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STATEMENT OF THE GROUP OF SEVEN

1. The Finance Ministers and Central Bank Governors of seven major industrial countries have conducted close consultations in recent weeks on their economic policies and prospects in light of developments in financial markets. They reaffirmed their conviction that the basic objectives and economic policy directions agreed in the Louvre Accord remain valid and provide for a positive development of the world economy. They will continue to carry forward their economic policy coordination efforts in 1988 under the arrangements endorsed at the Venice Summit.

2. The Ministers and Governors reemphasized their view that the major external imbalances in the world economy must be corrected. The policies which have been implemented this year are gradually showing the intended effects. In particular, the balance between domestic demand and output in the United States and in Japan and the Federal Republic of Germany has shifted in a direction which promotes external adjustment and in volume terms their trade imbalances are diminishing. The greater stability of exchange rates achieved for much of the past year, following the earlier substantial exchange rate changes, contributed to this adjustment. The marked exchange rate changes over the past few weeks, however, stress the need to strengthen underlying economic fundamentals and to continue policy cooperation.

3. Developments in stock markets since mid October may have some adverse effect on prospects for economic growth for the industrialized countries as a group. The Ministers and Governors believe, however, that with sound economic policies and effective coordination the rate of growth should be substantial. To this end they agreed that appropriate policies for strengthening non-inflationary growth in their countries are necessary.

4. Accordingly, the Ministers and Governors agreed to intensify their economic policy coordination efforts. Their common efforts are directed towards reducing external imbalances. In particular, the United States has secured Congressional action to implement the agreement between the President and the bipartisan Congressional Leadership on a two-year package of additional budget savings that will reinforce progress in reducing the budget deficit. Japan has implemented a major stimulus program to strengthen domestic demand and will see to it that in the FY 1988 budget the expenditure for general public works will not be less than that for the FY 1987 budget including the July supplemental. The Federal Republic of

Germany is supplementing the previously announced increase in tax reductions in 1988 with new measures to increase investment and will not seek to offset the budget revenue losses arising from recent developments. There have also been coordinated reductions in interest rates in Europe which should contribute to the expansion of domestic demand and reduce trade imbalances. The specific policy intentions and undertakings by each country are set forth in the annex to this statement.

5. The Ministers and Governors are of the view that the recent monetary policy decisions and the reduction of interest rates in some countries were appropriate and will contribute to a restoration of stability to financial markets. They agreed that monetary policies should continue to be directed towards providing adequate monetary conditions to achieve strong economic growth in the context of price stability as well as to foster financial market stability.

6. The Ministers and Governors strongly rejected protectionist measures as a means of dealing with present imbalances. Protectionism constitutes a direct and serious danger to world prosperity and equilibrium and would have harmful consequences for those countries which resort to it. They reaffirmed their determination to fight protectionism and to promote an open world trading system.

7. The Ministers and Governors believe that the reduction of world trading imbalances requires cooperative action by other countries, particularly those with surpluses. They expressed particularly serious concern that some newly industrialized economies have failed to take adequate action to deal with large and growing trade surpluses which are exacerbating global imbalances and fostering protectionist pressures. They urged the newly industrialized economies to implement without delay trade and exchange rate policies that will facilitate the reduction of excessive trade surpluses and allow their currencies to fully reflect the strong competitive position of their economies.

8. The Ministers and Governors agreed that either excessive fluctuation of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that becomes destabilizing to the adjustment process, could be counter-productive by damaging growth prospects in the world economy. They reemphasized their common interest in more stable exchange rates among their currencies and agreed to continue to cooperate closely in monitoring and implementing policies to strengthen underlying economic fundamentals to foster stability of exchange rates. In addition, they agreed to cooperate closely on exchange markets. The Ministers and Governors stressed the need for consistent and mutually supportive policies and believe that the measures being taken

will accelerate progress towards the increased, more balanced economic growth, and sustainable external positions necessary for greater exchange rate stability.

