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Prime Minister

MR. COLES

A.J.C. 17.12

Dinner for Mr. George Shultz
Friday, 17 December

I attach the list of guests attending the dinner tomorrow evening together with a draft seating plan.

If you agree, the seating plan, please could it go into the Prime Minister's box.

Sue Goodchild

16 December 1982

Sir K. Couzens may arrive a little late for the talks at 7.00 p.m. as he will be travelling back from Brussels

DRAFT SEATING PLAN FOR DINNER ON FRIDAY, 17 DECEMBER 1982

Sir Kenneth Couzens

Sir Oliver Wright	Mr. Richard Burt
Mr. Allen Wallis	Rt. Hon. Francis Pym
PRIME MINISTER	THE HON. GEORGE SHULTZ
HE The Ambassador of the United States of America	Sir Robert Armstrong
Sir Antony Acland	The Hon. Edward J. Streator

Mr. John Coles

ENTRANCE

Ref. A082/0565

PRIME MINISTER

Meeting with Mr George Shultz: 17 December 1982

You have agreed to give a small working dinner for the United States Secretary of State, Mr Shultz, on the evening of Friday 17 December. He is due to see the Chancellor of the Exchequer on the afternoon of 16 December and the Foreign and Commonwealth Secretary will be giving a private supper for him that evening. You have already received separately briefing on a range of subjects which Mr Shultz has said that he wishes to raise. The purpose of this minute is to suggest some points you might make to him on the international economic situation, which he has said he would particularly like to discuss with you. It reflects the conclusions of a discussion amongst the Permanent Secretaries of the Departments principally concerned.

2. You could say that we fully share Mr Shultz's concern about the world economic situation and the dangers it poses for world trade on the one hand and the stability of our financial system on the other; and you could ask him how he sees the problems and what his prescription is for managing them. In the subsequent discussion you could aim to make the following points:

a. The United States and the United Kingdom share a common approach to economic policy, based on the control of inflation through monetary discipline and creating a climate within which the economy can grow without a return to inflation. The international economies are highly interdependent: whilst we are resolved to play our part, an enormous responsibility is inevitably carried by the United States as the single largest Western economy.

b. Three causes of deep concern have beome prominent of late. The first is the heavy indebtedness of some major developing countries; the second is the risk of a slide into protectionism; and the third, which is at the root of the matter, is the fear that the resumption of world growth will be jeopardised by the rising United States budget deficit, which could both keep interest rates high and put the United States counter-inflation programme at risk.

c. The first of these factors poses a threat to the stability of the international financial system, and there is an evident risk that the measures taken to combat that threat could have adverse consequences for world trade and economic growth. Recent events - the very sharp downturn in imports by non-oil developing countries - suggest that these consequences are already with us. But it would be a mistake to react to this by setting up some form of international entitlement programme, with automatic welfare handouts for every country in trouble. The result would be to destroy all incentives towards prudent financial management by borrowers and lending institutions. Debt problems should continue to be handled sensitively on a case by case basis, with constructive use of IMF conditionality. We must ensure that the IMF is strong enough to meet the demands on it.

d. Many of the problems of the heavily indebted developing countries stem from the economic situation in the West. It is much harder for them to pay interest on their debts as long as the recession in industrialised countries reduces their opportunities to export; and high interest rates have in themselves been one of their main problems. The system will remain at risk until there is a general confidence that the United States budget deficit is on a downward path.

e. High interest rates are the link between the LDC debt problem, protectionism and the United States budget deficit. Interest rates and the whole system will remain at risk until there is general confidence that the United States budget deficit is on a downward path. But the figures for future deficits are constantly going up. Our fear is that a combination of a rising United States budget deficit and an excessive weakening of the dollar as a result of a large external deficit could face the United States with a choice between letting inflation rip or again putting up interest rates.

f. It would be a tragedy if the United States were to go down the protectionist road, and if its major partners were to follow suit. The demands for protectionist measures against Japanese steel just made by Mr David Roderick, the Chairman of United States Steel, illustrate how strong the protectionist pressures are becoming. The recent GATT Ministerial Meeting attempted to wrestle with the problem. On a number of items which the GATT will now follow up - services and trade with the newly developed countries - we have common interests with the United States and we shall be ready to work with the United States Administration in pursuing these matters.

g. The size of the imbalance in Japanese trade also poses a threat for both of us. This would be significantly eased by an appreciation of the yen. The fact that the yen has improved recently has eased some of the pressures, but a fall in United States interest rates would be a key element in bringing about a further improvement. The United States and the European Community also have a common interest in curbing Japanese protectionism. The Community has now agreed to tackle this within the framework of Article XXIII of the GATT: it would greatly increase the prospects of success if the United States were to join the Community in this approach.

