WHORM Subject File Code: FO006-06 (Economic Summit, Williamsburg, Virginia, 05/29/1983-05/30/1983)
Case file Number(s): 145282 (9 of 10)

#90410

THE WHITE HOUSE
WASHINGTON

April 1, 1983

Mr. Darman:

Copy will be given to the
President on the aircraft.
Original attached.

Per Admiral Poindexter.

SYSTEM II
90410

THE WHITE HOUSE

WASHINGTON

ACTION

March 31, 1983

MEMORANDUM FOR THE PRESIDENT

FROM: WILLIAM P. CLARK

SUBJECT: Give-and-Take Session on Summit Issues, Monday, April 4, 1983 - 2:30 p.m., Oval Office

Issue

This is the second of a series of give-and-take sessions on Summit issues. The first one dealt with economic policies and prospects of the other Summit countries. The second one deals with the search for discipline and compatibility among the domestic economic policies of the major industrialized (currency) countries. In many respects, this issue constitutes the core problem of the international economic and monetary system, whether that system is based on the gold standard, fixed or floating exchange rates.

Discussion

Don Regan has provided you with two background papers. At the last give-and-take session, you expressed an interest in the pattern of interest rate developments among the Summit countries since your Administration took office. Tab A provides a brief analysis and charts showing this pattern.

At Tab B is the background paper for your session on Monday, April 4. Several points should be highlighted:

- The discussion of the international monetary system in historical perspective (pp. 1-2) makes clear that although the gold standard system exerted strong discipline over national economic policies, even this system failed when countries were unwilling to accept this discipline and maintain complementary economic policies aimed at low inflation and sustainable growth.

- The loss of discipline in U.S. policy in the late 1960s was the root cause of the demise of the fixed exchange rate system established at Bretton Woods. All of this occurred before the first oil shock of fall 1973.

-- The French have been the strongest advocates of going back to a fixed rate exchange system, yet ironically are one of the countries least willing to maintain disciplined domestic policies necessary to assure exchange rate stability.

-- The multilateral surveillance initiative which we proposed and which was agreed to at the Versailles Summit has the great virtue of addressing the core problem of the international monetary system, namely discipline and complementarity among the domestic economic policies of the major industrialized countries (which are also the major currency countries) aimed at low inflation and sustainable growth.

-- Strengthening this initiative at Williamsburg is timely because it will reinforce the success of anti-inflation policies just as the economic situation begins to improve -- precisely the point in the past when the emphasis on fighting inflation has been lost.

-- If the Summit countries cannot make progress on this core problem of discipline and convergence of their economic policies toward low inflation and sustainable growth, other steps -- exchange market intervention, going back to fixed exchange rates or even restoring the gold standard -- cannot make any difference. The European Monetary System is a classic example of what happens when you try to achieve discipline through intervention or other secondary means without attacking the central problem of discipline and convergence of domestic policies around low inflation. The EMS has experienced seven realignments of exchange rates in four years, hardly a success for a so-called fixed exchange system.

RECOMMENDATION

That you read the papers at Tab A and B before our meeting on Monday and begin the meeting with your questions or observations.

Approve _____ Disapprove _____

~~CONFIDENTIAL~~

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

March 31, 1983

MEMORANDUM FOR THE PRESIDENT

Subject: Interest Rates in the Summit Countries

Following up on our discussion last Friday of economic conditions in the Summit countries, George Shultz suggested that we prepare charts on interest rate developments since your Administration took office. Two charts are attached. The first shows percentage changes in short-term rates since January 1981; the second shows short-term interest rate levels since the same date. In sum:

-- Interest rates have fallen sharply in the group of countries that has pursued successful anti-inflation policies. U.S. rates have been cut in half, from 18 percent to 9 percent. U.K., German and Japanese rates have fallen by between 2 and 6 percentage points.

-- Interest rates in France and Italy remain above their January 1981 levels (though they have been trending down over the past 1 to 1-1/2 years) and remain above rates in the other Summit countries.

-- Canada is something of a special case, in that they have broadly followed U.S. interest rate trends, maintaining a somewhat higher Canadian rate in order to attract funds and support the Canadian dollar. Since the Canadian shift toward anti-inflation policies in mid-1982, however, the difference between Canadian and U.S. rates has narrowed.

The implications are clear. The countries recording the most success on the anti-inflation front have been able to get interest rates down. The others -- France and Italy -- still face relatively high interest rates. This reflects their relatively poor inflation performance and, closely related, their efforts to use interest rates as a defense against downward exchange market pressures on their currencies.

