WHORM Subject File Code: FO006-06 (Economic Summit, Williamsburg, Virginia, 05/29/1983-05/30/1983)
Case file Number(s): 145282 (8 of 10)

THE WHITE HOUSE

WASHINGTON

April 21, 1983

MEMORANDUM FOR WHITE HOUSE SUMMIT GROUP MEMBERS

FROM: MICHAEL K. DEAVER Mike

I am calling together a meeting of the White House Summit Group Members on Monday, April 25th at 10:00 a.m. This meeting will be held in the Roosevelt Room and should last no more than 30 minutes.

James A. Baker
William P. Clark
Allen Wallis
Beryl Sprinkel
Richard Darman
Craig Fuller
David Gergen
Edwin Harper
Martin Feldstein
Michael A. McManus
Henry Nau

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THE WHITE HOUSE

WASHINGTON

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April 21, 1983

ACTION

MEMORANDUM FOR THE PRESIDENT

FROM: WILLIAM P. CLARK

SUBJECT: Give-and-Take Session of Summit Issues -- April 22, 1983 -- 2:00 P.M., Cabinet Room

Issue

This is the fourth of your in-depth discussion of Summit issues. This one concerns the debt and financial aspects of the world economy.

Discussion

Treasury has prepared the background paper at Tab A. It describes our broad-based program for dealing with immediate debt servicing problems through interrelated and balanced efforts by borrowing governments, lending governments, international institutions, and commercial banks. In many respects, this program illustrates one of the central points you will be trying to make at the Williamsburg Summit -- that world economic recovery and improvements in international economic procedures and institutions must be pursued, not by a search for quick fixes or single-policy initiatives, but by acting steadily in several areas that reinforce one another, such as sound growth policies which strengthen the ability of Summit countries to reverse protectionist restrictions, thus permitting indebted LDCs to export more and thereby to maintain their imports which, in turn, are our exports and hence help to reinforce our recovery.

At the same time, as you know, we have called an initial joint meeting of the Trade and Finance Ministers of the Summit countries for May 10-11. This is an ad hoc, informal effort to address the relationship of trade and financial issues. If it succeeds, further meetings may be called to include other key industrial countries and also developing countries. This process could begin to focus on some longer-term improvements in

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BY dh NARA DATE 12/18/2019

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the international trade and financial system, particularly means for dealing with the long-term aspects of the debt problem. It will also help to reinforce confidence in the short-term that our strategy is taking longer-term issues into account and not merely anticipating that renewed growth will solve all problems.

Recommendation

OK	No	
______	______	That you read the background paper at Tab A before our meeting on April 22 at 2:00 p.m.

Attachment
Tab A - Background Paper

Prepared by:
Henry R. Nau

~~LIMITED OFFICIAL USE--ENTIRE~~ TEXT

Debt and Finance

Background

In order to foster a favorable long-run climate for developing countries (LDCs) and for developed countries as well, LDCs accumulation of debt should not exceed a sustainable pace.

- Many LDCs need to undertake strong adjustment measures in order to reduce external imbalances.

- But foreign lending should not decline abruptly, as that would force a disruptive adjustment process and impose strain on the international financial and trading system.

- It is crucial that significant problems be dealt with quickly, in a multilateral context, in order to maintain confidence--both confidence of private lenders in the ability of borrowers to service their debt over the longer run, and public confidence in the private lending institutions which have significant exposure in these countries.

Private bank lending is the major element of financing for LDCs in the aggregate, but most of the borrowing is accounted for by the largest, more advanced LDCs.

- Our primary concerns are Mexico, Brazil and Argentina, all of whom have encountered difficulty in renewing maturing credits and obtaining net additional funds.

- Similar concerns have arisen over Eastern European countries (Poland, Romania and Yugoslavia), which are relatively more important for European countries' banks than for U.S. banks.

In addition, there are a number of acute debt problem cases in smaller countries, principally in Africa and other parts of Latin America, where official creditors as well as private creditors are involved in rescheduling exercises. (Official creditors are involved as well in the Eastern European countries mentioned, but have relatively smaller shares than the banks.)

Total private bank claims on non-OPEC LDCs amount to about $270 billion (mid-1982), but the rate of growth in 1982 and 1983 may be under 10 percent as contrasted with growth rates exceeding 20 percent in preceding years.

° The deceleration has been abrupt, reflecting a more or less normal increase in the first half of 1982 followed by no growth--and in some important cases such as Mexico an actual decrease in outstanding loans--in the third quarter.

° There was probably only modest net lending in the fourth quarter (data are not available).

° This deceleration both reflects a perceived decline of LDC creditworthiness and to some degree is the cause of the liquidity problems that have emerged.

Current U.S. Appproach

The U.S.G. has adopted a five part strategy aimed at both resolving the immediate debt servicing problems of key debtor countries and laying the basis for longer term restoration of stability.

° First and foremost is the need for LDCs with present and prospective liquidity problems to undertake prompt and effective adjustment.

° Generally, this adjustment will take place in the context of an IMF agreement, and thus another key element in the strategy is the availability of sufficient financing from the IMF, and other official lenders.

