Euro Pol

CONFIDENTIAL

FM FCO

TO WASHINGTON TELNO SAVING 1 OF 17 MARCH 82

DESKBY

FM FCO MARCH 1982

OECD WP3 MEETING, PARIS

TELEGRAM NUMBER

A/ McMahon (Chairman) recalled the changes that had taken place in the world economy since the last meeting. The price of oil had fallen. There had also been some important changes in exchange rates. These included the EMS realignment, strengthening of the US dollar and a surprisingly weak situation for the Yen. The deutschemark was also probably below trend. This implied that US competitiveness was out of line, as was that of Japan and Germany. Real interest rates had persisted unusually high for a time of weak activity. Recovery of output had been less than expected but inflation had slowed more.

McMahon suggested that WP3 should concentrate its attention on the questions raised in the Secretariat's paper (CPE/WP3(82)1). Did US interest rates cause policy problems through exchange rate movements for countries outside the US? Why were real interest rates high? What were the implications of the changes in competitiveness brought about by recent exchange rate changes?

Japan

FUJINO

CONFIDENTIAL

Fujino (Japan) said that growth in the Japanese economy had been less than expected. He blamed high overseas interest rates (which prevented Japan reducing its own rates) and the prolonged deflationary effects of high oil prices. Nevertheless the rundown in stocks was finished and he expected investment to recover. He said the current surplus largely reflected the fall in oil imports. The slowdown in exports in November was expected to continue. Japan's capital outflow was larger than its current surplus, reflecting high overseas interest rates. The yen had fallen until mid-February but was now rising against the dollar. It was also strong against the European currencies, and was expected to appreciate in future.

He ruled out fiscal measures to stimulate domestic demand. Fiscal reform to reduce the deficits as a firm commitment of the government. The yen exchange rate had not been manipulated to boost exports. An appreciation would be welcome to improve real incomes and stabilise prices. But it was impossible to maintain stable rates in present circumstances. Timely and appropriate intervention with other countries would help to avoid disorderly movements. A change in policy mix towards a more relaxed fiscal policy and tighter monetary policy would not be acceptable, both because of political commitments and because of the risk of renewed inflation and loss of confidence in the yen.

Wallich (US) said that Japan's high savings were not being absorbed domestically. They must therefore be offset by capital exports or budget deficits. Capital exports however implied a depreciation of the yen and problems for the rest of the world. Wouldn't a larger budget deficit be preferable? Foreign exchange reserves had risen in the past year - partly reflecting interest earnings. Why not let these be put through the market and help raise the yen? Lamfalussy (BIS) stressed that government borrowing in Japan was a low proportion of savings. Couzens (UK) drew attention to the large share of GDP growth accounted for by external demand.

FLANDORFFER

Flandorffer (Germany) said that the yen exchange rate was the most important way of tackling the balance of payments problem. But the only way to influence the yen was through interest rates. Was it really so important for the recovery of domestic demand to have such low interest rates? Jurgensen (France) supported the need for a different fiscal/monetary policy mix. Sprinkel (US) welcomed Japan's recent reduction in tariff and non-tariff barriers but suggested the effect on imports was likely to be rather nominal.

Ogata (Bank of Japan), replying, said it would be difficult to contemplate a higher fiscal deficit. Amortisation of the accumulated deficit was going to be a heavy burden in the mid-to late 1980s. Government bond issues were already a heavy weight on the financial markets accounting for 85% of new issues. It would be difficult and impracticable to raise interest rates in Japan because of the weakness of smaller firms. Real interest rates were still positive.

Germany

Gleske (Bundesbank) said the current account had moved into a satisfactory position since October and was expected to be in balance in 1982, but most of the increase in exports had been to OPEC markets which were expected to weaken as the oil price fell. German imports had been low due to oil savings and low domestic demand. They should pick up as activity recovered. German competitiveness had improved against the US and in third markets but had worsened against other EC countries. The devaluation of the Belgian franc was likely to reduce demand for German goods. Germany would be happier with a strong deutschmark against the dollar so that interest rates could come down. He was sceptical about a system of two-tier interest rates.

Wesselkock (Finance Ministry) said some increase in output was expected and GDP might grow at about $2\frac{1}{2}$ per cent a year up to 1986, but unemployment would remain at 1.7 million. Growth of 5%

A YEAR

a year would be needed to return to full employment.

Ostry (Secretariat) said that Germany's growth had been even more export-led than that of Japan. How could more domestic demand be achieved - by lower interest rates? Fujino, disengenuously, asked whether German budget policy could be more flexible in the short-term.

Wesselkock said a fall in unemployment would require a better investment climate which implied lower real interest rates and a lower budget deficit. Flandorffer said the budget deficit could not be raised because of its adverse effect on confidence. Germany was a more open economy than Japan.

United States

Sprinkel (US) gave a reasoned defence of the US budget. He emphasised that public expenditure in FY1983 was only projected to rise by $4\frac{1}{2}$ per cent (although this might need to be revised upwards). The deficit, therefore, reflected reduced revenue. Including off-budget items it would be $127 billion in FY1983 - lower than FY2982. The deficit was too large but it was difficult to reduce quickly. The President would not abandon his tax cuts nor the projected increases in defense spending, but would listen to Congressional suggestions for other spending cuts. The deficit was not as high as a percentage of GNP as in 1976.

