1

10 DOWNING STREET

Prime Minister

This is a very clear account of why Louvre was bad and its relationship to the crash.

It is weak however on the need to deal with the US deficit.

Worth reading.

Brian Griffiths

SECRETARY BAKER'S CRASH

by Allan H. Meltzer

Treasury Secretary James Baker's fingerprints can be found all over the October stock market crash. It was Secretary Baker's Louvre Accord that caused interest rates to rise sharply in the late summer and fall. The rise in interest rates was the single most important factor pushing down stock prices in October.

It was not the only factor. While we will probably never know why the stock markets fell so violently on October 19, the sudden realization that interest rates were about to ratchet up again had a major role. Rising interest rates lower stock prices unless they are offset by rising corporate profits. During the spring, that is exactly what happened. Anticipations of rising corporate profits offset the effect of higher interest rates. From mid-July to mid-October, interest rates on long-term government bonds rose nearly 25%, from 8½% to almost 10½%, so even if prospects for corporate earnings growth remained unchanged, stock prices had to fall by 25%.

Why did the Louvre Accord force interest rates up? The accord set a band around the permissible movements of the exchange rate between the dollar, the West German mark and the Japanese yen. The exact band was kept secret, but it was widely believed that the dollar would not be allowed to fall below 1.8 German marks or 160 Japanese yen. These exchange rates may have been appropriate when the agreement was made in January 1987 but, by late summer, the dollar was overvalued.

People wanted to sell dollars and buy marks or yen. Between June and September, private Japanese investors shifted from large net buyers to net sellers of U.S. bonds. Europeans and Americans did the same. They all shifted away from dollar investments. Under the Louvre Accord, the German and the Japanese central banks had to buy dollars that private investors sold to keep the dollar from falling below the band, just as they had bought dollars under the Bretton Woods system before 1971 and under President Nixon's short-lived Smithsonian agreement in 1972-73. These earlier agreements had been followed by inflation. There is a well established relation between substantial dollar purchases and high money growth and between sustained high

money growth and inflation. The most closely watched measure of money growth in Japan rose from about 8% last year to almost 12% in October. Fears of another round of inflation rose. Interest rates in Germany and Japan rose, partly in response to central banks' efforts to slow money growth, partly from fear of inflation.

The Louvre Accord required the United States to support the dollar by lowering money growth. The most widely watched measure of money growth--currency and checking deposits--slowed from an annual rate of nearly 20% in 1986 to barely 3% in the first nine months of 1987. Other measures of money growth declined, though by smaller amounts. Slower money growth raised U.S. interest rates to match the increases abroad. Without the increases in U.S. interest rates, the dollar would have fallen below the band.

Secretary Baker and the Finance Ministers of the cooperating countries reconsidered the agreement in September, only a few weeks before stock markets here and abroad came tumbling down. Instead of scrapping the agreement, they renewed it without change.

This was a mistake. Exchange rates cannot remain fixed during periods of substantial payments imbalance unless countries are willing to accept the rates of inflation, disinflation or deflation that sustain the exchange rates. Exchange rate changes compensate for differences in inflation, saving rates, productivity growth and costs of production between individual countries. By fixing exchange rates, or setting a band, governments force adjustments to take other forms including inflation in some countries and recession in others.

The Louvre Accord broke down because the Germans were unwilling to risk inflation and we were unwilling to push our economy toward recession by raising interest rates again. Once the stock markets crashed, frightened governments and central banks abandoned the Louvre Accord. The dollar tumbled below the band. Interest rates fell, and the U.S. stock market recovered part of its loss. The risk of a recession in 1988 remains, but the risk is lower now than under the Louvre Accord if we maintain money growth stable at about 6 to 7% this year and next.

Lessons from the Louvre

Everyone seems eager to draw lessons from the stock market crash. I

believe the main lessons to be learned are about the Louvre Accord. If learned, these lessons will help to avoid a repetition of the stock market collapse.

First, no one knows how to set exchange rates that will be the correct rates to balance trade and payments, three, six or nine months from now. Exchange rates are prices. In an uncertain, changing environment, prices and exchange rates must be allowed to adjust to new events.

Second, governments and central banks should not try to push exchange rates down or to hold them up. Markets are not perfect judges of exchange rates, but they have an advantage over governments and central bankers. When markets are wrong, they correct. When governments are wrong, it usually takes a crisis to get them to recognize their error.

Third, policy coordination should not be abandoned. The mistake of the Louvre Accord was to coordinate in the wrong way -- to believe that stability could be achieved by fixing the exchange rate. Proper coordination requires an agreement about policies, for example a commitment that major countries will act to achieve price stability. The commitment cannot be an empty promise. The specific policies of each country must be spelled out, and the policies must be seen to lead to the goal.

The Budget Deficit

It will surprise many that I have discussed the problems of the U.S. economy and have not even mentioned the budget deficit. Should I be burned as a heretic? I think not.

The budget deficit is part of a larger problem. That problem is that the United States consumes much more than it produces both publicly and privately and borrows to finance its excess spending. The difference between spending and production is the amount we borrow from foreigners and the assets we sell to foreigners--currently about $150 billion a year.

We have a problem, really a set of problems. We do not have a crisis, and can avoid a crisis with proper policies and, as always, a bit of good luck. Proper policies will encourage saving, productivity growth and output and will reduce spending, especially consumption spending. A wise budget policy would work toward these ends by reducing government spending on consumption and by shifting taxes to encourage saving and investment. We are,

of course, far from a wise budget policy and the recent compromise has not helped.

The October fall in the stock market was a warning from foreign and domestic investors that our policy of raising interest rates to keep the dollar at some arbitrary level was a mistake. Once the dollar resumed its decline, interest rates fell, and investors regained a bit of confidence. It remains to be seen whether their confidence was misplaced.

President Reagan or Secretary Baker should announce: No more exchange rate agreements. Let the dollar float.