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TO FOREIGN & COMMONWEALTH OFFICE

TELNO 15 SAVING OF 24 JULY 1984

INFO: BERNE, BONN, BRUSSELS, THE HAGUE, OTTAWA, PARIS, ROME
TOKYO, STOCKHOLM, WASHINGTON, UKDEL IMF/IBRD WASHINGTON,
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OECD WORKING PARTY NO. 3, PARIS 19 - 20 JULY

Summary

1. The Working Party discussed the medium term prospects for international debt. There were differences about the prospects for world recovery and interest rates, but many felt there were significant risks in the medium term situation and the margin for manoeuvre in achieving a durable solution to debt problems was small. There was an inconclusive discussion of possible conditions for export credit cover when IMF packages and debt rescheduling were being negotiated. The Export Credit Group was asked to study this. A session on current imbalances revealed wide differences between the US and others on the causes and sustainability of the present US deficit.

International Debt

2. The Secretariat paper, CPE/WP3(84)8, showed that on the basis of a medium-term scenario assuming continued modest growth in industrial countries and high real interest rates the main debtor countries were likely to reduce the stock of their debt relative to exports only gradually over the period to 1988. The scenario was based on medium-term projections done for WP1 earlier this year. The main focus was on a sample of problem debtors including Argentina, Brazil, Chile, Mexico, Nigeria, the Philippines and Venezuela. The paper suggested that improved growth prospects and/or lower interest rates might be needed to improve the prospects for debtors.

3. Littler (UK), opening the discussion, said that it was useful to look at the group of major debtors since they accounted for a large part of the overall problem. It was important to remember that although some had taken adjustment measures, others

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had not yet. He doubted whether a single base line value for an indicator such as debt relative to exports was an adequate guide to creditworthiness. He preferred to look at the real interest rate relative to real GDP growth. He found aspects of the Secretariat's medium-term scenario implausible, including the continued imbalance in payments flows.

4. He drew attention to the substantial adjustment already achieved by some major debtors, including a significant reduction in their current deficits since 1981. This reflected largely reductions in imports and had been accompanied by falls in output. It was difficult to judge the rate of adjustment which was tolerable - particularly if it had to be sustained over 5 - 10 years - but it was important to keep up pressure on those debtors which had not yet undertaken adequate adjustment. The Secretariat was right to stress the importance of lower interest rates but he did not favour attempts to manipulate them artificially for borrowers. The London Summit had suggested various ways to improve debtors' liquidity and the quality of flows to them, including multi-year rescheduling, encouragement of private investment and bond issues, an increase in IBRD flows and continued access for their exports to industrial countries.

5. Lamfalussy (BIS) said that even on relatively faithful growth assumptions and with continued adjustment by debtors there was no safety margin to cope with a worse outcome on activity in the world economy, high interest rates or political shocks. It was important to seek a bigger margin or to be prepared to meet shocks.

6. There was widespread agreement among the European members that the Secretariat's projections might be on the optimistic side. Flandorffer (Germany) did not believe that US output growth would be sustained. Asbrink (Sweden) suggested there were risks of a cyclical slowdown. Jurgensen (France) shared the pessimism about the outlook for activity in the industrial countries.

7. There was also a preference for looking at debt service relative to exports or to GDP rather than concentrating on debt stocks relative to exports. Sarcinelli (Italy) argued the need to reduce interest rates by changing the mix of policies in some industrial countries. Jurgensen added that it was particularly important for the US to reduce its deficit. He ruled out artificial measures to reduce interest rates, but suggested that there was a need to discuss solutions with the debtors themselves.

8. Sprinkel and Poole (US) both argued that the Secretariat's projections of US growth were too pessimistic. The latest private forecasts were suggesting faster growth for this year. Shafer (Secretariat) agreed with this but said that interest rates were also turning out higher than the Secretariat had assumed. Sprinkel said that he did not expect US interest rates to remain high in

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the medium term; they would fall as markets became convinced of the reduction in inflation. He did not believe that the limits of tolerance for adjustment by debtors had been reached. Some had not started to adjust. Others had far to go. It was important to work to a 5 - 10 year time horizon. He hoped there would be more growth in Europe for the sake of both debtors and the US. He was opposed to artificial measures to reduce interest rates.

