



Foreign and Commonwealth Office

London SW1A 2AH

16 July 1981

Dear Michael,

p/w my briefs
cc. In Whitmore -

Paul

NORTH/SOUTH SUMMIT

In your letter of 1 June, you enclosed a memorandum which the Prime Minister had received from Mr Heath about the North/South Summit in Mexico. You also enclosed a copy of the Prime Minister's acknowledgement.

We have now studied Mr Heath's memorandum in some detail and we have set out our views in the enclosed commentary which has been cleared in Whitehall.

As you will see, we do not share Mr Heath's view that the international banking system is in serious difficulty, and believe that he himself would now be less alarmist on this point. Nor do we share his enthusiasm for a deal with the OPEC countries, although we recognise the value of a general discussion with them. The High Level Monitoring Group which reports to the Economic Summit has considered these issues and shares our view.

We see little purpose in a substantive reply seeking to refute the arguments in Mr Heath's memorandum, and the Prime Minister has not undertaken to do so. Our preference would be to draw on the enclosed commentary as and when Mr Heath's memorandum becomes public or the arguments in it are deployed by our critics. We know that Mr Heath sent copies of his paper to other Heads of Government attending the
/Cancún

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Cancún meeting, and the arguments deployed may come up at the Ottawa meeting and in other conversations with the Prime Minister's in this question. I am sorry that the commentary has taken so long to prepare.

I am sending copies of this letter and its enclosures to John Wiggin (Treasury), Julian West (Energy), Kate Timms (MAFF), John Rhodes (Trade) and David Wright (Cabinet Office).

*Yours,
Alan*

A K C Wood
Assistant Private Secretary
to the Lord Privy Seal

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COMMENTARY ON MR HEATH'S MEMORANDUM TO THE MEXICO SUMMIT

1. Mr Heath invites the Summit to seek a common assessment of the problems, a sense of priorities and greater precision and direction of policy. In essence, he advocates an oil and financial deal with OPEC for which Cancun would provide the impetus.
2. His Memorandum starts from a doomsday view of the implications for the international banking system of developing country current account deficits. He argues that greater official action is required because the private sector will be unable to cope. Since OPEC hold the surpluses, they must be encouraged to help (by the offer of more votes in the IMF/IBRD and indexed assets). These financial aspects are linked to a deal with OPEC on oil prices. His proposals on food and trade are, by comparison, extremely limited.
3. Section I of Mr Heath's summary outlines the problems in a dramatic tone. We would question his stress on the debt problem and on the likelihood of a major default. We note that the draft World Development Report of the World Bank concludes that, while developing countries will face more serious debt management problems in the future, these difficulties do not point to a generalised debt problem. In the report's view, the outcome is more likely to be a greater emphasis on the creditworthiness of individual countries and the viability of particular economic projects.
4. As regards the measures he proposes on debt (Section II(a)), we question his emphasis on the need for greater official action. The financial markets have taken the main burden of recycling and, so far, have done so satisfactorily. There is no firm evidence that they will experience real difficulties. The IMF can play a complementary role, particularly for countries with limited access to commercial markets. More generally, we believe that there should be more stress on the need for adjustment by both developed and developing countries.
5. The argument that more OPEC surpluses should be attracted to the IMF also requires examination. The Fund's borrowed

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resources are small compared to quota subscriptions of over \$60 billion. There is broad agreement that any sustained increase in resources should be achieved by a general increase in quotas; borrowing is regarded as temporary. This implies less need to offer OPEC a greater share in decision-making in exchange for lending their funds. Nevertheless, the Saudi quota has recently been doubled to reflect their greater share in the world economy. (Developing countries now hold 41% of the votes in the IMF.)

6. The other suggested incentive, indexed assets, would be a major innovation and is unacceptable to the main industrialised countries. First the indexation of assets would remove a major constraint on the oil producers to price their oil responsibly. At present the value of their assets depends on the health of the industrialised economies, which in turn is affected by oil prices. If this link were removed oil producers would be insulated from the harmful effects, of rapid oil price increases. Secondly, those who issued indexed assets would be required to accept contingent liabilities of an unknown and possibly enormous size. Alternatively the indexing of assets could be accompanied by a similar indexing of liabilities. In this case, the eventual borrowers, mainly the non-oil developing countries, would bear the potential cost. Finally, the indexation of assets might encourage the spread of indexation into other areas such as commodity prices and wages. Wider indexation would add very greatly to inflationary pressures by creating a direct link between cost and price increases.

7. The position on the other financial points contained in the summary is, briefly, as follows:-

(a) More resources for subsidising IMF/IBRD interest rates.

The rate of interest on most of the IMF's resources is already well below market rates. Further subsidisation would be costly; there is little enthusiasm for it. It has not been established that a reduction in the Fund's rate of interest would help the developing countries to any significant extent.

