



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

Prime Minister

Jan 11 - would you like to
discuss with the Chancellor next
week? A.J.C. 21/5

Yes no

THE WORLD ECONOMIC OUTLOOK AND THE VERSAILLES SUMMIT

Following last week's OECD and IMF meetings it seems to me fairly clear what are the main economic issues we are likely to encounter at the Versailles Summit.

2. In both Paris and Helsinki I was struck by how little pressure there was - at least from developed countries - for general reflation and a switch in the priorities of policy. While the slow pace of economic recovery causes general concern, there was general agreement that the present anti-inflationary policy stance must be maintained. No-one claimed to have a quick or easy solution to unemployment, and most of the industrial country spokesmen stressed that a further reduction in inflation remained essential to the sustainable expansion of output.

3. I conclude that at Versailles we can probably count on the firmly counter-inflationary views of at least four of our partners (United States, Germany, Japan and Canada) to help ensure that the Summit produces no explicit pressure for "reflation". But we may encounter a diluted French version of such pressure. This consists of seeking agreement that everybody will use such "margin of manoeuvre" as they have to achieve higher growth. In one sense this is an acceptable platitude, but if rehearsed as a general proposition it would probably be seen as a general exhortation to moderate reflation. On the latest version of the draft Declaration for Versailles, there is no risk here, but it is worth noting that



the French have rehearsed this line of argument before.

4. The main specific topic of discussion at last week's meetings was interest rates and the impact of US policy on them. Most industrial country spokesmen argued, as we have done, that achieving a declining trend for the US budget deficit would contribute more than any other single development to an easing of US interest rates, and thus to more investment and growth in the world generally. We continue to have a major national interest in the definitive success of US policy to reduce inflation, and in lower US interest rates.

5. At Versailles I believe we must join in urging President Reagan to do his utmost to secure a resolution of the US Budget argument before the summer legislative recess. If he fails, the uncertainties could drag on far into the autumn, reducing our chances of garnering benefits from a fall in US interest rates. It is in our national interest that the US Administration should settle this matter and produce a declining sequence of Budget forecasts, even if they have to accept tax increases as well as expenditure cuts in order to achieve it. I believe it is also in the interests of their own counter-inflationary policy. Cutting spending is much the best means, but it is crucial that they bring the deficit under control: and if this requires tax increases, they must not shirk them. We didn't, and it is paying off now.

6. The Japanese last week came in for some criticism, in which I joined, for the undervaluation of the yen and the excessive dependence of their economy on exports. At Versailles we must keep up the pressure on them to follow policies which reduce the pressure of their exports on the rest of us. But I am concerned that we should not get out in front in tackling the Japanese and find ourselves with little support from others, or, still worse, find some of our friends giving comfort to the Japanese. If that happens they would feel that the pressure on them is quite ineffective. We therefore need to do all we can in advance to get the Americans



and Germans on our side and to encourage the French to take as firm a line about Japan in wider groupings as they do in private discussion with us.

7. Tactical aspirations of both the Americans and the French seem likely to produce at Versailles an agreement on international monetary co-operation, which would be enshrined in an annex to the Declaration. The Americans want to divert some of the pressure on them on exchange market intervention and care for the dollar by urging more talks on convergence of policies as a means of securing greater stability of exchange rates. Mitterrand for his part wants a monetary agreement as part of a Summit success, and his people envisaged that this would enshrine ideas about a new "tripolar" monetary system based on the dollar, the yen and the EMS which he rehearsed in a speech in Canada. Perhaps he also has in mind that Giscard's first Summit at Rambouillet produced a monetary agreement.

8. I need not bother you at this stage with the details of the agreement which is emerging, but at present it looks perfectly satisfactory from our standpoint. The stress is on achieving a greater exchange rate stability through lower inflation and the maintenance of the value of currencies. We have also been able to inject into the agreement the idea of special co-operation with the IMF in surveillance of the five currencies constituting the SDR. This builds on a theme of my IMF speech last year that the five countries concerned have a special responsibility to the international system within the framework of the IMF: it also provides an umbrella covering both US and French preoccupations, while keeping the emphasis firmly on achieving lower inflation; and it of course gives sterling a status in its own right, since it is one of the five currencies.

9. It suits us to stress the monetary role of the IMF, and to extend to an international level a modest piece of counter-inflationary discipline in support of currencies. And I am sure



that it is right that we should show concern, both domestically and externally, for promoting a more stable international monetary system under the IMF umbrella.

10. The general background to Versailles is one of widespread expectation that the world economic environment will remain difficult, with the recovery in output in major countries like the United States and Germany remaining slow, and with serious down-side risks. On the other hand, inflation is coming down; there is some gain from moderation in oil prices; and there is a real chance that the recovery, though gradual, will be more soundly-based, and less exposed to reversal, than was the one which followed the first oil price shock. In short, summit participants are not coping with a common crisis, or approaching a cross-roads: they can reasonably reaffirm their conviction that the responsible policies being widely pursued are the right ones. From our point of view, the greatest potential gain would be a firm determination from President Reagan that his fiscal deficits, and with them interest rates world-wide, must and will come down.

11. I would value a talk with you on these central Summit issues before the welter of detailed briefing descends on us.

12. Copies of this minute go to Francis Pym and to Sir Robert Armstrong.

G.H.

20 May 1982