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CONFIDENTIAL (FR)
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TO: Federal Open Market Committee

FROM: Murray Altmann M.A.

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

Attachment.

CONFIDENTIAL (F.R.)
CLASS II - FOMC

Charles J. Siegman
June 12, 1981

Report on Meeting of Working Party Three at the OECD
(Paris, May 13-14, 1981)

Introduction and Summary

The discussions at the recent meeting of WP3 at the OECD focussed on two topics: (1) current economic situation and economic policies in industrial countries and (2) recycling.

Much of the discussion on the first topic concentrated on U.S. economic conditions and policies. The recent rise in U.S. interest rates evoked only limited expressions of concern, primarily by representatives of the smaller economies. Widespread concern, however, was expressed about the recently announced U.S. intervention policy. While there was general agreement that intervention should not be viewed as a substitute for sound monetary and fiscal policies, a number of delegates maintained that in a variety of circumstances intervention could be a useful supplementary policy, particularly for open economies. Some representatives stressed that coordinated intervention in recent years fostered international cooperation. Critics of the new U.S. intervention policy maintained that exchange-rate movements were not only determined by fundamentals, and psychological factors could be dealt with by intervention. Concern also was expressed by some that a declaration of policy intention about intervention was not helpful in stabilizing markets. Finally, some delegates maintained that the new U.S. intervention policy would reduce the freedom of action of others.

The delegates were reassured by Under Secretary Sprinkel that U.S. intervention policy was not a form of benign neglect, foreign countries could use dollars to intervene, the Federal Reserve Bank of New York was explicitly authorized to execute orders of foreign central banks and treasuries, and U.S. monitoring of other countries' intervention was intended to focus on situations where countries attempt to use their exchange rate to gain an unfair competitive advantage.

With regard to conditions and policies in other countries, the Germans indicated that their continued large current-account deficit was delaying a recovery in the exchange rate. Germany felt compelled to adjust German interest rates to international rates. High German interest rates, however, create tensions in the EMS, and may not be appropriate for domestic economic conditions. The Japanese stressed that they would prefer a strong yen to help combat inflation. Thus far a widening of interest-rate differentials against Japan had not had a significant effect on the yen.

On the recycling issue, there was broad agreement that recycling thus far has occurred with fewer strains than had been anticipated. There was widespread concern that there may be too much financing and not enough adjustment, and that the exposure of banks may be growing too rapidly. Most spokesmen noted that there is no generalized recycling problem, and that it is individual countries that face financing and adjustment problems.

U.S. Economic Policies

Under Secretary Sprinkel's review of recent economic developments in the United States attributed the strong first-quarter GNP to the expansion of money growth in much of the second half of 1980. Similarly, he attributed the recent rise in interest rates to the recent growth of the money supply. He stated that inflation still remained the main economic problem, noting that the Administration and the Federal Reserve were in agreement on the objective of reducing the expansion of the money supply in a stable fashion. Once this happens interest rates will decline. Governor Wallich indicated that movements of U.S. interest rates are the outcome of the implementation of the Federal Reserve's money supply objectives. The slowing of the aggregates through January and February at a time when economic activity was strong suggested that there may have been a downward shift in the demand for money following a period of high interest rates. The March rise in the aggregates and the April surge raise some doubts about such a shift. M1B is on track, but M2 and M3 are above the announced path. Administration support for a tight monetary policy is helpful. When inflation rates slow interest rates will decline.

Some delegates (Japan and Sweden) questioned the reliance by the United States on monetary policy in reducing inflation, the Italian delegate maintained that the fiscal deficit was contributing to high interest rates, and the delegates from Sweden, Belgium and France noted that high U.S. interest rates were creating difficulties for their economies and for the developing countries. Sprinkel responded that the President, the Treasury and the Federal Reserve are determined to get inflation under control, and we all have to live with the short-run effects that efforts to do so are having on interest rates and exchange rates. A high interest rate is not a tool or objective of the Administration. The Administration desires low interest rates for both domestic and international reasons. Once the money supply growth is under control inflationary expectations will be lowered and interest rates will decline. Sprinkel argued that a fiscal deficit need not be inflationary if it is not accommodated by the creation of money and credit.

