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

STRICTLY CONFIDENTIAL (FR)
CLASS I - FOMC

TO: Federal Open Market Committee DATE: March 11, 1987

FROM: Normand Bernard N.B.

The attached note summarizes a conference call with voting FOMC members held on February 23, 1987, at which Chairman Volcker reported on the meeting held in Paris February 21-22, 1987. The Chairman emphasized the extemely sensitive and highly confidential nature of information covered in this conference call. The summary is intended for the exclusive use of the Presidents and Governors only and it should not be shared with anyone else, including staff.

Attachment

STRICTLY CONFIDENTIAL (FR) March 6, 1987
CLASS I - FOMC

Summary of Telephone Conference on February 23, 1987, discussing the meeting in Paris of the Ministers of Finance and Central Bank Governors of Canada, France, Germany, Japan, U.K., and U.S.

At the conference call, Chairman Volcker summarized the results of the meeting held on the previous weekend. (A copy of the joint statement issued at the end of the meeting is attached.)

Fiscal Policy

Chairman Volcker indicated that only two aspects of the Paris statement were in any policy sense new. The first related to the sentence inserted by the Germans saying "the Government will propose to increase the size of the tax reductions already enacted for 1988." That was a pretty flat statement about taxes, but it did not say what the Germans were going to do concurrently about expenditures or what they would do in different economic circumstances. Also, they put off doing anything until 1988.

The second element of note was a sentence by the Japanese which said "A comprehensive economic program will be prepared after the approval of the 1987 budget by the Diet, so as to stimulate domestic demand, with the prevailing economic situation duly taken into account." If such a program is approved, Chairman Volcker said it would probably be September before anything would be effective. He presumed the program would be contingent upon the Japanese economy remaining sluggish.

On the U.S. side, the commitment to "policies with a view to reducing the fiscal 1988 deficit to 2.3 percent of GNP from its estimated level of 3.9 percent in fiscal 1987" was consistent with the Gramm-Rudman-Hollings target.

Monetary Policy

There was virtually no discussion of monetary policy at the meeting and no monetary policy commitments were made by anyone, including the United States. The communique does have a sentence on U.S. monetary policy, which he felt would be entirely acceptable to the FOMC, stating that "Monetary policy will be consistent with economic expansion at a sustainable non-inflationary rate."

Exchange Rates and Intervention Policy

Chairman Volcker indicated that there was considerable discussion about intervention at the meeting and about how such intervention might be coordinated in connection with the statement, "in current circumstances, they [the Ministers and Governors] agreed to cooperate closely to foster stability of exchange rates around current levels" (i.e., around levels of February 20). Because of the innumerable hypothetical circumstances, no one tried to pin down any agreement on intervention very closely at the meeting, but general understandings were reached that are not public and which should by no means be made public.

One of the very sensitive points was a general understanding that U.S. intervention would not be, at least without further consultation, more than $4 billion net in either direction. There would be similar limits before consultation for Japan and Europe (i.e., $4 billion for Japan and $4 billion for the European countries, including Germany, as a group). The Bundesbank was not very eager to conduct large operations because of the implications for their monetary base, and would prefer to see any intervention in Europe spread around as broadly as possible. To the extent that there was intervention, in a very rough way all countries would do an equal amount but not on a particular day or in a particular week. There would be no announcement of intervention, but of course it would become known in the market as operations were conducted.

The understandings on intervention did not mean the U.S. would intervene with every small movement of the dollar, but if such movements cumulated to 2 or 3 percent from current levels, the U.S. might "begin" to intervene. The U.S. might intervene more promptly in particular market circumstances if something happened to make the dollar plummet -- or rise -- by several yen or several pfennigs in a brief period of time. There was no formula about intervention and there would be constant discussion among the Germans, the Japanese, and the United States.

