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cc Mr Alexander



Primo Minister ^{Evon} PDI 21

Two points -

y the 'substitution account' proposal has gone into cold storage

Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

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China have been admitted to the IMF and will probably join the IBRD too.

This may eventually lose us the automatic right to an Executive Directorship on the IMF Board because we may no longer be

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Dear Tim,

The Chancellor recently attended meetings in Hamburg of the International Monetary Fund's Interim Committee, and of the Development Committee, a joint Committee of the Fund and the World Bank. He has suggested that the Prime Minister may like to have a brief account of the main developments. She may also like to know about the People's Republic of China taking up China's membership in the Fund and Bank, since this might, in a few years' time, affect the UK's representation in these institutions. in the Big 5. TL 9/15

The Interim Committee (which is a kind of Governing Council of the IMF, but goes on being "interim" because the LDCs will not allow it to become a Council) discussed the sombre world economic outlook, and was agreed about the need for the IMF to take a bigger role in the so-called "recycling" process. The international private banking system will continue to carry out most of this recycling. But there is no doubt that the less well-off countries are finding commercial bank loans more difficult to get hold of now, and more expensive.

The more that countries turn to the IMF the better, because IMF help depends on willingness to take steps to adjust domestic economic policies to world conditions: and, however unpleasant, such adjustment is essential. But the Chancellor and others argued that the Fund should find ways of making recourse to its facilities more palatable - in particular by giving access to larger sums of money - so as to make acceptance of the Fund's conditionality more defensible domestically and more worthwhile.

The proposed Substitution Account was put into cold storage. The Prime Minister will recall that the arrangements would have enabled countries to deposit US dollars from their reserves with the Account, and receive SDR-denominated assets in exchange. This might have reduced the "dollar overhang"

/and helped



and helped to protect the foreign exchange markets from some of the pressures caused when countries diversify the currency holdings in their reserves. There was very little discussion of the Account in the Interim Committee itself, because meetings the Chancellor attended just beforehand - notably with Finance Ministers of the Group of 5 (USA, UK, Germany, France and Japan) - had shown an important difference of view between the Europeans and the Americans which was not capable of being resolved quickly: and the Committee generally had little option but to recognise this.

The disagreement was about underwriting the Account - ways of ensuring that its dollar assets and its SDR liabilities could always be brought into balance. In other words, the question was: who should bear the exchange risk if the dollar depreciated substantially in terms of the SDR? It looked at an earlier stage as if it might be possible to persuade the Americans to take a fair share of this risk, provided other participants took a share also. It was also agreed in the Group of Five that some of the IMF's remaining gold holding might also be used to back the Account. But in the end the Americans wanted to rely on gold only or at most to accept a remote and contingent share of the risk. Like the French and Germans, the UK view was that if the Account was to carry conviction there would have to be a reasonable degree of financial - and therefore political - commitment from the United States. The Americans were not going to change their position on this in their Presidential election year, and there was no point in trying to negotiate further with them about it.

The Chancellor and his European colleagues tried, with reasonable success, to avoid any open breach ^{of} ~~or~~ manifestation of failure. The Interim Committee as a whole was content to agree that it would "continue its work on this subject", but not in any prescribed timescale. The Chancellor's view has always been that the proposed Account would be modestly useful, but only if it could be set up in a sensible and equitable fashion. So while he thought it worthwhile to help to avoid undue drama, he saw no harm for the UK in this state of suspended animation.

Apart from the Hamburg meeting, the most potentially significant aspect of Bank/Fund affairs in recent weeks has been the recognition of the People's Republic of China (PRC) as the representative of "China", which was a founder member of the two institutions. The PRC suddenly went into action a few weeks ago, and formally requested recognition as the proper representatives of "China" in the IMF, undertaking to meet the obligations of membership. After a quick visit to Peking by the IMF Staff, and various consultations, the IMF's Executive Board recognised the PRC on 17th April, and withdrew recognition from the Taiwanese authorities. The Board of the World Bank is expected to follow suit shortly.

/There is now



There is now a risk that, in due course, the presence of the PRC in the Fund might mean that the UK no longer qualified for one of the 5 largest quotas in the IMF, and would accordingly no longer be entitled to appoint an Executive Director. Most countries have to group together to form "constituencies", which then elect an Executive Director from one of their larger members.

Quotas in the Fund govern voting power and drawing rights, and are intended to reflect economic size in relation to the total membership of the Fund. The UK's initial quota was so large - partly because of its imperial responsibilities - that the subsequent 5-yearly quota reviews have kept us in second place, despite relatively poor growth. At present we come behind the United States and before Germany, France and Japan. If the PRC had not appeared on the scene, we would probably have dropped to fifth next time.

"China" was a founder member of the Fund, with a substantial initial quota, but this was never increased during the 30 years that Taiwan held the seat. In the near future - and provided that they can produce enough relevant information - the PRC is likely to be fitted in below the big 5.

The longer term issues are whether the PRC want to be in the top 5, and whether, if they do, their economic strength can be shown to justify this, when quotas are next reviewed so as to take effect in, probably, 1983 or 1984. It might turn out to be a near thing. There should be plenty of scope for argument. Decisions will in the event be made on a mixture of statistics and political considerations. There will be plenty of cross-currents, with other major countries as well as ourselves having interests of status affected by the newcomer.

Even if we failed to stay in the first 5, it would not matter all that much. It would not of itself displace us from the Group of 5 (mentioned above), or from the economic summit group of countries, though it might mark our more junior status. We would probably be able to ensure that the UK took the Directorship in a constituency. But the Chancellor thought that the Prime Minister ought to know of this possible change in the UK's standing in the Bretton Woods institutions, even though - if it is to happen - it is still some way away.

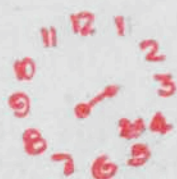
I am sending a copy of this letter to George Walden (FCO) and David Wright (Cabinet Office).

yours

John

A.J. WIGGINS

- 8 MAY 1960



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TO : SAC, NEW YORK (100-100000) (P)
FROM : SAC, PHOENIX (100-100000) (P)
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