries. In the case of the United States alone, 40% of exports currently went to developing countries, compared with 29% 11 years earlier. The same was true in Europe and elsewhere. The IBRD could be helpful in achieving this end, particularly since commercial banks were drawing their horns in at present.

The Prime Minister commented that many banks had overlent, and many developing countries had overborrowed. The last thing that the member governments of the IBRD should do would be to encourage imprudent lending and borrowing. Mr. Clausen agreed. The soundness and prudence of the World Bank's operations had created the ironical situation in which the IBRD enjoyed the finest spreads, notwithstanding that its lending was to developing countries, while commercial banks, with less concentration in their loan portfolios on developing countries, were obliged to pay wider spreads. The Prime Minister commented that the IBRD's backing for its lending was, no doubt, in part its past profits; but also the backing of its member governments. Mr. Clausen said that the developing countries had considerable resources to mobilise and develop. Even where there were serious debt problems, as in the case of Mexico, there was frequently no insolvency, but simply a liquidity problem. The World Bank could be of great assistance in some of these cases. The Prime Minister said that she accepted that there was an important role for the IMF and IBRD in such cases. But she had to insist that no action should be taken which might lead to undermining the soundness of the Western banks. Such action would lead to calamity. In the case of many countries with debt problems, if their difficulties could properly be described as liquidity difficulties, these were often difficulties which would last for many years. One always had to remember that liquidity difficulties could lead to bankruptcy and collapse.

/ Mr. Clausen

Mr. Clausen said that the commercial banks' lending was unconditional. Many countries which sought to borrow from the IBRD were following unsound policies, for example, subsidising consumption, and with little confidence in their financial markets. The conditionality of IBRD lending was in these circumstances vital. The Prime Minister agreed, and said that it was essential for the necessary conditionality to be tough and to extend over a sufficient period of time. There was always a temptation, as in Britain in the latter years of the previous Government, to go back to the bad old ways once the loans had been disbursed. Mr. Benjinck said that the loans were disbursed in tranches, and that no tranche would be released if the loan conditions were not being honoured. Mr. Clausen pointed out the extent to which IBRD lending was project-directed.

The Prime Minister said that we were spending more and more of our aid through multilateral channels. We found that we earned no credit for such aid from recipient countries. She noted, too, that our contribuiton to IDA was larger than would be justified by our relative GNP. Mr. Clausen recalled, with gratitude, the initiative which the United Kingdom had taken in breaking the log-jam of IDA VI. He said that he believed that there was an understanding amongst many of the member countries that the United Kingdom's IDA percentage should be reduced. But he very much hoped that the United Kingdom would be prepared to show the leadership on IDA VII which it had showed in IDA VI. The accession of the People's Republic of China to the IDA (with which the United Kingdom had agreed) made it all the more essential that there should be an adequate Seventh Replenishment. He believed that a Replenishment of $15-16 billion was becoming something of a rallying point for IDA VII. The Prime Minister said that she could give no promises about IDA VII. The United Kingdom's record on IDA was a good one. One of the problems was that a large percentage of IDA's funds went to India, and no-one was ready to argue that India should receive a reduced percentage. Mr. Clausen said that the proportion going to India was 40% a few years ago. Two years ago it was 37% and still going down. But both India and China had access to capital markets, and the aim must be to concentrate IDA lending on those countries whose credit rating meant they had little or no alternative source of capital - for example, the countries in sub-Saharan Africa.

Mr. Clausen expressed the hope that there would be discussion at Williamsburg of conditional development assistance, and that the Prime Minister would feel able to urge President Reagan to see to it that the United States met its commitments on IDA VI. The Prime Minister said that the United States had historically been a very generous country. She would not be prepared to criticise the Americans publicly. She pointed out that the United States had already done much in recent months to help the developing world, for example, in drip-feeding Mexico: the Fed's motive in this had been largely, no doubt, to sustain the United States' banks with high exposure to Mexico, but this action had not been without cost to the United States economy, given the monetary and inflationary consequences of this action.

/ Mr. Clausen

Mr. Clausen went on to ask the Prime Minister for her support in removing constraints on IBRD lending, referring specifically to the $60 billion lending ceiling. The Prime Minister enquired what the cost to the UK would be. Mr. Clausen said it might mean bringing forward the next IBRD capital increase by about 6 months; or issuing a guarantee. The Prime Minister said that she, again, could make no promises, and expressed doubts about the issuing of a guarantee, however unlikely it was to be called.

Summing up the points he wished to make, Mr. Clausen said that he hoped that the British Government would support action to allow the IBRD to grow a little more to accommodate China; and to show leadership at the Williamsburg Summit on IDA VII. The Prime Minister said that China was able to raise capital on her own credit, and was capable, with her natural labour resources, of becoming a wealthy country, if her political system were to change. She noted Mr. Clausen's points, and reiterated that she and Mr. Clausen shared the same objective, of promoting sound and sustained non-inflationary world growth.

I am sending copies of this letter to Brian Fall (Foreign and Commonwealth Office), Michael Power (Overseas Development Administration), and Richard Hatfield (Cabinet Office).

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
H.M. Treasury.

10 DOWNING STREET

Prime Minister

Mr Clausen ("Claw-son")

You saw, earlier, notes by Alan Walters and others.

At flag D is the 'official' brief for Mr Clausen's visit.

You will recall that you have a meeting with Ministers later on tomorrow to settle the line for Williamsburg on IDA etc.

MCS 12/4

OVERSEAS DEVELOPMENT ADMINISTRATION
ELAND HOUSE
STAG PLACE LONDON SW1E 5DH

Telephone 01-213 5409

From the Minister

11 April 1983

Dear Willie,

VISIT BY MR CLAUSEN, PRESIDENT OF THE WORLD BANK: 12-15 APRIL 1983

... I attach an outline programme and a set of briefs for Mr Clausen's visit this week.

The briefing covers the issues that we understand Mr Clausen will wish to raise:

a. Developments in the world economic situation;

b. Restraints in commercial bank lending and intermediation of the World Bank;

c. IBRD lending levels and capital requirements;

d. Structural Adjustment Lending;

e. International Development Association (IDA); and

f. Future of the IMF/IBRD Development Committee.

Detailed discussion on the second item will be covered during Mr Clausen's call on the Governor of the Bank of England.

You will doubtless have seen the article in today's 'Times' by Professors Bauer and Yamey, linked to Mr Clausen's forthcoming visit, criticising the principle of overseas aid. You may be interested to see the enclosed paper, written very much from a World Bank viewpoint, which attempts to answer the sort of objections raised by Professor Bauer.

Flag C

July 1982 filed on Part I

There has been some discussion here about the correct pronunciation of Mr Clausen's surname. The Prime Minister has, of course, already met him, but may like to be reminded that his surname is pronounced "Claw-son".

I am copying this letter and enclosures to John Kerr (Chancellor's Office) and to John Holmes (FCO).

Yours sincerely,
Mike Power

(M A Power)
Private Secretary

W Rickett Esq
10 Downing Street

PROGRAMME FOR THE VISIT OF MR TOM CLAUSEN, PRESIDENT OF THE WORLD BANK, TO THE UK BETWEEN TUESDAY, 12 APRIL AND FRIDAY, 15 APRIL

<u>Tuesday, 12 April</u>

	Arrive, Evening

<u>Wednesday, 13 April</u>

1030	Prime Minister
Lunch	Lunch with Commonwealth Secretariat
1500	Chancellor of the Exchequer
1730	Meeting with Conservative Back Bench Parliamentary Committees on Foreign Affairs, Finance, Trade and Industry, organised by Mr Bowen Wells, MP
1930 for 2000	Governor of the Bank of England's dinner for bankers

<u>Thursday, 14 April</u>

1000	Governor of Bank of England
1215	Minister for Overseas Development
Lunch	Minister for Overseas Development
1515	Press Conference (ODA)
1630	Secretary of State
1945 for 2000	Chancellor of the Exchequer: Small informal dinner (with wives) at 11 Downing Street

<u>Friday, 15 April</u>

	Depart, morning

LIST OF BRIEFS

No	Subject
1.	Personality Note
2.	World Economic Prospects (including points that may arise at Williamsburg Summit)
3(a).	World Bank Group
(b).	Brandt/UNCTAD VI: Implications for World Bank
4.	Development Committee (including forthcoming meeting in Washington and future role of Committee)
5.	British Aid Policy and Programme

BRIEF NO. 1

PERSONALITY NOTE
MR A W (TOM) CLAUSEN

Mr Clausen has been President of the World Bank since July 1981. He is a US national of Norwegian ancestry (of which he is very proud). He was born in Illinois in 1923, and educated at Carthage College and the University of Minnesota, where he studied law. He joined the Bank of America immediately on leaving university in 1949, and served as its President and Chief Executive Officer from 1969 to 1981. During his time there he was active in a large number of business, civic, and educational organisations. These included the Federal Advisory Council, which is associated with the US Federal Reserve System; and the Government Borrowing Committee of the American Bankers Association, which involved working very closely with the US Treasury. He was also a member of the Advisory Council on Japan/US economic relations, and the Pacific Basin Economic Council; and a Director of organisations concerned with US trade with the USSR and with China.

In his time as Head of the Bank of America, he was largely responsible for the Bank's flair for picking out the businesses with the most potential, and getting behind them with large amounts of cash. He was also known as a phenomenal worker and a master of organisational detail, but at the same time he did a good deal to delegate decision-making. He thus came to the World Bank with a vast experience of banking matters, particularly in the Pacific area, and of managing one of the two largest banks in the United States. He has, however, been feeling his way in a type of organisation, and intergovernmental political environment, which was largely new to his experience. There were also some important gaps in his knowledge of developing countries, although his public utterances had shown sympathy for their problems; he had, for example, never visited Africa.

On joining the World Bank, he identified as priority tasks the need to improve its internal working, and its public image, particularly in donor countries. Internally, he has sought to improve management and coordination, especially in the fields of finance and personnel management. He has also sought to introduce a more collegiate approach within the senior management. In personnel management, he has introduced more flexible arrangements designed to relate grading and reward more closely to performance. He has also initiated a substantial reorganisation of the Bank's research effort, intended to link this more closely to operational needs. In the financial field, he has pushed through important changes designed to strengthen the Bank and reduce its exposure to the risk of mismatch between the rates at which it can borrow and those at which it has committed itself to lend. These changes have included the introduction of a variable lending rate and the imposition of a front-end fee.

Externally, his immediate aim was to make the Bank a less controversial institution, especially in the United States, and to defuse some of the previous hostility. He has placed particular stress on the policy of IBRD and IDA of investing only in projects which are rigorously appraised from the economic and technical viewpoints, and of seeking to open developing country economies to market influences. While the Bank's traditional opponents still oppose it, they do so in a less dogmatic fashion. In the most recent vote on IDA in the US Senate, only one vote would have sufficed to produce a more favourable result. He has sought to maintain close relations with the Treasury Secretary and the Secretary of State, and with influential people on Capitol Hill.

He has spent considerable time in contacts with the private sector, seeking to make the Bank more acceptable to conservative public opinion, particularly through the stronger emphasis of co-financing. He has also now become much more aware, from first-hand experience, of the needs of developing countries. He quickly grasped the need for strengthening IDA. He had not realised that the United States would take such a restrictive position on IDA, and this has been quite a revelation to him.

During the coming months, he will be continuing to pursue these general aims, but his priority will be to get adequate support for the 7th replenishment of IDA. IDA 7 will be all the more important in view of the chequered history of IDA 6, which has been spread out over 4 years due to the failure of the United States to appropriate its contributions over the planned 3-year period.

He is also examining whether the IBRD can also do more in the face of the present serious world economic situation. He is concerned that, by comparison with the IMF, the IBRD may appear at present to be too passive. He has therefore brought forward proposals to accelerate its programme, for example, by increasing the commitment rate beyond the $60 billion envisaged for the 5-year period FY82-86, possibly supported by a selective capital increase for countries whose IMF share will increase as a result of the present review of IMF quotas. More immediately, he has suggested that, within the present commitment programme, funds might be disbursed more quickly on high priority investment projects; and that there should be a larger proportion of quick-disbursing types of loans, such as

/structural

structural adjustment loans and sector or programme loans.

Another concern of Clausen's has been the poor performance of the joint IMF/IBRD Development Committee - a concern which is shared by its present Chairman, the Pakistan Finance Minister. Clausen feels that the present round of set speeches achieves little, and he would like to see more time devoted to informal discussion - perhaps closer in style to a Commonwealth Meeting. He would like to see the Committee take a special topic and discuss it in greater depth. One such topic which he has been particularly anxious to promote is the significance of trade for developing countries; it is significant that the Vice-President whom he has recruited to head the Bank's research effort has previously done much of her work on trade issues.

Those who knew him in his days with Bank of America have described him as a very private man who shuns publicity, and is not easy to get to know - a quiet thinker and an introvert pragmatist. His performance at the World Bank has rather belied this personality assessment. While not easy to get to know well, he has sought, much more than his predecessor, to operate through discussion rather than on paper. He is a somewhat compulsive talker and he is not a good listener. Under his leadership, however, the Bank has already taken some important steps to maintain its financial soundness and to improve the efficiency of its operations.

VISIT OF IBRD PRESIDENT: 12 - 15 APRIL 1983

BRIEF NO 2: WORLD ECONOMIC PROSPECTS

POINTS TO MAKE

ECONOMIC OUTLOOK

i. World activity has yet to recover fully. Encouraging signs that modest recovery in 1983 is getting underway. Lower inflation and interest rates lays basis for resumption of sustainable growth.

ii. Lower oil prices should, on balance, improve world growth and reduce inflation. Some oil exporting debtors may suffer, more so if prices fall further but benefits to OECD countries should outweigh these difficulties.

iii. International financial scene still requires close monitoring. Considerable adjustment achieved and should continue. Most major debtors now have stabilisation programmes in place with IMF help. Helpful that IMF giving positive lead to commercial banks.