3. You will be receiving a more detailed brief on agriculture. On this, you will wish to welcome Mr Shultz's statement to the European Commission in Brussels that the United States does not want an export subsidy war. The agreement to hold official talks between the United States and the Community on areas of difficulty in agricultural trade is particularly welcome. We hope these talks will result in a mutually acceptable compromise. We share many of the United States' doubts about the Common Agricultural Policy (CAP); but the CAP could not be dismantled without

precipitating the break up of the Community. Most countries (including the United States) find it necessary to have some form of agricultural support regime; and the United Kingdom is seeking to secure changes in the CAP rather than to abolish it. A constructive use of American pressure might help to moderate further price increases within the CAP, but it would be in none of our interests to have a subsidy war.

4. A further question which it might be useful to raise in an exploratory way with Mr Shultz, if time permits, is technology transfer, on which I attach a separate note.

FLAG *

5. Also attached by way of background are

FLAG "A"

a. a note by the Treasury containing up to date statistics on the United States economy;

FLAG "B"

b. a report from the Financial Times of 14th December of a helpful statement by Mr Martin Feldstein, Chief Economic Adviser to the Reagan Administration; and

FLAG "C"

c. a report from the Financial Times of 16th December of a call by Mr David Roderick, the Chairman of United States Steel, demanding far reaching protectionist measures against Japanese steel imports.

FLAG "D"

d. the conclusions of a report by an interdepartmental group of officials under Cabinet Office chairmanship on the international debt problem and its impact on trade. The main message is that a solution has to be considered within the context of overall economic strategy. Mr Shultz is believed to share this view.

6. Copies of this minute, with attachments, go to the Chancellor of the Exchequer and the Foreign and Commonwealth Secretary.

RA

ROBERT ARMSTRONG

16th December 1982

Technology Transfer

"Technology transfer" is shorthand for the acquisition by the Soviet Union (and other Warsaw Pact countries) of Western technology, by legal and illegal means. The Americans have become very concerned about the present scale and scope of the technology transfer which they believe is currently taking place: and it is one of the subjects the Allies have undertaken to examine in Mr Shultz's "Summary of Conclusions" which helped to resolve the pipeline dispute.

2. The Americans claim that technology transfer has helped to reduce the technological gap between the United States and the USSR from eight to two years over the past decade; and that it has contributed significantly to the need for higher defence expenditure by the West as a whole simply in order to maintain a lead. Mr Perle, Mr Weinberger's deputy, visited Europe in November to explain American concerns. He saw British industrialists and officials. At one stage, he stated that unless tighter controls were introduced by individual NATO countries, there would be a greatly reduced willingness on the part of the United States to share sensitive technology with its Allies: and there is some evidence (which is still being investigated) that British firms who collaborate with the United States in the manufacture of high technology products for export may already be experiencing difficulties on this score.

3. It would be appropriate to emphasise to Mr Shultz that the United Kingdom takes the issue of technology transfer very seriously, and will play its full part in tackling the problem, both in COCOM and elsewhere, in the context of the follow up to the Summary of Conclusions. This should provide an opening to explore how far the Weinberger/Perle campaign has the backing of the United States Administration as a whole (as distinct from being a hobbyhorse of the Department of Defense); and at the same

time to leave Mr Shultz in no doubt that any application of restrictive or discriminatory measures against British (or European) firms would be damaging for our relations, disruptive for the Alliance and counter-productive in terms of the studies now in hand in COCOM.

A

US ECONOMY

Recent developments

The economy has experienced a 'double-dip' recession since 1979. GDP which fell in 1980, recovered briefly early in 1981, but then fell steeply through last winter and the early part of this year. Output recovered slightly in the second quarter of this year but preliminary estimates suggest it was flat in the third. The fall in industrial production has been steeper than in GDP. It was still falling in October when it was 8½ per cent lower than a year ago.

	1980	1981	1982 est	Q1	2	3
GDP (per cent changes, annual rates)	-½	2	-2	-5	2	0

2. The recession has been accompanied by a sharp rise in unemployment, which now stands at a post-war peak of 10.4 per cent.

