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OF THE
FEDERAL RESERVE SYSTEM
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CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida

For your information there is attached a report by Mr. Truman on the meeting of Working Party Three of the OECD held in Paris on May 18, 1976.

Attachment

RESTRICTED

E.M. Truman
May 21, 1976

Report on Meeting of Working Party Three
(Paris, May 18-19, 1976)

The meeting considered three topics: recent exchange-rate movements for the Italian lira, the pound sterling and the French franc; the improving economic outlook for member countries; the usefulness of analyses of countries' competitive positions.

I. Recent Exchange-Rate Movements

A. The Italian Lira

The representatives of Italy reviewed recent developments in the Italian economy and for the Italian lira. They emphasized that the external problems started with their current account deficit in the fourth quarter of 1975. The size of the 100-day decline of the lira starting in mid-January was viewed by the Italian authorities as not corresponding to any realistic evaluation of the lira. Faced, however, with a delicate electoral test the Italian authorities were forced on May 5 to adopt the deposit scheme as the only effective immediate stop gap to protect the lira during the period of the elections. The major purposes of the deposit scheme along with other recent technical measures are to reduce speculative demand for foreign currency and to reduce liquidity in order to restore the competitive position of the lira to a more appropriate level vis-à-vis other currencies. On the other hand, it was recognized that the devaluation of the lira would help to prevent a further worsening of the domestic employment situation later this year. The deposit scheme is expected to expire on August 5 if not earlier, but its effects will last for another three months.

The group generally recognized that it was difficult to make forecasts for the Italian economy before the June 20-21 elections and the program of the government is known. The group emphasized, however, the need to reduce the public sector deficit further and to maintain the reduction, the need to exert tight monetary control especially after the expiration of the deposit scheme, and the need to bring about a reduction in real wages. The Italian representatives said that the technicians were working on all these problems, and especially the indexation problem, in preparation for the new government. On monetary growth, they noted that the large volume of maturing treasury bills in May and June might lead to problems in holding down the growth of the monetary base.

B. The British Pound

The U.K. representative presented a review of the circumstances surrounding the decline in the pound sterling. They argued that the decline had occurred in two phases. First, the market belatedly recognized that the pound's value had not kept pace with the relative U.K. inflation rate. This myopia was ascribed to an unrealistic appraisal of the first phase of the U.K. incomes policy in 1975. Nevertheless, the British authorities were surprised by the exchange market turbulance when the pound broke through the $2 level. Second, the market responded to the uncertainties surrounding the change in the labor party's leadership and the negotiation of the second phase of the incomes policy. This nervousness is apparently continuing.

In passing, the U.K. representatives made several points. (1) The narrowing of the differential between U.K. and U.S. interest rates was thought to be a return to a more normal relationship especially with the decline in the expected U.K. inflation rate. Consequently, the authorities were surprised by the reaction of the market to the narrowing of the differential. (2) No particular pressure on sterling had come from withdrawals of sterling balances, but false rumors about such withdrawals did play a role. (3) Sterling was never sold on a falling market. In fact, there had been more than $2.5 billion in official intervention in March and April. These sales had reduced British gross reserves to a low level of about $5 billion including the drawing on the SDR 700 million IMF stand-by. It was hoped that this level of reserves was adequate, they were approaching a danger point and they had little leeway with which to play. (4) They thought the value of the pound was in a reasonable range at about the average 1973-74 level of competitiveness--taking account of relative price movements. It might be slightly undervalued, but inflation would tend to erode that situation. The British would like to see a stable pound, but this depended on the inflation rate. They did not think that intervention or interest rate policy should be used to promote a recovery of the pound. In the British view, exchange market intervention was only justified when the market was driving the exchange rate or the rate was moving threateningly fast. (5) They are worried about the continued rise in British unemployment in particular because this rise delays the possibility of progress on structural problems such as reducing public expenditures.

The group raised three main question about the British situation.

First, a concern was expressed about the stance of British monetary policy. It was suggested, in particular, that the British authorities might direct their interest rate policy for the next six months at holding the exchange rate while the second phase of the incomes policy was taking hold. The British representatives rejected this suggestion, but they acknowledged a need for monetary policy to support the incomes policy and the possibility of a conflict between this objective and the objective of providing adequate financing to industry.

Second, concern was also expressed about the size of the British public sector borrowing requirement (PSBR). The British representatives indicated that the PSBR for the general government was only 7-1/2 per cent of GDP and the long run aim was to bring it down to 4 per cent, that the PSBR was not regarded as an immediate policy objective although its size was bothering the exchange market, and that they would convey the Working Party's concern to the British authorities. The essential unspoken point was that as long as unemployment was not rising it was politically difficult to cut the PSBR from the expenditure side; the tax side is pretty much frozen.