POLICIES

iv. Monetary policy should be flexible but firm enough to prevent any renewed upsurge in inflation. Fiscal policy should aim to put structural deficits on a convincing declining medium term path.

v. Expect Williamsburg to endorse continuation of prudent counter-inflationary financial policies and to resist calls for excessive reflation. Policies need to sustain recovery.

iv. Major countries especially SDR block should pursue convergent policies to achieve non-inflationary growth. Only way to exchange rate stability. Welcome recent French recognition.

vii. All countries, particularly Summit partners, need to resist protectionism. Developing countries need access to industrial markets. Trade restrictions inhibit growth and impoverish us all.

ESSENTIAL FACTS

Economic Outlook

Early signs of the modest recovery (1-2 per cent growth in output) forecast for the major industrial economies in 1983 are accumulating. In the US industrial production and housing starts have continued rising while in Europe and particularly in Germany business confidence may have turned round. Lower inflation and lower interest rates should help promote the recovery in activity. The fall in oil prices should also increase output.

2. Output growth in the non-oil developing countries (NODCs) after falling last year is also forecast to pick up slightly in 1983 to around 3 per cent though this remains below the 5 per cent growth achieved in 1973-79. World trade (UK weighted) is expected to recover only slowly growing by 1 per cent after falling by over 3 per cent last year.

3. Unemployment is likely to reach around 9 per cent for the major OECD economies this year. With the pick-up in activity the rise in unemployment may however start to level off towards the end of the year.

4. Inflation has fallen faster than expected. For the major countries it has come down from 12 per cent on average in 1980 to 5 per cent in February. Some further fall is likely in the early part of the year but thereafter higher activity may push inflation up somewhat. Nominal interest rates fell markedly late in 1982. In the US three-month market rates fell from around 16½ per cent last summer to 8½ per cent by the end of 1982. They have remained broadly flat until recently, edging up towards 9 per cent. Although real interest rates have eased slightly they remain high compared to past experience.

5. Weak demand for oil and overcapacity led OPEC to agree a 15 per cent cut in the marker price to $29 pb in March. OPEC's current account may move into deficit as a result. Lower oil prices will help many sovereign debtors but hurt those who are also oil exporters (Mexico) and may create some new problems (eg Venezuela, Nigeria, Indonesia, Egypt). A further fall would aggravate these difficulties. On balance the agreed oil price reduction should however improve economic prospects.

6. The large prospective US current account deficit (over $20 bn) dominates the rise in deficits expected for the major countries in 1983. The Japanese and German surpluses are expected to increase this year. Non-oil developing countries' (NODCs) considerable adjustment last year cut imports sharply thereby reducing their current account deficits from $100 bn to $90 bn. Net new bank lending to NODCs contracted sharply last year - growing by only 9 per cent compared to over 20 per cent in previous years.

7. Financing constraints on NODCs are likely to persist. IMF expects net new bank lending to grow by only 8 per cent or so in 1983. Import growth will remain depressed but the up-turn in the OECD area should allow some recovery in export growth and some pick-up in commodity prices. Together with the benefits of lower interest rates this should help NODCs to reduce their current account deficits further to around $70 bn. The recent fall in oil prices should also help.

8. Exchange rates have remained volatile. After rising sharply throughout 1982 the effective dollar rate depreciated by around 8 per cent between November and February this year. Uncertainty over oil prices and concern over monetary and fiscal policy have resulted in the dollar strengthening again. As a result of the EMS realignment the DM appreciated by 8 per cent against the French franc (5½ per cent from the DM revaluation and 2½ from the franc devaluation). Despite the strong appreciation since last November which has reversed the losses in 1982 the yen remains undervalued.

9. Most major debtors including Mexico, Brazil and Argentina are now implementing stabilisation programmes with IMF assistance. Although the imminent threat of major international default has receded financing difficulties still persit. The quota increase (from SDR 61 bn to SDR 90 bn - an increase of 47½ per cent) agreed at the IMF's February Interim Committee together with the increase in the General Arrangements To Borrow and its greater availability should enable the Fund to play an effective role in helping countries to adjust their economies. The World Bank also needs its resources adequately replenished.

Policies

10. Experience with monetary policy last year is difficult to assess, particularly in the US, at a time of institutional change and changing liquidity demands. Last

year US monetary growth overshot the targets partly due to distortions. The Fed has announced higher targets for 1983 as the distortions may persist but stressed the counter-inflationary goal. The M2 target was increased from 6-9 per cent to 7-10 per cent for 1983 and the base changed to the average February/March 1983 level. The Fed has expressed concern over the rapid growth in the monetary aggregates so far this year. Some have argued policy is now too lax.

11. Monetary growth in Germany in 1982 was within the 4-7 per cent target. Policy may be easier this year as the same targets are to be maintained despite lower inflation. France's single figure target has been reduced from 10 to 9 per cent for this year and is tighter than in 1982. Italian monetary control last year was wrecked by the high public sector deficit. No new targets have been set for 1983.

12. As regards fiscal policy, since 1979 despite most government's attempts to achieve firm public expenditure control general government deficits have risen, mostly due to the recession, from 2 per cent of GDP in 1979 to over 4 per cent in 1982. Only Japan and the UK have secured a reduction in their deficits while Germany has contained the increase. Mildly expansionary policies in France and the US have, along with the recession, increased budget deficits.

13. Last December OECD estimated that deficits for the major economies this year would remain at 4 per cent of GDP despite the expected recovery. The new French measures to accompany the devaluation are designed to keep the budget deficit in 1983 and 1984 to 3 per cent of GDP. The restrictive 1983 budget introduced by the Japanese Government has been tempered only slightly by the concession of income tax cuts later this year and the acceleration of public works programmes.

14. The US budget measures for FY1984 should reduce the Federal deficit from 6½ per cent of GDP in FY1983 to 3½ per cent by FY1986. But deficits still remain high compared with past experience in spite of good growth forecasts. The budget measures are still being debated and have yet to be passed by Congress. So far at least the budget has not entirely satisfied concern over the Administration's future fiscal stance.

15. We share the hopes already expressed for a relatively informal discussion at Williamsburg concentrating on a few key economic issues. Discussion might explore

the broad monetary and fiscal policy stance of all the major countries, both individually and collectively, which is necessary to ensure the recovery becomes firmly established while at the same time preventing any renewed upsurge in inflation. Other focal points might include exchange rate stability (the Jurgenson report on intervention is to be published soon), the need to minimise the threat to recovery from increased protectionism, international debt issues, help for the poorer developing countries including IDA and the outlook for oil prices.

16. There is already considerable pressure, notably from the French and the Scandanavians, for some co-ordinated reflation by the major low inflation countries. Such expectations need to be defused in advance of the Summit. Lower inflation should, within the bounds of prudent counter-inflation policies, allow greater real growth. But there is scope for a better policy mix to ensure a more balanced and sustainable recovery. In particular the US should be encouraged in its efforts to reduce its budget deficit while there is a need for high inflation countries such as Italy and France to bring their performance into line with that of their Summit partners.

HM Treasury/Bank of England
April 1983

VISIT OF IBRD PRESIDENT: 12-15 APRIL 1983

BRIEF NO 3a: WORLD BANK GROUP

POINTS TO MAKE

WORLD BANK

1. Welcome steps taken to improve Bank's financial soundness and efficiency.

2. UK has supported Bank's appropriate and timely measures to help borrowers. Structural Adjustment Lending especially helpful. If necessary, prepared to see this extended. Initiative on co-financing welcomed. (IBRD in touch with Bank of England on details.)

3. (If raised) UK's instrument of subscription under 1979 General Capital Increase will be deposited next month.

4. Would not stand in the way of a selective Capital Increase for those members whose positions under the IMF 8th Quota Review have improved. This unlikely to allow significant increase in lending.

5. Proposals for new general capital increase will need careful consideration in light of Bank's justification for increased lending.

INTERNATIONAL DEVELOPMENT ASSOCIATION

IDA 6

6. US badly at fault. Mr Clausen is an American and was nominated by the US President. What action is he taking to persuade the US to provide their contribution on time? UK has done its best (the Prime Minister herself having played a part). We initiated recent Community Démarche to the American Administration.

7. (If raised) Prepared to support pressure on US on this at Williamsburg. We cannot at this stage say what we would do if Congress fails to approve the supplementary appropriation now before it.

8. (if raised) Special contribution for FY 84. Statutory Order to go before Parliament next month to allow deposit of UK instrument of subscription before start of FY 84 (July 1983).

/IDA 7

IDA 7

9. [It is suggested that Ministers should avoid being drawn into discussion about specific figures at this stage.] IDA good form of aid. However British aid funds scarce and over-stretched. Future UK support must be on reduced scale more closely reflecting our relative economic strength.

10. Volume of IDA 7 depends upon degree of US support. Bank's ambitious target of $16-$18 billion unlikely to be realised and to give further publicity to such figures will arouse expectations in developing countries which may be disappointed.

11. Support for IDA must be broad-based. Fair burden-sharing and full US participation from outset essential. Prospect of IDA 7 no greater or even less than IDA 6 in nominal terms has to be faced.

12. Recycling of IDA funds important. What is Bank's current thinking about reducing maturities or introduction of interest charges?

INTERNATIONAL FINANCE CORPORATION

13. Attach importance to promoting private investment in developing countries. But our aid resources limited and already heavily deployed on multilateral assistance. Nevertheless ready to consider case for capital increase.

WORLD BANK

ESSENTIAL FACTS

1. The World Bank is owned by the governments of 144 countries and finances its operations by borrowing on world capital markets. Total lending commitment in FY 82 was $10,330 million, most active borrowers being India, Indonesia and Brazil. The Bank itself borrowed $8,521 million.

2. As one of the largest shareholders, we have a general interest in the success of the Bank as one of the Bretton Woods institutions and the most effective international development agency. There are procurement benefits for British companies and we more than recoup the cost of our contribution.

3. In response to recent world conditions the Bank has adopted a system of Structural Adjustment Lending which provides what is essentially programme rather than project aid. Under present rules it cannot exceed 10% of the Bank's lending.

<u>Recent Measures by the Bank</u>

4. An assessment of Mr Clausen's influence on the Bank is given in the Personality Note. Recent important policy changes are adoption of a variable interest rate for Bank borrowers; a Programme of Special Assistance to assist those borrowers making a determined effort to carry out difficult measures to sustain development; and a trial period to test new financial instruments designed to promote additional co-financing with commercial banks. (IBRD are in touch with Bank of England on technical details on supervisory aspects of co-financing.)

5. We support all of these measures which are appropriate and timely responses to the needs of the Bank's borrowers. Under Structural Adjustment Lending, we are ready to consider changing the 10% limit on Bank's non-project lending, if this becomes an undue constraint.

<u>Lending Levels and Capital Requirements</u>

6. Management has recently reviewed its five-year lending plans in light of potential increases in demand for Bank loans and quicker

/disbursements

disbursements under the Programme of Special Assistance. The original programme was $60 billion over FY 82-FY 86; but having agreed to higher annual figures for the first two years of this period, member governments are now being asked to sanction higher lending totals in the later years, including a roll-over into FY 87, and with the corollary of further expansion of the Bank's capital. A figure of $21 billion was referred to prematurely in drafts of Development Committee papers, but the issues of longer-term lending limits and capital requirements are now to be considered separately.

7. We believe Management will probably seek to obtain agreement (before the Annual Meeting in September) to a two-stage capital expansion programme involving a Selective Capital Increase following the IMF 8th Quota Review for those whose share in the IMF has been increased (in which UK will not be involved), to be implemented from 1984, and a General Capital Increase for all members to be mounted towards the end of this decade. Sums raised could be around $2.9 billion and $19.7 billion respectively. (GCI figure would be open to negotiation.)

8. The principle of parallelism between positions in the IMF and World Bank has always been followed and there are no grounds for opposing an SCI on that basis. However, Ministers would have to consider whether the UK could accept a lower position in the Bank than in the Fund (where we remain in second place) if large SCIs were offered to Germany and Japan.

1979 (Current) General Capital Increase

9. The 1979 general capital increase of $40 billion, when fully subscribed, should double the Bank's capital. Shares have been allocated pro rata according to member countries' existing holdings. UK's allotment was 24,336 shares, but we released one half (12,168) to enable the Bank to meet the legitimate claims of other countries to increase their shareholdings. Saudi Arabia was the main beneficiary. The paid-in element is 7½% of the cost of shares; ¾% in dollars and 6¾% in sterling. Total will be around £70 million and will be spread over several years; our instrument of subscription will be deposited with the Bank at the end of May.

/Energy

Energy Affiliate

10. This proposal is moribund. There has been no support from the United States and little enthusiasm shown by OPEC countries, even in the past. It is presumed that Bank support for energy projects will continue up to a maximum 25% of its lending programme and that the volume of lending to this sector will be extended as capital increases for both the IFC and the Bank take place.

INTERNATIONAL DEVELOPMENT ASSOCIATION

ESSENTIAL FACTS

11. IDA was established in 1960 as an affiliate of the World Bank to provide low cost investment funds to those countries who were not sufficiently creditworthy to borrow on capital markets or from the Bank itself. IDA's credits are provided on near grant terms and its resources are made up of grant contributions from 33 countries (the great bulk from developed countries) supplemented by repayments of earlier IDA credits, transfers from IBRD profits and a special contribution from non-member Switzerland.

12. IDA is the largest as well as the most efficient multilateral aid agency. As an apolitical multilateral organisation, it is better placed than individual bilateral aid donors to bring about policy reform necessary in recipient countries to ensure aid is effective.