	1980	1981	1982 October
Unemployment rate (per cent)	7	7½	10.4

3. Inflation, however, has come down more rapidly than many commentators expected. The latest consumer price figures show a year-on-year rise of 5.1 per cent for October. This compares with a peak rate of 13½ per cent reached in 1980.

	1980	1981	1982 October
Consumer prices (per cent changes)	13½	10½	5.1

4. US interest rates have been highly volatile in the past two years and have been high in real terms, ie as measured against the increase in prices. The slowdown in the economy and the reduction in inflation, however, has led to a sharp decline in interest rates since the summer.

	1980	1981	1982 Q1	2	3	Dec 6
3-month CD interest rates	13	15¾	14¼	14	11½	8½

5. The high level of interest rates and the firm monetary policies followed by the US authorities have led to a sharp rise of about 30 per cent in the <u>dollar's exchange rate</u> over the past two years. This, together with generally higher US inflation, has contributed to a large loss of competitiveness. US unit labour costs relative to those overseas measured in dollar terms have increased by about 50 per cent in the past two years.

	1980	1981	1982 Q1	2	3	Dec 15
Dollar effective rate (1975 = 100)	93.7	105.1	111.7	115.7	121.2	120.9
Dollar/sterling rate	2.33	2.03	1.85	1.78	1.70	1.62

6. The reduction in US interest rates since the summer coupled with signs that the external current account may be moving into deficit (visible trade showed a $13 billion deficit in the third quarter) has led to some weakening in the dollar in recent weeks. Its effective exchange rate has fallen 4 per cent in the past month to mid-December.

	1980	1981	1982 Q1	2	3
Visible trade balance $b	-25	-28	-6	-5	-13
Current balance $b	1½	4½	1	2	NA

Prospects

7. Hopes for recovery in the US economy have been constantly disappointed. The Administration's own projections have proved over-optimistic and have reduced its credibility. President Reagan's first Economic Report to Congress in early 1981 forecast that GDP would rise by about 4 per cent or more in each of the five years 1982-87. In his second Economic Report early this year, the Administration was still expecting 3 per cent growth in 1982 followed by 5 per cent in 1983 and about 4½ per cent a year thereafter.

8. In the event, GDP seems likely to show a 1½ per cent fall in 1982. Senior Administration officials, however, are still optimistic about the prospects for recovery next year. The newly-appointed chairman of the Council of Economic Advisers, Martin Feldstein, has said he expects 3-4 per cent GDP growth. The Treasury Under-Secretary for Monetary Affairs, Beryl Sprinkel, has forecast 3½-4½ per cent growth. Many outside forecasters, however, are less optimistic. The OECD, for example, in its December Economic Outlook expects US growth to be only 2-2½ per cent next year.

	1981	1982	1983
President's Economic Report 1981	1	4	5
President's Economic Report 1982	2	3	5
OECD Economic Outlook*	2	-1½	2¼

* To be published 22 December.

9. Evidence for an early recovery is so far slim. Retail sales continued to fall in July, August and September despite the July tax cut. The leading indicators, however, have risen in six of the past seven months and housing starts rose in October.

Policies

10. The United States in common with other major industrial countries responded to the second steep rise in oil prices in 1979-80 with firm policies to contain the inflationary impact. In particular, heavy reliance was placed on monetary policy, with firm targets for the growth of the monetary aggregates. The rate of growth of M1 slowed down to an annual rate of less than 5 per cent in the first half of this year, compared to more than 8 per cent in 1978. Interpretation of the monetary aggregates, however, has been complicated by institutional changes, and on 16 November the Federal Reserve chairman, Paul Volker, announced that the Fed would be 'attaching much less weight than usual' to M1 over the period immediately ahead.

11. The progress in monetary policy in the past two years has not been matched by corresponding action on fiscal policy despite the Administration's commitment to reduce the budget deficit. Projections of the fiscal deficit have been successively revised upwards. The Administration's initial budget proposal for FY 1982 - introduced last year - was for a deficit of $43 billion. The outturn seems likely to be about $110 billion.

12. The Administration similarly expected to be able to reduce the budget deficit for FY 1983 to about $20 billion. This was revised up to $92 billion earlier this year. The head of the Congressional Budget Office, Alice Rivlin, is reported to have suggested in September that it could be as high as $155 billion. The Budget Director, David Stockman, was reported last month to have said that it could rise to $180-195 billion.