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(b) Reform of IMF lending practices.

These have recently been reviewed and, some believe, have gone far enough. In any case, more experience of the policy of larger scale lending will be required before further reforms could be usefully considered.

(c) Improved marrying of OPEC surpluses with Third World projects.

Already takes place to some extent; could be examined further.

(d) Increased co-financing between IMF/IBRD and OPEC official holders.

Sixty per cent of co-financing funds made available between 1973 and '79 came from official sources, including OPEC.

(e) Cancel debts of poorest countries.

We have already cancelled the debts of 17 of the poorest countries through Retrospective Terms Adjustment. Little scope for further action by the UK.

8. The second major element in the Memorandum is a suggested deal with OPEC on oil prices, possibly involving some form of price indexation. This has been fully considered by the High-Level Energy Monitoring Group (who report to the Economic Summits). They have advised against pursuing it at present. Such a scheme would tend to favour producers without protecting consumers. Without a commitment by OPEC to maintain supplies during shortages, which it is unwilling and probably unable to make, a price scheme would operate simply to avoid the real price of oil falling; it would not prevent sharp price increases. Furthermore, it could not cope with political disruption which is the main risk of oil shortages. Moreover, the lack of cohesion within OPEC, and the widely differing political and economic interests of its members, would leave the agreement open to serious risk of abrogation, either collectively or by individual producers, on those occasions when supply was tight and the scheme worked against immediate producer interests. Our view therefore is that bilateral and informal discussions are the best way of maintaining a good working relationship, although we would not exclude a broader dialogue on general energy issues.

9. The Memorandum makes four suggestions on food:-

(a) Increased assistance to R&D for basic agriculture.

Could be considered, but main need is often proper application of research.

(b) A joint OECD/OPEC effort to increase fertiliser aid.

Fertiliser aid is already given in substantial quantities, both bilaterally and multilaterally. We do not accept the need for substantial increases.

(c) More food aid.

We doubt the value of this except for crises (which currently take up only 10-20% of total food aid). Other types of aid are more effective in fostering production. Food aid can even impede efforts to improve local production.

(d) Conclusion of a Wheat Trade Convention.

We favour this and are committed to negotiations on it.

10. On trade, the Memorandum makes two suggestions:-

(a) A standstill on protectionism, especially in the next MFA.

We could not agree to a standstill on the MFA. We believe that the new MFA will have to reflect today's less favourable economic circumstances.

(b) An indication of our determination to remove trade barriers against LDCs.

In current circumstances, there seems little scope for action in this field. In general, access to industrialised markets is already very liberal.

Economic Relations Department
8 July 1981

1. In the evaluation of the international situation our talks revealed full agreement on the key issues which face our countries and on its implications. We are firmly decided to face the challenges which confront us in a spirit of solidarity, cooperation and responsibility.

2. We all view with concern the continuing threats to world peace. Lasting peace can only be built on respect for freedom and dignity of nations and individuals. We appeal to all governments to exercise restraint and responsibility in international affairs and to refrain from exploiting crises and tensions.

3. In East-West relations, we are seriously concerned with the continuing build up of Soviet armaments. We are concerned as well by Soviet actions that are incompatible with the exercise of restraint and responsibility in international affairs. We will be firm in insisting on military balance and political restraint. Equally, we will be prepared for dialogue and cooperation if Soviet actions make these possible.

4. We agree that meaningful and verifiable arms control agreements are an important element of security policy.

5. We recognise that economic stability and social justice are a precondition for maintaining our defence capabilities.

6. On the question of Afghanistan, in spite of the fact that we publicly stated our firm and unanimous position at last year's Venice Summit, the situation remains unchanged. Therefore, with the overwhelming majority of nations, we continue to condemn the Soviet military occupation of Afghanistan. We support international efforts to achieve the complete withdrawal of Soviet troops and to restore to the Afghan people their right to determine their own future.

We note with approval the constructive proposal of the European Council for an international conference to bring about this result.

7. Together with regional organisations or States, we are resolved to do what is necessary to ensure a peace built on the independence and dignity of sovereign nations. All peoples should be free to chart their own course without fear of outside intervention. To that end, we are determined to promote peaceful resolution of disputes and to address underlying social and economic problems.

We are firmly resolved to continue our policy of finding political solution to crisis and conflict situations.

8. We reaffirm our conviction that respect for independence and genuine non-alignment are important elements of international peace and security.

We reconfirm our commitment to help the developing countries promote their economies and social evolution. All nations irrespective of their political systems are called upon to make their appropriate contributions. We reaffirm our willingness to continue our

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cooperation with developing countries on the basis of equal partnership.

9. Recalling the statement on refugees adopted at the Venice Summit, we are seriously concerned over the growing plight of refugees throughout the world. We reaffirm our support for international relief efforts and our appeal to all governments to refrain from actions which can lead to massive flows of refugees.