10 DOWNING STREET

PERSONAL

6th February 1984

Dear Alan,

The Prime Minister would like to know whether you see any banana skins in the attached paper prepared for the next meeting of Personal Representatives who are paving the way for the Economic Summit. It ought to be circulated by the middle of this week. Could you please ring me as soon as you have had time to study it.

Yours ever,
Robin

File

Mr. R. Butler PPS/ No.10

Summit Paper for Sir Alan Walters returned as requested. (He noted that some of the pages in the Treasury paper were missing)

*With the compliments of*

THE BRITISH EMBASSY

ECONOMIC DEPARTMENT

Julian Exeter

13 February '84.

WASHINGTON, D.C.

DRAFT NO 3

# MEETING OF PERSONAL REPRESENTATIVES: 17/19 FEBRUARY 1984: DISCUSSION PAPER

A. MACROECONOMIC PROSPECTS FOR LONDON ECONOMIC SUMMIT

(A detailed factual note on the macro-economic background is at Annex).

1. The economic recovery in industrial countries which began early last year, has continued but progress has been uneven. Growth has been particularly strong in North America but activity is still weak in some countries, particularly in Europe. Nevertheless, the prospect is for a broadening of the recovery in the next year or so, with perhaps slower growth in North America but strengthening activity elsewhere.

2. Lower inflation and interest rates have contributed to the recovery, although both may now have levelled off for the Summit group as a whole. Continued progress in Europe is being offset by a firmer trend in the US. The prospect of an upturn which is moderate by past standards, should avoid any sharp overall rise in either inflation or interest rates in the period ahead, although pressures may differ between countries.

3. The recovery in activity has been accompanied by a rise in world trade with increasing demand in North America a particularly important expansionary factor. The recovery in trade should continue to broaden. But it is essential to resist protectionism and implement existing commitments to rolling back protection.

4. The continuing difficulties faced by developing countries will be an important theme for discussion in the context of the world economic situation. Western industrialised nations have major strategic, economic and financial interests in the stability of developing countries and in the strengthening of the international financial and trading system.

5. The recovery in the industrial countries has improved the balance of payments position of non-oil developing countries. Despite these encouraging trends, however, the flow of aid and other capital to developing countries generally remains constrained, and the major debtors among them are still encountering great difficulty in meeting their debt repayment obligations. Persistently high international interest rates and the exceptional strength of the dollar exchange rate add greatly to the strains on them. The sharp reduction in net new bank lending last year is another cause for concern, especially the levels of unconstrained lending not undertaken as part of an internationally agreed debt rescue package. It remains to be seen in the longer run what the impact will be of prolonged severe adjustment on the political and social fabric on these countries and the effects of sharp import contraction upon their export potential and prospects of balanced economic development. The debt strategy evolved at Williamsburg has worked successfully but the underlying risks in the situation have not been eliminated.

6. The uneven pattern of recovery in industrial countries, coupled with changes in competitiveness, is leading to growing current payments imbalances, with the United States moving into substantial deficit.

7. These payments imbalances have so far not been accompanied by any offsetting exchange rate movements as markets have continued to give greater weight to other factors, including perhaps the rate of return on assets in the US and the role of the US as a 'safe haven'. The dollar has strengthened in effective terms since Williamsburg.

8. Developments in the world economy will continue to need careful monitoring between now and June - particularly the evidence for the strengthening of the recovery in Europe, as well as pressures in both domestic and international financial markets.

9. It remains important to avoid instability in the international oil market. Economic growth in the industrialised countries should help strengthen the market, but for the present it remains fragile and continues to be dependent on OPEC countries maintaining their agreement on prices and production.

B. TAKING STOCK OF WILLIAMSBURG SUMMIT

10. The London Summit will need to review the decisions and commitments taken at Williamsburg, to assess progress made upon them since then, and to decide where further impetus or emphasis are needed, or whether the time has come to set a new direction.

Pursue appropriate monetary and budgetary policies
(Point 1 of Williamsburg Declaration)

11. This general line was endorsed by the IMF Interim Committee at its September meeting. Monetary growth has been brought down in the Summit countries following the rapid expansion earlier last year, and is now more closely in line with the rise in nominal national incomes. Progress on budgetary policies has been more uneven, with underlying structural deficits tending to rise in North America while in other Summit countries they are now on a declining trend.

Enhancing the consultation process in order to promote convergence of economic performance and greater stability of exchange rates (Point 2)

12. Major reserve currency countries have continued their periodic consultations with the IMF Managing Director. This has helped reinforce understanding of the inter-actions between each others' policies and the continued need for convergence of both policies and performance. Exchange markets have on occasion still shown some volatility in recent months. Intervention has played a modest role. The studies of the international monetary system now under way provide an opportunity for considering further ways in which the surveillance process can be strengthened.

A halt to protectionism and, as recovery proceeds, its reversal by dismantling trade barriers (Point 3)

13. The EC has decided specific measures on the lines discussed at the quadrilateral (EC, USA, Canada, Japan) meeting in Ottawa. These include acceleration of Tokyo Round tariff cuts, subject to confirmation during 1984

of current forecasts of EC economic growth in 1985 of the order of 2 per cent and provided its principal trading partners in the OECD do likewise. In parallel, the EC will eliminate to the maximum possible extent quotas on imports from the least developed countries. Japan has also announced new measures of tariff reductions, bringing forward to the Spring of 1984 the tariff cuts scheduled for 1985. The USA has indicated that it intends to introduce parallel rollback legislation shortly. The EC and Japanese measures were the first substantive responses to the OECD Secretary-General's two-phase initiative (immediate concrete measures and a longer-term process) for governments to fulfil the commitments in the Communique of the 1983 Ministerial (broadly similar to those in the Williamsburg Declaration). The Secretary-General has also arranged for the Trade Committee and Working Party 3 to have joint discussions in a search for practical ideas based on linking trade and finance issues. There may be other meetings of Trade and Finance Ministers.

14. Personal Representatives will therefore wish to monitor progress so far in existing fora, and consider how the Summit should handle the Japanese proposal for a new round of multilateral trade negotiations in the light of the Williamsburg commitment to consult on such a round. This would provide a major forum in which to pursue trade liberalisation. But the range of subjects to be covered is ambitious and contentious: there is at present no consensus of view between developed and developing countries, or even between developed countries, on them. It will be important for the credibility of the GATT to have a generally accepted framework for carrying forward multilateral work on a range of connected trade issues over the next three or four years - but it will be equally important to ensure that moves towards trade liberalisation are not jeopardised by an over-ambitious or insufficiently prepared agenda and that the proposal does not divert attention from existing GATT work in the follow-up to the 1982 Ministerial. The Summit, with the OECD Ministerial, will be the first high-level international meeting to address the issue of a new round, though it will be far too early (and in any case the wrong forum) to reach firm views on it; the Summit should aim to give impetus to a discussion of its content and timing, without labelling the idea firmly as a developed-country initiative and so alienating the Third World. It might look beyond the scheduled meeting of GATT Contracting Parties in November 1984 to a meeting at Ministerial level in 1985 to consider when and how a new round might be held.

Strategy for dealing with the international debt problem (Point 4)

15. The basic strategy laid down at Williamsburg continues to be relevant. IMF resources have been replenished by ratification of increases in quotas and the General Arrangements to Borrow, now reinforced by further loan arrangements. Agreement has been reached on a revised level of access to the Fund's main facilities. This strengthening of institutional arrangements, together with the improved global economic prospect, has meant that the main preoccupation has been shifting from broad systemic issues to management of individual country adjustment programmes. Further operational changes are in train but have still to be fully carried through. Examples: statistical improvements, including closer contacts between agencies and commercial banks; co-operation between banks in the International Institute of Finance; provision of technical assistance in information gathering; deepening international co-operation between banking supervisory agencies.

Review of the international monetary system and the part which an international monetary conference might play in reforming it (Point 5)

16. G10 Ministers agreed during the IMF Annual Meeting in Washington in September to an early study by Deputies. A first meeting of Deputies in November in Paris agreed to study the functioning of floating exchange rates, how to strengthen multilateral surveillance, the management of international liquidity and the role of the IMF. Deputies are meeting again on in mid-March, and Ministers are expected to meet in May to consider an interim report for Summit leaders. The international financial institutions are taking part in the studies. The Commonwealth Consultative Group is also pursuing its own studies with a view to providing consensus on the New Delhi Statement on Economic Action. The Group had its first meeting on 16-17 January and plans to have further meetings in February (informal Ministers meeting), April (official-level meeting), May (Ministerial level) and July (official-level) so as to present a report well in advance of the Commonwealth Finance Ministers meeting in Toronto in September.

