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10 DOWNING STREET

THE PRIME MINISTER

18 May 1984

Dear Lord Roll.

Thank you very much for your letter of 11 May; and for the memorandum on the issues for the London Economic Summit.

The analysis in your paper is similar in many ways to that which has been arrived at in the course of the final preparations for the Summit. But it is most helpful to have the benefit of the opinions and insights of the very distinguished group of people whom you assembled at Wiston House. I am very grateful to you, and to them.

Yours sincerely

Margaret Thatcher

The Lord Roll of Ipsden, K.C.M.G., C.B.

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11 May. 1984

My dear Prime Minister,

On behalf of Harold Lever, Jeremy Morse and myself, I am sending you the enclosed memorandum containing some views on the forthcoming Economic Summit. I do not think I need add anything to the introductory paragraphs which set out the basis on which these notes were prepared. The participants are listed at the end of the memorandum.

We hope that these ideas - or at least some of them - may be of use as additional briefing material.

Yours sincerely,

Eric Roll

Roll

The Rt. Hon. Mrs. Margaret Thatcher, PC, MP,
10 Downing Street,
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Issues for the
Economic Summit Conference of the Seven Industrialised Nations
7th June 1984

As in previous years, a group drawn from the seven countries whose heads of government are shortly to meet at the Economic Summit in London have been discussing the issues which are expected to be before that meeting. The participants have experience in economic and financial matters in government and in the private sector and believe that heads of government might wish to have their views before them. This paper reflects broadly the opinions of the participants, but does not attempt to achieve unanimity on all points discussed.

We subscribe to the analysis of the world's economic and financial problems as set out in the Williamsburg Declaration after last year's Summit and endorse the policies decided upon at that meeting. We must, however, record that progress on the objectives then adopted has in a number of important respects been very disappointing.

As events have developed, the seven countries appear to be entering a year of expansion, although unemployment has reached record post-war levels in Europe and concern still runs high regarding those developing countries with debt servicing difficulties which impair their ability to contribute to world growth. There are, moreover, serious strains within the system that may interrupt the promising prospects. For example, high interest rates in the United States, low growth notably in Europe, and the forces that lie behind the Japanese export surplus, may in combination seriously inhibit further expansion for the seven countries as a whole. Further recovery and growth in Europe and Japan will be necessary if these countries are to continue as a nucleus for further expansion of the world economy and to balance the expected settling down in the recently rapid growth in the US economy.

In what we say below we have attempted to give special emphasis to those issues which we consider require early attention and on which we hope collective agreement can be achieved and action taken. A number of specific dangers for which contingency plans will be needed are also noted.

We arrange our comments under three broad heads - economic recovery, international trade and international debt - which are in fact interrelated, but separated in the text for the purpose of exposition.

I. ECONOMIC RECOVERY

Economic recovery is under way, especially in the USA. Although considerable progress has been made in many countries on the inflation front, governments must continue to guard against a revival of inflationary pressure. This could occur for a number of reasons, in particular, prolonged over-stimulation of the US economy through large government budget deficits and also wage cost pressures. There is also a possibility that international hostilities, or other developments, may cause a sudden interruption in the supply of Opec oil upon which our economies remain dependent, leading to a rise in oil prices. All these pressures could lead to a return to stagflation. Growth will only be sustainable if it is non-inflationary; a permanent improvement in the unemployment problem, which is especially acute in Europe, can only be brought about by sustainable rates of growth.

Three factors which threaten the maintenance of the recovery are:

- the high level of interest rates, especially in the USA;
- the low growth and rigidities in European economies;
- increasing protectionist pressures due to payments imbalances and heavy unemployment, to which Japan's export surplus has added further impetus.

Interest Rates

High interest rates are fundamental to the concerns outlined in this paper. A reduction in interest rates, especially in the USA, would make a major contribution to resolving many of the issues identified; it would encourage growth and investment and alleviate the debt servicing problems of major borrowing countries, thus also helping to relieve the pressures giving rise to calls for protectionism.

