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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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Edwin M. Truman
December 15, 1981

Report on the Meeting of the OECD's Working Party Three
(Paris, December 9-10, 1981)

Introduction and Summary

The agenda for this meeting of Working Party Three (WP-3) focussed primarily on the implications for exchange rates of the projected movement of the U.S. current account into deficit, the German current account into surplus, and the Japanese current account into larger surplus. The issues raised were (1) whether exchange rate pressures were expected for these countries' currencies or other currencies, (2) what might be the appropriate response to such pressures, and (3) more broadly, the role of exchange rate or balance-of-payments policy in the WP-3 countries.

The Working Party did not entirely accept the premise of the exercise -- the projected current account developments. Partly for this reason, significant exchange rate pressures were not generally expected. With respect to the yen and the Deutschemark, some appreciation would clearly be welcomed by the authorities of these countries to the extent that such developments would be consistent with other economic objectives. In the case of the yen, concern was expressed that the Japanese surplus on current account was contributing to severe trade frictions that would be alleviated by an appreciation.

Although no participants endorsed the minimalist intervention policy of the United States, most emphasized their view that intervention in the exchange market is a policy tool to reinforce other policies. Most participants also indicated that exchange rate and balance-of-payments developments influence economic policies in their countries.

The discussion dealt with the major countries -- Japan, Germany, the United States, the United Kingdom, and France. The remainder of this report summarizes these discussions in order.

Japan

Watanabe (Finance Ministry) argued that Japan's current account surplus in 1982 would not be double the rate expected for 1981 -- about $8½ billion. He said that the 1982 surplus might rise slightly (which is consistent with our staff's forecast) but that expanding domestic demand, the effects of the yen's appreciation, and a continuing large deficit on service transactions would contain the growth of the current account surplus. He also argued that market forces dominate the effects of intervention on exchange rates and advocated intervention in exchange markets only in cases of extreme disorder; in such cases, he said, intervention should be joint. He and Ogata (Bank of Japan) expressed a willingness to see the yen appreciate, which they contrasted with Japanese views in 1977-78.

Several participants in the Working Party, including the Germans, the chairman (McMahon of the Bank of England), and Marris (OECD), stressed the importance of reducing the Japanese surplus in order to limit trade frictions which are currently very intense. In this connection, the mix of monetary and fiscal policies in Japan was criticized, the need for opening up Japan to imports was cited, and the possibility of an across-the-board export tax was mentioned.

During the initial discussion, before the Bank of Japan announced the reduction of its discount rate by 3/4 percent to 5½ percent, several participants argued that the recent appreciation of the yen should not be viewed as providing leeway to ease monetary policy and stimulate domestic demand, since the appreciation would help to reduce Japan's surplus on current account. After the announcement of Bank of Japan's action on the second day of the meeting, this criticism was repeated by McMahon and Marris. The criticism was so harsh that I suggested that it might be appropriate for the Japanese to pay some attention to domestic demand while trying to open up their market more to imports and while not resisting an appreciation of the yen if it occurred.

Germany

Gleske (Bundesbank) said that he did not expect a surplus in the German current account in 1982; he expects a deficit of about DM 10 billion ($4½ to $5 billion) because a continuing very large deficit on tourism, interest and transfer payments will be offset only partly by an increasing trade surplus. (The staff's forecast is that Germany will have a small surplus in 1982.) He indicated that if the current account improves more rapidly, the Bundesbank could ease up on monetary policy. He commented that the market expects such a development, although he did not sound pleased about such a tight link. Gleske also said that under current conditions an exchange rate of 2.20 DM/dollar is more or less satisfactory, though he emphasized that this is not a target. In answer to a question, he said that if the Deutschemark were to appreciate this leeway might also be used to ease up on internal monetary policy, although he also mentioned that an appreciation would help to reduce German price inflation. Gleske did not comment on exchange market intervention.

