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THE GOVERNOR

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WORKING PARTY THREE, 8-9 JULY

I attach my usual Chairman's summary of this meeting. It went quite well, in particular having Leland instead of Sprinkel was a great improvement in that, instead of getting a simple gramophone record on the US and nothing on anything else, we got a large number of short and lively interventions on US policies, other countries and on the general outlook.

The conclusions of the meeting were sombre. We spent a lot of time puzzling over the persistence of high US interest rates; and most people were rather disturbed by the virtual admission by the Americans that they could do nothing about it. Everybody agreed that the situation was worse than when last considered and indeed that the Secretariat forecasts, just published, were unlikely to be 'central'.

On the other hand, in discussing the prospects for international bank financing a fairly robust attitude was taken to the possibility of a crisis. Many people - especially the Americans and the Germans - welcomed the extra degree of adjustment they saw as inevitable in the borrowing countries.

We have discussed the worsening economic scene in a number of meetings in the Bank recently. I must say I find it significant and disturbing that, without exception, each set of forecasts produced by each individual forecasting unit around the world is more pessimistic than the one before about activity and employment.

On the whole of course the forecasts of inflation have at the same time improved; but this trend is I think less strongly marked and in any case while the forecasts for activity and employment are everywhere most unsatisfactory, those for inflation still leave a lot to be desired.

The conventional response, exemplified by the Summit, has been to say simply we must keep on at it. But the question must surely be asked: for how much longer and with what ultimate strategic ideas? Furthermore:

(i) Do we believe (and if so what is the evidence) that on present policies the world will move into a slow and sustained recovery?;

(ii) If it does will inflation continue to go down, and if so why?;

(iii) If we get the recovery and inflation goes no lower - and indeed gradually creeps up - will it have in any sense been worthwhile, granted the very high levels of unemployment implied for many years;

(iv) Alternatively there may not be much recovery; in which case, at what point - and on what criterion - do we think policies should be reversed and some stimulus given?

More fundamentally, while we may all believe that inflation is an enemy to growth, are there really grounds for believing that when the inflation rate gets below a certain point growth will automatically recur?

It seems to me that the Summit was a gigantic missed opportunity to start considering these kind of questions. They are bound to be debated both domestically and internationally from the IMF meetings onwards. I think we should be prepared with our own answers to play a part in the debate at that time.

(I apologise for the clear pre-holiday tone of this note.)

16 July 1982

(Dictated by the Deputy Governor and circulated in his absence.)

PERSONAL AND CONFIDENTIAL

WORKING PARTY NO 3 OF THE OECD ECONOMIC POLICY COMMITTEE
120th Meeting, 8-9 July: Chairman's Summary

We discussed two topics: the present state of the economic conjuncture and the Secretariat forecasts: and the financing implications of these forecasts. The two subjects were linked by the common threads of present and prospective levels of interest rates and problems of uncertainty and lack of confidence.

The Secretariat's latest forecast, summarised in CPE/WP3(82)3 and published in the Economic Outlook just before our meeting, provided the background for our discussion of the conjuncture. Mrs Ostry gave us a helpful summary of the main features. There seemed to me two crucial points. First, the revival projected for the second half of this year relies very much on what happens to stockbuilding and household consumption. Projections for both must be in some degree uncertain. Stockbuilding is intrinsically difficult to forecast, certainly so far as precise timing is concerned. And household spending obviously depends a good deal on consumer confidence, where - with unemployment and real interest rates at their present levels - we are quite a long way outside previous experience. Secondly, and in a way more important, the forecast seems to indicate that any revival may be hard to sustain. For growth to continue beyond the short term, fixed investment would need to strengthen appreciably. There is not much sign of this at present; and there are elements in the outlook - notably high interest rates and weak business confidence - which are not conducive to an investment recovery. In addition, Mr Marris drew our attention to the divergence in the forecast between the (slow) growth of output and the (perhaps over-strong) projection for trade, and implied - with support, I believe, elsewhere round the table - that here too was reason for caution about the prospect.

