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Prime Minister.

A.J.C. 19/11.

Dear John,

I gather that it was suggested, at this morning's CHOGM briefing meeting, that the Prime Minister might like to see texts of the Chancellor's remarks about the Helleiner report on 28 September at the IMF/IBRD meetings in Washington, and on 21 September at the Commonwealth Finance Ministers meeting in Trinidad.

... I accordingly enclose both texts. The Helleiner section of the IMF speech comes on pages 17 and 18. The Trinidad text deals only with Helleiner, and does so more extensively, though it was ostensibly "off the cuff", for we had not been invited in advance to speak on that agenda item.

Copies of this letter and the texts goes to Brian Fall and Richard Hatfield.

Yours ever,

John Kerr.

J O KERR

Transcribed 21/IX.

1. My first meeting. Know how much Sir Geoffrey Howe valued and enjoyed these meetings, and playing host at Lancaster House in 1982. See why: friendliness, informality of Commonwealth ties, and sessions and worthwhile discussions. Can't hope to emulate Mr de Mal's longevity but look forward to further such meetings.

2. But thought it right to intervene informally on this item, given importance of issues discussed in Helleiner report. Valuable study, and pay tribute to New Zealand Prime Minister for his original initiative. Like him, found much in report with which to agree; but also, like him, cannot support all its recommendations, or go along with all the underlying analysis.

3. Agree with call for increased coordination of macro-economic policies, and stress on danger that high real interest rates could abort recovery. Note Williamsburg call for greater coordination. Secretary-General referred this morning to problem presented by US Administration's unwillingness to cut Fed deficit by fiscal action: This is single most difficult current problem, with great ramifications. Not one which any international conference will solve.

4. Agree too with stress on need to avoid protectionism. And encouragement of direct investment. Excessive growth of bank indebtedness partly due to too much development having been financed by bank debt and too little by long-term direct investment. Responsibility on industrialised world to encourage much investment. Responsibility too on developing countries to promote favourable climate for it.

5. UK has financial problems. Much greater problems in developing countries. But let's not invent extra problems. Do not believe that there is a major world liquidity shortage. As recovery takes off, and *if* the US rein in their urgent account deficit, such a shortage could develop - but it doesn't exist at present. US current account deficit this year forecast at $34 billion: actual figure in latest quarter $9 billion.

6. Doubts have been expressed about whether we are seeing a recovery at all. There undoubtedly is a significant recovery, with US economy expanding rapidly, and growth in most European countries including UK. Of course effects take time to work through to developing countries, but commodity prices are rising again. Situation now less gloomy than at Lancaster House only a year ago.

7. Agree that problems aren't cyclical. Don't agree that problems which are not cyclical are by definition systemic; and can therefore only be cured by institutional changes. There is a third category of problems which are structural and which include the problems of demography, the problems of technological innovation, which in short term puts people out of work, the problems of excessive expectations, which have in the past generated inflation. Governments, in developed and developing countries alike, cannot offload responsibility for tackling these problems; and no Conference will solve them. Need to put our own house in order. And We all know ~~this~~ The double Oil Shock in 1973-74 and 1979-80 would have been a problem for any system.

/8. That's

8. That's not however to suggest that institutional reform, and joint international study and refinement of the workings of the system, is not important. Of course it is. But like Mr Muldoon, I do think it is important to be practical and business -like in our prescriptions.

9. The idea of a new Bretton Woods catches the imagination. But it risks some dangerous misunderstandings. It carries a suggestion that the entire original Bretton Woods system has failed, that that failure is a major cause of present world problems, and that we need a new system to combat those problems: all of which I believe to be wrong.

10. The Bretton Woods system served us well for many years. It showed a continuous and vigorous ability to grow and change through its first 25 years - the vast expansion of the World Bank from post-war reconstruction to the new concept of development assistance; the invention of the IDA; the concept of the SDR; the evolution of the IMF. But the institutions need to be supported, not replaced.

11. In the last 15 years, however, we have seen the system under strain, and elements of it, in particular the fixed exchange rate system have broken down. Why? Fixed exchange rate system based on premise of a dollar numeraire with a constant value. This was invalidated by inflationary financing of Vietnam war, which led to a decade of inflation.

12. That doesn't mean that we need a new system - but rather the continued improvement of the existing system, and let us by all means as the Commonwealth, give a further impetus to that.