## Annex

## Policy Intentions and Undertakings

The Government of Canada's fiscal strategy has succeeded in achieving a drop in the rate of growth of its spending and substantial, on-going declines in the budget deficit. Marked progress has been made in slowing the growth of debt, and towards the medium-term objective of stabilizing the debt-to-GDP ratio. Fiscal restraint has been accompanied by impressive growth of domestic demand, output and employment. Major structural initiatives directed at enhancing competitiveness and the underlying potential of the economy have been undertaken, particularly tax reform and the negotiation of a free trade agreement with the United States. Monetary policy remains geared to non-inflationary growth in a climate of orderly exchange markets.

The Government of France has fully met its commitment to reduce its fiscal deficit and tax burden. The fiscal deficit will be reduced by 0.8% of GNP from 1986 to 1988. Over the same period of time, tax cuts will amount to 1.3% of GNP. A further reduction of 45 billion french francs in the fiscal deficit and an additional 45 billion french francs in tax cuts are scheduled in a 1989-1991 three year program which constitutes the long term strategy of the government and will be implemented in the yearly budgets. The privatization program decided upon in early 1987 is being carried out, and its initial objectives have even been surpassed. The full implementation of the program will be resumed as soon as market conditions permit.

The French Government will continue to pursue its adjustment and liberalization policies. New measures to sustain household savings, develop financial markets and improve the competitiveness of firms have been taken. Additional steps will be taken in the same direction in 1988.

The Government of the Federal Republic of Germany has increased the amount of the tax reductions for 1988 and beyond to about 14 billion DM, and will not seek to offset the budget revenue losses arising from recent developments. In addition, the necessary decisions have been taken for the structural tax reform with a further net tax reduction of 20 billion DM from 1990 onward.

In order to strengthen private and public investment, the Federal Government will provide special loans for the next 3 years of about 21 billion DM under preferential conditions. Moreover, it will accelerate investment in telecommunication infrastructure and take initiatives for further deregulation of markets.

The Bundesbank has reduced short-term interest rates substantially during the last few weeks. Monetary policy will continue to maintain appropriate conditions for sustained non-inflationary growth.

The Government of Italy, in the context of continuous significant growth, has taken temporary measures to halt the deterioration of the balance of payments due to a higher rate of domestic demand in Italy than in other industrialized countries. For 1988 the objective embodied in the Finance Bill is to maintain a relatively high level of growth and to reduce inflation, while making progress in correcting the public sector imbalance.

In the medium-term, to alleviate unemployment the Italian authorities intend to achieve satisfactory rates of growth while maintaining the balance of payments current account in substantial equilibrium, to stabilize the debt/GDP ratio, and to devote more resources to the financing of productive as well as infra-structural investments, thus improving the quality of public services.

The Government of Japan noted that the Japanese economy is in a vigorous expansionary phase, led by domestic demand growth. The Government will steadfastly continue implementing the 6 trillion-yen-plus package decided on last May, and will see to it that in the FY 1988 budget the expenditure for general public works will not be less than that for the FY 1987 budget including the July supplemental.

The Bank of Japan will follow appropriate and flexible monetary policy supportive of non-inflationary growth and exchange rate stability.

The United Kingdom Government, in the context of the British economy's continued vigorous growth of output and domestic demand, coupled with sound public finances, will continue to strive to reduce inflation by pursuing a prudent monetary policy, while increasing its capacity for non-inflationary growth by further measures designed to free the operation of markets and increase the efficient use of resources, including tax reduction and tax reform. Public expenditure will continue to increase less rapidly than the growth of the economy as a whole, and the government will continue to work for the dismantling of barriers to trade both within the European Community and in the context of the Uruguay round of the GATT.

The United States Government has secured Congressional action to implement the agreement between the President and the bipartisan Leadership of the Congress on a two-year package of budget savings to reduce the U.S. budget deficit. This agreement provides for total budget savings, through a combination of spending restraint and increased taxes, in fiscal 1988 and 1989 of approximately $76 billion.

The budget agreement is part of an ongoing process of deficit reduction provided for under the revised Gramm-Rudman-Hollings legislation. It will reinforce the progress already achieved in reducing the deficit (including a fiscal 1987 cut of $73 billion or 1.9 percent of GNP) that has brought the deficit down to 3.4 percent of GNP from a peak of 6.3 percent.

