PO-CH/NL/0081

PART C

Part .C.

SECRET

(Circulate under cover and
notify REGISTRY of movement)

Begins : 1/4/87
Ends : 18/05/87

PO -CH /NL/0081

PART C

Chancellor's (Lawson) Papers:

GROUP OF FIVE AND GROUP
OF SEVEN MEETING 1987

PO -CH /NL/0081
PART C

Disposal Directions: 25 years

27/7/95

Chief Economic Adviser to the Treasury

c Mr Evans
Mr O'Donnell

Sir G Littler

I attach a draft of a note I am preparing for the Chancellor. I would be grateful for any comments. I am hoping to put it to him tomorrow

TB
1/4/87

Mr Allan

The Chancellor might like to glance at this draft before the 4pm meeting. As you see I am inviting comments from Sir G Littler et al.

TB

THE PARIS AGREEMENT: THE NEXT STEPS

You asked me to record my views about how we might take the Paris Agreement forward. This note sets out a possible approach.

2. I begin with the presumption that we would prefer to see greater exchange rate stability over the medium term. Some commentators continue to argue that exchange rates are market determined and that it is impractical for Governments to exercise much influence over them. However, a casual observation of the path of the effective exchange rates of the major industrial countries demonstrates that fluctuations have been much greater than was expected; and much greater than could possibly be justified by the underlying economic circumstances. The interaction of the currency markets has led to exchange rates running in one direction for sustained periods during which very large shifts in real exchange rates have taken place. Once the tide has turned we have then seen sustained movements in the opposite direction which have virtually unwound all the previous real exchange rate change.

3. It is becoming increasingly evident that these large swings in real exchange rates have damaged the performance of the major industrial economies. They do not adapt quickly to change, and substantial shifts of emphasis between domestic and external demand, and between tradeables and non-tradeables have been disrupting. Forward markets can help companies to cover shorter term transactions but can not reduce the risk of expanding or contracting capacity in particular countries.

4. At the same time we recognise that it would not be feasible to direct policy exclusively towards exchange rate stability. There are other important considerations. The first is that, from time to time, changes in the underlying performance of the economies will require significant real exchange rate changes. Second, the scale and volatility of capital flows mean it may be impossible to put rigid limits on exchange rate variation.

Third, it is important to avoid destabilising domestic monetary conditions in the individual countries and in the aggregate. Otherwise we would have merely solved one problem and created many others. And finally it is important that greater exchange rate stability should be combined with a maintenance of low inflation. We need to avoid any procedures that have a built-in inflationary or deflationary bias for the industrial countries, as a whole.

5. It is sometimes argued that greater exchange rate stability requires more compatible policies - both fiscal and monetary. There is much truth in this argument. But we have seen that only small differences in policy stance can create very large swings in real exchange rates. And more importantly past experience suggests that an effective commitment to stable exchange rates can itself be an important discipline to produce compatible policies.

6. What follows is conditional upon the acceptance of the objective of greater exchange rate stability. I attempt to outline an approach that would gradually bring us towards greater exchange rate stability. As far as possible it is based upon our own experience of operating policy and attempts to extend the approach we have adopted to international co-ordination. If in the process it turns out that the disadvantages and the problems are too great, then this would be a clear indication that it would be futile to try to go any further.

7. My starting point is that there should be two components:

- an agreement to give significant weight to exchange rate changes in the operation of financial policy - primarily monetary but also fiscal;

- an agreement to develop a nominal framework to monitor and to control the average inflation rate of the G7 collectively.

In other words we need a nominal framework to pin down the average inflation rate of the G7 and to combine it with steady growth; and an exchange rate discipline to keep individual countries' performance reasonably close to the average whilst permitting some differences.

<u>Agreement to foster exchange rate stability</u>

8. The agreement to foster exchange rate stability might have the following components:

- a "reference range" for each currency expressed in terms of its own rate against the SDR; initially this could be plus or minus 5 per cent. These ranges themselves would have to be revised periodically;

- an agreement by each country involved to give significant weight to movements of exchange rate relative to the reference range in the operation of monetary policy. There would be no absolute requirement to keep exchange rates within the reference range but it would be a requirement to take explicit action if there were signs of the exchange rate moving outside the range;

- countries would be called to account for their actions during the previous period on a regular basis; particularly to explain any sustained deviation of exchange rate from its reference range. G7 Ministers might meet 3 or 4 times a year to review developments and the ranges. Deputies would meet more often;

- there would be a role for judicious tactical intervention, preferably of a concerted nature. But we would not normally look to massive and sustained intervention to defend the limits of ranges. Any intervention would have to remain largely unsterilised. In other words it would be important that countries allowed their intervention to ease or tighten monetary conditions;

- initially the reference ranges would be unpublished, although it would be necessary to accept that this may not be possible for long;

- each country would monitor its rate of growth of money GDP and possibly domestic demand relative to productive potential. This would be an important indicator as to whether adjustments to reference ranges were necessary.

Agreement to control G7 Inflation Rate

9. Any exchange rate agreement needs to be buttressed by a mechanism to stabilise the average inflation rate of the individual countries. If this is absent persistent inflationary or deflationary biases might emerge. In the Bretton Woods system the dollar played this role and until the mid 60s it played it quite effectively. Subsequently US inflation picked up and the progressive failure of the dollar to fulfil its role as an anchor for price stability was an important reason for the crumbling of the system.

10. The aggregate inflation control component of the agreement could be developed from the present surveillance methodology but in a much simpler form. The important component would be an agreement to establish a clear nominal framework for the average of the G7 countries. We would have to compute accepted indicators for the G7 as a whole and agree to conduct policy in aggregate so that performance was in line with the overall inflation objective.

11. Following our own experience this would be best done by setting medium term objectives for money GDP, although there may be some inclined to concentrate on inflation and output separately. These objectives would have to be monitored using the same sorts of procedures that we currently employ in the UK. There would be some role for monitoring monetary aggregates and other financial indicators but it would take time to develop confidence in them.

12. In this process I would give an important role to commodity prices. They are the most flexible prices in the world economy and respond most quickly to changes in monetary conditions. Generally if commodity prices are falling this is a sign that there is continuing downward pressure upon money GDP and inflation and vice versa. For the aggregate G7 economies the level of commodity prices would play much the same role as the exchange rate for individual countries.

Some Questions

Why Now?

The recent reversal of the dollar and the accompanying rise of the Yen and DM are extra evidence of the unnecessary shifts in exchange rates we have seen over the past 6 years. In addition the constellation of exchange rates is now better than it has been for 5 years. This would also be a convenient moment to begin from the point of view of world inflation. The indicators continue to point to an absence of inflationary pressure and the objective would be to lock in the present low rate.

What would signal the need for a change in reference rates?

Changes in reference rates would obviously have to be a matter for mutual agreement. In practice they would often be the result of persistent market pressures in one direction or another that seem to call for an inappropriate monetary response. For example if a country was experiencing persistent upward pressure on its exchange rate despite recent interest rate reductions and there was a threat of excessive growth of money GDP there would be a clear suggestion that the exchange rate should be revised upwards.

What would signal the need for a change of fiscal policy?

The presumption would be against fiscal policy changes which should be set in a medium term context. If current account surpluses or deficits persist and there is little scope for further adjustments of interest rates there would be some suggestion of the need for supporting fiscal policy changes.

How detailed should intervention procedures be?

Not very detailed. I see no immediate prospect of setting up a G7 equivalent of EMS. In addition I doubt if it would be desirable. The important next step is to get some shift of behaviour - not a complete change. It follows that we would not be looking for complicated intervention rules, diversion indicators, or open-ended intervention when limits are reached.

What would have changed?

The biggest change would be the acceptance by countries, particularly Germany and the US, that exchange rate changes have a significant weight in monetary policy decisions and that domestic money indicators have a smaller weight. Discussions of the G7 economy as a whole would be a development of the indicators exercise.

What are the implications for the objective indicators exercise?

Most of it would be unnecessary. A simplified version would be directed towards the aggregate G7, the rest would be only relevant if it supported the exchange rate objectives.

What interest rates response would we expect for given exchange rate changes?

There is no obvious rule. It would be for individual countries to choose but partner countries would have to be persuaded it was sufficient.

What powers of enforcement exist? None other than potential exclusion from the club and having to explain and defend actions to member countries.

Why monitor money GDP growth? We have found it useful as a focus for monetary policy design. It represents the growth of total cash spending in the economy. Experience suggests that if it can be gradually reduced the result is steady growth of real output at close to productive potential and gradually declining inflation.

What are the implications for the present stance of policy in the G7 as a whole?

The oil price decline has produced a sharp reduction in the growth of G7 money GDP. In other words most of the benefits have been taken in the form of lower inflation rather than faster output growth. If anything I would conclude that policy in aggregate has been too tight. This also shows up in the behaviour of commodity prices. After falling in the 12 months up to last October we have had 6 months of virtual stability despite the low level of real commodity prices. This also suggests some room for an easing of the overall policy stance.

What implications for the present stance of monetary policy in individual countries?

Continued Yen and DMark strength combined with dollar weakness suggests that, if anything, there is further scope for Japanese and German interest rates to fall. US rates may have to rise but as there may be some room for an easing in the aggregate G7 stance this is less urgent.

What are the implications for the present stance of fiscal policy in individual countries?

Interest rates in Germany and Japan are already at very low levels; and current account imbalances are expected to persist. In general this points to a further tightening of US fiscal policy and maybe some easing in Japan and Germany.

Are present exchange rates satisfactory?

We have had a big exchange rate correction. It will take time to have an effect and meanwhile J-curve effects hide progress. A period of stability whilst the effects come through could be welcome. We may then have to conclude that a further change is necessary but it should be gradual and come at a later stage.

Are any other actions necessary?

Clearly Europe has to continue to do what it can to strengthen the supply performance of the economy. Lower taxes, greater labour market flexibility and more deregulation would help. And Japan has to take much more active steps to open its markets to other countries. It is not possible to have free movement of capital and such widespread restrictions on trade. This can only lead to huge imbalances in the world economy that invites retaliation - both on trade and capital movements.

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

MANAGING DIRECTOR

ADDRESS
RFUND

To: Mr. Dallara
Mr. Grosche
Mr. Lankester
Mr. Massé
Mrs. Ploix
Mr. Yamazaki
Mr. Zecchini

April 2, 1987

From: The Managing Director

Subject: Economic Indicators and Policy Issues

I should be grateful if you would transmit the attached note and tables to your authorities by confidential channels.

Attachment

Economic Indicators and Policy Issues

Note Submitted by the Managing Director

1. Introduction

This note provides a revised assessment of economic prospects and issues in the light of recent developments and the policy commitments made at the Louvre meeting. It begins with a brief recapitulation of these commitments, noting the extent to which they have so far been put into effect, and the assumptions the Fund staff has made in revising its projections. There then follows an assessment of the revised forecasts; a review of the possible "tensions" that may emerge; and a listing of policy issues that warrant attention. The tables attached to this note assume full implementation of the Louvre Agreement (in the sense described below); in this, they differ somewhat from the projections circulated to the Interim Committee.

2. Policy commitments

The United States has stated its aim of reducing its fiscal deficit from 3.9 percent of GNP in FY 1987 (ending September 30, 1987) to 2.3 percent in FY 1988. To achieve this, it is stated that spending increases are to be held to under 1 percent in FY 1988. In the projections attached to this note, it is assumed that the measures proposed in the FY 1988 budget (which are directed at achieving these objectives) will be implemented in full. This fiscal stance is assumed to be associated with a further decline in interest rates of about 3/4 percentage point from the levels prevailing at end-March 1987.

Japan reduced its discount rate by 1/2 percent on February 23rd, as foreshadowed in the Louvre Communique. The projections attached to this note assume that the 1987/88 budget and the proposed tax reform will be approved as proposed. They also assume that a package of stimulus measures equivalent to 0.3 percent of GNP will be introduced toward the end of calendar 1987. Consideration of the economic program alluded to in the Communique awaits the passage of the FY 1987/88 budget, which has been delayed.

The Federal Republic of Germany has undertaken to pursue a comprehensive tax reform, and to increase the size of the 1988 tax cuts. The attached projections assume additional tax cuts of DM 5 billion (0.3 percent of GNP) to take effect on January 1, 1988. Monetary policy is to be directed at improving the conditions for sustained growth while maintaining price stability.

The United Kingdom intends to pursue a prudent monetary policy and to maintain public sector borrowing at a low level. The recent budget and the associated cuts in interest rates would appear consistent with these objectives. It is assumed that the U.K. budget deficit will remain at approximately its current level in 1988. France has undertaken to reduce its central government deficit by 1 percent of GNP from 1986 to 1988. In 1987, the deficit is estimated to fall by close to 1/2 of 1 percent; it is therefore assumed that a cut of a further 1/2 percent will be made next year. Canada has also stated its commitment to budget deficit reduction; since significant cuts were already envisaged in the projections presented in February, no further changes are made in the attached tables. As far as Italy is concerned, a withdrawal of fiscal stimulus of about 1 percent in 1987 is expected to be followed by little further change in the following year.

In reflection of the policy commitments made in the Louvre Accord, and the related agreement to cooperate closely to foster exchange rate stability, exchange markets were more settled in the several weeks after the Accord than they were before it. Initially the main movement was a 4 percent effective appreciation of the pound sterling in the four weeks following the Accord, apparently in response to relatively high interest rates and perceptions of improved economic performance in the United Kingdom. More recently, market tensions have re-emerged, indicating that markets are still highly sensitive, and can react sharply to official statements and changes in sentiment.

3. Key features of the projections

The new set of forecasts incorpofate the Louvre commitments, and differ from those presented to the Louvre meeting in the following ways.

- Fiscal policies are assumed to be directed toward increased restraint of expenditure in the United States and France and, to a lesser extent, toward increased stimulus in Germany. In Japan, the measures of stimulus incorporated in the attached projections were already assumed in February.

- Balance of payments disequilibria are somewhat less than had been envisaged in the forecasts presented in the Louvre meeting. Nevertheless, the deficit of the United States is projected to remain large into the medium term, as are the corresponding surpluses of Japan and, to a lesser extent, Germany.

- Economic growth seems likely to be less robust in the short term. This largely reflects the fact that the additional fiscal restraint in the United States and France will be greater than the additional stimulus assumed for Germany. Additional fiscal restraint in the United States can be expected to exert a negative effect on GNP in the short run. (Looking further ahead, of course, the eventual "crowding in" of private investment should enable a strengthening of the medium term growth performance in the United States.)

- Inflation prospects are little changed from those presented in February. The underlying pace of inflation appears to be around 2 1/2-3 1/2 percent in Canada, the United States, France, Germany, and Japan, and somewhat higher in Italy and the United Kingdom.

4. Tensions in the projections

The potential tensions in the accompanying projections are of two major types.

(i) Current account imbalances, while smaller than those considered in February, remain large. On the basis of projections, the accumulation of net assets by Japan would reach some 25 percent of GDP by 1991; by the same date the U.S. net debtor position would be around $900 billion (over 15 percent of GDP). The question arises of whether these payments positions can be regarded as sustainable, and under what terms and conditions they could be financed.

(ii) Economic activity in the short run is likely to be weaker than is consistent with absorbing unemployment and laying the basis for a satisfactory solution of the debt situation. The basic reason for this is that a rapid correction of the fiscal problem in countries with large deficits is expected to have some short-run adverse effects on output.

The foregoing tensions would be alleviated if structural changes took place that enabled economies to respond more effectively and quickly to changes in fiscal positions and in exchange rates. Without such changes (which in any event would have their main effects over the medium term) interest and exchange rates might tend to be different from those currently prevailing. Payments imbalances, if they continued to be large, would presumably generate upward pressure on the currencies of countries in surplus. Weakness of economic activity would tend to make interest rates lower than they would otherwise be, thus helping limit a decline in demand.

5. Policy issues

The key policy issue facing the large industrial countries is, as it has been for some time, how to combine the reduction of fiscal and payments imbalances with the maintenance of growth and an environment conducive to dealing with the problems of indebted countries. Several requirements appear to be of central importance in achieving this outcome.

- First, a continuing and credible reduction in the U.S. budget deficit is needed to free resources for strengthening the payments position, and to underpin confidence in financial markets. The probability that stronger fiscal action in the U.S. would lead to a short-term deceleration in domestic demand in that country is not a reason for avoiding such action.