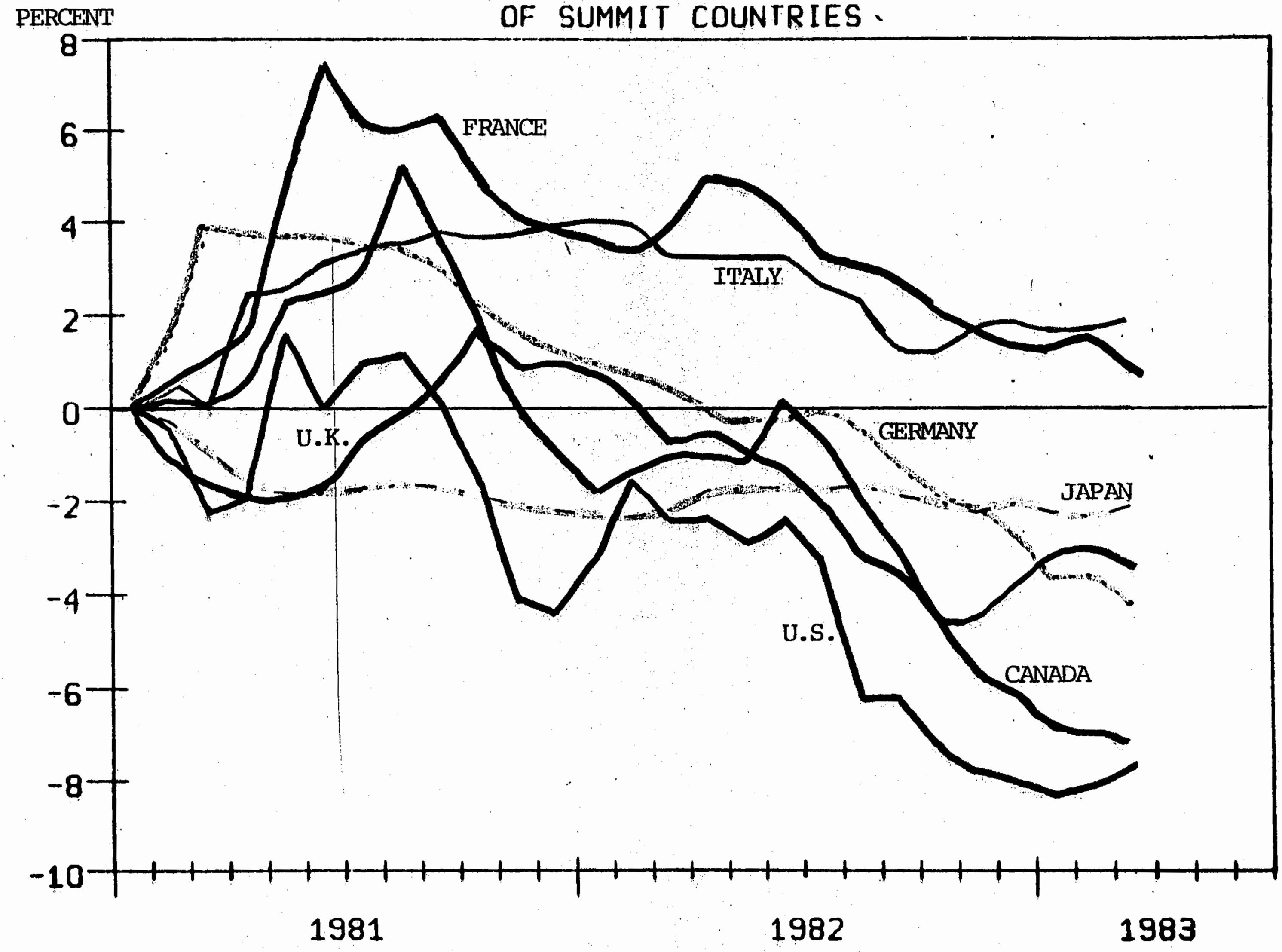
Don

Donald T. Regan

Attachments

~~CONFIDENTIAL~~

CHANGE IN SHORT-TERM INTEREST RATES
OF SUMMIT COUNTRIES



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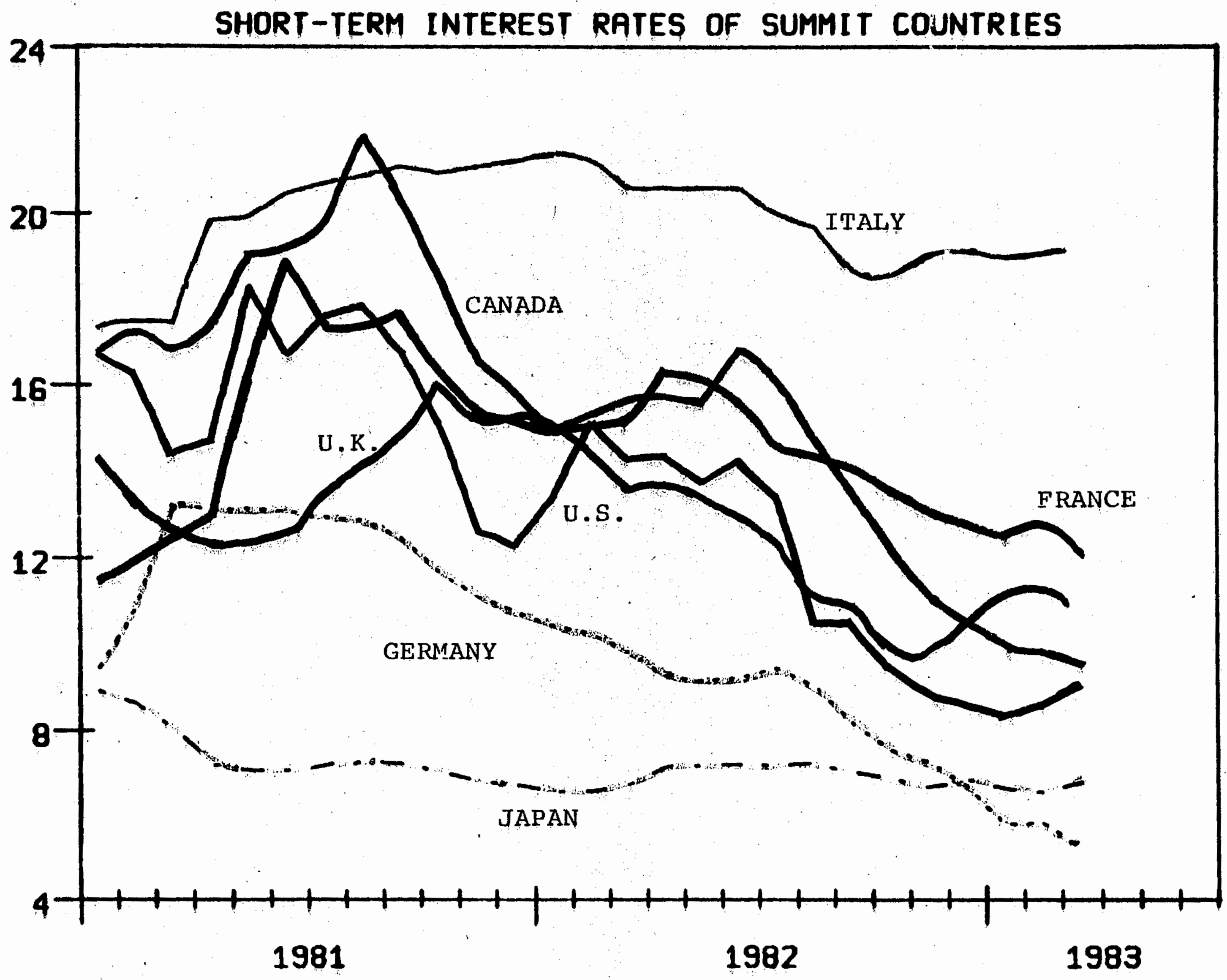

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Attached is a background paper that discusses the issue of Multilateral Surveillance. The Multilateral Surveillance initiative--the effort to get coordinated and complementary economic policies among the Summit participants--was first raised at the Versailles Summit and will be a topic of discussion at Williamsburg. This will be the subject of your next regular Williamsburg Summit preparatory briefing.

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Donald T. Regan

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Background on Multilateral Surveillance

"The Search for Discipline"

Historical Perspective

° The post-World War II fixed exchange rate system established under the Bretton Woods Agreement was preceded intermittently in the late 1800's and early 1900's by the classical gold standard. The gold standard system exerted strong discipline over national economic policies, because a country's money supply was directly linked to changes in the gold stock brought about by trade or current account imbalances. If a country's balance of payments was in deficit, an outflow of gold occurred, the money supply then declined; growth and inflation slowed until balance in external accounts was restored. It broke down because it ultimately required either deflation or inflation on a scale that national authorities would not tolerate.

° The Bretton Woods system of fixed exchange rates (par values) was not as binding; it assumed basic stability in world economic conditions; looked to countries to adjust domestic policies as needed to maintain exchange rate stability; and provided for exchange rate changes only in instances of "fundamental disequilibrium."

° Par values were defined in terms of gold. The U.S. undertook to buy and sell gold freely at the par value for the dollar, and other currencies maintained their par values by buying and selling U.S. dollars. In this way, the whole system was linked to gold.

