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CLASS II - FOMC

TO: Federal Open Market Committee

FROM: Murray Altmann M.A.

Attached for your information is a report by Messrs. Truman and Promisel on recent meetings of the OECD.

Attachment

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Report on Meetings of the OECD's Economic Policy Committee and Its Working Party Three, May 19-21, 1980

by

Larry Promisel and Edwin M. Truman

Summary. The Economic Policy Committee (EPC) of the OECD met in Paris on May 20-21. That meeting was preceded on May 19 by a meeting of the EPC's Working Party Three (WP-3). Serving as background for both meetings was a consensus forecast for a significant recession in the United States and very slow growth elsewhere in the OECD area. Despite this outlook, delegates agreed that the persistence of high inflation rates required the continuation of restrictive monetary and fiscal policies for the foreseeable future. There was some support for selective policies to stimulate investment.

Working Party Three, especially, devoted considerable time to a discussion of monetary policy. Delegates welcomed reassurances that the recent decline in U.S. interest rates should not be interpreted as an easing of Federal Reserve policy. The relationship between monetary policy and exchange rates was explored: the key role of interest rates as a determinant of recent exchange-rate movements was cited and a question was raised about the implications for exchange rates of widespread pursuit of money growth targets.

Working Party Three also discussed recycling. Delegates reiterated the view that for non-oil developing countries as a group the problem appeared to be manageable, at least this year, but individual countries might well experience significant difficulties.

In addition to the general outlook and policy concerns, the EPC discussed energy policy. There was widespread support for the view that OECD countries cannot rely on prices alone to reduce their dependence on OPEC oil.

Charles Schultze was relected Chairman of the EPC. Christopher (Kit) McMahon of the Bank of England was elected to succeed Michiya Matsukawa as Chairman of Working Party Three.

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MONETARY POLICY

Current monetary policy in the United States, Germany, Japan, and, to a lesser extent, elsewhere was described. The U.S. presentation emphasized that (1) the Federal Reserve's part of the March 14 package of measures was temporary and a supplement to the basic Federal Reserve Policy of restraining the growth of the monetary aggregates and should not be construed as a shift to a policy of reliance on credit controls; (2) the change in operating procedures adopted last October was to be used symmetrically, so that interest rates would be allowed to fall if money growth was slower than targeted; (3) in fact, the Federal Reserve has not adhered slavishly to its money target in the very short run; but (4) the Federal Reserve does intend to stick to its target over the course of the year and, indeed, to lower its targets in the years ahead. Nevertheless, several delegates expressed skepticism as to whether interest rates should have been allowed to come down so quickly or so far given the high U.S. inflation rate.

The Germans explained the Bundesbank's April 30 increases in its discount and Lombard rates and its enlargement of rediscount quotas. In order to offset the restrictive impact of earlier official exchange market intervention, it was necessary to provide liquidity to the banks. Since the Lombard facility, which is meant to be a short-term facility, was deemed inappropriate for this purpose, quotas on use of the rediscount facility were raised. However, the Bundesbank feared that this would signal an easing of policy; such a signal was considered inappropriate, given Germany's inflation rate, and therefore, the Bundesbank raised its official lending rates, as well.

The Japanese explained that interest rate policy in Japan has been designed for domestic purposes. The excessive decline in the yen in February-April was attributed to higher U.S. interest rates and was met with intervention, not a further

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increase in Japanese interest rates. The fact that high Japanese interest rates so far have had a limited impact on investment (because firms have ample internal funds) was said to confirm that Japanese interest rates are not inconsistent with domestic concerns.

The more general monetary policy discussion focussed on two issues. Have interest rate movements dominated exchange rate movements, or more broadly, what is the interaction between monetary policy and exchange rates? To what extent have exchange rate pressures induced countries to adopt more restrictive monetary policies than they otherwise would have?

While there was a consensus that interest-rate movements in the recent past have been the major factor in exchange markets, it was also accepted that other factors (such as current account balances and relative inflation rates) generally play a role, as well. The question was raised as to whether widespread targeting on money growth rates would lead to greater exchange rate instability. It was pointed out that only to the extent that the targets were uncoordinated (and therefore presumably inconsistent) might there be a problem. More fundamentally, it was argued that monetary targets are designed to achieve domestic stability and thus, if successful, would lead to international stability, as well.

No major country delegate who addressed the question said that monetary policy in his country was inappropriate from the domestic viewpoint.[1/] Few of the smaller countries had the opportunity to address the question, although the Austrians did say

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1/ For example, the French said they were lucky in the interest rate tempest because the strength of the franc within the EMS meant that French interest rates did not have to rise too much.

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that they would welcome a decline in international interest rates when appropriate so that Austria could revert to its low interest rate policy (to encourage investment).

THE GENERAL ECONOMIC OUTLOOK AND POSSIBLE POLICY RESPONSES

The OECD Secretariat forecast a rise of real GNP in the OECD area at a 1-1/2 percent annual rate in 1980-H1, followed by an actual decline in 1980-H2 at a 1 percent rate and a recovery at a 1 percent rate in 1981-H1. The rate of increase of the area-wide consumption deflator was forecast to decline gradually from a peak of 12-1/4 percent in 1980-H1 to 9-1/2 percent in 1981-H1.[2/] On balance, delegates thought the Secretariat might be too pessimistic on real growth in 1980 but perhaps too optimistic in 1981. There was little discussion of the inflation forecasts.