- Second, in order to offset the effects of reduced spending in the United States, domestic demand in other countries has to grow robustly. This calls for a flexible implementation of macroeconomic (especially fiscal) policies, and a willingness to employ structural measures that encourage spending, particularly investment spending.

- Third, net exports of industrial countries to the developing world may need to grow. This could result from a combination of faster import growth in certain newly industrialized countries that have strong external positions, and larger financial flows to indebted countries with sound medium-term adjustment programs.

- Fourth, in view of the current threat to an open trading environment, firm resistance to protectionist pressures is needed to enable deficit countries to strengthen their external position to the extent that their competitive position warrants. The evident sensitivity of exchange markets to trade frictions provides an additional reason for the major countries to make a concrete demonstration of their commitment to avoid such frictions.

If these conditions are met, then stability of exchange rates at levels that are consistent with confidence in the functioning of the international monetary system and with a narrowing of payment imbalances could provide an appropriate environment for encouraging sustainable noninflationary growth in the world economy.

DATE : APRIL 2, 1987

A. OUTPUT
(CHANGES, IN PERCENT)

	YEAR-ON-YEAR CHANGES			THROUGH THE YEAR CHANGES		
	1986	1987	1988	1986 Q4	1987 Q4	1988 Q4
REAL GNP/GDP						
CANADA	3.1	2.0	2.5	1.6	2.6	2.6
UNITED STATES	2.5	2.3	2.0	2.0	2.9	1.5
JAPAN	2.5	2.7	3.0	2.0	2.8	2.9
GERMANY, FED. REP. OF	2.4	1.9	2.0	2.4	1.7	2.0
FRANCE	2.2	1.8	2.0	1.9	2.0	2.0
ITALY	2.8	2.9	2.3	3.0	2.7	2.0
UNITED KINGDOM	2.5	3.0	2.2	3.3	2.1	2.1
MAJOR INDUSTRIAL COUNTRIES	2.5	2.4	2.3	2.2	2.7	2.0
OTHER INDUSTRIAL COUNTRIES	1.5	1.5	1.8			
DEVELOPING COUNTRIES	3.5	3.0	4.0 4.1			
REAL TOTAL DOMESTIC DEMAND						
CANADA	3.5	2.5	2.8	1.3	3.7	3.0
UNITED STATES	3.5	1.6	1.2	2.4	1.8	0.7
JAPAN	4.0	3.8	3.8	3.8	3.9	3.6
GERMANY, FED. REP. OF	3.7	3.2	2.5	4.1	2.1	2.5
FRANCE	4.0	2.2	2.4	3.9	2.4	2.4
ITALY	3.6	4.1	3.0	4.9	3.1	3.0
UNITED KINGDOM	3.2	3.7	2.8	3.8	3.9	2.2
MAJOR INDUSTRIAL COUNTRIES	3.6	2.5	2.2	3.0	2.6	1.9
OTHER INDUSTRIAL COUNTRIES	2.1	1.6	2.0			
DEVELOPING COUNTRIES	0.1	2.2	3.3			

GENERAL NOTE: THE PROJECTIONS IN THIS AND THE FOLLOWING TABLES WERE FINALIZED AS OF MARCH 30, 1987 AND REFLECT THE FOLLOWING WORKING ASSUMPTIONS: OIL PRICES ARE ASSUMED TO AVERAGE $15 PER BARREL IN 1987 AND REMAIN UNCHANGED IN REAL TERMS IN 1988; EXCHANGE RATES ARE ASSUMED TO REMAIN UNCHANGED IN REAL TERMS FROM THE LEVEL PREVAILING IN THE LAST WEEK OF FEBRUARY, 1987; AND "PRESENT" ECONOMIC POLICIES OF THE NATIONAL AUTHORITIES, AS EMBODIED IN THE LOUVRE ACCORD AND OTHER STATEMENTS, ARE ASSUMED TO BE MAINTAINED. THE MAIN DIFFERENCE BETWEEN THE POLICY ASSUMPTIONS USED HERE AND THOSE USED IN THE FUND'S WORLD ECONOMIC OUTLOOK IS THE ASSUMPTION THAT, IN LINE WITH THE PARIS ACCORD, THE FEDERAL BUDGET DEFICIT IN THE UNITED STATES WILL BE CUT BY $42 BILLION RELATIVE TO THE "CURRENT SERVICES" ESTIMATE IN FY 1987/88. THIS CUT, WHICH IS EQUIVALENT TO ABOUT 1 PERCENT OF GNP, HAS INITIAL ADVERSE EFFECTS ON DEMAND AND OUTPUT THAT ARE REVERSED ONLY GRADUALLY, IN PART BECAUSE OF THE ASSUMED CONSTANCY OF REAL EXCHANGE RATES.

DATE : APRIL 2, 1987

B. INFLATION
(CHANGES, IN PERCENT)

	YEAR-ON-YEAR CHANGES			THROUGH THE YEAR CHANGES		
	1986	1987	1988	1986 Q4	1987 Q4	1988 Q4
GNP/GDP DEFLATOR						
CANADA	2.8	3.5	3.2	3.0	3.3	3.2
UNITED STATES	2.6	2.8	3.4	2.1	3.5	3.4
JAPAN	1.8	1.1	2.6	1.1	1.5	2.3
GERMANY, FED. REP. OF	3.3	2.5	2.6	3.2	2.6	2.6
FRANCE	5.3	3.0	2.6	4.9	2.9	2.5
ITALY	9.1	5.7	5.2	9.5	4.2	5.6
UNITED KINGDOM	3.6	4.6	5.0	2.3	4.8	5.2
MAJOR INDUSTRIAL COUNTRIES	3.1	2.7	3.3	2.7	3.1	3.2
CONSUMER PRICES						
CANADA	4.2	4.0	3.3	4.3	3.6	3.2
UNITED STATES	1.9	3.4	3.3	1.3	4.0	3.1
JAPAN	0.6	0.1	2.9	-0.2	0.8	2.9
GERMANY, FED. REP. OF	-0.3	0.7	2.6	-1.1	2.1	2.6
FRANCE	2.2	2.5	2.6	2.1	2.6	2.6
ITALY	5.8	4.7	5.0	4.9	5.2	4.8
UNITED KINGDOM	3.4	4.4	4.8	3.4	4.8	4.9
MAJOR INDUSTRIAL COUNTRIES	1.9	2.6	3.3	1.3	3.2	3.2

DATE : APRIL 2, 1987

C. TRADE AND CURRENT ACCOUNT BALANCES

	1986	1987	1988
CURRENT ACCOUNT (IN BILLIONS OF U.S. DOLLARS)			
CANADA	-6	-9	-12
UNITED STATES	-141	-139	-115
JAPAN	86	83	78
GERMANY, FED. REP. OF	36	35	27
FRANCE	4	-4	2
ITALY	5	4	1
UNITED KINGDOM	-2	-5	-8
MAJOR INDUSTRIAL COUNTRIES	-18	-27	-26
OTHER INDUSTRIAL COUNTRIES	9	9	3
DEVELOPING COUNTRIES	-48	-41	-30
CURRENT ACCOUNT (IN PERCENT OF GNP/GDP)			
CANADA	-1.7	-2.2	-2.7
UNITED STATES	-3.3	-3.1	-2.4
JAPAN	4.4	3.7	3.3
GERMANY, FED. REP. OF	4.0	3.1	2.3
FRANCE	0.5	0.4	0.2
ITALY	0.9	0.6	0.2
UNITED KINGDOM	-0.3	-0.8	-1.1
MAJOR INDUSTRIAL COUNTRIES	-0.2	-0.3	-0.2
OTHER INDUSTRIAL COUNTRIES	0.7	0.6	0.2
DEVELOPING COUNTRIES	-1.7	-1.4	-1.0
TRADE BALANCE (FOB/FOB)(IN BILLIONS OF U.S. DOLLARS)			
CANADA	7	7	6
UNITED STATES	-148	-151	-127
JAPAN	93	89	84
GERMANY, FED. REP. OF	58	70	70
FRANCE	-2	-4	-7
ITALY	3	2	-2
UNITED KINGDOM	-12	-18	-21
MAJOR INDUSTRIAL COUNTRIES	-2	-6	3
OTHER INDUSTRIAL COUNTRIES	2	1	-4
DEVELOPING COUNTRIES	9	10	17
TRADE BALANCE (IN PERCENT OF GNP/GDP)			
CANADA	2.0	1.7	1.3
UNITED STATES	-3.5	-3.4	-2.7
JAPAN	4.7	4.0	3.5
GERMANY, FED. REP. OF	-6.5	-6.3	-5.7
ITALY	0.6	0.2	-0.2
UNITED KINGDOM	-2.2	-2.8	-3.3
MAJOR INDUSTRIAL COUNTRIES	—	—	—
OTHER INDUSTRIAL COUNTRIES	0.2	—	-0.2
DEVELOPING COUNTRIES	0.3	0.4	0.6

DATE : APRIL 2, 1987

D. CENTRAL AND GENERAL GOVERNMENT BALANCES 1/
(IN PERCENT OF GNP/GDP)

	1986	1987	1988
CENTRAL GOVERNMENT BALANCE 2/			
CANADA	-4.9	-4.2	-3.8
UNITED STATES	-4.8	-3.0	-2.9
JAPAN	-4.3	-4.7	-4.6
GERMANY, FED. REP. OF	-0.7	-0.8	-0.9
FRANCE	-2.9	-2.5	-2.0
ITALY	-14.2	-13.1	-13.1
UNITED KINGDOM	-2.6	-2.4	-2.3
MAJOR INDUSTRIAL COUNTRIES	-4.6	-4.1	-3.6
GENERAL GOVERNMENT BALANCE 3/			
CANADA	-5.4	-4.6	-4.2
UNITED STATES	-3.2	-2.9	-2.0
JAPAN	-1.1	-1.4	-1.3
GERMANY, FED. REP. OF	-1.0	-1.0	-1.1
FRANCE	-2.8	-2.8	-2.3
ITALY	-12.3	-11.5	-11.5
UNITED KINGDOM	-2.9	-2.7	-2.6
MAJOR INDUSTRIAL COUNTRIES	-3.2	-2.9	-2.4

1/ FOR JAPAN, IT HAS BEEN ASSUMED THAT AS IN FY 1986/87, SOME ADDITIONAL STIMULATIVE MEASURES WOULD BE TAKEN IN THE LATER PART OF FY 1987/88.
2/ DATA FOR JAPAN INCLUDE THE SURPLUS OF THE SOCIAL SECURITY ACCOUNTS AND NET LENDING BY THE FISCAL INVESTMENT AND LOAN PROGRAM (FILP) TO NONFINANCIAL PUBLIC ENTITIES. DATA FOR FRANCE ARE ON AN ADMINISTRATIVE BASIS AND DO NOT INCLUDE SOCIAL SECURITY TRANSACTIONS. DATA FOR GERMANY ARE ON A MODIFIED ADMINISTRATIVE BASIS, WITH REVENUE FROM THE SALE OF GOVERNMENT ASSETS COUNTED AS A FINANCING ITEM, AND INCLUDE THE SOCIAL SECURITY SYSTEM. DATA FOR ITALY ARE ON A CASH BASIS. DATA FOR OTHER COUNTRIES ARE ON A NATIONAL INCOME ACCOUNTS BASIS.
3/ NATIONAL INCOME ACCOUNTS BASIS.

Table E.
Major Industrial Countries: Spot Exchange Rates, and Nominal and Real Effective Exchange Rates

	1980	1985	1986	1985 Q1	1987 Jan.	1987 Feb.	1987 Mar.	1987 Feb. 20 1/	1987 Feb 23-27 2/	1987 Mar. 31
Spot exchange rates (currency units per U.S. dollar except as noted)										
Canada	1.17	1.37	1.39	1.35	1.36	1.33	1.32	1.33	1.33	1.31
Japan	227	239	169	258	154	153	152	154	154	146
Germany, Fed. Rep. of	1.82	2.94	2.17	3.26	1.86	1.83	1.83	1.83	1.83	1.81
France	4.23	8.99	6.93	9.96	6.19	6.08	6.11	6.10	6.09	6.03
Italy	856	1909	1491	2021	1315	1299	1305	1303	1300	1287
United Kingdom (US$/ £)	2.33	1.30	1.47	1.12	1.51	1.53	1.59	1.53	1.54	1.61
Effective exchange rates (Indices, 1974-86=100)										
In real terms 3/										
Canada	91.9	94.8	86.7	98.4	87.1	88.7	89.5	89.0	88.8	89.8
United States										
IMF estimates	85.7	125.9	100.7	135.1	93.0	91.4	90.8	91.6	91.4	89.0
Morgan Guaranty estimates										
Narrow definition 4/	92.6	126.1	104.7	134.6	97.6	95.7	...	...	...	...
Broad definition 5/	90.1	123.5	106.9	129.7	101.2	100.0	...	...	...	...
Japan	93.1	92.7	112.5	92.4	112.3	112.4	113.7	112.3	112.4	117.2
Germany, Fed. Rep. of	105.1	93.7	102.6	91.6	107.7	108.8	108.0	108.7	108.5	108.2
France	104.9	96.2	97.9	94.3	97.5	97.6	97.0	97.4	97.4	95.8
Italy	97.2	99.2	101.5	102.0	107.3	106.4	105.7	106.2	106.2	105.6
United Kingdom	114.0	113.2	108.3	103.3	102.1	102.5	105.7	102.9	103.4	105.9
In nominal terms 6/										
Canada	92.5	95.0	85.6	98.5	84.5	85.8	86.6	86.2	86.0	86.9
United States	85.0	127.6	104.1	135.9	95.6	94.3	93.7	94.5	94.4	91.9
Japan	92.9	118.1	149.7	113.5	154.2	153.9	155.7	153.5	153.9	160.6
Germany, Fed. Rep. of	108.1	103.7	115.0	100.1	123.5	124.2	123.3	124.1	124.1	123.5
France	112.3	79.0	83.8	75.7	85.9	86.4	86.0	86.4	86.4	85.9
Italy	100.2	67.2	69.7	68.4	72.3	72.3	71.8	72.3	72.3	71.8
United Kingdom	109.7	80.3	93.2	82.3	79.6	78.8	82.0	79.0	79.5	81.5

1/ Rates prevailing prior to the Paris meeting.
2/ This pattern of exchange rates was used as a basis for the staff projections shown in Tables A to D.
3/ Based on the Fund's calculations of relative normalized unit labor costs in manufacturing adjusted for exchange rate changes, except where otherwise noted.
4/ Vis-à-vis 15 industrial country currencies.
5/ Vis-à-vis 18 industrial country and 22 developing country currencies.
6/ Based on the Fund's MERM calculations.

Table F.

Major Industrial Countries: Nominal and Real Short-Term Interest Rates, 1/

(In percent)

				1986				1987			
	1984	1985	1986	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Mar.31 2/
Nominal rates											
Canada	11.3	9.6	9.2	8.4	8.4	8.4	8.3	8.0	7.4	7.1	6.9
United States	10.4	8.0	6.5	5.7	5.7	5.8	6.0	5.9	6.1	6.2	6.3
Japan	6.3	6.7	5.1	4.8	4.8	4.3	4.4	4.3	4.2	3.9	4.0
Germany, Fed. Rep. of	6.0	5.4	4.6	4.5	4.6	4.7	4.8	4.4	3.9	3.9	4.0
France	11.7	9.9	7.7	7.1	7.4	7.5	7.9	8.5	8.4	8.0	7.9
Italy	17.1	14.9	12.6	10.8	10.8	11.1	11.4	11.4	11.1	10.6	10.5
United Kingdom	9.9	12.2	10.9	10.1	11.1	11.1	11.3	11.0	10.8	10.0	9.9
Real rates 3/											
Canada	7.3	5.3	4.5	3.4	3.5	3.5	3.5	3.1	2.7	2.4	2.2
United States	7.1	5.3	4.2	3.1	3.1	3.1	3.2	2.9	3.0	3.1	3.2
Japan	4.5	6.0	4.7	4.2	4.0	3.4	3.4	3.2	3.0	2.7	2.8
Germany, Fed. Rep. of	3.7	4.7	4.0	3.4	3.3	3.2	3.2	2.7	2.1	2.1	2.2
France	5.5	5.2	3.8	3.3	3.6	3.7	4.1	4.7	4.5	4.1	4.0
Italy	6.3	4.1	4.7	3.4	3.4	3.7	4.1	4.2	4.0	3.5	3.4
United Kingdom	4.2	6.4	6.6	5.7	6.7	6.6	6.8	6.4	6.2	5.4	5.3

1/ Interest rate on the following instruments: Canada, three-month financial paper; United States, 90-day bank certificates of deposit in secondary market; Japan, discount rate on two-month private bills; France, the Federal Republic of Germany, Italy, and the United Kingdom, three-month interbank loan rate.