The US economic recovery is due, at least in part, to an expansionary fiscal policy. But the fear of a continuation into the medium-term of large budget deficits relative to domestic savings is contributing to high and rising interest rates in the USA.

Progress to reduce this structural budget deficit would help to lower long-term interest rates by reducing the pressure of future government credit demands and by improving confidence in the financial markets. This would permit a moderate easing of monetary policy without impairing progress towards lower rates of inflation.

The resulting lower actual and expected rates of interest would:

- encourage an orderly retreat of the US dollar from its present level, which is widely acknowledged to be overvalued;

- stimulate investment, which has been discouraged by high interest rates and has been predominantly in short-term assets;

- permit lower interest rates elsewhere, thus encouraging investment and recovery outside the USA.

Contingent Danger: A continuation of the US current account deficit of the present order of magnitude may eventually produce the desired decline in the dollar on the foreign exchanges, and the dollar content in portfolios of internationally mobile funds may reach a level at which a slowdown of capital flows into the USA would take place. Thus a rush out of the US currency may occur with the result that the adjustment in its parity could be abrupt, and could overshoot. Such a sharp fall in the dollar threatens a revival of inflation, both imported and domestic, and thereby could provoke a rise in US interest rates with detrimental consequences for recovery in the USA and elsewhere.

Recommendation: At last year's Summit, governments agreed to "....improve consultations, policy convergence and international cooperation to help stabilise exchange markets....". Governments should be prepared to act to prevent an abrupt and disorderly fall in the US dollar, including early and concerted intervention.

Low Growth in Europe

In Europe, structural rigidities result in low profitability, low investment and low growth of real output and employment. They have also stimulated the growth of large "black" or "underground" economies.

These structural rigidities reflect:

- demographic changes - the European countries have ageing populations with attendant problems of slow growth in the labour force and relatively few workers to carry the financial burden of pensions and welfare schemes.

- high real wages, which are a major factor in the poor performance of Europe in creating jobs compared with the USA. Conversely, Europe has enjoyed a better performance on productivity than the USA. It is important to generate sufficient economic growth to allow rises in both productivity and employment.

- inflexibility in the labour market - the high cost of redundancy and other social benefits means that employers not only find it difficult to shed labour but are also very reluctant to hire additional workers as sales increase.

- relatively high tax and social security burdens. Taxes and social security account for some 45 per cent of GDP in Europe, compared with 34 and 29 per cent in the USA and Japan, respectively (1981 data).

- there are some technological gaps between Europe on the one hand and the USA and Japan on the other. As stated in the Williamsburg declaration, advanced technology needs to be encouraged along with the public acceptance of its role in promoting growth, employment and trade.

The above factors are all of a structural nature and require the development of positive long-term adjustment policies to deal adequately with them. The adjustment process is, of course, a global phenomenon which involves new patterns of investment and production in many developing nations as well as in mature industrialised countries. Many countries, including the European nations, need to adopt policies to reduce labour and product market rigidities and to encourage an appropriate balance in the industrial structure.

While governments need to give these long-term problems urgent consideration, there are some more immediate concerns requiring prompt attention.

European recovery has only just begun and must not be allowed to falter. The UK and German economies are in comparatively good health and their continued expansion would help foster growth in the rest of Europe. Other European countries, such as France and Italy, have further progress to make in both internal and external adjustment; a general climate of economic growth would be conducive to the success of attempts made by such countries to contain inflation and reduce balance of payments deficits.

Contingent Danger: The recently rapid rates of growth in the US economy may begin to settle down and as noted above there are fears of even higher interest rates. European countries would only exacerbate an economic downturn and prolong the existing imbalance between themselves and the USA if they were to respond to higher US interest rates by raising their own commensurately.

Recommendation: European countries should avoid a rise in their domestic interest rates even in the face of a rise in rates in the USA. If higher US interest rates are provoked by a fall in the dollar on the foreign exchanges, European countries will not need to raise their own rates in order to protect their currencies. If, as is hoped, the constraining effect of high US interest rates and a strong dollar is relaxed, European governments will be able to be more ambitious in encouraging their own recovery.