United States

Sprinkel questioned the basic thrust of the documentation that had been prepared for the meeting: overshooting by exchange rates of their equilibrium levels is a problem that must be dealt with. He argued that overshooting is not easy to recognize ex ante, that it is likely not to impose significant real costs, that it cannot easily be prevented, and that there are costs associated with preventive measures. I commented that the term "overshooting" was being used loosely to cover all developments in exchange markets that are viewed as unattractive. I said that this general use of the term obscured the differences involved in specific cases, which should be examined individually in order to judge the appropriateness of intervention in exchange markets in such cases. Sprinkel also noted that U.S. interest rates have declined and said that he expected them to continue to decline. He noted that interest rates abroad, where the United States has been criticized for its high rates, have not declined as much as in the United States.

The U.S. presentation led to a general discussion of the role of intervention in exchange markets. Most participants acknowledged the limitations of this policy instrument. However, some participants (Couzens (U.K. Treasury), Languetin (Swiss National Bank,) and Lamfalussy (BIS)) said that in support of other policies intervention in the exchange market demonstrated a clear and often needed expression of concern by the authorities. Other participants (Jurgensen (French Treasury) and Tullio (Italian Budget Ministry)) stressed the importance of coordinated intervention. Another group of comments concerned the greater importance of exchange rates for smaller, more open economies (Westerberg (Swedish Ministry of Economic

Affairs) and Janson (Belgian National Bank)) and the fact that movements in exchange rates of some countries cause externalities for other countries (Ostry (OECD) and Languetin). McMahon commented at the end of the discussion that there was a great deal of agreement in the Working Party on the appropriate role of intervention, that the remaining differences largely reflect the different sizes of participants' countries, and that the Working Party should refrain from discussion of the merits of intervention in exchange markets for the next several meetings.

United Kingdom

Couzens argued that the pound sterling is not overvalued today and expressed doubts whether it ever had been overvalued under the current U.K. government. The essential points of his argument were that sterling has been strongly affected by oil as well as by a reassessment of U.K. policies. He noted the strength of the U.K. current account position, which remained positive as Germany and Japan moved into deficit and the United States only moved into a balanced position. He argued that the relatively strong pound helped to prevent the accommodation of three years of bad wage rounds and that it was inevitable, under an anti-inflation policy, that the exchange rate will move out of line with the cost structure for a time, forcing the latter to adjust to the former.

Couzens said that the United Kingdom does not have an exchange rate policy but takes account of sterling's external value in making interest rate decisions, especially since the fall of 1980, when the strength of sterling helped to convince the authorities that monetary policy was tight despite the rapid growth of sterling M3. He noted that in the fall of 1981 effects on policy had been reversed and sterling interest rates were raised to "comply with" dollar interest rates.

With respect to intervention, Couzens argued it has a limited role primarily in indicating that the authorities care about the exchange rate -- an attitude that he commended to the U.S. authorities. He also expressed the view that massive intervention in the exchange market may be destabilizing.

Most participants accepted most of what Couzens had to say. A few (Marris and Flandorffer (Germany Ministry of Economics)) expressed doubts, however, about whether sterling was not a candidate for further depreciation. Doubts were also expressed about whether the sharp real appreciation of the pound had not had pervasive, adverse effects on the U.K. economy. To this Couzens replied that the effects on the economy of twenty years of inflation were also pervasive.

France

Jurgensen presented an upbeat report on France and the franc. He said that the growth of M2 in 1981 (December to December) was expected to be 13½ percent, compared with an original target of 10 percent, and monetary policy would be kept strict in 1982. He noted that the deficit in the French current account was likely to increase to FF 45 billion in 1982 from FF 38 billion in 1981 -- about in line with the staff's forecast. However, inflation as measured by the GNP deflator should not increase in 1982 from the 13½ percent expected in 1981. In conclusion, Jurgensen said that the French franc should be remarkably stable in 1982, aided by its participation in the European Monetary System. The Working Party did not have the opportunity to comment on his presentation.