10 DOWNING STREET

(4)

Prime Minister

At the December seminar Sir Keith Joseph mentioned an article by Jan Tumlir, Director of Research at GATT. Policy Unit were asked to appraise the article.

Attached are

(i) a summary of the article

(ii) a comment by John Redwood

(iii) a note by Nick Owen

which provides useful background for the E(S) discussion on Trade Policy on 8 March.

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24/2

24 February 1984

THE WORLD ECONOMY TODAY: CRISIS OR A NEW BEGINNING?

Summary of an Article Published in 1983 by Jan Tumlir, Director of Economic Research at GATT

Tumlir's judgement was that the world economy is in a precarious state. The vast overhang of debt, and its accumulating interest, tempts debtor countries to repudiate their obligations and creditor countries to "cut and run". How did the world get into such a state? Tumlir traces this back to the Great International Inflation in the 1970s, following the creation of Special Drawing Rights. Real wages grew, real interest rates fell, leading to

- over-indebtedness, an erosion of savings by inflation, driving people to look to the State and their employers for security

- the introduction of covert forms of protectionism (VRAs and industrial subsidies) in the interests of "reconquering the domestic market" or "safeguarding vital industries". This caused structural rigidities in advanced industrial countries and made it all the more difficult for debtor countries to pay off their debts through exports.

- much wasted investment, undertaken because capital was apparently costless in real terms, and labour was expensive.

The combination of these factors yielded heavy borrowing, low growth and protective attitudes.

What Can Be Done?

Reflation is out of the question, as the French experience in 1981-82 demonstrated. Protection leads to uncertainty and discourages investment. It undermines international rules. For example, the bilateral deals on steel are reinforcing an international steel cartel of dubious legality. Politicians are torn between preserving "viable industries" and restoring a viable international trading and financial system. They cannot sustain this contradiction. Trade liberalisation is necessary for growth to recover.

Nicholas Owen

NICHOLAS OWEN

10 DOWNING STREET

19 January 1984

The Rt Hon Sir Keith Joseph Bt MP
Secretary of State
Department of Education and Science
Elizabeth House
York Road
LONDON SE1

Dear Keith

You mentioned to me yesterday the question of Jan Tumlir's article on the world economy. As I mentioned to you then, Nicholas Owen, one of the Policy Unit economists, who is our Assistant Secretary in charge of trade matters, is currently investigating. In the meantime, I enclose some personal reflections on the main thrust of Tumlir's article, and attempt to answer your question of yesterday about what politicians should do if they believe his analysis.

With best wishes,

Yours sincerely

John Redwood

JOHN REDWOOD

A PERSONAL VIEW

Jan Tumlir is far too apocalyptic about the state of the world economy. Of course, recovering from a rapid inflationary boom, fuelled in its later stages by frenzied lending to those whose ability to repay was not sufficiently considered, is a painful process. Of course, the returns to capital have been too low, and these are now being corrected with a vengeance in an era of high interest rates necessary to prise out the savings from societies who have been taught by their inflationary experience that saving does not pay.

However, there are signs of hope in some sectors of the free world. Technical change is extremely rapid, and rates of return in the new industries are more than a match for the high real cost of capital in many instances. More importantly, we are likely to witness a resurgence of equity funding. There are several ways of recovering from heavy indebtedness. One is to tighten your belt and apply any spare amounts of income to repaying your borrowings. Another is to go out manfully and take a risk and try and make more money to repay your borrowings in due course or to add to your stock of wealth, which would make your backers happier with the level of advances they have made to you. A third is to persuade your backers that you are not as overborrowed as they think, so that they will indeed lend you more to tide you over a bad patch until something turns up. Mr Tumlir would argue that nothing will turn up, and that this latter course is an evil counsel. However, many of the countries that are experiencing debt problems are exporters of commodities. Commodity markets are notably volatile, and the prospects of any given heavy-debtor nation could be transformed in a few weeks by hectic trading on a speculative commodities market.

Many of the imbalances in the world economy did arise because of the rapid increase in the price of oil in the two successive oil crises of the 1970s. But the price of oil can go up and down. If it goes up, then one group of nations in heavy debt who are oil importers will suffer badly, and their indebtedness will be even shakier. However, simultaneously, the prospects of another group of heavy debtor nations - including countries like Nigeria and Mexico, who built up great stockpiles of debt on the back of their oil wealth - will see their prospects transformed.

Conversely, if the oil price falls, those who are heavy oil importers will gain relief on their balance of trade, giving them much needed extra financial resource to meet their interest charges. In summary, a competitive world market which does exist in many commodities adds a touch of delectable uncertainty to the future, which means that you cannot predict with safety that all is for the worst in the worst possible of worlds.