° A demonstrated will by governments to cooperate by providing in limited instances very short-term assistance while a country is formulating and implementing an adjustment program is also important.

° Because the scale of the problem precludes sole reliance on official lenders and because of the need to ensure burden sharing between banks and governments, if only to avoid charges of a "bail out", it is necessary to encourage banks to continue providing net new lending flows, albeit at a slower pace.

° Finally, it is crucial to have in place a set of economic policies in the major industrialized countries that will provide for sustainable economic growth. Adequate growth is needed to enable LDCs to adjust promptly and to counter the impetus to protectionist sentiment in developed countries which will be associated with that adjustment. But this growth should not be attained through excessively stimulative policies, or it will not last--and the resulting renewed global stagnation would bring even worse debt problems.

Current U.S. and International Efforts

The international debt situation is being reviewed within the U.S.G. under the auspices of the SIG-IEP.

° A study has been mandated by the President (NSSD-3), and the response is near completion.

° The debt problem and related matters have also been discussed in various international fora such as the Group of Ten.

° Legislation to authorize and appropriate funds for U.S. participation in the recently negotiated increase in IMF quotas and to appropriate funds for an expanded GAB was introduced in early March.

° The Administration is giving the legislation high priority, and it has been favorably reported by the Senate Foreign Relations Committee.

Department of the Treasury
April 19, 1983

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THE WHITE HOUSE

WASHINGTON

~~CONFIDENTIAL~~

April 21, 1983

MEMORANDUM FOR THE WHITE HOUSE SUMMIT GROUP

SUBJECT: Give-and-Take Session with the President -- April 22, 1983, 2:00 P.M., Cabinet Room

Attached is the background paper sent to the President for the give-and-take session on Summit issues, April 22, 1983, at 2:00 P.M., Cabinet Room.

Bill

William P. Clark

Attachment
Tab A - Background Paper

cc: The Vice President
George Shultz
Donald Regan
Martin Feldstein
Edwin Meese
James Baker
Michael Deaver
Beryl Sprinkel
Allen Wallis
David Gergen
Edwin Harper
Craig Fuller
Richard Darman
Michael McManus
Charles Tyson
Henry Nau

DECLASSIFIED
Sec.3.4(b), E.O. 12958, as amended
White House Guidelines, Sept. 11, 2006
BY NARA dw, DATE 10/18/2019

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Declassify on: OADR

CONFIDENTIAL

TAB A

~~LIMITED OFFICIAL USE--ENTIRE TEXT~~

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Department of the Treasury
April 19, 1983

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ab 12/18/2015

THE WHITE HOUSE

WASHINGTON

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April 13, 1983

MEMORANDUM FOR THE SUMMIT WHITE HOUSE GROUP

FROM: WILLIAM P. CLARK wpc

SUBJECT: Give-and-Take Session and Overall Review of Summit Issues -- Thursday, April 14, 1983 1:00 p.m., Cabint Room

The Summit White House Group will meet with the President on Thursday, April 14, at 1:00 p.m. in the Cabinet Room for a give-and-take session on trade, and a review of overall Summit issues before the next preparatory meeting this weekend in Williamsburg. The agenda and papers for the meeting are attached.

Attachments

cc: E. Meese
J. Baker
D. Regan
W. Brock
M. Feldstein
M. McManus
E. Harper
R. Darman
C. Fuller
D. Gergen
A. Wallis
B. Sprinkel
R. McFarlane
H. Nau

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AGENDA

SUMMIT WHITE HOUSE GROUP MEETING

April 14, 1983

1:00 P.M., Cabinet Room

1. Overview of Strategy for Williamsburg Preparatory Meeting (Review of our issues; issues others are raising).

   Allen Wallis

2. Give-and-Take Session on Trade Issues and Trade/Debt/ Finance Initiatives at the Summit.

   .. Attached at Tab A is Background Paper on Trade.
   .. Attached at Tab B is a Strategy Memo on Trade/ Debt/Finance Issues.

   William Brock
   Donald Regan

3. Revised Summit Schedule and Administration

   Mike McManus

4. Status of Pre-Summit Bilaterals

   Henry Nau

TAB A

THE UNITED STATES TRADE REPRESENTATIVE
WASHINGTON
20506

April 12, 1983

MEMORANDUM FOR THE PRESIDENT

FROM: WILLIAM E. BROCK

Expansion of Trade:

Expanded trade made possible by the removal of trade barriers through successive rounds of negotiations especially in manufactures (average tariffs down from over 50% to less than 5%) has been a major source of U.S. and global economic growth over the past 35 years. World trade increased from $155 billion in 1952 to $1.8 trillion today, an average growth of 8.2 percent per year. World GNP grew more slowly. Adjusted for inflation, since 1960, world trade in real terms grew 6.0 percent, while the growth in real production of goods averaged 4.4 percent.

System Under Stress:

Today's system is under stress due to economic recession, longer-term structural adjustment problems in basic industries such as textiles, steel, autos, and agriculture, and the growing difficulty of major developing countries to service their external debt. An increase in import restrictions now threatens to undermine our efforts to achieve global economic recovery. In 1982 world trade declined by 6 percent, our exports to developing countries declined by 7 percent (from $89 billion in 1981 to $82.7 billion in 1982). Our exports to Latin America, where debt is large and problems severe, declined by 22 percent.