US interest rates were below their 1981 peaks and Sprinkel believed that they would continue to fall. They reflected a 3-4 per cent real return on capital, an inflation premium and an uncertainty premium. The Administration needed to establish credibility that it would reduce inflation. The Fed's control of the money supply and the recent reduction in price inflation were encouraging signs. People were moving out of speculative assets such as property and gold into financial assets. The next move would be into real investment.

Wallich said countries outside the US now had an opportunity for more flexible interest rates. The Fed's M1 target assumed a rise

/IN

in velocity, helped by financial innovations. The increase in M1 in the first quarter was now unwinding. Fratianni (Council of Economic Advisers) said that GDP was expected to fall by 0.6 per cent in 1982. The fall in the first quarter was expected to be about 3 per cent at annual rate, followed by increase of 1 per cent in the second quarter and rises of 4 per cent at an annual rate in the third and fourth quarters.

Lamfalussy asked about the Fed's control techniques Jurgensen asked whether the Fed attached greater importance to M1 or the wider aggregates. Languetin (Switzerland) suggested that the Fed should have an interest rate target.

Wallich acknowledged the difficulty of controlling monetary growth. He said that the Fed attached importance to M1 because it was largely transactions balances. M2 and M3 included some savings, and one could not control the economy by controlling savings. He ruled out an interest rate target on the grounds that the Fed did notknow what the right level of interest rates should be.

Ostry and Couzens both stressed that high real interest rates probably reflected the uncertainty about fiscal policy. Sprinkel acknowledged the problem, but said that if the Fed and Administration "hung in", inflationary expectations would be reduced.

United Kingdom

Couzens described the main features of the UK budget. This was within the medium-term counter-inflation strategy. The public sector borrowing requirement would be reduced as a percentage of GDP. The principle of a declining growth for the money supply was also being retained but was being reshaped to include not only £M3 but also M1 and PSL2. The Government would also look at the exchange rate. The direct and indirect measures tax measures were broadly offsetting. The main thrust of the measures was to help industry, particularly the reduction in the NIS.

The slowdown in inflation has been delayed by last year's depreciation of sterling, but the rate of increase in prices should fall below 10 per cent by the end of 1982. GDP was expected to grow by about $1\frac{1}{2}$ per cent this year. The current surplus was projected to decline.

Sprinkel was worried that the money supply targets were becoming more discretionary. Would the Government merely draw attention to the one which it happenedto be hitting at any one time? Rieke (Bundesbank) asked what the Government's exchange rate target was. Couzens, in reply, said that the three monetary aggregates had tended to run together in the long run. When money was shifting between aggregates it was important to look at all three. The Government would not necessarily average them, but would try to interpret them. The exchange rate should be regarded as an indicator of monetary conditions but the government did not have a target for it.

OPEC Trade Study

The second morning was given over to a discussion of the Secretary General's Trade Study. Marris (Secretariat) introducing the discussion, said it was important to distinguish how far domestic regulations, industrial policies and export credit were doing duty for tariffs. It was important also to ask whether changes in the exchange rates themselves, stimulated protectionist pressures. He hoped in particular that the US could resist pressures for protection.

The two-way interaction between trade policies on the one hand and exchange rate and monetary policies on the other was emphasised by Wesselkock. Sprinkel stressed that poor macro-economic policies would make it difficult to follow liberal trade policies. Couzens said that although it was right to consider the implications of exchange rate changes for industrial policy, this was not the sole role of the exchange rate. When countries were following counter-inflationary policies, the exchange rate

WAS

was likely to appreciate as part of the process of changing fundamentals.

Several speakers stressed the need for better cooperation between the OECD, IMF and GATT referring in particular to the IMF surveillance role. Hood (Fund) said the Fund was conscious of the risk of protectionism and reported regularly on members' trade policies. It was anxious to explore how cooperation with the OECD could be improved. Several speakers mentioned the need to include trade in services and agricultural products. The need to integrate these newly industrialising countries into the open trading system was also stressed.

The danger of competitive devaluations was mentioned by the Netherlands and France.

The Chairman said he would circulate quickly a record of the working party's views, without trying to achieve agreement.

Chairman's summing up

The chief feature of McMahon's summing up of the two days discussion was his suggestion that the general view of the working party was that Japan's fiscal and monetary mix needed to be changed. He drew an analogy with the need for change also in US policy. The working party recognised the political difficulties in both countries, but if policies were not brought into better balance there was a risk of national measures in other countries and of protection. The Japanese made a final defence of their position and Sprinkel came to their rescue dissenting from the general view. He said the Japanese had reduced their fiscal deficit and monetary growth - just what any other country is trying to do. His own quarrel was with Japan's trade restrictions.

The next meeting was arranged provisionally for 8-9 July. The subject will be recycling, including international indebtedness and the implications of lower oil prices.

CARRINGTON

/B

Distribution

Monetary

ERD

Copies to:

Mr Holland
Mr Clews } Bank of England.