13. The geographical allocation of its assistance resembles our own bilateral aid programme more than any other aid donor's - 80% of IDA credits have gone to countries with less than $410 GNP per head (1980); 60% to the large poor countries in South Asia and (as with the UK aid programme) India has traditionally been the major recipient. IDA offers important opportunities for British industry and direct procurement returns to UK are about 70% of contributions.

IDA 6

14. The Sixth Replenishment (IDA 6) was originally intended to provide $12 billion for commitments in three fiscal years beginning 1 July 1980 (FY 81), but the Carter Administration was unable to obtain Congressional authorisation for the US contribution ($3.24 billion - 27%) and the present US Government decided to accept the commitment

/but

but to phase payment over 4 years instead of three (ie to FY 84). Only $1.9 billion has so far been authorised by Congress. Other IDA donors have agreed to provide IDA with additional commitment authority over the extended 4 year period - first by advancing their first year's IDA 6 instalments, then by delinking their second and third year's instalments from the level of the US contribution (this was agreed by the Prime Minister during Mrs Gandhi's visit last year) and finally by agreeing special funding for FY 84 of which the UK share will be about £105 million.

15. So far in this financial year the US Congress have appropriated only $700m out of the $945m agreed US contribution. The US Administration have submitted a supplementary appropriation for the balance (and have included the rest of the US contribution to IDA 6 - $1095m - in their budget for next year). If the $245m supplementary is approved IDA 6 will be more or less completed on time even if the US contribution for FY 84 is only the same as this year's as the result of a continuing resolution; this will be a hopeful augury for IDA 7. If the supplementary is not approved the US contribution to IDA 6 will drag out over five years and the prospects for IDA will be seriously weakened. This is a big risk to take for a comparatively small sum (for the Americans). Mr Clausen is likely to ask the Prime Minister to raise this question with President Reagan at the Williamsburg Summit or at least to lend support if others raise it. We suggest that it would be sufficient to agree to do the latter.

16. Resulting from a UK initiative, the European Community decided to make a démarche on this issue to the US Administration. The German Ambassador in Washington delivered this on 1 March.

IDA 7

17. Negotiations on the seventh replenishment began in Washington last year with the intention of reaching agreement by the time of the September 1983 Annual Meeting of the IMF and World Bank. Meetings have also been held in Paris and Copenhagen. Meaningful negotiations cannot begin until the US position under IDA 6 is clarified, and the size of the US contribution to IDA 7 is known. It is hoped (but by no

/means

means certain) that the US position will be clearer by the time of the next meeting of IDA 7 Deputies in July (Tokyo).

UK Interest

18. The UK has been a strong supporter of IDA under successive Governments and our interest is probably to work for a continuing high level of resources for IDA, but towards an IDA 7 replenishment target that is realistic and includes full US participation. It would be futile to fix an overall volume implying a US share which the US Administration could not meet or to start IDA 7 without the US. At the present time the US Administration is thought to be considering contributions of around $750 million a year which would produce an IDA 7 total of $9 billion over 3 years or $12 billion over 4 years - substantially less in nominal terms than the agreed total for IDA 6. Despite this, the World Bank is continuing to give wide currency to a $16-$18 billion figure.

19. On burden sharing, we have already made clear our intention of reducing our share from the very high level of 10.1% for IDA 6, and from the 7.6% for the special funding for FY 84 to one more in line with UK's relative economic strength (the UK's share of donors' GNP is 5.4%).

INTERNATIONAL FINANCE CORPORATION

ESSENTIAL FACTS

20. Established in 1956 as an affiliate to the World Bank, with capital of $78 million to promote growth of productive private investment. Authorised capital increased in 1978, and now stands at $650 million, with 123 member countries. The previous Government decided to take up our shares and a payment of £12.2 million was made in 1978. That Capital Increase came to a close in July last year, with 90 per cent of the shares allotted. UK is the second largest shareholder (7.6%) - the US being the largest at 29.49%.

21. IFC Management now looking for a new capital increase to enable increase in volume of its lending, particularly in Africa; increased

/equity

equity investment; increased support for the development of capital markets; and increased investments in private sector energy development. In FY 82, some $280 million was provided by commercial banks in association with IFC projects.

22. Major donors, including the United States, support concept of further general capital increase. Probable size $750 million. Mr Clausen will defer making formal proposition until after IMF/IBRD Annual Meeting. We are generally satisfied with IFC's programme for promoting private investment in developing countries. Subscriptions are fully paid as grants and for UK this could mean around £38 million - but phased over several years.

Overseas Development Administration
8 April 1983

VISIT OF MR A W CLAUSEN, PRESIDENT OF THE WORLD BANK, 12-15 APRIL

BRIEF 3(b): UNCTAD VI/BRANDT: IMPLICATIONS FOR THE WORLD BANK

<u>Points to Make</u>

1. In preparation for UNCTAD VI, the UNCTAD Secretariat, Brandt Commission and others are calling for massive extra flows of funds from the World Bank and other sources to the developing countries (LDCs). This is not the right solution to the LDCs' present economic difficulties. [It is beyond the capacity of donors to provide or LDCs to absorb.]

2. UK appreciates World Bank's own response based on modest increases in certain types of lending and closer policy dialogue with borrowers. Endorse World Bank Programme of Special Assistance for 1983 and 1984.

3. Prepared to discuss at UNCTAD VI ideas on lines of World Bank's own thinking, eg for a modest increase in structural adjustment lending. But important to discourage unrealistic expectations.

4. UNCTAD must respect the independence of the International Financial Institutions.

JCRACC

Essential Facts

1. Financial matters are outside UNCTAD's main field of competence. But there will be a discussion of financial and monetary issues at UNCTAD VI. Group B (the OECD countries) has stressed that UNCTAD must respect the independence of the international financial institutions, and has warned the Group of 77 (G77) in informal contacts, not to build up unrealistic expectations.

2. The final G77 negotiating position for UNCTAD VI is under discussion at the G77 Ministerial meeting in Buenos Aires (28 March-9 April). G77 is likely to take up ideas put forward by the UNCTAD Secretariat for a package of 'immediate measures' to help LDCs. These proposed measures include a major injection of liquidity from the IMF, World Bank and other sources. Much of the package is on too grandiose a scale, and would prove beyond the capacity of donors to provide or recipients to absorb.

3. The UNCTAD Secretariat's specific proposals for action by the World Bank and IDA are: to increase lending by committing the present 5 year programme over 4 years, to increase structural adjustment lending (SAL) as a proportion of total lending, to increase IBRD's resources by a new capital increase and/or doubling the bank's gearing ratio, and to increase IDA7 in real terms. (See brief 3(a)).

4. The World Bank Executive Directors have recently approved a sensible and realistic Programme of Special Assistance for 1983 and 1984. This will result in an increase in World Bank disbursements over the next two years of approximately US $2bn. As part of the programme the World Bank will make greater efforts to discuss economic policy matters with LDC borrowers (the 'policy dialogue').

5. Group B will be prepared to discuss at UNCTAD VI realistic ideas for using World Bank lending to give LDCs rather more help with their balance of payments problems, for example through a modest expansion of structural adjustment lending.

6. Leeds Castle Conference on UNCTAD VI, 30 April-2 May

Mr Rees invited Mr Clausen to attend the Conference but he is unable to come and will be represented by a senior IBRD official.

7. Brandt

The Second Brandt Report makes proposals for action by the World Bank very similar to those put forward by the UNCTAD Secretariat.

Economic Relations Department
6 April 1983

JCRACC

VISIT OF IBRD PRESIDENT: 12-15 APRIL

BRIEF NO 4: IMF/IBRD DEVELOPMENT COMMITTEE

POINTS TO MAKE (if raised)

FORTHCOMING MEETING ON 28-29 APRIL

1. Look forward to useful meeting of Committee. Chancellor will attend. No major problems with draft agenda.

2. Reluctant to set up new Task Forces or Sub Committees on debt or trade and development issues. Risks duplicating work best left to other institutions eg IMF and GATT.

FORMAT OF MEETINGS

3. Can support moves for sensible changes in format: eg less speech-making and more genuine discussion (cf Commonwealth Finance Ministers meetings). Needs strong chairmanship.

FUTURE ROLE OF COMMITTEE

4. Understand disappointment of some members about lack of tangible results. But Committee has commissioned useful work (eg report of its Task Force on non-concessional flows).

5. See advantage in keeping Committee as deliberative (<u>not</u> decision-taking) body. Should resist more formalised arrangements (eg permanent Secretariat) which might impinge on independence of parent institutions (IMF, IBRD.)

BRIEF NO 4: IMF/IBRD DEVELOPMENT COMMITTEE

ESSENTIAL FACTS

The Development Committee was established in 1974 as the "Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries". Its remit is to maintain a general overview of the development process. It meets twice a year (normally in conjunction with the Interim Cttee). The 22 members (one from each IBRD/IMF constituency) are mainly Finance Ministers (the Chancellor normally attends for the UK). The present Chairman (elected last September) is the Finance Minister for Pakistan, Ghulam Ishaq Khan. There is an official Secretary to the Committee (at present Mr H E Kastoft from Denmark) but documentation for meetings is largely in the hands of IMF and IBRD management.

FORTHCOMING MEETING ON 28-29 APRIL

The next meeting will take place in Washington on 28-29 April. Unusually there will not be an Interim Committee meeting at the same time, as this was brought forward to February. The Chancellor will still attend.

The draft agenda includes one substantive item covering the resources of the international financial institutions (including IDA), external debt problems of developing countries and linkages between trade and the promotion of development. This structure is broadly acceptable, although there may be some problems with the draft communiqué.

There were reports following the Non-Aligned summit meeting in Delhi that the ldc's might press in the Development Committee for a new debt restructuring facility. It is not yet clear whether the Chairman will seek to push this. Mr Benjenk (IBRD Vice President) has also floated the idea that the Development Committee might set up a small sub-committee of Ministers (perhaps chaired by the Chancellor) to consider this proposal and report back to the September meeting. However, the IMF management do not favour this (nor would many G5 countries) and the idea is probably dead for the present.

The Americans are thought to want to set up a Task Force on trade and development issues. Their motives are unclear (perhaps to pre-empt discussion in UNCTAD VI or to pursue ideas floated in GATT). There is no objection to a discussion of trade linkage in the Development Committee. (Mr Clausen is also known to be interested in this subject). Follow up work might be better left to the GATT.

FORMAT OF MEETINGS

Mr Clausen is known to be concerned about the poor performance of the Development Committee. He feels that the present round of set speeches achieves little and would like to see more time devoted to informal discussion - perhaps closer in style to a Commonwealth meeting. We should support any practical moves in this direction, although it will take effective chairmanship to implement them.

FUTURE ROLE OF COMMITTEE

The Development Committee is often accused of making little impact. This is partly because of its working methods and partly because it tends to be overshadowed by the Interim Committee. The fact that it rarely produces positive recommendations for action is probably to be welcomed.

Unlike the Interim Committee, where there is a good deal of common interest, debate in the Development Committee tend to be polarised between the interests of developing and developed countries, with some of the smaller industrials (eg Nordics) often siding with the developing countries. There is no weighted voting in the Development Committee as there is in the World Bank Board. Thus, while the Development Committee has value as a forum in which developmental issues can be discussed in a less contentious way than in UN fora, it would not be in our interests for it to be given a more positive and decision-taking role in relation to the World Bank or other IFI's. We need therefore to avoid hasty decisions being taken on beefing up the role of the Committee. If there is a move in this direction at the next meeting, the better course would be to remit the subject for further study.

BRIEF NO 5

BRITISH AID POLICY AND PROGRAMME

POINTS TO MAKE

1. POLICY - British Government continue to take seriously the difficulties being experienced by countries of the developing world, and recognise that aid has an essential part to play in assisting the less developed.

Moral and humanitarian case for aid remains overwhelming and developmental objectives are basic to our programme. We are however giving greater weight to political, commercial and industrial objectives which we regard as complementing the developmental ones.

Although official aid flows are important, they are only one of the means. In addition to need for sensible domestic policies to be followed by developing countries, the flow of private resources and trade are essential. Britain's record in both these areas is good.

2. AID VOLUME - British aid programme is a considerable one - well over £1,000 million in current financial year. 10% higher in cash, and thus likely to represent an increase in real terms over 1982-83.

3. ALLOCATION OF AID - Multilateral share of aid programme in 1983-84 is expected to be about 40% of total; bilateral aid allocation to individual countries expected to be about 43%; remainder on other bilateral spending, eg Pensions, Aid and Trade Provision, Sectoral Programmes. Expect a large proportion (currently about 2/3rds) of total bilateral country programme to go to "poorest" countries. We shall continue to concentrate a high level of aid on Commonwealth countries.

4. MULTILATERAL AID - Government have stressed that while accepting that past commitments meant multilateral aid would take greater part of the programme over next few years, this expenditure would be examined critically to minimise squeeze on bilateral aid and to bring our contributions more in line with our economic strength relative to other traditional Western donors. Nevertheless we remain convinced of the value of our contributions to those agencies with whom we have enjoyed long and close relationships.

BRITISH AID POLICY AND PROGRAMME

ESSENTIAL FACTS

1. POLICY - Combined official and private flows from Britain to developing countries in 1981 (last year for which figures available) totalled £4,980 million, equivalent to 2.01% of GNP. This is well above the UN target for combined official and private flows of 1% of GNP - a target consistently surpassed by Britain for many years.

2. AID VOLUME - Net aid programme in 1982-83 totalled £959 million. Gross programme (net plus repayments of capital on past aid loans) totalled £1,028 million.