New Restrictions:

Despite a continuing commitment by the leaders of most major developed countries to the ideal of an open trading system, most countries have found it necessary to restrict imports directly by quotas and escape clause actions or by manipulating non-tariff barriers, including domestic, industrial, tax and other policies. LDCs under the weight of their debt burdens have particularly increased import restrictions. Restrictions now cover a substantial portion of world trade in goods like textiles, autos, steel, television sets, video recorders, semiconductor chips, machine tools and footwear.

The most subtle restrictions take the form of more government intervention through subsidies, preferential regulatory treatment and other means to support industries. Our inability to curb these distortive practices through agreed international trading rules has helped create growing domestic frustration and tension that is fostering protectionist sentiment. Americans are growing increasingly resentful of practices like EC agricultural export subsidies, Japanese industrial targeting practices and widespread subsidization of exports by developing countries.

Consequences for Recovery:

New trade restrictions and increased domestic intervention by our major trading partners in their own economies is likely to slow world economic recovery. If current tensions with our OECD trading partners spill over, provoking further increases in protection, or if financial and trade problems lead to further increases in barriers to trade between developing and developed countries, the threat to world economic recovery could be extremely serious.

Cutback in U.S. Exports:

North/South trade problems are of particular concern. In recent years, our exports to developing countries grew the fastest, and now account for 39 percent of our exports (more than the EC and Japan combined). But last year in the wake of the debt problems our exports to key Latin American debtor countries declined (by 36 percent to Mexico, 10 percent to Brazil, and 40 percent to Argentina). Overall, the decline in U.S. exports to Latin America was $8.9 billion, which translated into a loss of over 200,000 American jobs. Simultaneously, developing countries exports have fallen because of the economic recession and of increasing trade barriers in developed countries. Developing debtor countries that must now devote large proportions of their foreign exchange earnings to service their debt (59 percent for Mexico, 67 percent for Brazil, 88 percent for Argentina), are finding it increasingly difficult to import necessities and to service their debt obligations.

In the short-term developing countries need financial help to sustain essential imports, such as that provided by the recently agreed increases in IMF resources. In the long run the only solution to the debt problem is increased capacity to export. Hence trade and finance are interrelated as the basic guarantees of world economic stability.

Challenge to the U.S.:

Our challenge now is to halt the trend toward more trade restrictions and to establish firm commitments to the dismantling of recent restrictions and other forms of government intervention as renewed economic growth takes hold. Unless the current trend is reversed, world economic recovery will be weak, and could be aborted altogether.

GATT Ministerial:

We made a major effort last fall, during the meeting of the GATT Trade Ministers, to reverse current negative trends and to achieve agreement on a new set of goals for the future. In particular, we proposed that Trade Ministers commit themselves to avoid new import restrictions and to roll back existing trade restrictions and distortions which were inconsistent with trade rules. We also proposed that the GATT begin to focus on new forms of government intervention that distort trade, particularly in areas with the greatest growth opportunities such as high technology trade and trade in services. We achieved some of our objectives, and we did not slip backwards; but the results fell short of what we sought and perhaps short of what we will need.

Views of Other Summit Countries

- Germany is likely to be the most supportive of our efforts. Kohl's support is critical. The recent realignment of European exchange rates may have given Kohl some leverage to secure strong EC support against protectionism.

- Britain is relatively supportive but somewhat passive. Thatcher is less inclined to push for free markets than we are.

- France (with Italy trailing along) is likely to strongly resist statements that would commit them to open their markets. They may emphasize the importance of the ongoing dialogue with the LDCs. Mitterand believes an open trading system is only possible in an environment of fixed exchange rates.

- Nakasone is supportive of freer trade but lacks credibility. The Japanese are feeling defensive and are likely to try to deflect EC and US criticisms regarding access to their market. Japan also has political problems at home that will make it difficult for them to accommodate LDC demands.

- Trudeau is likely to be helpful but unenthusiastic. Canada is hesitant about accepting more LDC exports given its own production and unemployment problems.

- The EC Commission does not seem to be in a liberalizing mood. It is slow to develop common positions and hesitant to change them.

Relationship of Growth, Trade and Debt:

One reason that the results of the GATT Ministerial meeting was disappointing is that the Trade Ministers' ability to keep markets open is strongly dependent on economic growth and international financial confidence. Similarly, economic recovery and successful handling of international financial problems are now strongly dependent on our ability to keep world markets open for expanded trade. Since overall responsibility for these policy areas comes together only at the top level of governments, the Summit has a key role to play in bringing the interrelationships into clearer focus, and establishing the basis for coordinated commitments in each of these areas.

Williamsburg Summit:

It would be unrealistic to expect the Summit to bridge many of the deepseated differences that prevented last fall's meeting of the GATT Trade Ministers from being more successful. But, the Summit can establish a clearer understanding of the interrelationships between international trade and other policy areas, and a greater degree of consensus that open trade, investment and financial policies must go hand in hand with macroeconomic policies aimed at non-inflationary growth. The Summit could also boost closer working relationships among trade, monetary and macroeconomic officials. We expect that such closer working relationships would help us persuade other countries to adopt more open trade policies.