Developing countries (Point 6)

17. Many developing countries will be disappointed by the outcome of recent discussions on IDA7. Consultations continue in the IDA Deputies. The World Bank staff are pursuing contacts with governments to see what scope exists for further movement. It will be important to reach early agreement on adequate funding for the IDA. Developing countries issues this year will be discussed in particular during the Review of the International Development Strategy which will be taking place in UNCTAD.

Versailles Working Group, environmental protection, better use of natural resources and health research (Points 7 and 10)

18. The projects identified in the report of the Versailles Working Group are being pursued, as explained in the preliminary report to Personal Representatives at Annex B. A progress report may need to be presented to the Summit. The commitment in relation to other matters was in general terms. The Summit may receive a report on the outcome of the Japan Foundation Conference on Life Sciences and Mankind in Hakone on 19-22 March 1984.

Energy (Point 8)

19. The commitment was in general terms. No specific follow-up is envisaged by Personal Representatives.

Continuing work by multilateral organisations on East/West economic relations (Point 9)

20. Work continues in OECD, COCOM, NATO and IEA to keep the situation under review. It is unlikely that a report will be needed.

## C. IMPLICATIONS FOR DIRECTION AND THEMES OF LONDON ECONOMIC SUMMIT

21. It is too early to make definite predictions about the broad issues on which attention will focus in London. But, assuming the kind of macroeconomic background outlined above, it would be important to convey the message that the strategy agreed at successive summits since the second oil shock and reinforced at Williamsburg has lost none of its relevance. It has already helped to achieve significant gains and represents the best means of making further progress. If so, the aims of the participating countries might remain to:

- achieve and maintain lower inflation. In particular, it will be important that those countries with above average inflation should continue to follow firm policies to reduce it and that, as the recovery proceeds, it will be essential to prevent a rekindling of inflationary expectations. The likelihood that non-oil commodity prices will rise, and the need to secure improving profits, both point to the importance of moderating other costs - notably wages and Government-imposed costs if companies are to have the resources for the investment necessary to sustain the recovery;

- maintain prudent monetary policies. This is important for all countries, but especially for those where inflation remains high or where other policy instruments are less easily used. In setting monetary policies, however, countries will continue to need to take account of the international environment and particularly the effect on exchange rate stability;

- put structural budget deficits onto a sustainable basis. It will be important, as recovery proceeds, to ensure not only that rising activity is reflected in lower deficits, but also that public spending and tax policies are designed to achieve a suitably moderate and sustainable level of structural deficits;

- promote conditions conducive to productive investment and greater employment opportunities;

- <u>encourage industrial adaptation and new technology</u>;

- <u>reduce the actual and potential strains on the international financial system created by major debtors</u>. This suggests maintenance of adjustment programmes beyond the short-term and creation of a more stable medium-term financial environment. This might include:

    - further restructuring by <u>commercial banks</u> of debt profiles and longer loan maturities - particularly relevant for major debtors which are either industrialising or resource-rich countries. It might also include an increased role for the <u>World Bank</u>, with some expansion of facilities and loan techniques. Establishment of a new subsidiary (World Bank bank) is worth active consideration and would be particularly relevant for poorer developing countries without access to commercial markets;.

    - encouragement by <u>Governments</u> of removal of remaining constraints on direct investment. Restoration of balance relative to bank flows, reflecting special qualities of project-related funding;

    - wider dissemination by <u>IMF</u> of information or country programmes.

22. Against this background the major themes of the London Summit may prove to be:

- the improved prospects for sustained recovery, provided that sound macro-economic policies continue to be pursued;

- progress made so far in resisting and reversing protectionism and proposals for a possible new GATT trade round;

- the strategy for continuing to deal with the problem of international debt, the difficulties faced by developing countries, and practical ways of improving the operations of the international financial system;

- and the need for more rapid progress in tackling major environmental hazards.

# THE MACRO-ECONOMIC BACKGROUND



HM Treasury
18 January 1984

PAGINATION

AS SEEN

PGS 2, 4, 6, 8 AND 10

MISSING IN ORIGINAL.

## I. DEVELOPMENTS SINCE THE WILLIAMSBURG SUMMIT

The recovery of the world economy has continued since the Williamsburg Summit but progress has been uneven. The very rapid growth of the US economy in the summer and autumn of 1983 has now given way to a slower rate of expansion. Elsewhere, however, the recovery has been muted with renewed modest growth in Japan but output lagging in continental Europe.

Table 1: Activity, inflation and trade in the Summit countries

(per cent changes)

| | 1982 | | 1983 | | 1984 |
|---|---|---|---|---|---|
| | H1 | H2 | H1 | H2 | H1 (est) |
| GDP | -1½ | 0 | 2½ | 5 | 3½ |
| Unemployment | 7½ | 8¼ | 8½ | 8 | 8 |
| Consumer prices | 6¼ | 6¼ | 4¼ | 4¾ | 5¼ |
| Import volumes | -2¾ | -5¼ | 6½ | 11 | 6¾ |
| Current balance ($bn) | +1½ | -16¼ | -6 | -23¼ | -33 |

2. The recovery of activity in the Summit group as a whole has led to an overall levelling off of unemployment, but this masks different experiences between countries. Unemployment has fallen sharply in North America reflecting the strong rise in output but in continental Europe the number of jobless has continued to increase.

3. The turnround in activity has been accompanied by a halt to the overall progress that Summit countries have made in reducing inflation. Here again, however, experiences have differed. In the US, prices have risen more rapidly with the ending of temporarily favourable factors in early-1983. France and Italy have continued to make progress, but their inflation rates remain relatively high. In Japan and Germany, inflation has stayed at a low level, while in the UK and Canada it has levelled out at close to the average for Summit countries as a whole.

for their own imports has allowed them to halve their current deficit from more than $20 billion in 1982 to around $10 billion in 1983.

7. Non-oil developing countries have similarly benefitted from rising external demand and the implementation of tough adjustment measures at home - often with IMF help. Their current account deficit which fell from $80 billion in 1981 to $65 billion in 1982, is estimated to have fallen again to around $45 billion last year. The share of export revenues needed to service their debts fell from about two-thirds to a half as a result of both lower interest rates and rescheduling. Latest estimates suggest that they also began to increase their imports again in the middle of last year.

Table 3: Trade and payments in developing countries

| | 1981 | 1982 | 1983 |
|---|---|---|---|
| Non-oil developing countries | | | |
| Import volume (per cent changes) | 6 | -5 | -1 |
| Current balance ($bn) | -80 | -65 | -45 |
| Debt service/exports (per cent) | 50 | 63 | 51 |
| Memorandum | | | |
| OPEC current balance ($bn) | 50 | -15 | -17 |

8. Falling demand for oil and lower oil prices, however, have reduced OPEC countries' export revenues sharply. Their overall current balance has swung from a surplus of $50 billion in 1981 to a deficit of $15-20 billion in both 1982 and 1983. This has been financed temporarily by running down net overseas assets but development plans and imports are now being reduced substantially in a number of oil-producing countries.

Table 5: Contributions to growth in Summit countries

(per cent of GDP)

| | 1982 | 1983 | 1984 |
|---|---|---|---|
| Private consumption | ¾ | 2 | 2 |
| Public expenditure | ¼ | 0 | ¼ |
| Private housebuilding | -¼ | ½ | ¼ |
| Other private investment | -¼ | 0 | ¾ |
| Stockbuilding | -½ | ¼ | ¾ |
| Net foreign balance | -½ | -¼ | 0 |
| GDP | -½ | 2½ | 3¾ |

lower interest rates have also helped the recovery. In particular, they have probably tended to encourage consumers to run down their savings and increase spending in a number of countries.