Provision for 1983-84 is £1,057 million (net) and - depending on repayments of capital on former aid loans - gross programme should total about £1,126 million. This represents increase of almost 10% over 1982-83.

Provisional planning figures for net aid programme in 1984-85 and 1985-86 are £1,100 million and £1,130 million respectively.

3. ALLOCATION OF AID - "Poorer" countries are defined as those with per capita income of US $370 and less in 1980 (Source: World Bank Atlas 1981) and all Least Developed Countries.

We expect Commonwealth share of bilateral country programmes to increase from unusually low level of 60.5% in 1982-83 to 74.1% in 1985-86. A very high proportion of bilateral aid outside country programmes (Commonwealth Development Corporation, Research) also devoted to Commonwealth.

In 1983-84 we expect top 10 recipients of bilateral country programme aid to be:

1. India
2. Bangladesh
3. Sudan
4. Kenya
5. Sri Lanka
6. Zimbabwe
7. Tanzania

/8.

8. Gibraltar
9. Pakistan
10. Zambia

4. MULTILATERAL AID - Rise of EC spending in particular has led to severe pressure on bilateral country programmes. Their share of total has been reduced from 53% to 43% between 1979-80 and 1983-84. If, as we expect, EC programmes continue to achieve annual growth rates in excess of 10%, we fear further reduction in overall share of country programmes.

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

PRIME MINISTER

VISIT OF IBRD PRESIDENT: 12-14 APRIL

Since we shall both be seeing Tom Clausen shortly after the Easter break, it occurs to me that you might like ... to see, over the break, the attached background briefing which has been prepared for me.

2. It consists of an extended personality note on Clausen prepared by John Anson, the UK Executive Director at the World Bank, and a short position paper by Treasury officials on the International Development Association (IDA), which figures high among Clausen's priorities. I understand that the latter has not yet been cleared with ODA, because the relevant experts there are now in Copenhagen at an IDA meeting. But I don't detect anything controversial in it: Francis Pym and I have already agreed on the broad lines of our approach to the negotiations on IDA's seventh replenishment.

3. A copy of this minute goes to Francis. His people will no doubt be circulating formal briefing nearer the time of your meeting with Clausen.

G.H.
30 March 1983

CONFIDENTIAL

MR. A.W. (TOM) CLAUSEN

Mr. Clausen has been President of the World Bank since July 1981. He is a US national of Norwegian ancestry (of which he is very proud). He was born in Illinois in 1923, and educated at Carthage College and the University of Minnesota, where he studied law. He joined the Bank of America immediately on leaving university in 1949, and served as its President and Chief Executive Officer from 1969 to 1981. During his time there he was active in a large number of business, civic, and educational organisations. These included the Federal Advisory Council, which is associated with the US Federal Reserve System; and the Government Borrowing Committee of the American Bankers Association, which involved working very closely with the US Treasury. He was also a member of the Advisory Council on Japan/US economic relations, and the Pacific Basin Economic Council; and a Director of organisations concerned with US trade with the USSR and with China.

In his time as Head of the Bank of America, he was largely responsible for the Bank's flair for picking out the businesses with the most potential, and getting behind them with large amounts of cash. He was also known as a phenomenal worker and a master of organisational detail, but at the same time he did a good deal to delegate decision-making. He thus came to the World Bank with a vast experience of banking matters, particularly in the Pacific area, and of managing one of the two largest banks in the United States. He has, however, been feeling his way in a type of organisation, and intergovernmental political environment, which was largely new to his experience. There were also some important gaps in his knowledge of developing countries, although his public utterances had shown sympathy for their problems; he had, for example, never visited Africa.

On joining the World Bank, he identified as priority tasks the need to improve its internal working, and its public image, particularly in donor countries. Internally, he has sought to improve management and coordination, especially in the fields of finance and personnel management. He has also sought to introduce a more collegiate approach within the senior management. In personnel management, he has introduced more flexible arrangements designed to relate grading and reward more closely to performance. He has also initiated a substantial reorganisation of the Bank's research effort, intended to link this more closely to operational needs. In the financial field, he has pushed through important changes designed to strengthen the Bank and reduce its exposure to the risk of mismatch between the rates at which it can borrow and those at which it has committed itself to lend. These changes have included the introduction of a variable lending rate and the imposition of a front-end fee.

/Externally,

Externally, his immediate aim was to make the Bank a less controversial institution, especially in the United States, and to defuse some of the previous hostility. He has placed particular stress on the policy of IBRD and IDA of investing only in projects which are rigorously appraised from the economic and technical viewpoints, and of seeking to open developing country economies to market influences. While the Bank's traditional opponents still oppose it, they do so in a less dogmatic fashion. In the most recent vote on IDA in the US Senate, only one vote would have sufficed to produce a more favourable result. He has sought to maintain close relations with the Treasury Secretary and the Secretary of State, and with influential people on Capitol Hill.

He has spent considerable time in contacts with the private sector, seeking to make the Bank more acceptable to conservative public opinion, particularly through the stronger emphasis of co-financing. He has also now become much more aware, from first-hand experience, of the needs of developing countries. He quickly grasped the need for strengthening IDA. He had not realised that the United States would take such a restrictive position on IDA, and this has been quite a revelation to him.

During the coming months, he will be continuing to pursue these general aims, but his priority will be to get adequate support for the 7th replenishment of IDA. IDA 7 will be all the more important in view of the chequered history of IDA 6, which has been spread out over 4 years due to the failure of the United States to appropriate its contributions over the planned 3-year period.

He is also examining whether the IBRD can also do more in the face of the present serious world economic situation. He is concerned that, by comparison with the IMF, the IBRD may appear at present to be too passive. He may therefore be bringing forward proposals to accelerate its programme, for example, by increasing the commitment rate beyond the $60 billion envisaged for the 5-year period FY82-86, possibly supported by a selective capital increase for countries whose IMF share will increase as a result of the present review of IMF quotas. More immediately, he has been suggesting that, within the present commitment programme, funds might be disbursed more quickly on high priority investment projects; and that there should be a larger proportion of quick-disbursing types of loans, such as structural adjustment loans and sector or programme loans.

Another concern of Clausen's has been the poor performance of the joint IMF/IBRD Development Committee--a concern which is shared by its present Chairman, the Pakistan Finance Minister. Clausen feels that the present round of set speeches achieves little, and he would like to see more time devoted to informal discussion--perhaps closer in style to a Commonwealth Meeting. He would like to see the Committee take a special topic and

/discuss it in

discuss it in greater depth. One such topic which he has been particularly anxious to promote is the significance of trade for developing countries; it is significant that the Vice-President whom he has recruited to head the Bank's research effort has previously done much of her work on trade issues.

Those who knew him in his days with Bank of America have described him as a very private man who shuns publicity and is not easy to get to know--a quiet thinker and an introvert pragmatist. His performance at the World Bank has rather belied this personality assessment. While not easy to get to know well, he has sought, much more than his predecessor, to operate through discussion rather than on paper. He is a somewhat compulsive talker and he is not a good listener. Under his leadership, however, the Bank has already taken some important steps to maintain its financial soundness and to improve the efficiency of its operations.

February 16, 1983

INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA)

Background

IDA was established in 1960 as an affiliate of the World Bank (IBRD) in order to provide low cost investment funds to very poor countries which were not sufficiently creditworthy to borrow on capital markets or from the IBRD. It shares the same staff and facilities as the IBRD and applies the same criteria for assessing projects. However, its "credits" are offered on near grant terms (50-year maturities, 10-year grace period, 0.75% service charge) and it relies for funds primarily on three-yearly "replenishments" of its resources made up of contributions from the major aid donor countries supplemented by small amounts from (a) repayments of earlier IDA credits which are recycled (now about $50m a year) and (b) contributions from IBRD profits (usually about $100m a year).

IDA is the largest multilateral aid agency and is traditionally regarded as the most efficient. A recent study of completed projects shows an average rate of return of 21% at appraisal and 18% at audit. More widely, IDA management also claim success in persuading recipients to follow sensible macro-economic policies in aided sectors (an often quoted example is the "green revolution" in India). IDA as well as IBRD funds are used for structural adjustment lending. It is clear that an apolitical multilateral agency such as IDA is better placed than individual bilateral aid donors to ensure that unpalatable advice is acted upon. IDA is also a significant source of foreign exchange for the poorest countries: in aggregate 1980 disbursements represented 10% of the total current account deficit of IDA recipients (12% of total aid flows). It also acts as a focus for donor cooperation in particularly difficult cases such as Sudan and Bangladesh.

UK interest

The UK has been a strong supporter of IDA under successive Governments. Our original share of IDA contributions was set at 17%. This has gradually declined to 10.1% in the current replenishment (IDA6). Even this is well above our share of IDA donors' GNP (about 5.4%) and was only agreed by the present Government because IDA6 negotiations were nearly complete when they took office. Other countries accept that the UK share will fall again in IDA7: our special contribution for fiscal year 1984 was based on a 7.6% share and we have clearly stated our intention to reduce it further. Nevertheless the UK's positive attitude during the IDA6 negotiations (eg the decision following Mrs Gandhi's visit last year to waive the pro rata conditions tying our contributions to the US) have been generally welcomed internationally.

Leaving aside the question of the UK share, our interest is probably to work for a continuing high level of resources for IDA. This is because the geographical allocation of IDA credits resembles our own bilateral aid programme more than any other aid donors - 80% of IDA credits have gone to countries with less than $410 GNP per head (1980); 60% to the large poor countries in South Asia and (as with the UK aid programme) India has traditionally been the major recipient.

X Moreover, IDA offers important procurement opportunities for British industry: our cumulative share of offshore procurement up to June 1981 was 14.4% - just below Japan (15.5%) and the US (14.7%). Taking IDA alone, procurement returns are now running at about 70% of contributions (much the same as for bilateral aid)

Y but, if the World Bank Group is taken together, we more than recoup the cost of our contributions. Of course British firms which win business funded by multilateral agencies such as IDA have to prove themselves fully competitive as international tendering is mandatory. This is not always the case with the bilateral aid programme, where bidding is confined to UK firms - even less so for ATP where substantial subsidies can be involved.

IDA 6

IDA 6 was originally intended to provide $12 billion for commitments in the three years beginning 1 July 1980. The Carter Administration was unable to obtain Congressional authorisation for the US contribution ($3.24 billion or 27% of the whole). The present US Government decided to accept the total contribution as an existing commitment but to rephase the payments to IDA over 4 years instead of 3 and to backload payments into the third and fourth years. In the event only $1.9 billion has so far been appropriated by Congress (although the full $3.24 billion has been authorised), and there is a serious risk that the US contribution will not be complete until the fifth year (1985). The other IDA donors apart from the US have agreed to various mechanisms to keep IDA in funds over this period - first by advancing their first year's IDA 6 instalments, then by delinking their second and third year's instalments from the US contribution and finally by agreeing special funding for 1984. Any further delay in appropriating the US contribution could set back the seventh replenishment period (already put back from 1984 to 1985) by another year and build up pressure for more special contributions from the non-US donors. It is common ground that every opportunity should be used to persuade the US Administration to make a major effort to secure approval of their original four-year appropriations. This topic might be raised with President Reagan at Williamsburg.

IDA 7

Negotiations on IDA 7 began in November last year, with the aim of reaching agreement by the Annual Meetings of the IMF and World Bank in September, so that the necessary ratification procedures can be put in hand in good time. In practice discussions may well drag on until the end of 1983. The main issues for decision will be:-

(i) the volume of the replenishment;
(ii) the burden-sharing arrangements between donors;
(iii) the broad allocation of IDA lending between recipients; and
(iv) possible hardening of the terms of IDA credits.

The volume of the replenishment will effectively be determined by the size of the US contribution, as given their relative economic strength the other donors are unlikely to accept an American share much less than 25%. The US Administration is thought to be considering contributions of about $750m a year which would produce and IDA 7 total of $9 billion over 3-years or $12 billion over 4 years - ie substantially less in nominal terms than the agreed total for IDA 6. On burden sharing, the UK has already stated its intention of reducing its share from the 7.6% agreed for the 1984 contributions to a figure more in line with its share of donors' GNP (5.4%). (A 5.4% share of a $9 billion IDA 7 at £1 = $1.45 would cost £335 million - compared with our £555 million contribution to IDA 6). The question of allocation between IDA recipients centres on the rival claims of India (traditionally the largest IDA borrower) and China which will be fully eligible for IDA credits for the first time in the IDA 7 period. Our interests are clearly to support the Indian case for maintaining a reasonable share of IDA funds, while accepting China's right to borrow. We should also support a hardening of the terms of IDA credits (including the introduction of a low-interest charge for some countries), if this seems likely to make a difference in the size of other countries' contributions. In the longer term this will make IDA less dependent on donors' contributions.

HM Treasury
30 March 1983

30 MAR 1983

CONFIDENTIAL

Prime Minister 2

You will see from this that Alan doesn't like the IDA. But not everyone agrees - see Tony Parsons at flag A and the Treasury at flag B X + Y. MES 31/3

24 March 1983

ALAN WALTERS

PRIME MINISTER

VISIT OF TOM CLAUSEN, PRESIDENT OF THE WORLD BANK 13 APRIL

REPLENISHMENT OF IDA 7

Mr. Clausen may be hoping to get your support for the 7th IDA replenishment and in particular favourable comments at Williamsburg. IDA is the soft loan facility - lending money at virtually zero interest rates for 50 years with 10 years grace. It's really a give-away. The funds are provided partly from profits on the World Bank Operations, which really come from the contributors to World Bank capital (the West), and from periodic donations from developed countries of the West. The United Kingdom has always contributed more than its proper share. Britain contributed 10% to IDA 6, whereas France with a national income 50% greater than Britain's, contributed only 5%; and Germany with a national income 70% greater than that of Britain, contributed only 12%; while Japan with a national income almost three times that of Britain, contributed only 15%. Clerarly, we are over-contributing relative to our resources.

