cc P/UP

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

You are seeing the Chancellor immediately before a meeting on Public Expenditure. There may be one or two points that you will wish to raise with him privately (though I have none to suggest).

Otherwise, possible topics for discussion include:

- the Washington meetings and, in particular, any implications for CHOGM;

- the markets, with the continuing strength of Sterling against the Mark, and intervnetion, yet no downward pressure on interest rates.

- chairmanship of the SIB.

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(DAVID NORGROVE)
2 October 1987

BOA[illegible]S OF GOVERNORS • 1987 ANNUAL MEETINGS • WASHINGTON, D.C.

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL MONETARY FUND

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Statement by the Rt. Hon. NIGEL LAWSON,
Chancellor of the Exchequer and Governor of the Fund
for the UNITED KINGDOM, at the Joint Annual Discussion

I welcome the progress that we have made at these meetings on a number of issues of great importance. We have reaffirmed the Louvre agreement. There is now full support for an early and substantial general capital increase for the World Bank. And there is increasing recognition that within the general debt strategy, special action is required to help the very poorest and most heavily indebted countries, particularly in sub-Saharan Africa.

At the meetings of the Interim and Development Committees this April, I put forward a three-point proposal for assisting these countries, provided they pursue appropriate adjustment policies: the conversion of aid loans into outright grants; longer repayment and grace periods on Paris Club reschedulings; and reductions in the rates of interest on those reschedulings.

The Managing Director of the International Monetary Fund and the President of the World Bank have put forward complementary proposals for helping the poorest countries by concessional interest rates, including a substantial increase in the size of the Fund's structural adjustment facility (SAF). I support these proposals, and believe that heavy indebtedness should be a major factor in determining the allocation of funds under any enlargement of the SAF.

It is of the first importance that we make a real effort to reach agreement on all these proposals at the earliest possible date.

The U.K. Economy

I now turn to the experience of my own country during the past year. Since the sharp fall in the oil price in 1986, the growth rate of the U.K. economy, so far from slowing down as was expected, has actually picked up. At the same time, the growth rate for the major industrial

countries as a whole has been below expectations. At first sight, this seems paradoxical. The industrial countries in aggregate were significant beneficiaries from lower oil prices, whereas the United Kingdom, as a major oil producer and exporter, stood to lose significantly.

What has happened is that the U.K. economy has adjusted more smoothly to the fall in oil prices than many thought possible. The latest Fund forecast puts U.K. growth at 3.4 percent this year--the fastest growth of all the major industrial countries. And U.K. manufacturing productivity, currently rising at about 6 percent, has continued to exceed expectations, thus containing the growth of unit labor costs.

The United Kingdom's strong growth performance has not been brought about by any fiscal stimulus. The public sector borrowing requirement has in fact been reduced to less than 1 percent of GDP. We have been able to bring down tax rates by maintaining a declining path for public expenditure as a proportion of GDP. Nor has there been any relaxation of monetary policy. Interest rates have been held at levels necessary to maintain sound anti-inflationary conditions. In short, it is the enterprise economy that has done the trick. One consequence of this improved performance has been a significant drop in unemployment, which has fallen by 400,000 over the last 14 months.

The strong growth of U.K. output and demand has caused some to suggest that the U.K. economy is in danger of overheating, while others are forecasting a slowdown. Some manage to combine both predictions. But while, as in most countries, inflation is a bit higher than last year when the impact of falling oil prices was greatest, there has been no significant change in underlying inflationary pressure.

The United Kingdom is now well into its seventh year of steady growth at 3 percent a year. During that period there have been minor fluctuations, and after the slight spurt this year, I would expect something closer to the 3 percent average rate next year.

The Background to the Louvre

I now turn to the evolution of exchange rate policy.

For the first 25 years after World War II, exchange rate stability was achieved through the Bretton Woods system. This formed a cornerstone of the postwar economic order, not least as a force for financial discipline. But it began to break down in the late 1960s, and by the early 1970s it had collapsed altogether. Thereafter, with countries pursuing divergent economic policies, and many suffering from high and volatile inflation, a system of floating exchange rates was virtually inescapable. Indeed, many at the time believed this new flexibility to be desirable.