Third, interest was expressed in the acceptance by the Trades Union Congress of the broad concept of the government's proposal for a second wage limit. The British representatives explained that in their personal view the electorate had realized the connection between pay, prices and jobs. Thus it was possible, to appeal to the electorate over the heads of the TUC leadership. The problems now would come with the distortions that would arise in the third stage of the policy.

C. The French Franc

The representative of France explained that the decline of the franc was, in part, attributable to the September stimulus to the economy that had gotten the French economy moving more rapidly than had been expected and was, in part, attributable to "circumstances" such as the speculative consequences of the decline of the lira, some withdrawal of official foreign assets from francs, and leads and lags. France had "played the community game" until it had spent the reserves it had acquired in 1975. It was pointed out that the market for the franc had been very quiet since March 14, that the French authorities did not want to take advantage of their "new freedom" because of the international effects and the negative effects on domestic inflation, and that a tightening of monetary policy was regarded as necessary for an orderly exchange-rate policy.

There was no discussion of the report on the French franc.

II. The Economic Outlook

A. Outlook for Current Account Positions

The OECD secretariat has not yet completed its forecasts of current account (goods, services, remittances and government grants) balances. Preliminary estimates were, however, presented based upon assumptions that in 1976 for the OECD the volume of imports would rise by

10 per cent, the volume of exports would rise 9 per cent, the price of imports would rise 8 per cent, and the price of exports would rise 6-1/2 per cent. A negative swing of about $15 billion is expected in the total OECD current account balance, while positive swings are expected for OPEC ($10 billion) for the non-oil developing countries ($5-1/2 billion) and other countries ($1-1/2 billion). All of the change in the OECD deficit is accounted for by a $16 billion swing estimated for the United States, which is roughly the same figure that was presented by the U.S. delegation.

B. The Dangers of Over-Expansion

The general view is that the economies of the OECD countries are not only expanding rapidly but that they might be expanding too rapidly.

This was the view expressed by Under Secretary Yeo. He said (1) the U.S. economy is now in an expansion phase; (2) the improvement in productivity is greater than is shown by the industrial production index which might be misleading; the economy is facing shortages in paperboard, flat-rolled steel, textiles and some chemicals; (3) he is not worried about expanded U.S. profit margins because investment was needed to solve the economy's structural problems; (4) moderation in the U.S. expansion is needed; and (5) the swing in the U.S. current account is desirable. The Germans and French also expressed surprise and concern at the strength of their economic upswings; they were joined to some extent by the Dutch and Canadians. The Swiss, Swedes and British expressed less concern.

The OECD secretariat pointed to potential worries in the recent rise in commodity prices, the rise in profit margins which could lead to a wage explosion, the possibility of a boom developing as a result of lower savings rates and stronger stock building, and the prospect of uneven inflation rates which would upset exchange markets. It was suggested by a representative of the secretariat that countries should coordinate their monetary policies with the weaker countries taking the lead in tightening (raising interest rates) in order to avoid exchange-market disturbances. This suggestion received little support. The representatives of Belgium and Sweden expressed concern about a tightening of German monetary policy. The British said that if tightening were necessary it should be in the area of fiscal policy. The Swiss, Germans, and Americans generally indicated that they would follow appropriate monetary policies and coordination was unnecessary.

III. Competitive Positions, Exchange Rates and Inflation

Following the discussion by the working party in February, the OECD Secretariat had been asked to prepare some material for the analysis of countries' competitive positions.

The U.S. delegation was strongly critical of the approach taken in the Secretariat's paper. The following arguments were advanced: (1) the exchange market is now fascinated by countries' relative inflation rates, but this is just a passing fad; (2) competitiveness calculations focus only on a small portion of flows through exchange markets; (3) the data used for the calculations--export unit values, unit labor costs, and consumer prices were inappropriate or insufficient for this purpose; (4) such calculations tempt government officials to think that they can determine the "right exchange rate" for their currencies; this is impossible especially because the rates chosen by each country are likely to be incompatible; and (5) the exercise was in large part based upon the view that price and exchange-rate movements were generated by vicious or virtuous circles; this view neglects the fact that, in general, such movements do not occur exogenously and, in particular, they are often generated or supported by countries' macro-economic, and especially monetary, policies.

Other participants in the group were not as critical of the Secretariat's efforts as was the United States. But the Japanese and Swiss came close. Some participants suggested that it would be useful to look at other determinants of competitiveness such as non-price factors, the profitability of export industries and the role of income elasticities. It was, however, generally agreed that this type of exercise should not and could not be used to judge whether an existing exchange-rate relationship is "right" or out of line, or what will or should happen to a particular exchange rate in the future: On this basis the group may return to the topic at a later date after the participants have had the chance to study the paper more closely.