I am not usually one to recommend a course of muddling through. But in the case of the banking crisis, muddling through is exactly what I think we ought to do, and have been doing quite successfully. The surge of outward bank lending from America to other countries has been stopped. This, in my view, is one of the main reasons for the enormous strength of the American dollar against all other currencies, because the taps of dollars flowing outwards have been turned off. This, over time, will help reduce the debt pressures, although in the worst cases of heavily-borrowed nations, the powers of compound interest are, I confess, terrifying, and leave them very exposed. Secondly, individual countries - by applying a rigorous straitjacket on their spending, or by winning the commodity lottery, or by applying capital to productive uses, which gradually improves the strength of their economy - will come out of difficulty and be accepted back again amongst the fraternity of those to whom it is reasonable to lend money. The banks themselves will have learnt from experience, and will be naturally more cautious in the next few years about their lending policies. The top man in the banking parlours of the 1980s will not be the debt salesman who put most new debt on his bank's books in the previous 3 years: he will be the risk analyst who took the most cautious and canny line.

Governments will resort to some bad habits. The US Government has already accommodated the potential banking crisis by easing its monetary policy, and thereby also lowering interest rates. Governments will undoubtedly continue to do this where necessary, but it looks as if they are going to do it in a sufficiently subdued way to avoid opting for the hyper-inflationary final "solution".

Mr Tumlir's other main thrust is that the world is indulging in a bout of dangerous competitive protectionism. He is right to warn us. Protectionism does indeed damage trade and job prospects across the world. For any individual country, additional protectionism is an attractive option if only they could get away with it without others doing the same. In practice, others always do do the same, as they too have the same perception of the need to steal a march on others.

Mr Tumlir is also right to suggest that unilateral removal of protectionist measures by any individual country is an act of folly. Just as the United Kingdom Government disdains the idea of unilateral nuclear disarmament, so too it should rightly disdain the idea of unilateral removal of protectionist measures. What is needed is patient and difficult diplomatic work across a wide front, to encourage multilateral reductions of barriers to trade - whether they be tariff or non-tariff in their nature. If the UK Government wishes to find a constructive role in trade policy, it could do no better than to use the undoubted political skills and reputation for statesmanship and consistency of purpose which its current administration has engendered to provide leadership both within Europe and, on a broader canvas, in favour of multilateral protectionist reduction.

I believe this is exactly this Government's intention, and Nick Owen's briefing and better-considered thoughts on this subject will be brought forward at the time when Norman Tebbit presents his proposals concerning freeing restrictions on international trade.

J.R.

CONFIDENTIAL

Chron. F.
- Trade Policy

10 DOWNING STREET

The Rt Hon Sir Keith Joseph MP
Department of Education and Science
Elizabeth House
York Road
LONDON
SE1

7 February 1984

Dear Secretary of State

THE WORLD ECONOMY TODAY

The other day John Redwood sent you some comments on an article by Jan Tumlir, "The World Economy Today: Crisis or a New Beginning", which you drew to colleagues' attention last December. I enclose some further thoughts on this subject, which address some of the policy issues which I think Tumlir's article raises. You may find these relevant to the discussion of Trade Liberalisation which ES will have on ~~16 February~~ 8 March.

Yours sincerely

Nicholas Owen

NICHOLAS OWEN

CONFIDENTIAL

HOW TO RECOVER THE GROWTH RATES OF PRE-1973?

1. The quarter century 1948-1973 was a golden age of growth and trade. It saw world production grow by 5% a year, world trade by 8% a year. The growth rates predicted to 1985 are half as great, insufficient, probably, to reduce the levels of unemployment in Western Europe. What are the obstacles to resuming the earlier growth rates? Can they be removed?

2. It was both fashionable and convenient to blame the "oil crisis", and of course, foreigners, but this distracts attention from the home-grown problems identified in 1976 Stockton Lecture - excessive demand, unrealistic expectations about the capacity of the economy, a desire by the private sector workforce for the same secure and cosy conditions as those offered by the rapidly growing public sector, and the bureaucratisation of business through intervention and a corporatist state.

3. The point which commentators have sometimes lost sight of is that these policies are fundamentally hostile to the liberal trading system, since Government priorities replace the logic of the market; and that interventionist policies are still with us. The liberalisation achieved by successive GATT rounds was undermined by intervention of various forms to protect the industries which proved unable to survive in a free trading environment. The benefits of trade require changes in the trading partners industrial structures; block those changes and the trading benefits are denied. The two factors which made it harder to stomach these changes were the rising levels of unemployment - unconnected with trade but very much connected with inflationary policies - and the emergence of Japan and the NICs - principally the South East Asian "Gang of Four". These countries proved capable of knocking out whole industries in an alarming way - motor cycles, shipbuilding - with excellent products produced at low costs attributable to high volume, three shift operation, a motivated workforce unencumbered with European legislation surrounding the workplace.