The Administration will also continue to oppose steadfastly protectionist trade measures, while working for legislation authorizing negotiations to foster a more open and fair system for the international exchange of goods, services and investment.

Plaza Agreement

September 22, 1985

Announcement of the Ministers of Finance and
Central Bank Governors of France, Germany,
Japan, the United Kingdom, and the United States

1. Ministers of Finance and Central Bank Governors of France, the Federal Republic of Germany, Japan, the United Kingdom, and the United States met today, September 22, 1985, in the context of their agreement to conduct mutual surveillance and as part of their preparations for wider international discussions at the forthcoming meetings in Seoul, Korea. They reviewed economic developments and policies in each of their countries and assessed their implications for economic prospects, external balances, and exchange rates.

2. At the Bonn Economic Summit in May 1985 the Heads of State or Government of seven major industrial countries and the President of the Commission of the European Communities issued an Economic Declaration Towards Sustained Growth and Higher Employment. In that Declaration the participants agreed that:

> The best contribution we can make to a lasting new prosperity in which all nations can share is unremittingly to pursue, individually in our own countries and cooperatively together, policies conducive to sustained growth and higher employment.

3. The Ministers and Governors were of the view that significant progress has been made in their efforts to promote a convergence of favorable economic performance among their countries on a path of steady noninflationary growth. Furthermore, they concluded that their countries are restoring the vitality and responsiveness of their economies. As a result of these developments, they are confident that a firm basis has been established for a sustained, more balanced expansion among their countries. This sustained growth will benefit other industrial countries and will help ensure expanding export markets for developing countries, thereby contributing importantly to the resolution of problems of heavily indebted developing countries.

4. They believe that this convergence of favorable economic performance has been influenced increasingly by policy initiatives undertaken by their countries. Moreover, each of their countries is committed to the implementation of further policy measures which will reinforce favorable convergence and strengthen the sustainability of the current expansion.

5. Ministers and Governors were of the view that recent shifts in fundamental economic conditions among their countries, together with policy commitments for the future, have not been reflected fully in exchange markets.

Recent Economic Developments and Policy Changes

6. Ministers and Governors expect that real growth in aggregate for their countries will be about 3 percent this year, compared to negative growth of -0.7 percent in 1982. Although this figure is down slightly from 1984, growth will be more balanced than at any time in the last four years. After the particularly rapid U.S. growth of 1983-84, there is now increased evidence of internal growth in the other countries. In particular, private investment has picked up strength. The current expansion is occurring in a context of fiscal consolidation; it is not dependent on shortlived fiscal stimulus. As a result of the changes in the components of growth, real growth in their countries can be expected to remain strong as U.S. growth moderates.

7. The current sustained expansion is occurring within a framework of declining inflation, a phenomenon that is unprecedented in the past three decades. Inflation rates are at their lowest in nearly 20 years, and they show no signs of reviving.

8. There has been a significant fall in interest rates in recent years. Apart from welcome domestic effects, this has been particularly helpful in easing the burden of debt repayments for developing countries.

9. This successful performance is the direct result of the importance given to macroeconomic policies which have reduced inflation and inflationary expectations, to continued vigilance over government spending, to greater emphasis on market forces and competition, and to prudent monetary policies.

10. These positive economic developments notwithstanding, there are large imbalances in external positions which pose potential problems, and which reflect a wide range of factors. Among these are: the deterioration in its external position which the U.S. experienced from its period of very rapid relative growth; the particularly large impact on the U.S. current account of the economic difficulties and the adjustment efforts of some major developing countries; the difficulty of trade access in some markets; and the appreciation of the U.S. dollar. The interaction of these factors -- relative growth rates, the debt problems of developing countries, and exchange rate developments -- has contributed to large, potentially destabilizing external imbalances among major industrial countries. In particular, the United States has a large and growing current account deficit, and Japan, and to a lesser extent Germany, large and growing current account surpluses.

