



10 DOWNING STREET

From the Private Secretary

1 October 1985

G5 MEETING

The Prime Minister has seen and noted the Chancellor's minute to her of 30 September, which reported the outcome of the G5 meeting of 22 September.

(David Norgrove)

Mrs. Rachel Lomax,
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PRIME MINISTER

G5 MEETING *mb*

I have already given you an oral report of the meeting at the Plaza Hotel, New York, on 22 September, but I thought you might welcome a written report.

US Treasury Secretary Jim Baker first contacted me by telephone in the middle of August to say that he was increasingly worried about the protectionist legislation which the Congress threatened to pass on its return from the summer holidays, and that he was concerned that this pressure might be reinforced by a strengthening of the dollar. He felt that it was necessary for him to take some major international initiative to avert it, building on the Bonn Summit Communique. He told me that he had already had some so far inconclusive bilateral discussions with the Japanese, and proposed to put his wider proposals to Stoltenberg, the German Finance Minister, the same day as he spoke to me. If I was in principle sympathetic to his view he would like to ask Mulford (his no. 3 at the US Treasury) to talk to Sir Geoffrey Littler in greater detail. He was understandably anxious that any discussions should be conducted in the greatest secrecy, with knowledge kept to the smallest possible circle. It was clear that at that stage he had not even informed Volcker of his thinking.

I told him that, in principle, I welcomed his approach, and that Mulford should certainly get in touch with Littler. I said that I felt it important that any initiative should take place within the framework of the G5, building on the Washington agreement in January. I added that an obstacle hitherto had been US policy towards intervention in the foreign exchange markets: if that had now changed, I saw no fundamental problems at our end.



Over the ensuing weeks there followed a series of (successfully) secret meetings, some of them in London, at G5 Deputy level, with the Deputies regularly reporting to their Ministers.

In the initial approaches, the US put some pressure on Germany and Japan and token pressure on us (at that stage France had not yet been brought in) to announce new policy action to stimulate growth in our own countries which might impress Congress. Not surprisingly, this approach quickly ran into the sand, but both Stoltenberg and I felt that there ought to be scope for some restatement of policy in positive terms which, linked with co-ordinated action in the foreign exchange markets, might have a helpful effect. The final Statement, of which I attach a copy, reflects this approach. Most of it is not new. But the public acknowledgement that the high value of the dollar is a problem to them is something which the United States have only recently come round to and the emphasis on countering protectionism is unequivocal. And of course the most important new element is the virtual 180° turn the Americans have made on concerted intervention in the foreign exchange markets.

Baker made it clear during our meeting in New York that he could not expect to turn the tide of American public opinion on the question of protectionism quickly. His aim was the more modest one of using the G5 operation to influence sufficient members of Congress to prevent key protectionist measures gaining a two-thirds majority, thus enabling the President to use his veto. Throughout our discussions, Baker repeatedly emphasised the firmness of the line the President is taking over protectionism and his willingness to use the veto.

Bak will he be able to sustain it in Congress?

So far, the impact of the announcement has been satisfactory. Over the ensuing week the \$ fell by 8.2% against the Yen, 5.7% against the DM, and 2.5% against sterling. The US objective, which was generally agreed at the New York meeting, was that, over the

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\$ down by 6 % against
DM and 9 % against
Yen so far.

following 6 weeks during which intervention would be engaged in as necessary, the DM should rise against the \$ by up to 10-12% and the Yen by rather more. The matter could be reviewed at the end of the 6-week period. So far as the Fed was concerned, intervention would (for essentially political reasons) consist of resisting any tendency for the \$ to bounce back. Others would not be similarly inhibited. We secured agreement on the broad sharing of intervention - 30% US, 30% Japan, 40% Europe and, in recognition of our relatively low reserves, the UK share is only 5%.

Volcker hopes to keep US interest rates from rising over the next 6 weeks, but understandably did not feel able to give a cast-iron guarantee. There was general agreement (including that of Baker) that the US needed to do more to reduce its Budget deficit, and this is reflected in the Communique. But it is clear that the President remains adamantly opposed to any increase in taxation.

Thanks to the careful preparation, and the changed position of the US, which to some extent reflects the change from Regan to Baker, we managed on this occasion to reach much clearer and better agreement about the arrangements for intervention than was possible last January. This should mean less risk of differences between the participants being identified in the markets and undermining the co-operation. Central Bank experts met last weekend to polish the details. But international co-operation of this kind is not easy, there are some mutual suspicions deriving from past experience, and it would be rash to conclude that no misunderstanding could arise.