4. The picture, then, is one of liberalism in traditional GATT terms. The UK can claim that in 1980, 80% of its imports of manufactures were free of all restriction, tariff or quota; and that excluding agricultural products, only 4% of imports were subject to non-tariff restraints. (This is an ambiguous claim, which may

simply reflect the effectiveness of the restraints. Who knows how much greater these imports might have been had there been no restraints?) But alongside this surface liberalism, and undermining it, is an apparatus for supporting uncompetitive industries, either through subsidies, or VRAs which can be summoned into place outwith the GATT rules. In addition, there are of course nationalistic public sector purchasing policies in defence, medical equipment, nationalised industries. To the extent that nationalised industries cannot support their suppliers in a manner to which they became accustomed (generating equipment, railway equipment, process plant) these sectors' problems are exported with subsidies costing vast sums per job involved. These factors, coupled with the protectionism of agriculture which elevates European food prices sometimes several times higher than the world price, subvert the international economy.

A New Approach?

5. It is debatable whether traditional trade negotiations can, by themselves, lead us out of this position; we have comparatively few formal trade restrictions left to bargain with. There are four linked problems here:

(i) trade policy is conducted with the interests of producers primarily in mind. In this sense, it turns economics on its head. The purpose of economic activity is to satisfy the needs of consumers. Imports of cheaper, or better, products are obviously beneficial in this, the most relevant sense. But in trade parlance, this would count as a concession, which should be made only if trading partners concede something which enables us to increase exports. Governments boast about exports because they represent achievement, and never take credit for imports. Yet imports are the ultimate point of trade. Exports are simply the means by which we can earn the foreign exchange to buy them, and absorb resources which we could use in other ways to benefit ourselves;

(ii) trade policy should be made more consistent with competition policy. It seems odd to exercise a watchful vigilance over restrictions of supply in the domestic market which raise prices, or restrict choice, and to refer these to the Monopolies Commission, yet on the other hand, to impose restrictions on imports which have precisely these harmful effects. If anything the latter are more damaging to the public interest, since it can at least be said of home-grown restrictions that the excessive profits so derived accrue to other nationals, rather than to foreigners. Restrictions on foreign supply also encourage, or sustain anti-competitive behaviour at home - the British Shoe Corporation was allowed by the last Government to retain excessive prices if it agreed to make more effort to buy British; restrictions on imported coal perpetuate an inefficiently structured coal industry; specious barriers to imported milk perpetuate a producer's monopoly and a cartelised milk distribution system; and so on. In competition policy terms, we strain at gnats, in the form of relatively minor peccadilloes while swallowing whole camels in the form of the grossest distortions of the international market;

(iii) trade negotiations need to be cast in a wider context, of industrial policies, purchasing policies, and in the case of some countries, the management of the entire economy. As was pointed out above, tariffs are now a minor component of our protection arrangements. Looking at our LDC trading partners one finds that their, often enormous tariffs and restrictive quota arrangements are themselves integrally linked to grosser mismanagements of their economies. It would be unrealistic, perhaps, to expect them to trade away these restrictions unless they are encouraged to manage themselves differently. For example, a number of developing countries mainta artificially high exchange rates, which are sustained in part by import licences, which themselves generate and sustain corrupt bureaucracies, and which also require export subsidies if these countries are to develop export-orientated industries. The countries concerned therefore risk the accusation of unfair trade. The growth prospects of these countries would improve if they allowed their exchange rates and internal prices to float free, as the World Bank is urging them to do. But until and unless they do it seems unlikely that they have much to concede either at the trade negotiating table.

(iv) The Japanese trading imbalance is another problem which ought to be viewed in a broader context, if it is not to hold discussions back. The Japanese deficit with Europe is probably structural: given Japan's high dependence on imported energy and raw materials, it is bound to run a surplus on its manufacturing account to pay for these. In a multilateral world, this is no problem whatsoever. The surpluses which a number of raw material suppliers run with Japan match deficits which they run with Europe. Is it necessary to deprive European consumers of low cost cars and consumer electronics on the mistaken belief that if we do not restrict these imports, Japan will over-run us in everything. By definition, Japan cannot specialise in everything. Moreover, to the extent that Japan is persuaded to import more from Europe and the United States, resources will be released from the Japanese industries concerned, which will probably find their way into other export activities. It is not clear that the Japanese bilateral surplus with Europe can, or should be negotiated down significantly.

