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INTERNATIONAL ACTION ON GROWTH, CURRENCY STABILITY, ENERGY AND OTHER MATTERS

Diagnosis

1. Since the early 1970s the world has been suffering from a growing economic malaise. The causes are partly economic but partly political, in the very broad sense that Governments have felt themselves to be under constraints which effectively prevent them from taking remedial actions.

2. The six main economic causes may be described as follows:

(i) The unprecedented world-wide inflation of the early 1970s

This was partly instrumental in bringing about the breakdown of the Bretton Woods system and the rise in oil prices (see below). But in its own right it did major damage to confidence in both the public and private sectors in almost every country. Many Governments felt forced to tackle the inflation primarily through restrictive fiscal and monetary policies. At the same time the private sector was drawing in its horns: savings rates rose and investment plans were everywhere cut back.

(ii) The breakdown of the exchange rate system established at Bretton Woods

The virtue of the Bretton Woods system was that although it appeared to be one of equal rules for all, in reality it was a means whereby an enlightened US could, by accepting moderate deficits* in many years, permit other countries to be in surplus on average and, if they were efficient, to develop high-technology economies based on export-led growth. For the world outside the US the adjustment process was a "positive sum game" ie one country's surplus was not automatically another country's deficit. Production and employment flourished and trade restrictions were dismantled. Under the regime of

*balances on current and long-term capital account combined

/floating rates

floating rates the United States renounced that role and took part in the game with everybody else. The adjustment process became a "zero sum game". There was no longer any assurance of a continuing but controlled US deficit from which others could benefit. That was a situation already fraught with political difficulty since most industrial countries have a marked bias in favour of being in surplus rather than in deficit.

(iii) The OPEC surplus

Following the five fold increase in oil prices the OPEC surplus amounted in 1974 to some $60 billion. The surplus in 1977 was still around $35 billion, about three-quarters of which accrued to only 4 countries. This means that the rest of the world is coping, for an indefinite period, with a "negative sum" game. The deficit to match the OPEC surplus has to be carried by someone. This is proving, not altogether surprisingly, a recipe for cumulative deflation, restriction and, perhaps, beggar-my-neighbour nationalism. While the size of the problem is likely to diminish over the near year or two, the surpluses generated by the low absorber oil producers will remain significant. The OPEC surplus may diminish in 1978 compared with 1977, but this will be largely because of the low level of world activity and the restraining effect of relatively low oil consumption on the price. The problem could increase again if faster growth were resumed.

(iv) The consequence of an inadequate international reserve system.

During the 1970s the alternative potential reserve assets for the system - gold SDRs and sterling - have been effectively demolished. We went into the floating system with the dollar as the only acknowledged reserve asset but with no accepted framework of responsibility within which it could play that role.

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(v) The growing mass of internationally mobile funds

The volume of internationally mobile funds has been growing since the Sixties and has been managed with increasing sophistication. One aspect of this is the ability of countless companies engaged in international trade to affect currencies by "leading and lagging" their payments, their cash and stock holdings and even their production.

(vi) The super competitive developing countries

Partly by historical coincidence, the 1970s have seen a dramatic rise in the ability of a number of developing countries to produce at vastly lower cost a wide range of goods traditionally produced in the industrialised world.

3. In combination, these factors are very dangerous indeed. They have created a long and deepening recession, and threaten to break up the present world trading system through beggar-my-neighbour policies. While some OPEC countries run a large surplus, the rest of the world will have to live with the matching deficit. If, therefore, individual countries adopt deflationary measures to reduce it, they are bound to fail and to damage the world economy still further in the attempt. But there has been no consensus on the role of surplus countries in relation to deficit countries, still less on handling the counterpart deficit of the low absorbing oil-producers' surpluses. So secure arrangements have not been made for financing deficits in a way which would avoid deflationary consequences. The international institutions have proved inadequate for negotiating bargains and for imposing the necessary pressure to produce the right solution. Both before and after the collapse of the Bretton Woods system the IMF has been geared overwhelmingly towards lending to debtors and putting pressure on them to reduce their deficits. It has been able to put virtually no pressure on surplus countries.

4. Moreover although, in varying degrees, countries agreed in the abstract that they should keep up activity and accept deficits, there was great pressure on some governments to deflate so as to get inflation under control. In the light of the unprecedented level that inflation has reached it is difficult to tell any individual country that this was wrong; but it has certainly exacerbated the other problems.