2/ Estimates for March are from provisional sources and may be subject to minor revisions.

3/ Short-term interest rates deflated by an average of the increase in the private final doemstic demand deflator in the current and the following two quarters; for the most recent period, staff projections of the deflator are used.

88

STOLTENBERG SAYS PARIS ACCORD POLICY TO CONTINUE NRFN

BONN, APRIL 3 - WEST GERMAN FINANCE MINISTER GERHARD STOLTENBERG SAID THE CURRENCY AGREEMENT REACHED IN PARIS IN FEBRUARY HAD BEEN SUCCESSFUL AND WOULD BE CONTINUED.

STOLTENBERG TOLD JOURNALISTS BEFORE HE ATTENDS NEXT WEEK'S INTERNATIONAL MONETARY FUND MEETING IN WASHINGTON THAT: "THE ... STRATEGY TO STABILISE CURRENCIES AROUND CURRENT LEVELS HAS PROVEN ITS WORTH AND WILL ALSO DETERMINE FUTURE DEVELOPMENTS."

STOLTENBERG DECLINED TO COMMENT SPECIFICALLY ON WHAT HE WOULD CONSIDER TO BE AN UNDERVALUED DOLLAR BUT SAID A DOLLAR AROUND 1.80 MARKS CREATED PROBLEMS FOR WEST GERMANY'S EXPORTS.

03-APR-1202 MON076 MONQ

CONTINUED ON - NRFO

P

REUTER MONITOR 0813

STOLTENBERG SAYS =2 BONN NRFO

STOLTENBERG SAID STUDIES BY INTERNATIONAL ORGANISATIONS HAD MADE IT CLEAR THAT ESPECIALLY IN THE U.S. AND IN JAPAN MAJOR EFFORTS REMAINED NECESSARY TO SUPPORT ADJUSTMENTS IN FOREIGN TRADE BALANCES VIA NECESSARY CORRECTIONS TO ECONOMIC POLICY.

"NO ONE WOULD BENEFIT IF, AFTER YEARS OF OVER-VALUATION, THE U.S. DOLLAR FELL INTO THE OTHER EXTREME, THAT IS, STRONG UNDER-VALUATION," HE SAID.

STOLTENBERG SAID WEST GERMANY HAD A KEEN INTEREST IN A SWIFT AGREEMENT BETWEEN THE U.S. AND JAPAN CONCERNING THE CURRENT TRADE DISPUTE OVER SEMI-CONDUCTORS.

03-APR-1202 MON078 MONQ

CONTINUED FROM - NRFN REUTER

P

REUTER MONITOR 0813

pwp

SECRET

From: Sir G.Littler
Date: 3 April 1987

CHANCELLOR

c.c. Governor

G5/G7

We have picked up some indications of most recent Italian thoughts about this - which seem a little more helpful.

2. The first point is that Ruggiero has been advising that Italy must attend the Washington G7, whatever else happens, as a means of reaching agreement on future arrangements.

3. The second is an indication of what Italy might settle for:

- G7 must be seen as the public forum for settlement of matters concerning the international monetary system;
- Governors must be included in G7 meetings (presumably not at Summits);
- Italy and Canada must be included in any collective stage of preparation: this means that G7 Deputies would join in any preliminary drafting work (I think now that we must accept this);
- If US, Japan or Germany are having key bilaterals among each other, they bring in Italy and Canada (perhaps by contact from Germany and US in particular) on similar terms to UK and France (I think we could accept, while leaving precise arrangements fuzzy - as they are now!);
- In return they would not insist on defining separate areas of responsibility for G5; they would still like - but on practical grounds might not insist on it - to have G5 and G7 separated in time.

GL

GEOFFREY LITTLER

FROM: SIR T BURNS
DATE: 3 APRIL 1987

CHANCELLOR

Ch
Revised version
of Terry's paper
AA

cc Financial Secretary
Sir P Middleton
Sir G Littler
Mr Cassell
Mr Evans
Mr Peretz
Mr Odling-Smee

POST-LOUVRE: THE NEXT STEPS

You asked me to record my views about how we might take the Paris Agreement forward. This note sets out a possible approach. It has been assembled quickly. Obviously we need to look at the particular arrangements in much more detail. I put it forward with the aim of stimulating discussion.

2. I begin with the presumption that we would prefer to see greater exchange rate stability over the medium term. Although some exchange rate changes have reflected oil price shocks and changes in underlying performance many have not. A casual observation of the path of the effective exchange rates of the major industrial countries demonstrates that fluctuations have been much greater than was expected; and much greater than could possibly be justified by the underlying economic circumstances. The interaction of the currency markets has led to exchange rates running in one direction for sustained periods during which very large shifts in real exchange rates have taken place. Once the tide has turned we have then seen sustained movements in the opposite direction which have virtually unwound all the previous real exchange rate change. (See Chart 1).

3. It is becoming increasingly evident that these large swings in real exchange rates have damaged the performance of the major industrial economies. They do not adapt quickly to change, and substantial shifts of emphasis between domestic and external demand, and between tradeables and non-tradeables have been disrupting. Forward markets can help companies to cover shorter term transactions but cannot reduce the risk of expanding or contracting capacity in particular countries.

nominal v real

4. At the same time we recognise that it would not be feasible to direct policy exclusively towards exchange rate stability. There are other important considerations. The first is that, from time to time, changes in the underlying performance of the economies will require significant real exchange rate changes. Second, the scale and volatility of capital flows mean it may be impossible to put rigid limits on exchange rate variation. Third, it is important to avoid excessive volatility in interest rates and domestic monetary conditions in the individual countries and in the aggregate. Otherwise we would have merely solved one problem and created many others. And finally it is important that greater exchange rate stability should be combined with a maintenance of low inflation. We need to avoid any procedures that have a built-in inflationary or deflationary bias for the industrial countries, as a whole.

5. It is sometimes argued that greater exchange rate stability requires more compatible policies - both fiscal and monetary - and therefore the emphasis should be on policy co-ordination. There is much truth in this argument. But attempts to co-ordinate policy may not be sufficient. We have seen that only small differences in policy stance can create very large swings in real exchange rates. This points to an explicit focus on exchange rate movements. Past experience suggests that an effective commitment to stable exchange rates can itself be an important discipline to produce compatible policies. It is no guarantee of compatibility but it exercises pressure in the appropriate direction.

6. What follows is conditional upon the acceptance of the objective of greater exchange rate stability. I attempt to outline an approach that would gradually achieve that objective. As far as possible it is based upon our own experience of operating policy and attempts to extend that approach to international policy co-ordination. If in the process it turns out that the disadvantages and the problems are too great, then this would be a clear indication that it would be futile to try to go any further.

7. My starting point is that there should be two components:

- an agreement to give significant weight to exchange rate changes in the operation of financial policy - primarily monetary but also fiscal;

- an agreement to develop a nominal framework to monitor and to control the average inflation rate of the G7 collectively.

In other words we need a nominal framework to pin down the average inflation rate of the G7 and to combine it with steady growth; and an exchange rate discipline to keep individual countries' performance reasonably close to the average whilst permitting some differences.

Agreement to foster exchange rate stability

8. The agreement to foster exchange rate stability might have the following components:

- a "reference range" for each currency expressed in terms of its own rate against the SDR; initially this could be plus or minus 5 per cent. These ranges themselves would have to be revised periodically;

- an agreement by each country involved to give significant weight to movements of exchange rates relative to the reference range in the operation of monetary policy. There would be no absolute requirement to keep exchange rates within the reference range but it would be a requirement to take explicit action - either intervention or interest rate changes - if there were signs of the exchange rate moving outside the range;

- countries would be called to account for their actions during the previous period on a regular basis; particularly to explain any sustained deviation of the exchange rate from its reference range. G7 Ministers might meet 3 or 4 times a year to review developments and the ranges. Deputies would meet more often;

- there would be a role for judicious tactical intervention, preferably of a concerted nature. But we would not normally look to massive and sustained intervention to defend the limits of ranges. Any intervention would have to remain largely unsterilised. In other words it would be important that countries allowed their intervention to ease or tighten monetary conditions;

ghow!

- the main policy instrument for responding to movements of the exchange rate towards the edges of its reference range would be interest rates. This would mean that most monetary authorities would have to give relatively more weight to the exchange rate in their operation of policy than they are accustomed to;

- initially the reference ranges would be unpublished, although it would be necessary to accept that this may not be possible for long. Eventually the aim would be to publish ranges to act as an anchor for exchange rate expectations.

Agreement to control G7 Inflation Rate

9. Any exchange rate agreement needs to be buttressed by a mechanism to stabilise the average inflation rate of the individual countries. If this is absent persistent inflationary or deflationary biases might emerge. In the Bretton Woods system US monetary policy played this role and until the mid '60s it played it quite effectively. Subsequently US inflation picked up and the progressive failure of the dollar to fulfil its role as an anchor for price stability was an important reason for the crumbling of the system.

10. The aggregate inflation control component of the agreement could be developed from the present surveillance methodology but in a much simpler form. An important component would be an agreement to establish a clear nominal framework for the average of the G7 countries. We would have to compute accepted indicators for the G7 as a whole and agree to conduct policy in aggregate so that performance was in line with the overall inflation objective.

11. Following our own experience we would prefer this to be done by setting medium term objectives for money GDP, although I accept that this carries little weight with other countries and initially we may have to consider inflation and output separately. These objectives would have to be monitored. We would wish to use similar procedures to those we currently employ in the UK; but it is likely that the Fed and Bundesbank have their own ways of looking at these things. The aim would be to agree on monetary aggregates and other financial indicators, including general economic indicators, which would be taken into account in assessing monetary conditions at G7 level.

12. In this process I would give an important role to non-oil commodity prices. They are the most flexible prices in the world economy and respond most quickly to changes in monetary conditions. Although they only have a small direct weight in consumer prices (about 10 per cent), generally if commodity prices are falling this is a sign that there is continuing downward pressure upon money GDP and inflation and vice versa. For the aggregate G7 economies the level of commodity prices would play much the same role as the exchange rate for individual countries.

NKW.

13. As well as procedures for assessing monetary conditions there would also have to be arrangements for deciding who does what when there is an agreed need for an aggregate adjustment. In practice this would be reviewed at the same time as the balance of policy in individual countries.

Some Questions

Why Now?

The recent reversal of the dollar and the accompanying rise of the Yen and DM are extra evidence of the unnecessary shifts in exchange rates we have seen over the past 6 years. In addition the constellation of exchange rates is now better than it has been for 5 years. This would also be a convenient moment to begin from the point of view of world inflation. The indicators continue to point to an absence of inflationary pressure and the objective would be to lock in the present low rate.

What would signal the need for a change in reference rates?

Changes in reference rates would obviously have to be a matter for mutual agreement. In practice they would often be the result of persistent market pressures in one direction or another that seem to call for an inappropriate monetary response. For example if a country was experiencing persistent upward pressure on its exchange rate despite recent interest rate reductions and there was a threat of excessive growth of money GDP there would be a clear suggestion that the exchange rate should be revised upwards.

Assumes all implications of mix setting Int rates & XRs.

What would signal the need for a change of fiscal policy?

The presumption would be against fiscal policy changes as a way of keeping within the reference ranges because it should normally be set in a medium term context. However the persistent use of monetary policy to keep to the exchange rate objectives could lead to a level of interest rate and/or a pattern of current account surpluses/deficits which were unsatisfactory and/or unsustainable. At this stage fiscal policy correction could be the way to restore balance while keeping within the exchange rate reference rates. In these circumstances fiscal policy changes might be an important adjunct to changes in reference rates.

???

How detailed should intervention procedures be?

Not very detailed. I see no immediate prospect of setting up a G7 equivalent of EMS. In addition I doubt if it would be desirable. The important next step is to get some shift of behaviour - not a complete change. It follows that we would not be looking for complicated intervention rules, diver~~sion~~gence indicators, or open-ended intervention when limits are reached.

What would have changed?

The biggest change would be the acceptance by countries, particularly Germany and the US, that exchange rate changes have a significant weight in monetary policy decisions and that domestic money indicators have a smaller weight. The other major change would be the increased emphasis on developments in the G7 economy as a whole.

What are the implications for the objective indicators exercise?

Most of it would be unnecessary. A simplified version would be directed towards the aggregate G7. For individual countries indicators would be directed towards supporting the exchange rate objectives. By far the most important "real" variable is the growth of domestic demand.

What interest rates response would we expect for given exchange rate changes?

There is no obvious rule. It would be for individual countries to choose but partner countries would have to be persuaded it was sufficient.

What powers of enforcement exist?

None other than potential exclusion from the club and having to explain and defend actions to member countries.

Why monitor money GDP growth?

We have found it useful as a focus for monetary policy design although recognise that policy could also be framed in terms of an inflation target. Money GDP represents the growth of total cash spending in the economy. Experience suggests that if it can be gradually reduced the result is steady growth of real output at close to productive potential and gradually declining inflation.

What are the implications for the present stance of policy in the G7 as a whole?

See Tables 1 and 2. The oil price decline has produced a reduction in the growth of G7 money GDP. In other words most of the benefits have been taken in the form of lower inflation rather than faster output growth. If anything I would conclude that policy in aggregate has been too tight whilst recognising a wide margin of uncertainty about the timing of the effect of lower oil prices. Policy tightness also shows up in the behaviour of commodity prices. After falling in the 12 months up to last August we have had 6 months of virtual stability despite the low level of real commodity prices. This also suggests some room for an easing of the overall policy stance. I would not want to go too far in response to recent events given the overrun of individual countries' monetary targets but in my view that is the direction in which to move.

What implications for the present stance of monetary policy in individual countries?

Continued Yen and DMark strength combined with dollar weakness suggests that, if anything, there is further scope for Japanese and German interest rates to fall. US rates may have to rise but as there may be some room for an easing in the aggregate G7 stance this is less urgent.

What are the implications for the present stance of fiscal policy in individual countries?

By historical standards, interest rates in Germany and Japan are already at very low levels although on crude calculations "real" interest rates remain high; and current account imbalances are expected to persist. In general this points to a further tightening of US fiscal policy and less urgency for fiscal consolidation in Japan and Germany. However we have argued that, if anything, fiscal policy in the G7 in aggregate is too easy; the bulk of the adjustment should be in the US.

France & Italy, but not [illegible]

[illegible] G5 [illegible] US

Are present exchange rates satisfactory?

We have had a big exchange rate correction. It will take time to have an effect and meanwhile J-curve effects hide progress. A period of stability whilst the effects come through would be welcome. We may then have to conclude that a further change is necessary but it should be gradual and come at a later stage.

Are any other actions necessary?

Clearly Europe has to continue to do what it can to strengthen the supply performance of the economy. Lower taxes, greater labour market flexibility and more deregulation would help. And Japan has to take much more active steps to open its markets to other countries. It is not possible to have free movement of capital and such widespread restrictions on trade. This can only lead to huge imbalances in the world economy that invite retaliation - both on trade and capital movements.

Is this simply target zones?

There are clear similarities to proposals for target zones with soft buffers. But the emphasis is on the nominal exchange rate rather than real rates; and a key part of the proposal is emphasis on the G7 inflation rate as a whole. In particular it attempts to build on the framework we have been developing for the operation of policy in the UK.

Next Steps?

If there was any interest in principle the next steps would be to develop in more detail the relevant indicators and to give more thought to the circumstances that would justify a change in the reference range.

