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Sir R Armstrong
Cabinet Office

29 October 1987
Richard
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Dear Robert,

NS 29/10

TORONTO ECONOMIC SUMMIT:
FIRST MEETING OF PERSONAL REPRESENTATIVES

1. In his letter of 20 October to Geoffrey Adams, Paul Cuthbert-Brown asked for briefing in the form of a letter for the first meeting of Personal Representatives, which takes place on Vancouver Island on 6/8 November, to reach you by 29 October.
2. The agenda for the Vancouver meeting covers follow up to Venice and preparation for Toronto. Both will be overshadowed by the state of the financial markets and the consequences for the world economy and exchange rate management.
3. I gather that you were only able to see Delvoie today. He may have told you more about Sylvia Ostry's intentions than does the Canadian paper which Nicola Brewer sent to Cuthbert-Brown on 26 October. Under the agenda item covering the review of developments since Venice, the first issue she flags, economic policy coordination, is bound to have pride of place. Sylvia Ostry has proposed (her letter of 27 October) inviting financial sub-Sherpas to Vancouver. We and the Treasury do not think this is a good idea, and the Treasury are drafting a reply. Nevertheless there is bound to be some discussion of the effect on exchange rates and interest rates of the recent fall in share prices. To set this fall in historical perspective, since the early eighties equity prices had at their peak more than doubled in real terms in the US and Germany, trebled in France and the UK and quadrupled in Japan - a far greater rise than the improvement in current and expected profitability. So it was neither unexpected nor unprecedented that there would be a correction at some stage. What was not foreseen was the scale and speed of that correction once it began. The fall in equity prices is bound to have a deflationary effect upon investment and consumption, but how much we do not know.

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4. At the Annual Meetings, before the recent turmoil, Ministers were able to reiterate that the major seven economies were in their fifth year of expansion, and that growth appeared to be strengthening a little despite some weakening in average real GNP growth in the second half of 1986, from around 3% a year to just below 2½%. At the recent meeting of the OECD's Executive Committee in Special Session, Henderson for the Secretariat was inevitably more pessimistic.

5. Summit countries now need to reassure the markets that economic fundamentals are still sound and that the necessary actions to restore confidence are being taken. When we meet on 4 November, Geoffrey Littler will no doubt have more to say about the three key elements in any package: exchange rates, interest rate differentials (especially between the US and Germany) and action to reduce the US fiscal deficit and hence the imbalances. We can welcome the substantial cut in the US Federal deficit in fiscal year 1987 (just ended) and the willingness of the Administration to implement, if necessary by tax increases, the full \$23 billion cut in FY1988 from the estimated baseline specified by Gramm-Rudman, mark II. But next year's deficit is still likely to be above the FY 1987 level; and we should urge larger cuts in the deficit and above all a sustained programme to reduce it year on year, if market confidence is to be restored. The FRG too could do more, and the Chancellor has twice said so in terms in the last week. The immediate target is a reduction in German interest rates, but this will be opposed by influential voices in the Bundesbank and elsewhere.

6. We gather that Mrs Ostry would be particularly interested to hear how the Chancellor's proposal at the Annual Meetings for a more permanent regime of managed floating will be carried forward. Geoffrey Littler will be able to advise on this.

7. Debt Sylvia Ostry's second issue. If the stock market collapse does herald lower growth in developed countries it will curtail debtors' export earning opportunities, and reduce their capacity and willingness to repay. They will, however, benefit from lower interest rates. There has been good progress since Venice on a General Capital Increase for the World Bank. The IBRD Board will begin serious negotiations next month, and for US, German and Japanese budgetary reasons these negotiations have to conclude by mid-December if the GCI is not to be delayed for a year. Camdessus's initiative to enlarge the IMF's Structural Adjustment Facility continues to gather support. We have said we will contribute an interest rate subsidy, and we are ready in principle to contribute capital too if the



arrangements for repayment etc are satisfactory. Whether discussions can be concluded by the end of 1987, as proposed in the Venice Communiqué, is open to doubt (though it may be unwise to say so in public). That is certainly true of the Chancellor's debt initiative, but we should continue to urge the case for interest rate cuts and cite CHOGM's endorsement of the initiative.

8. Turning to trade, the Vancouver Declaration at CHOGM usefully reaffirmed the need for liberalisation of trade and agriculture in the Uruguay Round. The Geneva negotiations are now on schedule. The Community has put forward two major outline proposals: on Tropical Products where the Community's negotiating directive has been particularly welcomed by developing countries; and on Agriculture, on which a position paper has been submitted. Although the latter contains a number of unwelcome elements from the UK point of view, tactically it is far better for the Community to have a paper on the table in Geneva which demonstrates its commitment to negotiate constructively. The US, Canada and the Cairns Group have accepted that the Community's move is a useful step forward, though they too find parts of the paper unattractive. They have also tabled position papers for a first round of talks. Progress in the GATT should provide a useful external stimulus for the CAP reforms we are working for (though the latter must not be dependent on the former).

9. If it were not for recent stock market developments, Sylvia Ostry would probably be tempted to concentrate discussion at Vancouver on trade and agriculture. The Canadians have been pressing for a mid-term Ministerial review which could decide on measures for early agreement in the GATT negotiations (the so-called 'early harvest'). They may be considering proposing such a review in Vancouver in late 1988. We do not object in principle, but have consistently argued that it is premature at present to decide areas for agreement: far better to wait until it is clear what subjects can be included in any mid-term review or 'early harvest'. At CHOGM the Canadians (and Australians) appeared to recognise that these arguments had some force.

10. It is also too early to consider preparations for the political subjects at the Summit, although Sylvia Ostry will presumably confirm that she intends Political Directors from foreign ministries to attend the final preparatory meeting of Personal Representatives before the Summit, as they have done in recent years. There are just two points on the political side of which you might like to be reminded:



- Terrorism. The counter-terrorism experts continue to meet to follow up work after Venice. Progress has been slow under shaky Italian Chairmanship, and the French (aided by the Germans and Japanese) have seized the opportunity to be obstructive, thereby irritating the Americans. We are now waiting for an Italian initiative to take work forward again.

- Impact of technological change. Shultz is keen that Heads of Government at Toronto should discuss the impact of technological change on world trends and on international relations. At this year's dinner for Summit Foreign Ministers in the margins of the UN General Assembly in New York in September it was agreed that Shultz would circulate a paper on this subject by the end of the year, and that Genscher would host an informal 'brain-storming' meeting of Foreign Ministers in the Spring to consider how to take things further.

11. Finally, a brief word on the Brundtland Report since the Canadians have suggested that energy/environment issues might be briefly addressed in Toronto if the debate on this Report is carried further. The World Commission on Environment and Development, which Mrs Brundtland chaired, published in April a Report entitled 'Our Common Future'. It has attracted considerable public attention, and will no doubt be the subject of further international discussion. Although we have problems with parts of it, we have on the whole welcomed it as comprehensive, realistic and balanced. Sir Crispin Tickell made a statement in the UN General Assembly on 19 October endorsing the Report's central theme of sustainable development based on economic growth. CHOGM likewise welcomed the Report.

Yours ever.

Rodric

R Q Braithwaite

gc Sir G Littler *SLM*

Annex to Richardson to Wickes. 5/2/88