The Americans are proposing that for IDA 7 the levels of replenishment will be cut substantially. They plan "a big reduction" in funding.

This will be a good opportunity for us to reduce, or at least contain, our funding of the replenishment.

Disputed at flag A, X + Y

Even if there were no replenishment, IDA would still go on, partly because it is funded from the fact that we do not get any return from the capital we invested in the World Bank; any real return which does accrue to the Bank is syphoned off to IDA. That would continue. Similarly, the funds would be returned over the 50-year period. They could be recycled, but clearly the result would be a cut in the annual dispersements of additional multilateral concessionary aid.

Yet it cannot be claimed that IDA is essential to development. The biggest IDA recipient, India, for instance finances only 1.6% of its investment through IDA. It is quite trivial. Indeed in 1980 only two countries financed more than 10% of their investment programme with IDA funds, the Central African Republic and Bangladesh.

/India has

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India has received 40% of IDA funds. But one also finds considerable IDA flows to the dedicated enemies of the West, including the Lao People's Democratic Republic, Somalia, Vietnam, the Yemen People's Democratic Republic, as well as, one of the favourite countries of Robert MacNamara, Tanzania. Furthermore, funds have been made available for such murderous regimes as the Central African Republic, Equatorial Guinea, Uganda. More recently IDA funds have been lavished on Nicaragua - even as late as 1981.

GLOBAL NEGOTIATIONS

One of the fears of the recent push for a new international economic order was that the debtors (developing countries) would get control of the Bank and the IMF. In effect some considerable control has been secured, mainly by the deliberate discrimination of the World Bank when appointing and promoting staff. Preference for Third World countries and in particular Africa is institutionalised. There is an absolute quota on British and American; virtually no British subject (and this includes oddly enough Hong Kong citizens) can now be employed by the World Bank. The preference is all for Third World staff. I believe that much of the same is true in the IMF, but I will gather information on this during the next week or so.

MULTILATERAL/BILATERAL BALANCE

Tony Parsons believes that the multilateral/bilateral balance is now about right. I do not agree. But even if you agreed that the present balance is right, this would require us either to contain the ever growing percentage that is multilateral or to expand considerably the total aid budget. I think containment is the best policy - and the IDA replenishment presents an opportunity to put this policy into effect.

AW

ALAN WALTERS
24 March 1983

T w P

c.c. Alan Walters

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10 DOWNING STREET

From the Private Secretary

23 March 1983

INTERNATIONAL MONETARY ARRANGEMENTS

The Prime Minister was grateful for the Chancellor's minute of 21 March in which he sought formal drafting authority for a new IMF Bill.

The Prime Minister agrees to the Chancellor's proposals.

I am sending copies of this letter to the Private Secretaries to the other members of OD and to Sir Robert Armstrong.

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury.

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ho

cc NO

1

No question of SDR creation arises at this time: para 4 simply proposes the use of existing SDR.

Yes. I hope we shan't create too many SDR's. They are a form of international inflation. MT

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

Prime Minister

This seeks formal agreement to the introduction of a IMF Bill at the beginning of next session.

Agree, subject to colleagues?

MCS 23/3

PRIME MINISTER

INTERNATIONAL MONETARY ARRANGEMENTS

I have been considering the arrangements for implementing the recently agreed increase in IMF resources.

2. As I reported to Cabinet on 17 February the Interim Committee of the International Monetary Fund (IMF) agreed at their meeting on 10-11 February to increase IMF quotas from SDR 61 billion to SDR 90 billion. As a result of this agreement, and of the decision of Finance Ministers of the Group of Ten countries to increase the funds available under the General Arrangements to Borrow (GAB) from some SDR 6½ billion to SDR 17 billion, the usable facilities available to the IMF will be substantially increased.

3. In my capacity as Chairman of the Interim Committee I have pressed for decisions in these areas to be accelerated so that increased resources should be available to the IMF as soon as practicable to help it perform its central role in the global adjustment process. It was agreed in Washington last month that we should all aim to complete the necessary legislative procedures by the end of this November.

4. For our part some amendment to the existing legislation is needed. The IMF Act 1979 provides only for subscriptions from the National Loans Fund, which contains sterling, while 25 per cent of the increase in quotas is to be subscribed in SDRs or other reserve assets. Consequently powers are needed to make payments in SDRs or other reserve assets held by the Exchange Equalisation Account. Similarly our subscription to the GAB is currently limited to drawings from the

National Loans Fund. It would be prudent to make provision for subscription in SDRs or foreign currencies and provision is in any event needed to denominate the limit on lending arrangements in SDRs.

5. The need for this legislation provides a suitable opportunity to seek powers to cover indemnities of the type given to the Bank of England in respect of its participation in the international arrangements to provide credit facilities for Mexico and Brazil. These indemnities were given in August and December of last year before drawings on IMF facilities were negotiated. If it were ever necessary for the Bank of England to invoke either indemnity the Treasury would need to present an Estimate or a Supplementary Estimate. Authority would rest on the Estimate and the confirming Appropriation Act. However it is an important principle of Parliamentary control of expenditure that where the Government exercises functions which may involve financial liabilities extending beyond a given financial year, the powers and duties involved should be defined by specific statutory authority.

6. I have consulted the Lord President about the legislative timetable and we agree that our aim of securing Royal Assent by the end of November could be put at risk if the Bill is not introduced until the beginning of next Session. He has suggested that we should press ahead as quickly as we can with the preparation of the Bill leaving a final decision on the timing of its introduction to be taken by Legislation Committee.

7. The Treasury Solicitor expects to complete the preparation of Instructions to Counsel shortly. I should be grateful if formal drafting authority could now be given for this Bill.

8. I am copying this minute to other members of OD and to Sir Robert Armstrong.

(G.H.)
21 March 1983

Alan Walters

IMF file

THE MORAL HAZARD

OF IMF LENDING

Roland Vaubel

Institute of World Economics

Kiel, W. Germany

Prepared for the Conference in memory of Wilson Schmidt, "The Future of the International Monetary Fund, World Bank and International Lending", Washington, D.C., March 3, 1983.

Two farmers meet. "I've just insured myself against fire and hail" says one. "I can see your point about fire" replies the other", but how do you make hail?"

"In principle, countries always have the ability to pay debt service ... If the creditor adopts a policy of offering new aid whenever a debtor threatens to default, debtors are likely to increase their threats of default in order to gain more assistance" (Wilson Schmidt, 1965, pp. 404, 408).

I. The Moral Hazard Hypothesis

On February 11, 1983, the Interim Committee of the Board of Governors of the International Monetary Fund (IMF) decided to raise total member quotas from SDR 61.1 billion to SDR 90 billion, i.e., by more than 47 per cent. The increase is to become effective at the beginning of 1984; normally the next quinquennial adjustment of quotas would have been due in 1985 (the last was in November 1980).

On January 18, 1983, the Ministers and Governors of the Group of Ten and Switzerland decided to increase the aggregate credit commitments under the General Arrangements to Borrow (GAB) from SDR 6.4 billion to SDR 17.0 billion, i.e., by about 166 per cent. They agreed that in the future the GAB would also be available for conditional financing by the IMF when

> "the Fund was faced with an inadequacy of resources arising from an exceptional situation associated with requests from countries with balance of payments problems of a character or of aggregate size that could pose a threat to the stability of the international monetary system".

Finally, since last summer the Bank for International Settlements (BIS) has provided special "bridging loans" for Hungary, Mexico, Brazil, Argentina and Yugoslavia. Venezuela is expected to be the next applicant.

Are these startling increases in official international lending (or "liquidity")necessary? Are they dangerous?

When the par-value system of Bretton Woods finally collapsed in 1973, many observers expected the demise of the IMF, at least of its lending operations. In fact, as can be seen from Table 1, international liquidity made available by the IMF more than doubled from 1970 to 1975 <u>in real terms</u> (using the U.S. GDP deflator); from 1975 to 1982, it increased by another

TABLE 1

International Liquidity Creation by the IMF

SDR b. outstanding at end of	1955	1960	1965	1970	1975	1980	1981	1982 Nov.
Unconditional Liquidity								
Special Drawing Rights (net cumulative allocations)	-	-	-	3.4	9.3	17.4	21.4	21.4
Buffer Stock Facility	-	-	-	-	0	-	-	0.2
Subtotal in SDRs	-	-	-	3.4	9.3	17.4	21.4	21.6
in 1975 US dollars	-	-	-	4.7	10.9	15.8	16.0	14.1
as share of total	-	-	-	.51	.53	.52	.44	.43
Low-conditionality Liquidity								
(minus first credit tranche)								
Compensatory Financing	-	-	0.1	0.1	0.7	2.8	3.3	4.8
Oil Facilities	-	-	-	-	4.8	1.9	0.9	0.2
Trust Fund Loans	-	-	-	-	-	1.3	0.4	3.0
Subtotal in SDRs	-	-	0.1	0.1	5.5	6.0	4.6	8.0
in 1975 US dollars	-	-	0.2	0.1	6.4	5.4	3.4	5.2
as share of total	-	-	.03	.02	.31	.18	.10	.16
Higher-conditionality Liquidity								
(plus first credit tranche)								
Credit tranche drawings	0.1	0.4	2.9	2.9	1.8	2.6	6.0	7.7
Extended facility drawings	-	-	-	-	-	1.1	3.1	5.2
Undrawn balances under								
- Standby arrangements	0.1	0.4	0.3	0.2	1.0	2.3	3.8	3.0
- Extended arrangements	-	-	-	-	0.1	3.9	9.3	4.9
Subtotal in SDRs	0.2	0.8	3.2	3.1	2.9	9.9	22.2	20.8
in 1975 US dollars	0.4	1.5	5.4	4.3	3.4	9.0	16.6	13.5
as share of total	1.00	1.00	.97	.47	.16	.30	.46	.41
Total International Liquidity Creation by IMF								
- in SDRs	0.2	0.8	3.3	6.6	17.7	33.3	48.2	50.4
- in 1975 US dollars	0.4	1.5	5.6	9.1	20.7	30.2	36.0	32.8
- relative to world exports	.002	.007	.020	.023	.026	.023	.030	.031[e]

Sources: IMF, International Financial Statistics, Supplement on Fund Accounts, 1982, Yearbook 1982, and January 1983 issue.

58 per cent (in real terms). Even relative to world exports, IMF international liquidity was 35 per cent larger in 1982 than in 1970, and four and a half time larger than in 1960. Is this an instance of Parkinson's Law? Is the IMF growing though the need for its lending is diminishing, just as the British Admiralty augmented its administrative personnel by more than three quarters from 1914 to 1928, though the number of large combat ships diminished from 62 to 20 and total crew personnel declined by almost a third?

Faced with the threat of decline in 1973, the IMF grasped the opportunity provided by the two oil price shocks. At first it was mainly low-conditionality lending which expanded, but by about 1981 higher-conditionality lending had reattained its 1970 share (see Table 1). While the subsidisation of SDR use was gradually reduced by raising its interest rate toward market levels, those countries which were most likely to request assistance from the Fund, i.e., the developing countries, could increasingly obtain subsidies from the newly created Oil Facility Subsidy Account, Supplementary Financing Facility Subsidy Account and the Trust Fund.

Loans in the credit tranches and under the compensatory financing and buffer stock financing facilities are also available at periodic rates of charge that are concessionary when compared with market rates of interest[1]. Standby credits beyond 200 per cent of quota and extended facility credits beyond 140 per cent of quota can be obtained at periodic charges that are linked to the yield on certain U.S. government securities[2]. For SDR drawings a weighted average of treasury bill rates applies. For the typical IMF borrower these "market" rates of interest include a subsidy because they do not allow for the fact that he represents a higher risk[3]. The Fund has also terminated its practice of raising its periodic charges with the relative size of the loan[4].

At first glance, the increase in IMF international liquidity and in subsidized lending to marginal borrowers which points toward leniency

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[1] Gold (1979, p. 9); IMF Annual Report, 1982, p. 117.

[2] Gold (1979, p. 26).

[3] According to Gold (1979, p. 10), "the Fund has no power to levy different charges for the use of its resources under the same policy".

[4] Gold (1979, p. 10).

may seem to contradict the growing emphasis on stringent conditionality. However, the economic theory of bureaucracy would predict precisely this: a bureacracy which wants to maximize its budget and its staff will always demand more money, more decision-making power and more subsidies for its product[1].

With the advent of widespread floating, the Fund's justification of its own lending operations has shifted from the goal of exchange-rate maintenance to that of "facilitating balance of payments adjustment" and, most recently, to the prevention of debt crises and bank failures. This is where the interests of the Fund and of bankers meet. The politician faces an alliance of official and private "experts" who all tell him that more IMF international liquidity is needed. Not surprisingly, the potential borrowers in the less developed part of our world do not object to this view, and UNCTAD, the Brandt Commission and the other advocates of the less developed countries push it on every occasion. Is a debt crisis imminent?

Table 2 shows that the external debt of the non-OPEC developing countries (excluding borrowing from the IMF)has been growing fairly steadilyin real terms (using the U.S. GDP deflator). The compound average rate of change has been about 11 per cent per annum, with a somewhat slower rate since 1979 but an estimated acceleration in 1982. Table 2 also shows that debt to the capital market and notably to banks has been growing faster than total debt in almost every year, and that its real rate of growth has accelerated in 1982. In that year, new international bond issues by the non-OPEC developing countries have been large by historical standards, but not relative to the size of the market. New gross Eurocurrency credits to non-OPEC developing countries have declined somewhat, but not relative to total Eurocurrency credits. The only significant change is reported by the Bank for International Settlements: in the first three quarters of 1982 the change in external claims of Eurobanks on non-OPEC developing countries at constant exchange rates has been only half as large as in 1979-81, but with the exception of the third quarter it

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[1] Gold (1979, p. 10) states quite frankly that "the necessity to levy charges that meet the cost of borrowing (under the temporary Fund policies) is one reason why the Fund prefers quotas and subscriptions that are adequate to satisfy the needs of members".