° The system worked well in the early postwar decades, which were characterized by dominance of the U.S. economy and by general price stability in the United States and most other major countries. Exchange rate changes were frequent, but tended to be isolated to one country at a time.

° The system began to come under increasing strain in the latter 1960s.

-- The rigidity of exchange rates tended to delay or prevent changes needed to reflect evolution of countries' relative economic positions.

-- The resurgence of inflationary pressures, particularly in the United States, undermined the U.S. competitive position and led to increasing divergences of economic performance among the major nations.

-- These factors led to increasing world payments imbalances, pressures on the dollar, and ultimately to collapse of the fixed rate system.

-- The U.S. ended convertibility into gold in August 1971, and initiated negotiations on major realignments of exchange rates. After two major realignments in 1971, and early 1973, the new structure of exchange rates came under attack and could not be sustained. The period of generalized floating began in March 1973.

-- Discussions were continued during this period on the reforms of the international monetary system, focusing on reestablishment of some kind of fixed, but adjustable, exchange rate system.

-- Following the oil shock of late 1973/early 1974, which abruptly caused massive balance of payments deficits for oil importing countries, it was agreed to abandon efforts to reestablish a fixed rate system. This was motivated in part by recognition that efforts to maintain fixed rates in the face of the huge oil deficits would likely lead to an increasing spiral of protectionist steps and harsh domestic economic measures, as each country tried to improve its trade and balance of payments position -- and thus "protect" its exchange rate -- at the expense of others.

-- Subsequent discussions of the international monetary system focused on the operation of a flexible rate system, and culminated at the first Economic Summit in Rambouillet, France in 1975.

° The Rambouillet Summit understandings, later incorporated in amended IMF Articles of Agreement, reaffirmed the desirability of exchange rate stability, but recognized explicitly that the achievement of exchange rate stability depends on development of orderly underlying economic and financial conditions in the major nations.

° In essence:

-- The Bretton Woods system had attempted to exert discipline over national economic policy through the mechanism of fixed exchange rates, but had failed -- both to foster orderly economic conditions and to provide needed scope for change in response to evolution of world economic conditions.

-- The Rambouillet Summit and subsequent amendment of the IMF Articles of Agreement retained the strong emphasis on discipline, but placed responsibility directly on national economic policy-makers and gave the IMF new authority -- called "surveillance" -- to oversee the operations of the international monetary system and the compliance of its member countries with their undertakings to achieve orderly growth with reasonable price stability and to promote stability by fostering orderly underlying economic and financial conditions.

The Versailles Summit

° The IMF's surveillance provisions have developed only gradually. In the period leading up to the Versailles Summit, some countries, notably France, advocated increased governmental intervention in exchange markets as a route to greater exchange rate stability. The United States, convinced that large-scale governmental intervention in markets is neither desirable nor an effective substitute for proper economic policy:

-- proposed a study of the impact of past exchange market intervention; and

-- proposed a major strengthening of "surveillance," with the objective of fostering better convergence of economic performance among the major countries and thus providing the underlying basis for greater exchange market stability.

° In an annex to the Versailles Communique ("Statement on International Monetary Undertakings"), the Summit countries accepted joint responsibility to achieve stability in the international monetary system through better convergence of policies aimed at producing lower inflation, economic recovery and higher employment; and agreed to strengthen surveillance of economic policies.

-- The IMF's existing surveillance of countries' policies, performance and prospects tended to look at each country in isolation from others. One aim of the Summit agreement was to broaden the procedure to review a group of important countries simultaneously (multilateral surveillance) -- to compare and contrast their policies, performance and prospects; to identify which countries are moving in the "right" direction; and to determine which are "out of line" and hence likely to be subject to pressure in the exchange markets.

-- The group agreed to cooperate with the IMF, with multilateral surveillance focused primarily on the five major countries (the G-5 -- the U.S., Germany, Japan, France and the U.K.) -- in the expectation that intensified international consultations on, and examination of, policies and performance would encourage better convergence of economic conditions and thereby greater international monetary stability.

° The first meeting of G-5 finance ministers and central bank governors for this purpose was held in September 1982. IMF Managing Director de Larosiere (in his private capacity) prepared a discussion paper and participated in the exchange, giving his assessment of major policy changes needed in various countries to improve convergence.

-- Talks were frank. Pointed up policy and performance differences. Showed France as being "out of line" in medium-term policy stance and economic performance. Suggested exchange rate pressure would continue.

-- Urged all but U.K. to reduce budget deficits, and all to stick to anti-inflation thrust in policies.

° A second meeting is scheduled for late April. We expect the April talks to focus on policy differences and their near-term implications; exchange rate pressures stemming from relatively poor performance in some countries; and need for "out of line" countries to move toward others in both policies and performance if greater stability for their currencies is to be achieved.

Our Aims at Williamsburg

° We remain convinced that the lasting way to achieve greater stability in exchange rates is to move toward better convergence of economic conditions among the major economies. (This is an essential conclusion of the intervention study referred to above, although the Summit countries have varying views on the utility and desirability of shorter-term intervention. This will be the subject of a later briefing.)

° We want the Summit to reaffirm and strengthen multilateral surveillance. Specifically, we are working toward:

-- reaffirmation of the objectives of the surveillance effort;

-- elaboration of policy goals by the major countries;

-- definition by each country of the policy approaches it intends to follow to achieve its goals; and

-- establishment of agreed criteria for assessing progress.

° This approach confirms the need for discipline and underlying stability and exerts that discipline by forcing key policy-makers to specify goals and policies; to collectively consider their likely effects, including exchange rate effects; and to assess their results.

° Such an agreement at the Williamsburg Summit would represent a concrete and useful initiative in the economic policy area.

° A more upbeat economic setting at time of May Summit will also provide the opportunity to highlight the success of anti-inflation policies: a number of the Summit countries have reduced inflation substantially; recovery is already under way; conditions have been established for sustained, noninflationary growth.

-- With inflation under better control in these countries, logical to shift emphasis to sustaining growth; reaping employment gains; expecting more stable international monetary conditions.

-- Those that have succeeded in reducing inflation and building recovery can expect more stability for their currencies; exchange rate pressures will remain for those that don't get inflation under control.

Why Strengthen Surveillance?

1. In general, the countries with relatively poor performance, particularly France, have called for systematic intervention in foreign exchange markets to stabilize exchange rates. With policies and performance out of step with others, they face exchange market pressures on their currencies and want to try to force exchange rate stability through such government intervention.

2. The recent realignment of the European Monetary System -- preceeded by massive speculation, official intervention, and market disruption -- is strong evidence of the futility of intervention and of the inability of the exchange rate system to impose discipline and order.

3. Attempts to broaden the EMS-type experience, to try to deal with basic problems through market intervention, must be resisted. The debate needs to be shifted to fundamental policy approaches and problems -- including exchange market problems -- resulting from differences in approach. (Our resistance to solving exchange market problems through intervention does not apply to our commitment to intervene if necessary to counter serious episodes of exchange market disorder in fulfillment of our IMF Article IV obligations.)