Chairman Volcker said he presumed that any U.S. intervention would be split 50/50 with the Treasury. The implication was an outer limit of $2.0 billion for the System over the next six weeks -- the understandings reached in Paris covered the period until the next G-7 meeting scheduled for early April. At this point, no Commmittee action was needed but some would be required later if intervention approached the maximum amount.[1] The FOMC would only be operating in DM and yen, he thought, if it operated at all.

Attachment - Paris Meeting Statement

1/ Secretariat note: The Committee's "Procedural Instructions with Respect to Foreign Currency Operations" specify that any changes in holdings of foreign currencies between regular Committee meetings that exceed $1.5 billion must be cleared with the Committee members.

STATEMENT

1. Ministers of Finance and Central Bank Governors of six major industrialized countries met today in Paris to conduct multilateral surveillance of their economies in the framework of the Tokyo Economic Declaration of May 6, 1986 pursuant to which the group of seven Finance Ministers was formed. The Ministers and Governors, using a range of economic indicators, reviewed current economic developments and prospects. The Managing Director of the IMF participated in the discussions.

2. The Ministers and Governors were of the view that further progress had been made since the Tokyo Summit in their efforts to achieve a sustainable, non-inflationary expansion. Their national economies are now in the fifth year of expansion, and the prospects are for continued growth this year, although the level of unemployment remains unacceptably high in some countries. A high degree of price stability has been attained, and there have been substantial reductions in interest rates. Exchange rate adjustments have occurred which will contribute importantly in the period ahead to the restoration of a more sustainable pattern of current accounts.

3. Progress is being made in reducing budget deficits in deficit countries, and fundamental tax reforms are being introduced to improve incentives, increase the efficiency of economies, and enhance the prospects of higher growth. Other important structural reforms are also being carried forward, including deregulation of business to increase efficiency and privatization of government enterprises to strengthen reliance on private entrepreneurs and market forces.

4. These positive developments notwithstanding, the Ministers and Governors recognize that the large trade and current account imbalances of some countries pose serious economic and political risks. They agreed that the reduction of the large unsustainable trade imbalances is a matter of high priority, and that the achievement of more balanced global growth should play a central role in bringing about such a reduction.

5. The Ministers and Governors reaffirmed their concern over continuing pressures for protectionism. They agreed that efforts to deal with economic problems by erecting trade barriers were self-defeating and pledged to intensify their efforts to resist protectionism and reaffirmed their strong support for the new round of trade negotiations. They welcomed the progress made in the preparatory work for the new GATT round and the recent positive conclusions of discussions between the United States and the European Community on bilateral trade issues.

6. The Ministers and Governors recognized that the major industrial countries have a special responsibility to follow policies which foster an open, growing world economy in order to support the efforts of developing countries, especially debtor countries, to restore steady growth and viable balance of payments positions. They noted that the progress achieved by many debtor countries toward these ends have not solved all the problems and stressed the importance of all participants in the strengthened debt strategy reinforcing their cooperative efforts.

7. The Ministers and Governors agreed to intensify their economic policy coordination efforts in order to promote more balanced global growth and to reduce existing imbalances. Surplus countries committed themselves to follow policies designed to strengthen domestic demand and to reduce their external surpluses while maintaining price stability. Deficit countries committed themselves to follow policies designed to encourage steady, low-inflation growth while reducing their domestic imbalances and external deficits. To this end, each country has agreed to the following undertakings.

The Government of Canada's policy is designed to sustain the current economic expansion through its fifth year and beyond. In the budget for 1987/88, the Government has cut the fiscal deficit for the third consecutive year and remains committed to further progressive reduction. Canada will propose shortly an extensive reform of its tax system. It will continue with its policies of regulatory reform, privatization and liberalization of domestic markets. It will vigorously pursue trade liberalization bilaterally with the United States and multilaterally within the Uruguay round. Monetary policies will continue to aim at the reduction of inflation and be consistent with orderly exchange markets.