TAB B

UNDER SECRETARY OF STATE
FOR ECONOMIC AFFAIRS
WASHINGTON

~~CONFIDENTIAL~~

April 5, 1983

MEMORANDUM FOR: William P. Clark
National Security Advisor

Michael Deaver
Assistant to the President and
Deputy Chief of Staff

SUBJECT: Trade/Finance and North/South Issues at the Summit

The President has decided that we should organize our discussions at the Summit around three central themes: 1) Economic policy; 2) Trade, debt and finance; and 3) East-West economic relations. This memorandum deals with the second of these areas.

The President and his counterparts at Williamsburg could make significant contributions in the trade, debt and finance area. On a procedural level, it would be a major accomplishment if we could achieve better coordination between trade and finance issues by endorsing ongoing, joint meetings between trade and finance officials. On a substantive level, it would be a major step forward if the Summit leaders suggested the desirability of trade liberalization negotiations between developed and developing countries as a critical avenue toward ensuring increasing trade and the long-term ability of the developing countries to meet their debt obligations. If we are to take these steps, however, we must rapidly lay the groundwork with the other Personal Representatives and, for the second initiative, bring key members of Congress on board.

The attached paper describes these proposals in more detail. We need the President's approval of the proposals and his okay to proceed with preliminary consultations with key members of Congress. I would hope we could discuss these proposals with him at a meeting next week before we go to the next Summit preparatory meeting in Williamsburg on April 15-17.

Approve ______________ Disapprove ______________

Allen Wallis
Allen Wallis

Attachment:
As Stated.

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DECL: OADR

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BY dls NARA DATE 12/18/2019

Trade and Finance Ministers Meetings

On the basis of the President's instructions, the Sherpas explored at their planning session in San Diego both the procedural and substantive initiatives. Reactions were guarded. The Sherpa meeting on 16-17 April will give us a better reading. In the meantime, Treasury Under Secretary Sprinkel has contacted his G-7 counterparts to indicate that we would like to discuss the trade/finance relationships at the G-5 and G-7 meetings on 29 and 30 April scheduled after the IMF/IBRD Development Committee meeting. Ambassador Brock and Deputy USTR Smith are trying to arrange a meeting of Summit country Trade Ministers in Brussels on 27-28 April to discuss the trade/finance relationship. Prior to these meetings, Don Regan and Bill Brock will have issued invitations for a joint meeting of Trade and Finance Ministers on May 10 and 11. Invitations would go to the G-7 countries, the EC Commission and IMF Managing Director deLarosiere, GATT Director-General Dunkel and OECD Secretary-General VanLennep. These meetings will let us know how much support we can expect for possible Summit initiatives in the trade, debt and finance area. Although we may wish to push ahead on these initiatives in any event because they would put the President in a strong leadership position, the reactions of the other Summit countries will help the President decide whether, how hard, and how fast to press.

The reasons for trying to organize joint meetings of Trade and Finance Ministers is to address the interrelationship of international trade and financial issues that have become critical to growth and stability in the world economy. If the exploratory meetings are successful, Summit leaders would endorse continued meetings which would, over time, be enlarged to include other key OECD and developing countries. The ultimate objective is to improve coordination among macroeconomic, financial and trade policies, on one hand and the working relationship between the existing international trade and monetary institutions on the other, in order to assure better management of stresses in the international economy. It would also put us in a better position to oppose proposals by the developing countries that would challenge, displace, or disrupt our existing institutional arrangements. The system of international economic management needs to evolve to meet today's challenges, but should not be junked in favor of a new system.

The debt situation, the global recession, and the slowdown in trade have brought the relationship between trade and finance issues into sharper focus. It is clear that the availability of adequate financing tied to sound domestic adjustment is necessary to preserve the short-term ability of LDC's to import. In other words, without continued external finance, LDC imports will continue to fall in the months to come. In the longer term, the key is the ability of the LDCs to export. Otherwise they will not be able to generate enough foreign exchange both to meet their debt obligations and sustain a rising level of imports essential to their economic growth and helpful to our own. Joint meetings between trade and finance officials will help assure closer cooperation and coordination of their efforts.

Trade Relations Between Developed and Developing Countries

One area in which trade/finance cooperation is vital is the short- and long-term management of the trade/debt problem of developing countries. To this end, the President has repeatedly stressed the importance of trade in the development process. At Cancun he committed himself to renew the Generalized System of Preferences (GSP) which provides LDCs with preferential access for many of their products to our market. He has proposed a Caribbean Basin Initiative (CBI) as a way to provide still greater access to our markets for our Caribbean neighbors. To complement these two initiatives the United States last year floated the idea of new North-South trade negotiations. In such negotiations, developed countries would agree to improve preferential access for LDC products in their markets, in exchange for commitments by developing countries to limit and to reduce their trade barriers.

Although the North-South idea did not fly at the GATT Ministerial, the aggravated debt situation has made it more crucial that a breakthrough on North-South trade openness be achieved. While it is thus more important than ever that developed countries keep open their markets to permit LDCs to service their debts, some developed countries (including the U.S.) will find it politically more difficult unless LDCs make reciprocal market access commitments.