4. Strengthening "surveillance" provides a desirable alternative to expensive -- and ultimately fruitless -- exchange market intervention. The only way to obtain meaningful and lasting exchange market stability is through convergence of policies and performance, and that is where the focus of our efforts should be.

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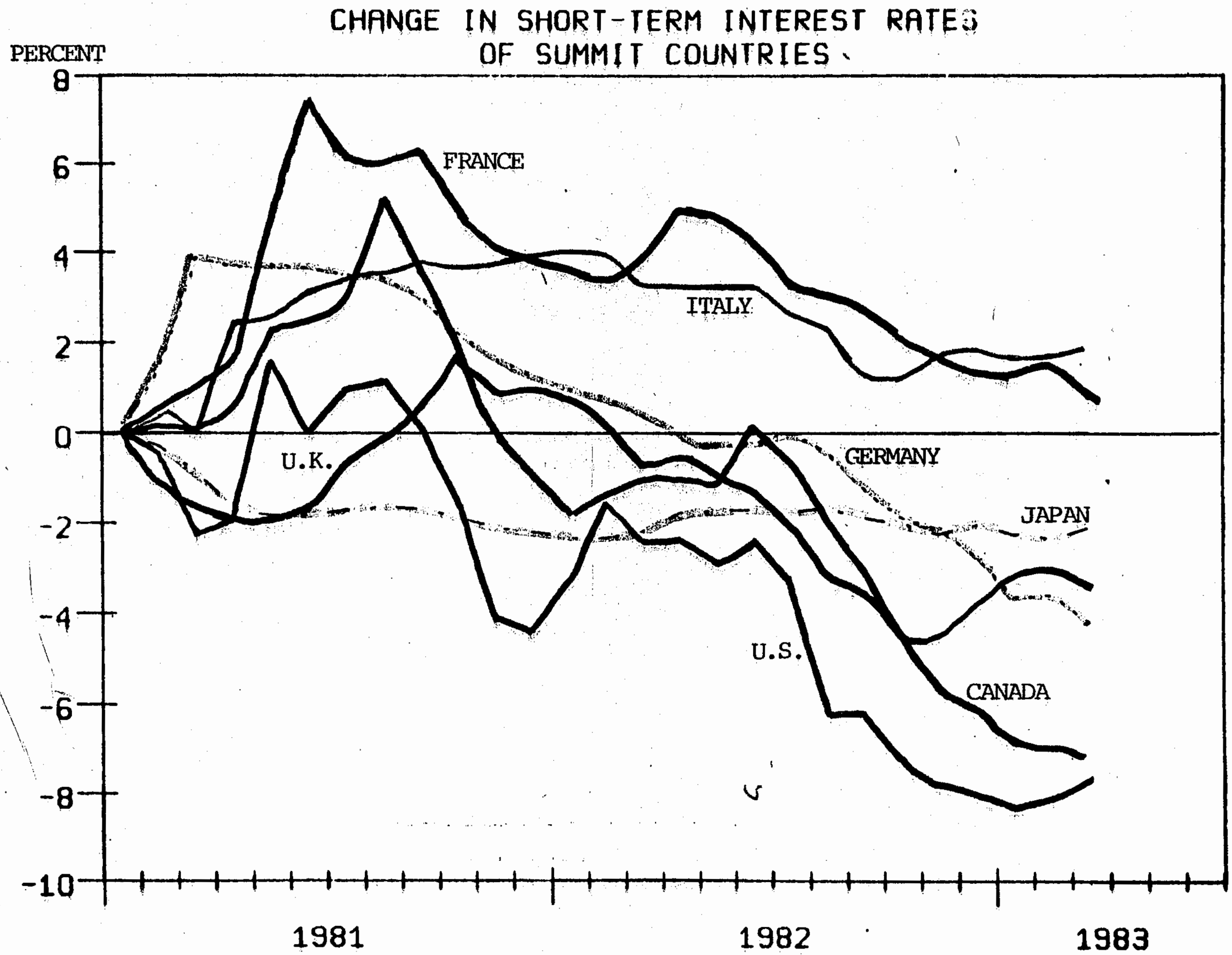

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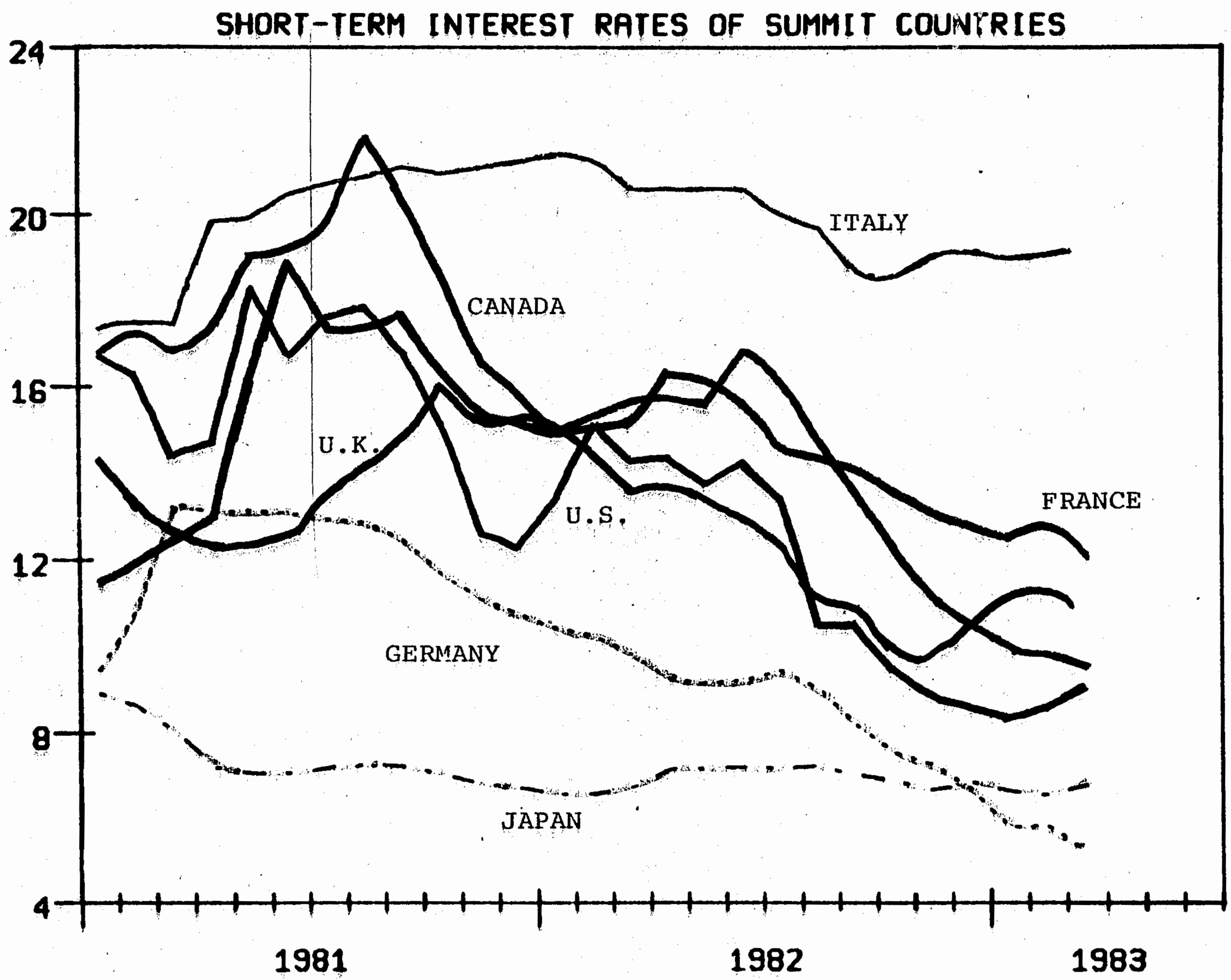