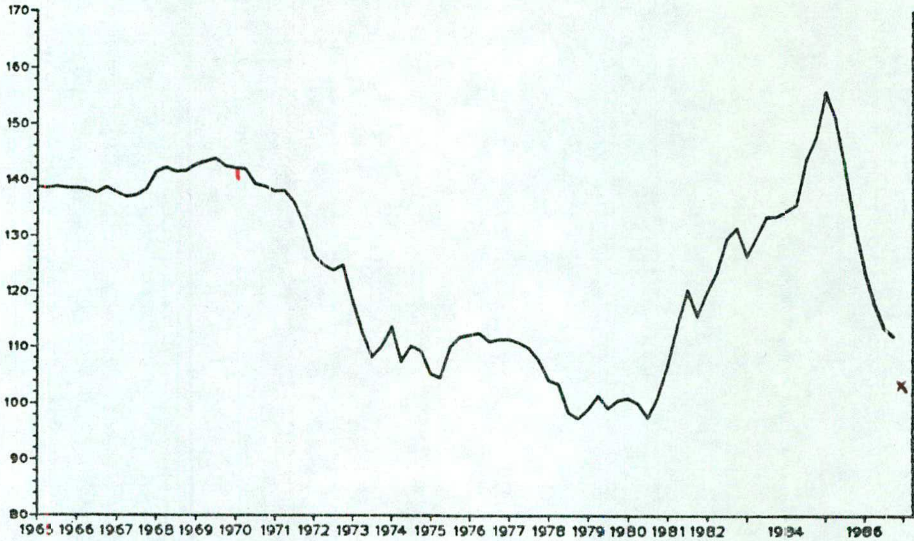
Steve

PG

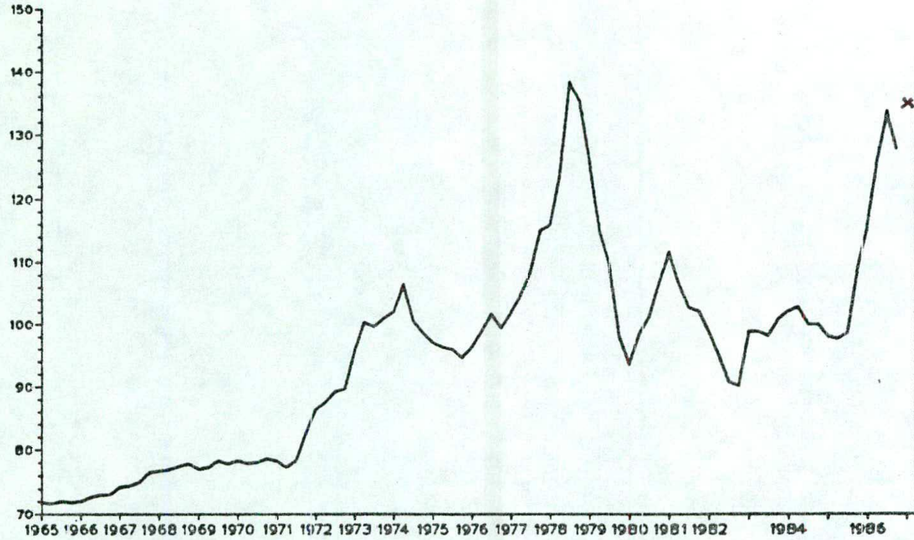
T BURNS

Chart 1

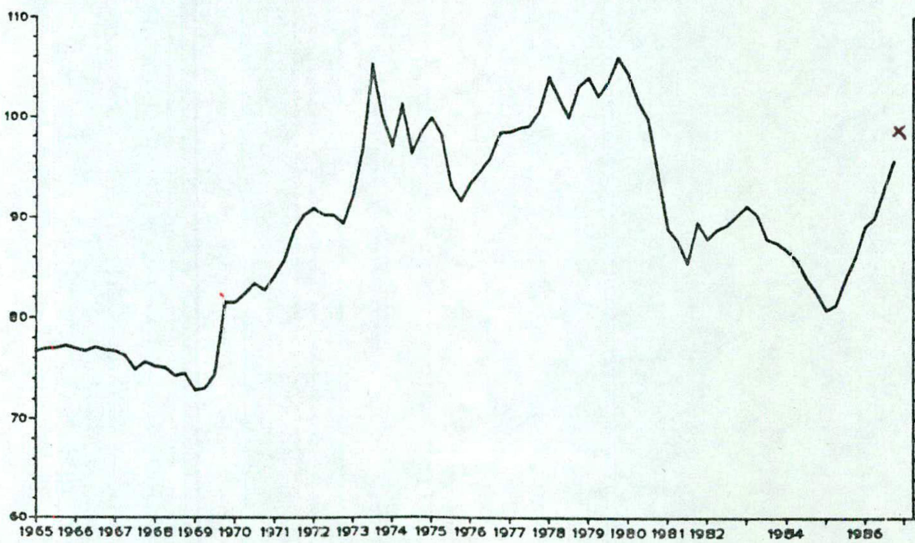
REAL EFFECTIVE EXCHANGE RATE, 1980 = 100
UNITED STATES



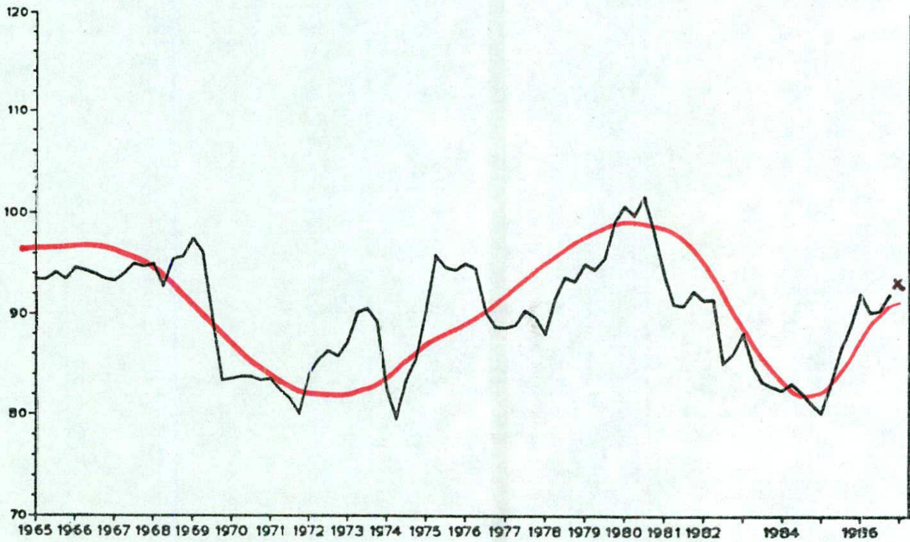
REAL EFFECTIVE EXCHANGE RATE, 1980 = 100
JAPAN



REAL EFFECTIVE EXCHANGE RATE, 1980 = 100
GERMANY

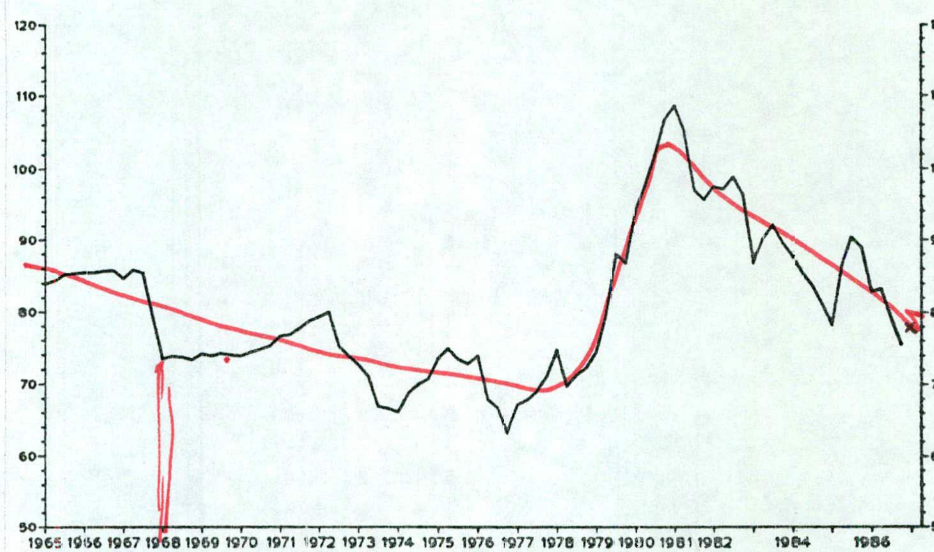


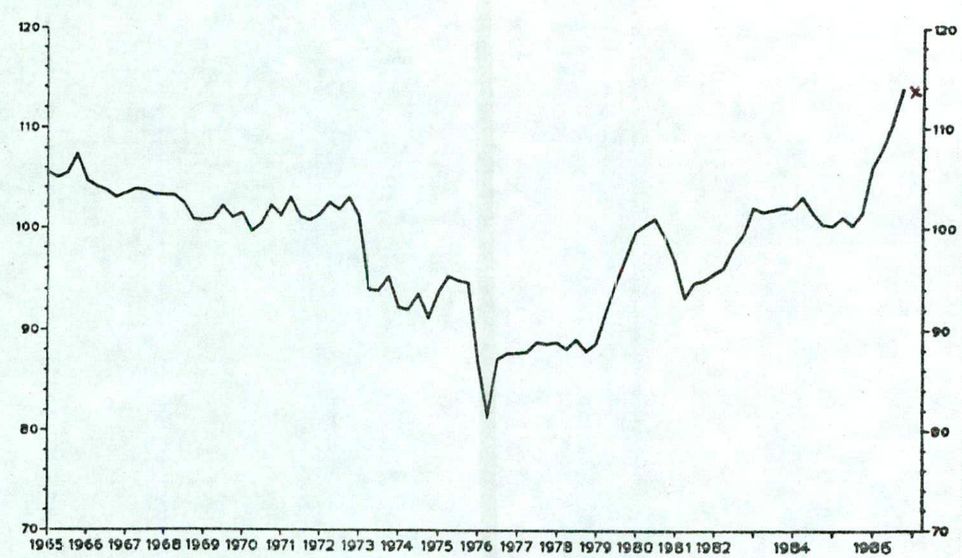
REAL EFFECTIVE EXCHANGE RATE, 1980 = 100
FRANCE



x Real exchange rate, 2.4.87.

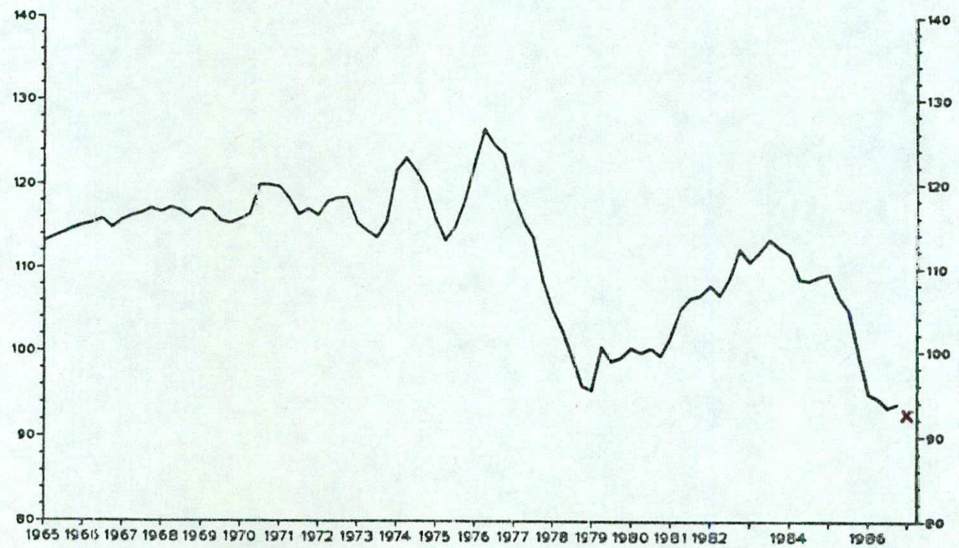
Chart 1 (cont.)





GNP falls sharper than trade-weighted real eff. XRs in c) 1970 & b) 1980 ↓

(US & Canada ↑ a lot
Japan ↑ a little
EMS no change
UK)



also see UK REXR Mar 1979 Apr 1987

X Real exchange rate: 2-4-87-

td30

TABLE 1

KEY ECONOMIC INDICATORS FOR THE G7 COUNTRIES

	Nominal GNP	Real GNP	GNP Deflator	Consumer prices
Annual percentage changes				
1980	10.5	1.1	9.3	12.0
1981	10.4	1.6	8.7	9.9
1982	6.2	-0.6	6.8	7.0
1983	7.4	2.8	4.5	4.4
1984	9.1	5.0	3.9	4.4
1985	6.9	3.0	3.8	3.8
1986	5.7	2.5	3.1	1.9
Change from four quarters earlier (per cent)				
1985 Q1	6.6	2.8	3.7	4.0
Q2	7.0	3.1	3.8	4.2
Q3	7.2	3.2	3.9	3.9
Q4	7.1	2.9	4.1	3.6
1986 Q1	6.4	2.7	3.6	3.1
Q2	6.3	2.7	3.5	1.8
Q3	5.7	2.4	3.2	1.6
Q4	5.0	2.3	2.6	1.4
Change from twelve months earlier (per cent)				
1986 Oct				1.4
Nov				1.3
Dec				1.3
1987 Jan				1.3
Feb				1.7 (est)
Mar				

TABLE 2

KEY FINANCIAL INDICATORS FOR THE G7 COUNTRIES

	Narrow Money (M1)	Broad Money	Three-month interest rate (per cent)	Commodity prices (SDRs, 1980 = 100)
Annual percentage changes				
1980	5.8	9.4	12.7	100.0
1981	6.5	10.1	14.2	95.1
1982	6.9	9.5	11.7	89.9
1983	10.3	10.5	9.2	102.7
1984	7.5	7.9	9.7	105.7
1985	8.3	8.6	8.5	96.0
1986	11.4	8.2	7.1	87.0
Changes from four quarters earlier				
1985 Q1	7.4	9.3	9.1	102.5
Q2	7.6	8.8	8.6	99.4
Q3	9.0	8.4	8.2	92.1
Q4	9.9	7.8	8.3	90.1
1986 Q1	9.8	7.6	8.2	93.7
Q2	11.0	7.9	7.0	90.8
Q3	11.6	8.5	6.5	81.3
Q4	12.7	8.8	6.6	82.4
Changes from twelve months earlier				
1986 Oct	12.2	8.6	6.6	81.8
Nov	13.1	8.8	6.6	83.6
Dec	12.7	8.8	6.7	81.9
1987 Jan			6.7	80.3
Feb			6.6	81.7
Mar			6.4	82.9

M1 or broad money 8%

Can draw on an aggregate G7 basis? (or comparability problems)

3889/045

SECRET

G5

FROM: C W KELLY

DATE: 6 April 1987

CHANCELLOR

cc Economic Secretary
Sir G Littler
Mr Cassell
Mr H Evans
Mr Peretz
Mr Culpin

G5 BRIEFING : EXCHANGE RATES

I attach a contribution to the G5 briefing in the form of tables and charts on exchange rate movements and intervention.

