cc JU

(2)

It is precisely this kind of vague letter (para 6) 'vital' gives rise to false expectations

Prime Minister

To see - especially para 7.

A.J.C. 11/3.

FCS/83/44

CHANCELLOR OF THE EXCHEQUER

US Economy and Williamsburg Summit

1. I read with great interest your minute of 24 February to the Prime Minister about the US economy and the prospects for the Williamsburg Summit. During my recent visit to the United States I discussed these issues with Donald Regan and George Shultz.

2. It is encouraging that there are now more optimistic signs of an upturn in the US economy. The leading and current indicators appear to be moving in the right direction. President Reagan and George Shultz are taking the line that the United States is firmly on the road to recovery and, though Donald Regan sounded a more cautious note, he acknowledged that the corner had been turned.

3. The size of the prospective US budget deficit remains a major cause for concern. There is still a good deal of doubt about the ability of the US authorities to bring it down in the longer term. This uncertainty in turn inhibits a further reduction in interest rates. Nevertheless I had the impression that the US administration is coming to grips with the problem of the deficit with greater resolve than seemed to be the case in the past. Recovery from recession would make their task on the budget much easier.

4. The prospects for world recovery will of course be the principal theme of Williamsburg. I entirely agree that we should damp down excessive expectations about the Summit. At the same time, I was struck by a recent article by Henry Kissinger in Newsweek of 24 January (I enclose a copy). Kissinger took the line that the political as well as economic and financial risks in the present situation are so serious that Western leaders must give a positive and coordinated lead. I think this is right.

5. At Williamsburg, the Prime Minister will be able to point to the successes we have already achieved. We have significantly lowered the level of inflation. We aim to sustain a rate of expansion of domestic demand of around 3% in real terms. This will be a significant contribution to a process of world recovery. I think we should meanwhile be encouraging the other participants to think in terms of what they might contribute to such a process. It seems to me essential that Williamsburg should add to international confidence; and that a necessary condition for this is that the Summit countries should demonstrate that they possess both the will and the capacity to help bring the world out of recession.

6. George Shultz recently argued in his testimony to the US Senate that the opportunities for growth must be seized. He identified ? four main elements in his approach: creating an adequate level of global activity; preserving ~~creating~~ open markets; improving the international monetary system; and strengthening the political stability of developing countries. I would have added the reduction of exchange rate volatility and of interest rates. Should we not build on these ideas in planning for Williamsburg?

/ 7. Donald Regan suggested that I should discuss with George Shultz the possibility of a joint preparatory meeting of Finance and Foreign Ministers before the Summit if this seemed likely to be helpful nearer the time. (I enclose a copy of the reporting telegram). I wonder whether the idea of such a meeting, perhaps in April, might have merit? I recognise the difficulties and dangers of an unproductive meeting. There is a risk that the meeting might complicate rather than clarify the issues, and I am conscious of the general desire not to pre-cook the Summit too much and inhibit discussion. But effective preparation at the political level, to which such a meeting could contribute, should help rather than hinder.

8. When you are free of work connected with the Budget, I should be interested to have your views, in particular on the advisability of a joint meeting as suggested by Regan.

9. I am copying this to the Prime Minister and Sir Robert Armstrong.

FP

(FRANCIS PYM)

Foreign and Commonwealth Office

8 March, 1983

PRESS REPORTS

FOR INTERNAL CIRCULATION ONLY

This article, "Saving the World Economy," by Henry A. Kissinger, former U.S. Secretary of State, appeared on pages 46-49 of Newsweek, January 24, 1983.

INTERNATIONAL

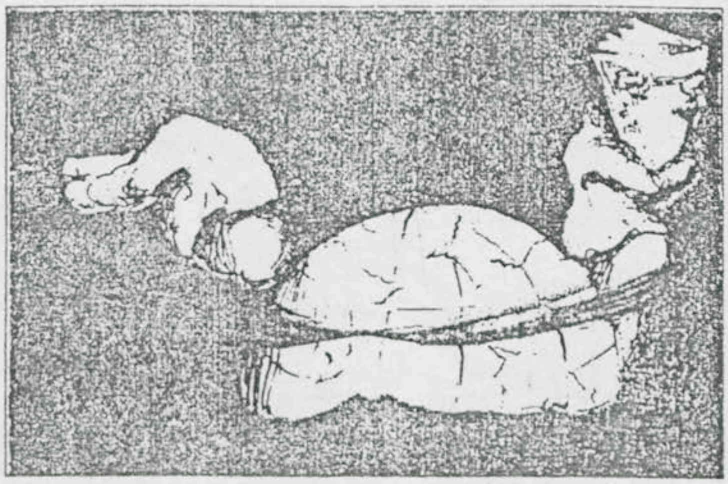
Saving the World Economy

The challenge is not simply economic; at stake is the survival of free societies.

