R13/6

The Royal Institute of International Affairs

Chatham House 10 St James's Square London SW1Y 4LE
Telephone 01 930 2233 Fax 01 839 3593

Ref:WW/CH

13th June 1988

Charles Powell,
Private Secretary to the Prime Minister,
10, Downing Street,
LONDON SW1A 2AA

Dear Charles,

I attach, at the request of Christopher Tugendhat, a copy of the Tokyo Club proposals as presented to Mr Takeshita this morning. It is being released to the press in Tokyo today, and we are releasing it to the Financial Times at their request in London this evening.

You may know a little about the "Tokyo Club", which was an initiative of the Nomura Research Institute two years ago to set up a "G-5 of the Think-Tanks" alongside the intergovernmental G-5. The economists of the five institutes meet twice a year to compare perspectives and review their research work; at the June meeting they placed this in the context of the forthcoming G-7 Summit, and brief the Japanese Prime Minister on their recommendations. At their winter meeting they participated in a major conference in Tokyo (which appears in full on Japanese television, a briefer version of this year's conference was broadcast on Channel 4).

We are also sending copies to the Private Offices of Nigel Lawson and Sir Geoffrey Howe, at Christopher's request.

Yours ever,

William Wallace

Enc.

The Royal Institute of International Affairs
Chatham House 10 St James's Square London SW1Y 4LE
Telephone 01 930 2233 Fax 01 839 3593

Ref:WW/CH

13th June 1988

The Rt Hon. Mrs M.H. Thatcher, MP FRS,
Prime Minister,
10, Downing Street,
LONDON SW1A 2AA

Dear Prime Minister,

I attach on behalf of our Chairman, Christopher Tugendhat, the "Proposals for the Toronto Summit" from the Tokyo Club Foundation for Global Studies, which Christopher Tugendhat and his colleagues from institutes in the United States, Federal Germany, France and Japan presented to Mr Takeshita this morning in Tokyo. We hope that these may be of interest to you and your advisers in the preparations for the Summit.

Yours sincerely,
William Wallace

William Wallace
Deputy Director

Enc.

PROPOSALS FOR THE TORONTO SUMMIT

June 13, 1988

Tokyo Club Foundation for Global Studies

Brookings Institution (U.S.A.)

IFO-Institut für Wirtschaftsforschung (F.R.G.)

Institut Français des Relations Internationales (France)

The Royal Institute of International Affairs (U.K.)

Nomura Research Institute and Nomura Computer Systems (Japan)

Proposals

The world economy has absorbed the shock of the decline in stock markets in October 1987 far better than was anticipated immediately after the declines occurred. The risks of recession during the year 1988 now appear to be small, while the risks of renewed inflation have somewhat increased.

The problems to which the turbulence in financial markets called attention remain unresolved. For example, although the huge current account imbalances among the major developed countries have begun to decline, the pace of reduction is still too slow. More progress is necessary to assure healthy, noninflationary growth in the world economy.

The role of the United States in promoting the needed adjustments is central. Japan and West Germany, with their large surpluses and economic power, bear the next heaviest responsibility for reducing the imbalances.

In addition to macroeconomic imbalances, the world economy is plagued by other systemic problems. These include the lack of progress in the current round of GATT negotiations, the fragility of the international monetary system, and the continuing seriousness of the debt problems of developing countries.

I. Macroeconomic Imbalances

The imbalances in current accounts are still enormous, casting dark shadows over the stable growth of the world economy. During the past 12 months, since the Venice Summit in May 1987, the need for international cooperation to curb the current account imbalances has been stressed a number of times. Apart from measures in Japan to stimulate domestic demand, little has been done to modify economic policies. The current approach to the problem seems to be to wait for the next U.S. president to take some drastic action to cut the U.S. fiscal deficit, in the meantime trying to buy time through rhetorical support for improved international cooperation.

1. The United States

The urgent task for the United States is to reduce the still swollen deficit of the federal government. Past agreements between the President and the Congress to deal with the budget deficit have been timid and inadequate. Regrettably, effective action is likely to be postponed until after the November 1988 elections. As their highest economic priority, early in 1989 the new President and the new Congress should act decisively to adopt a multi-year program for reducing the structural budget deficit. A credible budget compromise must include both expenditure cuts and tax increases.

The failure of the United States to adopt adequate changes in fiscal policy is rekindling inflation. In the absence of such changes, increases in the rate of capacity utilization, reductions in the unemployment rate, and the 1987-88 depreciation in the exchange value of the dollar are threatening to put upward pressure on wages.

Based on the current economic conditions, the recent actions of the Federal Reserve to tighten credit slightly seem appropriate. More tightening in the future may be necessary if domestic demand threatens to grow too rapidly. However, this monetary tightening will be costly to domestic investment in the United States and to successful servicing of the debts of the developing countries. It would be much better, for the United States and for other countries, to resist inflation pressures through U.S. fiscal rather than monetary restraint.

2. Japan

Important progress has been made in shifting the sources of expansion in the Japanese economy to domestic demand away from exports, while maintaining a high rate of growth. However, this progress is primarily due to the income effects of higher growth and the price effects of yen appreciation. Market opening measures that entail real pain have only been taken slowly. To sustain progress in reducing its external surplus, Japan must be more decisive in pursuing structural policies that open its markets further and alter regulations that inhibit adjustment. The Japanese government must be more courageous in adopting such measures even if they are painful and politically difficult. In particular, further deregulation and market opening in the fields of agriculture, distribution, telecommunications, construction, and transportation should result in improved efficiency in those industries and lead to a better life for the Japanese people.

While opening its markets, Japan must be careful to follow macroeconomic policies that sustain the noninflationary expansion of the domestic economy.