11. The U.S. current account deficit, together with other factors, is now contributing to protectionist pressures which, if not resisted, could lead to mutually destructive retaliation with serious damage to the world economy: world trade would shrink, real growth rates could even turn negative, unemployment would rise still higher, and debt-burdened developing countries would be unable to secure the export earnings they vitally need.

Policy Intentions

12. The Finance Ministers and Governors affirmed that each of their countries remains firmly committed to its international responsibilities and obligations as leading industrial nations. They also share special responsibilities to ensure the mutual consistency of their individual policies. The Ministers agreed that establishing more widely strong, noninflationary domestic growth and open markets will be a key factor in ensuring that the current expansion continues in a more balanced fashion, and they committed themselves to policies toward that end. In countries where the budget deficit is too high, further measures to reduce the deficit substantially are urgently required.

13. Ministers and Governors agreed that it was essential that protectionist pressures be resisted.

14. Ministers recognized the importance of providing access to their markets for LDC exports as those countries continue their essential adjustment efforts, and saw this as an important additional reason to avoid protectionist policies. They welcomed the GATT preparatory meeting scheduled for late September and expressed their hope that it will reach a broad consensus on subject matter and modalities for a new GATT round.

15. In this context, they recalled and reaffirmed the statement in the Bonn Economic Declaration on the debt situation.

> Sustained growth in world trade, lower interest rates, open markets and continued financing in amounts and on terms appropriate to each individual case are essential to enable developing countries to achieve sound growth and overcome their economic and financial difficulties.

16. The Ministers agreed that they would monitor progress in achieving a sustained noninflationary expansion and intensify their individual and cooperative efforts to accomplish this objective. To that end, they affirmed the statements of policy intentions by each of their countries, which are attached.

## Conclusions

17. The Ministers of Finance and Central Bank Governors agreed that recent economic developments and policy changes, when combined with the specific policy intentions described in the attached statements, provide a sound basis for continued and a more balanced expansion with low inflation. They agreed on the importance of these improvements for redressing the large and growing external imbalances that have developed. In that connection, they noted that further market-opening measures will be important to resisting protectionism.

18. The Ministers and Governors agreed that exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has been the case. They believe that agreed policy actions must be implemented and reinforced to improve the fundamentals further, and that in view of the present and prospective changes in fundamentals, some further orderly appreciation of the main non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when to do so would be helpful.

The French Government intends to pursue its policy aimed at reducing inflation, moderating income growth, and achieving continued improvements in external accounts. It will further intensify its efforts to speed up structural adjustment and modernization and thus lay the basis for job creating growth.

Therefore, it is determined:

1. To pursue vigorously disinflation.

2. To secure the attainment of monetary aggregates growth targets, consistent with decelerating inflation.

3. To curb public expenditures progressively so as to lower the tax burden while reducing the government borrowing requirement.

4. To foster the investment recovery allowed for by the improved financial situation in the business sector.

5. To take further steps towards liberalization and modernization of financial markets, to increase competition in the financial sector so as to reduce financial intermediation costs and give a greater role to interest rates in monetary control.

6. To foster job creation through the implementation of an innovative and active policy in the field of education and training and by promoting constructive discussions between social partners on work organization.

7. To resist protectionism.

The Government of the Federal Republic of Germany, noting that the German economy is already embarked on a course of steady economic recovery based increasingly on internally generated growth, will continue to implement policies to sustain and extend the progress achieved in strengthening the underlying conditions for continuing, vigorous, job-creating growth in the context of stable prices and low interest rates.

In particular, the Government of the Federal Republic of Germany will implement policies with the following explicit intentions.

1. The priority objective of fiscal policy is to encourage private initiative and productive investments and maintain price stability.

2. Toward this end, the Federal Government will continue to reduce progressively the share of the public sector in the economy through maintaining firm expenditure control. The tax cuts due to take effect in 1986 and 1988 form part of the ongoing process of tax reform and reduction which the Federal Government will continue in a medium-term framework.

3. The Federal Government will continue to remove rigidities inhibiting the efficient functioning of markets. It will keep under review policies, regulations, and practices affecting labor markets in order to enhance the positive impact of economic growth on employment. The Federal Government and the Deutsche Bundesbank will provide the framework for the continuing evolution of deep, efficient money and capital markets.