9. Drabble (Canada) agreed with the Americans that the Secretariat's base line scenario was probably pessimistic. He also shared the US view that increased confidence in lower inflation would reduce both nominal and real interest rates. He believed, however, that it was important to look at growth prospects for debtors to assess the sustainability of their adjustment efforts. It was possible however that some of these were moving towards a mature status and IMF adjustment programmes would help them to improve domestic savings and reduce their reliance on external savings without harming growth.

10. Oba (Japan) suggested that debtors might be encouraged to switch from dollar denominated borrowing to other currencies such as the Yen, Deutschmark or Swiss Franc which had low interest rates.

11. Hood (IMF) said that both lower inflation and slower output growth in the US might help to reduce credit demands and hence interest rates. He agreed that the margins of manoeuvre on the debt problems were limited, but the Fund's own World Economic Outlook suggested that the debt problem was manageable and that developing countries could return to growth in the medium term.

12. Loehnis (UK) agreed broadly with the Secretariat's growth forecast but suggested that depreciation of the dollar might bring a steeper fall in the ratio of developing countries debt to exports than the Secretariat expected. There was no certainty, however, that banks would be content if debtors merely returned to the previous relationship between debt and exports. Banks had become more reluctant to lend generally. Projections by the Bank of England suggested that if debtors were able to continue to increase their exports as the world economy recovered, imports would also rise. This would reduce the temptations of debtors.

13. Henderson (Secretariat) said that the Secretariat had not tried to bias its results in any particular direction. It was also not putting forward any particular solution such as interest rate capping. He recognised that indicators other than the ratio of debt to exports could be useful. The Secretariat would be ready to take forward the technical analysis e.g. with an expert sub-group if the Working Party would welcome this.

14. McMahon (Chairman), summing up, said that even if many people had objected to the use of the ratio of debt to exports,

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most had agreed with the broad thrust of the Secretariat's scenario although he recognised that some, such as the Americans, believed the scenario was too pessimistic. Most also believed that the margin for manoeuvre was not great whether on adjustment by debtors, bank lending or industrial countries' growth. Some, such as Jurgensen and Asbrink, believed that the situation was likely to be untenable.

Export Credit (Secretariat Paper CPE/WP3(84)6)

15. Sprinkel argued the case for agreed guidelines on cover offered by export credit agencies when adjustment packages and rescheduling for debtors were being negotiated. The US stayed on cover if a country was following an IMF programme, if bank lending was being increased and in the interests of burden-sharing with other creditors. If agencies followed diverse approaches, debtor countries would be receiving mixed signals. He suggested that the Export Credit Group should discuss suitable guidelines and report back to WP3.

16. Jurgensen said that some agencies continued on-cover too long in some cases but then returned to cover too late especially as debts were rescheduled. There was a need to avoid competition between agencies.

17. Sarcinelli said it would be difficult to harmonise policies since individual export credit agencies had their own balance sheet problems with different spreads of risks. Nevertheless, perhaps the Berne Union or the Export Credit Group could be asked to discuss guidelines.

18. Asbrink agreed that export credit agencies had a role in sustaining capital flows to debtor countries but this should not be expanded excessively. Agencies should not continue to provide cover where a country was in payments difficulties. But they should be ready to restore cover promptly when debtors took action to correct their problem. Perhaps G10 could play a more active coordinating role among creditors when the IMF, governments, banks and export credit agencies were all involved.

19. Ogata (Japan) said that agencies should be ready to reopen short term cover in special cases as rescheduling was taking place, but agencies' finance would be limited to normal trade and they should not become a further source of extra concessional finance. Agencies should share their thinking about credit risks and seek to agree guidelines on the conditions for withdrawal and restoration of cover but this would need to be done on a case by case basis.

20. Drabble said that experience of using export credit to "top up" finance alongside IMF programmes had not always worked well. One problem was that normal imports by debtors had often been reduced as programmes were cut as part of an adjustment effort.