2. I also attach a copy of the Louvre Communique and (top copy only) the record of the meeting.

C W KELLY

encs

exrat1

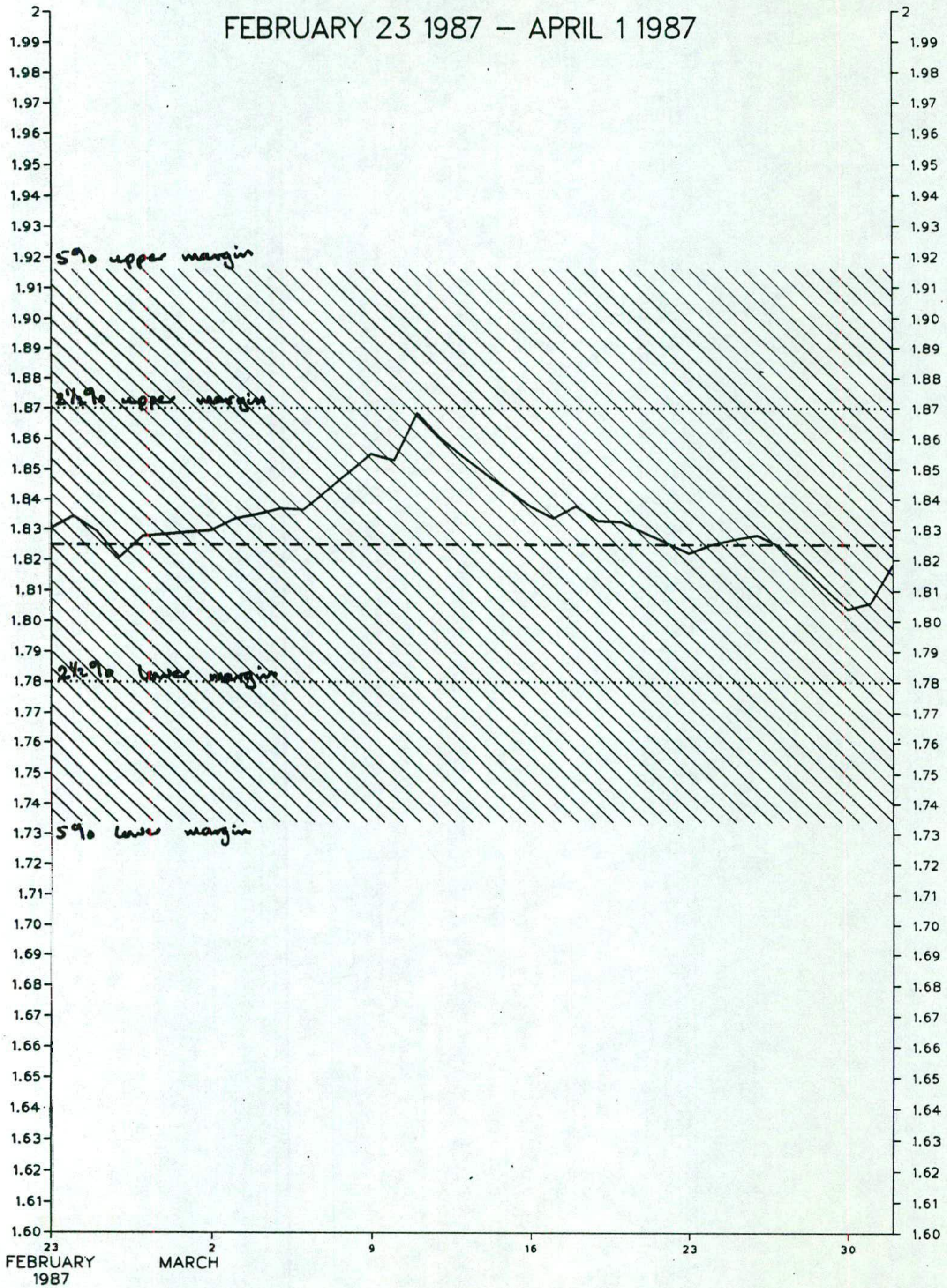
EXCHANGE RATE MOVEMENTS

	£ ERI	$/£	DM/£	Yen/$	DM/$	$ ERI
Plaza (20 Sept '85)	82.0	1.374	3.903	238.5	2.840	139.6
Louvre (20 Feb '87)	69.1	1.528	2.791	153.5	1.826	104.0
6 April (noon)	72.4	1.621	2.956	146.1	1.824	101.4
% change since Plaza	-11.7	18.0	-24.2	63.3	55.7	-27.4
% change since Louvre	4.8	6.0	5.9	5.1	0.1	-2.5

EXCHANGE RATES SINCE LOUVRE

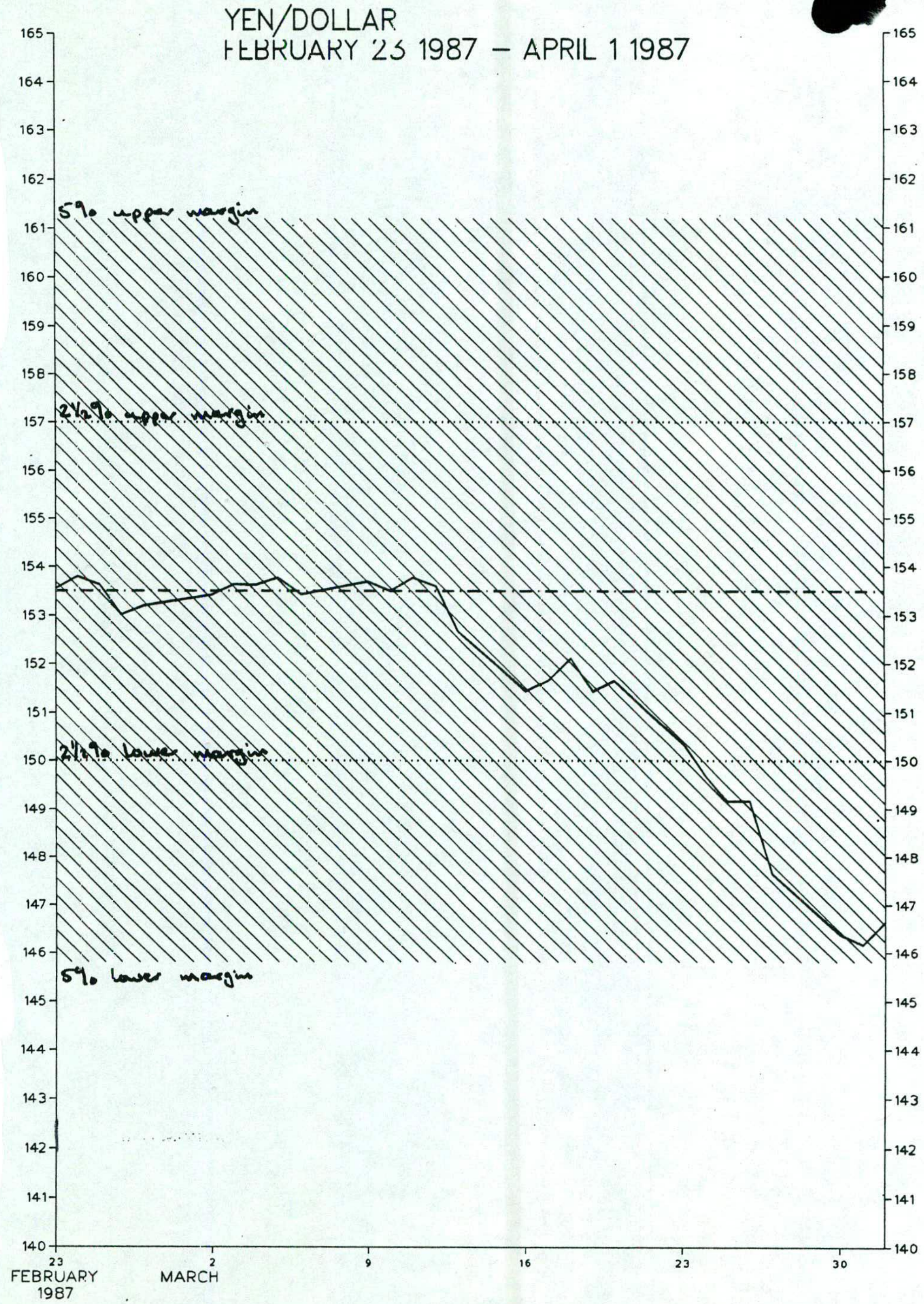
DEUTSCHEMARK/DOLLAR

FEBRUARY 23 1987 – APRIL 1 1987

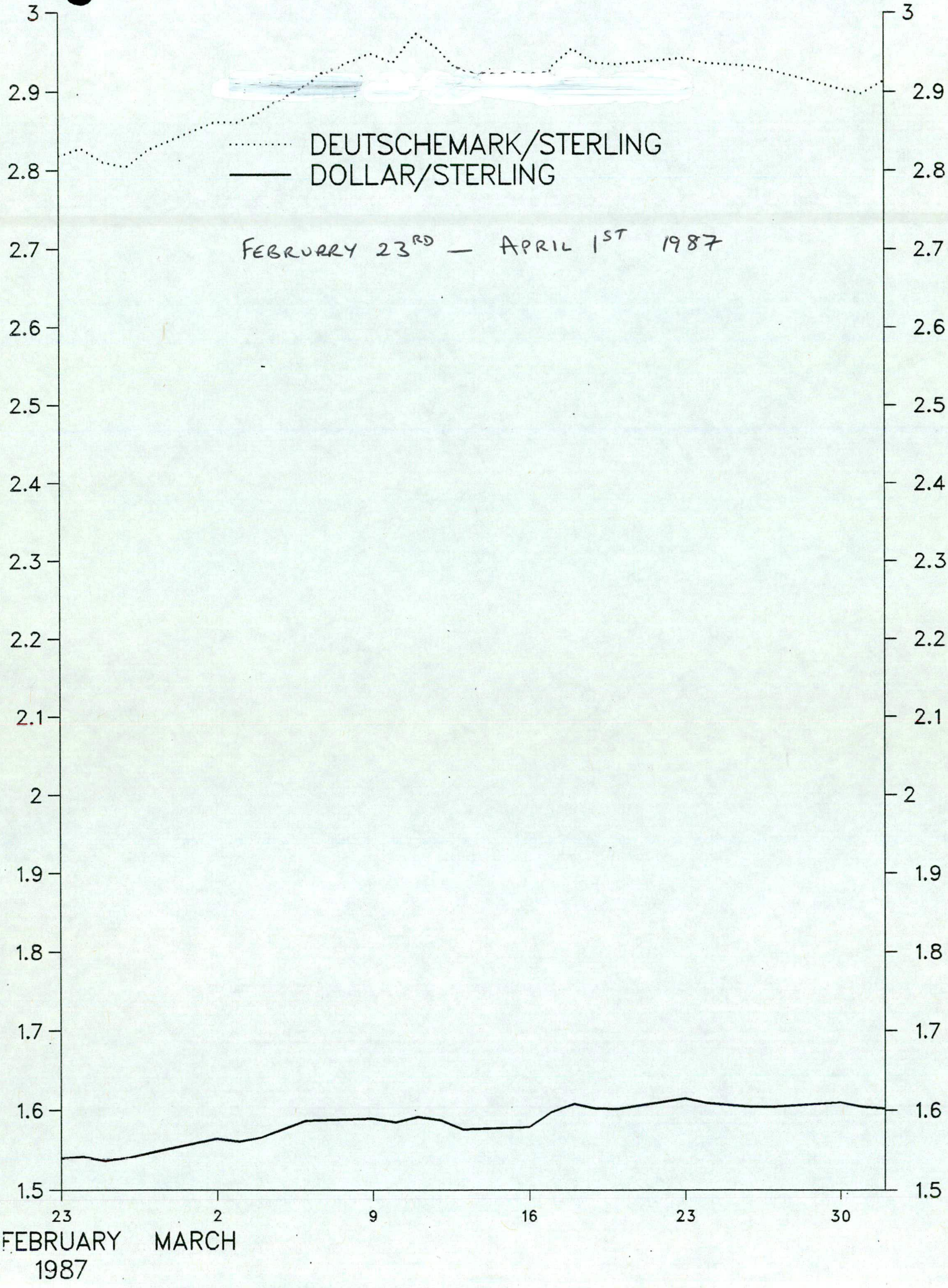


YEN/DOLLAR

FEBRUARY 23 1987 – APRIL 1 1987



EXCHANGE RATES SINCE LOUVRE



INT 3

SECRET

TOTAL MARKET INTERVENTION ($ TRANSACTIONS) SINCE 23 FEBRUARY PARIS ACCORD

$ million equivalent

Intervention week ending:	(1) US	(2) Japan	(3) W.Germany	(4) France	** (5) UK	* (6) Total Europe	(7) Canada
27 February	0	0	0	122	139	721	41
6 March	0	0	0	0	1111	1625	-50
13 March	-30	0	0	0	769	1137	0
20 March	0	0	0	0	625	732	667
27 March	1449	6421	200	1133	1010	2567	256
3 April	1370	3415	0	294	0	1480	15
TOTAL	2789	9836	200	1549	3654	8262	929
% OF TOTAL G5 PLUS OTHER EEC COUNTRIES INTERVENTION	13.4	47.1				39.6	

overall total: (including Canada)

21.816 billion

* Total Europe includes European G5 countries

** Figures reported at Bank's concertation.
UK's actual market intervention since 23 February currently stands at: $ 4287 million (to 3 April)

FINAL

STATEMENT

1. Ministers of Finance and Central Bank Governors of six major industrialized countries met today in Paris to conduct multilateral surveillance of their economies in the framework of the Tokyo Economic Declaration of May 6, 1986 pursuant to which the group of seven Finance Ministers was formed. The Ministers and Governors, using a range of economic indicators, reviewed current economic developments and prospects. The Managing Director of the IMF participated in the discussions.

2. The Ministers and Governors were of the view that further progress had been made since the Tokyo Summit in their efforts to achieve a sustainable, non-inflationary expansion. Their national economies are now in the fifth year of expansion, and the prospects are for continued growth this year, although the level of unemployment remains unacceptably high in some countries. A high degree of price stability has been attained, and there have been substantial reductions in interest rates. Exchange rate adjustments have occurred which will contribute importantly in the period ahead to the restoration of a more sustainable pattern of current accounts.

3. Progress is being made in reducing budget deficits in deficit countries, and fundamental tax reforms are being introduced to improve incentives, increase the efficiency of economies, and enhance the prospects of higher growth. Other important structural reforms are also being carried forward, including deregulation of business to increase efficiency and privatization of government enterprises to strengthen reliance on private entrepreneurs and market forces.

4. These positive developments notwithstanding, the Ministers and Governors recognize that the large trade and current account imbalances of some countries pose serious economic and political risks. They agreed that the reduction of the large unsustainable trade imbalances is a matter of high priority, and that the achievement of more balanced global growth should play a central role in bringing about such a reduction.

5. The Ministers and Governors reaffirmed their concern over continuing pressures for protectionism. They agreed that efforts to deal with economic problems by erecting trade barriers were self-defeating and pledged to intensify their efforts to resist protectionism and reaffirmed their strong support for the new round of trade negotiations. They welcomed the progress made in the preparatory work for the new GATT round and the recent positive conclusions of discussions between the United States and the European Community on bilateral trade issues.

6. The Ministers and Governors recognized that the major industrial countries have a special responsibility to follow policies which foster an open, growing world economy in order to support the efforts of developing countries, especially debtor countries, to restore steady growth and viable balance of payments positions. They noted that the progress achieved by many debtor countries toward these ends have not solved all the problems and stressed the importance of all participants in the strengthened debt strategy reinforcing their cooperative efforts.

7. The Ministers and Governors agreed to intensify their economic policy coordination efforts in order to promote more balanced global growth and to reduce existing imbalances. Surplus countries committed themselves to follow policies designed to strengthen domestic demand and to reduce their external surpluses while maintaining price stability. Deficit countries committed themselves to follow policies designed to encourage steady, low-inflation growth while reducing their domestic imbalances and external deficits. To this end, each country has agreed to the following undertakings.

The Government of Canada's policy is designed to sustain the current economic expansion through its fifth year and beyond. In the budget for 1987/88, the Government has cut the fiscal deficit for the third consecutive year and remains committed to further progressive reduction. Canada will propose shortly an extensive reform of its tax system. It will continue with its policies of regulatory reform, privatization and liberalization of domestic markets. It will vigorously pursue trade liberalization bilaterally with the United States and multilaterally within the Uruguay round. Monetary policies will continue to aim at the reduction of inflation and be consistent with orderly exchange markets.

The Government of France will reduce the central government budget deficit by 1 percent of GNP from 1986 to 1988 and in the same period will implement a tax cut program of the same order of magnitude (1 percent of GNP) with substantial tax rate cuts for corporations and individuals. It will pursue in 1987 its privatization program (with a projected $6 to $7 billions sale of assets) and reinforce the liberalization of the French economy, especially of labor and financial markets.

The Government of the Federal Republic of Germany will pursue policies to diminish further the share of public expenditures in the economy and to reduce the tax burden for individuals and corporations with a comprehensive tax reform aimed at reinforcing the incentives for private sector activity and investment. In addition, the Government will propose to increase the size of the tax reductions already enacted for 1988. The Federal Government will emphasize policies that enhance market forces in order to foster structural adjustment and innovation. Short-term interest rates, although already at a very low level in international comparison, have further dropped substantially during the last few weeks. Monetary policy will be directed at improving the conditions for sustained economic growth while maintaining price stability.

The Government of Japan will follow monetary and fiscal policies which will help to expand domestic demand and thereby contribute to reducing the external surplus. The comprehensive tax reform, now before the Diet, will give additional stimulus to the vitality of the Japanese economy. Every effort will be made to get the 1987 budget approved by the Diet so that its early implementation be ensured. A comprehensive economic program will be prepared after the approval of the 1987 budget by the Diet, so as to stimulate domestic demand, with the prevailing economic situation duly taken into account. The Bank of Japan announced that it will reduce its discount rate by one half percent on February 23.

