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Author Floriane GALEAZZI, PhD candidate, University of Rouen, France
Contact floriane.galeazzi@gmail.com

Paper title: The WP3 face global shock and inflation theoretical shift (1971-1987)

Inflation and global payments balance are strongly linked. Recently, several works have questioned the policymaker theoretical turn in the second part of the twenty century. On one hand, they point to International organizations as a key element of the transnational circulation of ideas. And on the other hand, they stress that senior government officials which regularly attending to international meetings are an important scattering vector (Abdelal 2007; Chwioroth, 2010). But in this international context, the OECD working party on monetary questions (WP3 of the economic policy committee) is too often overlooked. It is a unique framework which only includes the Ten, group of the more industrialized countries¹. This “between oneself” associate to its weak political involvement made of the WP3 the ideal place for debates and exchange of ideas on the imbalance of international payments. This contribution aims to present the WP3 particular role in the perception, analysis and definition of policies to face the inflation issue since 1973 to 1987. It focus on the Ten approach of inflation but also to what extent they take into account the international implications of their domestic policy choices. I divide it into two main periods. The first over from an oil shock (1973) to another (1979), it addresses, on one hand, the WP3 specific role in the analysis of the new economic environment of stagflation. And on the other hand its implications in the amendment of inflation perception that result from this new context. Especially, I want to highlight the gradual rise of monetarist theories and the distribution between the OECD secretariat influence and the member states impregnations. The second period over from 1979 to 1987 and question the 1980’s deflation issue. It is focus on the Ten approach of this new paradigm shift. I seek to emphasize their understanding of the 1982 debt crisis regarding the inflation issue and monetary policy impact.

WP3 FACE STAGFLATION SHIFT

At the end of 1972, Inflation became a major concern in WP3 while a speculative surge was at play through the rise of raw materials’ wholesale prices and the loss of confidence in the international monetary system. Therefore, the factors favoring inflation were clearly identified, but policy measures do not follow. Fiscal and monetary policies of the major part of the Ten focused on expansion,

¹ Group of Ten: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom, United States.

according to the BIS, inflation then not being seen as a fundamental problem for economic development.² However, the coexistence of inflation's high level and unemployment was a new element for national authorities. Indeed, it was considered as impossible according to the theories followed in previous decades.³ Therefore, they became skeptical about the efficiency of usual solutions to resolve this original paradigm. Many countries were turning to new approaches. Especially towards the monetarist ideas that defend, since the mid-1960s, that the link induced between inflation rate and the unemployment rate by the Phillips curve cannot be true in all situations. It assumed that some external factors influence this relationship until annihilation.⁴

Understand the new paradigm

Analyses defending the idea of a structural change rapidly emerged within WP3. But, on one hand, the Working Group retained its monetary approach to the problem. The secretariat and BIS documents bring their general reflection but the analysis focused on the links between the economic crisis and the exchange rate.⁵ Thus, at the February 1976 meeting, the representative of the German Ministry of Finance, Dr. Weber and the president of the group (then Otmar Emminger former member of the Bundesbank) reported: "Mr Weber stated that where monetary policy was deliberately changed with a view to specific domestic ends, any fluctuations in exchange rates induced by this should be tolerated. The chairman associating himself with this view, noted that events in the past several years may not be a good guide to the future and that, in any case, it would be difficult to lay down hard and fast rules on what "erratic" movements are".⁶ Moreover, it appeared from WP3 meetings that members had diverging views on how to deal with this new situation. The WP3 discussions of 14 February 1974 meeting concluded with a joint position of US officials, French and Japanese to respect national policy choices : « *Bennett, Inamura and de Lattre took an intermediate position. They considered that it would be unwise to decide in advance what policy measures, should be adopted to offset a fall in demand. The action required would depend on the timing of the effects and on each country's particular situation* ".⁷

² BRI, Rapport annuel 1973, *op cit.*, p13

³ Lucette LE VAN-LEMESLE, Les théories économiques et la crise de 1973, *Vingtième Siècle. Revue d'histoire*, 2004/4 no 84, p. 83-92.

⁴ Pierre-Cyrille HAUTCŒUR « L'ambiguïté historique du monétarisme libéral », *Projet 2/ 2008*, n ° 303, p. 69-75.

⁵ Pierre-Cyrille HAUTCŒUR « L'ambiguïté historique du monétarisme libéral », *Projet 2/ 2008*, n ° 303, p. 69-75.

⁶ OCDE, EPC WP3, résumé des débats lors de la réunion du groupe de Travail n°3 tenue à Paris les 16 et 17 février 1976, p 4, intervention du docteur Weber représentant du ministère des finances allemand et du président du groupe Otmar Emminger.