The Japanese Export Surplus

The Japanese export surplus remains substantial. In the last year, however, there has been a welcome shift in the impetus of the recovery away from export-led growth, with a less important contribution from the trade balance, towards domestically generated growth, with increased domestic expenditure on consumption and investment.

Nevertheless, the export surplus continues to exacerbate protectionist pressures (see the next section on Trade). There is also a widespread perception of the existence of barriers to foreign investment of all forms in Japan, despite the welcome moves of the Japanese authorities to open economic and financial markets to foreigners.

Recommendation: The Japanese government should encourage all forms of foreign investment in Japan. This will help to remedy the under-valuation of the yen and ultimately to reduce the trade surplus, thus alleviating protectionist pressures.

II. INTERNATIONAL TRADE

Exchange rates which are not in line with economic fundamentals and which fluctuate violently are a powerful hindrance to the free flow of trade, as much or more so than direct barriers. We support the sentiments expressed in the Williamsburg Declaration on the subject of trade barriers, but would point out that little progress appears to have been made in achieving the agreed objectives. Protectionist and other tensions continue to exist both between the industrialised countries themselves and between industrialised and developing countries. In some cases, these tensions have worsened over the last 12 months.

The causes of these tensions can be seen in the following:

- the large current account imbalances, especially the deficit in the USA and the surplus in Japan. These imbalances create tension between the major trading nations, by generating pressure for protection which would distort the flow of trade.

- the strength of the US dollar, by reducing the competitiveness of US exports and increasing the attractiveness of imports, strengthens the protectionist lobby.

- the high levels of unemployment in the industrialised countries are encouraging the governments of those countries to impose import barriers to protect their own industries and labour forces.

- the debt repayment problems of a number of LDCs have disrupted the international trade and payments system. As a result of the introduction of austerity programmes, earlier high levels of imports have been reduced sharply in some countries. LDCs are also taking steps to increase levels of exports, including the use of subsidies, to provide the required amounts of foreign exchange for foreign debt service. At the same time, however, LDCs are faced with restrictions on their exports to industrialised countries in the form of trade barriers. A vicious circle is created whereby the developing countries' subsidised exports result in the imposition by industrialised countries of higher trade barriers. This only serves to make it more difficult for developing countries to earn the necessary foreign exchange, thus resulting in additional measures which further distort trade flows.

- Lack of coordination with regard to politically related trade policy has created friction between the seven, particularly in the case of high technology exports to the East Bloc countries or the Trans-Siberian Gas Pipeline.

The growing incidence of managed trade, including counter and barter trade, is symptomatic of the various underlying economic problems which need to be dealt with. Although these devices are not in themselves desirable because they constitute an inefficient way of conducting international trade, they are nevertheless better than no trade at all.

Recommendation: A new round of international trade negotiations should be instituted as soon as feasible to address the underlying problems causing the tensions which exist between the world's major trading nations.

Consideration should be given to the "graduation" into the community of mature trading nations of some of the Newly Industralised Countries since these should now be conducting trade on a normal Most-Favoured-Nation basis.

As recommended in the document prepared by a similar group for last year's economic summit conference, governments should now agree on a "standstill" on the introduction of new trade barriers during the period leading up to the next round of trade negotiations, otherwise the vested interests that grow up behind trade barriers will be difficult to remove. In addition, the liberalisation measures agreed at the talks in Tokyo should be accelerated.

Steps should be taken to establish more unified principles of control over East-West trade. A strengthening of the scientific and technical support of COCOM could contribute to this end.

III INTERNATIONAL DEBT

So far, international debt problems have been treated on a case by case basis. This approach has been successful in providing temporary accommodations which fit the disparate nature of each individual country's debt problems, but it should not preclude governments from developing a common strategy on an issue which is of common concern.

