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Mr Nigel Wicks, CBE
Principal Private Secretary
to the Prime Minister
Prime Minister's Office
10 Downing Street
LONDON SW1

Dear Nigel

Herewith a copy of the thematic
paper.

*It came in just
after we spoke
this am.*

L. J. TAYLOR
Minister

With the Compliments
of the Commercial/Economic Division

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May 31, 1988

TORONTO ECONOMIC SUMMIT
THEMATIC PAPER

INTRODUCTION

1. The world economy has undergone profound changes during the 1980s. The information-technology revolution, deregulation and the globalization of markets have increased economic interdependence and shifted the division of labour among nations. It is now essential - even unavoidable - for decision-makers to consider fully the international dimensions of their decisions.

2. Summits have provided a forum for leaders to promote and catalyze the evolving process of international collaboration essential to cope with a changing world.

3. At Summits, especially since mid-decade, Leaders have achieved consensus on broad objectives:

- a shift from short-term considerations to a medium-term framework for the development and implementation of economic policies;
- a greater reliance on market forces to improve efficiency and adaptability;
- a strengthened role for structural reform to respond to change and stimulate growth;
- enhanced international policy coordination to achieve greater stability of exchange rates;
- the importance of strengthening the multilateral trading system of the GATT;
- an effective strategy to deal with development and debt.

DEVELOPMENTS SINCE VENICE

4. Since the Venice Summit, there have been a number of positive developments in the world economy:

- the industrialized countries have grown at a robust rate and are now in their sixth year of economic expansion. Employment has continued to expand, inflation has been restrained, and progress has been made toward the correction of major external imbalances;
- international economic cooperation has been strengthened by intensification of the process of policy coordination, including structural policies which improve the prospects

for sustainable non-inflationary growth in the years ahead;

- the situation of some developing countries was improved by the recovery in their terms of trade and strong growth in world trade. On aggregate, debt-export ratios declined for the first time since 1982.

5. These encouraging economic developments are cause for optimism, but not for complacency. A number of challenges face Summit-country governments:

- to continue narrowing the large international imbalances;
- to spur job creation and reduce the high unemployment in a number of countries, particularly in Europe;
- to forestall any resurgence of inflationary pressures;
- to foster the process of structural adjustment;
- to resist protectionist pressures and strengthen the multilateral trading system;
- to provide support for developing countries in their efforts to implement effective programs of structural reform and macroeconomic adjustment, which would increase capital formation and ease external debt-servicing difficulties.

To meet these challenges, Summit-country governments must reinforce their commitment to economic cooperation. This will enhance credibility, the key to market confidence.

POLICY COORDINATION

Macroeconomic Policies and Exchange Rates

6. To manage the transition over the medium term to more sustainable economic and financial positions in the context of non-inflationary growth, governments will follow the agreed strategy of coordinated efforts to reduce spending in countries with large external deficits and sustain the momentum of domestic demand in countries with large external surpluses.

7. The reduction of external imbalances will require the cooperation not only of the Summit countries, but also of some of the smaller European economies and of newly industrializing economies with rapidly growing external surpluses.

8. The Summit countries have undertaken a series of fiscal and structural policies to foster the adjustment of

international imbalances which is underway. Efforts in those directions must continue if the progress to date is to be sustained. In particular, the existing pattern of relative growths of domestic demand and income across countries should be maintained and where feasible strengthened.

9. The large exchange rate changes in the past three years, especially the real depreciation of the U.S. dollar against the Japanese yen and the major European currencies, have played a major role in the adjustment of real trade balances. Under present circumstances, further large exchange rate changes would not serve the adjustment process and could be counterproductive.

10. Monetary policy has actively supported international policy coordination. On occasion, however, it may have been overburdened by being assigned a number of potentially conflicting objectives: to sustain growth, control inflationary pressures, and stabilize exchange rates. It is imperative that both fiscal and structural policies play a greater role if non-inflationary growth is to be sustained in a context of stable exchange rates.

11. At the Tokyo and Venice Summits and in the G-7 forum, the Summit countries have developed and strengthened the process of policy coordination. The Summit welcomes the progress made in refining the analytical use of indicators, as well as the agreement to include a commodity-prices indicator.

Structural Reforms

12. International cooperation involves more than macroeconomic policies. Summit countries have increasingly been concerned with monitoring and promoting structural policies. By removing impediments to the working of markets, structural policies complement macroeconomic policies and enhance their effectiveness. In so doing, they facilitate the sectoral adjustments associated with the correction of international imbalances. Moreover, a more efficient use of existing production possibilities improves the prospects for sustained strong growth. This is all the more important in countries where spare capacity is becoming a constraint on non-inflationary growth.