The United Kingdom Government will maintain conditions for continuing the steady growth of GDP of the past five years and will continue to work to reduce inflation by following a prudent monetary policy. On external account the aim will be broad balance over the medium term. The share of public expenditure in the economy will continue to fall and the burden of taxation will be reduced, while public sector borrowing is maintained at low level. These and other measures to strengthen the supply performance of the economy, such as the privatization programme, will reinforce improvement over recent years in the growth of productivity.

The United States Government will pursue policies with a view to reducing the fiscal 1988 deficit to 2.3 % of GNP from its estimated level of 3.9 % in fiscal 1987. For this purpose, the growth in government expenditures will be held to less than 1 percent in fiscal 1988 as part of the continuing program to reduce the share of government in GNP from its current level of 23 percent. The United States will introduce a wide range of policies to improve its competitiveness and to enhance the strength and flexibility of its economy. Monetary policy will be consistent with economic expansion at a sustainable non-inflationary pace.

8. The Ministers and Governors noted that a number of newly industrialized economies were playing an increasingly important role in world trade. These economies have achieved strong growth based significantly on their access to open, growing export markets. Recently, some have accumulated trade surpluses which have contributed importantly to the present unsustainable pattern of global imbalances, thus increasing protectionist pressures. The Ministers and Governors considered that it is important that the newly industrialized developing economies should assume greater responsibility for preserving an open world trading system by reducing trade barriers and pursuing policies that allow their currencies to reflect more fully underlying economic fundamentals.

9. The Ministers and Governors also agreed to additional refinements in the use of economic indicators for the multilateral surveillance arrangements approved in the Tokyo Economic Declaration. As part of these refinements, they will :

- periodically review medium-term economic objectives and projections involving domestic and external variables. The medium-term objectives and projections are to be mutually consistent and will serve as a basis for assessing national policies and performance ;

- regularly examine, using performance indicators, whether current economic developments and trends are consistent with the medium-term objectives and projections and consider the need for remedial action.

Initially, the objectives and projections will involve the following key variables : growth, inflation, current accounts/trade balances, budget performance, monetary conditions and exchange rates.

10. The Ministers and Governors agreed that the substantial exchange rate changes since the Plaza Agreement will increasingly contribute to reducing external imbalances and have now brought their currencies within ranges broadly consistent with underlying economic fundamentals, given the policy commitments summarized in this statement. Further substantial exchange rate shifts among their currencies could damage growth and adjustment prospects in their countries. In current circumstances, therefore, they agreed to cooperate closely to foster stability of exchange rates around current levels.

Paris, February 22, 1987

Points for G7/Baker

1. "If will ends must will means";
if want exchange rate stabilisation must be prepared to conduct policy to achieve
4. Some countries (eg UK) are familiar with taking account of exchange rate — big 3 must do same. Can't just concentrate on domestic indicators

2. Indicators exercise must be as simple as possible; important not to be too complicated. And most important indicator from point of view of balance of payments adjustment is growth of domestic demand

3. More concentration upon G7 in aggregate: growth, inflation, global fiscal deficit, real interest rates.

INDICATORS

sw26

PWP

FROM: S W MATTHEWS
DATE: 6 April 1987

CHANCELLOR

Ch
Earlier papes now attached
AA

cc: Sir T Burns
Sir G Littler
Mr Evans
Mr Culpin
Mr Walsh
Mr Dolphin

G5/G7 SURVEILLANCE DISCUSSION: "INDICATORS"

As background to the G5/G7 discussions the IMF Managing Director has circulated a note setting out a new set of forecasts and his comments on policy issues.

2. These forecasts assume full implementation of the Louvre Agreement and differ from the World Economic Outlook (WEO) projections circulated for the Interim Committee mainly on fiscal policy assumptions:

(a) the US is assumed to cut its Federal deficit in FY1988 to 2.3 per cent of GNP (i.e. the Gramm-Rudman target of $108 billion) - this compares with a "current services" estimate of $164 billion in FY1988 made in the WEO;

(b) Germany is assumed to increase the size of its 1988 tax cuts by DM5 billion (0.3 per cent of GNP), so the budget deficit in 1988 in the revised forecast is a little higher than in the WEO; but

(c) no change has been made to the assumption about Japanese budgetary policy: the forecast for G5/G7 and the WEO both assume a package of measures equivalent to about 0.3 per cent of GNP toward the end of 1987.

3. The IMF's projections for the G5/G7 meetings are summarised in tables (i) and (iv) in the same format as the summary tables A to D on the WEO forecast that Mr Dolphin has already submitted, i.e.

(i) Nominal GNP growth in G7 and broken down by country;
(ii) Real GNP growth;
(iii) Inflation; and
(iv) Current Account balances.

4. The following tables (v) to (viii) set out a comparison of the two IMF projections (WEO and G5/G7) with the December OECD Economic Outlook and the FSBR WEP projection:

(v) Real GNP, inflation and budget balances for the G7 as a whole;
(vi) United States - real GNP, inflation, current account;
(vii) Japan - real GNP, inflation, current account;
(viii) Germany - real GNP, inflation, current account.

5. The tighter fiscal policy in the G7 as a whole assumed in the G5/G7 forecast produces slower growth in 1988, particularly in the US. This could well strengthen demands for offsetting fiscal action by other countries, but there are also arguments in the opposite direction:

- the staff still forecast US real GNP growth in 1988 of 2 per cent, which is not bad at this stage in the cycle;

- as the Managing Director notes, a continuing and credible reduction in the US budget deficit is needed to free resources for strengthening the balance of payments and to underpin confidence in financial markets;

- the outlook for the budget deficit in FY1987 is worsening (e.g. the President's failure to sustain his veto on the Highway Bill, forthcoming requests for $11.5 billion of supplemental appropriations) and the Administration and Congress are far from agreement on FY1988, so other countries should not necessarily base their own policies on the assumption that the US will in fact cut its deficit to $108 billion;

- the fall in interest rates that the staff assume will be permitted by tighter US fiscal policy is relatively modest ($^3/_4$ per cent);

6. The difference between the WEO and G5/G7 projections cannot be regarded as a realistic simulation of the effects of tighter US fiscal policy, in that one of the main channels for crowding in additional expenditure in the US is excluded by the assumption of an unchanged exchange rate. While the US growth would be strengthened if a larger cut in the Federal deficit also meant a lower dollar, the slowdown in domestic demand in other countries could be greater and the case for additional measures to support demand in the short term could then be stronger. It is therefore regretable that the staff's projections for the G5/G7 indicators/ surveillance exercise once again focus on the short term outlook, rather than looking at the medium term implications of policies (as the staff in fact attempted to do for the WEO itself).

SM.

S W MATTHEWS

NOMINAL INCOME GROWTH

	1984	1985	1986	1987	1988	1985-87
<u>IMF forecasts</u>						
US	10½	6½	5	5	5½	5½
Japan	6½	6	4½	4	5½	5
Germany	5	5	6	4½	4½	5
France	9	7½	7½	5	4½	6½
UK	7	10	6	8	7½	8
Italy	14	11	12	9	7½	10½
Canada	9½	7½	6	5½	6	6½
G7	9½	7	6	5	5½	6
<u>UK forecast</u>						
UK - MTFS (published FY figures in brackets)				7 (7½)	6½ (6½)	

Notes:

1. Forecasts for G7 meeting.

2. Money GDP at market prices.

REAL GNP/GDP GROWTH

	1984	1985	1986	1987	1988	1985-87
<u>IMF forecasts</u>						
US	6.4	2.7	2.5	2.3	2.0	2.5
Japan	5.1	4.7	2.5	2.7	3.0	3.3
Germany	3.0	2.5	2.4	1.9	2.0	2.3
France	1.5	1.4	2.2	1.8	2.0	1.8
UK	2.9	3.4	2.5	3.0	2.2	3.0
Italy	2.8	2.3	2.8	2.9	2.3	2.7
Canada	5.5	4.0	3.1	2.0	2.5	3.0
G7	4.7	2.8	2.5	2.4	2.3	2.6
<u>UK forecast</u>						
UK - latest HMT view				3.0	2.4	

Notes:

1. Forecasts for G7 meeting.

2. Fund figures for UK are average measure of GDP at market prices.

INFLATION

	1984	1985	1986	1987	1988	1985-87
<u>IMF forecasts</u>						
US	3.9	3.3	2.6	2.8	3.4	2.9
Japan	1.3	1.4	1.8	1.1	2.6	1.4
Germany	1.9	2.2	3.3	2.5	2.6	2.7
France	7.2	5.8	5.3	3.0	2.6	4.7
UK	4.1	6.1	3.6	4.6	5.0	4.8
Italy	10.8	8.8	9.1	5.7	5.2	7.9
Canada	3.6	3.4	2.8	3.5	3.2	3.2
G7	4.0	3.7	3.3	2.9	3.3	3.3
<u>UK forecast</u>						
UK - latest HMT view				4.1	4.2	

Notes:

1. Forecasts for G7 meeting.

2. GNP/GDP deflators

(iv)

CURRENT ACCOUNT ($ billion, % of GDP in brackets)

	1985	1986	1987	1985
<u>IMF forecasts</u>				
US	-118 (-3)	-141 (-3½)	-139 (-3)	-115 (-2½)
Japan	49 (3½)	86 (4½)	83 (3½)	78 (3½)
Germany	14 (2)	36 (4)	34 (3)	27 (2½)
France	0 (-)	4 (½)	4 (½)	2 (-)
UK	4 (1)	-2 (-½)	-5 (-1)	-8 (-1)
Italy	-4 (-1)	5 (1)	4 (½)	1 (-)
Canada	0 (-1)	-6 (-2)	-9 (-2)	-12 (-2½)
G7	-5	-18	-28	-30
<u>UK forecast</u>				
UK - latest HMT view			-4 (-½)	

Note:

1. Forecast for G7 meeting.

COMPARISON OF FORECASTS: G7

	1986	1987	1988
A. Demand and activity (% change)			
Gross national product			
IMF - WEO	2.5	2.4	2.9
IMF - G5/7	2.5	2.4	2.3
OECD	2½	2¾	
WEP	2.6	2.6	3.0
B. Inflation (% change)			
GNP deflator			
IMF - WEO	3.1	2.7	3.3
IMF - G5/7	3.1	2.7	3.3
OECD	3	2½	
WEP	3.3	2.5	2.8
C. General government balance (% GNP)			
IMF - WEO	-3.2	-2.9	-2.6
IMF - G5/7	-3.2	-2.9	-2.4
OECD	-3.4	-2.7	
WEP	-3¼	-3	-2¾

Note: OECD forecasts are taken from Economic Outlook (December 1986)

COMPARISON OF FORECASTS: UNITED STATES

	1986	1987	1988
A. Demand and activity (% change)			
Gross national product			
IMF - WEO	2.5	2.3	3.1
IMF - G5/7	2.5	2.3	2.0
National	2.7	3.1	3.5
WEP	2.6	2.5	2.7
B. Inflation (% change)			
GNP deflator			
IMF - WEO	2.6	2.8	3.4
IMF - G5/7	2.6	2.8	3.4
National	2.8	3.3	3.5
WEP	2.6	2.0	2.9
C. Current account ($ bn)			
IMF - WEO	-141	-139	-133
IMF - G5/7	-141	-139	-115
National			
WEP	-140	-153	-155
(% GNP)			
IMF - WEO	-3.3	-3.1	-2.7
IMF - G5/7	-3.3	-3.1	-2.4
National			
WEP	-3.3	-3.2	-3.2

COMPARISON OF FORECASTS: JAPAN

	1986	1987	1988
A. Demand and activity (% change)			
Gross national product			
IMF - WEO	2.5	2.7	3.3
IMF - G5/7	2.5	2.7	3.0
National	3.0	3.5	
WEP	2.4	2.7	4.2
B. Inflation (% change)			
GNP deflator			
IMF - WEO	1.8	1.1	2.6
IMF - G5/7	1.8	1.1	2.6
National	1.4	1.1	
WEP	1.9	1.2	1.1
C. Current account ($ bn)			
IMF - WEO	86	83	73
IMF - G5/7	86	83	78
National	88	77	
WEP	84	83	78
(% GNP)			
IMF - WEO	4.4	3.7	3.2
IMF - G5/7	4.4	3.7	3.3
National	4.4	3.6	
WEP	4.4	3.7	3.3

Note: National forecasts are for fiscal years (April - March)

COMPARISON OF FORECASTS: GERMANY

		1986	1987	1988
A. Demand and activity (% change)				
Gross national product				
	IMF - WEO	2.4	1.9	2.0
	IMF - G5/7	2.4	1.9	2.0
	National	2.5	2½	
	WEP	2.7	2.5	3.1
B. Inflation (% change)				
GNP deflator				
	IMF - WEO	3.3	2.5	2.6
	IMF - G5/7	3.3	2.5	2.6
	National	3.0	1¾	
	WEP	3.4	1.3	1.4
C. Current account ($ bn)				
	IMF - WEO	36	34	26
	IMF - G5/7	36	35	27
	National			
	WEP	39	33	22
(% GNP)	IMF - WEO	4.0	3.0	2.2
	IMF - G5/7	4.0	3.1	2.3
	National			
	WEP	4.3	2.9	1.9

UNDERSTANDINGS ON INTERVENTION <u>*SECRET*</u>

95

1. BASIC STRATEGY

To promote greater exchange rate stability by seeking to maintain exchange rates around current levels for the time being. These understandings will be reviewed in a normal way at a meeting in early april in conjunction with the spring meeting of the Interim Committee. There would be no bias toward dollar purchases as opposed to dollar sales.

2. TACTICS

Participants will seek to avoid predictability in intervention activity. Intervention may occur when there is large and/or volatile movement of exchange rates, and would be expected as exchange rates deviate substantially from current levels. Levels and amounts of intervention would be discussed among participants on a day-to-day basis in light of market conditions.

18 20
5 4½
5 4½
5 4½

3. SCALE

Total <u>net</u> intervention (dollar market only) would be maximum of $12 billion during the period until the next meeting. Daily amounts would vary, but would not ordinarily exceed $300 million for either the United States, Europe and Japan.

4. CURRENCY

As a general rule : for the United States, yen/$, DM/$; for others (except EMS interventions), dollars against national currency.

5. PROPORTIONATE SHARES

United States, Europe and Japan would have approximately equal shares over time. (Dollar sales or purchases offset through other EMS transactions would not be included in totals.) Participants would endeavour not to intervene in directions inconsistent with the basic purpose of the exercise without prior consultation.

6. VISIBILITY

Operations will be conducted without attempting to disguise them, and on occasion with the intention that they become known in the market. However, no official confirmation of intervention except in accordance with established subsequent publication policies.

7. LOCUS OF OPERATIONS

Presumption that each participant would have responsability for its own market and would not be expected to intervene in another market, although it could do so after consultation.

8. COORDINATION

Central banks continue to maintain close contacts on intervention operations pursuant to established channels. Finance ministries intensify their bilateral channels of communication.

PWP 8/4/87

AGREED TERMS OF REFERENCE
ON THE QUESTION RAISED BY ITALY

1. Both G5 and G7 have their official existence as it is stated in the Communique of the Tokyo Summit .

It reaffirms Quote " the undertaking at 1982 Versailles Summit to cooperate with the IMF in strengthening multilateral surveillance, particularly among the countries whose currencies constitute the SDR. (.....) "

and it requests

"the Group of Five Finance Ministers to include Canada and Italy in their meetings whenever the management or the improvement of the international monetary system and related economic policy measures are to be discussed and dealt with " Unquote.

2. The G5 might thus have convened an official meeting on matters of multilateral surveillance as it does regularly, before today's G.7 meeting.

3. Instead, there has been a series of bilateral and informal meetings and a private dinner. Our Italian colleague was given advance notice.

4. Bilateral and informal contacts have been established with all members including Canada and Italy as well before the meeting of the G 7.

5. We regret that the Italian delegation did not find it possible to attend and we are all hopeful that Italy will maintain its active participation in the group of the seven Finance Ministers and look forward to its participation in our spring meeting in Washington.

April 8, 1987

Economic Policy Coordination

We have agreed on refinements of the Tokyo arrangements on closer economic policy coordination. The objectives of the agreement are (1) simplification of the indicators and (2) the provision of greater discipline to the process.