The national interventions which followed served to illustrate these concerns, as well as to indicate how policy was responding. Our German colleagues noted that some immediate economic indicators showed better signs; interest rates had come down; wage increases were low. Yet confidence had deteriorated, perhaps because of continuing uncertainty about the budget, or because the world outlook, and with

it export orders, seemed to have worsened, or because interest rates, although they had fallen, nevertheless looked set to remain high. Certainly it was now hard to see further declines in German rates unless US rates eased; and US rates had actually moved up again recently. As for Germany's current account, the Bundesbank were expecting something no more than rough balance this year. Mr Pieske went on to give us an outline of German budget objectives for 1983. These involved quite stringent targets for the deficit - a fall to 1 1/2% of GDP - and for spending - a rise of only about 2% in nominal terms.

From Mr Jurgensen, we had a very full explanation of the package of measures in France which had accompanied the latest EMS realignment. In terms of objectives - a sharp lowering in inflation , a firm limit on government borrowing, efforts to stimulate investment - the measures were, I am sure, generally welcomed. But there were perhaps doubts about just how effective they would be; where precisely spending cuts would be made; how far curbs on prices and profit margins might conflict with the target of promoting investment; how the "re-entry" stage would be managed. Still in relation to the EMS, Mr Padoa-Schioppa offered us some interesting observations on its evolution over the last two years. There was, he suggested, reason for satisfaction in the way that policy adjustments were increasingly put in place to support parity changes. But in terms purely of the foreign exchange side, things had gone less well. Realignments had become bigger and more frequent; and even now there were important divergences between countries still to be absorbed.

Moving to Japan, Mr Watanabe and Mr Ogata gave us their latest views on the outlook - especially for trade - and on the dilemmas facing policy. They suggested that the Secretariat's projection for the Japanese current account surplus in 1983 was substantially too large. As for the surprisingly weak performance of Japanese exports recently, something might perhaps be attributed to export restraints. But there were other factors as well: the relative stability of the yen against the European currencies (and a relatively modest competitive advantage) which tended to be masked by the weakness against the dollar; a shift in corporate objectives more towards profits and away from simply maximising market share; and keen competition from the

newly industrialising countries. Mr Ogata, although sympathetic to the aim of bringing about a higher rate for the yen, reminded us of the difficulty of meeting, at the same time, the need to support domestic demand. On the fiscal side, substantial shortfalls in tax revenue last year, and a consequent overshoot on borrowing, made caution all the more important.

The remaining part of our discussion of the conjuncture concerned the US. The American representatives were, I believe, in broad agreement with the Secretariat in their interpretation of the forecast. But there was some feeling that the US external position might be weaker - and that of other major countries correspondingly stronger - than the forecast suggested. There were differences, too, about the path of nominal income and its relationship with the money targets and velocity. The main concerns, however, domestically as well as internationally, were the budget and interest rates. On the budget, there had been some progress. But there was still a lot of uncertainty about how the overall cuts were to be translated into individual programmes; and that uncertainty - against a background of market scepticism - was having an unhelpful effect. On monetary control, Mr Wallich told us of the decision to move to contemporaneous reserve accounting and of the plans to publish the weekly money figures in moving average form. Some concern was expressed, I think understandably, that the new reserve regime might contribute to interest rate volatility. And so far as volatility had been one factor leading to higher average rates, there might be reason for worry there too.

All this led us back on to the familiar ground of why interest rates, especially real rates, remained so high; and how they were likely to move in future. We perhaps did not achieve any very novel insights into these difficult questions; indeed besides the problem of explaining what was happening, our American colleagues seemed increasingly doubtful about the authorities' ability to influence it either. But Prof Lamfalussy raised the interesting question of why American experience seemed to differ so sharply from that in other countries, where similar policy objectives were being pursued. One reason might be the tax regime and its relatively generous treatment

of interest charges; another, the uniquely intense scrutiny given to financial developments in the US and the markets' sensitivity to them. How far these go towards an explanation I am not sure. Perhaps as, or more, important is the effect of uncertainty, for example as it influenced those in the longer term markets who had repeatedly been caught out with the general upward shift in rates.

Interest rates were again a central concern when the Working Party moved on to consider the second issue on the agenda - the question of how far financing strains were implicit in the forecast. Our discussion assessed these strains at two levels of severity: a financial crisis, and a constraint or constraints on financing such that borrowers were required to adjust more than the forecast presently allowed. An assessment of this kind is perhaps unavoidably vaguer and more impressionistic than an argument in terms of income and spending, if only because our financial models are generally much less well determined than those which deal with the "real" side of the economy.