Table 6: Inflation, interest rates and savings in Summit countries

| | 1981 | 1982 | 1983 |
|---|---|---|---|
| Terms of trade (per cent change) | -1½ | 2 | 2 |
| Consumer prices (per cent change) | 9 | 6½ | 4¾ |
| 3-month interest rate | 14 | 11¾ | 9¼ |
| Savings ratio | 13½ | 13 | 12 |

13. Monetary developments and their contribution to the recovery have not always been easy to interpret. The modest monetary growth of 1981 and early 1982. was followed by a sharply faster rise in the period to mid-1983, particularly in the United States and Germany. Institutional changes and temporary factors contributed to distort the figures but it is difficult to know what weight to attach to these. The result, however, was a rate of monetary expansion sharply faster than nominal GDP with a fall in velocity. This was accompanied by a marked fall in interest rates in all Summit countries except Japan where nominal rates were already below those elsewhere.

Table 8: General government budget deficits (per cent of GDP)

| | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|
| US | -1 | -3¾ | -3¾ | -3¾ |
| Canada | -1 | -5¼ | -5¾ | -5 |
| Japan | -4 | -4 | -3½ | -2½ |
| Germany | -4 | -3½ | -3 | -2 |
| France | -2 | -2½ | -3½ | -3¾ |
| Italy | -11¾ | -12 | -12 | -12½ |
| UK | -2¾ | -2 | -2¾ | -2¼ |
| Summit average | -2½ | -4 | -4 | -3¾ |

18. In the United States the underlying structural deficit has risen in the past two years and is expected to rise further in 1984. Canada, too, has seen some underlying increase. All other Summit countries, however, have on balance been reducing their underlying deficits. The UK moved early in this direction. Japan and Germany have also made substantial progress, and France in turn is now reducing its structural deficit. Progress is similarly being made in Italy - albeit from a significantly higher level than elsewhere.

Table 9: Cyclically-adjusted changes* in budget deficits

| | 1982 | 1983 | 1984 |
|---|---|---|---|
| US | -1¼ | -½ | -¾ |
| Canada | 0 | -¾ | 0 |
| Japan | 0 | 1 | 1 |
| Germany | 1¾ | 1½ | 1½ |
| France | ¼ | -¼ | ¾ |
| Italy | 1 | 1½ | ¾ |
| UK | 1¾ | -½ | ¼ |
| Summit average | ¾ | ½ | ¾ |

(* - = move towards deficit).

have been the high rate of return on both real and financial assets in the US. A number of special factors may also have been important including the US relative success in reducing inflation, the flight of capital from problem areas and the after-effects of the relaxation of exchange controls in the UK and Japan.

## III. THE PROSPECTS FOR SUMMIT COUNTRIES IN 1984 AND 1985

23. Most forecasters assume that the major countries will continue to follow prudent macro-economic policies. Among the Summit countries, several members - the US, Germany and France - have already announced monetary targets for 1984 below those for 1983. Achievement of these objectives, alongside similarly moderate monetary growth in other major countries, would seem to imply a continuation of the slower rate of expansion seen in the latter part of last year.

24. The thrust of budgetary policies in most Summit countries is also still moving to reduce underlying structural deficits. The combination of these policies with resumed growth should allow actual deficits to fall. The reduction in the US, however, seems likely to be relatively small and the structural component to become more important.

Table 11: Prospects for activity, inflation and trade in Summit countries

(per cent changes)

| | 1983 | 1984 | 1985 |
|---|---|---|---|
| GDP | 2½ | 3¾ | 2½-3 |
| Unemployment rate | 8¼ | 7¾ | 7½-8 |
| Inflation | 4¾ | 5 | 5-5½ |
| Import volumes | 4½ | 7½ | 6-7 |
| Current balance ($bn) | -15 | -40 | -45-50 |

25. The prospects for the next year or so on the basis of existing policies in the Summit countries are for a continuation of the recovery. The pace, however, is likely to be moderate and some

to concern about financing the budget deficit - could work in the opposite direction.

31. The extent to which any US interest rate pressures affect other countries will depend at least partly on the development of the dollar. Continued strength of the dollar will face others with the choice between following any US interest rate moves or allowing their exchange rates to fall. But an easing of the dollar might allow others greater scope for lower interest rates.

Table 2: Output in Summit countries

(Per cent changes annual rates)

| | 1983 | 1984 | 1985 (H1) |
|---|---|---|---|
| US | 3½ | 5 | 3 |
| Canada | 3 | 5 | 2½ |
| Japan | 3 | 4 | 3 |
| Germany | 1¼ | 2 | 2¼ |
| France | ½ | 0 | 1½ |
| Italy | -1½ | 2 | 1¼ |
| UK | 2½ | 2¼ | 2 |
| Summit 7 | 2½ | 3¾ | 2¾ |

Table 3: Consumer prices in Summit countries

(Per cent changes annual rates)

| | 1983 | 1984 | 1985 (H1) |
|---|---|---|---|
| US | 4 | 5¼ | 5¾ |
| Canada | 6 | 5 | 5¼ |
| Japan | 1½ | 1½ | 2¼ |
| Germany | 3 | 3¼ | 3½ |
| France | 9¼ | 7¼ | 6 |
| Italy | 14¾ | 12 | 10 |
| UK | 6 | 6 | 5¼ |
| Summit 7 | 4¾ | 5 | 5¼ |

## IV. PROSPECTS FOR DEVELOPING COUNTRIES

32. The recovery in industrial countries' markets, together with a rising demand for raw materials, should allow non-oil developing countries to improve both the volume and price of their exports. This should enable them to finance a rising level of imports while still sustaining the recent improvement in their current balance of payments.

Table 14: Non-oil developing countries' payments and financing ($bn)

| | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|
| Current balance | -65 | -45 | -40 | -45 |
| Financed by: | | | | |
| Commercial banks | 20 | 14 | 15 | 16 |
| Direct investment | 9 | 9 | 10 | 12 |
| International agencies (including IMF) | 19 | 18 | 19 | 19 |
| Other | 12 | 12 | 10 | 14 |
| Change in reserves | -5 | 7 | 14 | 18 |
| Memorandum items | | | | |
| Import volumes (per cent change) | -7 | -1 | 6½ | 7 |
| Reserves/imports (per cent) | 24 | 26 | 29 | 30 |
| Debt services/exports (per cent) | 63 | 51 | 50 | 44 |

33. The prospects for financing flows to developing countries remain uncertain. But their gradually improving position may perhaps be expected to encourage commercial banks to continue lending at least at the comparatively low levels of recent years. This, together with continued support from the international financial institutions, seems likely to allow developing countries not only to cover their current deficits but also to begin to rebuild reserve levels.

34. The ratio of their reserves to their imports could return towards the average of the late-1970s - around 30 per cent. At the same time, the share of their export revenues needed to service

their debts could also continue to fall.

Table 15: Effects of ẚower world growth or higher interest rates on LDCs ($bn)

| | 1st year | 2nd year | 3rd year |
|---|---|---|---|
| 1 per cent a year slower GSP growth in OECD | | | |
| (a) Export volume | -5 | -10 | -15 |
| (b) Terms of trade | -2 | -3½ | -6 |
| 1 per cent higher interest rates | 1¾ | 2 | 2¼ |

35. Developing countries are of course particularly vulnerable to developments in the OECD countries. Slower OECD growth would reduce both the volume and price of LDC exports. A slowdown of 1 per cent a year in OECD output, for example, might reduce LDC export earnings by $6-7 billion immediately, rising to around $20 billion after three years. This would reduce their capacity to import or to service their debts, and would put further pressure on their depleted reserves. Similarly higher interest rates would also offset LDCs adversely with a 1 per cent increase in rates raising their debt service costs by about $2 billion a year.

36. It is important to remember, however, that these effects may not always be cumulative. Lower OECD growth, for example, may be accompanied by lower rather than higher interest rates. It may also lead to lower oil prices which benefits oil-developing countries even though oil-exporting countries are adversely affected. A broad conclusion, however, might be that prospects for trade and commodity prices are perhaps the most important factors for the LDCs.

37. It has been suggested that liberalisation of industrial countries' trade barriers could increase debtors' export earnings and contribute to easing their financial problems. A 50 per cent increase in the exports of the major nine debtors currently subject to restraint - both agricultural goods and manufactures - might raise their export receipts by about 4 per cent. The main beneficiaries would be Argentina, Brazil, the Philippines, South Korea and Yugoslavia.