5. Differences in rates of productivity growth, in the timing and effectiveness of counter-inflationary policies, and in energy policies, combined with the fall in primary product prices, have produced very big swings in balances of payments and in exchange rates. Some of the exchange rate changes have helped to promote long run adjustment between major industrial countries by compensating for differences in production costs. But in respect of the biggest imbalance of all - that with the OPEC surplus countries - exchange rate movements are powerless to produce adjustment. Even elsewhere, pessimism has grown among most observers about the extent to which nominal exchange rate movements will produce real exchange rate changes (that is, will go beyond compensating for differences in inflation); and, further, about the time taken for any real exchange rate changes to have their desired effects on balances of payments.

6. In the short run the net effects of the main recent exchange rate changes - those between the dollar on the one hand and the yen, the mark and the Swiss franc on the other - have probably been deflationary. The dollar depreciation, though moderate when averaged across all US trade, will improve US competitiveness and so help employment in the US. But these effects on employment take time to appear. Meanwhile they are offset by adverse effects on confidence, and thus on investment. The state of Wall Street is an expression of this. In the surplus countries the appreciation depresses exporting industries and industries which compete with imports, and so reduces employment. The rational response in Germany and Japan would be measures to stimulate domestic demand, but patently this is not happening on the necessary scale. For complex reasons, the German authorities are fearful of taking further action: and they are under less pressure from their people to do so than one might expect, although pressure is growing there.

7. All this is producing a prolonged and deep recession, even though inflation is still high. There are increasing pressures everywhere to protect employment by trade restrictions. Meanwhile, the financing problems caused by the deficits of the smaller OECD countries, many of the developing countries, and some of the Eastern European bloc are likely to grow. We are now in a

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situation in which deficits are being created partly by the unavoidable surplus of some OPEC countries; partly by the Japanese, German and Swiss surpluses, which could be eliminated in time if their Governments adopted the right policies; partly by the impact of the recession on the prices of some industrial raw materials, as in Zambia; and partly by mistaken policies in the deficit countries themselves, as with Turkey. Some of these deficits could produce banking failures. In many cases there is no escape from some restrictive action, under IMF auspices or otherwise; in all cases there is the risk of political instability, as in the European countries along the Mediterranean.

8. With a problem as complex as this there can be no easy solution. Ideally an agreement on growth and convergence would in itself stabilise the financial markets and lead to more appropriate availability of balance of payments finance. But agreement in this area will only be partial, changes in balance of payments performance take time and the idea of economic convergence has little meaning in relation to deficits created by the low-absorbing oil producer surpluses. Continued financing flows will be required on a large scale and on appropriate terms. Even here the timescale for change is long. Agreements will be slow in coming (as the problems over the Witteveen Facility clearly show) and financing patterns take time to change. The result is likely to be continued currency disturbance and a need for measures designed specifically to create greater stability in the foreign exchange markets.

9. Different people give different weight to the three elements - economic convergence, balance of payments financing, currency stabilisation. In part this is a result of differing views about the timescale for achieving change in each. But whatever our analysis of the problems there is an urgent need to bring the factors together in a major effort to avert the dangers which we face.

/10. The elements

10. The elements of a new initiative have been present in recent international discussions. But for several reasons any new approach will require these elements to be composed into a joint initiative by the world's leaders. Part of the problem is the existence of a power vacuum in international monetary and economic affairs. Though in the long run it may be possible to fill this by increasing the authority and improving the policies of international institutions, in the short run an ad hoc agreement by the major powers to take control will be essential. Secondly, it will only be possible to persuade Chancellor Schmidt (and perhaps also Prime Minister Fukuda) to take effective action against all the domestic pressures for inaction, if they are given the widest international backing. Thirdly, the different countries see different elements in the situation as the major problem: it will in practice only be possible to get action on individual fronts in the context of some sort of international understanding. The plan proposed can be defended on intellectual grounds as self-consistent: but it also has the merits of offering something politically for each of the main partners.