By HENRY A. KISSINGER

John Maynard Keynes wrote that practical men who believe themselves quite exempt from intellectual influences are usually the slaves of some defunct economist. Politicians these days certainly have many economic theories to choose from; most discordant, not a few of them defunct. No previous theory seems capable of explaining the current crisis of the world economy. Until recently it would have been thought impossible that prices could rise during a recession; that a system of relatively free trade and floating exchange rates could spur embryonic trade wars; that the developing nations, through defaulting on their debts, could threaten the economies of the industrial nations.

When reality clashes fundamentally with expectations, a political crisis is inevitable. That condition is upon us today. Since World War I we have expected progress. The historical business cycle of boom and bust seemed a relic of history. In virtually every Western nation the standard of living rose uninterrupted. Jobs were so plentiful that many countries encouraged the immigration of foreign labor. Although the developing countries lagged far behind, the more advanced among them—such as Brazil, Mexico and South Korea—were beginning to share in the seemingly permanent prosperity.



This illusion of uninterrupted progress was suddenly shattered in the middle '70s. There were many causes: the welfare state grew dramatically faster than productivity; inflation accelerated; high taxation reduced incentives; a generation of economic security eroded the work ethic. But what transformed these structural problems into a crisis was the more than tenfold increase in oil prices between 1973 and 1980. At first it drove inflation out of control and—when governments put on correspondingly severe brakes—it triggered global recession. Thirty million workers are now unemployed in the industrial democracies and their number continues to increase. The developing nations are crushed under the twin burden of debt and collapsing hopes of progress.

No government of an industrial democracy has survived an election since these conditions became chronic. Socialist or liberal governments in West Germany, Britain and the United States have been replaced by conservative ones; conservative governments in France, Greece, Spain and Sweden have been succeeded by socialist ones. The common feature is not the program of the parties but the condition of the societies: restlessness with a recession that seems to have neither remedy nor end; fear of a future to which there are no signposts.

If the peoples of the West lose faith that democratic governments have control over their economic destinies, the economic crisis could become a crisis of Western democracy. Each country will turn inward to protect its immediate patrimony, eroding cooperation and paradoxically deepening the world recession. In a world of many perils, continuing economic weakness is likely to undermine the democracies' ability to conduct an effective foreign policy or to maintain their collective defense.

Historians will never settle conclusively whether the economic policies of the New Deal overcame the crisis of the '30s or delayed its resolution. But Franklin Delano Roosevelt has earned his place among our great presidents not because of his economic theories but because he restored confidence in the ability of our democratic institutions to master their difficulties. Today's crisis poses a comparable challenge. Now, as then, the first reaction is to cut consumption, reduce imports and expand exports. Now, as then, purely economic measures will not work.

In the first place, economic recovery through austerity almost surely will take longer than the citizens of most advanced democracies will tolerate; in the developing world, austerity may cause political chaos. More important, a remedy appropriate for the economic ills of one nation may prove self-defeating if applied by many nations at once. If many nations simultaneously reduce consumption and imports and boost exports, none can possibly succeed. Trade will be stifled, recession will be institutionalized and the risks of political instability compounded.

Before this downward cycle goes too far, the governments of the industrial democracies must reverse the process. They must promote economic growth, and they can do so only in coordination; solitary efforts are bound to fail.

If we do not act, we face many risks, including the loss of the relatively free international trading system that was the basis of postwar prosperity. Contrary to classical economic theory, a free trading system does not run itself; it requires a conscious act of political leadership. In the best of circumstances that task is formidable; deep recession makes it next to impossible.

The Politics of Free Trade

In theory free trade benefits everybody. Tariffs and other trade barriers, it is said, encourage inefficiency, restrict commerce and lower the general standard of living. But the theory of free trade is rooted in a world that no longer exists. Adam Smith first advanced it in 1776, when Great Britain had a near monopoly in industrialization. Competition benefited some British industries and not others, but it did not affect Britain's total employment. As other nations industrialized (almost invariably behind temporary tariff walls), free trade prospered because there were abundant world markets and only a few key nations—no more than four or five—representing homogeneous cultures with comparable living standards operating by the discipline of the gold standard.