## V. THE OIL MARKET AND OPEC

38. World demand for oil which fell by almost 20 per cent between 1979 and 1982, appears to have levelled off last year. The reduction in oil demand was borne wholly by OPEC suppliers since production by countries outside OPEC increased their production. The fall in demand for oil has led to weaker prices so that in real terms prices are some 15-20 per cent below their 1981 peak.

Table 16: Oil demand and supply (millions of barrels a day)

| | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|
| World oil demand | 43 | 43 | 44 | 45 |
| Non-OPEC output | 23 | 24 | 24 | 24 |
| OPEC | 20 | 19 | 20 | 21 |
| Oil prices ($ barrel) | 34 | 30 | 29 | 29 |

39. The recovery of world activity may be expected to increase demand for oil and the levelling-off of non-OPEC production will mean that this extra demand is reflected in rising OPEC output. This, however, is likely still to remain some way below OPEC capacity. In these circumstances the overall oil market may continue weak at least for the next year or so with a risk of a fresh sharp upsurge in prices - at least from economic factors - correspondingly reduced.

40. The reduction in OPEC countries' oil revenues has already led to a sharp turnround in the group's current balance, from a surplus of more than $100 billion in 1980 to deficits of $20-30 billion in 1982 and 1983. In consequence, OPEC countries have been forced to reduce sharply their imports and this process appears to be continuing. The group may be able to finance modest deficits temporarily from the assets accumulated between 1978 and 1981 but most oil producers are likely to have to make further economies and restrain imports which will be a factor holding back the overall growth in world trade.

But if price of oil is lower, consumers of oil have more to spend on imports etc. — so why does it hold back world trade



High price of oil promotes world

ANNEX B

Working Group on Technology, Growth and Employment

Preliminary report to Personal Representatives of Heads of State and Government of the countries of the Economic Summit

1. At the meeting of Personal Representatives on November 5-6, 1983 in London, it was agreed that an early meeting of the Working Group on Technology, Growth and Employment should take place in order to review progress on the areas for co-operation set up as a result of the Group's report to the Williamsburg Summit.

2. Accordingly the Working Group met on January 27-28 at the Royal Greenwich Observatory, Herstmonceux Castle. Names of the representatives of the seven countries and of the European Communities are given in the Annex.

3. The declaration of the Williamsburg Summit indicated that Heads of State and Government had "noted with approval the report of the Working Group on Technology, Growth and Employment" and would "look forward to receiving a further report at (their) next meeting". This meeting will be the London Economic Summit to be held in June 1984.

4. The Group will submit their report to Heads of State and Government prior to the London Economic Summit through Personal Representatives. The report will comprise an overview and commentary on aspects of science and technology and a review of the 18 areas for co-operation listed in the 1983 report.

5. The Group decided that the present meeting should consist of a first review of the 18 areas for co-operation and a preliminary discussion of the form and scope of its report. A second meeting would be necessary to finalise the report and this should be held before the meeting of Personal Representatives scheduled for April 7-8. It was recognised that it might also be desirable to update the review of areas for co-operation nearer to the date of the Summit but that this could be done by correspondence.

6. Leaders and co-leaders of areas for co-operation presented status reports. It was agreed that significant progress had been made in many areas for co-operation in one or more of the following respects:

a. the establishment of effective and informal international networks between research institutes in specific fields of science and technology;

b. the identification and initiation of collaborative research activities within the chosen areas for co-operation;

c. the involvement of countries outside the Economic Summit grouping and of relevant international scientific and technological organisations.

7. The activities stimulated by the Technology, Growth and Employment initiative had both improved the climate of international co-operation and helped focus national science and technology discussions, thereby strengthening the linkage between national and international science and technology effort.

8. The Group agreed that the scope for the involvement of non-Economic Summit countries or international scientific and technological organisations was different in each of the chosen areas for co-operation. It re-affirmed that the principal criterion for such involvement must be the beenfit that co-opration in the chosen areas might acquire by this participation.

9. The Group had a preliminary discussion on the form and content of its report to the Heads of State and Government at the London Economic Summit.

LIST OF PARTICIPANTS AT MEETING ON
TECHNOLOGY, GROWTH AND EMPLOYMENT 27/28 JANUARY HERSTMONCEUX CASTLE

| | |
|---|---|
| United Kingdom | Dr R B Nicholson, Chief Scientific Adviser, Cabinet Office (in the Chair) |
| | Mrs E M Ransom, Science and Technology Secretariat, Cabinet Office |
| | Mr C Burdess, Energy, Science and Space Department Foreign and Commonwealth Office |
| Canada | Dr B A Gingras, Vice-President of External Relations, National Research Council |
| | Dr D Crosby, Science Counsellor, London |
| France | Professor F Gros, Special Counsellor to the Prime Minister |
| | Mr Y Stourdze, Director of CESTA |
| | Mr D Lellouche, Science Attache, London |
| Germany | Mr R Loosch, Director for International Relations, Bundesministerium Fur Forschung und Technologie |
| | Dr K E Fest, Federal Ministry of Economics, Head of Division "International Economic Development" |
| Italy | Professor U Colombo, President of ENEA |
| | Dr C Mancini, Director International Affairs, ENEA |
| Japan | Mr T Ishiwatari, Administrative Vice-Minister, STA |
| | Dr S Ishizaka, Ex-Director General Agency for Industrial Science and Technology, MITI |
| | Mr M Endo, Minister in Geneva |
| | Mr H Satake, Director International Affairs Division, STA. |
| | Mr K Abe, Senior Executive Office for International Research and Development Co-operation, Agency for Industrial Science and Technology, MITI |
| | Mr K Takagi, Science Attache, London |
| USA | Mr W Kornack, Assistant Director for Energy, Natural Resources and International Affairs, Office of Science and Technology |
| | Mr J Boright, Science Counsellor, American Embassy, Paris |
| European Commission | Professor P Fasella, Director General DGXII |
| | Dr M Paillon, Principal Administrator DGXII |

CONFIDENTIAL

Prime Minister
Content that Sir Robert Armstrong should circulate the paper below?
FERB 3.2.

1

Ref.A084/409

PRIME MINISTER

I should like Alan Walters to see it first
MT.

Discussion Paper for Second Meeting of Personal Representatives on 17-19 February 1984

As you know, Personal Representatives are due to convene for their second meeting over the weekend of 17-19 February in the Cabinet Office. On this occasion, we shall be assisted by financial and economic experts, in my case by Sir Crispin Tickell from the Foreign and Commonwealth Office and Mr Geoffrey Littler from the Treasury.

2. At the last meeting of Personal Representatives I undertook to prepare a paper to serve as a focus for discussions at the February meeting. I attach a copy of the final draft of such a paper. If you are content, I will now circulate this paper to the other Personal Representatives.

3. At the first meeting of Personal Representatives last November, a number of them suggested that the paper should include factual background material on the main macro-economic parameters, on the grounds that discussion would be more productive if they could develop their arguments on the basis of mutually accepted fact. Annex A has therefore been drafted with this in mind. Part A of the discussion paper itself tries to suggest certain broad conclusions; I hope that the discussion will show how far these conclusions are agreed or disagreed. Part C tries to draw preliminary conclusions for the direction and themes of the Summit. It is inevitably tentative, although it is potentially important: if the pattern set during preparation of Williamsburg is followed, this part of the paper will form the basis for preparing the thematic paper which will follow.

4. I should be grateful for your authority to circulate this discussion paper to Personal Representatives.

5. I am sending copies of this minute, together with a copy of the discussion paper, to the Foreign and Commonwealth Secretary and the Chancellor of the Exchequer.

Approved by
ROBERT ARMSTRONG
and signed in his absence.

3 February 1984

CONFIDENTIAL

CONFIDENTIAL

DRAFT NO 3

MEETING OF PERSONAL REPRESENTATIVES: 17/19 FEBRUARY 1984: DISCUSSION PAPER



CONFIDENTIAL

A. MACROECONOMIC PROSPECTS FOR LONDON ECONOMIC SUMMIT

(A detailed factual note on the macro-economic background is at Annex).

1. The economic recovery in industrial countries which began early last year, has continued but progress has been uneven. Growth has been particularly strong in North America but activity is still weak in some countries, particularly in Europe. Nevertheless, the prospect is for a broadening of the recovery in the next year or so, with perhaps slower growth in North America but strengthening activity elsewhere.