Sprinkel reviewed the main elements of his May 4 Congressional testimony on U.S. intervention policy, indicating that the minimalist intervention policy was not benign neglect, and that by getting the U.S. house in order there will be no need to intervene. Wallich added that the change in intervention policy should not interpreted as an ideological shift but as a change in circumstances. When the United States wanted to cover the Carter bonds it was appropriate to have sizable intervention; now there is no need for intervention on that scale. Intervention cannot deal with recent jumps in interest rates that are translated into exchange-rate changes.

The extensive comments on, and questioning of, the U.S. intervention policy reflected widespread anxiety about the U.S. attitude toward exchange rates. Languetin (Swiss National Bank) stated that while sound and stable monetary policies are essential to achieve exchange-rate stability, it does not follow that intervention cannot be useful or have a psychological impact. There is a ratchet effect on inflation in foreign countries when the dollar appreciates and then depreciates. The exchange markets in the past suffered from an open mouth policy; statements on intervention policy intentions could be damaging for the market and leave doubts about the determination of the authorities. Hayami (Bank of Japan) indicated that while the exchange rate should reflect fundamentals, speculative exchange-rate movements, activated by psychological reactions, could lead to excessive movements. The dollar and the yen in recent years were helped by cooperative intervention. The swap network has been helpful in maintaining more stable exchange rates. If the dollar should weaken in the future, a hands-off policy by the United States would be harmful. Gleske (Bundesbank) noted that exchange rates are subject to a variety of influences, not all of which are related to fundamentals. If policy is in the right direction intervention could help if the market is disorderly. While the market should not be interfered with unnecessarily, exchange markets are not immune to bandwagons, stampedes, and mass psychology. Intervention permits central banks to keep in contact with the market and has been helpful in developing international cooperation and consultations. Finally, the public declaration of policy intervention is not helpful. Janson (National Bank of Belgium) observed that if the United States intended to limit the right of other countries to intervene this would be a new and dangerous policy. McMahon (Bank of England and Chairman of WP3) noted that there are two sides to an exchange rate; it therefore follows that it is important to watch what other countries are doing to affect their exchange rates. It would be useful to avoid making overly ambitious statements about intervention intentions. Markets should be kept guessing, and market testing of the resolve of governments should be avoided. Padoa-Schioppa (EEC) inquired if the dollar should decline as rapidly as it has risen, would the U.S. intervention attitude be symmetric?

In his response, Sprinkel stated that he would not resist a decline in the dollar ("can't be two faced"), and won't keep it up artificially. He reassured the delegates that he hoped that there was no misunderstanding about freedom of action by others to intervene if they desire to do so. Foreign authorities are free to use dollars as they see fit and the FRBNY has been explicitly authorized to execute orders of central banks and treasuries. If in the process of monitoring foreign exchange rates the United States detects that a country is using the exchange rate to gain an unfair competitive advantage he would be inquisitive, although he doubted whether a country could succeed in maintaining an artifical rate.

Foreign Economic Conditions and Policies

Gleske noted that the estimate for the German current-account for 1981 is for a slightly higher deficit than last year's $15½ billion. If the German external accounts are to avoid successive J curves, an improvement in the exchange rate, or at least no further depreciation, is needed. In current circumstances, however, no exchange-rate improvement is likely until the trade account improves. The recent decline in the DM rate is entirely due to the rise in U.S. interest rates. To avoid an even sharper depreciation of the DM, Germany felt compelled to adjust its interest rates to international rates. The strength of the DM in the EMS resulting from the interest-rate rise, however, creates tensions in the EMS. In addition, high German interest rates may be inappropriate for domestic conditions. In response to questions, Gleske observed that even if the current account and exchange rate show improvement, there is at present limited leeway to lower German interest rates. In the third quarter of 1980 domestic interest rates rose in order to keep monetary aggregates on path. While Central Bank Money in recent months has been at the mid-point of the range, if near money (short-term bonds for which there are no minimum reserve requirements) is taken into account both CBM and M3 are growing more rapidly. Flandorfler (Ministry of Economics), in response to questions why German exports have not benefitted from the improvement in German international competitiveness resulting from the sharp real depreciation of its currency, observed that in the 1970's Germany's export structure adapted to the sharp appreciation of the DM, and that it takes time to reverse such a structural change.