Budget projections ($b)		FY 1982	FY 1983	FY 1984
Administration	July 1981	43	23	28
"	Feb 1982	99	92	
"	Aug 1982	109	115	93
CBO (Rivlin)	Sept 1982	-	155	
OMB (Stockman)	Nov 1982	-	180-195	

13. The burgeoning budget deficit presents the Administration with its most acute problem if monetary growth is to be contained and if the pressure on interest rates both in the United States and internationally is to be eased. The Administration so far, however, has shown little signs of readiness to take firm enough measures either to cut public spending or raise taxes. Its commitment to substantial increases in defense spending, the entrenched opposition to cuts in social security programmes and the President's strong desire to adhere to his programme of income tax reductions all make it difficult to see how the deficit can be put on a firmly declining medium-term path.

14. The President will publish in January his budget proposals for FY 1984, which starts next September.

6

FINANCIAL TIMES - 14th DECEMBER 1982

U.S. trade deficit may be record $75bn

BY ANATOLE KALETSKY IN WASHINGTON

AN OVERVALUED dollar is likely to result in a record trade deficit of about $75bn (£47bn) next year and lead to the U.S. economic recovery's being "lopsided," with export-oriented industries remaining in the doldrums, Mr Martin Feldstein, chief economic adviser to the Reagan Administration, said yesterday.

The causes of the huge trade deficit are to be sought in Washington, however "not in London or Tokyo," Mr Feldstein said. A better balance of trade could be restored only by changes in the U.S. government's fiscal policy, which would bring down the dollar exchange rate.

He warned that protectionist measures against foreign competitors would not improve the overall U.S. trading position and might make the situation worse by pushing the dollar still higher.

Mr Feldstein's comments, in a speech to the National Press Club, appear to be the strongest expression to date of the Reagan administration's growing realisation that the sharp increase in the nation's trade deficit is a major reason why the expected economic recovery has failed to materialise this year.

Despite the administration's tax cuts, which have boosted demand, U.S. industrial production is still declining, largely because of U.S. industry's inability to compete for both home and export markets.

Mr Feldstein, who is emerging as the administration's chief economic policymaker since his appointment as chairman of the Council of Economic Advisers in the autumn, pointed out that a merchandise trade deficit of $75bn next year would be far greater than the cumulative trade surpluses enjoyed by the U.S. in the whole of the 35 years since World War II.

He did not give $75bn as the Administration's official forecast for the 1983 trade deficit, which is due to be published early next year with the 1984 budget, but he repeatedly implied that he believed this figure to be about right. Other Administration officials in the past month have referred to figures of $60bn and "up to" $75bn when asked about the likely trade deficit in the coming year.

Mr Feldstein's attitude to the growth in the trade deficit, and to the strength of the dollar, which he repeatedly identified as its major cause, contrasts sharply with statements made earlier in the year by Mr Donald Regan, the Treasury Secretary. Mr Regan has tended to attribute the strength of the dollar to foreign confidence in U.S. economic management.

C

U.S. threat to Japan steelmakers

BY ANATOLE KALETSKY IN WASHINGTON

JAPANESE steelmakers have been threatened with a range of punitive quotas and levies against their exports to the U.S.

The U.S. steel industry yesterday announced the move, in a series of trading petitions against the Japanese.

Mr David Roderick, U.S. Steel chairman, attacked the "predatory, discriminatory and illegal" trading practices of the Japanese and EEC steel industries. He accused Japan and the EEC of "flagrantly victimising" the U.S. steel industry by carving up the world steel market into "spheres of influence."

Their actions had violated the General Agreement on Tariffs and Trade (Gatt), U.S. trade laws, and U.S. Japanese treaties, Mr Roderick claimed.

He accused the Japanese Government of "artificially maintaining an undervalued yen" exchange rate. This, too, he alleged, was a violation of rules embodied in the Gatt, the multinational accord governing world trade. The Japanese steel industry had acquired its dominant position in world markets through a "programme of government subsidisation and protectionism," he claimed.

Petitions detailing the charges will be made this morning, under Section 301 of the 1974 Trade Act, with Mr William Brock, the U.S. Trade Representative. The petitions will be filed by U.S. Steel, seven other major steel companies and the American Iron and Steel Institute, of which Mr Roderick is chairman.