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file economic summit

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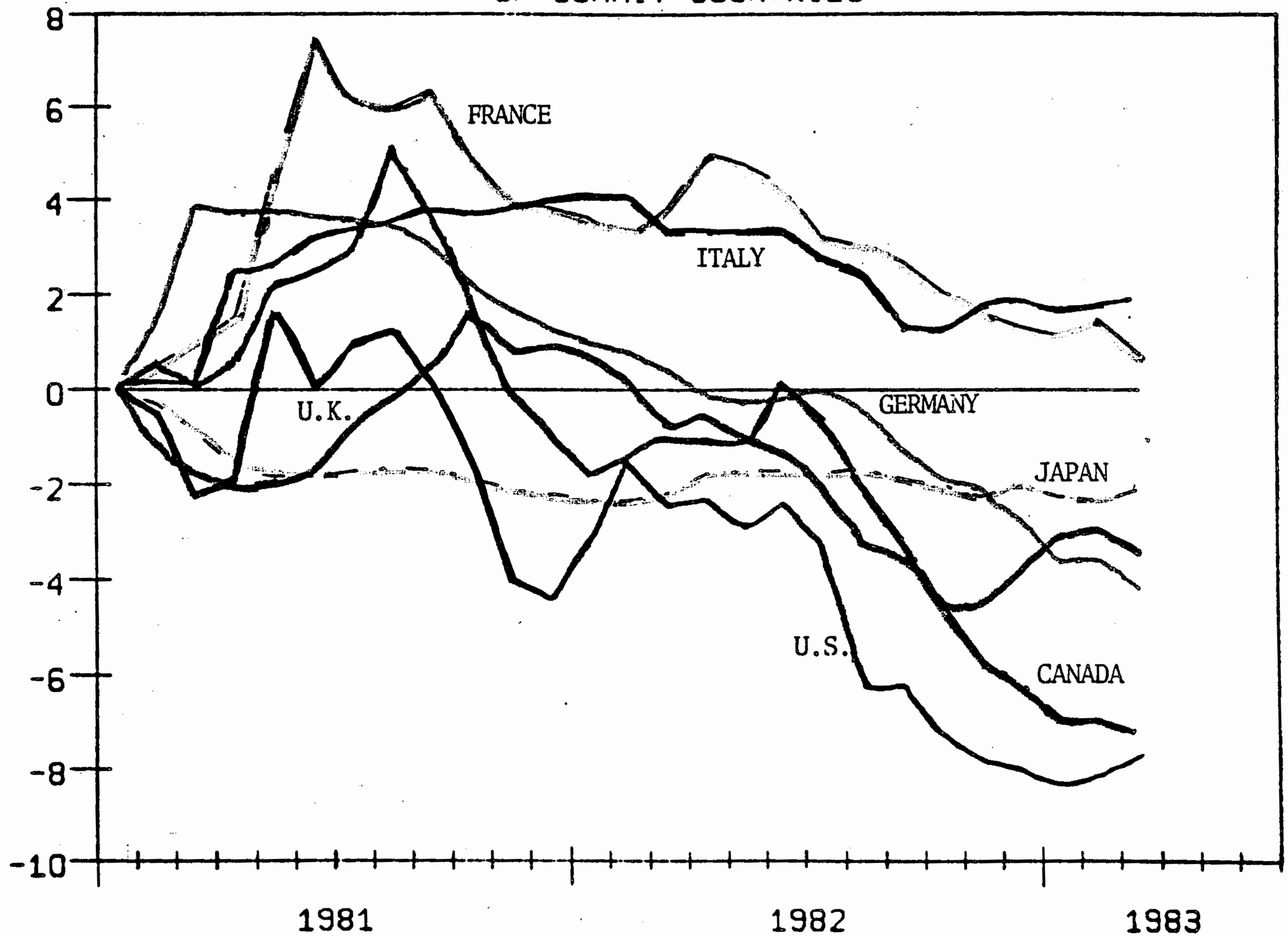

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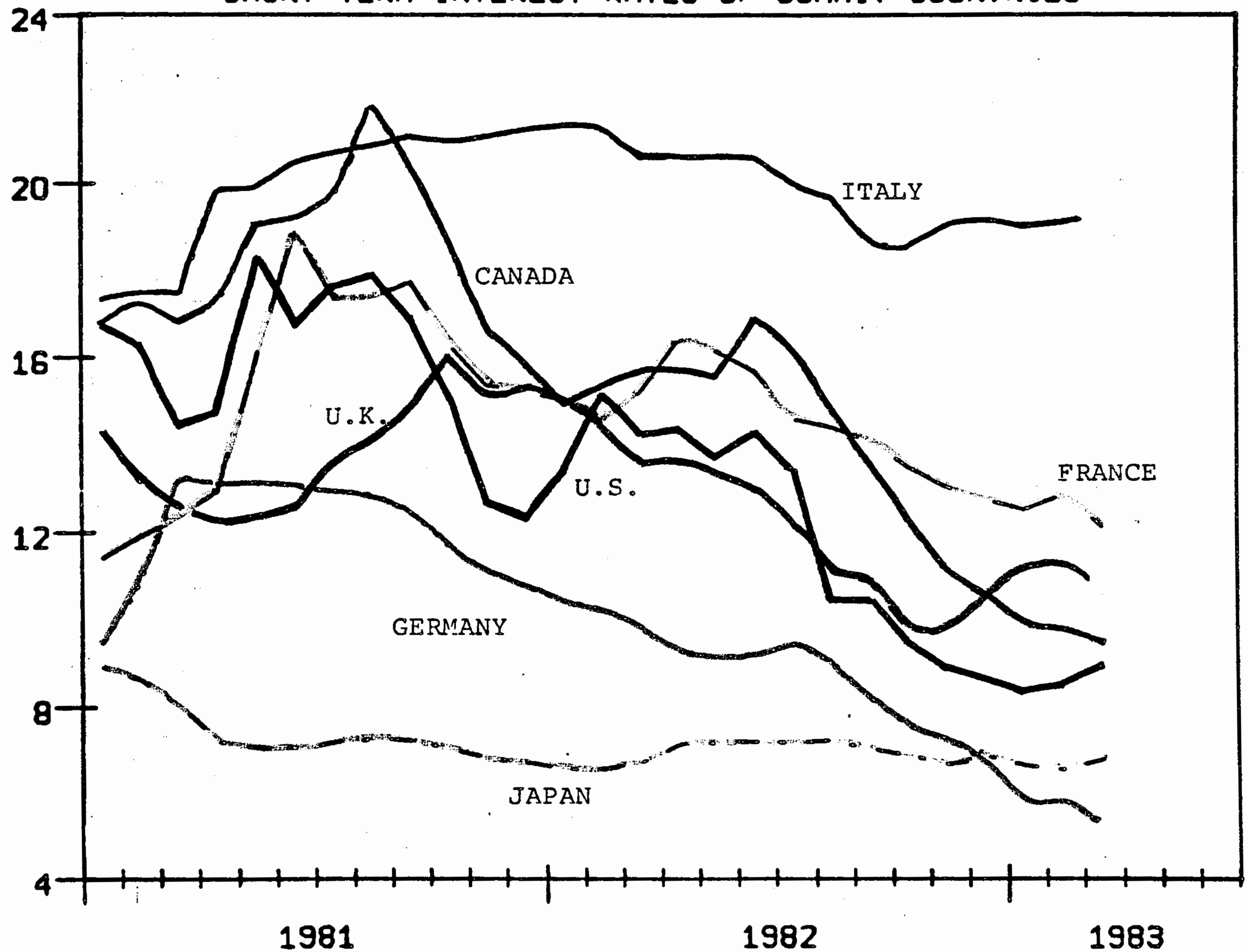
SHORT-TERM INTEREST RATES OF SUMMIT COUNTRIES