13. Summit countries will continue to pursue structural reforms by:

- removing barriers, controls and regulations;
- increasing exposure to market competition;

- providing incentives to the private sector through tax reform; and by
- improving the stock of human capital.

14. In Europe, structural reforms to complement macroeconomic policies are particularly called for in order to spur job creation and to realize Europe's growth potential. Desirable structural reforms would include further liberalization of capital movements, removal of impediments to labour mobility, and the strengthening of competition policy. Especially important for promoting significant structural reform and growth potential is the programme to complete the European Community internal market in 1992. A promising start has been made, but full and timely implementation must be assured. A faster pace of structural reform in the Federal Republic of Germany, in addition to fostering growth and contributing to price stability in Germany, would also lead to a more sustainable pattern of external balances within Europe.

15. In Japan, structural reforms are necessary to support and sustain the greater reliance on domestic demand-led growth which has quickened remarkably over the past year. Japan could undertake to promote reform of government regulations in key sectors, the tax system, the distribution system, and in the areas of agricultural and land-use policies.

16. The most promising areas of structural reform in Canada would be implementation of the Free Trade Agreement with the United States, the implementation of sales tax reform, and the proposed liberalization of the financial services sector.

17. For the United States, where recent indications that the declining trend in private savings may have bottomed out are encouraging, it is nonetheless a priority to increase incentives to save. Reform of agricultural support policies is essential for both domestic and international reasons.

18. The governments of all Summit countries have undertaken, or will be pursuing, tax reform to remove distortions and to render their tax systems more equitable.

19. Summit countries should welcome the further development of the OECD's surveillance of structural reform. Analysis and monitoring of government subsidies to industry and agriculture are particularly important to reveal their impact on government budgets, consumer prices, and international trade.

20. Reform of agricultural policies is fully consistent with, and can assist, the maintenance of a viable rural economy. Many of the declared objectives of agricultural

policies, such as satisfactory levels of farm incomes, the preservation of rural communities, and environmental protection, can be achieved more efficiently by policies aimed directly at the desired objectives. The Summit should welcome the OECD's increased emphasis on structural adjustment and development in the rural economy.

21. Financial and technological innovations are rapidly integrating financial markets internationally, contributing to a better allocation of capital but also increasing the speed and extent to which disturbances in one country may be transmitted to other countries. Summit countries should continue to cooperate amongst themselves and with other countries in the examination of the functioning of the global financial system, including securities markets.

22. To realize fully the benefits of structural policies to liberalize markets and enhance competition, it is crucial that an open international trading system be maintained. Thus, a successful Uruguay Round is of critical importance.

MULTILATERAL TRADING SYSTEM/URUGUAY ROUND

23. The multilateral trading system is fragile and must be strengthened. Countries must continue to resist protectionism and the temptation to adopt unilateral measures or bilateral arrangements outside the framework of GATT rules.

24. The Summit should welcome the Free Trade Agreement (FTA) between Canada and the United States, which is not only consistent with international obligations but extends trade liberalization to new areas such as services. The Agreement should serve as a catalyst for progress in the Uruguay Round. Summit leaders are committed to ensure that such regional cooperation as the Canada-USA FTA, intensification of economic relations in the Pacific region and between the EC and EFTA and completion of the European internal market do not weaken, but rather strengthen, the open, multilateral trading system and the liberalizing impact of the Uruguay Round.

25. A successful Uruguay Round will assure the integrity of an open, predictable multilateral trading system based on the rule of law, permitting trade expansion to resume its role as the engine of world economic growth and development. At Punta del Este, Ministers committed themselves to further trade liberalization across the wide range of goods and services, including such new areas as trade-related intellectual property and investment measures.

26. Nowhere is the need for progress more evident than in agriculture. Reflecting the clear terms of reference provided by the Punta del Este Declaration and the political impetus provided by the 1987 OECD Ministerial and the Venice Economic Summit, good progress was made during 1987 in the Uruguay Round negotiations on agriculture, with the tabling of major proposals. However, this promising start now faces the difficult task of moving the negotiations themselves forward. Building upon the 1988 OECD Ministerial, the Summit should provide fresh political impetus to reinforce and underpin the efforts at domestic reform, and to advance the process of agricultural trade reform and liberalization in the multi-country, multi-commodity context of the GATT round.