13. Bretton Woods was possible because US was in historically unusual dominant position and able to impose a solution. Thank goodness Keynes there to advise. Political circumstances now very different. Only in circumstances which existed after the war could one start from scratch. Mr Muldoon referred to problems of managing interdependence. I would put it that problems are those of of managing sovereignty. This is not just a Commonwealth problem: it is a world problem. We cannot solve it within the Commonwealth. We need to cooperate with others - and I most warmly agree with Mr Muldoon's comment that we cannot hope for success by a confrontational demand on others. We must persuade - the United States and others - and it will not be easy.

14. We need a practical strategy; a plan for carrying forward further work. And progress may be easier to achieve piecemeal, than if we attempt to promulgate a great design. Should like to build upon the particular advantages of the Commonwealth in two ways. What I am proposing are practical lines of action:

i) First, taking advantage of the more intimate and frank discussion among us than is usually possible in UNCTAD and similar fora, let us ask a group of our own people, with the Secretariat, to undertake discussion with representatives of the IMF, World Bnk and GATT, to identify the kinds of changes which might find international acceptance and could help gradually to restore the sense of multilateral cooperation which has been weakened, and strengthen the authority and scope for action of the international institutions, which we must cherish. The best place to do this is Washington, where it can be done within the IMF/IBRD framework; using our representatives and our Embassies there. Some of us might review progress in the margins of next Spring's Development Committee meeting. And we might envisage a progress report at this meeting next year.

ii) Secondly let us all use our influence in the different fora in which many of us meet other countries, to develop a climate of opinion favourable to the changes we want to see. That means avoiding confrontational rhetoric, not least because of its counter-productive effect in the United States, so well illustrated by the sad history of IDA 6 and IDA 7.

15. I would be willing to join with others, in consultation with the Secretary General, in approaching the Institutions to set up arrangements in Washington as I have suggested. For I think it important that we should not only draw the Helleiner report to their attention, but work out with them a realistic, practical and selective plan of action.

16. It may be that this process, and that action, will need in the end to be capped by a conference, though I am somewhat sceptical. But that is a long way down the track. as Professor Helleiner, and Mr Muldoon today, stressed. And to force that issue now would be a great mistake.

17. Phrase "Towards a new Bretton Woods" both helpful and unhelpful. Helpful in drawing attention to serious problems. Unhelpful in suggesting what is needed is new "grand design". Hope my practical procedural proposal will be of some help.

IMF SPEECH

It is 22 years since I first had the privilege of attending the Annual Meetings of the Bank and Fund-- although on that occasion, in Vienna, I held the very different responsibility of a financial journalist.

Last year's Annual Meetings in Toronto, when the UK was represented by my distinguished predecessor, Sir Geoffrey Howe, coincided with the low point of the recession for the world economy as a whole. Deep concern was then expressed about the prospects of recovery, and there was some hesitation over the right strategies for national economies. And the first major outbreak of the debt problem had just occurred.

/Since then we have

Since then we have experienced an eventful and troublesome year, for governments and peoples alike, and for the institutions in which we meet today. Debt problems have multiplied, and we are still far from seeing a clear way through all of them. The course of exchange rates and interest rates has been unsettled, and present levels, particularly interest rate levels, cannot be regarded as satisfactory. The economic and political strains of adjustment have inevitably proved painful. Impatient voices are heard demanding new approaches, new systems, new institutions.

But despite all that there has been undoubted progress; particularly on the all-important struggle against inflation; and recovery is now clearly under way. We are not yet out of the wood, but we are moving forward again. It is a good time to take stock of how best to make further progress, and tackle the problems which remain.

That is our common purpose at these meetings. An occasion such as this is one on which the Finance Ministers who bear many of the political burdens of painful adjustments can share their experiences and

/perhaps even

perhaps even fortify each other thereby. So it may be helpful if I spend a few minutes describing our recent experience in the United Kingdom, where a clear adjustment strategy was adopted four years ago, has since been steadily pursued, and is showing good results.

UK Economy

In the United Kingdom we have, during these past four years, followed a three-part strategy. We have exercised steady downward pressure on monetary conditions. Despite the recession, we have reduced our budget deficit significantly as a percentage of GDP. And we have introduced reforms to remove structural rigidities in the economy, abolishing a whole raft of controls, on pay, prices and dividends, on industrial development and consumer credit, and perhaps most important of all, on foreign exchange transactions.