6. As part of this broader approach, the more developed countries should consider the contribution which rolling back protectionism could make to easing the LDCs' debt problems, whose financing costs fall ultimately on the OECD countries. DTI economists have compared the effects of liberalisation on the earnings of nine debtor countries with their debt servicing obligations in 1982. Their calculations compared an increase of 50% in the value of their earnings from exports of goods subject to restraint in US and EC markets. The average impact was 10% of the debt service requirements; it ranged from negligible (Indonesia and Mexico) to quite substantial (Argentina, 18%; Philippines, 25%; South Korea and Yugoslavia, 40%). Clearly, liberalisation can make only a modest contribution overall but compared to any other policy instruments on offer, this must be considered quite important.

7. Conclusions These reflections suggest that approaching the forthcoming trade negotiations (the Williamsburg rollback initiative, a possible GATT round, the MFA expiry in 1986, the Community's commercial policy discussions) we ought to give consideration to the following:

(i) whether it is not necessary to situate trade negotiations in a wider context which would include industrial and economic policies? The London Summit in June is surely the place to attempt this.

(ii) whether the conventional wisdom that we should only trade our VRAs in exchange for concessions from trading partners is in fact sensible. We would be better off without these, even if our partners made no concessions whatever. The public is beginning to understand the costs which these impose eg on cars. The concessions we might hope to obtain would not actually help the industries which these devices protect. It is not even clear that they are all in the longrun interests of the industries concerned, in so far as VRAs stimulate foreign competitors to trade-up the market into segments in which we should specialise, in attempts to exploit the maximum value of the quotas. And of course, the arrangements damage other industries in so far as they apply to intermediate products;

(iii) whether in the European Community we exploit our pivotal position between the free-trading northerners and the protectionist southerners to push the Community towards a more liberal stance. The Community is proposing a new "Common Commercial Policy Regulation" designed to achieve a rapid retaliatory response to "unfair" trade practices of third countries. It is not clear what "unfair" amounts to, other than "incompatibility with GATT rules". The device is almost certainly illiberal. The dilemma for us is whether we accept this as the price worth paying to persuade the French to make the Community's internal market more of a reality;

(iv) whether we should attempt to defuse protectionist lobbying in anticipation of greater liberalisation. At present, the Government itself institutionalises the lobbies within the NEDO's "working parties", whose deputations regularly troop into the offices of Secretaries of State to ask for subsidies, protection and "breathing space". These creatures of intervention and Labour's "industrial strategy" have no legitimate place within a liberal economy. They should either be abolished, or emasculated under the umbrella of some kind of "industrial advisory committee", which would also include academics and representatives of consumers.

8. Only through the acceleration of world trade can we hope to recover anything like the pre-1973 growth rates which are necessary to reduce unemployment. This is particularly important for Europeans: as the Commission remarked in 1982, in the previous 10 years the number of available jobs increased by only 2 million in the European Community compared to 4 million in Japan and 19 million in the USA.* The recovery of the OECD economies makes it politically easier to take the initiative on rolling back protectionism, in all its forms - tariffs, VRAs, subsidies and public purchasing policies. Britain's traditional commitment to free trade, and paramount need for a higher growth rate to reduce unemployment, marks us out as a natural leader in these initiatives, rather than merely a supporter, or an adroit tactical player of divide-and-rule within the Community. The initiative could include:

1) The abandonment of industrial aids, particularly to industries which are not able to compete. (We estimate that in 1984, four of DTI's clients (BL, BSL, BS, RR) will make a combined loss of around £300 million, and cost the Government £800 million in cash.)

2) An approach to public purchasing which allows an opportunity to foreign competition. This would reduce public expenditure and it would encourage greater specialisation within the domestic equipment supply industries.#

3) No renewal of the MFA in 1986 and a dismantling of the VRAs; we would, of course, seek corresponding responses on the part of our partners, but the policy would not be conditional upon achieving this.

4) Exploit our role as host of the 1984 Summit to give impetus to rolling back protection, seen in the wider economic context in which it forms an integral part. It is unrealistic to expect trade negotiations by themselves to create an international economy.

NICHOLAS OWEN

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* Relaunching Europe: A New Community for Industry and Employment, European File, 3/82

Research on defence procurement costs by Keith Hartley at the University of York suggest that savings of 20% are possible, equivalent to £1600m on £8000 procurement bill. Open tendering for recent missile projects prompted even greater reductions in tender prices by British contenders.