…ry's world economy, by contrast, contains at least 20 significant trading nations of widely different cultural backgrounds with great variations in labor costs and standards of living, each claiming sovereign control over its economic decisions. In such conditions, competition became more ruthless and its impact more drastic. No longer does one sector of industry within one country benefit at the expense of another; rather whole industries decline simultaneously or even move from one country to another. The problems of our steel and automobile industries require no elaboration; very few television sets are still made in the United States. Many European countries with high expenditures for social welfare and inflexible labor costs are in an even more difficult position.

All political pressures and incentives of the modern democratic state work against the acceptance of the bitter medicine of government-sponsored austerity and cutthroat foreign competition. The loss of jobs sets up fierce pressures for protectionism. Nearly all industrial democracies—even while they give lip service to the ideals of free trade—have sought to nudge the terms of trade in a nationalist direction. Subsidies of exports, nontariff barriers to imports, guaranteed credits, as well as the manipulation of exchange rates become the order of the day. While one or two nations can occasionally manipulate the free-trading system to their advantage, the attempt by all nations to do so will surely wreck it.

The hope for recovery of a cooperative world order depends on the preservation of the free trading system. The industrial democracies must either agree to adhere to the principles of free trade—or else they will live in a mercantilistic world of unilateral actions and bilateral deals. At the same time, the free-trading system will not survive in a world of chronic recession. There is no hope of resisting the tide of protectionism unless the world returns to a path of economic growth.

But recovery will not take place if different countries in the industrialized world continue to pursue incompatible economic policies. America, as the strongest country, must take the lead. It cannot do so, however, in isolation. The industrial democracies must achieve an unprecedented coordination of their national economic policies. No single American initiative would more effectively reverse the deterioration of the Western Alliance than a call for a coordinated program to insure the general economic expansion of the free world. Nothing is more likely to encourage a sound political evolution in the developing countries than the hope that they may share soon in renewed growth. And nothing would more effectively strengthen our hand with our adversaries than the assurance that the democratic world has dedicated itself to the recovery of economic strength.

> Thirty million workers are now unemployed in the industrial democracies. The developing nations are crushed by debt and dashed hopes of progress. Economic recovery through austerity will likely be intolerable even to most advanced democracies; in the developing world austerity could cause political chaos.

Exchange-Rates Politics

Perhaps no other field so dramatically illustrates the changing fashions in economic theory and its growing incompatibility with political practice than the current system of international exchange rates. Throughout the 19th century currencies were stable; prices in 1914 were essentially unchanged from 1812. The gold standard gave political leaders an alibi for self-discipline. And even when the gold standard was abandoned after World War I, nations fixed their exchange rates by formal agreement.

As recently as 1969, fixed-exchange rates were still an article of faith. I remember a meeting of cabinet-level officials when someone suggested a change in the value of the dollar. He was never given a chance to put forward his case. It was explained to him—with the forced patience of the exasperated—that the dollar as a reserve currency *had* to have a fixed value; indeed it was technically impossible either to revalue or to devalue it for all other currencies would simply follow suit.

Within a few years intellectual fashion had made a 180-degree turn. By 1973 a totally new system of floating exchange rates emerged from largely unilateral American actions. The new rules made possible—indeed encouraged—continuous changes in the value of all currencies. The value of currencies was no longer fixed; the market was supposed to determine it. No country, it was held, would tolerate an overvalued currency because it reduces the competitiveness of exports, or an undervalued one because it creates inflationary pressures. When the value of their currency changed, governments were expected to take immediate remedial action.

Unfortunately, practice belied theory; far from establishing discipline the floating system tended to erode it. When currencies weaken, exports thrive; for a country eager to sell abroad, the incentive to remedy this state of affairs is minimal. Some major trading nations—Japan is the prime example—have even been accused of deliberately maintaining an undervalued currency. Other countries have overvalued their currency to serve domestic policies. The United States, for example, has relied on high interest rates to fight inflation, thus boosting demands for the dollar. The remedy was successful—at least in the short run—but the consequence was to drain the world's liquidity, reduce global investment, and to weaken the competitiveness of American products, both at home and abroad.