What results has the strategy brought? First, inflation has been reduced dramatically. It has fallen from a rate of around 15 per cent for much of the 1970s to around 5 per cent now. The long upward trend of rising inflation rates from one cycle to another has been decisively broken. Secondly, we have secured

/renewed economic growth

renewed economic growth. Despite unfavourable world trade conditions which impact particularly sharply on the UK, our economy has been growing at an average annual rate of around 2½ - 3 per cent since the trough of the recession in the first half of 1981. This compares favourably with our long-run pre-recession trend. And unemployment, although still tragically high, is starting to level off.

Some observers in the UK used to argue that such a recovery was impossible without government stimulus. So far from that being the case, economic recovery in the UK can now been seen to have started in the immediate wake of my predecessor's courageously tough budget of 1981.

Now the critics argue that the recovery is not sustainable; that it is unbalanced; and that inflation is bound to rise again. I shall briefly explain why I believe they are wrong on all counts.

It is true that the recovery so far has been primarily based on increased personal spending and the end of destocking. But that is not a cause for concern, for all recoveries have that characteristic in the early stages. That is a well-established cyclical patte

/What is significant

What is significant is that on this occasion the familiar first stages of an end to destocking, a rise in spending on consumer durables, and an acceleration of house-building, came about without any Government stimulus to demand: they resulted instead from lower interest rates, increased confidence and above all low inflation, which in turn have been the result of responsible monetary and fiscal policy.

It would now be normal for the emphasis of the recovery to switch from the personal sector to the company sector, in the form of increased capital investment and positive stockbuilding. The pattern - in no way unusual or surprising - that investment follows consumption increases should be encouraged by the very substantial increase in company sector profitability which we have seen over the past year. Certainly, there are no signs, in the forward indicators, that the UK recovery is coming to an end. Quite the contrary.

Provided that monetary control is maintained - and it will be - and that inflationary expectations continue to improve, and providing we can continue to hold down our budget deficit and avoid unnecessary pressure on interest rates, which are still too high, we will see the recovery spread more widely throughout the economy.

/As for

As for the critics' concern that UK inflation would rise with economic recovery, the fact is that there is no sign so far of re-emerging inflationary pressure even though, as I have explained, the recovery has already been under way for two years. Of course, there will be temporary variations caused by special factors, but there is no sign in the inflation figures, when we strip out the volatile impact of changes in housing costs (themselves the result of changing interest rates) and seasonal food prices, of any change in the underlying trend. The growth of labour costs per unit of output continues to be low, helped by substantial increases in productivity.

THE WIDER STRATEGY

I think it worthwhile to set out these facts from this rostrum, for there is an important conclusion to be drawn from all this, and it applies, I believe, not only to the United Kingdom.

It was one of the characteristics of the cycles of the 1960s and 1970s that many observers underestimated the continuing strength of recovery. Indeed, one of

/ the reasons for

the reasons for accelerating world inflation during the 60s and 70s was that, at the stage of the cycle which the UK has now reached, governments worried about the strength of recovery and were persuaded to stimulate the level of demand. Because that stimulus was in addition to the already powerful forces of recove the result was excessive inflationary pressure.

The lesson of that experience is one which we should all heed. It is important that we all recognise that powerful forces arising from lower inflation, lower interest rates and lower labour costs can both start and sustain recovery; and that the facto which are most likely to damage recovery would be an excessive expansion of demand by mistaken monetary and fiscal policies, bringing about their own inevitable reverse, and in particular an unsustainable structural budget deficit that puts damaging pressure on interest rates.

Let us also remember that high interest rates bear particularly heavily on developing and debtor countries; and that protectionist forces are inevitabl strengthened when exchange rates are determined more by capital flows than by trade flows.

/So let me

So let me now draw some specific conclusions from our UK experience -

First, the strategy works: our experience demonstrates that it is possible for governments to reduce and control inflation through appropriate monetary and fiscal policies; and that financial discipline does not stifle growth - on the contrary, it helps to create the conditions for healthy and sustainable growth.

Secondly, perseverance is necessary, and it is important for the government to convey its determination to persevere; this is not easy, because it takes time before benefits are seen, and it may take additional time to see the benefits convincingly, even after they have begun to take effect. But is is crucial to demonstrate to the markets that there is, and will remain in place, a firm medium-term financial strategy.

Thirdly, although conditions in different countries may vary, I am convinced of the need to have monetary and fiscal policy operating in harmony. Otherwise, there will be risk of severe strain,

/especially if public

especially if public sector borrowing so pre-empts flows of savings that monetary restraint can be achieved only at the cost of very high real interest rates.

Fourthly, while no country can insulate itself against the rest of the world economy, the more firmly engaged any country is on a sound financial strategy, the better it will be able to withstand external shocks or weaknesses.