Sagami (Ministry of Finance) and Hayami stated that Japan was watching with some concern the recent rise in U.S. rates. Japan currently has the lowest interest rates in the world. They wondered how long the wide differential in interest rates could persist without a sharp depreciation of the yen. Meanwhile, continued large capital inflows are maintaining the strength of the yen. Sagami observed that Japan preferred a stronger yen in order to combat inflation, but Japan won't manipulate the rate in order to achieve a stronger yen.

Westerberg (Ministry of Economic Affairs) observed that Sweden typified perhaps the smaller countries that face the political repercussions of trying to adjust to the higher oil price. Sweden has experienced no difficulty in financing its large current-account deficits, and the ease of financing was perhaps harmful since Sweden felt no need to adopt more restrictive policies.

Recycling

Lamfalussy (BIS) reviewed the latest data on bank lending to various country groupings, and reported that net banking flows (increases in claims less increases in deposits) to non-OPEC developing countries in 1980 reached $35 billion, with a third of that amount extended in the final quarter. In the past two years, net flows to these countries amounted to $60 billion. He thought that perhaps there had been too much lending.

Sprinkel stated that capital markets were functioning well in recycling. He saw no problems of recycling in the aggregate, although unlimited financing is not the solution. Some countries have not made an effort to adjust adequately and may face debt problems. It is advisable for countries to start adjustment early. Once a country shows that it is willing to take adjustment action -- e.g., Brazil -- access to additional credits is improved. The United States sees no obvious benefits from having private banks join governments in debt-rescheduling negotiations. Wallich added that he was troubled by the buildup of concentration of bank lending by large U.S. banks to particular countries. There may be a false sense of security by banks, and some banks may be subject to making peer group loans. While much effort has been devoted to evaluating country risk, the emergence of surprise cases -- e.g., Nicaragua and Iran -- suggests another reason for caution in bank lending.

Camdessus (who serves as Chairman of Paris Club debt renegotiations) expressed satisfaction at the way the creditor groups have functioned in recent years. Since 1978, the refinancing negotiated under the creditors group format has amounted to some $9 billion -- a sum that is larger than the amount over this period of OPEC lending to developing countries or World Bank or net IMF lending. For rescheduling to be successful it is necessary that all parties -- IMF, creditor countries, bilateral aid donors -- take actions that are reinforcing. It would be useful to have better cooperation between the IMF and the World Bank. Comparability clauses in debt reschedulings link private banks to official debt renegotiations. Where private debt is large, banks should handle reschedulings themselves. In contrast to official debt rescheduling, however, private bank refinancing is made difficult by the fact that there are a large number of banks involved, and debtor countries do not always know to whom to address requests.

Couzens (U.K. Treasury) observed that most of the problem countries have been those where there has been mismanagement. Prudent behavior by banks is in everyone's interest. If the failure of the banking system would be damaging for industrial countries, how much more so for developing countries. A weakening of IMF conditionality would be a grave mistake. Loehnis (Bank of England) added that private banks have gained experience in rescheduling, but thus far most reschedulings have involved small amounts. The system has not yet been tested for large amounts. Poland is perhaps a test.

Dini (Bank of Italy) shared the view that banks were lending too much to developing countries. More adjustment is necessary, especially for the middle-high income group of countries. There is a risk that banks were assuming that they will be bailed out.

Rieke (Bundesbank) observed that recycling has perhaps gone too well. Any financial market that expands by 25 percent a year, as bank lending to developing countries has done, may be a problem. If the current-account deficit of developing countries will be larger than what is now anticipated, financing problems could emerge. While WP3 representatives share view of a need for more adjustment and insist on maintaining conditionality of IMF loans, other government departments in G-10 countries do not share this view and these departments sometimes determine final policy. Rieke observed that while unregulated financial markets could handle recycling, prudent regulations are necessary to maintain the soundness of financial markets. The Bundesbank is starting to share U.S. views for the need of some regulation of the Euromarkets. Sprinkel responded that "if it ain't broke, don't try to fix it." The Euromarkets work well, and he was not inclined to tinker with them.