4. The fiscal policy of the Federal Government and the monetary policy of the Deutsche Bundesbank will continue to ensure a stable environment conducive to the expansion of domestic demand on a durable basis.

5. The Federal Government will continue to resist protectionism.

The Government of Japan, noting that the Japanese economy is in an autonomous expansion phase mainly supported by domestic private demand increase, will continue to institute policies intended to ensure sustainable noninflationary growth; provide full access to domestic markets for foreign goods; and internationalize the yen and liberalize domestic capital markets.

In particular, the Government of Japan will implement policies with the following explicit intentions.

1. Resistance of protectionism and steady implementation of the Action Program announced on July 30 for the further opening up of Japan's domestic market to foreign goods and services.

2. Full utilization of private sector vitality through the implementation of vigorous deregulation measures.

3. Flexible management of monetary policy with due attention to the yen rate.

4. Intensified implemention of financial market liberalization and internationalization of the yen, so that the yen fully reflects the underlying strength of the Japanese economy.

5. Fiscal policy will continue to focus on the twin goals of reducing the central government deficit and providing a pro-growth environment for the private sector. Within that framework, local governments may be favorably allowed to make additional investments in this FY 1985, taking into account the individual circumstances of the region.

6. Efforts to stimulate domestic demand will focus on increasing private consumption and investment through measures to enlarge consumer and mortgage credit markets.

The United Kingdom Government, noting that the British economy has been experiencing steady growth of output and domestic demand over the past four years, will continue to pursue policies designed to reduce inflation; to promote sustained growth of output and employment; to reduce the size of the public sector; to encourage a more competitive, innovative, market orientated private sector; to reduce regulation and increase incentives throughout the economy; and to maintain open trading and capital markets free of foreign exchange controls.

In particular, the United Kingdom Government intends:

1. To operate monetary policy to achieve further progress towards price stability and to provide a financial environment for growing output and employment; and to buttress monetary policy with a prudent fiscal policy.

2. To continue to reduce public expenditure as a share of GDP and to transfer further substantial parts of public sector industry to private ownership.

3. To reduce the burden of taxation in order to improve incentives and to increase the efficient use of resources in the economy.

4. To take additional measures to improve the effective working of the labour market, including the reform of Wages Councils and improvements in youth training; and implement proposals to liberalize and strengthen competition within financial markets.

5. To resist protectionism.

The United States Government is firmly committed to policies designed to: ensure steady noninflationary growth; maximize the role of markets and private sector participation in the economy; reduce the size and role of the government sector; and maintain open markets.

In order to achieve these objectives, the United States Government will:

1. Continue efforts to reduce government expenditures as a share of GNP in order to reduce the fiscal deficit and to free up resources for the private sector.

2. Implement fully the deficit reduction package for fiscal year 1986. This package passed by Congress and approved by the President will not only reduce by over 1 percent of GNP the budget deficit for FY 1986, but lay the basis for further significant reductions in the deficit in subsequent years.

3. Implement revenue-neutral tax reform which will encourage savings, create new work incentives, and increase the efficiency of the economy, thereby fostering noninflationary growth.

4. Conduct monetary policy to provide a financial environment conducive to sustainable growth and continued progress toward price stability.

5. Resist protectionist measures.

April 13, 1988

# Statement of the Group of Seven

1. The Finance Ministers and Central Bank Governors of seven major industrial countries met today to conduct multilateral surveillance of their economies pursuant to the economic policy coordination process adopted at the 1986 Tokyo Summit and strengthened at the 1987 Venice Summit. The Managing Director of the IMF participated. They discussed the medium-term objectives and projections for each of their economies and for their countries as a group, together with prospects for short-term performance, as a basis for assessing current economic trends. As part of their continuing efforts to strengthen coordination, they agreed to develop for inclusion in the set of existing indicators a commodity price indicator as an additional analytical instrument. In this context, they agreed to consider ways of further improving the functioning of the international monetary system and the coordination process.