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UNCLASSIFIED/W
CONFIDENTIAL ATTACHMENT

THE WHITE HOUSE

WASHINGTON

SYSTEM II
90353

ACTION

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MEMORANDUM FOR THE PRESIDENT

FROM: WILLIAM P. CLARK

SUBJECT: "Give and Take" Session on Summit Issues, Friday, March 25, 1983, 11:00 a.m.

Issues

This meeting with Shultz, Regan, the Sherpa team and Senior White House staff is the first of a series of small, informal, "give and take" sessions on Summit issues. These sessions are intended exclusively for your benefit, to enable you to become thoroughly familiar and comfortable with the issues which you will be discussing as host of the Williamsburg Summit.

Discussion

We begin with a session on the economic situation and policies of each of your colleagues at the Summit.

From this session, you should gain a clear picture of the economic circumstances and prospects faced by each of the other leaders and a sense of the domestic political consequences and constraints affecting economic options of each country. It is the latter in particular that will shape the objectives of these leaders at the Summit.

The paper at Tab A gives a summary overview of the current situation faced by the other leaders. When you read it, note down any questions or concerns you may have. We can begin the session with your questions. These sessions will be more effective if they respond to your specific needs.

Recommendation

OK No

____ ____ That you read the attached paper before our meeting on Friday.

Attachment
Tab A - Summary Overview

cc Vice President
Ed Meese / Jim Baker
Mike Deaver
Prepared by:
Henry R. Nau

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Background on Economic Policies and Prospects of Other Summit Countries

Setting:

-- Prospects for world economic recovery have strengthened in the last few months. Real growth in the industrial countries is likely to be around 2 1/2 percent in 1983 after zero in 1982. Several factors have contributed to a more favorable outlook.

  o U.S. recovery is recognized as underway, and U.S. real growth is likely to be stronger than in the budget scenario.

  o Oil price declines and the U.S. turnaround have bolstered consumer/investor confidence and growth prospects.

  o Inflation expectations are easing in most countries and interest rates have fallen.

-- By the time of the Summit in late May, differences in policies, performance and prospects among participants will be in sharp focus. Two distinct groups have emerged since 1981 Ottawa Summit in terms of policy and performance.

  (1) The U.K., Germany and Japan -- with varying emphasis -- have generally stuck to policies of fighting inflation, deregulating economies, decreasing structural budget deficits, controlling monetary growth. All have achieved big declines in inflation, setting the stage for sustainable, non-inflationary recovery.

  (2) France, Italy and -- until around the middle of last year -- Canada have, by and large, put emphasis on direct government programs to bolster employment, support social objectives, and resist economic adjustment to market realities. The result has been high inflation rates, large government roles in the economy and rising subsidies to inefficient sectors, contributing to growing budget deficits. The effort to maintain these policy approaches in the face of disinflationary trends in other countries has put their payments balances and exchange rates under pressure.

-- Recent German and French elections point to divergences. Chancellor Kohl returned to power. Vote of strong confidence in conservative economic program. Likely to continue budget restraint; resist pressures for reflation. On other hand, President Mitterrand lost support in recent election; dissatisfaction with socialist/nationalization program. Pressure on franc intensified. Mitterrand devalued and reorganized cabinet; new policies to be announced shortly (hopefully to restrain inflation).

Prospects:

-- For those countries which have succeeded in reducing inflation, the outlook is for solid recovery in 1983, strengthening during the year; continued low inflation; and small reductions in unemployment rates this year, with larger reductions coming in 1984.

- o UK: Mrs. Thatcher's policies are bearing fruit. 1983 will be the second year of positive real GNP growth (perhaps 2 to 2 1/2 percent year over year), despite oil price declines. But lost revenues have reduced trade and current account surpluses. Could be rough balance in 1983. Reduction of the budget deficit as a percent of GNP continues. Inflation remains low. Unemployment at 12.9 percent -- 3 years of increases. Likely peak in 1983.

- o Japan: Continued expansion is in prospect. Growth should pick up during 1983 (to 4 percent year over year) remaining the highest in Summit group. Japan will be among the largest gainers from the oil price declines. Trade and current accounts in sizeable surplus; still growing. Unemployment rate (2.7 percent) is at postwar record, but should ease this year.

- o Germany: Recovery should finally begin around mid-year, with growth about 1/2 percent year over year versus a 1 percent decline in 1982. Investor/consumer confidence is now building; inflation continues to ease; and the external balance is getting stronger. Historically high 9 percent unemployment rate; should peak in late 1983. Trade and current account surplus rising.

-- For those which have been relatively unsuccessful in reducing inflation, the outlook is less optimistic:

- Canada: May be moving out of this group. Inflation has recently improved to single digits. The growth outlook, assuming strong U.S. recovery, is good following very severe recession in 1982. Unemployment at record 12.5 percent. No reduction expected in 1983. Trade and current accounts reflecting deep recession were in record surplus in 1982. Some weakening expected. Investment-discouraging policies are being put on the back burner. Prime Minister Trudeau admits that past policies were inflationary, but there is a risk that inflation may revive, and anti-market policies resume, as the 1984 election nears.