It would be an extremely important breakthrough if the President in connection with the Summit could secure endorsement of the idea of North-South negotiations. This would represent a strong demonstration of our concern and would put us in a very favorable posture just before UNCTAD VI convenes in June. Moving forward with a positive U.S./Summit proposal for helping the developing countries with their trade and debt problems would take us off the defensive and might help to defuse the rhetoric from UNCTAD. Securing endorsement of the idea of North-South negotiations at the Summit will also help us eventually to win Congressional approval of this idea, since Congress will not want the U.S. to negotiate trade liberalization with LDCs if the other Summit countries do not participate.

It is essential that we have not only our Summit partners, but also the Congress on board before proceeding too far. New negotiations will require Congressional authorization. With trade as controversial as it is on the Hill, it is essential that we have a good understanding with key legislators and staff on both sides about the utility and importance of moving toward new negotiations with the developing countries. We also need to make clear to all those concerned that such negotiations would be complementary to GSP and CBI. We will demonstrate this by bringing the GSP renewal to the Hill before the Summit. We may also make another push for CBI by then. We believe that we will need to initiate consultations with the Congress in the very near future, in order to be sure that we have Congressional support before we get the President too far out in front. It is vital that the President not be undercut by his own Congress. We do not want to initiate such consultation, however, until the President has agreed that we should proceed.

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THE WHITE HOUSE

WASHINGTON

ACTION

April 7, 1983

DECLASSIFIED
Authority NSC Waiver
BY dw NARA DATE 12/18/2019

MEMORANDUM FOR THE PRESIDENT

FROM: WILLIAM P. CLARK

SUBJECT: Give-and-Take Session on Summit Issues
Friday, April 8, 1983 -- 2:00 p.m., Cabinet Room

Issue

This is the third of your give-and-take sessions on Summit issues. The first reviewed the economic policies and prospects of other Summit countries, the second dealt with the search for discipline and compatibility in the alignment of domestic economic policies of the major currency (Summit) countries, and the third now deals with exchange market intervention.

Discussion

The issue of exchange market intervention is closely related to the search for discipline and complementarity in the relationship of domestic economic policies among the principal currency countries. The Europeans, particularly the French and Italians, see the commitment to intervene to maintain a fixed exchange rate or a target zone for exchange rates as the means to force domestic policy changes and greater discipline. The experience of the European Monetary Community (EMS) suggests, however, that what often results is not domestic policy change, but exchange rate adjustments. The U.S. and to a lesser extent, Britain and Canada, believe that better alignment of domestic economic policies around the common objectives of low inflation and sustained growth is a prerequisite for maintaining fixed exchange rates. If the political and economic prospects of such alignment are not present, intervention simply delays exchange rate adjustments and avoids altogether domestic policy changes.

Treasury has prepared the background papers. At Tab A is a summary of the basic issues. At Tab B is a more detailed explanation of the issues, including a one-page description at the end of the European Monetary System. This is a lot of reading, but the issues are complex and will figure centrally in your discussions with other heads at Williamsburg.

Recommendation

OK	No	
____	____	That you read the papers at Tab A and B before our meeting at 2:00 p.m., April 8, 1983.

Attachments
Tab A - Talking Points on Exchange Rates and Intervention
Tab B - Background on Foreign Exchange Rates/Intervention

Summary of Exchange Rates and Intervention

1. Exchange rate policy, like trade policy and East-West relations, has been an area of continuing tension and discussion between the United States and other Summit countries.

-- The U.S. shift to a minimal exchange market intervention policy in early 1981 brought protests from our allies.

2. At Versailles, we started two initiatives to help resolve tensions over this issue:

-- Multilateral surveillance process, aimed at getting greater exchange rate stability through policy convergence; and

-- Intervention study, the first really comprehensive look any of us have taken at how effective exchange market intervention by all of the Summit countries has really been during the decade of floating exchange rates.

3. Intervention study concludes basically:

-- that economic convergence is a precondition for greater exchange rate stability;

-- that while intervention can have a modest short-run impact on rates, other policy measures are necessary for more powerful and lasting impact; and

-- that "coordinated" intervention by two or more countries is more powerful than intervention by just one country (but even in this case underlying policies have to be moving in the right direction for it to work).

4. These conclusions are basically consistent with U.S. policy approach to date of intervening only very modestly and infrequently to counter market "disorder".

-- They reaffirm the validity of our basic reliance on markets to guide exchange rates, and on economic policy convergence as the key to getting greater exchange rate stability.

5. Despite broad acceptance of these points, varying views on intervention, and varying degrees of emphasis among our Summit partners:

-- French and Italians tend to advocate frequent, large-scale intervention with a view to substantial management of exchange rates. Basically they would like others to help them protect their chronically weak currencies -- a losing bet.

-- Germans and Japanese would like U.S. to intervene at times to support their goals (which are not always very clear, and which change), but do not support heavy exchange rate "management" through intervention.

-- Canadians and British do not think intervention itself is very important, and have been least vocal in urging U.S. intervention.

-- However, common thread is that some greater U.S. willingness to intervene would help settle market psychology, avoid extreme market reactions to economic or political developments.