TABLE 2

External Debt of Non-OPEC Developing Countries

$ billion at year end/during year	1971	1975	1976	1977	1978	1979	1980	1981	1982
Total disbursed debt Outstanding[a]	75	152	184	227	282	332	385	445[p]	520[e]
- in 1975 U.S. dollars(GNP deflator)	98	152	175	204	236	256	272	286[p]	314[e]
- rate of change of deflated debt	-	-	15.1	16.6	15.7	8.5	6.3	5.1[p]	9.8[e]
Capital market debt(incl.banks)[a]	17	54	70	89	113	136	162	192[p]	228[e]
- share in total d. debt	22.7	35.5	38.0	39.2	40.1	41.0	42.1	43.1[p]	43.8[e]
- in 1975 U.S. dollars(GNP deflator)	22	54	67	80	95	105	115	124[p]	138[e]
- rate of change of deflated debt	-	-	24.1	19.4	18.8	10.5	9.5	7.8[p]	11.3[e]
Debt to banks outstanding[a]	10	43	56	69	87	109	132	156[p]	182[e]
- share in total d. debt	13.3	28.3	30.4	30.4	30.9	32.8	34.3	35.1[p]	35.0[e]
- in 1975 U.S. dollars(GNP deflator)	13	43	53	62	73	84	93	100[p]	110[e]
- rate of change of deflated debt	-	-	23.3	17.0	17.7	15.1	10.7	7.5[p]	10.0[e]
Change in external claims of BIS-reporting banks on non-OPEC developing countries at constant exchange rates[b]	n.a.	n.a.	n.a.	n.a.	21.8	35.3	39.2	41.6	1982 I-III 14.5
- share in change of total external claims	-	-	-	-	12.1	17.2	16.2	15.5	10.4
New gross Eurocurrency credits to non-OPEC developing countries[c]	0.9	8.3	11.0	13.4	26.7	35.4	24.0	33.4	26.7
- share in total new gross Eurocurrency credits	23.6	39.4	38.2	32.3	38.1	42.8	31.0	25.0	32.4
New international bond issues of non-OPEC developing countries[c]	0.1	0.5	1.5	2.8	2.7	2.7	1.9	4.3	3.8
- share in total new international bond issues	1.6	2.6	4.5	8.5	7.8	6.5	4.6	8.1	4.8

Sources: a - OECD, External Debt of Developing Countries, 1982 Survey.
b - BIS, Annual Report 1982, and quarterly statements, 1982-3.
c - Morgan Guarantee, World Financial Markets, various issues.

has still been positive.

Apart from the size of external debt, or its rate of growth, various other indicators have been used to predict a debt crisis, notably debt/GNP ratios and debt service/export ratios. The relevance of these indicators is quite doubtful. Does an increase in any of these ratios signal that debt servicing has become more difficult, or, on the contrary, that the borrower is considered increasingly creditworthy by the lenders? The ultimate criterion of whether debt servicing has become more difficult or not is whether the borrower's rate of return exceeds the interest he has to pay. The answer to this question cannot be gained from inspection of some macroeconomic aggregates or relatives. It depends on the use of the funds.

Another method is to proceed by extrapolation. In the 1970s, external public debt had to be rescheduled in one to four cases each year (see Table 3). In 1981 and 1982, this number rose to 11 and 18, respectively (excluding Poland which is not a member of the IMF). If Wilson Schmidt was right that "countries always have the ability to pay debt service" (see page 1), either by raising taxes or by selling public property, these reschedulings indicate a liquidity problem but not a solvency problem[1]. It would also follow that they indicate an unwillingness, but not inability to repay[2].

To reschedule is to invite demands for further rescheduling. This is the second point Wilson Schmidt was making. The argument can be extended. If the IMF steps in and extends subsidized loans to member countries that threaten to default (incidentally, few of them low-income developing countries), it encourages both further threats of default and further bank lending to borrowers which have proved to be not creditworthy. Like any no-fault insurance, the Fund is bound to generate an avoidable moral hazard. Since debt service obligations are not enforced for international public debt, the temptation to default or to threaten default is much larger for international public debtors than for domestic private

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1 For the view that "few of the developing country debt crises have involved solvency crises" see also Aliber (1980, p. 13).

2 If this conclusion is not accepted, the following consideration applies: "Persistent inability to service external debt implies that the capital has been used wastefully, as otherwise incomes in the recipient countries would have increased by more than the cost of capital... And this inability is now advanced as an argument for further handouts" (Peter Bauer, 1974, p. 44).

TABLE 3

Debt Rescheduling and Standby or Extended Arrangements for IMF Members, 1960-1982[a]

	'60	'61	'62	'63	'64	'65	'66	'67	'68	'69	'70	'71	'72	'73	'74	'75	'76	'77	'78	'79	'80	'81	'82[a]	No. of R	No. of R+(R)	No. of A	No. of A+(A)
Afghanistan						A	A		A	A				A		A										6	6
Argentina	A	A	RA	(R)	(R)	R		A	A								A	A					R	3	5	7	7
Australia		A																								1	1
Bangladesh															A	A				A	A	(A)	(A)			4	6
Barbados																							A			1	1
Bolivia		A	A	A	A	A	A	A		A				A							A	R	R	2	2	10	10
Brazil		RA	(R)	(R)	R	(R)A	A	A	A	A	A	A	A											2	5	9	9
Burma										A				A	A			A	A			A				6	6
Burundi						A	A	A	A	A	A						A									7	7
C.A.R.																					A	RA	R	2	2	2	2
Chile		A		A	A	RA	(R)A		A	A			R	(R)	RA	RA								4	6	9	9
China																						A				1	1
Colombia		A	(A)	A	A		A	A	A	A	A	A	A	A												11	12
Congo P.R.								A										A		A						3	3
Costa Rica		A	A			A	A	A									A				A	A	R(A)	1	1	8	9
Cyprus																					A					1	1
Dominica																						A	(A)			1	2
Dominican R.	(A)				A																					1	2
Ecuador		A	A	A	A	A	A			A	A		A													9	9
Egypt																		A		A	(A)					2	3
El Salvador	A	A	A	A		A		A		A	A		A								A		A			11	11
Equ. Guinea																					A					1	1
Ethopia			A		A																	A				3	3
Fiji														A	A											2	2
Finland								A								A										2	2
France										A																1	1
Gabon																			RA		A	(A)		1	1	2	3
Gambia																		A		A			A			3	3
Ghana							RA	(R)A	RA	(R)A	R	(R)	(R)	(R)	R					A				4	9	5	5
Grenada																A	A			A		A				4	4
Guatemala	A	A					A	A	A	A	A		A									A				9	9
Guyana								A	A	A	A	A	A	A	A	A	A		A	A	A	(A)	R(A)	1	1	13	15
Haiti	A	A	A	A	A	A	A				A	A	A	A	A	A	A	A	A	(A)	(A)		A			17	19

TABLE 3 continued

	'60	'61	'62	'63	'64	'65	'66	'67	'68	'69	'70	'71	'72	'73	'74	'75	'76	'77	'78	'79	'80	'81	'82[a]	No.of R	No.of R+(R)	No.of A	No.of A+(A)
onduras	A	A	A	A	A		A		A	A		A	A							A	(A)		R	1	1	11	12
celand	A	A	A																							3	3
ndia			A	A		A			R	(R)	(R)	R	(R)	R	R	R	R	R				A	(A)	7	10	4	5
ndonesia		A		A			R	R	RA	(R)A	RA	(R)A	(R)A	(R)A	(R)	(R)	(R)	(R)	(R)	(R)	(R)	(R)	(R)	4	17	8	8
ran	A																									1	1
srael															A	A	A									3	3
taly															A			A								2	2
vory Coast																						A	(A)			1	2
amaica				A										A				A	A	A	(A)	RA	(A)	1	1	6	8
apan			A		A																					2	2
ampuchea													R	(R)										1	2		
enya																			A	A	A		A			4	4
orea						A	A	A	A	A	A	A	A	A	A	A	(A)	A			A	A				14	15
aos																					A					1	1
iberia				A	A	A	A	A	A	A	A		A	A	A		A			A	RA	RA	RA	3	3	16	16
adagascar																		A			A	RA	RA	2	2	4	4
alawi																				A	A	(A)	RA'	1	1	3	4
ali					A			A	A	A		A											A			6	6
auritannia																		A		A	A	A				4	4
auritius																			A	A	A	A				4	4
exico		A																A	(A)							2	3
orocco						A	A	A	A	A		A									A	A	A			9	9
epal																	A									1	1
ew Zealand								A																		1	1
icaragua	A			A	A				A	A	A		A							A	R	R		2	2	8	8
akistan						A			A				RA	RA	RA	(R)	(R)	(R)A	(R)		A	RA	(A)	4	8	8	9
anama						A			A	A	A	A	A	A	A	A		A	A	A	A		A			14	14
araguay	A	A			A		A		A	A																6	6
eru	A	A	A	A	A	A	A	A	RA	R	(R)A	(R)						A	RA	(R)A	(R)		RA	4	8	14	14
hilippines			A	A	A	A	A	A	A		A	A	A	A	A	A	A	(A)	(A)	A	A					16	18
ortugal																		A	A							2	2
omania																A		A				A	R	1	1	3	3
wanda							A	A	A	A										A						5	5
negal																				A	A	RA	R(A)	2	2	3	4
ierra Leone							A		A	A								RA	(R)	A	R	(R)A	R(A)	3	5	6	7
olomon Isl.																						A				1	1
omalia					A	A	A	A	A	A	A										A	A	A			[illegible]	10
outh Africa		A														A	A									3	3
ain	A																		A							2	2

TABLE 3 continued

	'60	'61	'62	'63	'64	'65	'66	'67	'68	'69	'70	'71	'72	'73	'74	'75	'76	'77	'78	'79	'80	'81	'82[a]	No.of R	No.of R+(R)	No.of A	No.of A+(A)
Sri Lanka						A	A		A	A		A			A			A	A	(A)	(A)					8	10
Sudan							A	A	A				A	A	A					RA	(R)(A)	(R)(A)	RA	2	4	8	10
Syria	A		A		A																					3	3
Tanzania																A					A	(A)				2	3
Thailand																			A			A	(A)			2	3
Togo																				RA	(R)	RA	R(A)	3	4	2	3
Tunesia					A	A	A	A		A	A															6	6
Turkey	(R)	(R)A	(R)A	(R)A	A	RA	(R)A	(R)A	A	A	A								RA	RA	RA	(R)(A)	(A)	4	11	13	15
Uganda												A									A	RA	RA	2	2	4	4
U.K.		A	A	A	A			A		A						A		A								8	8
U.S.				A	A																					2	2
Uruguay		A	A				A		A		A	A	A			A	A	A		A	A	A				13	13
Venezuela	A																									1	1
Vietnam																							R	1	1		
W. Samoa																A		A	A	A						4	4
Yugoslavia		A				A		A			A	A								A	RA	A	(A)	1	1	8	9
Zaire																	RA	RA	(R)	RA	(R)(A)	RA	R(A)	5	7	4	6
Zambia														A			A		A			A	(A)			4	5
Zimbabwe																						A				1	1
No. of R	0	1	1	0	1	3	2	1	4	1	2	1	3	2	4	2	2	3	3	4	5	11	18	74	-	-	-
No. of R+(R)	1	2	3	3	2	4	4	3	4	4	4	4	6	6	5	4	4	5	7	6	10	15	19	-	125	-	-
No. of A	13	22	17	17	21	22	26	26	28	29	20	15	17	16	15	17	14	23	16	28	28	31	15	-	-	476	-
No. of A+(A)	14	22	18	17	21	22	26	26	28	29	20	15	17	16	15	17	15	24	18	30	35	38	31	-	-	-	514
No. of IMF members[b]	68	71	76	87	102	102	103	106	107	111	115	117	120	125	125	126	128	131	134	138	139	141	146	Ø : 113,7			

Sources: OECD, External Debt of Developing Countries, 1982 Survey.
Euromoney, Aug. 1982, p.21.
IMF, Annual Reports; Memorandum, Dec. 6, 1982.
J. Gold (1970, pp. 203-210).

[a] - until October 31, 1982
[b] - on April 30 (end of financial year).
R - year of debt rescheduling
(R) - consolidation period following debt rescheduling
A - year of standby or extended arrangement
(A) - additional year(s) covered by standby or extended arrangement

debtors. Since the foreign creditors of governments will be correspondingly more impressed by such threats, it is all the more important that third parties, like the IMF, do not aggravate the moral hazard by rewarding demands for rescheduling.

Table 3 shows that 18 of the 21 IMF member countries which rescheduled their debts in 1980-82 received new IMF credits under standby or extended arrangements during this period. Taking a longer view, Table 3 reveals that 30 out of (on average) 114 IMF members accounted for all cases of debt rescheduling (R) in 1960-82, and that 14 member countries accounted for more than 80 per cent of the (country) years for which debt was rescheduled (R + (R)). If debt rescheduling were necessitated by random accidents, such an outcome would be extremely improbable[1]. However, the outcome is consistent with Wilson Schmidt's hypothesis that rescheduling begets further rescheduling for the same debtors.