- Italy: Inflation remains in double digits (15 percent) though down from earlier peaks. Budget expenditures are virtually out of control, and monetary policy is being forced to accommodate huge budget deficits. The Government has been unable to put together a coherent program. Unemployment at 9.2 percent and rising. Trade and current account deficits narrowed in 1982; should be smaller again in 1983.

- France: After the first year of wildly inflationary policies, making effort with marginal success to cut back. Nationalistic/socialistic policies run strongly counter to market forces, leading to pressures for subsidies, protectionist policies. Serious exchange rate problems continue (the French have spent enormous amounts to try to support the franc in the face of strong exchange market pressures). This week's EMS realignment -- franc devaluation -- should temporarily ease pressures. Major policy shifts are anticipated. If these fail to stick, as in the past, further weakening of the franc is inevitable.

Potential Differences at Summit:

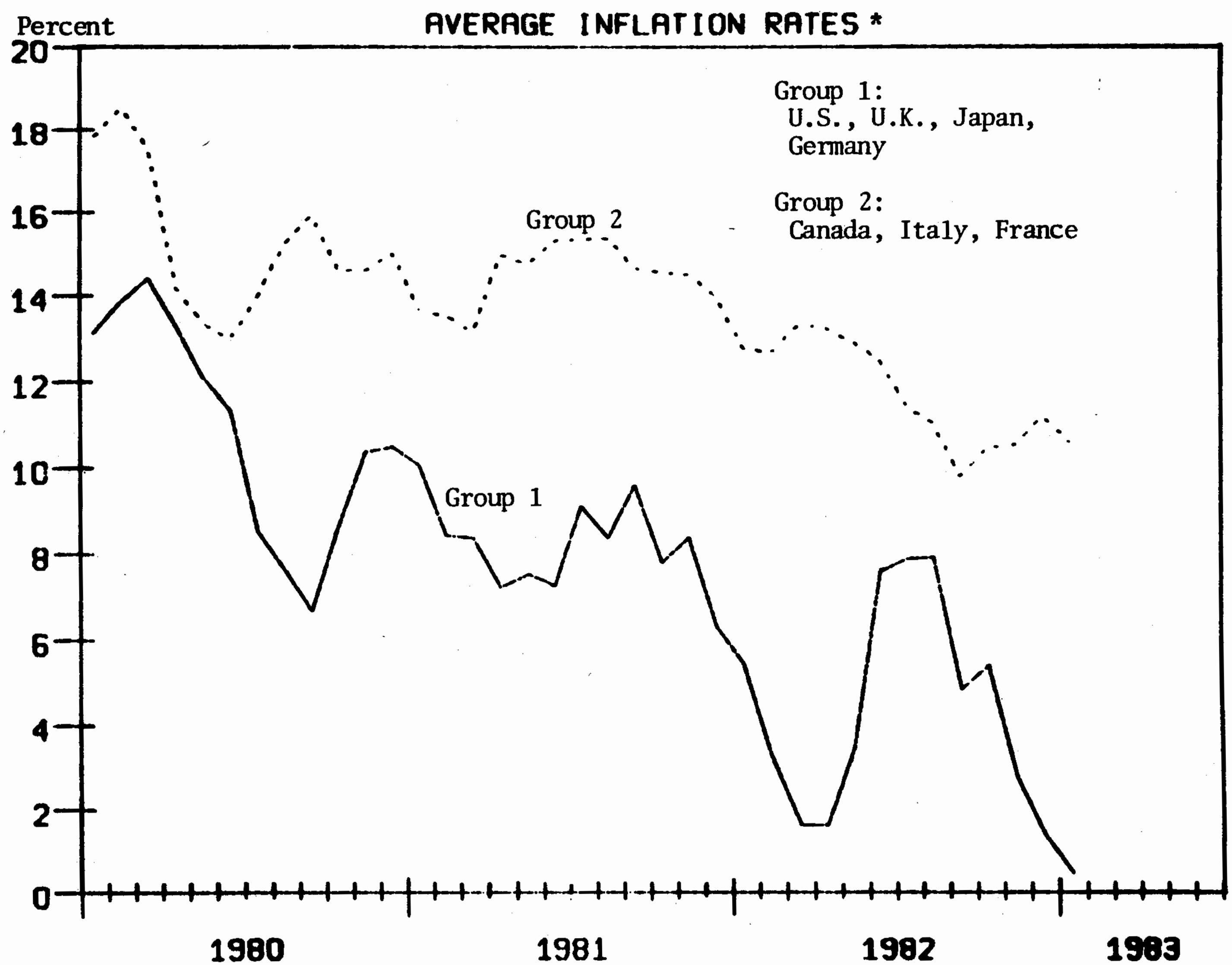
The differences in performance and prospects outlined above point to potential differences at the Summit in areas of macroeconomic policy, exchange rates, both focusing on French.

Growth policies - President Mitterrand has failed to generate sustainable growth and has little political room in his traditional constituency to impose further austerity and lower inflation. He blames French problems on others -- especially U.S.-- and would like to see additional expansion undertaken by U.S., Germany and Japan through stimulatory policies so as to ease severe unemployment problems by increasing French exports. The French claim U.S. interest rates are too high (monetary policy too tight) and a root cause of French problems.

Exchange rates - The French are leading calls for greater governmental intervention in exchange markets. The Government is under attack. Exchange market pressure on the franc is a vote of "no confidence" by international community and hurts Mitterrand's domestic image. He may argue for U.S. intervention in market to hold the dollar down (i.e., help hold the franc up).

Attitudes of Others:

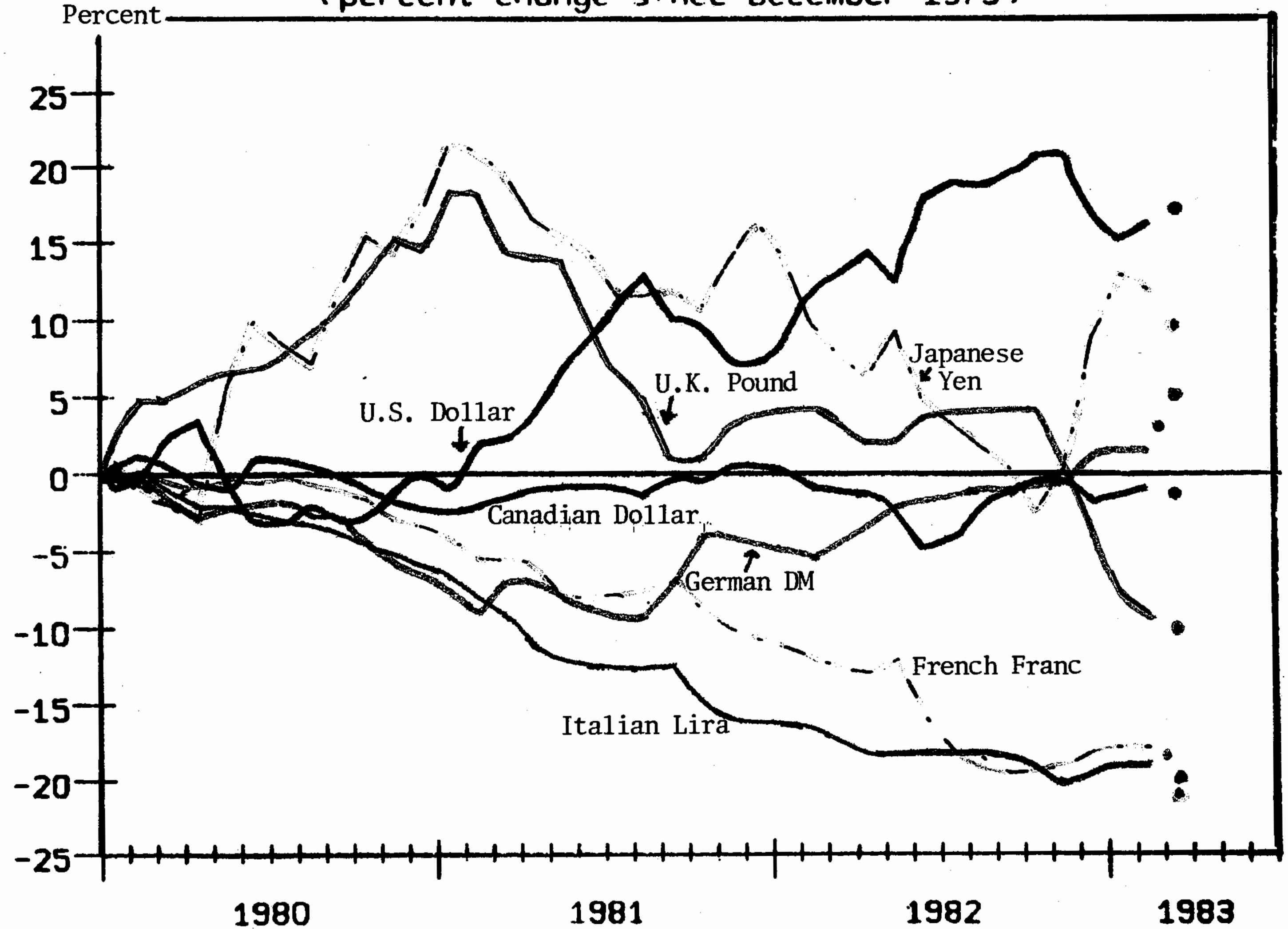
By the time of the Summit, the Germans and Japanese should feel much more confident about the economic outlook. Neither is willing to risk a shift to expansionary policies. On the whole, the improving economic climate is likely to promote greater consistency of views among Germany, Japan, the U.K. and U.S. on the major economic policy issues.



*GNP-weighted, three-month moving average of month/month changes (annualized) in Consumer Price Indices.

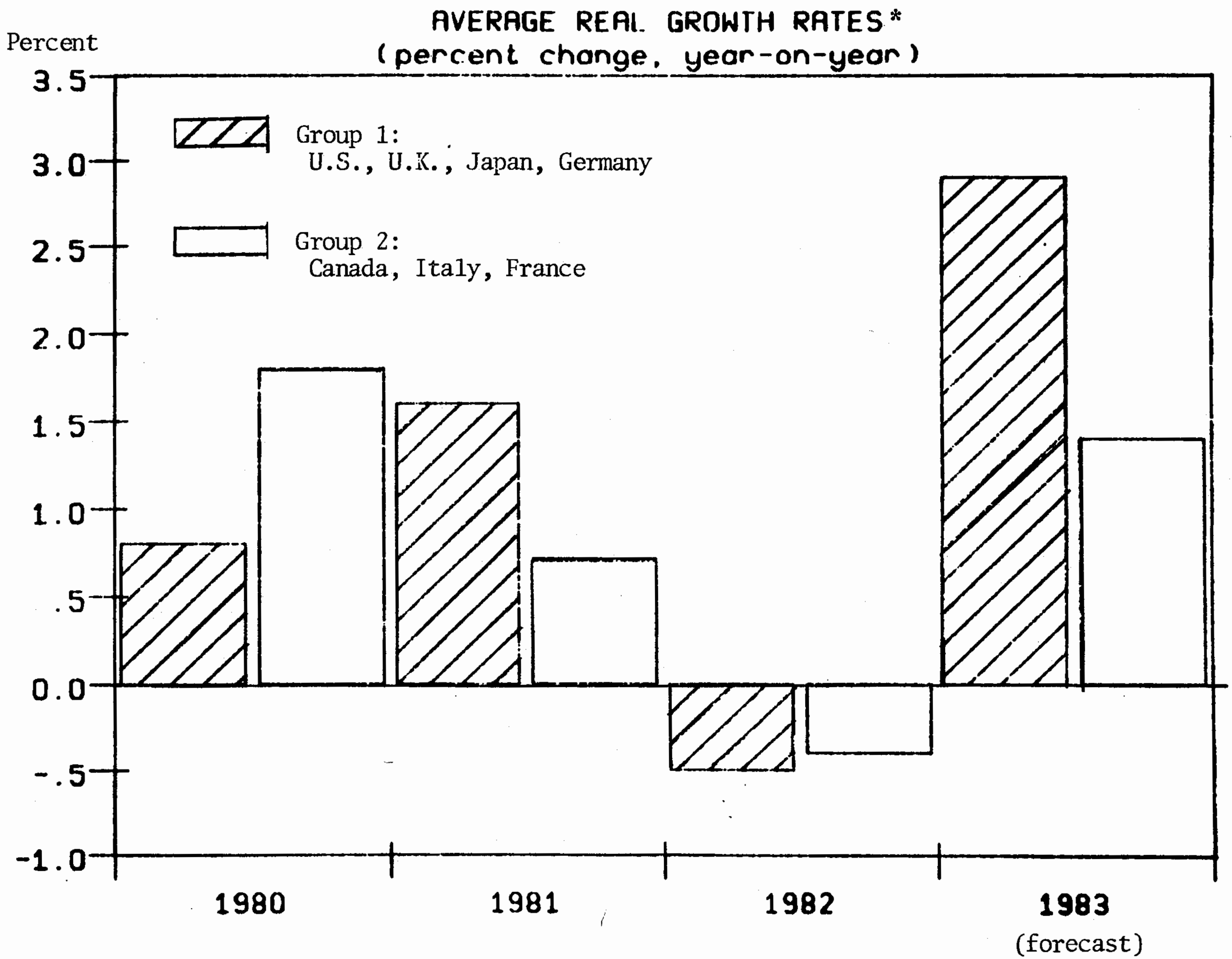
Latest Observation: January 1983

TRADE-WEIGHTED EXCHANGE RATES*
(percent change since December 1979)



*Positive change indicates appreciation.

Dots indicate post EMS realignment rates on March 22, 1983. All other rates are monthly averages.



*GNP-weighted