The Government of France will reduce the central government budget deficit by 1 percent of GNP from 1986 to 1988 and in the same period will implement a tax cut program of the same order of magnitude (1 percent of GNP) with substantial tax rate cuts for corporations and individuals. It will pursue in 1987 its privatization program (with a projected $6 to $7 billions sale of assets) and reinforce the liberalization of the French economy, especially of labor and financial markets.

The Government of the Federal Republic of Germany will pursue policies to diminish further the share of public expenditures in the economy and to reduce the tax burden for individuals and corporations with a comprehensive tax reform aimed at reinforcing the incentives for private sector activity and investment. In addition, the Government will propose to increase the size of the tax reductions already enacted for 1988. The Federal Government will emphasize policies that enhance market forces in order to foster structural adjustment and innovation. Short-term interest rates, although already at a very low level in international comparison, have further dropped substantially during the last few weeks. Monetary policy will be directed at improving the conditions for sustained economic growth while maintaining price stability.

The Government of Japan will follow monetary and fiscal policies which will help to expand domestic demand and thereby contribute to reducing the external surplus. The comprehensive tax reform, now before the Diet, will give additional stimulus to the vitality of the Japanese economy. Every effort will be made to get the 1987 budget approved by the Diet so that its early implementation be ensured. A comprehensive economic program will be prepared after the approval of the 1987 budget by the Diet, so as to stimulate domestic demand, with the prevailing economic situation duly taken into account. The Bank of Japan announced that it will reduce its discount rate by one half percent on February 23.

The United Kingdom Government will maintain conditions for continuing the steady growth of GDP of the past five years and will continue to work to reduce inflation by following a prudent monetary policy. On external account the aim will be broad balance over the medium term. The share of public expenditure in the economy will continue to fall and the burden of taxation will be reduced, while public sector borrowing is maintained at low level. These and other measures to strengthen the supply performance of the economy, such as the privatization programme, will reinforce improvement over recent years in the growth of productivity.

The United States Government will pursue policies with a view to reducing the fiscal 1988 deficit to 2.3 % of GNP from its estimated level of 3.9 % in fiscal 1987. For this purpose, the growth in government expenditures will be held to less than 1 percent in fiscal 1988 as part of the continuing program to reduce the share of government in GNP from its current level of 23 percent. The United States will introduce a wide range of policies to improve its competitiveness and to enhance the strength and flexibility of its economy. Monetary policy will be consistent with economic expansion at a sustainable non-inflationary pace.

8. The Ministers and Governors noted that a number of newly industrialized economies were playing an increasingly important role in world trade. These economies have achieved strong growth based significantly on their access to open, growing export markets. Recently, some have accumulated trade surpluses which have contributed importantly to the present unsustainable pattern of global imbalances, thus increasing protectionist pressures. The Ministers and Governors considered that it is important that the newly industrialized developing economies should assume greater responsibility for preserving an open world trading system by reducing trade barriers and pursuing policies that allow their currencies to reflect more fully underlying economic fundamentals.

9. The Ministers and Governors also agreed to additional refinements in the use of economic indicators for the multilateral surveillance arrangements approved in the Tokyo Economic Declaration. As part of these refinements, they will :

- periodically review medium-term economic objectives and projections involving domestic and external variables. The medium-term objectives and projections are to be mutually consistent and will serve as a basis for assessing national policies and performance ;

- regularly examine, using performance indicators, whether current economic developments and trends are consistent with the medium-term objectives and projections and consider the need for remedial action.

Initially, the objectives and projections will involve the following key variables : growth, inflation, current accounts/trade balances, budget performance, monetary conditions and exchange rates.

10. The Ministers and Governors agreed that the substantial exchange rate changes since the Plaza Agreement will increasingly contribute to reducing external imbalances and have now brought their currencies within ranges broadly consistent with underlying economic fundamentals, given the policy commitments summarized in this statement. Further substantial exchange rate shifts among their currencies could damage growth and adjustment prospects in their countries. In current circumstances, therefore, they agreed to cooperate closely to foster stability of exchange rates around current levels.

Paris, February 22, 1987