In short, unilateral decisions regarding exchange rates have profoundly affected the world economy and the well-being of many countries that had no part in them. Unpredictability encourages speculation; the system tempts imbalances instead of adjusting them. A new form of nationalistic competition evolves, all the more bitter for never having to be made explicit; the floating system encourages the myth that governments make no decision at all.

An overhaul of the international monetary system is therefore a precondition to world economic recovery. Secretary of the Treasury Donald Regan's suggestions for reform are an important start; they need to be translated into specific initiatives. While a more fundamental reform is being negotiated, the central banks could in the meantime agree on a realistic range for permissible exchange-rate fluctuations and take action when relationships among major currencies move outside this range. Reform of exchange markets and practices is only a partial step. Monetary reform, like free trade, will not succeed without the coordination of fiscal and monetary policies to prevent the imbalances that give rise to the misalignment of currencies in the first place.

OPEC's Ominous Legacy

Any serious effort to restore the world economy must come to grips with the massive debts of the developing nations and the threat they pose to the international economic and political order. There is a special irony here. For the better part of a decade, the developing countries have been insisting on a massive transfer

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.. resources in the name of what they called a New International Economic Order. The industrial democracies have either rejected or evaded the proposal. Now it transpires that a vast and virtually unnoticed transfer of resources has in fact been undertaken by the much-maligned capitalist banking system on a scale that not even the most enthusiastic advocates of official aid would have dared to propose.

The energy crisis of the '70s has turned into a parable on the fallibility of human foresight. Each party acting perfectly reasonably in response to immediate pressures nevertheless created an almost insoluble complexity. The oil producers, suddenly awash in dollars, placed their surpluses into Western commercial banks, usually in the form of short-term deposits. The banks, flush with resources unimaginable even a few years earlier, competed fiercely for long-term loans to developing countries—especially to the more advanced countries of Latin America. Governments encouraged the process of "recycling" the petrodollars in order to maintain the oil producers' incentive to pump oil and also to foster the economic growth of the developing world. The passiveness of government and the competitiveness of the banks solved an immediate problem by mortgaging the future. When the short-term deposits of the oil producers were converted into the long-term lending of the banks, the Western financial system became enormously vulnerable.

The industrial democracies have therefore wound up paying for the energy crisis three times: first in the inflation and recession induced by high oil prices; then in the inflationary pressures arising from the massive extension of credit to help developing nations, and finally in the threat to the Western financial system caused by the inability of the developing nations to repay their debts.

The developing countries face a comparable triple jeopardy. First the rising oil prices consumed most if not all of the official aid extended to them. Next the high interest rates caused by the oil-price increases made it impossible to repay the commercial debt that served as a supplement to official aid. Now they confront an austerity from which even stable oil prices may not be able to extricate them. Falling oil prices help energy-importing countries like Brazil; they spell potential disaster to overextended oil-producing debtors like Mexico, Nigeria or Venezuela.

The wealthy oil producers are free of debt, but caught in the vicious circle as well. They have geared their development budgets to rising oil prices. Now that prices are stable and even declining, they are left with a budgetary deficit that they meet by drawing down their balances in Western banks. But this reduces the funds available to help the non-oil-producing developing countries through their debt crisis.

In 1982 interest payments alone ranged up to 45 percent of the total exports of goods and services of the developing countries. An attempt to repay principal—amounting to some $500 billion—would increase that percentage substantially. These figures spell a crisis. The debtor countries cannot possibly earn enough to meet their present obligations, at least for so long as the recession continues and probably for long afterward.

Creditors and debtors are thus bound together in a system in which disaster for one side spells ruin for the other. The creditor cannot cut the debtor off from further aid without risking not only a banking disaster but also a deepening of the recession. The developing countries, after all, absorb more than one-third of U.S. exports (and more than 40 percent of the exports of the industrial democracies). For the United States this is more than we export to the European Community and Japan combined.

Because the debtors can never escape their plight unless they receive additional credits, the comforting view has developed that no debtor country would dare default and wreck its creditworthiness. Unfortunately political leaders march to a different drummer than financial experts. They see the political interests of their country through the prism of their own survival. If pushed into a corner, a political leader may well seek to rally populist resentment against foreign "exploiters." This will surely occur if the so-called rescue operation concentrates primarily on the repayment of interest. A blowup is certain sooner or later if debtor countries are asked to accept prolonged austerity simply to protect the balance sheets of foreign banks.