The U.S. House of Representatives late last night passed a controversial trade Bill requiring imported cars to contain a high percentage of American-made parts. The Bill now goes to the Senate.

Despite President Reagan's objections, the House voted 215 to 188 for a Bill which supporters said would send a message to Japan from recession-hit U.S. car workers even though it was unlikely to become law this year.

Four remedies are being demanded. They are:

- A reduction of 1.75m tonnes in Japanese steel exports to the U.S., "by way of compensation for past harm." (Japanese exports have been running at an annual rate of 5.6m tonnes in the first 10 months of this year.)
- Phasing out an alleged worldwide market-sharing agreement between Japan and the EEC, under which Japanese steelmakers allegedly limit their exports "west of Suez" while Japan sets prices and keeps the Europeans out of "coastal markets in the Far East plus India and Pakistan." There are no quota limitations in other areas, including the Middle East, Eastern Europe and China, but Japan and Europe operate a price-fixing agreement for these regions, according to Mr Roderick.
- Enforcement of Japan's obligations to the U.S. under the Most-Favoured Nation trade laws. This would include the opening of Japanese markets to imports.
- A 25-per-cent import levy on all Japanese steel to reflect the "undervaluation" of the yen, which Mr Roderick said should stand between Y190 and Y200 to the dollar, compared with its current value of more than Y245.

Mr Brock will have 45 days to decide whether to initiate an investigation once the petitions are filed.

D

PART 3: CONSEQUENCES AND POLICY RESPONSES

Resume of Parts 1 and 2

103. Part 1 of the Report showed how the protracted failure of the world economy to recover from the 1979 oil shock has exposed the fragility of the external financial position of certain NODCs and Eastern European countries, and damaged the financial health of the corporate sector. The strains thus created, particularly for the banking system, have been serious but, to date, manageable.

104. Part 2 considered possible developments over the next few years, in particular the central case based on the WEP forecast. It also examined ways in which the position might get worse before getting better and the situation which could develop under three scenarios. First, if the financial institutions became significantly more cautious about lending to NODCs and the CPE; second, if, as a result of this or for other reasons, an increasing number of them sought to reschedule their debts; and third, as a worst case, if one or more were led to repudiate debt i.e. outright default. Part 2 examined the implications of such scenarios for trade and economic activity generally, as well as for the financial system.

105. The likelihood of events evolving in one or other of the foregoing ways is hard if not impossible to predict. Furthermore, there are many reasons why the situation may turn out to be worse or better although the risks seem significantly greater downside than upside. Parts 1 and 2 of the report have not sought to predict the future but rather to show how, under deteriorating circumstances, the economic, trade and financial aspects interact. As noted in paragraph 20, it has concentrated on those countries of greatest concern which at present are situated in Latin America and Eastern Europe.

106. One point emerges from the analysis with some clarity. NODCs have already reacted to their particular debt crisis (or been driven so to react by their worsening financial circumstances) in part at least by cutting back their imports. In this respect, the process of adjustment has already started: it reflects reduced imports and a decline in deficits on current account associated with a reduction in the scale of further borrowings. In strictly banking and financial terms, therefore, adjustment in this way through reduced trading flows is a sensible, even inevitable, process.

107. But the key question is the extent to which this process could become self-defeating on account of its negative effects. It would be idle to assume that if the imports of the NODCs and the CPE are reduced sufficiently to improve their current account deficits that their problems thereby disappear. The consequential cut in living standards will of course vary from country to country, as will the nature and severity of any political consequences. But such financial medicine could seriously depress world economic activity if the cutbacks on exports from countries such as USA, Germany and Japan were on a large enough scale to damage confidence and abort economic recovery in those countries. This would then effect all industrial countries and could lead to further downward pressure towards a new equilibrium at lower levels of trade and activity. Such a scenario might be protracted and long drawn out, but as bad as a sudden crisis.

International Political Aspects

108. Financial strain and economic recession make for international political instability and tension.

109. Debt servicing requirements, and the implementation of the stringent domestic economic measures necessary to bring about recovery, can impose severe political pressures on debtor countries. Many of these already have fragile political structures and a limited capacity for rapid adjustment. High interest rates, sharply reduced export earnings and diminishing access to new credits compound their difficulties.

