BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

March 20, 1981

CONFIDENTIAL (FR)
CLASS II - FOMC

TO: Federal Open Market Committee

FROM: Murray Altmann M.A.

Attached for your information is a report by Mr. Truman on a recent meeting of OECD's Working Party Three.

Attachment

CONFIDENTIAL (F.R.)
CLASS II - FOMC

Edwin M. Truman
March 19, 1981

Report on Meeting of Working Party Three
(Paris, March 11-12, 1981)

Introduction and Summary

The discussions at the recent meeting of Working Party Three (WP-3) at the OECD in Paris dealt primarily with two topics: (1) recent economic policy developments in the United States, Germany and the United Kingdom and (2) the evolution of the multi-currency reserve system.

On the first topic, the U.S. economic program was generally well received, although some skepticism concerning its likely results was expressed. The level of dollar interest rates received little criticism. The recent Bundesbank actions with respect to the availability of Lombard credit were described as temporary and flexible; although this description was accepted, there was some criticism that the Bundesbank had delayed too long and some skepticism that German interest rates are likely soon to decline relative to dollar interest rates. The discussion of the new U.K. budget with its reassertion of the Thatcher government's medium-term strategy generated little controversy.

On the second topic, the representatives of the countries with the newer reserve currencies (Germany, Japan, Switzerland) felt that they enjoyed no special benefits from the emerging multi-currency reserve system. The representatives of the older reserve currencies (the United States and the United Kingdom) felt that the system was evolving satisfactorily. The representatives of other countries had more mixed views. Some advocated greater reliance on the SDR, others argued that the present market-oriented system provides positive benefits.

Recent Economic Policy Developments

Undersecretary-Designate Sprinkel introduced himself to the Working Party as a monetarist with free market leanings. He described the four parts of the Reagan Administration's program: spending cuts, tax cuts, reduction of the regulatory burden, and gradual reduction in the growth of the monetary aggregates. (In answer to a question he volunteered that he would favor reducing the rate of growth of the monetary base by 50 percent by 1986.) I described the Federal Reserve's monetary targets for 1981 and indicated that short-term interest rates on dollar-denominated assets had declined substantially in recent weeks, which may have contributed to an easing of hectic conditions in foreign exchange markets.

The questions addressed to the U.S. delegation were not particularly critical of U.S. monetary policy or the level of dollar interest rates.[1/] One delegate felt that short-term dollar interest rates had become less variable; another asked whether the Federal Reserve had changed its technique to achieve such a result. Several delegates expressed some skepticism concerning the chances of success for the U.S. program, especially concerning the achievement of reductions in inflation in the short run. A few expressed concern that the Federal Reserve might be "overburdened" if the program is not successful in reducing expectations of inflation. Sprinkel responded that the Administration was

1/ The Swiss delegate did complain that U.S. policy always contributes to inflation in Switzerland. In 1978, he argued, the weakness of the dollar had caused Switzerland to intervene in the foreign exchange market which led to a rapid increase in the money supply that contributed to inflation; in late 1980 and early 1981, high U.S. interest rates, he argued, contributed to the strength of the dollar and have led to "imported inflation" in Switzerland.

following a "low interest rate" policy through its program, which apparently relieved some delegates.

Rieke (Bundesbank) said that the closing of the Lombard window and the decision to offer Lombard credit only through a special overnight facility at a variable interest rate was triggered by the persistent decline of the Deutschemark that had not been stopped by substantial exchange market intervention.[1/] He emphasized that the measures were temporary and flexible. He said that while Germany has no exchange rate target, the government and the Bundesbank have an idea of what constitutes overshooting of the exchange rate and what is dangerous in terms of exchange rate movements; the aim had been to "stop the rot." Rieke argued that the special Lombard facility was a more flexible instrument compared with an increase in the basic discount rate. He also argued that such limited action was appropriate given the weak cyclical situation in the German economy and in light of the possible adverse psychological effects associated with subsequent reductions in the official lending rates. He said that the special Lombard facility would be managed flexibly in response to developments in the exchange and the money markets. Decisions on whether the special Lombard facility should be open or closed and at what interest rate are made by the Bundesbank Directorate rather than the Central Bank Council, although I was told that there is a range for the interest rate prescribed by the latter body. He noted that it was not an accident that a certain amount of uncertainty had been introduced into financial markets by the Bundesbank actions.

1/ The Lombard rate had been 9 percent and to date the rate on special Lombard credit, when available, has been 12 percent. The discount rate is 7½ percent.

Rieke linked the Bundesbank actions, including the decision to abolish the final control on capital inflows (to purchase claims with less than one-year maturity), to the German current account deficit and the need to finance it. He described that deficit as part of the overall disequilibrium in the German economy. Although he did not predict a quick turn around in the German current account position, he did hint that the use of the special Lombard facility as an instrument is likely to be temporary.

The German actions were criticized as having been delayed too long, as having been too severe, and as having been caused by the United States. Several delegates questioned whether the German actions -- indexed by the level of German interest rates relative to U.S. interest rates -- were likely to be temporary.