⁷ OCDE, EPC WP3, résumé des débats lors de la réunion du groupe de Travail n°3 tenue à Paris le 14 février 1974, p10, résumé des positions de Jack Bennett sous-secrétaire suppléant aux affaires monétaires du Trésor américain, d'André De Lattre, sous-gouverneur de la Banque de France et du vice-ministre des Finances japonais chargé des affaires internationales, Inamura.

There was an awareness of the paradigm shift and answers attempted within WP3 but our experts were struggling to define clearly the changes that were emerging. The link made between Keynesian and the Phillips curve theories leads them to condemn the pattern of previous decades and to turn to monetarist ideas.

WP3 look to monetarism

Central Banks were undeniable pivots between the national economy and the world. True heart of national financial systems, they were directly affected by the structural changes that have shaken the international economic, monetary and financial relations in the early 1970. Their role and status at both national and global levels were questioned by the emergence of the new context mingling stagflation and floating exchange rates. So Kessler, the bank representative of the Netherlands, said during the WP3 meeting of February 1976 : *Kessler noted that in considering liquidity in the present situation, it would probably be much the same whether or not the central authorities intervene as, in any case, the banking system would do the job.*⁸ In all the countries members of the Group of Ten, the monetary authorities were overwhelmed by the new challenges that had emerged. It enhanced divergences of views among member states. Proponents of a liberal vision attached to occasional coordinated actions (especially the Anglo-Saxon countries) while countries like France defended the introduction of a binding regulatory framework as the only way to ensure the stability of the market. However, the Governor of the Bank of England, Gordon Richardson did not hide his reservations about the monetarist analysis, despite an inflation rate that exceeds 25%.⁹ So the recovery plan to be proposed at the end of 1976 remains Keynesian. The latter was supported by the IMF and the entire WP3 during his presentation at WP3 the meeting on 21 December 1976. "Ultimately, the WP3 endorsed the conclusions of the IMF, under which the program started, based on the development of exports, can provide a solid basis to changing economic trends in the United Kingdom, provided that the situation interior lends itself well defined and that policies are implemented with continuity." The Federal Republic of Germany was, to some extent, the industrialized countries that fared best in terms of inflation. The maximum price increase was 8% at the height of the crisis in 1973-1974. Throughout its history, this was probably the country that was socially, most sensitive to the dangers of inflation, keeping the memory of the hyperinflation of the 1920s and its consequences both economic and political. The monetary authorities were out of step

⁸ OCDE, EPC WP3, résumé des débats lors de la réunion du groupe de Travail n°3 tenue à Paris des 16 et 17 février 1976, p 11, intervention de Kessler, représentant de la banque des Pays-Bas.

⁹ Forrest CAPPIE, *The Bank of England, 1950-1979*, Cambridge, Cambridge University Press, 2010, p 644-706; G. Richardson, «reflections on the conduct of monetary policy», *Bank of England Quaterly Bulletin*, 18 mars 1978.

with the Keynesian logic regarding the role of inflation in growth, they were still rigorous about rising prices.

WP3 is original in combined the "international acculturation" motion to maintain strong national positions. It appears from our study that the more or less conversion of participants depends on a range of other factors such as the adequacy of national positions with those of the OECD but also their sensitivity to different monetary theories. It seems that the Working Group No. 3 be the mouthpiece of its most influential member countries - the United States - rather than the host organization.

WP3, DEFLATION AND DEBT ISSUE

Beyond the adaptation of national economies to oil shocks and the new paradigm that was established in the 1970s, the early 1980s composed with a major financial crisis. Perhaps the biggest since 1929. It resulted from the simultaneous emergence of debt management problems in major borrowing countries and a consequent threat to the solvency of several international banks. It was proof of the adjustments defects in the international system as well as within national economies. The result was a general feeling of worthlessness global monitoring, questioning the role of international institutions in global regulation. This structural change has been well received within the WP3. As shown the note prepared by the representative of the Banque de France [Gabriel Lefort] to the meeting of 16 November 1983: "There was little doubt that in the 1970s, the growth in capital imports by the developing countries was primarily due to the development of Euro-markets. This was even truer that developing countries were strongly seekers since they were an effective means of escaping the conditionality that the IMF makes its competition". At that time a further rise in US interest rates weighed down the debt burden then that the debt crisis seemed under control thanks to the economic recovery in industrialized countries and the IMF in favor of debtor countries.