110. The strategic interests of the West are involved in many of the poorer LDCs, particularly in Africa, even if their individual debt problems do not threaten the stability of the international financial system. Latin America is a major area of concern for the West and for the United States in particular. So is Eastern Europe: a significant feature of East/West relations at present is the extent of the dependence of the Eastern European countries on access to Western finance which their current debt problems have revealed. The present international financial strains in so many countries have in fact served to heighten understanding of the interdependence of the economic and financial interests of individual countries. Problems in one country affect all

the others, in varying degrees. As countries increasingly come to understand that they sink or swim together, the compulsion to cooperate (rather than to confront, as has been the tendency in the North/South dialogue) may prove beneficial. But this healthy trend cannot be taken for granted. The present and growing frustration of the developing countries is causing mounting friction in North/South relations. We have just seen a polarisation in the negotiating positions of the industrialised and the developing countries at the GATT Ministerial meeting; and UNCTAD VI next June is likely to prove difficult.

111.The international effort to find solutions to the present problems will require concentrated multilateral and bilateral negotiation. Within the Western alliance, the attitudes of the major countries to specific debt settlement operations can differ sharply, and this can in itself induce strains within the Alliance.

Policy implications

112. What is needed, therefore, is the concerted use of policy instruments to permit the world economic system to recover its health but on a rising trend of economic and trade activity, political expectations and financial confidence.

113. The two developments which would do most to ease the situation generally would be United States recovery and a continuation of the trend towards lower world interest rates. While a counter-inflationary strategy on the part of the industrial countries remains the only sustainable basis for eventual economic recovery, this should be tempered by a sensitive interpretation of monetary conditions. Regard should also be had to the international effects of policies to lend support to domestic industries at a time when recession may mask the fact that these are in structural rather than cyclical difficulties. The importance of countries taking account of the international repercussions of their policies must be stressed. Attempts to steal a march by competitive devaluation (eg Sweden) or protectionism could quickly lead to a worsening of the international climate and interrupt or reverse the process of recovery. While the aberrant behaviour of a handful of less important countries could be accommodated, such moves by one or more of the major industrial countries could prove disastrous.

Institutional Arrangements

114. One obvious result of the present crisis is the intense strain which it has imposed on the present international arrangements for trade and payments. The recent GATT Ministerial meeting in Geneva demonstrated the precariousness of the open trading system, not its permanence or solidity. On the basis that it is usually better to improve existing institutions than to make new ones, the time does not seem right for grandiose new institutional initiatives; and it would equally be wrong to imagine that a complete solution to the crisis is to be found in major institutional changes. But adjustments and improvements of one kind or another will clearly form part of any strategy for recovery and the need is to ensure that the present institutions work as effectively as possible.

115. The IMF is likely to be central to a satisfactory relationship between trade and financing. There is already evidence that its involvement with problem countries makes possible the negotiation, not only of appropriate adjustment programmes but also of a package of financing by other official and private institutions. In order to strengthen this central role and to improve confidence in the international financial system, speedy agreement is needed on the size of the next quota increase and enlargement of the General Arrangements to Borrow (GAB), originally set up by the Group of Ten to provide supplementary finance for IMF drawings by their own number. This enlargement might be both by amount and by eligibility to enable non-GIO countries to participate as lenders or borrowers. The increase in the Fund's resources needs to be large enough not only to meet the collective needs of problem countries, but also to provide an incentive to individual members to make earlier approaches to the Fund. Difficult choices lie ahead in striking the right balance between financing and adequate adjustment, i.e. in the severity of IMF conditionality. This balance needs to avoid on the one hand a political climate in which there is a cumulative failure to implement the programmes or, on the other, a degree of laxity that fails to restore the creditworthiness of the problem countries.

Improved co-ordination between official and private lenders

116. Ad hoc institutional procedures are developing for improved co-ordination of emergency bridging finance to problem countries by official and private creditors as in the case of Mexico. These have included central bank credit arranged through the BIS and inter-government loans. Some of the larger international banks, with the encouragement of the IMF, are likely to agree shortly to make advance contributions to jumbo loans to Brazil and perhaps other countries, ahead of final agreement on the IMF programme. These procedures need to be put onto a sounder footing.