6. On operational-type questions, although we cannot see enough benefit for ourselves in more active intervention to overcome its drawbacks, some others would like us to join in "coordinated" intervention.

-- Would be easiest on bilateral basis, as has been suggested by Japanese in past.

-- But can affect exchange rates of third countries. (For instance, if we support DM, could weaken French franc. Could create EMS tensions, and anger the French.)

-- Thus support, especially by Europeans, for "multilateral coordination." Major problems, substantive and logistical:

° Would have to involve formation of common view of fairly large number of countries on rate levels or movements.

° "Coordination" among 6 or 7 countries on an operational, day-to-day basis, would be a logistical impossibility.

° Could lead to regular and systematic intervention at potentially sizeable taxpayer cost.

7. In light of basic substance, wide range of other countries' views, and varying degrees to which they want more U.S. intervention, would propose the following U.S. approach on complex of intervention/macroeconomic policy issues:

-- First, major emphasis on macroeconomic consultations, surveillance, sound policy, as route to greater exchange rate stability. Push for progress in strengthening multilateral surveillance at Summit, as discussed you at the last give and take session.

-- Second, no major change in U.S. philosophy and approach on intervention.

-- Third, however, indication of:

- greater U.S. understanding of others' exchange market concerns and policies;
- U.S. willingness to avoid divisive public comments on intervention (assuming others do likewise); and
- possibly greater U.S. preparedness to enter markets promptly, though on modest scale and infrequently, in instances of market disorder.

8. As practical matter, U.S. would not expect to intervene frequently, in size, or in currencies other than DM or yen. Specifics would be discussed bilaterally with Germany and Japan; and care would be needed to avoid being drawn in to regularized, large-scale intervention.

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Background on Foreign Exchange Rates and Intervention Policy

Exchange rate policy, like trade policy and East-West relations, has been an area of continuing tension and discussion between the United States and other Summit countries.

- The U.S. shift to a minimal exchange market intervention policy in early 1981 brought protests from our allies. We have gone a long way since then toward reaching common understandings and defusing tensions over this issue.

- Still differences remain, both on intervention in a narrow sense (where most others would like us to be more active), and on broader exchange rate issues, where some would like us to be willing to change our monetary and fiscal policies to influence exchange rates.

A. Current U.S. Intervention Policy and its Rationale

Prior to the Reagan Administration taking office in January 1981, the United States intervened frequently in the exchange markets. Authorities bought and sold foreign exchange in the market -- sometimes in very large amounts -- in an effort to change the trend in the dollar exchange rate; to counter perceived disorder in the market; or to build up foreign exchange reserves for future intervention. For example:

- From the beginning of 1978 to September, 1979, the Treasury and Federal Reserve made net sales of about $8.5 billion worth of German marks in the exchange market in an effort to moderate the rise of the mark against the dollar. Yet by the end of September 1979, the mark exchange rate had risen to 1.74 per dollar from 2.11 per dollar at the end of 1977 -- a rise of 21 percent. The dollar only began a lasting recovery against mark after the Federal Reserve announced a package of monetary control measures in October 1979.

- Similarly, from October 1980 to the end of February 1981, the U.S. bought $6.9 billion worth of German marks, in part to cushion the fall of the mark against the dollar and in part to build up U.S. foreign exchange reserves. Over this period the mark nonetheless fell by 15 percent against the dollar.

When this Administration took office, the Treasury initiated a review of exchange market policy. As a result of that review, it was concluded that potential gains from exchange market intervention were outweighed by the costs, and that the new intervention policy

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would be a minimalist one. The only goal of intervention would be to counter severely "disorderly" exchange markets. Since March of 1981, that policy has been followed.

Under the Bretton Woods system, maintaining fixed exchange rates constrained each country's freedom to have an independent monetary policy. Flexible rates have increased the possibility of independent policies, but only if governments are willing to accept the exchange rate consequences of differing policies. The choice of exchange rate regime is partly a political one, but in any regime stable exchange rates are fundamentally only a by-product of stable and convergent economic policies and performance.

Even though successive Summit communiques have stressed harmonization, over the last decade economic policies were too divergent, and the world economic environment too turbulent, to make stable exchange rates possible. We have been working actively with our Summit partners (particularly through the multilateral surveillance process agreed at Versailles) to get them to adopt sound economic policies necessary for sustainable non-inflationary growth -- and thereby to also set the stage for greater exchange market stability.

Exchange market intervention has not proved capable of resisting the exchange rate movements caused by differing economic policies. While intervention can impact on exchange rates, its effects are small and short-lived, since exchange markets are sophisticated and are far larger than the resources governments have available to manipulate them. It is possible for governments to alter exchange rate behavior in a significant and lasting way if they do not like current exchange rates -- but to do so they must make the necessary changes in their economic policies (including monetary policy) to eliminate major differences. Attempts to reconcile existing economic policies with a different exchange rate path through intervention alone do not work.