27. It is necessary to ensure that the Mid-Term Review in Montreal in December 1988 spurs the negotiating process in this as in other fields. Summit countries should agree on a framework approach, including a commitment to concrete short-term as well as long term elements which will promote the reform process as launched last year and relieve current strains in agricultural markets by reducing agricultural surpluses and trade distorting effects. More precisely, this would be facilitated by agreement on the measures to be included and the target depth of cuts in the aggregate level of support and protection. Also in this context, ways should be developed to take account of concerns about food security. Any short term measures to prevent agricultural trade distortions from becoming worse would need to be consistent with long term goals. The prime objective of the framework would be to make the agricultural sector more responsive to market signals.

28. Underlining our concern to improve the functioning of the GATT would be an important step in ensuring that the liberalization of trade in goods and services achieved by the Uruguay Round is secured and enhanced. The GATT should become a dynamic organization able to undertake a leading part in trade policy; Ministers should take on a greater role in the GATT; and linkages among GATT, the IMF and the World Bank should be strengthened. As a first step in that direction, Summit countries could make a commitment to greater transparency by allowing GATT surveillance of all trade policies. It would also be necessary to strengthen the GATT dispute settlement system.

29. The future role of developing and newly industrializing economies in the GATT system should also be a major part of this message. These countries (especially the NIEs), should be encouraged to undertake increased commitments and obligations and a greater role in the GATT, commensurate with their importance in international trade and the international adjustment process, as well as their respective

stages of development. Equally, developed countries should consider what they are prepared to do to meet the legitimate need of developing countries for greater, more secure access for their exports.

30. As the Uruguay Round enters a more difficult phase, it is vital to ensure the momentum of these ambitious negotiations. The Mid-Term Review will provide a unique opportunity to send a credible political signal to the trading world. The greatest possible advance must be made in the months to come, in all areas of the negotiations, so as to reach before the end of the year the stage where tangible progress can be registered. Thus Summit countries are committed to ensure that the Mid-Term Review establishes a solid base for the full and complete success of the negotiations, in accordance with the Punta del Este Declaration.

31. Summit countries all recognize the critical and expanding role of international investment in the world economy. They share a deep concern that increased protectionism would undermine the benefits of open investment policies. Governments should express their resolve to progressively liberalize international investment policies.

NEWLY INDUSTRIALIZING ECONOMIES

32. The international integration of goods and financial markets and the rapid diffusion of new technologies have been changing the pattern of international specialization of production. Certain newly-industrializing economies (NIEs) in the Asia-Pacific region have become increasingly important in world trade in manufactures. Although these economies differ in many important respects, they are all characterized by dynamic, export-led growth which has allowed them to treble their share of world trade since 1960. Other outward-oriented Asian countries are also beginning to emerge as rapidly-growing exporters of manufactures, and intra-regional investment and trade are progressively integrating the economies of the region.

33. With increased economic importance come greater international responsibilities and a strong mutual interest in enhanced cooperation. There is a need for improved constructive dialogue between the industrialized countries and the Asian NIEs, as well as the other outward-oriented countries in the region. The dialogue should centre on cooperative efforts to achieve the international adjustment necessary for sustained, balanced growth of the world economy. The development of informal processes which would facilitate multilateral discussions of issues of mutual concern should be encouraged.

DEVELOPING COUNTRIES AND DEBT

34. The performance of developing countries and their role in world trade have become increasingly important to the world economy. The situation of individual developing countries varies widely; many still face serious economic difficulties. Central to the prospects of all is a global economic environment conducive to strong and sustainable growth, an open trading system, and a commitment to economic reform.

Middle-Income Countries

35. The market-oriented, growth-led strategy based on the case-by-case approach for dealing with the debt problems of the highly indebted middle-income countries remains the only viable strategy. This strategy has met with some success:

- the risk to the international financial system has been greatly lessened as commercial banks have strengthened their financial positions;
- many indebted countries have begun the process of macroeconomic adjustment and structural reform necessary for sustained progress, encouraging the return of flight capital and new investment flows;
- lending from official sources has continued to grow at a significant rate; and
- the 'menu approach' has continued to expand and has facilitated the channelling of commercial bank lending into productive uses.

36. Progress toward a lasting solution, however, has been slower than earlier expected. High debt ratios persist and the return to creditworthiness for many countries remains distant. The financing situation generally is expected to remain difficult.

37. Official financing and the international financial institutions have played and will continue to play a central role in the debt strategy:

- most net new lending to the debtor countries is from official sources;
- through the Paris Club, over \$73 billion of principal and interest have been consolidated since 1983. Export credit agencies will continue to play a flexible role;

- the \$74.8 billion General Capital Increase (GCI) for the World Bank will substantially increase available resources. Speedy approval and subscription to the GCI by all governments is essential;
- the modified Extended Fund Facility (EFF) will provide financing on more favourable terms and will place greater emphasis on medium-term structural adjustment. Also, the incorporation into Fund programs of external contingency mechanisms would assist countries adhere to their adjustment programs in the face of unexpected adverse external events.