Couzens (U.K. Treasury) summarized the U.K. budget which had been submitted the previous day. He characterized the budget as a rejection of the reflation option and a reassertion of the government's medium-term strategy. Though a central emphasis is still on the control of monetary growth, greater weight is being placed on fiscal policy, and the burden of fiscal policy is being shifted from the business to the personal sector.[1/] He noted that monetary policy had been tight in 1980 when indicators other than the explosive growth of sterling M-3 are examined. He also said in answer to questions that some of the emphasis has been

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1/ The target for sterling M-3 has been reduced from 7-11 percent to 6-11 percent, accepting the base drift implied by an expected outcome of 19-20 percent this year. The Minimum Lending Rate has been cut 2 points to 12 percent. The public sector borrowing requirement has been reduced from an estimated six percent of GDP for the next fiscal year to an estimated four percent. However, the target for the fiscal year just ending was originally 3-3/4 percent of GDP.

taken off the "uniqueness" of sterling M-3 as the principal monetary target variable; they will look at M-1 as well, are trying to construct an M-2 measure, and are continuing to restructure monetary management. However, he said that they still believe that sterling M-3 is the most meaningful monetary aggregate for the United Kingdom, although it is not the easiest aggregate to control.

Couzens and Loehnis (Bank of England) stated that the United Kingdom does not have an exchange rate policy. Although they care about the exchange rate, they are not trying to hold sterling up by maintaining high interest rates or to depress sterling through lower interest rates. Loehnis said that he could only guess at the effects of the new U.K. budget on the external value of sterling. He noted that sterling's strength during the previous year could be attributed to several factors: interest rates and differentials especially early in 1980, oil self-sufficiency, a current account surplus, and favorable perceptions of the Thatcher government's policies.

In answer to a question, Loehnis explained the U.K. decision to seek new powers to control capital inflows. He noted that such powers were mandated by an EC directive in the early 1960s; he also noted that contingency planning during 1980, when sterling was very strong, had revealed that the existing Exchange Control Act could not easily be applied to capital inflows. He said that included in the new powers are: restrictions on foreign currency or sterling borrowing abroad, negative interest rates on foreign deposits, countervailing deposits against foreign borrowings, and controls on the sales of commercial bills of exchange to non-residents. He said that use of the new powers would be contrary to the government's philosophy, was not needed now that sterling has declined recently, and might, in any case, not be useful.

Multi-Currency Reserve System

The Working Party held a discussion of the evolution of the multi-currency reserve system. The delegates from the so-called "newly emerging reserve currency countries" (Germany, Japan and Switzerland) did not in general indicate a great deal of dissatisfaction with the present system. They all argued explicitly that their currencies' roles as secondary reserve currencies place burdens on their countries, and they argued implicitly that those burdens are larger than those shouldered by the primary reserve currency because their financial markets are smaller and their currencies are less widely used in transactions.

Rieke (Bundesbank) asserted that the present multi-currency reserve system is likely to remain. He said he could not deny that there has been some change in German attitudes toward the reserve role of the Deutschemark, which is now estimated to have a 12 percent share of official reserves. He argued that such a role creates problems rather than opportunities in Germany's economic management, but that not much can be done to restrict the reserve use of the Deutschemark.

Fujino (Japan) argued that discipline on economic policies under floating and the multi-currency reserve system is stronger than under fixed rates and a single reserve currency system. He said that Japan has accepted the international use of the yen -- about 3 percent of official reserves -- and has adapted its economy to the changing role of the yen.

He said that they have sought to maintain and improve swap arrangements and view off-market transactions only as exceptional arrangements.

Languetin (Swiss National Bank) asserted that the share of the Swiss franc in international reserves has not increased significantly in recent years, remaining around 3 percent. He said that Switzerland views diversification as an ongoing development and tries to control diversification by non-G-10 central banks by facilitating such diversification in calm periods, by avoiding the development of secondary markets in Swiss franc claims, and by trying to direct business from the Eurocurrency market to the national market.

The representatives of the older reserve currency countries also commented. Sprinkel said the new administration shares the view of the Carter administration with regard to the multi-currency reserve system: we have no objection to these trends toward greater burden sharing.1/ He said he recognizes the pressures on some countries to diversify, but with sound U.S. policies these trends would not accelerate. Couzens said that the United Kingdom has no enthusiasm to increase sterling's reserve role -- currently about 2½ percent of international reserves. He argued that the multi-currency reserve system reinforces through the market cautious economic policy and, thus, is counter inflationary. (This point was also made by others.) He noted that the system should impose certain responsibilities on the holders, i.e., to avoid rapid portfolio shifts, as well as on the issuers of reserve currencies.

1/ The dollar's share of international reserves is between 75 and 80 percent and has not declined significantly since the early 1970s. It has declined somewhat since its peak share in 1975-76.

In the general discussion, several delegates (especially from France and Belgium) expressed greater concern about the evolution of the multi-currency reserve system than had the delegates from the principal countries. On the other hand, some delegates (especially from Canada) viewed the system as not posing any dramatic, serious problems and, indeed, as a positive development because of the emphasis on market forces. Several delegates commented that the functioning of the present international financial system should be viewed from a broader perspective than just the distribution of stocks of official reserve assets across currencies. The behavior of private participants was mentioned as was the role of non-reserve countries as issuers of debt denominated in reserve currencies as well as holders of claims. Although there was no consensus that something needed to be done to manage more actively the evolution of the multi-currency reserve system, several delegates mentioned positively the SDR and the substitution account proposal. Undersecretary-Designate Sprinkel had left the meeting by this point, and the United Stated did not comment.