We shall obviously be watching with particular interest the development of discussions in Congress on the key protectionist measures pending. We shall also need to keep up the pressure for the new GATT round. Meanwhile, I judge this to have been a useful and successful exercise. If it does turn the tide against the protectionist lobby in Congress it will have proved an event of

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some importance. And finally there is the added bonus for the UK of possibly achieving rather more realistic exchange rates vis-a-vis the Yen and the DM without any £ depreciation overall.

N.L.

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30 September 1985

FINAL

Only para 18

is worth reading

September 22, 1985

Announcement of the Ministers of Finance and
Central Bank Governors of France, Germany,
Japan, the United Kingdom, and the United States

1. Ministers of Finance and Central Bank Governors of France, the Federal Republic of Germany, Japan, the United Kingdom, and the United States met today, September 22, 1985, in the context of their agreement to conduct mutual surveillance and as part of their preparations for wider international discussions at the forthcoming meetings in Seoul, Korea. They reviewed economic developments and policies in each of their countries and assessed their implications for economic prospects, external balances, and exchange rates.
2. At the Bonn Economic Summit in May 1985 the Heads of State or Government of seven major industrial countries and the President of the Commission of the European Communities issued an Economic Declaration Towards Sustained Growth and Higher Employment. In that Declaration the participants agreed that:

The best contribution we can make to a lasting new prosperity in which all nations can share is unremittingly to pursue, individually in our own countries and cooperatively together, policies conducive to sustained growth and higher employment.
3. The Ministers and Governors were of the view that significant progress has been made in their efforts to promote a convergence of favorable economic performance among their countries on a path of steady noninflationary growth. Furthermore, they concluded that their countries are restoring the vitality and responsiveness of their economies. As a result of these developments, they are confident that a firm basis has been established for a sustained, more balanced expansion among their countries. This sustained growth will benefit other industrial countries and will help ensure expanding export markets for developing countries, thereby contributing importantly to the resolution of problems of heavily indebted developing countries.
4. They believe that this convergence of favorable economic performance has been influenced increasingly by policy initiatives undertaken by their countries. Moreover, each of their countries is committed to the implementation of further policy measures which will reinforce favorable convergence and strengthen the sustainability of the current expansion.

5. Ministers and Governors were of the view that recent shifts in fundamental economic conditions among their countries, together with policy commitments for the future, have not been reflected fully in exchange markets.

Recent Economic Developments and Policy Changes

6. Ministers and Governors expect that real growth in aggregate for their countries will be about 3 percent this year, compared to negative growth of -0.7 percent in 1982. Although this figure is down slightly from 1984, growth will be more balanced than at any time in the last four years. After the particularly rapid U.S. growth of 1983-84, there is now increased evidence of internal growth in the other countries. In particular, private investment has picked up strength. The current expansion is occurring in a context of fiscal consolidation; it is not dependent on shortlived fiscal stimulus. As a result of the changes in the components of growth, real growth in their countries can be expected to remain strong as U.S. growth moderates.

7. The current sustained expansion is occurring within a framework of declining inflation, a phenomenon that is unprecedented in the past three decades. Inflation rates are at their lowest in nearly 20 years, and they show no signs of reviving.

8. There has been a significant fall in interest rates in recent years. Apart from welcome domestic effects, this has been particularly helpful in easing the burden of debt repayments for developing countries.

9. This successful performance is the direct result of the importance given to macroeconomic policies which have reduced inflation and inflationary expectations, to continued vigilance over government spending, to greater emphasis on market forces and competition, and to prudent monetary policies.

10. These positive economic developments notwithstanding, there are large imbalances in external positions which pose potential problems, and which reflect a wide range of factors. Among these are: the deterioration in its external position which the U.S. experienced from its period of very rapid relative growth; the particularly large impact on the U.S. current account of the economic difficulties and the adjustment efforts of some major developing countries; the difficulty of trade access in some markets; and the appreciation of the U.S. dollar. The interaction of these factors -- relative growth rates, the debt problems of developing countries, and exchange rate developments -- has contributed to large, potentially destabilizing external imbalances among major industrial countries. In particular, the United States has a large and growing current account deficit, and Japan, and to a lesser extent Germany, large and growing current account surpluses.

11. The U.S. current account deficit, together with other factors, is now contributing to protectionist pressures which, if not resisted, could lead to mutually destructive retaliation with serious damage to the world economy: world trade would shrink, real growth rates could even turn negative, unemployment would rise still higher, and debt-burdened developing countries would be unable to secure the export earnings they vitally need.

Policy Intentions

12. The Finance Ministers and Governors affirmed that each of their countries remains firmly committed to its international responsibilities and obligations as leading industrial nations. They also share special responsibilities to ensure the mutual consistency of their individual policies. The Ministers agreed that establishing more widely strong, noninflationary domestic growth and open markets will be a key factor in ensuring that the current expansion continues in a more balanced fashion, and they committed themselves to policies toward that end. In countries where the budget deficit is too high, further measures to reduce the deficit substantially are urgently required.