38. Commercial banks hold nearly two-thirds of the external debt of the middle-income countries, and their continued involvement in the debt strategy is essential. Although banks have refinanced substantial amounts of principal and interest, since 1984 private lending has declined on a net basis. In this regard, the World Bank and IMF can play an important catalytic role in mobilizing additional financing from private (and official) sources in support of debtor countries' adjustment programs.

39. In recent years there has been increasing recourse to innovative financing techniques. The important characteristics of these techniques are that they are voluntary, market-oriented, and applied on a case-by-case basis. The "menu approach" has engendered new financial flows and, in some cases, reduced the existing stock of debt. The flexibility of the present strategy would be enhanced by the further broadening of the menu approach and the encouragement of innovative financing techniques to improve the quality of new lending.

40. International direct investment can play an important role in spurring economic growth in developing countries. The positive contribution that the Multilateral Investment Guarantee Agency and the International Finance Corporations are making in stimulating international direct investment should be encouraged.

Debt of the poorest

41. The debt burden of the poorest developing countries, especially in Sub-Saharan Africa, is part of a broader developmental challenge that requires the developing countries to persist with strong adjustment measures and developed countries to provide adequate concessional assistance. Progress in dealing with the debt burden has been encouraging:

- the implementation of IDA-8 has made another \$12.4 billion available to low-income countries;
- the enhancement of the IMF's Structural Adjustment Facility by SDR 6 billion will substantially increase disbursements on highly concessional terms to low-income countries;
- the World Bank, in conjunction with ODA agencies, has put in place an enhanced program of co-financing aimed at the poorest countries;
- Paris Club creditors are rescheduling debt at extended grace and repayment periods.

42. In cases where it is extremely difficult for countries to meet their debt-service obligations, an increase in concessional resource flows will be necessary to help those countries resume sustained growth. One proposal is to reschedule the commercial debts of the poorest countries at concessional interest rates. An alternative is for official creditors to choose between shorter repayment periods at concessional rates and longer repayment periods at commercial rates. Yet another alternative would be the provision of grants. The adoption of options, as in the menu approach, to allow creditors the choice to offer concessional interest rates with shorter maturity periods or grants in lieu of concessions would be a positive development. The relief provided would be additional to countries' existing aid programs. Other techniques for reducing the burden of debt service should also be explored, notably in the areas of ODA debt cancellation and the lowering of interest rate spreads and fees charged by export credit agencies on rescheduled debt.

FUTURE SUMMITS

43. The Toronto Summit is the 14th: the end of the "second cycle". The challenge for the future remains the same as that confronting leaders today: coping effectively with change in an increasingly interdependent world. There is a proven way to achieve this -- through an evolutionary process of improved international cooperation. That is the lesson of past Summits and the challenge for future ones.

OTHER ISSUES

ENVIRONMENT

1. Protection and enhancement of the environment is essential. The report of the World Commission on Environment and Development has stressed that environmental considerations must be integrated into all areas of economic policy-making if the globe is to continue to support humankind. Summit countries welcome the Report and endorse its concept of sustainable development.
2. Threats to the environment recognize no boundaries. Their urgent nature requires strengthened international cooperation, not merely among the industrialized countries, but between East and West and North and South. Significant progress has been achieved in a number of environmental areas. The Montreal Protocol on Substances that Deplete the Ozone Layer is a milestone. All countries should be encouraged to sign and ratify it. Completion of negotiations on a protocol on emissions of nitrogen oxides within the framework of the Geneva Convention on Long-range Transboundary Air Pollution is important. The efforts of UNEP for an agreement on the transportation of dangerous wastes are welcomed and encouraged.
3. Further action is needed. Global climate change, air and water pollution, hazardous substances, deforestation, and endangered species require priority attention. A worldwide consciousness must be developed and maintained to counter threats that diminish the heritage of humankind. In this respect the Summit welcomes the Conference on the Changing Atmosphere to be held in Toronto.

HUMAN FRONTIER SCIENCE PROGRAM

4. We welcome the successful completion of the feasibility study on the Human Frontier Science Program in which scientists of the Summit countries participated, and express our continued support for Japan's initiative to implement the program as soon as possible.

BIOETHICS

5. We note that, as part of the continuing review of the ethical implications of developments in the life sciences, the Italian government hosted the fifth conference on bioethics in April 1988.