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Foreign and Commonwealth Office

London SW1A 2AH

26 February 1988

N L Wicks Esq CBE
10 Downing Street

Dear Nigel,

BRIEFING FOR THE SECOND SHERPAS' MEETING

I have just two final points on the briefing for this weekend's meeting. Geoffrey Littler is discussing some changes to brief No 5 ('Financial Market Mechanisms') with the DTI; if a revised version is not available later today, Geoffrey will brief you on the 'plane.'

2. The other point is that you might like to bolster the defence of the Community's decisions on agriculture provided in supplementary brief No 4 with a few statistics: the agreed package of stabilisers should cut the level of EC agricultural support by £205 million in 1988, £853 million in 1989 and £1272 million in 1990, a total saving of £2.3 billion.

Yours ever,

Rodric

R Q Braithwaite

cc Sir Geoffrey Littler KCB
HM Treasury

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Imports in the US continue to be stronger than might be expected, because:

- the DM has appreciated less in real terms against the dollar than against the yen, hence the German surplus does not look like being reduced nearly as much as that of Japan;
- the real effective exchange rates of NICS (eg in Chart 1, Korean won and new Taiwan dollar) have depreciated, not

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appreciated, against the dollar despite their surpluses;

- because trade surplus countries have had weak domestic economies, either currently or recently, export companies have been able to cut costs and pass on only about 50% of the higher exchange rates in higher dollar prices. In chart 1 a 100% pass-through on import prices would mean that export prices reflected fully the depreciation of the dollar. As can be seen from Chart 1, however, a major gap has emerged between a 100% pass-through import price and actual import price.

As the devaluation continues to have an effect, however, the balance of payments deficit should be reduced.

External Financing and the Dollar

Will the dollar continue to fall or has it fallen enough?

The most precise answer to this question came from Morgan Guarantee. They have a sophisticated analysis of the US balance of payments, very similar to the Fed.

us. 2 1/2
over 3 1/2

If the dollar were to remain at around 125 yen and DM 1.65, and if the average annual growth rate were to be 2 1/2% in the United States, and 3 1/2% in Japan and Europe together, the US trade deficit would begin to rise again after 1989 and reach \$150 billion in 1992. The US current account deficit would be even larger and reach \$225 billion in 1992. As a result, on Chart 2, the US net foreign debt (official and private, bonds, equities, direct investment, etc) would be \$1.3 trillion by the end of 1992 and rise rapidly even beyond. It is highly unlikely that this is an acceptable financial and political scenario. Assume that the next US President sets as a goal a US current account deficit close to zero by the end of his first term. Assume further that

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the average annual domestic demand growth rate for the United States be contained to only about 1.5%, and that those for Japan and Europe were to be raised to about 4% for 1988-1992. The model indicates that the dollar would then have to be corrected downward by an additional 12% on a real effective basis, or 22% in nominal terms. In this case, US net external liabilities would not rise much above \$700 billion.

The assumptions in the analysis need of course not be true: the balance of payments need not balance by 1992; growth in Japan and Europe may fall well short of 4%; and the currencies of the four Asian tigers could be revalued.

But whatever the precise outcome, and however much it improves the US trade deficit looks like being large and therefore needing to be financed for the foreseeable future. This has two major implications:-

- (a) direct foreign investment in the US and increased lending by foreign banks to US firms would seem likely to rise;
- (b) the growth of consumption in the US is likely to be well below the growth of GDP: in the Morgan guarantee analysis it rises by well below 1% a year for a number of years.

The major lesson is that reducing a balance of payments deficit is never painless.

Europe: selected indicators
percent change per year

	1986	1987	1988
Real GNP growth	2.5	2.5	2.0
Germany	2.5	1.7	1.6
France	2.0	2.0	1.8
Italy	2.7	2.8	2.2
United Kingdom	3.0	4.3	2.7
Trade balance (\$billions)			
Germany	58	73	67
Bilateral with			
United States	13	13	-
EC	24	34	-
France	-2	-8	-10
Italy	5	-1	-5
United Kingdom	-12	-16	-22