Fifthly, liberalising industry, cultivating competition, and giving free rein to market forces helps recovery. This applies across as well as within national frontiers: liberalisation of trade and payments contribute importantly to the development of world trade and economic activity.

Sixth, our general election result earlier this year has demonstrated that, despite all the inescapable pains of adjustment, a Government which steadfastly pursues this strategy, and which clearly explains to the people the need for the policies it is carrying out, has no cause to fear that it is exceeding the bounds of the politically possible.

/I make no apology

I make no apology for having dwelt at some length on the U.K. experience. At repeated international meetings Finance Ministers have agreed that the successful pursuit of a firm anti-inflationary strategy is the only sound basis for recovery. The Managing Director of the Fund has consistently and helpfully urged this on us all, not just those who are immediate clients in drawing on IMF resources. He did so again, most eloquently, from this rostrum yesterday. What is happening in my country is, I believe, both relevant and encouraging.

DEBT

The Fund's main concern over the past year - and that of the World Bank too - has been with countries facing debt problems. The growth of such problems in the last 18 months has been dramatic because a number of factors come together at the same time. A combination of world recession and sharply reduced commodity prices has limited export earnings by debtors. Very high dollar interest rates, applying to borrowing of which an increasing amount had become short-term, have magnified their problems.

Both elements in this squeeze have already eased a little, and should ease still further as world economic recovery continues, and particularly if the relative

/ burden of dollar

burden of dollar interest rates can be reduced. Because of this, it is important not to overstate the problem, while remaining mindful of the risks.

On the other hand, it is abundantly plain with hindsight that the scale of reliance on borrowing by some countries had by 1981 become greatly excessive, reflecting the over-ambitious quest to maintain unsustainable growth rates in a deteriorating world environment.

Balancing these various factors, the IMF have produced, in their latest survey of the World Economic Outlook, a careful assessment of the risks and possibilities in both directions. I do not dissent from it. My own view is that our joint efforts to sustain world recovery and maintain the attack on inflation will help, but that there is an unavoidable, urgent and continuing need for adjustment by the major debtors.

There can be no escaping the need for adjustment, and the IMF has served us all well in holding firmly to this basic requirement. I should also like to add a word of appreciation, indeed congratulation, to those of our colleagues who have displayed the determination and political will to move quickly and decisively in the right direction.

/If adjustment is crucia

If adjustment is crucial, so also is the provision of some time for its effects to be achieved. I believe we have developed a sensible emergency strategy, with the IMF playing a central role in working out necessary programmes of adjustment, which unlock IMF assistance, and in turn some mobilisation of new commercial lending. But I suggest we should now begin thinking further into the future.

Three issues might be worth pursuing.

First, many of the arrangements which are being made create the prospect of a very considerable hump of debt maturities a few years ahead. If - and I emphasise this basic requirement yet again - if the course of adjustment is satisfactory, it seems to me that it would be right for the borrowers and lenders concerned to think in terms of trying to reshape maturities for a further period ahead, on a longer time-scale. Much will depend on the degree of confidence in the borrower, and on world prospects generally; much may also depend on the evolution of interest rates and international flows of funds generally. In the main, however, we are dealing with countries which have considerable potential resources, if they can be effectively mobilised.

/Second, it is very

Second, it is very likely that the pattern of international flows of funds in the next decade will differ sharply from what we have seen in the last decade. We are already well past the peak period of accumulation of surplus wealth by the major oil-producing countries. We may well be moving into a period in which the current deficits which are the natural condition of most of those countries in the developing stage will have as their counterpart the more traditional surpluses of industrial countries, whose capital formation and distribution are very different. There is food for reflection here for commercial banks, but particularly also for the borrowing countries themselves. I suggest in particular that many of them ought to look again at their attitudes towards private investment, and to reflect on the advantages they could draw from encouraging long-term flows in that form, rather than the short-term borrowing of which they have had such uncomfortable recent experience, and which may in any case be less freely available.

Finally, as the world economy recovers strength, we need to give increasing attention to ways of strengthening the role of the World Bank, and to means of association between it and private investment. No country should delude itself that massive increases of official assistance are likely--or indeed would be helpful in securing sustainable growth. But there is some scope for a stronger role here.