Aid during the convalescent period

117. One of the defects of the rescheduling system is that the debtor country has often been starved of new credits for a certain period before credit-worthiness is re-established. Enlargement of the international financing institutions will contribute to a solution and bilateral economic assistance might also be considered. The objective would be to provide credit facilities during the period immediately following a debt rescheduling operation in order to maintain a flow of essential imports on terms which would not add to the existing debt problems. A pattern is recently emerging whereby private banks have recognised their responsibility to maintain some credit facilities as part of a joint official and commercial package. Adequate co-ordination between all the creditors is needed to design the package in a systematic way that dove-tails with the IMF programme. This may emerge as an extension of procedures mentioned in the previous paragraph.

Rescheduling terms

118. While it remains vital that rescheduling of debt should not become an automatic or easy option, consideration might be given to promoting some changes in existing Paris Club conventions and procedures, with the aim of making rescheduling more effective as an instrument for restoring creditworthiness. Consideration might be given to -

i. Extending the scope of the rescheduling. At present the Paris Club generally only looks about one year ahead which leaves in doubt whether or not a further rescheduling might be arranged. It may be sensible in this way to ensure compliance with the IMF programme by retaining some leverage over the debtor who may not, anyway, be in a position to make long-term commitments. The commercial banks may also prefer not to be committed too far ahead. However, in suitable cases where it is clear that the debt structural problem will persist for some time, agreement in principle to reschedule 3 year debts, subject to some performance criteria, might be indicated at the outset. Yugoslavia is a possible case in point. Such an approach might also reduce the danger that a country might seriously consider default as an alternative option.

ii. Relaxing the present insistence that other creditors (eg private lenders) should also reschedule their debts. While no one would wish to encourage the thought that governments should bale out private lenders, the contributions of official and private lenders to solving a debt crisis need not necessarily by identical.

iii. Shortening the Paris Club procedures and examining whether pledges of principle to reschedule debt might be given in advance of formal Paris Club meetings in order to dispel uncertainty.

Action to reduce the risk of further debt crises

119. Improvements are desirable to reduce the risk in future of similar debt crises. These might include -

a. Better collection and circulation of data - BIS/OECD/IBRD efforts to improve coverage are making slow progress but there are big gaps in the data provided (especially on short term debt) and some "double counting" in the statistics now available. The creation by the commercial banks of an institution in Washington (sometimes called Ditchley II) to exchange information between themselves and to encourage a better flow from borrowers may help.

b. Wider consultation and exchange of information on potential debt commitments between the international agencies, the export credit agencies and the commercial banks would be mutually beneficial in forecasting potential debt problems. At present there is a reasonable exchange between the international agencies and the official lenders. There is no formal systematic link-up with the private sector largely for reasons of confidentiality. One aim of Ditchley II is to provide a channel for informal exchanges, especially with the IMF and IBRD.

120. These improvements could not, however, be sufficiently refined to become a fail safe mechanism. Differences between the political systems and the economies of borrowing countries are too great to make useful the adoption of automatic debt indicators of potential crises or of automatic actions by creditors in response to them. But the combination of improvements already described should reduce the risk of sudden shifts in confidence which trigger the crises.

Trade issues

121. Among the issues at stake in the trading field are the following -

a. What other ways are there of helping debtors to adjust, short of cutting back on trade? Should the IMF discourage debtor countries from using trade barriers to improve their external payments positions?

b. Can the articulation between the various institutions (eg GATT, IMF etc) be improved through better co-ordination of activities?

c. Should LDCs encourage foreign investment by relaxing their own constraints of foreign ownership? This might enable them to industrialise without heavy borrowing. This might also be made a condition of assistance or a requirement in future borrowing.

d. A reduction in the cost of borrowing might be brought abut by reversing the recent consensus moves to raise interest rates on export credit. But this seems undesirable for other reasons.

Trade and Payments one ball of wax

122. The one overriding conclusion which emerges from the Report is that the pressures on the international monetary and economic system are inter-related and inter-dependent. The policy measures to which Governments are increasingly tempted to resort to relieve the pressures on them must be seen as alternative ways of achieving the same ends. Whether a government decides to manipulate its currency, impose trade restrictions, reschedule or default on its debts will in the last resort depend on its judgement of what best suits its particular interests and whether and what net advantage it can hang on to in the face of retaliation by other governments. If the situation is not to unravel even further, the idea that any unilateral advantage can be secured in this way must be squashed and corresponding incentives created to observe the rules.

123. The beginning of wisdom therefore is that a strategy for recovery cannot be partial in scope but must treat the issues as one ball of wax and deal with them accordingly.