B. <u>State of Play on Versailles Initiatives</u>

At the last Economic Summit, in Versailles, we initiated two measures to help resolve the exchange rate policy debate:

- <u>Multilateral Surveillance</u>. Last year at Versailles, the Summit countries reaffirmed the understanding reached at the Rambouillet Summit in 1975, that better convergence in the underlying economic policies and performance in the major trading nations is necessary to achieve greater exchange market stability. All pledged to pursue policies designed to foster a convergence toward sustainable, non-inflationary growth, as the primary means of attaining more stable exchange rates. The multilateral surveillance process -- a series of frank consultations that takes place mainly among the G-5 countries and the IMF Managing Director -- was begun in the hope of hastening the convergence of economic conditions.

- Intervention Study. Even though all our Summit partners were willing to at least give lip-service to the notion that economic convergence was necessary for greater exchange rate stability, some felt that exchange market intervention could also be a powerful means of stabilizing exchange rates.

  The United States proposed that an international study be undertaken in order to take stock of the experience with foreign exchange market intervention in the decade of floating exchange rates. This study was carried out by a working group of the Summit participants and has been submitted to Finance Deputies as background to their policy discussions.

On the basis of the intervention study and the Deputies' follow-up discussions, we believe there are a number of points of general agreement on intervention and exchange rate policy:

- Economic convergence is a precondition for greater exchange market stability. The Summit countries should redouble their efforts in this area.

- Intervention can have a modest, short-run impact on exchange rates. But other policy measures are necessary to have a more powerful and lasting impact.

- Intervention cannot achieve exchange rate objectives inconsistent with the implications of underlying economic policies and world economic conditions. Large swings in exchange rates cannot be prevented in the presence of diverging economic policies and performance conditions.

The results of the intervention study have made the position of those who would use intervention in an ambitious way -- to fix or manage exchange rate levels, or to hold exchange rate levels inconsistent with the basic thrust of economic policies -- difficult to sustain. They also suggest that intervention could not succeed in maintaining a fixed exchange rate system in the absence of the necessary convergence in economic policies and performance.

- The experience of the European Monetary System (EMS) provides further evidence. (A background note on the EMS is attached.) The French, in particular, have attempted to use EMS intervention to try to hold the franc steady against the German DM at a time when France's Socialist economic policies are causing weak French economic performance, while German performance is getting stronger.

- The French have strong political reasons to want to avoid a weak franc -- it is widely regarded in Europe as a sign of the failure of Socialist policies. But economic reality has led to continuing market pressures.

° The French franc has now been devalued three times in the EMS since Mitterrand took office: by 3% in October, 1981; by 5.75% in June, 1982; and by 2.5% in March, 1983. (On each occasion the DM was also revalued, so that the effective devaluation of the French franc against the DM was larger -- 8.5% in October, 1981; 10% in June, 1982; and 8% in March, 1983.) Each of these devaluations was preceded by massive intervention to support the French franc, and by prolonged unwillingness by the French to take other policy measures. The most recent EMS realignment also included bitter public recriminations between the French and Germans.

On balance, between the time Mitterrand became a serious contender for public office in March 1981, and the most recent realignment, the French (and others supporting their efforts) made intervention purchases of nearly $28 billion equivalent to support the franc, to no avail overall.

° One can also view the recent history of the EMS as demonstrating what happens in an attempt to establish a fixed parity system before the economic conditions necessary for exchange rate stability have been established.

C. Remaining Areas of Controversy

All six of our Summit partners would like to see the United States intervene more often in exchange markets.

° Their exact positions vary importantly:

French and Italians would like frequent, large-scale intervention with a view to substantial management of exchange rate movements. They want our help in trying to defend their chronically weak currencies.

Germans and Japanese are not so ambitious, but would like us to intervene at times to support their goals (although their goals are neither clear nor constant).

Canadians and British do not think intervention itself is terribly important, and have thus been least vocal in urging U.S. intervention.

° However, their common view is that some greater willingness by the U.S. to intervene would help to "settle" exchange market psychology, and possibly therefore to avoid some "extreme" market reactions to economic or political events.

U.S. Response

- The results of the study do suggest that intervention could be used for some short-term purposes; but is not clear that any of these are economically important for the United States. Also, we are concerned that government intervention can inhibit private transactions necessary for efficient and stable exchange markets, and are reluctant to risk the taxpayer's money on a dubious undertaking.

Others are also interested in the possiblity of "coordinated" intervention.

- The intervention study found that "coordinated" intervention by two or more countries could be more powerful than intervention by a single country (due to the impact on market psychology of a show of common purpose and determination). However, it is difficult both to reach detailed agreement on such a course, and to carry out the agreement; and even this type of intervention does not succeed unless underlying policies are moving in the right direction.

- "Coordination" would be easiest to accomplish if it took place between only two countries -- as has been suggested by the Japanese. However, this would require a mutual judgment that macro policies are moving in the right direction on both sides, and an agreement on what intervention was meant to accomplish. In addition, intervention to influence one bilateral rate could have unwanted effects on "cross-rates" with other currencies, and thus put us in direct conflict with our other Summit partners. (For instance intervention to support the DM against the dollar could also weaken the French franc against the DM; such intervention could thus exacerbate EMS tensions and worsen our relations with France.)