A Five-point Plan

11. There is now a degree of support for some concerted international action to reduce the risk of a deepening recession and to boost confidence in the economy of the free world. The IMF and OECD staff could be counted on to support this line. Other countries of the EEC, Italy, Belgium, Holland as well as France, favour a concerted growth effort within the EEC; so does the Commission. The official German position is however at present a negative one. They have been prepared to go no further than an undertaking to review matters in the light of the figures for the development of their economy in the first quarter of 1978: those figures will not be available until May. Whatever the information before them in May it seems probable that before accepting the case for concerted action the Germans will be seeking assurances which only the US can offer. At the same time, the Germans must clearly play a large part in any further arrangements to prevent disorderly conditions in the exchange markets that may be necessary following the 13 March declaration. There is therefore a need for a genuinely structural plan.

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12. The plan we propose has five elements:-

(i) Growth;

(ii) Long-term capital flows including aid;

(iii) Energy;

(iv) Trade;

(v) Greater currency stability.

All the elements are inter-related and their impact on confidence depends on them being linked. It is therefore important to design and present the plan as one whole and to avoid loss of impact by a dribbling out of individual elements.

Growth

13. It would not be enough for participants to pledge themselves to target growth rates as at Downing Street in 1977. The Germans are in any case likely to oppose a new round of targetry. There would have to be, no later than the July Summit in Bonn, a pledge to take specific measures leading to growth of GNP and domestic demand. Those measures would have to be described in detail if not by the time of the July Summit, then very soon afterwards. But an effort would be made to remove any flavour of the "locomotive" theory. The aim would be to negotiate a graded response within Europe, ranging from German measures to stimulate their GNP by at least 1 per cent down to no more than a token response from Italy. It would be essential to ensure that neither cumulatively nor individually should the measures undertaken lead to a refuelling of inflation.

14. Discussion in the EEC Finance Council suggests that development of a concerted growth programme within the EEC might be possible. The aim should be to take a decision in principle to embark on such an exercise at the European Council in April and reach agreement on specific undertakings in time for approval by the European Council in July before the Bonn Summit.

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15. Outside the EEC, as well as within it, it may be possible to build on the discussions at the OECD Economic Policy Committee on February 27/28. But clearly no great contribution to growth can be expected from the smaller OECD countries. The main responsibility outside the EEC must inevitably lie with Japan and the US. For Japan the aim would be to keep her to her declared targets, particularly the reduction of her surplus to $6 billion in 1978 with a further reduction in 1979. Japan has already given undertakings to the US that she will keep to this target and pressure on her must be maintained. The leverage which might be exerted to this end would be increased if Japan could be persuaded to state the quarterly path which she expects to follow towards the targets. The US should be invited to reaffirm her determination to keep to her published growth targets.

16. If action of a kind described in paragraphs 13-15 could be achieved, that could produce a marked improvement in world growth and greater convergence of the major economies. OECD have calculated that if Japan, Germany, Holland, Belgium and Switzerland were to expand domestic expenditure by about one per cent of GNP, total OECD output might be increased by 0.8 per cent. One effect of action confined to these countries would be to improve the balance of payments positions of other countries. If however Britain, France, Italy and Canada were also to expand domestic demand, converting to higher employment and growth the benefit to their balance of payments which would otherwise result from faster growth in the stronger economies, total OECD GNP could rise by 1.1 per cent. The OECD has already raised its growth forecast for member countries from 3½ per cent to 3¾ per cent because of lower than expected oil prices and higher growth in the United States. An increase of about one per cent on top of that would begin to produce progress in reducing world unemployment.

Long-term Capital Flows Including Aid

17. Unless and until the major current account surpluses are reduced, the surplus countries should as a long-term policy build up sustainable capital outflows. Aid and long-term flows help activity; short-term flows commonly do not, unless some intermediary like the banking system is ready to carry the risk of borrowing short and lending long. Increased direct investment, particularly in the developing and smaller OECD countries, would be one element. Another would be increased provision of aid by the surplus countries, particularly Japan, placing aid more in the

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context of the overall world adjustment process. Some form of debt relief for the least developed countries may also have a place: there are indications that a common line on this may be developing between the main donor countries.

18. An agreement on these lines would recognise the importance of all these issues to the Third World and increase the chances of their support for the plan as a whole. Certainly it would offer them great advantages under all its headings. And it would reduce the risk of financial collapse in some of these countries and possible extremist takeover. But beyond this, the surplus countries should clearly play a greater part in the provision of balance of payments finance to countries in difficulties. The aim would be to create an expectation that a small group of countries, including Saudi Arabia, Japan and possibly Germany, should be prepared to provide substantial support for the IMF or other multilateral financing operations.