Even without rescheduling the prospect of cheap IMF lending is likely to generate moral hazard by reducing the incentive not to become needy; for it pays to pass the international means test regardless of whether the assistance is conditional or not[2]. Table 3 shows that 42 out of 114 countries account for 78 per cent of all years for which a member country received a standby or extended credit from the IMF (A + (A)). Once more, this is not the result we would expect if unfavorable random disturbances were the cause of the credit requests. It implies that the IMF has not achieved durable adjustment in the recipient countries[3]. Instead, the Fund has become a recurrent, in some cases an almost permanent, provider of aid. A number of developing countries have come to rely and depend on the Fund's cheap credits - the outcome predicted by the moral hazard hypothesis.

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1 The significance level could be determined with a Chi-Square test for the equality of multinomial distributions.

2 In contrast, Williamson (1980, p. 274) claims that "The Fund's conditions no doubt should be, and are, tough enough to avoid the problem of moral hazard".

3 The opposite impression is generated by Donovan (1982). However, his study merely demonstrates that during the period of IMF assistance the recipient countries attained a larger reduction of their current account deficits, their inflation rates and their consumption relative to GDP than the other non-oil developing countries. Since the recipient countries were in deep trouble, they would probably have put more emphasis on corrective policies even if they had not received IMF loans conditional on such policies.

In view of these shortcomings and dangers of IMF lending, it seems appropriate to raise the more fundamental question whether IMF lending can be justified on welfare-theoretic grounds at all. As John Williamson noted in 1980, "unfortunately, there does not as yet exist any systematic, critical appraisal of Fund programs written from a middle-of-the-profession position" (p. 270). In the following, I shall assume that a middle-of-the-profession position is defined by Williamson's basic assumption that

> "the least-cost way of satisfying a budget constraint is to let the market decide how it is to be done, except where there are specific reasons for believing that there are divergences between private and social costs and benefits" (Williamson, forthcoming).

II. Why IMF Lending?

1. The Exchange-Rate Argument

Under the exchange rate system of Bretton Woods, IMF lending was supposed to be necessary to maintain par values through foreign exchange interventions. However, this argument did not remain unchallenged. It was pointed out that, even under a fixed exchange rate system, "the need for employing foreign-exchange reserves ... may be reduced almost to zero if the central bank conducts its monetary policy with (sufficient) flexibility..." (Egon Sohmen, 1969, p. 219). After all, (non-sterilized) foreign exchange interventions are not the only instrument of monetary policy that can be used to attain exchange rate targets. Indeed, in comparison with open market operations, they have the important disadvantage of interfering with the money-supply policies of at least one foreign central bank. Since currency depreciation can always be avoided through a sufficiently restrictive (usually disinflationary) monetary policy, exchange crises are, from a technical point of view, always the fault of the country's monetary authorities. To extend subsidized loans to such monetary authorities for the purpose of exchange rate maintenance is both unnecessary and harmful because it creates severe moral hazard.

Those who do not consider the exchange-rate argument invalid at least are forced to conclude that the transition to widespread floating has reduced the need for IMF lending. As the London Economist wrote in 1976 (under the headline "Do we need an IMF?"),

> "the IMF did its best to resist the change to floating. Now that it has had to be accepted, why is the IMF still bent on credit creation?" (Jan. 17, 1976, p. 82).

To repeat, the most dramatic increase in IMF international liquidity creation occurred in the 1970s (Table 1).

2. The Gradual Adjustment Argument

According to the Fund,

> "its concern should be with both the financing of temporary payments imbalances and the adjustment of unsustainable ones... in the medium term" (Annual Report, 1982, p. 73).

It suggests, therefore, that

> "the global demand for reserves may be expected to grow in some relationship - not necessarily a proportional one - to world trade and to countries' payments imbalances" (Annual Report, 1982, p. 71).

The underlying assumptions are that

- "payments imbalances" are often the result of real disturbances in the goods market which are not caused by the economic policies of the borrowing government, and that
- gradual adjustment to such real disturbances is often more efficient than shock treatment.

Both assumptions will be accepted for the sake of argument[1]. However, there remain two crucial questions.

In the first place, it is not possible to use the size of current account deficits as a yardstick of the need for international liquidity. As has been mentioned, large net capital imports should signal a high marginal productivity of capital and, consequently, a high degree of creditworthiness for the recipient country. Whether a current account deficit is sustainable or not cannot be determined by looking at its absolute or relative size. Since current account deficits depend on the extent of IMF lending, they are not even exogenous to what they are supposed to determine. If the Fund's criterion were accepted, the IMF could demonstrate an increased demand for international liquidity by increasing its supply of subsidized loans. IMF lending cannot be the cause of a need for it.

Second and more important, the question has to be asked why countries that have been hit by unfavorable real disturbances should not finance temporary deficits or spread real adjustment by borrowing in the international capital market. As Sohmen has pointed out,

> "a country can thus gain access to voluntarily supplied private funds without any need for 'international liquidity'... One major advantage of (this method) is that every country ... would borrow funds at the opportunity cost of lending in the rest of the world..." (1969, p. 221).

Another advantage would be that such borrowing, unlike borrowing from the IMF, would not entail money creation in the capital exporting country.

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[1]However, even leading Fund Officials admit that "the issue, usually referred to as the choice between a 'shock' versus a 'gradual' approach to the adjustment process has not been conclusively resolved ... because it is not at all obvious that a gradual adjustment is preferable to a rapid one in all circumstances" (Gold, 1979, p. 39). John Williamson believes that "the Fund has (at least up to now) been overdisposed toward shock treatment" (1980, p. 274). This is also the view of the Brandt Commission (1980, p. 216). By contrast, the Group of Thirty regrets that "the oil facility had even slowed down adjustment in the sense that it made money too easily available" (1981, p. 39).

As for the first assumption, Dell (1981, pp. 19, 33) has suggested that the availability of IMF loans should depend on whether the member country itself is responsible for its payments imbalance.

The Brandt Commission (1980, pp. 212 f.) rejects the view that the market can play a key role in financing deficits. It gives four reasons:

- private financing "is very imperfectly subject to international monitoring let alone control, and is easily affected by crises of confidence";
- "it is not easily accessible to the poorer developing countries";
- "it tends, because of its terms, to exacerbate the problem of servicing and refinancing debt";
- "there are growing doubts as to the continuing availability of adequate private bank financing in the future".

Similarly, Fred Bergsten (1981, p. 29) asserts that

> "we cannot rely exclusively on private markets. Some borrowers will face serious constraints on their access to private markets, and we must assure that official financing is available in adequate amounts to support required adjustment programs and maintain financial stability while adjustment is taking place."

Finally, Robert Heller (1980, p. 268) proposes a division of labor between the Fund and private lenders:

> "The important distinction between the banks and the IMF is that while countries are likely to rely on commercial bank financing on a continuing basis, their use for IMF resources is likely to be temporary."

The objections advanced by the Brandt Commission are inconsistent with Williamson's middle-of-the-profession assumption that, as a rule, "the least-cost way of satisfying a budget constraint is to let the market decide how it is to be done". For the Brandt Commission, the market is inherently inferior to government action; it is unstable and in need of control by governments. Both the Brandt Commission and Bergsten start from a self-defined target for international lending to developing countries, the target being: much more than now. They reject the market solution because they do not expect it to yield their predetermined preferred result. They are unwilling to use the market as a search process. They are unwilling to let individuals decide. No welfare-theoretic reason is given for the assumption of market failure or for a division of labor between markets and governments in this field.

3. The Insurance Argument

According to Williamson, the Fund

> "provides insurance against a class of risks which would not seem well suited to a private market" (1980, p. 273).

According to Cline (1982, p. 144), international risk sharing should be extended to increases in debt servicing needs that are caused by interest rate fluctuations.

A special case of the insurance argument is the widespread view that the IMF acts as a lender of last resort and is needed to prevent the international banking system from collapsing[1].

There is no reason for a country to go to the IMF if it can borrow on equal or better terms in the market. Thus, in order to be able to lend, the IMF has to subsidize its loans[2]. In the extreme case, the Fund lends to countries which the market does not consider creditworthy. It insures member governments against the market's judgement.

One way of trying to justify such a system is to consider the subsidy part of IMF loans as the only relevant insurance benefit. However, in an insurance, contributions would differ according to risk. As Table 3 has shown, the frequency of borrowing (standby and extended) differs considerably among IMF member countries. IMF lending is not an actuarily fair insurance. It is biased in favor of the main borrowers (mostly developing countries). It provides a net subsidy to them. This net subsidy is a form of program aid. Would the recipients of the net subsidy also chose to insure with the IMF if they could use this aid as they liked (or for any of a number of different programs approved by the donor countries)? Does IMF lending create a needless distortion of the recipients' preferences?

The IMF is not a lender of last resort. Very often, countries lend from the Fund without having exhausted their borrowing capacity in the international capital market. To the extent that the Fund offers subsidized loans, one should expect that it acts as a lender of first resort[3].

Does the world need a lender of last resort to prevent the international banking system from collapsing? Peter Kenen, an advocate of debt rescheduling, has argued that

> "defaults by developing countries, even if widespread, would not seriously threaten the stability of the international financial system, loose talk to that effect not withstanding. Some banks and other private lenders would be hurt. A few might be wounded mortally. But there is little justification for the fear thet defaults could wreck the Eurocurrency market or would do grave damage to national financial systems" (1977, p. 54).

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[1] See, for example, Neu (1979, p. 242); Gold (1979, p. 38); Group of Thirty (1982a, p. 42; 1982b, pp. 26 f.).

[2] This is not denied by Williamson (1980, p. 273).

[3] This is also the view of Neu (1979, p. 246).

The Group of Thirty (1982a, p. 42) reports the results of an opinion poll among 111 international bankers: 56 per cent disagreed with the view that "there is a need for a supranational organisation (e.g., IMF, BIS or a new institution) to assume the role of lender of last resort for the international banking system". Only 39 per cent agreed. The reason is that the national monetary authorities are expected to act as lenders of last resort for the commercial banks in their jurisdiction and for the latters' foreign affiliates.

There is a widespread fear that the Great Depression could repeat itself, and that bank failures would be the trigger. However, bank failures do not lead to depression if the monetary authorities prevent the money supply from being affected. To prevent a depression it is not necessary to prevent default by augmenting the IMF's lending potential. What is necessary is an announcement by the national monetary authorities that, in case of bank failures, the monetary base will be increased (say, through open market operations) so as to stabilize monetary expansion. The Fed's failure to maintain the U.S. money supply in the face of a banking crisis was the cause of the Great Depression[1].

4. The Externality Argument

It is sometimes argued that subsidized credits for balance of payments financing, or specifically for debt service financing, are needed to prevent the recipient countries from adopting protectionist measures, restrictions of convertibility, or other beggar-thy-neighbor policies. According to a Keynesian variant of this argument, IMF lending is also a welcome instrument of maintaining the developing countries' demand for imports from the industrialised countries. The general idea is that the recipient countries must be bribed so that they do not impose negative externalities on the donor countries[2].

An institution that tries to buy international "social peace" by giving in to blackmail on a permanent basis behaves in a myopic way because it encourages further threats and ultimately aggravates international discord. Strategic behavior requires resistence to repetitive blackmail - the more so as restrictions of international transactions would harm the threatening countries as well. That the level of aggregate

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[1]See the classic by Friedman, Schwartz (1963, Ch. 7).

[2]See, for example, Neu (1979, p. 239).

demand in the donor countries can be raised by spending public money[1] abroad rather than at home cannot even be shown in a Keynesian framework as long as the domestic sector of the donor countries suffers from excess capacity as well.

5. The Conditionality Argument

According to a widely accepted view, the IMF ought to extend subsidized loans to its members to induce them to adopt the required adjustment policies . The subsidies serve not only as a bait; they are also supposed to be justified by the fact that the acceptance of the policy conditions reduces lending risk both for the Fund and for private lenders. However, it is still difficult to see why the Fund should lend at a lower interest rate than private lenders - given the agreement on the adjustment measures to be taken.

The conditionality argument immediately raises the question why countries are supposed to face an insufficient incentive to adopt the necessary policies on their own. After all, the extent to which, and the terms on which, a country can borrow in the market will crucially depend on the policies which it is expected to follow . As Irving Friedman (1981, p. 241) has put it, "private bank 'conditionality' is unavoidable". The question has been answered in several ways.

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[1] In the case of liquidity creation through IMF drawings the donor countries give up part of their seigniorage. To finance their expenditure, the governments of the donor countries have to raise taxes (thus reducing the supply of savings) and/or borrow more in the capital market. In both ways, they crowd out private lending - also lending to the developing countries.

A. The Superior Information Argument

Most observers seem to believe that the Fund knows better than private lenders whether a country is creditworthy. IMF officials like to report the fear that bank lending may be available too easily so that adjustment is postponed[1]. It is doubtful whether this view is correct. If it is true that creditworthiness depends on specific rates of return (and willingness to repay) rather than merely on the set of broad macroeconomic variables that figure prominently in the Fund's adjustment programs, bankers - not (macro-)economists - are likely to be at a comparative advantage. Moreover, there are reasons to criticize some of the typical IMF policy conditions, notably the emphasis on devaluation (which is bound to aggravate inflation)[2] and the recommendation of coercive incomes policies.

The Fund is probably at an advantage to the extent that it possesses confidential information. However, this raises the obvious question why the Fund does not disclose all information that is relevant for the evaluation of creditworthiness[3]. To say that the member countries would not agree is no answer. After all, knowledge is generally recognized as a public good.

The public good aspect rules out the withholding of information by governmental bureaucracies, but it does not necessarily justify the collection, analysis and dissemination of such information. As is witnessed by the foundation of the new Institute of International Finance in Washington, the collection of information can be efficiently arranged by private voluntary associations if the number of beneficiaries is small. Fratianni and Pattison (1982) have even suggested that international economic organisations are unlikely to provide reliable forecasts about the effects of the policies of their member countries:

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[1] See, e.g., Witteveen (1976, pp. 253 f.), Gold (1979, p. 39), IMF (1981, p. 39). Not surprisingly, bankers like Friedman (1981, p. 250) do not share this fear.