2. Lower inflation and interest rates have contributed to the recovery, although both may now have levelled off for the Summit group as a whole. Continued progress in Europe is being offset by a firmer trend in the US. The prospect of an upturn which is moderate by past standards, should avoid any sharp overall rise in either inflation or interest rates in the period ahead, although pressures may differ between countries.

3. The recovery in activity has been accompanied by a rise in world trade with increasing demand in North America a particularly important expansionary factor. The recovery in trade should continue to broaden. But it is essential to resist protectionism and implement existing commitments to rolling back protection.

4. The continuing difficulties faced by developing countries will be an important theme for discussion in the context of the world economic situation. Western industrialised nations have major strategic, economic and financial interests in the stability of developing countries and in the strengthening of the international financial and trading system.

5. The recovery in the industrial countries has improved the balance of payments position of non-oil developing countries. Despite these encouraging trends, however, the flow of aid and other capital to developing countries generally remains constrained, and the major debtors among them are still encountering great difficulty in meeting their debt repayment obligations. Persistently high nominal international interest rates and the exceptional strength of the dollar exchange rate add greatly to the strains on them. The sharp reduction in net new bank lending last year is another cause for concern, especially the levels of unconstrained lending not undertaken as part of an internationally agreed debt rescue package. It remains to be seen in the longer run what the impact will be of prolonged severe adjustment on the political and social fabric on these countries and the effects of sharp import contraction upon their export potential and prospects of balanced economic development. The debt strategy evolved at Williamsburg has worked successfully but the underlying risks in the situation have not been eliminated.

6. The uneven pattern of recovery in industrial countries, coupled with changes in competitiveness, is leading to growing current payments imbalances, with the United States moving into substantial deficit.

7. These payments imbalances have so far not been accompanied by any offsetting exchange rate movements as markets have continued to give greater weight to other factors, including perhaps the rate of return on assets in the US and the role of the US as a 'safe haven'. The dollar has strengthened in effective terms since Williamsburg.

8. Developments in the world economy will continue to need careful monitoring between now and June - particularly the evidence for the strengthening of the recovery in Europe, as well as pressures in both domestic and international financial markets.

9. It remains important to avoid instability in the international oil market. Economic growth in the industrialised countries should help strengthen the market, but for the present it remains fragile [and continues to be dependent on OPEC countries maintaining their agreement on prices and production.]

Alan comments that OPEC's agreement on prices and production will produce great pressures to break the quotas which could in turn cause the price to fall dramatically.

B. TAKING STOCK OF WILLIAMSBURG SUMMIT

10. The London Summit will need to review the decisions and commitments taken at Williamsburg, to assess progress made upon them since then, and to decide where further impetus or emphasis are needed, or whether the time has come to set a new direction.

Pursue appropriate monetary and budgetary policies
(Point 1 of Williamsburg Declaration)
11. This general line was endorsed by the IMF Interim Committee at its September meeting. Monetary growth has been brought down in the Summit countries following the rapid expansion earlier last year, and is now more closely in line with ~~the rise in nominal national incomes~~ low inflation and steady growth. Progress on budgetary policies has been more uneven, with underlying structural deficits tending to rise in North America while in other Summit countries they are now on a declining trend.

Enhancing the consultation process in order to promote convergence of economic performance and greater stability of exchange rates (Point 2)

12. Major reserve currency countries have continued their periodic consultations with the IMF Managing Director. This has helped reinforce understanding of the inter-actions between each others' policies and the continued need for convergence of both policies and performance. Exchange markets have on occasion still shown some volatility in recent months. Intervention has played a modest role. The studies of the international monetary system now under way provide an opportunity for considering further ways in which the surveillance process can be strengthened.

A halt to protectionism and, as recovery proceeds, its reversal by dismantling trade barriers (Point 3)

13. The EC has decided specific measures on the lines discussed at the quadrilateral (EC, USA, Canada, Japan) meeting in Ottawa. These include acceleration of Tokyo Round tariff cuts, subject to confirmation during 1984

of current forecasts of EC economic growth in 1985 of the order of 2 per cent and provided its principal trading partners in the OECD do likewise. In parallel, the EC will eliminate to the maximum possible extent quotas on imports from the least developed countries. Japan has also announced new measures of tariff reductions, bringing forward to the Spring of 1984 the tariff cuts scheduled for 1985. The USA has indicated that it intends to introduce parallel rollback legislation shortly. The EC and Japanese measures were the first substantive responses to the OECD Secretary-General's two-phase initiative (immediate concrete measures and a longer-term process) for governments to fulfil the commitments in the Communique of the 1983 Ministerial (broadly similar to those in the Williamsburg Declaration). The Secretary-General has also arranged for the Trade Committee and Working Party 3 to have joint discussions in a search for practical ideas based on linking trade and finance issues. There may be other meetings of Trade and Finance Ministers.

14. Personal Representatives will therefore wish to monitor progress so far in existing fora, and consider how the Summit should handle the Japanese proposal for a new round of multilateral trade negotiations in the light of the Williamsburg commitment to consult on such a round. This would provide a major forum in which to pursue trade liberalisation and would reduce the danger of trade restrictions continuing to mount for lack of such a forum. But the range of subjects to be covered is ambitious and contentious: there is at present no consensus of view between developed and developing countries, or even between developed countries, on them. It will be important for the credibility of the GATT to have a generally accepted framework for carrying forward multilateral work on a range of connected trade issues over the next three or four years - but it will be equally important to ensure that moves towards trade liberalisation are not jeopardised by an over-ambitious or insufficiently prepared agenda and that the proposal does not divert attention from existing GATT work in the follow-up to the 1982 Ministerial. The Summit, with the OECD Ministerial, will be the first high-level international meeting to address the issue of a new round, though it will be far too early (and in any case the wrong forum) to reach firm views on it; the Summit should aim to give impetus to a discussion of its content and timing, without labelling the idea firmly as a developed-country initiative and so alienating the Third World. It might look beyond the scheduled meeting of GATT Contracting Parties in November 1984 to a meeting at Ministerial level in 1985 to consider when and how a new round might be held.

Strategy for dealing with the international debt problem (Point 4)

15. The basic strategy laid down at Williamsburg continues to be relevant. IMF resources have been replenished by ratification of increases in quotas and the General Arrangements to Borrow, now reinforced by further loan arrangements. Agreement has been reached on a revised level of access to the Fund's main facilities. This strengthening of institutional arrangements, together with the improved global economic prospect, has meant that the main preoccupation has been shifting from broad systemic issues to management of individual country adjustment programmes. Further operational changes are in train but have still to be fully carried through. Examples: statistical improvements, including closer contacts between agencies and commercial banks; co-operation between banks in the International Institute of Finance; provision of technical assistance in information gathering; deepening international co-operation between banking supervisory agencies.

Review of the international monetary system and the part which an international monetary conference might play in reforming it (Point 5)

16. G10 Ministers agreed during the IMF Annual Meeting in Washington in September to an early study by Deputies. A first meeting of Deputies in November in Paris agreed to study the functioning of floating exchange rates, how to strengthen multilateral surveillance, the management of international liquidity and the role of the IMF. Deputies are meeting again on in mid-March, and Ministers are expected to meet in May to consider an interim report for Summit leaders. The international financial institutions are taking part in the studies. The Commonwealth Consultative Group is also pursuing its own studies with a view to providing consensus on the New Delhi Statement on Economic Action. The Group had its first meeting on 16-17 January and plans to have further meetings in February (informal Ministers meeting), April (official-level meeting), May (Ministerial level) and July (official-level) so as to present a report well in advance of the Commonwealth Finance Ministers meeting in Toronto in September.

Developing countries (Point 6)

17. Many developing countries will be disappointed by the outcome of recent discussions on IDA7. Consultations continue in the IDA Deputies. The World Bank staff are pursuing contacts with governments to see what scope exists for further movement. It will be important to reach early agreement on adequate funding for the IDA. Developing countries issues this year will be discussed in particular during the Review of the International Development Strategy which will be taking place in UNCTAD.

Versailles Working Group, environmental protection, better use of natural resources and health research (Points 7 and 10)

18. The projects identified in the report of the Versailles Working Group are being pursued, as explained in the preliminary report to Personal Representatives at Annex B. A progress report may need to be presented to the Summit. The commitment in relation to other matters was in general terms. The Summit may receive a report on the outcome of the Japan Foundation Conference on Life Sciences and Mankind in Hakone on 19-22 March 1984.