The international scene 1987- 88- 89

Real effective dollar

Index, 1980=100

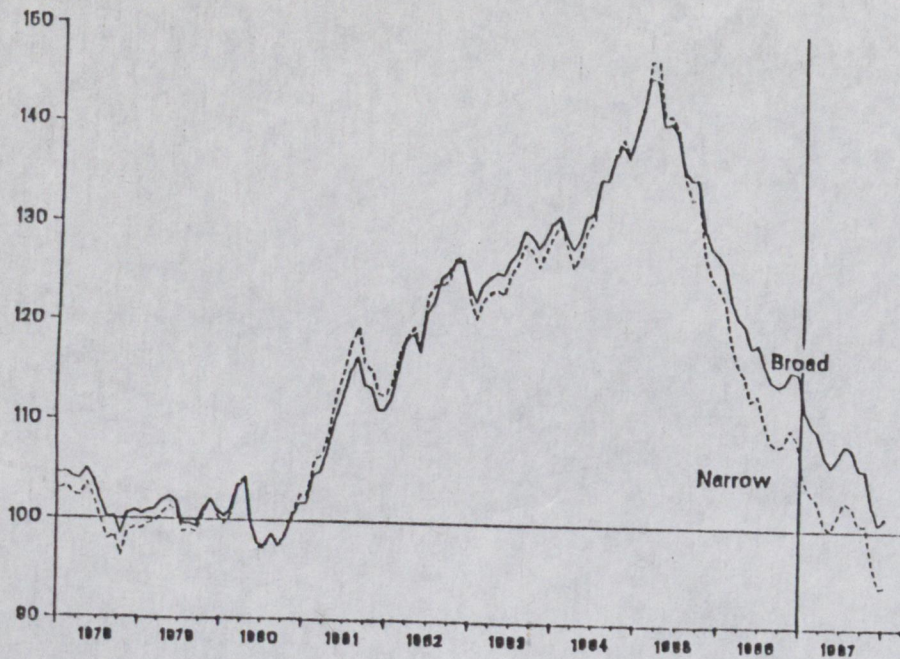
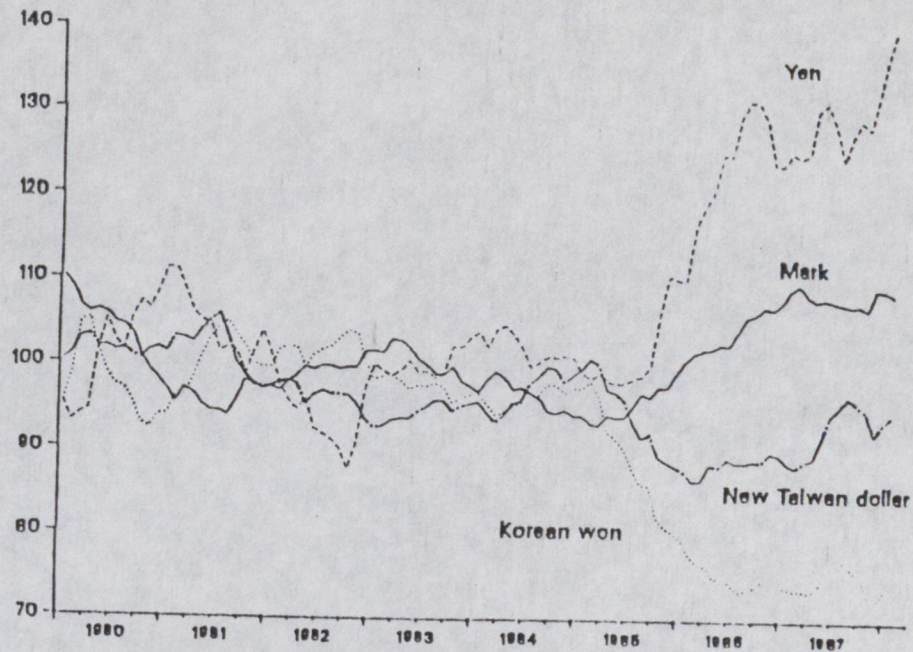