[2] It is also paradoxical in view of the Fund's long-standing preference for fixed exchange rates.

[3] Suggestions that the Fund should make more of its information available to private banks have come from Michael Blumenthal, Arthur Burns, Robert Heller, Henry Wallich and many bankers.

"Why do governments purchase these forecasts? We venture one hypothesis. Each country has a say in what the forecast is concerning the country's performance. These forecasts need not be good in a statistical sense, but may be useful politically. A policymaker may desire public release of false or misleading information in order to pursue certain stabilisation policies despite the fact that private economic agents may efficiently assess all of the information available in the market" (p. 259).

Nevertheless, assume for the sake of argument that the Fund possesses superior information, or at least that private lenders believe this. Does it follow that the IMF should extend subsidized loans to some of its members? Would it not be sufficient for the Fund to act as a (paid?) agent of private lenders in providing information about the required adjustment policies?[1] Why IMF lending?

Williamson (1980) believes that the IMF should lend to enhance the credibility of the information it provides:

"There do ... seem to be some advantages in a position to put up a fair bit of money directly, rather than simply giving a seal of approval that, with luck, will induce the private market to resume lending" (p. 274).

An analogous argument is sometimes made in favor of foreign-exchange intervention. It is logically impeccable but dangerous in practice. How much public money is a government permitted to spend or commit in order to persuade the public of its views? Is government propaganda good economics?

Moreover, the same degree of credibility could be attained with much smaller amounts - if the Fund were not committing the money of taxpayers in the creditor countries but part of the salary of those IMF officials who confer the "seal of approval".

B. The Coherence Argument

According to Williamson (1980, p. 274),

"commercial banks are not well suited to fulfill the role of negotiating necessary policy changes with sovereign governments ... partly because optimal competitive strategies for individual banks may not add up to coherent pressure for rational policies..."

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[1] There are several instances in which private banks made their loans conditional on prior acceptance of an IMF stabilisation program (see, e.g., Friedman, 1981, pp. 250-254, and Group of Thirty, 1982b, pp. 54 ff.). The Group of Thirty favors this practice (p. 15) but reports that bankers do not regard the borrower's acceptance of an IMF program as a "decisive influence on their decision" (1981, p. 41). The bank loans to Peru in 1976 are usually cited as a proof that banks cannot formulate and monitor a stabilisation program on their own (e.g., O'Brien, 1982, p. 139). However, many of the Fund's standby or extended arrangements have had to be interrupted as well.

The incoherence problem is well known from multilateral debt reschedulings. An individual creditor does not want to concede grace periods or commit additional funds unless the debtor promises not to use the resulting leeway to repay other creditors. However, this problem has often been solved: the creditors either combine in consortia ("clubs"), or individual creditors make their offers conditional upon the conclusion of similar contracts with other creditors[1]. It is conceivable that the creditors could ask the Fund to act as their coordinating agent in such negotiations. But this does not mean that the Fund itself ought to lend.

C. The Enforcement Argument

The IMF is probably in a better position to enforce policy conditions attached to international loans and, indeed, to enforce repayment itself. This is because the IMF, as an intergovernmental organisation, can impose sanctions that are not at the disposal of private banks. However, to argue that, for this reason, the IMF should co-finance all stabilisation loans is like suggesting that to enforce private domestic contracts the government of the country ought to be a party to each of them. The IMF is well advised to use its sanctions to enforce international loan contracts but it need not lend.

D. The Bogeyman Argument

It is frequently argued that the IMF should offer stabilisation loans because it is the ideal bogeyman to be blamed for unpopular policy changes. Politicians and voters in the borrowing countries would not be willing to accept policy conditions from private bankers ("the gnomes of Zurich") or even from particular foreign governments. Only "an international body with no direct interests other than maintaining order in the international financial system" (Neu) can "apply policies of conditionality without giving intolerable offense to its members" (Gold) and "without a dangerous fanning of nationalistic flames" (Williamson)[2].

It is an open question whether aid should be given so as to minimize the humiliation for the recipient, thus weakening the incentive for self-help ("the Samaritan's dilemma"). With regard to commercial lending, the

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[1] See, for example, Friedman (1981, pp. 257, 261, 263).

[2] Neu (1979, p. 240), Gold (1979, p. 20), Williamson (1980, p. 274).

situation is different. The lenders will pay attention to the borrower's susceptibilities if they can gain money by doing so. If the borrower prefers policy conditions formulated by the IMF, lenders are likely to entrust the Fund with this task. Once more, it does not follow that the Fund should lend.

6. The Argument from Capital-Market Imperfection

Finally, according to an altogether different argument, the case for IMF lending may be based on the assumption of capital market imperfection. Capital markets are said to be inefficient because lenders charge a higher interest rate (or are unwilling to lend) if the borrower cannot offer adequate collateral. This is, for example, why the provision or guarantee of student loans is usually considered a proper task of government. Howe if Wilson Schmidt and Robert Aliber were right that IMF debtors do not suffer from insolvency, the argument is not relevant.

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OD

Econ. Pol

Prime Minister (2)

Not a very illuminating discussion.

MS 7/3

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

7 March 1983

Michael Scholar Esq.
10 Downing Street
LONDON
SW1

Dear Michael,

IMF ARTICLE IV CONSULTATION

The Chancellor thought that the Prime Minister might be interested to see the attached summing up by the Acting Chairman of the 1982 Article IV Consultation with the United Kingdom.

The Prime Minister might like to know that the Executive Board discussion of the UK this year was very positive.

Yours sincerely,

Jill Rutter

JILL RUTTER
Private Secretary

February 25, 1983 - 83/61

The Acting Chairman's Summing Up at the Conclusion
of the 1982 Article IV Consultation with the United Kingdom
Executive Board Meeting 83/36 - February 23, 1983

Directors warmly commended the U.K. authorities for the success of their anti-inflationary policies, which, it was stressed, had been much more striking than earlier expected. However, bearing in mind that the effects of the recent significant depreciation of the pound had yet to be reflected in retail prices, most Directors concluded that the prospects for consolidating the recent gains in dampening inflation hinged critically on further substantial moderation of pay settlements.

While recognizing that pay increases had slowed down markedly since 1981, Directors nevertheless viewed with concern the fact that wage increases were still rising much more rapidly than prices at a time of little, if any, growth in real national income. That development had tended to retard progress in restoring profitability and international competitiveness in the non-oil traded goods sectors, despite the quite exceptional growth in productivity that had recently been achieved. Recognizing the limitations of incomes policy in the U.K. context, some Directors nevertheless thought that progress in containing incomes could be enhanced by a more active role of government in the establishment of wage guidelines and in enhancing constructive dialogue regarding the labor market among the interested parties.

Directors stressed that the emphasis the authorities had placed on financial restraint in combating inflation, coupled with the slow response of wages, had resulted in very large costs in terms of foregone output and increased unemployment. The large shedding of labor by hard-pressed enterprises, particularly in manufacturing, had contributed to raising unemployment to a very high level with relatively little prospect of early improvement. Most Directors nevertheless considered the strategy pursued to have been necessary to lay the basis for sound growth in the medium term.

Speakers generally welcomed the increased flexibility that the authorities had shown, especially the budget for 1982-83, in adjusting their specific monetary and fiscal targets in the light of changing circumstances while adhering to the broad anti-inflationary thrust of the Medium Term Financial Strategy (MTFS). That flexible approach, together with the rapid abatement of inflation, had provided the basis for the recovery in real money balances and domestic demand that was now under way and that, Directors hoped, would lead to a broadly based upturn in domestic output and employment before long.

- over -

There was general agreement that the poor rate of return on capital and the unsatisfactory level of international competitiveness were the main obstacles that had to be overcome if the eventual payoff of the MTFS in the form of sustained expansion in output and employment was to be realized.

Some Directors felt that exchange rate policies should be pursued in a more flexible manner in order to help eliminate the remaining distortions in relative prices and to arrest the tendency for the United Kingdom to lose market shares at home and abroad. Most Directors, however, agreed that too rapid a depreciation of the exchange rate would risk a reacceleration of the rate of inflation, which had been brought down at considerable cost. Therefore, they stressed that continued and accentuated moderation in wage settlements should remain the critical element in the control of inflation and in the improvement in international competitiveness. In that respect, Directors commended the authorities' continuing efforts through legislation and other means to restore the balance in industrial relations. The importance of labor mobility and manpower training measures was also stressed.

Some Directors believed that in view of recent trends in unemployment, capacity utilization, prices, and the balance of payments, the emphasis of economic policy should be shifted toward stimulating growth. They believed that there was scope for some relaxation of fiscal policy and that monetary policy should be eased. Most Directors, however, felt that the current stance of monetary policy was generally well-balanced and appropriate. Some adjustment in the quantitative targets for the main aggregates might be necessary from time to time, but the room for maneuver remained limited.

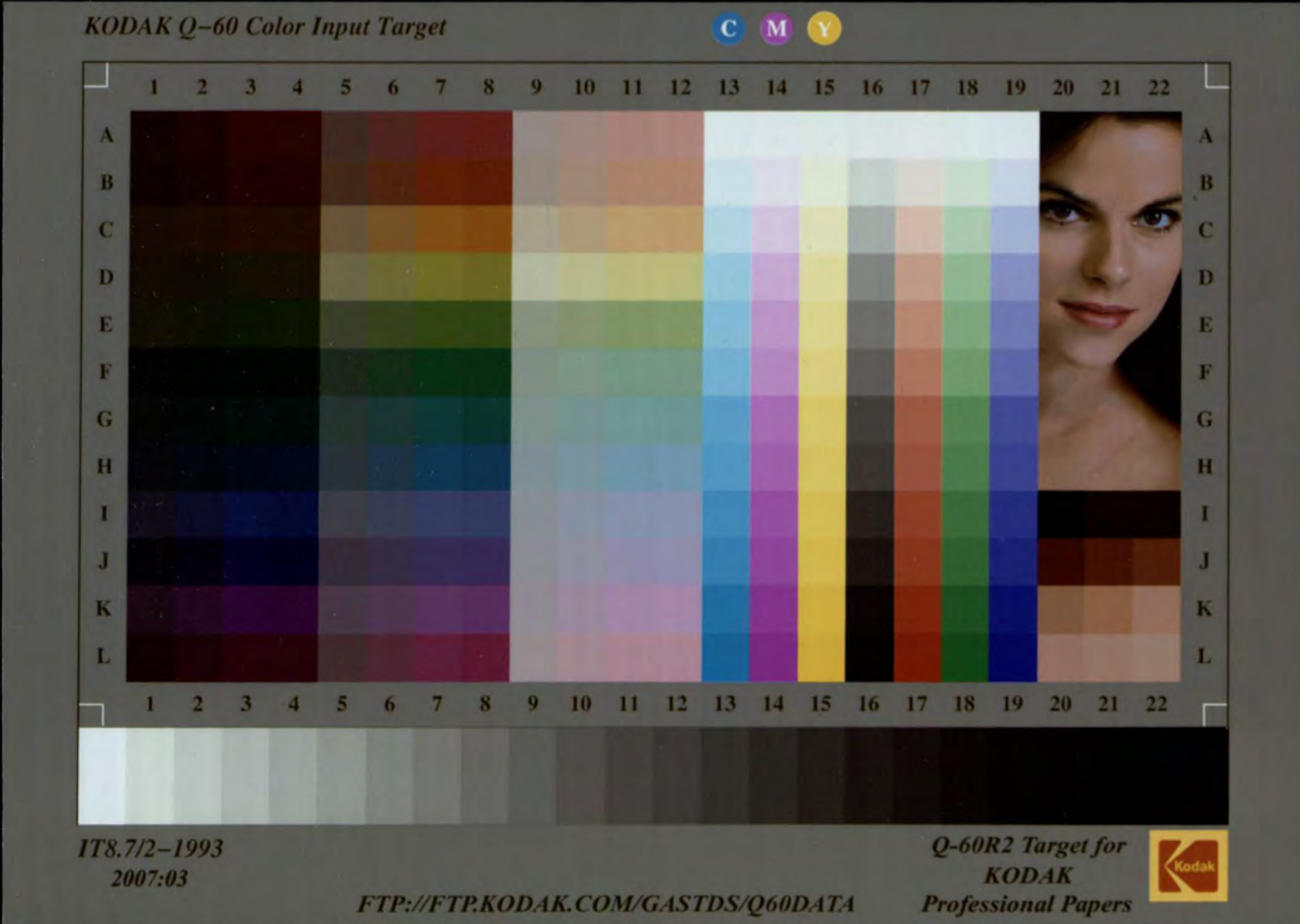
With regard to fiscal policy, the reduction of public expenditure as a proportion of GDP, which was becoming apparent, was welcomed by a number of Directors. Most Directors agreed that the present projection of the Public Sector Borrowing Requirement (PSBR) for 1983-84 was within the appropriate range. If room could be found for fiscal adjustment in the forthcoming budget, it was felt that the emphasis should be on improving the cost competitiveness of industry.

Some Directors noted with concern the recent increase in the strength of protectionist pressures in the United Kingdom and they urged the authorities to resist firmly such pressures. While noting with approval the sizable private financial flows to developing countries, Directors also welcomed the real increase in development assistance planned for 1983-84 and they encouraged the authorities not to scale down such assistance.

PART I ends:-

AJC to HMT 15.2.83

PART 2 begins:-


KODAK Q-60 Color Input Target
C M Y
1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22
A B C D E F G H I J K L
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