13. Ministers and Governors agreed that it was essential that protectionist pressures be resisted.

14. Ministers recognized the importance of providing access to their markets for LDC exports as those countries continue their essential adjustment efforts, and saw this as an important additional reason to avoid protectionist policies. They welcomed the GATT preparatory meeting scheduled for late September and expressed their hope that it will reach a broad consensus on subject matter and modalities for a new GATT round.

15. In this context, they recalled and reaffirmed the statement in the Bonn Economic Declaration on the debt situation.

Sustained growth in world trade, lower interest rates, open markets and continued financing in amounts and on terms appropriate to each individual case are essential to enable developing countries to achieve sound growth and overcome their economic and financial difficulties.

16. The Ministers agreed that they would monitor progress in achieving a sustained noninflationary expansion and intensify their individual and cooperative efforts to accomplish this objective. To that end, they affirmed the statements of policy intentions by each of their countries, which are attached.

Conclusions

17. The Ministers of Finance and Central Bank Governors agreed that recent economic developments and policy changes, when combined with the specific policy intentions described in the attached statements, provide a sound basis for continued and a more balanced expansion with low inflation. They agreed on the importance of these improvements for redressing the large and growing external imbalances that have developed. In that connection, they noted that further market-opening measures will be important to resisting protectionism.

18. The Ministers and Governors agreed that exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has been the case. They believe that agreed policy actions must be implemented and reinforced to improve the fundamentals further, and that in view of the present and prospective changes in fundamentals, some further orderly appreciation of the main non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when to do so would be helpful.

The Government of Japan, noting that the Japanese economy is in an autonomous expansion phase mainly supported by domestic private demand increase, will continue to institute policies intended to ensure sustainable noninflationary growth; provide full access to domestic markets for foreign goods; and internationalize the yen and liberalize domestic capital markets.

In particular, the Government of Japan will implement policies with the following explicit intentions.

1. Resistance of protectionism and steady implementation of the Action Program announced on July 30 for the further opening up of Japan's domestic market to foreign goods and services.
2. Full utilization of private sector vitality through the implementation of vigorous deregulation measures.
3. Flexible management of monetary policy with due attention to the yen rate.
4. Intensified implementation of financial market liberalization and internationalization of the yen, so that the yen fully reflects the underlying strength of the Japanese economy.
5. Fiscal policy will continue to focus on the twin goals of reducing the central government deficit and providing a pro-growth environment for the private sector. Within that framework, local governments may be favorably allowed to make additional investments in this FY 1985, taking into account the individual circumstances of the region.
6. Efforts to stimulate domestic demand will focus on increasing private consumption and investment through measures to enlarge consumer and mortgage credit markets.

The United Kingdom Government, noting that the British economy has been experiencing steady growth of output and domestic demand over the past four years, will continue to pursue policies designed to reduce inflation; to promote sustained growth of output and employment; to reduce the size of the public sector; to encourage a more competitive, innovative, market orientated private sector; to reduce regulation and increase incentives throughout the economy; and to maintain open trading and capital markets free of foreign exchange controls.

In particular, the United Kingdom Government intends:

1. To operate monetary policy to achieve further progress towards price stability and to provide a financial environment for growing output and employment; and to buttress monetary policy with a prudent fiscal policy.
2. To continue to reduce public expenditure as a share of GDP and to transfer further substantial parts of public sector industry to private ownership.
3. To reduce the burden of taxation in order to improve incentives and to increase the efficient use of resources in the economy.
4. To take additional measures to improve the effective working of the labour market, including the reform of Wages Councils and improvements in youth training; and implement proposals to liberalize and strengthen competition within financial markets.
5. To resist protectionism.

The United States Government is firmly committed to policies designed to: ensure steady noninflationary growth; maximize the role of markets and private sector participation in the economy; reduce the size and role of the government sector; and maintain open markets.

In order to achieve these objectives, the United States Government will:

1. Continue efforts to reduce government expenditures as a share of GNP in order to reduce the fiscal deficit and to free up resources for the private sector.
2. Implement fully the deficit reduction package for fiscal year 1986. This package passed by Congress and approved by the President will not only reduce by over 1 percent of GNP the budget deficit for FY 1986, but lay the basis for further significant reductions in the deficit in subsequent years.
3. Implement revenue-neutral tax reform which will encourage savings, create new work incentives, and increase the efficiency of the economy, thereby fostering noninflationary growth.
4. Conduct monetary policy to provide a financial environment conducive to sustainable growth and continued progress toward price stability.
5. Resist protectionist measures.