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

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

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* 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 in extremis need to consider other forms of Fund endorsement, provided the adjustment programmes are right. What do you think?

(e) G10/G24 Reports

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) Other IMF Issues

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.