Energy (Point 8)

19. The commitment was in general terms. No specific follow-up is envisaged by Personal Representatives.

Continuing work by multilateral organisations on East/West economic relations (Point 9)

20. Work continues in OECD, COCOM, NATO and IEA to keep the situation under review. It is unlikely that a report will be needed.

## C. IMPLICATIONS FOR DIRECTION AND THEMES OF LONDON ECONOMIC SUMMIT

21. It is too early to make definite predictions about the broad issues on which attention will focus in London. But, assuming the kind of macro-economic background outlined above, it would be important to convey the message that the strategy agreed at successive summits since the second oil shock and reinforced at Williamsburg has lost none of its relevance. It has already helped to achieve significant gains and represents the best means of making further progress. If so, the aims of the participating countries might remain to:

- <u>achieve and maintain lower inflation</u>. In particular, it will be important that those countries with above average inflation should continue to follow firm policies to reduce and eventually eliminate it and that, as the recovery proceeds, it will be essential to prevent a rekindling of inflationary expectations. The likelihood that non-oil commodity prices will rise, and the need to secure improving profits, both point to the importance of moderating other costs - notably wages and Government-imposed costs if companies are to have the resources for the investment necessary to sustain the recovery;

- <u>maintain prudent monetary policies</u>. This is important for all countries, but especially for those where inflation remains high [or where other policy instruments are less easily used]. In setting monetary policies, however, countries will continue to need to take account of the international environment and particularly the effect on exchange rate stability;

Alan doesn't know what this means

- <u>put structural budget deficits onto a sustainable basis</u>. It will be important, as recovery proceeds, to ensure not only that rising activity is reflected in lower deficits, but also that public spending and tax policies are designed to achieve a suitably moderate and sustainable level of structural deficits;

- <u>promote conditions conducive to productive investment and greater employment opportunities</u>;

- encourage industrial adaptation and new technology;

- reduce the actual and potential strains on the international financial system created by major debtors. This suggests maintenance of adjustment programmes beyond the short-term and creation of a more stable medium-term financial environment. This might include:

    - further restructuring by commercial banks of debt profiles and longer loan maturities - particularly relevant for major debtors which are either industrialising or resource-rich countries. [It might also include an increased role for the World Bank, with some expansion of facilities and loan techniques. Establishment of a new subsidiary (World Bank bank) is worth active consideration and would be particularly relevant for poorer developing countries without access to commercial markets].

Alan says it would be premature to propose this until the future of the IDA is clearer

    - encouragement by Governments of removal of remaining constraints on direct investment. Restoration of balance relative to bank flows, reflecting special qualities of project-related funding;

    - wider dissemination by IMF of information or country programmes.

22. Against this background the major themes of the London Summit may prove to be:

- the improved prospects for sustained recovery, provided that sound macro-economic policies continue to be pursued;

- progress made so far in resisting and reversing protectionism and proposals for a possible new GATT trade round;

- the strategy for continuing to deal with the problem of international debt in the long term as well as the short term, the difficulties faced by developing countries, and practical ways of improving the operations of the international financial system;

- and the need for more rapid progress in tackling major environmental hazards.

# THE MACRO-ECONOMIC BACKGROUND



HM Treasury
18 January 1984

## I. DEVELOPMENTS SINCE THE WILLIAMSBURG SUMMIT

The recovery of the world economy has continued since the Williamsburg Summit but progress has been uneven. The very rapid growth of the US economy in the summer and autumn of 1983 has now given way to a slower rate of expansion. Elsewhere, however, the recovery has been muted with renewed modest growth in Japan but output lagging in continental Europe.

Table 1: Activity, inflation and trade in the Summit countries

(per cent changes)

| | 1982 | | 1983 | | 1984 |
|---|---|---|---|---|---|
| | H1 | H2 | H1 | H2 | H1 (est) |
| GDP | -1½ | 0 | 2½ | 5 | 3½ |
| Unemployment | 7½ | 8¼ | 8½ | 8 | 8 |
| Consumer prices | 6¼ | 6¼ | 4¼ | 4¾ | 5¼ |
| Import volumes | -2¾ | -5¼ | 6½ | 11 | 6¾ |
| Current balance ($bn) | +1½ | -16¼ | -6 | -23¼ | -33 |

2. The recovery of activity in the Summit group as a whole has led to an overall levelling off of unemployment, but this masks different experiences between countries. Unemployment has fallen sharply in North America reflecting the strong rise in output but in continental Europe the number of jobless has continued to increase.

3. The turnround in activity has been accompanied by a halt to the overall progress that Summit countries have made in reducing inflation. Here again, however, experiences have differed. In the US, prices have risen more rapidly with the ending of temporarily favourable factors in early-1983. France and Italy have continued to make progress, but their inflation rates remain relatively high. In Japan and Germany, inflation has stayed at a low level, while in the UK and Canada it has levelled out at close to the average for Summit countries as a whole.

4. Increased activity has also brought with it a revival of trade with a sharp reversal of the 1982 falls in major countries' imports. The rise in imports over the past year has been particularly marked in those countries leading the recovery - the US, Canada and the UK. Imports by Japan and the continental European economies have been more sluggish.

5. The rise in Summit countries' imports has run well ahead of the growth of their exports as countries outside the group, particularly both oil and non-oil developing countries, have put in place firm adjustment programmes. As a result, the Summit group has moved from a position of broad current balance in early-1982 to significant deficit. The deterioration reflects very largely the widening US current deficit with Japan and Germany in increasing surplus and France and Italy sharply lowering their own deficits.

Table 2: Activity, inflation and trade in smaller industrial countries

(per cent changes)

| | 1982 | | 1983 | | 1984 |
|---|---|---|---|---|---|
| | H1 | H2 | H1 | H2 | H1 (est) |
| GDP | ½ | ¼ | ½ | 2 | 2 |
| Unemployment rate | 10 | 10½ | 11½ | 12 | 12½ |
| Consumer prices | 11¾ | 11¾ | 10 | 9 | 9 |
| Import volumes | ½ | -1½ | -1 | 4 | 2½ |
| Current balance ($bn) | -25 | -20 | -10 | -10 | -5 |

6. The recovery in activity in the Summit countries has been accompanied by a modest upturn in output in the smaller industrial countries in the most recent period, but this has not been enough to check rising unemployment. Many countries are still having to take firm adjustment measures to curb inflation which remains appreciably higher on average than in the Summit countries. Nevertheless, the combination of rising demand in smaller countries' major export markets, together with a restrained level

for their own imports has allowed them to halve their current deficit from more than $20 billion in 1982 to around $10 billion in 1983.

7. Non-oil developing countries have similarly benefitted from rising external demand and the implementation of tough adjustment measures at home - often with IMF help. Their current account deficit which fell from $80 billion in 1981 to $65 billion in 1982, is estimated to have fallen again to around $45 billion last year. The share of export revenues needed to service their debts fell from about two-thirds to a half as a result of both lower interest rates and rescheduling. Latest estimates suggest that they also began to increase their imports again in the middle of last year.

Table 3: Trade and payments in developing countries

| | 1981 | 1982 | 1983 |
|---|---|---|---|
| Non-oil developing countries | | | |
| Import volume (per cent changes) | 6 | -5 | -1 |
| Current balance ($bn) | -80 | -65 | -45 |
| Debt service/exports (per cent) | 50 | 63 | 51 |
| Memorandum | | | |
| OPEC current balance ($bn) | 50 | -15 | -17 |

8. Falling demand for oil and lower oil prices, however, have reduced OPEC countries' export revenues sharply. Their overall current balance has swung from a surplus of $50 billion in 1981 to a deficit of $15-20 billion in both 1982 and 1983. This has been financed temporarily by running down net overseas assets but development plans and imports are now being reduced substantially in a number of oil-producing countries.

## II. FEATURES OF THE RECOVERY AND THE ROLE OF POLICY

9. The Summit partners' shared commitment to reducing inflation and following prudent macro-economic policies is tending to bring into play a number of common factors in the recovery. But the progress of individual countries is also being influenced by the speed with which their economies are adjusting to lower inflation and the pace at which policies are being implemented. These are also tending to affect the balance between domestic and external factors in individual economies and the balance of growth within the Summit group as a whole.