3. Europe

The macroeconomic situation in European countries exhibits significant diversity. The extent of the external imbalance varies widely among individual economies, with current account surpluses excessively concentrated in Germany and to a lesser extent Switzerland, the Netherlands, and Belgium. Some countries, notably the United Kingdom, Italy and Spain, have achieved relatively high growth, while others like France and Germany seem trapped in a slow growth future. Accordingly, macroeconomic constraints differ widely. Everywhere, however, unemployment remains a paramount concern.

Within the current EMS-exchange rate environment, appropriate stimulus to growth coming from Europe requires Germany to take the lead. In effect, France is constrained by the need to capitalize on the progress toward disinflation and structural adjustment; Britain and Italy are confronted with a delicate weighing of their internal and external objectives for growth, inflation, and the exchange rate. Germany, with its high unemployment and huge current account surplus, has the margin of maneuver to provide the needed stimulus with a clearly expansionary fiscal policy. That could be achieved by moving forward the tax reduction scheduled for 1990 and foregoing the consumption tax increase proposed for 1989. If it fails to do so, a significant realignment of EMS currencies and appreciation of the Deutsche Mark will be necessary, although it may carry some destabilizing effects, notably on inflation in devaluating countries.

In the longer term, however, Europe can deal with its unemployment problem and reach a sustainable, higher rate of growth, only if supply conditions improve. Liberalization and deregulation have been helpful in reducing impediments to growth in some countries, but more is required, especially in Germany. In this respect, completion of the internal market provides a welcome opportunity and a worthwhile challenge.

4. Newly Industrialized Countries (NICs) of Asia

The Asian NICs, Korea, Taiwan, Hong Kong and Singapore, have achieved high rates of economic growth, and they have become important players in the world economy, providing an example to developing countries in other parts of the world. At the same time, they have developed substantial trade surpluses. It is desirable that Asian NICs contribute over time to the reduction of world trade imbalances. Since their individual circumstances vary, they should develop their own policies to achieve that goal, while continuing their progress in modernization and industrialization.

II. International Systemic Problems

1. The World Trading System

The Punta del Este agreement to launch a new round of trade negotiations was an important and positive step. Including the large area of services for the first time in multilateral trade discussions and covering both direct and indirect support to agriculture set an ambitious agenda for the talks. Now, however, the talks appear to be stalled in several key areas. This lack of progress encourages protectionist sentiment in the United States, causes the European Community to focus more on its internal reform effort and less on its multilateral context, and encourages efforts to reduce bilateral trade imbalances through circumvention of GATT rules.

The most important area of GATT stalemate is agriculture. The U.S. insistence on full liberalization as the negotiating goal has met firm rejection from the EC. Meanwhile, the Japanese proposal has little common ground with either of the others. The U.S. and the EC negotiators should begin to seriously explore the room for a compromise agreement on the negotiating framework (such as a target of 50% reduction in subsidies over 5 years) so that real progress can be demonstrated at the December mid-term review. The Japanese government should be willing to liberalize agricultural imports and reduce subsidies in concert with the other countries.

Economic integration of a huge area like the 12 members of the EC and the U.S.-Canada free-trade block will enhance their economies by expanding the size of some markets. However, these arrangements should provide free access and opportunities to third parties, which reinforces the need for continuing market opening in other parts of the world.

2. The International Monetary System

The demand of private investors for U.S. dollar assets declined sharply in 1987. The American current-account deficit was financed, indirectly, by heavy support of the dollar in exchange markets by central banks. This exchange-market intervention was extraordinary and cannot be indefinitely sustained. Since the beginning of 1988, the foreign exchange markets have remained relatively tranquil. But exchange and other financial markets remain vulnerable to adverse changes in expectations about economic policies.

In this situation, the governments of the major countries seem likely to continue supporting the "invisible reference zone" approach, which they have de facto been pursuing since early 1987. This approach, however, is at best fragile. Stabilization of exchange rates around the levels current in June 1988 cannot be viable without changes in domestic macroeconomic and structural policies that foster adjustment of existing payments imbalances.

For the longer run, governments should continue to explore ways to improve the international monetary system. These improvements might include cooperative guidelines and institutional arrangements for the management of exchange rates and the coordination of macroeconomic policies.

3. Debt and Aid Problems

There still is a debt crisis. The current debt rescheduling process is becoming less effective, while smaller banks increasingly seek to get disentangled from this process. In addition, the Baker plan has succeeded in mobilizing only very limited new resources from the commercial banks to support LDC adjustment. We are "muddling on" rather than "muddling through."

A number of new initiatives has been proposed. These include forgiveness of debt for some of the lowest income countries. In other cases, a partial reduction of principal and long term restructuring can be effective. The implementation of these options will need the active encouragement of governments. In any event, several countries are on the brink of serious social/political disruption. The situation is so serious that it behooves the summit leaders to give a higher priority to the resolution of this problem.

Besides considerations of debt forgiveness for the poorest countries, the quantity, structure and quality of foreign aid must be reviewed. The industrialized countries should increase their foreign aid, which is currently far below the benchmark of 0.7% of GNP postulated by the OECD. The quality of official development aid would improve if the grant element were raised and the loan element untied. Japan, in particular, could provide more official development aid by substantially increasing its contribution to the capital of the major international institutions, including the IMF and the World Bank. If the United States is unwilling to contribute as large a share of new capital contributions as in the past, it should agree to reduce its voting share in the institutions as a means of allowing others to raise their contributions.

These measures on the part of the industrialized countries must be matched by a willingness on the part of the developing countries to undertake structural reforms, and to open their economies to alternative financial instruments including equity and direct investment.