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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

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RESTRICTED

E.M. Truman
September 18, 1981

Report on OECD's Working Party Three
(Paris, September 9, 1981)

This meeting of Working Party Three (WP-3) focussed on the topic of the external implications of countries' efforts at domestic monetary control. The documentation for the meeting was based primarily upon submissions from the central banks of the major countries.[1/] The discussion at the meeting, perhaps because it was somewhat abstract, produced no sharp criticism of U.S. policies. Concerns were expressed more about the level than about the volatility of dollar interest rates. Although there was a consensus that countries' efforts at domestic monetary control could and did have external implications for many countries that sometimes are not entirely appreciated by the country exercising the control, strong views were not, in general, expressed and no consensus emerged about adjustments in monetary or other policies that should be made.

Chairman McMahon (Bank of England) tried to organize the discussion around three broad questions: How much concern is there about exchange rate and interest rate variability? How should such concerns be dealt with? How should conflicts between external and internal policies be resolved?

Sprinkel chose not to focus primarily on these questions. Instead he presented a defense of disciplined domestic monetary control, arguing that until credibility is established the transition to such a policy could involve economic difficulties. He said that short-term control over the monetary aggregates was not essential and endorsed the monetary base as the

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1/ The U.S. submission consisted of the Federal Reserve staff study of the new monetary control procedure and Under Secretary Sprinkel's testimony on April 8, 1981 on U.S. monetary policy and the Administration's economic recovery program.

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aggregate on which there should be primary focus. He denied that the United States has a high interest rate policy and argued that dollar interest rates had had little to do with the dollar's external strength in 1981 -- in contrast with 1980. He acknowledged that U.S. monetary policy could have effects on other countries especially if U.S. policy is relatively successful. He defended U.S. policy of minimal exchange market intervention.

Wallich commented on several points in the documentation for the meeting. He drew a distinction between very short-run interest rate variability and the cyclical swings in 1980. He observed that the Federal Reserve's new operating procedure probably had little effect on the current level of U.S. interest rates -- the old procedure would have led to the same level, though maybe at a somewhat later date. He said that the major influence of U.S. monetary policy on exchange rates was through the monetary target itself and not the techniques employed to achieve it.

Wallich noted that there may have been some effects on the domestic economy in the recovery phase in 1980 from the new Federal Reserve procedure, but they were small. He said that there had been considerable portfolio effects, leading to a concentration on short-term assets. He noted that a strong dollar helped reduce U.S. inflation but was not without pain in terms of U.S. exports. He expressed skepticism about the existence of a ratchet effect on inflation from swings in exchange rates, especially given that in an inflationary environment exchange-rate appreciation does not require actual reductions of domestic prices to be effective in reducing inflation.

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Wallich also noted that the impacts of short-run deviations from monetary targets depend very much on their effect on expectations but that those expectations concern the full range of economic policies, not just monetary policy, especially in a democracy. He stated that it would not be meaningful to try to use monetary policy to bring down dollar interest rates. He also rejected the use of credit controls as a permanent solution to high interest rates in the U.S. economy.

Jordan (C.E.A.) argued, in response to a question, that U.S. long-term interest rates are now more responsive to perceptions of deviations in monetary growth from targets than are short-term rates. He explained that when participants in the financial markets look at the U.S. budget deficit they consider three possible alternatives: economic growth will be less rapid than expected and the Reagan Administration might lose its resolve in the face of the stagnation; government expenditures (defense and non-defense) might be reduced further, which the markets feel is not a safe bet, or monetary policy will "give" in 1982. He did not say what was the right interpretation, though he suggested that the last was the dominant interpretation and noted that the Reagan Administration was under increasing pressure to "do something about interest rates". (Some participants interpreted this observation as a suggestion that something would be done about high, U.S. interest rates.) Later Jordan argued that U.S. interest rates are higher in 1981 than they were on average in 1980 because foreign central banks this year have not only not been buying U.S. Treasury securities but have been selling them to finance their exchange market intervention. (NOTE:

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Given that the U.S. current account position is about the same in 1981 as it was in 1980, net capital flows (private plus official) must be about the same. The reduced foreign purchases of U.S. Treasury securities at most might have an influence on interest rates on short-term Treasury securities relative to interest rates on other dollar assets, but they should have no effect on the average level of dollar interest rates.)

Couzens (U.K. Treasury) made the comment that concern should not be focussed on particular forms of variability (in exchange rates or in interest rates) but on total economic variability, which has increased in recent years. With respect to the U.K. situation, he said that economic policy is not just a question of monetary targets and high interest rates. In the United Kingdom, monetary targets are regarded as a guide to a broad anti-inflation policy. He argued that while relative interest rates had influenced exchange rates in recent years, fundamental factors (current account positions, oil developments, relative determination to fight inflation) had been more important than interest rate variability, and he agreed with Wallich's skepticism about ratchet effects. He argued that the primary focus of the financial markets was on governments' anti-inflation determination and the chances of success, though efforts to educate the market might help. With respect to U.S. policy he felt that the U.S. authorities should make every effort to convince the market of their determination and ability to succeed in their policies in order to get it over with.