Inflation role and consequence

For all actors, it was the deflationary policy initiated by industrial countries in the late 1970s which was directly responsible for developing countries payments difficulties. And more particularly the United States through Paul Volker policy instituted since 1979. These breaks were quickly analyzed by WP3 experts. The representative of the Bank of France summarizes the key implications in a preparatory note to the meeting of January 16, 1983: "At the root of the crisis, the focus is now much more clearly on sharing of responsibility cases between debtors who have not always borrowed wisely and lenders such as commercial banks, were strongly encouraged to take on debt when they were much more sensitive to the margins applied at security of their claims". But at the meeting following, Philippe Jurgensen, head of international relations department of the French Treasury, sets: "As to the

debt problem, it appeared to be closer to the subject of international liquidity than of surveillance, because indebtedness had been considerably feeding international liquidity. A distinction had to be made between public and private sources of liquidity, which led to the role of Euromarkets, the control of which was related to surveillance".¹⁰ Thus multilateral surveillance, international liquidity, developing countries debt and inflation issues were intertwined. The same applied to national and global levels as well as public and private sectors, whose interdependence complex the crisis management.

In this new context, WP3 did not seem suited to meet the new challenges of international monetary management. He began to lose ground to IMF, which found its full place as international finance regulator. On the one hand, the need for appropriate economic policy to obtain its loans reassured private and state creditors. On the other hand, the IMF was both a place of control and an instance of international funding which could provide a full response to developing countries crises. Finally, new instances emerging on the international scene such as the Club de Paris, founded in 1956, but taking on a new dimension in the context of the early 1980s.

Redesign monetary policy role

The second oil crisis highlighted the excessive confidence in the sustainable and inevitable nature of the development process and the private financial institutions increasingly important role in the imbalance of economic fundamentals. Within the Working Group No. 3, the issue was debated before the bubble bursts and the minutes of the meeting of 8 and 9 July 1982 highlights the differences in viewpoint among member countries: *On Latin America, some were daunted by the sheer size of the borrowing which Mexico, for example, now needed to undertake each year. Others, however, were less concerned, pointing to the huge medium – to long- term potential of these countries and to the fact that loans were anyway, spread over a large number of banks. There were anxieties that default might become fashionable – a “commune of debtors” was I believe the phrase Mr Jurgensen used; and on the other hand there was the proposition – perhaps not altogether comforting- that the biggest borrowers were too big to be allowed to fail. The main impression to come from all this seemed to be that the banks were in future likely to be much more selective in their lending.*¹¹ This summary of the debates reveals the group members mixed anxiety vis-à-vis developing countries widespread default risk. The confirmation of the fears raised led the WP3 to changed its focus as indicated in the minutes of the meeting in March 1983 (first report available for the period following the start of the crisis in August

¹⁰ ABF, 1489200304.75, compte-rendu de la réunion des suppléants du groupe des Dix, le 17 novembre 1983, intervention de Philippe Jurgensen.

¹¹ ABF, 1489200206.69, compte rendu de la réunion du groupe de Travail n°3 des 8 et 9 juillet 1982 tenue au château de la Muette à Paris, p4

1982): *A number of general themes had emerged in the debt negotiations, notably: a concern amongst the banks and the burden should be equitably shared; a worry that the capacity for flexible response should not be constrained by mechanistic legislation of the kind mooted in the US Congress; and questions about the relationships between commercial banks, supervisory authorities and the IMF.*¹²

Within this new framework, experts are trying to establish the relationship between the different means for creating international liquidity, changes in national reserves and prevailing interest rates. Especially, they questioned the debtor countries central bank power to adjust and control the liquidity creation. And that, from autumn 1982 at the meeting of the Working Group # 3 in Toronto: « *A third group of issues concerned the relationship between the banks and the authorities. Some doubted whether the banks, even collectively, were really able to insist on and then to monitor an adjustment program on IMF lines.*».¹³

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Finally, it appears that senior officials have a relatively clear understanding of the problems and risks they confront in the years 1970 and 1980. However, it seems that stagflation had been more complex to understand than deflation. Indeed, the debt crisis was identified and monitored before its beginning. But it is difficult to define if it was a greater shift or if their expertise and understanding had grown between the two moments. Our study also reveals on one hand, that the rise of monetarism was due to a combination of factors and could not be reduced to an acculturation to OECD secretary analysis. On the other hand, that the WP3 highlights the experiential aspect of the political choices made and the predominance of national in crisis situations. At last, from the WP3 perspective national level remains a key factor of understanding of these two global switches.

¹² ABF, 1489200206.69, compte rendu de la réunion du groupe de Travail n°3 des 9 et 10 mars 1983 tenue au château de la Muette à Paris, p1

¹³ ABF, 1489200206.69, Note de la DGSE compte-rendu de la réunion du groupe de Travail n°3 de l'OCDE qui s'est tenue à Toronto le 5 septembre 1982, p5.»