The Establishment of Economic Objectives and Projections

In order to provide a framework for surveillance, each country will present, early in the year, the medium-course of its intended policies and establish its economic objectives and projections. In this context, a small group of indicators that measure domestic and external economic performance and policies will be used with a special focus on those which reflect interactions among our economies. The objectives and projections will in some cases be quantified; in others they may be more general in nature. Broad, mutually consistent objectives will be developed also for the group as a whole. Both the collective and individual country objectives and projections are to be consistent and will serve as standards against which to assess country policies and performance. Initially, the objectives and projections involve the following key variables: growth, domestic demand, inflation, current account balances, budget performance, monetary conditions and exchange rates.

Review Process

The Ministers and Governors will meet regularly to develop objectives and projections, to review national economic policies and performance, and to assess current trends and prospects.

In order to assist in these meetings, the IMF will develop further the approach taken in the initial surveillance exercise by preparing papers for each meeting. Such papers, including tables on the indicators, will examine economic developments and prospects in each country, and assess the progress and problems in achieving the objectives and projections. In this context, an assessment will be made of the possible need for policy action to assure that current and prospective trends are consistent with achievement of the objectives or to modify them.

In order to assist in this assessment, interim performance indicators will be developed. In selecting the interim performance indicators, attention will be focused on specific measures from a range of variables such as those referred to in the Tokyo Communique. The selection of interim performance indicators may vary from year to year to cover in the best possible way the full range of the underlying economic policies and performance.

Ministers and Governors will meet to review progress and prospects and undertake best efforts to reach understandings regarding appropriate remedial action if necessary. Substantial deviations from the intended course will lead to consultations. When circumstances warrant, a special meeting of Ministers and Governors would be convened.

Role of IMF Managing Director

The Managing Director of the IMF would be invited to express his views about underlying economic policies, performance, and prospects and to offer his advice on improvements in policies, including exchange rates, necessary for the smooth functioning of the international monetary system.

The Role of Exchange Rates

Exchange rates are one of the key variables in the international adjustment process. A common understanding of the role of exchange rates is essential to reaching judgments concerning the extent to which imbalances are expected to be reduced through exchange rates or by other adjustment measures. In connection with their consideration of desirable adjustments of underlying policy fundamentals, Ministers and Governors will seek to reach informal, confidential understandings on the appropriateness of exchange rates and, if necessary, of desired exchange rate changes, taking into account the established economic objectives and projections. If they agree that it would be helpful either to stabilize or to promote adjustment of exchange rates, they will seek joint action to that end. This could, under certain circumstances, involve the use of ranges.

April 8, 1987

pmp

STATEMENT OF THE GROUP OF SEVEN

1. The Finance Ministers and Central Bank Governors of seven major industrial countries met today. They continued the process of multilateral surveillance of their economies pursuant to the arrangements for strengthened economic policy coordination agreed at the 1986 Tokyo Summit of their Heads of State or Government. The Managing Director of the International Monetary Fund also participated in the meeting.

2. The Ministers and Governors reaffirmed the commitment to the cooperative approach agreed at the recent Paris meeting, and noted the progress achieved in implementing the undertakings embodied in the Louvre Agreement. They agreed, however, that further actions will be essential to resist rising protectionist pressures, sustain global economic expansion, and reduce trade imbalances. In this connection they welcomed the proposals just announced by the governing Liberal Democratic Party in Japan for extraordinary and urgent measures to stimulate Japan's economy through early implementation of a large supplementary budget exceeding those of previous years, as well as unprecedented front-end loading of public works expenditures. The Government of Japan reaffirmed its intention to further open up its domestic markets to foreign goods and services.

3. The Ministers and Governors reaffirmed the view that around current levels their currencies are within ranges broadly consistent with economic fundamentals and the basic policy intentions outlined at the Louvre meeting. In that connection they welcomed the strong implementation of the Louvre agreement. They concluded that present and prospective progress in implementing the policy undertakings at the Louvre and in this statement provided a basis for continuing close cooperation to foster the stability of exchange rates.

1987

	GDP IMF	GDP HMT unpublished	whole year on whole year GDP deflator IMF	Q4 on Q4 CPI HMT unpublished
Canada	2·0	3·0	3·5	2·8
US	2·3	2·6	2·8	3·3
Japan	2·7	2·6	1·1	-0·3
France	1·8	2·5	3·0	2·8
Germany	1·9	2·6	2·5	0·7
Italy	2·9	3·1	5·7	4·4
UK	3·0	3·0	4·6	(RPI) 4·0
average	2·4	2·6	2·9	2·5

I am astonished by the GDP figs.

Mr Allan
Sir PEM gave me this. I am returning it to you

T Burns

(1) WCW
(2) WIC

GRS 1600

COLLAR

CONFIDENTIAL

FM PARIS

TO IMMEDIATE FCO

TELNO 401

OF 221520Z APRIL 87

INFO PRIORITY BONN, MOSCOW, UKDEL NATO, UKREP BRUSSELS, ROME

Confidential

AMENDED DISTRIBUTION
23RD APRIL

22/4/87

CHIRAC'S VISIT TO LONDON: 26 APRIL

SUMMARY

1. CHIRAC'S POLITICAL POSITION REMAINS LESS ASSURED THAN HE WOULD WISH. THE FRENCH ECONOMY IS NOT HELPING. EAST-WEST QUESTIONS ARE HIGH ON HIS AGENDA. HIS VISIT TO MOSCOW IS NOT YET OFFICIALLY FIXED, BUT MID-MAY IS STILL ON THE CARDS. BILATERAL RELATIONS GOOD, WITH SOME SMALL POINTS TO COVER.

DETAIL

POLITICAL

2. CHIRAC'S VISIT TO CHEQUERS FOLLOWS EASTER OPINION POLLS THAT SUGGEST SOME RECOVERY IN HIS PUBLIC STANDING, AFTER THE ROUGH 3 MONTHS AT THE TURN OF THE YEAR (SEE ALSO SIR JOHN FRETWELL'S LETTER TO RATFORD OF 13 APRIL FOR FULLER BACKGROUND). HE IS STILL BEHIND MITTERRAND AND BARRE, BUT HAS MADE UP SOME OF THE GROUND LOST IN THE WINTER. THIS OFFERS HIM SOME CHEER IN WHAT IS OTHERWISE A RATHER DISCOURAGING SCENE. THE RPR/UDF GOVERNING MAJORITY IS DIVIDED OVER POLICIES AND PERSONALITIES, AND THE ECONOMY IS PICKING UP LESS QUICKLY THAN CHIRAC HAD HOPED AND PREDICTED WHEN HE CAME TO OFFICE. WITH PRESIDENTIAL ELECTION HORIZONS INCREASINGLY COMING INTO VIEW, HIS PRIORITY NOW IS TO AVOID FURTHER MISHAPS WHILE STEADILY REPAIRING HIS POLITICAL CREDIBILITY AND AUTHORITY. HE WILL SEE HIS TALKS WITH THE PRIME MINISTER AS CONTRIBUTING TO THIS PROCESS.

ECONOMIC

3. THE FRENCH GOVERNMENT HAS REVISED 1987 GDP GROWTH FORECASTS DOWNWARDS TO 2.0 PER CENT INSTEAD OF 2.8 PER CENT, BUT MOST ECONOMIC AGENCIES THINK THAT EVEN THIS IS OPTIMISTIC AND PREDICT 1.5 PER CENT. VIRTUALLY ALL THE MAIN ECONOMIC INDICATORS ARE MOVING IN THE WRONG DIRECTION. OF PARTICULAR CONCERN ARE THE CONTINUED POOR FOREIGN TRADE FIGURES, THE INADEQUATE LEVEL OF INDUSTRIAL INVESTMENT AND THE STEADY RISE IN UNEMPLOYMENT (A GOVERNMENT ECONOMIC INSTITUTE PREDICTS 3.4 MILLION BY 1991). THE ONE CURRENT SUCCESS IS THE ACCELERATED PRIVATISATION PROGRAMME WHICH IS EXPECTED TO RAISE AROUND 4 BILLION POUNDS THIS YEAR.

Confidential

/DEFENCE

DEFENCE

4. THE BROAD BACKGROUND TO FRENCH DEFENCE POLICY REMAINS AS SET OUT IN SIR J FRETWELL'S DESPATCH OF 18 FEBRUARY. THE BILATERAL RELATIONSHIP IS CURRENTLY WELL NOURISHED AFTER THE SUCCESSFUL VISITS TO PARIS BY MR YOUNGER FOR A FULL PROGRAMME WITH GIRAUD IN MARCH, AND BY THE HOUSE OF COMMONS DEFENCE COMMITTEE IN APRIL. A NEW 5-YEAR DEFENCE PROGRAMME LAW HAS RECENTLY BEEN VOTED, WITH THE SUPPORT OF ALL FRENCH POLITICAL PARTIES BAR THE COMMUNISTS, PROVIDING FOR A 12 PER CENT REAL INCREASE IN DEFENCE EQUIPMENT SPENDING THIS YEAR AND 6 PER CENT THEREAFTER ANNUALLY TILL 1991. THE UNDERLYING TREND IS FOR FRANCE INCREASINGLY TO LOOK FOR COMMON POSITIONS WITH HER ALLIES ON MATTERS AFFECTING DEFENCE AND SECURITY IN EUROPE. BOTH GERMANY AND THE UNITED KINGDOM ARE SEEN AS PRIVILEGED PARTNERS IN THIS PROCESS, THE IMPORTANCE OF WHICH IS FURTHER UNDERLINED FOR THE FRENCH BY WHAT THEY SEE AS THE ALMOST GIDDY EVOLUTION OF THE ARMS CONTROL PICTURE OVER RECENT WEEKS.
(SEE ALSO BELOW).

CHANNEL FIXED LINK

5. FRENCH COMMITMENT TO THE CHANNEL TUNNEL REMAINS AS STRONG AS EVER, NOT LEAST FOR ITS JOB CREATION BENEFITS IN NORTHERN FRANCE. THE FRENCH BILL LEADING TO RATIFICATION OF THE TREATY WILL BE DEBATED IN PARLIAMENT THIS WEEK, AND IS NOT EXPECTED TO ENCOUNTER OPPOSITION. THE IMPORTANCE OF THE TUNNEL IN THE CONTEXT OF A NORTHERN EUROPE RAIL NETWORK HAS INCREASED IN FRENCH EYES OVER RECENT MONTHS, AND DECISIONS HAVE TO BE MADE SOON ON WHETHER TO CONSTRUCT A SPECIAL HIGH SPEED RAIL LINE LINKING PARIS TO BRUSSELS AND (VIA THE TUNNEL) TO LONDON: AND, IF SO, ON HOW TO FINANCE IT (PRIVATE OR PUBLIC SECTOR) AND ITS EXACT PATH. THE FRENCH PREFER TO GO FOR PRIVATE SECTOR FUNDINGS: HENCE THE PRESSURE ON THE UK TO MAXIMIZE SPEED AND FREQUENCY OF CHANNEL TUNNEL DIRECT TRAINS SO AS TO INCREASE THE PROFITABILITY OF THE RAIL INVESTMENT. THEY REGARD AN AGREEMENT BETWEEN THE RAILWAY COMPANIES (BR AND SNCF) AND EUROTUNNEL ON THE TERMS ON WHICH THE COMPANIES WILL USE THE TUNNEL AS BOTH ESSENTIAL AND URGENT.

AGENDA

6. FOR CHIRAC, STRATEGIC AFFAIRS AND EAST-WEST RELATIONS WILL BE THE PRIORITY FOR HIS DISCUSSIONS WITH THE PRIME MINISTER. MATIGNON TELL US THAT IN PRINCIPLE THE RUSSIANS HAVE AGREED THAT CHIRAC SHOULD VISIT MOSCOW IN MID-MAY. FRANCO-SOVIET RELATIONS, ALREADY POOR BECAUSE OF THE HARD FRENCH LINE ON ARMS CONTROL AND HUMAN RIGHTS, DETERIORATED SHARPLY AT THE BEGINNING OF APRIL WHEN THE FRENCH EXPELLED SIX SOVIET DIPLOMATS FOR ESPIONAGE. IT LOOKED VERY MUCH AT ONE POINT AS IF CHIRAC'S VISIT WOULD BE POSTPONED AS A RESULT. THE FRENCH ARE STILL HAVING DIFFICULTY OVER DETAILS OF THE PROGRAMME. CHIRAC WILL PROBABLY HAVE TO SETTLE FOR SOMETHING NEARER A SHORT, WORKING VISIT THAN THE SORT OF RECEPTION ACCORDED BY GORBACHEV TO MRS THATCHER. BUT HE WILL, LIKE HER, AIM TO MEET LEADING DISSIDENTS.

Confidential

7. CHIRAC WILL BE KEEN TO HEAR A FULL ACCOUNT OF THE PRIME MINISTER'S VISIT TO MOSCOW, HER LATEST IMPRESSIONS OF GORBACHEV AND BRITISH REACTIONS ON ARMS CONTROL ISSUES, ESPECIALLY INF SINCE THE SHULTZ VISIT. COHABITATION IN PARIS HAS MEANT THAT THE FRENCH LINE ON INF IS A COMPROMISE BETWEEN THOSE (GIRAUD, RAIMOND), WHO FEAR THAT THE ZERO OPTION WILL LEAD TO A WEAKENING OF EUROPEAN SECURITY, AND MITTERRAND WHO PLACES A HIGH PRIORITY ON POLITICAL SOLIDARITY WITH THE FRG. CHIRAC HAS BEEN CAREFUL TO CONSULT MITTERRAND BEFORE FIXING THE FRENCH ATTITUDE TO A ZERO OPTION ON SRINF. ACCORDING TO HIS STAFF, IT HAS EMERGED AS FOLLOWS:-

(A) THE FRENCH ARE VERY RESERVED, IT NOT HOSTILE, TO SUCH A PROPOSAL BECAUSE IT WOULD REPRESENT A FURTHER STEP TOWARDS WHAT THEY SEE AS THE DENUCLEARISATION OF EUROPE. THEY WOULD PREFER THE OBJECTIVE OF SRINF NEGOTIATIONS TO BE THE ESTABLISHMENT OF EQUAL CEILINGS AT LOWER LEVELS BUT ABOVE ZERO ON MISSILES BETWEEN 500 AND 1000 KM. THE TERMS OF REFERENCE OF A SRINF NEGOTIATION SHOULD BE SPECIFIED IN AN LRINF AGREEMENT.

(B) HOWEVER, FRANCE IS NOT PARTY TO ALLIANCE DECISION-MAKING ON THIS SUBJECT. BOTH SOME GERMANS AND THE AMERICANS SEEM TEMPTED BY GORBACHEV'S PROPOSALS. IF THE ALLIANCE DECIDED THAT NEW US SRINF DEPLOYMENTS IN DUE COURSE WERE NOT FEASIBLE AND THAT ZERO SRINF SHOULD BE ACCEPTED, THEN FRANCE WOULD GO ALONG, BUT ONLY ON CONDITION THAT THERE WAS NO FURTHER NEGOTIATION IN ANY CONTEXT ON SYSTEMS WITH RANGES BELOW 500 KM.

(C) FRENCH (AND BRITISH) STRATEGIC AND TACTICAL NUCLEAR FORCES SHOULD NOT BE INCLUDED. IN THIS CONTEXT THE FRENCH WOULD SEE ANY CONCESSION TO ALLOW THE GERMAN DUAL-KEY PERSHING IAS TO BE INCLUDED IN US REDUCTIONS AS THE THIN END OF THE WEDGE OVER THIRD COUNTRY FORCES.

8. ONE POINT ON WHICH THERE IS UNANIMITY IN PARIS IS THAT THE INF AFFAIR POINTS UP THE NEED FOR GREATER EUROPEAN DEFENCE COOPERATION. CHIRAC'S MAIN PROPOSAL IN THIS AREA IS THAT FOR A WEU CHARTER. HE CLAIMS TO HAVE WON REAGAN'S SUPPORT FOR THIS AND WILL SEEK TO PERSUADE THE PRIME MINISTER AT CHEQUERS OF THE IDEA'S MERITS, SINCE THE UK IS SEEN HERE AS FOOT-DRAGGING. MATIGNON SAY THAT WORK IN THE WEU SO FAR HAS SHOWN MUCH COMMON GROUND ON THE SUBSTANCE. IF WE BELIEVE IN DEVELOPING A VOICE ON KEY ISSUES OF EUROPEAN SECURITY TO REINFORCE SOLID DECISIONS WITHIN NATO, THEY HOPE THAT MINISTERS WILL BE ABLE TO ADOPT IN THE AUTUMN A PUBLIC DUCUMENT SETTING OUT THIS COMMON GROUND. CHIRAC MAY ALSO RAISE BILATERAL COOPERATION, PARTICULARLY IN THE NUCLEAR FIELD.