The key question thus becomes: what is the likely impact on the political structure of the debtor country of the conditions demanded for "rescheduling," or stretching out, their debt payment? At risk here is the internal political evolution of several developing countries, including many important friends of the United States. If the debt crisis winds up spawning radical anti-Western governments, the financial issues will be overwhelmed by the political consequences.

Of course it would be absurd for the International Monetary Fund (IMF) to launch a rescue operation without seeking to correct the economic practices that brought debtor nations to the edge of the precipice. But the conditions imposed must be relevant to the real problem. How meaningful, for example, is the commitment to austerity of an Argentine military government daily losing legitimacy and in the process of turning over its authority to civilians of a quite different political orientation? With the best of intentions, can these targets be met? And if not, what incentive does such a government have to refrain from a politically popular repudiation of debt?

But the IMF conditions can be even more dangerous when they *are* fulfilled. For then, the debtor country may undermine itself politically. Western governments in economic trouble have occasionally used conditions imposed by international lenders as an excuse to practice an austerity that domestic politics might otherwise have prevented—Britain in late 1976 is a good example. In most developing countries, however, prolonged austerity is bound to shake, perhaps to shatter, the legitimacy of political structures that are the principal expressions of national cohesion and identity.

Few debtor nations have unemployment insurance or other institutions that in the West cushion the social impact of economic downturns. A policy of forcing developing countries to reduce their standard of living drastically over a long period is likely to weaken precisely those moderate governments that are the most likely to accept Western advice. If pushed too far it risks provoking radicalism that will rally public opinion (and perhaps other debtors) by defying foreign creditors. This must be the opposite of the West's intent.

Existing international arrangements are hardly well-designed to recognize this danger, much less deal with it. The principal institution for overcoming the liquidity and repayment crisis of the debtor nations is the IMF. But the IMF's original purpose was to lend to *individual* countries that found themselves in *temporary* difficulty. The IMF has performed this function admirably. But the IMF was *not* designed to deal with a crisis of the system affecting scores of debtor nations simultaneously.

As country after country admits its inability to pay even interest—and therefore renounces any immediate prospect of repaying capital—the IMF will quickly discover that it does not have the resources to rescue the entire developing world. But even an increase in its resources—and in recent weeks the United States has thrown its weight behind the effort to beef up the IMF's available funds—cannot cure the inherent contradiction in the IMF's basic strategy. As a condition for its assistance, the IMF almost invariably insists on measures that have the effect of contracting the economy, increasing unemployment and reducing consumption, in order to slow imports and shift resources to exports. The problem is that IMF conditions cannot work if applied at the same time in many countries, particularly in a period of global recession.

Above all, austerity in a developing nation is politically bearable only if rapid progress can be shown toward an escape from the vicious circle in which debt service consumes export earnings. The heart of the problem is that the current rescue effort pretends to "solve" a debt problem that is in fact insoluble in the immediate future. In the process it does provide an excuse for banks to continue lending. But our real objective must be to promote a sustained process of growth in the developing world; without it, all the frantic activity of rescheduling is simply delaying the inevitable crisis.

The first step must be to change the bargaining framework; the debtors should be deprived—to the extent possible—of the weapon of default. The industrial democracies urgently require a safety net permitting some emergency governmental assistance to threatened financial institutions. This would reduce both the sense of panic and the debtor's capacity for blackmail. At the same time it would permit a more farsighted approach to the debt crisis focusing on the long-term growth of the developing world. Simultaneously, new crisis machinery should be created. The IMF needs an early-warning system and advance consultation among the principal lenders so that crises can be anticipated and prevented. But in the end the issue is psychological. The debt problem is the symptom, not the cause, of a structural crisis. The developing world must be given hope for a better future if it is to sustain the immediate and inevitable austerity without convulsions.

> Our real objective must be to promote sustained growth in the developing world; without it, all the frantic debt rescheduling simply delays the inevitable crisis. Only America can lead the world to rapid economic recovery, and we cannot fulfill this goal either in isolation or without a long-term economic strategy.

The Challenges to America

Only America can lead the world to rapid economic recovery, and we cannot fulfill this role without a long-term economic strategy. The free market is the most successful mechanism of producing prosperity and freedom. But the free market alone will not overcome the present economic crisis. The government must play a crucial role. We need clear decisions in at least two crucial domestic areas relevant to foreign policy.