CHART 1

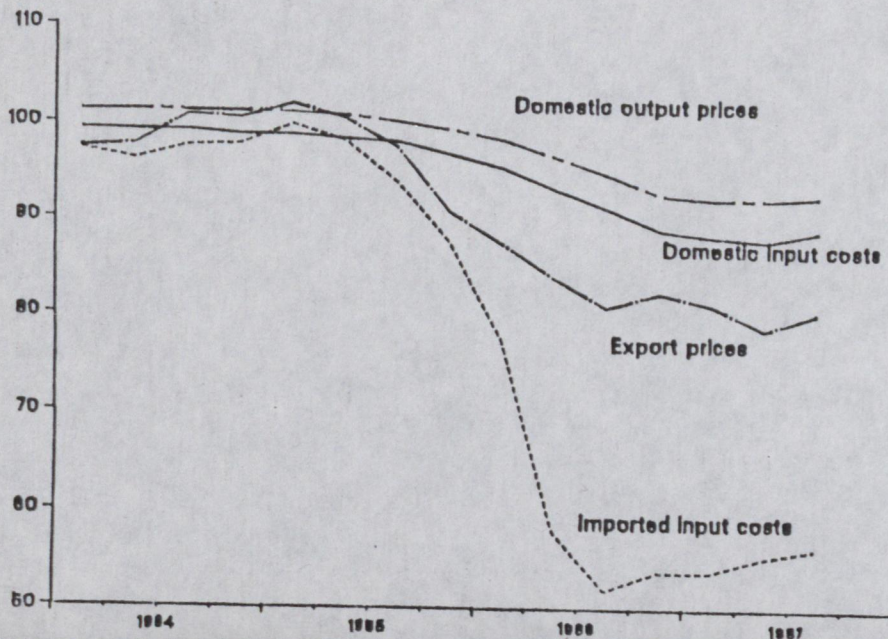
Real effective exchange rates

Index, 1980-82=100



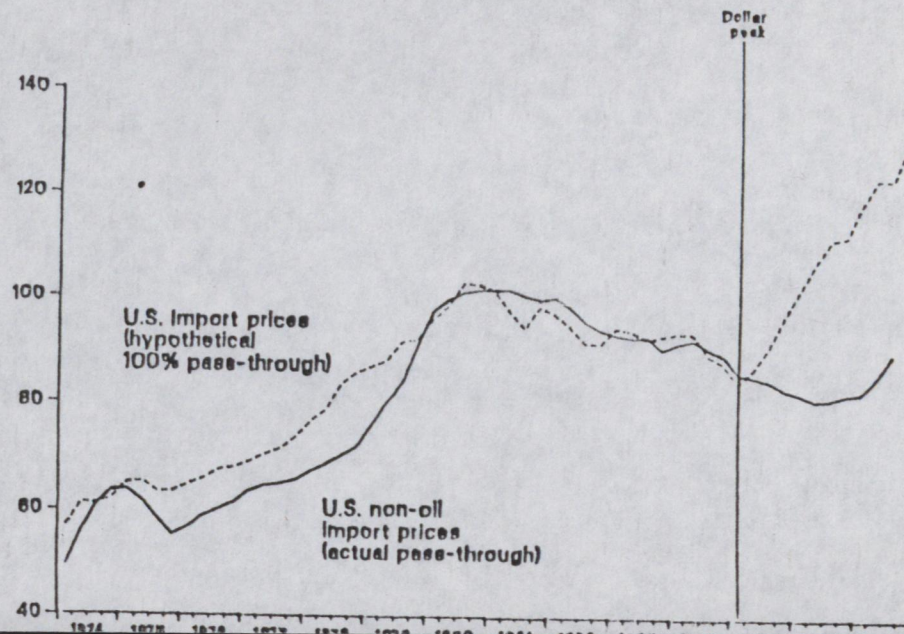
Japan: pricing for exports

1980=100



Import price pass-through

1980=100



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U.S. external financing vulnerability

	U.S. net foreign debt, end-1992		Effective dollar, % change to 1992*	Average annual real GNP growth 1988-92, %		U.S. inflation** 1988-92 average, %	CIF trade balance, 1992 \$ bil.	Current account, 1992 \$ bil.	Net interest payments, 1992 \$ bil.	Peak unemployment	Per capita demand annual average, %
	\$ bil.	% of GNP		United States	Japan & Europe						
1. No financing constraint	1300	(21)	0	2.5 (2.2)***	3.4 (3.5)	4.8	-155	-220	130	7.3	1.2
2. Accelerated cooperative adjustment to zero current account deficit by 1992, with dollar decline front-loaded and faster U.S. and foreign growth	720	11	-22 (-12)	2.3 (1.4)	3.7 (4.1)	5.4	10	0	55	8.2	0.5
3. Less adjustment: dollar decline front-loaded, less foreign growth.	920	15	-16 (-7)	2.3 (1.7)	3.4 (3.7)	5.2	-60	-80	75	8.0	0.6

*Percent change from January 1988 average. Figures in parentheses show the change in real terms.

**Manufactures wholesale prices.

***Domestic demand growth.

Table 6

Break-even exchange rates

(January 1988)

Average government bond yields, percent per annum

	One year	Three years	Ten years
United States	6.67	7.48	8.27
Germany	3.65	4.68	6.26
Japan	4.01	4.23	4.60

Implied break-even exchange rates

	1989	1992	1998
DM/\$	1.64	1.56	1.40
Yen/\$	125	117	91

Purchasing-power-parity exchange rates*

	1989	1992	1998
DM/\$	1.48	1.40	1.29
Yen/\$	121	113	101

*Notional exchange rates that maintain the bilateral purchasing-power-parity of the dollar at the level reached in the fall of 1980.