Energy

19. Much more could be done worldwide to promote:

(a) energy conservation and
(b) investment in both oil and non-oil sources.

This should be the theme under the energy heading.

20. We are convinced that major new action by the US Administration on energy policy is essential in the interests of the United States, including the stability of the dollar; and of the whole of the rest of the world, consumers and producers, developed and less developed. To the outside world it seems clear that such action would have both to conserve energy and to promote development of indigenous resources. However action by the US on energy policy should be related to the package as a whole.

21. The Summit countries should themselves introduce further programmes of energy conservation and development and should collectively give the fullest support to the preparation of a new set of proposals on energy policy by the IEA in the course of this year.

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22. There should be agreement that the Summit countries would act together to get an urgent programme agreed in the IBRD and elsewhere to promote energy investment in underdeveloped countries in accordance with the conclusions reached in CIEC and at the Downing Street Summit meeting.

Trade

23. The pressures for increased protectionism, in all its forms, are already very great. It is remarkable, given the circumstances, that these pressures have so far been resisted to the extent that they have. The major industrialised countries should reaffirm their determination to resist the growth of protectionism. They should give practical effect to this by bringing the multilateral trade negotiations to a successful conclusion and in particular working out rules by which the open trading system can be sustained in the 1980's. And they should explore ways of reducing pressures for protection by, among other things, improved consultation procedures. However, the best guarantee against the spread of protection is a higher level of growth.

Currency Stability

24. An agreement on the lines set out above would in itself make for increased stability in the foreign exchange markets. But to make the package as a whole generally acceptable and to provide further reassurance to the markets, further direct action by the US in the currency area would be essential.

25. The recently extended US/German arrangements for intervention, though useful, will not of themselves suffice. Intervention alone, even on a substantial scale (German/US intervention in support of the dollar since 4 January has totalled about \$3½ billion), is unlikely to solve the problem. It will not restore long term confidence in the dollar.

26. What is required is that any further steps should be taken (a) multilaterally and (b) clearly in the context of measures taken in other fields along the lines already set out above. There are several reasons why it is important that any further moves in the currency area should be on a multilateral basis. First, it would reinforce the general effect being aimed at, that the world's leaders are seen to be jointly taking hold of the world's monetary

and economic problems. Secondly, multilateral action would confront countries other than the US with the fact, which is often disregarded, that securing a satisfactory form or forms of international reserve asset must be a shared responsibility and cannot be left on the shoulders of the United States alone.

27. The most limited form of multilateral action would involve activating the swap lines with a wider group of central banks and intervening with a wider group of currencies in support of the dollar. This might have a helpful effect in the markets, though of its nature it would be short-term and superficial.

28. A larger step would be for the US authorities, in agreement with those in other countries, to acquire, not through short-term swaps, but on a more permanent basis, significant quantities of foreign currencies to increase their at present small reserves of these currencies. One method of doing this would be to raise foreign currency loans: the US authorities have, however, stated that for a number of reasons they would be unwilling to take this step. Another approach would be to sell SDRs. The US has already agreed to sell 600 million SDRs to the Bundesbank for deutschemarks. Sales could, however, be on a substantially greater scale if they were made to a wider group of central banks.

29. The most promising step, however, might be one which the US has already signalled its willingness in principle to take: to draw in non-dollar currencies on its existing $5 billion unconditional reserve position in the IMF. The use of that reserve position could provide a substantial addition to US foreign currency reserves. It would require the activation by the IMF of the General Arrangements to Borrow and the participation of a number of other governments. But this would be a normal and rational exercise of its rights under the existing international monetary rules.

30. Steps along these lines could greatly strengthen the US's actual and perceived ability to defend the dollar. It would, of course, be for the US authorities themselves to determine their precise objective in the exchange markets. But they would be able to demonstrate to the markets their concern for the value

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of the dollar and their ability to make this concern effective.

31. Other options are on a smaller scale. They include arrangements to reduce the use of dollars in the IMF lending programmes (which would probably follow automatically from a US drawing on its reserve position); and reduction or elimination of the use of dollars in the intervention policies of European "snake" countries, perhaps with moves to increase their reserves of marks and other non-dollar currencies.