Some factors affecting the capacity for intermediation were set out in the papers prepared for the meeting [CPE/WP3(82)4 and 5] and a number of glosses and extensions were put forward during our discussion. There was widespread concern about the position of Eastern Europe, aggravated by the absence of reliable economic data. On Latin America, some were daunted by the sheer size of the borrowing which Mexico, for example, now needed to undertake each year. Others, however, were less concerned, pointing to the huge medium- to long-term potential of these countries and to the fact that loans were, anyway, spread over a large number of banks. There were anxieties that default might become fashionable - a "commune of debtors" was I believe the phrase Mr Jurgensen used; and on the other hand there was the proposition - perhaps not altogether comforting - that the biggest borrowers were too big to be allowed to fail. The main impression to come from all this seemed to be that the banks were in future likely to be much more selective in their lending. Some countries, especially in the Far East, might enjoy a relative improvement in their position, while others may find that the banks take a much more rigorous attitude than in the past.

Besides questions about the regional pattern of loans, we had a number of interventions on other aspects of the banks' behaviour. The banks, it was suggested, had in the past set internal management targets - emphasising balance sheet growth rather than long-term profitability - which may have contributed to their becoming over-extended. Maybe the emergence of problems with certain of their loans and the need to devote substantial management time to negotiations on, for example, rescheduling, would help to encourage a better balance in future. Certainly many felt that recent experience had brought a more realistic appraisal of sovereign risk (though it was pointed out that the risks attached to domestic lending had also increased). More immediately, several members of the Working Party mentioned a shift of preferences towards short-term lending explicitly linked to trade transactions.

A third group of issues concerned the relationship between the banks and the authorities. Some doubted whether the banks, even collectively, were really able to insist on and then to monitor an adjustment programme on IMF lines. Adjustment at the banks' behest tended to come too late and, partly for that reason, could be unnecessarily disruptive. Against this, the case of Brazil was quoted - without the same formal arrangements, the end result had perhaps been similar to what might have happened with the IMF. Looking forward, we had some debate on the possible value of new machinery to pool information, between the banks themselves and between the banks and governments. Some felt that it was unreasonable to expect the banks to behave satisfactorily if they only had part of the picture. It was suggested, on the other hand, that if all banks drew their information from the same source, it might reinforce the "lemming instinct" which was identified, quite generally, as a reason for concern. In the past, there had seemed to be something like the economists' hog cycle in the banks' behaviour with first an excess and then a deficiency of credit. But whereas with the original hog cycle centralised information served to dampen the fluctuations, with the banks there was a suspicion that it tended to reinforce them. In any case, other factors besides information

influenced lending decisions, notably political considerations. Governments - who were presumably as well armed with information as anyone - had continued to extend credits to Poland when the Polish economy was clearly in trouble and when the banks had withdrawn from new lending on their own account. There was wide support, though, for pursuing the various co-financing proposals.

It seemed to me that the following conclusions emerged from our discussions. First, an acute financial crisis was not thought likely; but the Working Party recognised the difficulty of reaching a proper assessment of an event which, while improbable, was at the same time potentially extremely serious.

Secondly, there was general agreement that bank finance was unlikely to be extended to deficit countries on the scale indicated by the Secretariat forecasts. While some were concerned at the potential consequences of sharp cut-backs in bank lending, others welcomed the degree of domestic adjustment in a number of borrowing countries that would thereby be brought about.

Thirdly, linking the two subjects of our discussions together, it was generally agreed that considerations raised during the meeting had pointed to downside rather than upside risks to the Secretariat forecasts. Lower activity in the borrowing countries as a result of further domestic adjustment might not have very big macro-economic consequences but could be significant at the margin and for particular industries. In any case the indications from individual country contributions to our discussions were that exports in general were proving rather weak. Most important perhaps, the prospect of continued high real interest rates, nervous markets both domestically and internationally, and weak business and consumer confidence all suggested that the Secretariat forecasts were more likely to prove too high than too low.

For completeness, I should record that the Secretariat's paper on the relationship between trade and macro-economic policies [CPE/WP3(82)6] was tabled at the meeting, with the intention of considering it further at our Toronto meeting in September.