The first is energy. There are powerful national-security reasons for reducing our dependence on foreign oil, and with it the risk of blackmail. But with oil prices stable or declining, there is little incentive for the large investments needed for systematic development of alternative sources of energy—even though it is all but certain that within the decade the energy crisis will return. When the recession ends, demand will increase; the Persian/Arabian gulf has surely not seen its last political convulsion. In addition, some oil-producing countries will deplete their reserves. The oil glut is temporary, a breathing space for the democracies to insure themselves against future crises. Since current market conditions do not encourage the necessary investments, the government should provide the incentives to encourage alternative sources—as well as creation of strategic oil reserves.

Similarly if we are serious about free trade, we have an obligation to cushion some of its harmful consequences on our people. International competition and automation can no longer be counted on to create more jobs than they abolish, as theorists used to assure us. High unemployment may in fact become chronic even after the recession ends. And as unemployment reaches the white-collar labor force, discontent may spread to the middle class whose frustrations have historically been the breeding ground of extremism and rampant nationalism. If we prize either domestic or international stability, a conscious strategy to ease the adjustment process is therefore imperative—including programs of retraining, emergency assistance, and tax incentives and other measures to encourage the flow of resources to the sectors with the most potential for growth.

Finally, it is not too early to prepare a fall-back position, in case we and the other industrial democracies fail to coordinate our economic policies; we may then have no choice except to prepare to insure our competitive survival—deliberately and systematically—in the rough new world of unilateral trade practices and bilateral arrangements that is sure to follow.

This agenda will require a major change in the role of our government. Government, industry and labor must act as partners in setting the broad outlines of a national strategy, which should then be maintained on a bipartisan basis. Of the industrial democracies only Japan has managed this tour de force, and its national strategy is one reason for Japan's competitive edge in world markets.

In the immediate postwar period the Marshall plan saved the European democracies by offering the vision of a better world. Sacrifice was sustained by hope. The United States faces a comparable challenge today, both toward the industrial democracies and toward the moderate countries of the developing world. Clemenceau said that war is too serious an affair to be left to generals. By the same token the current global economic crisis is too grave to be left to financial experts. The political and moral impetus to restore hope to Western economies must come from the heads of state and their foreign ministers. For the stakes are high: whether the economic system as we have known it will hold together—as well as the political relationships that go with it. The next economic summit at Williamsburg—or perhaps a less public forum—could serve as the launching pad for a new policy.

Nearly two centuries ago the German philosopher Immanuel Kant predicted that eventually world order would come about either through intellectual and moral insight or through the experience of chaos. We are still in a position to make that choice. If the United States does not lead, we will sooner rather than later be confronting a panicky stampede. If we seize the initiative, we can draw from uncertainty and incipient despair an act of creation. And this, after all, is how almost all great creations have come about.

USA, Economic Situation, Pt 2

CONFIDENTIAL File USA da

10 DOWNING STREET

From the Private Secretary 14 March 1983

US Economy and Williamsburg Summit

The Prime Minister has seen the minute of 8 March by the Foreign and Commonwealth Secretary to the Chancellor of the Exchequer on this subject.

She agrees that it is necessary to damp down excessive expectations about the Summit but has commented that the general description of the Summit's objectives given by Mr. Shultz in his testimony to the US Senate (paragraph 6 of Mr. Pym's minute) is precisely the type of public comment which will give rise to excessive expectations.

I am copying this letter to John Kerr (HM Treasury) and Richard Hatfield (Cabinet Office).

A. J. COLES

Roger Bone, Esq.,
Foreign and Commonwealth Office.

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Foreign and Commonwealth Office

London SW1A 2AH

10 March 1983

Corrected.

AR 11/3.

Dear John,

The US Economy and Williamsburg

Mr Pym's minute of 8 March to the Chancellor contains a typing error in paragraph 6. One of Mr Shultz's four elements has been omitted. The second sentence of paragraph 6 should read: 'He identified four main elements in his approach: creating an adequate level of global liquidity; preserving open markets; improving the international monetary system; and strengthening the political stability of development countries.'

I am copying this letter to John Coles and Richard Hatfield.

Yours ever

John Holmes

(J E Holmes)
Private Secretary

J Kerr Esq
HM Treasury

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