32. A clearer indication by the Saudis that they were prepared to place funds in the US at longer term would strengthen the capital account. Agreement on a major initiative on the lines discussed in this paper would itself provide an inducement in this direction. Greater openness about it would increase the confidence of other investors if it could be achieved. An operation to fund one particular block (say $1 billion) of Saudi dollar holdings into holdings in excess of say 10 years maturity would be a major contribution. A note about the lines on which the Saudi Arabian government might be approached is at Annex A.

33. We do not suggest that any of these "currency stability" measures could individually, or even as a group, change market trends or prevent any further dollar fall. What we do believe is that they would be a helpful and necessary constituent of a wider confidence-restoring package.

34. <u>Future of the international monetary system:</u> even if the measures discussed in the preceding paragraphs succeeded in their immediate objective, as part of the wider package, certain central questions about the world monetary system would remain unresolved. Those questions are whether the US authorities are going on a continuing basis to ensure that the dollar functions appropriately as the only important international reserve asset; and how the other main powers - and the markets - are going to react over time if the dollar does not fulfil this function. Linked with these questions there will also be that concerning the viability of the present exchange rate regime.

/ 35. The US

35. The US authorities might be prepared to shoulder the burden of operating an effective reserve currency alone, though this would be likely to impose on them domestic restraints which they might find irksome, especially in view of the still small size of their foreign trade sector. Alternatively, the world might move towards a greater use of the SDR, as has so often been mooted in the past. However a substantial use of SDRs would require special and difficult arrangements for the conversion of dollar balances into SDRs.

36. If neither of these routes is to be taken there could in due course be a joint decision to move, in an orderly and planned way, in the direction that markets are hunting blindly for at present: i.e. towards a multiple currency reserve system, in which other currencies or currency blocs shared the reserve and trade vehicle role fully with the dollar. This would chime in with a greater willingness by surplus countries to develop long-term capital outflows in their currencies (paragraph 17-18). It would also be bound to mean difficult decisions about long-term mutual currency support which would have to be taken jointly by the new and old reserve currency powers.

37. It is neither necessary nor appropriate to decide in the next few months which way we want the system ultimately to develop. But if we can provide ourselves, through a plan on the lines sketched out in this paper, with a breathing space, we shall have to put our minds to these larger questions. They will not go away; and if we do not try to steer events in the direction we want to go, we may be confronted all too quickly with further deterioration.

<u>Procedure</u>

38. The aim should be to have worked out a plan, covering these aspects, which can be endorsed at the Summit in July. Within the EEC the European Councils of April and July (before the Summit) will provide opportunities for developing the European contribution to the plan.

39. The Interim Committee of the IMF on 29/30 April, and the associated G5 meeting of Finance Ministers, will provide further opportunities both for collective and bilateral discussions.

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THE PLAN AND SAUDI ARABIA

1. There would be a good case for explaining to Saudi Arabia (and other low-absorbing oil producers in the Gulf) the advantages for them of the plan and seeking to obtain some contribution from them to its objectives. It would be for consideration whether the approach would best be made to them by the United States or in some other way but if it helped it could be expressed as an approach on behalf of all seven countries participating in the July Summit.

2. The advantages for Saudi Arabia of the plan might be presented as follows:

(i) the plan is a major effort to stabilise the currency in which a large part of their assets and most of their current income is expressed; and to do so by a collective effort of the industrialised countries through a whole package of measures. The effect should be to reduce the impact of western inflation on Saudi Arabia, and indeed on the OPEC countries generally;

(ii) the energy element in the package recognises the importance of the conservation of Saudi Arabia's main resource;

(iii) the plan recognises the claims of the underdeveloped countries with the heading about long term investment and aid;

(iv) more broadly, Saudi Arabia has been in the lead in impressing on its OPEC partners the importance of maintaining the health of the economy of the free world generally. This is an important effort in that same direction.

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3. The hope would be that these arguments might provide a basis for asking the Saudis to collaborate on lengthening the term of their dollar investments; and also on stepping up flows of aid and long term lending to developing countries, perhaps in collaboration with other surplus countries. An operation to fund one particular block (say $1 billion) of Saudi dollar holdings into holdings in excess of say ten years maturity would be a major contribution to the currency stability element of the whole package.