/IMF Finance

IMF FINANCE

I have already spoken of the key role of the IMF in helping to encourage and support adjustment policies. Recognising that the Fund must be equipped with sufficient resources to discharge this task, the Interim Committee, under the Chairmanship of my predecessor, reached important decisions in February on the 8th Quota Review. The effect of this, together with that of the decisions reached in advance on the enlargement of the GAB, should be to double the useable resources available to the Fund.

It is clearly essential that these decisions are implemented as soon as possible by all Fund members. I glad to say that the United Kingdom has already passed the necessary legislation. It would be difficult to overstate the importance of the US Congress doing so too, and on time.

Provided that they do, the decisions reached, at the end of the day, at the latest meeting of the Interim Committee, in which the United Kingdom was glad to have been able again to offer some assistance, will provide a firm but flexible basis for carrying forward the Fund's work.

/Given uncertainties

Given uncertainties about future developments it would not have been sensible to seek to reach a view on the level of members' access to the Fund more than a year ahead: nor was that necessary. The Committee, rightly in my view, envisage a gradual phasing out of the enlarged access arrangements. But it is evident that their extension into 1984 was necessary and fully justified.

I believe the Committee was also right not to conclude that a case has yet been established for a further SDR allocation. There clearly is imbalance in the distribution of world liquidity: but I am not convinced that there is an overall world liquidity shortage. At the same time I welcome the fact that further studies in this field are being put in train, and that the issue remains on the table.

IBRD/IDA FINANCING

The World Bank, too, cannot perform its role without adequate funds, and a selective capital increase is now required in order to help raise the level of lending which the Bank can sustain. I have accordingly suggested that an increase of around $8 billion might be appropriate, provided that the details were settled in a satisfactory way, taking account of adjustments in the relative positions

/ of shareholders

of shareholders.

But we must recognise that an increase in World Bank lending will not help the poorer countries whose credit-worthiness precludes substantial borrowing from commercial banks. For them, IDA is crucial. The UK has always been a strong supporter of IDA, which we regard as a highly efficient means of channelling resources to the poorest countries. We are prepared to play our part, with due regard to our relative economic capacity, in securing a Seventh Replenishment of adequate size. I hope that all countries will be willing similarly to play their part, and I would particularly like to appeal to our United States colleagues, as IDA's originators and generous supporters, to consider whether there is more they can do to contribute to a satisfactory agreement. Their role in the final settlement will be crucial.

/INTERNATIONAL MONETARY SYSTE

INTERNATIONAL MONETARY SYSTEM

I would like, in conclusion, Mr Chairman, to add a word on the perennial question of the overall working of the international monetary system. The International Financial Institutions represented here have served us well over the years, developing to match changing circumstances and meet new needs. Provided that we continue to equip them with adequate resources, I am convinced that this will remain the case.

They have shown resilience and adaptability in confronting the difficult issues arising in a period of transition from one of high inflation. The past few years have in a very practical sense been a period of evolution in which all our countries have shared, in particular through participation in the operational decisions of the Fund.

In the wake of the second oil price increases, the international community has reached a general agreement on the stance of policy which can best provide the basis for sustainable non-inflationary growth. This strategic consensus provides a framework in which we can consider what further improvements to the operation of the monetary system might be sensible.

/It is right that there

It is right that there should be continuing exploration and debate about specific aspects of the system. The recent Commonwealth Study Group report represents a thoughtful contribution to that debate. And I welcome the decision of the Group of Ten to carry out further work to identify areas where progressive improvements might be sought.

But I would just add this. Let us remember that it was inflationary domestic policies that precipitated the breakdown of the original Bretton Woods arrangements, not the other way about. When things go wrong, there is a temptation to blame the system. This is a temptation to assume that all problems that are not cyclical must be systemic, and can be solved only by changes to the international system. But none of us can in fact duck responsibility for the way we conduct our domestic economic and financial policies. That in the end is still what this discussion is really all about.

/Conclusion

CONCLUSION

It was for that reason, Mr. Chairman, that I began my remarks today with an account of our recent experience in the United Kingdom, and suggested some conclusions about the roots of our current recovery which might have wider relevance and applicability. It was for that reason too that, in discussing current debt problems, and putting forward some suggestions for their handling in the medium and longer term, I have stressed the cardinal importance of appropriate adjustment programmes. And it is precisely because both the Fund and the Bank play a key role in encouraging the adoption of such policies, and helping countries see them through, that I have today emphasised the importance of ensuring that both institutions continue to have the resources they need to do their job, supporting and sustaining a soundly-based recovery in national economies, and hence in the world economy. If we do not fail them, I am confident that they will not fail us.

Thank you, Mr. Chairman.