2. The Ministers and Governors reviewed economic and financial developments since their statement of December 22/23, 1987. They noted that their renewed cooperation has provided a basis for improvements in their economies that will strengthen economic performance. They reaffirmed the validity of the policy directions and commitments set forth in that statement, which are contributing to continued growth with low inflation. Furthermore, they welcomed the additional evidence that the correction of external imbalances is underway, as well as the increased stability in exchange rates. They also agreed that greater attention will be given to structural reforms to increase the flexibility of their economies and to improve growth and adjustment.

3. The Ministers and Governors expressed their determination to continue to coordinate economic policies to strengthen the underlying fundamentals and thereby reinforce the conditions for exchange rate stability. They reiterated that either excessive fluctuation of exchange rates, a further decline of the dollar, or a rise in the dollar to an extent that becomes destabilizing to the adjustment process, could be counterproductive by damaging growth prospects in the world economy. The Ministers and Governors also reemphasized their common interest in stable exchange rates among their currencies and agreed to continue to cooperate closely in monitoring and implementing policies to strengthen underlying economic fundamentals to foster continued stability of exchange rates. In addition, they agreed to continue to cooperate closely on exchange markets.

4. The Ministers and Governors noted that other countries also have responsibilities for supporting the global adjustment process. In particular, while noting that certain newly industrialized economies have performed remarkably well, they called upon their authorities to accept greater responsibility for ensuring an open trade and payments system and correcting global payments imbalances. Toward this end, they urged them to continue to take actions to reduce trade barriers and to allow their currencies to reflect fully the underlying strength of their economies.

5. The Ministers and Governors stressed their strong opposition to protectionist measures as a means of responding to global imbalances. They reaffirmed their determination to continue to resist protectionism and to promote an open world trading system. In that connection, they emphasized the importance of early progress in the Uruguay Round towards trade liberalization by all participants.

6. The Ministers and Governors reaffirmed their full support for the current case-by-case debt strategy as the only viable and realistic approach for overcoming international debt problems. They welcomed the progress being made by some debtor countries in achieving increased growth and reduced payments deficits through the implementation of sound macroeconomic and structural policies. They noted that a major contribution to the financing of indebted developing countries has been made through Paris Club rescheduling of public credit. They emphasized the important role commercial banks have in supporting debtor countries' reform efforts through adequate and appropriate financing options under the menu approach. The Ministers and Governors reiterated their strong opposition to global debt-forgiveness proposals that transfer risks from the private sector to the international institutions or creditor governments. They urged the IMF and the World Bank to continue to work with debtor countries on a case-by-case basis to support debtor countries' reform efforts and to catalyze needed external financing through techniques consistent with the evolving, growth-oriented debt strategy.

The Brookings Institution
1775 MASSACHUSETTS AVENUE N.W. / WASHINGTON D.C. 20036-2188 / TELEPHONE: (202) 797-6000

June 13, 1988

The President
The White House
Washington, D. C.

Dear Mr. President:

The group of five think tanks, members of the Tokyo Club, presented and discussed the enclosed joint statement with Prime Minister Takeshita this morning in advance of the Toronto Economic Summit. I hope you will find it a useful consensus on key issues that will come before the G-7 meeting next weekend. Copies are being transmitted to the other G-5 heads of state.

The five research organizations who drafted and approved the statement are: Institut fur Wirtschaftsforschung (West Germany), Institut Francais des Relations Internationales (France), Royal Institute of International Affairs (United Kingdom), The Brookings Institution (United States), and Nomura Research Institute and Nomura Computer Systems Co., Ltd. (Japan).

Respectfully,

Bruce MacLaury
Bruce K. MacLaury
President

enclosure

cc: The Honorable Alan Greenspan
The Honorable John Whitehead
The Honorable Allen Wallis
The Honorable Beryl W. Sprinkel
The Honorable David C. Mulford

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# PROPOSALS FOR THE TORONTO SUMMIT

June 13, 1988

Tokyo Club Foundation for Global Studies

## 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 reconsider its opposition to the use of "producer subsidy equivalents" in the negotiations -- as agreed by the US, EC and Cairns Group 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.