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TO: Federal Open Market Committee

FROM: Arthur L. Broida ALB

Attached for your information is a report by Mr. Truman on the recent Paris meeting of Working Party Three.

Attachment

RESTRICTED

E.M. Truman
May 31, 1977

Report on Meeting of Working Party Three
(Paris, May 25, 1977)

The Working Party discussed three related topics: the general direction in which countries' payments positions appear to be evolving, the respective roles of demand management and exchange-rate changes in the adjustment process, and the appropriate mix of balance-of-payments financing and adjustment.*/

I. The Direction of Adjustment

General satisfaction was expressed with the direction in which the current account positions of the countries participating in Working Party Three -- i.e., the G-10 countries -- appear to be evolving. The current account deficits of Italy and the United Kingdom are declining along with the surpluses of Germany and The Netherlands. It was noted, however, that all of the expected $12 billion 1976-1978 swing in the combined current account position of the WP-3 countries other than the United States could be accounted for by the expected swing in the U.S. current account to a $12 billion deficit in early 1978. But no concern was expressed about the developing U.S. current account deficit; in fact, some participants regarded it as essential to over-all equilibrium. Japan

*/ This was also the last WP-3 meeting for Ed Neufeld (Canada), Sir Derek Mitchell (United Kingdom), and the Chairman of the Working Party, Otmar Emminger. (Agreement has apparently been reached that Michiya Matsukawa of Japan will succeed Emminger as Chairman with Kit McMahon of the Bank of England serving as the Vice Chairman.)

was singled out for criticism because of the expected surplus in its current account in 1977. The only defense Matsukawa offered was that Japan's surplus would decline in the second half of the year and would be less than the $6 billion forecast by the OECD Secretariat. The representative of The Netherlands also indicated that any move into current account deficit by The Netherlands would not be passively accepted by his authorities.

In contrast to the situation for the WP-3 countries, concern was expressed about the situation of the smaller OECD countries whose combined current account deficit is expected to be unchanged in 1977 and 1978 from their $20 billion deficit in 1976. Six countries were singled out for particular attention: Portugal, Spain, Turkey, Finland, Greece and New Zealand. It was noted that the first three countries face especially acute short-term financing problems.

The discussion revealed considerable uneasiness about the longer-run functioning of the adjustment process. It was the view of some participants, than many countries were approaching limits beyond which it would be difficult or impossible to maintain differential rates of expansion of domestic demand. Other participants emphasized their view that the countries with current account deficits would have no choice but to maintain tight restraints on domestic demand. However, the fact that adjustment problems would apparently remain was interpreted by some as evidence of an ex ante excess supply of world savings, i.e., evidence of a dificiency of world demand. In this connection, a number of participants commented on the difficulty of ensuring that international capital flows are attracted to countries that could and would best use them to increase their rates of real capital formation.

II. Instruments of Adjustment

It was the general view of the Working Party that demand management and exchange-rate adjustment should not be regarded as independent instruments of balance-of-payments adjustment. On the one hand, it was noted that a relatively poor performance on demand management policies would necessitate an exchange-rate adjustment. On the other hand, it was noted that exchange-rate changes had been indispensible in the achievement of the balance-of-payments adjustments that have occurred over the past six years.

It was observed by some, including Tony Solomon, that real exchange-rate changes -- i.e., exchange-rate changes that more than compensate for changes in relative prices in national currencies -- might be needed if the adjustment process was to work more smoothly in the future. It was noted that such changes are difficult to accomplish and maintain in an environment in which expected rates of inflation are large. Solomon also commented that erratic exchange-rate movements appear to have complicated the process of achieving desired current account adjustments.

In this connection, it was pointed out that countries in strong payments positions should allow their currencies to appreciate while maintaining the level of domestic demand. The OECD Secretariat also reported on a calculation indicating that if the smaller OECD countries were to restrain domestic demand in order to cut their combined current account deficit from $20 billion in 1976 to $10 billion in 1978, this would in the absence of offsetting actions reduce the growth of real GNP in the OECD countries by one per cent per year. This calculation led some participants to argue for slower adjustment and more emphasis on official financing.

III. Financing and Adjustment

Alexandre Lamfalussy (B.I.S.) reported to the Working Party on his view of the outlook for foreign lending by banks in the G-10 countries. He expects that such lending will continue to expand but at a slower rate than in recent years. (He also asserted without supporting evidence that the share of U.S. banks in such lending is likely to increase.) The basic reason for his view was that banks find international lending profitable. This situation should continue, he suggested, as long as governments and international institutions are prepared to step in to maintain the flow of financing and as long as there is some evidence that balance-of-payments problems are being corrected.

Emminger mentioned the proposal that authorities might try to influence the process of bank lending by setting down standards of good behavior in bank lending. Although this idea did not receive extensive discussion, there was some support for discouraging balance-of-payments loans that are not linked to IMF programs, for discouraging banks from believing that official lending would be available to prevent short-term payments crises, and for increased contact between the IMF and commercial banks. However, the general view of most participants in the Working Party was that the commercial banks should continue to bear the responsibility for their own decisions on foreign lending.