In many cases these solutions have focused on short term remedies to ensure that debtor countries are provided with sufficient liquidity to meet their obligations, thereby preserving the international payments system from collapse. The arrangements reached have often involved a degree of involuntary lending on the part of the commercial banks. Governments also have a part to play alongside the banks in maintaining the liquidity of debtor countries. Such lending by governments should be undertaken within the existing structure of international institutions and might include guaranteed export credits in support of sound economic development.

Repayment of principal in dollars often of substantially higher real value than when the debts were contracted and also at higher real rates of interest are, together with the overall reduction in new bank lending and the maturing of the borrowings contracted in the 1970s, now resulting in some net transfer of resources from developing countries back to commercial and official lenders. In the aggregate, there are no net new money inflows to developing countries.

While it is recognised that there are no universal answers, it is essential that governments ensure a workable pattern of resource flows to developing countries. This must involve a less important role for the banks than the excessive and inappropriate one which circumstances created for them in the last decade, and the encouragement of other forms of private sector flows, especially direct investment. Governments must play their part by providing sufficient levels of development finance to allow developing countries to create wealth-producing assets.

Contingent Danger: The problems of some debtor countries may be of a long-term structural nature. In such cases, governments and institutions should, both for economic and political reasons, make contingency plans which in certain cases could include funding of outstanding debt and thus ensure that the disruptive effects of continued short-term reschedulings do not persist and that the long-term economic situation in the country does not deteriorate to such an extent that serious social and political consequences could be expected.

Recommendation: In encouraging the availability of funds suitable for the development needs of borrowing countries, direct foreign investment and the resources of international agencies will be the most appropriate sources. The IMF and IBRD should be encouraged to strengthen their cooperation in helping borrowing countries to develop longer term programmes of structural adjustment.

Direct foreign investment has the advantage of making funds available to developing countries with no fixed repayment terms and links the provision of funds to the success of the investment. Encouragement should be given to potential investors as well as to developing countries which should work to institute suitable economic regimes to foster inward investment.

It is strongly recommended that the member governments increase the lending capacity of the international institutions, by increasing their resources and relaxing gearing constraints. All of the following institutions should be encouraged to play an even larger part in providing new inflows of long-term funds to developing countries: IBRD, IDA, IFC, regional and other development banks.

Wiston House
27th-30th April 1984

Pre-Summit Meeting for the
Economic Summit Conference in London on 7th June 1984

LIST OF PARTICIPANTS

Lord Roll	Chairman, S.G. Warburg & Co. Ltd. Former Permanent Under-Secretary for Economic Affairs
Professor B. Andreatta	Member of Parliament Former Minister of the Treasury
Senator G. Carli	Former Governor, Bank of Italy President UNICE
Dr. A. Greenspan	Chairman, Towsend-Greenspan Former Chairman, US Council of Economic Advisers
Mr. J-Y Haberer	Chairman, Banque Paribas Former Directeur du Trésor
Mr. T. Hosomi*	President, Overseas Economic Corporation Fund. Former Vice-Minister of Finance for International Affairs
Mr. Y. Kashiwagi	Chairman, Bank of Tokyo Former Vice-Minister of Finance for International Affairs.
Lord Lever	Former Chancellor of the Duchy of Lancaster
Mr. R. Marjolin	Former Vice-President, European Commission. Former Secretary General, OEEC.
Sir Jeremy Morse	Chairman, Lloyds Bank. Former Executive Director, Bank of England.
Mr. R.V. Roosa	Partner, Brown Brothers Harriman. Former Under Secretary of the Treasury for Monetary Affairs.
Mr. D. Spethmann	Chairman, Thyssen AG
Mr. J.H. Warren	Vice-Chairman, Bank of Montreal. Former High Commissioner to UK. Former Ambassador to USA.
Dr. Marina Whitman	Vice President and Chief Economist, General Motors Corporation. Former Member of the US Council of Economic Advisers.

* Mr. Hosomi was unable to attend but contributed in writing to the Group's deliberations.