- For this and other reasons, some Summit participants insist that any intervention by the United States be coordinated in an mutlilateral framework involving all of them (France and Italy are most insistent, and the Germans are sympathetic). The practical difficulties of "coordinating" with several countries on specific exchange market operations would be such as to make this approach non-operational.

U.S. Response

- In principle, it would be possible for us to engage in somewhat more frequent intervention in support of our major allies, on a limited basis for short periods in response to significant market unrest. However, any attempt to cooperate in this way would have to carefully restricted and monitored to keep it from slipping into prolonged, large-scale intervention.

In addition, what would please some of our allies could put us in conflict with others, so that political gains from supporting one ally could be offset by political losses with others.

- All of our Summit partners (excluding the EC Commission, which has a heavily bureaucratic interest) agree that economic conditions are not presently such as to make a return to a system of fixed exchange rates or exchange rate "zones" a reasonable possibility for the foreseeable future.

- Some nevertheless feel a fixed-parity system would be a desirable goal to aim toward eventually (particularly the French and Italians). Few are dead-set against it in principle if the necessary conditions for stability emerge, but the Germans and British (at a minimum) would doubt that the necessary conditions are likely to be met.

There is more immediate interest in the possibility of trying to reach common views on exchange rate levels from time to time -- and in the event of agreement, to try to adjust economic policies accordingly. All six of our Summit partners find this idea attractive.

U.S. Reponse

In theory we could alter macro policies to pursue certain types of exchange rate goals -- for example, to weaken the dollar against all other currencies. In practice, we are constrained by at least four factors: (a) the practical difficulty of "fine-tuning" monetary and fiscal policy given the respective decision-making processes; (b) the undesirability of being perceived in markets as being willing to abandon our long-run policy course; (c) our lack of certainty about what U.S. policy changes might be necessary to affect dollar exchange rates and (d) our belief that many of the policy changes that have been suggested would have undesirable consequences.

In current circumstances, we are not as certain as many of our partners appear to be that the sole reason for a strong dollar is the fear that U.S. interest rates will be high in the future due to our budget deficits. Thus, we are not so sure that slashing the deficit would lead to a weaker dollar, although budget slashing would tend to have other desirable consequences; in addition, the means that most have suggested for doing this are large tax increases and major cuts in defense expenditures. It is likely that we could bring down the dollar eventually through a protracted spell of inflationary money growth -- but this would have undesirable longer-term consequences for both the U.S. and the rest of the world, through the resurgence of U.S. inflation and the resulting rebound in U.S. interest rates.

Strategy for Williamsburg

-- Seek reaffirmation of necessity for policy convergence as basic means of attaining greater exchange market stability; notion that intervention is not a panacea.

-- Stick to current overall philosophy and policy.

-- Different tone and nuances in implementing current U.S. policy. Convey cooperative attitude over exchange rate issues, and understanding of others' concerns. Perhaps consider standing ready to intervene slightly more often, on a very limited basis, to counter exchange market "disorder". Avoid open confrontations or disagreements with others on exchange rate issues, provided they are willing to do the same.

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The European Monetary System

The European Monetary System (EMS), is an arrangement which maintains a fixed exchange rate and intervention system for participating countries (Germany, France, Belgium, Luxembourg, Denmark, Italy, the Netherlands, Ireland). The EMS has periodically experienced severe problems since its inception in March 1979, reflected in seven currency realignments -- the most recent being March 21, 1983. The frequency with which these realignments have taken place, and the increasing difficulty in arriving at agreements acceptable to all members, particularly France and Germany, have led EMS members and outside observers to question the merits of the system.

The predecessor of the EMS -- a fixed exchange arrangement known as the "snake", initiated in April 1972 -- was plagued by similar problems. Membership in the "snake" was initially more extensive than the EMS, (including the U.K., Sweden, Norway and Denmark in addition to the current EMS members) but exchange rate pressures caused by divergent economic policies prompted members to drop out of the system. The EMS was created as a symbol of Franco-German resolve to improve cooperation in the EC. It was designed as a somewhat tighter system than the "snake" in terms of policy convergence obligations, and included expanded lending facilities.

The objective that the EMS seeks to achieve by fixing exchange rates is to create stability in rates in order to facilitate trade. The EMS members also argue that fixed rates help to induce economic policy convergence, since it is often necessary to adjust policies in order successfully to defend the fixed rate.

EMS members have failed to obtain convergence of economic policies necessary to allow for exchange rate stability and thus, parity rates have held for only limited periods of time. In the most recent realignment, countries that pursued successful anti-inflationary policies -- notably Germany and Holland -- were forced to revalue, while France, Italy and Ireland -- relatively poor inflation performers -- devalued.

Under the EMS, countries must intervene if their currency exceeds prescribed limits against other members' currency. Prior to realignments -- as market forces act to change the rates -- massive intervention by EMS members is usually required to keep currencies within their limits. Intervention, used in this way, has only delayed inevitable adjustments in exchange rates and fundamental economic policies, and contributed to volatile speculative flows of capital which have disrupted the exchange markets. For example, France alone spent $7.4 billion of its reserves in support of the French franc from the beginning of 1983 until the latest realignment. Despite this, the French franc was effectively devalued by 8 percent against the German mark and the Government of France was forced to enact new economic austerity measures to calm the exchange markets.