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21. McMahon, summing up, said there was a need to coordinate export credit policies as part of the overall management of debt packages, but WP3 was not the right place to discuss details. There had been a difference of views about the possibility for harmonising policies, but perhaps WP3 could monitor work done elsewhere. The Secretariat agreed that the Export Credit Group would be informed of the WP3 discussion and would itself keep under review the question of harmonising arrangements for providing export cover around the time of IMF debt packages and rescheduling.

Current Imbalances

22. The Secretariat paper, CPE/WP3(84)7, suggested that a major cause of the present US current account deficit was the faster growth in the US compared with other industrial countries since 1982, although past losses of competitiveness as a result of the dollar's high exchange rate had also contributed. It presented simulations to show the effect of a lower dollar or slower relative US growth in reducing the deficit over the period to 1988.

23. Sprinkel complained that the Secretariat paper had concentrated excessively on the US deficit and had ignored the emerging Japanese and European surpluses. It had also not paid enough attention to the effects of slow European growth. It seemed to imply that the US deficit could only be reduced by a US recession.

24. He denied that the US budget deficit had contributed to the current account deficit by stimulating domestic demand. He also denied that the budget deficit had helped to cause an appreciation of the dollar through higher interest rates.

25. He agreed that some of the factors which had contributed to the high dollar exchange rate might now be less important e.g. the relatively good US inflation performance since others, too, were now reducing their inflation rates. He did not, however, expect a sharp fall in the dollar since a lower US budget deficit might strengthen rather than weaken the dollar. He expected faster growth abroad, especially in Europe, to help reduce the US deficit.

26. On the technical side, both the US Treasury and the Federal Reserve believed that the lags between exchange rate changes and trade volumes were shorter than those assumed by the Secretariat and that activity effects on the current account would be bigger.

27. Poole argued that the US current account deficit was not unsustainable if the real rate of return on investments in the US was greater than the return on investments in other countries. Siegman (Federal Reserve) said that the Secretariat had been wrong to start its analysis from 1982 when the US economy was relatively depressed. The Fed's own analysis, starting in 1980 when the US and the rest of the world were in broadly the same cyclical

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position, suggested that much of the increase in the current deficit was due to the appreciation of the dollar with a smaller part due to changes in relative activity. The Fed's own work suggested that a change of 20% in the dollar exchange rate would improve the current account by $55 billion after two years. He denied that the Fed was holding up interest rates in order to sustain the dollar.

28. Ogata suggested that the US removal of withholding tax on non-resident investments in the US and US government plans to issue bonds in the Eurodollar market both seem designed to encourage a high dollar exchange rate. Sprinkel claimed that the removal of withholding tax was designed solely to stop the distortion of capital flows through the Netherlands Antilles. He noted that some Europeans were also considering removing withholding tax. No decision had been taken on issuing US government bonds in the Euromarkets.

29. Oba suggested that it would be difficult to reduce current account imbalances quickly. This would require prudent policies everywhere. In the US it would require a reduction of the budget deficit. Japan's current surplus was largely outside its own control - reflecting lower oil prices, recovery in the US and the high dollar due to high US interest rates. Japan's economy, however, was now growing and imports were increasing, including imports of manufactures. He did not believe that there should be a return to the 1970's "locomotive" experiment which had contributed to global inflation and high budget deficits.

30. Padoa-Schioppa (Italy) said that the US had played the role of a Keynesian locomotive to help world recovery, but there was now a need for greater growth in Europe - although Italy itself still needed to follow restrained policies.

31. Flandorffer said that he expected German growth this year to be $2\frac{1}{2}$ - 3% but accepted the need to improve the prospects for investment through improving market flexibility. Lamfalussy echoed the need for Europe to follow the US example of flexibility to encourage growth.

32. Loehnis suggested that though real wages had contributed to adjustment in the US since 1979, both demand and supply factors had been important. The US was becoming a post-industrial economy with high returns in services. The internationalisation of financial markets was also making US assets close substitutes for domestic assets, so that the limits on the share of dollar assets in investors' portfolios might prove larger than expected.

33. McMahon, summing up, said that it had been useful to concentrate on the long-run determinants of exchange rates and growth prospects for countries outside the US. He noted the US reassurance that prudent American policies would prevent disruptive moves in the dollar.

Footnote

McMahon will address ECSS on 13 September on debt problems. The next meeting in Paris of the WP3 will be on 12 December.

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