With hindsight, some of the arguments for free floating seem much less compelling. And the belief that markets would provide a stabilizing influence, through the operations of medium-term speculators, has not been borne out.

In particular, we have seen wild gyrations in the dollar that have clearly not been a reflection of economic fundamentals, which are essentially slow moving. Few could seriously argue that two deutsche mark to the dollar was "correct" in 1979, and again at the end of 1986, and yet that three deutsche mark to the dollar was "correct" in 1985. Moreover, these gyrations have damaged growth in world trade. Businesses have had to divert scarce management time and skills to coping with currency fluctuations, rather than improving company performance. And the major uncertainties about exchange rate movements inhibited risk taking and required a switching of resources at a pace that was wholly unrealistic.

The explanation for these gyrations in the dollar derives in large part from the nature of the foreign exchange markets. We now have global 24-hour markets in which turnover has increased dramatically, with only a small part of that related to commercial transactions. This presents particularly acute problems for the dollar, which still dominates the world's money markets. In 1986, on the London foreign exchange market, 97 percent of all transactions were in dollars.

Of course, all financial markets have a certain amount of speculative froth. But to function well they need some players to take a longer view, and so provide a stabilizing influence. In foreign exchange markets, they have been conspicuous by their absence.

This means that once the dollar starts to move in one direction, it can continue in the same direction for months and even years, even if there is a general consensus that the rate is out of line. This is what happened in 1984 and early 1985. Almost everybody agreed that the dollar was overvalued, and that, in the long run, it was bound to fall. But they continued to buy dollars in the belief that, in the short run, it would move even higher--which is, of course, what consequently occurred.

The result is that trends have been greatly magnified. Capital movements have generated fluctuations in the dollar; but equally, fluctuations in the dollar have themselves generated further capital movements. This is how exchange rates have often acquired a momentum of their own, which has not been reversed until they have reached extreme levels of over- or undervaluation.

Background to Plaza

It was a growing concern about this process that led ~~to~~ a small group of us to meet in the Plaza Hotel in September 1985. We shared three perceptions:

- first, that the gyrations in exchange rates had proved damaging;
- second, that the immediate problem was that the dollar was much too high; and
- third, that the time was right for the authorities of the major countries to give the markets a clear lead.

The Plaza agreement marked an important step toward a more managed system. In private, we discussed the scale of fall we saw as desirable, and although no figures were given in public, everyone was aware that we were looking for substantial changes. We agreed to cooperate to bring that about. And that agreement played an important role in securing a continuing fall in the dollar over the succeeding 15 months.

The Louvre

The Louvre accord earlier this year marked another important step forward--Plaza II, as I called it at the time to emphasize the continuity. By then the broad objectives agreed at Plaza had been achieved. The yen and the deutsche mark had appreciated by as much as 50 percent or so against the dollar.

We agreed that, given the policies being followed, the dollar was by then broadly in line with economic fundamentals and that the interests of the world economy would best be served by a period of stability, to allow time for the major economies to adjust to the exchange rate changes that had occurred. We were not, of course, thinking in terms of rigid exchange rates, but we did discuss the scale of fluctuation, around the then current levels, which we would not wish to see exceeded. Figures were agreed in private, but not, of course, revealed in public.

In spite of widespread skepticism when it was first concluded seven months ago, the agreement has proved a success.

Managed Floating

The move to managed floating has been made possible by two fundamental changes:

- First, we have at last returned to a world of low inflation. The average inflation rate for the major seven economies has fallen from 12 percent in 1980 to about 3 percent today. In the process, inflation differentials have been narrowed considerably.

- Second, there is now a clear consensus among the major countries about the approach to economic policy. And we all agree on the need for a greater reliance on market mechanisms within the framework of a firm monetary and fiscal policy.

We have been able to make this regime work because:

- We have chosen the right time to give a lead to the markets. In this sense we have been working with, rather than against, the grain of the markets.