Table 4: Nominal GDP, inflation and output in Summit countries

(per cent changes)

| | 1981 | 1982 | 1983 |
|---|---|---|---|
| Nominal GDP | 10 | 6 | 7½ |
| GDP deflator | 8¾ | 6½ | 5 |
| Real GDP | 1¼ | -½ | 2½ |

10. One of the arguments for reducing inflation has been that within a firm financial framework it leaves room for real growth. The rise in Summit countries' overall nominal GDP which slowed unexpectedly sharply in 1982, recovered in 1983. It was also accompanied by a more favourable trade-off between inflation and output with a slower rise in prices leaving more scope for rising real activity.

11. The early stages of the recovery have relied heavily on higher spending by private consumers, increased housebuilding and a turnround in the stock cycle in the Summit countries as a whole. This is a normal pattern.

12. Lower world oil prices and the weakness of other commodity prices have tended to raise consumers' real incomes in Summit countries, although exchange rate changes have meant that these terms of trade benefits have been uneven. Lower inflation and

Table 5: Contributions to growth in Summit countries

(per cent of GDP)

| | 1982 | 1983 | 1984 |
|---|---|---|---|
| Private consumption | ¾ | 2 | 2 |
| Public expenditure | ¼ | 0 | ¼ |
| Private housebuilding | -¼ | ½ | ¼ |
| Other private investment | -¼ | 0 | ¾ |
| Stockbuilding | -½ | ¼ | ¾ |
| Net foreign balance | -½ | -¼ | 0 |
| GDP | -½ | 2½ | 3¾ |

lower interest rates have also helped the recovery. In particular, they have probably tended to encourage consumers to run down their savings and increase spending in a number of countries.

Table 6: Inflation, interest rates and savings in Summit countries

| | 1981 | 1982 | 1983 |
|---|---|---|---|
| Terms of trade (per cent change) | -1½ | 2 | 2 |
| Consumer prices (per cent change) | 9 | 6½ | 4¾ |
| 3-month interest rate | 14 | 11¾ | 9¼ |
| Savings ratio | 13½ | 13 | 12 |

13. Monetary developments and their contribution to the recovery have not always been easy to interpret. The modest monetary growth of 1981 and early 1982. was followed by a sharply faster rise in the period to mid-1983, particularly in the United States and Germany. Institutional changes and temporary factors contributed to distort the figures but it is difficult to know what weight to attach to these. The result, however, was a rate of monetary expansion sharply faster than nominal GDP with a fall in velocity. This was accompanied by a marked fall in interest rates in all Summit countries except Japan where nominal rates were already below those elsewhere.

14. In the most recent period, monetary growth in the US and Germany has been more moderate. This, coupled with further progress in slowing monetary growth in France, has helped bring the overall rise in the monetary aggregates for the Summit group as a whole more nearly in line with nominal GDP. Interest rates have in turn shown a relatively firm trend over recent months.

Table 7: Monetary growth and interest rates in Summit countries

| | 1982 | | 1983 | |
|---|---|---|---|---|
| | H1 | H2 | H1 | H2 |
| Narrow money (M1) | 4½ | 11¾ | 9¼ | 7¼ |
| Broad money (M2/M3) | 8¾ | 9¾ | 11¼ | 8¾ |
| Money GDP | 5½ | 5½ | 7½ | 9½ |
| 3-month interest rates | 13 | 10½ | 9 | 9½ |

15. Last year's fall in nominal interest rates was not mirrored in a decline in real interest rates measured in terms of current inflation rates. In the United States, in particular, real interest rates remain high with long-term bond rates around 12 per cent compared to an underlying current inflation rate of 4-5 per cent. Real rates are typically rather lower in most other Summit countries although they, too, are high when the low level of activity is taken into account.

16. The level of budget deficits in Summit countries has risen sharply over the past three years to about 4 per cent of GDP in 1983, and only a modest fall seems likely this year. This compares with an average level of 2 per cent in the 1970s and about ½ per cent in the late-1960s.

17. These figures, however, are strongly influenced by the level of activity in individual countries. These help to mask a divergence in the pace at which countries are implementing the common policy of reducing structural deficits. This in turn helps to explain the uneven pattern of recovery in the Summit countries.

Table 8: General government budget deficits (per cent of GDP)

| | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|
| US | -1 | -3¾ | -3¾ | -3¾ |
| Canada | -1 | -5¼ | -5¾ | -5 |
| Japan | -4 | -4 | -3½ | -2½ |
| Germany | -4 | -3½ | -3 | -2 |
| France | -2 | -2½ | -3½ | -3¾ |
| Italy | -11¾ | -12 | -12 | -12½ |
| UK | -2¾ | -2 | -2¾ | -2¼ |
| Summit average | -2½ | -4 | -4 | -3¾ |

18. In the United States the underlying structural deficit has risen in the past two years and is expected to rise further in 1984. Canada, too, has seen some underlying increase. All other Summit countries, however, have on balance been reducing their underlying deficits. The UK moved early in this direction. Japan and Germany have also made substantial progress, and France in turn is now reducing its structural deficit. Progress is similarly being made in Italy - albeit from a significantly higher level than elsewhere.

Table 9: Cyclically-adjusted changes* in budget deficits

| | 1982 | 1983 | 1984 |
|---|---|---|---|
| US | -1¼ | -½ | -¾ |
| Canada | 0 | -¾ | 0 |
| Japan | 0 | 1 | 1 |
| Germany | 1¾ | 1½ | 1¼ |
| France | ¼ | -¼ | ¾ |
| Italy | 1 | 1½ | ¾ |
| UK | 1¾ | -½ | ¼ |
| Summit average | ¾ | ½ | ¾ |

(* - = move towards deficit).

19. The US deficit has helped to encourage the recovery of domestic demand. In particular, tax rate reductions have meant that tax payments have lagged behind incomes tending to boost the spending power available to consumers. By contrast, tax receipts in other Summit countries have tended to take an increased share of households' incomes restraining their spending in the interests of controlling Government budget deficits.

20. The divergence between the US and other Summit countries has been reflected in US imports rising more rapidly than exports. The US has thus been providing a fillip to demand in the rest of the world equivalent to about 1 per cent of US GDP a year in the period 1981-84. The recoveries in the UK and Canada have also added to demand elsewhere with other Summit members among the beneficiaries.

Table 10: Current balances ($ billion annual rates)

| | 1982 | | 1983 | |
|---|---|---|---|---|
| | H1 | H2 | H1 | H2 |
| US | 4 | -26 | -27 | -59 |
| Canada | 1 | 4 | 3 | 3 |
| Japan | 8 | 6 | 19 | 26 |
| Germany | 2 | 5 | 5 | 5 |
| France | -12 | -12 | -10 | -1 |
| Italy | - 6 | -5 | 2 | 1 |
| UK | 6 | 13 | 1 | 2 |

21. The US has moved into significant current account deficit and the UK has shown a reduced surplus while other Summit countries have generally improved their payments positions with increased surpluses in Japan and Germany, together with lower deficits in France and Italy.

22. The dollar exchange rate has remained firm despite the deterioration in the US current balance. Its effective rate has risen by 11 per cent over the past year. Among the factors cited

have been the high rate of return on both real and financial assets in the US. A number of special factors may also have been important including the US relative success in reducing inflation, the flight of capital from problem areas and the after-effects of the relaxation of exchange controls in the UK and Japan.

## III. THE PROSPECTS FOR SUMMIT COUNTRIES IN 1984 AND 1985

23. Most forecasters assume that the major countries will continue to follow prudent macro-economic policies. Among the Summit countries, several members - the US, Germany and France - have already announced monetary targets for 1984 below those for 1983. Achievement of these objectives, alongside similarly moderate monetary growth in other major countries, would seem to imply a continuation of the slower rate of expansion seen in the latter part of last year.

24. The thrust of budgetary policies in most Summit countries is also still moving to reduce underlying structural deficits. The combination of these policies with resumed growth should allow actual deficits to fall. The reduction in the US, however, seems likely to be relatively small and the structural component to become more important.