Confidential /9.

Confidential

9. EUROPEAN COMMUNITY ISSUES WILL ALSO FEATURE ON CHIRAC'S LIST. THESE WILL INCLUDE THE AGRICULTURAL PRICE FIXING EXERCISE, ESPECIALLY CEREALS, OILS AND FATS AND THE AGRIMONETARY SYSTEM: THE BUDGET FOR 1987 AND THE FUTURE FINANCING OF THE COMMUNITY: AND POSSIBLY ALSO RELATIONS WITH JAPAN AND THE QUESTION OF THE SUCCESSION TO NOEL AS SECRETARY-GENERAL OF THE COMMISSION (WHERE THE FRENCH CANDIDATE WILL BE PIERRE ACHARD).

10. OTHER MISCELLANEOUS ISSUES THAT CHIRAC MAY RAISE INCLUDE THE CHANNEL TUNNEL AND LAUNCH AID FOR AIRBUS. IT IS ALSO CONCEIVABLE THAT HE MIGHT BE BRIEFED TO MENTION BILATERAL NUCLEAR SUBMARINE VISITS, ON WHICH THE FRENCH REMAIN UNPERSUADED BY OUR LATEST FORMULATION ON ACCIDENT INDEMNITY. FROM OUR SIDE, COMPENSATION FOR BRITISH LAMB TRANSPORTERS IS NOT YET SETTLED AND MAY NEED TO BE RAISED (PARIS TELEGRAM 383). THE FRANCO-BRITISH COUNCIL PERHAPS ALSO DESERVES A BRIEF MENTION: AN EXPRESSION OF JOINT PRIME MINISTERIAL INTEREST IN REORDERING OF THE COUNCIL'S ACTIVITY WOULD BE VALUABLE TO HELP DAMP DOWN FRENCH SCEPTICISM ABOUT ITS FUTURE HEALTH.

WESTON

YYYY

PCLNAN 8666

EUROPEAN POLITICAL

WED.

Confidential

PPS 12/2

ABC Gil

G-7 OFFICIALS TO MEET IN SARDINIA THIS WEEK NRHT

ROME, APRIL 27 - REPRESENTATIVES OF THE GROUP OF SEVEN WILL MEET IN THE SARDINIAN RESORT OF PORTO CERVO FROM APRIL 30 TO MAY 2 TO DISCUSS THE AGENDA FOR THE GROUP'S VENICE SUMMIT IN JUNE, SOURCES CLOSE TO THE ITALIAN FOREIGN MINISTRY SAID.

THE SOURCES SAID THE MEETING WOULD BE INFORMAL AND ATTENDED BY THE PERSONAL REPRESENTATIVES OF G-7 LEADERS.

THE SOURCES DID NOT COMMENT ON REPORTS FROM OSAKA THAT DEPUTY FINANCE MINISTERS WOULD ATTEND THE PORTO CERVO MEETING, AND SAID
THERE WOULD BE A COMPLETE INFORMATION BLACKOUT ON THE GATHERING.

27-APR-1202 MON364 MONQ

CONTINUED ON - NRHU

P

QUOTE - SEE AAQA 1502

G-7 OFFICIALS =2 ROME NRHU

THE SOURCES HAD NO COMMENT ON STATEMENTS BY JAPANESE OFFICIALS IN OSAKA YESTERDAY THAT THE FALLING DOLLAR WOULD BE AMONG TOPICS DISCUSSED.

THE JAPANESE OFFICIALS HAD SAID THE MEETING, WHILE FOCUSING ON LONGER-TERM ISSUES, WOULD PROVIDE SENIOR GOVERNMENT OFFICIALS WITH THEIR FIRST CHANCE TO DISCUSS THE RECENT SHARP DROP OF THE DOLLAR.

27-APR-1204 MON370 MONQ

CONTINUED FROM - NRHT

REUTER

P

QUOTE - SEE AAQA 1502

NRHO

BALLADUR URGES ADHERENCE TO G-7 CURRENCY ACCORDS

MILAN, APRIL 27 - FRENCH FINANCE MINISTER EDOUARD BALLADUR SAID THE GROUP OF SEVEN MAJOR INDUSTRIAL NATIONS, G-7, CAN ACHIEVE STABLE CURRENCY VALUES BY ADHERING TO ACCORDS REACHED THIS YEAR IN PARIS AND WASHINGTON.

BALLADUR, ASKED AT A NEWS CONFERENCE IF COORDINATED MARKET INTERVENTION BY CENTRAL BANKS WAS SUFFICIENT TO HALT THE DOLLAR'S RECENT SLIDE, SAID "EACH COUNTRY HAS TO FULFILL COMMITMENTS" OUTLINED IN THE G-7 ACCORDS.

EARLIER THIS MONTH IN WASHINGTON, FINANCE MINISTERS OF THE U.S., JAPAN, WEST GERMANY, FRANCE, ITALY, BRITAIN AND CANADA REAFFIRMED AN EARLIER PARIS ACCORD TO ARREST THE DOLLAR'S FALL.

27-APR-1146 MON334 MONQ

CONTINUED ON - NRIE

P

QUOTE - SEE AAQA 1502

NRIE

BALLADUR URGES =2 MILAN

BALLADUR SAID THE CURRENT NERVOUSNESS IN FOREIGN EXCHANGE MARKETS CAN BE PARTLY ATTRIBUTED TO "SOME OPERATORS IN THE MARKET ONLY WATCHING SHORT TERM ECONOMIC INDICATORS. YOU HAVE TO KEEP A COOL HEAD," HE SAID, DECLINING TO ELABORATE FURTHER.

IN AN EARLIER SPEECH BEFORE THE MILAN CHAMBER OF COMMERCE, THE MINISTER SAID EUROPEAN COUNTRIES HAVE TO SEEK "A BETTER CONSENSUS OF ECONOMIC AND MONETARY POLICIES."

ON THE EUROPEAN MONETARY SYSTEM, HE SAID, "THE PERSISTENT VULNERABILITY OF THE FOREIGN CURRENCY MECHANISM, PARTICULARLY TO THE MOVEMENTS OF THE DOLLAR, CAN BE EXPLAINED BY THE ABSENCE OF A COMMON POLICY FOR CURRENCIES OF OTHER COUNTRIES."

AAMM 1410 FRENCH MARCH ADJUSTED UNEMPLOYMENT 11.1 PCT (FEB 11 PCT) - INSEE

CONTINUED ON - NRIF

P

QUOTE - SEE AAQA 1502

NRIF

BALLADUR URGES =3 MILAN

BALLADUR SAID, "I AM PROFOUNDLY CONVINCED THAT THE EUROPEAN COUNTRIES HAVE TO DEFINE TOGETHER THIS POSITION WITH RESPECT TO THE DOLLAR AND THE YEN."

HE SAID ITALY EVENTUALLY WOULD HAVE TO ABANDON ITS HIGHER MARGIN OF FLUCTUATION WITHIN THE EUROPEAN MONTETARY SYSTEM. "I HOPE THAT THE SPECTACULAR IMPROVEMENT OF THE ECONOMIC SITUATION AND OF THE BALANCE OF PAYMENTS WILL PERMIT (ITALY) TO DO IT SOON."

THE LIRA IS CURRENTLY ALLOWED A FLUCTUATION MARGIN EITHER SIDE OF ITS AGREED MIDPOINTS WITH OTHER EMS CURRENCIES OF SIX PCT, AGAINST 2.25 PCT PERMITTED FOR THE OTHER MEMBERS.

27-APR-1246 MON418 MONR

REUTER

CONTINUED FROM - NRIE

P

QUOTE - SEE AAQA 1502

sw3

1 ALEX
2C.

FROM: S W MATTHEWS
DATE: 28 April 1987
cc Sir P. Middleton
~~Mr Dolphin~~

PMP

1. SIR TERENCE BURNS 28/4/87

2. CHANCELLOR

copied to Sir TB
Mgt.

Thanks

GROWTH RATES IN G7 IN 1987

You asked for our latest estimates of real GNP growth in each of the major seven economies.

2. The last full WEP forecast was completed in January, with some updating of the main output, inflation and trade aggregates in February for the FSBR. It was not at that stage fully clear how weak growth in France and Germany was turning out in 1987Q1, although we revised down our forecasts for both countries between the January WEP and the FSBR. In view of the deterioration in business confidence in France and Germany it is unlikely that their poor performance will be caught up later in the year, so our best forecast now would be growth of about 2 per cent in both countries - roughly the same as in the IMF's World Economic Outlook.

3. We shall not be starting a new WEP forecasting round until mid-May and, since the IMF staff have been able to take account of later information, I suggest that the IMF forecasts for 1987 are for the moment the best ones to use. They also have the advantage that they have been published.

4. We are less confident about the IMF's inflation forecasts, which tend to be on the high side, particularly for Germany and Japan. The position for these countries is, however, complicated by the marked divergence between consumer price inflation and the growth of the GDP deflator.

SM.

S W MATTHEWS

350/4/211

CONFIDENTIAL

e.c. Mr Kuczys

FROM: R Q Braithwaite

DATE: 13 May 1987

1. AL
2. RJP

Private Secretary

cc Mr Maud
Mr Richardson, ERD
Mr Adams, ERD

Good

RJP

G7 MEETING

I spoke to Ruggiero, as the Secretary of State requested. I said that we thought that a meeting before the Summit was unnecessary and could be unhelpful. Goria had, I understood, shared this view when the Secretary of State spoke to him.

2. Ruggiero agreed that there was little point in a G7 meeting on the eve of the Venice Summit. It could rouse expectations of new moves on institutions which the Summit would be unlikely to be able to satisfy. This would not be helpful to the markets.

?

13 May 1987

R Q Braithwaite

bc Sir Geoffrey Littler KCB
HM Treasury

17/5/87.

CONFIDENTIAL

Note for the Record

MEETING OF G7 DEPUTIES

G7 Deputies met for over two hours after dinner on 15 May in the Danieli Hotel, Venice (in the margins of the final preparatory meeting for the Venice Summit).

2. The draft of the "Finance Ministers' Report to the Summit" was agreed except for paragraph 7 (on exchange rates) before Tietmeyer (Germany) joined us - and he quickly added his agreement to the draft. We then turned to the question of a pre-Summit meeting of G7 Finance Ministers before pursuing paragraph 7.

3. Ranuzzi (Italy - in the chair) said that his minister, Goria, very much wanted as a minimum to have a G7 lunch on Monday 8 June. For convenience (sic) it would be held at Stra outside Venice. The necessary agenda would have three items:

- completion of the Report to the Summit;
- review of actions taken and their results;
- connsideration of a programme of future meetings and action.

There would be no publicity, but there would be a communique. He concluded by saying that he thought only the U.K. found this proposal difficult, because of the elections, and asked me to comment.

4. I said I was happy to explain the U.K. position, although I thought I was not the only one with objections. The elections were not the original or main point. It was true that, because of the election time-table, the Chancellor was now planning to arrive in Venice only on Tuesday 9 June; but his opposition to a G7 meeting had other and previous strong grounds. He feared that the holding of such a meeting would inevitably become public knowledge and could well unsettle foreign exchange markets and create expectations which there would be no possibility of satisfying: this was a risk it would be foolish to run without very good reasons. A second consideration was the risk of providing a peg for EC Commission complaint. These reasons could be overcome if there was vital business to be done, but I did not regard the suggested agenda as being anywhere near vital.

5. Ranuzzi then called for comments round the table, starting with Drabble (Canada) who said that Canada had favoured a meeting because such a meeting in the margins of Summits had been envisaged as part of the G7 structure confirmed at the most recent Washington meeting.

CONFIDENTIAL

6. Gyohten (Japan) said that it might be useful for ministers to meet to approve the report, therefore he could accept the idea of an informal lunch in Venice - but he was not happy to see the other agenda items suggested; he was against a communique; he was against a location outside Venice; and he was even less happy if the Chancellor was not going to be available.

7. Tietmeyer (Germany) said that Stoltenberg was not in favour of a meeting: he had said only that he would be willing to attend if the proposal was an informal lunch in Venice desired by all the other ministers. Since then, in the light of discussion by the deputies in Sardinia, Stoltenberg had decided against a meeting, and he would now arrive in Venice in the afternoon with the main German delegation.

8. Lebegue (France) said the decision was up to the Italians!

9. Mulford (US) recalled that Baker's original idea was that he could agree to a meeting if it was separate from Venice in time and place, and if it had something real to do. Mulford's own position now, in the light of the discussion was negative: he was worried about provoking a confrontation with the EC Commission; he believed that the Chancellor's worries about the risk of a bad effect on exchange markets were extremely important and this was underlined by the fragility of markets at present (and he was very surprised that Gyohten had not given more weight to this). Also he very much disliked the idea of a communique (that there would be nothing to say made it worse) - and he was even worried by not having a communique, remembering that Goria had a track record of making unhelpful public comments! Finally, he was opposed to an agenda item of the future programme of work.

10. Ranuzzi and Drabble both tried to argue the need for a G7 meeting "to conclude the year's work" and to plan future work. All the G5 representatives protested against systematising and bureaucratising of the work, and several explicit and sorrowful remarks were made about never having had this sort of nonsense in the good old days!

11. Ranuzzi tried once more to represent the problem as being simply the UK election. But he was immediately called to order by Tietmeyer and Mulford, who said that the Chancellor's worries were real and shared by them, and that it seemed to be Goria who was playing domestic politics!

12. Ranuzzi's final effort was a declaration that there had to be a meeting because we had been unable to agree paragraph 7 of the draft report in earlier discussion. I immediately proposed a formulation which I thought met all the earlier arguments: the other five agreed to it, and so - reluctantly - did Ranuzzi. We therefore emerged with a complete and unanimously agreed draft.

13. Before we broke up, somebody asked Ranuzzi what he could tell us about Commission representation at the Summit. His reply

CONFIDENTIAL

was that there might not be a Commission representative among the Finance Ministers for dinner on Monday 8 June (or at the meeting on the following morning). Six of us gleefully hailed this as a perfect solution to the problem of a G7 meeting. But it seems likely that the Commission team will not be settled until the last moment, so we cannot rely on serendipity!

14. There were two relevant developments the following day. First, our main meeting was held at Stra: a very imposing garden villa, but it took twenty minutes by boat plus forty-five minutes by bus from the main Venice hotels; it took half-an-hour for the sherpas, who had a special helicopter; and the helicopter quickly attracted crowds of sightseers from the surrounding village and the passing traffic. Mulford said he would now certainly advise Baker against Stra; Lebegue said that Balladur would not like it at all.

15. Finally, Tietmeyer, Gyohten, Mulford and I talked briefly together. All (including Gyohten) said they hoped our Ministers could stick together in opposing a meeting. We shared a fear that Goria may simply try to bounce an invitation through. We agreed that any of us receiving any further approach would at once contact the others so as to concert refusals.

(Geoffrey Littler)
H.M.Treasury
17 May 1987

psl/7A

CONFIDENTIAL

pmj

FROM: A C S ALLAN

DATE: 18 May 1987

SIR G LITTLER

G7

The Chancellor was very grateful for your minute of 18 May. He feels it would be helpful if Baker could forcefully confirm the US position to Goria - no G7 meeting. That might be the best way of settling the issue.

ACSA

A C S ALLAN

Mr Allan

4·30 p.m.

Mulford is about to report to Baker – I put this thought to him and he will bring it on.

GL 18/5

Many thanks. It would be helpful if Baker could forcefully confirm to Goria ~~[illegible]~~ US position that no G7 mtg. That might be one way of settling the issue.

CONFIDENTIAL

From: Sir G.Littler
Date: 18 May 1987

MR ALEX ALLAN

G7

I am afraid that Goria is still wanting a G7 meeting just ahead of the Summit. He tried to pin down the UK election as the only obstacle; but he did not succeed, and indeed his attempt served only to stiffen Tietmeyer and offend Mulford! I think that we ended with a fairly solid alliance (with US, Germany and slightly less firmly Japan) against a meeting.

2. I thought it worth a detailed note of our discussion, which I attach. Please let me know if you have any further approach from the Italians, so that I can contact our "allies".

3. (I shall send forward shortly the text of the draft report which was completely agreed among deputies).

(Geoffrey Littler)