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Gleske (Bundesbank) downplayed the importance of short-term variability in interest rates and exchange rates, but he argued that medium-term varability was more troublesome. He said Germany was prepared to accept the consequences of U.S. anti-inflation efforts for German interest rates, because it wants the United States to succeed and because Germany has its own fiscal problems. He agreed that factors other than interest rates had dominated movements in exchange rates in 1981. Gleske said that the Bundesbank had in February acted resolutely in response to the Deutschemark's weakness out of concern that the weakness might be self-reinforcing. However, he said the Bundesbank did not act later when the DM went to 2.50 per dollar because monetary growth was relatively low in the target range.[1/] He said that there might be more room for maneuver on German interest rates if the German current account improves. He observed that the Bundesbank does not respond to short-run deviations in monetary growth rates where they are the obvious result of temporary factors. The target range allows the absorption of some fluctuations. Thus, monetary policy can be flexible and consider exchange rates as well. He argued that German monetary targets permitted some discretion and a certain degree of interest rate stability without involving an interest rate policy per se.

Haberer (French Treasury) did not use WP-3 to criticize U.S. policy, though he did circulate the paper the Monetary Committee of the European Communities had drafted in June on the subject. (The

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[1/] Subsequent to the meeting the Bundesbank announced that in August the growth of central bank money was 4.2 percent (annual rate) from the 1980Q4 base compared with a target range of 4-7 percent.

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paper is very critical of the external impacts of U.S. monetary policy.) He explained that French monetary policy focusses on three sources of money creation -- the external sector, the budget and private credit -- and the monetary target was designed to be slightly less than the rate of expansion of nominal GDP.[1/] Monetary policy is only one aspect of anti-inflation policy in France, he said. Growth in M2 through July was 13.7 percent which, he argued, gave some margin still.

Haberer explained recent French efforts to lower the costs of funds to banks -- largely through tightening access of individuals to instruments with market-related yields -- and to lower prime lending rates, which are now below short-term money market rates. He said that efforts to "decouple" French interest rates from rates in other markets will continue, but the scope was limited even with credit and capital controls. He said that France intended to stay in the EMS. Haberer noted that France has no problems with the publication of its monetary aggregates because the data are published only once a month with a two-month lag.

Watanabe (Japanese Finance Ministry) reported that high U.S. interest rates have affected Japan through the exchange rate and wholesale prices, through sympathetic rises in long-term interest rates, through increased investment in foreign bonds, and through variability and uncertainty that has had a "seriously disturbing" effect on the Japanese economy. He said that the response of the Japanese authorities has been to try to keep the economy flexible, not to rely exclusively on monetary policy, and to urge other countries to take account of the international implications of their policies.

1/ The external sector in 1981, he explained, has absorbed liquidity, contrary to expectations, but the large budget deficit (financed by banks) has compensated.

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Ogata (Bank of Japan) noted that the Bank of Japan was not sophisticated or courageous enough to have a monetary growth target; the central bank only provides limited forecasts one quarter out and thus avoids the problem of deviations from targets. He noted that window guidance helps in the execution of Japanese monetary policy but it is viewed as a supplement to other policies.

Lamfalussy (BIS) presented some data on the variability of U.S. interest rates and on the relation between interest rates and exchange rates. The latter data indicated that the simple correlation has not been very strong in 1981. He argued that exchange rates respond to expectations about policy which have changed greatly in 1981. In this context, he argued that exchange market intervention might well be ineffective in resisting depreciation but that strong interest rate action might sometimes be called for, such as the action the Bundesbank had taken (too late) in February.

Padoa Schioppa (EC Commission) said that he did not accept the assertion that medium-term exchange rate variability has little economic impact. He also expressed concern about the possible emergence of conflicts among countries' economic objectives, e.g., France versus other industrial countries. His solution involves a non-absolutist position on the stability of monetary growth rates, use of exchange market intervention, and use of other policies -- though he was skeptical about credit and capital controls.

Thiessen (Bank of Canada) stated frankly that Canada has no fundamental complaints about U.S. monetary targets. He said that to date there have been no conflicts between the Bank of Canada's monetary targets

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and exchange rate concerns as a result of spillovers from the United States.

Izzo (Italian Treasury) expressed a more skeptical view. He was concerned about exchange-rate overshooting and called for coordinated exchange market intervention, coordinated interest rate policies and the "organization" of international capital flows.

Janson (Belgian National Bank) stated that he was not convinced by the claims of monetarism, arguing that inflation is a complex phenomenon that cannot be solved by monetary policy alone. He said that Belgian problems were exacerbated by high U.S. interest rates, and therefore pleaded that the United States achieve quick success in its policies.