- We have been prepared to commit ourselves publicly to appropriate and consistent domestic policies.

- In particular, we have all been prepared in practice to give significant weight to exchange rates in the conduct of monetary policy.

- We have been prepared to back up our agreement with coordinated intervention, sometimes on a substantial scale.

- We have deliberately not revealed details of our arrangements. And we have worked within margins of a size sufficient to allow us the necessary tactical room for maneuver.

A Regime for the Future

I believe that we can and should use the experience we have gained to build a more permanent regime of managed floating. I do not see the past two years simply as a temporary phase. Our objectives should be clear: to maintain the maximum stability of key exchange rates, and to manage any changes that may be necessary in an orderly way.

Let me make it clear that I am not suggesting that we can or should return to Bretton Woods. That system was undermined by its rigidity; the margins were too narrow; it required a predictable and mechanical response from the authorities that made them an easy target; necessary realignments were postponed too long, and consequently, when they came, they were inevitably large.

For the future, it is important, therefore, that we continue to keep an adequate degree of flexibility in terms of the width of the bands within which currencies are able to fluctuate. And, if and when the time comes to adjust one of the rates, that adjustment should be made by moving the midpoint within the confines of the existing range. This means that the markets are not given a one way bet, and the authorities retain tactical flexibility.

As I have already emphasized, what made the Plaza and Louvre agreements possible was that the countries participating were, and remain, in effect, members of an anti-inflationary club, with a clear

commitment to taking whatever steps are necessary to curb their own inflation. It is vital that that commitment continues, individually and collectively. A resurgence of inflation in any individual country would make it difficult for that country to remain within the club.

At the same time, we must also ensure that there is no persistent inflationary (or for that matter deflationary) bias for the group as a whole. This can be helped by:

- the development of indicators for the group as a whole; these will be mainly financial but special attention should also be given to the trend of world commodity prices;

- a nominal framework for policy, in terms either of a path for GDP growth for the group as a whole, or one for the average inflation rate; and

- a medium-term perspective when setting out the path and in gauging actual performance. We should not become involved in an exercise in short-term fine tuning.

In recent meetings we have put a lot of effort into developing performance indicators for individual countries. I have to say that I have considerable doubts whether we can usefully take that exercise much further. I believe it would be far more useful to devote our efforts to monitoring the performance of the group as a whole, so that we can ensure that we maintain the correct noninflationary policy stance.

Current Account Imbalances

Some fears have been expressed that the Louvre agreement will be undermined by the persistence of current account imbalances between the major countries. I do not believe this need be so.

What we are seeing is not altogether surprising. It is the familiar J-curve effect, and although the imbalances remain large, trade volumes are adjusting.

In any case, there is no law that dictates that the current accounts of the major industrial countries should always be in balance. We have an integrated world economy and we encourage the free flow of capital and goods. Clearly there are limits to the accumulated external liabilities or assets that can be sustained without creating major anxieties for capital markets. But investment opportunities and savings propensities inevitably differ from country to country and it is natural for this to produce substantial, and often sustained, capital account flows. These flows necessarily have their counterparts in current account surpluses and deficits.

The present combination of deficits and surpluses has emerged over several years during which the growth of domestic demand in the Federal Republic of Germany and Japan has been consistently below the growth of output, while in the United States it has been consistently above. The process of unwinding the imbalances requires a reversal of the differences between domestic demand and output in those countries. This is bound to take time to complete, but--and this is important--it has now begun.

It would be a serious mistake to seek a shortcut by a further dollar depreciation. It was undoubtedly necessary to correct the huge misalignment of the dollar in 1985. But there is no case for going to the opposite extreme of an artificially low dollar. The benefits to the current account would be small compared to the damage to U.S. inflation and the dislocation to the world economy. The main lesson from recent years is that we should avoid exchange rate misalignments, not encourage them.

Conclusion

In conclusion, I believe that external stability should now complement the internal financial stability that we have already achieved. It will remedy a major weakness in the world financial order and provide a sounder basis for the prosperity we all seek.