Table 11: Prospects for activity, inflation and trade in Summit countries

(per cent changes)

| | 1983 | 1984 | 1985 |
|---|---|---|---|
| GDP | 2½ | 3¾ | 2½-3 |
| Unemployment rate | 8¼ | 7¾ | 7½-8 |
| Inflation | 4¾ | 5 | 5-5½ |
| Import volumes | 4½ | 7½ | 6-7 |
| Current balance ($bn) | -15 | -40 | -45-50 |

25. The prospects for the next year or so on the basis of existing policies in the Summit countries are for a continuation of the recovery. The pace, however, is likely to be moderate and some

unevenness between countries will remain. Growth in North America should continue but at a slower rate than in the earlier phase of the upturn. Activity seems likely to rise in Japan and the continental European economies - although in some cases strong growth may not be evident until the turn of the year. The UK seems likely to continue to show moderate growth.

26. The rise in activity in the Summit group as a whole may still not be rapid enough to bring any marked reduction in unemployment. Some further decline seems likely in North America but at least some European countries may see further increases.

27. The prospects for a relatively modest rise in output by past standards, coupled with a continued high level of unemployment in many countries, seem likely to be consistent with avoiding any sharp resurgence of inflation. Some modest pick-up may be evidence in the US but other Summit countries may either manage to keep inflation close to present levels or even achieve some reduction.

28. The continued rise in activity in the major countries should be accompanied by a further increase in their imports, helping to underpin the recovery of world trade. The rise in imports into the US - reflecting both relatively strong domestic growth and the lagged effects of past competitiveness losses - seems likely to be a continued expansionary factor for other countries.

29. The Summit group as a whole seems likely to remain in significant current deficit with the rest of the world - in contrast with its traditional position of surplus. The US will remain in substantial deficit with Japan and Germany in surplus.

30. Particular uncertainties surround the prospects for interest rates and exchange rates. The prospect of moderate growth and inflation in the Summit group as a whole coupled with firm budgetary policies should be factors helping to reduce the risk of an early rise in interest rates. In the US the prospective moderation in the rate of output growth will also tend to check interest rate pressures but any recovery in inflation - particularly if allied

to concern about financing the budget deficit - could work in the opposite direction.

31. The extent to which any US interest rate pressures affect other countries will depend at least partly on the development of the dollar. Continued strength of the dollar will face others with the choice between following any US interest rate moves or allowing their exchange rates to fall. But an easing of the dollar might allow others greater scope for lower interest rates.

Table 2: Output in Summit countries

(Per cent changes annual rates)

| | 1983 | 1984 | 1985 (H1) |
|---|---|---|---|
| US | 3½ | 5 | 3 |
| Canada | 3 | 5 | 2½ |
| Japan | 3 | 4 | 3 |
| Germany | 1¼ | 2 | 2¼ |
| France | ½ | 0 | 1½ |
| Italy | -1½ | 2 | 1¼ |
| UK | 2½ | 2¼ | 2 |
| Summit 7 | 2½ | 3¾ | 2¾ |

Table 3: Consumer prices in Summit countries

(Per cent changes annual rates)

| | 1983 | 1984 | 1985 (H1) |
|---|---|---|---|
| US | 4 | 5¼ | 5¾ |
| Canada | 6 | 5 | 5¼ |
| Japan | 1½ | 1½ | 2¼ |
| Germany | 3 | 3¼ | 3½ |
| France | 9¼ | 7¼ | 6 |
| Italy | 14¾ | 12 | 10 |
| UK | 6 | 6 | 5¼ |
| Summit 7 | 4¾ | 5 | 5¼ |

Table 4: Current balances in Summit countries

($ billion annual rates)

| | 1983 | 1984 | 1985 (H1) |
|---|---|---|---|
| US | -43 | -82 | -99 |
| Canada | 3 | 1 | 0 |
| Japan | 23 | 32 | 36 |
| Germany | 5 | 6 | 7 |
| France | -5 | 1 | 4 |
| Italy | 2 | 1 | 2 |
| UK | 2 | 3 | 3 |
| Summit 7 | -15 | -39 | -47 |

## IV. PROSPECTS FOR DEVELOPING COUNTRIES

32. The recovery in industrial countries' markets, together with a rising demand for raw materials, should allow non-oil developing countries to improve both the volume and price of their exports. This should enable them to finance a rising level of imports while still sustaining the recent improvement in their current balance of payments.

Table 14: Non-oil developing countries' payments and financing ($bn)

| | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|
| Current balance | -65 | -45 | -40 | -45 |
| Financed by: | | | | |
| Commercial banks | 20 | 14 | 15 | 16 |
| Direct investment | 9 | 9 | 10 | 12 |
| International agencies (including IMF) | 19 | 18 | 19 | 19 |
| Other | 12 | 12 | 10 | 14 |
| Change in reserves | -5 | 7 | 14 | 18 |
| Memorandum items | | | | |
| Import volumes (per cent change) | -7 | -1 | 6½ | 7 |
| Reserves/imports (per cent) | 24 | 26 | 29 | 30 |
| Debt services/exports (per cent) | 63 | 51 | 50 | 44 |

33. The prospects for financing flows to developing countries remain uncertain. But their gradually improving position may perhaps be expected to encourage commercial banks to continue lending at least at the comparatively low levels of recent years. This, together with continued support from the international financial institutions, seems likely to allow developing countries not only to cover their current deficits but also to begin to rebuild reserve levels.

34. The ratio of their reserves to their imports could return towards the average of the late-1970s - around 30 per cent. At the same time, the share of their export revenues needed to service

their debts could also continue to fall.

Table 15: Effects of lower world growth or higher interest rates on LDCs ($bn)

| | 1st year | 2nd year | 3rd year |
|---|---|---|---|
| 1 per cent a year slower GSP growth in OECD | | | |
| (a) Export volume | -5 | -10 | -15 |
| (b) Terms of trade | -2 | -3½ | -6 |
| 1 per cent higher interest rates | 1¾ | 2 | 2¼ |

35. Developing countries are of course particularly vulnerable to developments in the OECD countries. Slower OECD growth would reduce both the volume and price of LDC exports. A slowdown of 1 per cent a year in OECD output, for example, might reduce LDC export earnings by $6-7 billion immediately, rising to around $20 billion after three years. This would reduce their capacity to import or to service their debts, and would put further pressure on their depleted reserves. Similarly higher interest rates would also offset LDCs adversely with a 1 per cent increase in rates raising their debt service costs by about $2 billion a year.

36. It is important to remember, however, that these effects may not always be cumulative. Lower OECD growth, for example, may be accompanied by lower rather than higher interest rates. It may also lead to lower oil prices which benefits oil-developing countries even though oil-exporting countries are adversely affected. A broad conclusion, however, might be that prospects for trade and commodity prices are perhaps the most important factors for the LDCs.

37. It has been suggested that liberalisation of industrial countries' trade barriers could increase debtors' export earnings and contribute to easing their financial problems. A 50 per cent increase in the exports of the major nine debtors currently subject to restraint - both agricultural goods and manufactures - might raise their export receipts by about 4 per cent. The main beneficiaries would be Argentina, Brazil, the Philippines, South Korea and Yugoslavia.

## V. THE OIL MARKET AND OPEC

38. World demand for oil which fell by almost 20 per cent between 1979 and 1982, appears to have levelled off last year. The reduction in oil demand was borne wholly by OPEC suppliers since production by countries outside OPEC increased their production. The fall in demand for oil has led to weaker prices so that in real terms prices are some 15-20 per cent below their 1981 peak.

Table 16: Oil demand and supply (millions of barrels a day)

| | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|
| World oil demand | 43 | 43 | 44 | 45 |
| Non-OPEC output | 23 | 24 | 24 | 24 |
| OPEC | 20 | 19 | 20 | 21 |
| Oil prices ($ barrel) | 34 | 30 | 29 | 29 |

39. The recovery of world activity may be expected to increase demand for oil and the levelling-off of non-OPEC production will mean that this extra demand is reflected in rising OPEC output. This, however, is likely still to remain some way below OPEC capacity. In these circumstances the overall oil market may continue weak at least for the next year or so with a risk of a fresh sharp upsurge in prices - at least from economic factors - correspondingly reduced.

40. The reduction in OPEC countries' oil revenues has already led to a sharp turnround in the group's current balance, from a surplus of more than $100 billion in 1980 to deficits of $20-30 billion in 1982 and 1983. In consequence, OPEC countries have been forced to reduce sharply their imports and this process appears to be continuing. The group may be able to finance modest deficits temporarily from the assets accumulated between 1978 and 1981 but most oil producers are likely to have to make further economies and restrain imports which will be a factor holding back the overall growth in world trade.