Most attention, so far as real growth in 1980 is concerned, focussed on the United States and Germany. Charles Schultze said the U.S. economy is now in a recession, with the peak having been reached perhaps in February. However, the recovery in the United States will be only moderate because restrictive policies must be kept in place in the face of high inflation rates and because the lack of a sharp inventory rundown in the forecast implies only a moderate inventory recovery.

There was considerable disagreement as to the outlook for real growth in Germany. Everyone agreed that German growth will slow considerably in 1980, but the Germans see the outlook as stronger than does the Secretariat. The discussion, which was especially important to Germany's European trading partners, turned on whether one gave weight to full first-quarter data (which suggest considerable strength) or to just the most recent month (which suggests a slowdown).

2/ These forecasts are basically similar to those of the Board staff.

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So far as 1981 is concerned, the main issue is whether the forecast recovery for the OECD countries will be self-levitating or whether some policy stimulus will be required. Although several delegates expressed concern that the recovery will be delayed and/or weaker than forecast, little support was expressed for any generalized stimulus so long as inflation rates remain so high. The Germans, for example, warned of a reversion to stop-go policies.

Considerably more support was expressed for specific stimulus or incentives to increase investment or the share of investment in GNP. Some delegates thought that the outlook for demand was sufficiently weak that an increase in investment was not likely to be forthcoming, so that tax or other investment incentives were required. Some argued that such incentives would not be effective unless the outlook for demand were stronger. Others, however, thought that some kinds of incentives should be adopted and would be effective.

EXTERNAL PAYMENTS IMBALANCES

The most controversial aspect of the external payments situation was the notion of "burden-sharing", i.e., how should the total OECD current account deficit, which reflects the counterpart of the OPEC surplus, be divided among countries? The Germans, who are forecasting that they will have a $13-14 billion deficit this year, acknowledged that there is little they can do to reduce their 1980 deficit but stated their intention to reduce the deficit over the medium term. The Germans were asked which country could better afford (i.e., more easily finance) a deficit than Germany. The German response, put most generously, had two elements. First, the total OECD deficit is not fixed; energy conservation can reduce it. Second, if a country has sufficiently high real interest rates, financing a deficit will be no problem.

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In the context of financing deficits, the Secretariat introduced the notion of "organizing" capital flows to help avoid excessive exchange market disruptions. (German government borrowing from Saudi Arabia is an example of an "organized" capital flow.) No one liked the connotation of the word "organized" in this context, but several delegates expressed support for the notion that various schemes whereby deficit countries could attract financing might be appropriate. There was no explicit recognition that some of the exchange rate movements that such "organization" might inhibit might themselves lead to desirable adjustment of current account imbalances.

Working Party Three spent some time discussing the issue of recycling. The Secretariat had prepared background material which looked at the financing requirements of the non-oil developing countries in a fairly disaggregated way. In general, no one challenged the conventional wisdom that the overall problem was manageable in 1980 but 1981 looks more worrisome. The British delegate did remind the group that the critical question is not whether recycling will take place (since ex post it will) but rather how much real growth can be enjoyed by the non-oil developing countries. It was agreed that considerable downward adjustment of growth plans will be necessary in at least some of the newly industrializing countries (Argentina, Brazil, Korea, Mexico, and Taiwan), but that perhaps such adjustment was necessary anyway. The low-income countries, which have limited access to private financing, are likely to face serious problems in the years ahead, especially if fiscal stringency in industrialized countries inhibits increases in official development assistance.

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ENERGY

Steven Marris of the OECD Secretariat summarized his view of the energy problem. Price elasticities of energy demand are sufficiently high that the price mechanism works to reduce demand significantly. Unfortunately, he said, the real price of oil was fairly stable in 1975-1978, thereby slowing the reduction in the use of energy relative to GNP; he argued that the OECD countries would have been better off if the real oil price had risen earlier than 1979.

Marris said member countries should not leave energy policy to interaction of OPEC decisions and the market. In the short run, he argued, the oil market is unstable. We need some dependable mechanism to allocate limited oil supplies to avoid disruptions. In the long run, we need alternative energy sources, which requires government intervention given the great risks involved. In the medium run, cyclical weakening of the oil market would tend to lower oil prices, thereby slowing the longer-run adjustment process.

Therefore, Marris argued, the OECD countries need inventory policies, to ensure that inventory rundowns do not result in a temporary reduction in oil prices, and tax policies, to drive a wedge between those prices facing consumers and those facing OPEC.

The basic thrust of Marris' arguments was generally accepted. The greatest opposition came from those delegations who questioned whether his policy prescriptions were practical, e.g., how do you coordinate oil taxation internationally, how do you establish a dependable oil allocation mechanism, or how do you implement an inventory policy. Some delegates, including Schultze, wondered why the current oil price, and not a lower one, is deemed appropriate as a starting point.